BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Spencer Edwards, Inc. Centennial, CO, Respondent.	DECISION Complaint No. 2013035865303 Dated: December 10, 2019

Spencer Edwards: (1) sold unregistered and nonexempt microcap securities; (2) failed to establish and maintain a supervisory system, including written supervisory procedures, that was reasonably designed to prevent the sale of unregistered and nonexempt microcap securities; (3) failed to establish and maintain a supervisory system, including written supervisory procedures, related to the retention and review of its registered representatives' emails; (4) failed to adequately implement the firm's anti-money laundering policies and procedures to detect and cause the reporting of suspicious transactions related to its microcap securities liquidation business; and (5) failed to preserve its registered representatives' emails. Held, findings affirmed in relevant part and sanctions modified.

Appearances

For the Complainant: Gregory Firehock, Esq., Perry Hubbard, Esq., Jason Gaarder, Esq., Leo Orenstein, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: David Zisser, Esq.

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Decision

Spencer Edwards, Inc. ("Spencer Edwards" or the "Firm") appeals an extended Hearing Panel decision issued on March 21, 2017. The Hearing Panel's decision concerns Spencer Edwards's liquidation of more than four billion unregistered shares of six microcap issuers on behalf of seven customer accounts during a two-year period.

The matters that are the subject of this appeal relate to the circumstances surrounding Spencer Edwards's liquidation of the unregistered microcap shares, and, more generally, to the operations, policies, and procedures effecting the Firm's microcap securities liquidation business. Specifically, on appeal, we examine whether: (1) Spencer Edwards's liquidations of the unregistered microcap securities were subject to two registration exemptions under the Securities Act of 1933 ("Securities Act"); (2) Spencer Edwards established and maintained a supervisory system, including written supervisory procedures ("WSPs"), that was reasonably designed to prevent the sale of unregistered microcap securities; (3) Spencer Edwards established and maintained a supervisory system, including WSPs, related to the retention and review of its registered representatives' emails; (4) Spencer Edwards adequately implemented its anti-money laundering policies and procedures to detect and cause the reporting of suspicious transactions related to its microcap securities liquidation business; and (5) Spencer Edwards preserved its registered representatives' emails.

In the proceedings below, the Hearing Panel examined each of these issues and determined that Spencer Edwards engaged in the misconduct as alleged in each cause of action in the complaint. For sanctions, the Hearing Panel fined Spencer Edwards a total of $707,000, consisting of $600,000 in fines and $107,000 in disgorgement, and it suspended Spencer Edwards until the Firm retains an independent consultant who determines that the Firm has implemented procedures adequate to reasonably ensure that the Firm is not improperly participating in unregistered securities sales. After an independent review of the record, we affirm, in relevant part, the Hearing Panel's findings and modify the sanctions that the Hearing panel imposed.

I. Background

The period relevant to the conduct discussed in this decision is the one-year period between January 2011 and December 2011.[1]

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[1] The Department of Enforcement's ("Enforcement") complaint, and the Hearing Panel's decision, focus on Spencer Edwards's unregistered microcap securities sales during the two-year period between January 2011 and December 2012. The record, however, does not contain independent evidentiary support, such as account statements or trade blotters, for the Firm's unregistered securities sales after December 2011. Consequently, we have limited our review to Spencer Edwards's unregistered securities sales for the one-year period between January 2011 and December 2011. In addition, because the number of unregistered securities sales directly relates to customer deposits that Spencer Edwards may have unlawfully liquidated, and customer proceeds and Firm commissions received as a result of the unregistered securities sales, we have prepared a revised "Exhibit A" (attached to this decision) detailing by issuer and customer the

[Footnote continued on next page]

A. Spencer Edwards

Spencer Edwards became a FINRA member in 1988. The Firm was a small retail broker-dealer headquartered in Denver, Colorado. On December 17, 2018, Spencer Edwards filed a Form BDW to terminate its FINRA membership. The Firm is no longer a registered broker-dealer.

During the relevant period, Spencer Edwards's business focused on executing transactions in low-priced, thinly traded securities, and much of its revenues were derived from commissions on trades of microcap securities.[2] In fact, during the relevant period, the Firm described itself as "one of the few remaining firms that actively trade low price securities and accept stock certificates." Between January 2011 and December 2012, Spencer Edwards received more than $1.6 million in commissions on sales of roughly 16.5 billion shares of microcap securities.

B. Other Relevant Persons

Although our decision focuses on Spencer Edwards, as the respondent in this case, the conduct at issue involves several individuals who were associated with the Firm during the relevant period.

1. Gordon Dihle

For most of the relevant period, Gordon Dihle, an attorney and certified public accountant, owned Spencer Edwards and held the titles of president, chief executive officer, chief financial officer, chief compliance officer, and anti-money laundering compliance officer. While holding all of these positions and supervising all of the Firm's registered representatives, Dihle also devoted 100 hours per month to his outside law firm and accounting practice. As a result, Dihle was often absent from Spencer Edwards's office.

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deposits, liquidations, customer proceeds, and Firm commissions discussed in this decision. The figures in that Exhibit A form the basis of our decision.

[2] The term "microcap" security applies to a company that has a low or "micro" capitalization, meaning the total value of the company's stock. *Microcap Stock: A Guide for Investors* (Sept. 18, 2013), https:// https://www.sec.gov/reportspubs/investor-publications/investorpubsmicrocapstockhtm.html (last visited December 10, 2019). The typical definition of a microcap security applies to a company that has a market capitalization of less than $250 or $300 million. *Id.* Microcap companies typically have limited assets and operations, and microcap stocks tend to be low priced and trade in low volume. *Id.* The Commission has cautioned that "all investments involve risk, [but] microcap stocks are among the most risky." *Id.* The Commission also has warned that many microcap companies are new and have no proven track record, and that some microcap companies have no assets, operations, or revenues, lack publicly available information, and do not submit to minimum listing standards, such as a minimum amount of net assets or a minimum number of shareholders. *Id.*

Dihle entered the securities industry in September 1999 and joined Spencer Edwards in January 2003. Dihle remained associated with Spencer Edwards until November 2013. He has not registered with another FINRA member firm since that time.

2. Donna Flemming

In June 2012, Dihle sold Spencer Edwards to an attorney and former registered representative named Wesley Pietrasik. After Spencer Edwards's sale, Donna Flemming, Dihle's assistant and former paralegal, was named the Firm's president, chief executive officer, and chief compliance officer. Flemming had no prior supervisory experience and received those positions largely because she was the only person at Spencer Edwards who held the necessary licenses.

Flemming entered the securities industry in January 1988. She joined Spencer Edwards when Dihle joined the Firm in January 2003. Flemming remained associated with Spencer Edwards until the Firm closed. Flemming is not currently registered or associated with a FINRA member firm.

3. The Selling Registered Representatives – Stephen Biley and Adam Warga

Stephen Biley and Adam Warga are the representatives who sold the unregistered microcap securities that are central to this case. During the relevant period, Dihle supervised Biley and Warga. At some point, however, Flemming took on responsibility for Biley's and Warga's supervision. The record is unclear as to when Flemming did so.

a. Biley

Biley entered the securities industry in 1993 and registered with Spencer Edwards in 1999. Biley remained registered with Spencer Edwards until the Firm terminated its FINRA membership in December 2018. Biley is currently registered with another FINRA member firm.

Biley worked from Spencer Edwards's Denver office, the same office where Dihle was located. Biley had little to no experience with microcap securities liquidations prior to selling the unregistered microcap shares discussed in this decision.

b. Warga

Warga entered the securities industry in 1995. He registered with Spencer Edwards in March 2011 and remained associated with the Firm until December 2012. Warga is not currently registered or associated with a FINRA member firm. Warga's most recent FINRA registration terminated in July 2018.

During his tenure with Spencer Edwards, Warga worked out of his house in Atlanta, Georgia. He never met either Dihle or Flemming. He never visited Spencer Edwards's office in Denver, and no one from Spencer Edwards ever visited him in Atlanta.[3]

II. Procedural History

In November 2015, Enforcement filed a four-count complaint against Spencer Edwards.[4] The first cause of action alleged that Spencer Edwards violated FINRA Rule 2010 because the Firm sold unregistered and nonexempt microcap securities in contravention of the Securities Act.[5] The second cause of action had two different components to it. First, the second cause of action alleged that Spencer Edwards violated NASD Rule 3010 and FINRA Rule 2010 because the Firm failed to establish and maintain a supervisory system, including WSPs, that was reasonably designed to prevent the sale of unregistered and nonexempt microcap securities. Second, the second cause of action alleged that Spencer Edwards violated NASD Rule 3010 and FINRA Rule 2010 because the Firm failed to establish and maintain a supervisory system, including WSPs, related to the retention and review of its registered representatives' emails. The third cause of action alleged that Spencer Edwards violated FINRA Rules 3310 and 2010 because the Firm failed to adequately implement the firm's anti-money laundering policies and procedures to detect and cause the reporting of suspicious transactions related to its microcap securities liquidation business. Finally, the fourth cause of action alleged that Spencer Edwards violated Rule 17a-4 of the Securities Exchange Act of 1934 ("Exchange Act"), NASD Rule 3110, and FINRA Rules 4511 and 2010 because the Firm failed to preserve its registered representatives' emails in accordance with the books and records requirements of the Exchange Act.

An eight-day hearing took place in Denver, Colorado, in October 2016. Eight individuals testified at the hearing. Biley, Flemming, and Warga testified. In addition, Enforcement proffered Spencer Edwards's former operations manager, an examiner from FINRA's anti-money laundering investigative unit, a principal attorney investigator from Enforcement, and an expert witness. Spencer Edwards proffered a witness whom Spencer Edwards had hired to "review[] proposed deposits of stock by Spencer Edwards customers[] and suspicious transactions. Dihle did not testify at the hearing because he was not subject to FINRA's jurisdiction when the hearing occurred.

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[3] Dihle, Biley, and Warga all settled charges with FINRA related to their roles in the violations at issue in this disciplinary proceeding. Biley and Warga settled charges that they violated Section 5 of the Securities Act. Biley agreed to a suspension for 30 business days and a $30,000 fine. Warga consented to a 20-business-day suspension. Warga demonstrated a bona fide inability to pay, and Enforcement imposed no fine against him. Dihle settled charges related to supervision and anti-money laundering violations. Dihle agreed to a principal suspension for 90 days and a $25,000 fine.

[4] Enforcement's complaint also named Dihle as a respondent. *See supra* n.3.

[5] We discuss the rules in effect when the conduct occurred.

An extended Hearing Panel issued a decision in March 2017. The Hearing Panel found that Spencer Edwards engaged in the violations as alleged in the complaint. For the violations, the Hearing Panel fined Spencer Edwards a total of $707,000 as follows: $407,000, inclusive of $107,000 in disgorgement, for the unregistered securities sales (cause one) and $300,000 for the supervisory and anti-money laundering violations (causes two and three). The Hearing Panel also suspended Spencer Edwards from accepting deposits of certificated securities until an independent consultant determines that the Firm has adopted and implemented adequate supervisory procedures related to the offering of unregistered securities. The Hearing Panel did not impose any sanction for Spencer Edwards's failure to retain its registered representatives' emails (cause four). This appeal followed.

III. Discussion

We affirm, in relevant part, the Hearing Panel's findings of liability for each cause of action as it is alleged in the complaint.

A. Spencer Edwards Liquidated Unregistered and Nonexempt Microcap Securities (Cause One)

The Hearing Panel found that Spencer Edwards violated FINRA Rule 2010 because the Firm acted in contravention of Section 5 of the Securities Act and sold more than four billion shares of unregistered microcap securities without the benefit of a registration exemption. When the Hearing Panel made this determination, the Hearing Panel also found that Enforcement had established a prima facie violation of Section 5 of the Securities Act, and that Spencer Edwards's claimed exemptions from securities registration did not apply. We affirm the Hearing Panel's findings.

1. FINRA Rule 2010

FINRA Rule 2010, FINRA's ethical standards rule, requires that associated persons "observe high standards of commercial honor and just and equitable principles of trade." FINRA Rule 2010; *see Dep't of Enforcement v. Mielke*, Complaint No. 2009019837302, 2014 FINRA Discip. LEXIS 24, at *39 (FINRA NAC July 18, 2014), *aff'd*, Exchange Act Release No. 75981, 2015 SEC LEXIS 3927, at *1-2 (Sept. 24, 2015). The reach of FINRA Rule 2010 is not limited to rules of legal conduct, but states a broad ethical principle. *See Timothy L. Burkes*, 51 S.E.C. 356, 360 n.21 (1993). The principal consideration underscoring FINRA Rule 2010 is whether the conduct at issue "reflects on the associated person's ability to comply with the regulatory requirements of the securities business." *Mielke*, 2015 SEC LEXIS 3927, at *46. Selling unregistered and nonexempt securities, in contravention of Section 5 of the Securities Act, violates FINRA Rule 2010. *See Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 SEC LEXIS 199, at *46 n.63 (Jan. 20, 2012) (explaining that "[a] violation of Securities Act Section 5 also violates [the predecessor to FINRA Rule 2010]").

