BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Wilson-Davis & Co., Inc., James C. Snow, and Byron B. Barkley Salt Lake City, UT, Respondents.	DECISION Complaint No. 2012032731802 Dated: December 19, 2019

Member firm engaged in short selling in violation of federal securities laws. The firm, its president, and its head of trading failed to supervise short sales. In addition, the firm and its president failed to supervise and failed to establish and implement anti-money laundering policies and procedures. Held, findings affirmed and sanctions modified.

Appearances

For the Complainant: Jeffrey Bloom, Esq., Carolyn Craig, Esq., Leo Orenstein, Esq., Payne Templeton, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondents: Richard Ensor, Esq., Evan Strassberg, Esq.

Decision

Wilson-Davis & Co., Inc., ("Wilson-Davis"), James C. Snow, and Byron B. Barkley (collectively the "Respondents") appeal a February 7, 2018 Hearing Panel decision pursuant to FINRA Rule 9311. The Hearing Panel found that from July 9, 2012, to April 29, 2013 (the "relevant short-selling period"), Wilson-Davis engaged in short selling in violation of Rule 203(b)(1) of Regulation SHO of the Securities Exchange Act of 1934 ("Reg SHO") and FINRA Rule 2010 because the firm failed to find locates for 122 short transactions effected in four low-priced stocks. The Hearing Panel also found that Wilson-Davis, Snow, and Barkley failed to reasonably supervise the short sales during the relevant short-selling period to ensure compliance with Reg SHO, in violation of NASD Rule 3010 and FINRA Rule 2010.[1] In addition, and

[1] The conduct rules that apply in this case are those that existed at the time of the conduct at issue.

separate from the Reg SHO-related supervisory violations, the Hearing Panel found that from January 1, 2011, through April 30, 2014 (the "relevant period"), Wilson-Davis and Snow failed to supervise generally registered representatives and principals, failed to supervise whether registered representatives should be subject to heightened supervision, and failed to supervise instant message ("IM") communications, in violation of NASD Rule 3010 and FINRA Rule 2010. Finally, the Hearing Panel found that Wilson-Davis and Snow failed to establish and implement anti-money laundering ("AML") policies and procedures and conduct adequate AML training in violation of FINRA Rules 3310(a), (e) and 2010. After an independent review of the record, we affirm the Hearing Panel's findings and modify the sanctions.

I. Factual Background

A. Respondents

Wilson-Davis has been a FINRA registered broker-dealer since December 1968. The firm maintains its principal place of business in Salt Lake City, Utah, and has three branch offices. During the relevant period, there were between 32 and 44 representatives registered with the firm. Most of the firm's business consists of buying and selling penny stocks in its own proprietary accounts. The firm earned its revenue largely from retail sales commissions and profits earned by its traders through their proprietary trading accounts.

During the relevant period, Wilson-Davis was largely managed by three principals: Snow, Barkley, and LD. PD served as the firm's chairman of the board. His involvement in the firm's daily operations during this time was very limited due to his advanced age.

Snow entered the securities industry in June 1996 when he registered with Wilson-Davis. He is registered as a general securities representative and a general securities principal. Snow also served as the firm's president, chief compliance officer ("CCO"), and AML compliance officer ("AMLCO") during this time. In addition, Snow also was responsible for the firm's written supervisory procedures ("WSPs").

Barkley entered the securities industry in 1969 when he joined Wilson-Davis. He is registered as a general securities representative, general securities principal, and an equity trader limited representative. He is a part owner of Wilson-Davis and served as the firm's vice president and the head of its trading department during the relevant period.

B. The Firm's Short Sales

1. Regulation SHO

Reg SHO of the Exchange Act governs short sales.[2] Rule 203(b) of Reg SHO prohibits a broker-dealer from accepting a short sale order in an equity security from another person or effecting a short sale in an equity security for its own account unless the broker-dealer has borrowed the security, entered into a bona-fide arrangement to borrow the security, or has "reasonable grounds" to believe that the security can be borrowed so that it can be delivered on the delivery date. 17 CFR § 242.203(b)(ii). This is generally referred to as the "locate" requirement. Rule 203(b) also requires the broker-dealer to document its compliance with the "locate" requirement. 17 C.F.R. § 242.203(b)(2)(iii).

The locate requirement is subject to four exceptions. 17 C.F.R. § 242.203(b)(2). Broker-dealers can disregard the locate requirements if they have accepted the short sale order in question from another broker-dealer subject to Rule 203 (unless the receiving broker dealer is contractually obligated to be responsible for Rule 203 compliance). 17 C.F.R. § 242.203(b)(2)(i). In addition, the requirement does not apply to "[a]ny sale of a security that a person is deemed to own pursuant to § 242.200, provided that the broker or dealer has been reasonably informed that the person intends to deliver such security as soon as all restrictions on delivery have been removed." 17 C.F.R. § 242.203(b)(2)(ii). The locate requirement is also inapplicable to security futures transactions. 17 C.F.R. § 242.203(b)(2)(iv). Finally, the locate requirements of Rule 203 do not apply to "[s]hort sales effected by a market maker[3] in connection with bona-fide market making activities in the security for which this exemption is claimed." 17 C.F.R. § 242.203(b)(2)(iii). It is this final exception that is at issue in this appeal.

2. Wilson-Davis's Short Sale Procedures

During the relevant short-selling period, Wilson-Davis's WSPs provided that the firm was obligated to borrow securities before entering short sales except in those circumstances when the firm was engaged in "bona fide market making transactions in [over the counter] securities where the firm publishes a two-sided quotation in an independent quotation medium." However, the WSPs were silent with respect to how supervisors should determine whether a particular short sale was executed in connection with bona fide market making activity. The firm had no processes or procedures for locating or borrowing securities for its short sales because the firm considered all trading to be bona-fide market making.

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2 "A short sale is the sale of a stock that an investor does not own or a sale which is consummated by the delivery of a stock borrowed by, or for the account of, the investor." https://www.sec.gov/answers/shortsale.htm.

3 "A 'market maker' is a firm that stands ready to buy and sell a particular stock on a regular and continuous basis at a publicly quoted price." https://www.sec.gov/fast-answers/answersmktmakerhtm.html.

3. Anthony Kerrigone

Anthony Kerrigone was an equity trader at Wilson-Davis from September 2009 to July 2013 and worked from the firm's Centennial, Colorado branch office. He primarily traded small cap, over the counter bulletin board ("OTCBB"), and pink sheet stocks. Pursuant to his contract with Wilson-Davis, Kerrigone's compensation was determined by a percentage of his trading profits—60 percent, which increased by 10 percent if he made over $20,000 in a month, minus expenses. Kerrigone was by far the firm's most profitable trader and his net pay for 2011, 2012, and 2013 was approximately $4.5 million, $3.6 million and $900,000 respectively.

Kerrigone specifically focused on penny stock companies that traded in high volume following promotional campaigns. Kerrigone researched stocks to find those that were experiencing a run up in price because of promotional campaigns even though the securities often had no value. There were no formal limits on Kerrigone's intraday trading. Initially, he had a deposit of $25,000 with the firm that limited his overnight positions. Eventually however, the deposit requirement was eliminated and Kerrigone could carry a $1.5-2 million position overnight. Kerrigone also had discretion to set the prices on the stocks he traded. It was not unusual for Kerrigone to short stocks he was trading or to have a sizeable short position.

4. Kerrigone's Trading Activity

During the relevant short-selling period, Wilson-Davis, acting through Kerrigone, did not find locates for 122 short positions[4] in four low-priced stocks—Preventia, Inc. ("PVTA"), PM&E, Inc. ("PMEA"), China Teletech Holding ("CNCT"), and Lot78, Inc. ("LOTE") (together, the "Stocks"). There was little to no trading activity in the Stocks until shortly before Kerrigone began trading in them, when the Stocks were the subjects of promotional campaigns, including press releases and internet promotions. Kerrigone then ceased trading in each of the Stocks within a few days and did not trade in them again.

Kerrigone's trading in each of the Stocks followed a similar pattern. He would accumulate a short position in each stock as its price began to rise and then attempt to cover his position as the stock price fell. He frequently bought and sold at prices that were far away from the firm's own quotes in the Stocks, sometimes a difference in excess of 250 percent. Kerrigone frequently posted quotes significantly away from the national best bid and offer and accumulated short positions and held those positions overnight.

