

SECURITIES AND EXCHANGE COMMISSION  
Washington, D.C.

SECURITIES ACT OF 1933  
Release No. 10662 / July 17, 2019

SECURITIES EXCHANGE ACT OF 1934  
Release No. 86404 / July 17, 2019

Admin. Proc. File No. 3-18045

In the Matter of the Application of  
MERRIMAC CORPORATE SECURITIES, INC.  
  
and  
  
ROBERT G. NASH  
  
For Review of Disciplinary Action Taken by  
  
FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION — REVIEW OF DISCIPLINARY  
PROCEEDING

Registered securities association found that member firm and its chief compliance officer violated the association's rules. Both applicants provided falsified documents to FINRA, and failed to maintain an effective supervisory system. Firm also caused the unregistered sale of securities not subject to exemption in violation of Section 5 of the Securities Act of 1933, failed to establish and implement an effective anti-money-laundering system, and effected securities transactions while its registration was suspended. *Held*, FINRA's findings of violations and imposition of sanctions are *sustained in part*.

APPEARANCES:

*Stephen Pizzuti*, pro se, for Merrimac Corporate Securities.

*Robert Nash*, pro se.

*Alan Lawhead*, *Michael Garawski*, and *Celia L. Passaro* for FINRA.

Appeal filed: June 27, 2017

Last brief received: January 2, 2018

Merrimac Corporate Securities (“Merrimac”), a broker-dealer and FINRA member firm, and Robert G. Nash, Merrimac’s Chief Compliance Officer (“CCO”) and one of its general securities principals, appeal from a FINRA disciplinary action. On July 3, 2013, FINRA’s Department of Enforcement (“Enforcement”) filed an eight-count complaint against Merrimac, Nash, and several other individuals: Stephen Pizzuti, Merrimac’s chief executive officer; David W. Matthews, Jr., Merrimac’s president, anti-money-laundering (“AML”) officer, and its CCO before Nash; and John DuBrule and Kevin Tuttle, two of Merrimac’s general securities principals. Pizzuti, Matthews, DuBrule, and Tuttle settled with FINRA before the hearing.

After a seven-day hearing, a FINRA Extended Hearing Panel (the “Hearing Panel”) issued a decision finding violations and imposing sanctions.<sup>1</sup> Merrimac and Nash appealed to FINRA’s National Adjudicatory Council (“NAC”), which issued a decision sustaining most of the Hearing Panel’s findings of violation and the sanctions it imposed.<sup>2</sup>

The NAC found five violations.<sup>3</sup> First, Merrimac and Nash violated FINRA Rules 8210 and 2010 by providing falsified documents in response to FINRA’s requests for information. Second, Merrimac violated FINRA Rule 2010 through the unregistered sale of securities, without an applicable exemption from registration, in violation of Section 5 of the Securities Act of 1933. Third, Merrimac violated NASD Rule 3011(a) and FINRA Rules 3310 and 2010 by failing to establish and implement an effective anti-money-laundering (“AML”) system. Fourth, Merrimac and Nash violated NASD Rules 3010 and 2110 and FINRA Rule 2010 by failing to establish and maintain an effective supervisory system, including written supervisory procedures (“WSPs”). Fifth, Merrimac violated FINRA Rule 2010 by effecting securities transactions while suspended. FINRA fined Merrimac \$225,000; imposed a 30-day suspension on the firm in all capacities and a one-year suspension from receiving and liquidating unregistered low-priced stocks not listed on a national securities exchange (“penny stocks”);<sup>4</sup> and required that it retain an independent WSP

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<sup>1</sup> See FINRA Rule 9231(c) (providing for the appointment of “a Hearing Panel or an Extended Hearing Panel to conduct the disciplinary proceeding and issue a decision” and that the matter “shall be designated an Extended Hearing, and . . . shall be considered by an Extended Hearing Panel,” upon “consideration of the complexity of the issues involved, the probable length of the hearing, or other factors that the Chief Hearing Officer deems material”).

<sup>2</sup> The NAC found that Nash did not violate NASD Rule 3011 and FINRA Rule 3310 because he was not responsible for the firm’s AML program at the time.

<sup>3</sup> See Table 1 at the end of this opinion.

<sup>4</sup> See 15 U.S.C. § 78c(a)(51); 17 C.F.R. § 240.3a51-1 (defining the term “penny stock”).

consultant. FINRA fined Nash \$50,000; imposed a one-year suspension in a principal capacity; and required that he requalify as a general securities principal. This appeal followed.

Section 19(e)(1) of the Securities Exchange Act of 1934 governs our review of this self-regulatory organization (“SRO”) disciplinary action. Under Section 19(e)(1), we determine whether: the applicant engaged in the conduct that FINRA found; such conduct violates FINRA’s rules; and those rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.<sup>5</sup> We base our findings on an independent review of the record and apply the preponderance of the evidence standard.<sup>6</sup>

Exchange Act Section 19(e)(2) directs us to sustain FINRA’s sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive.<sup>7</sup> As part of our review, we consider any aggravating or mitigating factors.<sup>8</sup> We also consider whether the sanctions are remedial or punitive.<sup>9</sup> In imposing sanctions, the NAC relied on FINRA’s Sanctions Guidelines in effect at the time of the Hearing Panel’s decision.<sup>10</sup> Although not binding on us, we have used the Guidelines as a benchmark.<sup>11</sup>

## I. PROVIDING FALSIFIED DOCUMENTS TO FINRA

### A. Merrimac and Nash violated FINRA Rules 8210 and 2010 by providing to FINRA documents that they knew had been falsified by a registered representative.

The NAC found that Merrimac and Nash violated Rules 8210 and 2010 because they responded to FINRA’s requests for information by producing falsified documents. FINRA Rule 8210 is the principal means by which FINRA obtains information from its member firms and

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<sup>5</sup> 15 U.S.C. § 78s(e)(1).

<sup>6</sup> *Robert Marcus Lane*, Exchange Act Release No. 74269, 2015 WL 627346, at \*5 (Feb. 13, 2015).

<sup>7</sup> 15 U.S.C. § 78s(e)(2). The record does not show, nor do Merrimac and Nash claim, that FINRA’s sanctions impose any unnecessary or inappropriate burden on competition. *Id.*

<sup>8</sup> *Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013).

<sup>9</sup> *PAZ Sec., Inc. v. SEC*, 494 F.3d 1059, 1065-66 (D.C. Cir. 2007).

<sup>10</sup> *See FINRA Sanction Guidelines* (2013).

<sup>11</sup> *See, e.g., John Joseph Plunkett*, Exchange Act Release No. 69766, 2013 WL 2898033, at \*11 & n.68 (June 14, 2013) (using the Guidelines as a benchmark but explaining they are not binding).

their associated persons.<sup>12</sup> It provides that FINRA may require a member or associated person “to provide information orally, in writing, or electronically” and may “inspect and copy the books, records and accounts of such member or person.”<sup>13</sup> FINRA Rule 2010 requires members and associated persons, in the conduct of their business, to “observe high standards of commercial honor and just and equitable principles of trade.”<sup>14</sup> As we have held repeatedly, the violation of another Commission or FINRA rule constitutes a violation of FINRA Rule 2010.<sup>15</sup> A member or associated person violates both Rules 8210 and 2010 by providing false or misleading information in response to a Rule 8210 request.<sup>16</sup>

FINRA addressed to Nash four Rule 8210 requests between 2010 and 2012 that are relevant here. Each request sought information about either transactions in certain penny stocks or certain customers who traded in penny stocks. The documents responsive to the requests included Deposit Securities Request (“DSR”) forms. DSR forms are customer questionnaires that elicit information about, among other things, the source of a penny stock deposited into customer accounts and its registration status under the Securities Act. Merrimac used the DSR forms to provide information to its clearing firm about the source of penny stocks deposited into customer accounts to determine the manner in which the stocks could be resold consistent with Section 5 of the Securities Act, and to provide supporting documentation. The DSR forms bore the signature of the CCO—Nash—certifying that he had undertaken supervisory review of the information about the stock. At least by the time of the last three requests, Nash knew a Merrimac registered representative had falsified his signature on certain DSR forms. These falsified forms were produced to FINRA. The NAC found that Merrimac and Nash violated Rules 8210 and 2010 because they responded to FINRA’s requests for information by producing “in excess of 30 falsified” documents on which Nash’s signature was falsified.

In *Thaddeus J. North*, we stated that, “absent unusual mitigating circumstances, when a CCO engages in wrongdoing, attempts to cover up wrongdoing, crosses a clearly established line, or fails meaningfully to implement compliance programs, policies, and procedures for

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<sup>12</sup> See, e.g., *Charles C. Fawcett, IV*, Exchange Act Release No. 56770, 2007 WL 3306105, at \*6 & n.29 (Nov. 8, 2007) (describing the purpose of Rule 8210).

<sup>13</sup> FINRA Rule 8210.

<sup>14</sup> FINRA Rule 2010; see also FINRA Rule 140(a) (providing that FINRA’s rules “shall apply to all members and persons associated with a member” and that “[p]ersons associated with a member shall have the same duties and obligations as a member under the Rules”).

<sup>15</sup> *William J. Murphy*, Exchange Act Release No. 69923, 2013 WL 3327752, at \*8 n.29 (July 2, 2013) (describing this as a “long-standing and judicially-recognized policy”).

<sup>16</sup> See, e.g., *Geoffrey Ortiz*, Exchange Act Release No. 58416, 2008 WL 3891311, at \*7 (Aug. 22, 2008).

which he or she has direct responsibility, we would expect liability to attach.”<sup>17</sup> The facts of this case establish that this is the situation here. Because the record establishes that Merrimac and Nash knew that DSR forms had been falsified at the time the firm and Nash responded to the Rule 8210 requests for information yet did not ensure that FINRA was informed that the DSR forms had been falsified, we sustain the finding of violation.<sup>18</sup>

### **1. Merrimac and Nash engaged in the conduct that FINRA found.**

FINRA directed to Nash requests for information about the firm’s penny stock activity on September 23, 2010; January 6, 2011; March 23, 2011; and December 20, 2012.<sup>19</sup> For each request, Nash supervised the collection, review, and production of responsive documents. In coordinating Merrimac’s response to the document requests, Nash directed other firm employees to collect the documents at issue. As Nash knew, DSR forms were responsive to the requests for documents related to Merrimac’s due diligence into the receipt and delivery of penny stocks into customer accounts. Nash emailed FINRA the production responsive to the September 2010 request himself and had another employee email the other productions. Nash confirmed at the hearing that even if “someone else collected the information in response to a [Rule] 8210 request, [he was] still ultimately responsible for the information in the response.”<sup>20</sup>

The DSR form required registered representatives to complete the form, sign it, attach supporting documentation, and submit it for review and approval by two supervisors, including the CCO. But for over six months, Merrimac registered representative Cecilia Schiffer falsified DSR forms by copying and pasting supervisors’ signatures—including Nash’s signature—onto DSR forms rather than submitting them for supervisory review.<sup>21</sup> Merrimac responded to the

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<sup>17</sup> Exchange Act Release No. 84500, 2018 WL 5433114, at \*9 (Oct. 29, 2018).

<sup>18</sup> *Cf. Johnson v. BAE Sys., Inc.*, 307 F.R.D. 220, 227 (D.D.C. 2013) (imposing sanctions where lawyer failed to satisfy his duties under Federal Rule of Civil Procedure 26(e) and (g) “to make a reasonable inquiry” or “to correct the prior production” when he found out that documents previously produced to the opposing party “were not authentic”).

<sup>19</sup> FINRA directed the last request to Nash, care of Merrimac’s outside counsel.

<sup>20</sup> Nash disputed that he was responsible for the production in response to the December 2012 request—even though it was addressed to him—on the ground that the firm’s president at the time was responsible for collecting and producing the responsive documents. We do not base our findings of liability on the documents produced in response to the December 2012 request.

<sup>21</sup> FINRA barred Schiffer from associating with a member firm after she failed to respond to requests for information under Rule 8210 that sought her testimony about the falsifications.

requests for information by producing 1 falsified DSR form in September 2010, 33 falsified forms in January 2011, 1 falsified form in March 2011, and 2 falsified forms in January 2013.<sup>22</sup>

The record establishes that Merrimac and Nash knew Schiffer had falsified DSR forms at least by the time they responded with forged documents to FINRA’s second request for information in January 2011. In his 2013 on-the-record (“OTR”) testimony, Pizzuti admitted that he and Nash learned of Schiffer’s falsifications at a meeting with her in September 2010, months before the falsified documents were submitted to FINRA. Nash admitted in his 2013 OTR testimony that “at the time that [he] made th[e] production in or around January of 2011, [he was] aware that the production” included falsified DSR forms. Because FINRA issued the first request in September 2010, and it is unclear exactly when in September 2010 the meeting with Schiffer at which Pizzuti and Nash learned of the falsifications occurred, we find that Merrimac and Nash knew DSR forms had been falsified *at the latest* by the time of Merrimac’s second document production in January 2011—yet did not ensure FINRA was informed that responsive documents had been falsified.<sup>23</sup>

We reject Merrimac and Nash’s claim that they were unaware of the falsifications until after the last request for information at issue. Although both attempted to recant their OTR testimony and later asserted that they did not learn of the falsified forms until 2013, the record corroborates their OTR testimony. Around the time of the September 2010 meeting, Schiffer’s falsifications ceased and the firm adopted a new penny stock policy specifying that a DSR form must be “signed by the registered representative, . . . reviewed and approved by the designated DSR processor reviewer and compliance[, and] . . . signed by compliance or corporate management before being forwarded to the clearing firm.” Previously, only the DSR form itself and not the firm’s policies and procedures specified that the form needed to be reviewed. The record does not support Pizzuti’s later suggestion that the timing of the firm’s adoption of this policy was a “coinciden[ce].” Merrimac concedes in its brief on appeal—signed by Pizzuti—that it adopted the new penny stock policy “based on both CS” (Schiffer’s initials) “and an expected ramp up in DSR business.”<sup>24</sup> The firm could not have implemented a policy in

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<sup>22</sup> The two forms produced in January 2013 in response to the December 2012 request were duplicates of falsified forms Merrimac produced in January 2011. We do not base liability on the forms produced in response to the December 2012 request. *See supra* note 20.

<sup>23</sup> We need not decide whether, assuming Nash learned of the falsifications in September 2010 shortly after the first document production and not before, Nash had to determine if the first production included falsified documents and, if so, inform FINRA of that fact. Because Nash learned of the falsifications at least by the time of the second document production, his failure to inform FINRA that subsequent document productions included falsified documents is sufficient to form the basis for his liability without regard to the first document production.

<sup>24</sup> Despite its concession, Merrimac objects that Pizzuti did not know about the full scope of Schiffer’s falsifications at the time. As discussed above, Pizzuti and Nash did not know about the full scope of Schiffer’s falsifications because they did not conduct an investigation after

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September 2010 “based on” falsifications that were purportedly not discovered until three years later.

