BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of the New Membership Application of Firm A	DECISION Application No. 20090182345 Dated: September 28, 2010

Department of Member Regulation denied Firm's application for FINRA membership. Held, the NAC remanded the matter with specific instructions for Member Regulation to reconsider the application in a manner consistent with the NAC's directives.

Appearances

For Firm A: Attorney 1

For FINRA's Department of Member Regulation: FINRA Staff Attorney 1

Decision

Pursuant to NASD Rule 1015(a), Firm A ("Firm A" or "the Firm") appeals from a January 4, 2010 decision of FINRA's Department of Member Regulation ("Member Regulation") denying the Firm's application for FINRA membership ("Application"). After reviewing the record, including the briefs filed on appeal, we vacate Member Regulation's decision and remand the matter to Member Regulation for reconsideration of the Application in light of our specific findings and directives as stated in this decision.

I. BACKGROUND

A. The Firm and Its Principals

The owners of Firm A are: Owner 1 ("Owner 1"), the Firm's proposed president and Anti-Money Laundering ("AML") officer; Owner 2 ("Owner 2"), the Firm's proposed chief financial officer, chief compliance officer, options principal, and financial and operations principal ("FINOP"); and Owner 3 ("Owner 3"), the Firm's proposed equity trader. Owner 1, Owner 2, and Owner 3 each hold a 33 1/3 percent interest in the Firm. All three owners are associated with Firm B ("Firm B"), a registered broker-dealer operating in Sherman Oaks,

California.[1] Firm A's Form BD identifies Firm B as a control affiliate because the two firms are under common control as a result of Owner 1's and Owner 2's aggregate ownership of greater than 10 percent but less than 20 percent of Firm B.[2]

B. Firm A's New Membership Application

Firm A filed the Application with FINRA on May 22, 2009, seeking to register as a general securities broker-dealer. The Firm plans to operate in an agency capacity, conduct 90 percent of its business with institutional customers and 10 percent of its business with retail customers, and act as a broker-dealer in many product lines including, but not limited to: corporate equity and debt securities, mutual funds, municipal securities, options, and private placements. The Firm also intends to act as an underwriter or selling group participant. Firm A plans to engage in the same business activities as Firm B, with the exception of market-making and proprietary trading.

Owner 1, Owner 2, and Owner 3 plan to split their time equally between Firm B and Firm A and to operate Firm A out of Firm B's existing location. Firm A's Application states that the Firm seeks FINRA membership to enable Owner 1 to take advantage of government programs available to minority business owners and to market its services to the Hispanic community.[3]

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[1] Owner 1 has been associated with Firm B since September 2005 as a general securities representative, general securities principal, options principal, AML officer, and equity trader. Firm B lists Owner 1 on its Uniform Application for Broker-Dealer Registration ("Form BD") as a five to ten percent owner of the firm. Owner 1 also is a member of Firm B's Board of Directors.

Owner 2 has been associated with Firm B since October 2005 as a general securities representative, general securities principal, FINOP, options principal, equity trader, and general securities sales supervisor, and since March 2006 as a municipal securities principal. Firm B lists Owner 2 on its Form BD as a five to ten percent owner of the firm.

Owner 3 has been associated with Firm B since February 2006 as a general securities representative, general securities principal, options principal, equity trader, and general securities sales supervisor.

[2] Firm B also has five passive investors who are not employed by, or registered with, Firm B. Owner 1 runs the day-to-day operations of Firm B.

[3] The record does not describe in any detail the specific government programs in which Owner 1 is interested or the advantages of such programs to Firm A's business activities. Owner 1 contends that he could not qualify for these programs as a principal at Firm B because he owns less than ten percent of the firm. He states that, to qualify for such programs, the minority business owner is required to hold a 50 percent or greater ownership interest. Owner 1 and Owner 3, who are immigrants from El Salvador and Cuba, respectively, have a combined ownership interest in Firm A that exceeds 50 percent.

C. Regulatory Actions Against Firm B

Member Regulation considered FINRA regulatory actions against Firm B in connection with its review of Firm A's Application because Owner 1 and Owner 2, principals of Firm B, also would operate Firm A if the Application is approved.

