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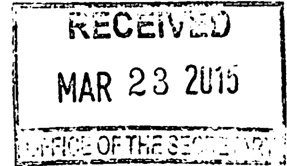

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION

In the Matter of: THE ROBARE GROUP, LTD., MARK L. ROBARE, AND JACK L. JONES, JR., Respondents.	ADMINISTRATIVE PROCEEDING File No. 3-16047 **Honorable James E. Grimes**

RESPONDENTS' POST-HEARING BRIEF

Alan M. Wolper
awolper@ulmer.com
Heidi VonderHeide
hvonderheide@ulmer.com
Ulmer & Berne, LLP
500 West Madison Street, Suite 3600
Chicago, Illinois 60661
(312) 658-6500 – General
(312) 658-6565 – Fax

Counsel for Respondents

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Respondents The Robare Group, Ltd. ("TRG" or the "Firm"), Mark L. Robare, and Jack L. Jones, Jr. (collectively, "Respondents"), by and through their attorneys and in accordance with the Court's Order dated February 13, 2015, hereby submit this Post-Hearing Brief in further support of their defense.

I. INTRODUCTION

As Respondents promised in their Pre-Hearing Brief, this case, at its core, is simple. The question presented to this Honorable Court is whether or not Respondents' client disclosures, including those made in TRG's Forms ADV and elsewhere, disclosed the fact that the Firm could receive certain commission payments from Fidelity Brokerage Services, LLC ("Fidelity") pursuant to two written agreements, along with any potential conflicts created thereby. The Division carries the burden of proof in this case, requiring it to prove each element of each claim by a preponderance of the evidence. A review of the evidence presented at the recent hearing reveals that the Division has failed to carry that burden.

More specifically, it has failed to show that Respondents did not make a required disclosure, that Respondents acted with scienter, or that Respondents acted willfully, or even negligently. To the contrary, the evidence presented established that: (1) there was no failure to disclose a material fact or conflict; (2) Respondents, at all times, acted in good faith and in the

best interests of their customers; and (3) there was no negative impact on either the Firm's customers or the investing public at large.

Because the Division has failed to carry its burden, the charges alleged in the Order Instituting Proceedings ("OIP") should be dismissed in their entirety and the Division's request for sanctions and civil penalties should be denied.

II. FACTS

TRG is an independent SEC-registered Registered Investment Advisor, located in Houston, Texas. Stipulations of Fact filed February 2, 2015 ("2.2.15 Stipulations"; Stipulation No. 1). The Firm was formed in 2000 by Mark Robare, who has worked in the financial services industry for over 35 years and the securities industry for the last 27 years. RX-110; Tr. 287:1-288:3.[1] Mr. Robare is also a FINRA registered representative, a Chartered Financial Consultant (ChFC), Chartered Life Underwriter (CLU) and a Certified Financial Planner (CFP). RX-110; Tr. 285:18-286:25. Mr. Robare co-owns TRG with his son-in-law, Mr. Jones (also a FINRA registered representative, CFP and ChFC), who has over 20 years' experience. RX-109. Over this combined 55 years of experience, Messrs. Jones and Robare have maintained a spotless disciplinary record – save only the instant proceeding. Tr. 292:5-293:13; RX-109; RX-110.

A. TRG

TRG is a small investment advisory firm, formed in 2003 after Mr. Robare decided to leave his prior firm (Allmerica) and create his own independent investment advisor, to obtain greater flexibility in managing his customer accounts than Allmerica afforded. Tr. 297:2-18; Tr. 328:23-329:1. The Firm currently employs seven people and services approximately 300 families as clients. Tr. 370:12-17; Tr. 301:23-24; Tr. 663:14-16. Its client base has essentially

[1] The Transcript of Proceedings is cited herein using the abbreviation "Tr."; Respondents' exhibits are referenced with the abbreviation "RX"; the Division's exhibits are referenced with the abbreviation "DX."

doubled since the Firm went independent. Tr. 301:25-302:3. Respondents' customers are, primarily, former and current oil and gas executives who are approaching, or just entering retirement, and who have account balances averaging between $500,000 and $800,000. Tr. 302:4-18; Tr. 332:5-9. The Firm does relatively little marketing and instead finds most of its clients through referrals by existing – and happy – clients. Tr. 303:21- 24; Tr. 661:19-23.

