FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. WOOD (ARTHUR W.) COMPANY, INC. (CRD No. 3798), Respondent.	Disciplinary Proceeding No. 2011025444501 Hearing Officer—DRS **HEARING PANEL DECISION** October 29, 2015

Member firm (1) failed to implement and enforce its anti-money laundering program, (2) failed to conduct adequate independent anti-money laundering tests, (3) charged unreasonable and unfair commissions on equity transactions, (4) failed to establish, maintain, and enforce a supervisory system, including written supervisory procedures, (5) prepared and maintained inaccurate books and records, (6) failed to file a net capital notice, and (7) conducted a securities business while net capital deficient. For these violations, Respondent is censured, fined $75,000, ordered to pay restitution, prohibited for two years from executing penny stock liquidation transactions in new accounts, and ordered to pay hearing costs.

Appearances

For the Department of Enforcement, Complainant: Bonnie S. McGuire, Esq., Robert Kennedy, Esq., Boston, Massachusetts, and John Luburic, Esq., Chicago, Illinois.

For Wood (Arthur W.) Company, Inc., Respondent: Alan M. Wolper, Esq., and Heidi VonderHeide, Esq., Ulmer & Berne LLP, Chicago, Illinois.

DECISION

I. Introduction

The Department of Enforcement filed a complaint charging FINRA member firm Wood (Arthur W.) Company, Inc. ("Firm" or "Wood") with a number of disparate violations relating to the implementation of its anti-money laundering ("AML") program, commission charges on equity transactions, and net capital compliance. Wood has been a FINRA-registered firm since

January 1937.[1] Its principal office is located in Boston, Massachusetts, and it conducts a retail brokerage business.[2]

The Complaint alleges that Wood failed to implement its AML procedures in connection with potentially suspicious penny stock trading activity by its customers; failed to properly test its AML procedures; charged customers excessive commissions in connection with equity transactions; failed to establish, maintain, and enforce a reasonable supervisory system regarding commission charges; prepared and maintained inaccurate books and records regarding its net capital computations; failed to file with FINRA a required notice that its net capital fell below a certain level; and conducted a securities business while net capital deficient.

Wood filed an answer denying all charges and requesting a hearing. Before the hearing, however, the Firm stipulated to the charge that it had conducted a securities business while net capital deficient. A four-day hearing was held on March 3–6, 2015, in Boston, Massachusetts. The material facts in this case were largely undisputed. As discussed below, the Hearing Panel concludes that with the exception of one charge, Enforcement proved the violations alleged in the Complaint and imposes appropriate sanctions.

II. Findings of Fact and Conclusions of Law

A. The AML Charges

Enforcement charged Wood with two types of AML violations: failing to implement its AML procedures and failing to adequately and independently test them. We first address the charge that Wood failed to implement its AML procedures. Accordingly, we begin with a discussion of those procedures.

1. The AML Procedures

At all times relevant in this case, the Firm maintained written AML policies and procedures.[3] They stated that it was the Firm's policy "to prohibit and actively prevent money laundering and any activity that facilitates money laundering or the funding of terrorist or criminal activities."[4] The AML procedures required the Firm to monitor accounts for suspicious activity. Specifically, they required account monitoring "to permit identification of patterns of unusual size, volume, pattern or type of transactions" or any red flags of potentially suspicious activity.[5] Further, they required the Firm's Anti-Money Laundering Compliance Officer

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[1] Answer ("Ans.") ¶ 4; Stipulations ("Stip.") ¶ 1.

[2] Ans. ¶ 4; Stip. ¶¶ 1, 3.

[3] JX-21, at 150–69; JX-22, at 151–71; JX-23, at 152–72; JX-24, at 167–88; JX-25, at 182–216.

[4] JX-21, at 150; JX-22, at 151; JX-23, at 152; JX-24, at 167; JX-25, at 182. The procedures recognize that "[m]oney laundering is generally defined as engaging in acts designed to conceal or disguise the true origins of criminally derived proceeds so that the unlawful proceeds appear to have derived from legitimate origins or constitute legitimate assets." JX-21, at 150; JX-22, at 151; JX-23, at 152; JX-24, at 167; JX-25, at 182.

[5] JX-21, at 160; JX-22, at 161; JX-23, at 162; JX-24, at 177–78; JX-25, at 203.

("AMLCO") to conduct the monitoring and to document in a report no later than 15 days after the beginning of each month "when and how it is carried out." The Firm's Chief Compliance Officer ("CCO") was required to review the report, which was to be maintained in a designated AML file.[6]

The procedures identified various "[r]ed flags that signal possible money laundering or terrorist financing," including but not limited to:

a. 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.

b. The customer exhibits unusual concern about the firm's compliance with government reporting requirements and the firm's AML policies.

c. The customer exhibits a lack of concern regarding risks, commissions or other transaction costs.

d. 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 that, although legitimate, have been used in connection with fraudulent schemes and money laundering. "Such transactions may warrant further due diligence to ensure the legitimacy of the customer's activity."[7]

In the presence of these red flags, the procedures required further investigation "under the direction of the AML Compliance Officer," including "gathering additional information internally or from third party sources, contacting the government, freezing the account, and filing a SAR [i.e., a Suspicious Activity Report]."[8] The procedures also required the Firm to document and maintain records associated with such investigations, including "information relating to all 'red flag' investigations."[9]

Enforcement alleges that the Firm failed to implement these procedures by not properly investigating, or by ignoring red flags raised by: (1) certain activity in customer accounts; (2) the customers' backgrounds; (3) email communications between Edwin Quinones, a Firm registered representative, and his customers; and (4) alerts and inquiries from Wood's clearing firm, Pershing, regarding Quinones's accounts. The Hearing Panel finds that the Firm failed to properly investigate or ignored red flags relating to: certain customers' account activity; concerns raised by the clearing firm; and certain email communications. And, as a result, the Firm failed to implement and enforce its AML procedures. Enforcement did not demonstrate, however, that

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[6] JX-21, at 160; JX-22, at 162; JX-23, at 162; JX-24, at 178; JX-25, at 203.

[7] JX-21, at 161–62; JX-22, at 162–64; JX-23, at 163–65; JX-24, at 178–80; JX-25, at 205–06.

[8] *See, e.g.*, JX-21, at 163.

[9] *See, e.g.*, JX-21, at 165–66.

the Firm would likely have discovered certain questionable information regarding the customers' background had it conducted further investigation based on these red flags.

We now turn to a description of the customers' trading, and why it constituted red flags that should have prompted further inquiry by the Firm.

2. Trading by Edwin Quinones's Customers

a. Overview

In June 2008, Wood hired registered representative Edwin Quinones[10] and permitted him to conduct a new business line for the Firm: penny stock liquidations.[11] Before hiring Quinones, Wood checked into his background, which included customer complaints and internal reviews of his conduct by prior firms, leading, in one instance, to his discharge.[12] Upon hiring Quinones, the Firm placed him on heightened supervision.[13] In early August 2008, Quinones opened accounts for customers CE, AG, GE, and TM.[14] Quinones was the registered representative for these accounts.[15] Paul F. Testa, Wood's Chief Executive Officer ("CEO") and CCO,[16] approved the account applications.[17] At or about the time the Firm opened these accounts, the customers deposited into their accounts blocks of penny stock Brite-Strike Tactical Illumination Products, Inc. ("BSTK") in amounts ranging from 25,000 to 2 million shares.[18] Most of the shares were deposited on the same day. Then, shortly after opening their accounts and depositing the shares, three of these customers—CE, AG, and GE—sold portions of their BSTK holdings and disbursed all or some of the sales proceeds out of their accounts.

A similar pattern occurred in connection with INVO Bioscience, Inc. ("IVOB"), another penny stock. Five of EQ's customers—AG, GE, TM, MH, and LVH collectively deposited shares of IVOB between March 2009 and August 2010 in amounts ranging from 50,000 to 300,000 shares.[19] After depositing these shares, the customers sold a portion of their shares and disbursed some or all of the proceeds out of their accounts. Two of the customers, AG and LVH, began liquidating transactions and disbursements within a few days of depositing their shares.

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[10] Stip. ¶ 10.

[11] Hearing Transcript ("Tr.") 996–98.

[12] Tr. 993–95; CX-2, at 5, 22–28, 35–37; CX-3, at 2–3.

[13] Tr. 746. 990, 1060, 1102. The record does not clearly reflect the reasons it did so.

[14] Ans. ¶¶ 25–26, 28; Stip. ¶¶ 12–15.

[15] Stip. ¶¶ 12–15.

[16] Stip. ¶¶ 4–6. Testa no longer holds those titles and is semi-retired. Tr. 1117.

[17] Stip. ¶¶ 12–16.

[18] Stip. ¶ 17; Ans. ¶ 18.

[19] Ans. ¶ 21. *See also* JX-2.o, at 4 (referencing a 300,000 share deposit of IVOB, then known as Emy's Salsa). *But see* Stip. ¶ 28 (referencing deposits of up to 500,000 shares).

The relevant trading activity of each customer is described below.

b. Customer CE's Account Activity

The day after CE opened his account in August 2008, he deposited 2 million shares of BSTK into the account.[20] During the remainder of that month, CE sold approximately 4% of those shares,[21] generating approximately $40,000 in proceeds. He then promptly disbursed most of the funds out of the account.[22] Seven months later, he transferred the remainder of his holdings (approximately 1.8 million shares) out of the account.[23]

c. Customer AG's Account Activity

The day after AG opened his account in August 2008, he deposited 140,000 shares of BSTK into the account.[24] Within two weeks, AG sold approximately 7% of those shares,[25] generating approximately $3,400 in proceeds, which he disbursed out of the account three weeks later.[26] In August 2009, he sold his remaining BSTK shares, along with other holdings, withdrew part of the proceeds, and reinvested the remaining sales proceeds in another security.[27]

AG repeated this pattern of selling shares and disbursing the proceeds the next year in connection with IVOB. In March 2009, AG deposited 300,000 shares of IVOB.[28] During that month and in April, he sold approximately 12% of those shares, generating approximately $16,000 in sales proceeds.[29] By the end of April, AG had disbursed most of those proceeds out of his account.[30] In August 2009, AG resumed this pattern. During that month, he sold his remaining shares of IVOB, generating sales proceeds of approximately $76,000.[31] Beginning on the date of the last sales transaction, AG began disbursing the sales proceeds, which he completed by the first week of October 2009. From March through October 2009, he made

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[20] RX-115.

[21] RX-115.

[22] RX-115; JX-4.a, at 4; JX-4.b, at 4.

[23] JX-4.i, at 3.

[24] RX-115.

[25] RX-115.

[26] JX-3b, at 3.

[27] RX-115.

[28] JX-3.h, at 3.

[29] JX-3.h; JX-3.i.

[30] JX-3.h; JX-3.i.

[31] JX-3.m.

fourteen check disbursements from his account.[32] In August 2009, he also used some of the sales proceeds to purchase other securities.[33]

d. Customer GE's Account Activity

GE and CE are brothers.[34] The day after GE opened his account, he deposited 200,000 shares of BSTK.[35] On August 19, 2008, GE sold approximately 3.5% of his holdings,[36] generating approximately $2,500 in proceeds.[37] Less than three weeks later, he disbursed those proceeds out of the account.[38] The next year, in September and October 2009, he sold approximately 48,000 shares of BSTK, generating approximately $14,000 in proceeds, which he disbursed out of the account shortly afterwards.[39]

GE followed the same pattern with respect to his IVOB shares. In October 2009, he deposited 300,000 of IVOB (then known as Emy's Salsa).[40] In December, he sold 12.7% of those shares, generating approximately $12,000, which he disbursed out of his account one week after the last sale.[41] In April 2010, GE also purchased shares of another security.[42]

e. Customer TM's Account Activity

The day after TM opened her account in August 2008, she deposited 25,000 shares of BSTK. Over a year later, in September 2009, she sold 6,250 of those shares, generating approximately $2,450 in sales proceeds.[43] She did not, however, disburse those funds out of her account. In December 2009, she sold her shares and used the proceeds to purchase another security.[44]

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[32] JX-3.h–16.o.