1. April 2009 FINRA Examination of Firm B

On April 29, 2009, Member Regulation issued an Exit Meeting Report relative to Examination No. 2009XXXXXXX of Firm B's business activities ("April 2009 Exit Meeting Report"). The April 2009 Exit Meeting Report identified several compliance problems at Firm B, referred to as "Exceptions," including, but not limited to, failures to comply with AML and Bank Secrecy Act requirements and inadequacies in the firm's supervisory procedures. With respect to AML and Bank Secrecy Act requirements, Member Regulation found that Firm B failed adequately to: (1) file nine out of 11 Suspicious Activity Reports; (2) establish an AML compliance program; and (3) implement a Customer Identification Program. As to Firm B's supervisory procedures, Member Regulation found that the firm did not enforce its written supervisory procedures related to its review of correspondence from January 1 through March 31, 2009,[4] and that neither Firm B's written supervisory procedures, nor its supervisory control procedures, designated a principal to establish a system of supervisory control policies and procedures.[5] The April 2009 Exit Meeting Report also advised Firm B that, "[a]fter supervisory review of the examination file, FINRA will be issuing an Examination Report that documents the [E]xceptions," and that the firm would be required to submit a written response describing the corrective action taken to address each Exception.

On July 21, 2009, Member Regulation issued its "Report on the Examination of Firm B" ("July 2009 Examination Report") formalizing many of the Exceptions in its April 2009 Exit Meeting Report. Member Regulation identified 13 Exceptions in the July 2009 Examination Report, including the inadequacies in Firm B's written supervisory procedures and supervisory control procedures alleged in the April 2009 Exit Meeting Report. Excluded from the July 2009 Examination Report, however, were the April 2009 Exit Meeting Report findings of alleged AML and Bank Secrecy Act violations.

On July 31, 2009, Owner 2 responded by letter to the July 2009 Examination Report. As to the allegation that Firm B failed to adequately review correspondence, Owner 2 asserted that nearly all of the 22,640 emails cited in the report were emails that Firm B's clearing firm sent it

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[4] Firm B's procedures stated that Owner 2 was responsible for reviewing one percent of all correspondence on a bi-monthly basis, but he did not review any electronic correspondence for that period; and Owner 1 reviewed only 26 out of 22,640 emails, which was approximately 0.1 percent of all email.

[5] In addition, Member Regulation found that Firm B's supervisory control procedures were inadequate because the procedures: (1) "were contained in [Firm B's] WSPs [written supervisory procedures]"; (2) failed to adequately identify the steps Firm B would follow for drafting and approving new procedures when updating and amending deficient written supervisory procedures; and (3) failed to address how Firm B would ensure and document adequate customer confirmation of transactions.

and that the emails were reviewed by the appropriate individuals. In addition, Owner 2 asserted that the "examination report grossly overstates the number of emails" at issue. Moreover, Owner 2 contended that NASD Rule 3010(d) "sets separate standards for written correspondence and electronic mail" and that the rule requirements for electronic correspondence pertain to emails with the public, not emails with a clearing firm. He argued that Firm B therefore was not required to separately review each email from its clearing firm and document such review. Owner 2 also stated that he appointed a designee to conduct routine reviews of customer correspondence, identify and handle customer complaints, and ensure that customer funds and securities are handled in accordance with firm procedures.

As to the allegation that Firm B failed to establish adequate written supervisory control procedures because they were not set forth in a separate document, Owner 2 asserted that Firm B was not aware of a FINRA requirement to that effect. With respect to the allegation that Firm B's supervisory control procedures failed to designate a principal to establish a system of supervisory control policies and procedures, Owner 2 asserted that Firm B's supervisory control procedures include a Designation of Supervisors that specifically identifies by name, title and registration status the person charged with overall responsibility for each specific area. In that regard, Owner 2 stated that he is the individual "identified as having overall responsibility for the Written Supervisory Procedures and Supervisory Systems review." He further represented that Firm B has expanded the specific items listed in the Designation of Supervisors to more clearly identify the person responsible for each specific area. Although Owner 2 indicated in his response that he included a copy of the revised Designation of Supervisors, the record does not include a copy of the document.

In an Examination Disposition Letter dated September 25, 2009 ("September 2009 Disposition Letter") issued in Examination No. 2009XXXXXXX (the April 2009 Examination), Member Regulation advised Firm B that it was taking cautionary action with respect to 10 Exceptions, including those that address deficient supervisory procedures, and no further action with respect to three other Exceptions. The September 2009 Disposition Letter also advised Firm B that the review of Firm B's compliance with AML and Bank Secrecy Act requirements would be "handled separate and apart" from the April 2009 examination. Thus, there was no final disposition with respect to the alleged AML violations that Member Regulation included in its April 2009 Exit Meeting Report (but excluded from its July 2009 Examination Report and September 2009 Disposition Letter).

