FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. C.L. KING & ASSOCIATES, INC., (CRD No. 6183), and GREGG ALAN MILLER (CRD No. 4163500), Respondents.	Disciplinary Proceeding No. 2014040476901 Hearing Officer—MJD **EXTENDED HEARING PANEL DECISION** September 6, 2017

Respondent Firm negligently made material misrepresentations and failed to disclose all material facts to issuers in connection with its redemptions of debt securities on behalf of a customer, in contravention of Sections 17(a)(2) and (3) of the Securities Act of 1933, which constitutes a violation of FINRA Rule 2010.

In connection with its debt securities business, the Firm failed to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to ensure that the Firm complied with Section 17(a) of the Securities Act.

The Firm and Respondent Gregg Alan Miller failed to establish and implement an Anti-Money Laundering program reasonably designed to cause the detection and reporting of suspicious transactions under the Bank Secrecy Act related to the liquidation of billions of shares of low-priced penny stocks by two Firm customers.

Respondents failed to conduct adequate due diligence and respond to red flags indicative of potential money laundering activity by a Firm customer, a foreign financial institution.

The Firm is censured and fined $750,000. Miller is suspended in a principal capacity for six months and fined $20,000. Respondents also are ordered to pay costs, for which they are jointly and severally liable.

Appearances

For the Complainant: Paul D. Taberner, Esq., and John Luburic, Esq., Department of Enforcement, Financial Industry Regulatory Authority.

For the Respondents: Christopher F. Robertson, Esq., William L. Prickett, Esq., and Katherine R. Moskop, Esq., Seyfarth Shaw LLP.

DECISION

I. Introduction

The Department of Enforcement filed a four-cause Complaint against Respondents C.L. King & Associates, Inc. (the "Firm" or "C.L. King") and the Firm's Anti-Money Laundering Compliance Officer, Gregg Alan Miller ("Miller"). The first two causes of action relate to the Firm's negligent misrepresentations and omissions in connection with its debt securities business. The last two causes relate to the Firm's anti-money laundering ("AML") obligations in connection with its penny stock business.

This case stems from misstatements and omissions that the Firm made to issuers of debt securities when the Firm took on the business of one of its new customers, Donald F. "Jay" Lathen. Lathen and his hedge fund, Eden Arc Capital Management LLC ("Eden Arc"), pursued an investment strategy in which they recruited terminally ill persons ("Participants") to open brokerage accounts with Lathen as joint tenants with rights of survivorship ("JTWROS"). Eden Arc then used the joint accounts to purchase at a discount corporate debt securities that contained a survivor option, or death put ("survivor bonds"). The death put feature allowed Lathen, as the account's survivor, to redeem—through C.L. King—the investments for the full principal amount before maturity upon the death of a Participant. Enforcement alleges that C.L. King had an obligation to disclose to issuers during the redemption process that terminally ill Participants were not in fact beneficial owners of the survivor bonds because Eden Arc required them to sign side agreements in which they gave up their ownership rights to the assets held in the accounts with Lathen.

Cause one charges C.L. King with violating Sections 17(a)(2) and (3) of the Securities Act of 1933 ("Securities Act"), which constitutes a violation of FINRA Rule 2010, by negligently making material misrepresentations and omissions to issuers of survivor bonds. Cause one also alleges, in the alternative, that the Firm's conduct constitutes an independent violation of FINRA Rule 2010.

Cause two charges C.L. King with violating NASD Rule 3010 and FINRA Rules 3110 and 2010 by failing to establish and maintain a reasonable supervisory system, including written supervisory procedures, to address its handling of redemptions of the survivor bonds by Lathen and Eden Arc after the death of a Participant.

Separate from the Firm's debt securities business, the Firm also sold penny stocks on behalf of two customers. From 2009 to 2014, the two customers generated proceeds of

$19 million by selling billions of shares in penny stocks. A bank based in the Principality of Liechtenstein ("PL Bank") sold 41 million shares of 40 penny stocks generating proceeds of $4.87 million. From 2012 to 2013, another client ("ABC Corp.") sold more than 11 billion shares in 138 penny stocks, generating proceeds of more than $14 million. The Firm and Miller, its AML Compliance Officer, had a duty to ensure that its AML program addressed the risks presented by its penny stock business.

Cause three alleges that the Firm and Miller failed to develop and implement an AML program reasonably designed to detect, investigate, and report potentially suspicious activity, as required by the Bank Secrecy Act. Specifically, cause three alleges that Respondents failed to (i) tailor the Firm's AML program to the risks presented by the penny stock liquidation business of the two customers, and (ii) detect and investigate red flags indicative of potentially suspicious activity. Cause three charges Respondents with violating NASD Rule 3011(a) and FINRA Rules 3310(a) and 2010.

Cause four also charges Respondents with AML-related violations. It alleges that Respondents failed to conduct adequate due diligence and respond to red flags regarding the trading activities of PL Bank, a foreign financial institution, as required by the Bank Secrecy Act, in violation of NASD Rule 3011(b) and FINRA Rules 3310(b) and 2010.

Respondents filed an Answer denying that the Firm's actions in connection with the survivor bond business violated any FINRA rules or Federal securities laws. Respondents also denied that they violated FINRA's AML rules in connection with the two customers' liquidations of penny stocks.

The Extended Hearing Panel[1] finds that Respondents committed the violations alleged in the Complaint. For its misconduct, the Firm is censured and fined $750,000. Miller is suspended for six months from associating with any FINRA member firm in a principal capacity and fined $20,000. He is also ordered to requalify as a principal upon reentry as a principal.

As noted above, this case involves two distinct topics—the Firm's redemption of survivor bonds and its sales of penny stocks.[2] Accordingly, after a discussion of the Respondents, the Panel addresses the two topics separately.

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[1] A ten-day hearing was held in Boston, Massachusetts, on February 6 – 17, 2017. In addition to Respondent Miller, the following persons testified: a Director in FINRA's Office of Fraud Detection and Market Intelligence; a FINRA investigator; Jeffrey Maier, a Senior Vice President who was in charge of the Firm's Prime Services Department; the Firm's Chief Operating Officer ("COO"), Chief Compliance Officer ("CCO"), Chief Financial Officer ("CFO"), Director of Operations, and General Counsel. Enforcement also called two senior officers of two issuers—SG Americas Securities, LLC and Gateway Bank of Florida—who sold survivor bonds that were redeemed by Eden Arc through the Firm.

The parties' expert witnesses testified on anti-money laundering issues. Arthur D. Middlemiss was Enforcement's AML expert; Evan Rosser testified on behalf of Respondents.

[2] The Complaint originated from a 2013 on-site examination conducted by FINRA staff during which the staff learned of the Firm's debt securities business with Lathen and its penny stock business with PL Bank and ABC

II. Respondents

A. C.L. King

C.L. King has been a FINRA member since May 1972.[3] The Firm is headquartered in Albany, New York, with branch offices in New York City and Boston. It provides investment research, equity and fixed income trading, corporate finance, prime brokerage, and clearing services to institutional clients and other broker-dealers. At all times relevant to the Complaint, the Firm had between approximately 70 and 105 registered persons.[4]

In 2007, to diversify its business and bring new clients to the Firm, C.L. King formed the Prime Services Department. In March 2007, the Firm hired Jeffrey Maier ("Maier") as Senior Vice President to manage the new department.[5] While the Firm's main offices were located in Albany, Maier and the Prime Services Department were located in New York City. Maier's job was to bring new clients to the Firm, including institutional clients, investment firms, investment advisers, introducing broker-dealers, and hedge funds.[6] Maier introduced about seven new customers to C.L. King, including the three customers involved in this action—Lathen (and Eden Arc), PL Bank, and ABC Corp.[7] Although Maier described his duties as a "relationship manager," he was also the account executive on each of the new accounts he brought to the Firm, including all of the joint accounts that Lathen opened with Participants.[8]

Once it became operational, the Prime Services Department accounted for less than ten percent of the Firm's total business.[9] C.L. King closed the Prime Services Department in late 2013.[10]

Corp. FINRA's Office of Fraud Detection and Market Intelligence also conducted investigations into the trading activity of some of the securities PL Bank and ABC Corp. sold at C.L. King specifically identified in the Complaint as raising red flags indicative of potential suspicious activity. Hearing Transcript ("Tr.") 67-68, 148, 164, 683-84, 688, 695-96; *see also, e.g.*, Complainant's Exhibit ("CX-_") 165; CX-166; CX-167; CX-168; CX-252; CX-281; CX-295.

[3] FINRA has jurisdiction over C.L. King pursuant to Article IV of FINRA's By-Laws because the Firm currently is a FINRA member and the Complaint charges the Firm with misconduct committed while it was a FINRA member. Complaint ("Compl.") ¶ 9; Respondents' Answer ("Ans.") ¶ 9; Joint Stipulations ("Stip.") ¶ 2.

[4] Compl. ¶ 8; Ans. ¶ 8; Stip. ¶ 1.

[5] Tr. 1935. Maier was a General Securities Representative and General Securities Principal. CX-343, at 2. He was the designated supervisor of the Prime Services Department and supervised the persons who worked in the department. Tr. 2046, 2056, 1844; Respondents' Exhibit ("RX-_") 161, at 19; RX-163, at 26-27.

[6] Tr. 1936-37.

[7] Tr. 1938.

[8] Tr. 1940, 2046.

[9] Tr. 339.

[10] The testimony at the hearing was that the Firm closed the Prime Services Department because the Firm's CCO had decided to retire and because of the regulatory inquiries into the survivor bond and penny stock business handled by the Prime Services Department. Tr. 500, 2170-71, 2572.

B. Gregg Alan Miller

Miller first became registered with FINRA through C.L. King as a General Securities Representative in February 2001. Since joining C.L. King, Miller has been registered as a General Securities Principal, Registered Options Principal, Equity Trader Limited Representative, Municipal Securities Principal, and Research Principal. At all times relevant to this matter, he was the Firm's Anti-Money Laundering Compliance Officer ("AML Compliance Officer") and Compliance Manager. Since February 1, 2015, he has been C.L. King's Chief Compliance Officer.[11]

III. The Firm's Violations Relating to Its Debt Securities Business

A. Findings of Fact

1. Description of a "Death Put"

A death put, also known as a survivor's option, is an optional redemption feature in a debt instrument that allows a beneficiary of a joint account to sell, or "put," the instrument back to the issuer upon the death of a joint account owner. This feature requires the issuer of the survivor bond to repay the full principal amount of the investment prior to maturity upon the death of a beneficial owner, so long as certain requirements are met. Although specific features vary among issuers, survivor bonds contain certain conditions that must be met before the investment can be redeemed. First, the decedent must be a beneficial owner of the investment at the time of death. Second, the party exercising the death put must be the survivor of the decedent.[12]

A debt security with a survivor option can be an attractive feature in family estate planning because it provides survivors, typically spouses, with the certainty that the investment will be worth at least par upon the death of a co-owner of the investment.

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[11] Compl. ¶ 10; Ans. ¶ 10; Stip. ¶ 3. FINRA has jurisdiction over Miller pursuant to Article V of FINRA's By-Laws because he is currently registered with FINRA and associated with a member firm and the Complaint charges him with misconduct committed while he was registered with FINRA and associated with a member firm. Compl. ¶ 11; Ans. ¶ 11; Stip. ¶ 4.

[12] Separate from a beneficial owner's right to exercise the death put in a survivor bond, issuers also typically impose a limit in their prospectuses on the dollar amount of the notes that they will agree to redeem under the survivor option in a given year. The purpose is to limit the issuer's risk exposure in the event it unexpectedly receives a large number of redemption requests in one year. For example, one of the issuers of survivor bonds, Societe Generale, limited the redemptions it would honor to two percent of the outstanding principal amount of a particular bond or note. It would honor redemptions on a first-come, first-served basis, so that if the company had already reached the two percent limit in one year, an investor seeking to redeem a survivor bond would be first in line the next year. However, in its discretion, Societe Generale has paid redemptions submitted after the two percent annual limit was reached. Provisions in survivor bonds also commonly require a minimum holding period before an owner can make a redemption request—typically, three or six months. Tr. 1512-13, 1539, 1544; CX-119, at 5-6.

2. The Firm's Debt Securities Clients: Lathen and Eden Arc

Lathen is the founder, President, and CEO of Eden Arc. Lathen represented to investors that he had 16 years of experience as an investment banker, primarily with Citigroup and Lehman Brothers. At Citigroup, he was a Managing Director and co-head of mergers and acquisitions in the U.S. energy sector.[13] Lathen conceived the survivor bond investment strategy and generated a business plan in 2009. Eden Arc entered into its first transaction in a survivor bond with a terminally ill Participant in July 2009, which Lathen personally funded. It redeemed its first investment in a survivor bond with a Participant in September 2009. In early March 2010, Eden Arc, which was headquartered in New York City, formed a referral relationship with a hospice in New Jersey. In September 2010, Eden Arc received capital from its first outside investor.[14]

The survivor bond market is well known and active. In 2010, there were billions of dollars in survivor bonds outstanding.[15] Large, established issuers sell survivor bonds, including, for example, AIG, Bank of America, Barclays Bank ("Barclays"), General Motors Acceptance Corporation (now Ally Financial), Goldman Sachs Bank USA ("Goldman Sachs Bank"), HSBC, Societe Generale, and Wells Fargo.[16] Lathen and Eden Arc purchased survivor bonds from each of these issuers, among many others.

In October 2012, the Securities Exchange Commission ("SEC") approved Eden Arc's application as a registered investment advisor.[17] After Eden Arc registered as an investment advisor, Lathen served as its Managing Member and Chief Compliance Officer.[18]

3. The Firm's Introduction to Lathen and Eden Arc

Maier, the manager of the Firm's Prime Services Department, was introduced to Lathen in 2011 by the accounting firm of one of C.L. King's largest clients.[19] Lathen was looking for

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[13] CX-1, at 4, 14.

[14] CX-1, at 5.

[15] RX-178, at 2.

[16] CX-77.

[17] CX-341, at 3.

[18] CX-341, at 5.

[19] In August 2016, the SEC issued an Order instituting administrative and cease-and-desist proceedings against Lathen and Eden Arc (including its general partner, Eden Arc Capital Advisors, LLC) in connection with Lathen's survivor bond business. The SEC alleged that respondents violated Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Section 17(a) of the Securities Act by falsely representing to issuers that Lathen was the owner of the survivor bonds so he could redeem them at par value before maturity. (The SEC also charged respondents with violating Section 203 of the Investment Advisers Act of 1940 and Section 9(b) of the Investment Company Act of 1940.) CX-334; *Donald F. Lathen, Jr.*, Exchange Act Release No. 78572, 2016 SEC LEXIS 3064 (Aug. 15, 2016).

On August 16, 2017, the SEC issued its Initial Decision in which it dismissed all of the charges against each of the Respondents. *Donald F. Lathen, Jr.*, Initial Decision Release No. 1161, 2017 SEC LEXIS 2509 (Aug. 16, 2017).

another broker-dealer to handle Eden Arc's business. Maier had never heard of Lathen or Eden Arc or the survivor bond investment strategy that Lathen had developed.[20] Maier and the Firm's then-CCO had several face-to-face meetings with Lathen in late 2011, during which Lathen described his investment strategy.

In early October 2011, Lathen emailed Maier a 20-page Eden Arc investment presentation and a list of Eden Arc's survivor bond holdings, which at the time totaled over $19 million.[21] Maier forwarded Lathen's email and attachments to the Firm's CCO and its CFO. Maier told them that Lathen was "running $16 million in margin debt versus the bonds. Normal leverage is 2:1 but he has gone to 3:1 at times."[22] He summarized the business, adding that Lathen had accounts at another broker-dealer that cleared through another clearing firm but Lathen was not happy with the high interest rate Eden Arc was paying on its debt balances. Maier told the CCO and CFO that Lathen would not trade much but the Firm would make money on extending margin to Eden Arc. Maier said, "It would take very little effort to handle this type of account."[23] In another email, Maier told them that the Firm's "earnings would come from the spread on the debt interest and the spread on the bonds that we buy for [Eden Arc] on the secondary market … we should be able to make $200,000 [per month] on the relationship when you add in everything."[24] C.L. King's role in Eden Arc's business was to provide back office services, clear its purchases and sales of survivor bonds, custody the securities, extend margin, and submit redemption requests to issuers after the death of a Participant.

4. Eden Arc's Survivor Bond Investment Strategy

Lathen's strategy was to take advantage of a death put feature in debt securities that carried a survivor option. Accordingly, Eden Arc invested only in survivor bonds. Lathen—not C.L. King—decided which survivor bonds Eden Arc purchased and sold for the joint accounts.

The SEC determined that Lathen and Eden Arc did not act with scienter because they did not intend to deceive, manipulate, or defraud issuers of survivor bonds and therefore did not violate Section 10(b) of the Exchange Act. *Lathen*, 2017 SEC LEXIS 2509, at *126-34. It also found that the Enforcement Division did not prove that Lathen and Eden Arc acted negligently, in violation of Sections 17(a)(2) and (3) of the Securities Act, because the Division's "presentation assumed scienter" and did not provide sufficient evidence that they were negligent. *Lathen*, 2017 SEC LEXIS 2509, at *134-35.

As set forth below, the Hearing Panel finds, based on the evidence presented at the hearing and the arguments of the parties, that Enforcement proved that C.L. King acted negligently in redeeming survivor bonds on behalf of Lathen, and accordingly violated Sections 17(a)(2) and (3) of the Securities Act, which constitutes a violation of FINRA Rule 2010.

[20] Tr. 1940, 2097.

[21] Tr. 2135-36; CX-1, at 1-26.

[22] CX-1, at 27.

[23] CX-1, at 27. The Firm expected that it would make money from charging Eden Arc margin interest. Tr. 952.

[24] CX-1, at 37. Maier also told the CCO and CFO that Lathen had ten joint accounts with between $500,000 and $1 million that he wanted to transfer to C.L. King. The Firm's CCO believed that margin interest would be the primary source of the Firm's income from Eden Arc's business. Tr. 461-62.

To take maximum advantage of such instruments, Lathen and Eden Arc identified terminally ill persons (the Participants) and offered to pay them $10,000 to open a securities account with Lathen as a JTWROS.[25] Under the strategy, when a Participant died, the assets held in the account passed to Lathen as the surviving joint tenant and he could redeem them from issuers at par, plus interest. Eden Arc's profit was the difference between the cost of purchasing a survivor bond—either in the initial offering or on the secondary market—and the proceeds derived from redeeming the investment from the issuer at par (or selling the investment in the market)[26] after the death of a Participant.

Ensuring that a co-owner of the investment was terminally ill increased the rate of return from the investment strategy. As Lathen put it in a presentation to investors, "The contingent [death] put feature shortens the duration of the investment, leading to high annualized returns, especially when the bond is purchased at a discount to par."[27] Stated differently, having a terminally ill person on the joint account significantly shortened the time within which a survivor bond could be redeemed at par, plus interest, after its purchase at a discount.[28]

C.L. King researched the survivor bond industry. Maier testified that a March 2010 Wall Street Journal article, cited by Eden Arc in its promotional materials, "gave [him] comfort" because it showed that other persons appeared to be using the same survivor bond investment strategy.[29] The Wall Street Journal article cited an attorney who believed that there was nothing in the prospectuses of survivor bonds that prohibited a stranger and a terminally ill person from buying a survivor bond. It also cited a representative from AIG, an issuer of survivor bonds, who claimed that the "bond's fine print doesn't prohibit such activity."[30] The article did not address the situation—such as exists here—where one owner limits by contract the other putative beneficial owner's rights to the bonds or assets in the joint account.

Lathen told C.L. King that Eden Arc's attorneys had reviewed the investment strategy before the business was launched and determined that it was legal.[31] C.L. King did not get a

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[25] To be eligible to participate in Eden Arc's business, a prospective Participant had to be enrolled in hospice care or have a life expectancy of less than six months as verified by a physician. An applicant also had to be over 18 years old and be mentally fit or have delegated a durable power of attorney to another person who could act on the applicant's behalf. Tr. 2141; CX-3.

[26] Eden Arc elected to sell approximately 100 survivor bonds on the open market instead of redeeming them from an issuer. *See, e.g.*, Tr. 84; CX-77.

[27] CX-1, at 5.

[28] C.L. King understood that Lathen's strategy was to redeem survivor bonds within three to six months after purchase. A survivor bond purchased at $96.00, for example, redeemed three months later at par (assuming the holding period was met) generated a 12 percent annual return. CX-121, at 2.

[29] Tr. 2204-05; CX-1, at 18; RX-178.

[30] Tr. 2206; RX-178.

[31] CX-1, at 17; Tr. 458-59.

separate legal opinion of its own about whether or not Lathen's strategy was legal.[32] Maier concluded that Lathen was providing terminally ill persons with a benefit because they "really needed money," and $10,000 was "very important to them at this stage of what they were going through."[33] He also concluded that Lathen was not misleading Participants about their role in his investment strategy.[34]

C.L. King agreed to handle Eden Arc's and Lathen's business. In early January 2012, Lathen opened his first joint account with a Participant at the Firm.[35]

5. Key Components of the Investment Strategy: The Participant Agreements and Limited Powers of Attorney

To execute their investment strategy, Eden Arc and Lathen required a Participant (or a Participant's representative or power of attorney) to sign a contract called a "Participant Agreement," which Lathen also signed. The Participant Agreement informed a Participant that the account would pursue an investment strategy "conceived and executed by" Lathen, with funding provided by Lathen or Eden Arc and its investors. A Participant acknowledged and agreed to open an account with Lathen that would be a JTWROS account and that the account would invest in instruments containing a survivor option that would be sold, or put, back to the issuer at par, plus interest.[36] A Participant had no responsibility for funding the joint account or the purchase of investments.