[33] RX-116.

[34] CX-40.

[35] RX-115.

[36] RX-115.

[37] JX-2.a, at 3.

[38] JX-2.b, at 4.

[39] JX-2.n, at 3–4; JX-2.o, at 3.

[40] JX-2.o, at 4.

[41] JX-2.q, at 3–4.

[42] RX-116.

[43] JX-6.n, at 4.

[44] RX-115.

In September 2009, TM deposited 50,000 shares of IVOB. TM sold the shares in February 2010, generating approximately $5,540 in sales proceeds, which she did not disburse out of her account. Instead, she purchased shares of another security.[45]

f. Customer MH's Account Activity

In June 2010, MH opened an account at the Firm,[46] with Quinones as the registered representative.[47] Two weeks later, MH deposited 238,000 shares of IVOB into the account. Beginning in July, and continuing into August, October, and December 2010, and February 2011, MH sold 61% of his IVOB shares.[48] The sales generated approximately $8,000 in proceeds, most of which he disbursed from his account at various times, generally in several hundred dollar increments, in each month from August through December 2010 and in January and February 2011. He also used some of the proceeds to purchase another security.[49]

g. Customer LVH's Account Activity

On or about July 28, 2010, GE opened a corporate account at the Firm through Quinones on behalf of Lionshare Venture Holdings LLC, a limited liability company ("LVH").[50] GE represented to Wood that he was the President and sole owner of LVH.[51] On August 2, 2010, LVH deposited 500,000 shares of IVOB into its account.[52] About a week later, LVH sold approximately 20% of its IVOB holdings, generating approximately $6,600, and wired most of the funds out of the account a few days afterward.[53] LVH sold its remaining IVOB shares in October 2010, and January and February 2011, and disbursed additional funds out of the account in December 2010 and January, February, and April 2011. Between October 2010 and January 2011, LVH also purchased shares of other securities.[54]

3. The Firm Ignored or Failed to Investigate Red Flags of Potentially Suspicious Conduct Relating to Quinones's Customers' Trading

The record does not clearly reflect when the Firm became aware of the trading activity described above, though it is undisputed that the Firm did not find the trading suspicious at the

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[45] RX-116.

[46] Stip. ¶ 16.

[47] Stip. ¶ 16.

[48] RX-116.

[49] RX-116.

[50] Ans. ¶ 27; Stip. ¶ 27.

[51] Stip. ¶ 27. *See also* Ans. ¶ 27.

[52] RX-116, at 2.

[53] JX-5.e, at 4.

[54] RX-116, at 2; JX-5.c, at 4; JX-5.a, at 4–5; JX-5.r, at 4. McCarthy's primary responsibilities included branch supervision and retail sales. Stip.¶ 9; Tr. 988.

time. Donald McCarthy, Vice President, Sales Manager,[55] and Quinones's supervisor,[56] maintained that the Firm knew about the customers' trading activity but did not find it suspicious.[57] Testa, the Firm's CEO and CCO, performed daily and monthly trade reviews[58] and looked at the transactions broken down first by registered representative (including Quinones), and then by customer account.[59] He testified that he was not aware of the BSTK deposits by TM, AG, GE, and CE at the time they occurred.[60] He further testified that he "probably" was aware of the trading activity following the deposits, but was not sure because he only reviewed the trade blotter randomly.[61] Testa also claimed that he did not see any suspicious activity in Quinones's customer accounts.[62] It is not clear whether Kristen H. Kennedy, the Firm's AML Compliance Officer and FINOP,[63] knew of the BSTK trading activity while it was occurring.[64] Further, while she performed daily trade reviews, including reviews of the customer accounts at issue here, looking for anomalies or unexpected activity, she testified that she did not see anything that concerned her. [65]

Moreover, in this proceeding, the Firm maintained that, even in retrospect, there was nothing even potentially suspicious about the trading for several reasons. The Firm claimed that it was unaware of negative information about the customers; certain of the customers sold only relatively small portions of the penny stocks at issue, or reinvested a portion of the proceeds in other securities or, in some instances, they did not disburse all of the sales proceeds out of their accounts; and according to Enforcement's expert, selling a small portion of their holdings did not comport with "the picture of a pump and dump" scheme.[66]

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[55] Stip. ¶ 9. McCarthy currently serves as the Firm's CEO. Tr. 988.

[56] Stip. ¶ 11.

[57] Tr. 751–53.

[58] Tr. 1126–29. *See also* Stip. ¶ 49.

[59] Tr. 1127–28.

[60] Tr. 454–56.

[61] Tr. 454–56.

[62] Tr. 1128.

[63] Stip. ¶ 7. Currently, Kennedy is the Firm's Chief Operating Officer, and President. Tr. 1169.

[64] Tr. 596–600.

[65] Tr. 1239–42.

[66] Tr. 902.

The Panel disagrees with the Firm's assessment. We find that certain facts, taken together, constituted red flags of potentially suspicious activity warranting a thorough inquiry by the Firm.[67] The Panel found the following facts, collectively, compelling:

- A relatively new registered representative, who is under heightened supervision, introduces the Firm to a new business line—penny stock liquidations;
- The Firm's AML procedures recognized that penny stocks have been used in connection with fraudulent schemes and money laundering;
- EQ opens accounts for several customers on the same day;
- Several of the account holders are related to each other;
- Several of these customers then deposit large blocks of the same penny stock and almost immediately begin liquidating shares and disbursing some or all of the cash out of the account;
- Several of these customers liquidated shares on the same day;
- The pattern is repeated by several of the customers in connection with another penny stock;
- The majority of the trades in six accounts were penny stock sales, rather than purchases;[68] and
- The commissions on the sales of the BSTK stock were over 8% for all of the customers except CE.[69] These commissions were excessive,[70] yet there is no evidence than any of the customers expressed any concern about the charges.

The Panel's findings of red flags were buttressed by the testimony of Enforcement's AML expert witness, Steve Ganis.[71] He testified that there were numerous red flags of potentially suspicious activity present here. For example, he noted that: deposits and "precipitous sales" of large amounts of "Microcap shares can be a red flag signaling potential fraud or manipulation, especially when combined with other red flags;"[72] large sales of Microcap shares

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[67] The Panel does not find that any one, single, fact constituted a red flag. For example, merely depositing penny stock shares into an account is not, by itself, necessarily a red flag of potentially suspicious activity. Tr. 236, 878–79, 893, nor is selling small amounts of the stock deposited. "The point is that it is the composite effect which is determinative, not a dissection of each fact as if it were the whole." L. Nizer, *The Implosion Conspiracy* at 7 (1973).

[68] JX-2–JX-7. Specifically, the accounts referenced are: AG, TM, GE, CE, MH and LVH. GE's first purchase did not occur until April 2010, JX-2.u, at 3, almost two years after he opened the account and had liquidated approximately 355,000 shares of BSTK and IVOB. JX-2. Similarly, AG made no purchases in his account until a year after he opened it, JX-3.m, at 4, and after he had liquidated approximately 145,000 shares of BSTK. JX-3. Finally, MH made no purchases in his account. JX-7.

[69] Ans. ¶ 20; Stip. ¶ 19.

[70] *See* discussion at pp. 23–25.

[71] The Firm did not call an expert witness to rebut Ganis's testimony.

[72] CX-70A, at 12.

"potentially create reason to suspect violations" of the provisions of the federal securities laws governing sales of unregistered securities;[73] and Microcap stock trades with excessive commissions, and customer indifference to those fees (or losses), can be red flags potentially indicating fraudulent or manipulative trading."[74] In the face of these red flags of potentially suspicious activity, the Firm should have investigated whether suspicious activity was occurring at the Firm, but it did not do so.

Additionally, as discussed, below, the Firm did not conduct such an inquiry in light of red flags raised by Pershing about Quinone's customers' penny stock transactions. Nor did the Firm do so as a result of email communications it should have detected between the customers and Quinones reflecting potential manipulative activity.

4. The Firm Failed to Conduct an Investigation Based on Red Flags Raised by Its Clearing Firm

Beginning in March 2009, the Firm received alerts and inquiries from its clearing firm, Pershing, regarding Quinones's customers and their activities. Specifically, Pershing questioned the deposits of low-priced securities in the accounts of AG, MH, and PL, another of Quinones's customers.[75] In March 2009, Pershing sent the Firm a low-priced security inquiry regarding deposits in AG's account.[76] The next year, in July 2010, it sent a similar inquiry regarding the deposits of a low-priced security into MH's account.[77]

Two months later, matters reached a crucial juncture with Pershing. On September 20, 2010, Pershing sent Wood a penny stock inquiry expressing concern about PL's account activity.[78] Among other things, Pershing noted that the account had been opened and funded with a large block of a security; shortly afterward, the shares were sold, at a yearly high, following "a lot of positive news" about the issuer; and the funds were wired out of the account. Pershing further noted that an internet search yielded "some negative news" about PL. Pershing questioned the Firm about the account and the customer.

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[73] CX-70A, at 12–13.

[74] CX-70A, at 13. The Panel found Ganis credible. He was well qualified to opine on issues regarding AML compliance. Ganis is an attorney with relevant governmental—including SEC—and private practice experience. Among other things, he headed all AML compliance efforts at Fidelity Investment and served as the AML officer at Fidelity's retail and clearing broker-dealers. CX-70A, at 2–6. The opinions he expressed in his report and testimony were well reasoned and supported. Ganis testified in a clear and forthright manner, and his testimony was not undercut by cross-examination or other credible evidence.

[75] Stip. ¶¶ 29–31; CX-43, at 4; CX-42.

[76] Ans. ¶ 39; Stip. ¶ 29; JX-11.

[77] Ans. ¶ 40; Stip. ¶ 30; JX-14.

[78] CX-43, at 4; CX-42.

Kennedy responded to Pershing's email the day she received it, providing verbatim responses prepared by Quinones.[79] Those answers generated additional questions by Pershing the next day.[80] Kennedy forwarded Pershing's questions to Quinones, noting that Pershing was "apparently now scrutinizing all penny stock transactions in-depth as there have been directives from the SEC and FINRA regarding the use of penny stocks for money laundering." In her forwarding email, she commented that this was "a 'hot button' with the regulators right now."[81] Again, the Firm forwarded verbatim Quinones's responses.[82]

The Firm's responses did not satisfy Pershing. On September 22, 2010, Pershing emailed the Firm stating that it "could not get comfortable with the account or the activity" and requested that PL's account be closed and that no further business be conducted with the customer.[83] Pershing went even further, recommending that Quinones "not open any other accounts referred to him by [PL] or any other individuals involved in low price securities" unless approved by Pershing's AML unit. Pershing also recommended that Wood not open any new accounts for low price security transactions unless there are special circumstances and Pershing's AML unit approved.[84]

At the hearing, the Firm attempted to place these emails into context. According to Kennedy and McCarthy, by the time the Firm had received its third inquiry from Pershing in September 2010,[85] it had decided to no longer support customer trading in low-priced securities.[86] Kennedy explained that the securities and transactions required a tremendous amount of work for little gain; therefore, the Firm decided to shut it down.[87] Kennedy emailed McCarthy and Testa that Quinones's penny stock business had "been nothing but a lot of aggravation for everyone, to say the least."[88] And, in the wake of the September 2010 inquiries from Pershing, plus a check from a Quinones customer to the Firm that had been returned for insufficient funds, it confirmed to Kennedy "the need to shut [Quinones] off from any penny stock transactions."[89]

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[79] CX-43, at 2.

[80] CX-43, at 1.

[81] CX-43, at 1.

[82] CX-44, at 1–2.

[83] CX-44.

[84] CX-44, at 1. Also, on September 22, 2010, Quinones attempted to open an account for an individual, CF. Compl. ¶ 43; Ans. ¶ 43. The next day, Pershing notified the Firm that CF had been barred from the securities industry, and asked for information regarding the type of transactions that he wished to conduct. CF's account ultimately was not opened.

[85] CX-47.