2. May 21, 2009 Wells Letter Issued to Firm B

On May 21, 2009, FINRA's Department of Enforcement ("Enforcement") issued a Wells letter[6] to Firm B in Case No. 2006XXXXXXX ("May 2009 Wells letter") alleging that, from January 2005 through March 2008, Firm B failed to comply with AML requirements under NASD Rules 3011 and 2110 and MSRB Rule G-41 by: (1) failing to implement policies and procedures reasonably designed to detect and report suspicious transactions; and (2) failing to

[6] A "Wells" letter refers to a letter sent by Enforcement advising a respondent "that a recommendation of formal disciplinary charges is being considered" and typically provides the respondent with an opportunity to "submit a written statement explaining why such charges should not be brought." *NASD Notice to Members 97-55* (Aug. 1997).

identify suspicious activity, properly investigate it, and file suspicious activity reports. The May 2009 Wells letter did not identify the evidence upon which the AML and Bank Secrecy Act allegations are based. Member Regulation indicated on appeal that the May 2009 Wells letter resulted from an investigation that predated the April 2009 Examination.

D. Member Regulation's Requests for Additional Information Related to Firm A's New Membership Application

In a letter dated June 22, 2009, Member Regulation advised Firm A that its Application contained insufficient information and documentation to permit Member Regulation to determine whether Firm A satisfied the standards set forth in NASD Rule 1014. The letter advised Firm A that it needed to "explain how its principals will maintain compliance with SEC [Securities and Exchange Commission] and FINRA rules and regulations for Firm A and Firm B going forward" given that the April 2009 Exit Meeting Report identified an "apparent violation of supervisory procedures," and that the principals would be dividing their time between Firm A and Firm B.

On August 6, 2009, Owner 2 responded by letter, asserting that "the examination report is still being processed and has not been finalized," and that he and Owner 1 have "responsibly run" Firm B with "no major violations of SEC or FINRA rules." The letter also assured Member Regulation that Owner 2 and Owner 1 "believe" they can "carry on this tradition of compliance" at Firm A.

On October 20, 2009, Member Regulation sent Firm A a letter expressing concern that Firm B was subject to a Wells letter that alleged violations that predated the April 2009 Examination of AML and Bank Secrecy Act requirements. The letter instructed Firm A to submit a detailed explanation demonstrating how, notwithstanding the May 2009 Wells letter, it proposes to comply with applicable SEC and FINRA rules and regulations. The letter also questioned Owner 2's ability to serve as Firm A's FINOP, chief compliance officer, principal, and options principal, while also serving in the same capacities at Firm B. The letter directed Firm A to provide a detailed explanation of how Owner 2 will meet his obligations to Firm A and Firm B, considering that Owner 2's "allocation of time to both entities is stretched and may be unrealistic."

On December 3, 2009, Firm A responded. The Firm stated that the May 2009 Wells letter against Firm B is not relevant to its Application because neither Firm A nor any of its associated persons are the subject of the May 2009 Wells letter.[7] As to Member Regulation's concern about Owner 2's ability to split his time effectively between Firm B and Firm A, the Firm contended that Owner 2 was capable of fulfilling his "supervisory and oversight responsibilities" at each broker-dealer by "arriv[ing] at his office by the time the market opens,

[7] As to the May 2009 Wells letter's allegations of AML violations, Firm A argued that the identification of "red flags" and the determination of suspicious activity are actions based upon "subjective standards," and that "[r]easonable persons may differ in their determination of subjective standards." Firm A contended further that, based upon discussions with Enforcement, Firm B's principals now "have an understanding of the Staff's recommended review of the subject . . . accounts, and [that] Firm B has taken additional steps to ensure that future concerns with respect to Firm B's implementation of AML procedures will not arise."

and . . . remain[ing] at his office after the market close[s] for the additional hours that are necessary to fully perform his corporate and regulatory responsibilities as the FINOP, [chief compliance officer], Principal and [options principal] to both broker-dealers."

E. Member Regulation's Denial of Firm A's New Membership Application

Member Regulation issued a decision letter on January 4, 2010, denying Firm A's Application based on findings that the Firm failed to satisfy the standards in NASD Rules 1014(a)(13), 1014(a)(9), and 1014(a)(10).

1. Member Regulation's Findings under NASD Rule 1014(a)(13)

Member Regulation concluded that it possessed information that Firm A might "circumvent, evade, or otherwise avoid compliance with federal securities laws, the rules and regulations thereunder and NASD Rules" and that the Firm therefore did not satisfy NASD Rule 1014(a)(13).[8] Specifically, Member Regulation relied on the fact that: (1) Firm B is subject to the May 2009 Wells letter; (2) the April 2009 Examination identified "a number of violations"; and (3) Firm A failed to disclose the May 2009 Wells letter on its Form BD and New Membership Application Form NMA ("Form NMA").