Eden Arc and Lathen used different versions of the Participant Agreement for accounts opened at C.L. King. Although the versions varied, they did not differ materially. The Participant Agreement limited the Participant's rights to the assets held in the joint account, as follows:

- A Participant permitted Lathen to transfer cash and securities out of the account without the Participant's prior consent and agreed to cooperate with Lathen to facilitate such transfers, if necessary.

- A Participant could not pledge, borrow against, or withdraw funds from the assets in the account without Lathen's consent.

- A Participant's remuneration was limited to five percent of the net profits in the joint account subject to a minimum one-time fee of $10,000 and a maximum of $15,000. The Participant acknowledged that he or she, or his or her estate, would

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[32] Tr. 459-60. The Firm's CCO talked about Lathen's strategy with the Firm's General Counsel, who raised no concerns before the Firm accepted Eden Arc's business. Tr. 460, 468.

[33] Tr. 2208-09, 2229. Lathen told the Firm's CCO that the $10,000 payment was meaningful to Participants and they were accordingly "very appreciative." Tr. 472.

[34] Tr. 2208; *see also* Tr. 1103.

[35] CX-8, at 3.

[36] *See, e.g.*, CX-49, at 1, ¶¶ 1-2; CX-50 to CX-75.

not receive any share of the profits in the joint account after the Participant died, which the Participant acknowledged were "likely to be substantially in excess" of the initial $10,000 payment. The Participant Agreement did not limit the amount of Lathen's or Eden Arc's profit.

- Should Lathen predecease a Participant, the Participant was limited to receiving five percent of the account proceeds after expenses. The remaining 95 percent of the proceeds would go to Eden Arc and its investors. A Participant agreed to cooperate with Eden Arc to liquidate the account and ensure that funds were returned to Eden Arc if Lathen predeceased a Participant.[37]

The Participant Agreement also required a Participant to execute a limited power of attorney (POA) which further limited his or her rights in the joint account. The Firm saw the Participants' POAs because Lathen and Eden Arc submitted copies of them with each new account application. The POAs permitted Lathen and Eden Arc to take the following actions with respect to the joint accounts without a Participant's prior consent:

- Open, manage, handle, and direct the joint brokerage accounts in the Participant's name, either individually or jointly;
- Transfer funds and securities into and out of the accounts;
- Buy, sell, exchange, convert, tender, trade, lend, and otherwise dispose of or acquire any securities in the joint accounts;
- Pledge and grant a security interest in the joint accounts and the Participant's interest therein;
- Execute agreements relating to the joint accounts on behalf of the Participant; and
- Sign the Participant's name to any assignments in connection with the joint accounts.[38]

An outside consultant's memo reviewing the Firm's survivor bond business in August 2013 failed to adequately address whether the Participant Agreements affected the joint tenancy.[39] By early 2013, the Firm should have understood that issuers would want to understand the nature of the relationship between Lathen and Participants. In early 2013, C.L. King obtained

[37] *See*, *e.g.*, CX-49, at 1-2, ¶¶ 2-4; CX-50 to CX-75.

[38] *See*, *e.g.*, CX-4, at 9. The limited POAs were also signed by Lathen and Eden Arc.

[39] Tr. 483-89; CX-121, at 2-3. The memo mentions only in passing that an issuer might contest the survivor redemption provision. It focuses on the financial risks to C.L. King of extending margin to Eden Arc, which it concluded were "tolerable."

from Lathen a copy of a recently drafted legal memorandum prepared by his attorneys.[40] The attorneys advised Lathen that he should provide copies of Participant Agreements to broker-dealers so they "are fully aware of the nature and intent of the program." The memorandum cautioned Lathen that broker-dealers "may be reluctant to establish" accounts with Participants after he disclosed to them his investment strategy.[41] C.L. King did not take "any action based on" the memorandum nor ask Lathen for copies of the Participant Agreements, according to the Firm's CCO, because none of the issuers asked for the agreements.[42]

In August 2013, two issuers of survivor bonds, Goldman Sachs Bank and Barclays, asked the Firm for copies of Participant Agreements. A month later, Goldman Sachs Bank refused to honor Lathen's redemptions. At about the same time, Barclays asked for the agreements. Even after Goldman Sachs Bank and Barclays had asked for the Participant Agreements, C.L. King provided copies of them only to issuers who asked for them. "From C.L. King's perspective, … we didn't take a position on this. If an issuer was not going to respond [honor a redemption], I felt our position was just to tell Mr. Lathen."[43]

6. Eden Arc's Accounts at the Firm

Lathen opened the first joint account with Participant in early 2012. After opening a joint account, Eden Arc used funds from its investors and proceeds from prior redemptions to purchase survivor bonds at a discount on behalf of the joint accounts. Eden Arc typically executed the purchases in an account at C.L. King and then journaled or transferred the bonds into the joint accounts.[44]

From January 2012 to October 2013, Eden Arc opened 36 accounts as JTWROS at C.L. King in the name of a terminally ill Participant and Lathen.[45] From January 2012 to March 2015, C.L. King processed redemption requests for approximately $62 million in survivor bond

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[40] Tr. 539-41; CX-104. The memorandum was triggered by the resolution, in November 2012, via a plea agreement, of a criminal action against Joseph Caramadre, an estate planning attorney, and one of his employees. Caramadre pursued a similar investment strategy involving survivor bonds that identified terminally ill and elderly persons with whom to open accounts. The indictment alleged that Caramadre made fraudulent material misrepresentations and omissions to terminally ill persons who co-owned accounts, bond issuers, insurance companies, and intermediaries that included broker-dealers and transfer agents. According to the memorandum, Caramadre falsely represented to terminally ill persons that his program was charitable and he concealed from them that he stood to make money in exchange for their participation in his investment scheme. He also concealed from broker-dealers that the co-owners of bonds were terminally ill and he hid his ownership interests in the investments and accounts by using names of friends and family members. CX-104, at 2-3, 6.

[41] CX-104, at 6.

[42] Tr. 541.

[43] Tr. 496. *See also* Tr. 977-78 (testifying that the Firm relied on issuers to ask it for documents they needed).

[44] CX-1, at 37, 43; CX-2.

[45] Compl. ¶ 17; Ans. ¶ 17; CX-337.

investments on behalf of 26 joint accounts opened by Lathen and a Participant at the Firm.[46] The 26 accounts held a total of approximately 600 survivor bonds. Although most accounts held a dozen or more survivor bonds, one joint account held just one investment[47] and five other joint accounts held between two and five investments.[48] The largest account, between Lathen and customer CMK, held 75 survivor bonds and generated $14.2 million in redemptions, or nearly one quarter of the total amount Eden Arc redeemed through C.L. King.[49] Another account, with Participant FJ, held approximately 80 bonds and generated approximately $8 million in redemptions.[50]

C.L. King did not earn income directly by redeeming the survivor bonds on behalf of Eden Arc. The Firm made money by providing margin to Eden Arc and from markups and markdowns on the survivor bonds that Eden Arc bought or sold on the market. From 2012 to 2014, C.L. King earned approximately $1.28 million from Eden Arc—approximately $804,903 in margin interest and $480,467 from service fees and buying and selling survivor bonds.[51] Although Lathen transferred Eden Arc's business out of C.L. King in late 2013, the Firm continued to handle redemptions of survivor bonds initiated before the business was transferred. C.L. King completed the last redemption on behalf of Eden Arc in March 2015.[52]

7. The Firm's Failure to Monitor the Eden Arc Accounts

a. The Firm Did Not Review the Contracts

Eden Arc did not provide copies of the Participant Agreements to C.L. King during the initial stages of the Firm's due diligence into Lathen's survivor bond business. However, in its

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[46] Compl. ¶¶ 17, 28; Ans. ¶¶ 17, 28; Stip. ¶ 6; CX-77; CX-338. Some Participants did not die during the period that the accounts were held at C.L. King. As a result, the survivor bonds they held in accounts with Lathen were not redeemed through C.L. King. Ans. ¶ 17. The 26 joint accounts for which C.L. King redeemed survivor bonds represented 25 Participants because Lathen had two joint accounts with the same Participant, GB. *See* CX-77, at 3, 6; CX-128; CX-143.

[47] CX-77, at 5; CX-138.

[48] CX-77, at 3-5, 8-9; CX-128; CX-133; CX-140; CX-146; CX-148. Lathen's and Eden Arc's purchases of survivor bonds for the joint accounts ranged from $2,000 to $3 million. CX-77.

[49] CX-77, at 8-10; CX-147. In order to maximize the returns on the survivor bond strategy, Lathen and Eden Arc would transfer survivor bonds to a joint account with a Participant that Lathen believed was close to death. One extreme example involves customer CMK. Lathen journaled or transferred dozens of bonds into his joint account with her immediately after opening the account. In another case, Lathen journaled dozens of survivor bonds into the joint account he held with Participant FJ within days of opening the account in early February 2013. FJ died three months later, in May 2013. CX-4; CX-90, at 30-38; CX-144, at 1.

[50] CX-77, at 6-8; CX-144. Lathen and Eden Arc sold approximately a dozen of the survivor bonds purchased in the account with FJ in the market instead of redeeming them.

[51] Compl. ¶ 3; Ans. ¶ 3; CX-339, at 2. According to Enforcement's calculations, based on information the Firm provided, revenues from Eden Arc accounted for just over one percent of C.L. King's revenues from 2012 to August 31, 2014. CX-339, at 1.

[52] Compl. ¶ 28, n.1; Ans. ¶ 28; Tr. 2175.

promotional materials, Eden Arc disclosed that Participants signed a contract.[53] C.L. King did not ask Lathen to produce a copy of any contract during the due diligence process. C.L. King believed that the Participant Agreements did not concern the Firm because they were between Lathen and a Participant.[54] The Firm did not see a Participant Agreement until December 2012, nearly a year after Eden Arc began its business at C.L. King, when the Firm asked an outside consultant to review an unexecuted Participant Agreement that Lathen provided.[55]

The Firm did not obtain copies of any of the executed Participant Agreements for the joint accounts until June 2013—more than a year after it made its first redemptions on behalf of Eden Arc—and did not obtain copies of all executed Participant Agreements until approximately mid-August 2013, two months before Lathen moved the business from C.L. King to another broker-dealer.[56] The Firm first got copies of signed Participant Agreements when Goldman Sachs Bank, an issuer of survivor bonds, asked for them after receiving redemption requests. After reviewing the Participant Agreement, Goldman Sachs Bank told C.L. King that it would not redeem the survivor bonds. The Firm did not send Participant Agreements to issuers or inform them of their existence after Goldman Sachs Bank said it would not redeem the bonds.[57] It continued to redeem survivor bonds for another year and a half, until March 2015.

b. The Firm Did Not Speak with Participants

No one at C.L. King, including Maier who was the registered representative on the joint accounts, ever met or spoke to a Participant (or his or her agent) who agreed to open an account with Lathen. The Firm did not send account statements to the Participants.[58] Maier explained that because the Participant surrendered certain rights to the account, giving Lathen the sole discretion and power to manage the account, there was no need to send Participants copies of account statements. C.L. King also did not send the Participants confirmations that would show transfers of assets into or out of the joint account.

There is no evidence that a Participant knew that his or her joint account with Lathen was opened at C.L. King. Participants did not sign C.L. King's new account documents, only the limited POA, which Lathen would use as his authority to open a joint account with a Participant. The Firm assumed that Participants knew that Lathen intended to open a joint account but did not know at which broker-dealer.[59]

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[53] CX-1, at 21.

[54] Tr. 1090.

[55] Tr. 479-81; CX-112.

[56] Compl. ¶ 27; Ans. ¶ 27; Stip. ¶ 5. *See also* Tr. 76-78, 483; CX-111.

[57] Tr. 978-79.

[58] Tr. 2143-45, 955.

[59] Tr. 954-55, 1034.

The evidence suggests that Lathen did not want a Participant to know at which broker-dealer he intended to open a joint account. This avoided the risk of a Participant claiming the assets in a joint account by directly contacting the broker-dealer. In some instances, a Participant executed a limited POA on the same date that Lathen signed C.L. King's new account documents on his own behalf and as power of attorney for the Participant.[60] Lathen asked C.L. King to be sure that no account statements or confirmations were sent to a Participant.[61] In some cases, Lathen included one of his relatives as a third co-owner of a joint account as additional protection so that in the event Lathen pre-deceased a Participant the Participant would not acquire the assets in the account.[62]

8. The Redemption Process

Eden Arc and Lathen would begin the redemption process promptly after a Participant died. Typically, Lathen instructed C.L. King's Prime Services Department staff about which documents to send to an issuer or its redemption agent to support a redemption request after a Participant died. Prime Services Department staff then collected the various documents needed for a redemption, which they prepared for an issuer or its agent.[63] The Operations Department would send the paperwork to an issuer or agent.[64] In most cases, the Prime Services Department included a cover letter from C.L. King to the issuer or its agent informing it that a joint owner of the account had died. The Firm also provided copies of a Letter of Authorization and the Participant's death certificate. The Firm also typically provided copies of a survivor option election form (signed by Lathen),[65] an affidavit of domicile concerning the Participant (executed by Lathen),[66] and monthly statements for the joint account.[67] Some redemption requests that C.L. King submitted contained copies of the new account documents.[68]

Redemption requests included documents with Eden Arc letterhead, specifically, Eden Arc's letters to C.L. King asking the Firm to begin the redemption process after the death of a Participant.[69] All of the statements were addressed to the Participant and Lathen "c/o Eden Arc" at Eden Arc's business address in New York City.[70]

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[60] Tr. 1028, 1034-35; CX-10, at 3-5; CX-27, at 1-2, 5.

[61] CX-20, at 12.

[62] Compl. ¶ 20; Ans ¶ 20; Tr. 1017-18, 1026 .

[63] Compl. ¶ 30; Ans. ¶ 30; Stip. ¶ 7.

[64] Tr. 903.

[65] *See, e.g.*, CX-118; CX-129, at 2, 5, 7, 16-17; CX-143, at 12-13.

[66] *See, e.g.*, CX-124, at 1; CX-127, at 6; CX-142, at 2; CX-145, at 8; CX-147, at 1.

[67] Compl. ¶ 31; Ans. ¶ 31; Stip. ¶ 8. *See, e.g.*, CX-131, at 12-27; CX-143, at 2; CX-144, at 30-57; CX-145, at 20-31.

[68] *See, e.g.*, CX-137, at 5-7.

[69] *See* CX-124 to CX-149; CX-360, at 5.

[70] *See, e.g.*, CX-143, at 2; CX-145, at 20.

Many issuers or their transfer agents received multiple redemption requests from Lathen. And each request identified Lathen and Eden Arc as acting on behalf of different recently deceased Participants. BNY Mellon, for example, handled multiple redemptions from C.L. King. It was the transfer agent for Countrywide Financial, General Electric, Goldman Sachs Bank, GMAC, and HSBC, among other issuers. Depository Trust & Clearing Corporation (DTCC) also handled many redemption requests from the Firm. DTCC was the agent for Barclays, J.P. Morgan, MBIA, Societe Generale, and Wells Fargo, among others.[71]

B. Conclusions of Law

1. The Firm Made Negligent Misstatements and Omissions in Connection with Its Redemptions of Survivor Bonds

Cause one charges C.L. King with violating Sections 17(a)(2) and (3) of the Securities Act, which constitutes a violation of FINRA Rule 2010. Enforcement also charges, in the alternative, that C.L. King's conduct constitutes a separate and distinct violation of FINRA Rule 2010.[72]

The Complaint alleges that C.L. King made misrepresentations and omissions in two ways. First, Enforcement charges that during the process of redeeming the survivor bonds C.L. King misrepresented the status of the deceased Participants as "joint owners" of accounts with Lathen in its cover letters to issuers and their agents.[73] Enforcement contends this statement is a misrepresentation because, by surrendering their rights to the accounts they opened with Lathen in the Participant Agreements, Participants were not beneficial owners of the accounts under New York law.

Second, Enforcement alleges that the Firm made material omissions by failing to provide issuers or their transfer agents with copies of Participant Agreements even though C.L. King knew of their existence by at least December 2012.[74] Enforcement contends that the existence of the Participant Agreements, which affected a Participant's ownership rights in the account, would have had a material effect on issuers' decisions whether or not to honor Eden Arc's redemption requests.

Section 17(a)(2) prohibits any person in the offer or sale of securities, by the use of any means or instruments of transportation or communication in interstate commerce or by the use of the mails, directly or indirectly, from obtaining money or property "by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make

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[71] CX-77. DTCC and NBNY Mellon were the agents for most of the issuers whose survivor bonds Eden Arc redeemed. Other agents included CitiBank, U.S. Bank, and Deutsche Bank. CX-77.

[72] Compl. ¶ 193.

[73] Compl. ¶ 190. C.L. King's redemption letters to issuers or their transfer agents typically stated, "[Participant], a joint owner on internal account number [], has passed away. Please exercise the survivor's option with respect to the following bonds in the account." *See*, *e.g.*, CX-146, at 2.

[74] Compl. ¶ 191.

the statements made, in light of the circumstances under which they were made, not misleading." Section 17(a)(3) makes it unlawful for any person, in the offer or sale of securities, "to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser."

Enforcement need not prove that C.L. King acted with scienter to find a violation of Sections 17(a)(2) and (3) of the Securities Act. Negligent conduct alone is sufficient.[75] Thus, in addition to showing that C.L. King used the instrumentalities of interstate commerce, to prove a violation of Sections 17(a)(2) and (3), Enforcement most show (i) a material misrepresentation or materially misleading omission; (ii) in the offer or sale of a security; and (iii) made with negligence.[76]

The SEC has found that it is negligent to fail "to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights. The term connotes culpable carelessness."[77] This standard of care imposes a duty to take reasonable steps to become informed about a security, and to do much more than to rely unquestioningly on information provided by another person.[78] Omitting material information violates this standard of care, and is inconsistent with the high standards of commercial honor and the just and equitable principles of trade required by FINRA Rule 2010.

There is no dispute that the survivor bonds were securities.[79] Redeeming or putting the bonds back to the issuer constitutes a sale of the instrument to the issuer.[80] It also is not disputed that C.L. King used the instrumentalities of interstate commerce in connection with the redemptions of the investments. C.L. King sent redemption packets to issuers or their agents using the mails and also communicated with them by email or telephone.[81] Accordingly, we address below only the materiality and negligence issues.

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[75] *Aaron v. SEC*, 446 U.S. 680, 697 (1980) ("[T]he language of § 17(a) requires scienter under § 17(a)(1), but not under § 17(a)(2) or § 17(a)(3).").

[76] *SEC v. Morgan Keegan & Co., Inc*., 678 F.3d 1233, 1244 (11th Cir. 2012).

[77] *John P. Flannery*, Initial Decisions Release No. 438, 2011 SEC LEXIS 3835, at *104 (Oct. 28, 2011) (quoting Black's Law Dictionary, 1056 (7th ed. 1999)), *rev'd in part on other grounds*, Exchange Act Release No. 73840, 2014 SEC LEXIS 4981 (Dec. 15, 2014), *petition granted and vacated on other grounds*, 810 F.3d 1 (1st Cir. 2015).

[78] *Dep't of Enforcement v. Reynolds*, No. CAF990018, 2001 NASD Discip. LEXIS 17, at *42-43 (NAC June 25, 2001) (finding respondent was negligent in relying on information provided by an issuer when he participated in the publication of advertisements about the issuer).

[79] The definition of a "security" in Section 2(a)(1) of the Securities Act and Section 3(a)(10) of the Exchange Act includes a note or bond. C.L. King admits that the survivor bonds C.L. King redeemed were securities. Compl. ¶ 187; Ans. ¶ 187.

[80] *See* Section 2(b)(3) of the Securities Act ("The term 'sale' or 'sell' shall include every contract of sale or disposition of a security or interest in a security for value.").

[81] Tr. 871; CX-313, at 46-54. *See also, e.g.*, CX-125, at 7; CX-142, at 41; CX-143, at 15.

a. The Existence of the Participant Agreements Was Material

A fact is material if there is a "substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available."[82] Whether a fact is material is something to be determined on the basis of the particular facts of a case.[83] Stated differently, a misstatement or omission is material if "there is a substantial likelihood that it would be perceived as important by a reasonable investor."[84] The standard for determining materiality is an objective one.[85]

In an instrument containing a survivor option, a debt security can be exercised only after the death of a "beneficial owner." A typical prospectus, one issued by Societe Generale for example, defined a "beneficial owner" in one of the notes that Lathen purchased and C.L. King redeemed as "a person who has the right, immediately prior to such person's death, to receive the proceeds from the disposition of that Note, as well as the right to receive payment of the principal of the Note."[86]

Each Participant Agreement stated that it "shall be governed and construed as to its validity, interpretation and effect by the laws of the State of New York."[87] Enforcement argues that under New York law Participants were not the beneficial owners of the assets in the joint accounts and therefore Lathen had no lawful right of survivorship because the accounts were not valid joint tenancies.[88] Enforcement argues that, pursuant to the terms of the Participant Agreements, a Participant did not have the right immediately prior to his or her death to receive the proceeds from the disposition of the investment. Stated differently, Lathen was not a survivor because the Participant Agreements created unequal rights to the accounts such that they were not valid joint tenancies. Therefore, when C.L. King told an issuer during the redemption process that a Participant was a joint owner of a survivor bond at the time of death, the Firm made a false statement. Enforcement contends that because the Participant Agreements restricted, if not eliminated, a Participant's ownership of the bonds, they are material because they determined whether Lathen was eligible to redeem them.