[86] Tr. 723; 1300–01.

[87] Tr. 1300–01.

[88] JX-15, at 1.

[89] JX-15, at 1.

To that end, after responding to Pershing's September 2010 inquiry, according to Kennedy, she contacted Pershing to discuss it further,[90] and asked Pershing to send the Firm an email which Kennedy could use to inform Quinones that he would no longer be permitted to open accounts to be used for low-priced trading. This, Kennedy testified, would enable the Firm to give Quinones the impression that Pershing was driving the decision.[91] Kennedy testified that Pershing complied and sent the requested email, [92] referenced above, stating that Pershing "could not get comfortable" with the account at issue (PL) and recommended that Quinones not open any other accounts for low-priced securities.[93] Kennedy claims that after receiving that email from Pershing, she revised it, with Pershing's permission—to make it stronger—and forwarded it to Quinones.[94] Thus, Kennedy explained, with Pershing's assistance, the Firm succeeded in amicably convincing Quinones not to open any new accounts. Nevertheless, the Firm permitted penny stock trading by Quinones's customers to continue for months, even after Quinones left the Firm in January 2011.[95]

At the hearing, the Firm maintained that it had acted appropriately in response to the Pershing inquiries and concerns, responding to each one and providing the requested information.[96] As evidence that it acted properly, the Firm noted that after receiving the Firm's responses, Pershing did not inform the Firm that its responses were incomplete or inadequate.[97]

The Firm's view of its responsibilities, however, is too narrow. According to Ganis, Enforcement's AML expert, Pershing's March 2009 and July 2010 inquiries should have caused the Firm to conduct an investigation to determine whether the Firm had SAR reporting obligations.[98] As Ganis explained: "[i]t is a widely recognized best practice among AML professionals at introducing brokers to investigate accounts and activity when the clearing firm, regulators, or law enforcement inquires about potentially suspicious activity." In Ganis's

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[90] Tr. 1224–26.

[91] Tr. 1224–26.

[92] CX-44; Tr. 1328–29.

[93] CX-44.

[94] CX-47; RX-87; Tr. 1224–26, 1231–32. The modified version that Kennedy forwarded to Quinones (CX-47) is, indeed, stronger than the original email she received from Pershing (CX-44). When Kennedy revised the email and forwarded it to Quinones, she did not change the addressees, sender, and date and time of transmittal appearing on the original email. Thus, Kennedy made it look as though the modified email was the one that Pershing had originally sent to her. Kennedy provided no corroboration for her self-serving claim that Pershing authorized her to modify CX-44. Therefore, the Panel makes no finding to that effect.

[95] Stip. ¶¶ 10, 34–37; JX-2.ff at 3; CX-21, at 49; Tr. 1271–73. For example, in November 2010, LVH deposited 700,000 shares of a penny stock into its account. Ans. ¶ 45; Stip. ¶ 33. After Quinones left the Firm, McCarthy became the registered representative on the LVH account. Stip. ¶ 35. Thereafter, LVH continued to sell penny stocks through Wood. Stip. ¶ 36. McCarthy also became the registered representative for GE's account after Quinones left the Firm. And in March 2011, GE was permitted to deposit 250,000 shares of a penny stock into his account. CX-15ff.

[96] JX-11; JX-14; RX-87; Tr. 933.

[97] Tr. 388.

[98] Tr. 957–59.

opinion, which we find persuasive, Pershing's July 2010 and March 2009 inquiries, and its September 22, 2010 email, should have made it clear to the Firm that Pershing had serious concerns about the trading in Quinones's customers' accounts. Ganis concluded that Pershing's "inquiries should have triggered a reasonable investigation of the AG, MH and PL accounts and related accounts and transactions to ascertain whether SAR filing was required."[99] We agree.

But instead of undertaking an investigation in response to Pershing's communications, the Firm delegated the review and response to Quinones and did not independently corroborate the representations that it made to Pershing.[100] Quinones gave Kennedy short responses to Pershing's questions and did not identify the source of the information or how it was obtained.[101] Kennedy, in turn, forwarded these responses verbatim to Pershing, and took no further steps (unless prompted by Pershing).[102] The Panel finds that the communications from Pershing constituted red flags that should have prompted a diligent investigation, especially in light of the trading activities described above which, themselves, constituted red flags.

Ganis enumerated various reasonable measures that the Firm might have undertaken had it chosen to follow up appropriately on the red flags. Such measures included, among other things:

- the "reasonable use of some combination of internet search engines, regulatory data bases, and criminal background checks";
- "a review of electronic communications---more comprehensive than the email sampling typically performed for routine supervisory surveillance";
- "obtaining detailed explanations of account activity and communications from the customers in question";
- "ascertaining which accounts were transacting or coordinating with one another and toward what end";
- "evaluating the size of the deposits in relation to the issuer share float and the size of sales in relation to average volume to look for signs of red flag" of violative activity; and
- "searching for evidence of touting to identify potentially misleading communications indicative of pump and dump activities."[103]

The Firm failed to undertake these or similar measures in response to the red flags raised by Pershing. Additionally, as discussed below, the Firm failed to discover (and, accordingly, failed to investigate) red flags relating to communications between CE and Quinones.

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[99] CX-70A, at 17–18.

[100] CX-38; CX-42; CX-43; CX-44; JX-14.

[101] CX-38; CX-42; CX-43; CX-44; JX-14.

[102] Tr. 652.

[103] CX-70A, at 19–20.

5. The Email Communications between CE and Quinones

During the relevant period, CE and Quinones exchanged a series of emails that Enforcement claims, and the Hearing Panel finds, were red flags of potentially manipulative trading:

- August 12, 2008: Quinones emailed CE informing him that he had sold 39,800 shares of BSTK at $0.5481 and asked CE if he should continue selling. [104] Later that day, CE responded: "Let's wait for it to firm up over .50 again . . . he has lots of pr starting this week."[105]
- April 28, 2009: CE wrote to Quinones asking if another individual was "unloading."[106] CE stated that, "I'm trying to get something going but someone is in the way . . ."[107] Quinones responded, "It's not him that is in the way someone is hitting it."[108]
- April 30, 2009: CE wrote to Quinones asking him to "move away from .51 . . . I'm trying to get something going for next week."[109]
- May 27, 2009: CE wrote to Quinones saying, ". . . anyway your buddies … have lots of power . . . they worked WW AG weeks ago. . . went crazy on huge volume . . . they have 5 different websites and coordinate with many others svcs . . . IVOB within 10 days . . . at $.10 it's a steal. I'm bidding .08 myself."[110]
- June 16, 2009, CE wrote to Quinones saying:

> Yes, I've been tweeting on my www.twitter.com page . . . check it out. . . FOLLOW ME. . . I nailed SPNG on 4/30 at .015 cents . . . hit .28 Friday on 560 mil shs volume . . . my latest pick was WNBD at .0095 hit .023 today . . . massive volume coming in . . I am getting 25-30 new followers per day that are all getting messages of IVOB . . . IVOB has 5 MAJOR events staring later today over the next two weeks, including Live TV interviews with CEO on FOX BUSINESS NEWS AND NECN.[111]

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[104] Stip. ¶ 21.

[105] Stip. ¶ 21.

[106] Stip. ¶ 22.

[107] Stip. ¶ 22.

[108] Stip. ¶ 22.

[109] Stip. ¶ 23.

[110] Stip. ¶ 24.

[111] Stip. ¶ 25.

- September 4, 2009: CE wrote to Quinones stating "BSTK is in play . . . best get in today . . . it gets more expensive in coming days . . . call [AG]."[112]
- November 3, 2010: CE wrote to Quinones asking "is it true that you can deposit up to $100,000 shares without scrutiny."[113]

The Firm did not detect these emails,[114] and does not contest that they are troublesome on their face. Instead, the Firm claims that it was unreasonable to expect it to have discovered them. During the relevant period, the Firm maintained and operated an email review system through an outside vendor that allowed the Firm to filter, search, and review its representatives' emails.[115] The system was "lexicon based." It identified emails containing certain words or phrases and then collected random samples of all emails for the Firm's review in determining whether improper communications may have existed.[116] Testa, who performed the email review for the Firm, did not review all the emails that the system flagged.[117] Rather, on a bi-weekly basis, he reviewed a random sample of the Firm's emails, using search terms consisting of 14 words.[118] The Firm did not alter its list of search terms to account for the risks of penny stock liquidations after Quinones brought that new business line to the Firm.[119]

The system did not select the emails at issue for review, and the Firm did not see them.[120] The Firm defends its failure to discover the troublesome emails on the basis that FINRA rules do not require firms to review every email sent to or received by its representatives;[121] the Firm had a reasonable email review system in place through a respected third party vendor;[122] and, nevertheless, failed to detect these emails.

The Firm's failure to detect these emails—which raised red flags of potential manipulation[123]—is problematic. The issue is not whether the Firm's normal review of emails

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[112] Stip. ¶ 26.

[113] Stip. ¶ 32.

[114] Tr. 476–81.

[115] Tr. 1123–24.

[116] Tr. 297–98, 1123–24; RX-97.

[117] Tr. 1137–38.

[118] Tr. 1123–26; RX-97.

[119] Tr. 1152–53.

[120] Tr. 476–82.

[121] Tr. 296–97.

[122] Tr. 297–98, 1123–24.

[123] The November 3 email is especially disconcerting, and falls directly within one of the red flags listed in the Firm's AML procedures: "The customer exhibits unusual concern about the firm's compliance with government reporting requirements and the firm's AML policies." Ganis characterized this email as an "unmistakable AML red flag which should have immediately triggered an investigation into the account in question, all related accounts and transactions." According to Ganis: "[t]his red flag potentially indicates not just suspicious but also criminal activity." CX-70A, at 17.

was adequate, but whether, in the face of existing red flags, the Firm should then have more thoroughly reviewed Quinones's communications with his penny stock customers, especially given that the Firm had placed Quinones on heightened supervisory review. According to Enforcement's expert, the red flags arising from the activity in Quinones's customers' accounts should have caused the Firm to conduct additional due diligence to monitor and detect instances of suspicious activity.[124] In the presence of such red flags, according to Ganis, the Firm should have reviewed Quinones's email communications with his customers.[125] Had the Firm undertaken that review, he concludes, it would likely have uncovered the red flag emails, which would have "raised further questions as to coordination of trades potentially indicative of pump and dump activity."[126] The Hearing Panel agrees.

On the other hand, as discussed in the next section, the Panel disagrees with Enforcement's contention that the Firm should have uncovered certain questionable information about Quinones's customers.

6. Enforcement Failed to Demonstrate that the Firm Should Have Uncovered Certain Questionable Information About Quinones's Customers

Enforcement alleges that had the Firm conducted additional due diligence into Quinones's clients in response to the allegedly ongoing suspicious activity, it would have revealed their criminal and otherwise questionable backgrounds and pre-existing relationships with one another. Set forth below is the negative information regarding these customers that Enforcement claims the Firm should have uncovered.

CE had worked in the securities industry and had a disciplinary history. In October 1997, he entered into a Consent Order placing a restriction on his securities registration in Massachusetts.[127] In 1998, he was sanctioned by the Massachusetts Securities Division for fraud, dishonest and unethical sales practices, and failure to obey that Consent Order.[128] He was barred from being registered in Massachusetts for 10 years, and ordered to make a $10,000 contribution to the Massachusetts Investor Protection and Investor Fund.[129]

GE had a criminal history. As reflected in an internet search, GE was named in a February 2000 indictment along with AG.[130] According to a news article available in the public domain, GE was indicted along with 26 other "organized crime figures" in connection with an

[124] Tr. 929–30.

[125] CX-70A, at 19.

[126] CX-70A, at 20.

[127] CX-4, at 23–25.

[128] CX-4, at 31–33.

[129] CX-4, at 31–33.