2. Section 5 of the Securities Act

Section 5 of the Securities Act prohibits the sale of securities in interstate commerce unless a registration statement is in effect as to the offer and sale of the securities, or there is an applicable exemption from the registration requirement. 15 U.S.C. § 77e(a), (c) (2011); *see Midas Sec.*, 2012 SEC LEXIS 199, at *25-26. The purpose of these registration requirements is to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions." *Midas Sec.*, 2012 SEC LEXIS 199, at *26.

To establish a prima facie case of a violation of Section 5 of the Securities Act, Enforcement must show that: (1) no registration statement was in effect as to the securities; (2) Spencer Edwards sold or offered to sell the securities; and (3) Spencer Edwards sold or offered to sell the securities using interstate facilities or mails. *See Midas Sec.*, 2012 SEC LEXIS 199, at *27. Violations of Section 5 of the Securities Act are based on a strict liability standard. "Scienter – i.e., an intent to deceive – is not a requirement." *Id.*

The parties do not dispute that no registration statement was in effect for the microcap shares at issue, that Spencer Edwards sold the shares, and that Spencer Edwards sold the shares using interstate means. Consequently, Enforcement has established a prima facie case of a violation of Section 5 of the Securities Act, and the burden shifts to Spencer Edwards to show that the transactions at issue were exempt from the Securities Act's registration requirements. *See Robert G. Leigh*, 50 S.E.C. 189, 192 (1990) ("It is well settled that the burden of establishing the availability of [a Section 5] exemption rests on the person claiming it.").

Exemptions from the registration requirements of the Securities Act are affirmative defenses that must be established by the person claiming the exemption. *See Zacharias v. SEC*, 569 F.3d 458, 464 (D.C. Cir. 2009) ("[k]eeping in mind the broadly remedial purposes of federal securities legislation, imposition of the burden of proof on an issuer who would plead the exemption seems to us fair and reasonable"); *Midas Sec.*, 2012 SEC LEXIS 199, at *28. Registration exemptions are construed strictly to promote full disclosure of information for the protection of the investing public. *See Midas Sec.*, 2012 SEC LEXIS 199, at *28-29. "Evidence in support of an exemption must be explicit, exact, and not built on conclusory statements." *Id.* at 29. "A broker, as an agent for its customers, ha[s] a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and should be reasonably certain such an exemption is available." *Id.* at *33. Spencer Edwards claims exemptions under Section 4(4) and Rule 144 of the Securities Act.

3. Section 4(4) and Rule 144 of the Securities Act

Section 4(4) of the Securities Act is commonly referred to as the "brokers' exemption." *Id.* at *30. The exemption applies to "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market[,] but not the solicitation of such orders." 15 U.S.C. § 77d(4) (2011).

Rule 144 sets forth the requirements for the use of the exemption under Section 4(1) of the Securities Act for the public resale of restricted and control securities.[6] 17 C.F.R. § 230.144 (2011) (preliminary note no. 2); *see Rule 144: Selling Restricted and Control Securities*, *supra* note 6. Specifically, Rule 144 provides a safe harbor from Section 4(1)'s definition of "underwriter."[7] 17 C.F.R. § 230.144 (2011) (preliminary note no. 2). If all the requirements for Rule 144 are met, the seller of the restricted or control securities will not be deemed an underwriter, and the purchaser will receive unrestricted securities. 17 C.F.R. § 230.144 (2011) (preliminary note no. 2). As Rule 144 stresses:

> A person satisfying the applicable conditions of the Rule 144 safe harbor is deemed not to be engaged in a distribution of the securities and therefore not an underwriter of the securities for purposes of Section 2(a)(11). Therefore, such a person is deemed not to be an underwriter when determining whether a sale is eligible for the Section 4(1) exemption . . . .

17 C.F.R. § 230.144 (2011) (preliminary note no. 2).

a. The Duty of Inquiry Under Section 4(4) and Rule 144 of the Securities Act

Section 4(4) operates in concert with Rule 144. Specifically, Section 4(4) and Rule 144 limit their availability to "brokers' transactions." 15 U.S.C. § 77d(4) (2011); 17 C.F.R. § 230.144(f)(1)(i) (2011). In order to determine what constitutes brokers' transactions under Section 4(4) and Rule 144, Section 4(4) and Rule 144 point to Rule 144(g).

Rule 144(g) defines the term "brokers' transactions," and, in doing so, sets forth the obligations of a broker-dealer that seeks an exemption pursuant to Section 4(4). *See* J. William Hicks, Resales of Restricted Securities at § 4:8 ((Broker's Duties – General) (2017 ed. (March 2017 Update))). Rule 144(g) has subsections, but only one subsection of the rule, Rule 144(g)(4), is at issue here.

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[6] "Restricted securities" include "[s]ecurities acquired directly or indirectly from the issuer, or from an affiliate of the issuer, in a transaction or chain of transactions not involving any public offering." 17 C.F.R. § 230.144(a)(3)(i) (2011) (Definitions). "Control securities" are securities "held by an affiliate of the issuing company." *Rule 144: Selling Restricted and Control Securities* (Jan. 16, 2013), https://www.sec.gov/reportspubs/investor-publications/investorpubsrule144htm.html (last visited December 10, 2019).

[7] Section 4(1) of the Securities Act provides an exemption for transactions "by any person other than an issuer, underwriter, or dealer." 15 U.S.C. § 77d(1) (2011). Section 2(a)(11) of the Securities Act defines underwriter. Section 2(a)(11) of the Securities Act states that an underwriter is "any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with, the distribution of any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking." 15 U.S.C. § 77b(a)(11) (2011); 17 C.F.R. § 230.144 (2011) (preliminary note no. 2).

Rule 144(g)(4) relates to a broker-dealer's duty of inquiry, and it states that:

> The term brokers' transactions in [S]ection 4(4) of the [Securities] Act shall for the purposes of this rule be deemed to include transactions by a broker in which such broker . . . . [a]fter reasonable inquiry[,] is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is a part of a distribution of securities of the issuer.

17 C.F.R. § 230.144(g)(4) (2011); *see* Hicks, *supra* page 7, at § 4:8 (Broker's Duties – General). Rule 144(g)(4) underscores the broker-dealer's obligations in this area noting that "the broker shall be deemed to be aware of any facts or statements contained in the notice required by paragraph (h) of this section [i.e., Form 144 (Notice of Proposed Sale of Securities Pursuant to Rule 144 Under the Securities Act of 1933)]." 17 C.F.R. § 230.144(g)(4) (2011).

When selling restricted and unregistered securities, Rule 144(g)(4), by its own terms, instructs broker-dealers to inquire into the following:

> (a) The length of time the securities have been held by the person for whose account they are to be sold . . . ;
>
> (b) The nature of the transaction in which the securities were acquired by such person;
>
> (c) The amount of securities of the same class sold during the past [three] months by all persons whose sales are required to be taken into consideration . . .;
>
> (d) Whether such person intends to sell additional securities of the same class through any other means;
>
> (e) Whether such person has solicited or made any arrangement for the solicitation of buy orders in connection with the proposed sale of securities;
>
> (f) Whether such person has made any payment to any other person in connection with the proposed sale of the securities; and
>
> (g) The number of shares or other units of the class outstanding, or the relevant trading volume.

17 C.F.R. § 230.144(g)(4)(ii) (2011).

Essentially, Section 4(4) and Rule 144 of the Securities Act are not available as exemptions "if the broker knows or has reasonable grounds to believe that the selling customer's part of the transaction is not exempt from Section 5 of the Securities Act." *Midas Sec.*, 2012

SEC LEXIS 199, at *30; *see* 17 C.F.R. § 230.144(g)(4) (explaining the broker's obligation to conduct a "reasonable inquiry"). Consequently, in order to determine whether the seller's transaction is exempt from Section 5 of the Securities Act, and satisfy the reasonable inquiry requirements of Section 4(4) and Rule 144(g)(4), the broker-dealer must examine of the facts surrounding a proposed sale. *Midas Sec.*, 2012 SEC LEXIS 199, at *30.

b. The Commission's and FINRA's Guidance Concerning a Broker-Dealer's Duty of Inquiry

In 1962 and 1971, respectively, the Commission provided guidance on a broker-dealer's duty of inquiry when facilitating the sale of unregistered securities. For example, in an interpretative release from 1962, the Commission provided insight into the amount of inquiry required for certain unregistered securities sales. *Distribution by Broker-Dealers of Unregistered Securities*, Exchange Act Release No. 6721, 1962 SEC LEXIS 74 (Feb. 2, 1962). The Commission explained that:

> The amount of inquiry called for necessarily varies with the circumstances of particular cases. A dealer who is offered a modest amount of a widely traded security by a responsible customer, whose lack of relationship to the issuer is well known to him, may ordinarily proceed with considerable confidence. On the other hand, when a dealer is offered a substantial block of a little-known security . . . where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for.

Id. at *4; *see Midas Sec.*, 2012 SEC LEXIS 199, at *31-32 (quoting the Commission's interpretative release from 1962).

The Commission added that a broker-dealer's duty of inquiry:

> [B]ecomes particularly acute where substantial amounts of a previously little known security appear in the trading markets within a fairly short period of time and without the benefit of registration under the Securities Act . . . . In such situations, it must be assumed that these securities emanate from the issuer or from persons controlling the issuer, unless some other source is known and the fact that the certificates may be registered in the names of various individuals could merely indicate that those responsible for the distribution are attempting to cover their tracks.

Distribution by Broker-Dealers of Unregistered Securities, 1962 SEC LEXIS 74, at *4-5. In such cases, the Commission cautioned that the broker-dealer who "is asked to sell a substantial amount of securities must take whatever steps are necessary to be sure that this is a transaction not involving an issuer, person in a control relationship with an issuer or an underwriter." *Id.* at *3. In making this determination, the Commission stressed that "[i]t is not sufficient for [the broker-dealer] merely to accept self-serving statements of [its] sellers and their counsel without reasonably exploring the possibility of contrary facts." *Id.* at *3.

In a subsequent interpretative release from 1971, the Commission observed that "the most obvious situations" calling for heightened scrutiny are those "where a previously unknown customer may be seeking to sell a significant amount of securities and the issuer may be relatively unknown to the public." *Sales of Unregistered Securities by Broker-Dealers*, Exchange Act Release No. 9239, 1971 SEC LEXIS 19, at *7 (July 7, 1971). In the 1971 interpretative release, the Commission noted that "information received from little-known companies or their officials, transfer agent or counsel must be treated with great caution as these are the very parties that may be seeking to deceive the firm." *Id.*

In 2009, FINRA added to the guidance in this area and issued a regulatory notice concerning unregistered securities sales. *Unregistered Resales of Restricted Securities*, *FINRA Regulatory Notice 09-05*, 2009 FINRA LEXIS 19, at *1 (Jan. 2009). Under the heading, "Red Flags and the Duty to Make an Inquiry," FINRA offered examples of "situations in which firms should conduct a searching inquiry to comply with their regulatory obligations under the federal securities laws and FINRA rules." *Id.* at *2. FINRA's examples included circumstances where:

- A customer opens a new account and delivers physical certificates representing a large block of thinly traded or low-priced securities.
- A customer has a pattern of depositing physical share certificates, immediately selling the shares and then wiring out the proceeds of the resale.
- A customer deposits share certificates that are recently issued or represent a large percentage of the float for the security.
- The company was a shell company when it issued the shares.
- The issuer has been through several recent name changes, business combinations or recapitalizations.

Id. at *7-8. FINRA cautioned that each of these situations required further inquiry. *See id.*

c. Rule 144's Five Conditions

Beyond the duty of inquiry discussed in Section 4(4) and Rule 144(g)(4) of the Securities Act, this case also implicates certain conditions articulated in Rule 144. Rule 144 has five specific conditions that must be satisfied in order for the exemption to apply. 17 C.F.R. § 230.144 (2011). Rule 144's five conditions relate to the: (1) current public information about the issuer of the securities (Rule 144(c)); (2) period of time that the seller holds the securities, or, the securities' "holding period" (Rule 144(d)); (3) limitations on the amount of the securities sold, or, the securities' "trading volume formula" (Rule 144(e)); (4) manner of the securities' sales, i.e., the transactions must be "ordinary brokerage transactions" that are unsolicited, sold directly to market makers, or sold in "riskless principal transactions" (Rule 144(f)); and (5) notice of the sales of the securities via the Commission's Form 144 (Notice of Proposed Sale of Securities Pursuant to Rule 144 Under the Securities Act of 1933) (Rule 144(h)). 17 C.F.R. § 230.144(c)-(f), (h) (2011). In addition, the protections of Rule 144 do not extend to "shell companies," or "issuers with no or nominal operations and no or nominal non-cash assets." 17 C.F.R. § 230.144(i) (2011).

