

**FINANCIAL INDUSTRY REGULATORY AUTHORITY  
LETTER OF ACCEPTANCE, WAIVER AND CONSENT  
NO. 2005002895501**

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

RE: Southwest Securities, Inc.  
CRD No. 6220

Pursuant to NASD Rule 9216 of FINRA's Code of Procedure, Southwest Securities, Inc. ("Southwest Securities" or "Respondent") 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 herein.

**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**

Southwest Securities, Inc. has been a member of FINRA (f/k/a National Association of Securities Dealers or NASD) and the New York Stock Exchange ("NYSE") since May 1972. The firm is also registered as a broker/dealer with the Securities and Exchange Commission. ("SEC"). Southwest Securities, which is headquartered in Dallas, Texas, currently provides securities clearing services to over 200 correspondent member firms, and conducts a full service retail brokerage business through its Private Client Group, including stock and bond trading, market making, securities lending, and public finance activities. The firm currently employs over 300 registered personnel and operates over 30 branch offices.

**RELEVANT PRIOR DISCIPLINARY HISTORY**

On June 30, 2006, NASD accepted a Letter of Acceptance, Waiver and Consent (No. 2004200022501), in which the firm was censured and fined \$160,000 for its failure to properly register certain of its associated persons and for trade reporting and supervisory violations. The firm was cited for violations of NASD Rules 1021, 2110, 3010, 5262 and 6955(a) and was required to revise its written supervisory procedures within 30 days of acceptance of the AWC.

On June 29, 2006, the NYSE issued Hearing Panel Decision (“HPD”) 06-132, in which the firm consented to findings that it violated NYSE Rules 342(a) and (b), 345(a), 346, 351(d) and 410, in that it failed to conduct annual branch office inspections of certain branch offices and to ensure that certain employees were properly registered with the NYSE. In addition, the firm failed to evidence written supervisory approval prior to effecting account designation changes; failed to obtain dual employment approval from the NYSE for certain supervisory personnel; and failed to accurately report customer complaints. The firm also failed to supervise by having inadequate systems or procedures in place with respect to the foregoing matters. The firm consented to the imposition of a censure and a \$100,000 fine.

On January 5, 2006, the NYSE issued HPD 05-157, in which the firm consented to findings that it violated NYSE Rules 410(a), 401 and 342, in that it failed to submit accurate electronic trading information requested by the NYSE and other regulators, and failed to establish and maintain appropriate systems and procedures for the supervision and control of this reporting requirement. The firm consented to the imposition of a censure and a \$300,000 fine and undertook to validate its trade reporting processes and confirm the validations to the NYSE.

On June 3, 2005, NASD accepted a Letter of Acceptance, Waiver and Consent (No. CLG050074), in which the firm was censured and fined \$10,000 and cited for violations of NASD Rules 2110, 3010 and 5220(e) for its failure to maintain continuous two-sided quotations in the absence of a grant of excused withdrawal or a functional excused withdrawal by NASD and for related supervisory violations. The firm was also required to revise its written supervisory procedures with respect to the maintenance of continuous two-sided quotations in ITS/CAES.

In January 2005, in actions announced jointly by the SEC and the NYSE, the firm consented to findings that it failed to reasonably supervise employees who engaged in illegal market timing and in the case of one employee, in late trading of mutual funds. The firm consented to a censure and a \$10,000,000 penalty (which included \$2,000,000 in disgorgement and interest) and to an undertaking to retain an independent consultant to conduct a review of its policies and procedures relating to the areas of conduct at issue.

On February 12, 2004, NASD accepted a Letter of Acceptance, Waiver and Consent (No. CAF040016), in which the firm was censured and fined \$36,971 in connection with breakpoint discounts in the sales of mutual funds to customers, and was ordered to provide written notification to each customer involved who might have been entitled to a refund. The firm was cited for violations of NASD Rule 2110 and ordered to provide refunds to customers who were entitled to them, and to provide a status report to NASD of its progress with that endeavor. The firm was also ordered to certify in writing to NASD that it had implemented procedures and a system for identifying such procedures that could reasonably be expected to prevent and detect failures to provide breakpoint discounts for which customers were eligible on purchases of front-end load mutual funds.

### **OVERVIEW**

This matter involves violations of NASD and MSRB anti-money laundering (AML) rules by Southwest Securities, Inc., in that the firm failed to implement an AML program that was reasonably designed to detect and report patterns of suspicious activity in customer accounts. The firm also failed to timely resolve deficiencies noted in three consecutive independent tests of its AML program.

### **FACTS AND VIOLATIVE CONDUCT**

During the period from April 24, 2002, through at least October 2005 (the "relevant period"), Southwest Securities violated NASD anti-money laundering (AML) rules. NASD Conduct Rule 3011(a) and (b) provide, in relevant part that AML programs of member organizations shall establish and implement:

- (i) 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; and
- (ii) policies, procedures and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder.

MSRB Rule G-41 requires MSRB members that are also FINRA members to comply with NASD Rule 3011. NASD Rule 2110 requires that a member observe high standards of commercial honor and just and equitable principles of trade in the conduct of its business.