[130] CX-13.

alleged gambling operation.[131] Similar articles also noted that AG had a criminal record as a bookmaker dating back to 1980. In September 2011, GE was indicted on drug trafficking charges.[132]

AG also had a background that included criminal charges. He was named in the same February 2000 indictment as GE. The indictment described AG as the leader of the "'multi-level' ring of '27 reputed members of organized crime.'"[133] News articles about that indictment noted that AG previously had been placed on probation for a year and fined in connection with an illegal sports gambling network.[134]

It is undisputed that the Firm was unaware that CE had an extensive regulatory disciplinary history and that AG and GE had an inter-related criminal history. The Firm did not conduct internet searches or otherwise review publically available information related to AG, GE or CE.[135] But, the Firm maintains, it had no reason to investigate these individuals' backgrounds beyond the Firm's normal customer intake procedures. These procedures, the Firm claims, were adequate. For example, the Firm used Pershing to perform certain customer identification functions, including various searches through Equifax's information data bases, checking for negative information.[136]

Each of these customers, according to the Firm, was processed through the Firm's intake procedures and cross-checked by Equifax. And none triggered a notice from Equifax signaling any negative background information of any nature.[137] Specifically, the Equifax search revealed neither the indictments issued in 2000 nor the Massachusetts action.[138] Thus, according to the Firm, it had no reason to conduct an additional investigation into their backgrounds; there was no reason for the Firm to have been aware of the negative information about them; and that without this information, which it characterizes as "the linchpin of Enforcement's argument that the Firm missed a claimed parade of subsequent red flags–Enforcement's case unravels."[139]

This argument, however, misconstrues Enforcement's allegations. The Complaint alleged that the customers' trading, itself, was "potentially suspicious" and should have triggered "additional due diligence into these clients … which would have revealed their criminal and

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[131] In the indictment, GE was charged with keeping a place for registering bets and using the telephone for gaming purposes. *See* CX-13.

[132] Ans. ¶ 47; Stip. ¶ 38; CX-57.

[133] CX-13.

[134] CX-13.

[135] Tr. 617–18; *see also* Tr. 1309–12.

[136] RX-90, at 7; Tr. 1191–92.

[137] Tr. 1191–93.

[138] Tr. 1192–93, 1196.

[139] Respondent's Post-Hr'g Br. at 2.

otherwise questionable backgrounds and pre-existing relationships with one another."[140] Nonetheless, it is unclear whether additional due diligence would have revealed the negative information. There were publically available news sources (including the Boston Herald) which carried information regarding the customers' criminal and regulatory histories.[141] And, according to the testimony from FINRA's examiner, she easily uncovered troubling information about Quinones's customers by conducting basic internet searches.[142] But Enforcement presented no evidence establishing that such information was available and readily discoverable on the internet, or elsewhere, during the relevant time period.[143] Thus, while the Firm's procedures identified as a red flag a customer's "questionable background" or news reports about a customer "indicating possible criminal, civil, or regulatory violations," the evidence did not show that the Firm failed to implement its AML procedures by not uncovering and following-up upon these red flags.[144]

7. Conclusion

The Panel finds that the Firm failed to have an adequate system to monitor for potentially suspicious activity; failed to detect and investigate red flags indicative of potentially suspicious activity; and failed to adequately respond to additional red flags presented to it by the Firm's clearing firm. As alleged, the Firm failed to implement its AML procedures.[145]

8. Conclusions of Law—Wood Violated NASD Rules 3011(a) and 2110 and FINRA Rules 3310(a) and 2010 by Failing to Implement and Enforce Its Anti-Money Laundering Program (First Cause of Action)

The Bank Secrecy Act ("BSA"), initially adopted in 1970, established the framework for AML obligations imposed on financial institutions. The U.S. Department of the Treasury delegated the authority to administer the BSA to the Financial Crimes Enforcement Network ("FinCEN"),[146] a bureau within Treasury. The BSA was amended in 2001 by Title III of the USA PATRIOT Act (the "Patriot Act").[147] Among other requirements, the Patriot Act requires

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[140] Compl. ¶ 24.

[141] Tr. 128, 829–30.

[142] Tr. 124–25 (FINRA examiner testifying that she found the articles when conducting her investigation in early 2012).

[143] Tr. 252, 255–57; *see also* Tr. 847–48.

[144] Ganis stated in his report that had the Firm conducted proper additional due diligence, "it would have likely led to the discovery of" these additional red flags. RX-70A at 21. But this conclusion is unsupported and, therefore, the Panel makes no such finding.

[145] The Complaint alleges that the Firm's failure to implement its AML procedures began in June 2008. Compl. ¶¶ 1, 14–15. But none of the customers at issue here opened their accounts until August 2008. Therefore, the Hearing Panel does not find that the Firm's failure to implement its procedures began in June 2008.

[146] *See* Amendment to the Bank Secrecy Act Regulations—Requirement that Brokers or Dealers in Securities Report Suspicious Transactions, 67 Fed. Reg. 44048, at 44053 (July 1, 2002).

[147] Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001, Pub. L. No. 107-56,

that all broker-dealers establish and implement AML programs designed to achieve compliance with the BSA and the regulations thereunder, including the requirement that broker-dealers file a SAR with FinCEN.[148]

The BSA is extremely broad and generally requires firms to report any suspicious transaction relevant to a possible violation of law or regulation.[149] It is not necessary for a broker-dealer to prove that a customer has engaged in illegal activity or to have actual knowledge of illicit or unlawful trading by a customer. Rather, it is sufficient that the broker-dealer has reason to suspect that a transaction involves unlawful activity or lacks an apparent lawful purpose.[150] Section 352 of the Patriot Act requires broker-dealers to establish AML programs which must include written internal policies, procedures, and controls, the designation of a responsible compliance officer, ongoing training programs, and an independent audit to test the AML program.

FINRA Rule 3310, formerly NASD Rule 3011, requires each member firm 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 [BSA] . . . , and the implementing regulations promulgated thereunder by the Department of the Treasury." Rule 3310(a) requires each member to establish and implement policies and procedures "that can be reasonably expected to detect and cause the reporting of" suspicious activity and transactions.

FINRA has provided guidance to member firms concerning AML compliance. In Notice to Members ("NTM") 02-21, FINRA emphasized that effective AML procedures "must reflect the firm's business model and customer base."[151] The Notice advised that "in developing an appropriate AML program …, [a firm] should consider factors such as its … business activities, the types of accounts it maintains, and the types of transactions in which its customers engage."[152] The Notice emphasized that each firm has a duty to detect red flags that might be a sign of money laundering. And if a firm detects any red flag, it should "perform additional due diligence before proceeding with the transaction." [153] The guidance included 25 red flags as examples of the types of activity for which firms should monitor.[154] Additionally, in NTM 02-47, FINRA advised broker-dealers of their duty to file a SAR form 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

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[148] *See* 31 U.S.C. § 5318(h); 31 C.F.R. § 103.120(c). The regulations provide that "[e]very broker or dealer in securities within the United States … shall file with FinCEN … a report of any suspicious transaction relevant to a possible violation of law or regulation." 31 C.F.R. § 103.19(a)(1).

[149] 31 U.S.C. § 5318(g).

[150] 31 C.F.R. § 103.19(a)(2).

[151] Special NASD Notice to Members 02-21, 2002 NASD LEXIS 24, at *17 (Apr. 2002).

[152] *Id.* at *20.

[153] *Id.* at *37.

[154] *Id.* at *37–42.

business or apparent lawful purpose by looking for red flags such as those enumerated in NTM 02-21.

By failing to implement its AML procedures with respect to monitoring for, and reasonably following up on, potentially suspicious activities, Wood violated NASD Conduct Rules 3011(a) (for misconduct before January 1, 2010) and FINRA Rule 3310(a) (for misconduct after December 31, 2009).[155]

The Complaint also charges the Firm with violating NASD Rule 2110 and FINRA Rule 2010. NASD Rule 2110, FINRA's ethical standards Rule, states that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." Effective December 15, 2008, NASD Rule 2110 was re-codified, without change, as FINRA Rule 2010.[156] "A violation of any FINRA rule . . . violates NASD Rule 2110 and FINRA Rule 2010."[157] Accordingly by virtue of Wood's violation of NASD Conduct Rule 3011 and FINRA Rule 3310, the Firm violated NASD Conduct Rule 2110 (for misconduct before December 15, 2008) and FINRA Rule 2010 (for misconduct after December 14, 2008).

9. The Firm Fails to Conduct Adequate and Independent AML Tests

The Complaint alleges that the Firm failed to conduct adequate and independent tests of its AML program for calendar years 2008 through 2011. Enforcement alleges that the tests were substantively inadequate and evidenced only a cursory review of the AML procedures. Specifically, Enforcement claims that the Firm did not test the adequacy of its suspicious activity monitoring program or Customer Identification Program. Additionally, Enforcement avers that the 2008 through 2011 AML tests wrongfully asserted that the Firm was not required to conduct certain searches requested by FinCEN. As explained below, the Hearing Panel finds that the tests were neither adequate nor independent.

a. The Annual Tests Were Inadequate

The Panel finds that the tests were inadequate for a number of reasons. First, the AML tests failed to examine a number of areas, including higher risk activity such as the trading in penny stocks, a new area for the Firm.[158] Second, the testing reports do not evidence actual sampling or review of certain records, namely: (1) records of any risk-based monitoring of the red flags described in the AML procedures to confirm that it was being performed; or (2) records of underlying securities transactions to confirm that any red flags were being effectively

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[155] NASD Conduct Rule 3011 became effective on April 24, 2002, (*see* NASD Notice to Members 02-50 (Aug. 2002), http://www.finra.org/industry/notices/02-50) and, as amended, became FINRA Rule 3310, effective January 1, 2010 (*see* FINRA Regulatory Notice 09-60 (Oct. 2009), http://www.finra.org/industry/notices/09-60).

[156] *See* FINRA Regulatory Notice 08-57, 2008 FINRA LEXIS 50, at *32–33 (Oct. 2008).

[157] *Dep't of Enforcement v. Mielke*, No. 2009019837302, 2014 FINRA Discip. LEXIS 24, at *8 (NAC July 18, 2014), *aff'd*, Exchange Act Release No. 75981, 15 SEC LEXIS 3927 (Sept. 24, 2015).

[158] JX-17; Tr. 209–10, 527–29, 532–33, 833–36.

detected.[159] Third, the reports represented that the Firm "manually monitors account activity in an effort to identify patterns of unusual size, volume, pattern or type of transaction."[160] As discussed above, however, the evidence showed that the Firm did not monitor this activity, and, therefore, this representation was inaccurate with respect to suspicious activity monitoring.[161] Fourth, Wood's test reports indicated that the Firm believed that it was Pershing's responsibility to conduct so-called 314(a) searches, and consequently, the Firm was not performing them.[162] Although the Firm was cited by FINRA for not performing 314(a) searches, the language of the reports did not change and they were not updated to reflect the citation and the fact that they should be conducting those searches.[163] Finally, there is no explanation in the reports about how the AML program was tested or the results of that testing.[164]

For all of these reasons, the Hearing Panel found that the AML testing was inadequate. Additionally, as addressed in the next section, it was also not independent.

b. The Annual Tests Were Not Independent

At all relevant times, Testa was the Firm's CEO and CCO. [165] Testa was responsible for all aspects of Firm compliance.[166] He also was responsible for approving account applications[167] and verifying that the new account forms were complete and that all required documents and information was included.[168] He testified that he did not review and sign the new account forms for AML purposes but, instead, did so as part of the Firm's books and recordkeeping obligations (requiring the signature of a principal evidencing the Firm's acceptance of the account).[169] Testa also held certain positions, and had certain responsibilities, in connection with the Firm's AML program. He was the alternate AML Officer;[170] was one of the two contact persons at the Firm

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[159] CX-70A, at 22.

[160] CX-70A, at 22; JX-17, at 2; JX-18, at 3; JX-19, at 3; JX-20, at 3.

[161] CX-70A, at 22.

[162] JX-17, at 3; JX-18, at 3; JX-19, at 3; JX-20 at 4 ("[FinCEN] form 314(a) requirements to determine if new accounts are identified as suspected terrorists and money launderers are conducted for WOOD by it's [sic] clearing agent, Pershing, LLC. Pershing reports promptly any accounts so identified to the firm. Therefore, FinCen reporting requirements do not apply to WOOD.") According to the FINRA examiner, these requirements involved "responding to FinCen's e-mails and conducting a search to see if any of those individuals generate a hit." Tr. 210.