Member Regulation found that Firm B's alleged violations of AML obligations (identified in the May 2009 Wells letter) are relevant because Firm B's business activities are similar to those proposed by Firm A, and Firm B's principals and supervisors, Owner 1 and Owner 2, also are Firm A's proposed president, AML officer, chief compliance officer, and FINOP. Member Regulation similarly considered the "results" of the April 2009 Examination of Firm B. Member Regulation found that, "[g]iven the similarities in management, ownership and business lines between Firm B and the Applicant," it is relevant to the Application that the April 2009 Exit Meeting Report found that Firm B's failed to: (1) establish an adequate AML compliance program; (2) implement an adequate Customer Identification Program, particularly as to verifying the identity of foreign customers; (3) properly file suspicious activity reports relating to suspicious foreign transactions; (4) follow its written supervisory procedures for the review of correspondence; and (5) establish adequate written supervisory control procedures.

Member Regulation also concluded that, as a control affiliate of Firm B, Firm A should have disclosed the May 2009 Wells letter against Firm B on its Form NMA and on the Securities and Exchange Commission's ("SEC's") Form BD that it filed to register as a new broker-dealer.[9]

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[8] NASD Rule 1014(a)(13) states that, in connection with a membership application, the applicant must demonstrate that FINRA does not possess any information indicating that the applicant may circumvent, evade, or otherwise avoid compliance with the federal securities laws, rules, and regulations and NASD Rules. As with each section of Rule 1014(a), the burden of proof is on the applicant.

[9] Member Regulation failed to include a copy of the Form NMA in the certified record on appeal and did not include any analysis with respect to the Form NMA disclosure issue in its denial decision. We therefore are unable to consider that issue on appeal.

2. Member Regulation's Findings under NASD Rules 1014(a)(9) and (a)(10)

Member Regulation determined that Firm A did not meet the standards in NASD Rules 1014(a)(9)[10] and (10)[11] because Owner 1 and Owner 2 proposed to maintain the same responsibilities at Firm B and Firm A, and both broker-dealers have the same AML procedures.[12]

Another area of concern that Member Regulation identified was that Firm A failed to adequately address Member Regulation's inquiry during the application process about how the supervising principals (Owner 1 and Owner 2) would be able to divide their time between Firm A and Firm B and maintain compliance with SEC and NASD/FINRA rules and regulations for both entities. Member Regulation concluded that, in light of the violations alleged in the May 2009 Wells letter[13] and the April 2009 Examination Report, Firm A has not demonstrated that it has compliance, supervisory, operational and internal control practices and standards that are adequate and designed to prevent and detect, violations of the federal securities laws, the rules and regulations thereunder, and NASD Rules.

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[10] NASD Rule 1014(a)(9) states that, in connection with a membership application, the applicant must demonstrate that it "has compliance, supervisory, operational and internal control practices and standards that are consistent with practices and standards regularly employed in the investment banking or securities business, taking into account the nature and scope of Applicant's proposed business."

[11] NASD Rule 1014(a)(10) states that, in connection with a membership application, the applicant must demonstrate that it "has a supervisory system, including written supervisory procedures, internal operating procedures (including operational and internal controls), and compliance procedures designed to prevent and detect, to the extent practicable, violations of the federal securities laws, the rules and regulations thereunder, and NASD Rules." Additionally, NASD Rule 1014(a)(10)(J) "requires [Member Regulation] Staff to consider: 'Any other condition that will have a material impact on the Applicant's ability to detect and prevent violations of the federal securities laws, the rules and regulation thereunder, and NASD Rules.'"

[12] Member Regulation's decision letter, however, did not include information about any specific problems with respect to the written AML procedures of either Firm B or Firm A. Rather, it simply restated the allegations of the May 2009 Wells letter and April 2009 Examination Report without providing additional detail.

[13] The denial letter stated further that, although Owner 1 and Owner 2 were not charged with the violations listed in the May 2009 Wells letter, "both principals had responsibilities for AML compliance as specified in Firm B's AML procedures and . . . were the key principals responsible for the overall management and operation of that firm."

F. Firm A's Appeal of Member Regulation's Denial

Pursuant to NASD Rule 1015(a), Firm A filed an appeal of Member Regulation's decision on January 25, 2009.[14] On appeal, the Firm requests that the NAC reverse Member Regulation's denial of its Application for several reasons.

First, the Firm contends that FINRA issued the May 2009 Wells letter to Firm B, "without any findings, consents or further action" and that the existence of the May 2009 Wells letter is not evidence of any wrongdoing or misconduct by Owner 1, Owner 2, and Owner 3. The Firm notes that, to date, FINRA has not filed a disciplinary action against Firm B as a result of the May 2009 Wells letter and argues that the May 2009 Wells letter should not have been determinative as to the Application.