The applicability of Rule 144's five conditions vary based on two factors: (1) whether the issuer is a reporting company, and (2) whether the sellers of the unregistered securities are affiliates of the issuer. The parties did not litigate, and the Hearing Panel did not reach, the issue of whether the six issuers involved in this case were reporting companies during the relevant period. We decline to reach this issue on appeal, and, accordingly, we focus on whether the sellers of the unregistered and restricted microcap securities discussed in this case were affiliates of the issuers.

The determination of the sellers' status as affiliates of the issuers is critical for Spencer Edwards's ability to satisfy the conditions of Rule 144 and rely on the rule as an exemption for its liquidation of the 4.25 billion microcap shares at issue. If an affiliate of the issuer resells restricted unregistered shares, the securities are subject to Rule 144's six-month or one-year holding period *and* the four other conditions listed in Rule 144. On the other hand, if a nonaffiliate resells restricted unregistered shares, no Rule 144 condition applies, except for the six-month or one-year holding period. For these reasons, we focus our discussion on the definition of "affiliate," which turns on the definition of "control."

d. Rule 144's Applicability to "Affiliates"

"An affiliate of an issuer is a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, such issuer." 17 C.F.R. § 230.144(a)(1) (2011) (Definitions); *see Rule 144: Selling Restricted and Control Securities*, *supra* note 6 (explaining that an affiliate is "a person, such as an executive officer, a director or large shareholder, in a relationship of control with the issuer"). "Control means the power to direct the management and policies of the company in question, whether through the ownership of voting securities, by contract, or otherwise." *Rule 144: Selling Restricted and Control Securities*, *supra* note 6. In order to be deemed a nonaffiliate of an issuer, the seller of the restricted and unregistered shares must not be an affiliate of the issuer "at the time of the sale," or the "preceding three months." 17 C.F.R. § 230.144(b)(1) (2011). The Commission admonishes that purchasers who "buy securities from a controlling person or 'affiliate,' . . . take restricted securities, even if they were not restricted in the affiliate's hands." *Rule 144: Selling Restricted and Control Securities*, *supra* note 6. Although "not necessarily determinative," ownership of 10 percent or more of the issuer's outstanding shares is a fact that "must be taken into consideration" when examining whether the seller of the restricted and unregistered shares is an affiliate of the issuer. *American-Standard*, 1972 SEC No-Act. LEXIS 3787, at *1 (Oct. 11, 1972); *see* Hicks, *supra* page 7, at § 4:38 (Affiliate: Rule 144(a)(1) – Directors, Officers, and Key Shareholders) (stating that owners of at least 10 percent of an issuer's securities are "presumptively" affiliates of the issuer).

The record for this case contains Spencer Edwards's "Due Diligence Files" for 22 microcap securities deposits. These 22 deposits ultimately led to the liquidation of the unregistered 4.25 billion microcap shares at issue here. We have reviewed each Due Diligence File in order to ascertain what information Spencer Edwards had in hand when it accepted the deposit, and, subsequently, liquidated the unregistered microcap shares. Specifically, we look to each Due Diligence File to determine whether Spencer Edwards fulfilled its duty of inquiry and made the important determination of whether the sellers of the unregistered microcap shares were affiliates of the issuers.

4. Spencer Edwards's Liquidations of Microcap Securities: Six Issuers, Seven Customer Accounts, 22 Microcap Securities Deposits, and 4.25 Billion Unregistered Microcap Shares

The liquidations that are the subject of this case involve six issuers, seven customer accounts, 22 microcap securities deposits, and 4.25 billion unregistered microcap shares.

a. The Six Issuers

Each of the six subject companies were microcap issuers.

(1) All-State Properties Holdings, Inc. (ATPT)

All-State Properties Holdings, Inc. ("ATPT") was a Nevada corporation headquartered in Lexington, Kentucky. ATPT described its business operations as "attempting to locate and negotiate with eligible portfolio companies to acquire an interest in them." In its quarterly periodic filing for the period ending on December 31, 2010 (Form 10-Q), ATPT stated that it had "re-entered the development stage [on] July 1, 2007 when revenue generation ceased and the [c]ompany refocused its activities to raising capital." ATPT's Form 10-Q explained that "[t]he [c]ompany is currently in the development stage, has limited assets, and is in the process of acquiring assets and changing business philosophies and, consequently, has no revenues." From July 2007 to December 2010, ATPT had no revenues and net losses of more than $10 million. As of March 2011, the issuer also had less than $5,000 in assets.

(2) Eastern Asteria, Inc. (EATR)

Eastern Asteria, Inc. ("EATR") was a Florida corporation headquartered in Boca Raton, Florida. EATR described its business operations as "acquir[ing] gemstone raw materials and/or minerals and . . . arrang[ing] for the finishing and marketing of the gemstone material and finished jewelry through our [i]nternet website at www.thegemstore.com." In its annual periodic filing for the period ending on December 31, 2010 (Form 10-K), EATR disclosed that it was operating with a total liability of more than $24 million, inclusive of a "total stockholders' equity deficiency." EATR's Form 10-K cautioned, "Our shares of common stock are 'penny stocks' as that term is generally defined in the [Exchange Act] as equity securities with a price of less than $5.00. Our shares are subject to rules that impose sales practice and disclosure requirements on broker-dealers who engage in certain transactions involving a penny stock."

(3) Encounter Technologies, Inc. (ENTI)

Encounter Technologies, Inc. ("ENTI") was formed in 1986 under the name Sure Hair, Inc. ENTI was a Colorado corporation headquartered in Fort Myers, Florida. Starting in 1997, ENTI changed its name successively to Palmer Medical, Inc., Edatenow.com, Inc., and Encounter.com, Inc., before becoming ENTI. RD was ENTI's chief executive officer and sole officer and director until his brother, AD, succeeded him in those capacities. ENTI's Form 10-K for the period ending on December 31, 2010 states that ENTI "provides end-to-end technology and online marketing services," operating a website called MusicMatrix.com, "a fully integrated social community which will allow[] users to participate in music video editing competitions in

order to win both prizes and recognition." For the period ending on December 31, 2010, ENTI reported losses of $312,284 on revenues of $25,482.

(4) Healthnostics, Inc. (HNSS)

In July 1996, Healthnostics, Inc. ("HNSS") was incorporated in Delaware under the name IHS of Virginia, Inc., a wholly owned subsidiary of Integrated Healthcare Systems, Inc. HNSS was headquartered in Annapolis, Maryland. HNSS described itself as a "healthcare software and internet information company" specializing in "internet portal services," "patient care monitoring systems," and "management consulting services." For the period ending on December 31, 2010, HNSS reported that it had total liabilities of more than $2 million, which included a shareholders' equity deficit.

(5) Greene Concepts, Inc. (LKEN)

Greene Concepts, Inc. ("LKEN") was incorporated in 1952. It is a New York corporation headquartered in Fresno, California. LKEN originally incorporated as Tech-Ohm Resistor Corporation. In 1960, it changed its name to Tech-Ohm Electronics, Inc., and, in 1975, to International Citrus Corporation. Between 2003 and 2010, it changed its name successively to Princeton Commercial Holdings, Inc., Eurowind Energy, Inc., First Petroleum and Pipeline, Inc., Luke Entertainment, Inc., and LKEN. During the relevant period, LKEN stated that it was "an ink technology manufacturing and distribution company that manufactures and distributes . . . inkjet refill kits." For the six-month period ending on January 31, 2011, LKEN reported revenues of $62,645, expenses of $173,378, and an operating net loss of $124,839. The issuer also reported negative retained earnings of $606,545.

(6) Strategic Management & Opportunity Corporation (SMPP)

Strategic Management & Opportunity Corporation ("SMPP") was a Nevada corporation headquartered in Clinton, Washington. SMPP was incorporated under the name Skytalk Communications, Inc. in 1999, changed its name to SMO Multimedia Corporation in 2002, and then to SMPP in 2004. In an issuer disclosure statement dated November 2010, SMPP described itself as an "internet based marketing and advertising company" with "a video and sales platform that allows every person involved in online video production and advertising to log into a single interface." SMPP's disclosure statement reported that the issuer had no revenues and was operating at a net loss of $40,660 for the nine-month period ending on September 30, 2010.

b. The Biley-Managed Accounts (Four Accounts and 3.92 Billion Shares of Liquidated Microcap Securities)

(1) The Three RD-Controlled Accounts: JLP&R Corporation, BBC Financing, Inc., and Flash Funding, Inc. (13 Deposits and 3.56 Billion Liquidated Shares)

On January 26, 2011, a new customer, RD,[8] contacted Biley by telephone to discuss opening accounts for three recently created entities: JLP&R Corporation, BBC Financing, Inc., and Flash Funding, Inc.[9]

JLP&R Corporation. After RD and Biley spoke on the telephone, RD immediately sent Biley an email from a JLP&R Corporation email address. RD's email provided Biley with contact information, which represented that RD worked at JLP&R Corporation in "Longwood, FL."

Later that same day (January 26, 2011), RD submitted new account documentation to open an account for JLP&R Corporation. RD submitted JLP&R Corporation's new account application to Biley and Spencer Edwards's operations manager. RD sent the new account application from his JLP&R Corporation email address to Biley at his personal email address and the operations manager at her Spencer Edwards's email account.

JLP&R Corporation's handwritten new account application indicated that JLP&R Corporation was a New York corporation, and that the company had been formed four months earlier. The new account application noted that an individual named JC from Farmingville, New York, was the company's chief executive officer and the account's "primary authorized person."

Nothing in JLP&R Corporation's new account application mentioned RD or a location in Florida. RD was not mentioned anywhere in the documents supporting JLP&R Corporation's new account application, including the "co-authorized person" designation. RD also does not appear on JLP&R Corporation's corporate resolution form, which provides the names of individuals with authority to effect securities transactions on behalf of the company. JC signed JLP&R Corporation's corporate resolution form, but he left blanks where the names of officers authorized to effect securities transactions for the company were meant to be filled in. There are

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[8] As noted in Part III.A.4.a.(3) (Encounter Technologies, Inc. (ENTI)), RD was the chief executive officer, officer, and director of ENTI. RD relinquished those roles when his brother assumed them. The record does not contain information about when the transfer of responsibilities between RD and AD occurred.

[9] JLP&R Corporation was created in September 2010, Flash Funding was created in December 2010, and BBC Financing was created in January 2011.

little to no records of direct communications between anyone at Spencer Edwards and JC at any time about the JLP&R Corporation account.[10]

On the same day that RD contacted Biley and submitted JLP&R Corporation's new account application (January 26, 2011), RD, Biley, and Dihle participated in a conference call. Biley introduced RD to Dihle during that call. Biley testified that getting Dihle to participate in the call was "a big deal," and that he coaxed Dihle to participate in the conference call by telling Dihle that RD could send the firm a lot of business. Biley testified that he also told Dihle he was "in over his head on this one" due to his lack of experience with liquidations of microcap securities. During the conference call, Dihle answered RD's questions concerning Spencer Edwards's procedures for depositing certificated securities.

Within hours of the conference call, RD emailed Biley a completed Deposited Securities Request Form for the deposit of 270 million shares of LKEN into JLP&R Corporation's account. RD's email included 35 pages of supporting documents for the deposit, but nothing in the documents supporting the deposit acknowledged that RD had any role in JLP&R Corporation.

BBC Financing. The same day that RD contacted Biley to establish the JLP&R Corporation account (January 26, 2011), BBC Financing executed new account documentation to open an account at Spencer Edwards. BBC Financing's new account application bore striking resemblances to JLP&R Corporation's application. The handwriting on BBC Financing's new account application was the same as that on the JLP&R Corporation application. The address provided for BBC Financing also was in "Longwood, FL." The "primary authorized person" for BBC Financing's account was CW, an individual identified as the president of BBC Financing, and the "assistant" to JLP&R Corporation's chief executive officer, JC.[11] Similar to JLP&R Corporation's new account application, RD did not appear in BBC Financing's new account application or supporting documentation for the application. RD was not designated as BBC Financing's "co-authorized person," and, like the corporate resolution that RD submitted for JLP&R Corporation, BBC Financing's resolution did not provide the names of any officers authorized to effect securities transactions for the company. In fact, incorporation documents submitted with BBC Financing's new account application showed that the company had been formed 23 days earlier.

On January 27, 2011, the day after RD contacted Biley about opening new accounts for three recently created corporate entities, Biley, Flemming, and Dihle signed off on new account applications for JLP&R Corporation and BBC Financing, and Biley informed RD by email that "[JLP&R Corporation's deposit of] LKEN has been reviewed and received a thumbs up from

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[10] JLP&R Corporation's new account application did not include a copy of any photo identification for JC, so RD followed up in a later email with a copy of JC's New York driver's license.