[82] *Basic v. Levinson*, 485 U.S. 224, 231-32 (1988) (quoting *TSC Indus., Inc. v. Northway, Inc.,* 426 U.S. 438, 449 (1976)).

[83] *Id*. at 238.

[84] *SEC v. Research Automation Corp*., 585 F.2d 31, 35 (2d Cir. 1978).

[85] *TSC Indus., Inc.,* 426 U.S. at 445.

[86] CX-119, at 5. Lathen purchased such a Societe Generale note in an account with Participant FJ, which C.L. King redeemed. *See* CX-68; CX-144. Respondents admit that a survivor bond is properly redeemable so long as the deceased Participant possessed a beneficial interest in the investment at the time of death and the party exercising the death put (Lathen) is a surviving owner of the security. Compl. ¶ 14; Ans. ¶ 14.

[87] *See*, *e.g.*, CX-49, at 3.

[88] Compl. ¶¶ 33, 189-191; Enforcement's Post-Hearing Br., at 26-28.

C.L. King, on the other hand, argues that the deposit of funds or securities into a joint bank or brokerage account with rights of survivorship constitutes *prima facie* evidence of their intent to create a joint tenancy. C.L. King's argument focuses on the form of the relationships between Lathen and the Participants instead of their economic substance. Under the Participant Agreements, C.L. King argues, Lathen and the Participants expressly intended to create such an account. It also argues that nothing in the Participant Agreements specifically dissolved the joint tenancy and that a Participant continued to possess some interest in the account until the Participant died.[89] The new account documents also stated that the accounts were JTWROS. According to C.L. King, even if Lathen died before a Participant, the Participant still had "equity" in the account.[90] The Firm therefore claims that its statements to issuers that a Participant was a "joint owner" were accurate.

We first discuss whether the accounts Lathen opened with Participants were in fact JTWROS accounts under New York State law. This case presents a novel issue under New York law. The parties have not cited, and the Panel has not found, cases in which, as we find in the Participant Agreements, a putative joint tenant effectively contracts away his rights to the assets in an account. The Panel must rely on basic principles of New York property law.

New York law defines a joint tenancy as an estate "held by two or more persons jointly, with equal rights to share in its enjoyment during their lives, and creating in each joint tenant a right of survivorship."[91] A key characteristic of a joint tenancy is that during the life of the tenancy each tenant is entitled to one-half of the assets.[92] A second characteristic is that each tenant is entitled to the entire property on the death of the other joint tenant.[93]

In New York, the law presumes that an account is a joint account if it is titled as one. When Lathen opened each joint account at C.L. King he checked the box designating the account as JTWROS. Immediately below the JTWROS box, C.L. King's application form explained that this meant, "If one owner dies, his/her interest passes to the surviving owner(s)."[94] Accordingly, the accounts are presumed to be joint accounts. This presumption can be rebutted by a showing that an account is missing one of the two characteristics of a true joint account—(i) sharing equally in the assets during the life of the co-tenancy, and (ii) having rights of survivorship.

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[89] Respondents' Post-Hearing Br., at 38-39.

[90] Respondents' Pre-Hearing Br., at 39.

[91] *Goetz v. Slobey*, 908 N.Y.S.2d 237, 239 (App. Div. 2010) (quotations omitted) (citing 24 N.Y. Jur. 2d, Cotenancy and Partition, § 16, at 332-33).

[92] *Matter of Estate of Zecca*, 544 N.Y.S.2d 40, 41 (App. Div. 1989) ("In a true joint account, each party has the right to withdraw one half of the funds during the lifetime of both tenants."). *See also Brezinski v. Brezinski*, 463 N.Y.S.2d 975, 976 (App. Div. 1983) ("One incident of a joint tenancy is that so long as both tenants are living, each has a 'present unconditional property interest in an undivided one half of the moneys deposited.'").

[93] *In re Will of Filfiley*, 313 N.Y.S.2d 793, 799 (Sur. Ct. 1970) ("In a true joint tenancy, … the whole fund will vest in the surviving joint tenant."); *see also Trotta v. Ollivier*, 933 N.Y.S. 66, 69 (App. Div. 2011).

[94] *See*, *e.g.*, CX-47, at 1.

The presumption that these were true joint accounts is rebutted by the evidence presented at the hearing. Even before an account was opened and assets placed in the account, Lathen and the Participants intended that Participants would have no access or control over the assets in the accounts. In a sales brochure, Lathen told prospective Participants that all they would receive financially "comes in the form of a one-time cash payment made within 15 days of enrollment."[95] By the terms of the Participant Agreements, Participants gave up ownership in the investments or other assets held in the accounts. Participants permitted Lathen to transfer cash and securities from the accounts, without their prior consent. They further agreed that they could not pledge, borrow against, or withdraw funds from the accounts without Lathen's consent, which he could withhold at his sole discretion. They also gave Lathen power of attorney to buy, sell, exchange, convert, tender, trade, lend, and otherwise dispose of or acquire any securities in the account. Participants therefore were stripped of all rights to the account.

Under these circumstances, the accounts were not true joint accounts. Under New York law, they were "convenience accounts" despite being styled as JTWROS accounts in C.L. King's new account documents. A "convenience account" exists when a depositor does not intend to give a present beneficial interest in the assets of the account to the co-tenant. An account created for convenience rebuts the presumption that it is a true joint account.[96] A party challenging the title of the survivor of a joint tenancy must provide "clear and convincing evidence" that the "accounts were only opened for convenience and were never intended to be joint accounts."[97] Enforcement met this burden at the hearing. Enforcement proved that Lathen did not intend to give Participants a beneficial interest in the assets held in the accounts. He intended to do the exact opposite—ensure that they could not get their hands on the accounts. Accordingly, the accounts Lathen opened with Participants were not valid joint tenancies.

A true JTWROS account also entitles the surviving joint tenant to the entire estate. Under the terms of the Participant Agreements, a Participant could not acquire the entire estate if Lathen predeceased the Participant. Most of the Participant Agreements limited a surviving Participant to five percent of the profits earned in the account, while the remaining 95 percent was to go to Eden Arc and its investors.[98] For this reason as well, the accounts were not true joint tenancies.

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[95] CX-3, at 2.

[96] *See Matter of Friedman*, 478 N.Y.S.2d 695, 696-97 (App. Div. 1984) (concluding that it was "clear from [decedent's] actions vis a vis the subject accounts that she did not … intend to confer a present interest of one half on [her niece]" when she placed money in a joint account merely for convenience in the event of her death or illness and thus "the presumption of joint tenancy was effectively rebutted"); *Fischedick v. Hietmann*, 699 N.Y.S.2d 508, 509 (App. Div. 2012) (presumption of joint tenancy rebutted where depositor did not intend to confer a "present beneficial interest" on the other tenant or intend that the other tenant "acquire any ownership interest therein").

[97] *Matter of Grancaric*, 936 N.Y.S.2d 723, 726 (App. Div. 2012).

[98] C.L. King made redemptions for 26 joint accounts between Lathen and a Participant. Stip. ¶ 6. Sixteen Participant Agreements had the 5/95 percent provision. CX-49 to CX-53; CX-55 to CX-58; CX-61 to CX-67. Three Participant Agreements contained no provision should Lathen predecease a Participant. CX-54; CX-59; CX-60. Eight Participant Agreements state that the assets of the account are to be liquidated to repay a loan taken by Lathen to

None of the accounts for which C.L. King made a redemption on behalf of Eden Arc and Lathen were valid joint accounts with rights of survivorship. Accordingly, Lathen could not redeem the survivor bonds because he was not a lawful survivor of the accounts.

Enforcement alleges that C.L. King violated Sections 17(a)(2) and (3) by negligently making material misstatements and omissions by falsely stating that Participants were "joint owners" and by not providing issuers or their agents with copies of Participant Agreements during the redemption process. Whether the Participant Agreements are material or not is established by applying an objective standard. Given the circumstances present in this case, the Panel determines that issuers' reactions upon learning of the existence of Participant Agreements are relevant to a determination of materiality. Enforcement presented evidence that Goldman Sachs Bank rejected redemption requests after analyzing the Participant Agreements. Barclays asked for copies of Participant Agreements before agreeing to redeem survivor bonds. Representatives of two issuers—Societe Generale and Gateway Bank of Florida—testified at the hearing that the Participant Agreements, had they known of them, would have caused them to question whether the accounts were lawful joint accounts entitling Lathen to redeem their survivor bonds.

The Firm acknowledges that it did not receive copies of any executed Participant Agreements before June 2013 and did not receive all of them until mid-August 2013. The Firm knew before it took on Eden Arc's business that Participants signed contracts with Lathen or Eden Arc in exchange for the one-time $10,000 payment and agreeing to open a joint account.[99] It also had copies of the Participants' POAs which were submitted with the account application. The POA severely restricted a Participant's rights to the account.

The first time that C.L. King provided an issuer with a copy of a Participant Agreement was in August 2013, when Goldman Sachs Bank requested copies of all agreements between three recently deceased Participants and Lathen and Eden Arc. After receiving the documents it sought, including Participant Agreements,[100] Goldman Sachs Bank rejected the redemption requests. In a September 2013 letter, counsel for Goldman Sachs Bank told C.L. King, "None of the accounts are bona fide joint tenant accounts, but rather were established to permit Mr. Lathen to acquire securities with survivor's options. Accordingly, [Goldman Sachs Bank] is under no obligation to honor the redemption requests as Mr. Lathen's status as a joint tenant with rights of survivorship is not legally cognizable."[101]

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fund the $10,000 payment to the Participant and cover the costs of purchasing the investments in the account. These provisions made it unlikely, if not impossible, for a surviving Participant to receive any money from an account should Lathen die first. CX-68 to CX-75.

[99] CX-1, at 21.

[100] CX-78.

[101] CX-80. Counsel for Eden Arc wrote to Goldman Sachs Bank's counsel immediately after Goldman Sachs Bank rejected the redemptions, citing C.L. King's new account documents that created the accounts as JTWROS and arguing that nothing in the Participant Agreements "undermines or contradicts the express intention of the parties to create a JTWROS account. The accounts are therefore *bona fide* JTWROS accounts." CX-81, at 1.

Societe Generale issued bonds that were redeemed by Lathen and Eden Arc after the deaths of two Participants. A senior official of Societe Generale testified that it appeared to him that under the Participant Agreement a Participant did not "really own[] anything because they've kind of given up every aspect of ownership" to Lathen.[102] According to Societe Generale, if it had seen a Participant Agreement when a survivor bond was redeemed, it would have raise questions about whether the accounts were true joint accounts. Societe Generale would have shown the Participant Agreements to its attorneys if it had seen them during the redemption process.[103]

Gateway Bank of Florida also issued bonds that were redeemed by Lathen and Eden Arc.[104] A senior officer of Gateway Bank testified on behalf of Enforcement.[105] The bank issued $100 million in survivor bonds. Eden Arc purchased $1,042,000 in bonds for accounts Lathen opened with three Participants. Lathen and Eden Arc redeemed each of the bonds from Gateway Bank through its transfer agent, DTCC, in 2013.[106] DTCC forwarded C.L. King's redemption packages to Gateway Bank with instructions on paying the proceeds of the bond. The packages did not include copies of Participation Agreements or POAs.[107]

Gateway Bank relied on statistical mortality assumptions. Accordingly, Lathen's strategy of buying bonds with terminally ill Participants upended the bank's calculations. Gateway Bank had to redeem more survivor bonds than it had projected would be presented for redemption. This caused the bank to sell other investments to honor the earlier-than-anticipated redemptions.[108] Had Gateway Bank seen the Participation Agreements, it would have questioned whether the Lathen accounts were true JTWROS accounts because it understood that in a joint account both tenants "have full and unrestricted access and rights to the account, the statements, the ability to transfer money, or add money, or transact."[109] According to Gateway Bank, there is

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[102] The official who testified was a managing director at Societe Generale and its head of equity and derivative sales. Tr. 1502. Societe Generale issued bonds that were redeemed by C.L. King on behalf of Lathen and Eden Arc after the deaths of two Participants. CX-77, at 5, 10; CX-141, at 6-7; CX-149, at 7-8.

[103] Tr. 1516-17.

[104] Gateway Bank is a $300 million community bank operating three branches in the area around Daytona Beach, Florida. Tr. 2549-55.

[105] The officer who testified was Gateway Bank's Chief Financial Officer, Chief Operating Officer and Chief Investment Officer.

[106] CX-77, at 6, 9, 11; CX-360; CX-361; CX-362.

[107] The office testified that Gateway Bank was "completely oblivious" as to who Eden Arc was in relation to the redemptions even though its name appeared on redemption paperwork DTCC forwarded to it. Tr. 1567.

[108] Tr. 1553-54, 1559-60, 1572-73. Gateway Bank projected that over a ten-year period five percent of the value of the bonds would be redeemed, or about one-half a percent per year. Instead, it redeemed $4.6 million in bonds ($1,046,000 of which were Eden Arc's) over an 18-month period from 2013 to 2015. Tr. 1604-05.

[109] Tr. 1621.

"no doubt [that such an account] would be heavily scrutinized by compliance" and this "would definitely, had we seen [the Participant Agreement], cause us to be concerned."[110]

Besides Goldman Sachs Bank, one other issuer, Barclays, in September 2013, requested copies of Participant Agreements from C.L. King.[111] After reviewing the agreements and talking to C.L. King, Barclays agreed to honor Lathen's redemption requests.[112] The Panel finds that the fact that one issuer redeemed the bonds after seeing the Participant Agreements does not resolve the materiality issue in favor of the Firm because materiality is determined by applying an objective standard. That Barclays asked for the Participant Agreements suggests to the Panel that the agreements were sufficiently significant to alter the "total mix" of information available to the bank. There is also no evidence in the record as to why Barclays ultimately elected to redeem the bonds.

The Panel finds that the Participant Agreements were material. The Participant Agreements determined whether Participants had a beneficial ownership in the account. Because Participants were not joint owners, their deaths did not permit Lathen to put investments to issuers before maturity. C.L. King's statements to issuers in redemption letters that Participants were joint owners in accounts with Lathen were contradicted by the terms of the Participant Agreements. Providing the Participant Agreements to issuers would have given them notice of questions about the legal validity of Lathen's rights to redeem survivor bonds. A reasonable issuer would have wanted to know of the existence of Participant Agreements in order to come to its own conclusion as to whether the Participants were in fact beneficial owners of the bonds held in joint accounts at the time of their deaths.

b. The Firm Acted Negligently

C.L. King acted negligently when it told issuers that Lathen was a beneficial owner of a bond and did not provide them with copies of Participant Agreements. The Firm understood that Eden Arc's strategy was to take advantage of a loophole in survivor bond prospectuses that could generate considerable profits. It also understood that Lathen targeted terminally ill persons so that there was a greater chance that bonds could be redeemed more quickly, thereby generating larger profits. It also knew that the Participants never saw the activity in their accounts because they did not receive copies of statements.

Even though during the onboarding process the Firm learned that Participants signed a contract (the Participant Agreement), it did not ask to see them. Instead, the Firm concluded that the agreements, because they were between Lathen and the Participant, were not its concern. The Firm did not recognize that Participant Agreements might be important to an issuer's determination of Lathen's eligibility to redeem the survivor bonds. C.L. King's in-house counsel,

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[110] Tr. 1622.

[111] RX-120; RX-121. *See also* Tr. 498, 535, 976-77, 1680, 1873, 1890-91, 2436-38.

[112] Tr. 239, 491, 1874, 1890-91. Lathen and Eden Arc redeemed millions of dollars in Barclays survivor bonds purchased for accounts Lathen held with six Participants. CX-77, at 7-11.

testified that he did not find that the Participant Agreements affected the joint accounts.[113] The Firm relied on Participants' POAs for the authority to follow Lathen's instructions to transfer or journal bonds between accounts as he saw necessary. Lathen submitted all of the POAs with new account paperwork but the Firm did not properly review them to determine if they could affect the Participants' ownership rights to the accounts.

C.L. King argues that because the survivor bond strategy was well known in the industry, issuers were on notice that Lathen was pursuing a strategy involving survivor bonds.[114] It also claims that during the redemption process it never withheld any information from an issuer or its transfer agent nor concealed the underlying relationship between Lathen and a Participant. The Firm claims that it provided all documents and information that an issuer or its agent requested.[115] According to the Firm, issuers or their agents were also on notice that Eden Arc, in particular, was involved in the survivor bond investment. The Firm argues that this put issuers on notice that Lathen and Eden Arc had made investments in survivor bonds with multiple Participants, particularly because some transfer agents represented multiple issuers.[116]

C.L. King provided DTCC a copy of a Participation Agreement in late September 2013. The Firm argues that this provided notice to all the issuers represented by DTCC that a Participant Agreement existed between Lathen and every Participant.[117] However, Eden Arc had opened accounts at the Firm in January 2012, and the Firm had submitted most of its redemption requests before late September 2013.

The Firm claims that redemption requests included a copy of the Participant's POA, which in a few cases referred to a "previously executed Agreement between the Participant and Lathen."[118] According to the Firm, a POA gave notice to an issuer that there were other agreements between Lathen and the deceased Participant besides what was contained in new account and other documents.[119] However, of the 26 redemption requests C.L. King made to issuers[120] only one contained a copy of the Participant's POA—even though the POA was

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[113] Tr. 1856-57.

[114] Respondents' Post-Hearing Br., at 16, 36-37.

[115] Ans. ¶¶ 3-4, 189, 191. There is no evidence, and Enforcement does not allege, that C.L. King, Lathen, or Eden Arc intentionally withheld documents that issuers or their agents may have asked for during the redemption process.

[116] Respondents' Post-Hearing Br., at 10, 14; CX-77.

[117] Respondents' Post Hearing Br., at 15-16. DTCC received Participation Agreements on behalf of Barclays, which had asked C.L. King for copies. RX-121.

[118] Respondents' Post-Hearing Br., at 10, citing CX-137, at 8. Most POAs did not refer to the existence of the Participant Agreement, even indirectly. *See, e.g.*, CX-10, at 5.

[119] Tr. 987-89.

[120] CX-124 to CX-149.

included in every new account application.[121] In the one case, C.L. King made redemption requests to just four issuers on behalf of Eden Arc.[122]

The Panel rejects C.L. King's argument that issuers and their agents understood, or should have understood, Lathen's strategy. There is no evidence that issuers who had not seen Participant Agreements knew that Participants had contractually surrendered all or most of their interests in the survivor bonds held in the accounts. Furthermore, issuers or their agents process a large volume of redemptions in a routinized manner. It is not reasonable to expect that they should be alert to the particular strategy Lathen developed.

A striking example of C.L. King's negligent misconduct was displayed in its handling of Participant CMK's account with Lathen. Eden Arc submitted executed new account documents to the Firm on May 30, 2013. (Lathen signed the documents the same day on behalf of himself and as POA for CMK.) When transmitting the documents, which included the POA, Eden Arc told the Prime Services Department that "this is a 'time is of the essence' situation."[123] CMK died the next day at 6:55 a.m. Later that day, May 31, 2013, Eden Arc transferred $3.0 million in recently purchased survivor bonds from other accounts that Lathen held with other Participants into the joint account with CMK. He also journaled or transferred approximately another 70 bonds into the account from other accounts.[124] Over the next few months, from July to December 2013, C.L. King sent redemption requests to issuers and their agents on behalf of Eden Arc and Lathen even after learning that CMK had died before the transactions in her account were effected.[125] All of the bonds were redeemed (with the exception of two that Goldman Sachs Bank rejected).

The Firm's representations to issuers that a beneficial owner of the account, CMK, had died were made negligently. CMK died before the transfers were effected, converting the account into one solely owned by Lathen when the bonds were transferred into the account. Accordingly, Lathen was not a "survivor" of a joint account entitled to redeem the survivor bonds. Even if C.L. King did not immediately know that CMK had died, it knew when she had

[121] CX-137, at 8.

[122] Also, the redemption requests made to issuers for the one Participant that contained copies of the deceased's POA were made in late 2012 and early 2013, nearly a year after C.L. King had begun processing redemptions for Eden Arc. CX-77, at 5; CX-137. There is no evidence that the four issuers or their agents reviewed the POA that C.L. King submitted with its redemptions requests.

[123] CX-98, at 1.

[124] CX-6; CX-89, at 19-43; CX-100, at 2-4.

[125] CX-77, at 8-10. Enforcement also argues that CMK was not a true "joint tenant"—and Lathen had no legitimate right of survivorship—because the account was not in good order at the time bonds were journaled or transferred into the account. A principal approved the account before the Firm received a copy of the power of attorney CMK had executed weeks earlier in favor of a family member that gave that person power to execute the Eden Arc POA that Lathen used to open the account. Compl. ¶ 37; CX-99; Enforcement's Post-Hearing Br., at 25-26. Enforcement cites no authority for the proposition that an account is not lawfully opened and able to trade securities until a firm principal performs the ministerial function of approving the account.

died by the time it submitted redemption requests for her joint account. Eden Arc provided the Firm with a copy of her death certificate on June 26, 2013.[126]

The Panel finds that C.L. King acted negligently when it redeemed the survivor bonds on behalf of Eden Arc and Lathen by describing the Participant as a joint tenant. It also was negligent in failing to obtain copies of Participant Agreements and provide them to issuers. The misrepresentation that Participants were "joint owners" of the accounts and the failure to provide issuers with Participant Agreements were material.