In addition, as the NAC noted, it “defies logic” that neither Pizzuti nor Nash would have “remembered” in their respective February and March 2013 OTR testimony that they had only learned of the falsifications “in the previous three months.” As discussed above, we find that Merrimac and Nash knew that DSR forms had been falsified *at the latest* by the time Merrimac produced documents in response to FINRA’s second request in January 2011.

## **2. Merrimac and Nash’s conduct violated FINRA’s rules.**

Merrimac and Nash directly engaged in misconduct by producing falsified DSR forms to FINRA in violation of Rule 8210 and 2010.<sup>25</sup> We reject their claim that they should not be held liable because most of the DSR forms produced to FINRA were not falsified. The record establishes that numerous falsified forms were produced and that Merrimac and Nash knew at least by the January 2011 production that falsifications had occurred.

Merrimac also argues that (1) it “did not falsify or alter any documents” in the course of responding to the Rule 8210 requests; (2) the DSRs were “subject to supervisory review” because Nash reviewed the initial falsifications after they occurred “and acted swiftly to remedy the situation” by telling Schiffer not to do it again; (3) and certain DSRs “were never even cleared” with Merrimac’s clearing firm, “were duplicates” of others at issue, and were incorrectly dated as occurring in 2009. These arguments do not undermine our finding that Merrimac and Nash responded to requests for information about penny stock activity by producing at least 34 DSR forms that contained falsified signatures despite knowing that Schiffer had falsified signatures on DSR forms and not informing FINRA of that fact.<sup>26</sup>

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learning DSR forms had been falsified. In any case, the record supports a finding that the change occurred because Merrimac learned that Schiffer had falsified forms, even though the scope of her falsifications was not yet apparent due to the lack of an investigation.

<sup>25</sup> See, e.g., *Ortiz*, 2008 WL 3891311, at \*7 (providing false information to FINRA violates the precursor rules to FINRA Rules 8210 and 2010); *Murphy*, 2013 WL 3327752, at \*8 n.29 (violating another FINRA rule is a separate basis for violating Rule 2010).

<sup>26</sup> We address only those arguments developed with sufficient clarity. See *infra* note 158. Merrimac submitted a two-page reply brief purporting to incorporate by reference an additional 89 pages of pleadings before FINRA, stating that “nothing more . . . can be said or explained.” Our Rule of Practice 450(c) provides that “reply briefs shall not exceed 7,000 words, exclusive of” certain content not relevant here. 17 C.F.R. § 201.450(c). In addition, Rule 450(d) provides that “[a] reply brief that does not exceed 15 pages in length . . . is presumptively considered to” meet that word limit and therefore need not “include a certificate by the party’s representative . . . stating that the brief complies with” Rule 450’s requirements. *Id.* § 201.450(d). Merrimac

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Nash seeks to shift responsibility to others to whom he delegated the task of responding to FINRA's requests. We have said that the person to whom FINRA directs its Rule 8210 requests has the "duty to respond [personally] or supervise others diligently with adequate follow-up."<sup>27</sup> And Nash did not merely have his name on a transmittal letter. He acknowledged in his testimony that he was responsible for supervising the collection, review, and production of Merrimac's responses. Nash knew that the requests sought information about penny stock activity at Merrimac, knew that DSR forms had been falsified, and directed firm personnel to collect and produce responsive documents. Yet Nash failed to flag the issue for personnel working on responding to the requests or otherwise reasonably supervise them to ensure that FINRA would be notified that falsified documents were responsive to the requests and would be produced by Merrimac. Under the circumstances, Nash is properly held liable for providing false information to FINRA in response to the Rule 8210 requests.<sup>28</sup>

Nor is there merit to Nash's argument that he cannot be liable for violating Rule 8210 by producing documents that had been falsified because David Matthews, the firm's president, settled a charge that he violated Rule 3010 by failing to supervise customers' penny stock trading and related DSR forms. It is "well established that an administrative body may settle with one respondent while proceeding against other respondents in the same case."<sup>29</sup> Indeed, "more than one individual or firm can be responsible and thus held liable for the same violation."<sup>30</sup> In any case, the basis for Matthews's liability is separate from the basis for Nash's liability, and thus

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did not include such a certificate. We do not consider these pleadings because Merrimac did not move to exceed the page limitations. See *Jose Zollino*, Exchange Act Release No. 55107, 2007 WL 98919, at \*2 n.12 (Jan. 16, 2007). In any case, our Rule of Practice 450(c) provides that briefs may not incorporate other pleadings by reference. 17 C.F.R. § 201.450(c).

<sup>27</sup> *Richard J. Rouse*, Exchange Act Release No. 32658, 1993 WL 276149, at \*3 (July 19, 1993).

<sup>28</sup> See, e.g., *Michael David Borth*, Exchange Act Release No. 31602, 1992 WL 388741, at \*2 (Dec. 16, 1992) (stating that associated person's "attempt to shift his responsibility to others [does not] change his duty to provide the requested information"); accord *Markowski v. SEC*, 34 F.3d 99, 104 (2d Cir. 1994) (rejecting argument that firm's senior officer reasonably delegated Rule 8210 obligations to employee where officer was aware those obligations were not met).

<sup>29</sup> *Kabani & Co.*, Exchange Act Release No. 80201, 2017 WL 947229, at \*17 (Mar. 10, 2017), *petition denied*, 733 F. App'x. 918 (9th Cir. 2018) (mem. disp.).

<sup>30</sup> *Pac. On-Line Trading & Sec., Inc.*, Exchange Act Release No. 48473, 2003 WL 22110356, at \*6 (Sept. 10, 2003).

Matthews's settlement of his supervisory violation does not preclude Nash's liability under Rules 8210 and 2010 for his production of falsified DSR forms to FINRA.<sup>31</sup>

We recognize that CCOs may receive numerous requests for information from FINRA. Firms should ensure that their CCOs have sufficient time and resources to respond to the requests they receive while also performing their many other responsibilities. But any CCO must respond appropriately when he knows that information that may be responsive to a Rule 8210 request that he has received has been falsified by an associated person of the firm.

**3. FINRA's rules are, and were applied in a manner, consistent with the Exchange Act.**

Rule 8210 is consistent with the purposes of the Exchange Act because it "is essential to FINRA's ability to investigate possible misconduct by its members and associated persons."<sup>32</sup> Rule 2010 is consistent with the purposes of the Exchange Act because it reflects the mandate of Exchange Act Section 15(A)(b)(6) that FINRA adopt rules to promote just and equitable principles of trade.<sup>33</sup> Here, FINRA applied Rule 8210 and 2010 consistently with the Exchange Act's purposes because Merrimac and Nash's production of falsified documents without alerting FINRA to the falsifications hampered FINRA's ability to determine whether Merrimac's customers were transacting in penny stocks consistent with Securities Act Section 5.

**B. Sanctions.**

FINRA's Sanctions Guidelines for a failure to respond truthfully to requests for information recommend a fine between \$25,000 and \$50,000; suspending or, in egregious cases, expelling the firm; and barring the individual or suspending him in any or all capacities for up to two years.<sup>34</sup> The Guidelines also provide that a principal consideration is the "importance of the information requested as viewed from FINRA's perspective."<sup>35</sup> Here, the NAC fined Merrimac \$50,000, fined Nash \$25,000, and suspended Nash for one year in all principal capacities.

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<sup>31</sup> *See id.* (rejecting argument "that NASD's acceptance of a settlement with [other respondents] forecloses this proceeding" because "[s]ubsequent time periods are at issue here").

<sup>32</sup> *Michael Nicholas Romano*, Exchange Act Release No. 76011, 2015 WL 5693099, at \*5 (Sept. 29, 2015).

<sup>33</sup> *Fuad Ahmed*, Exchange Act Release No. 81759, 2017 WL 4335036, at \*17 (Sept. 28, 2017); 15 U.S.C. § 78o-3(b)(6).

<sup>34</sup> *See FINRA Sanction Guidelines* at 33.

<sup>35</sup> *Id.*

These sanctions are within the guidelines. The falsified documents concerned important information because they pertained to the firm's processing of penny stock deposits and its due diligence for determining the manner in which the stocks could be resold consistent with Section 5 of the Securities Act.<sup>36</sup> By including falsified documents in the production without alerting FINRA, Merrimac and Nash falsely portrayed their supervision of penny stock deposits. As Merrimac and Nash do not challenge the sanctions imposed, they identify no pertinent mitigating factors or dispute that the sanctions are remedial. Under the circumstances, we find that the sanctions the NAC imposed for these violations were neither excessive nor oppressive.

## II. UNREGISTERED SALE OF SECURITIES NOT SUBJECT TO AN EXEMPTION

### A. Merrimac violated FINRA Rule 2010 by engaging in the unregistered offer and sale of securities not subject to an exemption in violation of Securities Act Section 5.

Securities Act Section 5(a) prohibits the sale of securities through use of the mails or interstate commerce unless a registration statement is in effect with respect to the transaction or an exemption from registration is available.<sup>37</sup> The purpose of the registration requirements is to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions."<sup>38</sup> "This policy . . . is equally applicable to the distribution of a new issue and to a redistribution of outstanding securities which 'takes on the characteristics of a new offering by reason of the control of the issuer possessed by those responsible for the offering.'"<sup>39</sup>

A broker violates Rule 2010, which prohibits conduct inconsistent with just and equitable principles of trade, by engaging in the unregistered offer and sale of securities without an exemption from registration in violation of Section 5.<sup>40</sup> FINRA establishes a *prima facie* case of a Section 5 violation by showing that (1) Merrimac directly or indirectly sold or offered to sell securities; (2) through the use of interstate commerce; (3) when no registration statement was

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<sup>36</sup> See *Midas Sec., LLC*, Exchange Act Release No. 66200, 2012 WL 169138, at \*15 (Jan. 20, 2012) (stressing, in connection with a broker who allowed its customer to use his "account to liquidate large blocks of penny stocks without questioning his activities," that brokers have the responsibility "to prevent their firms from being used as conduits for illegal distributions").

<sup>37</sup> 15 U.S.C. § 77e(a).

<sup>38</sup> *SEC v. Ralston Purina*, 346 U.S. 119, 124 (1953).

<sup>39</sup> *World Trade Fin.*, Exchange Act Release No. 66114, 2012 WL 32121, at \*7 (Jan. 6, 2012) (quoting *Ira Haupt & Co.*, Exchange Act Release No. 3845, 23 SEC 589, 1946 WL 24150, at \*5 (Aug. 20, 1946)), *petition denied*, 739 F.3d 1243 (9th Cir. 2014).

<sup>40</sup> See, e.g., *KCD Fin. Inc.*, Exchange Act Release No. 80340, 2017 WL 1163328, at \*4 (Mar. 29, 2017) (collecting authorities).

filed or in effect.<sup>41</sup> Once FINRA establishes a *prima facie* case, Merrimac must prove that it is entitled to an exemption from the registration requirements.<sup>42</sup> The NAC found that Merrimac violated Rule 2010 by facilitating the unregistered sale of 56.5 million shares of a penny stock without an available exemption in violation of Section 5. We agree because FINRA established a *prima facie* case of a Section 5 violation, and Merrimac has not proven that the transaction was exempt under either Securities Act Section 4(a)(1) or Securities Act Section 4(a)(4).<sup>43</sup>

### **1. Merrimac engaged in the conduct that FINRA found.**

The unregistered transaction at issue involved the acquisition and resale by Merrimac’s customer Acadia LLC (“Acadia”) of 56.5 million shares of United States Oil & Gas, Inc. (“USOG”), a penny stock. Acadia acquired the USOG shares from Jeff Turnbull, who sold his company Turnbull Oil to USOG in May 2009 in exchange for cash and a promissory note. Turnbull Oil became USOG’s wholly owned subsidiary, and Turnbull remained as Turnbull Oil’s president and a member of its board of directors pursuant to an employment agreement. USOG later issued Turnbull a convertible note authorizing the conversion of up to \$250,000 of the note into 500 million USOG shares. As reported on a Form 8-K in October 2010, Turnbull exercised his conversion rights with respect to all 500 million shares “from time to time from July 9, 2010 to August 31, 2010.” Acadia bought 100 million shares from Turnbull on July 15 for \$50,000, and deposited 56.5 million shares into its Merrimac account on August 9. Less than two months later—between October 1 and October 8—Acadia sold this stock to the public.<sup>44</sup>

Merrimac used a DSR form to process the sale. The form indicated that Acadia acquired the stock from Turnbull, stated that Turnbull was not an affiliate or 10% holder of USOG, and included a letter from USOG’s President attesting as much. It stated that a Form S-1 registration statement was in effect for the sale. It also stated that the sale was subject to an unspecified

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<sup>41</sup> *SEC v. Big Apple Consulting USA, Inc.*, 783 F.3d 786, 806-807 (11th Cir. 2015).

<sup>42</sup> *Id.* at 807.

<sup>43</sup> *See* 15 U.S.C. § 77d(a)(1), (a)(4); 17 C.F.R. § 230.144. While the Section 4(a)(1) and 4(a)(4) exemptions were codified at Securities Act Section 4(1) and 4(4) respectively at the time of Merrimac’s conduct, the JOBS Act redesignated them in 2012. *See* Jumpstart Our Business Startups Act, Pub. L. No. 112-106, §§ 201(b)(1), (c)(1), 126 Stat. 306, 314 (2012).

<sup>44</sup> We later suspended trading in USOG pursuant to Exchange Act Section 12(k) because of questions “concerning the adequacy and accuracy of press releases concerning the company’s operations and stock promoting activity.” *Am. Pac. Rim Commerce Grp. et al.*, Exchange Act Release No. 64612, 2011 WL 2207548, at \*2 (June 7, 2011).

exemption from registration and that the securities were “free trading.”<sup>45</sup> In fact, no registration statement had been filed or was in effect with respect to the shares Turnbull sold to Acadia.

## **2. Merrimac’s conduct violated the rules that FINRA found it to have violated.**

FINRA established a *prima facie* violation of Securities Act Section 5 by showing that Merrimac facilitated the sale of USOG shares in its customer’s account, by means of interstate commerce, while no registration statement was in effect as to the sale. Merrimac appears to contend that the sale was exempt from registration under Sections 4(a)(1) or 4(a)(4) of the Securities Act.<sup>46</sup> Such exemptions “are construed strictly to promote full disclosure of information for the protection of the investing public.”<sup>47</sup>

### **a. Section 4(a)(1)**

Merrimac argues that the sales at issue were exempt from registration pursuant to the Securities Act Section 4(a)(1) exemption for “transactions by any person other than an issuer, underwriter, or dealer.”<sup>48</sup> We reject that argument because Merrimac has failed to demonstrate that its customer was not an underwriter under the facts and circumstances of this case.