[11] CW emailed Spencer Edwards on behalf of JLP&R Corporation and identified herself as "Assistant to [JC]."

legal." Within days, BBC Financing made deposits of ENTI and ATPT,[12] and JLP&R Corporation added a deposit of SMPP to its existing deposit of LKEN.[13]

Flash Funding. On February 10, 2011, two weeks after Spencer Edwards opened the JLP&R Corporation and BBC Financing accounts, JC, the authorized person for JLP&R Corporation, executed documentation to open an account for Flash Funding.[14] The handwriting on Flash Funding's new account application was the same as that on the JLP&R Corporation and BBC Financing applications. Flash Funding's new account application identified JC as the chief executive officer of the company, and it designated JC as the "primary authorized person" on the account. There was no "co-authorized person" designated, and RD appeared nowhere in Flash Funding's new account application or the documentation supporting the application. Like the corporate resolutions submitted with the JLP&R Corporation and BBC Financing applications, the Flash Funding resolution did not provide the names of any officers authorized to effect securities transactions on behalf of the company. Rather, the accompanying incorporation documents showed that Flash Funding had been incorporated about two months earlier, in December 2010, and that the company's address was the same Longwood, Florida, address that RD had given Biley as his own address during their initial contact. On February 24, 2011, Biley signed the account application and Flemming approved it.

(2) Belmont Partners, LLC (Two Deposits and 363 Million Liquidated Shares)

On February 28, 2011, JM submitted an application to open an account at Spencer Edwards in the name of Belmont Partners.[15] Belmont Partners' new account application identifies JM as the owner of Belmont Partners and Belmont Partners' "managing member." The new account application notes that JM is the "primary authorized person" for the Belmont Partners account.[16] Biley signed Belmont Partners' new account application as the account's registered representative of record. Dihle and Flemming approved the account.

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[12] CW signed BBC Financing's Deposited Securities Request Forms for the ENTI and ATPT deposits on January 14, 2011 and January 17, 2011, respectively. These dates are nine to 12 days before RD contacted Biley, and BBC Financing submitted its new account application to Spencer Edwards.

[13] JC dated JLP&R Corporation's Deposited Securities Request Form for the LKEN deposit on January 26, 2011, the same day that RD contacted Biley and the company submitted its new account application to Spencer Edwards. The Deposited Securities Request Form for JLP&R Corporation's deposit of SMPP, however, is dated January 5, 2011, three weeks before these events occurred.

[14] Although JC and JLP&R Corporation already had opened accounts at Spencer Edwards, RD referred JC's company, Flash Funding, to the Firm.

[15] Biley testified that JM referred RD to Spencer Edwards.

[16] JM is also the president of Pacific Stock Transfer Company, the transfer agent for ENTI and LKEN.

(3) The Liquidating Transactions in the Four Biley-Managed Accounts

The liquidating transactions in the four Biley-managed accounts cover 15 of the 22 subject deposits and result in the liquidation of 3.92 billion shares of microcap issuers – ATPT, ENTI, LKEN, and SMPP. The JLP&R Corporation account opened in January 2011. The BBC Financing account opened in January 2011. The Flash Funding account opened in February 2011. Each of the deposits for these three RD-controlled accounts occurred within three months of the subject account's opening.[17] Even the one non-RD-controlled account discussed in this section, Belmont Partners, implicated RD. As noted below in Deposit Nos. 14 and 15, Belmont Partners received the shares for its deposits from an RD-controlled entity, Flash Funding.

- Deposit Nos. 1 and 2. On January 31, 2011 and April 11, 2011, respectively, BBC Financing deposited 600 million and 300 million shares of ENTI. Between February 2011 and April 2011, Spencer Edwards liquidated all 900 million shares that BBC Financing had deposited with the Firm. Spencer Edwards also liquidated another 60 million shares of ENTI that BBC Financing had acquired and placed in its account at the Firm. The liquidations resulted in proceeds of $410,377 for BBC Financing and commissions of $18,868 for Spencer Edwards.

- Deposit Nos. 3 and 4. On January 31, 2011 and February 15, 2011, respectively, JLP&R Corporation deposited 270 million and 50 million shares of LKEN. Over a four-day period in February 2011, Spencer Edwards liquidated the 270 million shares of LKEN that JLP&R Corporation had deposited with the Firm just days before. Spencer Edwards liquidated the last 50 million shares of LKEN that JLP&R Corporation had deposited at the Firm in March 2011. The liquidations resulted in proceeds of $698,555 for JLP&R Corporation and commissions of $34,573 for Spencer Edwards.

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[17] RD is not listed on any of the account documents for the RD-controlled accounts. The sellers are JLP&R Corporation, BBC Financing, and Flash Funding. As we reviewed the record, however, we determined that JLP&R Corporation, BBC Financing, and Flash Funding were under RD's control, and that the companies acted in concert. JLP&R Corporation's, BBC Financing's, and Flash Funding's account opening documents were completed by the same individual and shared the same idiosyncrasies. The accounts were all brought to Spencer Edwards by RD, an individual unknown to the Firm who had no documented authority to act on behalf of any of the three companies. RD supplied account-opening documents for JLP&R Corporation and the Deposited Securities Request Form and supporting documentation for JLP&R Corporation's initial deposit. RD supplied supporting documentation for BBC Financing's stock deposits. RD instructed Spencer Edwards to disburse funds from the JLP&R Corporation and Flash Funding accounts. RD communicated with Spencer Edwards and the Firm's clearing firm using JLP&R Corporation, BBC Financing, and Flash Funding email addresses. RD also shared a physical address with Flash Funding.

- Deposit No. 5. On February 2, 2011, BBC Financing deposited 400 million shares of ATPT. On February 15, 2011 and February 16, 2011, Spencer Edwards liquidated all 400 million shares that BBC Financing had deposited with the Firm. The liquidations resulted in proceeds of $40,000 for BBC Financing and commissions of $1,922 for Spencer Edwards.

- Deposit No. 6. On February 4, 2011, JLP&R Corporation deposited 400 million shares of SMPP.[18] Between February 15, 2011 and February 22, 2011, Spencer Edwards liquidated all 400 million shares that JLP&R Corporation had deposited with the Firm. The liquidations resulted in proceeds of $87,654 for JLP&R Corporation and commissions of $4,195 for Spencer Edwards.

- Deposit No. 7. On February 15, 2011, JLP&R Corporation deposited 100 million shares of ENTI. On February 28, 2011, Spencer Edwards liquidated all 100 million shares that JLP&R Corporation had deposited with the Firm. The liquidations resulted in proceeds of $40,000 for JLP&R Corporation and commissions of $1,974 for Spencer Edwards.

- Deposit No. 8. On February 18, 2011, JLP&R Corporation deposited 400 million shares of ATPT. On March 2, 2011, for reasons not disclosed in the record, Spencer Edwards delivered 200 million of the deposited shares back to the customer. The following day, on March 3, 2011, Spencer Edwards liquidated the remaining 200 million shares that JLP&R Corporation had deposited with the Firm. The liquidations resulted in proceeds of $20,000 for JLP&R Corporation and commissions of $974 for Spencer Edwards.

- Deposit No. 9. On March 3, 2011, Flash Funding deposited 600 million shares of ENTI. On March 15, 2011 and March 16, 2011, respectively, Spencer Edwards liquidated all 600 million shares that Flash Funding had deposited with the Firm. The liquidations resulted in proceeds of $169,145 for Flash Funding and commissions of $8,290 for Spencer Edwards.

- Deposit Nos. 10 and 11. On April 20, 2011 and May 23, 2011, respectively, Flash Funding deposited 406 million and 438 million shares of ENTI at Spencer Edwards. Spencer Edwards's clearing firm rejected the Flash Funding deposit of 406 million shares of ENTI because, as the clearing firm explained, acceptance of the deposit would result in Flash Funding owning more than 10 percent of ENTI's outstanding shares. Flash Funding circumvented the clearing firm's ownership limitation requirements by transferring the 406 million shares of ENTI to another RD-controlled entity, BBC Financing. The record does not contain evidence related to Spencer Edwards's liquidation of the remaining 438 million shares of ENTI in the Flash Funding account.

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[18] JLP&R Corporation received the shares of SMPP from ExtremeView, Inc., a company controlled by RD's wife.

- Deposit No. 12. On March 4, 2011 and March 9, 2011, respectively, BBC Financing deposited 360 million and 20 million shares of SMPP.[19] In two transactions, on March 25, 2011, Spencer Edwards liquidated all 380 million shares that BBC Financing had deposited with the Firm. The liquidations resulted in proceeds of $41,750 for BBC Financing and commissions of $2,035 for Spencer Edwards.

- Deposit No. 13. On March 8, 2011, BBC Financing deposited 200 million shares of LKEN. In three transactions, on March 23, 2011, Spencer Edwards liquidated all 200 million shares that BBC Financing had deposited with the Firm. The liquidations resulted in proceeds of $130,500 for BBC Financing and commissions of $6,373 for Spencer Edwards.

- Deposit Nos. 14 and 15. When Belmont Partners opened its account in February 2011, it had a "portfolio asset" consisting of 50 million shares of ENTI. Spencer Edwards liquidated 80 percent of those shares in April 2011. In June 2011 and July 2011, respectively, Belmont Partners deposited another 263 million and 500 million shares of ENTI at Spencer Edwards. JM received all 763 million shares of ENTI from a RD-controlled entity, Flash Funding. Throughout July 2011, Spencer Edwards liquidated 323 million of the shares that Belmont Partners had deposited.[20] The liquidations resulted in proceeds of $51,315 for Belmont Partners and commissions of $2,539 for Spencer Edwards.[21]

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[19] BBC Financing received its shares of SMPP from RD's wife's company, ExtremeView. *See supra* n.18.

[20] We reduced the number of liquidations related to this deposit by 34 million because there was no documentation for those sales. This reduction lowered Belmont Partners' proceeds by $3,296 and Spencer Edwards's commissions by $257.

[21] Belmont Partners did not sell the remaining 450 million shares of ENTI through Spencer Edwards because the Firm closed the account after the Commission sued JM and Belmont Partners in December 2011. The Commission alleged that JM and Belmont Partners aided and abetted a company that had fraudulently issued and sold unregistered shares of its common stock. The case settled in January 2014. JM and Belmont Partners agreed to pay $224,500 in civil penalties, and JM agreed to be barred from the penny stock business for five years.

c. The Warga-Managed Accounts (Three Accounts and 331 Million Shares of Liquidated Microcap Securities)

(1) The JY and KN Accounts and Liquidations of HNSS (Six Deposits and 82 Million Liquidated Shares)

In March 2011, Warga opened accounts at Spencer Edwards for JY and KN. Within weeks of opening the accounts, JY and KN deposited millions of shares of HNSS at Spencer Edwards, and the Firm began liquidating shares on their behalf.

JY's and KN's shares of HNSS derived from JY's conversion of a promissory note that HNSS had issued to JY. Documents included with KN's Due Diligence File for his deposit of shares of HNSS with Spencer Edwards show that JY was using his HNSS convertible promissory note to assign shares of HNSS to others, including KN. In fact, KN acquired all 20 million shares of HNSS that he deposited and liquidated through Spencer Edwards from JY.

HNSS also issued 415 million shares of its common stock to Carlthon Corporation for the fiscal year ending on December 31, 2011. JY is Carlthon Corporation's chief executive officer. Carlthon Corporation did not liquidate its shares of HNSS through Spencer Edwards.

- Deposit Nos. 16, 17, 18, and 19. Between April 2011 and August 2011, JY deposited 80 million shares of HNSS. JY began liquidating the deposited shares through Spencer Edwards almost immediately. By December 2011, Spencer Edwards had liquidated 78 million of the 80 million shares of HNSS that JY had deposited at the Firm. The liquidations resulted in proceeds of $159,743 for JY and commissions of $8,216 for Spencer Edwards. The record does not contain evidence related to Spencer Edwards's liquidation of the remaining two million shares of HNSS in the JY account.

- Deposit No. 20. On April 12, 2011, KN deposited five million shares of HNSS. Over a two-week period in June 2011, Spencer Edwards liquidated 4.5 million of the shares that KN had deposited with the Firm. The liquidations resulted in proceeds of $15,128 for KN and commissions of $779 for Spencer Edwards.

- Deposit No. 21. In September 2011, KN deposited another 15 million shares of HNSS at Spencer Edwards. The record does not contain evidence related to Spencer Edwards's liquidation of the 15 million shares of HNSS from this deposit or the remaining 500,000 shares of HNSS in the KN account from Deposit No. 20.[22]

[22] We eliminated all liquidations related to Deposit No. 21 because there was no documentation for the sales. This reduction lowered KN's proceeds by $3,425 and Spencer Edwards's commissions by $175.

(2) The TES Dragon, Inc. Account (One Deposit and 249 Million Liquidated Shares)

In March 2011, Warga opened an account in the name of TES Dragon, Inc. for a customer named AS. Flemming and Dihle approved TES Dragon's new account.

