TO: Department of Enforcement  
Financial Industry Regulatory Authority (FINRA)  

RE: McNally Financial Services Corporation (Respondent)  
Member Firm  
CRD No. 121196  

Pursuant to FINRA Rule 9216, Respondent McNally Financial Services Corporation (MFS) submits this Letter of Acceptance, Waiver, and Consent (AWC) for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Respondent alleging violations based on the same factual findings described in this AWC.

I. ACCEPTANCE AND CONSENT

A. Respondent hereby accepts and consents, without admitting or denying the findings and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

MFS has been a FINRA member since 2002. MFS is headquartered in San Antonio, Texas. The firm employs approximately 27 registered individuals and has approximately 10 branch offices.¹

OVERVIEW

From March 2014 through March 2019, MFS failed to establish and maintain a supervisory system and enforce written supervisory procedures (WSPs) reasonably designed to achieve compliance with FINRA Rule 2111 in relation to the sale of non-traditional exchange traded products (NT-ETPs).²

MFS also failed to reasonably supervise a registered representative who recommended complex options trading strategies to customers. MFS was aware of red flags in the options trading that indicated the trading and strategy may be inconsistent with the customers’ investment profiles but failed to take reasonable action to investigate these red flags.

¹ For more information about the firm, including prior regulatory events, visit BrokerCheck® at www.finra.org/brokercheck.  
² NT-ETPs include leveraged and inverse exchange traded notes (NT-ETNs) and funds (NT-ETFs).
As a result, MFS violated FINRA Rules 3110, 2360(b)(20)(C), and 2010, and NASD Rule 3010.³

**FACTS AND VIOLATIVE CONDUCT**

FINRA Rule 3110(a), and its predecessor, NASD Rule 3010(a), require that, “each member shall establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA rules.” Rule 3110 also requires firms to investigate red flags of potential misconduct by its registered representatives. FINRA Rule 2010 provides that “[a] member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.” A violation of FINRA Rule 3110 is a violation of FINRA Rule 2010.

FINRA Rule 2111 requires member firms or their associated persons to have a reasonable basis to believe, based on reasonable diligence, that a recommended securities transaction or investment strategy is suitable for at least some investors. Supplementary Material .05(a) to FINRA Rule 2111 provides:

> In general, what constitutes reasonable diligence will vary depending on, among other things, the complexity of and risks associated with the security or investment strategy and the member’s or associated person’s familiarity with the security or investment strategy. A member’s or associated person’s reasonable diligence must provide the member or associated person with an understanding of the potential risks and rewards associated with the recommended security or strategy. The lack of such an understanding when recommending a security or strategy violates the suitability rule.

FINRA Rule 2360(b)(20)(C) requires that members provide principal supervisory review of options trading in customer option accounts, including, but not limited to: (i) the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved; (ii) the size and frequency of options transactions; (iii) commission activity in the account; (iv) profit or loss in the account; and (v) undue concentration in any options class or classes. A violation of FINRA Rule 2360 is a violation of FINRA Rule 2010.

**Non-Traditional ETPs**

NT-ETPs are designed to return a multiple of an underlying index or benchmark (leveraged ETPs), the inverse of that benchmark (inverse ETPs), or both, over only the course of one trading session—usually a single day. NT-ETPs typically rebalance their portfolios on a daily basis (also known as the “daily reset”). Accordingly, holding NT-ETPs for longer than one day typically subjects them to the effects of compounding of

³ FINRA Rule 3110 superseded NASD Rule 3010 on December 1, 2014.
daily returns during the holding period. As a result, the performance of NT-ETPs over periods longer than a single trading session "can differ significantly from the performance ... of their underlying index or benchmark during the same period of time."\(^4\) Because of these risks and the complexity of the products, FINRA has advised broker-dealers that NT-ETPs "typically are not suitable for retail investors who plan to hold them for more than one trading session, particularly in volatile markets."\(^5\) Prospectuses for the NT-ETPs an MFS registered representative (Representative 1) recommended to customers warned that the products were risky and were intended to be daily trading tools for sophisticated investors, and should be actively and frequently monitored, even intraday.

