FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. WILSON-DAVIS & CO., INC. (CRD No. 3777), JAMES C. SNOW (CRD No. 2761102), and BYRON B. BARKLEY (CRD No. 12469), Respondents.	Disciplinary Proceeding No. 2012032731802 Hearing Officer–DW **EXTENDED HEARING PANEL DECISION** February 27, 2018

Respondent Wilson-Davis & Co. is fined $1,170,000 and ordered to disgorge $51,624 for improper short sales. For its failure to supervise and implement adequate AML procedures, Wilson-Davis is fined an additional $300,000, while Respondents James Snow and Byron Barkley are fined $140,000 and $115,000, respectively, and both are suspended for one year and ordered to requalify before re-entering the industry.

Appearances

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

For the Respondent: Richard F. Ensor, Esq. and Evan S. Strassberg, Esq., Michael, Best & Friedrich, LLP.

DECISION

I. Introduction

"Market makers" are dealers "who hold themselves out to all comers as ready to buy or sell a security for their own account."[1] Firms acting in this role promote market efficiency for a security by "react[ing] swiftly to company news and reported financial results by buying or selling stock and driving it to a changed price level."[2] Because market makers are required to purchase or sell stock for their own account, they incur market risk.[3] The difference between the price a market maker is willing to pay for a security, or its "bid," and the price at which it is willing to sell a security, or its "ask" price, is referred to as its "spread."[4] "The spread traditionally compensates a dealer for its … risk and for providing liquidity and immediacy of execution."[5]

A central question in this case is whether a broker-dealer's trading in various securities constituted legitimate market making. The Department of Enforcement brought the action against Respondents Wilson-Davis & Co., Inc., ("Wilson-Davis" or the "Firm") along with its President and Chief Compliance Officer James Snow ("Snow"), and Byron Barkley ("Barkley"), the Firm's Head of Trading (collectively, "Respondents"). Enforcement's Complaint alleges that the Firm willfully violated Rule 203(b)(1) of Regulation SHO (the "Rule") by short selling several stocks without first borrowing the securities. Snow and Barkley are charged with failing to adequately supervise trading and other activities at the Firm, and failing to establish and implement adequate Anti-Money Laundering ("AML") procedures tailored to the Firm's business.

The allegations involving Wilson-Davis' trading activity focus on the period between July 2012 and April 2013, when the Firm, through one of its registered representatives, engaged in dozens of short sales of four penny stock securities. Enforcement alleges that these short sales were improper, as the Firm did not first borrow the stock as required by the Rule. Respondents do not dispute that the Firm shorted stock without first documenting that it had borrowed the securities or had reason to believe that the securities could be borrowed. But they claim that the borrow requirement was excused because the Firm executed its short sales as a part of "bona-fide market making activities" in each of the securities. A hearing on the circumstances surrounding

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[1] *In re Merrill Lynch Sec. Litig.*, 911 F. Supp. 754, 758 (D.N.J. 1995).

[2] *Cammer v. Bloom*, 711 F. Supp. 1264, 1287 (D.N.J 1989).

[3] *Merrill Lynch*, 911 F.Supp. at 758.

[4] *See Certain Market Making Activities on NASDAQ*, Exchange Act Release No. 34-40900, 1999 SEC LEXIS 64, at *2-3 (Jan. 11, 1999).

[5] *Meyer Blinder*, Exchange Act Release No. 31095, 1992 SEC LEXIS 2019, at *20 (Aug. 26, 1992).

the Firm's trading in the four penny stocks, as well as supervisory and AML violations alleged in the Complaint, was held in Salt Lake City, Utah.

II. Respondents

Wilson-Davis has been a FINRA member since 1968.[6] The Firm trades mostly low-cost "penny" stocks for its customers and in its own account.[7] Its principal place of business is Salt Lake City, Utah, with branch offices elsewhere.[8] Between 2011 and 2014, the Firm employed between 32 and 44 registered representatives.[9] During this period Snow served as the Firm's President, Chief Compliance Officer, and AML Compliance Officer, while Barkley was the Firm's Vice President and Head of Trading.[10] Snow entered the securities industry in 1996 when he associated with Wilson-Davis.[11] Barkley entered the industry in 1969, also when he associated with Wilson-Davis.[12] Both remain associated with the Firm.[13]

III. Wilson-Davis' Short Selling Activity Violated Section 203(b) of Regulation SHO

A. Findings of Fact

Wilson-Davis hired registered representative Anthony Kerrigone ("Kerrigone") as a trader in September of 2008.[14] Although Kerrigone maintained a small number of retail customers, his primary business was trading in one of the Firm's proprietary accounts as a market maker in various securities.[15] Kerrigone's "niche" as a market maker was the markets of penny stock companies that traded in high volume following promotional or touting campaigns.[16] Kerrigone researched stocks to find those that were experiencing a run up in price because "they were being promoted and touted," even though the securities were "generally worthless" and "had zippo, no value."[17] Because the promoters "managed to figure out how

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[6] Answer ("Ans.") ¶ 12.

[7] Ans. ¶ 13.

[8] Ans. ¶ 14.

[9] Ans. ¶ 15.

[10] Ans. ¶¶ 16, 18.

[11] Ans. ¶ 17.

[12] Ans. ¶ 19.

[13] Ans. ¶¶ 17, 19.

[14] Complainant's Exhibit ("CX")-27.

[15] Hearing Transcript ("Tr.") (Kerrigone) 410.

[16] Tr. (Barkley) 511-13.

[17] Tr. (Barkley) 516-17.

they'd get a lot of people to buy" these "worthless" stocks, they presented a "trading opportunity" for Kerrigone.[18]

Once Kerrigone identified a suitable "trading opportunity," his activity in the security followed a consistent pattern. Kerrigone entered the market of an actively promoted stock by first selling the security short, on the assumption that once the market impact of promotional activity dissipated the stock would lose value.[19] Although Kerrigone typically posted both "bid" and "ask" quotes as a market maker when he was first active in a stock, during this early period his "bid" quotes were generally not competitive with other market quotes, minimizing the possibility that he would actually purchase any significant quantities of the stock from the market as he shorted.[20] Later, as the effect of the promotional activity dissipated and value of the stock began to fall, Kerrigone moved his "bid" to a competitive level and executed market purchases of the stock sufficient to cover his short positions.[21] During this latter stage, his "ask" quotes were typically away from the "inside" and not competitive with other market quotes, minimizing the possibility that he would sell additional stock and increase his diminishing short position.[22] After fully covering his short position, he exited the market of the security.[23] His trading in each security was brief, typically only a few trading days.[24] By starting out as a net seller of the promoted stocks, accumulating his short position, and then buying to cover the stock he shorted, Kerrigone effectively piggy-backed the trajectory of potential "pump and dump" schemes to sell stock to the public while it was artificially inflated.

Kerrigone and his superiors at Wilson-Davis knew that Regulation SHO generally required a seller to borrow a security before selling the security short.[25] But the Firm made no effort to do so before Kerrigone's short selling. Instead, the Firm assumed that its trading fell within an exemption to the borrow requirement provided to Firms who engage in "bona-fide market making."[26]

Kerrigone's strategy was lucrative for both himself and Wilson-Davis.[27] Kerrigone, who worked on a commission based on his trading profits, made in excess of $15 million between

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[18] *Id*.

[19] Tr. (Barkley) 552-53.

[20] *See* CX-1; CX-6; CX-11; CX-16.

[21] *See* CX-1; CX-6; CX-11; CX-16.

[22] *See* CX-1; CX-6; CX-11; CX-16.

[23] *See* CX-1; CX-6; CX-11; CX-16.

[24] *See* CX-1; CX-6; CX-11; CX-16.

[25] Tr. (Barkley) 524.

[26] Tr. (Barkley) 523-27.

[27] Tr. (Barkley) 518-19.

2011 and 2013.[28] During this time the Firm similarly made "tens of millions of dollars in profit."[29] The strategy is illustrated by Kerrigone's trading in four penny stocks—Preventia, Inc. ("PVTA"), PM&E, Inc. (PMEA"), China Teletech Holdings ("CNCT"), and Lot 78, Inc. ("LOTE").

1. Preventia, Inc.

Preventia, Inc. was a firm that purported to operate an electronic trading platform.[30] There was limited or no trading in the market for the company's stock until promotional activity began in July 2012.[31] On July 9, 2012, the website "hotstocked.com"[32] published a promotional article touting the company and proclaiming PVTA the "the hottest stock pick (or hottest pick) of the summer" that was "extremely undervalued at the current market cap" with projected profits of more than 366 percent.[33] That day, price and volume in the stock spiked, and Kerrigone decided to make a market in the stock by submitting a "market maker application" to his superiors at Wilson-Davis.[34] Kerrigone's market maker application explained that he decided to make a market in the stock because of a "trading opportunity."[35]

Kerrigone then entered the PVTA market by short selling.[36] Kerrigone shorted the stock exclusively during his first day of trading.[37] As Kerrigone continued to short the stock, Wilson-Davis' posted bid quotes were always significantly away from the inside bid.[38] During this first day of trading, Kerrigone accumulated a net short position of approximately 32,400 shares.[39] Shortly after the market opened on the second day, the price of the stock started to decline and Kerrigone started purchasing shares to close out his short position.[40] Once he shifted direction Kerrigone was exclusively a buyer, and by the close had bought enough PVTA to nearly fully cover his short position.[41] During this period, he posted offer quotes for Wilson-Davis that were

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[28] Joint Exhibit ("JX")-12.

[29] CX-34.

[30] CX-28.

[31] Tr. (Kassar) 110; CX-3.

[32] The website is an aggregator of promotional materials and newsletters that collects materials from various sources and disseminates them to the public. Tr. (Kassar) 106-07.

[33] CX-28.

[34] Tr. (Kassar) 112; CX-3.

[35] Tr. (Kassar) 82-84; JX-13.

[36] Tr. (Kassar) 78-79.

[37] Tr. (Kassar) 79.

[38] Tr. (Kassar) 99; CX-4.

[39] Tr. (Kassar) 78; CX-1.

[40] CX-1; CX-2.

