

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

THADDEUS JAMES NORTH
(CRD No. 2100909),

Respondent.

Disciplinary Proceeding
No. 2012030527503

Hearing Officer – CC

HEARING PANEL DECISION

July 23, 2015

Chief compliance officer is fined \$5,000 for failing to enforce the firm’s written supervisory procedures regarding oversight of electronic communications, in violation of NASD Rule 3010 and FINRA Rule 2010.

Appearances

Paul D. Taberner, Esq., and Bonnie McGuire, Esq., for the Department of Enforcement, Complainant.

Constance J. Miller, Esq., for Thaddeus James North, Respondent.

DECISION

I. Introduction

This case involves Respondent Thaddeus James North’s failure to supervise electronic communications at former FINRA member firm Ocean Cross Capital Markets, LLC (“Ocean Cross”). North was one of two principals at Ocean Cross and the firm’s Chief Compliance Officer (“CCO”).¹ North was associated with Ocean Cross and registered with FINRA in various capacities, including as a general securities principal and operations professional, from August 4, 2011, when FINRA approved Ocean Cross’s membership, through January 29, 2013.²

II. Discussion

A. Procedural Background

On October 24, 2013, FINRA’s Department of Enforcement (“Enforcement”) filed a Complaint alleging that, while North was associated with Ocean Cross and serving as the firm’s CCO, he was responsible for reviewing Ocean Cross’s electronic communications with

¹ December 9, 2013 Answer (“Ans.”) ¶ 1; Transcript of April 27, 2015 Hearing (“Tr.”) 48.

² Ans. ¶¶ 2-5; Complainant’s Exhibit (“CX”)-6 at 2.

customers. The Complaint alleges that, between September 8, 2011, and April 30, 2012 (“the review period”), North failed to conduct a daily review of an appropriately sized sample of electronic communications, as required by Ocean Cross’s Written Supervisory Procedures (“WSPs”). The Complaint alleges that North failed to maintain a record of his review of electronic communications, as required by the firm’s WSPs. The Complaint also alleges that North failed to review the electronic communications generated by one person associated with the firm who transmitted some of her electronic communications through a Bloomberg account. The Complaint alleges that, as Ocean Cross’s CCO, North failed to enforce the firm’s WSPs regarding the review of electronic correspondence.

North ultimately retained counsel to represent him in this proceeding, but he represented himself when he filed a December 9, 2013 Answer to the Complaint. North’s Answer admits that he served as Ocean Cross’s CCO, but denies that the firm designated him as the principal responsible for reviewing electronic communications. North contends that Ocean Cross’s WSPs identified the firm’s president, William Schloth (“Schloth”), as responsible, and Schloth had not designated another principal to be responsible. North admits that he periodically reviewed electronic communications, but denies that he was the designated responsible individual.

Enforcement examiner JM testified that he began an on-site examination of Ocean Cross’s main office in Westport, Connecticut on January 30, 2012.³ The examination led to the filing of the Complaint in this matter. FINRA maintains jurisdiction over North because North currently is associated with another member firm. The parties participated in a hearing in Boston, Massachusetts on April 27, 2015.

The parties agree that, during the review period, Ocean Cross used Smarsh, Inc. (“Smarsh”) to archive Ocean Cross’s emails and one associated person’s Bloomberg messages and that North used Smarsh exclusively to review electronic communications at Ocean Cross.⁴ Thus, Smarsh was the source of several of Enforcement’s Exhibits.

On August 29, 2014, North moved to permit the testimony of proposed expert Andy Thomas (“Thomas”). North contended that Thomas would testify about Enforcement’s alleged spoliation of the electronically-stored emails Enforcement had obtained from Smarsh.⁵ The Hearing Officer denied North’s motion. In a September 10, 2014 Order, the Hearing Officer found that Thomas’s proposed testimony was not relevant because it would not address the issues that are of consequence here, namely whether North was responsible during the relevant

³ Tr. 15.

⁴ Ans. ¶ 17; Tr. 67-68.

⁵ Respondent argued that the bases for Thomas’s proffered testimony of spoliation included visible differences in the emails that Enforcement provided during discovery in this matter and the emails that Enforcement produced during discovery in another disciplinary proceeding involving some of the same parties. Respondent also argued that Thomas’s testimony would demonstrate that the Bloomberg emails produced by Enforcement during discovery in this case contained visible differences from the Bloomberg emails contained in the “Bloomberg vault” of the associated person who used Bloomberg, suggesting that they were not produced in Bloomberg’s native format, and that some of the Bloomberg vault emails were absent from Enforcement’s production.

period for reviewing Ocean Cross's electronic correspondence and, if so, whether he conducted and documented the daily review, as required by the firm's WSPs.

On September 11, 2014, North filed a motion to stay these proceedings. The issues that North raised in the stay motion were similar to the issues that he identified in his motion to present Thomas's testimony. In a September 17, 2014 Order, the Hearing Officer denied North's request for a stay of the proceedings, continued the hearing scheduled for September 2014, and ordered the parties to participate in a pre-hearing evidentiary proceeding to resolve North's challenges to the accuracy and reliability of electronic information provided by Smarsh.