Securities Act Section 4(a)(1) “is intended to exempt routine trading transactions between individual investors with respect to securities already issued and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions.”<sup>49</sup> An

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<sup>45</sup> This term is not defined in the Securities Act or our rules, and the meaning is subject to varied interpretations. In common parlance, it has been used to refer to shares that may be resold pursuant to the exemption from registration in Securities Act Section 4(a)(1); however, it also has been used at times to refer either to shares that lack restrictive legends or shares that were purchased in a registered offering. As a result, any representation that securities are “free trading” or “freely tradeable,” on its own, cannot provide a sufficient basis for a broker to conclude that the securities may be resold without registration under the Securities Act. *See, e.g., Charles F. Kirby*, Exchange Act Release No. 47149, 2003 WL 71681, at \*5 n.34 (Jan. 9, 2003) (holding “that a securities professional cannot rely on the determination of a transfer agent that stock is free trading”), *petition denied sub nom., Geiger v. SEC*, 363 F.3d 481 (D.C. Cir. 2004).

<sup>46</sup> Although Merrimac’s brief does not identify Section 4(a)(4) explicitly, the structure of its argument suggests that it is relying on both exemptions.

<sup>47</sup> *SEC v. Cavanagh*, 445 F.3d 105, 115 (2d Cir. 2006).

<sup>48</sup> 15 U.S.C. § 77d(a)(1).

<sup>49</sup> *Rodney Schoemann*, Securities Act Release No. 9076, 2009 WL 3413043, at \*7 (Oct. 23, 2009), *aff’d*, 398 F. App’x 603 (D.C. Cir. 2010).

“underwriter” includes one “who has purchased from an issuer with a view to . . . the distribution of any security, or participates or has direct or indirect participation in any such undertaking.”<sup>50</sup> The Commission has promulgated Securities Act Rule 144, which creates a non-exclusive safe harbor by identifying certain conditions under which a person will be deemed not to be an “underwriter” for purposes of Section 4(a)(1).<sup>51</sup> In order to rely on the Rule 144 safe harbor, a non-affiliate who acquires restricted securities from an affiliate must, among other requirements, hold the security for at least six months to not be deemed an “underwriter.”<sup>52</sup>

The sales Merrimac effected for Acadia were not eligible for the Rule 144 safe harbor because Turnbull was an “affiliate” of USOG; as a result, the USOG stock, which Acadia held for only about two months, was restricted because Acadia acquired it directly from Turnbull in a transaction not involving any public offering.<sup>53</sup> Rule 144 defines an “affiliate” as “a person that directly, or indirectly . . . controls, or is controlled by, or is under common control with [the] issuer.”<sup>54</sup> Although Rule 144 does not define “control,” Rule 405 of Regulation C, which contains an identical definition of “affiliate,” does;<sup>55</sup> we therefore look to Rule 405.<sup>56</sup> Rule 405 defines “control” as “the possession, direct or indirect, of the power to direct or cause the direction of the management and policies of a person, whether through the ownership of voting

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<sup>50</sup> 15 U.S.C. § 77b(a)(11). We find, and it is undisputed, that USOG is an “issuer.” *See* 15 U.S.C. § 77b(a)(4). For purposes of the definition of the term “underwriter” in 15 U.S.C. § 77b(a)(11), an “issuer” also includes “any person directly or indirectly controlling or controlled by the issuer, or any person under direct or indirect common control with the issuer.”

<sup>51</sup> *See* Preliminary Note to Rule 144, 17 C.F.R. § 230.144.

<sup>52</sup> *See id.* § 230.144(a)(3)(i), (b)(1)(i), (d)(1)(i). Merrimac does not appear to argue that the sale would still be exempt under Section 4(a)(1) if the Rule 144 safe harbor is not available. We have said that “individuals who do not comply with the Rule 144 safe harbor face a substantial burden in establishing the availability of an exemption from registration.” *Schoemann*, 2009 WL 3413043, at \*7 n.19 (citing *Notice of Adoption of Rule 144*, Securities Act Release No. 5223, 1972 WL 121583, at \*2 (Jan. 11, 1972)); *see also Cavanagh*, 445 F.3d at 113 (stating that the Commission’s adopting release to Rule 144 “establishes a presumption that those not covered by [Rule 144] are likewise outside Section [4(a)(1)]”).

<sup>53</sup> *See* 17 C.F.R. § 230.144(a)(3)(i).

<sup>54</sup> 17 C.F.R. § 230.144(a)(1).

<sup>55</sup> *See* 17 C.F.R. § 230.405.

<sup>56</sup> *See SEC v. Kern*, 425 F.3d 143, 149 (2d Cir. 2005) (referencing Rule 405’s definition of control in assessing affiliate status under Rule 144).

securities, by contract, or otherwise.”<sup>57</sup> Although indicia of control may include a person’s status as an officer, director or large shareholder, the determination of whether control exists is “a question of fact which depends upon the totality of the circumstances including an appraisal of the influence upon management and policies of a corporation by the person involved.”<sup>58</sup> “A person may be in control even though he does not own a majority of the voting stock.”<sup>59</sup>

We find that Turnbull controlled USOG and was its affiliate under the facts and circumstances of this case, including because Turnbull beneficially owned a third of its outstanding shares, had discretion over the proceeds of one of its two revenue-generating subsidiaries and thus influence over USOG’s management and policies, and was described by USOG as one of its “officers.” As to Turnbull’s beneficial ownership of USOG stock, the terms of the convertible note issued to Turnbull by USOG gave Turnbull a right, not limited to any period of time, “to convert up to a total of \$250,000 [of the note] . . . from time to time, into up to an aggregate of 500 million shares.” Under Exchange Act Rule 13d-3, a “beneficial owner of a security” includes a person who “has the right . . . within sixty days” to acquire such securities, including “through the conversion of a security.”<sup>60</sup> Turnbull therefore became the beneficial owner of 33% of USOG’s outstanding common stock upon issuance of the convertible note.<sup>61</sup>

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<sup>57</sup> 17 C.F.R. § 230.405.

<sup>58</sup> *United States v. Corr*, 543 F.2d 1042, 1050 (2d Cir. 1976); *accord SEC v. Platforms Wireless Int’l Corp.*, 617 F.3d 1072, 1087 (9th Cir. 2010); *Schoemann*, 2009 WL 3413043, at \*7.

<sup>59</sup> *Corr*, 543 F.2d at 1050; *Schoemann*, 2009 WL 3413043, at \*7; *see also, e.g., Platforms Wireless Int’l Corp.*, 617 F.3d at 1087 (“[I]t is not necessary that one be an officer, director, manager, or even shareholder to be a controlling person.”) (quoting *Pennaluna & Co. v. SEC*, 410 F.2d 861, 866 (9th Cir. 1969)); *cf. Cavanagh*, 445 F.3d at 113 n.19 (“Although there is no bright-line rule declaring how much stock ownership constitutes ‘control’ and makes one an ‘affiliate’ under Section 4(1), some commentators have suggested that ownership of something between ten and twenty percent is enough, especially if other factors suggest actual control.”).

<sup>60</sup> 17 C.F.R. § 240.13d-3(d)(1)(i). As the parties do not address convertible securities held by third parties, neither do we. *See id.* (“Any securities not outstanding which are subject to such . . . conversion privileges shall be deemed to be outstanding for the purposes of computing the percentage of outstanding securities of the class owned by such person but shall not be deemed to be outstanding for the purpose of computing the percentage of the class by any other person.”); *cf. infra* note 154 (describing waiver of arguments before the Commission).

<sup>61</sup> Our calculations reflect that USOG issued new shares upon conversion. The Hearing Panel, the NAC, and the parties all incorrectly calculate Turnbull as having been eligible to convert 38% of USOG’s shares overall. This is based on an assumption that Turnbull received outstanding shares, but USOG’s Commission filings indicate otherwise.

Merrimac’s arguments focus on whether Turnbull held 10% of USOG’s outstanding shares. Relying on stock purchase agreements and account statements outside the appellate record, Merrimac contends that Turnbull structured his conversions “so as not to pass the 10% threshold to become an affiliate.” FINRA asks us to ignore this evidence because it is not part of the record, Merrimac has not moved to adduce it, and Merrimac has not demonstrated why it did not do so earlier. Although we have determined to strike this evidence,<sup>62</sup> even were we to accept it, we would still find under all the facts and circumstances that Turnbull’s ownership of USOG suggests that he was its affiliate. This is because Merrimac’s evidence establishes that, although Turnbull structured his transactions so that he would not *hold* more than 10% of USOG’s shares, he still *beneficially owned* at least 13% of USOG’s outstanding shares immediately before Acadia purchased the shares.

Between the time Turnbull received the convertible note and his sale to Acadia, Turnbull sold 300 million shares that he received upon conversions of portions of the note. Merrimac’s own evidence indicates that as a result of those conversions and sales, Turnbull’s beneficial ownership of USOG stock decreased from 33% to 13% immediately prior to the time Acadia purchased its shares from him. Turnbull’s beneficial ownership of at least 13% of USOG’s outstanding shares was not an insignificant amount.<sup>63</sup> Merrimac ignores the shares that Turnbull beneficially held. Merrimac also ignores that Turnbull beneficially owned 33% of the shares before he started selling the shares into the market. Under the USOG capital structure and facts and circumstances prevailing at the time, Turnbull’s beneficial ownership of USOG’s outstanding common stock is one factor supporting a finding that he controlled USOG.

Another factor relevant to the determination of a person’s status as an affiliate is that Turnbull’s leverage over one of USOG’s two sources of revenue gave him significant influence over USOG’s management and policies. As reflected in USOG’s Form 10 registration statement dated June 25, 2010, USOG recorded no revenues before acquiring Turnbull Oil; Turnbull had sole discretion over the proceeds from Turnbull Oil operations until USOG repaid the note; and “[i]mitations on [USOG’s] ability to receive funds from [its] operating subsidiaries are primarily a function of [its] ability to retire” its notes for the acquisition of those subsidiaries. USOG also reported that its \$3.75 million promissory note to Turnbull made up almost three quarters of its current liabilities as of December 31, 2009; repaying the notes for its acquisitions of Turnbull Oil and the only other operating subsidiary were a “top priority”; Turnbull had the right to repurchase Turnbull Oil if USOG defaulted; and first among its listed risk factors was the risk of

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<sup>62</sup> See *infra* text accompanying notes 172-173.

<sup>63</sup> See, e.g., *SEC v. Culpepper*, 270 F.2d 241, 246 (2d Cir. 1959) (members of control group that together held more than 43% of common stock were held to be “under direct or indirect common control with the issuer” even though individual members “owned only 1½ % of the issue[]”); see also, e.g., *Midas Sec. LLC*, Exchange Act Release No. 66200, 2012 WL 169138, at \*9 (Jan. 20, 2012) (noting that an “ownership interest” in 12.5% of outstanding shares coupled with “coordinated sales of a large block” of shares are “strong indicia” of control status).

being “forced to return” Turnbull Oil to Turnbull if it were to default on the note. We take official notice that USOG eventually defaulted, and Turnbull repurchased Turnbull Oil.

Finally, in Commission filings USOG held Turnbull out as one of its officers and key employees. After acquiring Turnbull Oil as a wholly-owned subsidiary, USOG continued to employ Turnbull as president and member of the board of directors of Turnbull Oil. Various filings listed him as holding those roles with Turnbull Oil, and some also identified him as one of USOG’s “officers.”<sup>64</sup> USOG’s Form 10 registration statement, dated June 25, 2010, likewise described him as a USOG “officer” and “affiliate[.]” Under all the facts and circumstances surrounding Turnbull’s relationship with USOG, we find that he controlled USOG and met the definition of an affiliate. Because Acadia did not meet the Rule 144 holding period for the stock it purchased from an affiliate, the Rule 144 safe harbor was not available.

#### **b. Section 4(a)(4)**

Merrimac also argues that it is entitled to the exemption under Securities Act Section 4(a)(4) for “brokers’ transactions executed upon customers’ orders on any exchange or in the over-the-counter market but not the solicitation of such orders.”<sup>65</sup> To rely on the Section 4(a)(4) exemption, a broker-dealer must conduct a “reasonable inquiry” into the facts surrounding a proposed unregistered sale of securities before selling the securities.<sup>66</sup> A broker-dealer “‘must make whatever inquiries are necessary under the circumstances to determine that the transaction is . . . not part of an unlawful distribution.’”<sup>67</sup> “The amount of inquiry called for necessarily varies with the circumstances of particular cases.”<sup>68</sup> Merrimac cites several factors that it

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<sup>64</sup> *Cf. Platforms Wireless Int’l*, 617 F.3d at 1088 (defendant’s “position as a top-ranking officer of [the company] with the explicit power to direct the specific share transfers at issue establishes control resting on [defendant’s] title and role in the company”).

<sup>65</sup> 15 U.S.C. § 77d(a)(4). The exemption only applies to the broker’s part of a transaction and does not extend to the customer, who would need to have her own exemption. *See Rule 154*, Securities Act Release No. 4818, 1966 WL 85228, at \*2 (Jan. 21, 1966). At any rate, even if the focus was only on Merrimac’s part of the transaction, as we describe below, the Section 4(a)(4) exemption was unavailable.

<sup>66</sup> *World Trade Fin. Corp. v. SEC*, 739 F.3d 1243, 1248 (9th Cir. 2014) (“[A] broker is not merely an ‘order taker,’ and must conduct a reasonable inquiry into the circumstances surrounding the transaction before the broker may claim the protection of the . . . exemption.”); *accord Wonsover v. SEC*, 205 F.3d 408, 415 (D.C. Cir. 2000); *Midas*, 2012 WL 169138, at \*11.

<sup>67</sup> *World Trade Fin. Corp.*, 739 F.3d at 1249 (quoting *Robert G. Leigh*, Exchange Act Release No. 27667, 1990 WL 1104369, at \*4 (Feb. 1, 1990)).

<sup>68</sup> *Wonsover*, 205 F.3d at 415 (quoting *Distribution by Broker-Dealers of Unregistered Securities*, Exchange Act Release No. 6721, 1962 WL 69442, at \*2 (Feb. 2, 1962)).

believes demonstrate it engaged in the appropriate inquiry, but we disagree based on the facts and circumstances of this case.

We have long held that the Section 4(a)(4) exemption “is not available when the broker knows or has reasonable ground[s] to believe that his customer is an underwriter since in that event the broker likewise violates Section 5 by participating in a non-exempt transaction.”<sup>69</sup> Thus, when a broker-dealer uncovers facts that may be indicative of a distribution or resale that goes beyond a typical secondary market transaction, additional inquiry is warranted in order for the broker-dealer to rely on the Section 4(a)(4) exemption. In 1962, in a release entitled *Distribution by Broker-Dealers of Unregistered Securities*, we explained that a “searching inquiry is called for” when a broker-dealer encounters red flags, such as being

offered a substantial block of a little-known security, either by persons who appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters.