Second, Firm A asserts that Member Regulation also incorrectly relied on certain findings from the April 2009 Examination as a basis for its denial of the Firm's Application. Firm A argues that Firm B addressed each of the Exceptions and provided FINRA staff with further documentation and information "to establish that it was, in fact, in compliance with the noted rules and regulations"; and that the September 2009 Disposition Letter specifically excluded a review of Firm B's AML procedures. The Firm notes that no fines or penalties were assessed against Firm B as a result of the April 2009 Examination, and contends that nothing in the Examination Report demonstrates that Firm B or Firm A are unfit to conduct business.

Finally, Firm A claims that its "no" answer on the Form BD regarding whether a control affiliate has been found to have violated the rules of a self-regulatory organization was appropriate because the May 2009 Wells letter against its control affiliate (Firm B) is not the type of regulatory action that is required to be disclosed on the Form BD.

II. DISCUSSION

After a de novo review of the record and all of the issues presented on appeal, we have determined to vacate Member Regulation's denial of Firm A's Application and remand this matter to Member Regulation for reconsideration in light of the findings set forth below. Specifically, we direct Member Regulation to review the May 2009 Wells letter directed to Firm B and provide additional explanation as to the evidence supporting the allegations in the May 2009 Wells letter and the nexus between the May 2009 Wells letter and Firm A's Application. We further direct Member Regulation to review the results of FINRA's April 2009 Examination of Firm B and provide additional explanation as to the evidence supporting the allegations in the July 2009 Examination Report and September 2009 Disposition Letter and the nexus between the results of the April 2009 Examination of Firm B and Firm A's Application. We also direct Member Regulation to provide a detailed explanation of the deficiencies (if any) in Firm B's supervisory procedures and Firm B's implementation thereof, and explain the nexus between Firm B's supervisory deficiencies and Firm A's Application. Finally, we direct Member Regulation on remand to provide Firm A with an opportunity to respond to the additional arguments that Member Regulation raised for the first time on appeal. These additional

[14] Firm A did not request a hearing, therefore this matter was considered on the basis of the written record, including briefs on appeal.

arguments are: (1) that AML compliance problems persisted at Firm B after the May 2009 Wells letter was issued in Case No. 2006XXXXXXX, as evidenced by a subsequent separate investigation of Firm B's compliance with AML requirements in Case No. 2009XXXXXXX; (2) that Firm A's AML procedures are deficient because they are identical to Firm B's AML procedures, which Member Regulation asserts are deficient; and (3) that Owner 1's and Owner 2's additional business activities with business entities other than Firm B and Firm A could adversely impact their ability to carry out their supervisory duties at Firm A.

A. New Member Application Requirements

At the outset, we note that the applicant in new member applications has the burden of establishing that it meets all of the standards for initial membership approval set forth in Rule 1014. Under NASD Rule 1013(a)(1), the applicant for FINRA membership must file an application with Member Regulation that includes the information set forth in NASD Rule 1013(a)(1) and must demonstrate that it will meet each of the 14 standards for membership approval contained in NASD Rule 1014(a).

B. NAC Analysis

Member Regulation denied Firm A's Application based on findings that the Firm failed to satisfy its burden of demonstrating that it met the standards contained in NASD Rules 1014(a)(13), 1014(a)(9), and 1014(a)(10). We find that Member Regulation has failed to explain, with sufficient particularity, the reasons for its denial under the standards set forth in NASD Rules 1014(a)(13), 1014(a)(9), and 1014(a)(10). Moreover, we find that Firm A did not receive adequate notice of, and the opportunity to respond to, certain arguments raised for the first time in Member Regulation's NAC appeal brief. Furthermore, we find that several issues remain unresolved in the record and that Member Regulation nevertheless cites to these unresolved issues to support its denial of the Application. We have determined therefore to remand the matter to Member Regulation for further consideration of the issues under NASD Rules 1014(a)(13), 1014(a)(9), and 1014(a)(10) consistent with the directives in this decision.

1. Member Regulation's Denial under NASD Rule 1014(a)(13) Is Remanded for Further Consideration

Member Regulation concluded in its denial decision that it possessed information demonstrating that Firm A might circumvent, evade, or otherwise avoid compliance with the federal securities laws, the rules and regulations thereunder, or NASD rules, and that the Firm therefore did not satisfy NASD Rule 1014(a)(13). We remand the matter to Member Regulation for further consideration.

Member Regulation's decision to deny the Application under NASD Rule 1014(a)(13) is based, in part, on its consideration of the May 2009 Wells letter against Firm B. Member Regulation did not, however, include any information in the denial decision about the factual basis for the allegations in the May 2009 Wells letter. We find that the May 2009 Wells letter alone, without more discussion of the evidence supporting the May 2009 Wells letter's allegations, is insufficient for us to fully assess Member Regulation's conclusions and affirm Member Regulation's findings as to whether Firm A has satisfied NASD Rule 1014(a)(13).