For its investment advisory clients, TRG actively manages between seven and ten model portfolios. Tr. 721:15-23. Clients are paired with an appropriate model following a complete review of their investment profile – net worth, investment objectives, risk tolerance, etc. Tr. 301:1-22. The various models are comprised exclusively of various no-transaction-fee mutual funds ("NTF" Funds), i.e., mutual funds that do not charge a commission on the purchase transaction. Tr. 306:10-16; 669:13-25. The commission-free purchase allows TRG to control the fees its clients incur and, in turn, increase the ultimate return on their investment. Tr. 307:11-308:10; 669:13-25. Fee control is a primary pillar of TRG's approach to investing and selection of client investments. Tr. 667:11-22; 670:13-670:3.

Mr. Robare and Mr. Jones maintain very close contact with their clients, hosting regular events to discuss the status of their customers' portfolios, assess and reassess their customers' goals, and ensure that their customers' needs are being met. Tr. 662:9-663:13. Clients are invited to meet with their adviser at least annually, although most have far more frequent contact. *Id.* The Firm's 97% client retention rate speaks loudly to the level of satisfaction it has achieved among its clients. Tr. 303:25-304:11.

B. Triad Advisors

Upon leaving Allmerica and going independent, Messrs. Robare and Jones also became registered representatives with Triad Advisors, Inc. ("Triad"), a Commission-registered broker-dealer headquartered in Norcross, Georgia. 2.2.15 Stipulations; Stipulation No. 8. When

Messrs. Robare and Jones joined Triad, their office became an Office of Supervisory Jurisdiction ("OSJ"). RX-17. As a result, Triad assumed supervisory responsibility over the TRG branch, including TRG's investment advisory business. RX-16, 17; Tr. 389:9-392:21; 660:17-25. TRG paid Triad $1,500 per quarter for this oversight, which included several supervisory functions RX-16; Tr. 389:20-24; Tr. 600:17-25.

One aspect of Triad's supervision was that it conducted annual reviews of TRG. The reviews covered a wide variety of compliance topics. RX-22-RX-28. Among other things, during each annual review, Triad obtained and reviewed a copy of TRG's Form ADV. Tr. 393; 4-395:9. If Triad identified any issues with the Form ADV, it would bring the issues to the Firm's attention. Triad audited TRG every year from 2004 to the present. Significantly, Triad never raised any issues or indicated there was any problem with TRG's ADV. RX-22, RX-23, RX-24, RX-25, RX-26, RX-27, Tr. 395:13-21.

In addition to having Triad review the Firm's ADV as part of its annual reviews, TRG was also required to (and did) send Triad copies of any amendments or updates to the ADV for Triad's approval. Tr. 630:7-17. Triad reviewed and approved those disclosures prior to submission. Tr. 630:7-17. Because Triad was a party to the Investment Advisor Commission Schedule and Servicing Fee Agreement (the "2004 Agreement") that is at issue in this case (and was processing the payments received from Fidelity), there can be no dispute that when it approved the language in the Form ADV, it did so fully aware of the 2004 Agreement and the compensation Respondents derived from it. Triad's supervision of TRG remained in place for the entire time period at issue in this dispute.

Triad was also responsible for monitoring Mr. Robare and Mr. Jones' compensation. On October 29, 2002, Mr. Robare executed an agreement with Triad outlining the terms of his

compensation structure ("Compensation Agreement"). RX-16. Pursuant to that agreement, Mr. Robare retained 100% of his fee business, defined under the Compensation Agreement as: Fidelity direct business; Triad Fee Account business; and all fees earned when preparing financial plans. For commission business, however, the parties agreed that Mr. Robare would receive 90% of the commissions he earned on packaged products and 80% of the commissions earned on individual securities. Triad would retain the remaining percentages. *Id.* What constituted a "commission" under the Compensation Agreement was clearly defined:

> Commission Business:
>
> - Packaged Products – This will include Mutual Funds, Variable Insurance, 12b-1 and other trails: 90% payout
> - Individual Securities (stocks, bonds): 80% payout.