FINRA Regulatory Notice 09-31 cautioned member firms about the need to establish a reasonable supervisory system "to ensure that their associated persons comply with all applicable FINRA and SEC rules when recommending any product, including leveraged and inverse ETFs," and implement written supervisory procedures that, among other things, require that associated persons perform appropriate suitability reviews.\(^6\) That Notice provided specific guidance regarding the risks and suitability concerns associated with NT-ETPs, and the need for a supervisory system to address those issues.

MFS Failed to Establish and Maintain a Reasonably Designed Supervisory System Regarding NT-ETPs.

From March 2014 through March 2019, MFS failed to establish, maintain, and enforce a supervisory system or WSPs reasonably designed to achieve compliance with FINRA's suitability rule as it related to NT-ETPs. MFS's supervisory system and WSPs were not reasonably tailored to address the unique features and risks associated with NT-ETPs, including the risks associated with holding NT-ETPs for extended periods of time. Specifically, although MFS's WSPs required a higher level of due diligence and supervision for sales of NT-ETPs, those WSPs provided no guidance regarding how supervisors should determine whether an NT-ETP was suitable for customers given the unique features and risks of those products. Moreover, the sole principal responsible for reviewing the daily trades of 25 registered representatives had no tools for identifying NT-ETPs. MFS had no alerts, exception reports, restrictions, or approval process that would have detected when NT-ETPs were purchased. The firm also had no method for monitoring the holding periods for NT-ETPs. Moreover, the firm failed to enforce the WSPs it had in place. There was no review or pre-approval process prior to 2018, although the firm has since implemented a stringent of review of NT-ETPs.

As a result of the firm's unreasonable supervisory system and procedures, MFS failed to detect that Representative 1\(^7\) sold NT-ETPs to two senior customers, Customer 1 and

\(^4\) FINRA Regulatory Notice 09-31 (addressing NT-ETFs).
\(^5\) Id.
\(^6\) Id.
\(^7\) Representative 1 was barred for refusing to appear for on-the-record testimony, requested pursuant to FINRA Rule 8210, in connection with FINRA's investigation into whether Representative 1 violated FINRA rules by making unsuitable recommendations to customers while associated with MFS.
Customer 2, who held those positions for between 33 months and four years. Because the firm failed to detect these transactions and their related holding periods, it could not determine whether or not the transactions were suitable for the customers. The firm also failed to determine whether or not Representative 1 understood the unique features and specific risks associated with NT-ETPs—including the risk of holding the products for long periods—and therefore could not determine whether Representative 1 lacked a reasonable basis for making the recommendations.

MFS Failed to Reasonably Supervise Representative 1’s Recommendations of Complex Options Trading

From March 2014 through March 2019, MFS failed to reasonably supervise Representative 1 with respect to complex options trading strategies he recommended to customers with very different investment profiles. MFS was aware of red flags in the risky options trading but failed to reasonably investigate whether the trading was suitable for the customers.

Representative 1 recommended various forms of options spread strategies to multiple customers that involved purchasing numerous options contracts at different strike prices and the same expiration dates. The common goal with each strategy was to limit risk with a known maximum loss as well as a maximum profit. However, some of the trades Representative 1 recommended presented an unreasonable risk since the potential maximum loss was as much as nine times greater than the maximum profit. In some cases, the overall positions guaranteed a loss.