We also find that Member Regulation provided inadequate notice to Firm A of an additional factor under consideration in connection with the Application. Member Regulation argues on appeal that AML violations persist at Firm B "even after . . . Owner 1, Owner 2 and Owner 3 were repeatedly made aware of those violations." In support of this finding, Member Regulation argues that the April 2009 Examination revealed "a continued failure to establish and implement an adequate AML compliance program," as evidenced by the commencement of a separate investigation of Firm B's compliance with AML obligations in Case No. 2009XXXXXXX.[15] The record here, however, includes no factual details about that separate investigation. Moreover, Member Regulation did not cite the separate AML investigation in its decision as a basis for denying Firm A's Application.[16]

"As long as a party to an administrative proceeding is reasonably apprised of the issues in controversy and is not misled, notice is sufficient." *KPMG Peat Marwick, LLP*, 55 S.E.C. 1, 4 (2001), *petition for review denied*, 289 F.3d 109 (D.C. Cir. 2002). Moreover, as we have stated previously, "Member Regulation's decision is the primary way for Member Regulation to provide notice of its concerns . . . ." *Membership Continuance Application of Member Firm*, Application No. 20060058633, at 20 (FINRA NAC July 2007), *available at*: http://www.finra.org/web/groups/industry/@ip/@enf/@adj/documents/nacdecisions/p117387.pdf. Advancing new grounds in defense of Member Regulation's decision for the first time on appeal raises fairness concerns if a party is not reasonably apprised of such grounds. *See id*. at 20-21 (finding that Member Regulation failed to provide the firm with notice about issues that it claimed on appeal were relevant to its decision). In light of the foregoing considerations, we find that Firm A did not receive proper notice of, and an opportunity to respond to, Member Regulation's consideration of FINRA's second investigation of Firm B AML compliance issues in Case No. 2009XXXXXXX. *Id*. We direct that Firm A be given the opportunity to respond to this issue on remand.

As further support for Member Regulation's denial under Rule 1014(a)(13), Member Regulation listed five findings from the April 2009 Exit Meeting Report. Member Regulation stated that it was important to take the "results" of the April 2009 Examination into consideration given the similarities in management, ownership, and business activities between Firm B and Firm A. We note, however, that three of the referenced findings in the April 2009 Exit Meeting Report – all of which concerned Firm B's compliance with AML requirements – cannot properly

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[15] According to Member Regulation's appeal brief, the investigation in Case No. 2009XXXXXXX was commenced as a result of the AML issues that were identified in the April 2009 Examination and post-dates the examination of Firm B that resulted in the May 2009 Wells letter, which also involves AML compliance issues. The record on appeal is unclear, however, with respect to the specific factual bases for each of these investigations.

[16] Member Regulation states in its appeal brief that it sent requests for information to Firm B in connection with FINRA's pending investigation of Firm B in Case No. 2009XXXXXXX and that Owner 1 provided on-the-record testimony on February 18, 2010, concerning that investigation. Member Regulation included these documents with its appeal brief, but it did not provide Firm A with adequate notice that it was utilizing this information as a basis for its denial decision. We therefore reject these documents as evidence. Likewise, we reject as evidence all other documents that Member Regulation included with its appeal brief that were not part of the record that it certified to us on appeal.

be characterized as examination "results" because they were specifically excluded from the September 2009 Disposition Letter. Accordingly, we give no weight to Member Regulation's findings in this regard.

Next we address the two remaining April 2009 Examination findings cited by Member Regulation as further support for its denial under NASD Rule 1014(a)(13). Specifically, Member Regulation noted that: (1) the 2009 Exit Meeting Report found that Firm B did not enforce its written supervisory procedures related to the review of correspondence from January 1 through March 31, 2009; and (2) that Firm B did not establish adequate written supervisory control procedures. In a letter dated July 31, 2009, Owner 2 responded to Member Regulation's specific concerns regarding Firm B's supervisory procedures and represented that he had provided revised documents to Member Regulation. The revised documents, however, are not included in this record. Owner 2's response also explained Firm B's interpretation of certain supervisory rules at issue in the April 2009 Examination. The record does not include Member Regulation's response to Owner 2's rule interpretation.