Id. p. 1.

C. Fidelity

This case arises out of two agreements entered into, successively, between and among TRG and Triad: (1) the 2004 Agreement (RX-1) and (2) the 2012 Investment Advisor Custodial Support Services Agreement ("2012 Agreement," RX-2). Long before those agreements were executed, however, Mr. Robare and Mr. Jones (and their clients) had utilized Fidelity to perform certain clearing and trading functions. Tr. 670:10-13. In fact, TRG first started working with Fidelity in 1998 prior to going independent (i.e., when the Firm was still affiliated with Allmerica). Tr. 297:19-298:15; Tr. 299:5-11; Tr. 670:10-13; Tr. 369:1-370:1. At that time, Fidelity served as the clearing firm for all of TRG's client accounts. Tr. 670:14-17. Thus, as early as 1998, all of TRG's clients were also customers of Fidelity. Tr. 297:19-298:15; Tr. 299:5-11; Tr. 811:21-24.

In 2003, when TRG severed from Allmerica to go independent, it elected to continue its relationship with Fidelity. On February 25, 2003, TRG and Fidelity entered into an agreement titled "Investment Advisor Representation and Indemnification Letter," pursuant to which Fidelity agreed to provide execution, custody, and clearing services for TRG's advisory clients and provide TRG access to Fidelity's mutual fund trading platform. 2.2.15 Stipulations; Stipulation No. 6.

Continuing its relationship with Fidelity was very important to TRG for three reasons. First, as noted above, TRG's model portfolios were comprised entirely of NTF mutual funds, and Fidelity maintained one of the largest NTF platforms available (offering over 6,600 NTF mutual funds), meaning it provided Robare (and its clients) a wide variety of investment options from which to choose. Tr. 810:19-811:3, RX-41. Second, by the time TRG went independent, the Firm and its employees had been operating, and were very familiar with, Fidelity's technology. Tr. 809:6-17; Tr. 811:4-20; Tr. 812:8-12. One of the largest challenges to TRG in going independent would be taking its trading in-house, and TRG wanted the transition to be as seamless as possible. Continuing to use the Fidelity platform eased this transition. Tr. 809:6-17.

Third, TRG's clients were already familiar with Fidelity. Tr. 809:6-17. By 2003, most of them had been customers of Fidelity for years and already held accounts there. Tr. 299:5-11; Tr. 811:21-24. Also, the continued relationship meant the client accounts would not need to be transferred to a new firm, which can be a complicated (and often irritating) procedure. In light of all these factors, staying with Fidelity was the obvious choice.

D. The 2004 Agreement

Approximately one year later, Mr. Robare and Mr. Jones attended a lunch meeting with Mark Mettelman, then Vice President and CEO of Triad, during which they came to discuss Fidelity's NTF platform. Tr. 314:10-21. Mr. Mettelman informed Mr. Robare that Fidelity had

a program available to advisors like TRG, who dealt exclusively in NTF Funds. *Id.;* Tr. 312:7-313:4; RX-36. Messrs. Robare and Jones contacted Fidelity to learn more, but from the onset, they articulated that they had two primary concerns: (1) would their clients incur any new or additional costs under the program; and (2) would this arrangement in any way be expected to affect or influence their investment decisions. Tr. 314:10-316:11; Tr. 667:4-22; Tr. 666:24-668:6.

The answer to both questions was a clear and certain "no." The payments from Fidelity would not come from clients, but, instead, would be carved out of the fees Fidelity itself received from the mutual fund companies for offering their mutual funds on Fidelity's platform. Tr. 667:4-668:9. TRG's clients would not be charged any new or additional fees. *Id.*

As for investment decisions, TRG would not be obligated to purchase any particular mutual funds in any particular amount. Tr. 316:1-11. Instead, Respondents continued to have access to Fidelity's *entire* NTF catalogue of mutual funds – the same funds they had been using for years – and the freedom to select whatever mutual funds best suited their customers' needs, regardless of whether those funds would result in any payment from Fidelity. Tr. 810:19-811:3, RX-41. It simply meant that, should they select an NTF fund that qualified as "eligible" under the program, TRG would receive a small piece of the commission paid by the mutual fund company to Fidelity.