[41] CX-1.

significantly away from the inside offer approximately 94 percent[42] of the time, ensuring that he would not sell additional stock.[43] Because the stock price declined substantially between Kerrigone's shorts and his subsequent covering purchases, he generated trading profits of $4,032.[44] Kerrigone never traded in PVTA again after his brief entry into the market.[45] And the Firm never borrowed or made arrangements to borrow the shares Kerrigone sold short.[46] In total, Kerrigone executed at least 13 trades in PVTA during his trading, including 7 short sales.[47]

2. PM&E, Inc.

Kerrigone traded in another penny stock company called PM&E, Inc. PMEA was purportedly a solar power technology company.[48] Like Preventia, there was limited or no trading in the stock before a flurry of activity in November 2012.[49] On November 12, 2012, "hotstocked.com" published a promotional article touting the company, claiming that as a result of its proprietary solar technology, PMEA "is coiled up and poised to explode," and its "upside is just mind-boggling!"[50] That day, price and volume in the stock spiked, and Kerrigone decided to enter the market.[51] Kerrigone's market maker application again explained that he decided to make a market in the stock because of a "trading opportunity."[52]

As with PVTA, Kerrigone entered the market of PMEA on November 21 by shorting.[53] Kerrigone executed his initial short sale with another firm at a price more than 28 percent away from Kerrigone's own quote.[54] As Kerrigone continued to short the stock, Wilson-Davis' posted bid quotes were never at the inside, and usually significantly away from the inside.[55] During this

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[42] Enforcement expained that the Wilson-Davis public quotes presented at the hearing were snapshots of the Firm's quotations at the point in time of specific trades and not necessarily a comprehensive representation of the Firm's quotations throughout the entire period. Tr. (Kassar) 89. Nevertheless, given the number of transactions memorialized, and in the absence of evidence to the contrary or reason to believe otherwise, we infer that these snapshots fairly and reasonably approximate the levels of Wilson-Davis' quotations over the trading period.

[43] Tr. (Kassar) 100; CX-4.

[44] CX-1.

[45] Tr. (Kassar) 80; CX-1. Kerrigone left the market the next day, after one small purchase to close out his position.

[46] Tr. (Kassar) 79.

[47] CX-1.

[48] CX-29.

[49] Tr. (Kassar) 141-42; CX-3.

[50] CX-29.

[51] Tr. (Kassar) 141-43; CX-8.

[52] Tr. (Kassar) 121; JX-14.

[53] Tr. (Kassar) 123-24.

[54] Tr. (Kassar) 124-25.

[55] Tr. (Kassar) 125-27; CX-7.

first day of trading, every transaction (except one) by Kerrigone was a short sale, and he accumulated a net short position of approximately 35,000 shares.[56] In the afternoon on the second day, the price of the stock started to decline and Kerrigone started purchasing shares to close out his short position.[57] By the close on the second day, Kerrigone had bought enough PMEA to cover his shorts and ended in a net flat position.[58] Because the stock price declined substantially between Kerrigone's shorts and his subsequent covering purchases, he generated trading profits of $8,495.[59] Kerrigone never traded in PMEA again after his brief entry into the market.[60] And the Firm never borrowed or made arrangements to borrow the shares Kerrigone sold short.[61] In total, Kerrigone executed at least 19 trades in PMEA during his trading, including 11 short sales.[62]

And while Kerrigone posted bid and ask quotes during the brief period of his trading, his quotations were again calculated to facilitate his trading strategy. While Kerrigone was shorting, Wilson-Davis posted competitive bid and ask quotes less than 5 percent of the time.[63] Its posted bid quotes were *never* at the inside, and usually more than 10 percent lower than the inside quote, making it unlikely that the Firm's posted bids would result in any actual purchase transactions.[64] And when Kerrigone later covered his short position, Wilson-Davis posted competitive bid and ask quotes approximately 7 percent of the time.[65] Its posted offer quotes were almost never at the inside, and usually more than 10 percent higher than the inside quote, making it unlikely that the Firm's posted offers would result in any actual sale transactions.[66]

3. China Teletech Holding

China Teletech Holding was a company that purportedly sold pre-paid calling cards and mobile phone handsets in China.[67] Like the other companies, there was limited or no trading in the security until the latter part of February 2013.[68] On about February 20, 2013, an article

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[56] Tr. (Kassar) 135-36; CX-6.

[57] Tr. (Kassar) 136; CX-6; CX-10.

[58] Tr. (Kassar) 120; CX-6.

[59] Tr. (Kassar) 120; CX-6.

[60] Tr. (Kassar) 142-43; CX-6. Kerrigone left the market the next day, after one small short sale and subsequent cover.

[61] Tr. (Kassar) 118.

[62] CX-6.

[63] CX-9.

[64] Tr. (Kassar) 131-32; CX-7; CX-9.

[65] CX-9.

[66] Tr. (Kassar) 132-33; CX-7; CX-9.

[67] CX-30.

[68] Tr. (Kassar) 177-79; CX-13.

appeared on "hotstocked.com" touting the company, where the author claimed that the company "is THE single most undervalued play that I have ever seen" and that the stock was "ready to explode."[69] The next day, price and volume in the stock spiked.[70] Kerrigone decided to enter the CNCT market and submitted a "market maker application" to his superiors at Wilson-Davis.[71] Kerrigone explained on the application that he decided to make a market in the stock because of a "trading opportunity."[72]

As with the other stocks, Kerrigone entered the CNCT market on February 21 by exclusively selling the stock short, building a net short position of approximately 2.8 million shares by the third day of trading.[73] Throughout the morning of that third trading day, Kerrigone continued shorting the stock with dozens more short sales (and a small number of buy transactions), accumulating a net short position of over 5 million shares.[74] Then, shortly after noon as the price of the stock started to decline, Kerrigone reversed direction and started purchasing shares in significant quantities.[75] Notwithstanding a small number of short sales that afternoon, by the end of the day he had reduced his net short position by more than 2 million shares.[76]

Kerrigone continued trading in the stock for two more days. Although he executed some short sales during this time, he was a significant buyer of the stock.[77] By the end of the fifth trading day, February 27, 2012, Kerrigone was net flat in his trading position, having purchased enough stock to cover his entire 5 million share short position.[78] Because the stock price declined substantially between the time of the promotional activity when Kerrigone started shorting the stock and his subsequent covering purchases, he generated trading profits of $116,532 over the five days of trading.[79] After this period, Kerrigone never traded in the stock again.[80] The Firm never borrowed or made arrangements to borrow the shares Kerrigone sold short.[81] In total,

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[69] CX-30.

[70] Tr. (Kassar) 178-79; CX-13.

[71] JX-15.

[72] JX-15.

[73] Tr. (Kassar) 146; CX-11.

[74] Tr. (Kassar) 148-49; CX-11.

[75] Tr. (Kassar) 150; CX-11.

[76] Tr. (Kassar) 150-51; CX-11.

[77] Tr. (Kassar) 151-52; CX-11.

[78] Tr. (Kassar) 152; CX-11.

[79] Tr. (Kassar) 152; CX-11; CX-13.

[80] Tr. (Kassar) 152; CX-11.

[81] Tr. (Kassar) 146-47.

Kerrigone executed at least 88 trades[82] in CNCT during the trading period, including 53 short sales.[83]

During the early trading when Kerrigone was shorting CNCT, he posted quotes as a market maker on behalf of Wilson-Davis to both purchase and sell the stock, but his posted quotes to purchase CNCT ("bid quotes") were generally nowhere near the inside, or best, quote.[84] During this period, approximately 90 percent of the Firm's posted bid quotes were at least 10 percent lower than the inside quote, making it unlikely that the posted bids would result in any actual purchase transactions.[85]

Over the latter two days of trading when Kerrigone made purchases of CNCT to cover his short position, his posted bids were more competitive with the inside quote.[86] Still, 71 percent of the time the Firm's bid quotes were at least 10 percent lower than the inside quote, making market purchase transactions resulting from those quotes less likely.[87] But in order to cover his short position, Kerrigone executed a substantial volume of buys by initiating purchases with other Firms *at prices higher than Wilson-Davis' own quoted bid*.[88] Sixty-five percent of Kerrigone's purchases were at prices more than 10 percent higher than the price Wilson-Davis was publicly quoting to the market.[89]

4. Lot 78, Inc.

Like the other companies, Lot 78 was a penny stock whose market saw little or no activity before Kerrigone decided to trade the stock.[90] Kerrigone began trading in LOTE on April 24, 2013.[91] Unlike the other stocks, Kerrigone's trading did not start immediately after promotional activity—instead, the promotion began on March 10, 2013, more than a month before Wilson-Davis entered the market.[92]

Kerrigone's trading varied slightly from his typical pattern. He briefly accumulated a long position by purchasing LOTE stock at the market open on April 24, before changing

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[82] The trades, as reflected on Wilson-Davis' trade blotter, frequently included multiple executions aggregated into a single transaction. Tr. (Kassar) 71-72, 145-46.

[83] Tr. (Kassar) 145-46; CX-11.

[84] Tr. (Kassar) 168-69; CX-14.

[85] Tr. (Kassar) 168-69; CX-14.

[86] Tr. (Kassar) 168-69; CX-14.

[87] Tr. (Kassar) 169-70; CX-14.

[88] Tr. (Kassar) 174-75; CX-15.

[89] Tr. (Kassar) 174-75; CX-15.

[90] CX-18.

[91] CX-16.