The Panel accordingly finds that C.L. King violated Sections 17(a)(2) and (3), which constitutes a violation of FINRA Rule 2010. We also find that C.L. King's conduct constitutes an independent violation of FINRA Rule 2010 because negligent misrepresentations are inconsistent with just and equitable principles of trade.[127]

2. The Firm Failed to Reasonably Supervise Survivor Bond Redemptions

Cause two alleges that C.L. King violated NASD Rule 3010 and FINRA Rules 3110[128] and 2010 by failing to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to ensure compliance with Section 17(a) of the Securities Act in connection with how it handled redemptions it submitted to issuers. 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 FINRA Rules."[129] Under NASD Rule 3010(b) and FINRA Rule 3110(b), the supervisory systems must be documented in the firm's written supervisory procedures. The procedures must also be tailored to the firm's business.[130]

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[126] CX-147, at 2.

[127] *Dep't of Enforcement v. Pellegrino*, No. C3B050012, 2008 FINRA Discip. LEXIS 10, at *14 n.13 (NAC Jan. 4, 2008) ("Negligent misrepresentations violate NASD Rule 2110."), *aff'd*, Exchange Act Release No. 59125, 2008 SEC LEXIS 2843 (Dec. 19, 2008).

[128] FINRA Rule 3110 became effective on December 1, 2014, superseding NASD Rule 3010 without substantive change, although with some modifications not at issue here. FINRA Regulatory Notice 14-10, 2014 FINRA LEXIS 17 (Mar. 2014). Thus, NASD Rule 3010 applies to C.L. King's conduct before December 1, 2014, and FINRA Rule 3110 applies to the Firm's conduct beginning that date.

[129] FINRA Rule 3010(a) contains the same provision but refers to "the activities of each associated person," without specific reference to registered representative and registered principals.

[130] *See* Rule Interpretive Material ("IM") IM-3010-1, replaced by FINRA Rule 3110.12, effective December 1, 2014. FINRA Regulatory Notice 14-10, n.29 (http://www.finra.org/industry/notices/14-10).

C.L. King's lack of reasonable supervision is evident in its handling of the joint accounts Lathen opened. Although the accounts were opened as JTWROS,[131] the Firm honored the Participants's POA, which gave Lathen authority to engage in any sort of transaction in an account without a Participant's consent. This was inconsistent with treating the accounts as true joint tenancies. The Firm effectively failed to view the Participants as true customers. No one ever communicated with a Participant or his or her agent. The Firm understood that Participants did not even know they had an account at C.L. King.

C.L. King also had no experience in the sort of survivor bond investment strategy that Lathen and Eden Arc pursued. Although the Firm redeemed hundreds of bonds for $62 million on behalf of Eden Arc, it had no procedures to provide instructions on handling redemptions of survivor bonds.[132] The lack of procedures was unreasonable given Lathen's unusual investment strategy that involved Participants surrendering ownership rights to the accounts. The Firm did not obtain copies of prospectuses or other disclosure statements for the survivor bonds so that it could determine whether Lathen's redemption requests were valid.[133] Nor did C.L. King obtain copies of Participant Agreements to determine whether they might affect Participants' and Lathen's ownership rights in the investments. Even after obtaining a Participant Agreement in early 2013, it did not provide Participant Agreements to issuers as part of its redemption process. The Firm failed altogether to understand the significance of the Participant Agreements.

These deficiencies involved supervisory failures. The Panel concludes that C.L. King violated NASD Rule 3010 and FINRA Rules 3110 and 2010 by failing to establish and maintain a supervisory system and written supervisory procedures designed to ensure compliance with FINRA Rules and federal securities laws in connection with the redemption of survivor bonds.

C. Sanctions

In considering the appropriate sanctions to impose on Respondents, the Panel consulted FINRA's Sanction Guidelines ("Guidelines"),[134] specifically the General Principles Applicable to All Sanction Determinations ("General Principles"), overarching Principal Considerations in Determining Sanctions, as well as guidelines for specific violations. The General Principles explain that disciplinary sanctions "should be designed to protect the investing public by

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[131] C.L. King's CFO testified that the Firm's new account application, in which Lathen elected to open the joint accounts as JTWROS, was "the prevailing document." Tr. 974-76. The Firm's CCO testified that, in the unlikely event that Lathen predeceased a Participant (and assuming there were no third joint owners), the Firm would have "had no choice" but to transfer the assets of the joint account to the Participant because he or she was the survivor. Tr. 470-71.

[132] CX-308; RX-161; RX-162; RX-163.

[133] The person who assembled the documents supporting the redemptions submitted to issuers was instructed that she did not have to review prospectuses or similar documents. CX-313, at 168-73.

[134] FINRA Sanction Guidelines (2017), http://www.finra.org/industry/sanction-guidelines. FINRA amended its Sanction Guidelines on April 10, 2017, which became effective immediately. Amendments included changes to the guideline for supervision violations. *See* Regulatory Notice 17-13, http://www.finra.org/industry/notices/17-13.

deterring misconduct and upholding high standards of business conduct."[135] Adjudicators are therefore instructed to "design sanctions that are meaningful and significant enough to prevent and discourage future misconduct by a respondent and deter others from engaging in similar misconduct."[136] Sanctions should also be "more than a cost of doing business." They should be "a meaningful deterrent and reflect the seriousness of the misconduct at issue."[137] Adjudicators should impose sanctions "tailored to address the misconduct involved in each particular case."[138]

1. The Firm's Negligent Misrepresentations and Omissions (Cause One)

Cause one charges C.L. King with making negligent misrepresentations and omissions in connection with its redemption of survivor bonds, in violation of Sections 17(a)(2) and (3) of the Securities Act, and in violation of FINRA Rule 2010. For a firm charged with making negligent misrepresentations and omissions, the Guidelines recommend a fine between $2,500 and $73,000 and instruct adjudicators to give consideration to suspending the firm with respect to a limited set of activities for up to 90 days.[139]

The Guidelines do not provide specific considerations for misrepresentations and omissions. Instead, the Guidelines direct adjudicators to apply the Principal Considerations for determining sanctions for all rule violations. One Principal Consideration is whether the misconduct occurred over an extended period of time. The misconduct here spanned over three years—from January 2012 to March 2015.[140] Another Principal Consideration is whether the Firm engaged in numerous acts or displayed a pattern of misconduct. The Firm redeemed hundreds of separate survivor bonds on behalf of 25 customers, from dozens of different issuers.[141] The Panel also considered the total size of the redemptions the Firm handled. C.L. King redeemed a total of $62 million in survivor bonds on behalf of Eden Arc.[142] The Panel also considered that C.L. King made $1.28 million from Eden Arc's business,[143] but also that it did not earn money directly from activities surrounding the redemption process.

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[135] Guidelines at 2 (General Principles Applicable to All Sanction Determinations, No. 1).

[136] *Id.*

[137] *Id.*

[138] Guidelines at 3 (General Principles Applicable to All Sanction Determinations, No. 3).

[139] Guidelines at 89.

[140] Guidelines at 7 (Principal Considerations in Determining Sanctions, No. 9) (whether the respondent engaged in the misconduct over an extended period of time).

[141] Guidelines at 7 (Principal Considerations in Determining Sanctions, No. 8) (whether the respondent engaged in numerous acts and/or a pattern of misconduct).

[142] Guideline at 8 (Principal Considerations in Determining Sanctions, No. 17) (the number, size, and character of the transactions at issue).

[143] Guideline at 8 (Principal Considerations in Determining Sanctions, No. 16) (whether the respondent's misconduct resulted in the potential for the respondent's monetary or other gain). Enforcement asked the Panel to include, as a unitary sanction for violations of causes one and two, an order that the Firm disgorge all of the $1.28 million in revenues it earned from handling Eden Arc's survivor bond business and fine the Firm $70,000. After

After carefully reviewing the facts and circumstances in this case, together with the parties' arguments concerning sanctions, and applying the factors and considerations contained in the Guidelines, the Panel finds that a fine above the high end of the Guidelines is appropriate for the Firm's negligent misrepresentations and omissions. Accordingly, C.L. King is fined $250,000 for the misconduct alleged in cause one.

2. The Firm's Failure to Supervise Its Survivor Bond Redemption Business (Cause Two)

The Guidelines for failing to supervise instruct adjudicators to consider a fine between $5,000 and $73,000. In egregious cases, adjudicators should consider limiting the activities of the branch office or department for a longer period or suspending the firm with respect to any or all activities or functions for up to 30 business days.[144] The most relevant principal considerations are, first, whether the respondent ignored "red flag" warnings that should have resulted in additional supervisory scrutiny and, second, the nature, extent, size and character of the underlying misconduct.[145]

The Guideline for maintaining deficient written supervisory procedures provides for a fine between $1,000 and $37,000.[146] The principal considerations are whether deficient written procedures allowed violative conduct to occur or to escape detection and whether the deficiencies made it difficult to determine the individuals responsible for specific areas of supervision or compliance.[147]

Lathen's business strategy was novel. He and Eden Arc employed elaborate contractual agreements and powers of attorney between them and a Participant, which the Firm should have understood significantly affected a Participant's ownership interests in an account. The business required the Firm to open numerous joint accounts between Lathen and a Participant, engage in multiple transfers or journaling of bonds among accounts as Lathen saw fit, and then redeem survivor bonds on behalf Eden Arc. The personnel in the Prime Services Department had little or

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weighing all the evidence, including testimony from persons associated with C.L. King, the Panel concludes that Enforcement's proposed sanction—totaling nearly $1.3 million for causes one and two—is not an appropriate sanction. The money the Firm made from Eden Arc was not directly related to the activities surrounding the redemption process. Also, approximately 100 survivor bonds were not redeemed from issuers. Accordingly, although the Panel considered the revenues earned from Eden Arc, we do not find it appropriate to order disgorgement of all of the revenues.

[144] Guidelines at 104.

[145] *Id.*

[146] Guidelines at 107. Adjudicators should also consider suspending the firm with respect to any or all relevant activities or functions for up to 30 business days and thereafter until the supervisory procedures are amended to conform to rule requirements. *Id.*

[147] *Id.*

no experience with the survivor bond business. The Firm did not adopt any written supervisory procedures or a supervisory structure to oversee the redemption of the survivor bonds.[148]

The Firm's failure to disclose the nature of the relationship between Lathen and Participants and provide copies of Participant Agreements to issuers deprived them of the opportunity to judge for themselves whether the joint accounts were true JTWROS accounts. By at least December 2012, the Firm had seen a Participant Agreement but it never provided copies to issuers or their agents, with the exception of the two issuers who asked for them—Goldman Sachs Bank and Barclays. Even after Goldman Sachs Bank rejected redemption requests in September 2013, C.L. King did not provide copies of Participant Agreements to issuers or otherwise alert them to possible issues surrounding the ownership of the accounts.

In light of all the facts and circumstances, the Panel concludes that a fine at the middle of the two ranges combined for failing to reasonably supervise and for having deficient written supervisory procedures is an appropriate and remedial sanction. According, the Panel fines C.L. King $50,000 for the supervisory violations alleged in cause two.

IV. Respondents' Violations Relating to the Firm's Penny Stock Business

A. Findings of Fact

C.L. King first became engaged in the business of liquidating penny stocks on behalf of a client in 2009. It had two large penny stock clients: PL Bank and ABC Corp.

In June 2009, PL Bank opened an account at the Firm and promptly started selling penny stocks. Three years later, in late 2012, ABC Corp. opened an account and immediately began liquidating penny stocks as part of its overall investment and business strategy.

Together the two customers sold over 11 billion shares of penny stocks and generated over $19 million in revenue from 2009 to 2014. C.L. King earned approximately $620,000 in commissions from selling the penny stocks on behalf of the two customers.

1. PL Bank's Penny Stock Transactions

a. The Firm's Introduction to PL Bank

The Firm met customer PL Bank through a broker-dealer and foreign financial institution based in Switzerland ("Swiss BD").[149] Swiss BD introduced approximately a dozen foreign financial institutions as customers to C.L. King.[150]

[148] Tr. 95, 2154; CX-308; RX-162.

[149] Tr. 2176; RX-44.

[150] CX-176, at 3-8, 11.

Swiss BD was one of the first clients that Maier introduced to C.L. King after he joined the Firm in March 2007.[151] Maier vouched for Swiss BD because during the 1990s he and its owner worked for the same U.S. broker-dealer. Maier told C.L. King's senior management that Swiss BD's owner had run the Swiss office of a U.S. broker-dealer before forming Swiss BD. Maier told them he had worked with Swiss BD's owner for eight years and "both he and his accounts are all first rate." Maier liked the owner because he was "careful, thorough, and easy to work with," and his business "hits right in our sweet spot." According to Maier, the accounts Swiss BD wanted to open had passed Office of Foreign Assets Control ("OFAC") and Patriot Act checks.[152]

Swiss BD's business was primarily trading U.S. equities for foreign institutions, mostly small or mid-sized banks. The Firm expected that Swiss BD's clients would trade securities of companies with medium or large capitalizations.[153] Maier also told the Firm that Swiss BD was then generating between $150,000 and $250,000 in commissions per month by trading U.S. equities for foreign financial institutions that had been his clients for many years. He estimated that the Firm could earn, "with no strain," between $50,000 and $100,000 per month by servicing Swiss BD's business.[154] Maier expected that Swiss BD's customers' would place orders ranging in size between 500 and 2,000 shares and valued at $20 to $80 per share. Maier told C.L. King's management, "I know his book of business and never had any problems or concerns with either [the owner] or his clients."[155]

C.L. King conducted due diligence on Swiss BD, including collecting documentation about the company. The documents included copies of the owner's *curriculum vitae*, Swiss BD's 2005 and 2006 audits and balance sheets, Swiss corporate registration documents, evidence of its authority to conduct a brokerage business, and its clearing agreement then in force with another U.S. broker-dealer.[156] In May 2007, C.L. King and Swiss BD signed an agreement for fully disclosed clearing services under which the Firm would receive 40 percent of commissions and Swiss BD 60 percent. Swiss BD would set the commission amounts that its customers would pay for transactions executed through C.L. King.[157]

The clearing agreement addressed AML issues. It required that Swiss BD "develop, implement and enforce written AML policies and procedures … , reasonably designed to ensure compliance with the requirements of U.S. Laws and Rules relating to AML, including, without

[151] Tr. 1944-45, 2199.

[152] CX-176, at 12-13.

[153] Tr. 924-25.

[154] CX-176, at 12.

[155] CX-176, at 12.

[156] CX-176, at 15, 25-29, 32-64.

[157] CX-176, at 74-98.

limitation, the Bank Secrecy Act, [and] the Patriot Act ….” Swiss BD's AML program was to be developed, implemented and enforced by a qualified compliance officer.[158]

b. PL Bank Opens an Account with C.L. King

PL Bank opened an account at the Firm in June 2009, two years after C.L. King began its relationship with Swiss BD. As with the other customers Swiss BD introduced to the Firm, Maier was the registered representative on the PL Bank account.[159]

PL Bank's trading activities immediately increased the Firm's AML risks because it began selling penny stocks right after opening its account. Miller, the Firm's AML Compliance Officer, understood that liquidating penny stocks or micro-cap stocks was a risk for the Firm.[160] Maier questioned Swiss BD's owner about the penny stock trading because it was not typical of the business Swiss BD's other customers had brought to C.L. King. The owner told Maier that he was trying to develop business with PL Bank, which was a new customer for Swiss BD. According to Maier, Swiss BD was "trying to earn the trust of a new client and show we could do a good job."[161] C.L. King was "comfortable" accepting PL Bank as a client because it was a "major bank in Europe" and there was no negative information about it from regulators.[162]

In November 2011, a person ("FJ") contacted C.L. King to place orders in the PL Bank account to sell shares of Cloud Star Corporation (CLDS), a new stock with little or no trading history.[163] The Firm took no measures to do a background check on FJ. In March 2013, after receiving orders from FJ to sell CLDS shares, the Firm determined that the SEC had barred him from the securities industry. The Firm confronted Swiss BD's owner and told him that it would not deal with FJ directly.[164] By mid-March 2013, PL Bank had sold approximately 480,000 shares of CLDS stock for nearly $180,000 even though the company had never earned any revenues. Respondents failed to adequately inquiry into PL Bank's trading activity in CLDS after learning that FJ may have been placing orders through PL Bank's account.

Miller also failed to conduct a proper inquiry when he learned in March 2013 that another broker-dealer, Knight Capital Americas LLC (later known as KCG Americas LLC), took the

[158] CX-176, at 79.

[159] Tr. 1948-49; CX-199; RX-127.

[160] Tr. 2535-36.

[161] Tr. 1950-51, 1954.

[162] Tr. 1993-94. Maier testified that he believed PL Bank was making investment decisions on behalf of its clients and their subaccounts. Tr. 2186. Maier "ma[de] a strong assumption that … there were other clients being introduced through [PL Bank's] account to us, but as common practice in Switzerland, they don't give up their account information." Tr. 1965.

[163] CX-200, at 2.

[164] Tr. 1261; CX-364; CX-365; CX-366. The SEC barred FJ in a principal capacity for three years and ordered him to pay a $50,000 civil monetary penalty. The SEC found that he failed to reasonably supervise a registered representative who engaged in manipulative trading in penny stocks. CX-301.

unusual step of questioning the Firm about whether PL Bank was involved in placing matched orders in CLDS. Miller testified that he did not know what a matched trade was.[165] C.L. King's traders asked Miller whether they could tell Knight the order was "legitimate." Within minutes, Miller responded that they could.[166] Miller also testified that he understood that PL Bank was looking for buyers for its sell orders in CLDS. C.L. King told Swiss BD that this was inappropriate but took no other action.[167]

c. PL Bank's Trading Activity at C.L. King

From June 2009 through at least April 2014, PL Bank sold approximately 40 penny stocks though its account at C.L. King. These transactions totaled approximately 41.4 million shares and generated proceeds of approximately $4.87 million.[168] PL Bank's securities were held in an account at another broker-dealer. Accordingly, C.L. King executed and cleared PL Bank's transactions on a DVP/RVP (delivery versus payment/receive versus payment) basis.[169]

The Complaint identified five specific penny stocks among the 40 that PL Bank traded at C.L. King. As discussed below, the volume of trading in penny stocks, combined with the amount of proceeds PL Bank generated, should have raised red flags for the Firm. Publicly available information about the issuers' relative lack of business and revenues, combined with promotional activity, should have raised additional red flags indicative of potentially suspicious activity in the PL Bank account.

i. Green Star Alternative Energy, Inc.

PL Bank's first transactions after opening its account at C.L. King in June 2009 were sales of shares of Green Star Alternative Energy, Inc. (GSAE). According to an April 2009 SEC filing, GSAE was incorporated in 2001 under a different name to engage in the business of offering educational seminars and workshops. In July 2008, the company abandoned the seminar business. It purportedly began focusing on clean energy joint venture opportunities, including wind energy projects.[170] The SEC filing disclosed that GSAE had no revenues in 2007 and 2008, had an accumulated deficit of $201,808 as of December 31, 2008, and carried a going concern

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[165] Tr. 1229.

[166] Tr. 1218-19; CX-176, at 613-14. That day, March 6, 2013, and the next day, PL Bank's sales of CLDS constituted over 90 percent of total market volume. Stip. ¶ 29.

[167] Tr. 1224, 1263. A few months earlier, Swiss BD asked C.L. King if it would execute a sale of 2 million shares of CLDS for $100,000 to a buyer PL Bank had located. The Firm informed Swiss BD it would not do the trade, but took no other steps. Tr. 1225-26, 1235-39. Middlemiss, Enforcement's AML expert, testified that a proper investigation into PL Bank's trading in CLDS shares would include finding out how it acquired the shares. Tr. 1391-92.

[168] Compl. ¶ 77; Ans. ¶ 77; Stip. ¶ 12; RX-129.

[169] Compl. ¶ 74; Ans. ¶ 74.

[170] CX-251, at 3-4.

opinion from its auditors.[171] In the filing, GSAE stated it had "minimal operations" and was considered a development stage company.[172] In early June 2009, before PL Bank began trading at C.L. King, the British Columbia Securities Commission issued a cease trading order to GSAE. The order was available on OTC Markets website.[173]

During the time that PL Bank was selling GSAE at C.L. King—June 2009 to December 2009—GSAE was the subject of promotions that included the dissemination of newsletters, stock alerts, and emails touting the company. Some promotions contained exaggerated share price predictions.[174] For example, on August 4, 2009, the Green Baron Report described GSAE as its "new stock pick," and the "next SHOOTING STAR."[175] On August 6, 2009, the Green Baron Report and Market Advisors Inc. issued a "speculative buy" recommendation for GSAE with a $2.38 target price. (The stock's closing price was approximately $.55 per share that day.)[176] On August 20, 2009, The Subway exclaimed, "Put GSAE on your radar! We have more to come!!" On August 23, 2009, The Subway again touted GSAE ("More on GSAE!!").[177] The Subway disclosed that it was paid 25,000 shares from a third party to market GSAE stock. The stock's closing price on August 20 and 23, 2009, was approximately $.30 per share. Accordingly, the 25,000 shares were then worth approximately $7,500.[178]

During the first three months after opening its account at C.L. King, from June 30 to September 30, 2009, all of PL Bank's sales transactions were in GSAE.[179] PL Bank liquidated its position in GSAE during 47 trading days. On 17 of these days, PL Bank's sales accounted for over 20 percent of the total market volume in GSAE. On four of these days, PL Bank's sales accounted for over 40 percent of the total market volume. On September 10, 2009, PL Bank's sales accounted for over 60 percent of total market volume.[180] From June 30 to December 14, 2009, PL Bank sold over 1.9 million shares of GSAE, generating proceeds of almost $864,000.[181]

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[171] CX-251, at 18-19.