In an October 24, 2014 Order, the Hearing Officer granted North's request that the evidentiary adjudication occur in person and Enforcement's request to offer the testimony of Jimmy Douglas ("Douglas"), Smarsh's Director of Web Services, by telephone. The Hearing Officer granted in part and denied in part North's second motion to offer Thomas's testimony. The Hearing Officer reiterated her prior ruling that Thomas may not testify as to matters deemed not relevant to this proceeding, including: the content and number of emails contained in the Bloomberg vault of Ocean Cross's associated person; the format, content, and appearance of emails produced by Enforcement or archived by Smarsh; comparisons of electronic information produced during discovery in this matter to electronic information produced during discovery in other FINRA disciplinary proceedings; and the appearance and content of printed emails archived by Smarsh. The Hearing Officer granted North's motion for leave to present Thomas's testimony relating to: North's logging onto Smarsh's email review system during the review period; the number of any such Smarsh-archived emails available for North's review during that period; the number of Smarsh-archived emails that North reviewed during the review period; the number and content of North's word searches of Smarsh-archived emails during the review period; and the dates of North's email reviews during the review period.

On October 31, 2014, North withdrew his request to present Thomas's testimony. On November 5, 2014, the Hearing Officer conducted a pre-hearing evidentiary proceeding, in which counsel for both parties participated. Enforcement offered Douglas's testimony to authenticate Enforcement's proposed exhibits: CX-9 (a daily report of Ocean Cross emails retained by Smarsh and the number of emails reviewed by North for the period of August 4, 2011, through April 30, 2012); CX-10 (a report of North's daily searches of Ocean Cross emails for the period of September 2011 through April 2012); CX-11 (a daily report of Ocean Cross Bloomberg messages retained by Smarsh and the number of Bloomberg messages reviewed by North for the period of August 4, 2011, through April 30, 2012); CX-12 (a report of North's daily searches of Ocean Cross Bloomberg messages for the period of September 2011 through April 2012); and CX-13 (an August 19, 2014 letter from Douglas to Enforcement examiner JM).⁶

⁶ See Transcript of November 5, 2014 pre-hearing evidentiary proceeding ("Nov. 5 Tr.") 32, 34, 41-42, 44. The parties were unable to complete their examination of Douglas on November 5, 2014. By agreement of the parties, the Hearing Officer reconvened the pre-hearing evidentiary proceeding on November 25, 2014. By Order dated December 2, 2014, the Hearing Officer accepted into evidence Complainant's Exhibits CX-9 through CX-13.

B. Factual Background

When Ocean Cross received FINRA approval in August 2011, it was not fully operating because it had not yet received approval from several states.⁷ Ocean Cross's largest producer, Leslie King ("King") operated out of Texas, and Ocean Cross did not receive approval to conduct business in Texas until approximately mid-September 2011.⁸ North estimated that Ocean Cross became fully functional at that time.⁹ North testified that the firm ceased operating approximately one year later.¹⁰

Ocean Cross was based in Westport, Connecticut, where North and Schloth worked.¹¹ The firm maintained a second office in Plano, Texas, where King worked.¹² During the review period, approximately 15 registered persons were associated with Ocean Cross, spread out in offices in different areas of the country.¹³ FINRA approved Ocean Cross to conduct multiple types of business, but during the review period, the firm generated the vast majority of its revenue from King's municipal securities business.¹⁴

During the review period, North was Ocean Cross's CCO and one of only two principals associated with the firm.¹⁵ Schloth was the other principal.¹⁶ Before Ocean Cross, North was associated with Southridge Investment Group, LLC ("Southridge"), and was Southridge's CCO.¹⁷ North testified that his supervisory duties at Southridge were similar to his supervisory duties at Ocean Cross, except that at Southridge, he was the designated principal responsible for reviewing electronic communications and at Ocean Cross he was not the designated principal.¹⁸

Ocean Cross's WSPs during the review period required its president (Schloth) or another designated principal to review daily an appropriately-sized sample of incoming and outgoing email and instant message ("IM") correspondence or review any emails and IMs flagged by filtering software.¹⁹ The WSPs also required the reviewer to maintain all examined emails and

⁷ Tr. 76.

⁸ Tr. 17-18, 76.

⁹ Tr. 76.

¹⁰ Tr. 76-77. FINRA cancelled Ocean Cross's registration on July 22, 2013. CX-6 at 4.

¹¹ CX-6; Tr. 15.

¹² Tr. 17, 59.

¹³ Tr. 67.

¹⁴ Tr. 59.

¹⁵ Tr. 48, 66, 81-82.

¹⁶ Tr. 49, 66, 81-82.

¹⁷ Tr. 49. King and Schloth also were associated with Southridge before they were associated with Ocean Cross. Tr. 58.

¹⁸ Tr. 49.

¹⁹ Respondent's Exhibit ("RX")-12.