Kerrigone and the firm knew that Reg SHO generally required a seller to borrow a security before selling the security short, but neither made any effort to do so before Kerrigone's short selling. Instead, Wilson-Davis assumed that its trading fell within an exemption to the borrow requirement provided to firms who engage in bona-fide market making. Kerrigone would submit market maker applications to the firm, specifically to Barkley, seeking permission to make a market in the Stocks. The market maker applications were submitted on the same day that Kerrigone began trading in the particular stock or shortly thereafter.

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4 Respondents do not dispute the number of short positions.

As the principal responsible for supervising Kerrigone, Barkley was charged with ensuring that Kerrigone's trading was consistent with the bona-fide market maker exception of Reg SHO. However, he did very little to supervise Kerrigone. Barkley never reviewed any quotes or exception reports to determine whether Kerrigone was actually participating in bona-fide market making. After approving Kerrigone's market maker application prior to entering the market for a particular stock, Barkley failed to engage in any meaningful evaluation of Kerrigone's short selling. Although Barkley monitored Kerrigone's trading in the relevant stocks in real time, he did not regularly monitor the market maker quotes Kerrigone was displaying to the market at the time of his trading. Consequently, Barkley failed to detect quotations in the relevant securities that were vastly different from competitive levels on either the buy or sell side.

a. PVTA

There was limited or no trading in the market for PVTA's stock until promotional activity began in July 2012. On July 9, 2012, the website "hotstocked.com" published a promotional article touting the company and claiming that it was extremely undervalued. That day, price and volume in the stock spiked, and Kerrigone decided to make a market in the stock by submitting a "market maker application" to Wilson-Davis. Kerrigone's market maker application explained that he decided to make a market in the stock because of a "trading opportunity."[5]

Kerrigone then entered the PVTA market and shorted the stock exclusively during his first day of trading, accumulating a net short position of approximately 32,400 shares. Shortly after the market opened on the second day, the price of the stock started to decline and Kerrigone started purchasing shares to close out his short position. Once he shifted direction, Kerrigone was exclusively a buyer, and by the close he had bought enough PVTA to nearly fully cover his short position. The firm never borrowed or made arrangements to borrow the shares Kerrigone sold short.[6] During this period, he posted offer quotes for Wilson-Davis that were significantly away from the inside offer approximately 94 percent of the time, making it unlikely that he would sell additional stock. Because the stock price declined substantially between Kerrigone's shorts and his subsequent covering purchases, he generated trading profits of $4,032.

b. PMEA

Until "hotstocked.com" published a promotional article touting the company on November 12, 2012, there was negligible trading in PMEA. As a result of the promotional material, the price and volume in the stock spiked, and Kerrigone decided to enter the market.

Kerrigone began shorting the PMEA market on November 21, 2012. Kerrigone executed his initial short sale at a price more than 28 percent away from Kerrigone's own quote. During

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5 Kerrigone provided the same "trading opportunity" justification on each market maker application at issue in this appeal.

6 Wilson-Davis never borrowed or made arrangements to borrow the shares Kerrigone sold short for any of the four transactions at issue in this appeal.

this first day of trading, all but one transaction by Kerrigone were short sales, and he accumulated a net short position of approximately 35,000 shares. In the afternoon of the second day, the price of the stock started to decline and Kerrigone started purchasing shares to close out his short position. By the close of the second day, Kerrigone had bought enough PMEA to cover his shorts and ended in a net flat position. Because the stock price declined substantially between Kerrigone's shorts and his subsequent covering purchases, he generated trading profits of $8,495.59.

While Kerrigone was shorting PMEA, Wilson-Davis posted competitive bid and ask quotes less than five percent of the time. Moreover, its posted bid quotes were never at the inside, and usually more than 10 percent lower than the inside quote, making it unlikely that its posted bids would result in any actual purchase transactions. When Kerrigone later covered his short position, Wilson-Davis posted competitive bid and ask quotes only seven percent of the time. Its posted offer quotes were almost never at the inside, and usually were more than 10 percent higher than the inside quote, making it unlikely that the firm's posted offers would result in any sales.

c. CNCT

Like the other companies, there was limited or no trading in CNCT until an article touting the stock appeared on "hotstocked.com" in February 2013. Kerrigone submitted a market maker application and began selling CNCT short on February 21, 2013. He accumulated a net short position of approximately 2.8 million shares by the third day of trading. Throughout the morning of that third trading day, Kerrigone continued shorting the stock with dozens more short sales and several buy transactions, accumulating a net short position of over 5 million shares. Then, early in the afternoon as the price of the stock started to decline, Kerrigone started purchasing shares in significant quantities. By the end of the day on February 25, 2013, he had significantly reduced his net short position.

Kerrigone continued trading in the stock for two more days. Although he executed some short sales during this time, he was a significant buyer of the stock. By the end of the fifth trading day, February 27, 2013, Kerrigone was net flat in his trading position, having purchased enough stock to cover his entire 5 million share short position. Because the stock price declined substantially between the time of the promotional activity when Kerrigone started shorting the stock and his subsequent covering purchases, he generated trading profits of $116,532 over the five days of trading. During this period, approximately 90 percent of the firm's posted bid quotes were at least 10 percent lower than the inside quote, making it unlikely that the posted bids would result in any actual purchases.

d. LOTE

Kerrigone's trading in CNCT, PMEA, and PVTA was profitable. He took large positions and was able to cover the shorts with a total net profit of approximately $130,000. However, his trading in LOTE was extraordinarily unsuccessful and cost the firm millions. Kerrigone began trading LOTE on April 24, 2013, and rapidly built up a large short position. He entered 25 different short sales over the course of five hours. At one point, he had a short position of over a million shares, which constituted around 2 percent of the total issued and outstanding shares of LOTE.

Unlike the three previous stocks, the market did not drop as Kerrigone expected. The price vacillated up and down throughout the day. Later that afternoon, both Kerrigone and the firm realized they had a problem—the firm ended the day short just under a million shares. At no time during the day did anyone at the firm attempt to locate shares of LOTE, not even after the firm's principals became aware of the size of the position being carried overnight.

The price of LOTE began to rise significantly the next day. For example, Kerrigone's last purchase on April 24 was at $2.453571 per share, but his first purchase the following morning was at $3.342916 per share. Despite his attempt to cover his large short position, Kerrigone entered 15 short sales on April 25 and only six purchases. Once again, the firm did nothing to attempt to locate shares.

LOTE's price continued to climb over the next three trading days. Wilson-Davis covered a significant portion of the short position soon after trading opened on April 26, 2013, buying 166,132 shares at $4.815921 per share for a total of $959,011.48. Despite continuing to attempt to cover his short position, Kerrigone entered additional short sales that same day, with the firm again failing to attempt to locate shares. Wilson-Davis finally covered the full short position after trading opened on April 29, 2013. The firm purchased 545,388 shares at $7.891965 per share for a total cost of over $4.3 million. Kerrigone entered additional short sales on April 29 after the original short position had been covered and ended the day flat. Wilson-Davis's net loss as a result of Kerrigone's LOTE trading was over $4.2 million. The firm did not have sufficient working capital to cover the losses and had to borrow the funds.

Shortly thereafter, Wilson-Davis required Kerrigone to reimburse the firm for its LOTE losses, and asked him to resign from the firm.

5. Firm's Written Supervisory Procedures and Related Policies

Other parts of the firm's WSPs, apart from the firm's Reg SHO procedures are also at issue in this appeal. Those portions of the WSPs are discussed herein.

a. Heightened Supervision Requirements in the WSPs

Under the firm's WSPs, Snow was responsible for identifying employees who should be subject to heightened supervision, determining the scope of that heightened supervision, notifying the employee's supervisor of the required supervision, and collecting certifications of such supervision from the supervisor. The WSPs identify criteria that trigger a review by compliance to determine whether a registered representative should be subject to heightened supervision, one of which is the filing of a complaint by a regulator.

On December 27, 2010, FINRA's Department of Enforcement ("Enforcement") filed a complaint against Wilson-Davis, PD, and Randy Carlson, a registered representative at Wilson-Davis. The complaint alleged that the firm and Carlson violated Section 5 of the Securities Act of 1933 and NASD Rule 2110 by engaging in unregistered sales of penny stocks. The complaint further alleged that PD failed to supervise Carlson's unregistered sales and failed to establish and maintain adequate supervisory systems to ensure compliance with Section 5 of the Securities Act. The firm and PD settled with FINRA in early October 2011. Enforcement then filed an amended complaint against Carlson for the same misconduct alleged in the original complaint. The matter proceeded to hearing, and on August 6, 2012, the Hearing Panel found that Carlson violated Section 5 of the Securities Act. Along with a fine and order of disgorgement, the Hearing Panel ordered that Carlson could only be employed by a member firm that subjected him to heightened supervision for his activities related to Section 5 of the Securities Act for a period of one year.