[163] Tr. 210.

[164] JX-17; JX-18; JX-19; JX-20.

[165] Stip. ¶ 4.

[166] JX-21, at 13; Tr. 513–14, 521, 1302–03.

[167] Ans. ¶ 55; Stip. ¶ 6.

[168] Tr. 516–17.

[169] Tr. 516–17.

[170] Tr. 508–09.

who received 314(a) requests from FinCEN;[171] and from October 17, 2011, through August 2, 2013, he was also the alternate AML Compliance Contact for the Firm.[172]

During calendar years 2008 through 2011, while he was the Firm's CEO and CCO, Testa was responsible for, and conducted, the Firm's annual independent AML test.[173] From 2008 through 2010, Testa prepared and submitted a written report to the Firm's Board of Directors describing the AML test and summarizing its findings.[174] Each of these annual reports stated that the AML test included a "review of new account documents and fund deposits."[175] In these reports, Testa concluded that the Firm's "vulnerability to money laundering [was] minimal" because his testing showed that "[d]ue diligence procedures on new customer accounts [were] reviewed by a registered principal prior to opening."[176] Testa also represented that the AML program was compliant, in part, because the Firm's "Compliance Officer [i.e. Testa] reviewed monthly trading activity reports, as part of the Firm's supervisory review, which included monitoring for unusual account activity."[177]

In response to FINRA's 2011 examination, Wood stated that it was not possible to conduct an independent test and review of the AML program with current supervisory personnel.[178] And in May 2012, Wood engaged the services of a third party to test its AML compliance program going forward.[179]

10. Conclusions of Law—Wood Violated NASD Conduct Rules 3011(c) and 2110 and FINRA Rules 3310(c) and 2010 by Failing to Conduct Adequate Independent Anti-Money Laundering Tests (Second Cause of Action)

FINRA Rule 3310(c), formerly NASD Rule 3011(c), requires that each member develop and implement an AML program to "[p]rovide for independent testing for compliance" with the firm's anti-money laundering obligations. The Rule requires that a firm's AML program must provide "for annual (on a calendar year basis) independent testing for compliance to be

[171] CX-59, at 13–14.

[172] CX-59A.

[173] Ans. ¶ 55; Stip. ¶ 39.

[174] Stip. ¶ 40.

[175] Stip. ¶ 41.

[176] JX-17, at 2; JX-18, at 2; JX-19, at 2. *See also* JX-20, at 2.

[177] *See* item No. 3 on 2008–2011 AML Compliance Test Reviews (JX-17, at 2–3; JX-18, at 3; JX-19, at 3; and JX-20, at 3).

[178] Stip. ¶ 42.

[179] Stip. ¶ 43.

conducted by member personnel or by a qualified outside party." [180] Independent testing "may not be conducted by . . . a person who performs the functions being tested."[181]

Notwithstanding his role and responsibilities in connection with the AML program, the Firm maintains that Testa was independent. The Firm argues that he was independent because: Kennedy, not Testa, was the person who performed the AML functions being tested; Kennedy, not Testa, was the designated AML Compliance person; and Testa did not report to Kennedy.[182] The Firm also claims that Testa did not review the new account forms for AML purposes—that review was performed by Kennedy.[183] Nevertheless, the Panel finds that given his responsibilities in connection with the Firm's AML program, and his role in reviewing and approving new account forms and monthly trading activity reports, Testa was inextricably entwined with the AML program. As a result, his tests of the AML program were not independent. In fact, the Firm admitted as much, as noted above, when it told FINRA that it was not possible for it to perform independent AML testing given its current supervisory personnel.

Based on the foregoing findings of fact, the Firm's testing was neither adequate nor independent. Therefore, the Firm violated NASD Conduct Rule 3011(c) (for misconduct before January 1, 2010) and FINRA Rule 3310(c) for misconduct after December 3, 2009); and violated NASD Conduct Rule 2110 (for misconduct before December 15, 2008) and FINRA Rule 2010 (for misconduct after December 14, 2008) by failing to conduct adequate independent anti-money laundering tests.

B. The Excess Commissions Charges

1. Wood Charged Excessive Commissions

First adopted in 1992,[184] Wood used a default commission schedule provided by its former clearing firm to determine the commissions it would charge customers on equity transactions during the relevant period.[185] When Quinones's customers began trading in low-priced securities, those transactions were processed using the existing commission schedule.[186] The commission schedule produced commissions in excess of FINRA's guidelines for certain equity transactions.[187] Specifically, from January 2009 through September 2011, the Firm

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[180] *See* FINRA Notice to Members 06-07 (Mar. 2006), http://www.finra.org/industry/notices/06-07 ("The rule establishes an expectation that ... the independent testing should be performed at least once each calendar year.").

[181] NASD IM-3011-1(c) (effective prior to January 1, 2010) and FINRA Rule 3320.01(c) (effective since January 1, 2010).

[182] Respondent's Pre-Hr'g Br. at 18.

[183] Respondent's Pre-Hr'g Br. at 18.

[184] Stip. ¶ 44.

[185] Ans. ¶¶ 62, 67; Stip. ¶ 44.

[186] Stip. ¶ 45.

[187] Stip. ¶ 45 (This stipulation references Schedule A to the Complaint. CX-72, Revised Schedule A, contains the same transactions as those listed on Schedule A to the Complaint.); CX-73; Tr. 98.

charged customers commissions in excess of 5% in 367 equity transactions.[188] Kennedy and McCarthy, collectively, executed 158 (43%) of these transactions.[189] Certain customers were charged commissions ranging from over 5% to over 18% of the principal amount of the trade,[190] including commissions of 7% or more in 185 transactions.[191]

Testa was responsible for reviewing commissions as part of his daily transaction review at Wood.[192] Although the Firm's written supervisory procedures (WSP's) required that it review the "reasonableness" of commissions charged, it never did so.[193] Testa conceded that the Firm did not review the methodology that was being used or the commission matrix,[194] and that his random review of the Firm's blotter was not really a commission review.[195]

The Firm first learned that its commission schedule produced commissions in excess of 5% as a result of a FINRA examination in October 2011.[196] Wood then twice amended the formula used to calculate commissions in its commission schedule in order to comply with FINRA's commission guidelines.[197] The most recent amended formula is designed to calculate commissions, together with administrative charges, not to exceed 5% of the principal amount of the trade for equity transactions.[198]

2. Conclusions of Law—Wood Violated NASD Conduct Rule 2440, IM-2440-1, and FINRA Rule 2010

NASD Rule 2440 provides, in pertinent part, that if a firm acts as an agent for its customer, the firm "shall not charge the customer more than a fair commission or service charge, taking into consideration all relevant circumstances." IM-2440-1 provides that "[i]t shall be deemed a violation of Rule 2110 and Rule 2440 for a member . . . to charge a commission which is not reasonable." Commissions in excess of five percent may be deemed unreasonable, based on FINRA's long-standing 5% policy.[199] IM-2440-1 states that this policy should be used as a guideline for determining the reasonableness of markups. Under IM-2440-1(c)(4), the 5% policy

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[188] Stip. ¶ 46 (This stipulation references Schedule A to the Complaint. CX-72, Revised Schedule A, contains the same transactions as those listed on Schedule A to the Complaint.); Tr. 98.

[189] CX-73.

[190] Stip. ¶ 45.

[191] CX-72; CX-73. Both exhibits contain the same 367 trades. Tr. 99.

[192] Stip. ¶ 49.

[193] JX-21, at 75; Tr. 548–49.

[194] Tr. 544.

[195] Tr. 548–49.

[196] Stip. ¶ 47.

[197] Stip. ¶ 48.

[198] Stip. ¶ 48.

[199] *See* IM-2440-1.

applies to transactions in which the member acts as agent. In connection with such transactions, "the commission charged must be fair in light of all relevant circumstances."

Additionally, commissions of 5% or even lower may be considered unfair or unreasonable under the 5% policy.[200] FINRA has informed its members that if a firm seeks to charge customers more than 5%, it "must be fully prepared to justify its reasons for the higher markup or markdown with adequate documentation."[201] Once FINRA shows that a firm has charged commissions over 5%, the burden shifts to the firm to justify those commissions.[202]

Here, the Firm failed to justify the commissions in excess of 5%. While the Firm disputes that the commissions charged were excessive, it provided no evidence to support that argument, other than Kennedy's testimony that she did not believe that the Firm charged excessive commissions.[203] The Firm also blamed its clearing firm and FINRA for not having discerned the so-called "glitch" in the commission schedule earlier. But the Firm was required to ensure that the customers were not overcharged and cannot shift that responsibility to others, including FINRA.[204]

The Panel finds that those commissions exceeding 5% were unreasonable and unfair and that the Firm was responsible for the overcharges. Accordingly, the Firm violated NASD Conduct Rule 2440, IM-2440-1, and FINRA Rule 2010 by charging unreasonable and unfair commissions.

3. Conclusions of Law—Wood Violated NASD Conduct Rule 3010 and FINRA Rule 2010

NASD Conduct Rule 3010(a) requires firms to "establish and maintain a system . . . reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." Further, NASD Conduct Rule 3010(b) requires member firms to "establish, maintain, and enforce written procedures . . . reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable Rules of NASD." Here, the Firm's WSP's required it to review the reasonableness of commissions on transactions.[205] Notwithstanding this requirement, the Firm did not review the reasonableness of

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[200] IM-2440-1(a)(4).

[201] NASD Notice to Members 92-16 (Apr. 1992), http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=1709.

[202] *See, e.g.*, *Steven P. Sanders*, 53 S.E.C. 889, 895 (1998).

[203] Tr. 1326.

[204] *See Dep't of Enforcement v. The Dratel Group*, No. 2009016317701, 2015 FINRA Discip. LEXIS 10, at *43 (NAC May 6, 2015) ("[A] securities dealer cannot shift its compliance responsibility to [its regulator]. A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation." (internal quotation marks omitted) (quoting *W.N. Whelen & Co.*, 50 S.E.C. 282, 284 (1990))).

[205] *See* JX-21, at 75.

commissions. Instead, it relied on a default schedule that it had not reviewed or amended in years[206] that it applied mechanically and without oversight.

Wood argued that it did not engage in a supervisory failure by not detecting the alleged excessive commission charges earlier. It pointed out that a principal of the Firm reviewed a report showing each trade in which the commission charged on the trade deviated from the commission schedule.[207] Essentially, the Firm blamed that report because it did not reflect the commissions as a percentage of the cost of the trade. Instead, the report showed the percentage by which a commission charge deviated from the commission schedule.[208] Therefore, because the commissions at issue did not vary from the schedule, they did not appear on the report.[209] The Firm failed to detect, however, and did not explain why it failed to detect, 112 transactions exceeding the 8% maximum allowed by its commission schedule.[210]

Wood cannot excuse its supervisory failures by arguing that it chose to rely on an insufficient report. In conclusion, the Panel finds that the Firm failed to establish, maintain and enforce an adequate supervisory system to ensure compliance with NASD Conduct Rule 2440. Consequently, the Firm violated NASD Conduct Rule 3010 and, by virtue of that violation, FINRA Rule 2010.[211]

C. The Books and Records Charge

1. The Firm Prepares Inaccurate Books and Records

In 2011, FINRA member firm Detwiler Fenton & Co. ("Detwiler") contacted the Firm and asked if it had an interest in acquiring certain of Detwiler's brokers.[212] Ensuing negotiations resulted in an executed Letter of Understanding ("LOU") in October 2010. [213] McCarthy testified that the LOU that he signed was "consistent" with his understanding of the arrangement.[214] The LOU provided for a total payment of $90,617 by the Firm to Detwiler on the following terms: an

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[206] Stip. ¶¶ 44–45.

[207] RX-94.

[208] RX-94; Tr. 1133–34.