TRG decided to enroll in the program and, on April 19, 2004, Mr. Robare entered into, on TRG's behalf, the 2004 Agreement. The other parties to the 2004 Agreement were Triad (TRG's broker-dealer) and Fidelity (through its entities Fidelity Brokerage Services ("FBS") and National Financial Services ("NFS")). Stipulation No. 11; RX-1; Tr. 317:14-18; Tr. 318:19-319:22.

The 2004 Agreement, drafted by Fidelity, provided for a "servicing fee revenue program," in which TRG would earn payments from Fidelity, ranging from 2 to 12 basis points, based on the volume of certain "eligible" mutual funds that TRG purchased on Fidelity's platform on behalf of its advisory customers. RX-1. Which NTF mutual funds were deemed "eligible" under the agreement was never defined, apart from the fact that Fidelity mutual funds were expressly defined not to be eligible. Moreover, no list of eligible funds was ever provided to TRG. RX-1; Tr. 669:3-7; Tr. 670:24-671:1. Accordingly, TRG was unaware in 2004 – or anytime thereafter – which NTF funds would result in a payment from Fidelity. *Id.*

Regardless, on a quarterly basis, the amounts that TRG earned on "eligible" NTF mutual funds were to be paid by Fidelity directly to Triad. Stipulation No. 18; RX-1; Tr. 330:20-331:3. Triad retained 10% of the amount it received from Fidelity – as it did with all commissions earned by Robare, pursuant to the Compensation Agreement – and passed the remaining 90% on to Robare. Tr. 614:4-19; Tr. 385:6-7; RX-29-35. The payments appeared on Mark Robare's regular commission statements from Triad. RX-29-35. This process continued from the time the 2004 Agreement was executed until April 2013, when the 2012 Agreement went into effect.

E. TRG Revises Form ADV to Disclose the Fidelity Payments and Potential Conflict of Interest

After executing the 2004 Agreement, TRG revised its Form ADV to disclose the existence of the compensation that agreement contemplated, and that the compensation could create a conflict of interest between TRG and its clients. Before making any changes to its Form ADV, the Firm engaged the services of Capital Markets Compliance ("CMC"), a regulatory compliance consultant, to assist it in drafting the new document. RX-101, 102. With CMC's assistance, the Firm updated its Form ADV, amending Item 13A as follows (comparing RX-4, left, and RX-6, right):

2003 ADV Part II, Item 13A	2005 ADV Part II, Item 13A
Mark Robare, Carol Hearn & Jack Jones sell securities and insurance products for sales commissions.	Certain investment adviser representatives of ROBARE, when acting as registered representatives of a broker-dealer, may receive selling compensation from such broker-dealer as a result of the facilitation of certain securities transactions on Client's behalf through such broker-dealer. *** These other arrangements may create a conflict of interest.

The amendment disclosed that (1) TRG may receive selling compensation from Triad as a result of facilitating certain securities transactions on its clients' behalf; (2) that the compensation would be received through Triad; and (3) that the compensation may create a conflict of interest.

No changes or amendments were ever made to the 2004 Agreement until it was ultimately replaced by the 2012 Agreement (in 2013). Accordingly, the fact that TRG received compensation from Fidelity (and that this compensation created potential conflicts of interest) remained constant until the new agreement was executed, and these facts were disclosed to customers through the above language. It was not, however, the only way the Firm communicated this to its clients.

F. Further Disclosure

The Forms ADV were the primary disclosure documents provided to customers – in terms of length and content – but they were not the only ones. Throughout this entire time period, in addition to its most current Form ADV, TRG also provided its customers with several other documents that likewise disclosed the fact that TRG was receiving compensation which could create a conflict of interest. *See* Exhibit B hereto, summarizing language of these non-ADV disclosures.