During the relevant period, Southwest Securities violated the above-described rules by failing to develop and implement a written AML program that was reasonably designed to achieve and monitor the firm's compliance with the requirements of the Bank Secrecy Act. Specifically, the firm's AML program was inadequate because it failed to set forth a reasonable process of detecting and reporting patterns of suspicious activity. Title 31 C.F.R. § 103.19, an implementing regulation of the Bank Secrecy Act, requires broker-dealers to identify and properly and timely report suspicious transactions, including any transaction conducted or attempted by, at, or through a broker-dealer, that involves or aggregates funds or other assets of at least \$ 5,000, and that the broker-dealer knows, suspects, or has reason to suspect:

- (i) involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity;
- (ii) is designed, whether through structuring or other means, to evade any requirements of the Bank Secrecy Act;
- (iii) has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage; or
- (iv) involves use of the broker-dealer to facilitate criminal activity.

Southwest Securities' AML program was also inadequate in that it failed to timely correct the problem which was identified in three consecutive independent tests of the program.

#### Inadequate AML Program for Detecting and Reporting Suspicious Activity

During the relevant period, Southwest Securities provided clearing services for over 200 correspondent broker dealers. The firm also had over 30 branch offices, and employed over 300 registered individuals. Each month, the firm was

responsible for monitoring for suspicious activity in approximately 103,750 transactions in over 28,000 customer accounts.

Southwest Securities' system for detecting possible suspicious activity included a manual review of electronic surveillance reports that were daily snapshots of money movement instead of trend analysis or exceptions reports. For example, the firm's reports tracked daily funds activity, and large funds transactions in new accounts. These reports did not enable the firm to identify patterns of suspicious transactions indicative of money laundering or other suspicious activity.

Southwest Securities' manual review of daily snapshot reports was inadequate based on its business model, risk profile, and the volume of transactions that the firm was responsible for reviewing. Accordingly, the firm's AML compliance program was not reasonably designed to achieve and monitor its compliance with the suspicious activity reporting requirements of the Bank Secrecy Act, as required by NASD Rule 3011(a).

#### Failure to Timely Resolve Deficiencies Identified in Independent Tests

Southwest Securities was on notice of the above-described deficiencies in its AML program. As early as August 2003, the firm's independent tests of its AML program found that the firm's procedures for detecting suspicious activity were inadequate. For example, the report for the 2003 test stated, "[m]onitoring procedures do not ensure patterns of suspicious activity are identified, researched, escalated and reported or dismissed in a timely manner." The report also recommended that the firm pursue the implementation of an automatic monitoring program. The report recommended that, in the interim, the firm should enhance its current reports to identify patterns of suspicious activity. The firm did not enhance its existing reports or add additional reports to assist it in identifying patterns of suspicious activity until October 2005.

The report for the August 2004 test stated, "AML surveillance reports do not identify patterns of suspicious customer activity." The report noted that this was a repeat comment from the previous independent test, and recommended that the firm consider an outside vendor to provide tools necessary for trend analysis.

The report for the October 2005 test identified the same deficiencies as the 2003 and 2004 reports. The report also recommended that the firm's AML Officer request reports or queries from the firm's Information Technology department that would "provide trend indicators with regard to account activity or description, rather than a daily activity of all accounts." In response to the above-described independent test findings, the firm pursued the development of AML trend

reports, first with an outside vendor beginning in October 2004. When those efforts were not successful, the firm then pursued the development of in-house reports. It was not until May 2006 that the firm actually implemented in-house trend reports to address the deficiencies noted in the independent tests.

Southwest Securities failed to timely address deficiencies noted in three consecutive independent tests of its AML program. Accordingly, the firm did not establish or implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act, as required by NASD Rule 3011(b).

Such acts, practices, and conduct constitute separate and distinct violations of NASD Conduct Rules 3011(a), 3011(b) and 2110; and MSRB Rule G-41 by Southwest Securities, Inc.

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

A censure and a monetary fine in the amount of \$75,000.

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 that it is unable to pay, now or at any time hereafter, the monetary sanction(s) imposed in this matter.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

## II.

### **WAIVER OF PROCEDURAL RIGHTS**

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

- A. To have a Formal Complaint issued specifying the allegations against it;
- B. To be notified of the Formal 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 General Counsel, 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 acceptance or rejection of this AWC. Respondent further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of NASD Rule 9143 or the separation of functions prohibitions of NASD 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 NASD 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 actions brought by FINRA or any other regulator against it;
  - 2. this AWC will be made available through FINRA's public disclosure program in response to public inquiries about Respondent's disciplinary record;

Letter of Acceptance, Waiver and Consent  
No. 20050028955 01 /Southwest Securities, Inc.

3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with NASD Rule 8310 and IM-8310-3; 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.
- 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 or its staff.

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; that it has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce Respondent to submit it.

06/26/08  
Date

Reviewed by: Betty Santangelo  
Schulte Roth + Zabel LLP  
Betty Santangelo  
Counsel For Respondent

SOUTHWEST SECURITIES, INC.

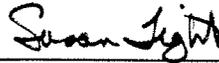
By: Phyllis Knowles  
[Signature]  
Phyllis Knowles  
[Name]  
COO/EVP  
[Title]

Letter of Acceptance, Waiver and Consent  
No. 2005002895501 /Southwest Securities, Inc.

Accepted by FINRA:

7/18/08  
Date

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



Susan Light  
Senior Vice President & Chief Counsel  
FINRA Department of Enforcement  
14 Wall Street, 14<sup>th</sup> floor  
New York, New York 10005  
Phone Number: (646) 315-7333  
Fax: (646) 315-7441



Andrew A. Favret  
Associate Vice President &  
Regional Chief Counsel  
FINRA Department of Enforcement  
1100 Poydras Street  
Energy Centre, Suite 850  
New Orleans, LA 70163-1108  
Phone Number: 504-412-2404  
Fax Number: 504-522-4077