At the time Enforcement filed its initial and amended complaints, neither the firm nor Snow considered Carlson or PD as possible candidates for heightened supervision, as directed by Wilson-Davis's WSPs. The firm eventually created a heightened supervision plan for Carlson two months after the Hearing Panel issued its decision. However, the plan did not identify the individuals responsible for implementing the plan and it did not identify the form and frequency that Carlson's supervisor was to certify compliance with the plan, as required by the firm's WSPs. Nor was the plan implemented adequately. PD, who was alleged to have failed to supervise Carlson with regard to the Section 5 violation, was, by default, the supervisor assigned to oversee Carlson's heightened supervision. But PD, who was then in his eighties, was only in the office a few hours a day and was himself unsure if he was responsible for the supervision. No supervisor ever certified the firm's and Carlson's compliance with the plan.

b. Supervision of Registered Representatives and Principals

According to the WSPs, Snow was the direct supervisor of the registered sales personnel during the relevant period. In addition, Wilson-Davis's procedures for the supervision of registered personnel also included the use of "head count lists" that identified Snow as the supervisor for registered representatives with retail accounts. But Snow, who was himself responsible for the firm's procedures, testified he did not have that supervisory responsibility. Snow testified that PD was responsible for supervising the firm's sales personnel, a contention that PD denied. As noted, PD was only in the office a few hours a day during the relevant period. There were no procedures regarding who was to assume his supervisory responsibilities in his absence. Additionally, the firm operated without clear supervisory roles with regard to the registered principals; rather, the principals claimed generally that they supervised each other.

c. Instant Messaging

Pursuant to the WSPs, the firm and Snow were required to review IMs, which were subject to the firm's review and record retention policies. Instead, Snow delegated the review of IMs to SD, an unregistered individual. In addition, Snow did not take any action to ensure that the delegated function was being properly executed.

6. The Firm's Anti-Money Laundering Policies and Procedures and Its Trading in Valley High Mining Company

a. The Firm's AML Policies and Procedures

Wilson-Davis's AML procedures required Snow, as the AMLCO, to implement the AML policies and procedures, and monitor the trading activity of the firm, its associated persons and customers to reasonably detect and prevent any money-laundering activity or financial crimes. The AML procedures also required that he detect and investigate transactional red flags, and report suspicious activity by filing a Suspicions Activity Report ("SAR") when appropriate. The WSPs specifically stated that Snow was "responsible for developing policies, procedures, and internal controls reasonably designed to achieve compliance with AML rules and regulations." The firm's AML procedures identified penny stock liquidation—the firm's primary business—as a red flag of potential money laundering. Yet the procedures failed to provide adequate guidance on how to detect potentially manipulative or suspicious trading. The procedures stated that it is a red flag if "the customer engages in suspicious activity involving the practice of depositing penny stocks, liquidates them, and wires proceeds. A request to liquidate shares may also represent engaging in an unregistered distribution of penny stocks which may also be a red flag."

The firm's AML policies and procedures also failed to include a list of other red flags indicative of suspicious and potentially manipulative trading associated with transacting in penny stocks, such as matched orders, wash sales, and pre-arranged trading. While Wilson-Davis had generic procedures in place that prohibited manipulation, it had no specific procedures in place describing how to identify and investigate potentially manipulative trading schemes. Wilson-Davis generated monthly exception reports to identify customers who maintained multiple accounts, and to identify whether securities were being transferred between customer accounts. But in general, the firm did not use reports to identify suspicious trading and instead relied upon its traders to identify suspicious activity and raise it with their superiors for further investigation.

Further complicating matters, while Snow is explicitly delegated as the individual responsible for the reasonable implementation of the firm's AML program, he maintains that he did not have the responsibility for detecting suspicious activity, nor did he delegate that responsibility to anyone else at the firm.

Finally, Wilson-Davis and Snow were required to train firm employees to ensure they were able to identify suspicious activity. The AML trainings provided by Snow on an annual basis, however, provided no instruction on red flags related to matched orders, wash sales, or the particular concerns of the firm's penny stock liquidation business. The firm's WSPs include examples of red flags indicative of potential money laundering, but provided little or no guidance as to how to detect potentially manipulative or suspicious trading.

b. Valley High Mining Company

The firm's anemic AML policies and procedures are highlighted in its involvement with Valley High Mining Company ("VHMC"). Wilson-Davis began making a market in VHMC in April 2012 after the president of VHMC asked Snow to have the firm make a market in the stock.

On April 10, 2012, on the firm's the first day of trading VHMC, a Wilson-Davis customer account bought 2,500 shares of VHMC from another Wilson-Davis customer account for $0.40 per share. A cross trade between customers of the firm was posted at 3:59 p.m. and was well above the previous reported trade of $.025 per share. The next day, LD reviewed a report that detailed all customer trades at the firm. According to LD, he reviewed the report to look for cross trades, wash sales, or other out of the ordinary transactions. The VHMC cross trade between the firm customers was apparently reviewed by LD, who hand-wrote the word "okay" next to the trade. According to LD, it was his practice to discuss questionable trades with the broker, but he never documented any review or inquiry he performed and there is no evidence in the record that he or anyone at the firm discussed with its customers the facts surrounding the trade.

The trading activity in VHMC at the firm occurred from April 2012 through November 2012, during which time its price rose approximately to $4.95 per share. At that price, VHMC, a shell company, had a market value of just over $75 million. The cross-trading activity described above, in addition to other information known to the firm regarding VHMC, raised several red flags indicative of potentially suspicious trading activity that the firm should have recognized and investigated, but did not. These red flags include:

- Prior to the firm's trading activity, VHMC was a dormant, little-known penny stock.
- VHMC was a shell company.
- There was publicly available information indicating familial or other affinities between the firm's customers and the individual who was once the sole director of VHMC.
- Wilson-Davis customers constituted a high percentage of the overall market volume of VHMC.
- Wilson-Davis customer trades in VHMC included numerous instances of apparent pre-arranged trades and matched orders.
- The share price of VHMC rose significantly during this period – from $0.40 to almost $5.
- The firm dominated both the buy and sell side of VHMC trading during this period, often making up 100 percent of the market.

Notwithstanding the percentage of the trading volume controlled by the firm, the price rise, and the relationships of the customers to a one time company insider, Wilson-Davis and

Snow failed to review the trading activity from an AML perspective. Nobody ever discussed the facts surrounding the trades with the customers. Neither the trader nor anyone else at the firm brought any of the activity to Snow's attention for AML review.

II. Procedural History

On December 16, 2016, Enforcement filed a complaint alleging that Wilson-Davis willfully violated Rule 203(b)(1) of Reg SHO and FINRA Rule 2010 by short selling without first borrowing the securities. Respondents were also charged with failing to supervise Kerrigone's short selling, in violation of NASD Rule 3010 and FINRA Rule 2010. The firm and Snow were further charged with failing to adequately supervise trading and other activities at the firm in violation of NASD Rule 3010 and FINRA Rule 2010, and failing to establish and implement adequate AML procedures tailored to the firm's business, in violation of FINRA Rules 3310 and 2010. Respondents filed an answer denying the allegations contained in the complaint and a hearing was held.

On February 27, 2018, the Hearing Panel issued its decision, finding that Respondents engaged in the misconduct alleged in the complaint. For its unlawful short sales in violation of Rule 203 of Reg SHO, Wilson-Davis was fined $1,170,000. For its failures to supervise and implement adequate AML procedures in violation of NASD Rule 3010 and FINRA Rules 3310 and 2010, Wilson-Davis was fined an additional $300,000. The Hearing Panel also ordered disgorgement of $51,624, plus prejudgment interest.[7]

For his failure to supervise Kerrigone's short sales, the Hearing Panel fined Barkley $115,000, suspended him in all capacities for one year, and ordered Barkley to requalify by examination before serving in any registered capacity in the securities industry. For his failures to supervise and failure to implement adequate AML procedures, Snow was fined $140,000, suspended for one year in all capacities, and ordered to requalify by examination before serving in any registered capacity in the securities industry.