[172] CX-251, at 21.

[173] CX-250; CX-255, at 3-4.

[174] CX-249, at 1, 16, 49, 64.

[175] CX-248, at 96 (emphasis in original).

[176] CX-248, at 112, 115; CX-353.

[177] CX-249, at 26-27.

[178] CX-249, at 26-27; CX-353, at 2. On June 24, 2009, OTC Picks disclosed that it was paid 5,000 shares of GSAE for marketing the company as a "featured company." CX-248, at 296-98, 309. The closing price of GSAE on June 24, 2009, was approximately $1.85 per share, making the 5,000 shares worth approximately $9,250. CX-353, at 1.

[179] CX-252, at 41-47.

[180] Compl. ¶¶ 136, 146; Ans. ¶¶ 136, 146; Stip. ¶ 28.

[181] CX-353; CX-354.

ii. Cloud Star Corporation

Cloud Star Corporation (CLDS) was in the business of researching and developing a software product to provide computers access to the Internet "cloud." It was incorporated in October 2011.[182] According to the Form 10-Q for the period ending August 31, 2012, CLDS had earned no revenues since its formation a year earlier, and had cash of $169, total assets of $61,448, total liabilities of $80,398, a net loss of $52,721, and a going concern statement by management.[183]

From February to May 2013, CLDS issued press releases announcing, among other things, that it had retained the services of an investor relations company to market itself and that it planned to explore expanding technology used to defend against cyberattacks.[184] In March and April 2013, CLDS was the subject of a promotional campaign that included the dissemination of alerts and a newsletter. The newsletter contained various claims about CLDS, including a price prediction of $3 per share, when the stock was trading at $0.35 per share.[185] The newsletter urged readers, "Bottom Line: You need to act on CLDS now!"[186] A disclaimer in a newsletter disclosed that an affiliate of the promoter was paid $10,000 for the report.[187] On April 1, 2013, Market Authority, a promotional website, encouraged readers to watch CLDS "this morning, it has been picking up momentum last week and is on a steady uptrend."[188] Market Authority disclosed that it was paid $25,000 by a third party "to build investor awareness for CLDS."[189]

On March 6, 2013, PL Bank's sales of CLDS accounted for more than 90 percent of total market volume. The following day, PL Bank's sales accounted for almost 97 percent of the total market volume. PL Bank's liquidations of CLDS on December 17, 2012, and February 21, 2013, accounted for 100 percent of total market volume in CLDS on those days.[190] From December 17, 2012, to March 12, 2013, PL Bank sold approximately 480,000 shares of CLDS in eight transactions. These sales generated proceeds of almost $180,000.[191]

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[182] CX-228, at 8. CLDS formerly was Accend Media before May 2012 when it changed its name and symbol to Cloud Star Corporation and CLDS as a result of a reverse merger transaction. CX-228, at 8.

[183] CX-228, at 4-5, 18. According to its Form 10-Q for the period ending November 30, 2013, CLDS still had earned no revenue. CX-229, at 5.

[184] *See* CX-223, at 1, 4.

[185] CX-225, at 3; CX-347. The newsletter also claimed that "It may only take a few months for CLDS to accelerate into $3.00 to $5.00 territory." CX-225, at 4, 21.

[186] CX-225, at 8.

[187] CX-225, at 12, 28.

[188] CX-225, at 40.

[189] CX-225, at 41.

[190] Compl. ¶ 159; Ans. ¶ 159; Stip. ¶ 29.

[191] CX-347; CX-348.

iii. Dethrone Royalty Holdings, Inc.

Dethrone Royalty Holdings, Inc. (DRHC) claimed it manufactured and distributed sports nutrition and energy beverages. According to its Form 10-Q for period ending October 31, 2012, it had "virtually no financial resources."[192] In its Form 10-Q for the period ending January 31, 2013, DRHC reported total assets of $351,142 (most of which was classified as deferred loan costs) and a cash balance of $2,529. The company also reported $117,529 in total liabilities and no revenues since its inception in 1997. DRHC reported operating at a net loss of $260,582 for the three months ending January 31, 2013.[193]

In March 2013, DRHC was the subject of penny stock promotional newsletters or reports, some of which were disseminated via email. Three promoters touting DRHC disclosed that they were compensated $10,000, $15,000, and $50,000 for promoting the company.[194] Each promotion contained questionable statements about DRHC's performance. A newsletter dated March 20, 2013, contained a link to a webcast interview with DRHC's CEO in which he made questionable statements, including a prediction that DRHC, even though it had never earned any revenues, would soon be as successful as Monster Beverage Company, a beverage company with revenues in excess of $2 billion.[195]

From January 7, 2013, to May 16, 2013, PL Bank liquidated approximately 7.8 million shares of DRHC through its account at C.L. King. These sales generated proceeds of almost $218,000.[196] C.L. King's liquidations of DRHC stock from the PL Bank account took place over 41 trading days. On 20 of those days, PL Bank's sales accounted for over 20 percent of total market volume in DRHC. On February 4, 2013, PL Bank's sales of DRHC accounted for over 60 percent of total market volume.[197]

iv. Innocap, Inc.

Innocap, Inc. (INNO) was in the business of locating and salvaging shipwrecks. According to its Form 10-Q for the period ending April 30, 2013, it had no revenues since its formation in 2004, total net losses of nearly $300,000, unaudited financial reports, and a going concern opinion.[198]

In approximately July 2013, multiple stock promotion websites touted the purported merits of investing in INNO. Some cited a research report that predicted a $2.00 price for

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[192] CX-235, at 8, 17.

[193] CX-234, at 4-5.

[194] CX-232, at 15, 23, 28, 33.

[195] CX-237; CX-237a, at 18. Monster Beverage Company's revenues in 2012 exceeded $2.3 billion, according to the Form 10-K filed for the period ending December 31, 2012. CX-238, at 39.

[196] CX-349; CX-350.

[197] Compl. ¶ 167; Ans. ¶ 167; Stip. ¶ 30.

[198] CX-298, at 6-10. *See also* CX-296.

INNO's shares.[199] According to a disclaimer contained in one of the promotions, the promoter was paid $32,500 for a one-day profile of INNO.[200] On July 25, 2013, one promotional site, Stock Reads, exclaimed that "INNO is my new pick! A stock which can only go up is an awesome thing." It disclosed it was paid $25,000 by a third party to promote INNO.[201]

C.L. King's liquidation of INNO stock from PL Bank's account took place over 18 trading days. On 14 of these days, PL Bank's sales accounted for over 20 percent of total market volume. On three of these days, PL Bank's sales constituted over 60 percent of total market volume in INNO. On August 14, 2013, PL Bank's sales of INNO accounted for over 80 percent of total market volume.[202] From June 11, 2013, to August 26, 2013, PL Bank sold over 2 million shares of INNO, generating proceeds of $39,685.[203]

v. Southridge Enterprises, Inc.

Before 2012, Southridge Enterprises, Inc. (SRGE) claimed it was in the ethanol business. In 2012, it purportedly moved into the gold and silver exploration and mining business in Mexico.[204] According to its unaudited annual report posted on the OTC Markets website, for the year ending August 31, 2011 (dated December 11, 2011), SRGE reported no revenues since at least September 2009, a net loss of over $2 million, and a going concern statement.[205] SRGE last made a disclosure filing with the SEC in 2008.[206] The company stopped filing reports with the SEC in April 2011.[207]

On January 16, 2012, an investment research firm based in Switzerland issued a report on SRGE that contained a "SPECULATIVE BUY" rating and a target price of $0.20, even though the company had never had any revenues. At the time, SRGE was trading at approximately $0.0003 per share.[208] The research firm disclosed that its owners or affiliates "may have interests or positions in equity securities of the companies profiled in this report, some or all of which may have been acquired prior to the dissemination of this report."[209]

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[199] CX-299, at 74-75.

[200] CX-299, at 10. Another promoter disclosed it was compensated $1,500 for one day of coverage of INNO. CX-299, at 25.

[201] CX-299, at 83, 85.

[202] Compl. ¶ 172; Ans. ¶ 172.

[203] Compl. ¶ 171; Ans. ¶ 171; CX-355; CX-356.

[204] CX-282, at 3.

[205] CX-279, at 13, 18, 22, 26.

[206] CX-278.

[207] CX-277.

[208] CX-283, at 1; CX-357.

[209] CX-283, at 7.

PL Bank liquidated its SRGE stock from its account at C.L. King over six trading days. On five of these days, PL Bank's sales accounted for over 20 percent of total market volume, and on two the days, its sales constituted over 40 percent of total market volume in SRGE. On January 12, 2012, PL Bank's sales of SRGE accounted for over 80 percent of total market volume.[210] From January 6 to January 18, 2012, PL Bank sold 11 million shares of SRGE for proceeds of approximately $3,246.[211]

2. ABC Corp.'s Penny Stock Transactions

a. The Firm's Introduction to ABC Corp.

During 2012, Maier met ABC Corp.'s owner through another broker-dealer where ABC Corp. had accounts. Maier had not heard of ABC Corp. or its owner before then.

Maier described ABC Corp.'s business model and C.L. King's anticipated role in a memo to the Firm's new business committee.[212] ABC Corp.'s business model involved depositing and then selling large volumes of penny stocks.[213] ABC Corp. loaned companies between $50,000 and $100,000, using a convertible note at 8 percent interest. According to Maier, ABC Corp. made approximately 50 loans per month to companies whose securities were quoted on the Over-the-Counter Bulletin Board or the Pink Sheets. It estimated its annual securities sales totaled $70 million and that it had 40 orders outstanding at a time. Maier estimated that at any one time the anticipated ABC Corp. account would hold securities with an approximate value of $40 million.[214]

According to Maier, ABC Corp. was a "lender of last resort" to companies who were not able to borrow money from traditional lenders because they had no track record of conducting business and no revenue. If the company could not repay the loan, ABC Corp. would be compensated with shares the company would issue to it at a discount of between 35 percent and 50 percent from the current market price of the shares.[215] ABC Corp., according to Maier, would sell the shares of the companies' stock they issued "when [ABC Corp.'s owner] felt it was the right time" to do so. This would allow the owner to "pay himself back and hopefully make a profit."[216] Maier understood that the shares in the companies ABC Corp. received were not registered but that ABC Corp. sold them pursuant to exemptions provided in SEC Rule 144 of

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[210] Compl. ¶ 178; Ans. ¶ 178; Stip. ¶ 31.

[211] CX-357; CX-358.

[212] Tr. 2012-16; CX-150c, at 1; CX-154, at 2-3.

[213] Tr. 940-41 .

[214] CX-150c, at 1.

[215] CX-154, at 6. *See also* CX-150c, at 5-30.

[216] Tr. 2009-10.

the Securities Act.[217] Maier did not have direct experience selling securities pursuant to Rule 144 and, although he traded low-priced stocks, he had never traded penny stocks.[218] Miller's experience with penny stocks by the time ABC Corp. opened its account was limited to PL Bank's penny stock sales.[219]

ABC Corp. employed a law firm whose role was to ensure that the securities it deposited at C.L. King would be in tradable form. ABC Corp.'s attorneys would provide C.L. King with a "Letter of Representation" stating that the securities may be sold pursuant to SEC Rule 144. C.L. King believed that ABC Corp.'s attorney was an authority on Rule 144, who "knew all the nuances" of the Rule so the Firm "was comfortable" with taking on ABC Corp.'s business.[220]

Maier conferred with C.L. King's traders, who reviewed the stocks ABC Corp. owned at the time, and were "comfortable with all of them." The traders saw no issue with ABC Corp.'s business strategy. Maier expected that ABC Corp. would pay "between 4-5% of the value of [each sell] order as commission" and the business would be "extremely profitable."[221] According to Maier, ABC Corp. paid other broker-dealers where it held accounts between $3 and $3.5 million in commissions in 2011.[222]

In August 2012, Maier, together with the Firm's CCO and its General Counsel, met with ABC Corp.'s owner and attorney. Shortly after the meeting, ABC Corp.'s attorney wrote to Maier. He said that ABC Corp. was "engaged in a portion of the investment venue which requires a high degree of sophistication and it was immediately obvious that both you and your firm could provide the expertise necessary to process the numerous transactions anticipated on a daily basis."[223]

ABC Corp.'s owner told C.L. King that at the time he was using more than one broker-dealer to handle all of ABC Corp.'s sales transactions but wanted to consolidate his business in one broker-dealer.[224] "C.L. King would be a good fit," the owner wrote to the Firm, adding that "There are possible synergies with your [investment banking] department as well."[225]

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[217] Tr. 2011. Though not itself a statutory exemption from the registration requirements of the federal securities laws, the safe harbor provisions in SEC Rule 144 allow the public resale of restricted securities if certain conditions are met.

[218] Tr. 1990.

[219] Tr. 1269-70.

[220] Tr. 408. The Firm's General Counsel described ABC Corp.'s outside counsel as "on the ball as to Rule 144." CX-165, at 4.

[221] CX-154, at 2.

[222] CX-150c, at 1. *See also* CX-154, at 1-3.

[223] CX-154, at 10; CX-155.

[224] Tr. at 448; CX-311, at 19.

[225] CX-154, at 7.

The Firm prepared a due diligence package on ABC Corp. and its owner, which included an internal new client questionnaire.[226] According to information ABC Corp. provided, its owner was at one time registered with FINRA members.[227] The Firm's CCO checked the SEC's EDGAR system and found that there were 700 corporate filings that mentioned ABC Corp., which demonstrated to him that it had been in business for a while.[228]

The Firm conducted reference checks into ABC Corp. and its owner and found no adverse information. Although Maier saw posts on the Internet describing the owner of ABC Corp. as a "toxic debt financier," he did not think they came from a "verifiable source." The CCO also saw the posts but the Firm did not find any regulatory actions or other formal proceedings against ABC Corp. or its owner after searching the Internet. Maier asked the owner and his attorney about the allegations of toxic debt financing and "got an answer that satisfied" the Firm.[229] Maier reasoned that ABC Corp.'s and its owner's business of loaning money and converting unpaid debt into penny stocks, then liquidating them, was different from a penny stock scam, which to him involved a pump-and-dump scheme—pumping up the price of a stock and then dumping it.[230]

At around the time the Firm was conducting its due diligence, ABC Corp. and its owner were named as defendants in a civil action filed in federal court in late 2012. The complaint alleged that the defendants had engaged in a fraudulent "massive 'pump and dump' scheme," in violation of Section 10(b) of the Exchange Act and Rule 10b-5 and sold unregistered securities in violation of Section 5 of the Securities Act. Respondents did not see this complaint during their due diligence.[231]

After the Firm completed its due diligence, the new business acceptance committee approved ABC Corp.'s business.[232] Even though no other C.L. King client had ever engaged in the sort of business that ABC Corp. had,[233] the Firm determined that there was "no real risk from

[226] Tr. 410, 2039, 2193; CX-154.

[227] CX-154, at 6.

[228] Tr. 538. ABC Corp. had been in business for four and a half years, according to the Firm's due diligence documents, which reflected that it was incorporated in 2008. CX-151, at 8.

[229] Tr. 2018-25; CX-195, at 1. In an August 2012 posting, the SEC explained that convertible security financings, with conversion formulas based on the prevailing market price of shares, can lead to dramatic stock price reductions. Such convertibles called "toxic" or 'death spiral" convertibles. CX-191, at 1; *see also* https://www.sec.gov/fast-answers/answersconvertibleshtm.html.

[230] Tr. 2026. According to the SEC, "pump-and-dump" schemes involve the touting of a company's stock (typically small, so-called "microcap" companies) through the dissemination of false and misleading statements to the marketplace. *See* https://www.sec.gov/answers/pumpdump.htm.

[231] Tr. 1282, 2034-36; CX-153, at 1, 4-5. There is no evidence that the pump and dump alleged in the civil action involved securities that ABC Corp. sold through C.L. King. Enforcement discovered the lawsuit through a link provided on Investors Hub website by conducting an Internet search. Tr. 158.

[232] CX-154, at 3.

[233] Tr. 376.

a financial point of view" because all the securities that ABC Corp. would deposit in its account would be fully paid for.[234] The Firm expected that it would not be a market maker in any of the stocks ABC Corp. would sell.[235]

b. Respondents' Creation of a "Checklist" to Clear ABC Corp.'s Stock Deposits

During the ABC Corp. onboarding process, the Firm's CCO directed its General Counsel and Miller to develop procedures to ensure that ABC Corp.'s stocks were saleable. He also directed Miller to develop procedures for the "surveillance of markets" to "ensure that the market is free from funny biz" relating to stocks ABC Corp. sold.[236] The CCO also consulted FINRA about ABC Corp.'s business. According to him, FINRA alerted the Firm to the risk that it "would be part of something like a stock manipulation or funding activity that would be of interest to [the Financial Crimes Enforcement Network]" ("FinCEN") by handling ABC Corp.'s business. The CCO also noted that anticipated areas of concern with ABC Corp.'s trading would be "unusual spikes" in stock price, "who is moving the stock?," and AML issues.[237] A month later, the CCO told Miller, "There is a healthy amount of concern that we stay on top of [ABC Corp.'s] activities." He instructed Miller that, once ABC Corp. became a customer, to check the price at which ABC Corp. sold stock ("make sure pricing is in line" with the market) and review the market before and after sales of a security.[238] Miller responded that "we plan to monitor [ABC Corp.'s] activity more closely" in the first year. He confirmed that the Firm would review pricing and volume before and after an ABC Corp. stock sale.[239]

As a result of management's concerns, C.L. King created a one-page form—the "[ABC Corp.] – Rule 144 Sales Due Diligence Checklist" (the "Checklist")—to document the Prime Service Department's due diligence efforts for each of ABC Corp.'s stock deposits.[240] The Firm had never created a similar checklist for any other clients because it had never engaged in the business of liquidating securities in the volume and manner that ABC Corp. did.

The Firm also developed a one-page set of procedures specifically for ABC Corp. The procedures addressed primarily the mechanics for confirming that ABC Corp.'s stock deposits were ready for trading. The procedures required that before ABC Corp. could sell stock the Prime Services Department had to complete the Checklist, the Operations Department had to

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[234] CX-154, at 2.

[235] On ABC Corp.'s instructions, C.L. King routed most of ABC Corp.'s sell orders for execution to one broker-dealer that specialized in market making.

[236] Tr. 2496-97; RX-107, at 2.

[237] Tr. 2400; RX-108.

[238] RX-104, at 1-2.

[239] Tr. 2540-41; RX-103, at 1.

[240] Tr. 418, 1272, 2049; CX-196; CX-215; RX-101, at 2.

confirm delivery of the shares, and Legal or Compliance had to give trading approval. The completed checklist was then sent to the trading department.[241]

It generally took about one hour, sometimes less, to run through a Checklist for a particular stock deposit. It could take considerably less time in the case when a deposit involved a security that was already reviewed as a result of a prior stock deposit. Some days, the Firm received multiple stock deposits from ABC Corp.[242] Because ABC Corp. had multiple convertible loans outstanding with the same issuer, it made multiple deposits of the issuer's securities.

The Checklist was developed with input from Miller, as the AML Compliance Officer, and other persons in compliance. During the first three months after ABC Corp. opened its account at the Firm, the General Counsel, with Miller's assistance, trained Maier and another Prime Services Department employee on what to look for to ensure that ABC Corp. provided all necessary documentation for its deposits. The Prime Services Department staff was ultimately responsible for completing the Checklist each time ABC Corp. deposited stock.

The Checklist required the name of the issuer whose stock ABC Corp. deposited, the number of shares currently outstanding, the number of shares ABC Corp. had deposited, and a calculation of ABC Corp.'s percentage of the issuer's shares outstanding. If ABC Corp. deposited less than ten percent of the outstanding shares, the Checklist would note that it was not an affiliate or control person of the issuer. ABC Corp. commonly deposited multiple tranches of stock of an issuer that, combined, exceeded ten percent of the total shares outstanding, but never at any one time. Maier and others in the Prime Services Department also had to review the issuer's SEC filings, and, if it was not a reporting company, obtain its recent financial statements. The Checklist also called for identifying where the stock was listed—on the Over-the-Counter Bulletin Board or Pink Sheets. The Checklist specified that the Prime Services Department review the prior five days of trading activity in the stock and "refer any suspicious activity" to the Legal and Compliance Departments. It did not explain what sort of trading activity during the preceding five days was suspicious.[243] At times, Miller and the Firm's Director of Operations were consulted on what to look for before approving the deposits.[244] The Firm relied on ABC Corp.'s attorney's legal opinion that the deposits satisfied the requirements of Rule 144.[245]

Finally, the Checklist required reviewers in the Prime Services Department to conduct a "visceral" Internet search using the issuer's name "to determine whether the company has been subject to any investigations and/or claims of regulatory/legal issues such as market

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[241] Tr. 2502-08; RX-89; RX-90; RX-91; RX-101.

[242] Tr. 2054-55, 2090-91.

[243] CX-101, at 2; CX-215.

[244] Tr. 2053.