- Deposit No. 22. One month after opening the account, TES Dragon deposited 300 million shares of EATR at Spencer Edwards in April 2011.[23] Between April 2011 and August 2011, Spencer Edwards liquidated 249 million of the shares that TES Dragon had deposited with the Firm. The liquidations resulted in proceeds of $26,920 for TES Dragon and commissions of $1,719 for Spencer Edwards. The record does not contain evidence related to Spencer Edwards's liquidation of the remaining 51 million shares of EATR in the TES Dragon account.[24]

5. Spencer Edwards Failed to Satisfy Its Duty of Inquiry Under Section 4(4) and Rule 144 of the Securities Act

Spencer Edwards has the burden of proof concerning the applicability of an exemption to its liquidations. *See Leigh*, 50 S.E.C. at 192. On appeal, Spencer Edwards argues that it has satisfied that burden, and that the liquidations were exempt from registration based on Section 4(4) and Rule 144 of the Securities Act. We disagree, and, on appeal, we find that Spencer Edwards cannot rely on an exemption under Section 4(4) and Rule 144 of the Securities Act because the Firm did not prove that it conducted a searching inquiry into whether the sellers of the subject securities were affiliates of ATPT, EATR, ENTI, HNSS, LKEN, and SMPP when the sales occurred. As explained with reference to each deposit below, Spencer Edwards failed to assess the facts surrounding the sales that might be probative of control, even in the face of significant seller ownership of each of the relevant securities and certain red flags connected to the sales.[25]

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[23] The president of EATR is GS. GS is the father of AS, the president, director, and primary authorized person on the TES Dragon account. Both AS and GS previously had been customers of Warga's.

[24] We reduced the number of liquidations related to this deposit by 51 million because there was no documentation for those sales. This reduction lowered TES Dragon's proceeds by more than $3,270 and Spencer Edwards's commissions by more than $202.

[25] Spencer Edwards criticizes the Hearing Panel's decision arguing that the Hearing Panel improperly applied a presumption that a seller's 10 percent ownership of an issuer's total outstanding shares means that the seller is, per se, an affiliate of the issuer. But the Hearing Panel applied no such presumption. Rather, as the Hearing Panel explained, quoting the *American-Standard* no-action letter, "[w]here a customer of the firm controls 10 percent or more of the outstanding securities of a company, such control is, at a minimum, a '*fact which must be taken into consideration*' in determining whether the customer may be an affiliate of the company." *American-Standard*, 1972 SEC No-Act. LEXIS 3787, at *1 (emphasis added). The 10 percent ownership threshold is only one factor in the seller-issuer affiliate analysis, and we have considered it. But we have also reviewed the Due Diligence Files for the 22 deposits for

[Footnote continued on next page]

- Deposit Nos. 1, 2, 7, 9, 10, and 11 (RD-Controlled Accounts – JLP&R Corporation, BBC Financing, and Flash Funding – Selling Shares of ENTI). Spencer Edwards did not examine the relationship between RD, his brother, AD, and ENTI. RD was ENTI's former chief executive officer,[26] and AD was ENTI's current chief executive officer, when JLP&R Corporation, BBC Financing, and Flash Funding, liquidated billions of shares of ENTI. Spencer Edwards also failed to aggregate JLP&R Corporation's, BBC Financing's, and Flash Funding's ownership of ENTI, or assess other factors related to the sales, to determine whether RD, JLP&R Corporation, BBC Financing, and Flash Funding were affiliates of ENTI.[27]

- Deposit Nos. 3, 4, and 13 (RD-Controlled Accounts – JLP&R Corporation and BBC Financing – Selling Shares of LKEN). JLP&R Corporation and BBC Financing liquidated more than 500 million shares of LKEN through Spencer Edwards. Despite the evidence that RD controlled the companies, Spencer Edwards did not aggregate JLP&R Corporation's and BBC Financing's ownership of LKEN, or assess other factors related to the sales, to determine whether RD, JLP&R Corporation, and BBC Financing were affiliates of LKEN.

- Deposit Nos. 5 and 8 (RD-Controlled Accounts – JLP&R Corporation and BBC Financing – Selling Shares of ATPT). JLP&R Corporation and BBC Financing liquidated 600 million shares of ATPT through Spencer Edwards. Despite the evidence that RD controlled the companies, Spencer Edwards did not aggregate JLP&R Corporation's and BBC Financing's ownership of ATPT, or assess other factors related to the sales, to determine whether RD, JLP&R Corporation, and BBC Financing were affiliates of ATPT.

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other evidence of the affiliate status of the seller in order to obtain a complete view of these transactions. Because we have focused our analysis on matters other than a particular percentage of ownership of an issuer's shares, we reject, as irrelevant, Spencer Edwards's arguments concerning the ownership percentages of the issuers' executives, officers, and directors.

[26] None of the deposits from the RD-controlled accounts include documentation of payment for the shares being deposited. Four of the ENTI deposits originated from RD's service agreements with ENTI from when he was the company's chief executive officer. And one of the BBC Financing deposits of shares of ENTI is based on the conversion of a promissory note dated January 4, 2010, which states that it was payable in full on or before the same date, January 4, 2010.

[27] A stock purchase agreement between Flash Funding and RD states that Flash Funding purchased more than 811 million shares of ENTI from RD in April 2010. Flash Funding did not come into existence until December 2010.

- Deposit Nos. 6 and 12 (RD-Controlled Accounts – JLP&R Corporation and BBC Financing – Selling Shares of SMPP). JLP&R Corporation and BBC Financing, RD-controlled companies, acquired nearly 800 million shares of SMPP from RD's wife's company, ExtremeView, Inc. Spencer Edwards did not examine the issue. Spencer Edwards also failed to aggregate JLP&R Corporation's and BBC Financing's ownership of SMPP, or assess other factors related to the sales, to determine whether RD, JLP&R Corporation, and BBC Financing were affiliates of SMPP.

- Deposit Nos. 14 and 15 (Belmont Partners Selling Shares of ENTI). Belmont Partners liquidated nearly 400 million shares of ENTI through Spencer Edwards. Belmont Partners received its shares of ENTI from an RD-controlled entity, Flash Funding. Belmont Partners' primary authorized person on the Spencer Edwards account, JM, referred RD to Spencer Edwards and served as ENTI's transfer agent. *See supra* n.16. Spencer Edwards did not investigate these connections.[28]

- Deposit Nos. 16, 17, 18, and 19 (JY Selling Shares of HNSS). JY, and his company, Carlthon Corporation, obtained more than 490 million shares of HNSS based on a convertible promissory note that HNSS had issued to JY. Spencer Edwards liquidated nearly 80 million shares of HNSS for JY without examining whether JY and Carlthon Corporation were affiliates of HNSS.[29]

- Deposit Nos. 20 and 21 (KN Selling Shares of HNSS). KN liquidated 20 million shares of HNSS that he received from JY through Spencer Edwards. Spencer Edwards liquidated KN's shares of HNSS without examining the relationship between KN, JY, Carlthon Corporation, and HNSS.[30]

- Deposit No. 22 (TES Dragon Selling Shares of EATR). TES Dragon liquidated 300 million of shares of EATR through Spencer Edwards. TES Dragon's primary authorized person on the Spencer Edwards account was AS, whose father, GS, was the president of EATR. Spencer Edwards did not investigate whether AS and TES Dragon were affiliates of EATR.

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[28] The Deposited Securities Form for one of Belmont Partners' deposit of shares of ENTI represented that RD had "transferred/sold" the shares to Flash Funding on June 22, 2011, and that Flash Funding had sold them to Belmont Partners on June 2, 2011, 20 days before Flash Funding owned them.

[29] The Deposited Securities Form for one of JY's deposits of HNSS states that JY had acquired the shares from himself.

[30] Many of the deposits involving the same issuer emanate from a single promissory note. For example, the six HNSS deposits (Deposit Nos. 16-21) emanate from one convertible promissory note – JY's promissory note with the issuer. In addition, the three LKEN deposits (Deposit Nos. 3, 4, and 13), two SMPP deposits (Deposit Nos. 6 and 12), and two ATPT deposits (Deposit Nos. 5 and 8) each derive from single promissory notes.

Spencer Edwards's approach to these transactions did little more than paper the file with checklists of customer-provided documents without undertaking any genuine review of the significance of the information found in the documents. Spencer Edwards's failure to scrutinize these transactions, and the sellers involved in these transactions, is fatal to its claimed exemptions under Section 4(4) and Rule 144 of the Securities Act.[31] "When a broker is faced with recurring red flags suggesting that its customer is engaging in unregistered distributions of securities, it cannot satisfy its reasonable inquiry obligations by relying on the mere representations of its customer, the issuer, or counsel for the same, without reasonably investigating the potential for opposing facts." *E*Trade Sec., LLC*, Exchange Act Release No. 73324, 2014 SEC LEXIS 3846, at *19 (Oct. 9, 2014). Based on these facts, we find that Spencer Edwards failed to satisfy its obligation to make a searching inquiry into whether the sellers were affiliates of the issuers, and, accordingly, the Firm cannot rely on an exemption under Section 4(4) and Rule 144 of the Securities Act. Because we have determined that Spencer Edwards failed to qualify for its claimed exemptions from the registration requirements of the Securities Act, we find that Spencer sold unregistered and nonexempt securities, in contravention of Section 5 of the Securities Act, and that the Firm violated FINRA Rule 2010.[32]

B. Spencer Edwards Failed to Supervise Its Microcap Securities Liquidation Business and the Retention and Review of Its Registered Representatives' Emails (Cause Two)

The Hearing Panel determined that Spencer Edwards had supervisory violations in two distinct areas. First, the Hearing Panel found that Spencer Edwards violated NASD Rule 3010 and FINRA Rule 2010 because the Firm failed to establish and maintain a supervisory system, including WSPs, that was reasonably designed to prevent the sale of unregistered microcap securities. Second, the Hearing Panel determined that Spencer Edwards violated NASD Rule 3010 and FINRA Rule 2010 because the Firm failed to establish and maintain a supervisory system, including WSPs, related to the retention and review of its registered representatives' emails. We affirm the Hearing Panel's findings for each of these supervisory violations.

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[31] Because Spencer Edwards assumed that the sellers were not affiliates of the issuers, the Firm neglected aspects of Rule 144 that apply to affiliate-involved sales, such as the public information requirement, holding period requirement, trading volume limitation, and notice requirement. As a consequence, the Belmont Partner deposits of ENTI (Deposit Nos. 14 and 15) and the KN deposits of HNSS (Deposit Nos. 20 and 21) did not satisfy Rule 144's one-year holding period requirement applicable to affiliates of issuers. *See* 17 C.F.R. § 230.144(d) (2011) (explaining that a six-month or one-year holding period applies based on whether the seller of the securities is an affiliate of the issuer).

[32] Enforcement contends that the Rule 144 exemption did not apply to the shares of ATPT that BBC Financing and JLP&R Corporation liquidated through Spencer Edwards because ATPT was a shell company. *See* 17 C.F.R. § 230.144(i) (2011) (stating that the protections of Rule 144 do not extend to shell companies). Spencer Edwards refutes Enforcement's argument. The Hearing Panel did not examine this issue in the proceedings below, the record does not contain sufficient evidence to decide the issue, and we decline to make this determination for the first time on appeal.

1. NASD Rule 3010

NASD Rule 3010 (a) requires that member firms "establish and maintain a system to supervise activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." Under NASD Rule 3010(b), the firm's system must be documented in its WSPs, and its procedures must be tailored to its business lines.[33] The firm's procedures must set out mechanisms for ensuring compliance and detecting violations, not merely set out what conduct is prohibited. *John A. Chepak*, 54 S.E.C. 502, 506 (2000). Procedures alone, however, are not enough. "Without sufficient implementation, guidelines and strictures do not assure compliance." *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843, at *43 (Dec. 19, 2008). Spencer Edwards's supervisory failures present a quintessential implementation problem.

2. Spencer Edwards Failed to Establish and Maintain a Supervisory System, Including WSPs, That Was Reasonably Designed to Prevent the Sale of Unregistered and Nonexempt Microcap Securities

Spencer Edwards's procedures, as implemented, were inadequate for the needs of its high-risk microcap securities liquidation business and directly resulted in the unlawful sales of unregistered securities discussed in this case. For example, Spencer Edwards's WSPs required that the Firm gather adequate information to identify its customers, but the Due Diligence Files demonstrate that the Firm,[34] through Dihle,[35] Flemming,[36] Biley, and Warga, failed to gather any

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[33] Violations of NASD Rule 3010 are also violations of FINRA Rule 2010. *Wedbush Sec., Inc.*, Exchange Act Release No. 78568, 2016 SEC LEXIS 2794, at *35 n.36 (Aug. 12, 2016), *aff'd*, 719 F. App'x 724 (9th Cir. 2018).

[34] The conduct of Dihle, Flemming, Biley, and Warga, as Spencer Edwards's registered principals and registered representatives responsible for the acceptance and liquidation of microcap securities at issue, is imputed to Spencer Edwards. *See CE Carlson, Inc. v. SEC*, 859 F.2d 1429, 1435 (10th Cir. 1988) ("[The broker-dealer] is responsible for the actions of its agents, including [its 'registered broker and president']."); *Midas Sec.*, 2012 SEC LEXIS 199, at *28 n.35 (explaining that the misconduct of the firm's registered representatives was imputed to the firm).