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[7] The disgorgement amount reflects Wilson-Davis's portion of the trading profits on CNCT, PMEA, and PVTA, 40 percent of the total trading profits (the remaining 60 percent was paid to Kerrigone). Respondents do not challenge this amount on appeal.

III. Discussion

A. Wilson-Davis Violated Reg SHO[8]

Subject to certain exceptions discussed above, Reg SHO requires market participants seeking to effect a short sale to borrow, arrange to borrow, or have reasonable grounds to believe a security can be borrowed in time to make delivery when due prior to effecting the short sale. This is known as the "locate requirement." Market makers, who ensure liquidity in the market, are exempted from the locate requirement if they are engaged in bona-fide market making activities in the security for which the exception is claimed.[9]

The proposing and adopting releases for Reg SHO provide guidance as to what may constitute bona-fide market making activities and what may not:

> Bona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security. In addition, where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona-fide market making for purposes of the exception. *Short Sales*, Exchange Act Release No. 50103, 2004 SEC LEXIS 1636, at *50 (July 28, 2004).

Furthermore, it is the market maker's burden to show that a short sale was effected "in furtherance of . . . bona fide market making activities" and was not subject to the requirements of Rule 203(b)(1). Exchange Act Release No. 50920, 2004 SEC LEXIS 3041, at *17 (Dec. 22, 2004).

We find that Wilson-Davis sold the Stocks short as part of a speculative trading strategy. The record reflects that Kerrigone intentionally entered into an artificially inflated market to implement his short-selling strategy and later covered his shorts when the market collapsed. During the time of the short selling, the Stocks were quoted on either the OTCBB or pink sheets and the Stocks had little to no trading activity. Immediately prior to Kerrigone's short sales, the

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8 In addition to the Stocks at issue here, during the relevant short-selling period there were other stocks that Kerrigone was trading, in violation of Reg SHO. The SEC brought an action against the firm regarding those short sales. Wilson-Davis settled with the SEC for a fine of $75,000 and was ordered to pay disgorgement of $208,645.71 plus pre-judgment interest. *See Wilson-Davis & Co.*, Exchange Act Release No. 80533, 2017 SEC LEXIS 1242 (Apr. 26, 2017).

9 The Commission has stated that "a market maker engaged in bona-fide market making is a broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and ask side of the market." *See, e.g., Amendments to Regulation SHO,* Exchange Act Release No. 58775, 2008 SEC LEXIS 2319, at *60 (Oct. 14, 2008).

Stocks were subject to questionable promotional activity. Kerrigone did not trade in the Stocks for more than a week and the firm had little to no history of making a market in the Stocks prior to the commencement of Kerrigone's short selling.

In each of the Stocks, Kerrigone engaged in a similar pattern of trading. Over the course of one to three trading days, Kerrigone accumulated a short position in the stock while posting bid quotations for Wilson-Davis that were significantly away from the inside bid, sometimes by more than 250 percent. He would carry the short position overnight (or longer) and then cover the entire short position, while posting offer quotations for Wilson-Davis that again were significantly away from the inside offer. The firm's quotes on the side it was not trading were frequently so far away from the inside that they were not competitive and were effectively not quotes at all. We conclude that the short sales were effected in furtherance of a speculative selling strategy with no real attempt to provide liquidity to the market. All of those factors evidence that Wilson-Davis was not participating in bona-fide market making activities when selling the Stocks short, and accordingly, Wilson-Davis has not met its burden to establish an applicable exception to Reg SHO.

There is no dispute that Wilson-Davis made these short sales in the four securities described above and that the firm failed to comply with the borrow requirement in connection with each of these short sales. The only issue is whether the firm properly relied on the bona-fide market maker exception.

Wilson-Davis argues that the Hearing Panel ignored factors that purportedly support its contention that that it was in fact acting as a bona-fide market maker.[10] Respondents argue that the Hearing Panel improperly relied on Enforcement's presentation of evidence related to how frequently Wilson-Davis's quotes were more than 10 percent away from the inside of the bid, the offer, or both, and claim, on that basis, that Enforcement is seeking to apply a new regulatory standard that is both nonsensical and imposed on the firm without any prior notice. We find no merit in Wilson-Davis's arguments. First, the Hearing Panel did not base its finding that the firm was not acting as a bona-fide market maker solely on the evidence that its quotes were more than 10 percent away from the inside bid or offer. Rather, the Hearing Panel considered all the relevant facts and circumstances in making its finding. Second, as one of several pieces of evidence, we find the fact that the firm's quotes were not competitive is useful because of the frequency with which this happened. SEC guidance states that "[c]ontinuous quotations that are at or near the market on both sides and that are communicated and represented in a way that makes them widely accessible to investors and other broker-dealers are also an indication that a market maker is engaged in bona-fide market making activity." The guidance does not define "near," but we conclude 10 percent is a reasonable measure of quotes being away from the inside so as to be considered not near the market. *See Dep't of Enforcement v. Legacy Trading, Co*, No. 2005000879302, 2010 FINRA Discip. LEXIS 20, at *28 (FINRA NAC Oct. 8, 2010)

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[10] The firm conceded at oral argument before the NAC subcommittee that in light of the SEC's and Enforcement's actions, the firm is now "well aware of the regulatory interpretation of Reg SHO," but maintained that during the relevant short selling period, the firm believed it was engaged in bona-fide market making.

(finding respondent was not engaged in bona-fide market making when it "almost never posted the inside bid or ask in connection with the short sales"). Wilson-Davis's quotations in each of the four Stocks were rarely at or near the market on both sides. Indeed, the record reflects that Wilson-Davis's quotes were frequently far more than 10 percent away from the inside—as far away as 250 percent.

Additionally, the firm argues that its short sales provided market liquidity and relies on the following Reg SHO guidance to legitimize their short selling activities: "a market maker engaged in bona-fide market making may provide liquidity to a security's market, take the other side of trades when there are short-term buy-and-sell-side imbalances in customer orders, or attempt to prevent excess volatility."[11] While it is true that the SEC notes that providing liquidity is a consideration in determining whether trading activity constitutes bona-fide market making, it is not the only consideration. Other factors, including those addressed above, must also be considered. And when all of those factors are taken into consideration, the evidence supports the Hearing Panel's determination that the firm was not acting as a bona-fide market maker. In addition, Wilson-Davis did not present any evidence to show that there was an actual trade imbalance or a lack of liquidity in any of the Stocks when Kerrigone began short selling; rather the evidence shows that these were relatively inactive stocks.

The firm similarly argues that "naked" short-selling is not necessarily a violation of federal securities laws, because in some instances, it contributes to market liquidity. It cites to the Commission's "Key Points Regarding Regulation SHO," which states:

> For example, broker-dealers that make a market in a security generally stand ready to buy and sell the security on a regular and continuous basis at a publicly quoted price, even when there are no other buyers or sellers. Thus, market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market. This may occur, for example, if there is a sudden surge in buying interest in that security, or if few investors are selling the security at that time. Because it may take a market maker considerable time to purchase or arrange to borrow the security, a market maker engaged in bona fide market making, particularly in a fast-moving market, may need to sell the security short without having arranged to borrow shares. This is especially true for market makers in thinly traded, illiquid stocks as there may be few shares available to purchase or borrow at a given time.[12]

This argument is circular and presupposes that the firm was a market maker. The record is clear that Kerrigone did not "stand ready to buy and sell the security on a regular and continuous basis"— a hallmark of market making. Kerrigone's trading in each of the Stocks occurred only for the brief period of his short sales and purchases to cover his short position. Therefore, this argument provides the firm no cover.

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11 *See* https://www.sec.gov/investor/pubs/regsho.htm. ("Naked Short Sales").

12 https://www.sec.gov/investor/pubs/regsho.htm.

The firm also argues that the Hearing Panel did not make any credibility findings "to explain why the factors and the evidence supporting Wilson-Davis's interpretation were ignored." Whether the firm violated Reg SHO is not a credibility inquiry. Regardless of what the firm believed as to the legitimacy of its status as a bona-fide market maker, its beliefs neither excuse nor justify its violations of Reg SHO.

In sum, the short sales at issue were effected to carry out a speculative trading strategy and did not involve bona fide market making.[13] The market maker exemption was not intended "to give market makers carte blanche to engage in speculative short selling of securities that could not be borrowed for delivery." *Dep't of Enforcement v. Fiero*, No. CAF980002, 2002 NASD Discip. LEXIS 16, at *71 (NASD NAC Oct. 28, 2002). Because the short sales were not subject to the market maker exemption, Wilson-Davis violated Rule 203(b)(1) of Reg SHO and FINRA Rule 2010.[14] We therefore affirm the Hearing Panel's findings that Kerrigone's trading in the Stocks for which Wilson-Davis failed to find locates for 122 short transactions was not bona-fide market making activity.