The problem becomes particularly acute where substantial amounts of a previously little known security appear in the trading markets within a fairly short period of time and without the benefit of registration under the Securities Act of 1933. In such situations, it must be assumed that these securities emanate from the issuer or from persons controlling the issuer, unless some other source is known . . . .<sup>70</sup>

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<sup>69</sup> *Ronald S. Bloomfield*, Securities Act Release No. 9553, 2014 WL 768828, at \*7 (Feb. 27, 2014), *petition denied in relevant part*, 649 F. App’x 546 (9th Cir. 2016); *accord John A. Carley*, Exchange Act Release No. 57246, 2008 WL 268598, at \*8 & n.40 (Jan. 31, 2008), *petition denied in relevant part sub nom. Zacharias v. SEC*, 569 F.2d 458 (D.C. Cir. 2009); *see also, e.g., Wonsover*, 205 F.3d at 415 (stating that a broker may claim the Section 4(a)(4) exemption if the broker “[a]fter reasonable inquiry is not aware of circumstances indicating that the person for whose account the securities are sold is an underwriter with respect to the securities or that the transaction is part of a distribution of securities of the issuer”).

<sup>70</sup> *Distribution by Broker-Dealers of Unregistered Securities*, 1962 WL 69442, at \*1-2; *accord* Section 21(a) Report, *Transactions in the Securities of Laser Arms Corp. by Certain Broker-Dealers*, Exchange Act Release No. 28878, 1991 WL 292009, at \*12 (Feb. 14, 1991) (describing this as “the duty of broker-dealers to take precautions”); *see also World Trade Fin.*, 739 F.3d at 1248 (endorsing this standard); *Geiger v. SEC*, 363 F.3d 481, 485 (D.C. Cir. 2004) (same); *Kane v. SEC*, 842 F.2d 194, 199 (8th Cir. 1988) (same). *See generally ACAP Fin., Inc.*, Exchange Act Release No. 70046, 2013 WL 3864512, at \*10 (July 26, 2013) (reiterating standard), *petition denied*, 783 F.3d 763 (10th Cir. 2015); *Midas*, 2012 WL 169138, at \*8 (same).

In light of red flags that Acadia’s transaction involved a distribution by an underwriter, Merrimac failed to conduct the required “searching inquiry.”<sup>71</sup> The transaction involved a substantial block of a little-known security: Acadia deposited 56.5 million shares of a low-priced stock in a single transaction.<sup>72</sup> Less than two months later, it directed Merrimac to sell the stock in the secondary market.<sup>73</sup> Merrimac also sent to its clearing firm a DSR form and stock purchase agreement that identified Turnbull as the source of the shares, even though USOG’s Commission filings identified Turnbull as one of USOG’s “officers.” In addition, the DSR form and stock purchase agreement were inconsistent—the stock purchase agreement specified that no registration statement was in effect and that the shares were exempt from registration under Regulation D,<sup>74</sup> but the DSR form stated erroneously that the shares were registered under a Form S-1 registration statement *and* that the transaction was “exempt from SEC registration” because the shares were “free trading.” In light of the inconsistencies in the forms—both the wholly inconsistent information in the DSR form itself and the inconsistencies between the DSR form and the stock purchase agreement—Merrimac was required to conduct a searching inquiry to determine that Acadia’s proposed sales were exempt from registration and not part of an unlawful distribution.<sup>75</sup> The record reflects that it did not do so.<sup>76</sup>

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<sup>71</sup> *Geiger*, 363 F.3d at 485; *Wonsover v. SEC*, 205 F.3d 408, 415 (D.C. Cir. 2001).

<sup>72</sup> *See Michael A. Niebuhr*, Exchange Act Release No. 36620, 1995 WL 757803, at \*4 (Dec. 21, 1995) (sale of 235,000 shares was a “substantial amount” and gave rise to a duty of searching inquiry); *cf. Quinn & Co. v. SEC*, 452 F.2d 943, 946 (10th Cir. 1971) (resale of 25,000 shares “constituted a public distribution”). The 56.5 million shares constituted slightly less than 4% of USOG’s outstanding shares at the time. There is no requirement that the number of shares sold be some percentage of those outstanding to constitute a “distribution.” *See Geiger*, 363 F.3d at 484 (rejecting argument that “a sale qualifies as a ‘distribution’ only if it involves a ‘substantial’ or ‘significant’ percentage of the issuer’s outstanding shares”).

<sup>73</sup> *See Jacob Wonsover*, Exchange Act Release No. 41123, 1999 WL 100935, at \*6 n.25 (Mar. 1, 1999) (“A distribution within a relatively short period after acquisition is evidence of an original intent to distribute.”), *petition denied*, 205 F.3d 408 (D.C. Cir. 2000); *see also, e.g., Big Apple Consulting USA*, 783 F.3d at 807-08 (six months).

<sup>74</sup> Merrimac does not argue that the sale was exempt from registration under Regulation D.

<sup>75</sup> *Midas Sec.*, 2012 WL 169138, at \*8 (citing *Niebuhr*, 1995 WL 757803, at \*4).

<sup>76</sup> The Division of Trading and Markets has provided responses to frequently asked questions concerning a broker’s ability to rely on the Section 4(a)(4) exemption “if a situation raises red flags” and the “additional steps a broker dealer [should] take in response to red flags.” Division of Trading and Markets, *Responses to Frequently Asked Questions about a Broker-Dealer’s Duties When Relying on the Securities Act Section 4(a)(4) Exemption to Execute Customer Orders* (Oct. 9, 2014), <https://www.sec.gov/divisions/marketreg/faq-broker-dealer-duty-section4.htm>. As we have previously observed, “expressions of views offered to the public  
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Instead of arguing that it engaged in a searching inquiry, Merrimac cites three factors that it suggests could have supported a conclusion that its customer was not an underwriter: (1) the absence of a restrictive legend on the stock certificate; (2) an account statement from Merrimac's clearing firm listing USOG stock as unrestricted; and (3) a letter from USOG asserting that Turnbull was not an affiliate. These three factors do not establish that Merrimac conducted the required searching inquiry. Indeed, courts have held that these are the type of facts that do not satisfy a broker's duty of inquiry when faced with a substantial block of a little-known security and other red flags of a distribution.<sup>77</sup> In light of the "indicia of an illegal distribution," described above, Merrimac "cannot claim that its sales of a security were exempt from registration simply because the stock certificates lack[ed] a restrictive legend or [because its] clearing firm or transfer agent raise[d] no objections to the sales."<sup>78</sup>

As for the letter from USOG, Merrimac took no steps to inquire into whether the facts supported USOG's assertion.<sup>79</sup> Had it done so, it would have learned that in various Commission filings USOG identified Turnbull as one of its "officers." A broker-dealer does not satisfy its duty of inquiry "merely [by] accept[ing] 'self-serving statements of his sellers and their counsel without reasonably exploring the possibility of contrary facts.'"<sup>80</sup> Merrimac did not

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by the Commission's staff . . . do not necessarily reflect the views of the Commission [and] do not have the force of law." *Allen Douglas Sec., Inc.*, Exchange Act Release No. 50513, 2004 WL 2297414, at \*4 n.31 (Oct. 12, 2004) (quotation marks omitted).

<sup>77</sup> *Geiger*, 363 F.3d at 485 (absence of restrictive legend not sufficient); *Wonsover*, 205 F.3d at 415 (stating that "[p]recedent will not suffer Wonsover's argument that he justifiably relied on the clearance of sales by the [restricted stock department or] the transfer agent"); *Kane*, 842 F.2d at 200 ("Under the circumstances, we think that Kane's reliance on the self-serving statements of his seller without reasonably exploring the possibility of contrary facts demonstrates behavior that does not comply with the [Securities] Act.").

<sup>78</sup> *ACAP Fin.*, 2013 WL 3864512, at \*10 (collecting authority); *see also Midas*, 2012 WL 169138, at \*10 (stating "it is well established that the clearance of sales by a transfer agent and clearing firm does not relieve a broker of its obligation to investigate" in these circumstances).

<sup>79</sup> *Cf. Charles F. Kirby*, Securities Act Release No. 8174, 2003 WL 71681, at \*5 (Jan. 9, 2003) (broker who did not try to obtain the issuer's "most recent annual or quarterly reports" did not, under the circumstances, engage in a "searching inquiry").

<sup>80</sup> *Distribution by Broker-Dealers of Unregistered Securities*, 1962 WL 69442, at \*1 (quoting *SEC v. Culpepper*, 270 F.2d 241, 251 (2d Cir. 1959)); *see also World Trade Fin.*, 739 F.3d at 1249 ("[B]rokers rely on third-parties at their own peril, and will not avoid liability through that reliance when the duty of reasonable inquiry rests with the brokers."); *G.C. George Secs., Inc.*, Exchange Act Release No. 20627, 1984 WL 50377, at \*2 & n.6 (Feb. 7, 1984) (finding that respondent did not conduct a searching inquiry because he "admitted that he never

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conduct the required searching inquiry into whether Acadia acted as an underwriter and has not established that the Section 4(a)(4) exemption applies.<sup>81</sup>

**3. FINRA’s rules are, and were applied in a manner, consistent with the Exchange Act.**

Merrimac’s unregistered sale of securities without an exemption from registration, in violation of Securities Act Section 5, violated Rule 2010 because that misconduct was inconsistent with just and equitable principles of trade.<sup>82</sup> We therefore find that Rule 2010 is, and was applied in a manner, consistent with the purposes of the Exchange Act.<sup>83</sup>

**B. Sanctions.**

FINRA’s Sanction Guidelines recommend a fine between \$2,500 and \$50,000 for unregistered sales in violation of Section 5.<sup>84</sup> The Guidelines also identify certain principal considerations for imposing sanctions for such violations, including (1) any attempted compliance with an exemption, (2) the share volume and dollar amount of the transaction, (3) the implementation of reasonable procedures to ensure no participation in an unregistered sale, and (4) the disregard of red flags suggesting the presence of an unregistered sale.<sup>85</sup> The NAC fined

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inquired as to the status of any mining securities beyond the [issuer’s] secretary or transfer agent” and rejecting reliance on assurances from the seller and on a letter from “one of the issuers stating that all . . . transactions by . . . [seller] involve free and tradeable stocks” because “no basis for [the] opinion was set forth” and “in view of its self-serving nature, any reliance on the letter was clearly misplaced”) (internal quotation marks omitted).

<sup>81</sup> See *Midas*, 2012 WL 169138, at \*9-10 (stating that a broker ““must make whatever inquiries are necessary under the circumstances to determine that the transaction is . . . not part of an unlawful distribution”” and at the least must question the customer upon the customer’s “request to sell a large block of an obscure stock without registration”) (quoting *Leigh*, 1990 WL 1104369, at \*4, and citing *Benjamin Werner*, Exchange Act Release No. 9422, 1971 WL 120510, at \*2 n.5 (Dec. 17, 1971) (noting broker’s obligation to question his customer to obtain facts reasonably sufficient to indicate whether the customer is engaged in a distribution)).

<sup>82</sup> *KCD Fin.*, 2017 WL 1163328, at \*9 (finding that FINRA Rule 2010 is, and was applied in a manner, consistent with the purposes of the Exchange Act because the unregistered sale of securities without the benefit of an exemption from registration, in violation of Securities Act Section 5, is inconsistent with just and equitable principles of trade).

<sup>83</sup> See *id.*

<sup>84</sup> *FINRA Sanction Guidelines* at 24.

<sup>85</sup> *Id.*

Merrimac \$50,000 for violating Rule 2010 by engaging in the unregistered offer and sale of securities, without an exemption from registration, in violation of Securities Act Section 5.

This fine is within the guidelines, and the principal considerations all support it. First, we find that Merrimac did not attempt compliance with any exemption. As to the Rule 144 safe harbor and Section 4(a)(1), there is no indication that Merrimac did anything other than rely on the issuer's assertion that Turnbull was not an affiliate. And as to a possible exemption under Section 4(a)(4), Merrimac ignored the longstanding requirement that a broker-dealer engage in a searching inquiry to determine whether the transaction involves an underwriter when faced with red flags such as those presented in this case. Second, the sale at issue involved over 56 million shares and generated about \$124,000 in gross proceeds for Acadia and more than \$5,500 in gross commissions for Merrimac. Third, Merrimac failed to implement supervisory procedures with respect to this transaction because the DSR form was internally inconsistent, contained falsified supervisory signatures, and was neither reviewed nor investigated by any compliance or supervisory personnel. Finally, Merrimac disregarded a number of red flags suggesting that the transaction involved an unregistered distribution. As Merrimac does not challenge the sanctions imposed, it identifies no pertinent mitigating factors or dispute that the fine is remedial. Under the circumstances, we find that the fine the NAC imposed was neither excessive nor oppressive.

### III. ANTI-MONEY LAUNDERING

#### A. Merrimac violated FINRA Rules 3310 and 2010 and NASD Rule 3011 by failing to establish and implement a reasonable AML program.

“FINRA Rule 3310 and NASD Rule 3011 set forth minimum standards for a FINRA member firm's AML compliance program.”<sup>86</sup> The rules provide that “[e]ach member shall develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the Bank Secrecy Act [(“BSA”)<sup>87</sup>] (31 U.S.C. 5311, *et seq.*), and the implementing regulations promulgated thereunder by the Department of the Treasury.”<sup>88</sup> These rules also require member firms to “establish and

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<sup>86</sup> *Lek Sec. Corp.*, Exchange Act Release No. 82981, 2018 WL 1602630, at \*4 (Apr. 2, 2018).

<sup>87</sup> *See* Currency and Financial Transactions Reporting Act of 1970, Pub. L. No. 91-508, 84 Stat. 1114 (1970) (codified at 31 U.S.C. §§ 5311 *et seq.*), as amended by, *e.g.*, the Annunzio-Wylie Anti-Money Laundering Act of 1992, Pub. L. No. 102-550, 106 Stat. 4059 (1992), the Money Laundering Suppression Act of 1994, Pub. L. No. 103-325, 108 Stat. 2243 (1994), and the USA PATRIOT Act, Pub. L. No. 107-56, 115 Stat. 296 (2001).

<sup>88</sup> FINRA Rule 3310; NASD Rule 3011. NASD Rule 3011 was adopted without substantive change into the Consolidated FINRA Rulebook as FINRA Rule 3310, effective on January 1, 2010. *See Order Approving Proposed Rule Change*, Exchange Act Release No. 60645, 2009 WL 2915633 (Sept. 10, 2009), 74 Fed. Reg. 47,630 (Sept. 16, 2009); *SEC Approves New*

implement policies, procedures, and internal controls reasonably designed to achieve compliance with the BSA and its implementing regulations.”<sup>89</sup> The NAC found that Merrimac violated these rules in two ways. First, the NAC found that Merrimac unreasonably failed to develop AML procedures that provided for the monitoring and reporting of suspicious penny stock transactions. Second, the NAC found that Merrimac unreasonably failed to implement its existing AML procedures regarding registered representatives’ use of DSR forms, reporting of suspicious activity, and monitoring new customers for relevant disciplinary history.