[92] CX-16; CX-32 (touting the stock by announcing that "this beast will be massive.").

direction less than an hour later placing a sale transaction of more than 1.1 million shares, resulting in a net short position of approximately 476,000 shares.[93] Similar to the other stocks, Wilson-Davis did not borrow the securities it sold short.[94] Kerrigone continued to increase his short position to approximately 1 million shares by the end of the trading day.[95] Kerrigone's last purchase of the day was at a price of $2.45 per share.[96]

The next day, Kerrigone began purchasing stock to cover his short position, but found that unlike the price trajectory of the other stocks, the price of LOTE *continued to increase*.[97] After a single purchase of 256,878 shares at $3.34 per share, Kerrigone stopped making substantial efforts to cover and traded in only small volumes of LOTE as the stock price continued to rise throughout the day.[98] Kerrigone's last trade of the day was at $4.05 per share.[99] Despite the fact that Kerrigone's net short position decreased by approximately 250,000 shares as a result of his purchase, the value of his outstanding LOTE short position increased from approximately $2.4 million to $2.9 million as a result of the rising price of the stock.[100]

On the third day after Kerrigone entered the market, the price of LOTE continued to rise.[101] That morning, Kerrigone purchased another 199,132 shares to reduce his short position to approximately 544,576 shares, this time at a price of $4.81 per share.[102] Kerrigone again traded only small volumes of the stock, with his last trade of the day at $6.05 per share.[103] Despite the fact that his short position was again reduced, the increased share price meant that the value of the outstanding position that Kerrigone still needed to cover had increased to *over $3.2 million*.[104]

Despite the rising price of LOTE, Firm policy required Kerrigone to cover his short position quickly.[105] Kerrigone finally covered his net short position on the fourth trading day.[106]

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[93] Tr. (Kassar) 188-89; CX-16.

[94] Tr. (Kassar) 190.

[95] Tr. (Kassar) 192-93; CX-16.

[96] Tr. (Kassar) 193; CX-16.

[97] CX-16.

[98] Tr. (Kassar) 194-96; CX-16.

[99] Tr. (Kassar) 195; CX-16.

[100] Tr. (Kassar) 192-96; CX-16.

[101] CX-16.

[102] Tr. (Kassar) 193-97; CX-16.

[103] Tr. (Kassar) 198; CX-16.

[104] Tr. (Kassar) 198; CX-16.

[105] Tr. (Barkley) 641-44; Respondents' Exhibit ("RX")-30.

[106] CX-16.

He did so by executing a purchase of 545,388 shares at a price of $7.89 per share.[107] After that fourth day, Kerrigone never traded in LOTE again.[108] In total, Kerrigone executed at least 102 trades in LOTE during his trading, including 51 short sales.[109] Because LOTE's stock price did not follow Kerrigone's anticipated trajectory and he had to purchase his covering shares at prices substantially higher than where he shorted, his trading in the stock resulted in a loss to Wilson-Davis of *more than $4.2 million*.[110] Shortly thereafter, Wilson-Davis required Kerrigone to reimburse the Firm for its LOTE losses, and asked him to leave the Firm.[111]

Kerrigone's posted market maker quotations for LOTE during the period of his trading were once again more consistent with his effort to execute his trading strategy than actually providing general liquidity to the market as a market maker. During the early part of the trading when Kerrigone was accumulating his short position, Wilson-Davis' posted bid was significantly away from the inside bid (82 percent of the time), ensuring that his bid would usually not result in market purchases.[112] Indeed, even when Kerrigone purchased a large quantity of stock before building his short position, he did so by initiating transactions with other brokers at prices higher than Wilson-Davis' own quoted bid price.[113] Later, when Kerrigone was attempting to cover, he ensured that Wilson-Davis' posted sell quotes would not increase his short position by moving those posted quotes to levels significantly away from the inside ask (approximately 55 percent of the time).[114] Moreover, during this later period, Wilson-Davis' posted bid quotes were also almost always significantly away from the inside bid (approximately 92 percent of the time), as Kerrigone sought to avoid buying as well in light of the increasing price of LOTE stock, providing little liquidity to the market in either direction.[115]

5. Wilson-Davis Was Not a Bona-Fide Market Maker

When Kerrigone entered the market for a stock, he did so to implement his trading strategy of short selling into an artificially inflated market and later covering his shorts when the market collapsed. Kerrigone and Wilson-Davis exploited the Firm's market maker access to profit from this strategy without regard to short sale borrow requirements. But the Firm had little interest in actually acting as a market maker. During periods that Kerrigone was shorting stocks, the Firm's bid was "not competitive" with prevailing prices such that there was "really no

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[107] Tr. (Kassar) 198-99; CX-16.

[108] Tr. (Kassar) 202; CX-16.

[109] CX-16.

[110] Tr. (Kassar) 202; CX-16.

[111] Tr. (Kerrigone) 456-59; CX-35.

[112] Tr. (Kassar) 226; CX-19.

[113] CX-17.

[114] Tr. (Kassar) 227; CX-19.

[115] Tr. (Kassar) 227; CX-19.

chance" that the Firm would buy any stock from the market.[116] When Kerrigone was buying to cover his short position, he adjusted his market maker offer quotes to uncompetitive levels to avoid additional sales.[117] And Kerrigone frequently bought and sold far away from Wilson-Davis' own published quotes, sometimes by more than 250 percent.[118]

Wilson-Davis presented the expert testimony of Professor Benjamin Blau regarding the Firm's trading in the markets of the four stocks at issue.[119] But Professor Blau offered no opinion as to the competitiveness of any of the Firm's particular quotes or whether its purported market making comported with Securities and Exchange Commission ("SEC") guidance.[120] Instead, he opined that Wilson-Davis' activity was "incredibly active" and that the Firm frequently updated its posted quotes.[121] And he opined that Wilson-Davis' quoted prices were, on average, as competitive as the average market maker.[122] But he did no analysis as to whether the Firm's bid and offer quotes were *both* competitive during any of the trading periods. His most significant finding was that the spread, or the difference between the bid and ask quotes, for Wilson-Davis was significantly greater than the spread between the bid and ask quotes of the most active market maker in each of the securities.[123] This suggests that the most active market maker was much closer than Wilson-Davis to the inside bid on *both* the bid and ask.[124] The significant difference in quotation spread between Wilson-Davis and the leading market maker—in the same markets of the same stocks at the same time—supports the inference that Wilson-Davis' market making was not "bona-fide."

B. Conclusions of Law

"In general, short selling is used to profit from an expected downward price movement, to provide liquidity in response to unanticipated demand, or to hedge the risk of a long position in the same security or in a related security."[125] The first cause of the Complaint alleges that Wilson-Davis willfully violated Rule 203(b)(1) of Regulation SHO through its short-selling activity described above. The Rule prohibits a broker-dealer from accepting a short sale order in any equity security from another person, or effecting a short sale order for the broker-dealer's own account unless the broker-dealer has (1) borrowed the security, or entered into an

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[116] Tr. (Barkley) 569-71, 575, 583-84.

[117] Tr. (Barkley) 575.

[118] CX-2; CX-7; CX-12; CX-17.

[119] RX-32.

[120] Tr. (Blau) 1298-1307.

[121] RX-32.

[122] Tr. (Blau) 1233.

[123] Tr. (Blau) 1287-89.

[124] Tr. (Blau) 1286-87.

[125] *Short Sales*, Exchange Act Release No. 50103, 2004 SEC LEXIS 1636, at *3-4 (July 28, 2004).

arrangement to borrow the security, or (2) has reasonable grounds to believe that the security can be borrowed so that it can be delivered on the date delivery is due. The broker-dealer must locate the security and document compliance with the Rule before effecting a short sale.[126] The Rule excepts from this borrow or locate requirement short sales effected by a market maker in connection with bona-fide market making activities in the security.[127]

There is no dispute that Wilson-Davis made at least 122 short sales in connection with Kerrigone's[128] speculative trading strategy in the four securities described above and that the Firm failed to comply with the borrow requirement in connection with each of these short sales. Wilson-Davis responds to this *prima facie* showing of violations by contending that its short sales were exempt from the Rule because they were made in connection with bona-fide market making activities. Wilson-Davis bears the burden of demonstrating that its trading was bona-fide market making,[129] and we find that it failed to meet that burden.

The federal securities laws define a "market maker" to include "any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer communications system or otherwise) as being willing to buy and sell such security for his own account on a regular or continuous basis."[130] So "bona-fide" market making activity exists where a firm engages in good faith efforts to hold itself out as willing to buy and sell securities in a market on a regular basis.[131] When it adopted Regulation SHO, the SEC provided guidance as to the facts and circumstances pertinent to determining whether a firm's conduct is bona-fide market making:

> Bona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security. In addition, where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona-fide market making for purposes of the exception.[132]

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[126] *Dep't of Enforcement v. Legacy Trading*, *Co., LLC*, No. 2005000879302, 2010 FINRA Discip. LEXIS 20, at *22 (NAC Oct. 8, 2010).

[127] 17 C.F.R. § 242.203(b)(2)(iii).

[128] Kerrigone was subject to a settled enforcement action as a result of his conduct.

[129] *Wilson-Davis & Co*., *Inc.,* Exchange Act Release No. 80533, 2017 SEC LEXIS 1242, at *9, n.10 (Apr. 26, 2017), citing *FTC v. Morton Salt Co*., 334 U.S. 37, 44 (1948); *see Schlemmer v. Buffalo R & P.R. Co.*, 205 U.S. 1, 18 (1907) (the "general rule of law is[] that a proviso carves special exceptions only out of the body of the act; and those who set up any such exception must establish it").

[130] Securities Exchange Act of 1934, Section 3(a)(38).

[131] *See* Ballantine's Law Dictionary, 3rd ed. (defining "bona-fide" as "[a]cting in good faith.")

[132] *Short Sales*, 2004 SEC LEXIS 1636, at *50.

The guideposts articulated by the SEC focus on whether a firm is genuinely trying to provide liquidity to the market for a stock by providing widely accessible quotes on both sides that are at or near the market.[133]

Wilson-Davis failed to demonstrate that its trading was consistent with these principles. Wilson-Davis argues that the relevant securities were in "fast-moving market[s] experiencing a surge in buying activities," and the firm was merely responding to those markets.[134] With respect to its trading in LOTE, for instance, it "updated its quotes 958 times during the day or about every thirty seconds."[135] And the Firm "sent hundreds of trade messages to other brokers and received hundreds of trade messages" while it "bought and sold stock throughout the day."[136] But the evidence was not that the Firm bought and sold LOTE on a regular basis throughout the day. Rather, during the initial phase of Kerrigone's strategy, the Firm sold the stock short while moving its bid quotes away from market levels to ensure that it did *not* buy.[137] Later, when Kerrigone was endeavoring to cover, the Firm moved its ask quotes away from the inside to ensure that it did not continue to sell.