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13 Our conclusion that the firm engaged in short selling that violated Rule 203(b)(1) of Reg SHO is further bolstered by the SEC's findings in *Wilson-Davis & Co.*, Exchange Act Release No. 80533, 2017 SEC LEXIS 1242 (Apr. 26, 2017), involving an identical short selling strategy for five different securities that occurred during the relevant short selling period at issue here. There, the SEC, among other things, imposed at civil penalty of $75,000 (for the firm's improper short selling activity as well as the firm's unrelated violations of the market access rule). In that case, the SEC noted that:

> [T]he adopting release to the 2008 Amendments to Regulation SHO provides guidance on trading activity that does not qualify as bona-fide market making and [Wilson-Davis's] conduct conforms to the factors describing non-bona-fide market making activity. Specifically, contrary to the guidance in the Commission's adopting release to the 2008 Amendments to Regulation SHO, [Wilson-Davis]: (1) posted quotations that were often not at or near the market on both sides; (2) posted a bid quotation at or near the market for that security, but failed to post an offer quotation at or near the market; (3) updated its bid quotation for the security during the trading day, as it often made few or no changes to its offer quotation throughout the entire trading day (at times, not changing an offer quotation that was far away from the market despite substantial movement in the price of the security); and (4) executed numerous short sales away from its posted offer quotations. 2017 SEC LEXIS 1242, at *13-14.

14 It is well settled that a violation of another FINRA rule is a violation of FINRA Rule 2010. *See William J. Murphy*, Exchange Act Release No. 69923, 2013 SEC LEXIS 1933, at *26 (July 2, 2013), *aff'd sub nom. Birkelbach v. SEC*, 751 F.3d 472 (11th Cir. 2014) (noting that the violation of another SEC or FINRA rule or regulation constitutes a violation of FINRA Rule 2010).

B. Respondents' Supervisory Failures

1. Failure to Supervise Reg SHO (Wilson-Davis, Barkley, and Snow)

NASD Rule 3010(a) required firms to "establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules."[15] NASD Rule 3010(b) required that these systems be documented in the firm's WSPs. The procedures must be tailored to the firm's business, and must set forth mechanisms for ensuring compliance and detecting violations, and not merely set forth what conduct is prohibited. *See* NASD Rules 3010(a), (b)(1). A member's failure to supervise the activities of its personnel is a violation NASD Rule 3010. *Dep't of Enforcement v. Pellegrino*, Complaint No. C3B050012, 2008 FINRA Discip. LEXIS 10, at *47 (FINRA NAC Jan. 4, 2008), *aff'd*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843 (Dec. 19, 2008); *see Richard F. Kresge*, Exchange Act Release No. 55988, 2007 SEC LEXIS 1407, at *35 (June 29, 2007) ("Members should determine that supervisors understand and can effectively conduct their requisite responsibilities."); *see also* NASD Rule 3010(a)(6) (stating that FINRA members must undertake "[r]easonable efforts to determine that all supervisory personnel are qualified by virtue of experience or training to carry out their assigned responsibilities").

"[A] broker-dealer's responsibility to supervise its employees by means of effective, established procedures is a critical component in the federal investor protection scheme regulating the securities markets." *Robert J. Prager*, 58 S.E.C. 634, 658 (2005). Furthermore, the "final responsibility for supervision of the trading activities at a member firm of NASD rests with the firm's president, unless the president reasonably delegates the duties to someone else and has no reason to know that person is not properly performing the delegated duties." *Id.* at 659 n.45.

Wilson-Davis, through Snow, failed to establish and maintain reasonable supervisory systems and WSPs in connection with the firm's use of the market maker exception, locate requirements, and general compliance with Reg SHO. Snow was responsible for establishing and maintaining adequate supervisory systems and procedures, including systems and procedures relating to the firm's Reg SHO compliance and the bona-fide market maker exemption. He did not do so. Wilson-Davis's WSPs did not provide procedures, processes, tests, or guidance that would permit an evaluation by supervisors at the firm of whether the particular facts of a short sale transaction established that a sale was made in connection with bona-fide market making activity. Moreover, the firm did not even have procedures for locating or borrowing securities for its short sales because the firm considered all trading to be bona-fide market making. Therefore, we find that the firm and Snow violated NASD Rule 3010(a) and (b) and FINRA Rule 2010.

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15 FINRA Rule 0140 (formerly NASD Rule 0115) provides that all of FINRA's rules shall apply equally to members and associated persons and that associated persons shall have the same duties and obligations as member firms.

While Snow was responsible for the firm's supervisory system and written procedures, Barkley was responsible for supervising trading and ensuring compliance with Reg SHO. Barkley failed to adequately fulfill these responsibilities.[16] During the relevant short-selling period, Barkley was responsible for ensuring that Kerrigone was acting as a bona-fide market maker and otherwise complying with Reg SHO. He did not. Barkley, who worked out of the Salt Lake City office, did little to supervise Colorado-based Kerrigone's trading or ensure that it complied with Reg SHO. Although Barkley monitored Kerrigone's trading in the Stocks in real time and communicated frequently with Kerrigone, Barkley did not regularly monitor the market maker quotes Kerrigone was displaying to the market at the time of his trading. Consequently, Barkley failed to detect quotations in the Stocks that were far away from competitive levels on either the buy or sell side. Barkley assumed that all of Kerrigone's short selling in the security was a part of bona-fide market making and simply signed off on his market maker applications. This is evidenced by Barkley's and the firm's concerns surrounding Kerrigone's trading in LOTE. Barkley was not concerned whether Kerrigone's quotations were consistent with genuine market making, but rather the concern lay in the exposure and potential loss that Kerrigone's trading in LOTE created for the firm.

Respondents defend Barkley's supervision of Kerrigone's short-selling by arguing that "no dispute exists that Barkley engaged in substantial supervisory efforts." Even if one assumed that Barkley's "efforts" were substantial, that is not the standard by which we judge supervision. Rather, under the NASD and FINRA rules, Barkley was required to supervise Kerrigone in a manner "that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD [and FINRA] rules." Furthermore, "the duty of supervision includes the responsibility to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation." *Michael T. Studer*, 57 S.E.C 1011, 1023 (2004), *aff'd*, 148 F. App'x 58 (2d Cir. 2005). Barkley did not supervise Kerrigone in a manner designed to achieve compliance with Reg SHO. Barkley's assumption that

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[16] We note that the SEC similarly concluded that Barkley failed to supervise the firm's trading for Reg SHO compliance. In *Byron B. Barkley*, Exchange Act Release No. 79578, 2016 SEC LEXIS 4658 (Dec. 16, 2016), which involved an identical short selling strategy for five different securities that occurred during the relevant short selling period at issue here, the SEC, among other things, imposed a civil penalty of $50,000 (for failures to supervise the improper short selling activity and the firm's unrelated violations of the market access rule). In that case, the SEC noted that:

> Barkley, the head of [Wilson-Davis] proprietary trading group, was the designated supervisor for the proprietary trading group . . . and, as such, he was responsible for supervising this trading activity. Barkley knew that [the firm] was relying on the bona-fide market making exception under Regulation SHO to execute these short sales without a locate. Nevertheless, Barkley did not adequately review the quoting activity of the traders or make other efforts to determine whether the short sales resulted from bona fide market making activity. In fact, many of [the firm's] short sales were not part of bona-fide market making activity and were, therefore, not eligible for the bona-fide market making exception in Rule 203(b)(2)(iii) of Regulation SHO. 2016 SEC LEXIS 4658 at *4.

Kerrigone was acting as a bona-fide market maker with no meaningful monitoring of Kerrigone's and other dealers' quotes violated NASD 3010(a) and FINRA Rule 2010.

In sum, Wilson-Davis and Snow failed to establish and maintain a reasonable supervisory system and WSPs for Reg SHO compliance, and the firm and Barkley failed to reasonably supervise Kerrigone's trading. They thereby violated NASD Rule 3010(a) and (b) and FINRA Rule 2010.