IMs in a separate folder and initial and date an electronic correspondence review log.²⁰ North testified that he purchased WSPs from an independent compliance provider and adjusted them to Ocean Cross's business.²¹ When North adjusted the procedures for Ocean Cross, he specifically chose not to identify himself as the principal responsible for reviewing electronic correspondence because he knew from his experience at Southridge how difficult and time-consuming the job could be.²² Instead, he listed Schloth as responsible.²³ North testified that, as CCO, he was responsible for enforcing Ocean Cross's WSPs.²⁴

Although North was not listed in the WSPs, he testified that he took it upon himself, as a practice, to review the firm's electronic communications once per week during the review period.²⁵ He stated that he knew, before April 30, 2012, that Schloth was not reviewing Ocean Cross's electronic communications daily and he therefore stepped in and assumed the responsibility.²⁶ North testified that he "took it upon [himself] to review emails" because, although he was not the "designated principal" for email review, he knew that Schloth was not conducting the review for which he was responsible.²⁷ North used the Smarsh system exclusively to review Ocean Cross's archived emails and King's Bloomberg messages that Smarsh also archived for Ocean Cross.²⁸ Although Ocean Cross's WSPs required the person who reviewed electronic communications to maintain all reviewed emails and IMs in a separate folder and initial and date an electronic correspondence review log, North stated that he instead relied upon Smarsh to maintain a record of his reviews.²⁹ He stated that he knew from his experience reviewing electronic communications at Southridge that, anytime he reviewed a communication, a record of his review would be stored "somewhere in the system" at Smarsh as an "electronic initial."³⁰

North testified that his other responsibilities at Ocean Cross included drafting and reviewing the WSPs, acting as the firm's anti-money laundering compliance officer, and

²⁰ RX-12.

²¹ Tr. 74. North also testified that, as of the review period, he had not had time to tailor the WSPs specifically to Ocean Cross to the extent that he wanted to tailor them. Tr. 115.

²² Tr. 74.

²³ Tr. 74.

²⁴ Tr. 93, 100.

²⁵ Tr. 75.

²⁶ Tr. 81-82, 93-95, 100-101.

²⁷ Tr. 50, 52, 54, 61. During North's on-the-record ("OTR") testimony on April 30, 2012, he testified that, as Ocean Cross's compliance person, it was his responsibility to review the firm's electronic communications. Tr. 57-58. During North's OTR, he did not suggest that reviewing electronic communications was Schloth's responsibility. Tr. 57-58.

²⁸ Tr. 67-68, 79, 82. On cross examination, North stated that Web.com hosted Ocean Cross's emails. Tr. 82, 112. He had not previously identified Web.com as Ocean Cross's email provider. Before mentioning Web.com, North testified consistently and unequivocally that Smarsh archived electronic communications for both Ocean Cross and Southridge. Tr. 67-68, 78-79.

²⁹ Tr. 117.

³⁰ Tr. 117.

handling the firm's "operational functions."³¹ North stated that, during the first three months of the firm's business, he spent a large amount of time migrating hundreds of accounts from Southridge to Ocean Cross because most of the individuals who associated with Ocean Cross moved to the firm from Southridge.³² North devoted much of his time to ensuring that account forms were properly completed, executed, and processed.³³

FINRA examiner JM testified that he was one of three FINRA examiners who spent one week in January 2012 at Ocean Cross conducting an examination of the firm.³⁴ JM was assigned responsibility for examining the firm's retention and review of electronic communications.³⁵ He testified that he asked both North and Schloth to identify the individual at the firm who was responsible for reviewing the firm's electronic communications and that both identified North as responsible.³⁶ North demonstrated for JM and other Enforcement staff how he logged onto the Smarsh system and conducted email reviews on that system.³⁷ Neither Schloth nor North ever suggested to JM that Ocean Cross stored email on any system other than Smarsh's, and neither suggested that North reviewed emails by any means other than through Smarsh.³⁸ In response to North's and Schloth's identification of Smarsh as Ocean Cross's email archiving facility, JM requested records of North's email reviews from Smarsh.³⁹

Douglas testified that Smarsh archives electronic communications in conformance with Securities and Exchange Commission ("SEC") and FINRA requirements for the financial services industry.⁴⁰ Smarsh provides Ocean Cross with tools to perform supervision and data production of archived electronic communications.⁴¹ Smarsh provided Ocean Cross with Web-based applications to enable individuals at the firm to log in and perform supervisory functions such as random sampling of electronic communications, searches by key word and phrase, searches by time periods, and searches based on individuals' names.⁴² Smarsh also could

³¹ Tr. 50. North testified that he also spent significant time during the review period responding to FINRA Rule 8210 requests for information related to this matter and to an Enforcement investigation of King's activities at Southridge. Tr. 65-66, 68-69. Like North, King was associated with Southridge before Ocean Cross. Tr. 58-59. He stated that he often reviewed and "word-smithed" Ocean Cross's Rule 8210 responses that Schloth had prepared and that he generally read the responses before Ocean Cross submitted them to Enforcement. Tr. 68-69.

³² Tr. 66.

³³ Tr. 66.

³⁴ Tr. 13-15. JM and the other examiners returned to Ocean Cross for a second week of examination in March 2012. Tr. 13-15.

³⁵ Tr. 15.

³⁶ Tr. 19-21, 24. JM testified that North never suggested that Schloth was the individual responsible. Tr. 21.

³⁷ Tr. 27.

³⁸ Tr. 27-28.