Wilson-Davis attributes the apparent one-sided nature of its trading to "short-term buy and sell side imbalances." It argues that its short-selling was merely a function of the presence of more buyers than sellers in the market, and points to language in the SEC guidance that recognizes a firm's willingness to take the other side of trades where such imbalances exist as a hallmark of bona-fide market making.[138]

We agree that a willingness to offer liquidity to either buyers or sellers in the absence of other market participants is consistent with the role of a market maker. But irrespective of whether there were more buyers than sellers, or more sellers than buyers, Wilson-Davis' evident desire to generally trade in a single direction, and not do business with sellers when shorting (or buyers when covering) distinguishes it from a genuine market maker. The SEC guidance emphasizes that even during periods of market imbalance, "[a] pattern of trading that includes *both purchases and sales* in roughly comparable amounts to provide liquidity to customers or other broker-dealers would generally be an indication that a market maker is engaged in bona-

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[133] *See* Amendments to Regulation SHO, Exchange Act Release No. 58775, 2008 SEC LEXIS 2319, *62 (Oct. 14, 2008) ("SEC 2008 Release").

[134] Respondents' Prehearing Brief at 19-20.

[135] Respondents' Prehearing Brief at 20.

[136] Respondents' Prehearing Brief at 20.

[137] Wilson-Davis argued that, at times, it made market transactions through an ECN that would have been viewable to the public (if made at the inside price). Tr. 429-31 (Kerrigone). But the limited number of such trades made at inside prices do not explain much of the Firm's non-competitve trading. *See* CX-1; CX-6; CX-11; CX-16. And even if these transactions were visible as an inside quote, the quotations originated from the ECN, not Wilson-Davis. Tr. 572-74 (Barkley). The Firm never explained how it indicated to the market its own willingness to transact by using effectively anonymous quotations.

[138] Respondents' Prehearing Brief at 19-20 (citing SEC 2008 Release).

fide market making activity."[139] Wilson-Davis' trading revealed no such pattern. A market maker's willingness to provide liquidity to a market, imbalanced or not, is evidenced by its "[c]ontinuous quotations that are at or near the market *on both sides* and that are communicated and represented in a way that makes them widely accessible to investors and other broker-dealers."[140] By contrast, "where a market maker posts continually at or near the best offer, but does not also post at or near the best bid, the market maker's activities would not generally qualify as bona-fide market making."[141] Wilson-Davis' quotations in each of the four securities were rarely at or near the market on both sides.[142]

And in fact, Wilson-Davis frequently engaged in short sales at prices away from its own posted quotations. "[A] market maker that continually executes short sales away from its posted quotes would generally not be considered to be engaging in bona-fide market making."[143]

On balance, we find that Wilson-Davis' overall conduct in each of the four securities was that of a speculative trader endeavoring to piggy-back the trajectory of potential "pump and dump" schemes, not that of a genuine market maker. "[B]ona-fide market making does not include activity that is related to speculative selling strategies or investment purposes of the broker-dealer and is disproportionate to the usual market making patterns or practices of the broker-dealer in that security."[144] In this regard, our conclusion is reinforced by the findings of the SEC in an enforcement action it brought against Wilson-Davis for its conduct involving different securities during the same time frame as the trading at issue here. The SEC concluded that:

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[139] SEC 2008 Release, 2008 SEC LEXIS 2319, at *63.

[140] SEC 2008 Release, 2008 SEC LEXIS 2319, at *64; *see generally Shamrock Partners, Ltd*., 53 S.E.C. 1008, 1011-12 (1998) ("to be treated as a market maker, a dealer must, among other things, advertise its willingness to buy and sell securities for its own account and stand ready to buy and sell to other dealers at its quoted prices"); *R.B. Webster Invs., Inc.*, Exchange Act Release No. 35754, 1995 SEC LEXIS 1309, at *5 (May 23, 1995) ("[i]n order to be treated as a market maker, a dealer must be willing to both buy and sell the security at issue in the inter-dealer market on a regular or continuous basis"); *Adams Sec, Inc*., 51 S.E.C. 311, 3114 (1993) (applicant was not a market maker where applicant "did not demonstrate a willingness to buy and sell [the] stock with other dealers during the review period at issue").

[141] SEC 2008 Release, 2008 SEC LEXIS 2319, at *65; *see R.B. Webster Invs.*, 1995 SEC LEXIS 1309, at *6 (applicant was not a market maker where applicant's "ask quotations were deliberately higher than any other dealer's," and as a result "never sold any of the stock to other dealers"); *Legacy Trading*, 2010 FINRA Discip. LEXIS 20, at *28 (respondent was not engaged in bona-fide market making where it "almost never posted the inside bid or ask in connection with the short sales").

[142] *See* CX-4 (market maker quotations in PVTA never within 10 percent of both inside bid and ask); CX-9 (market maker quotations in PMEA within 10 percent of both inside bid and ask between 4.75 percent and 6.82 percent of the time); CX-14 (market maker quotations in CNCT within 10 percent of both inside bid and ask between 3.94 percent and 26 percent of the time); CX-19 (market maker quotations in LOTE within 10 percent of both inside bid and ask between 3.94 percent and 9.57 percent of the time).

[143] SEC 2008 Release, 2008 SEC LEXIS 2319, at *65.

[144] *Id*. at *65–66.

> [C]ontrary to the guidance in the Commission's adopting release to the 2008 Amendments to Regulation SHO, [Wilson-Davis]: (1) posted quotations that were often not at or near the market on both sides; (2) posted a bid quotation at or near the market for that security, but failed to post an offer quotation at or near the market; (3) updated its bid quotation for the security during the trading day, as it often made few or no changes to its offer quotation throughout the entire trading day (at times, not changing an offer quotation that was far away from the market despite substantial movement in the price of the security); and (4) executed numerous short sales away from its posted offer quotations.[145]

We reach similar conclusions with respect to the trading at issue here. The market maker exemption was not intended "to give market makers *carte blanche* to engage in speculative short selling of securities that could not be borrowed for delivery."[146] Because Wilson-Davis failed to establish that it was engaged in bona-fide market making activities during the period of its short sales, those short sales violated the Rule.

IV. Wilson-Davis Failed to Supervise Its Trading and Operations

The second cause of action alleges that through a variety of supervisory failures, Wilson-Davis, Snow, and Barkley violated NASD Rule 3010 and FINRA Rule 2010. In particular, the Firm, Snow, and Barkley allegedly failed to supervise the Firm's compliance with Regulation SHO. The Firm and Snow also allegedly failed to supervise a plan of heightened supervision at the Firm, failed to ensure appropriate supervisors were assigned, and failed to adequately supervise the Firm's instant messages.

A. Findings of Fact

1. Wilson-Davis and Barkley Failed to Supervise Kerrigone's Trading in Violation of Reg SHO

As set forth above, Kerrigone's trading activity was a significant component of Wilson-Davis' business and a substantial driver of revenue for the Firm. The Firm understood that in order for Kerrigone to successfully execute his trading strategy and legitimately sell short securities in the various stocks without satisfying the borrow requirements, he was required to be engaged in bona-fide market making activity.[147] Yet the Firm made no effort to ensure that Kerrigone's activity was consistent with genuine market making activity.[148] The Firm's written

[145] *Wilson-Davis & Co.*, 2017 SEC LEXIS 1242, at *13-14.

[146] *Dep't of Enforcement v. Fiero*, No. CAF980002, 2002 NASD Discip. LEXIS 16, at *70 (NAC Oct. 28, 2002).

[147] Tr. (Barkley) 524.

[148] Tr. (Barkley) 527-30.

supervisory procedures ("WSPs") provide no procedures or required oversight to ensure that the Firm was in compliance with the bona-fide market maker exemption.[149]

The Firm's procedures recognize the requirement that a security must be borrowed in advance of a short sale unless the sale is subject to an exemption.[150] And the procedures identify an exemption for "bona-fide market making transactions in non-NASDAQ OTC securities[151] where the firm publishes a two sided quotation in an independent quotation medium."[152] But despite the importance of the exemption to the Firm's business, its WSPs provide no procedures, processes, tests, or guidance that would permit an evaluation by supervisors at the Firm of *whether* the particular facts of a short sale transaction established that a sale was made in connection with bona-fide market making activity.[153]

Wilson-Davis' lack of written procedures was compounded by a lack of meaningful oversight. Respondent Barkley oversaw all trading at Wilson-Davis and monitored Kerrigone's trading on a day-to-day basis.[154] Barkley was responsible for ensuring that Kerrigone's trading was consistent with the bona-fide market maker exemption of Regulation SHO.[155] But after approving Kerrigone's market maker application prior to entering the market for a particular stock, Barkley uncritically assumed that all of Kerrigone's short selling in the security was a part of bona-fide market making.[156] Neither Barkley nor anyone else at the Firm conducted any analysis or implemented any procedures to ensure that Kerrigone's trading was, in fact, genuine market making.[157] Although Barkley monitored Kerrigone's trading in the relevant stocks in real time, he did not regularly monitor the market maker quotes Kerrigone was displaying to the market at the time of his trading.[158] Consequently, Barkley failed to detect quotations in the relevant securities that were so far away from competitive levels on either the buy or sell side that they were effectively one-sided.[159]

Kerrigone's trading in LOTE attracted particular scrutiny at Wilson-Davis.[160] Barkley and others at the Firm devoted substantial attention to the trading, but the attention was not on

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[149] Tr. (Barkley) 649-52.

[150] Tr. (Barkley) 649; JX-7, at 398.

[151] Each of PVTA, PVEA, CNCT, and LOTE are non-NASDAQ OTC securities. Tr. (Barkley) 650.

[152] Tr. (Barkley) 650; JX-7, at 398.

[153] Tr. (Barkley) 649-52.

[154] Ans. ¶¶ 41, 44.

[155] Tr. (Barkley) 634.

[156] Tr. (Barkley) 532.

[157] Tr. (Barkley) 533-36.

[158] Tr. (Barkley) 563-65.

[159] Tr. (Barkley) 567-71, 581-84, 603-10.