[209] Tr. 1132–34.

[210] JX-26, at 1; CX-73.

[211] A failure to supervise constitutes a violation of both NASD Conduct Rule 3010 and NASD Rule 2110, now denominated as FINRA Rule 2010. *Dep't of Enforcement v. Pellegrino*, No. C3B050012, 2008 FINRA Discip. LEXIS 10, at *47 n.31 (NAC Jan. 4, 2008) (quoting *Robert J. Prager*, Exchange Act Release No. 51974, 2005 SEC LEXIS 1558, at *2 n.3 (July 6, 2005)), *aff'd*, Exchange Act Release No.59125, 8 SEC LEXIS 2843 (Dec. 19, 2008). *See also William J. Murphy*, Exchange Act Release No. 69923, 2013 SEC LEXIS 1933, at *26 (July 2, 2013), *aff'd sub nom. Birkelbach v. SEC*, 751 F.3d 472 (11th Cir. 2014) (noting that the violation of another Commission or FINRA rule or regulation constitutes a violation of FINRA Rule 2010).

[212] Tr. 1046.

[213] CX-84.

[214] Tr. 1050, 1057.

initial payment of $10,000 on November 30, 2010, the balance payable in four equal quarterly installments (February 15, May 15, August 15, and November 15, 2011). It also provided for certain reductions in the amounts owed if registered representatives left the Firm before the first day of each quarterly payment period. The LOU further stated, directly above the signature line, that it did "not constitute an agreement between the parties but is meant to express the intentions of the parties and their basic understandings."[215] The Firm executed the LOU, (as did Detwiler), but it never received a countersigned copy from Detwiler.[216] The LOU expressly provided that the parties would later execute a promissory note detailing the agreed upon terms.

The Firm and Detwiler, however, never executed a promissory note. Nevertheless, the Firm made five payments to Detwiler between November 30, 2010, and November 15, 2011,[217] based on invoices sent by Detwiler. The February 2, 2011 invoice that Detwiler sent to the Firm estimated the amount that the Firm was obligated to pay in February, May, August, and November. The invoices reflected the exact amounts Wood actually paid to Detwiler.[218] But Wood did not accrue for the amounts owed to Detwiler before November 24, 2011.[219]

In its defense, the Firm explains that it did not book the anticipated payments to Detwiler as a liability because it considered them too contingent. It based this conclusion on Detwiler's failure to provide it with a countersigned copy of the LOU and the parties' failure to execute a promissory note as envisioned by the LOU. [220] Moreover, Wood argues that the payments under the LOU were contingent upon meeting certain performance criteria, and the fact that the criteria were met and the payments were made does not evidence that the Firm's non-accrual was improper.

The Panel rejects the Firm's argument. The LOU contains clear and definite payment terms, including the payment amounts and due dates, though the amounts would be reduced in the event that any of the registered representatives left before a certain specified time. The only variable affecting the amounts owed was the number of representatives still employed by the Firm. But this did not negate the Firm's ability to estimate the liability.[221] The Panel finds that the Firm had an agreement or understanding with Detwiler, as evidenced by the fact that it made the payments specified in the LOU.[222] By not taking those payments into account in its net

[215] RX-99.

[216] Tr. 1245–46.

[217] Stip. ¶ 50.

[218] CX-85; Stip. ¶ 50.

[219] Stip. ¶ 51.

[220] Tr. 740–41, 1243–46.

[221] *See* Statement of Financial Accounting Standards No. 5: Accounting for Contingencies (Mar. 1975) (stating that an estimated loss "shall be accrued" if it is probable that a liability has been incurred and the amount of the loss can be "reasonably estimated").

[222] Tr. 1048–49, 1057.

capital computations, the Firm prepared inaccurate net capital computations between October 2010 and November 2011.

2. Conclusions of Law—Wood Willfully Violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder, and Violated NASD Conduct Rule 3110 and FINRA Rule 2010

NASD Conduct Rule 3110(a), in effect until December 5, 2011, provided that "[e]ach member shall make and preserve books, accounts, records, memoranda and correspondence in conformity with all applicable laws, rules, regulations and statements of policy promulgated thereunder and with the Rules of this Association as prescribed by SEC Rule 17a-3." SEC Rule 17a-3 requires broker-dealers that transact business in securities to make and keep current "[l]edgers (or other records) reflecting all assets and liabilities, income and expense and capital accounts."[223] Because the Firm did not book the anticipated payments to Detwiler as a liability, its books and records were inaccurate, and it therefore violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder and NASD Conduct Rule 3110. [224]

A violation of the federal securities laws is deemed willful if "the person charged with the duty knows what he is doing."[225] The Panel need not find that Wood intentionally violated those laws.[226] Here, the evidence demonstrates that the Firm knowingly decided not to accrue for the Detwiler liability. Therefore, Wood willfully violated Section 17(a) of the Exchange Act and Rule 17a-3 thereunder. By virtue of these violations, the Firm violated FINRA Rule 2010. [227]

The Complaint also charged the Firm with violating FINRA Rules 4511 (for conduct after December 4, 2011). But FINRA Rule 4511 did not become effective until December 5, 2011,[228] and the violative conduct ended before then. Thus, the Panel dismisses this charge.

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[223] 17 C.F.R. § 240.17a-3.

[224] As discussed in the Sanctions section, the Firm claimed that it reasonably relied on competent accounting advice from its auditor in deciding not to accrue the Detwiler deal as a liability. But even if proven, "[r]eliance on advice of accountants does not shift the ultimate burden of compliance." *NASD v Forbes, Walsh, Kelly & Co., Inc*., C10950101, 1997 NASD Discip. LEXIS 42, at *8–9 (NBCC Aug. 5, 1997). And, in any event, the Firm did not demonstrate reasonable reliance on the advice of its auditor.

[225] *Dep't of Enforcement v. McCune*, 2011027993301, 2015 FINRA Discip. LEXIS 22, at *25 (NAC July 27, 2015) (quoting *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000), *appeal docketed*, No. 3-16768 (SEC Aug. 25, 2015).

[226] *Id.*

[227] A violation of Conduct Rule 3110(a) is also a violation of FINRA Rule 2010. *See Blair C. Mielke and Frederick W. Shultz*, Exchange Act Release No. 75981, 15 SEC LEXIS 3927, at *51, n.40 (Sept. 24, 2015). *See* n.211. *See also Dep't of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *12–13 (NAC June 2, 2000).

[228] See FINRA Regulatory Notice 11-19 (Apr. 2011), http://www.finra.org/industry/notices/11-19.

D. The Net Capital Notice Charge

1. The Firm Fails to File a Net Capital Notice

In response to a FINRA examination, Wood accrued for the Detwiler payments and revised its net capital computations for the at-issue time period.[229] The revised net capital computation showed that Wood had a net capital deficiency for the month of June 2011.[230] Notwithstanding the deficiency, Wood did not file a Rule 17a-11(c) notice on or about June 30, 2011.[231]

2. Conclusions of Law—Wood Violated FINRA Rule 2010 and Willfully Violated Section 17(a) of the Exchange Act and Rule 17a-11 thereunder by Not Filing a Net Capital Notice (Sixth Cause of Action)

SEC Rule 17a-11(c)(3) requires every broker or dealer to "send notice promptly (but within 24 hours)" to the Securities and Exchange Commission if a "computation made by a broker or dealer pursuant to [17 C.F.R.] § 240.15c3-1 shows that its total net capital is less than 120 percent of the broker's or dealer's required minimum net capital."[232] A violation of SEC Rule 17a-11(c)(3) is also a violation of FINRA Rule 2010.[233] By failing to file notice of this event, the Firm violated FINRA Rule 2010. The Firm knowingly failed to accrue for the Detwiler liabilities resulting in the erroneous net capital calculation for June 2011 and knowingly failed to make its required SEC Rule 17a-11(c)(3) filing. Therefore, it willfully violated Section 17(a) of the Exchange Act and Rule 17a-11 thereunder.

E. Conducting a Securities Business While Net Capital Deficient Charge

1. Wood Conducts a Securities Business While Net Capital Deficient (Seventh Cause of Action)

On three separate days in 2012, Wood conducted a securities business while net capital deficient. On Friday, June 29, 2012, the Firm's minimum required net capital was the greater of $5,000 or $11,093, pursuant to SEC Rule 15c3-1(a)(i) (the Aggregate Indebtedness Standard).[234] The Firm's actual net capital on that day was $10,012, a deficiency of $1,081.[235] On Tuesday, July 31, 2012, the Firm's minimum required net capital was the greater of $5,000 or $10,387,

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[229] Stip. ¶ 52.

[230] Stip. ¶ 53.

[231] Ans. ¶ 77.

[232] 17 C.F.R. 240.17a-11(c)(3).

[233] *See Dist. Bus. Conduct Comm. v. First Heritage Investments*, No. C02910081, 1992 NASD Discip. LEXIS 47, at *9–10 (NBCC Dec. 9, 1992) (addressing predecessor to FINRA Rule 2010); *Fundclear, Inc.*, Exchange Act Release No. 34735, 1994 SEC LEXIS 2956, at *2 n.2, and *11 (Sept. 28, 1994) (Same).

[234] Ans. ¶ 80; Stip. ¶ 54.

[235] Ans. ¶ 80; Stip. ¶ 54.

pursuant to the Aggregate Indebtedness Standard.[236] On that date, the Firm's actual net capital was $1,653, a deficiency of $8,734.[237] On Friday, August 31, 2012, the Firm's minimum required net capital was the greater of $5,000 or $12,478, pursuant to the Aggregate Indebtedness Standard.[238] On that date, the Firm's net capital was $2,501, a deficiency of $9,977.[239] These deficiencies arose because the Firm improperly classified funds that were jointly held in a brokerage account at the Firm belonging to one of the Firm's principals and her mother as an allowable asset.[240] On each of the above three dates, the Firm conducted a securities business while net capital deficient.[241]

2. Conclusions of Law—Wood Violated FINRA Rule 2010 and Willfully Violated Section 15(c) of the Exchange Act and Rule 15c3-1 Thereunder

A firm violates Exchange Act Rule 15c3-1, and therefore violates FINRA Rule 2010,[242] if it effects securities transactions while net capital deficient.[243] Engaging in securities transactions while a firm's net capital is below the required amount is also an independent violation of FINRA Rule 2010.[244] Wood stipulated to liability regarding this cause of action.[245] Its violative conduct was willful because it classified a joint brokerage account owned by a principal, Kennedy, and her mother, as an allowable firm asset for the purposes of net capital calculations[246] and the conduct was done knowingly. As a result of this failure to maintain net capital compliance, the Firm violated FINRA Rule 2010 and willfully violated Section 15(c) of the Exchange Act and Rule 15c3-1 thereunder.

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[236] Ans. ¶ 82; Stip. ¶ 55.

[237] Ans. ¶ 82; Stip. ¶ 55.

[238] Ans. ¶ 84; Stip. ¶ 56.

[239] Ans. ¶ 84; Stip. ¶ 56.

[240] Ans. ¶ 86.

[241] Ans. ¶¶ 81, 83, 85; Stip. ¶ 57.

[242] *See Dep't of Enforcement v. Jarkas*, No. 2009017899801, 2015 FINRA Discip. LEXIS 50, at *20 (NAC Oct. 5, 2015).

[243] *Paul Joseph Benz*, Exchange Act Release No. 51046, 2005 SEC LEXIS 116, at *10 (Jan. 14, 2005).

[244] *Fox & Co. Inv., Inc.*, Exchange Act Release No. 52697, 2005 SEC LEXIS 2822, at *27 n.29 (Oct. 28, 2005); *Benz*, 2005 SEC LEXIS 116, at *10; *Joseph Ricupero*, Exchange Act Release No. 62891, 2010 SEC LEXIS 2988, at *17–18 (Sept. 10, 2010), *petition for review denied*, 436 F. App'x 31 (2d Cir. 2011)(citation omitted).

[245] Tr. 29; Stip. ¶¶ 54–58.

[246] Stip. ¶ 58.