1. TRG Disclosure Brochure

One such document was the Firm's Disclosure Brochure, which was provided to each client or prospective client. Clients were required to sign and date the document, affirming their review and understanding of its terms and to verify they received it. The General Information & Disclosure Brochure stated, in relevant part:

> We do investment advising and financial planning. As an investment advisor we manage your account for a percentage of the assets under our management...Additionally, we may select and monitor other money managers on your behalf. **When we do so, the other money managers pay us a portion of the fees generated by the referred clients – clients do not pay us directly for this service.** Mark Robare, Carol Hearn, and Jack Jones are also stockbrokers and insurance agents who may earn sales commissions when you purchase securities and/or insurance products through The Robare Group, Ltd. **You should be aware that a conflict may exist between your interests and those of The Robare Group, Ltd.** and if you elect to act upon any of the recommendations, you are under no obligation to effect the transactions through The Robare Group.
>
> ***
>
> For commission accounts, we recommend our broker/dealer – Triad Advisors, Inc. – and if you implement your securities (or insurance) transactions through it, we may earn sales commissions.

RX-97 (Emphasis added). The above language disclosed that (1) the Firm may receive a portion of the fees generated on client referrals; (2) that those fees were not paid by the customer directly, and (3) that they could create a conflict of interest.

2. The Fidelity Client Agreement

As noted above, each of TRG's clients was also a client of Fidelity and opened a custodial account directly with Fidelity. The Fidelity custodial account agreement ("Fidelity Customer Agreement") provided:

> **We also may pay your advisor for performing certain back-office, administrative, custodial support and clerical services for us in connection with client accounts for which we act as custodian. These payments may create an incentive for your advisor to favor certain types of investments over others.**

RX-76, 77, 78, 79 (Emphasis added).

All of TRG's customers signed the Fidelity Customer Agreement, indicating both their receipt of the document and acceptance of its terms. As Mr. Robare testified at hearing, TRG was aware that Fidelity made the above quoted disclosure in its Customer Agreement and, in fact, TRG was responsible for providing its clients with a copy of Fidelity's Customer Agreement. Tr. 357:13-20. Further, Mr. Robare testified that the Firm discussed the document with its clients at the time it was provided, focusing specifically on compensation items. Tr. 357:13-358:19; 359:20-22; 362:17-25. Finally, Mr. Robare testified that TRG considered the disclosures contained in the Fidelity Customer Agreement to be among the universe of disclosures that the Firm made to its clients and prospective clients. Tr. 359:1-360:17.

G. Retention of Compliance Consultants

TRG drafted and prepared all of its Forms ADV throughout the time period at issue with the help of compliance consultants. As Mr. Robare testified, the Firm has never filed a Form ADV without retaining a compliance consultant for advice and assistance. Tr. 368:9-23; Tr. 370:2-5. In 2005, after the 2004 Agreement was executed, the Firm retained CMC to assist it in filing its August 2005 revised Form ADV. RX-101; RX-102; Tr. 507:10-13.

In November 2007, Robare engaged a new compliance consultant, Renaissance Regulatory Services, Inc. ("Renaissance"), to replace CMC. RX-43. Renaissance agreed to provide compliance consulting and support for TRG, specifically including review and updating of the Firm's Form ADV. RX-43, 44, 45, and 46; Tr. 545:3-17; Tr. 548:1-10. TRG's relationship with Renaissance continues through the present day and, although the two parties

would execute new consulting agreements over the years, the material terms of their arrangement has remained the same. *Id.* From 2007 onward, Renaissance reviewed TRG's Form ADV (including Schedule F) many times. Tr. 553:18-20. Aside from the amendments discussed below, prompted by regulatory changes and Fidelity, respectively, Renaissance never indicated there were any issues with TRG's disclosures, specifically including the disclosures contained in Item 13A or 14. Tr. 714:8-18.

H. <u>Amendments to Form ADV</u>

The 2004 Agreement remained un-amended and in full effect until 2012, when it was replaced by the 2012 Agreement. But, because there were no changes to the 2004 Agreement over the years, including the provisions dictating how and why Fidelity made payments that made their way to Respondents, there was no reason for the Firm to make any changes to its existing disclosures. As a result, the 2005 disclosure, drafted with the help of CMC and reviewed regularly by Renaissance, remained in effect for many years. It was, however, updated in 2011, 2012, and 2013, as a result of regulatory changes and at the request of Fidelity.