³⁹ Tr. 37-42.

⁴⁰ Nov. 5 Tr. 12-13. Douglas is Smarsh's Director of Web Services. Nov. 5 Tr. 13. He testified that he had been promoted fairly recently from his former position as Director of Alliances & Industry Relations. Nov. 5 Tr. 14. He testified that he has been with Smarsh in various positions for more than five years. Nov. 5 Tr. 12.

⁴¹ Nov. 5 Tr. 12.

⁴² Nov. 5 Tr. 17, 24-26.

conduct discovery searches triggered by regulatory examinations.⁴³ Ocean Cross contracted with Smarsh to provide these services, and Smarsh archived the firm's emails, King's Bloomberg chat messages, and King's Bloomberg emails.⁴⁴ Douglas confirmed that North was one of the individuals at Ocean Cross granted search and oversight capabilities by Smarsh.⁴⁵

In the fall of 2013, Enforcement requested reports from Smarsh regarding North's review of electronic communications for Ocean Cross during the review period.⁴⁶ Douglas testified that, to review King's Bloomberg email, North had to conduct searches that were separate and independent from his searches of Ocean Cross's emails.⁴⁷ Smarsh produced reports demonstrating which days during the review period that North logged onto the Smarsh system, what searches he performed, how many emails were available for review, and how many emails North reviewed.⁴⁸ Smarsh reported that, although Ocean Cross emails were available for review every day beginning on September 8, 2011, North did not log onto the system to review Ocean Cross's emails for the first time until December 14, 2011.⁴⁹ Thereafter, he did not log onto the system again until January 31, 2012, when he reviewed one of 91 messages available that day.⁵⁰ He reviewed Ocean Cross's emails sporadically throughout February, approximately once or twice per week in March, and twice in all of April 2012.⁵¹

Smarsh reported that, although King's Bloomberg messages were available for review every day beginning on October 21, 2011, North did not log onto the system to review King's Bloomberg messages until February 2, 2012.⁵² Thereafter, he logged onto the system only six times between February 3, 2012, and April 30, 2012, to review King's Bloomberg messages, even though messages were available for review daily.⁵³

⁴³ Nov. 5 Tr. 17-18.

⁴⁴ Nov. 5 Tr. 19-20, 30.

⁴⁵ Nov. 5 Tr. 24, 52. Douglas did not know who else at Ocean Cross had search capabilities. Nov. 5 Tr. 52.

⁴⁶ Nov. 5 Tr. 36-37.

⁴⁷ Nov. 5 Tr. 20, 25-26.

⁴⁸ Nov. 5 Tr. 31-56. Smarsh transmitted the reports to FINRA electronically. Nov. 5 Tr. 56. In an August 19, 2014 letter, Douglas confirmed to Enforcement that Smarsh provided email hosting, email archiving, and Bloomberg archiving services to Ocean Cross from August 14, 2011, through July 31, 2011. CX-13. Douglas testified that the reports that it produced to Enforcement, however, indicate that Ocean Cross emails were first available for review on September 8, 2011, because that was the first date that Smarsh could confirm that all data was available for Ocean Cross's searches. Nov. 5 Tr. 50-52.

⁴⁹ CX-9 1-2.

⁵⁰ CX-9 3.

⁵¹ CX-9 3-4.

⁵² CX-11 2-3.

⁵³ CX-11 3-4.

C. Conclusions of Law

The Hearing Panel concludes that North failed to enforce Ocean Cross's written supervisory procedures with respect to the firm's review of electronic communications, in violation of NASD Rule 3010 and FINRA Rule 2010.

During the relevant period, NASD Rule 3010(a) required member firms to establish and maintain a system to supervise the activities of the firm and its registered representatives. Rule 3010(b) stated that each member firm shall establish, maintain, and enforce written supervisory procedures reasonably designed to achieve compliance with applicable laws, rules and regulations and to supervise the types of business in which the firms engages and the activities of the firm's associated persons.⁵⁴ North admitted that, at Ocean Cross, he was responsible for preparing and enforcing Ocean Cross's WSPs.⁵⁵

As a defense, North points to Ocean Cross's WSPs, which state that Schloth, the firm's president, was responsible for reviewing the firm's electronic communications. North testified that he specifically listed Schloth as the individual responsible for reviewing electronic communications because he did not want to be responsible for the task.⁵⁶ North argues that, because Schloth was responsible, he cannot be held to have "failed to supervise" in this regard. North argues that he was Ocean Cross's CCO, not a "supervisor."

We do not agree. "[P]ersons occupying positions in the legal or compliance departments of broker-dealers have been found by the [SEC] to be 'supervisors.'"⁵⁷ When a compliance officer becomes responsible along with one or more other supervisors for taking "reasonable and appropriate action" to address a problem, it is not sufficient for "one in such a position to be a mere bystander to the events that occurred."⁵⁸

North is correct that Ocean Cross's WSPs identify Schloth as the principal responsible for reviewing electronic communications and that the WSPs do not indicate that Schloth delegated that responsibility to another principal. But the evidence establishes that North assumed the responsibility for reviewing the firm's electronic communications after he recognized red flags indicating that Schloth was not conducting the required reviews.

