

NASD
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. EAF0300890002

TO: Department of Enforcement
NASD

RE: First Allied Securities, Inc., CRD No. 32444
Respondent

Pursuant to Rule 9216 of NASD Code of Procedure, First Allied Securities, Inc. ("First Allied" or "Respondent") submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described in Part II below. This AWC is submitted on the condition that, if accepted, NASD will not bring any future actions against Respondent alleging violations based on the same factual findings.

Respondent understands that:

1. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by NASD's Department of Enforcement and National Adjudicatory Council ("NAC") Review Subcommittee or Office of Disciplinary Affairs ("ODA"), pursuant to NASD Rule 9216;
2. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and
3. If accepted:
 - a. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future actions brought by NASD or any other regulator against Respondent;
 - b. this AWC will be made available through NASD's public disclosure program in response to public inquiries about Respondent's disciplinary record;
 - c. NASD may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-2; and
 - d. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any allegation in this AWC or create the impression that the AWC is without factual basis. Nothing in this provision affects

Respondent's testimonial obligations or right to take legal or factual positions in litigation or other legal proceedings in which NASD is not a party.

Respondent also understands that its experience in the securities industry and disciplinary history may be factors that will be considered in deciding whether to accept this AWC. That experience and history are as follows:

First Allied has been a member of NASD since March 1994. The firm is based in San Diego, California, employs approximately 500 registered representatives, and maintains approximately 200 branch offices around the country. The firm does not have any relevant disciplinary history.

I. WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under NASD's Code of Procedure:

- A. To have a Formal Complaint issued specifying the allegations against it;
- B. To be notified of the Formal Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the General Counsel, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of Rule 9143 or the separation of functions prohibitions of Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

II. ACCEPTANCE AND CONSENT

- A. Respondent hereby accepts and consents, without admitting or denying the allegations or findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of NASD, or to which NASD is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by NASD:

Summary

Between November 2002 and September 2003 (the "relevant period"), First Allied and Gary Ferraro, a First Allied registered representative in Chicago, facilitated the deceptive efforts of three of their customers to engage in market timing transactions in mutual funds that exceeded the limits of, and therefore violated, the funds' prospectuses.

First Allied and Ferraro assisted their customers in two ways. First, Ferraro negotiated or authorized two quid pro quo arrangements with certain fund advisors that enabled customers to execute more trades than allowed in the fund's prospectuses.

Under these secret arrangements ("sticky asset" or "sticky money" deals), their customers agreed to invest millions of dollars long-term in one fund in a mutual fund complex (the "sticky" money) for the opportunity to market time millions of dollars in other funds in the same fund family. These "sticky asset" deals were not disclosed during the relevant period to other shareholders in these mutual funds, which included other First Allied customers.

Second, First Allied and Ferraro enabled another client to use related accounts with the same beneficial owner to evade attempts by a mutual fund complex to restrict its trading. Ferraro opened an account for this client and, through employees who reported to him, some of whom were registered with First Allied, executed market timing transactions in one mutual fund family. After the fund restricted trading in one account, Ferraro and First Allied opened two related accounts, one of which was funded indirectly by a transfer of \$4 million from the first account. Ferraro, through employees who reported to him, then executed market timing transactions in violation of the fund prospectus limits in the two accounts.

As a result of these practices, these clients made 35 exchanges that exceeded mutual fund prospectus limits or violated fund restrictions and earned approximately \$326,500 in illicit profits. First Allied and Ferraro earned fees from the illicit activity.

By facilitating their client's deceptive activity, First Allied and Ferraro violated NASD Conduct Rule 2110, and by failing to supervise Ferraro's activities and failing to establish, maintain and enforce an adequate supervisory system and written *supervisory procedures with respect to Ferraro's activities*, First Allied violated Conduct Rules 3010(a) and (b) and 2110.

1. Market Timing Mutual Funds

“Market timing” is the short term buying and selling of mutual fund shares to exploit inefficiencies in mutual fund pricing. The share price of a mutual fund is determined by the “net asset value” of the funds. The “net asset value” of mutual funds holding equities typically is calculated once per day based on the closing price of the underlying securities as of 4:00 p.m. EST. Because mutual funds typically are priced only once per day, market timers may have an opportunity to engage in arbitrage based on market information that may not be reflected in that day’s net asset value. To accomplish the arbitrage, market timers typically buy and sell shares on a short-term basis, realizing quick gains and then retreating to the previous market position. Market timing may harm other mutual fund investors by raising mutual funds’ transaction costs, such as taxes and trading costs, and by requiring funds to retain more assets in liquid investments with lower returns, including cash positions. For these reasons, fund complexes typically discourage or restrict frequent trading in certain funds through restrictive language in their prospectuses or statements of additional information, limiting shareholders to a certain number of transactions or imposing fees on redeeming fund shares after a certain number of transactions.