III. Sanctions

A. Overview

In considering the appropriate sanctions to impose on Wood, the Panel looked to FINRA's Sanction Guidelines ("Guidelines").[247] The Guidelines contain General Principles Applicable to All Sanction Determinations ("General Principles"), overarching Principal Considerations, as well as guidelines for specific violations. The General Principles explain that "sanctions should be designed to protect the investing public by deterring misconduct and upholding high standards of business conduct."[248] 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."[249] Further, sanctions should "reflect the seriousness of the misconduct at issue,"[250] and should be "tailored to address the misconduct involved in each particular case."[251]

The General Principles also direct the Adjudicators to "consider a firm's size with a view toward ensuring that the sanctions imposed are remedial and designed to deter future misconduct, but are not punitive."[252] Additionally, "[w]hen raised by a respondent, Adjudicators are required to consider ability to pay in connection with the imposition, reduction or waiver of a fine or restitution."[253] The burden is on the respondent to raise the issue and to demonstrate its inability to pay.[254] In seeking to demonstrate an inability to pay, a respondent is held to "a very high standard of proof."[255] The respondent "must show that - in seeking to pay a fine - it is

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[247] FINRA Sanction Guidelines (2015) ("Guidelines"), http://www.finra.org/industry/sanction-guidelines.

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

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

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

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

[252] Guidelines at 2 (General Principles Applicable to All Sanction Determinations, No. 1). When assessing a firm's size, Adjudicators should consider, for example, "the financial resources of the firm; the nature of the firm's business; the number of individuals associated with the firm; and the level of trading activity at the firm." *Id*. If the violative conduct is fraudulent, willful or reckless, "Adjudicators should consider whether, given the totality of the circumstances involved, it is appropriate to consider a firm's small size and may determine that, given the egregious nature of the fraudulent activity, firm size will not be considered in connection with sanctions." *Id*. at n.2. Here, the Panel determined that given the totality of the circumstances, it is appropriate to consider the firm's small size in connection with sanctions.

[253] Guidelines at 5 (General Principles Applicable to All Sanction Determinations, No. 8).

[254] Guidelines at 5 (General Principles Applicable to All Sanction Determinations, No. 8); *Dep't of Enforcement v. Merrimac* Corporate *Sec., Inc.*, No. 2009017195204, 2015 FINRA Discip. LEXIS 4, at *15 (NAC Apr. 29, 2015) (quoting *William J. Murphy*, Exchange Act Release No. 69923, 2013 SEC LEXIS 1933, at *109 (July 2, 2013)).

[255] *Merrimac*, 2015 FINRA Discip. LEXIS 4, at *16 (quoting *Dist. Bus. Conduct Comm. v. Escalator Sec., Inc.*, No. C07930034, 1998 NASD Discip. LEXIS 21, at *12 (NBCC Feb. 19, 1998)).

unable to obtain the needed funds by, among other things, reducing expenses and salaries, raising capital, or borrowing money."[256] Further:

> [A] fine that otherwise appropriately sanctions a firms violative conduct . . . may not be limited by claims that the payment will cause the firm to be in noncompliance with its net capital requirement, or to close its doors. Because of the overriding public interest, member firms should be appropriately sanctioned based on their violative conduct, and not merely on the projected effect of the monetary sanction on the firm's balance sheet.[257]

Here, Wood raised the issue and argued that imposing substantial monetary sanctions would be punitive and impossible for the Firm to pay.[258] The Firm's 2014 audited financial statements showed that it ended that year with more than a $20,000 operating loss.[259] And, it ended the prior year with a loss of approximately $19,000.[260] Further, the total compensation paid to the Firm's four principals totaled only $167, 680.[261]

On the other hand, the Firm does not argue that it cannot afford to pay any monetary sanction. Also, its revenues have been stable over the past two years (approximately $1.6 million in 2013 and 2014) ;[262] its excess net capital in 2014 was $81,129,[263] an approximately $30,000 increase over the previous year;[264] and in 2014, its assets exceeded its liabilities by approximately $284,000,[265] an increase of approximately $24,000 over the prior year.[266] Moreover, the Firm did not show that it was unable to obtain the funds needed to pay any monetary sanctions imposed.

On balance, the Firm did not demonstrate that it has an inability to pay monetary sanctions. Still, in determining the sanctions to impose, the Panel took into account the Firm's

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[256] *Merrimac*, 2015 FINRA Discip. LEXIS 4, at *16 (quoting *Dep't of Enforcement v. Merrimac Corporate Sec., Inc.*, No. 2007007151101, 2012 FINRA Discip. LEXIS 43, at *44 (Bd. of Governors May 2, 2012)).

[257] *Merrimac*, 2015 FINRA Discip. LEXIS 4, at *16–17 (quoting *Merrimac*, 2012 FINRA Discip. LEXIS 43, at *44–45 (internal quotation marks omitted)).

[258] Respondent's Post-Hr'g Br. at 29; RX-114.

[259] RX-114, at 7; Tr. 1250–51.

[260] RX-106, at 6.

[261] RX-114, at 7; Tr. 1257.

[262] Enforcement's Post-Hr'g Br. at 31; RX-106, at 6; RX-114, at 7; Tr. 1256–57.

[263] RX-114, at 14.

[264] RX-106, at 13.

[265] RX-114, at 6.

[266] RX-106, at 5.

small size[267] and its finances, and reduced the size of the fine it would otherwise have imposed in order to ensure that the sanctions are remedial and not punitive.

Finally, in assessing sanctions, the Panel considered that the misconduct at issue was aberrant and not otherwise reflective of the Firm's historical compliance record.[268]

B. AML Violations

There are no sanction guidelines specific to the Firm's AML violations. But the Guideline for failure to supervise violations is most analogous.[269] Therefore, the Hearing Panel looked to that Guideline in determining the appropriate sanctions to impose. That Guideline recommends, in pertinent part, that the Panel impose a fine in the range of $5,000 to $73,000. Additionally, under that Guideline, the Panel should consider limiting activities of the appropriate branch office or department for up to 30 business days. And, in egregious cases, it should consider limiting the activities for a longer period or suspending the firm with respect to any or all activities or functions for up to 30 business days. In a case against a firm involving systemic supervision failures, it should consider a longer suspension of the firm with respect to any or all activities or functions (of up to two years) or expulsion of the firm.

Two principal considerations contained in the Guideline are relevant here: "Whether respondent ignored 'red flag' warnings that should have resulted in additional supervisory scrutiny" and the "Quality and degree of supervisor's implementation of the firm's supervisory procedures and controls." These considerations are aggravating factors, as the Firm ignored or failed to properly follow up on red flags of potentially suspicious activity by Quinones's customers. Similarly, the quality and degree of Testa and Kennedy's implementation of the procedures and controls were deficient. There are additional aggravating factors as well. The Firm's failure to implement its AML procedures occurred over an extended period of time.[270] Furthermore, the Firm's misconduct was reckless, and not merely negligent, as the Firm did not simply fail to discover or recognize red flags of potentially suspicious activity, but saw numerous red flags and either ignored them or did not reasonably follow up on them.

Finally, Wood failed to heed FINRA's admonition that "introducing brokers should understand that they are the first line of defense in detecting and deterring suspicious activity."[271]

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[267] Presently, the Firm has 18 employees (including four principals). Tr. 987. At the end of 2014, it had total assets of approximately $390,000, revenues of approximately $1.6 million, and net capital of approximately $88,000. RX-114, at 6–7, 14.

[268] Guidelines at 7 (Principal Considerations in Determining Sanctions, No. 16). While the Firm has been in business for over 100 years, its only disciplinary record consists of $750 in fines relating to late filings over 20 years ago. RX-108.

[269] *See Dep't of Enforcement v. Domestic Sec., Inc.*, No. 2005001819101, 2008 FINRA Discip. LEXIS 44, at *21 n.9 (NAC Oct. 2, 2008) (applying Guidelines for deficient written supervisory procedures to a case involving deficient AML procedures under NASD Rule 3011).

[270] Guidelines at 6 (Principal Considerations in Determining Sanctions, No. 9).

[271] FINRA Notice to Members 02-21 (Apr. 2002), http://www.finra.org/sites/default/files/NoticeDocument/p003704.pdf.

The Firm evidenced no appreciation, either at the time, or later, of the risks posed by Quinones's customers' trading activities[272] or of the laxity of its AML compliance. Nor did the Firm demonstrate that it appreciated its responsibility to maintain vigilance when monitoring for potentially suspicious activity and to follow-up aggressively and thoroughly when presented with red flags. Instead, Wood took a laissez-fair approach, focusing on Quinones's customers only when Pershing expressed concern, and, even then, it reacted with annoyance, rather than diligence. Wood's attitude of indifference to its AML obligations poses a risk to the public and is an aggravating factor in the Panel's sanction determinations.[273]

Based on the Panel's evaluation of the relevant factors set out in the Guidelines, we conclude that the Firm's AML violations are serious and warrant significant sanctions. Further, the Panel finds that the two AML violations are related and that the sanctions imposed should be designed and tailored to deter the same underlying misconduct, namely, a failure by Wood to appreciate and adhere to its AML obligations. Accordingly, the Panel imposes a unitary sanction for the AML violations.[274] The Firm is censured and fined $50,000. Additionally, the Sanctions Guidelines recognize that in tailoring sanctions to respond to the misconduct at issue, "FINRA may enforce compliance with its rules by: limitation or modification of a respondent's business activities."[275] Therefore, because the Firm failed to demonstrate that it appreciated the risks posed by penny stock liquidation activities, it is prohibited for a period of two years from executing liquidating transactions in penny stocks[276] for new accounts.[277]

C. Excessive Commissions and Related Supervisory Violations

The Sanction Guideline applicable to excessive commissions recommends a fine of $5,000 to $146,000 plus (if restitution is not ordered) the gross amount of the excessive commission. Additionally, the Adjudicators should consider requiring corrective action regarding the Firm's commission policy and, in egregious cases, suspending the Firm with respect to any or all activities or functions for up to two years or expulsion.[278] While the

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[272] Tr. 723.

[273] *See Dep't of Enforcement v. Evansen*, No. 2010023724601, 2014 FINRA Discip. LEXIS 10, at *55–56 (NAC Jun. 3, 2014), (quoting *Scott Epstein*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217, at *75 (Jan. 30, 2009)), *aff'd*, Exchange Act Release No.75531, 15 SEC 3080 (Jul, 27, 2015).

[274] *Mielke*, 2014 FINRA Discip. LEXIS 24, at *55 (citing *Dep't of Enforcement v. Fox & Co. Inv., Inc.*, No. C3A030017, 2005 NASD Discip. LEXIS 5, at *37 (NAC Feb. 24, 2005) (finding that "where multiple, related violations arise as a result of a single underlying problem, a single set of sanctions may be more appropriate to achieve [FINRA's] remedial goals"), *aff'd*, Exchange Act Release No. 52697, 2005 SEC LEXIS 2822, at *36 (Oct. 28, 2005)).

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

[276] 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." 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.

[277] For the purposes of this decision, "new accounts" means accounts opened by the Firm following the date this hearing panel decision becomes final.

[278] Guidelines at 90.

principal considerations in the Guideline are not applicable here, the Panel considered, and found aggravating, certain considerations pertaining to all violations. Specifically, the misconduct occurred over an extended period of time;[279] the Firm failed to develop reasonable supervisory, operational and/or technical procedures or controls that were properly implemented;[280] the misconduct involved numerous acts and a pattern of misconduct;[281] it was reckless;[282] and resulted in monetary gains for the Firm,[283] derived from numerous transactions (367),[284] which injured numerous customers (88).[285]

While the Firm took corrective measures and revamped its commission schedule, it did so only after detection by FINRA.[286] And, to date, it has neither accepted responsibility for its misconduct,[287] nor refunded the excessive commission charges to the affected customers.[288] Instead, and also aggravating, the Firm tried to shift blame to FINRA for not having detected the excessive commissions in its examinations of the Firm.[289] Not only can a firm not shift responsibility to a regulator for its compliance, as noted above,[290] but Wood's attempt to do so demonstrates its failure to accept responsibility for its actions[291] and serves to aggravate its misconduct.[292]

Regarding Wood's failure to establish, maintain, and enforce an adequate supervisory system designed to ensure compliance with NASD Rule 2440, the applicable supervisory

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[279] Guidelines at 6 (General Principles Applicable to All Sanction Determinations, No. 9).