MFS’s WSPs required the firm to review each options transaction to determine suitability, taking into account factors such as: “the compatibility of options transactions with investment objectives and with the types of transactions for which the account was approved; the size and frequency of options transactions; commission activity in the account; profit or loss in the account.” MFS, however, failed to reasonably supervise Representative 1’s activities and customer accounts to timely detect whether these complex options transactions, including the size and frequency of these transactions, were compatible with the investment objectives of each customer. Specifically, MFS failed to recognize that Representative 1 used the same options trading strategy for customers regardless of the customer’s age, net worth, and investment experience. For example, Representative 1 recommended Customer 1 make 108 sets of options spread trades (each set involving multiple options contracts) between August 2014 and March 2019. The customer had no prior experience trading in options and had a moderate risk exposure and long-term growth objective. Representative 1 employed the same options spread trading in the accounts senior Customer 2, as well as a high net worth executive and customers with significant options trading experience. MFS did not review the

---

8 Customer 1 and Customer 2 filed arbitration claims against MFS. The firm settled both claims with payments of approximately $465,000, covering each customer’s losses.

9 Some of these strategies have been referred to as vertical spreads, or wing spreads, intended to provide fixed risk and a capped profit.
frequency of options trading recommended by Representative I to determine whether the size and frequency of options transactions were suitable for each customer.

By virtue of the foregoing, MFS violated FINRA Rules 3110, 2010, and 2360(b)(20), and NASD Rule 3010 (for conduct prior to December 1, 2014).

In late 2016, MFS began requiring its registered representatives to first obtain customer signatures on risk disclosure forms for NT-ETP transactions. In 2017, MFS restricted the sales of NT-ETPs by requiring pre-approval by a supervisor. By 2018, approvals ceased, effectively banning all sales of NT-ETPs. MFS also prohibited its representatives from offering complex options trading strategies in 2018.

B. Respondent also consents to the imposition of the following sanctions:

- a censure

- a $35,000 fine; and

- an undertaking to provide the following: within 60 days of Notice of Acceptance of this AWC, MFS shall certify to FINRA in a submission signed by an officer and registered principal of the firm that, as of the date of the certification, MFS has revised its WSPs, established and implemented policies, procedures, and internal controls reasonably designed to address the deficiencies identified in this AWC. The certification and a copy of the firm’s most recent WSPs shall be sent to Jennifer C. Wang, Counsel, 12801 N. Central Expressway, Suite 1050, Dallas, Texas 75243. Upon written request showing good cause, FINRA staff may extend the procedural date set forth above.

Respondent agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim an inability to pay, now or at any time after the execution of this AWC, the monetary sanction imposed in this matter.

The sanctions imposed in this AWC shall be effective on a date set by FINRA.

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent specifically and voluntarily waives the following rights granted under FINRA’s Code of Procedure:

A. To have a complaint issued specifying the allegations against it;
B. To be notified of the complaint and have the opportunity to answer the allegations in writing;

C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made, and to have a written decision issued; and

D. To appeal any such decision to the National Adjudicatory Council (NAC) and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Respondent understands that:

A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs (ODA), pursuant to FINRA Rule 9216;

B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Respondent; and

C. If accepted:

1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future action brought by FINRA or any other regulator against Respondent;

2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
3. FINRA may make a public announcement concerning this agreement and its subject matter in accordance with FINRA Rule 8313; and

4. Respondent may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Respondent may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Respondent’s right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party. Nothing in this provision affects Respondent’s testimonial obligations in any litigation or other legal proceedings.

D. Respondent may attach a corrective action statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this statement. This statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA.

Respondent certifies that it has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; Respondent has agreed to the AWC’s provisions voluntarily; and no offer, threat, inducement, or promise of any kind, other than the terms set forth in this AWC and the prospect of avoiding the issuance of a complaint, has been made to induce Respondent to submit this AWC.

November 3, 2021
Date

McNally Financial Services Corporation
Respondent

Print Name: David D. McNally
Title: President

Reviewed by:

Gary S. Kessler
Counsel for Respondent
Kessler Collins P.C.
2100 Ross Avenue, Suite 750
Dallas, Texas 75210
November 23, 2021

Date

Accepted by FINRA:

Signed on behalf of the
Director of ODA, by delegated authority

Jennifer C. Wang
Counsel
FINRA
Department of Enforcement
12801 N. Central Expwy, Suite 1050
Dallas, Texas 75243