JM testified that both North and Schloth identified North as the person responsible during JM's on-site examination of the firm.⁵⁹ JM's testimony regarding Schloth's statement is

⁵⁴ FINRA Rule 0140 states that associated persons shall have the same duties and obligations as member firms under the rules. Thus, the requirements of Rule 3010 may also apply to individual associated persons.

⁵⁵ Tr. 93, 100, 117-121.

⁵⁶ Tr. 74, 120.

⁵⁷ *John H. Gutfreund*, 51 S.E.C. 93, 113 (1992) (settled case) (finding that compliance officers who are not designated as supervisors can nonetheless be held responsible for a failure to supervise based on specific facts and circumstances).

⁵⁸ *Id.* See also *George J. Kolar*, 55 S.E.C. 1009, 1018 (2002) (finding failure to supervise by individual who shared control and authority with others, notwithstanding that he was subject to countermand at a higher level).

⁵⁹ Tr. 19-21, 24.

hearsay.⁶⁰ The factors to consider to evaluate the probative value and reliability of hearsay evidence are: (1) the possible bias of the declarant; (2) the type of hearsay at issue; (3) whether the hearsay statements are signed and sworn to rather than anonymous, oral or unsworn; (4) whether the statements are contradicted by direct testimony; (5) whether the declarant was available to testify; and (6) whether the hearsay is corroborated.⁶¹

Here, we find that JM's testimony regarding Schloth's statements is reliable.⁶² We acknowledge that Schloth had a vested interest in shifting the responsibility for reviewing electronic communications to North. His potential bias in this regard, coupled with Enforcement's failure to call Schloth as a witness,⁶³ lessens the reliability of Schloth's statements to JM. JM's testimony, however, is corroborated by Ocean Cross's February 12, 2012 response to a FINRA Rule 8210 request for information ("February 12 Ocean Cross Letter").⁶⁴ The letter does not suggest that Schloth reviewed emails.⁶⁵ Rather, the letter states that North periodically logged onto Smarsh and conducted a random search and review of Ocean Cross's emails, regardless of whether they were sent from an office computer, a home computer, or a cell phone.⁶⁶ The letter also does not suggest that Schloth was conducting these reviews or that he was the responsible principal.⁶⁷

Furthermore, JM's account of Schloth's statements is corroborated to an extent by North's own testimony. North acknowledged during OTR testimony on April 30, 2012, that he reviewed Ocean Cross's emails as part of his responsibility as a compliance person at Ocean Cross.⁶⁸ JM testified that North told him during the on-site visit that reviewing electronic communications was part of his responsibility and never suggested that the responsibility lay with Schloth.⁶⁹ Furthermore, at the hearing, North did not flatly deny his responsibility. Rather, he stated that he was not the person identified in the WSPs, but admitted that he was the person

⁶⁰ The SEC has long held that hearsay evidence is admissible in administrative proceedings. *Rooney A. Sahai*, Exchange Act Release No. 51549, 2005 SEC LEXIS 864, at *24 (Apr. 15, 2005); *Robin Bruce McNabb*, 54 S.E.C. 917, 926 (2000). Hearsay evidence, however, "must be evaluated for its probative value, reliability, and the fairness of its use in order to be admissible in administrative proceedings." *Carlton Wade Fleming, Jr.*, 52 S.E.C. 409, 411 n.7 (1995); see also *Mark James Hankoff*, 50 S.E.C. 1009, 1012 (1992).

⁶¹ *Wendell D. Belden*, No. C05010012, 2002 NASD Discip. LEXIS 12, at *22 (NAC Aug. 13, 2002); *Charles D. Tom*, 50 S.E.C. 1142, 1145 (1992).

⁶² Overall, the Hearing Panel finds JM's testimony regarding his examination of Ocean Cross credible.

⁶³ Enforcement represented that Schloth was within FINRA's jurisdiction at the time of the hearing. Tr. 45.

⁶⁴ CX-3. Schloth's name appears in the signature block of the letter, although no one actually signed the letter. CX-3 at 7. North testified that he generally reviewed and edited most of Ocean Cross's responses to Rule 8210 requests for information. Tr. 68-69. He recalled reviewing the February 12 Ocean Cross Letter before sending it to FINRA. Tr. 69-70.

⁶⁵ Tr. 73.

⁶⁶ CX-3 at 2.

⁶⁷ CX-3.

⁶⁸ Tr. 58.