[280] Guidelines at 6 (General Principles Applicable to All Sanction Determinations, No. 5).

[281] Guidelines at 6 (General Principles Applicable to All Sanction Determinations, No. 8).

[282] Guidelines at 7 (General Principles Applicable to All Sanction Determinations, No. 13).

[283] Guidelines at 7 (General Principles Applicable to All Sanction Determinations, No. 17).

[284] Guidelines at 7 (General Principles Applicable to All Sanction Determinations, No. 18).

[285] Guidelines at 6 (General Principles Applicable to All Sanction Determinations, No. 11).

[286] Guidelines at 6 (General Principles Applicable to All Sanction Determinations, No. 3).

[287] Guidelines at 6 (General Principles Applicable to All Sanction Determinations, No. 2); Tr. 1326.

[288] Guidelines at 6 (General Principles Applicable to All Sanction Determinations, No. 4); Tr. 1262–63, 1325–26.

[289] Respondent's Pre-Hr'g Br. at 20, 25; Tr. 746.

[290] *See* n.203, above. *See, e.g.*, *Hans N. Beerbaum*, Exchange Act Release No. 55731, 2007 SEC LEXIS 971, at *19 n.22 (May 9, 2007) ("We have repeatedly held that members and their associated persons cannot shift their burden of compliance to the NASD.") (internal quotation omitted).

[291] *See Scott Epstein*, Exchange Act Release No. 59328, 2009 SEC LEXIS 217, at *73 (Jan. 30, 2009) (finding that respondent's blame-shifting arguments demonstrate failure to accept responsibility for own actions), *petition for review denied*, 416 F. App'x 142 (3d Cir. 2010), *aff'd*, *Michael G. Keselica*, 52 S.E.C. 33, 37 (1994) (stating that "attempts to blame others for his misconduct … demonstrate that [respondent] fails to understand the seriousness of [the] violations"), *appeal dismissed*, 1995 U.S. App. LEXIS 40288 (DC Cir. 1995). *Cf. Kent M. Houston*, Exchange Act Release No. 71589, 2014 SEC LEXIS 614, at *27–28 (Feb. 20, 2014) (finding respondent's purported acceptance of responsibility "unconvincing because of his attempts to shift blame for his misconduct").

[292] *See Dep't of Enforcement v. Eplboim*, No. 2011025674101, 2014 FINRA Discip. LEXIS 8, at *45 (NAC May 14, 2014) (finding that respondent's continued denial of responsibility and attempts to blame others including FINRA staff was "troubling and serves to aggravate his misconduct").

Sanction Guideline is discussed above, in connection with the Firm's AML violations. Each of the principal considerations identified in the supervision Sanction Guideline is aggravating here because: the Firm ignored red flag warnings that should have resulted in additional supervisory scrutiny;[293] the underlying conduct involved numerous instances of commission overcharges to numerous customers; [294] the wrongdoing was widespread (involving 14 of the Firm's registered representatives including McCarthy and Kennedy); occurred over a period exceeding two years; and the supervisors failed, utterly, to implement the Firm's supervisory procedures and controls,[295] which required review of commissions for reasonableness.[296] The SEC has made clear that "[a]ssuring proper supervision is a critical component of broker-dealer operations."[297] Here, the Firm abdicated its responsibility to ensure that customers were charged fair prices. Instead, Wood operated on auto pilot, mechanically applying a commission schedule that generated excessive commissions for transactions in low-priced securities.

Based on these violations, the Panel imposes the following remedial sanctions designed to deter the Firm and others from engaging in similar misconduct in the future: a censure, a $10,000 fine, and an order directing the payment of restitution[298] in the amount of $40,229.28 (representing the commission amounts charged in excess of 5%) to the affected customers, plus interest,[299] as set forth below in the Order.

D. Books and Records and Net Capital Violations

The Panel has determined that a unitary sanction is appropriate for Wood's recordkeeping and net capital violations. The Guideline for recordkeeping violations recommends a fine of $1,000 to $15,000 and, in egregious cases, a fine of $10,000 to $146,000. The Guideline directs the Adjudicators to consider the nature and materiality of the inaccurate or missing information.[300] For net capital violations, the Guideline recommends a fine of $1,000 to $73,000. The Guideline contains two principal considerations: whether the firm continued in business while knowing of deficiencies/inaccuracies or voluntarily ceased conducting business because of the deficiencies/inaccuracies; and whether the respondent attempted to conceal the deficiencies.[301] Both Guidelines recommend suspending the firm with respect to any or all

[293] Guidelines at 103 (Principal Considerations in Determining Sanctions, No. 1).

[294] Guidelines at 103 (Principal Considerations in Determining Sanctions, No. 2).

[295] Guidelines at 103 (Principal Considerations in Determining Sanctions, No. 3).

[296] JX-21.

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

[298] Guidelines at 4 (General Principles Applicable to All Sanction Determinations, No. 5) ("Where appropriate to remediate misconduct, Adjudicators should order restitution …. Adjudicators may order restitution when an identifiable person, member firm or other party has suffered a quantifiable loss proximately caused by a respondent's misconduct.").

[299] Guidelines at 11.

[300] Guidelines at 29.

[301] Guidelines at 28.

activities or functions for up to 30 business days and, in egregious cases, a lengthier suspension of up to two years or expulsion.

Regarding the books and records and failure to file a net capital notice violations, the Panel finds that the inaccurate or missing information was important, as it concerned an un-booked accrued liability of more than $57,000. It also served as the predicate for the Firm's failure to timely file a net capital notice with the SEC. These notices are important: the SEC requires that a firm file them within 24 hours if its net capital falls below 120% of its minimal requirement.[302] Therefore, the nature of the inaccurate or missing information is an aggravating factor.

For mitigation, the Firm argued that its independent auditor had advised that the Detwiler obligation under the LOU should not be reflected as a liability on the Firm's books because it was too contingent, and the Firm properly relied on that advice.[303] To establish mitigation, the Firm must demonstrate reasonable reliance on competent accounting advice.[304] If the Firm's reliance was unreasonable, it is not entitled to mitigation based on that advice. [305] In evaluating the Firm's mitigation argument, a hearing panel should examine all the attendant facts and circumstances relating to the advice.[306]

After examining the relevant facts and circumstances, we reject Wood's mitigation argument for several reasons. First, according to Kennedy, the Firm did not consult with its auditor until January 2011—at least three months after the LOU was executed and after the Firm made a $10,000 payment on December 1, 2011.[307] Second, Wood offered no written corroboration regarding the purported advice; the Firm did not seek an opinion letter from the auditor and the auditor did not provide one.[308] Nor did the Firm introduce documents reflecting what information it provided to the auditor about the Detwiler deal and what advice the auditor rendered as a result. And, finally, the auditor did not testify concerning the claimed reliance on

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[302] 17 C.F.R. 240.17a-11(c)(3).

[303] Guidelines at 6 (General Principles Applicable to All Sanction Determinations, No. 7); Tr. 1245–47.

[304] *Dep't of Enforcement v. Fergus*, No. C8A990025, 2001 NASD Discip. LEXIS 3, at *46–47 (NAC May 17, 2001) ("Under the Sanction Guidelines, the appropriate test is 'whether the respondent demonstrated reasonable reliance on competent legal or accounting advice.'"), *aff'd sub nom. Frank Thomas Devine*, Exchange Act Release No. 46746, 2002 SEC LEXIS 3407 (Oct. 30, 2002); *Mielke*, 2014 FINRA Discip. LEXIS 24, at *66–67 (quoting *Fergus*, 2001 NASD Discip. LEXIS 3, at *48).

[305] *See Fergus*, 2001 NASD Discip. LEXIS 3, at *46–47 (rejecting respondent's argument that his reliance on counsel was a mitigating factor because the reliance was not reasonable).

[306] *Dep't of Enforcement v. Steinhart*, No. FPI020002, 2003 NASD Discip. LEXIS 23, at *11 (NAC Aug. 11, 2003) ("In order to determine whether Steinhart's reliance was reasonable, we must examine the facts and circumstances surrounding his reliance."); *Fergus*, 2001 NASD Discip. LEXIS 3, at *47–48 (NAC "examined all the facts and circumstances of this case to determine whether the respondents reasonably relied on competent legal advice for purposes of assessing whether mitigation of sanctions is warranted.").

[307] Tr. 1335.

[308] Tr. 1324.

accounting advice. In short, Wood failed to demonstrate that it reasonably relied on competent accounting advice.

Finally, with respect to sanctions for having conducted a securities business while net capital deficient, the evidence does not demonstrate that the Firm continued in business while knowing of the deficiencies or inaccuracies. Instead, the Firm was negligent in not knowing of the deficiency. The Firm should have realized that classifying Kennedy and her mother's joint brokerage account as an allowable asset for the purposes of net capital calculations was improper, and that it would result in the Firm failing to comply with its net capital requirements.

After evaluating all the relevant factors, the Panel determines that the Firm should be censured and fined $15,000 for these violations.

IV. Order

Respondent Wood (Arthur W.) Company, Inc. is censured; fined $75,000; ordered to pay $40,229.28 in restitution to the customers identified on CX-73, in the amounts listed for each customer on CX-72, plus interest, until paid; [309] and is prohibited for a period of two years from executing liquidating transactions in penny stocks for new accounts, for:

(1) failing to implement and enforce its anti-money laundering program in violation of NASD Rules 3011(a) and 2110 and FINRA Rules 3310(a) and 2010;

(2) failing to conduct adequate and independent anti-money laundering tests in violation of NASD Conduct Rules 3011(c) and 2110 and FINRA Rules 3310(c) and 2010;

(3) charging unreasonable and unfair commissions on equity transactions in violation of NASD Conduct Rule 2440, IM-2440-1, and FINRA Rule 2010;

(4) failing to establish, maintain, and enforce a supervisory system, including written supervisory procedures, in violation of NASD Conduct Rule 3010 and FINRA Rule 2010;

(5) preparing and maintaining inaccurate books and records in willful violation of Section 17(a) of the Exchange Act and Rule 17a-3 thereunder, and in violation of NASD Conduct Rule 3110 and FINRA Rule and 2010;

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[309] CX-72 and CX-73 are attached to this decision. For each customer identified on CX-73, interest shall accrue on the total amount of excessive commissions charged to that customer, beginning on the date of the last excessive commission charged to that customer. Interest shall be paid at the rate established for the underpayment of income taxes in Section 6621(a) of the Internal Revenue Code, 26 U.S.C. § 6621(a). In the event that any customers on CX-73 cannot be located, unpaid restitution plus accrued interest should be paid to the appropriate escheat, unclaimed-property, or abandoned-property fund for the state of that customer's last known address. Satisfactory proof of payment of the restitution, or of reasonable and documented efforts undertaken to effect restitution, shall be provided to the staff of FINRA's Department of Enforcement, District 11, no later than 90 days after the date when this decision becomes final.

(6) failing to file a net capital notice in violation of FINRA Rule 2010 and in willful violation of Section 17(a) of the Exchange Act and Rule 17a-11 thereunder; and

(7) conducting a securities business while net capital deficient in violation of FINRA Rule 2010 and in willful violation of Section 15(c) of the Exchange Act and Rule 15c3-1 thereunder.

Wood is also ordered to pay the costs of the hearing in the amount of $11,844.41, which includes a $750 administrative fee and the cost of the hearing transcript.[310] If this decision becomes FINRA's final disciplinary action, the fine, restitution, 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.

Enforcement failed to prove that Wood violated FINRA Rule 4511, and that charge is dismissed.

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David R. Sonnenberg
Hearing Officer
For the Hearing Panel

[310] The Hearing Panel considered and rejected without discussion all other arguments by the parties.