[160] Tr. (Barkley) 624-25.

whether Kerrigone's quotations were consistent with genuine market making—the focus was instead on the size of Kerrigone's short position and the exposure and potential loss that the position created for the Firm.[161] Indeed, Barkley was less concerned with whether Kerrigone was offering quotations consistent with bona-fide market making than he was with the prospect that offering a truly competitive bid for the stock might drive the stock price up and make the Firm's short position more difficult to liquidate.[162] This was the case even though Barkley knew that publishing a two-sided quote was an important indicia of whether the Firm was engaging in bona-fide market making.[163] The Firm did nothing to ensure that it complied with the bona-fide market maker exception.[164]

2. Wilson-Davis and Snow Failed to Supervise Required Heightened Supervision of a Registered Representative

Problems with supervision at the Firm were not limited to its purported market making. Among other things, the Firm's WSPs required it to consider whether any employee needed heightened supervision.[165] Snow was responsible for identifying employees requiring heightened supervision and for determining its scope.[166] He was also responsible for documenting the decision of whether or not to impose heightened supervision when considered.[167] A regulator complaint against an employee was a circumstance that required Wilson-Davis and Snow to consider whether heightened supervision of the employee was needed under Firm policy.[168] Yet when a regulator filed a complaint against a Wilson-Davis broker, the Firm failed to follow this policy.

Around the time it shifted to Kerrigone's trading strategy as a revenue driver for the Firm, Wilson-Davis and one of its brokers were named in a FINRA disciplinary proceeding for

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[161] Tr. (Barkley) 625.

[162] Tr. (Barkley) 625.

[163] Tr. (Barkley) 655.

[164] The Firm never even provided training to its personnel on the requirements of bona-fide market making until 2014, after the period at issue here. Tr. (Moore) 906-08; CX-49.

[165] Ans. ¶ 61. In response to the Complaint's allegations regarding the contents of the Firm's WSPs, Respondents admit in their Answer "that the WSPs speak for themselves," while purporting to deny "any allegations inconsistent with the WSPs language" (without actually identifying any inconsistent allegations). But of course, WSPs (or any other written document) cannot "speak." *See State Farm Mut. Auto. Ins. Co. v. Riley*, 199 F.R.D. 276, 279 (N.D. Ill. 2001) ("This Court has been attempting to listen to such written materials for years (in the forlorn hope that one will indeed give voice)—but until some such writing does break its silence, this Court will continue to require pleaders to employ one of the three alternatives that are permitted by [the Federal Rules] in response to all allegations about the contents of documents (or statutes or regulations)."). By failing to specifically dispute any of the Complaint's characterizations of the contents of the WSPs, Respondents admit the allegations. FINRA Rule 9215(b) ("Any allegation not denied in whole or in part shall be deemed admitted.").

[166] Ans. ¶ 61.

[167] Ans. ¶ 62.

[168] Ans. ¶ 63.

selling unregistered penny stocks, in violation of Section 5 of the Securities Act of 1933.[169] The complaint also asserted that a principal of the Firm, Paul Davis, failed to supervise the broker.[170] The complaint was filed on December 27, 2010, and an amended complaint was filed on October 4, 2011.[171]

Paul Davis founded Wilson-Davis and was the chairman of the board at the time of the questioned trading.[172] It was alleged in the action that the Firm's WSPs required Paul Davis to supervise sales, approve new accounts, and review compliance forms relating to transfers of stock.[173] It was also alleged that Paul Davis ignored numerous red flags that the broker was engaging in illegal sales, but permitted the trading to occur anyway.[174] It was also charged that the Firm had inadequate procedures in place to prevent the sale of unregistered securities.[175] The Firm and Paul Davis settled the actions against them in November 2011.[176] The broker proceeded to hearing, and on June 8, 2012, the Hearing Panel issued a decision finding the broker liable for Section 5 violations.[177] As a part of the sanctions imposed, the broker was permitted to continue his employment in the industry only if a member firm agreed to subject the broker to heightened supervision for one year.[178]

Wilson-Davis continued to employ the broker, but failed to devise a heightened supervision plan for him until August 6, 2012.[179] There is no evidence that Wilson-Davis and Snow considered implementing the plan at the time the complaint was filed, or at any time before it was actually put in place.[180] Even after the Hearing Panel's June 2012 decision, the broker continued to transact Section 5 related business as usual until the plan of supervision was implemented in August 2012.[181]

The WSPs required that once imposed, a plan of heightened supervision should identify the scope of supervision, including the type, frequency, and time period of the supervision.[182]

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[169] Ans. ¶ 64.

[170] Ans. ¶ 65.

[171] Ans. ¶ 64.

[172] Tr. (Moore) 843; JX-22 (Davis OTR).

[173] CX-41.

[174] CX-41.

[175] CX-41.

[176] Ans. ¶ 68.

[177] Ans. ¶ 69.

[178] Ans. ¶ 70.

[179] Ans. ¶ 72.

[180] Tr. (Davis) 865; (Moore) 957-60.

[181] Tr. (Moore) 949-52; CX-47.

[182] Ans. ¶ 73.

The plan was also required to provide how the supervision was to be documented, be signed by the representative and supervisor, and be certified by the supervisor that the plan was being performed.[183]

But when the plan was finally put into effect, it consisted of nothing more than requiring the broker to follow the procedures relevant to certificated stock that he was already required to follow under Firm policy, while subjecting any customer transactions over $75,000 to outside counsel's review.[184] The plan also suggested the broker periodically have lunch with outside counsel.[185]

The plan failed to identify who at Wilson-Davis was responsible for the broker's supervision, much less require supervisor certification.[186] Supervision apparently fell to Paul Davis—the same Paul Davis who previously settled the action for inadequately supervising the broker's illegal trading.[187] By the time the decision against the broker was issued, Paul Davis still worked at the Firm but was in his eighties and spent little time in the office.[188] Leadership of the Firm had transitioned to his brother, Lyle Davis, and the other principals of the Firm, Barkley and Snow.[189] Although the Firm believed that Paul Davis was supervising the broker, the semi-retired Davis was himself unsure that he was responsible for supervision.[190]

Wilson-Davis observes that following the action against the Firm, it substantially overhauled the procedures relevant to its Section 5 business, and those changes diminished the need for heightened supervision—in essence, the entire Firm faced increased scrunity of transactions in this space.[191] But heightened supervision of the broker was required,[192] and it is unclear whether it was performed at all, as the written plan contained no requirement that the supervisor certify compliance, as required by the Firm's procedures.[193] And we find unreasonable and inadequate a plan of supervision that contemplates required heightened supervision be carried out without specific direction by the same individual who failed to

[183] Ans. ¶¶ 73-74.

[184] CX-46.

[185] CX-46.

[186] Tr. (Moore) 962-63.

[187] Tr. (Moore) 963.

[188] Tr. (Moore) 845-46; JX-22 (Davis OTR).

[189] Tr. (Snow) 1057-58.

[190] Tr. (Moore) 871, 963; JX-22 (Davis OTR).

[191] Tr. (Moore) 988-94.

[192] The Hearing Panel decision considered the changes Wilson-Davis made to its Section 5 policies and practices in determining necessary relief, including the plan of heightened supervision. CX-45, at 17.

[193] Tr. (Moore) 966.

adequately supervise the broker in the first place.[194] Having failed to consider whether heightened supervision was appropriate at the time required by its own policies,[195] Wilson-Davis and Snow ultimately implemented a heightened supervision program that did not comport with its written procedures and was inadequate to the situation presented to the Firm.

3. Wilson-Davis and Snow Failed to Devise a Reasonable System to Supervise the Firm's Registered Personnel

As a more general matter, Wilson-Davis lacked a clearly articulated and coherent system to supervise its representatives and principals. The supervisory structure at Wilson-Davis is laid out in WSPs that incorporate a "head count list" to identify particular supervisors for individuals at the Firm.[196] The "head count list" represented that traders in the Firm with retail customer accounts reported to Snow.[197] But Snow, the Firm's AML Compliance Officer responsible for devising and maintaining its WSPs, had no such responsibility.[198]

The testimony at the hearing was that Paul Davis was responsible for supervising the Firm's sales personnel during the relevant period.[199] But Paul Davis spent limited time in the office, less than three hours per day, due to his wife's illness.[200] In Paul Davis' absence, the other principals of the Firm made efforts to cover his responsibilities, but there were no policies or procedures implemented at the Firm that made clear the reporting responsibilities.[201] While Wilson-Davis contends that it employed a "team management" concept, it operated without clear

[194] The Hearing Panel decision found "that Respondent's supervisor approved the sales at issue" to be mitigating to the broker's violation. CX-45, at 17.

[195] Wilson-Davis argues that any delay in the implementation of the plan was immaterial, as it was implemented only a few days after the Hearing Panel decision became final. But the Firm was required by its own policies to consider implementation of such a plan *when the complaint was first filed*, more than a year before the plan was finally devised.

[196] Tr. (Davis) 738-39; (Snow) 1057; JX-5, at 21.

[197] JX-9; JX-10. Lyle Davis testified that the head count list was a draft, not intended to be a finished product. Tr. (Davis) 741-47. But draft or not, the documents were not accurate. And Wilson-Davis offered the head count lists as joint exhibits at the hearing to "[e]stablish[] Firm designated supervisors." *See* Joint Exhibit List. So the Firm had no written records that accurately reflected its supervisory and reporting structure, as required by its WSPs. At the hearing, the Firm produced an undated organizational chart. RX-52. But there was no evidence that the chart was retained as a regular practice as a part of Firm records. Tr. (Snow) 1189. Nor was there proof that it was referred to or referenced by the Firm's WSPs. Tr. (Snow) 1191. There was also no showing that it was made available as a reference to individuals working for the Firm.

[198] Tr. (Snow) 1055-58.

[199] Tr. (Snow) 1138-39.

[200] Tr. (Snow) 1138-39.