2. Failure to Supervise Registered Representatives and Principals (Wilson-Davis and Snow)

NASD Rule 3010(a)(5) required "[t]he assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities." NASD Notice to Members 99-45 explained that the "requirement . . . serves several functions. It provides the person being supervised with a clear line of authority and specifically identifies for the supervisor the persons for which he or she has responsibility." 1992 NASD LEXIS 20, at *17 (June 1999).According to the firm's WSPs, Snow was responsible for the direct supervision of registered sales personnel, yet he claimed to have no such responsibility. The firm and its principals were inconsistent in their attempts to identify which principals were responsible for supervising, leading to a lack of meaningful supervision. In addition, in the instances where PD was designated as the individual responsible for supervising registered representatives, his very limited time in the office meant that he was unable to effect reasonable supervision. Moreover, there was no supervisory system to supervise the firm's registered principals— they claim to have supervised one another—but without any clear delegation with respect to specific responsibilities.

Wilson-Davis, acting through Snow, failed to assign each registered person to an appropriately registered representative or principal responsible for supervising that individual's activities. As a result, Wilson-Davis and Snow failed to implement a reasonable supervisory system to supervise the registered representatives and principals at the firm, in violation of NASD Rule 3010(a) and FINRA Rule 2010.

3. Failure to Engage in Heightened Supervision (Wilson-Davis and Snow)

Wilson-Davis and Snow also violated NASD Rule 3010(a) as it relates to their untimely and unreasonable heightened supervisory plan for Carlson. Enforcement filed a complaint against Wilson-Davis, PD, and Carlson, and then later filed an amended complaint against Carlson. Under the firm's WSPs, the filing of the complaint triggered an obligation on the part of Snow to identify and consider Carlson and PD as possible candidates for heightened supervision. Snow was also obligated to appropriately document the decisions made with respect to heightened supervision. Wilson-Davis and Snow, however, did nothing.

It was not until after the Hearing Panel issued its decision, finding Carlson liable for violating Section 5 of the Securities Act and ordering Wilson-Davis to place Carlson under heightened supervision for one year, that the firm acted. Even then, the firm did not implement its plan promptly, waiting two months until after the decision was issued.

Snow and the firm created a heightened supervisory plan that was a one-page memo that simply incorporated the firm's WSPs with respect to stock liquidation, imposed requirements that Carlson submit any customer transactions over $75,000 to outside counsel's review, and that Carlson have quarterly lunch meetings with outside counsel to discuss any Section 5 issues.

Respondents argue that the firm had previously amended its policies and procedures related to Section 5 several months before Enforcement filed the 2010 complaint against the firm, PD, and Carlson, and that the revision of these policies and procedures increased the supervision on all registered representatives. They maintain that this overhaul, coupled with the $75,000 review threshold served as an effective heightened supervision plan. We agree with the Hearing Panel that it did not. The heightened supervisory plan eventually crafted by the firm for Carlson was inadequate and did not meet the requirements set forth in its own WSPs. The WSPs required that once imposed, a plan of heightened supervision should identify the scope of supervision, including the type, frequency, and time period of the supervision. The plan was also required to provide how the supervision was to be documented, be signed by the representative and supervisor, and be certified by the supervisor that the plan was being performed. The plan was not signed by Carlson's supervisor, PD, it did not identify the individuals responsible for implementing the plan, and it failed to identity the form and frequency of the supervisor's certification of compliance with the plan.

Therefore, because the heightened supervision plan was untimely and insufficient, we affirm the Hearing Panel's finding that the firm and Snow violated NASD Rule 3010(a) and FINRA Rule 2010.

4. <u>Failure to Supervise IM Communications (Wilson-Davis and Snow)</u>

Wilson-Davis and Snow also failed to reasonably supervise the IM communications of the firms' representatives. Snow delegated the review of IMs to SD, an unregistered person, and failed to take reasonable steps to ensure that the delegated function was executed properly. In this case, it was not. Snow relied upon SD's review of IMs and to bring to Snow's attention any issues that arose, but Snow did not implement any system to ensure that SD was performing the review properly. SD was provided only vague guidance as to how to conduct his review, and Snow was unaware of what parameters SD actually used to review the materials. Snow admits that this delegation was improper.

While the delegation of a function such as reviews of IMs is not improper, there has to be a reasonable system in place for review of the delegated function. Supervisors must take reasonable action to ensure delegated functions are properly executed and should document performance of these procedures in a manner that reflects appropriate supervision. "[I]t is not sufficient for the person with overarching supervisory responsibility to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention . . . . Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised." *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843, at *47 (Dec. 19, 2008) (internal citation omitted).

We find that the firm and Snow failed to reasonably supervise the firm's IMs, in violation of NASD Rule 3010(a) and FINRA Rule 2010.

C. Wilson-Davis's and Snow's AML Violations

The Hearing Panel concluded that the firm's AML program was not reasonably designed to achieve compliance with its AML responsibilities and the applicable SAR reporting requirements, and that the firm did not adequately implement its AML program or conduct appropriate AML training. We agree.

1. Overview of AML Requirements for All Broker-Dealers

In October 2001, Congress passed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("the PATRIOT Act"). Pub. L. No. 107-56, 115 Stat. 272. Title III of the PATRIOT Act imposes obligations on broker-dealers under AML provisions and amendments to the Bank Secrecy Act requirements. *See* 31 U.S.C. §§ 5311 *et seq*. Among other requirements, the PATRIOT Act requires that all broker-dealers establish and implement AML programs designed to achieve compliance with the Bank Secrecy Act and the regulations thereunder, including the requirement that broker-dealers file SARs with the Financial Crimes Enforcement Network ("FinCEN").[17] *See* 31 U.S.C. § 5318(h); 31 C.F.R. § 103.120(c).

In September 2009, the Commission approved FINRA Rule 3310 that sets forth the minimum standards required for each FINRA member firm's AML compliance program. *See Order Approving Proposed Rule Change to Adopt FINRA Rule 3310 (Anti-Money Laundering Compliance Program) in the Consolidated FINRA Rulebook*, Exchange Act Release No. 60645, 2009 SEC LEXIS 3098 (Sept. 10, 2009). FINRA Rule 3310 is the successor to NASD Rule 3011.[18] *See id*. FINRA Rule 3310 requires that AML programs, at a minimum, "[e]stablish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of" suspicious transactions; "[e]stablish and implement policies, procedures, and

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[17] The Department of Treasury issued the implementing regulation with respect to the SAR requirement. The regulation provides in part that "[e]very broker or dealer in securities within the United States . . . shall file with FinCEN . . . a report of any suspicious transaction relevant to a possible violation of law or regulation." 31 C.F.R. § 103.19(a)(1). The regulation further requires broker-dealers to report to FinCEN any transaction, alone or in the aggregate, that involves $5,000 in funds or assets and that the broker-dealer knows, suspects, or has reason to suspect that the transaction: (1) involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity; (2) is designed to evade the requirements of the Bank Secrecy Act; (3) has no business or apparent lawful purpose or is not the sort in which a particular customer would normally engage; or (4) involves the use of the broker-dealer to facilitate criminal activity. 31 C.F.R. § 103.19(a)(2).

[18] NASD Rule 3011 was adopted without substantive change into the Consolidated FINRA Rulebook as FINRA Rule 3310 (AML Compliance Program).

internal controls reasonably designed to achieve compliance with the Bank Secrecy Act" and its implementing regulations; provide independent testing by qualified persons of the AML program; designate and identify to FINRA an individual responsible for implementing and monitoring the AML program; and "[p]rovide ongoing training for appropriate personnel." FINRA Rule 3310(a)–(e).

In implementing an AML system that is in compliance with FINRA Rule 3310, FINRA members were advised to note the difference between "systems" and "written procedures." *See, e.g., NASD Notice to Members 09-45*, 1999 NASD LEXIS 20. Written procedures "are a critical part" of an overall system. *Id.* at *4.

> For example, a supervisory system may include elements such as automated exception reports and surveillance programs that monitor for unusual trading activity in customer accounts. The written supervisory procedures would instruct the supervisor on which reports produced by the surveillance system the supervisor is to review as part of his or her responsibilities, including a description of how often these reports should be reviewed, the steps to be taken if suspicious activity is discovered, and how to document the supervisor's oversight activities. *Id.*

Compliance with FINRA Rule 3310 requires *both* adequate systems and written procedures. *See, e.g., Dep't of Enforcement v. Domestic Sec., Inc.*, Complaint No. 2005001819101, 2008 FINRA Discip. LEXIS 44, at *14–18 (FINRA NAC Oct. 2, 2008). As discussed below, Wilson-Davis and Snow failed to satisfy the requirements of the rule.