[35] For much of the relevant period, Dihle was Biley's and Warga's direct supervisor. In that role, Dihle was responsible for reviewing and approving the opening of new accounts and the deposits of unregistered securities. But Dihle was often absent from the office, devoting much of his time to his law and accounting practices. To ensure that his absence did not interrupt the flow of microcap securities liquidations, Dihle gave another Spencer Edwards employee a stack of blank, pre-signed indemnification forms that attested to the legality and validity of the securities certificate to be deposited and the performance of necessary due diligence for acceptance of the deposit.

information to verify its sellers' identities. Spencer Edwards's procedures required any individual or entity holding more than five percent of an issuer's outstanding stock to be treated as a control person, i.e., an affiliate, and subjected to certain Firm-imposed limitations. But Spencer Edwards repeatedly permitted unrestricted selling by individuals and entities that controlled more than five percent of an issuer's outstanding shares. Spencer Edwards's WSPs also covered the Firm's use of Deposited Securities Request Forms as a means of obtaining information about microcap securities deposits, but the Firm failed to undertake any meaningful review of the answers on the forms in the face of red flags suggesting further inquiry was necessary.[37] The record in this case demonstrates that Spencer Edwards failed to implement its WSPs, and, in so doing, failed to maintain a supervisory system reasonably designed to prevent the sale of unregistered microcap securities. We therefore find that Spencer Edwards abdicated its supervisory responsibilities and violated NASD Rule 3010 and FINRA Rule 2010.

3. Spencer Edwards Failed To Establish and Maintain a Supervisory System, Including WSPs, Related to the Firm's Retention and Review of Its Registered Representatives' Emails

The record in this case also establishes that Spencer Edwards failed to implement its WSPs concerning the retention and review of its registered representatives' emails. Spencer

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[cont'd]

[36] When Dihle stepped down, Flemming succeeded him. Flemming did not even review the microcap securities deposits before submitting them to Spencer Edwards's clearing firm. Flemming had another Spencer Edwards employee "rubber-stamp" her signature on the deposit documents to represent that she had reviewed them. In fact, Flemming had no experience reviewing microcap securities deposits for liquidation, and she had no qualifications for her role at Spencer Edwards other than the necessary licenses. To compensate for her inexperience, Flemming hired outside counsel to review Spencer Edwards's microcap securities deposits. But outside counsel had no accountability to the Firm, had no accountability to regulators, and failed to document his reviews of the microcap securities deposits or explain the bases of his opinions concerning the deposits.

[37] For example, Spencer Edwards permitted microcap securities to be deposited where certain information on the Deposited Securities Request Form was left blank, and it failed to identify inconsistent and inaccurate information on the Deposited Securities Request Forms. Our review of the Deposited Securities Request Forms in the record identified the following problems with the forms: TES Dragon's Deposited Securities Request Form for its deposit of EATR overstated the outstanding shares of the stock, reporting that there were more shares outstanding of EATR than the company was authorized to issue; JY indicated on the Deposited Securities Request Form accompanying his deposits of HNSS that he acquired the shares from himself; KN's Deposited Securities Request Form for his deposit of HNSS indicated that he acquired the shares in February 2008, when the supporting documentation indicated that he acquired the shares in August 2010; and the Deposited Securities Request Forms for the deposits of ATPT, ENTI, LKEN, and SMPP indicated that the customers owned over five percent of the issuer's total outstanding shares, despite the fact that the customers responses on the forms indicated that they did not.

Edwards's WSPs prohibited registered representatives from using personal email accounts to transact Firm business. Despite this prohibition, Biley and Warga used personal email accounts to communicate with Spencer Edwards's customers, including the sellers of the microcap securities discussed here. Biley, in particular, used a personal email account systematically during the relevant period to communicate with customers, and he copied his supervisor, Dihle, on many of the communications.

According to Spencer Edwards's WSPs, Dihle was responsible for reviewing the emails of Spencer Edwards's registered representatives, and, upon receiving emails from Biley's and Warga's personal email addresses, it was incumbent on Dihle to ensure that the Firm's policies concerning the use of personal email accounts were being enforced. Dihle, however, abdicated his responsibilities and took no action to enforce Spencer Edwards's WSPs in this area. Based on these facts, we find that Spencer Edwards violated NASD Rule 3010 and FINRA Rule 2010 because the Firm failed to maintain a supervisory system related to the retention and review of its registered representatives' emails.[38]

C. Spencer Edwards Failed to Adequately Implement Its Anti-Money Laundering Policies and Procedures to Detect and Cause the Reporting of Suspicious Transactions Related to Its Microcap Securities Liquidation Business (Cause Three)

The Hearing Panel found that Spencer Edwards violated FINRA Rules 3310 and 2010 because the Firm failed to develop and implement adequate anti-money laundering policies and procedures related to its microcap liquidation business. We affirm the Hearing Panel's findings.

1. FINRA Rule 3310

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"). Title III of the PATRIOT Act imposes obligations on broker-dealers under the anti-money laundering provisions and certain amendments to the Bank Secrecy Act. *See* 31 U.S.C. §§ 5311 *et seq.* In April 2002, the Securities and Exchange Commission ("Commission") approved NASD Rule 3011, which, in January 2010, was adopted without substantive change as FINRA Rule 3310. *See Order Approving Proposed Rule Changes Relating to Anti-Money Laundering Compliance Programs*, Exchange Act Release No. 45798, 2002 SEC LEXIS 1047, at *1 (Apr. 22, 2002); *SEC Approves New Consolidated FINRA Rules, FINRA Regulatory Notice 09-60*, 2009 FINRA LEXIS 188, at *13-16 (Oct. 2009). FINRA Rule 3310 establishes the minimum standards required for each FINRA member firm's anti-money laundering compliance program.

FINRA Rule 3310(a) requires that FINRA member firms "[e]stablish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under [the Bank Secrecy Act] and the implementing regulations

[38] *See supra* n.34 (explaining that Dihle's supervisory failures may be imputed to Spencer Edwards).

thereunder." FINRA Rule 3310(b) extends this regulatory framework requiring that anti-money laundering programs, at a minimum, "[e]stablish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder."[39]

FINRA's guidance in this area, NASD Notice to Members 02-21, emphasized that a member firm's anti-money laundering procedures "must reflect the firm's business model and customer base" in order "[t]o be effective." *NASD Provides Guidance to Member Firms Concerning Anti-Money Laundering Compliance Programs Required by Federal Law, NASD Notice to Members 02-21*, 2002 NASD LEXIS 24, at *17 (Apr. 2002). The notice to members advised member firms that "in developing an appropriate [anti-money laundering] program . . ., [a firm] 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. The notice to members explained that the firm's procedures must address a number of areas, including "monitoring of account activities, including but not limited to, trading and the flow of money into and out of" accounts. *Id.* at *21. The notice to members also sets out a non-exhaustive list of "money laundering red flags" that called for "additional due diligence before proceeding with the transaction." *Id.* at *37. Examples included:

- The information provided by the customer that identifies a legitimate source for funds is false, misleading, or substantially incorrect.

- Upon request, the customer refuses to identify or fails to indicate any legitimate source for his or her funds and other assets.

- The customer appears to be acting as an agent for an undisclosed principal, but declines or is reluctant, without legitimate commercial reasons, to provide information or is otherwise evasive regarding that person or entity.

- For no apparent reason, the customer has multiple accounts under a single name or multiple names, with a large number of inter-account or third-party transfers.

- The customer maintains multiple accounts, or maintains accounts in the names of family members or corporate entities, for no apparent business purpose or other purpose.

Id. at *37-41. The record in this case establishes that Spencer Edwards's anti-money laundering program was not adequate for its high-risk microcap liquidation business.

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[39] A violation of any FINRA rule, including FINRA's rules governing a firm's anti-money laundering program, constitutes a violation of FINRA Rule 2010. *See Lek Sec. Corp.*, Exchange Act Release No. 82981, 2018 SEC LEXIS 830, at *33-35 (Apr. 2, 2018).

2. Spencer Edwards's Anti-Money Laundering Program Was Inadequate

As an initial matter, Spencer Edwards's anti-money laundering procedures were not tailored to the Firm's microcap liquidation business, a business that generated the bulk of the Firm's revenues. Spencer Edwards's anti-money laundering procedures contained substantial boilerplate language and descriptions of pertinent regulatory standards and requirements, but it was not specific to the risks associated with a business model focused on the liquidation of microcap securities. Spencer Edwards's anti-money laundering procedures failed to identify any exceptions associated with a microcap liquidation business, and it failed to provide guidance to its employees on how to recognize and act on exceptions.

Spencer Edwards's anti-money laundering procedures also failed to develop exception reports for microcap securities, and it failed to implement a system to monitor for suspicious patterns in the deposit or liquidation of microcap securities. Spencer Edwards's lack of adequate tools to address anti-money laundering exceptions for microcap securities meant that the Firm failed to detect, evaluate, and report suspicious activities for its liquidating transactions in a number of instances. Inexplicably, Spencer Edwards chose to rely on Dihle's manual review of microcap securities deposits (without any documentation or other memorialization of what that review actually entailed), while eschewing system-wide reports available to it that could have been used to identify exceptions.

Spencer Edwards's anti-money laundering program was inadequate because it was not tailored to the Firm's microcap securities liquidation business, failed to detect suspicious transactions involving microcap securities, and failed to detect and report suspicious transactions under the Bank Secrecy Act and its implementing regulations. *See Lek Sec. Corp.*, 2018 SEC LEXIS 830, at *1 (finding that the applicant violated FINRA's rules governing anti-money laundering programs because the firm failed to implement policies and procedures to detect and cause the reporting of suspicious transactions). Based on these facts, we find that Spencer Edwards violated FINRA Rules 3310 and 2010.

D. Spencer Edwards Failed to Preserve Its Registered Representatives' Emails (Cause Four)

The Hearing Panel found that Spencer Edwards violated the Commission's and FINRA's rules because the Firm failed to retain its registered representatives' emails. We have corrected the rule numbers that the Hearing Panel cited in connection with this violation, but we otherwise affirm the Hearing Panel's findings.

1. The Commission's and FINRA's Rules Governing the Retention of Emails

During the relevant period, Section 17(a)(1) of the Exchange Act required broker-dealers to "make and keep for prescribed periods" such records as the Commission "prescribes as necessary or appropriate in the public interest . . . for the protection of investors." 15 U.S.C. § 78q(a)(1) (2011). FINRA's recordkeeping rule, NASD Rule 3110, required the same.

NASD 3110(a) required that "[e]ach member [firm] . . . make and preserve books, accounts, records, memoranda, and correspondence in conformity with all applicable laws, rules, regulations and statements of policy promulgated thereunder and with the [r]ules of [NASD] and as prescribed by [Exchange Act] Rule 17a-3." NASD Rule 3110(a) noted that the "record keeping format, medium, and retention period shall comply with [Exchange Act] Rule 17a-4."[40]

Under Exchange Act Rule 17a-4(b)(4), broker-dealers were required to "preserve for a period of not less than [three] years, the first two years in an accessible place . . . [o]riginals of all communications received and copies of all communications sent . . . by the member, broker or dealer (including inter-office memoranda and communications) relating to its business as such." 17 C.F.R. § 240.17a-4(b)(4) (2011). Exchange Act Rule 17a-4(f) contemplated broker-dealers' electronic communications and required that broker-dealers that employ electronic storage media "[p]reserve the records exclusively in a non-rewriteable, non-erasable format." 17 C.F.R. § 240.17a-4(f)(2)(ii)(A) (2011). Spencer Edwards failed to retain its registered representatives' emails, and, in so doing, violated the Commission's and FINRA's recordkeeping rules.[41]

2. Spencer Edwards Failed to Retain Its Registered Representatives' Emails

As noted above, Biley and Warga used personal email accounts to communicate with customers and conduct firm-related business. Individuals at Spencer Edwards, including Biley's and Warga's supervisor, Dihle, were aware that the Firm's registered representatives were using personal email accounts for firm business, yet, these individuals allowed the use of personal email for firm business to continue, did not monitor or host the registered representatives' personal email accounts, and did not ensure that Spencer Edwards retained the emails. Based on these facts, we find that Spencer Edwards failed to ensure that its registered representatives' emails were preserved as required under Section 17(a)(1) of the Exchange Act, Exchange Act Rule 17a-4, NASD Rule 3110 and FINRA Rule 2010 (on or before December 4, 2011), and FINRA Rules 4510 and 2010 (after December 5, 2011). *See Mitchell H. Fillet*, Exchange Act Release No. 75054, 2015 SEC LEXIS 2142, at *54 (May 27, 2015) (explaining that "recordkeeping requirements are fundamental to the regulation of the securities industry, serving as the keystone of our surveillance of brokers and dealers").