[201] Tr. (Snow) 1187.

supervisory roles with regard to its employees or its registered principals, who generally claimed to have supervised each other.[202]

4. Wilson-Davis and Snow Failed to Supervise Instant Message Communications for the Firm's Registered Representatives

The Firm and Snow also improperly delegated the review of instant messages by its representatives to an unregistered person at the Firm.[203] Between 2011 and 2014, Snow was responsible for reviewing instant messages at the Firm, but delegated his responsibility to the Firm's information technology ("IT") specialist.[204] The IT specialist was provided vague guidance as to how to conduct his review, and Snow was unaware of what parameters the specialist used to review the materials.[205] Snow acknowledges that his delegation of his review to an unregistered person was done "in … error."[206]

B. Conclusions of Law

NASD Rule 3010(a) requires firms to "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), these systems must be documented in the firm's WSPs. The procedures also must be tailored to the business lines in which the firm engages.[207] In addition, the procedures must set out mechanisms for ensuring compliance and for detecting violations, not merely set out what conduct is prohibited.[208]

We find that Wilson-Davis and Snow failed to establish and maintain reasonable supervisory systems and WSPs in connection with the Firm's use of the market maker exemption to the borrow requirement of Regulation SHO. The Firm lacked reasonable supervisory systems, including WSPs, to (1) identify facts and considerations relevant to the bona-fide market maker exception to the locate requirement; (2) ensure compliance with the requirements necessary to invoke the exception; and (3) document any reviews performed or monitor compliance. Snow was responsible for establishing and maintaining adequate supervisory systems and procedures, including systems and procedures relating to the Firm's Regulation SHO compliance and the bona-fide market maker exemption. He did not do so. And Barkley was the principal directly

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[202] Tr. (Moore) 963, 979.

[203] Ans. ¶ 82.

[204] Tr. (Snow) 1078-79.

[205] Tr. (Snow) 1079-80.

[206] Tr. (Snow) 1079.

[207] *See* NASD Membership and Registration Rule Interpretive Material ("IM") 3010-1, http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=4396.

[208] *See Gary E. Bryant*, 51 S.E.C. 463, 471 (1993); *John A. Chepak*, 54 S.E.C. 502, 506 (2000); *A.S. Goldmen & Co., Inc.,* 55 S.E.C. 147, 166 (2001).

responsible for supervising the Firm's trading desk and market making activity. In that capacity, he was responsible for ensuring that Kerrigone was acting as a bona-fide market maker or otherwise complying with Regulation SHO. Yet he failed to adequately supervise Kerrigone's trading activity in each of the stocks at issue to ensure that Wilson-Davis was acting as a bona-fide market maker. As a result of these supervisory failures, Wilson-Davis, Snow, and Barkley violated NASD Rule 3010(a) and FINRA Rule 2010.

We also find that Wilson-Davis and Snow failed to adequately consider a broker for heightened supervision after a complaint was filed against the Firm, Paul Davis, and the broker, and document any decisions made in that regard. And when a a heightened supervision plan was finally devised, it was unreasonable and inadequate. These failures by Snow and the Firm also constituted a failure to reasonably supervise, in violation of NASD Rule 3010(a) and FINRA Rule 2010.

Further, NASD Rule 3010(a)(5) specifically required "[t]he assignment of each registered person to an appropriately registered representative(s) and/or principal(s) who shall be responsible for supervising that person's activities." Notice To Members 99-45 further explained that:

> [t]he requirement that every registered person be assigned at least one supervisor serves several functions. It provides the person being supervised with a clear line of authority and specifically identifies for the supervisor the persons for which he or she has responsibility. In addition, this requirement recognizes the obvious fact that a supervisory system reasonably designed to achieve compliance with the securities laws does not permit persons to supervise themselves.

For the reasons explained above, Wilson-Davis, acting through Snow, failed to clearly assign each registered person to an appropriately registered representative and/or principal responsible for supervising that individual's activities, as required by NASD Rule 3010(a)(5). As a result, Wilson-Davis and Snow failed to implement a reasonable supervisory system to supervise the registered representatives and principals at the Firm during the period now at issue.

Finally, we find that Wilson-Davis and Snow violated NASD Rule 3010 and FINRA Rule 2010 by failing to reasonably supervise instant message communications for the Firm's registered representatives.

V. Wilson-Davis Failed to Implement Adequate AML Policies and Procedures

A. Findings of Fact

The third cause of action alleges that during the period of 2011 through 2014, the Firm also failed to satisfy its obligations to prevent money laundering. Snow, the Firm's AML Compliance Officer, was responsible for ensuring that Wilson-Davis' AML program was

adequately tailored to the particular risks of its business.[209] The Firm's AML program required Snow to implement policies and procedures adequate to detect red flags indicative of suspicious activity, investigate those red flags, and report suspicious activity.[210]

Wilson-Davis generated monthly exception reports to identify customers who maintained multiple accounts,[211] and to identify whether securities were being transferred between customer accounts.[212] But by and large, the Firm did not use reports to identify suspicious trading—the Firm instead relied upon its traders to identify suspicious activity and raise it with their superiors for further investigation.[213]

Wilson-Davis failed to provide adequate AML training to its traders and Firm employees necessary to ensure that they were able to identify suspicious activity. The AML trainings provided by Snow on an annual basis gave no indication of red flags related to matched orders, wash sales, or the particular concerns of the Firm's penny stock liquidation business.[214] The Firm's WSPs include examples of red flags indicative of potential money laundering, but provided little or no guidance as to how to detect potentially manipulative or suspicious trading.[215]

When Wilson-Davis purchased its WSPs, they included a generalized template of AML "red flags," but the Firm never made any effort to tailor the boilerplate language to the specific issues presented by its business.[216] For example, according to the WSPs:

> [t]he customer engages in suspicious activity involving the practice of depositing penny stocks, liquidates them, and wires proceeds. A request to liquidate shares may also represent engaging in an unregistered distribution of penny stocks which may also be a red flag.[217]

Yet activity of this sort was at the core of Wilson-Davis' business model.[218] Despite WSPs that identify the Firm's primary business as a "red flag," Wilson-Davis never identified any particular circumstances that it might encounter in the course of its business that might raise

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[209] Ans. ¶ 86.

[210] Ans. ¶ 87.

[211] Tr. (Snow) 1153-55; RX-9.

[212] Tr. (Snow) 1156-57; RX-11.

[213] Tr. (Snow) 1157-58.

[214] Tr. (Snow) 1072-77.

[215] Tr. (Moore) 914-16; JX-4, at 45-47.

[216] Tr. (Snow) 1061-62.

[217] JX-4, at 46.

[218] Tr. (Snow) 1063-65.

heightened suspicion.[219] There are no procedures that would lead traders to look for, for instance, promotional activity at the time penny stock shares are being liquidated.[220] The procedures identified no red flags associated with matched orders, wash sales, or prearranged trading.[221]

The lack of appropriate AML procedures at Wilson-Davis is illustrated by trading of a number of Firm customer accounts in the stock of Valley High Mining Company ("VHMC"). There was little or no trading in the stock until April 2012.[222] Snow was contacted by the Chief Executive Officer of the company and asked if Wilson-Davis would make a market for the company.[223] Snow forwarded the request to the Firm's trading department, who then began making a market in the stock.[224]

The first day of trading was April 10, 2012, when one Firm customer account bought 2,500 shares of VHMC, from another Wilson-Davis customer account at a price of $0.40 per share.[225] That price was more than 60 percent higher than the previous trade in the stock, and took place at 3:59 p.m., less than one minute before the market close.[226] The Firm's procedures identify "marking the close" as a "prohibited activity" involving "[o]ne or more trades … executed or falsely reported at or near the opening or close of trading with the intention of affecting the opening or closing price of the security."[227] But the facts suggest the practices were not identified in the Firm's procedures as an AML red flag,[228] nor incorporated into the Firm's training, and were not identified by anyone at Wilson-Davis in the case of VHMC.

The next day, Lyle Davis reviewed a report that detailed all customer trades at the Firm.[229] According to Davis, he reviewed the report to look for cross trades, wash sales, or other out of the ordinary transactions. The VHMC cross trade between Firm customers was apparently reviewed by Davis, who hand-wrote the word "okay" next to the trade.[230] According to Davis, it

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[219] Tr. (Snow) 1065-67; (Renza) 1431. Not surprisingly, the Firm did nothing to test the effectiveness of identifying such generic "red flags." Tr. (Renza) 1428-29.

[220] Tr. (Snow) 1067-68.

[221] Tr. (Moore) 916.

[222] Tr. (Kassar) 242-43.

[223] Tr. (Snow) 1110-12.

[224] Tr. (Snow) 1110-12.

[225] Tr. (Kassar) 261-62; (Evans) 1336-38.

[226] Tr. (Kassar) 261-62; (Evans) 1336-38.

[227] Tr. (Snow) 1113-14; JX-5, at 404.

[228] *See Dep't of Enforcement v. Lek Sec. Corp.*, No. 2009020941801, 2016 FINRA Discip. LEXIS 63, at *28 (NAC Oct. 11, 2016) ("To be considered as a component of a firm's AML program, that firm's warnings to its employees about manipulative trading practices must be specifically presented in the AML context.").

[229] Tr. (Davis) 809-10.

[230] Tr. (Davis) 809-10; RX-8.

was his practice to discuss questionable trades with the broker, but he never documented any review or inquiry he performed.[231] There was no evidence that anyone at the Firm ever discussed with its customers the facts surrounding the trade.

The Firm continued to trade in VHMC for the next several months.[232] During this period, shares traded by Wilson-Davis customers constituted over 70 percent of the total volume of trading in the stock.[233] Throughout the period, the price of the stock rose to just under $5 per share.[234] Based on this price, VHMC—a shell company that did no business[235]—had a market capitalization of more than $75 million.[236] Wilson-Davis offered evidence that much of the trading was done by long-time customers known to the Firm, but there was no evidence that anyone at the Firm ever identified the trading as suspicious or asked its customers any questions about their trading.[237] And although there was publicly available evidence that several of these customers had familial and other connections to the individual who was the sole director of VHMC, no one at Wilson-Davis ever looked for this evidence or became aware of any connections.[238]

None of the significant percentage of trading volume emanating from the Firm, the apparent market dominance of Firm customers, or dramatic and unexplained price spikes raised any red flags at Wilson-Davis.[239] Neither the trader, his supervisor, Lyle Davis, nor anyone else at the Firm ever elevated any AML red flags for further investigation in connection with the trading activity.[240]

B. Conclusions of Law

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").[241] Title III of the PATRIOT Act imposes added obligations on broker-dealers under AML provisions and amendments to the Bank Secrecy Act requirements.[242] In April 2002, the SEC

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[231] Tr. (Davis) 811-13, 816-17.