1. The 2011 Amendments to Form ADV

Effective October 12, 2010, the Commission amended Form ADV and required most Commission-registered investment advisers to begin using, in early 2011, a separate client disclosure brochure that met the requirements of the new Part 2A. 2.2.15 Stipulations; Stip. No. 32. The Commission's amendment required a wholesale revision to Form ADV, converting the document from a schedule format to an entirely narrative "brochure" format. *Compare* RX-10 and RX-11. To comply with the new format, TRG, again with the help of Renaissance, revised its Form ADV, filing its first revised "brochure" in March 2011. Tr. 683:2-6; RX-11.

The revised ADV had many changes, including revisions to Item 14 (the disclosure formerly found, pre-amendment, at 13A) to describe more accurately the relationship at issue. Tr. 685:25-686:6:

2005 ADV Part II, Item 13A	March 2011 ADV 2A, Item 14
Certain investment adviser representatives of ROBARE, when acting as registered representatives of a broker-dealer, may receive selling compensation from such broker-dealer as a result of the facilitation of certain securities transactions on Client's behalf through such broker-dealer. *** These other arrangements may create a conflict of interest.	Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation.

RX-6 left; RX 11, right.

Mr. Jones testified that the amended language in this disclosure was included to detail more thoroughly TRG's arrangement with Fidelity. Tr. 685:25-686:6.

> **Q. So what changes have been made here?** (showing the witness the above chart comparing RX-6 and RX-11).
>
> A. Well, we named Triad specifically and speak to the selling compensation that we received at this time, still a 12b-1, on a commission statement through Triad. We used similar language about certain securities, but then we go on to provide more information about the source of this selling compensation where we list 12b-1s, front end sales charges, et cetera.
>
> **Q. This language includes the words 12b-1. What was important about that language?**
>
> A. Because we believe from the origin of this agreement that the agreement that Triad made us aware of that they were a part of the tri-party agreement to, that this compensation was 12b-1, and that was the reason it had to go through a broker-dealer, then through

> us as a commission haircut by 10 percent by the broker-dealer and listed as 12b-1 on many of our early commission statements.

Again, these above revisions were made with the advice and counsel of Renaissance. Tr. 406:14-23; Tr. 548:1-10; Tr. 553:18-22; Tr. 587:23-25.

2. Fidelity Requests Additional Language

The next amendment to Item 14 of TRG's ADV came approximately eight months later, in December 2011, at Fidelity's request. RX-80. Fidelity, through Tim Fahey, one of its Vice Presidents, contacted TRG and asked it to include additional language in Form ADV regarding the terms of the 2004 Agreement. RX-80, 81; Tr. 691:8-13. Fidelity provided TRG with sample language, but cautioned the Firm that

> ***This language is merely provided as an example, and should not be construed as (and does not constitute) legal advice. The adviser's own qualified legal counsel and compliance personnel should review and customize any disclosure language to determine if it is appropriate.***

RX-80, p. 2 (bold and italics in original).

Mr. Robare and Mr. Jones immediately agreed to amend the disclosure, and again turned to Renaissance for help in drafting language that complied with Fidelity's request, but was also specific to TRG. Tr. 693:10-13; 698:15-19. Before the Firm was able to finalize anything, however, Mr. Fahey e-mailed Mr. Jones again, apologetically telling him Fidelity had "escalated this issue" and that the revision must be complete by December 16, 2011 – giving the Firm seven days to make the revisions and file its updated ADV. RX-81.

Despite the time constraints, TRG and Renaissance modified the boilerplate language Fidelity provided to reflect the Firm's business model and its specific relationship with Fidelity.[2]

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[2] Not only was the Firm given just seven days to make the amendment, but Fidelity's request came while TRG and Renaissance were in the middle of preparing the final ADV for 2011. Tr. 696:10-20.

Tr. 691:24-693:13. Once they came up with a final draft, Mr. Jones sent the proposed language to Fidelity, to determine whether it was compliant with their request. RX-83 pp 1-2; Tr. 698:20-699:4. Mr. Fahey forwarded Mr. Jones' email on to Mr. Hawley, Fidelity's Director of Risk. Tr. 118:17-21. On December 12, 2011, Mr. Fahey responded to Mr. Jones, forwarding him Mr. Hawley's response, "Tim, I don't approve or disapprove any language, but if that was on their ADV I would think that would be great." RX-84. Reacting to Mr. Hawley's response, Mr. Fahey commented in his email to Mr. Jones, "Jack, as you can see, we can't approve/disapprove, but you seem to have the language nailed though." RX-84.