### **1. Merrimac engaged in the conduct that FINRA found.**

Merrimac’s 2007 AML manual was in effect when it began growing its penny stock trading business. Merrimac’s penny stock business grew from less than 1% of its revenue in 2008 to 18% in 2010. In January 2010, Merrimac adopted a new version of its AML manual.

Although Merrimac’s January 2010 AML manual attempted to follow FINRA’s AML Template for Small Firms,<sup>90</sup> it was inadequate. Merrimac left at least 18 placeholders throughout the manual. For example, the AML manual stated in a subsection entitled “Responding to Red Flags and Suspicious Activity” that “[w]hen an employee of the Firm detects any red flag or other activity that may be suspicious, he or she will notify [*include procedures for escalation of suspicious activity*].” No such procedures were included and the firm merely left the bracketed language in place. Nor were the procedures provided elsewhere.

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(continued . . .)

*Consolidated FINRA Rules*, FINRA Regulatory Notice 09-60, 2009 WL 3336928, at \*1 (Oct. 15, 2009). Merrimac’s misconduct occurred when both rules were in effect.

<sup>89</sup> FINRA Rule 3310(b); NASD Rule 3011(b). *Lek Sec. Corp.*, 2018 WL 1602630, at \*4-8, addressed Rule 3310(a) and Rule 3011(a), which require firms to “establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder.” These are a subset of requirements under the BSA and its implementing regulations.

<sup>90</sup> *AML Template for Small Firms*, available at <http://www.finra.org/industry/anti-money-laundering-template-small-firms> (providing that FINRA’s Small Firm Template is designed “to assist [small firms] in fulfilling their responsibilities to establish the [AML] compliance program required by the [BSA] and its implementing regulations and FINRA Rule 3310”).

**2. Merrimac’s conduct violated the rules FINRA found it to have violated.**

**a. Merrimac’s written policies were not reasonably designed to achieve compliance with the BSA and its implementing regulations.**

We agree that Merrimac violated FINRA Rule 3310(b) and NASD Rule 3011(b) because its written policies and procedures were not reasonably designed to achieve compliance with the BSA and its implementing regulations. One such regulation requires broker-dealers to report certain “suspicious transaction[s] relevant to a possible violation of law or regulation” conducted by, at or through their firms.<sup>91</sup> That regulation’s adopting release specified that broker-dealers would be expected to follow a “risk-based approach” under which they “evaluate customer activity and relationships for money laundering risks, and design a suspicious transaction monitoring program that is appropriate for the particular broker-dealer in light of such risks.”<sup>92</sup>

During the relevant period, Merrimac did not adopt an AML Manual that was appropriate in light of the AML risks related to the firm’s penny stock business.<sup>93</sup> The AML Manual that the firm adopted in January 2010 left in placeholders from the template in lieu of specific written procedures. As the NAC explained, “Merrimac did not even bother to fill in obvious blanks where the template called for the firm to insert information.”<sup>94</sup> We agree with the NAC that Merrimac’s written AML program was not, by any measure, reasonably designed to achieve compliance with the BSA and its implementing regulations.

**b. Merrimac’s written policies were not reasonably implemented.**

We likewise agree with the NAC that Merrimac’s implementation of its AML program violated FINRA Rule 3310(b) and NASD Rule 3011(b). Although we find that Merrimac’s AML program was not reasonably designed, we also find that the firm did not reasonably

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<sup>91</sup> 31 C.F.R. § 103.19(a)(1)-(2) (2010), *renumbered* 31 C.F.R. § 1023.320(a)(1)-(2); *see generally* *Lek Sec.*, 2018 WL 1602630, at \*4-10.

<sup>92</sup> FinCEN, *Amendments to BSA Regulations—Requirement that Brokers or Dealers in Securities Report Suspicious Transactions*, 67 Fed. Reg. 44,048, 44,053 (July 1, 2002).

<sup>93</sup> *See Lek Sec. Corp.*, 2018 WL 1602630, at \*5 (finding that firm violated FINRA Rule 3310(a) and NASD Rule 3011(a) when its AML “policies and procedures did not address the AML risks related to the firm’s high-frequency securities business”).

<sup>94</sup> *Cf. North*, 2018 WL 5433114, at \*6 (finding violation where WSPs “failed to replace the bracketed boilerplate placeholder language with any program requirements”).

implement the policies and procedures that it had in a manner likely to result in the detection and reporting of suspicious penny-stock transactions.<sup>95</sup>

First, Merrimac required that registered representatives use DSR forms to document whether penny stocks were qualified for resale under Securities Act Section 5. But several customers submitted blank, pre-signed DSR forms. Second, the AML Manual and WSPs identified penny stocks as a potential red flag of money laundering. Nonetheless, as reflected in account statements and transaction ledgers in the record, Merrimac failed to timely and consistently detect or investigate customers' repeated deposits and liquidations of large blocks of penny stocks. Third, even though its policies required that each new customer's background be researched, including for any securities-related disciplinary history, Merrimac failed to identify customers with significant disciplinary histories such as bars from the securities industry.

Merrimac argues that it was not required to treat as a "red flag" trading in a penny stock "after a press release and an increase in trading volume" by a customer barred from the securities industry. But we have said that a "customer who has a questionable background or is the subject of . . . reports indicating possible . . . regulatory violations" may be a red flag that penny stocks are being used for "money laundering."<sup>96</sup> And Merrimac ignores the evidence in the record that other customers with significant disciplinary history were allowed to open accounts, including those who had been barred from the industry for aiding and abetting a pump-and-dump scheme.

Merrimac's remaining arguments are meritless. First, Merrimac objects that FINRA did not present evidence that there were any "red flag[s]" that "ended in any securities law violation." But FINRA need not establish an underlying securities law violation to show that Merrimac's AML compliance program violated NASD Rule 3011(b) and FINRA Rule 3310(b).<sup>97</sup> Instead, NASD Rule 3011(b) and FINRA Rule 3310(b) require that the firm establish and implement an AML program reasonably designed to achieve compliance with the BSA and its implementing regulations. Merrimac failed to do so.

Second, Merrimac disputes FINRA's evidence about the extent of Merrimac's penny stock business in 2008 and 2009. But the requirement that broker-dealers adopt a risk-based approach means they must adopt an AML program "that is appropriate for the particular broker-

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<sup>95</sup> See 31 C.F.R. § 103.19(a)(1)-(2) (2010).

<sup>96</sup> *Bloomfield*, 2014 WL 768828, at \*3.

<sup>97</sup> See *Lek Sec. Corp.*, 2018 WL 1602630, at \*9 & n.23 (comparing subsection (a) of these rules to the requirement in FINRA Rule 3310 that firms have a reasonable supervisory system, which likewise "does not require an underlying rule violation," and contrasting these provisions with "administrative proceedings under Exchange Act Section 15(b)(4)(E)," which "authorize[s] bars for supervisory violations only where there is an underlying violation").

dealer in light of” the “money laundering risks” presented by their business.<sup>98</sup> Even if Merrimac were correct about the relatively small scope of its penny stock business during 2008 and 2009, by 2010 its penny stock business was 18% of its revenue. Under the risk-based approach, it was unreasonable for Merrimac’s January 2010 AML manual to contain the deficiencies noted above.

Third, Merrimac objects that FINRA charged violations that occurred before Merrimac “improved [its] AML procedures.” It was not improper for FINRA to charge those violations, and the record supports the finding that they occurred. Finally, Merrimac objects to various evidence that FINRA offered and to the absence of other evidence that FINRA did not offer. Merrimac does not contend that it was prevented from presenting evidence in support of its defenses. We find no basis for Merrimac’s evidentiary objections.

### **3. FINRA’s rules are, and were applied in a manner, consistent with the Exchange Act.**

Exchange Act Section 15A(b)(6) requires that FINRA design its rules to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and to protect investors and the public interest.<sup>99</sup> FINRA Rule 3310 and NASD Rule 3011 are consistent with these purposes because they “assist members in identifying and preventing money laundering abuses that can affect the integrity of the U.S. capital markets.”<sup>100</sup> These rules also “accurately, reasonably, and efficiently implement the requirements of the PATRIOT Act as it applies to [FINRA] members.”<sup>101</sup> FINRA applied these rules appropriately given Merrimac’s failure to establish and implement reasonable AML policies and procedures. We find that these rules are, and were applied in a manner, consistent with the Exchange Act’s purposes.<sup>102</sup>

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<sup>98</sup> *Requirement that Brokers or Dealers in Securities Report Suspicious Transactions*, 67 Fed. Reg. at 44,053.

<sup>99</sup> 15 U.S.C. § 78o-3(b)(6).

<sup>100</sup> *Notice of Filing of Proposed Rule Change to Adopt FINRA Rule 3310 (Anti-Money Laundering Compliance Program) in the Consolidated FINRA Rulebook*, Exchange Act Release No. 60112, 2009 WL 1675252, at \*3 (June 15, 2009).

<sup>101</sup> *Order Approving Proposed Rule Changes Relating to Anti-Money Laundering Compliance Programs*, Exchange Act Release No. 45798, 2002 WL 730731, at \*7 (Apr. 22, 2002).

<sup>102</sup> *See Lek Sec. Corp.*, 2018 WL 1602630, at \*10. We have found that FINRA Rule 2010 is consistent with the purposes of the Exchange Act. *See supra* text accompanying note 33. Merrimac’s failure to develop and implement adequate AML procedures was inconsistent with just and equitable principles of trade. We therefore find that FINRA applied NASD Rule 2110 and FINRA Rule 2010 in a manner consistent with the Exchange Act’s purposes.

## B. Sanctions.

FINRA’s Sanction Guidelines contain no specific guideline for AML violations.<sup>103</sup> As a result, the NAC applied the guideline for deficient WSPs; Merrimac does not challenge that decision here. The guideline for deficient WSPs recommends a fine between \$5,000 and \$50,000 for supervisory failures.<sup>104</sup> It also identifies certain principal considerations, such as (1) ignoring “red flags” that should have resulted in additional supervisory scrutiny; (2) the nature, extent, size, and character of the underlying misconduct; and (3) the quality and degree of the supervisor’s implementation of supervisory procedures and controls.<sup>105</sup> Here, the NAC fined Merrimac \$25,000 for its violations of FINRA Rule 3310 and NASD Rule 3011.

This fine is within the guideline the NAC applied, and the principal considerations support it. After penny stocks grew to 18% of the firm’s revenue, it failed to take even the basic step of filling in placeholders from FINRA’s Small Firm Template. Merrimac’s implementation of the AML policies it did have was also unreasonable. As Merrimac does not challenge the sanctions imposed, it identifies no pertinent mitigating factors. Nor does it dispute that the fine is remedial. Under the circumstances, the fine the NAC imposed was neither excessive nor oppressive.

## IV. SUPERVISION

### A. Merrimac and Nash violated NASD Rules 3010 and 2110 and FINRA Rule 2010 by failing to maintain an effective supervisory system.

NASD Rule 3010 required that FINRA member firms establish and maintain a supervisory system, including WSPs, that is reasonably designed to achieve compliance with applicable securities laws and regulations and FINRA Rules.<sup>106</sup> The reasonableness of a

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<sup>103</sup> *Lek Sec. Corp.*, 2018 WL 1602630, at \*11 (cleaned up).

<sup>104</sup> *FINRA Sanction Guidelines* at 103.

<sup>105</sup> *Id.*

<sup>106</sup> NASD Rule 3010 was superseded in relevant part by FINRA Rule 3110. *See Order Granting Approval of a Proposed Rule Change*, Exchange Act Release No. 71179, File No. SR-FINRA-2013-025, 2013 WL 6794111, at \*4, 6 (Dec. 23, 2013). “Violations of NASD Rule 3010 and FINRA Rule 3110 are also violations of NASD Rule 2110 and FINRA Rule 2010 respectively.” *Wedbush Sec., Inc.*, Exchange Act Release No. 78568, 2016 WL 4258143, at \*10 n.36 (Aug. 12, 2016), *petition denied*, 719 F. App’x 724 (9th Cir. 2018). In September 2008, the Commission approved new FINRA Rule 2010, which replaced NASD Rule 2110 without any material alteration. *See Order Approving Proposed Rule Change*, Exchange Act Release No. 58643, File No. SR-FINRA-2008-028, 2008 WL 4468749, at \*5 (Sept. 25, 2008).

supervisory system is an objective standard based on the facts and circumstances.<sup>107</sup> It is well established that “[t]he presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not ensure compliance.”<sup>108</sup>

The NAC found that Merrimac failed to establish and maintain an effective supervisory system with respect to: (1) the private securities transactions of two registered representatives (DuBrule and Tuttle); (2) penny stock deposits; (3) Merrimac’s use of foreign finders; and (4) investment-related websites. The NAC also found Nash liable for the last three violations. We address each in turn.

**1. Merrimac engaged in the conduct FINRA found with respect to private securities transactions and that conduct violated the rules FINRA found it to violate.**

FINRA and NASD rules require registered persons to provide written notice to their firms before engaging in private securities transactions.<sup>109</sup> This requirement ensures that “appropriate supervision [can] be exercised as necessary under applicable law.”<sup>110</sup> Upon first becoming associated with Merrimac in September 2007, DuBrule and Tuttle provided prior written notice to Merrimac and obtained its approval to engage in private securities transactions related to two hedge funds that they managed through an intermediary.<sup>111</sup> Merrimac’s approval,

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<sup>107</sup> See *Ronald Pellegrino*, Exchange Act Release No. 59125, 2008 WL 5328765, at \*10 (Dec. 19, 2008).

<sup>108</sup> *Rita H. Malm*, Exchange Act Release No. 35000, 1994 WL 665963, at \*4 n.17 (Nov. 23, 1994).

<sup>109</sup> See, e.g., NASD Rule 3040 (prohibiting associated persons from “participat[ing] in any manner in a private securities transaction” without providing prior written notice to the member firm “describing in detail the proposed transaction and the person’s role therein and stating whether he has received or may receive selling compensation in connection with the transaction”). NASD Rule 3040 applied during the period at issue but has since been superseded by FINRA Rule 3280 without substantive change. See *Notice of Filing and Immediate Effectiveness of a Proposed Rule Change to Adopt FINRA Rule 3280 (Private Securities Transactions of an Associated Person) in the Consolidated FINRA Rulebook*, Exchange Act Release No. 75757, 2015 WL 5013302 (Aug. 25, 2015), 80 Fed. Reg. 52,530 (Aug. 31, 2015).

<sup>110</sup> *Proposed Rule Change by National Association of Securities Dealers, Inc. Relating to Outside Business Activities of Associated Persons*, Exchange Act Release No. 26063, 1988 WL 902707, at \*1 (Sept. 6, 1988).