[232] CX-23.

[233] Tr. (Kassar) 253-54; CX-23.

[234] Tr. (Kassar) 263-64.

[235] Tr. (Kassar) 257-58; CX-24.

[236] Tr. (Kassar) 263-64.

[237] Tr. (Boyack) 1518; (Korkishko) 1539-40.

[238] Tr. (Moore) 926-31.

[239] Tr. (Snow) 1116-23.

[240] Tr. (Snow) 1112-13.

[241] Pub. L. No. 107-56, 115 Stat. 272 (2001).

[242] *See* 31 U.S.C. §§ 5311 et seq.

approved NASD Rule 3011, now FINRA Rule 3310, that sets forth the minimum standards required for each FINRA member firm's AML compliance program.[243] FINRA Rule 3310(b) requires that AML programs, at a minimum, "establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations."[244]

As early as 2002, FINRA emphasized to its members that to be effective, AML procedures "must reflect the firm's business model and customer base."[245] Members were advised that "in developing an appropriate AML 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."[246] "AML requirements encompass the detection and reporting of a broad range of unlawful financial activities … including market manipulation, prearranged or other noncompetitive trading, and wash or other fictitious trading."[247]

Wilson-Davis argues that the Firm employed robust AML policies, including policies adequate to identify wash and cross trades, and high volume trading.[248] But the only evidence of any review undertaken to identify cross trades was Lyle Davis' review of a daily customer trade blotter. While the report appears to have permitted Davis to consider the possibility of a cross trade in the case of VHMC, there is no documented evidence that he did anything to further investigate. Generating a report of a list of trades is not adequate where "the Firm did not institute any particular procedures for investigating the items identified in the exception reports or for determining whether to file a [Suspicious Activity Report]."[249] And there was no showing of any reports or analysis that permitted Wilson-Davis to analyze trading across days, assess the magnitude or volume of trading, or account for whether its customers were dominating the market for the $75 million shell company that did no business. These were factors the firm knew it was important to monitor in their line of business.[250]

Wilson-Davis also disputes that the questioned trading was improper, contending that "[n]obody was being manipulated" and "the historical trading information demonstrate that 'matched trades' or pre-arranged trading [n]ever occurred."[251] Yet the National Adjudicatory

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[243] *See* Order Approving Proposed Rule Changes Relating to Anti-Money Laundering Compliance Programs, Exchange Act Release No. 45798, 2002 SEC LEXIS 1047 (Apr. 22, 2002).

[244] FINRA Rule 3310(b).

[245] NASD Notice to Members 02-21, at 4 (Apr. 2002), http://www.finra.org/industry/notices/02-21.

[246] *Id.*

[247] *Dep't of Enforcement v. Domestic Sec. Inc.*, No. 2005001819101, 2008 FINRA Discip. LEXIS 44, at *16 (NAC Oct. 2, 2008).

[248] Respondents' Prehearing Brief at 10.

[249] *Dep't of Enforcement v. Lek Sec. Corp.*, 2016 FINRA Discip. LEXIS 63, at *22-23.

[250] Tr. (Snow) 1068-70; (Moore) 877-79; JX-22 (Davis OTR).

[251] Respondents' Prehearing Brief at 15.

Council has rejected this sort of "no harm, no foul" defense to inadequate AML procedures. "[A] determination that a respondent has violated FINRA's supervisory rules is not dependent on a finding of an underling violation."[252] Wilson-Davis' procedures were inadequate to detect suspicious trading that went on for *months* while the Firm did nothing to investigate.

We find that Wilson-Davis failed to establish and implement reasonable AML policies and procedures to detect, investigate, and report, where appropriate, suspicious trading activity. Snow was responsible for ensuring that the Firm's AML program was adequately tailored to the risks posed by Wilson-Davis' business in order to mitigate those risks. Wilson-Davis and Snow failed to establish or maintain AML policies and procedures tailored to the risks posed by its penny stock business.

As a result of these failures, Snow failed to detect and investigate a number of red flags indicative of potentially suspicious trading activity in VHMC. This enabled the suspicious activity to continue for an extended period without adequate review to assess the legitimacy of the trading. Also, Snow failed to provide adequate AML training to enable employees to detect potentially suspicious trading activity, including the risks and red flags associated with penny stock activity. Employees were not trained on specific steps to be taken in order to monitor for or detect any potentially suspicious trading activity. For these reasons, Wilson-Davis and Snow violated FINRA Rules 3310(e) and 2010.

VI. Sanctions

A. Short Sale Violations

We turn first to the FINRA Sanction Guidelines ("Guidelines") for short sale violations.[253] The Guidelines recommend a scale of fines: $5,000 to $15,000 for a "first action," $10,000 to $73,500 for a "second action," and $10,000 to $146,000 for "subsequent actions." But the Guidelines direct us to consider fines in greater amounts where the violations are egregious, involve "a pattern or patterns of misconduct," "took place over an extended period of time," or "can be quantified by number or percentage."[254] And in egregious cases, adjudicators may "consider suspending the firm with respect to any or all relevant activities or functions or suspending the responsible individual … for up to two years or expelling the firm or barring the responsible individual."[255]

In determining the appropriate sanction for the short sale violations at issue, we weighed these considerations along with the "principal considerations" provided by the Guidelines. On

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[252] *Dep't of Enforcement v. Lek Sec. Corp.*, 2016 FINRA Discip. LEXIS 63, at *35-36 (rejecting the argument that respondent's AML policies and procedures were effective because "there was not a single instance of money laundering or a manipulative transaction subject to this action").

[253] FINRA Sanction Guidelines at 65 (2017), http://www.finra.org/industry/sanction-guidelines.pdf.

[254] Guidelines at 65, n. 1.

[255] Guidelines at 65.

balance, we find that Wilson-Davis' conduct was egregious. The Firm abused its access to markets and market maker status to engage in speculative trading in an effort to profit from what it believed to be market manipulation, at the expense of market investors.[256] The Firm's misconduct involved multiple violations, spanning at least 122 trades over a period of years.[257] We believe that Wilson-Davis acted in at least reckless disregard for their obligations associated with legitimate market making activity as it enriched itself through its misconduct.[258]

In light of the Firm's misconduct, we find it appropriate to fine the Firm $10,000 for each of its improper short sales, for a total of $1,220,000. Wilson-Davis' egregious conduct involved a substantial number of trades (122) and a significant amount of money.[259] We do find mitigating, however, that the Firm was also disciplined by the SEC in its action.[260] Although that action involved different securities than the ones at issue here, it addressed substantially similar improper short selling activity by Wilson-Davis during the same time period.[261] In light of the $75,000 penalty imposed in that case, we reduce the fine that we impose by $50,000, to $1,170,000.[262] Having considered Wilson-Davis' remaining arguments, we find no other mitigating factors.

In addition, Wilson-Davis' trading was profitable. Although the Firm lost money on its trading in LOTE, its trading in each of the three other securities generated profits of $129,060.[263] Where a respondent "obtained a financial benefit from [the] misconduct, … Adjudicators may require the disgorgement of such ill-gotten gain by fining away the amount of some or all of the financial benefit derived, directly or indirectly" by the respondent where appropriate to

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[256] Guidelines at 7, Principal Consideration 11 (directing consideration to whether a respondent's misconduct resulted directly or indirectly to other market participants); Guidelines at 8, Principal Consideration 16 (whether the respondent's misconduct "resulted in the potential for the respondent's monetary or other gain").

[257] Guidelines at 7, Principal Consideration 8 (whether the respondent engaged in "numerous acts and/or a pattern of misconduct"); Principal Consideration No. 9 (whether the respondent "engaged in the misconduct over an extended period of time"); Guidelines at 8, Principal Consideration No. 17 (directing consideration of "[t]he number, size and character of the transactions at issue").

[258] Guidelines at 8, Principal Consideration 13 (whether the respondent's misconduct "was the result of an intentional act, recklessness or negligence")

[259] Guidelines at 8, Principal Consideration 17 ("The number, size and character of the transactions at issue.").

[260] Guidelines at 5, General Principal 7 ("Adjudicators should consider sanctions previously imposed by other regulators.").

[261] CX-40.

[262] Although a unitary penalty was imposed in the SEC case, that matter involved both the improper short selling activity at issue here as well as the Firm's unrelated violations of the market access rule. CX-40. Accordingly, we take into account only a portion of the penalty imposed in the SEC action. Because the disgorgement paid by Wilson-Davis in that case involved different securities than those at issue here, we give no weight to that payment.

[263] Guidelines at 8, Principal Consideration 16 (whether the respondent's misconduct "resulted in the potential for respondent's monetary or other gain").

remediate misconduct.[264] Disgorgement serves to remedy securities law violations by depriving violators of the fruits of their illegal conduct.[265] The amount to be disgorged need not be precise, but it should be a reasonable approximation of the wrongdoer's ill-gotten gains.[266]

Generally, "requiring respondents to disgorge the profits from their short sales is appropriate."[267] However, Wilson-Davis contends that its did not receive all of those profits, as "the monetary gain for the Firm is limited to the 30-40 percent of trading profits it received from Mr. Kerrigone's trading on three of the four stocks at issue."[268] We agree that to serve its remedial purpose, disgorgment should be limited to those profits Wilson-Davis actually received.[269] And we find by the preponderance of the evidence that the Firm's share was only 40 percent of the total profits.[270] Accordingly, we will impose disgorgement in the amount of $51,624, reflecting 40 percent of Wilson-Davis' trading profits on CNCT, PMEA, and PVTA. Wilson-Davis shall also pay prejudgment interest on this amount from April 29, 2013, the date of its last short sale in the relevant securities.[271]

B. Deficient AML and Supervisory Procedures and Supervision

For the supervisory and AML violations, we consider the Guidelines provision for systematic supervisory failures. Application of this provision is warranted where "a supervisory failure is significant and is widespread or occurs over an extended period of time."[272] Systematic supervisory failures, as reflected by the conduct here, "involve supervisory systems that have both ineffectively designed procedures and procedures that are not implemented."[273] The Guidelines recommend a fine of $5,000 to $73,000 and a suspension for responsible individuals,

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[264] Guidelines at 5, General Principle 6. "Financial benefit" is defined to include any "revenues, profits, gains, compensation, income, fees, other remuneration, or other benefits the respondent received directly or indirectly, as a result of the misconduct." *Id.; Dep't of Enforcement v. Evans*, No. 2006005977901, 2011 FINRA Discip. LEXIS 36, at *40 n.42 (NAC Oct. 3, 2011) ("We may order disgorgement after a reasonable approximation of a respondent's unlawful profits.").