[245] Tr. 2059-60; CX-197.

manipulation or possible sales/distribution violations." The Checklist directed them to include a search of the OTC Markets website "active message boards."[246] Miller understood that a "visceral" Internet search meant that the Prime Services Department did a "general" search, using Google or the OTC Markets website, but he was not certain because he was not directly involved with processing the stock deposits.[247] Maier testified that the "visceral" search involved reviewing Yahoo! Finance, the OTC Markets website, and FactSet (a provider of financial information and financial software). The Prime Services Department did not document which sites they reviewed. Instead, its staff simply checked the box indicating they did an Internet search. They never discovered any negative information about the issuers whose stock ABC Corp. liquidated.[248]

c. ABC Corp.'s Liquidations

ABC Corp. opened an account at C.L. King in November 2012.[249] From December 4, 2012, to November 25, 2013, ABC Corp. made approximately 788 deposits of common stock in approximately 138 penny stocks into its C.L. King account. The 788 deposits totaled approximately 11.7 billion shares.[250] ABC Corp. sold the 11.7 billion shares in approximately 2,100 trades, all at prices of less than a dollar per share and most at prices less than one cent per share, for gross sales proceeds of more than $14.39 million. C.L. King earned over $574,000 in commissions from ABC Corp.'s penny stock liquidations. From February 11, 2013, to September 2013, ABC Corp. withdrew the proceeds of these penny stock sales from its C.L. King account in 35 wire transfers, or at a rate of more than one wire transfer per week.[251] C.L. King terminated its brokerage relationship with ABC Corp. by the end of 2013.[252]

On ABC Corp.'s owner's instructions, C.L. King routed the majority of ABC Corp.'s sales transactions to another broker-dealer for execution, facilitating the Firm's sales of ABC Corp.'s low-priced shares to other customers and broker-dealers. C.L. King believed that the other broker-dealer "had a strong reputation and vast experience in the low priced securities trading market." It also considered its use of the other broker-dealer as an executing broker to be "an important supplement to the Firm's plan for handling [ABC Corp.'s] business."[253]

After approximately three months of selling securities for ABC Corp., C.L. King was not earning commissions from the sell transactions at the expected rate of $3 million per year. Instead, ABC Corp.'s business was about 25 percent of what Maier anticipated. C.L. King also

[246] CX-101, at 2; CX-215.

[247] Tr. 1274-75.

[248] Tr. 420, 2062-65.

[249] Compl. ¶ 68; Ans. ¶ 68; Stip. ¶ 9; CX-151.

[250] Compl. ¶ 69; Ans. ¶ 69; Stip. ¶ 10; CX-157; RX-81.

[251] Compl. ¶ 70; Ans. ¶ 70; Stip. ¶ 11; CX-158.

[252] Stip. ¶ 10.

[253] Compl. ¶ 71; Ans. ¶ 71.

expected that ABC Corp. would make about 250 deposits of securities per month, but it did not. In April 2013, Maier wrote to ABC Corp.'s owner to inquire about the expected consolidation of all of ABC Corp.'s business with C.L. King.[254] Despite the owner's assurances that he would consolidate ABC Corp.'s business with C.L. King, the Firm did not see any "meaningful increase in [ABC Corp.'s] business."[255]

When C.L. King agreed to take on ABC Corp.'s business, it imposed a four-day waiting period after the deposit of stock to ensure the shares were eligible for resale. Within a few months, under pressure from ABC Corp.'s owner, the Firm agreed to reduce the waiting time so ABC Corp. could sell its stock as fast as possible. In March 2013, ABC Corp.'s owner asked the Firm to reduce the waiting time from four days to three days for two securities it had deposited. ABC Corp.'s owner explained that he wanted to take advantage of positive market news about the securities.[256] In April 2013, ABC Corp. again asked that the waiting period be reduced for two other stocks because of a recent Form 10-K filing and a press release about changes in management.[257] Maier was not concerned because any seller of stock would want to take advantage of positive news. The Firm's CCO agreed to reduce the waiting time to three days.[258] A few months later, in June 2013, ABC Corp.'s owner asked the Firm to reduce the waiting period to one day, explaining that other firms where ABC Corp. had accounts sold its securities one day after they were deposited.[259] C.L. King agreed.[260] Maier explained that he believed there was no risk to reducing the waiting period because the securities ABC Corp. deposited were usually in sellable form within one business day. He testified that the Firm did not see this as a financial risk or an AML risk and it would not affect C.L. King's due diligence review of each deposit ABC Corp. made.[261]

The Complaint identifies seven specific penny stocks from the 138 penny stocks that ABC Corp. sold through its account at C.L. King. As with the stock that PL Bank sold, Enforcement alleges that the total volume of shares and the amount of proceeds ABC Corp. earned from the sales were red flags that should have been investigated for suspicious activity. The Panel finds that the red flags include the issuers had little or no business or revenues; they changed businesses and names; they were the subject of promotional activity by persons who were paid to promote the stock; and some issuers had connections to persons with regulatory or criminal histories. These facts should have raised red flags with Respondents but they did not.

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[254] Tr. 2070-72; CX-183.

[255] Tr. 2083.

[256] Tr. 431-32; CX-311, at 30.

[257] CX-322, at 2.

[258] Tr. 427-29; CX-322, at 1.

[259] Tr. 433-34, 2074-79; CX-190.

[260] Tr. 2083, 2203.

[261] Tr. 2080-81, 2202-03.

i. First Columbia Gold Corp.

First Columbia Gold Corp. (FCGD) described itself as an "exploratory stage enterprise" that was "devoting all of its present efforts in securing and establishing a new business."[262] In 2010, it changed its name to First Columbia. In the Form 10-Q for the period ending September 30, 2012, FCGD claimed that the "focus of its business and operations is on the development of our mineral property interests on properties located in the western United States" and that it was looking for other opportunities in other locations, including Colombia and Bolivia.[263] FCGD disclosed that it had an accumulated deficit of nearly $19 million.[264] In the Form 10-K for the period ending December 31, 2012, FCGD again described itself as an exploratory stage company. It had no full-time employees and its officers did not devote their services full-time to the company.[265] According to the Form 10-K, FCGD's only source of revenues in 2011 and 2012 was from issuing a total of $130,000 in convertible notes to ABC Corp.[266]

On April 24, 2013, FCGD was the subject of promotional activity on the Internet by multiple penny stock websites. On the same day, trading volume in FCGD rose to 168 million shares.[267] For example, Penny Stock General said FCGD is "our momentum play today" and "FCGD on momo [*i.e.*, momentum] alert."[268] Stock Market Watch wrote "This is the major announcement that you have been waiting for. We expect this play to kick up in a major way, due to the awareness campaign that we have established."[269] Stock Market Watch also stated, "I am very excited this morning. We have a hot new momo [momentum] play on tap that we think could reap members nice rewards."[270] Penny Stock General exclaimed "FCGD – Today's Big Alert!" and "our new pick is FCGD!," adding that "this is one momentum play you do not want to miss out on!"[271]

From December 21, 2012, to August 23, 2013, ABC Corp. deposited a total of approximately 30,649,033 shares of FCGD into its C.L. King account. On April 24, 2013, ABC Corp. sold 5,883,333 shares of FCGD, generating proceeds of over $31,000. On four of the five days that ABC Corp. sold FCGD, its sales represented over 30 percent of total market volume in FCGD. On three of the five days, ABC Corp.'s sales of FCGD represented over 40 percent of

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[262] CX-240, at 10. It was incorporated in 1997 under a different name.

[263] CX-240, at 39.

[264] CX-240, at 5.

[265] CX-239, at 6-7, 9.

[266] CX-239, at 40.

[267] CX-351c, at 2. Daily market trading volume in the previous ten trading days ranged from 761,000 shares to 16,518,666 shares.

[268] CX-242, at 46, 56; CX-351c, at 3.

[269] CX-242, at 64; CX-351c, at 3.

[270] CX-242, at 125.

[271] CX-242, at 113-15, 120-21; CX-351c, at 3.

total market volume.[272] Between January 2, 2013, and August 23, 2013, ABC Corp. liquidated its position in FCGD in five trades, generating approximately $44,204 in proceeds at an average sales price of approximately $.0015 per share.[273]

ii. Alternative Energy Partners, Inc.

Alternative Energy Partners, Inc. (AEGY) claimed to be "involved in the alternative energy sector."[274] In its Form 10-Q for period ending October 31, 2012, AEGY reported that in the four and a half years since its inception its revenues totaled $3,701 and it had incurred an accumulated deficit of more than $7.2 million.[275] According to press releases, in May 2013, AEGY changed its business. It announced it was acquiring an online payment system from iEquity Corp. that facilitated purchases of medical marijuana.[276] One press release also explained that the recent high volume of trading in AEGY stock was the result of issuing over 120 million shares to ABC Corp. from convertible promissory notes.[277]

From December 28, 2012, to June 24, 2013, ABC Corp. deposited approximately 395,872,013 shares of AEGY. On 27 of the 29 days that ABC Corp. liquidated AEGY shares, ABC Corp.'s sales accounted for over 20 percent of total market volume. On six of these days, ABC Corp.'s sales accounted for over 40 percent of total market volume.[278] From January 2, 2013, to June 24, 2013, ABC Corp. liquidated its position in AEGY in 29 trades, which, at an average sales price of approximately $.001 per share, generated proceeds of approximately $710,000 and approximately $27,529 in commissions for C.L. King.[279]

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[272] Compl. ¶¶ 79, 88-89; Ans. ¶¶ 79, 88-89; Stip. ¶¶ 13-15.

[273] CX-351c; CX-352.

[274] CX-221, at 12.

[275] CX-221, at 7, 26.

[276] Tr. 579; CX-220, at 1, 4; CX-180, at 1.

[277] CX-181, at 1. In July 2009, the SEC initiated an administrative proceeding against the incorporator of iEquity Corp., alleging that he certified false quarterly filings and materially misled the auditor of a company for which he was the Chief Financial Officer. In March 2010, the iEquity incorporator consented to an order in which he agreed to cease and desist from future violations of securities laws, including antifraud provisions, and that he would not serve as an officer or director of a public company and not appear before the SEC as an accountant. Tr. 189; CX-222.

[278] Compl. ¶¶ 90, 96; Ans. ¶¶ 90, 96; Stip. ¶¶ 16-17.

[279] Compl. ¶ 95; Ans. ¶ 95; CX-345; CX-346. After ABC Corp. completed liquidating its position in AEGY in June 2013, the InvestorsHub website posted messages in July and September 2013 from persons questioning AEGY's claims about its business activities, including the claim that it had a contract relating to medical marijuana worth $5 million. CX-219. One posted message questioned whether iEquity's incorporator was part of AEGY's "share selling scheme." CX-219, at 4.

iii. Stakool, Inc.

Stakool, Inc. (STKO) purportedly was in the business of developing and manufacturing natural food products.[280] It had no employees aside from its sole officer and director. Total revenues in 2011 and 2012 were $16,710 and $17,435, respectively. It had net losses of over $5.3 million as of December 31, 2012.[281]

In April 2013, STKO was promoted on the websites of Stock Market Watch, Penny Stock Tweets, and Stock Promoters. Some promotions described STKO as "another stock we've been tracking recently," and that it was on the website's "extended watchlist."[282] One website acknowledged that "on occasion [it] is compensated by a third party,"[283] but did not specifically state that it was paid to promote STKO.

From March 19, 2013, to July 26, 2013, ABC Corp. made five deposits of STKO totaling approximately 814,166,667 shares. All of the deposits were more than 100 million shares and two exceeded 200 million shares. ABC Corp. liquidated its position in STKO during 28 trading days. Between March 25, 2013, and August 6, 2013, ABC Corp. liquidated its position in STKO in 31 trades during 28 trading days. On 19 of these days, ABC Corp.'s sales accounted for over 20 percent of the total market volume in STKO. On three of these days, ABC Corp.'s sales accounted for over 40 percent of total market volume.[284] ABC Corp.'s sales of STKO generated approximately $136,893 in proceeds at an average price of $.0001 per share.[285]

iv. SafeCode Drug Technologies, Inc. and Medisafe 1 Technologies Corp.

SafeCode Drug Technologies, Inc. (SAFC) and Medisafe 1 Technologies Corp (MFTH) claimed to be in similar businesses—developing and marketing a device and software that would help ensure that the correct medicine is administered to patients in correct dosages. They both claimed that in November 2012, they entered into a licensing agreement granting SAFC the non-

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[280] According to the Form 10-K for the year ending December 31, 2012, STKO was incorporated in 1993 under a different name. According to information available on the OTC Market website, it changed its name five times before becoming Stakool in December 2009. CX-287, at 1; CX-293, at 6.

[281] CX-293, at 6-7, 19, 24. STKO filed the Form 10-K April 16, 2012. In May 2010, a federal indictment charged STKO's then-President and three other persons, with conspiracy to commit securities fraud, securities fraud and aiding and abetting securities fraud in connection with a scheme to manipulate two microcap stocks. Tr. 194; CX-289; CX-290; CX-291; CX-292. In September 2010, the SEC charged STKO's President with fraud in connection with the activity that led to his indictment. Compl. ¶ 102; Ans. ¶ 102; Stip. ¶ 19; CX-288.

[282] CX-286, at 1, 4, 7-9, 12, 14.

[283] CX-286, at 16.

[284] Compl. ¶¶ 97, 105; Ans. ¶¶ 97, 105; Stip. ¶¶ 18, 20.

[285] Compl. ¶ 104; Ans. ¶ 104.

exclusive right and license to manufacture and market MFTH's purported technology in this area.[286]

SAFC's Form 10-K for the year ending December 31, 2012 (filed March 25, 2013) reported that it had earned no revenue since its formation in November 2010 and had "no operations." As of December 31, 2012, SAFC had a cumulative net loss since inception of over $2.1 million.[287]

MFTH's Form 10-K for the year ending December 31, 2012, reported no revenues since its inception in 2009, aside from ten million SAFC shares that SAFC paid it for the license agreement, which the two companies valued at $1.8 million.[288] According to the Form 10-K, MFTH was in the development stage and had no operations. MFTH's accountants "expressed substantial doubt about [MFTH's] ability to continue as a going concern."[289]

From November 2012 to February 2013, SAFC and MFTH were the subjects of promotional activity. On November 7, 2012, for example, the website Stock Reads placed SAFC on its "alert list." The next day, it told its readers that SAFC was its "hot new pick" and the stock "is high alert today [so] don't get left behind when our brand new pick rises to new highs!"[290] On November 12, 2012, it said that SAFC was "a golden opportunity that our members should not miss!"[291] On January 6, 2013, Stock Lock and Load predicted that SAFC "could see Triple Digit Percent Gains."[292] On January 8, 2013, Stock Lock and Load said that a recent company news release "certainly Impressed Traders as they were Lined Up @ 9:30am EST to Pick Up shares of SAFC!" and investors "who Picked Up Shares at this Price Level were Handsomely Rewarded!" Stock Lock and Load disclosed that it was paid $15,000 for "one day coverage of SAFC" by a third party.[293]

On January 30, 2013, Stock Reads put MFTH on its list of stocks to watch that day. On February 14, 2013, The Stock Psycho released a newsletter describing MFTH as "Today's Hot 1 Day Play." It also said that MFTH is "set up for a huge increase in volume today, and possibly "a

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[286] CX-257, at 6, 29; CX-276, at 7, 26.

[287] CX-276, at 6-7, 13, 20, 25.

[288] CX-257, at 6, 19; CX-276, at 7.

[289] CX-257, at 7, 24. The attorney who issued an opinion supporting MFTH's initial Form S-1 to register its securities pleaded guilty in 2012 to Federal criminal charges that he conspired to commit securities fraud, wire fraud, and mail fraud. He had participated in falsifying documents that facilitated the issuance of shares of stock in a company (unrelated to MFTH) so the shares could be sold to the public. CX-258, at 78; CX-261, at 2.

[290] CX-275, at 1-2.

[291] CX-275, at 3. On November 13, 2012, Stock Reads ran an SAFC promotion that began "SAFC Show me the money!" CX-275, at 13.

[292] CX-275, at 97 (emphasis in original).

[293] CX-27, at 91-92 (emphasis in original). On January 6, 2013, another promoter of SAFC, Penny Stock Lock, disclosed it was paid $15,000 by a third party for a "one-day profile of SAFC." CX-275, at 95.

big ONE DAY POP perfect for a quick trade."[294] The Stock Psycho disclosed that it was paid $45,000 by a third party "to conduct two days of investor relations marketing of MFTH."[295] It also disclosed that nearly two years earlier, in May 2011, it was paid $30,000 by a third party to market MFTH for two days.[296]

From June 11, 2013, to August 27, 2013, ABC Corp. made four deposits of SAFC stock totaling approximately 23,825,277 shares. ABC Corp. liquidated its position in SAFC during 15 trading days. On 14 of these days, ABC Corp.'s sales accounted for over 20 percent of total market volume in the stock. On eight of these days, ABC Corp.'s sales accounted for over 40 percent of total market volume.[297] From June 14, 2013, to August 28, 2013, ABC Corp. sold its position in SAFC in approximately 15 trades, generating proceeds of approximately $66,431 in proceeds and $2,774 in commissions for C.L. King.[298]

From January 10, 2013, to January 22, 2013, ABC Corp. made two separate deposits of shares of MFTH totaling approximately 37,188,356 shares.[299] Between January 16, 2013, and January 28, 2013, ABC Corp. sold its position in MFTH in three trades, generating $83,580 in proceeds and $3,482 in commissions for C.L. King.[300]

v. FastFunds Financial Corp.

FastFund Financial Corp. (FFFC) was a holding company that, through a subsidiary, was purportedly in the business of providing check cashing services and credit and debit card cash advances to customers at Native American-owned gambling establishments. According to its Form 10-K for the year ended December 31, 2012, it had "incurred significant losses since its inception," and "presently has no ongoing business operations or sources of revenue." FFFC reported revenues of $44,225 and $36,518 for 2011 and 2012, respectively. It had a net loss of $512,444 for 2012. In the Form 10-K, FFFC stated that "any investment in the Company must be considered purely speculative."[301]

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[294] CX-259, at 12-13 (emphasis in original).

[295] CX-259, at 12, 17.

[296] CX-259, at 17. According to other evidence presented at the hearing, other promoters were paid between $5,000 and $20,000 between February 2012 and June 2012 to market MFTH's securities. CX-159, at 20-24.

[297] Compl. ¶¶ 106, 119; Ans. ¶¶ 106, 119; Stip. ¶¶ 21, 23.

[298] Compl. ¶ 118; Ans. ¶ 118.

[299] Compl. ¶ 107; Ans. ¶ 107; Stip. ¶ 22.

[300] Compl. ¶ 116; Ans. ¶ 116.

[301] CX-247, at 3-4, 6, 8, 21, 23. The Form 10-K was filed April 16, 2013. FFFC was incorporated 1985. In 1994, a person who later was the Chairman and Director of FFFC during the period that ABC Corp. liquidated FFFC shares was the subject of an SEC administrative action in which he consented to an order that he cease and desist from committing future violations of the Investment Company Act of 1940 and disgorge $73,775. Tr. 663, 669; CX-245, at 2; CX-246, at 33; CX-247, at 9.

In March 2013, FFFC was the subject of promotional activity on the Internet. On March 24, 2013, for example, Stock Reads claimed that FFFC "has positioned itself nicely over the course of the past week for another possible bounce play." The promoter was paid $3,500 for its marketing efforts by a third party.[302] More promotions about FFFC appeared on the website on March 25 and 26, 2013.[303]

From December 12, 2012, to September 10, 2013, ABC Corp. made four separate deposits of FFFC stock totaling approximately 25,673,881 shares. ABC Corp. liquidated its position in FFFC during 21 trading days. On 12 of these days, ABC Corp.'s sales of FFFC accounted for over 40 percent of total market volume. On February 12, 2013, ABC Corp.'s sales accounted for over 60 percent of total market volume.[304] Between December 19, 2012, and September 11, 2013, ABC Corp. sold its position in FFFC in approximately 21 trades, generating proceeds of approximately $70,773 and approximately $2,952 in commissions for C.L. King.[305]

vi. IC Punch Media (PNCH)

IC Punch Media Inc. (PNCH) claimed it owned and operated "a network of city-based Websites for travelers and local individuals," providing information about hotels, restaurants, and entertainment. PNCH's Form 10-K for the year ending December 31, 2012, reported revenues of $30,666 and $195,082 in 2011 and 2012, respectively, but also net losses of over $6 million in 2012.[306]

According to the Form 10-K, in July 2012 the company had entered into an agreement to acquire Punch Television Network. It agreed to pay 135 million shares of PNCH for the acquisition. In May 2013, PNCH disclosed in a Form 8-K that the acquisition had been cancelled, together with the shares issued to pay for the acquisition.[307] PNCH's CEO, a former registered representative, had a regulatory history.[308]

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[302] Tr. 623-24; CX-244, at 1-2.

[303] CX-244, at 4-8.

[304] Compl. ¶¶ 120, 124; Ans. ¶¶ 120, 124; Stip. ¶¶ 24-25.

[305] Compl. ¶ 123; Ans. ¶ 123.

[306] CX-270, at 5, 13, 18, 22.

[307] CX-271.

[308] In 1998, the SEC filed an action against the registered representative, who later became PNCH's CEO, and a company he controlled. The SEC charged that he publicly circulated recommendations about the securities of certain companies without disclosing he received at least $20,000 to make the recommendations, in violation of Section 17(b) of the Securities Act. Tr. 751-52, 771-72; CX-262, at 1; CX-264; CX-270, at 39-40; CX-271, at 4. In 2000, judgment was entered against the registered representative and his company ordering payment of a civil monetary penalty and enjoining them from future violations of the Securities Act. CX-265. PNCH's CEO was the subject of another regulatory action. In 2010, he entered into a stipulation and consent order with the Florida Division of Securities and Investor Protection in which he agreed not to engage in the offer and sale of securities from offices in Florida or to residents of Florida. CX-263, 17-18.