To maintain their ability to market time mutual funds, market timers have engaged in a number of deceptive practices. They entered into undisclosed arrangements with fund advisors called sticky assets deals. They also used multiple accounts under the same beneficial owner to hide their identities and thwart mutual fund attempts to restrict or stop their market timing activity.

2. First Allied Recruited Ferraro Knowing that His Clients Had Agreements with, and Were Going to Market Time, Mutual Funds

First Allied recruited Ferraro in the fall of 2002. During the recruiting process, Ferraro informed senior management of First Allied that he had agreements with mutual fund companies to allow his hedge fund clients to market time. He described himself as a “front door” market timer.

Before First Allied hired Ferraro, a representative of IFG, the investment advisor for Mutual Fund I, communicated to an officer of First Allied. The representative informed the officer of First Allied that the complex had a special arrangement with Ferraro that it did not offer to investors generally, and that the arrangement permitted Ferraro’s clients to market time within the limits established by the agreement. The representative also told the officer of First Allied that “working on this side of the business is something that most fund groups do not like to discuss openly.”

First Allied hired Ferraro and, despite what it knew about Ferraro’s business in general and his undisclosed deal with IFG in particular, it allowed Ferraro to establish an independent entity, Ferraro & Associates, through which he facilitated his clients’ market timing activities. Ferraro & Associates employed persons registered with First

Allied as well as unregistered individuals. First Allied allowed Ferraro and Ferraro & Associates to operate without adequate supervision. First Allied and Ferraro maintained brokerage relationships with each of their market timing clients. Each client opened a fee-based account with First Allied through Ferraro and Ferraro & Associates. First Allied allowed Ferraro & Associates to operate its own electronic mail system and receive its own correspondence without exercising sufficient oversight of either function. Moreover, while First Allied received a fee of between one and two percent of the assets held by the market timing clients, it would take a portion of the fee and transfer the rest to Ferraro. Ferraro, not First Allied, would then pay a salary to each of the employees of Ferraro & Associates.

3. Ferraro Arranged A Sticky Assets Deal That Enabled One of His Customers to Market Time a Mutual Fund in Violation of the Fund's Prospectus While At First Allied

As noted, in November 2001, Ferraro entered into a sticky assets deal with IFG, the investment advisor for Mutual Fund I, on behalf of his customer PM to enable PM to trade in Mutual Fund I beyond the limits established in the Funds' prospectus. After First Allied hired Ferraro, customer PM executed numerous trades in Mutual Fund I's funds pursuant to this arrangement, exceeding the limits established in the funds' prospectus.

Mutual Fund I represented to its investors in prospectuses in relevant part that they "may make up to four exchanges out of each Fund per twelve-month period." Ferraro and First Allied knew or should have known about these restrictions.

Pursuant to the sticky assets deal he negotiated for his customer PM with IFG, PM, with Ferraro's assistance, invested \$1.9 million in long-term assets (or "sticky assets" or "sticky money") in one of the funds in Mutual Fund I's complex while Ferraro was employed at First Allied. In return, IFG provided PM the opportunity to market time up to \$1.9 million in another fund in Mutual Fund I's complex. PM was allowed to execute up to two round trips (a round trip typically is defined as redeeming shares in fund A and purchasing shares in fund B, then redeeming shares in fund B and purchasing shares in fund A, i.e., two exchanges) a month in a fund in Mutual Fund I's family. This enabled PM to exceed the limitation in Mutual Fund I's prospectus. At no time during the relevant period was the arrangement disclosed to the investors in funds in Mutual Fund I's complex.

Between November 2002 and April 2003, pursuant to this undisclosed arrangement, PM executed 20 exchanges through First Allied and Ferraro in Mutual Fund I, well in excess of the limits established in Mutual Fund I's prospectus.

First Allied, through Ferraro, thus substantially assisted PM to engage in excessive market timing contrary to Mutual Fund I's prospectus. Such trading privileges were not available to the general public. PM earned \$191,906 in illicit profits from trading done pursuant to the sticky asset deal Ferraro negotiated on its behalf.

4. Ferraro Knew of and Authorized Another Sticky Assets Deal to Enable his Client to Market Time in Violation of Exchange Limits

From April until July 2003, client CP engaged in market timing in certain mutual funds in the Mutual Fund S family pursuant to a sticky assets deal negotiated by an employee of Ferraro & Associates with Ferraro's knowledge and authority with a representative of DWS, the investment advisor for funds in the Mutual Fund S complex.

Mutual Fund S represented to its investors in prospectuses that:

Up to eight exchanges may be effected free of charge in any calendar year. Thereafter, to discourage the potential adverse impact on the Sub-Funds and their Shareholders of abuses of this exchange privilege, the Company may impose an exchange charge that currently may not exceed .50% of the net asset value of the Shares being submitted for exchange.