IV. Sanctions

In the proceedings below, the Hearing Panel applied FINRA's Sanction Guidelines ("Guidelines"), fined Spencer Edwards $300,000 for the unregistered securities sales and fined the Firm an additional $300,000, as a unitary sanction, for the supervisory and anti-money laundering violations. The Hearing Panel also fined Spencer Edwards $107,000 as an order of

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40 FINRA Rule 4511(a), (b), and (c) superseded NASD Rule 3110(a), without substantive change, on December 5, 2011.

41 A violation of FINRA's recordkeeping rules violates FINRA Rule 2010. *See Meyers Assocs., L.P.*, Exchange Act Release No. 86497, 2019 SEC LEXIS 1869, at *41-43 (July 26, 2019).

disgorgement, and it suspended the Firm from depositing or liquidating deposited certificated securities until the Firm retains an independent consultant who determines that the Firm has implemented adequate supervisory procedures related to its acceptance of deposits of unregistered microcap securities.[42] The Hearing Panel's sanctions analysis resulted in a fine of $707,000 against Spencer Edwards.

As discussed below, we increase the Hearing Panel's sanctions as follows: (1) a $1.7 million fine and disgorgement of $90,940 for the unregistered securities sales (cause one); and (2) a unitary sanction of $1.7 million for the supervisory and anti-money laundering violations (causes two and three). We decline to impose sanctions for the recordkeeping violation based on the Firm's failure to retain the registered representatives' emails (cause four), and we agree with, but do not impose, a suspension on Spencer Edwards until the Firm engages an independent consultant who will monitor the Firm's acceptance and liquidation of microcap securities deposits and review the Firm's supervisory and anti-money laundering procedures related to its microcap securities liquidation business. Accordingly, our sanctions analysis results in the assessment of a total fine of $3,490,940 against the Firm.

A. Spencer Edwards's Disciplinary History and Prior Regulatory Warnings

We begin this sanctions analysis with the review and application of the Guidelines,[43] noting that Spencer Edwards has a substantial disciplinary history. Spencer Edwards has been involved with more than 16 disciplinary events, including regulatory actions involving unregistered securities sales and supervisory, anti-money laundering, and recordkeeping violations. Although we are mindful of all of these disciplinary events for the assessment of sanctions against Spencer Edwards,[44] we summarize only those events that put the Firm on notice of the problems with its unregistered securities sales and other violations discussed in this case.[45]

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[42] The Hearing Panel did not note a sanction for the Firm's failure to retain its registered representatives' emails.

[43] *See FINRA Sanction Guidelines* (March 2019), http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf [hereinafter, "*Guidelines*"]. In assessing the appropriate sanctions for Spencer Edwards's misconduct, we apply the applicable Guidelines in place at the time of this decision and consider the specific Guidelines related to each violation. *See id.* at 8. We also consult the General Principles Applicable to All Sanction Determinations and Principal Considerations in Determining Sanctions, which adjudicators consult in every disciplinary case. *See id.* at 2-8.

[44] *See Castle Sec. Corp.*, 58 S.E.C. 826, 836 (2005) (explaining that disciplinary history is a significant aggravating factor and an important consideration in weighing sanctions); *see also Guidelines*, at 2 (General Principles Applicable to All Sanction Determinations, No. 2) (considering the respondent's disciplinary history), 7 (Principal Considerations in Determining Sanctions, No. 1) (same).

[45] *See Guidelines*, at 8 (Principal Considerations in Determining Sanctions, No. 14) (considering whether the respondent engaged in the misconduct notwithstanding prior warnings

[Footnote continued on next page]

Spencer Edwards's microcap securities liquidation business has had a troubled history of noncompliance with the registration requirements of the Securities Act. As early as 2003, the Commission found that Spencer Edwards's head trader, and one of its registered representatives, unlawfully sold unregistered securities on behalf of customers.[46] In 2005, the Commission, again, found that Spencer Edwards, along with its then-president and two registered representatives, violated the registration requirements of the Securities Act.[47]

The facts of the 2005 disciplinary action, *Carley*, are strikingly similar to the problems plaguing Spencer Edwards here. In *Carley*, the administrative law judge determined that Spencer Edwards's unregistered securities sales stemmed from supervisory violations that had occurred at the Firm.[48] The administrative law judge explained that Spencer Edwards "did not have acceptable procedures in place to prevent or detect unregistered transactions," and that the Firm "failed to exercise reasonable supervision" over its registered representatives because the Firm did not conduct an adequate inquiry into circumstances surrounding its unregistered securities sales.[49] The administrative law judge concluded that Spencer Edwards was liable for the payment of nearly $1 million in disgorgement, prejudgment interest, and civil penalties, but the administrative law judge agreed to reduce these amounts to $25,000 because Spencer Edwards demonstrated an inability to pay.[50]

Despite an appeal, and an adverse ruling against Spencer Edwards from the Commission in *Carley* in January 2008, a subsequent Commission-lead examination of Spencer Edwards from 2009 determined that the Firm continued to facilitate the unlawful distribution of securities because the Firm continued to fail to inquire into the circumstances surrounding its customers' securities distributions. In response to the 2009 examination findings, Spencer Edwards, and its then-president, Dihle, explained that its problematic practices occurred "under prior management," and that the Firm was "revising its procedures" to identify red flags that might signal illegal, unregistered securities distributions. Dihle committed to having Spencer Edwards document its inquiry and review process and train its representatives on the new procedures.

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from FINRA or another regulator). The Commission's and FINRA's guidance in this area also put Spencer Edwards on notice of the potential problems with its microcap liquidation business.

46 *See Charles F. Kirby*, 56 S.E.C. 44 (2003), *aff'd sub. nom. Geiger v. SEC*, 363 F.3d 481 (D.C. Cir. 2004).

47 *See John A. Carley*, Initial Decision Release No. 292, 2005 SEC LEXIS 1745, at *1 (July 18, 2005), *aff'd*, Exchange Act Release No. 57246, 2008 SEC LEXIS 222 (Jan. 31, 2008), *aff'd in part, rev'd in part, sub nom. Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009).

48 *Carley*, 2005 SEC LEXIS 1745, at *156, 161.

49 *Id*.

50 *Id.* at *206-20.

Despite Dihle's representations, a Commission examination from 2011 found that Spencer Edwards's problems with unregistered securities distributions persisted. The 2011 examination found that Spencer Edwards continued to facilitate nonexempt unregistered securities distributions through customer liquidations, including several of the liquidations discussed here.[51] The Commission's 2011 examination criticized virtually every aspect of Spencer Edwards's microcap securities liquidation business. The Commission explained that Spencer Edwards had ignored red flags related to unlawful unregistered securities distributions, relied upon questionable Rule 144 legal opinions, failed to investigate red flags of suspicious activity for anti-money laundering purposes, failed to implement recommendations by its auditor or conduct a meaningful audit, failed to supervise its sales of unregistered securities, and failed to supervise the use of personal email by Biley to facilitate possible unregistered distributions. The Commission explained:

> Spencer [Edwards's] business of facilitating sales of unregistered shares for customers, many of whom appear to be affiliated with the issuers, is a high-risk activity that requires heightened supervision in order to be reasonably designed to prevent and detect possible violations of the federal securities laws and FINRA rules. Spencer [Edwards's] supervisory procedures have not met that standard. Because of the numerous examination deficiency letters issued to Spencer [Edwards] over the last 15 years, Spencer [Edwards] has had ample warning of the need to enhance its supervision of this risky line of business. Spencer [Edwards] has made commitments to enhance its supervisory procedures (most recently in 2009), but it has failed, in practice, to do so. Instead, it appears that the surveillance system for suspicious activity monitoring in effect during the review period was inadequate and not tailored to the risks that were posed by the type of business Spencer [Edwards] was conducting, and the type of securities that its customers were selling.

The Commission concluded that Spencer Edwards's "deficiencies and weaknesses" required "immediate corrective action," and that Spencer Edwards's repeated failures in the area of its microcap liquidation business rendered Spencer Edwards a "recidivist."

Even recently, Spencer Edwards is settling regulatory actions relating to its securities liquidation business. In June 2019, Spencer Edwards entered into a settlement agreement with FINRA. Spencer Edwards consented to charges that it had failed to establish and implement its anti-money laundering compliance program, and that, because of that failure, Spencer Edwards did not detect or investigate numerous warning signs of suspicious activity representing billions of shares of microcap issuers. The Firm agreed to pay a $250,000 fine and restitution of $512,261 to customers based on other violations. Spencer Edwards also agreed to a suspension until it implements an adequate anti-money laundering compliance program, and the Firm's chief compliance officer certifies that implementation.

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[51] Because a referral following the Commission's October 2011 examination led to the investigation that resulted in this case, we do not consider the findings from the Commission's October 2011 examination as a part of Spencer Edwards's disciplinary history.

Spencer Edwards's disciplinary history strongly supports our conclusion that it is a recidivist. Under the Guidelines, we should impose escalating sanctions on recidivist that are "beyond those outlined in the[] [G]uidelines." We follow this guidance here.

B. Sales of Unregistered Microcap Securities (Cause One)

Mindful of Spencer Edwards's extensive disciplinary history, and the fact that the Firm has been previously sanctioned for similar misconduct, we examine the specific violations that are the subject of this decision, beginning with the Firm's unregistered securities sales. The Guidelines for the sale of unregistered securities recommend that adjudicators consider a fine of $2,500 to $77,000.[52] When the respondent's conduct involves a high volume of recurring transactions in microcap securities, or penny stocks,[53] the Guidelines suggest a fine between $5,000 and $155,000.[54] The Guidelines advise adjudicators to consider a higher fine if aggravating factors predominate the respondent's conduct.[55]

The Guidelines contemplate suspensions and expulsions for firms that are involved in unlawful distributions of securities. The Guidelines advise adjudicators to consider suspending a firm with respect to any or all relevant activities or functions for up to 30 business days or until procedural deficiencies are remedied.[56] Where aggravating factors predominate, or where a firm's conduct involved a high volume of or recurring transactions in penny stocks, the Guidelines suggest that adjudicators consider a longer suspension or an expulsion.[57]

The Guidelines also set forth seven specific considerations for such violations, six of which are applicable here: (1) whether the respondent's unregistered securities sales resulted from an intentional act, recklessness or negligence; (2) the share volume of transactions, dollar amount of transactions, and amount of compensation earned by the respondent or the respondent's firm on the transactions involved; (3) whether the sales of unregistered securities were made in connection with an attempt to evade regulatory oversight; (4) whether the respondent had implemented procedures that were reasonably designed to ensure that it did not participate in an unregistered distribution; (5) whether the respondent disregarded "red flags" suggesting the presence of unregistered distribution; and (6) whether the respondent's conduct involved a high volume of, or recurring transactions in, penny stocks.[58] Spencer Edwards's unregistered securities sales were wrought with aggravating factors.

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52 *Guidelines*, at 24 (Sales of Unregistered Securities).

53 *Id.* The Guidelines use the term "penny stock" as it is defined in Section 3(a)(51) of the Securities Exchange Act of 1934 or related Exchange Act Rule 3a51-1. *See id.*

54 *Id.*

55 *Id.*

56 *Id.*

57 *Id.*

58 *Id.*

As an initial matter, the share volume and dollar amount of the transactions at issue are significant. The transactions involved billions of shares of microcap issuers, resulted in proceeds of more than $1.8 million for the sellers, and commissions of $90,940 for Spencer Edwards. The amounts involved in these unregistered securities sales are substantial and constitute an aggravating factor.

Second, Spencer Edwards's conduct was intentional and involved a high volume of, and recurring transactions in, penny stocks. Despite the fact that microcap securities liquidations comprised the bulk of Spencer Edwards's business, the Firm failed to take meaningful steps to ensure its compliance with the federal securities laws in this already risky enterprise. For example, Spencer Edwards did not make the most basic of inquiries into the transactions, failing to examine whether RD was an affiliate of ENTI based on his former role as the issuer's former chief executive officer, officer, and director, and the fact that his brother had assumed those positions.

Third, Spencer Edwards's inadequate supervisory system and WSPs, and approach to due diligence overall, ensured that red flags would be missed or outright ignored. The Due Diligence Files that Spencer Edwards compiled were rife with discrepancies and suspicious circumstances that should have triggered a searching inquiry by the Firm, but, when confronted with red flags, Spencer Edwards turned a blind eye.

Spencer Edwards's misconduct illustrates how, when left unfettered, sales of unregistered securities may harm the investing public and disrupt the integrity of the securities markets. The Securities Act requires that FINRA member firms and their registered representatives function as gatekeepers to prevent unlawful distributions.[59] As gatekeepers, FINRA member firms must determine if a sale of unregistered securities actually complies with the Securities Act's prohibition on the sale of unregistered and nonexempt securities.[60] Spencer Edwards utterly failed to discharge its gatekeeper responsibilities to prevent the unlawful distribution of unregistered securities.