From January 22, 2013, to September 10, 2013, ABC Corp. made 14 separate deposits of PNCH stock totaling approximately 492,271,881 shares. ABC Corp. liquidated its position in PNCH during approximately 40 trading days. On 29 of these days, ABC Corp.'s sales accounted for 20 percent of total market volume. On 16 of these days, ABC Corp.'s sales accounted for over 40 percent of total market volume in PNCH.[309] From January 22 to September 18, 2013, ABC Corp. sold its position in PNCH in 43 trades, generating approximately $839,136 in proceeds and approximately $34,964 in commissions for C.L. King.[310]

3. The Firm's AML Program

Enforcement's AML expert, Arthur D. Middlemiss, testified at the hearing.[311] In his expert opinion, C.L. King's AML program "was not appropriately tailored to identify and react to the level of risk to which it was exposed by its penny stock business."[312] A firm has to design an AML program that is risk based, Middlemiss testified, "to reflect the actual risk to which the firm is exposed." To ensure it has an adequate AML program, a firm should analyze the jurisdictions where it operates, the products and services it offers, and the types of customers it has. A firm should conduct an assessment of its risks periodically, but generally at least once a year but more frequently if its business changes dramatically.[313]

Middlemiss further testified that liquidating penny stocks for customers posed a heightened AML risk for C.L. King because they can be more easily manipulated. The prices of penny stocks may be inflated by promotional campaigns that publish false or misleading statements about an issuer's prospects to generate interest. A customer who obtains a large block of shares can benefit by selling the stock at a price that is higher than it otherwise would be without the promotional activity.[314] Promotions on the Internet in close temporal proximity to a customer's trading are a red flag, according to Middlemiss. With respect to the Checklist the Firm generated to process ABC Corp.'s stock deposits, Middlemiss opined that Miller, the

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[309] Compl. ¶¶ 125, 133; Ans. ¶¶ 125, 133; Stip. ¶¶ 26-27.

[310] Compl. ¶ 132; Ans. ¶ 132.

[311] Middlemiss was qualified as an expert at the hearing and prepared an expert report. CX-309. The Panel found Middlemiss credible. He is a former assistant district attorney in the New York County District Attorney's Office, where his prosecutions included securities-related cases. He was the head of AML surveillance for Bear, Stearns & Co. and JPMorgan Chase investment bank, including JP Morgan Securities and JP Morgan Clearing Corporation. He also served as the Director of JP Morgan Chase's Global Anti-Corruption Program. Since 2013, he has been the managing partner of a New York law firm, where his practice focuses on consulting on AML and anti-corruption issues. He is a frequent speaker on AML and Bank Secrecy Act issuers and has testified as an expert on AML issues. CX-309, at 2-4.

[312] Tr. 1348.

[313] Tr. 1350-52.

[314] Tr. 1362.

Firm's AML Compliance Officer, should have provided training to persons in the Prime Services Department and traders on what to look for, but he did not.[315]

In Middlemiss's opinion, Respondents failed to make an initial inquiry into whether PL Bank was engaged in proprietary trading or whether it also had customers who were accessing the U.S. financial system to trade securities. According to Middlemiss, Switzerland and Liechtenstein are considered high-risk AML jurisdictions because they are off-shore tax havens. This risk was compounded by the fact that Swiss BD was a Swiss company whose client, PL Bank, was based in Liechtenstein. The two countries have strong bank secrecy rules that reduce transparency.[316] PL Bank's trading in penny stocks magnified the AML risks to the Firm.

Middlemiss concluded that Respondents did not recognize and react appropriately to the risks associated with high-volume penny stock liquidations; conduct adequate due diligence to identify risks; design an AML program to address the risks presented by its customers' penny stock sales; or monitor penny stock transactions to detect potentially manipulative trading, including possible "pump and dumps."[317]

Respondents' expert, Evan Rosser, also testified at the hearing.[318] According to the opinions contained in Rosser's expert report, the Firm's AML policies, written supervisory procedures, and due diligence and monitoring were reasonable for a firm of C.L. King's size.[319] Rosser testified that the Firm's AML program as implemented with respect to PL Bank and ABC Corp. was reasonable.[320] Because of the ample evidence of red flags raised by PL Bank's and ABC Corp.'s trading activities presented at the hearing, the Panel disagrees with Rosser's fundamental conclusions.

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[315] Tr. 1395-97.

[316] Tr. 1354-55, 1378-79, 1386-87.

[317] CX-309, at 2, 41-42.

[318] Evan Rosser was qualified as an expert and submitted an expert report. RX-181. Rosser is a Director with Oyster Consulting, a financial services consulting firm that provides compliance, regulatory, audit, strategic management, and other consulting services. He has 30 years of experience as a regulator and compliance consultant in the securities and financial services industries. For many years, he was a senior executive with FINRA's Department of Enforcement where he supervised investigative staff. Since leaving FINRA in 2010, Rosser has been a regulatory and compliance consultant for broker-dealers and investment advisors. He has advised clients and testified on AML and related regulatory issues. Tr. 2612-16; RX-181, at 3-5, Ex. A.

[319] RX-181, at 7. At the hearing, Rosser acknowledged that the size of the risk to a firm is relevant, not the size of firm itself. Tr. 2677.

[320] Tr. 2655.

B. Conclusions of Law

1. C.L. King and Miller Failed to Ensure the Firm Had a Reasonable AML Program

Cause three charges Respondents with violating NASD Rule 3011(a) and FINRA Rules 3310(a)[321] and 2010. NASD Rule 3011, now FINRA Rule 3310, obligates "[e]ach member to develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the Bank Secrecy Act (31 U.S.C. 5311 et seq.), and the implementing regulations promulgated thereunder by the Department of the Treasury." NASD Rule 3011(a) (now FINRA Rule 3310(a)) requires that member firms "[e]stablish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) [of the Bank Secrecy Act] and the implementing regulations thereunder."

Pursuant to the Bank Secrecy Act, broker-dealers must report transactions of $5,000 or more "conducted or attempted by, at, or through a broker-dealer" that "involve funds derived from illegal activity" or that are "intended or conducted in order to hide or disguise funds or assets derived from illegal activity," that have "no business or apparent lawful purpose," or that involve "use of the broker-dealer to facilitate criminal activity."[322]

During the period in which PL Bank and ABC Corp. liquidated penny stocks, C.L. King had in place AML procedures that directed Miller, as the AML Compliance Officer, to review at least annually the Firm's AML policies and procedures, review new AML regulations, and engage in ongoing monitoring of activity at the Firm that could involve AML-related risks. Miller was responsible for developing and updating the Firm's AML program, monitoring (or designating others to assist with monitoring) the activity of "customers to reasonably detect and prevent money laundering activities."[323] The Firm's procedures also provided guidance on what sorts of activity Miller was also obligated to report in instances that the Firm "knows, suspects, or has reason to suspect that the transaction (or pattern of transactions …)" falls into a certain categories.[324]

a. Respondents Failed to Tailor the Firm's AML Program to Its Business

FINRA issued guidance to firms on AML issues in April 2002, in Notice to Members ("NTM") 02-21. The NTM defines "money laundering" as "engaging in acts designed to conceal

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[321] NASD Rule 3011 was adopted as FINRA Rule 3310 without substantive changes, effective January 1, 2010. *See* FINRA Regulatory Notice 09-60 (http://www.finra.org/industry/notices/09-60). Thus, NASD Rule 3011 applies to Respondents' conduct before January 1, 2010, and FINRA Rule 3310 applies to Respondents' conduct beginning that date.

[322] 31 C.F.R. § 103.19(a)(2) (re-numbered 31 C.F.R. § 1023.320(a)(2), effective March 1, 2011).

[323] CX-308, at 162-63; RX-161, at 103-04.

[324] CX-308, at 174-75; RX-161, at 111.

or disguise the true origin of criminally derived proceeds so that the unlawful proceeds appear to have derived from legitimate origins or constitute legitimate assets."[325] NTM 02-21 instructs members on how they should structure their AML programs. A broker-dealer's AML program must be risk based so that its AML program is tailored to its business model and customer base. The obligation to develop and implement an AML compliance program, FINRA told members, "is not a 'one-size-fits-all' requirement."[326]

Firm also must monitor for red flags of suspicious activity by customers indicative of money laundering activities and conduct due diligence to determine whether or not to report suspicious activity to law enforcement authorities when a red flag is detected.[327] NTM 02-21 contains examples of red flags that could indicate suspicious activity in connection with money laundering. The most relevant red flags in this case are the following:

- The customer, for no apparent reason or in conjunction with other red flags, engages in transactions involving certain types of securities, such as penny stocks.
- The customer engages in transactions that lack business sense or apparent investment strategy, or are inconsistent with the customer's stated business strategy.
- The customer (or a person publicly associated with the customer) has a questionable background or is the subject of news reports indicating possible criminal, civil, or regulatory violations.[328]

The NTM cautions that its enumerated red flags are "not exhaustive" and red flags appropriate to a firm's business should be described in its written policies and AML compliance procedures.[329]

In January 2010, FINRA updated its template for a small firm's AML program. It proposed that a small broker-dealer, like C.L. King, adopt procedures to "monitor account activity for unusual size, volume, pattern or type of transactions, taking into account risk factors and red flags that are appropriate to [its] business." It added that a firm should document and monitor its reviews of suspicious customer activity and conduct an appropriate investigation and

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[325] FINRA Notice to Members 02-21, at 1 (Apr. 2002) (http://www.finra.org/industry/notices/02-21).

[326] FINRA Notice to Members 02-21, at 4.

[327] FINRA Notice to Members 02-21, at 10-11.

[328] FINRA Notice to Members 02-21, at 10-11. C.L. King's written supervisory procedures in effect during the review period contained the red flags identified in NTM 02-21. RX-161, at 38-39; RX-163, at 63-64; RX-177, at 50-52; CX-308, at 66-67.

[329] In January 2009, FINRA issued Regulatory Notice 09-05 that reminded firms of their obligation to determine whether unregistered securities are eligible for public sale. The Notice told firms that they must ensure their AML compliance program addresses red flags that may be associated with unregistered resales conducted through the firm, including the sale of restricted securities under Rule 144. Regulatory Notice 09-05, at 5, 7, 9 (Jan. 2009) (http://www.finra.org/industry/notices/09-05).

review relevant information from internal or outside sources. The updated template warned members that "following this template does not guarantee compliance with AML Program requirements or provide a safe harbor from regulatory responsibility."[330] Additionally, in NTM 02-47, FINRA advised broker-dealers of their duty to file a Suspicious Activity Report for certain suspicious transactions, in accordance with the regulations issued by FinCEN. FINRA noted that broker-dealers must determine whether activities surrounding certain transactions raise suspicions of no business or apparent lawful purpose by looking for red flags such as those enumerated in NTM 02-21.[331]

The template included a section on "Transactions Involving Penny Stock Companies,"[332] which alerted firms to specific red flags to look for in connection with customers who trade penny stocks, each of which is relevant in this case:

- The company has no business, no revenues and no product.
- The company has experienced frequent or continuous changes in its business structure.
- Officer or insiders of the issuer are associated with multiple penny stock issuers.
- The company undergoes frequent material changes in business strategy or its line of business.
- Officer or insiders of the issuer have a history of securities violations.
- The company has not made disclosures in SEC or other regulatory filings.
- The company has been the subject of a prior trading suspension.[333]

Respondents did not revise the Firm's AML procedures to include the updated small firm AML template until June 2013, more than three years after FINRA revised the template.[334]

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[330] FINRA "Updated Small Firm Template, Anti-Money Laundering (AML) Program: Compliance and Supervisory Procedures," at 1, 31-32 (Jan. 1, 2010), *see* http://www.finra.org/industry/anti-money-laundering-template-small-firms.

[331] Notice to Members 02-47 (Aug. 2002) (http://www.finra.org/industry/notices/02-47).

[332] According to the SEC's website, the term "penny stock" generally refers to a security "issued by a very small company that trades at less than $5 per share." Penny stocks are generally quoted over the counter, such as on the OTC Bulletin Board or OTC Link LLC (which is owned by OTC Markets, Inc., formerly known as Pink OTC Markets Inc. (http://www.sec.gov/answers/penny.htm). The complete definition of "penny stock" is contained in SEC Rule 3a51-1, 17 C.F.R. § 240.3a51-1.

[333] FINRA Small Firm AML Template, at 34-35.

[334] Tr. 2301-02, 2295-97; CX-308, at 67; RX-162, at 67.

Miller testified that the Firm relied on a vendor to provide it with updates for its written supervisory procedures, including AML procedures.[335]

C.L. King, including Miller, had little or no experience in penny stocks. Miller understood that a customer who sells penny stocks increases AML risks for C.L. King.[336] Respondents accordingly should have gauged the AML risks presented by the new customers whose trading activity involved liquidating penny stocks. As Enforcement's expert report noted, a "properly executed risk assessment process would have identified the high inherent AML risks associated with [C.L. King's] penny stock business, and helped [the Firm] construct and execute an AML Program tailored to mitigate those risks."[337] Nonetheless, Respondents failed to tailor the Firm's AML program to handle the increased risks presented by PL Bank's and ABC Corp.'s trading in large volumes of penny stocks.[338]

b. Respondents Failed to Detect and Investigate Red Flags of Suspicious Activity

PL Bank began trading a speculative penny stock, GSAE, immediately after opening an account in June 2009. This type of trading was unexpected because during the preceding two years Swiss BD's other clients did not engage in penny stock transactions. Miller was surprised that PL Bank was trading penny stocks because he expected it would trade higher priced securities.[339]

Despite PL Bank's penny stock sales, Respondents did not adapt their procedures to the increased AML risks its client's trading activity created. FINRA's AML rules require that a firm's written procedures address the detection and reporting of manipulative trading practices and that AML procedures be tailored to a firm's business.[340] The securities that Enforcement

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[335] Tr. 2298-2300, 2484-90, 2559-60. Respondents note that by the time its procedures were revised, in June 2013, to include red flags designed for penny stock transactions that were in FINRA's updated small firm AML template, the "vast majority of the transactions challenged in FINRA's complaint had already occurred and C.L. King had decided to wind down the [Prime Services Department] business." Respondents' Post-Hearing Br., at 19.

[336] Tr. 1147, 1185, 2535-36.

[337] CX-309, at 7. The small firm template advised members that "It is good practice to develop a written analysis of your firm's money laundering and terrorist financing risk and how your firm's AML procedures manage that risk. This 'risk assessment' will help to ensure that the AML program is the right one for your firm and is a useful tool for demonstrating … that the firm used a reasonable approach for designing its AML program." Small Firm AML Template, at 1.

[338] *Dep't of Enforcement v. Merrimac Corp. Sec., Inc.*, No. 2011027666902, 2017 FINRA Discip. LEXIS 16, at *40 (NAC May 26, 2017) (respondent firm failed to develop and implement AML procedures even though it had recently begun trading penny stocks); *Dep't of Enforcement v. North Woodward Fin. Corp.*, No. 2011028502101, 2016 FINRA Discip. LEXIS 35, at *30-31 (NAC July 19, 2016) (Because firm's procedures "were not tailored to the specific nature of its business, they were not reasonably designed to achieve compliance with the [Bank Secrecy Act] and its implementing regulations.").

[339] Tr. 1147-48. Miller testified that PL Bank's penny stock transactions increased in 2012. Tr. 1149.

[340] *Dep't of Enforcement v. Lek Sec. Corp.*, No. 2009020941801, 2016 FINRA Discip. LEXIS 63, at *26-27 (NAC Oct. 11, 2016) (citing *Dep't of Enforcement v. Domestic Sec.*, No. 2005001819101, 2008 FINRA Discip. LEXIS 44,

identified in the Complaint that PL Bank and ABC Corp. traded contained multiple red flags of potentially suspicious activity that should have triggered an investigation. The information was publicly available and accessible from, for example, SEC filings and in press releases which issuers posted on the OTC Markets website. The promotional materials touting various securities were available through Internet searches.[341] Respondents never uncovered any evidence of the suspicious information about issuers that Enforcement presented at the hearing.

The red flags concerning the issuers' whose stock PL Bank and ABC Corp. liquidated included:

- *Little or no revenue*. For example, GSAE, CLDS, INNO, and SRGE had no revenues either since their inception or in the years just before PL Bank liquidated its shares. AEGY had revenues of $3,701 in the four years since it was formed and MFTH had no revenues since inception when ABC Corp. sold its shares. Most of the issuers had disclosed in their SEC filing that they had received going concern opinions from auditors.

- *No business operations*. For example, DRHC reported that it had no financial resources and FFFC reported that it had "no ongoing business operations or sources of revenue."

- *Recent name changes or business changes*. AEGY changed from an energy company to purportedly developing online systems to purchase medical marijuana. GSAE went from offering educational seminars to clean energy projects. SRGE moved from the ethanol business to gold and silver exploration. STKO changed its name five times since inception.

- *Persons associated with issuer had a history of securities-related misconduct*. FFFC's Chairman had been the subject of SEC regulatory action. The attorney who filed MFTH's registration documents was later convicted of securities fraud (a year before ABC Corp. sold MFTH). STKO's former President and CEO was charged with securities fraud (in connection with a stock other than STKO). PNCH's CEO had been found liable for securities-related misconduct in an action brought by the SEC.

- *Promotional campaigns*. Most of the issuers were the subjects of promotional campaigns on the Internet near the time PL Bank and ABC Corp. sold their securities.

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at *16 (NAC Oct. 2, 2008)) ("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.").

[341] Tr. 577-79, 681-82.

- *Promoters were paid for publicity efforts*. Some of the entities promoting stocks that PL Bank and ABC Corp. sold disclosed they were paid by a third party for marketing the stock. For example, a promoter of INNO was paid $25,000, two CLDS promoters were paid $25,000 and $10,000, and a promoter of SAFC disclosed it was paid $15,000. One promoter of DRHC was paid $50,000, and two others $10,000 and $15,000 each.

- *PL Bank and ABC Corp. sold large volumes of shares*. AEGY had 209,619,640 shares outstanding as of December 12, 2012. After converting multiple notes, ABC Corp. deposited and sold over 395 million shares by late June 2013.[342]

  STKO had just over 2 billion shares outstanding as of April 8, 2013. After ABC Corp. converted multiple notes into shares of STKO, it sold more than 814,000 shares of the stock from March to July 2013.[343]

  FFFC had 129,821,143 shares outstanding as of April 5, 2013; ABC Corp. sold over 25 million shares from December 2012 to September 2013.[344]

  PNCH had just over 1.4 billion shares outstanding as of April 15, 2013. ABC Corp. sold over 492 million shares of PNCH from January 2013 to September 2013.[345]

  GSAE had 26,250,000 million shares outstanding as of April 1, 2009; PL Bank sold 1.9 million shares of GSAE from June to December 2009.[346]

- *Daily sales volume*. Because PL Bank and ABC Corp. owned and liquidated a large number of shares of each of the stocks, their sales often constituted a high percentage of the daily trading volume in the stock.

- *PL Bank and ABC Corp. earned significant proceeds from sales*. For example, PL Bank's sales of GSAE, the first security it liquidated at C.L. King, generated $864,000 in proceeds, even though GSAE had no revenues in the two prior years and had "minimal operations."

  ABC Corp. sold AEGY shares for proceeds of $710,000, even though the company had minimal revenues in the four years since its inception.

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[342] CX-221, at 2.

[343] CX-293, at 3.

[344] CX-247, at 2.

[345] CX-270, at 3.

[346] CX-251, at 15.

> ABC Corp.'s sales of PNCH generated $839,136 in proceeds even though it had minimal revenues in the two years preceding ABC Corp.'s sales and net losses of over $6 million in the preceding year.

The Firm's AML procedures identified "heavy trading in low-priced securities" and "trading that constitutes a substantial portion of all trading for the day in a particular security" as particular red flags.[347] With respect to PL Bank, Miller testified that he did not find suspicious its sales of 1.9 million shares of GSAE over a six-month period in 2009, which generated $864,000 in proceeds.[348]

ABC Corp.'s trading in penny stocks significantly increased C.L. King's AML risks when it opened an account in November 2012. Miller characterized ABC Corp. as the "riskiest account" the Firm had ever had.[349] Respondents understood that ABC Corp.'s business model involved depositing a large volume of unregistered securities of speculative companies, then liquidating the shares. It expected that ABC Corp. would make hundreds of deposits a month in thinly traded securities of many different companies. Promptly after opening its account, ABC Corp. began liquidating enormous volumes of securities and generating significant proceeds. In less than a year, its liquidations generated over $14 million, which it periodically wired out of its account.

When asked why ABC Corp.'s volume of trading in multiple securities did not trigger an investigation, Miller responded that the Firm expected ABC Corp. to sell large volumes of stock because its business involved creating new shares in a company.[350] Miller also testified that because ABC Corp. was causing the issuance of new shares in a penny stock it was also creating interest in the company that caused overall market volume to increase. Miller explained that the market maker to whom C.L. King was directed by ABC Corp. to execute its sell orders was also contacting clients to purchase ABC Corp.'s stock.[351] Miller did not find ABC Corp.'s practices suspicious.

Notwithstanding the increased risks posed by ABC Corp.'s massive sales operation, Respondents failed to re-examine C.L. King's existing AML program to tailor it to ABC Corp.'s business so that it could detect suspicious trading activity. Miller testified that he believed the Firm already had appropriate AML procedures in place, and there was no reason to do anything differently because the Firm "can tell if a stock is acting out of character."[352] During the process

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[347] CX-308, at 174; RX-161, at 111; RX-162, at 174; RX-163, at 158.