First Allied, through Ferraro, knew or should have known of the prospectuses' exchange limitations.

Pursuant to the sticky assets deal, CP was allowed to market time approximately \$5 million in certain funds in Mutual Fund S' complex and execute one round trip per fund per quarter, in exchange for investing \$5 million in long-term ("sticky") money in another of Mutual Fund S' funds.

On approximately April 17, 2003, CP invested approximately \$5 million in sticky money in one of the Mutual Fund S funds. Between approximately April 28 and July 14, 2003, CP engaged in market timing in three other funds in the Mutual Fund S family. In trades effected through First Allied and Ferraro, CP executed 17 exchanges – nine more than the limits established in Mutual Fund S' prospectus. First Allied, through Ferraro, knew or should have known of this secret deal that allowed CP to trade in excess of Mutual Fund S's prospectus limit.

Accordingly, First Allied, through Ferraro, substantially assisted CP to engage in excessive market timing contrary to the fund prospectus. Such trading privileges were not available to the general public. CP thereby profited at the expense of fund investors, and earned illicit trading profits totaling approximately \$25,357.

5. Ferraro Facilitated His Client's Deceptive Practices Designed to Avoid Mutual Fund A's Attempts to Restrict Market Timing in its Funds

One of Ferraro's clients, MMRW, managed several hedge funds that had the same beneficial owner. MMRW, with Ferraro's assistance, used accounts opened for these hedge funds to avoid attempts by Mutual Fund A to restrict its market timing activity by continuing to market time funds in Mutual Fund A's family after Mutual Fund A had restricted a related account. With Ferraro's assistance, MMRW therefore was able to execute market timing transactions beyond the limitations established in the prospectuses governing mutual funds in Mutual Fund A's complex.

First Allied and Ferraro knew or should have known that prospectuses for Mutual Fund A limited an investor to ten exchanges per calendar year and that Mutual Fund A discouraged market timing activity. The prospectus stated:

You are limited to a maximum of 10 exchanges per calendar year, because excessive short term trading or market-timing activity can hurt fund performance. If you exceed that limit, or if a [Mutual Fund A] Fund or the distributor determines, in its sole discretion, that your short-term trading is excessive or that you are engaging in market timing activity, it may reject any additional exchange orders.

In approximately November 2002, Ferraro opened the first of several accounts for client MMRW with First Allied; Ferraro was the representative of record for this and subsequent accounts opened by MMRW. MMRW opened the first account for Hedge Fund N, a hedge fund it managed. MMRW market timed in Mutual Fund A's complex through Hedge Fund N's account. Between approximately December 30, 2002 and April 23, 2003, MMRW, in trades through First Allied, executed multiple exchanges in Hedge Fund N's account in two of Mutual Fund A's funds. On April 23, 2003, Mutual Fund A restricted trading in Hedge Fund N's account.

Mutual Fund A's April 23 letter informed Ferraro:

Over the past few months, we have closely monitored the effects of market timing and short-term trading within our family of funds. We have determined that these activities, if not properly addressed, may hinder our ability to achieve desirable long-term investment results for our shareholders; therefore we can no longer accommodate these activities. In accordance with the prospectus, all shareowners are restricted to a maximum of 10 exchanges. Additionally, if a [Mutual Fund A] Fund or the distributor determines, in its sole discretion that your short-term trading (buys and sells) is excessive, it may reject any of your purchase orders.

As of April 23, 2003, these accounts have already reached their exchange limit or have been identified as having excessive short-term trading activity for the

year. Please note that these accounts have been stopped and will no longer be permitted orders in 2003.

On approximately May 23, 2003, Ferraro opened two additional accounts for MMRW for hedge funds PB and PH, which MMRW managed. First Allied approved the opening of the two accounts. First Allied and Ferraro should have known that Hedge Funds N, PB and PH had the same beneficial owner.

After Mutual Fund A restricted Hedge Fund N's account from market timing, MMRW shifted funds from Hedge Fund N's account to Hedge Fund PB's account and continued to market time funds in Mutual Fund A's complex. MMRW closed the Hedge Fund N First Allied account on approximately June 16, 2003 and wired all assets in the account, totaling approximately \$4.07 million, to Hedge Fund PB's account through a bank account it controlled.

Between June 26, 2003 and August 14, 2003, in trades executed by Ferraro's team through First Allied, Hedge Fund PB made a total of 16 exchanges in the same funds in Mutual Fund A's complex that Hedge Fund N had market timed. Mutual Fund A restricted trading in the PB account on August 14, 2003. Mutual Fund A notified Ferraro of the restriction by a letter containing the same language as the April 23 letter. On approximately August 26, 2003, Hedge Fund PB's account was closed, and all proceeds from the account were wired to the same bank account that Hedge Fund N had wired assets to on June 16, 2003.