In sum, the aggravating factors here are well beyond predominating over the mitigating ones; instead, the aggravating factors are overwhelming. We find that the combination of Spencer Edwards's disciplinary history, the high volume of transactions, the intentional nature of

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[59] *See Sanction Guidelines: FINRA Revises the Sanction Guidelines, FINRA Notice to Members 11-07*, 2011 FINRA LEXIS 34, at *4 (Feb. 2011) ("The rules prohibiting the sale of unregistered securities are an important component of maintaining the integrity of the securities registration process. Broker-dealers perform an important gatekeeper role. When broker-dealers properly assume their regulatory responsibilities, they guard against the entry of unregistered securities into the markets . . . .").

[60] *See Paul L. Rice*, Admin. Proc. File No. 3-2451, 1973 SEC LEXIS 3477, at *26 (Apr. 30, 1973), *aff'd*, 45 S.E.C. 959 (1975) (stating that "[s]alesmen . . . should be aware of the requirements necessary to establish an exemption from [Securities Act Section 5's registration requirements] and should be reasonably certain such an exemption is available before engaging in the offer and sale of unregistered securities").

the misconduct, and the Firm's ignoring of red flags means that expulsion and a significantly higher fine would be in the range of sanctions that we would consider for this egregious misconduct. But we are mindful that Spencer Edwards already has ceased operations. Accordingly, we find that a fine above the Guideline range is appropriate. We impose on Spencer Edwards a $1.7 million fine for its unregistered securities sales, and we order the Firm to pay disgorgement of $90,940.[61] Given that Spencer Edwards is not operating as a broker-dealer, we do not impose an independent consultant requirement. These substantial sanctions are intended to remind Spencer Edwards, and other similarly situated firms acting in risky areas such as microcap deposits and liquidations, of their compliance obligations in this area.

C. Deficient Supervisory System and WSPs Related to the Firm's Microcap Liquidation Business, Retention and Review of Its Registered Representatives' Emails, and Anti-Money Laundering Compliance (Causes Two and Three)

For purposes of sanctions, we have decided to aggregate Spencer Edwards's supervisory and anti-money laundering violations and to apply the Guidelines applicable to systemic supervisory failures, failures to supervise, and deficient WSPs to the violations.[62] For systemic supervisory failures, the Guidelines recommend a fine between $10,000 and $310,000 for a firm.[63] Where aggravating factors predominate the misconduct, the Guidelines advise adjudicators to consider a higher fine.[64] The Guidelines also suggest that adjudicators consider ordering restitution or disgorgement.[65] The Guidelines for systemic supervisory failures direct adjudicators to consider the following factors: (1) whether the deficiencies allowed violative conduct to occur or to escape detection; (2) whether the firm failed to timely correct or address deficiencies once identified, failed to respond reasonably to prior warnings from FINRA or another regulator, or failed to respond reasonably to other "red flag" warnings; (3) whether the firm appropriately allocated its resources to prevent or detect the supervisory failure, taking into account the potential impact on customers or markets; (4) the number and type of customers, investors or market participants affected by the deficiencies; (5) the number and dollar value of

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61 *Guidelines*, at 5 (General Principles Applicable to All Sanction Determinations, No. 6) ("Adjudicators may require the disgorgement of such ill-gotten gain by ordering disgorgement of some or all of the financial benefit derived, directly or indirectly.")

62 *See Dep't of Enforcement v. N. Woodward Fin. Corp.*, Complaint No. 2011028502101, 2016 FINRA Discip. LEXIS 35, at *48 n.43 (FINRA NAC July 19, 2016) (aggregating violations of supervisory and anti-money laundering requirements for purposes of imposing sanctions); *see also Guidelines*, at 4 (General Principles Applicable to All Sanction Determinations, No. 4) (explaining that the aggregation or "batching" of violations may be appropriate for purposes of determining sanctions in disciplinary proceedings).

63 *Guidelines*, at 105 (Supervision – Systemic Supervisory Failures).

64 *Id.*

65 *Id.*

the transactions not adequately supervised as a result of the deficiencies; (6) the nature, extent, size, character, and complexity of the activities or functions not adequately supervised as a result of the deficiencies; (7) the extent to which the deficiencies affected market integrity, market transparency, the accuracy of regulatory reports, or the dissemination of trade or other regulatory information; and (8) the quality of controls or procedures available to the supervisors and the degree to which the supervisors implemented them.[66]

For failures to supervise, the Guidelines recommend a fine between $5,000 and $77,000.[67] The Guidelines suggest that adjudicators consider limiting the activities of the appropriate department for up to 30 business days, or longer in egregious cases, and suspending the firm with respect to any or all activities or functions for up to 30 business days.[68] The Guidelines for a failure to supervise advise that adjudicators consider the following factors: (1) whether respondent ignored "red flag" warnings that should have resulted in additional supervisory scrutiny; (2) whether individuals responsible for underlying misconduct attempted to conceal misconduct from respondent; (3) the nature, extent, size and character of the underlying misconduct; and (4) the quality and degree of supervisor's implementation of the firm's supervisory procedures and controls.[69]

For deficient WSPs, the Guidelines recommend a fine between $1,000 and $39,000.[70] In egregious cases, the Guidelines recommend that adjudicators consider suspending a firm with respect to any or all relevant activities or functions for up to 30 business days and thereafter until the supervisory procedures are amended to conform to the rule requirements.[71] The Guidelines for deficient WSPs direct adjudicators to consider: (1) whether deficiencies allowed the violative conduct to occur or to escape detection; and (2) whether the deficiencies made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance.[72] Spencer Edwards's supervisory and anti-money laundering violations were egregious.

When the anti-money laundering rules came into effect well over 10 years ago, Spencer Edwards should have adopted anti-money laundering procedures tailored to the inherent risks of its business and hired well-trained, knowledgeable, responsible personnel to engage in vigorous monitoring of customer activity. Instead of doing this, Spencer Edwards made its brokers the first line of defense, but failed to train them adequately. Warga did not know the identity of his

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66 *Id.*

67 *Id.* at 104 (Supervision – Failure to Supervise).

68 *Id.*

69 *Id.*

70 *Id.* at 107 (Supervisory Procedures – Deficient WSPs).

71 *Id.*

72 *Id.*

anti-money laundering compliance officer, and Biley admitted he knew nothing about anti-money laundering in general. Indeed, if Spencer Edwards did any anti-money laundering monitoring at all, or investigated any red flags, nobody at the Firm documented it.

Rather than provide robust oversight of its microcap securities business, Spencer Edwards's anti-money laundering program relied on a manual system of review of transactions, eschewed exception reports available from its clearing firm, and missed all of the red flags of violative activity related to the six issuers and seven customers discussed here. For example, Spencer Edwards's anti-money laundering program stated that "[n]o accounts [should be] opened without verification of identity." But no one at Spencer Edwards performed any due diligence on RD or the RD-controlled accounts, even as RD repeatedly requested the disbursement of all proceeds from the accounts and the authorized person on the BBC Financing account, CW, repeatedly instructed Spencer Edwards to "send all available monies overnight for early morning delivery EACH DAY as they become available." Spencer Edwards's microcap securities liquidation business was inherently risky, and its approach to anti-money laundering left an unsuspecting investing public and unprepared securities market completely unguarded against that risk.

Spencer Edwards's supervisory system, similar to its anti-money laundering program, was grossly inadequate. The inadequacies of Spencer Edwards's supervisory system facilitated the Firm's unlawful securities sales and allowed the unlawful securities sales to escape detection. Spencer Edwards did not critically review its microcap securities deposits and failed to conduct a meaningful inquiry into the source and origin of the securities that it accepted for deposit and liquidation. The Firm executed customer orders without asking the appropriate questions regarding the origin of the securities deposited for liquidation. And none of those responsible for supervision at Spencer Edwards conducted sufficient inquiry into any of the 22 deposits at issue, or recognized red flags in the accounts of the sellers. Spencer Edwards liquidated billions of shares of unregistered securities, yielding sales proceeds of nearly $2 million for its customers, all while putting the investing public at significant risk.

As we reviewed the record in this case, we determined that Spencer Edwards's unregistered securities sales, standing in isolation, were egregious. That said, when we viewed the unregistered securities sales within the broader context of the anti-money laundering and supervisory violations, Spencer Edwards emerges as a Firm steadfastly committed to noncompliance. To be sure, any implementation of Spencer Edwards's anti-money laundering program or WSPs would have required that the Firm inquire into its liquidating transactions and selling customers, and the Firm had no intention of engaging in that inquiry. Spencer Edwards's failure to implement its anti-money laundering program and WSPs facilitated the Firm's unregistered securities sales, and, for the benefit of its microcap liquidation business, that is exactly how the Firm intended for it to be.

Disciplinary sanctions should be designed to remediate misconduct by preventing the recurrence of misconduct, improving overall standards in the industry, and protecting the investing public. "Toward this end, [a]djudicators should design sanctions that are meaningful and significant enough to prevent and discourage future misconduct by a respondent and deter

others from engaging in similar misconduct."[73] The sanctions that the Hearing Panel imposed for Spencer Edwards's anti-money laundering and supervisory violations, a $300,000 fine, are insufficient to serve these goals.

The microcap securities liquidation business is a high-risk business that requires a robust anti-money laundering program and supervisory system, but Spencer Edwards failed to establish a supervisory system reasonably designed to achieve compliance with anti-money laundering rules, Section 5 of the Securities Act, or the "reasonable inquiry" requirements of Section 4(4) and Rule 144 of the Securities Act. Moreover, we find that Spencer Edwards's history of shortcomings in the anti-money laundering and supervisory areas, the high volume of liquidated shares, the red flags that the Firm ignored, and the substantial proceeds to the sellers and significant commissions to the Firm point toward expulsion or fines beyond those outlined in the Guidelines. Accordingly, based on the facts before us, we find that an upward departure from the Guidelines is necessary to address Spencer Edwards's supervisory failures, and we impose a $1.7 million fine for these two causes of action.[74]

D. Spencer Edwards Has Not Established an Inability to Pay

Spencer Edwards asserts that it has no ability to pay the fines that FINRA may impose. The only evidence that Spencer Edwards offered regarding its financial condition consisted of its Financial and Operational Combined Uniform Single (FOCUS) reports for the first two quarters of 2016 and testimony from Flemming. Flemming testified that, if FINRA imposed a fine in excess of $600,000, there was "no way" that Spencer Edwards could pay it, and the Firm would have to "close [its] doors." Spencer Edwards offered no evidence of its financial condition as of the time of the hearing in October 2016. Nor has it sought to supplement the record on appeal. We acknowledge that Spencer Edwards has ceased its broker-dealer business, but, based on the evidence presented, we are unable to find that Spencer Edwards has established a bona fide inability to pay.[75]

V. Conclusion

We affirm the Hearing Panel's findings that Spencer Edwards: (1) sold unregistered and nonexempt microcap securities, in violation of FINRA Rule 2010 (cause one); (2) failed to supervise its microcap securities liquidation business and the retention and review of its registered representatives' emails, in violation of NASD Rule 3010 and FINRA Rule 2010 (cause two); (3) failed to implement the anti-money laundering procedures related to its

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73 *Id.* at 2 (General Principles Applicable to All Sanction Determinations, No. 1).

74 We decline to impose a sanction on Spencer Edwards for its failure to retain its registered representatives' emails because we find that this cause of action is largely subsumed in the Firm's supervisory violation.

75 "It is well settled that a respondent bears the burden of demonstrating an inability to pay." *William J. Murphy*, Exchange Act Release No. 69923, 2013 SEC LEXIS 1933, at *109 (July 2, 2013), *aff'd sub. nom. Birkelbach v. SEC*, 751 F.3d 472 (7th Cir. 2014).

microcap securities business, in violation of FINRA Rules 3310 and 2010 (cause three); and (4) failed to retain its registered representatives' emails, in violation of Section 17(a)(1) of the Exchange Act, Exchange Act Rule 17a-4, FINRA Rules 4511 and 2010 (on or after December 5, 2011), and NASD Rule 3110 and FINRA Rule 2010 (on or before December 4, 2011) (cause four).

For sanctions, we fine Spencer Edwards a total of $3,490,940 as follows: (1) $1.7 million for the unregistered securities sales (cause one); (2) $1.7 million for the supervisory and anti-money laundering violations (causes two and three); and (3) $90,940, plus prejudgment interest,[76] as disgorgement for the unregistered securities sales. We also assess, but do not impose, a suspension on Spencer Edwards until the Firm engages an independent consultant who will monitor the Firm's acceptance and liquidation of microcap securities deposits and review the Firm's supervisory and anti-money laundering procedures related to its microcap securities liquidation business. Finally, we affirm the Hearing Panel's order that Spencer Edwards pays hearing costs of $16,813.43, and we assess appeal costs of $1,669.74.[77]

On Behalf of the National Adjudicatory Council,

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Jennifer Piorko Mitchell,
Vice President and Deputy Corporate Secretary

[76] Interest shall accrue from December 21, 2011, the date of Spencer Edwards's last unlawful liquidation for the sales discussed in this case, 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.

[77] Pursuant to FINRA Rule 8320, 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.