<sup>111</sup> There is some ambiguity in the record as to whether DuBrule and Tuttle’s participation in the hedge funds constituted private securities transactions under NASD Rule 3040 and FINRA Rule 3280, or outside business activities under NASD Rule 3030 and FINRA Rule 3270, which  
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in a November 2007 letter, was conditioned on DuBrule and Tuttle not marketing to prospective customers or soliciting new investments. Yet DuBrule and Tuttle solicited and received from three customers \$4.1 million in investments in the funds in 2009.

We agree with the NAC that “DuBrule and Tuttle’s management of the funds was essentially unsupervised by Merrimac.” No one at Merrimac followed up to determine whether DuBrule and Tuttle solicited investments in the fund after they joined Merrimac despite the terms of Merrimac’s approval. As a result, Merrimac was not aware that DuBrule and Tuttle had solicited and received the additional investments in the hedge funds. Merrimac’s failure to supervise DuBrule and Tuttle violated NASD Rule 3010 and 2110 and FINRA Rule 2010.<sup>112</sup>

Merrimac objects that these transactions did not involve new investments but rather the withdrawal and reinvestment of funds. Two investors who contributed \$3.85 million in March 2009 had withdrawn at least that much four years earlier while remaining invested in the funds. But their accountant offered uncontroverted testimony that the 2009 investment was new. Merrimac points to nothing in the record as to the third investor. There is no basis to conclude that investors reinvested withdrawn funds rather than made new investments. In any event, regardless of whether DeBrule and Tuttle were soliciting new investments, Merrimac does not contend that it monitored DuBrule and Tuttle to attempt to ensure that they were not. Merrimac’s violation is not based on DuBrule and Tuttle’s solicitation of new funds, but rather Merrimac’s failure to supervise their compliance with the conditions of their employment.

**2. Merrimac and Nash engaged in the conduct FINRA found with respect to penny stock deposits, and that conduct violated the rules FINRA found it to violate.**

Merrimac’s WSPs designated Nash as responsible for review of securities transactions. For penny stock deposits, Nash was supposed to sign DSR forms to evidence his review and approval: the DSR form required the registered representative, principal, and CCO each to “review” the form and its supporting documents, and to “represent[]” the truth and accuracy of the information and that it is “made in compliance with all applicable federal and state securities

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would have also required notice to Merrimac. The issue is immaterial to whether Merrimac properly supervised DuBrule and Tuttle’s participation in the hedge funds to ensure that it comported with the approval Merrimac gave. Because the NAC’s decision and Merrimac’s briefs on appeal characterize DuBrule and Tuttle’s participation as “private securities transactions,” we follow them in referring to DuBrule and Tuttle’s participation that way.

<sup>112</sup> *Clarence Z. Wurts*, Exchange Act Release No. 43842, 2001 WL 32844, at \*4 (Jan. 16, 2001) (imposing sanctions for supervisory failures including unchallenged finding that principal failed reasonably to supervise a registered representative’s outside business activities, such as by doing “nothing to confirm” false claim that representative’s outside limited “partnerships were not active, such as asking for current documentation about the partnerships’ trading activities”).

laws and regulations.”<sup>113</sup> As discussed above, Nash knew that Schiffer had falsified some DSR forms by forging Nash’s signature on the forms. Merrimac adopted a new penny stock policy, and Nash and his colleagues verbally warned Schiffer that additional falsifications would result in her dismissal. But Nash did not investigate the scope of Schiffer’s falsifications despite the fact that he was responsible for reviewing, approving, and signing the DSR forms and that it was his signature Schiffer falsified. Because no one investigated the scope of Schiffer’s falsifications, Nash and Merrimac did not learn that her actions resulted in over a billion shares of penny stocks being deposited into and liquidated from customer accounts without any supervisory review—including the shares of USOG.

We reiterate here that compliance officers “play a vital role in our regulatory framework.”<sup>114</sup> “That role in many instances has increased in complexity, and there are circumstances where the role presents difficult challenges.”<sup>115</sup> “In making determinations about CCO liability, the protection of investors and the public interest are at the forefront of our minds.”<sup>116</sup> “The principles of fairness and equity, applied in context, also shine brightly in our decisions.”<sup>117</sup> These considerations lead us to conclude that a CCO is properly held liable where his signature is required on a form designed to ensure that the firm does not engage in misconduct, he knows that his signature on the form has been falsified, and he does not ensure that an investigation occurs into the scope of the falsifications or the potential consequences.

As discussed above, we stated recently that, “absent unusual mitigating circumstances, when a CCO engages in wrongdoing, attempts to cover up wrongdoing, crosses a clearly established line, or fails meaningfully to implement compliance programs, policies, and procedures for which he or she has direct responsibility, we would expect liability to attach.”<sup>118</sup> “In contrast, disciplinary action against individuals generally should not be based on an isolated circumstance where a CCO, using good faith judgment makes a decision, after reasonable inquiry, that with hindsight, proves to be problematic.”<sup>119</sup> Here, we think it is clear that liability

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<sup>113</sup> DuBrule, the first-line supervisor with respect to the forms at issue, settled charges that he failed to adequately supervise Schiffer in connection with the deposit and liquidation of penny stocks.

<sup>114</sup> *North*, 2018 WL 5433114, at \*9.

<sup>115</sup> *Id.*

<sup>116</sup> *Id.*

<sup>117</sup> *Id.*

<sup>118</sup> *Id.*

<sup>119</sup> *Id.*

should attach. The DSR forms provided that Nash had to review the form and represent by signing that the information on the forms was true and accurate. Yet he did not conduct any meaningful investigation upon learning that his signature had been falsified on some forms. This is not a situation where a CCO made a reasonable inquiry and determined erroneously that no further action needed to be taken in light of that inquiry; rather, the CCO was faced with evidence of misconduct, was directly responsible for investigating the misconduct, and chose instead not to investigate further.

We find that Merrimac and Nash failed to maintain a supervisory system with respect to the firm's penny stock deposits that was reasonably designed to achieve compliance with the firm's obligation not to participate in unregistered distributions in violation of Securities Act Section 5.<sup>120</sup> By requiring both a principal and the CCO to "review" the form and "represent" its compliance with applicable laws and regulations, the DSR form established a procedure whereby both the principal and the CCO were responsible for ensuring the accuracy of and the firm's compliance with DSR forms. Yet Nash knew Schiffer had falsified DSR forms—including his signature. In this situation, Nash was responsible for investigating the falsifications.

The "duty of supervision includes the responsibility to investigate "red flags" that suggest that misconduct may be occurring and to act upon the results of such investigation."<sup>121</sup> "Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review."<sup>122</sup> "When indications of irregularity reach the attention of those in authority, they must act vigorously, decisively, and with the utmost vigilance to detect and prevent improper activity."<sup>123</sup>

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<sup>120</sup> Merrimac returns to its argument that the DSR forms were not falsified and that FINRA has unfairly faulted it with respect to falsified DSR forms when other forms were processed "perfectly." We have addressed variations on these arguments, *see supra* text accompanying note 26, which have no bearing on whether Merrimac and Nash supervised reasonably.

<sup>121</sup> *Dennis S. Kaminski*, Exchange Act Release No. 65347, 2011 WL 4336702, at \*1, 8-9 (Sept. 16, 2011) (involving an "executive vice president who oversaw [firm's] operations and compliance departments" and who became firm's "acting chief compliance officer").

<sup>122</sup> *William J. Murphy*, Exchange Act Release No. 69923, 2013 WL 3327752, at \*18 (July 2, 2013), *petition denied*, 751 F.3d 472 (7th Cir. 2014); *see also Kaminski*, 2011 WL 4336702, at \*8 ("Once indications of irregularity arise, supervisors must respond appropriately.").

<sup>123</sup> *Busacca v. SEC*, 449 F. App'x 886, 889 (11th Cir. Dec. 2011) (recognizing that "the duty of supervision includes the responsibility to investigate 'red flags' suggesting irregularities and to conduct adequate follow-up and review"); *accord Murphy*, 2013 WL 3327752, at \*18; *Kaminski*, 2011 WL 4336702, at \*8.

Nash knew Schiffer had falsified his signature on DSR forms so as to render misleading the form's representation that he had undertaken supervisory review of the information on the form. Despite this clear violation of the firm's procedures, Nash wholly failed to investigate the extent of Schiffer's falsifications or the underlying transactions to which the DSR forms pertained to ensure that the stock sales in fact complied with applicable laws and regulations.

Pizzuti testified that Nash "did a cursory review of client files" to satisfy Merrimac that no securities violations occurred as a result of the falsifications. But this "cursory review" was only of the files that they knew had been falsified. Nash did not investigate the scope of Schiffer's falsifications. Indeed, Nash admitted that he did not investigate the scope of Schiffer's falsifications because he might not "have found anything" and "didn't even know [if other misconduct] existed" and "why would I go back and look at something" if he did not know that there was additional misconduct. Although Nash also testified that he did not investigate further because Schiffer misrepresented the scope of her falsifications, it was unreasonable for Nash to rely on Schiffer given that her falsifications raised questions about her credibility. In fact, had he looked, Nash would have discovered—as did FINRA after it received and reviewed the DSR forms—that his signature had been falsified on many other DSR forms.

Under the circumstances, we sustain FINRA's finding of liability. We do not hold Nash liable for failing to detect Schiffer's falsifications of the DSR forms. Rather, we hold Nash liable for his failure, upon learning that Schiffer had falsified some DSR forms, to undertake any meaningful investigation into whether she had falsified other DSR forms or into the potential consequences for the firm, its clients, and investors.<sup>124</sup> Merrimac is responsible for Nash's failure, as "[i]t is well-established that a firm may be held accountable for the misconduct of its associated persons because it is through such persons that a firm acts."<sup>125</sup> Merrimac and Nash's failures violated NASD Rule 3010 and 2110 and FINRA Rule 2010.<sup>126</sup>

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<sup>124</sup> See *North*, 2018 WL 5433114, at \*9 (stating that we would expect "liability to attach" in cases involving CCOs where the CCO "fails meaningfully to implement compliance programs, policies, and procedures for which he or she has direct responsibility").

<sup>125</sup> *vFinance Invs., Inc.*, Exchange Act Release No. 62448, 2010 WL 2674858, at \*12 (July 2, 2010); accord *A.J. White & Co. v. SEC*, 556 F.2d 619, 624 (10th Cir. 1977).

<sup>126</sup> See, e.g., *North*, 2018 WL 5433114, at \*8 (finding a failure to supervise where WSPs made CCO responsible for compliance with firm reporting obligation yet CCO "ignored clear red flags" that "should have led [him] to inquire" further to determine whether reporting was necessary).

### 3. Merrimac and Nash engaged in the conduct FINRA found with respect to foreign finders and that conduct violated the rules FINRA found it to violate.

FINRA Rule 2040(c) permits member firms to pay ongoing transaction-based compensation to “foreign persons based upon the business of customers such persons direct to member firms” (“foreign finders”) who meet certain conditions.<sup>127</sup> A foreign finder whose activities are fully in compliance with FINRA Rule 2040(c) would not be considered an associated person of the member based solely on that activity.<sup>128</sup> One requirement of the rule is that “the *sole involvement* of a foreign finder in the business of a member will be the initial referral of non-U.S. customers to the firm.”<sup>129</sup> Because a foreign person that fails to comply with this requirement may be “considered an associated person of the member,” FINRA members that engage foreign finders are “required to have reasonable procedures that appropriately address the limited scope of activities permissible under such arrangements.”<sup>130</sup>

Nash, and through him Merrimac,<sup>131</sup> failed to establish supervisory procedures reasonably designed to achieve compliance with Rule 2040. Merrimac’s WSPs provided that Nash was responsible for “review of supervisory practices and procedures,” and his testimony confirmed that he was responsible for drafting WSPs. The release adopting Rule 2040 notified firms that they had to have procedures governing their activities with foreign finders. But Nash failed to establish a WSP pertaining to foreign finders for the six months after Merrimac entered into an agreement with a foreign entity in November 2010. Because “[m]embers that engage foreign finders [are] required to have reasonable procedures that appropriately address the

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<sup>127</sup> *Order Approving Proposed Rule Change Relating to Amendments to Parts VI and X of Schedule C of the NASD By-Laws Relating to Foreign Finders and Foreign Associates*, Exchange Act Release No. 35361, 1995 WL 71390, at \*1 (Feb. 13, 1995), (“1995 Approval Order”) (describing who counts as a “foreign finder” for purposes of NASD Rule 1060(b), the predecessor to FINRA Rule 2040(c)). FINRA transferred NASD Rule 1060(b) with “minor technical changes into the Consolidated FINRA Rulebook as FINRA Rule 2040(c).” *Order Approving Proposed Rule Change to FINRA Rules 0190 (Effective Date of Revocation, Cancellation, Expulsion, Suspension or Resignation) and 2040 (Payments to Unregistered Persons) in the Consolidated FINRA Rulebook, and Amend FINRA Rule 8311 (Effect of a Suspension, Revocation, Cancellation, or Bar)*, File No. SR-FINRA-2014-037, Exchange Act Release No. 73954, 2014 WL 7407470, at \*5 (Dec. 30, 2014) (“Rule 2040 Approval Order”).

<sup>128</sup> *Rule 2040 Approval Order*, 2014 WL 7407470, at \*6; see 15 U.S.C. § 78o(a).

<sup>129</sup> *1995 Approval Order*, 1995 WL 71390, at \*2 (emphasis added); see *Rule 2040 Approval Order*, 2014 WL 7407470, at \*5-6, 12.

<sup>130</sup> *Rule 2040 Approval Order*, 2014 WL 7407470, at \*6.

<sup>131</sup> See *supra* note 125 and text accompanying footnote in body of the opinion.

limited scope of activities permissible under such arrangements,”<sup>132</sup> Merrimac failed to have reasonable supervisory procedures as of the time it entered into the agreement with the foreign entity. Merrimac’s supervisory failures continued for the six months during which the agreement was in place without adopting supervisory procedures. Merrimac offered its broker-dealer services to the entity’s foreign customers, the foreign entity referred customers to Merrimac, and the foreign entity went beyond providing an initial referral and was instead the primary point of contact for clients who needed account-related support. As Nash knew at the time, Merrimac began paying transaction-based compensation under the agreement around March 2011, but Merrimac’s WSPs still did not address supervision of foreign finders.