MMRW thereafter commenced market timing funds in Mutual Fund A's complex through Hedge Fund PH's account. Between approximately September 2 and 10, 2003, Hedge Fund PH invested \$12 million in Mutual Fund A's cash reserve fund in four \$3 million increments. On approximately September 16, 2003, Hedge Fund PH invested \$3 million in two of Mutual Fund A's funds, and \$4 million and \$2 million in two other Mutual Fund A funds (including the same funds that Hedge Funds N and PB had market timed). One day later, Hedge Fund PH redeemed each Mutual Fund A fund purchased the day before.

Ferraro knew that MMRW market timed mutual funds, and specifically that it intended to market time funds in Mutual Fund A's complex through Hedge Fund PB and PH's accounts. He should have known Hedge Fund PB, PH and N had common beneficial owners. Moreover, he understood that a client could evade Mutual Fund A's restrictions by trading Mutual Fund A's funds in a different account after Mutual Fund A had restricted market timing in one account. He explained that when a client reached 10 exchanges with Mutual Fund A, the client opened another account to continue market timing funds in Mutual Fund A's complex.

In assisting MMRW with its market timing activity, Ferraro and First Allied facilitated MMRW's deceptive conduct to evade Mutual Fund A's restrictions. As a result of its deception, MMRW was able to execute 14 exchanges more than the limits established

in Mutual Fund A's prospectus. MMRW earned approximately \$109,278 in trading profits from this illicit activity.

6. First Allied Did Not Have an Adequate Supervisory System and Written Supervisory Procedures to Ensure Ferraro Did Not Engage in or Facilitate Violative Market Timing Activities

Beginning in approximately October 2002, First Allied's management knew that Ferraro's business was almost exclusively aimed at facilitating his clients' market timing trades. First Allied knew that Ferraro had an undisclosed arrangement to engage in market timing for his clients. Despite this knowledge, First Allied failed to implement a supervisory system designed to monitor the activity of Ferraro and the persons who worked for Ferraro. In addition, First Allied maintained no written supervisory procedures addressing market timing or excessive trading of mutual funds.

7. Violations

NASD Conduct Rule 2110 requires a member firm and its associated persons to observe high standards of commercial honor and just and equitable principles of trade.

NASD Conduct Rule 3010(a) requires a member firm to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of the Association."

NASD Conduct Rule 3010(b) states that "[e]ach member shall establish, maintain and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of this Association."

By virtue of the activities described above, First Allied violated NASD Conduct Rules 2110 and 3010(a) and (b).

B. Respondent also consents to the imposition, at a maximum, of the following sanctions:

1. A censure.
2. A fine of \$408,459, payable within 30 days of the acceptance of this AWC.
3. Within 90 calendar days of the issuance of this AWC, First Allied shall pay approximately \$326,500 to compensate the fund companies for the amounts listed on Schedule A, attached hereto and incorporated herein, and to return the illicit profits enjoyed by its customers in the improper market timing activity described above. Within 90 calendar days of the issuance of this AWC, an

officer of First Allied shall certify to NASD that First Allied has paid restitution to the fund companies in the amounts listed on Schedule A and include copies of cancelled checks or similar documents evidencing such payments.

4. In addition, within 30 calendar days after issuance of the AWC, an officer of First Allied shall certify in writing to NASD that First Allied has reviewed its procedures regarding market timing and has established systems and procedures reasonably designed to achieve compliance with the laws, regulations and rules concerning market timing and to ensure that prospectus fund exchange limits and provisions of selling agreements are enforced.

The sanctions imposed herein shall be effective on a date set by NASD staff.

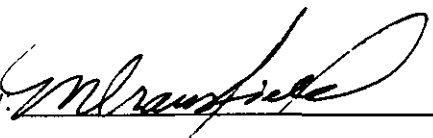
III. OTHER MATTERS

- A. Respondent understands that it may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by NASD, nor does it reflect the views of NASD or its staff.
- B. Respondent agrees to pay any monetary sanction imposed on it upon notice that this AWC has been accepted and that such payments are due and payable and has attached an Election of Payment form showing the method by which it proposes to pay any fine imposed.
- C. Respondent specifically and voluntarily waives any right to claim that it is unable to pay, now or at any time hereafter, any monetary sanction imposed in this matter.

Respondent certifies that it has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it, and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein, have been made to induce Respondent to submit it.

June 15, 2005
Date

First Allied Securities, Inc.

By: 

Reviewed by:

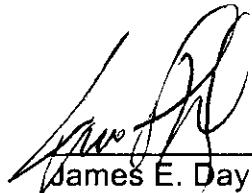


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Counsel for Respondent First Allied

Accepted by NASD:

July 5, 2005

Date



James E. Day,
Chief Counsel, Director,
Department of Enforcement

Signed on behalf of the Director of ODA,
by delegated authority