[265] *Dep't of Enforcement v. Springsteen-Abbott*, No. 2011025675501, 2016 FINRA Discip. LEXIS 39, at *38 n.26 (NAC Aug. 23, 2016), citing *Michael David Sweeney*, 50 S.E.C. 761, 768 (1991).

[266] *SEC v. Hughes Capital Corp*., 917 F. Supp. 1080, 1085 (D.N.J. 1996), *aff'd*, 124 F.3d 449 (3d Cir. 1997); *The Dratel Group, Inc*., Exchange Act Release No. 77396, 2016 SEC LEXIS 1035, at *73 (Mar. 17, 2016); *Evans*, 2011 FINRA Discip. LEXIS 36, at *40 n.42; *Laurie Jones Canady*, 54 S.E.C. 65, 84 (1999).

[267] *Legacy Trading*, 2010 FINRA Discip. LEXIS 20, at *49.

[268] Respondent's Prehearing Brief, at 26.

[269] *Ralph Calabro*, Exchange Act Release No. 75076, 2015 SEC LEXIS 2175, at *187-88 (May 29, 2015) (limiting broker's disgogement to his percentage of payout ratio).

[270] CX-27.

[271] CX-16, at 4. *See also Dep't of Enforcement v. Davidofsky*, No. 2008015934801, 2013 FINRA Discip. LEXIS 7, at *43 (NAC Apr. 26, 2013) (applying prejudgment interest to order of disgorgement).

[272] Guidelines at 105.

[273] Guidelines at 105.

and a fine of $10,000 to $292,000 for the responsible Firm. Where aggravating factors predominate, the Guidelines recommend a higher fine along with suspension of the responsible individual(s) for up to two years or a bar and a suspension of the firm for up to two years or expulsion.[274]

The Guidelines recommend that in addition to the Principal Considerations in Determining Sanctions,[275] our consideration should focus on (1) whether supervisory deficiencies allowed violative conduct to occur or to escape detection; (2) the extent to which the deficiencies were not corrected or addressed once identified; (3) whether the firm appropriately allocated its resources to prevent or detect the supervisory failure; (4) the extent to which the failures impacted customers or markets; and (5) the magnitude of the transactions not adequately supervised.[276]

In evaluating the conduct at issue in light of the Guidelines, we determined to aggregate the respondents' supervisory and AML violations because the violations "all resulted from the broad and systematic supervisory failures at the Firm."[277] On balance, we find that aggravating factors predominate our analysis and that the Respondents' violations were egregious.

We note the breadth of the supervisory deficiencies at Wilson-Davis. The shortcomings touched multiple corners of its business. It relied on the market maker exemption as a cornerstone of its market making business, but made no effort to design procedures adequate to ensure that it was acting in compliance with the exemption. It took no meaningful steps to apply adequate supervision to one of its brokers sued by its regulator for selling unregistered securities, and allowed that broker to proceed with business as usual. It knew that its penny stock business was a high risk area subject to trading abuses, but took inadequate steps to ensure that the Firm met its responsibilities to address those risks by identifying red flags it encountered. It even failed to clearly articulate to its personnel *who* was supervising them, much less apply adequate supervision.

We find that Wilson-Davis, Barkley and Snow's supervisory failures in connection to Kerrigone's market making activity were aggravated in that their failures permitted "violative conduct to occur or to escape detection."[278] Given the substantial impact that the trading had on the Firm's business, the failure to adapt and implement procedures necessary to ensure compliance reflected a failure to allocate "resources to prevent or detect the supervisory failure,

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[274] Guidelines at 105. *See also* Guidelines at 107 (deficient written supervisory procedures).

[275] Guidelines at 7.

[276] Guidelines at 105.

[277] *Dep't of Enforcement v. Hedge Fund Capital Partners, LLC*, No. 2006004122402, 2012 FINRA Discip. LEXIS 42, at *97 (NAC May 1, 2012); *Dep't of Enforcement v. Meyers Associates, LP.*, No. 2013035533701, 2017 FINRA Discip. LEXIS 47, at *40-41 (NAC Dec. 22, 2017) (imposing unitary sanction for supervisory violations and inadequate AML policies and procedures); *Dep't of Enforcement v. North Woodward Fin. Corp.*, No. 2011028502101, 2016 FINRA Discip. LEXIS 35, at *48 n.43 (NAC July 19, 2016) (aggregating or "batching" violations of supervisory requirements and AML requirements for purposes of imposing sanctions).

[278] Guidelines at 105, Principal Consideration 1.

taking into account the potential impact on customers or markets."[279] And given the substantial volume of the transactions, the "number and dollar value of the transactions not adequately supervised as a result of the deficiencies" is also aggravating.[280]

We also find that Wilson-Davis and Snow's failure to timely and appropriately devise a plan of heightened supervision over one of the Firm's brokers was an aggravated supervisory failure. It reflects a failure "to timely correct or address deficiencies once identified, [or] respond reasonably to prior warnings from FINRA."[281] For a Firm to take no remedial steps—failing to even *consider* heightened supervision of the broker until ordered to do so—when presented with the possibility that one of its brokers is engaged in unlawful conduct is not acceptable, and reflects a failure to properly allocate Firm resources.[282]

Wilson-Davis and Snow's failure to ensure that its employees were provided a clear supervisory chain of command and failure to adequately supervise the Firm's instant messages provide context to their failure to take seriously the Firm's AML obligations and their responsibility to diligently identify and report red flags that might be indicative of unlawful behavior. The Respondents are well aware that their penny stock business entails substantial risks and potential for abuse. But Respondents took little responsibility to act as guardians of the market and do their part to ensure that they did not facilitate misconduct. Consequently, their failures posed a significant risk of harm to investors.[283]

Wilson-Davis disputes our conclusions, pointing to the reforms it made in its stock deposit due diligence process. The Firm updated deficient procedures in that area, including requiring more robust documentation, increased involvement of counsel, extended investigation of third parties and the use of public databases, as well as other reforms.[284] But the weight of these reforms is substantially diminished by the fact that they coincided with the earlier disciplinary action against the Firm where Wilson-Davis was required, as a condition of its settlement, to certify that it had reviewed and updated procedures in the area of its stock deposits to a level adequate to ensure compliance with FINRA rules and the federal securities laws.[285] While the Firm appears to have updated these procedures as required in the prior action, there was no showing that it undertook a similar review across other areas significant to its business.[286]

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[279] Guidelines at 105, Principal Consideration 3.

[280] Guidelines at 105, Principal Consideration 5.

[281] Guidelines at 105, Principal Consideration 2.

[282] Guidelines at 105, Principal Consideration 3; Principal Consideration 2 (whether the firm "failed to respond reasonably to prior warnings from FINRA or another regulator").

[283] Guidelines at 105, Principal Consideration 4.

[284] Respondents' Prehearing Brief at 12.

[285] CX-43.

[286] Guidelines at 105, Principal Consideration 2 (whether the firm "failed to respond reasonably to prior warnings from FINRA or another regulator").

We find mitigating, as to Barkley, the sanction imposed against him in the SEC action for his failure to supervise Regulation SHO violations, and reduce the fine we would otherwise impose against him by $25,000.[287] We find no other mitigating factors. Accordingly, and in light of the breadth and scope of Respondents' supervisory and AML failures, we impose the following sanctions: (1) Wilson-Davis is fined $300,000; (2) Barkley is fined $115,000, and suspended for one year in all capacities; and (3) Snow is fined $140,000, and suspended for one year in all capacities.[288] Because the systematic violations of supervisory and AML processes in this case reflected a lack of appreciation and understanding of the obligations incumbent upon registered persons, we will also require Respondents Snow and Barkley to requalify by examination before serving in any registered capacity in the securities industry.

VII. Order

For its unlawful short sales in violation of Rule 203 of Regulation SHO, Wilson-Davis is fined $1,170,000. For its failures to supervise and implement adequate AML procedures in violation of NASD Conduct Rule 3010 and FINRA Rules 3310 and 2010, Wilson-Davis is fined an additional $300,000. Accordingly, the total fine imposed against Wilson-Davis is $1,470,000. We also impose disgorgement of $51,624, plus prejudgment interest.[289]

For their failures to supervise and implement adequate AML procedures in violation of NASD Conduct Rule 3010 and FINRA Rules 3310 and 2010, Respondents Byron Barkley and James Snow are fined $115,000 and $140,000, respectively, and both are suspended for one year in all capacities and ordered to requalify by examination before serving in any registered capacity in the securities industry.

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[287] Guidelines at 5, General Principal No. 7 ("Adjudicators should consider sanctions previously imposed by other regulators"); CX-40 (imposing unitary $50,000 fine for failure to supervise both the improper short selling activity as well as the Firm's unrelated violations of the market access rule).

[288] As discussed above, we took into consideration the Firm's prior disciplinary history in concluding that greater sanctions were needed to prevent future misconduct and to protect the investing public.

[289] Interest shall accrue from April 29, 2013, 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.

Respondents are ordered jointly and severally to pay costs in the amount of $13,443.39, which includes a $750 administrative fee and the cost of the hearing transcript, $12,693.39. If this decision becomes FINRA's final disciplinary action, Barkley and Snow's suspensions will begin with the opening of business on April 16, 2018. The fines and costs shall be payable on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final disciplinary action in this matter.[290]

SO ORDERED.

David Williams
Hearing Officer
For the Extended Hearing Panel

Copies to:

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[290] The Extended Hearing Panel considered and rejected without discussion all other arguments of the parties.