Although Member Regulation sent Firm B a follow-up letter, dated August 27, 2009, advising the firm that there were still areas in which its July 31, 2009 response was "incomplete," that letter did not identify as "incomplete" compliance issues with respect to Firm B's supervisory procedures. Moreover, Member Regulation's August 27, 2009 letter did not include any information about Member Regulation's position on the rule interpretation issues raised in Owner 2's letter. Nor did the letter indicate whether Member Regulation was satisfied with the revisions that Firm B had made to its supervisory documents. (We note that the revised supervisory documents that Owner 2 referenced in his response were not included in this record.) Member Regulation's September 2009 Disposition Letter advised Firm B that the "Exceptions" concerning Firm B's supervisory procedures were subject to cautionary action, but did not otherwise alert Firm B to ongoing supervisory deficiencies. Furthermore, although Member Regulation cited in its denial letter compliance problems that were identified in the April 2009 Examination associated with Firm B's written supervisory procedures and written supervisory control procedures, the record before us on appeal does not include copies of Firm B's supervisory documents or a detailed explanation of the nature and extent of Firm B's supervisory deficiencies. Based on these facts, we find that it is unclear whether Member Regulation found that Firm B was in compliance with applicable FINRA supervisory rules and the significance of these findings to Firm A's Application.

In light of the issues that we have identified with the record in this matter and with Member Regulation's denial decision, and given the notice issues that we have identified, we vacate Member Regulation's determination that Firm A failed to meet the standards set forth in NASD Rule 1014(a)(13) and remand the matter to Member Regulation to reconsider its decision with respect to the issues that we have identified.[17]

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[17] In addition, we find no factual or legal support for Member Regulation's conclusion that Firm A was required, and failed, to disclose the May 2009 Wells letter against Firm B on the SEC's Form BD. Question 11G on the Form BD includes the following question: "Is the applicant or a control affiliate now the subject of any regulatory *proceeding* that could result in a "yes" answer to any part of 11C, D, or E?" (Emphasis added.) The referenced questions under 11C, D, and E ask whether regulatory authorities have ever found the applicant or control affiliate to be in violation of regulations, and whether the applicant or control affiliate has been

[Footnote continued on next page]

2. Member Regulation's Denial under NASD Rules 1014(a)(9) and 1014(a)(10) Is Remanded for Further Consideration

Member Regulation found that Firm A did not have "compliance, supervisory, operational, and internal control practices and standards (including WSPs and internal controls and procedures) to meet the requirements of NASD Rules 1014(a)(9) and 1014(a)(10)." As support, it cited the existence of the May 2009 Wells letter against Firm B, the fact that Firm B's principals would also operate Firm A, and the April 2009 Examination of Firm B that "resulted in numerous violations," the same factors that it cited in its denial under NASD Rule 1014(a)(13). Consequently, the lack of notice, insufficiencies in the record, and other issues that we identified above with respect to NASD Rule 1014(a)(13) also undercut Member Regulation's findings in these areas pursuant to NASD Rules 1014(a)(9) and 1014(a)(10).

Member Regulation cited two additional grounds for denying the Application under NASD Rules 1014(a)(9) and 1014(a)(10): (1) that the written AML procedures for both Firm B and Firm A are identical; and (2) that the principals (Owner 1 and Owner 2) failed to adequately explain how they would be able to split their time between Firm B and Firm A and maintain compliance with applicable rules and regulations in light of the results of the April 2009 Examination.

Although Member Regulation expressed concern in the denial decision that Firm A is planning on utilizing AML procedures that are identical to Firm B's AML procedures, given that Firm B is subject to the May 2009 Wells letter that alleges "numerous AML violations," Member Regulation did not specify what the deficiencies are with respect to either firm's AML procedures. The denial decision also stated that Firm B's AML procedures were last revised on March 16, 2007, but contained no analysis of the significance of that fact in the context of the standards under NASD Rules 1014(a)(9) and 1014(a)(10). Based on these considerations, we conclude that it is unclear from the denial decision and the record whether Member Regulation is contending that there are any problems or deficiencies with respect to Firm B's or Firm A's written AML procedures and, if so, the specifics of the deficiencies.[18]

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fined or had its registration suspended or revoked by regulatory authorities. A Wells letter does not constitute a regulatory proceeding under the instructions included with the Form BD. Thus, we do not credit Member Regulation's finding with respect to this issue as a basis for its denial under NASD Rule 1014(a)(13).

[18] Member Regulation argues in its appeal brief that Firm A's written AML procedures are almost a verbatim rendition of Firm B's written AML procedures, and that "it was reasonable for [Member Regulation] Staff to conclude that those procedures, if implemented at Firm A . . . will be likewise deficient" given that a Wells letter was issued to Firm B regarding its AML procedures and that Firm B is currently under investigation by Enforcement with respect to additional AML compliance issues. Member Regulation asserts for the first time on appeal, however, that it has found that Firm B's written AML procedures are in fact deficient. As stated above, because Member Regulation's decision provides no explanation of Firm B's or Firm A's specific AML deficiencies, we find that Firm A had inadequate notice of this issue and direct that, on remand, Firm A be given an opportunity to respond to specific allegations of AML

[Footnote continued on next page]