2. Wilson-Davis's and Snow's AML Obligations

FINRA Rule 3310(a) required that Wilson-Davis develop and implement policies and procedures "that can be reasonably expected to detect and cause the reporting of" suspicious activity and transactions. FINRA emphasized to its members that to be effective, AML procedures "must reflect the firm's business model and customer base." *NASD Notice to Members 02-21*, 2002 NASD LEXIS 24, at *17 (Apr. 2002). Members were advised that "in developing an appropriate AML program," it should consider factors such as its "business activities, the types of accounts it maintains, and the types of transactions in which its customers engage." *Id.* at *20. Firms must also "establish and implement controls and written procedures that explain the procedures that must be followed, the person responsible for carrying out such procedures, how frequently such procedures must be performed, and how compliance with the procedures should be documented and tested. *Id.* at *21. FINRA further advised that "[a]ppropriate" red flags must be described in each firm's written AML procedures." *Id.* at *42. FINRA Rule 3310(e) in turn required Wilson-Davis to provide ongoing AML training for appropriate personnel.

During the relevant period, Wilson-Davis failed to establish and implement reasonable AML policies and procedures to detect, investigate and report, where appropriate, suspicious trading activity by filing a SAR. Snow was responsible for ensuring that the firm's AML program was adequately tailored to the risks posed by the firm's business activities and establishing an AML program to mitigate those risks. Specifically, Wilson-Davis and Snow failed to establish or maintain AML policies and procedures tailored to the risks posed by its penny stock business.

These shortcomings are reflected in the firm's market making in VHMC. Snow, LD, and others failed to detect and investigate a number of red flags indicative of potentially suspicious trading activity in VHMC. In addition, Snow failed to provide adequate AML training to enable employees to detect potentially suspicious trading activity, including the risks and red flags associated with penny stock activity. Employees were not trained on specific steps to be taken in order to monitor for or detect any potentially suspicious trading activity.

Respondents argue that there were no red flags for the firm to investigate and, in any event, there was no finding of actual manipulation or unlawful trading. As an initial matter, there does not need to be a finding of an actual underlying manipulation to conclude that Respondents violated FINRA's supervisory rules. *See Dep't of Enforcement v. Lek Sec. Corp.*, Complaint No. 2009020941801, 2016 FINRA Discip. LEXIS 63, at *35, 36 (FINRA NAC Oct. 11, 2016), *aff'd*, Exchange Act Release No. 82981, 2018 SEC LEXIS 830 (Apr. 2, 2018). Respondents also argue that there were no missed signs of suspicious timing or trade quantities, the firm's customers trading in VHMC were well-known to the firm, and that LD reviewed all the trades. We disagree that there were no red flags that the firm should have investigated. The stock of VHMC—a shell company—experienced an unexplained, significant increase in price during a period when Wilson-Davis dominated the market, primarily through cross trades between firm customers. Nobody at Wilson-Davis conducted any investigation to determine the reasons for the price increase or the trading.

Wilson-Davis and Snow failed to establish and implement reasonable AML policies and procedures; failed to detect and investigate suspicious trading activity; and failed to provide adequate AML training to firm staff. Therefore, we affirm the Hearing Panel's findings that Wilson-Davis and Snow violated FINRA Rules 3310(a) and (e) and 2010.

IV. Sanctions

A. Wilson-Davis's Reg SHO Violations

For the firm's short sale violations, the Hearing Panel fined Wilson-Davis $1,170,000[19] and ordered that the firm disgorge the profits it made from Kerrigone's 122 short sales, in the amount of $51,624. We affirm the disgorgement order but reduce the fine to $350,000.[20]

FINRA Sanction Guidelines ("Guidelines") address directly violations of Reg SHO.[21] The Guidelines recommend a fine of $5,000 to $16,000 for a first action, a $10,000 to $77,000 fine for a second action, and $10,000 to $155,000 for subsequent actions.[22] The Guidelines also direct an adjudicator to consider fines in greater amounts when the violations are egregious, involve a pattern or patterns of misconduct, took place over an extended period of time, or can be quantified by a number or percentage.[23] Similarly, the Guidelines state that "[in] all egregious cases, whether a first, second or subsequent action, consider a fine greater than or equal to the high of the range for a first, second or subsequent action."[24] Finally, the Guidelines direct us to consider the Principle Considerations in Determining Sanctions that apply to all sanction determinations in our assessment of the severity of Respondents' violations.[25]

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19 The actual amount of the fine imposed by the Hearing Panel for Wilson-Davis's misconduct was $1,220,000 ($10,000 for each of its 122 improper short sales). However, the Hearing Panel reduced the fine it imposed by $50,000—taking into account the fine previously imposed by the SEC. The Hearing Panel reasoned that "[a]lthough a unitary penalty was imposed in the SEC case, that matter involved both the improper short selling activity at issue here as well as the Firm's unrelated violations of the market access rule. Accordingly, we take into account only a portion of the penalty imposed in the SEC action." *See FINRA Sanction Guidelines* 5 (2019) https://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf. [hereinafter *Guidelines*]. (General Principles Applicable to All Sanction Determinations No. 7). We look to the most recent Guidelines in effect during the pendency of this appeal. The 2019 Guidelines "are effective as of the date of publication, and apply to all disciplinary matters, including pending matters." *Id*. at 8.

20 We impose a fine of $400,000 but reduce it by $50,000—for the reasons articulated by the Hearing Panel as discussed in footnote 19.

21 *Guidelines*, at 65.

22 *Id*.

23 *Id*. at n.1.

24 *Id*. at 65.

25 *Id*.

We agree with the Hearing Panel that there are several aggravating factors reflected in Wilson-Davis's misconduct that render the violations egregious. Wilson-Davis acted recklessly.[26] The firm's misconduct involved 122 trades[27] over a period of close to a year.[28] The short sales also resulted in monetary gain for the firm[29] and affected other market participants.[30]

However, we disagree that the misconduct at issue here was so egregious as to warrant the fine imposed by the Hearing Panel. The Hearing Panel provides no basis, nor does the record support, a fine so far in excess of the Guidelines. *See ACAP Fin., Inc. v. SEC*, 783 F.3d 763,769 (10th Cir. 2015) (noting several balancing factors that are considered when "fashioning a remedial sanction," including the seriousness of the offense); *Dep't of Mkt. Regulation v. Kresge*, Complaint No. CMS030182, 2008 FINRA Discip. LEXIS 46, at *35 n.32 (FINRA NAC Oct. 9, 2008) ("Whether a sanction is punitive or remedial . . . depends on the facts and circumstances of the case."); *see generally Guidelines*, at 7 (listing factors that should be considered in determining appropriate sanctions with respect to all violations). Both the Hearing Panel and Enforcement state that Wilson-Davis made tens of millions of dollars in profits from Kerrigone's short selling, but this contention is not supported by record. In fact, Wilson-Davis made just in excess of $50,000 on three of the four stocks—profits we are ordering be disgorged—and suffered losses in excess of $4.2 million on Kerrigone's LOTE trading.

Finally, while we decline to calculate the fine on a "per trade" basis as the Hearing Panel did, we do agree that a significant fine is warranted in excess of the recommended ranges. Thus, we believe, on balance, that a fine of $350,000 for the firm's violation of Reg SHO is appropriately remedial.

B. <u>Supervisory and AML Violations</u>

The Hearing Panel imposed a $300,000 fine for the firm's supervisory and AML violations.[31] For Snow's AML and supervisory violations, the Hearing Panel fined him

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26 *Guidelines*, at 8 (Principal Consideration No. 13).

27 *Id*. at 7, 8 (Principal Consideration Nos. 8, 17).

28 *Id*. at 7 (Principal Consideration No. 9).

29 *Id*. at 8 (Principal Consideration No. 16).

30 *Id*. at 7 (Principal Consideration No. 11).

31 We, like the Hearing Panel, impose a unitary sanction for Respondents' AML and supervisory violations. *See Dep't of Enforcement v. Hedge Fund Capital Partners, LLC*, Complaint No. 2006004122402, 2012 FINRA Discip. LEXIS 42, at *97 (FINRA NAC May 1, 2012) ("[W]e find that it is appropriate to impose a unitary sanction for these remaining violations because the remaining violations of FINRA rules all resulted from the broad and systematic supervisory failures at the Firm.").