Nash states that foreign finders made up only “1% of Merrimac’s business” and objects that Merrimac was not required to adopt WSPs regarding its foreign finder relationship. But there is no *de minimis* exception to the requirement that members have reasonable procedures if they engage foreign finders; our adopting release did not condition that requirement on the proportion of the member’s business that engaged foreign finders.<sup>133</sup>

The procedures Merrimac eventually adopted regarding foreign finders in May 2011 also were not reasonably designed to achieve compliance with Rule 2040(c). Although this one-page document was titled “Policies and Procedures for Payment of Foreign Finders,” it merely copied the requirements in Rule 2040(c) under which a member could pay a foreign finder compensation. The document did not contain any policies for ensuring that those requirements were satisfied. Indeed, the document offered no guidance regarding how to supervise the foreign finder business to achieve compliance with the rule’s requirements. Nor did the document address any procedures specific to the firm, such as identifying the Merrimac principal responsible for supervising compliance with the limited scope of activities permissible under arrangements with foreign finders, or how supervision would be conducted. This is not a situation where FINRA held Nash liable because his actions appear unreasonable only with the benefit of hindsight; rather, Nash failed in any meaningful way to develop the procedures that FINRA’s rules required and that he admitted he was responsible for developing.<sup>134</sup>

Nash’s remaining arguments are meritless. He contends that the NAC could not have found a supervisory violation because Enforcement did not “produce a witness to support [its] claims.” But the NAC’s finding was supported by documentary evidence and the testimony of Nash, who was responsible for the WSPs. Nash next argues that, had Enforcement called the

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<sup>132</sup> *Rule 2040 Approval Order*, 2014 WL 7407470, at \*6.

<sup>133</sup> *See id.* at \*6, 13.

<sup>134</sup> *See Castle Secs. Corp.*, Exchange Act Release No. 52580, 2005 WL 2508169, at \*3 (Oct. 11, 2005) (finding that firm’s WSPs with respect to trade reporting were not reasonably designed because the “procedures also failed to identify a person or process responsible for reviewing the accuracy and timeliness of trade reporting conducted by third parties on the Firm’s behalf”).

examiner who reviewed Merrimac's foreign finder relationship, he would have testified that the firm produced contemporaneous documentation of that business. He likewise argues that Merrimac adequately disclosed the existence of its foreign finder relationship to its clients. But Nash does not explain why these matters are material to whether he, and through him Merrimac, established WSPs reasonably designed to achieve compliance with Rule 2040. Merrimac and Nash's failure to establish reasonably designed written supervisory procedures regarding foreign finders violated NASD Rules 3010 and 2110 and FINRA Rule 2010.

**4. Merrimac's conduct with respect to investment-related websites violated the rules FINRA found it to violate, but we set aside FINRA's finding that Nash's conduct with respect to investment-related websites constituted a violation.**

As discussed above, NASD Rule 3010 required that FINRA member firms have reasonable supervisory procedures. Under the terms of the rule, these procedures must be designed to supervise the types of business in which the firm engages and the activities of its associated persons. Pizzuti created two non-password-protected publicly available websites. The websites offered a subscription-based "stock analyzer" that used "computational algorithms" to identify stocks with the "highest Alpha and strongest performance." The NAC found that Nash failed to establish, and Merrimac failed to implement, a supervisory system reasonably designed to ensure appropriate review and supervision of these two websites as advertising.<sup>135</sup>

We set aside the NAC's finding that Nash failed to establish a supervisory system reasonably designed to ensure appropriate review and supervision of these websites as advertising. Nash was responsible for reviewing and drafting the firm's WSPs, and the WSPs provided that all advertising would be reviewed for misleading or inaccurate statements and that David Matthews, the firm's president, would do so.<sup>136</sup> The WSPs also specified that "[a]ll business messages on the internet shall be considered advertising." And NASD Rule 2210 defined "advertisements" to include "[a]ny material . . . that is published, or used in any electronic . . . public media, including any Web site."<sup>137</sup> Yet the NAC faulted Nash for not "identify[ing]" in the WSPs that "websites [are] advertising to be reviewed"; its rationale for holding Nash liable was that "Merrimac's procedures did not specifically state that websites

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<sup>135</sup> See *CapWest Sec., Inc.*, Exchange Act Release No. 71340, 2014 WL 198188, at\*8 (Jan. 17, 2014) (finding that member firms are required to establish and maintain a supervisory system reasonably designed to achieve regulatory compliance, including with NASD Rule 2210, which contains standards applicable to all member firm communications with the public).

<sup>136</sup> As discussed above, Matthews settled with FINRA before the hearing.

<sup>137</sup> NASD Rule 2210(a)(1). This rule was in effect at the time of the alleged misconduct. FINRA revised the rule and adopted it as FINRA Rule 2210. See *Notice of Filing of Amendment No. 3 and Order Granting Accelerated Approval of a Proposed Rule Change*, Exchange Act Release No. 66681, 2012 WL 1066178 (Mar. 29, 2012), 77 Fed. Reg. 20,452 (Apr. 4, 2012).

were advertising.” Neither the NAC’s cursory explanation nor FINRA’s briefs on appeal have demonstrated why the WSPs were inadequate in light of the various provisions of the WSPs and the terms of NASD Rule 2210. Under the circumstances, Nash did not fail to establish a reasonably designed supervisory system with respect to the websites.<sup>138</sup>

Although Nash established a reasonably designed supervisory system with respect to the websites, we sustain the NAC’s finding that Merrimac failed to implement that supervisory system reasonably to ensure appropriate review and supervision of the websites. Despite the WSPs, neither Matthews nor anyone else at Merrimac reviewed the websites that Pizzuti created.

Merrimac contends that the websites were never publicly accessible, and it attempts to impeach the FINRA witness who testified that the sites were accessible and active. But Pizzuti conceded at the hearing that pertinent parts of the websites were accessible. And the record supports the Hearing Panel’s determination that FINRA’s witness was credible.<sup>139</sup> “It is well-established that ‘[t]he presence of procedures alone is not enough. Without sufficient implementation, guidelines and strictures do not ensure compliance.’”<sup>140</sup> Merrimac’s failure to supervise the websites violated NASD Rules 3010 and 2110 and FINRA Rule 2010.

**5. The rules are, and were applied in a manner, consistent with the Exchange Act’s purposes.**

Exchange Act Section 15A(b)(6) requires that FINRA design its rules to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles and trade, and to protect investors and the public interest.<sup>141</sup> Because we have “long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the

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<sup>138</sup> Cf. *CapWest Sec.*, No. 2007010158001, 2013 FINRA Discip. LEXIS 4, at \*26-30 (FINRA NAC Feb. 25, 2013) (finding that the firm did not adequately implement WSPs with respect to supervisory review and approval of “all advertisements and sales literature,” including websites, but noting that Enforcement had conceded that the WSPs were “reasonably designed”).

<sup>139</sup> See, e.g., *John Edward Mullins*, Exchange Act Release No. 66373, 2012 WL 423413, at \*13 (Feb. 10, 2012) (explaining that “we generally defer” to a FINRA Hearing Panel’s “credibility determinations in the absence of substantial evidence to support overturning them”).

<sup>140</sup> *KCD Fin., Inc.*, 2017 WL 1163328, at \*9 (citation omitted).

<sup>141</sup> 15 U.S.C. § 78o-3(b)(6). NASD Rule 2110 and FINRA Rule 2010 are consistent with the purposes of the Exchange Act. See *supra* text accompanying note 33. To the extent we do not set them aside above, Merrimac and Nash’s failures to establish and implement adequate supervisory procedures were inconsistent with just and equitable principles of trade. With respect to the violations we sustain, we find that NASD Rule 2110 and FINRA Rule 2010 were applied in a manner consistent with the Exchange Act’s purposes.

federal regulatory scheme,” and because FINRA’s application of Rule 3010 was appropriate given the unreasonableness of Merrimac and Nash’s failures to supervise (except to the extent we set aside FINRA’s findings of violation with respect to Nash), we find that NASD Rule 3010 is, and was applied in a manner, consistent with the Exchange Act’s purposes.

## **B. Sanctions.**

For his supervisory violations, the NAC fined Nash \$25,000, imposed a one-year suspension in a principal capacity, and required him to requalify as a general securities principal. The NAC based these sanctions, in part, on its finding that Nash failed to establish reasonable WSPs regarding the investment-related websites. Because we set aside that finding of violation, we remand for the NAC to determine the appropriate sanctions for Nash’s supervisory violations that we sustain. We express no opinion as to the appropriate sanctions on remand.

For its supervisory violations, the NAC fined Merrimac \$50,000, imposed a one-year suspension from receiving and liquidating penny stocks for which no registration statement is in effect, and required Merrimac to retain an expert to evaluate and approve its WSPs. The Guideline applicable to a firm’s failure to supervise recommends a fine of \$5,000 to \$50,000 and “limiting the activities of the appropriate branch or department for up to 30 business days.”<sup>142</sup> In egregious cases “involving systemic supervision failures,” the Guideline calls for “consider[ing] a longer suspension of the firm with respect to any or all activities or functions (of up to two years).”<sup>143</sup> The principal considerations for a failure to supervise include: (1) ignoring “red flags” that should have resulted in additional supervisory scrutiny; (2) the nature, extent, size, and character of the underlying misconduct; and (3) the quality and degree of the supervisor’s implementation of supervisory procedures.<sup>144</sup>

The Guideline applicable to deficient supervisory procedures recommends a fine of \$1,000 to \$25,000.<sup>145</sup> For egregious cases, the Guideline recommends considering suspending the firm for “up to 30 business days and thereafter until the supervisory procedures are amended to conform to rule requirements.”<sup>146</sup> The relevant principal considerations for deficient supervisory procedures include (1) whether the deficiencies allowed violative conduct to occur; and (2) whether the deficiencies made it difficult to determine the individual responsible for

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<sup>142</sup> *FINRA Sanction Guidelines* at 103.

<sup>143</sup> *Id.*

<sup>144</sup> *Id.*

<sup>145</sup> *Id.* at 104.

<sup>146</sup> *Id.*

specific areas of supervision and compliance.<sup>147</sup> The General Principles applicable to all sanction determinations also instruct that “[a]djudicators should tailor sanctions to respond to the misconduct at issue,” which may involve “design[ing] sanctions other than those specified,” such as by “requiring a respondent firm to retain a qualified independent consultant to design and/or implement procedures for improved future compliance with regulatory requirements.”<sup>148</sup>

The firm failed to establish and maintain an adequate supervisory system in four respects. First, the firm failed to monitor DuBrule and Tuttle’s private securities transactions after they joined Merrimac to ensure that they complied with the terms of Merrimac’s approval of their employment. Second, with respect to penny stock transactions, Merrimac failed to investigate the extent of Schiffer’s falsifications of DSR forms and whether these falsifications caused the firm to participate in unregistered distributions in violation of Securities Act Section 5. Third, Merrimac failed to establish reasonable supervisory procedures that addressed foreign finders. Finally, Merrimac failed to implement supervisory procedures to supervise communications with the public through websites. In each of these areas, Merrimac ignored red flags and repeatedly and systematically failed to establish or implement adequate supervisory procedures.

Merrimac has also engaged in similar supervisory misconduct previously,<sup>149</sup> and the NAC considered Merrimac’s “overall lax approach to supervision . . . in light of its disciplinary history.” “We have long held that prior disciplinary history . . . provides evidence of whether an applicant’s misconduct is isolated, the sincerity of the applicant’s assurance that he will not commit future violations and/or the egregiousness of the applicant’s misconduct.”<sup>150</sup> Merrimac’s disciplinary history indicates that the sanctions FINRA imposed are needed to protect the public in the future. As Merrimac does not challenge the sanctions imposed, it identifies no pertinent mitigating factors or dispute that the sanctions are remedial. Under the circumstances, the sanctions the NAC imposed on Merrimac were neither excessive nor oppressive.

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<sup>147</sup> *Id.*

<sup>148</sup> *Id.* at 3.

<sup>149</sup> *See, e.g., Dep’t of Enf’t v. Merrimac Corp. Sec., Inc.*, No. 2007007151101, 2012 WL 1564710, at \*8 (FINRA Bd. of Governors May 2, 2012) (finding Merrimac violated NASD Rule 3010 by failing to establish and maintain WSPs reasonably designed to supervise sale of five investment products, and upholding sanctions including \$2,500 fine for deficient WSPs); *Dep’t of Enf’t v. Merrimac Corp. Sec., Inc.*, No. 2009017195204, 2013 FINRA Discip. LEXIS 4 (FINRA NAC Apr. 29, 2015) (finding Merrimac failed to show it lacked ability to pay stipulated \$100,000 fine for its failure to supervise the outside business activities and private securities transactions of two registered representatives and related supervisory violations).

<sup>150</sup> *Midas Sec.*, 2012 WL 169138, at \*16.

## V. EFFECTING SECURITIES TRANSACTIONS WHILE SUSPENDED

### A. Merrimac violated FINRA Rule 2010 by effecting securities transactions while suspended.

FINRA Rule 2010 forbids a member from effecting securities transactions while its registration is suspended.<sup>151</sup> We find that Merrimac effected securities transactions while its registration was suspended in violation of FINRA Rule 2010.<sup>152</sup>

#### 1. Merrimac engaged in the conduct that FINRA found.

In April 2009, FINRA sent Merrimac an invoice for the firm's annual registration fee. After Merrimac failed to remit payment, FINRA sent additional notices and, in July 2009, warned that FINRA would suspend Merrimac if it failed to pay the fee within five business days. In August 2009, after Merrimac failed to respond, FINRA instituted an expedited proceeding under its Rule 9553.<sup>153</sup> FINRA warned Merrimac that the firm would be suspended effective September 2, 2009, unless it paid the fee in full, filed for bankruptcy, or requested a hearing to challenge the suspension. Merrimac did not respond, and the suspension became effective on September 2, 2009. Merrimac's registration was suspended until September 17, when it paid the fee. Merrimac effected more than 750 transactions while its membership was suspended.

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<sup>151</sup> See, e.g., *Troy A. Wetter*, Exchange Act Release No. 33086, 1993 WL 430285, at \*3 (Oct. 21, 1993).

<sup>152</sup> The NAC also stated that this conduct violated Article IV, Section 1 of FINRA's By-Laws. That section specifies that the firm's membership application shall contain "an agreement to pay such dues, assessments, and other charges" as properly set by FINRA. FINRA By-Laws, Art. IV, Sec. 1(a)(2); see *id.* Art. VI, Sec. 1 (authorizing FINRA to set such amounts); *id.* Art. VI, Sec. 3(a) (authorizing expedited proceedings to suspend or cancel membership for failure to pay). The NAC's finding that Merrimac effected securities transactions while its registration was suspended has no bearing on whether Merrimac's application contained the required agreement. It is unclear whether the NAC meant to find a violation of Article IV, Section 1, but to the extent it did we set aside any such finding of violation.

<sup>153</sup> See FINRA Rule 9553(a) (providing that upon a member firm's failure to make a required payment, "FINRA staff may issue a written notice . . . stating that the failure to comply within 21 days . . . will result in . . . suspension or cancellation of membership").