Member Regulation also stated as a basis for its denial under NASD Rules 1014(a)(9) and 1014(a)(10) that Firm A did not adequately address how principals Owner 1 and Owner 2 would be splitting their time for supervisory purposes between Firm A and Firm B. Member Regulation offered little in the way of an explanation of the basis for this conclusion. In its brief on appeal, Member Regulation states that it had required Firm A to provide "a delineation of proposed time division" in order to "fully assess either the adequacy of the supervisory personnel proposed for Firm A or to assess whether Firm B would be detrimentally affected by its sole supervisors spending time and attention focusing on Firm B." Notwithstanding this representation, there is no evidence in the record demonstrating that Member Regulation asked for such a specific delineation of the principals' proposed time division during the application process.[19] In light of the dearth of information in the record regarding Member Regulation's requests for additional information on this issue and Firm A's responses, we do not credit Member Regulation's conclusion that Firm A provided inadequate information about how the principals will split their time between Firm B and Firm A.[20] For these reasons, we find that Member Regulation's concerns as to whether Owner 1 and Owner 2 can split their time effectively between Firm B and Firm A provide an inadequate basis for denial of the Application under NASD Rules 1014(a)(9) and 1014(a)(10).[21]

[cont'd]

deficiencies. *See Membership Continuance Application of Member Firm*, Application No. 20060058633, at 20-23.

[19] As noted above, Member Regulation's June 22, 2009 letter to Firm A simply asked how the principals would maintain compliance with applicable rules given that, among other considerations, they would be dividing their time between Firm A and Firm B. In its October 22, 2009 letter to Firm A, Member Regulation requested that the Firm provide a detailed explanation with respect to how Owner 2 would be able to meet his obligations when his "allocation of time to both entities is stretched and may be unrealistic."

[20] Member Regulation also addresses Owner 1's and Owner 2's proposed time division in its appeal brief and asserts for the first time that it has concerns about the principals' ability to direct sufficient time and attention to their supervisory duties at Firm A based on information in Owner 1's and Owner 2's Uniform Application for Securities Industry Registration or Transfer ("Forms U4") that both perform business activities with business entities other than Firm B and Firm A. Because Member Regulation raises its concern about Owner 2's and Owner 1's additional business activities for the first time in its appeal brief, Firm A had inadequate notice of the issue. *Cf. Membership Continuance Application of Member Firm*, Application No. 2006005863, at 20-23. We direct that Firm A be given an opportunity to respond to this issue on remand.

[21] We note that the denial decision states that, although Owner 1 and Owner 2 were not named in the May 2009 Wells letter, "both principals had responsibilities for AML compliance as specified in Firm B's AML procedures." This finding needs to be further clarified in any future decision by referencing the particular section(s) in the written AML procedures that specify Owner 2's responsibilities.

Given the issues that we have identified with the record in this matter and with Member Regulation's denial decision, and the notice problems that we also have identified, we vacate Member Regulation's determination that Firm A failed to meet the standards set forth in NASD Rules 1014(a)(9) and 1014(a)(10) and remand the matter to Member Regulation to reconsider its decision with respect to the issues that we have identified.

* * *

On remand, we instruct Member Regulation to explain, with sufficient particularity, the nexus between the issues outlined in [its] decision, and the standards set forth in NASD Rules 1014(a)(13), 1014(a)(9), and 1014(a)(10), to explain the basis for concluding that Firm B's regulatory deficiencies affect Firm A's ability to satisfy the standards under NASD Rule 1014(a), to provide a more detailed analysis of the evidence that supports its findings of Firm B's and Firm A's regulatory deficiencies, and to ensure that the evidence that Member Regulation considered in support of its findings is included in the record certified to the NAC on appeal. *See First Potomac*, 50 S.E.C. 848, 850 (1992) (instructing NASD on remand to "set forth its overriding concerns and explain with some particularity how they outweigh the merits of First Potomac's proposal"). Furthermore, Member Regulation should comply with the directives stated above, which include providing Firm A with an opportunity to respond to the issues that it identified for the first time on appeal. Moreover, on remand, it is most helpful to the National Adjudicatory Council when both parties identify the evidence that supports or overcomes the reasons set forth in a Member Regulation decision, and that such evidence is included in the record.

III. CONCLUSION

Accordingly, we remand this matter to Member Regulation with specific instructions to Member Regulation staff to provide Firm A with an opportunity to respond to matters that Member Regulation raised for the first time on appeal and, within 45 days of Member Regulation's receipt of this decision, to undertake the following: (1) include in the record all relevant evidence and documents in support of its decision; (2) clarify its decision with respect to the issues identified in this decision; and (3) reconsider and issue a new decision regarding Firm A's Application, in light of our findings and instructions herein.[22]

On Behalf of the National Adjudicatory Council,

_____

Marcia Asquith, Senior Vice President
and Corporate Secretary

[22] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.