$140,000, suspended him in all capacities for one year, and ordered him to requalify by examination before serving in any registered capacity in the securities industry. For Barkley's failure to supervise Kerrigone's short selling, the Hearing Panel fined him $115,000, suspended him in all capacities for one year, and ordered him to requalify by examination before serving in any registered capacity in the securities industry.[32] For the reasons stated below, we modify the sanctions imposed on each of the Respondents.

The Guidelines for Systemic Supervisory Failures recommend a fine of $10,000 to $77,000 for responsible individuals, and a fine of $10,000 to $310,000 for the responsible firm.[33] When aggravating factors predominate, the Guidelines direct the adjudicator to consider a higher fine and a suspension between 10 business days and two-years.[34] We are also directed to consider imposing undertakings, ordering the firm to revise its supervisory systems and procedures, or ordering the firm to engage an independent consultant to recommend changes to the firm's supervisory systems and procedures.[35] The Hearing Panel concluded that aggravating factors predominate and that the Respondents' violations were egregious. We agree with the Hearing Panel that the misconduct was pervasive and the supervisory and AML violations were egregious.

1. Barkley's Failure to Supervise

The failure to supervise Kerrigone's short sales was egregious. For his part, Barkley's blind assumption that Kerrigone was acting as a bona-fide market maker resulted in the failure to scrutinize Kerrigone's market maker applications and his trading activity. This allowed Kerrigone's illegal short-selling to escape detection.[36] We find aggravating the substantial volume of the transactions, the "number and dollar value of the transactions not adequately supervised as a result of the deficiencies" is also aggravating.[37] While we note that Barkley did not act intentionally, we find his supervisory lapses grossly negligent.[38] We therefore fine Barkley $52,000, suspend him in all capacities for three months and in his principal and

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[32] In light of the civil penalty the SEC imposed for Barkley's failure to supervise Reg SHO, the Hearing Panel reduced the fine it imposed by $25,000.

[33] *Guidelines*, at 105.

[34] *Id*.

[35] *Id*. at 106.

[36] *Id*. (Principal Consideration No. 1).

[37] *Id*. (Principal Consideration No. 5).

[38] *Id*. at 8 (Principal Consideration No. 13).

supervisory capacities for one year, to run concurrently. We also order that he requalify as a principal by before acting in that capacity again.[39]

2. Wilson-Davis's and Snow's Failures to Supervise and AML Violations

As to Wilson-Davis's and Snow's failures to implement adequate procedures regarding the short-selling activities and failures to implement adequate AML policies and procedures, we agree with the Hearing Panel that these failures were egregious. As the Hearing Panel noted, "[t]he shortcomings touched multiple corners of its business." The Principal Considerations specific to the systemic supervisory failure Guidelines aggravate Wilson-Davis's and Snow's misconduct.

Related to the supervision of Reg SHO compliance, the firm and Snow failed to craft procedures adequate to ensure that it was acting as a bona-fide market maker and then failed to supervise Kerrigone's trading activity. The firm's supervisory deficiencies allowed Kerrigone's violative conduct to occur and escape detection.[40] Wilson-Davis did not allocate its resources to prevent or detect the Reg SHO violations, which resulted in harm to the markets.[41] Furthermore, the number and dollar value of the transactions not adequately supervised as a result of the deficiencies is also aggravating.[42]

In addition, as its AML procedures noted, the firm and Snow were well aware that the firm's penny stock business was vulnerable to trading abuses. However, they failed to take reasonable steps to ensure that the firm and its registered persons were capable of addressing those risks by identifying the red flags they encountered, particularly as illustrated by the myriad red flags raised by the trading in VHMC.[43]

We also agree with the Hearing Panel that that Wilson-Davis's and Snow's failure to timely and appropriately devise a plan of heightened supervision for Carlson was an alarming supervisory failure. The firm and Snow failed to consider imposing a heightened supervisory plan in direct contravention of the firm's WSPs and then waited two months after the Hearing Panel's decision to put in place a deficient plan."[44] The firm's and Snow's blatant disregard for the firm's own procedures and a FINRA order is aggravating.

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[39] Like the Hearing Panel, we find mitigating the sanction imposed against Barkley in the SEC action for his failure to supervise Reg SHO, and reduce the fine we would otherwise impose—$77,000—by $25,000.

[40] *Id*. at 105 (Principal Consideration No. 1).

[41] *Id*. (Principal Consideration No. 3).

[42] *Id*. (Principal Consideration No. 5).

[43] *Id*. (Principal Consideration No. 2).

[44] *Id*.

Finally, Wilson-Davis's and Snow's failure to ensure that the firm's employees were provided a clear supervisory chain of command and their failure to adequately supervise the firm's instant messages further reflect a firm culture that did not prioritize its supervisory or AML obligations.

Overall, Wilson-Davis's supervisory and AML deficiencies affected market integrity and market transparency.[45] The lack of quality controls and procedures available to the firm's supervisors are additionally aggravating.[46] Thus, we conclude that a fine higher than that imposed by the Hearing Panel is needed to adequately address Wilson-Davis's troubling and egregious supervisory and AML violations, particularly in light of the firm's extensive disciplinary history.[47] For example, from 2010 to 2016—prior to the filing of the instant disciplinary action—the firm entered into settlements with FINRA for misconduct specifically involving deficient supervisory processes and procedures five times. The frequency of Wilson-Davis's supervisory issues evinces a firm culture that does not afford its supervisory obligations appropriate weight. We therefore impose a $750,000 fine.

We also order that Wilson-Davis retain an independent consultant to recommend changes to the firm's WSPs, including policies, procedures, and supervisory systems related to AML obligations, and the firm's supervisory systems in general.[48] We order Wilson-Davis to comply with the following procedures related to the retention of an independent consultant: Wilson-Davis shall retain, within 60 days of this decision becoming FINRA's final disciplinary action, an independent consultant, acceptable to Enforcement. The independent consultant shall conduct a review of the firm's WSPs, including policies, procedures, and supervisory systems related to AML obligations, and the firm's supervisory systems in general. The independent consultant shall make recommendations of ways to improve these processes, policies, procedures, and systems. Once retained, Wilson-Davis shall not terminate its relationship with the independent consultant without Enforcement's written approval.

Wilson-Davis shall require the independent consultant to submit to the firm and FINRA staff its report, which includes: (1) a description of the review performed and the conclusions reached; and (2) recommended changes or additions to Wilson-Davis's WSPs, including policies, procedures, and supervisory systems related to AML obligations, and the firm's supervisory systems in general. Wilson-Davis shall provide to FINRA staff, within 60 days after receiving the independent consultant's report, a written implementation report, certified by an officer of the firm, attesting to the firm's implementation of the independent consultant's recommendations.

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45 *Id*. (Principal Consideration No. 7).

46 *Id*. (Principal Considerations No. 8).

47 *Id*. at 2 (General Consideration No. 2).

48 *Id*. at 106.

Finally, we find it appropriate to fine Snow $77,000, suspend him in all capacities for three months and in his principal and supervisory capacities for one year, to run concurrently, and order that he requalify as a principal by examination before acting in that capacity again.

V. Conclusion

For its unlawful short sales in violation of Rule 203 of Reg SHO, Wilson-Davis is fined $350,000 and ordered to disgorge $51,624, plus prejudgment interest.[49] For its failures to supervise and implement adequate AML procedures in violation of NASD Rule 3010 and FINRA Rules 3310 and 2010, Wilson-Davis is fined an additional $750,000 and directed to retain an independent consultant as detailed above.

For his failures to supervise and implement adequate AML procedures in violation of NASD Rule 3010 and FINRA Rules 3310 and 2010, Snow is fined $77,000, suspended in all capacities for three months and in his principal and supervisory capacities for one year, to be served concurrently, and ordered to requalify as a principal by examination before acting in that capacity again.

For his failure to supervise the short sales in violation of NASD Rule 3010 and FINRA Rule 2010, Barkley is fined $52,000, suspended in all capacities for three months and in his principal and supervisory capacities for one year, to be served concurrently, and ordered to requalify as a principal by examination before acting in that capacity again. We affirm the joint and several imposition of $13,443.39 in hearing costs.[50]

On Behalf of the National Adjudicatory Council,

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Jennifer Piorko Mitchell,
Vice President and Deputy Corporate Secretary

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49 Interest shall accrue from April 29, 2013 (the date of Kerrigone's last short sale), until paid. The prejudgment interest rate shall be the rate established for the underpayment of income taxes in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a). *See Guidelines*, at 11.

50 Pursuant to FINRA Rule 8320, the membership of any firm that fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.