⁶⁹ Tr. 21.

responsible for enforcing the WSPs, and he knew that the person identified in the WSPs (Schloth) was not adequately conducting reviews of the firm's electronic communications.⁷⁰

North admits that he knew before April 30, 2012, that Schloth had not been conducting the required reviews of the firm's electronic communications.⁷¹ He also states that he therefore assumed the responsibility to review electronic communications.⁷² North testified, "I took it upon myself to review emails because I knew that [Schloth] wasn't always doing it, and I decided to do it."⁷³ Ocean Cross had only two principals conducting supervision and compliance. One of them was North. As Ocean Cross's CCO and the person responsible for enforcing Ocean Cross's WSPs, when North realized that Schloth was not reviewing electronic communications, he chose to enforce the WSPs by assuming the responsibility himself. North was in a position of responsibility and saw red flags indicating that the firm was not complying with the WSPs. He took action by becoming the "supervisor" responsible for reviewing Ocean Cross's electronic communications.⁷⁴

Having determined to hold North responsible for Ocean Cross's review of electronic communications, we turn next to whether North's review of electronic communications was sufficient to constitute "reasonable supervision." "The standard of 'reasonable' supervision is determined based on the particular circumstances of each case."⁷⁵ Ocean Cross's WSPs, which North prepared, required a "daily" review of "an appropriately sized sample of incoming and outgoing email/IM correspondence; or review any emails/IMs flagged by filtering software (if utilized)."⁷⁶ North testified that, during the period prior to his April 30, 2012 OTR, he reviewed

⁷⁰ Tr. 81-82, 93-95, 100-101, 117-121. The Hearing Panel finds North's testimony credible and his description of the hectic atmosphere at Ocean Cross to be reliable.

⁷¹ Tr. 81-82, 93-95, 100-101.

⁷² Tr. 50, 52-54, 60-61, 75, 81-82, 83-85, 89, 92-95, 100-102.

⁷³ Tr. 54. *See also* Tr. 82 ("Well, in the beginning, [Schloth] didn't review much email to my recollection."), 92-93 (stating that, prior to April 2012, North alone reviewed Ocean Cross's emails because North did not believe that Schloth was reviewing emails), 101 ("[I]f [Schloth] was out of the office trying to get business, obviously he's not reviewing emails, and that's something that I did at the previous firm. It was easy for me to do, so I did it.").

⁷⁴ *See Kirk Montgomery*, 55 S.E.C. 485, 500-501 (2001) (holding that it is appropriate to find liable for a failure to supervise a chief compliance officer who "plays a significant, even if shared, role in a firm's supervisory structure."); *Gutfreund*, 51 S.E.C. at 113 (holding that a compliance officer who is not designated as a supervisor may be held responsible for a failure to supervise where he was informed of misconduct and took affirmative steps to address the misconduct); *Michael E. Tennenbaum*, 47 S.E.C. 703, 707 (1982) (holding that general partner who was not a designated supervisor was not insulated from liability for failure to supervise where he shared some oversight responsibility); *Dep't of Enforcement v. Levitov*, No. CAF970011, 2000 NASD Discip. LEXIS 12, at *24-26 (NAC June 28, 2000) (holding compliance person responsible for failing to supervise sales staff where he discovered facts that may have contributed to sales practice rule violations); *Dist. Bus. Conduct Comm. v. Gallison*, No. C02960001, 1999 NASD Discip. LEXIS 8, at *45 (NAC Feb. 5, 1999) (holding that firm's compliance officer failed to supervise where red flags existed and the compliance officer knew that registered representatives did not have effective line supervisors).

⁷⁵ *John Chepak*, 54 S.E.C. 502, 513 n.27 (2000) (citing *Christopher J. Benz*, 52 S.E.C. 1280, 1284 (1997), *appeal denied*, 168 F.3d 478 (3d Cir. 1988) (Table)). *See also Dep't of Enforcement v. Midas Sec., LLC*, No. 2005000075703, 2011 FINRA Discip. LEXIS 62, at *22 (NAC Mar. 3, 2011) (holding that the determination of whether supervision is reasonable is based on the particular circumstances of the individual case).

⁷⁶ RX-12 at 2.

a random sample of electronic communications “at least once a week” and did not conduct key word searches.⁷⁷ The records produced by Smarsh do not corroborate North’s testimony that he routinely reviewed Ocean Cross’s electronic communications one time per week, but do indicate that he did not conduct key word searches to monitor King’s communications. Smarsh’s records show that North randomly reviewed Ocean Cross emails less than once per week.⁷⁸ They also show that he reviewed King’s Bloomberg messages significantly less than that.⁷⁹

North contends that Smarsh’s records are unreliable. We disagree. Douglas credibly testified that every action that is taken inside Smarsh’s archiving system is attributed to the specific user who logged onto the system, and Smarsh’s system can generate a report to demonstrate supervisory search and review activity.⁸⁰ Douglas testified that actions taken at Ocean Cross to review electronic communications in Smarsh’s system are stored in a database that was built to report a record of the specific actions taken in Smarsh’s application.⁸¹ Smarsh generated the reports of North’s review activity from data within its database.⁸² Douglas also testified that Smarsh transmitted to Enforcement reports regarding North’s logging onto the Smarsh system electronically, making it less likely North’s argument that the data was compromised when it was placed onto disks.⁸³

In pre-hearing motions, North argued that the data that Smarsh produced included visible differences from the Bloomberg emails contained in King’s “Bloomberg vault.” He argued that these differences suggest that the emails were not produced in Bloomberg’s native format, and that some of King’s Bloomberg vault emails were absent from Enforcement’s production. Even if true, the content of each stored email and how that content is displayed is of minimal importance to the allegations here.⁸⁴

⁷⁷ Tr. 75, 82, 104-106. North testified that he was aware that King had a relationship with a former business associate who became statutorily disqualified from the securities industry. Tr. 61-66, 75. He stated that, he had not conducted key word searches to determine if King continued her business dealings with the statutorily disqualified person until Enforcement questioned him about it at his April 30, 2012 OTR. Tr. 61-66, 75.