**2. Merrimac’s conduct violated the rules that FINRA found it to have violated.**

Merrimac does not renew the arguments it made before the NAC about this violation. As a result, it has waived any challenge to this finding.<sup>154</sup> We therefore find that Merrimac violated Rule 2010 by effecting securities transactions while its registration was suspended.<sup>155</sup>

**3. FINRA’s rules are, and were applied in a manner, consistent with the Exchange Act.**

Exchange Act Section 15A(b)(6) requires that FINRA design its rules to “promote just and equitable principles of trade.”<sup>156</sup> A violation of a suspension order shows “disregard for [an SRO’s] disciplinary authority,<sup>157</sup> and effecting securities transactions while a firm’s registration is suspended thus violates just and equitable principles of trade. We therefore find that FINRA applied Rule 2010 in a manner consistent with the Exchange Act’s purposes.

**B. Sanctions.**

FINRA’s Sanction Guidelines contain no specific guideline for effecting securities transactions while suspended. As a result, the NAC applied the guideline for membership agreement violations; Merrimac does not challenge that determination here. That guideline provides for a fine of \$2,500 to \$50,000, and, in egregious cases, recommends consideration of a suspension or expulsion. The NAC found Merrimac’s conduct to be egregious, fined Merrimac \$50,000, and imposed a 30-day suspension from membership.

We agree that Merrimac’s violation was egregious. Merrimac ignored a series of notices notifying it of its past due membership registration fee and the possibility that it would be suspended if the fee remained unpaid. Merrimac effected more than 750 securities transactions during the two weeks when its registration was suspended. Merrimac does not challenge the sanctions, and it does not identify mitigating circumstances or dispute that the sanctions are remedial. Under the circumstances, the fine and suspension are neither excessive nor oppressive.

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<sup>154</sup> Rules of Practice 410(b), 450(b), 17 C.F.R. § 201.410(b), .450(b); *see also Anthony Fields*, Exchange Act Release No. 74344, 2015 WL 728005, at \*19 & n.115 (Feb. 20, 2015) (explaining that “arguments for reversal not made in the opening brief” are subject to waiver).

<sup>155</sup> *See Wetter*, 1993 WL 430285, at \*3.

<sup>156</sup> 15 U.S.C. § 78o-3(b)(6). We have found that NASD Rule 2110 and FINRA Rule 2010 are consistent with the purposes of the Exchange Act. *See supra* text accompanying note 33.

<sup>157</sup> *David C. Ho*, Exchange Act Release No. 54481, 2006 WL 2959662, at \*6 (Sept. 22, 2006).

## VI. MERRIMAC AND NASH’S REMAINING ARGUMENTS

We address Merrimac and Nash’s remaining arguments together to the extent there is overlap. But we address only those arguments developed with sufficient clarity in their briefs.<sup>158</sup>

### A. Merrimac and Nash do not establish improper conduct by FINRA or the Hearing Officer.

The NAC correctly rejected Merrimac’s claim that it was targeted for selective enforcement. To prevail on a claim of selective prosecution, Merrimac must establish that it was “singled out for enforcement while others similarly situated were not, and that [its] prosecution was motivated by arbitrary or unjust considerations such as [its] race, religion, or the desire to prevent [its] exercise of a constitutionally protected right.”<sup>159</sup> Merrimac has not attempted to substantiate its claim, and we find that it is without merit.

Merrimac and Nash argue that FINRA “forced” and “leverage[d]” its settlements with their co-respondents “to substantiate/exaggerate” the charges. We have rejected challenges to an SRO’s allegedly unfair use of “leverage” in settlement negotiations where “applicants do not claim or present any evidence that *they* were improperly pressured to enter into a settlement and thus subjected to an unfair proceeding.”<sup>160</sup> Here, the record does not suggest, let alone evidence, that the settlements prejudiced Merrimac and Nash or subjected them to an unfair proceeding.

Merrimac argues that the Hearing Officer was biased because of her rulings and her prior work experience with Enforcement. Under FINRA Rule 9233, a party seeking to disqualify a Hearing Officer on grounds of alleged bias must move for disqualification within fifteen days of

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<sup>158</sup> Merrimac and Nash’s briefs include many offhand assertions that are insufficiently developed. As the D.C. Circuit has explained, “[i]t is not enough merely to mention a possible argument in the most skeletal way, leaving the court to do counsel’s work.” *U.S. Telecom. Ass’n v. FCC*, 825 F.3d 674, 708 (D.C. Cir. 2016). The “Commission need not sift pleadings and documents to identify arguments that are not stated with clarity by a petitioner.” *FiberTower Spectrum Holdings, LLC v. FCC*, 782 F.3d 692, 696 (D.C. Cir. 2015); *see also* Rule of Practice 450(b), 17 C.F.R. § 201.450(b); *supra* note 154. While *pro se* litigants are “held to less stringent standards than counseled litigants,” *Spannus v. FEC*, 990 F.2d 643, 645 (D.C. Cir. 1993), a *pro se* party is not exempted from the requirement to present an argument to avoid waiver. *Cf. Brian J. Ourand*, Advisers Act Release No. 32211, 2016 WL 4258138, at \*3 (Aug. 12, 2016) (“We expect even unrepresented parties to comply with our rules.”) (internal quotation marks omitted).

<sup>159</sup> *Robert Radano*, Advisers Act Release No. 2750, 2008 WL 2574440, at \*8 n.74 (June 30, 2008).

<sup>160</sup> *Elec. Transaction Clearing*, Exchange Act Release No. 78093, 2016 WL 3345702, at \*10 & n.45 (June 16, 2016) (emphasis in original).

learning the facts that are the grounds for disqualification.<sup>161</sup> By failing to move timely for disqualification, Merrimac waived its bias objection.<sup>162</sup> In any case, the objection is meritless. To prevail on its bias claim, “the Hearing Officer’s supposed bias must ‘stem[] from an extrajudicial source *and* result[] in a decision on the merits based on matters other than those gleaned from participation in a case.’”<sup>163</sup> Adverse evidentiary rulings do not, without more, establish improper bias.<sup>164</sup> Merrimac identifies no basis to conclude that the Hearing Officer or any other member of the Hearing Panel exhibited improper bias.

**B. Merrimac and Nash do not establish any error in the admission or exclusion of evidence.**

Merrimac and Nash challenge several evidentiary rulings. Under FINRA Rule 9263(a), a hearing officer has discretion to “exclude all evidence that is irrelevant, immaterial, unduly repetitious, or unduly prejudicial.”<sup>165</sup> None of the arguments raised are meritorious.

First, Merrimac tries to impeach and exclude the testimony of FINRA investigator Joshua Wong.<sup>166</sup> Wong was called to authenticate documents and explain documentary evidence. Pizzuti and Nash cross-examined Wong extensively. Although they argue about inconsistencies in his testimony and about information Wong did not know, those arguments go to his credibility and not to his testimony’s admissibility.<sup>167</sup> The Hearing Panel found Wong credible, and “we

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<sup>161</sup> FINRA Rule 9233(b).

<sup>162</sup> *Ahmed*, 2017 WL 4335036, at \*21 (applicants waived objection that a FINRA Hearing Officer was biased by waiting to object until after the Hearing Panel issued its decision).

<sup>163</sup> *Mission Sec. Corp.*, Exchange Act Release No. 63453, 2010 WL 5092727, at \*11 (Dec. 7, 2010) (emphasis and alterations in original) (citation omitted).

<sup>164</sup> See *Scott Epstein*, Exchange Act Release No. 59328, 2009 WL 223611, at \*18 (Jan. 30, 2009). Merrimac also “ignore[s] the various times the [Hearing Panel] ruled in [respondents’] favor.” *Elec. Transaction Clearing*, 2016 WL 3345702, at \*9.

<sup>165</sup> FINRA Rule 9263(a).

<sup>166</sup> Nash’s reply brief raises several arguments for the first time, including that Wong was erroneously allowed to remain in the hearing room even when not testifying. “Arguments made for the first time in a reply brief are waived.” *James S. Tagliaferri*, Advisers Act Release No. 4650, 2017 WL 632134, at \*8 n.53 (Feb. 15, 2017) (cleaned up). In any case, Nash does not argue that he was prejudiced as a result of Wong’s presence in the hearing room.

<sup>167</sup> See, e.g., *Koch v. Puckett*, 907 F.2d 524, 531 (5th Cir. 1990); *NLRB v. Seafarers Int’l Union of N. Am.*, 496 F.2d 1363, 1365 (5th Cir. 1974).

generally defer to such credibility determinations in the absence of substantial evidence to support overturning them.”<sup>168</sup> Merrimac has furnished no such evidence here.

Second, Merrimac and Nash allege that the Hearing Officer abused her discretion in admitting FINRA summaries of instances in which Merrimac received blank DSR forms pre-signed by customers.<sup>169</sup> Merrimac objects that the summaries are improper because there was no evidence that its registered representatives asked clients to submit pre-signed blank DSR forms. But the evidence FINRA summarized demonstrates that Merrimac in fact received pre-signed blank forms from its customers. That evidence is relevant and probative.

Third, the Hearing Officer did not abuse her discretion in admitting other summary exhibits—including a filtered subset of trades from Merrimac’s trade blotter, a timeline of Merrimac’s sale of USOG stock, and a list of DSR forms falsified by Merrimac’s registered representative. These were also relevant to and probative of FINRA’s allegations. Although Merrimac now characterizes these summaries as “false and misleading,” the underlying evidence was proffered and admitted, and Merrimac had ample opportunity for cross-examination.<sup>170</sup>

Fourth, Merrimac contends that the Hearing Officer improperly excluded the testimony of Merrimac’s clearing firm’s representative John Kenny. But Kenny’s testimony was not excluded. Merrimac and Nash declined to call Kenny because, in Nash’s view, he “couldn’t [testify] over the telephone.” Nor is there merit to Merrimac’s objection that FINRA’s failure to interview or seek documents from Kenny prejudiced it. Merrimac does not explain how.

Fifth, Nash suggests that the testimony of FINRA supervisory attorney Blake Snyder was also excluded improperly. Again, it does not appear that the Hearing Officer excluded Snyder’s testimony. Nash initially listed Snyder on his witness list along with 26 other FINRA

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<sup>168</sup> See, e.g., *Mullins*, 2012 WL 423413, at \*13.

<sup>169</sup> Merrimac also objects that the summaries were omitted from FINRA’s production of its investigatory file. See Rule 9251(a) (requiring FINRA to “make available for inspection and copying . . . Documents prepared or obtained . . . in connection with the investigation that led to the institution of proceedings”). Even assuming Rule 9251(a) covers summary exhibits, Merrimac has not even attempted to demonstrate that FINRA’s failure to produce them as part of the investigatory file “was not harmless error.” Rule 9251(g). Merrimac possessed the underlying evidence being summarized (which it produced to FINRA), and had ample opportunity to examine witnesses on the summary and underlying exhibits.

<sup>170</sup> See *Pagel, Inc.*, Exchange Act Release No. 22280, 1985 WL 548387, at \*6 (Aug. 1, 1985) (rejecting challenge to admission of summary exhibits produced by Commission staff accountant who “testified fully with respect to the manner in which they were prepared, . . . no valid basis has been shown for questioning their reliability,” and “all of the underlying documentation from which the summaries were prepared . . . was introduced into evidence”).

employees. When Nash mentioned the possibility of calling him in rebuttal, there was a colloquy about Snyder's possible testimony.<sup>171</sup> Our review of the record reveals no ruling by the Hearing Officer excluding him; it appears Nash ultimately abandoned the plan to call Snyder when asked at the hearing to finalize his witness list. Under the circumstances, we deny Nash's request to draw an adverse inference from Snyder's absence.

Finally, Merrimac seeks to introduce additional evidence before the Commission. Rule of Practice 452 requires a party seeking to adduce additional evidence to demonstrate "with particularity" that "such additional evidence is material and that there were reasonable grounds for failure to adduce such evidence previously."<sup>172</sup> Merrimac neither moved to adduce its additional evidence nor demonstrated that this evidence satisfies the applicable standard under Rule 452.<sup>173</sup> Accordingly, we grant FINRA's motion to strike this evidence.

An appropriate order will issue.<sup>174</sup>

By the Commission (Chairman CLAYTON and Commissioners JACKSON, PEIRCE, ROISMAN, and LEE).

Vanessa Countryman  
Secretary

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<sup>171</sup> Merrimac also objects that FINRA misrepresented to the Hearing Panel that Snyder was out and unavailable to testify, when he was in fact in the same building that day. Contrary to Merrimac's suggestion, FINRA stated at most uncertainty about Snyder's work travel plans: "I'm not sure if he's in the office today or what his availability is."

<sup>172</sup> 17 C.F.R. § 201.452.

<sup>173</sup> *See, e.g., CapWest Sec.*, 2014 WL 198188, at \*7 n.43 (refusing to consider additional evidence where party did not move to adduce exhibits under Rule 452, and "neither explain[ed] why it did not adduce them previously, as both exhibits were available prior to commencement of FINRA's disciplinary proceeding, nor show[ed] their materiality").

<sup>174</sup> We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

**Table 1: The NAC's findings of violations**

Parties	Rules violated	Basis for violation
Merrimeac and Nash	FINRA Rule 8210 NASD Rule 2010	Providing falsified documents in response to FINRA's requests for information
Merrimac	FINRA Rule 2010	Facilitating the unregistered sale of securities, not subject to exemption from registration, in violation of Securities Act Section 5
Merrimac	NASD Rule 3011 FINRA Rule 3310 FINRA Rule 2010	Failing to establish and implement an effective anti-money-laundering system
Merrimac and Nash	NASD Rule 3010 NASD Rule 2110 FINRA Rule 2010	Failing to establish and maintain an effective supervisory system
Merrimac	FINRA Rule 2010	Effecting securities transactions while registration is suspended

UNITED STATES OF AMERICA  
before the  
SECURITIES AND EXCHANGE COMMISSION

SECURITIES ACT OF 1933  
Release No. 10662 / July 17, 2019

SECURITIES EXCHANGE ACT OF 1934  
Release No. 86404 / July 17, 2019

Admin. Proc. File No. 3-18045

In the Matter of the Application of  
MERRIMAC CORPORATE SECURITIES, INC.,  
and  
ROBERT G. NASH  
For Review of Disciplinary Action Taken by FINRA

ORDER SUSTAINING IN PART DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is

ORDERED that FINRA's disciplinary action and sanctions against Merrimac Corporate Securities, Inc., and Robert G. Nash, are sustained except as set forth below; and it is further

ORDERED that FINRA's findings that Robert Nash violated NASD Rules 3010 and 2110 and FINRA Rule 2010, and the sanctions imposed on Nash for such violations, are set aside to the extent described in and in accordance with the accompanying opinion; and it is further

ORDERED that this proceeding is remanded to FINRA for reconsideration of the sanctions imposed on Nash for such violations in accordance with the accompanying opinion.

By the Commission.

Vanessa A. Countryman  
Secretary