[348] Tr. 2467-68. Miller believed that it did not constitute "heavy trading" because PL Bank was trying to sell as much GSAE as it could over a five-and-a-half-month period, and it may have purchased shares through the broker-dealer where it custodied its securities.

[349] Tr. 2488.

[350] Tr. 2465-66, 2563-64.

[351] Tr. 2465, 2580-83.

[352] Tr. 2499.

of onboarding ABC Corp., the Firm confirmed the nature of its business by reviewing SEC filings. It ignored, however, information that ABC Corp.'s owner was a so-called "toxic debt financier," concluding that the charge could not be verified.

The Checklist that Respondents designed, specifically to handle ABC Corp.'s business, did not adequately address the AML risks posed by the customer's trading activity. Its purpose was primarily to ensure that the paperwork ABC Corp. submitted was complete and technically compliant with Rule 144. It was a routinized "check-the-box" procedure that failed to detect any suspicious trading activity. The Prime Services Department also did not document its reviews.[353] Miller did not find it suspicious that ABC Corp. deposited shares in 138 different penny stocks (including sub-penny stocks) because the deposits were expected as a result of its business model. Even ABC Corp.'s practice of ensuring that it never deposited at any one time more than ten percent of an issuer's outstanding shares did not concern Respondents. Miller explained that this was because the owner of ABC Corp. "told us right up front that that's what he was doing, so it was expected."[354] ABC Corp.'s liquidations never aroused suspicions for Miller because they were consistent with its stated business model.[355]

Respondents never spotted any promotional campaigns about an issuer whose securities ABC Corp. The Firm generally limited its Internet searches to OTC Markets, Bloomberg, and Yahoo! Finance websites.[356] Miller testified that he typically consulted financial websites like Yahoo! Finance or Bloomberg but it was not his practice to review an issuer's SEC filings.[357] He could not recall if he ever conducted Internet searches for promotional material about a penny stock.[358]

Miller did not instruct the Prime Services Department to look specifically for promotional activity about a security, only news generally.[359] Furthermore, Miller could not check the adequacy of the stock deposit reviews the Prime Services Department conducted because he did not required that they be documented.[360] It was also not a red flag for Miller when trading in a stock spiked at the same time ABC Corp. was selling the stock because ABC Corp. was "effectively creating shares."[361] In any event, when the Firm's traders examined trading activity

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[353] Enforcement's AML expert Middlemiss testified that an adequate AML program would include documentation of reviews. Tr. 1394-95, 1456-57.

[354] Tr. 2584.

[355] Tr. 2466-67.

[356] Tr. 1211-13.

[357] Tr. 1154-55, 1211-12. Miller testified that he relied more on Yahoo! Finance and Bloomberg than some other sites that carried promotional material because they may not be "truthful." Tr. 1156.

[358] Tr. 1158.

[359] Tr. 1213-14.

[360] Tr. 1215.

[361] Tr. 2470-71.

in a stock, they would look to news reports in Yahoo! Finance or Bloomberg to justify increases in trading volume. As Miller testified, so long as he saw some news about an issuer that he thought was "reasonable," he was not concerned about an increase in the issuer's stock price even if it occurred around the time ABC Corp. sold its stock. Miller testified that his suspicions would be aroused only in the case when there was a "big jump in the stock right at the time [ABC Corp.] sold the stock."[362] In practice, the Firm reviewed trading in a stock only during the preceding five days. As a result, no one in the trading department ever elevated a concern about ABC Corp.'s sales to Miller.[363]

It is apparent to the Panel that C.L. King and Miller were not familiar with the ample risks posed by the penny stock liquidations in which PL Bank and ABC Corp. engaged. Miller had little experience in the area and had little, if any, idea of what to look for. Many stocks that ABC Corp. sold involved issuers with no operating histories, little or no revenues, and no products. Miller did not know that many of the issuers whose securities ABC Corp. sold were subject to a going concern opinion and, in any case, he did not understand what the term meant.[364] Miller was not concerned that an issuer whose stock ABC Corp. sold had no business or revenues because "that was the expectation with [ABC Corp.'s owner], that he loaned money to those types of companies."[365] Some issuers were the subject of promotional campaigns that occurred around the time that ABC Corp. sold stock in the company. Some securities were thinly traded. On many of the days that ABC Corp. sold stock, its sales constituted a large portion of the daily trading volume in the stock.

The Panel finds that there were multiple red flags that should have alerted Respondents. Respondents argue that it is not reasonable to expect them to have identified all the red flags identified by Enforcement in the Complaint, including, for example, evidence that certain persons associated with issuers had securities-related criminal or regulatory histories. Respondents' argument misconstrues Enforcement's allegations. The Complaint alleges that the PL Bank's and ABC Corp.'s trading itself was suspicious and should have caused additional due diligence into the clients' trading. It alleges that PL Bank's and ABC Corp.'s "numerous transactions … presented red flags for suspicious activity, including manipulative trading."[366] Although the Panel agrees that it would not be reasonable to expect Respondents to have detected all of the red flags for each stock that PL Bank and ABC Corp. sold, they did not adopt an AML program that would reasonably ensure that they even understood what red flags to look

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[362] Tr. 2586. *See also* Tr. 2594-95 (Miller would be suspicious "if there's a spike in volume, along with a spike in price, and no news.").

[363] Tr. 2219-20, 2499-2500; RX-84.

[364] Tr. 1250.

[365] Tr. 2602.

[366] Compl. ¶ 203.

for. As a result, C.L. King and Miller failed to spot any red flags, and accordingly did not properly investigate them, as they were required to do under FINRA's AML rules.[367]

C.L. King and Miller permitted PL Bank and ABC Corp. to sell billions of shares of approximately 180 speculative securities. Together the customers earned proceeds exceeding $19 million. Respondents failed to structure an AML program to address PL Bank's and ABC Corp.'s penny stock liquidations. As a result, they were not able to detect and report suspicious activity indicative of potential money laundering. By failing to establish and implement an AML program reasonably designed to cause the detection and reporting of suspicious transactions under the Bank Secrecy Act C.L. King and Miller violated NASD Rule 3011(a) and FINRA Rules 3310(a) and 2010.

2. Respondents Failed to Perform Due Diligence on PL Bank

Section 312 of the Patriot Act, as implemented by 31 C.F.R. § 1010.610, requires that broker-dealers exercise due diligence when accepting correspondent accounts for a foreign financial institution ("FFI").[368] An FFI includes a bank organized under foreign law. The term "FFI" means any entity "organized under foreign law (other than a branch or office of such person in the United States) that, if it were located in the United States, would be a covered financial institution,"[369] as defined by statute, including a "broker or dealer in securities registered or required to be registered" with the SEC.[370] A broker-dealer's due diligence program for an FFI must include "appropriate, specific, risk-based, and, where necessary, enhanced policies, procedures, and controls that are reasonably designed to enable the covered financial institution to detect and report, on an ongoing basis, any known or suspected money laundering activity conducted through or involving any correspondent account."[371] Broker-dealers that handle FFI accounts must implement policies, procedures, and controls that "assess[] the money laundering risk presented by [an FFI] correspondent account, based on a consideration of all relevant factors, which shall include, as appropriate:"

- The nature of the FFI's business and the markets it serves;
- The type, purpose, and anticipated activity of such correspondent account;

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367 *See Domestic Sec.*, 2008 FINRA Discip. LEXIS 44, at *14 (firm did not establish AML policies and procedures to monitor, analyze, and investigate suspicious activity associated with [its business]"); *Lek Sec. Corp*., 2016 FINRA Discip. LEXIS 63, at *24 (firm failed to tailor is AML procedures to its business); *Merrimac Corp. Sec*., 2017 FINRA Discip. LEXIS 16, at *41 (firm "failed to detect, investigate, and document red flags in penny stock trading, including patterns of large deposits and liquidations of penny stocks").

368 Publ. L. No. 107-56, codified at 31 U.S.C. § 5318(i).

369 31 C.F.R. § 103.175(h)(1)(iii) (re-numbered 31 C.F.R. § 1010.605(f)(iii), effective March 1, 2011).

370 31 C.F.R. § 103.175(f)(1)(viii) (re-numbered 31 C.F.R. § 1010.605(e)(1)(viii), effective March 1, 2011).

371 31 C.F.R. § 103.176(a) (re-numbered 31 C.F.R. § 1010.610(a), effective March 1, 2011).

- The nature and duration of the covered financial institution's relationship with the FFI (and any of its affiliates);
- The AML and supervisory regime of the jurisdiction that issued the charter or license to the FFI, … ; and
- Information known or reasonably available to the covered financial institution about the FFI's AML record.[372]

With respect to an FFI, a broker-dealer must adopt risk-based procedures and controls that are reasonably designed to detect and report known or suspected money laundering activity, including "a periodic review of the correspondent account activity sufficient to determine consistency with information obtained about the type, purpose, and anticipated activity of the account."[373]

PL Bank was an FFI, as defined by the Bank Secrecy Act, because it was organized and domiciled in Liechtenstein. When it opened its account at the Firm, PL Bank disclosed in IRS Form W-8IMY ("Certificate of Foreign Intermediary, Foreign Flow-Through Entity, or Certain U.S. Branches for United States Tax Withholding"), which it submitted with account opening documents, that it was trading for accounts of others.[374] Accordingly, C.L. King and Miller were obligated to perform risk-based due diligence into PL Bank's business when it opened an account in June 2009, and conduct periodic reviews of its activities while the client maintained an account. However, they failed to do so.

The Firm failed to determine if PL Bank was trading for undisclosed customers. Miller believed PL Bank was trading for its own accounts, and not for others.[375] He also believed that AML rules do not obligate a Firm to know whether a customer with a DVP/RVP account is trading for itself or for others because the other broker-dealer knows more about the customer.[376] However, Middlemiss, Enforcement's expert, testified that a DVP/RVP account is not necessarily low risk in the case of a client trading penny stocks while based in an offshore high-risk jurisdiction.[377] The Panel found Enforcement's expert opinion persuasive. It was not until March 2013, nearly four years after PL Bank opened its account, that Respondents, through Maier, asked Swiss BD if PL Bank was trading for different subaccounts. Swiss BD confirmed that PL Bank had "sub accounts/banking clients" who traded.[378]

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[372] 31 C.F.R. § 103.176(a)(2) (re-numbered 31 C.F.R. § 1010.610(a)(2), effective March 1, 2011).

[373] 31 C.F.R. § 103.176(a)(3) (re-numbered 31 C.F.R. § 1010.610(a)(3), effective March 1, 2011).

[374] Tr. 1163-65; CX-176, at 526-27. Miller testified that he did not look at the IRS Form closely because, as a DVP/RVP account, C.L. King was not going to withhold any of PL Bank's funds for tax purposes. Tr. 1164-65.

[375] Tr. 1165. Maier never told Miller that he had learned PL Bank had subaccounts. Tr. 1182.

[376] Tr. 1142-46, 1167-68.

[377] Tr. 1368.

[378] CX-209.

The Firm failed to accurately understand the nature of PL Bank's business. Respondents failed to conduct their own separate due diligence into PL Bank.[379] Instead, C.L. King's information about PL Bank was limited to what Maier learned from Swiss BD's owner.[380] C.L. King incorrectly believed that PL Bank, like other clients that Swiss BD had introduced, would trade securities of companies with medium or large capitalizations.[381] Instead, as soon as it opened its account, PL Bank began selling penny stocks. During its first six months of trading at C.L. King, PL Bank sold more than 1.9 million shares of GSAE for proceeds of $864,000. GSAE had earned no revenues in two years, had minimal operations, and was the subject of promotional campaign touting its securities. It was also the subject of cease trading order issued by the British Columbia Securities Commission a few weeks before PL Bank began selling GSAE shares.

The Firm and Miller failed to conduct required risk-based due diligence to understand PL Bank's business even after it was apparent that PL Bank primarily sold penny stocks. Although C.L. King had no other customers who traded mostly penny stocks, Respondents did not adopt procedures specifically to supervise PL Bank's penny stock sales.[382] Miller never spoke directly with anyone from PL Bank or with the owner of Swiss BD about PL Bank's trading activity.[383] Maier, the registered representative on the account, did not understand the nature of the customer's business, and the Firm's CCO had never heard of the customer until FINRA began its investigation.[384]

The Panel finds that Respondents failed to conduct reasonable due diligence into the nature of PL Bank's business and the type and purpose of its trading activity at C.L. King, as required by 31 C.F.R. § 1010.610(a)(2). By failing to conduct adequate due diligence on PL Bank, an FFI, and appropriately respond to red flags associated with the customer's trading in the account, C.L. King and Miller violated NASD Rule 3011(b) and FINRA Rules 3310(b) and 2010.

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[379] CX-309, at 15-16.

[380] Miller also relied on what Maier said about Swiss BD because Maier knew its owner. Tr. 1175.

[381] CX-198.

[382] Tr. 353-54, 1147-50, 1337-43. Miller testified that because C.L. King was a small firm and its daily trading blotter was just 20 pages long on a busy day, he did not need to get any "specialized reporting form" to monitor PL Bank's trading. Tr. 1149.

[383] Tr. 1166, 1151-52, 1232.

[384] Tr. 351-353.

C. Sanctions

1. Violations Relating to the Firm's AML Program (Cause Three)

There is no specific Guideline for failing to establish and implement AML procedures. Because FINRA's rules requiring firms to implement AML programs are in substance supervisory requirements, the most analogous Guideline is the one for deficient supervision.[385]

Given the nature and duration of Respondents' AML-related misconduct, the Panel finds that the Guideline for systemic supervisory failures is appropriate. Adjudicators should use this Guideline "when a supervisory failure is significant and is widespread or occurs over an extended period of time." The Guideline further instructs that, while "system supervisory failures typically involve failures to implement or use supervisory procedures that exist, systemic supervisory failures also may involve supervisory systems that have both ineffectively designed procedures and procedures that are not implemented."[386]

The Guideline for a firm's systemic supervisory failures instructs adjudicators to consider a fine between $10,000 and $292,000. Where aggravating factors predominate, consideration should be given to imposing a higher fine and ordering restitution or disgorgement in appropriate cases and consider suspending a firm with respect to any or all relevant activities or functions for a period of 10 business days to two years, or expelling the firm. Adjudicators may also consider imposing an undertaking, ordering a firm to revise its supervisory systems and procedures, or ordering a firm to engage an independent consultant to recommend changes to the firm's supervisory systems and procedures.[387]

For a responsible individual, the Guidelines instruct adjudicators to consider a fine between $10,000 and $73,000, and, where aggravating factors predominate, suspending the person in any or all capacities for a period of 10 business days to two years, or barring the individual.

The Guideline for systemic supervisory failures contains eight principal considerations, each of which is relevant here. Accordingly, the Panel finds the presence of multiple aggravating factors and determines that Respondents' misconduct was egregious. There are no mitigating factors present.

One principal consideration is whether the deficiencies allowed the violative conduct to occur or escape detection. Another is whether Respondents failed to timely correct or address deficiencies once identified or failed to respond reasonably to "red flag" warnings. Respondents never critically questioned the liquidations by either client and never conducted a meaningful

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[385] *Lek Sec. Corp.*, 2016 FINRA Discip. LEXIS 63, at *38 (applying Guideline for deficient supervision to determine sanctions for AML violations).

[386] Guidelines at 105-06.

[387] The Panel does not believe that an undertaking or an independent consultant is necessary in this case because since 2014 C.L. King has not liquidated penny stocks for customers.

investigation into the companies whose securities were being sold. As a result, they did not detect many red flags indicative of suspicious activity. Respondents instead ensured that PL Bank's and ABC Corp.'s sell orders were executed without probing whether the sales were a timed to coincide with stock promotion campaigns, pump-and-dump schemes, or orchestrated with the direct or indirect participation of persons with questionable securities backgrounds. Respondents decided to use a checklist for ABC Corp.'s deposits of stock which effectively blinded them to the existence of potentially suspicious activity.

Other principal considerations are the number and dollar value of the transactions not adequately supervised as a result of the deficiencies and the nature, extent, size, character, and complexity of the activities or functions not adequately supervised. All of these considerations are aggravating factors here. The misconduct extended for nearly five years—the period that PL Bank and ABC Corp. were allowed to liquidate penny stocks.[388] The two customers sold over 11 billion shares in speculative securities of companies with little or no histories of operations or revenue. Together, the two customers generated proceeds of $19 million.[389] PL Bank's and ABC Corp.'s sales of the twelve penny stocks identified in the Complaint generated total proceeds of over $3.2 million—over $1.3 million by PL Bank and more than $1.9 million by ABC Corp.

Additional principal considerations include the number and type of customers, investors or market participants affected by the deficiencies and the extent to which the deficiencies affected market integrity or market transparency. The Panel finds that PL Bank's and ABC Corp.'s liquidations of speculative penny stocks created a significant risk of harm to the investing public.

The Panel is mindful that adjudicators should impose sanctions that are remedial in nature and not punitive. Sanctions should protect the investing public, not penalize brokers, and prevent the violating firm or individual from causing additional harm to the public. The Panel also considered a sanction that will serve to deter C.L. King and others from engaging in this serious misconduct. The Guidelines also require that the Panel take into account a firm's size to ensure that sanctions are remedial and not punitive. Factors to consider in connection with assessing a firm's size are its financial resources, the nature of its business, the number of persons associated with it, and the level of trading activity.[390] The Panel believes that a significant fine and a censure are necessary to impress upon C.L. King and other firms the importance of an adequate AML program.

After applying the principal considerations for systemic supervisory failures, the Panel concludes that the appropriate sanction for the Firm's AML violations under the facts and

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[388] Guideline at 7 (Principal Considerations in Determining Sanctions, Nos. 8 and 9) (whether respondent engaged in numerous acts and/or a pattern of misconduct and whether the respondent engaged in the misconduct over an extended period of time)

[389] Guideline at 8 (Principal Considerations in Determining Sanctions, No. 17) (the number, size and character of the transactions at issue).

[390] Guidelines at 2 (General Principles Applicable to All Sanction Determinations, No. 1 and n.2).

circumstances alleged in cause three should exceed the Guideline's suggested fine range. The Panel considered that the Firm earned commissions of over $600,000 from PL Bank's and ABC Corp.'s penny stock liquidations. Accordingly, C.L. King is fined $400,000 for the misconduct charged in cause three.

Applying the same principal considerations to Miller's misconduct, the Panel determines that the appropriate sanction for his AML violations, as charged in cause three, is a $15,000 fine and a five-month suspension from associating with any FINRA member in a principal capacity. He is also ordered to requalify as a principal.

2. AML Violations Relating to Due Diligence on PL Bank (Cause Four)

The Panel finds that Respondents altogether failed to understand their obligations with respect to foreign financial institutions under the Bank Secrecy Act and FINRA rules. This led to a failure by Respondents to comprehend the nature of PL Bank's trading activity in speculative, low-priced securities.

Again applying the Guideline for supervision violations, the Panel concludes that an appropriate sanction for the Firm is a $50,000 fine. The Panel imposes a $5,000 fine against Miller and suspends him for one month from associating with any FINRA member firm in a principal capacity. The suspension shall run consecutively with the five-month suspension imposed under cause three. Miller is also ordered to requalify as a principal.

V. Order

C.L. King violated FINRA Rule 2010 by virtue of violating Sections 17(a)(2) and (3) of the Securities Act, as alleged in cause one. The Firm also independently violated FINRA Rule 2010. It is censured and fined $250,000 for this misconduct. It also violated NASD Rule 3010 and FINRA Rules 3110 and 2010 by failing to have in place a reasonable supervisory system and reasonable written supervisory procedures to ensure that its debt securities business was in compliance with Section 17(a) of the Securities Act, as alleged in cause two. For the supervision violations, the Firm is censured and fined $50,000.

The Firm and Miller violated the anti-money laundering provisions of NASD Rule 3011(a) and FINRA Rules 3310(a) and 2010, as alleged in cause three. For these violations the Firm is censured and fined $400,000.

The Firm and Miller failed to conduct due diligence on a foreign financial institution, as required by the Bank Secrecy Act, in violation of NASD Rule 3011(b) and FINRA Rules 3310(b) and 2010, as alleged in cause four. For these violations, the Firm is censured and fined $50,000.

For engaging in the misconduct alleged in cause three, Miller is suspended for five months from association with any FINRA member in a principal capacity and fined $15,000. For

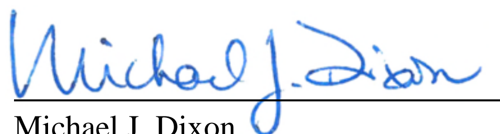
the misconduct alleged in cause four, Miller is suspended for one month from association with any FINRA member firm in a principal capacity and fined $5,000.

C.L. King is censured and fined a total of $750,000. Miller is suspended for six months from association with any FINRA member firm in a principal capacity and fined a total of $20,000. He is also ordered to requalify as a principal before associating with a firm as a principal.

Respondents are also ordered to pay costs in the amount of $20,175.20, for which they are jointly and severally liable. This amount includes a $750 administrative fee and $19,425.20 for the cost of the hearing transcripts.

If this decision becomes FINRA's final disciplinary action, Miller's suspension in a principal capacity will begin with the opening of business on November 6, 2017.[391]

The fines and assessed costs shall be due on a date set by FINRA, but not sooner than 30 days after this decision becomes FINRA's final disciplinary action in this proceeding.



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[391] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.