⁷⁸ Smarsh’s report indicates that Ocean Cross emails were available every day for review beginning on September 28, 2011, but that North did not log onto the system until December 14, 2011. CX-9 at 1-2. The report indicates that he next logged on more than one month later on January 31, 2012. CX-9 at 3. He thereafter reviewed Ocean Cross email messages periodically through April 2012, but not always once per week. CX-9 at 3-4.

⁷⁹ Smarsh’s report indicates that King’s Bloomberg messages first became available for review on October 21, 2011, but that North did not review any until February 2, 2012. CX-11 at 2-3. After February 3, 2012, he logged onto the system to review Bloomberg messages only six times before April 30, 2012. CX-11 at 2-3.

⁸⁰ Nov. 5 Tr. 27.

⁸¹ Nov. 5 Tr. 62.

⁸² Nov. 5 Tr. 63.

⁸³ North’s testimony also suggests that he may have reviewed Ocean Cross emails through other means. For example, he testified that Web.com hosted Ocean Cross’s emails. Tr. 82. North’s testimony in this regard is irrelevant, given his unequivocal testimony that he used Smarsh to review emails and Bloomberg messages. Tr. 67-68. Additionally, the February 12 Ocean Cross Letter states that North arranged for Smarsh, not Web.com, to host the firm’s emails and “begin capturing and archiving [Ocean Cross’s] emails.” CX-3 at 2.

⁸⁴ North offered into evidence CX-2, a document originally included among Enforcement’s proposed exhibits but not ultimately offered by Enforcement. Tr. 32-33. CX-2 includes the full texts of seven emails produced by Smarsh

Notwithstanding our conclusion that Smarsh's reports are reliable, our finding that North failed to reasonably supervise with respect to Ocean Cross's electronic communications is also based on North's own testimony. North never testified with any certainty exactly how often he reviewed emails and Bloomberg messages. Instead, he made the blanket and unsupported statement that Smarsh's numbers were "not reliable" because he believed that he conducted more reviews than the reports indicated.⁸⁵ Generally, however, he provided little indication of a regular and systematic review. He testified that he could not describe his "typical" day at Ocean Cross because he was overwhelmed with responding to Rule 8210 requests for information and the paperwork associated with moving customer accounts and registered representatives to Ocean Cross from Southridge.⁸⁶ He testified that he reviewed electronic communications "a lot" and "quite often," but he was unable to provide a description of any type of regular review or state with certainty that he reviewed electronic communications every day, as the WSPs required.⁸⁷ The closest that North came to describing any type of regular review was his statement that, before April 30, 2012, he reviewed emails "at least once a week."⁸⁸ North provided no evidence of reviews at reasonable and regular intervals or of the daily reviews required by the WSPs.

Our finding that North's review efforts were inadequate is also based on his failure to take action in the face of red flags.⁸⁹ North knew that King had had a business relationship with a person who had become statutorily disqualified and that FINRA was investigating whether she improperly continued to conduct business with him.⁹⁰ Nevertheless, North testified that, rather than conduct key word searches (for example a word search to determine if King continued to have business dealings with the statutorily disqualified person) before April 30, 2012, he simply conducted a random review of electronic communications.⁹¹ We find North's ignoring this significant red flag before April 30, 2012, to be unreasonable.

We also find that North failed to enforce the WSPs' requirement that Ocean Cross document its review of electronic communications. The WSPs required that the reviewer of

as among the Ocean Cross and Bloomberg communications that Smarsh archived for Ocean Cross. Tr. 32-33. These emails do not include any information about whether and when North reviewed them, which is what is relevant to this case. The Hearing Panel does not find that these emails demonstrate that Smarsh's reports of North's email reviews are unreliable.

⁸⁵ Tr. 90-91, 97.

⁸⁶ Tr. 65-66.

⁸⁷ Tr. 75, 102.

⁸⁸ Tr. 74-75. The February 12 Ocean Cross Letter states that although Ocean Cross's WSPs indicate that electronic communications will be reviewed daily, the firm intended to change the WSPs to reflect that the timing of its reviews will be "periodically." CX-3 at 2.

⁸⁹ The duty of reasonable supervision includes the duty to investigate red flags that suggest possible misconduct. *Michael T. Studer*, Exchange Act Release No. 50543A, 2004 SEC LEXIS 2828, at *23 (Nov. 30, 2004); *Dep't of Enforcement v. Midas Sec., LLC*, 2011 FINRA Discip. LEXIS 62, at *22-23. "[A] supervisor's failure to respond to such red flags constitutes a failure to supervise reasonably under NASD Rules 3010 and 2110 [now FINRA Rule 2110]." 2011 FINRA Discip. LEXIS 62, at *23; *see also Studer*, 2004 SEC LEXIS 2828, at *26.

⁹⁰ Tr. 61-65.

⁹¹ Tr. 75, 82, 104-106.

electronic communications “[m]aintain all reviewed emails/IM [sic] in a separate folder (electronic or hard copy); initial or date the electronic correspondence review log; initial and maintain record of any findings and actions taken (as appropriate).”⁹² North testified that, rather than maintain a log himself, he relied on Smarsh to record his review of emails in its system.⁹³ We find that North’s actions in this regard were insufficient to satisfy the requirements of the WSPs, and we note that it is this very record (Smarsh’s reports) that North now argues is unreliable.

Accordingly, we find that during the review period North failed to enforce Ocean Cross’s WSPs with respect to the review of electronic communications, in violation of NASD Rule 3010 and FINRA Rule 2010.⁹⁴

III. Sanctions

“Assuring proper supervision is a critical component of broker-dealer operations.”⁹⁵ FINRA relies on its member firms to maintain robust supervisory systems to ensure compliance with FINRA Rules and securities laws and to protect the investing public.

To determine sanctions, we turn first to FINRA’s Sanction Guidelines (“Guidelines”).⁹⁶ The Guidelines for failure to supervise recommend a fine of \$5,000 to \$73,000 and consideration of a suspension in all supervisory capacities for up to 30 business days.⁹⁷ The Guidelines also state that, in egregious cases, the adjudicator may consider suspension in any or all capacities for up to two years or a bar.⁹⁸

We do not find North’s misconduct to be egregious. The Guidelines for failure to supervise recommend consideration of whether North ignored red flags, the nature and extent of the underlying misconduct, and the quality and extent of the supervisor’s implementation of the firm’s WSPs.⁹⁹ The record here does not include evidence of underlying misconduct. The record does demonstrate, however, that red flags existed. King had had a prior business relationship with someone who became statutorily disqualified, and FINRA was investigating King’s business relationship with that person while she was at Southridge. Additionally, North knew that Schloth was not conducting the daily reviews of electronic communications that the WSPs required. We do not find that North fully ignored these red flags, but his efforts to address them were insufficient. He did not implement key word searches of emails to detect if King

⁹² RX-12 at 2.

⁹³ Tr. 116-117.

⁹⁴ A violation of NASD Rule 3010 is also a violation of FINRA Rule 2010, which requires associated persons to observe high standards of commercial honor and just and equitable principles of trade. *Dep’t of Enforcement v. Midas Sec., LLC*, 2011 FINRA Discip. LEXIS 62, at *21-23.

⁹⁵ *Richard F. Kresge*, Exchange Act Release No. 55988, 2007 SEC LEXIS 1407, at *27 (June 29, 2007).

⁹⁶ See *FINRA Sanction Guidelines* (2015), http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf.

⁹⁷ *Guidelines* at 103.

⁹⁸ *Id.*

⁹⁹ *Guidelines* at 103 (Principal Consideration Nos. 1, 2, 3).

continued her business relationship with a statutorily disqualified person and did not produce evidence that he endeavored to make Schloth undertake the necessary reviews. Instead, in an effort to comply with the WSPs, he conducted occasional, random reviews of electronic communications, but not enough to comply with the requirements of the firm's own WSPs.

We also considered the Guidelines' Principal Considerations applicable to all sanction determinations.¹⁰⁰ North understood and accepted that as the CCO he was responsible for enforcing Ocean Cross's WSPs. As such, when he discovered that Schloth was not conducting the necessary reviews of electronic communications, he took it upon himself to conduct reviews. Although North argued that he was not identified as the responsible principal in the WSPs, he did not attempt to conceal from Enforcement, during its investigation, that he assumed the responsibility for reviewing emails.¹⁰¹ The Principal Considerations suggest consideration of other factors, such as the Respondent's disciplinary history, whether Respondent's misconduct resulted in the potential for his monetary gain or customer injury, and whether Respondent's misconduct was intentional or reckless.¹⁰² None of these factors aggravate the misconduct in this case. Additionally, while the misconduct occurred over approximately eight months,¹⁰³ North did not completely ignore electronic communications during that time. He reviewed some communications, and the firm was not fully functional during some of the review period. Neither of these factors excuses the misconduct, but we do not find the length of time to be aggravating. North assumed Schloth's responsibilities for reviewing electronic communications, but his efforts in this regard were inadequate. Accordingly, we fine North \$5,000.

IV. Conclusion

Respondent Thaddeus James North is fined \$5,000 for failing to enforce Ocean Cross's WSPs, in violation of NASD Rule 3010 and FINRA Rule 2010. North also is ordered to pay costs of \$1,985.99, which amount includes a \$750 administrative fee and the cost of the hearing transcript. The fine and costs shall be payable on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final disciplinary action in this matter.¹⁰⁴

By Carla Carloni
Hearing Officer
For the Hearing Panel

¹⁰⁰ *Guidelines* at 6-7.

¹⁰¹ *Guidelines* at 6 (Principal Consideration Nos. 2, 10).

¹⁰² *Guidelines* at 6-7 (Principal Consideration Nos. 1, 11, 13, 17).

¹⁰³ *Guidelines* at 6 (Principal Consideration Nos. 8, 9).

¹⁰⁴ The Hearing Panel has considered all of the parties' arguments. They are rejected or sustained to the extent that they are inconsistent with the views expressed herein.