Despite the tight time constraints Fidelity imposed on TRG, the Firm was able to amend its Form ADV disclosure to include the language Fidelity requested. RX-14; Tr. 700:24-701:1. The amended language appeared in the Firm's December 2011 Form ADV:

March 2011 ADV 2A, Item 14	**December 2011 ADV 2A, Item 14**
Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation.	Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation. Additionally, we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity.

March 2011 ADV 2A, Item 14	December 2011 ADV 2A, Item 14
	This additional compensation does not represent additional fees from your accounts to us.

RX-12, left; RX-14, right.

Mr. Jones testified that upon receiving Fidelity's request to add additional language, the Firm was "happy" to accommodate their request. Tr. 701:17-21. Mr. Fahey confirmed Mr. Jones was appreciative of Fidelity's request, and took it very seriously. Tr. 122:12-17. Mr. Jones further testified, however, that while the Firm was happy to add the additional language Fidelity desired, it did not believe – nor was it ever told – that its prior disclosure was in any way inadequate. Tr. 701:12-24.

3. The 2012 Custodial Agreement and Resulting ADV Amendment

The 2004 Agreement with Fidelity remained in place until 2012, at which time Fidelity sent TRG an updated and amended agreement, asking them to execute it. Tr. 702:4-7; RX-87. Mr. Robare and Mr. Jones were initially hesitant to sign it, as there were several changes in the agreement that gave them pause. First, the new agreement was directly between them and Fidelity – Triad was cut out. Messrs. Robare and Jones did not understand why the commission payments would no longer be transmitted through their broker-dealer. Tr. 702:15–703:4. Accordingly, they sent the draft agreement to Triad for review and comment. Tr. 703:14-704:4. Triad approved it. Tr. 703:19-704:4. They also sent it to Renaissance for its review and comment to help TRG determine whether any additional disclosures would be required. Tr. 703:17-704:4.

In 2013, the new agreement was signed. RX- 2. Other than the elimination of Triad, however, the underlying payment structure remained the same. As before, no commissions or

fees were charged to TRG customers. The Firm, with the help of Renaissance, filed an updated Form ADV in April 2013. Item 14 was revised again:

December 2011 ADV 2A, Item 14	March 2012 ADV 2A, Item 14
Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation. Additionally, we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional compensation does not represent additional fees from your accounts to us.	We do not receive an economic benefit from a non-client for providing investment advice or other advisory services to our clients. Additionally, we do not have any arrangement under which we, or a related person, directly or indirectly compensate any person, who is not our supervised person, or receive compensation from another for client referrals at this time. Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation. Additionally, we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional compensation does not represent additional fees from your accounts to us.

RX-13 (left) RX-14 (right).

With each revision, TRG intended to (and believed it did) disclose the fact it was receiving compensation from Fidelity and that the receipt of that compensation could create a conflict of interest between TRG and its clients. Tr. 677:10-21; 684:16-20; Tr. 694:10-17; Tr. 717:3-14.

Despite the presence of this disclosure, TRG's obvious willingness to comply with its obligations, the fact it sought and heeded the advice of its consultants, and its immediate compliance with Fidelity's requests to supplement, Respondents nevertheless found themselves the subjects of this proceeding. For the reasons set forth herein, the allegations contained in the OIP should be dismissed in their entirety.

III. GOVERNING AUTHORITY

A. Burden of Proof

The Division of Enforcement carries the burden of proof in this case. Unless the Division has established every element of every claim put forth in the OIP by a preponderance of the evidence, the allegations must be dismissed. *Steadman v. S.E.C.*, 450 U.S. 91, 95 (1981).

B. Investment Advisers Act of 1940; Provisions at Issue

The Division has alleged that TRG violated Sections 206(1) and (2) of the Investment Advisers Act of 1940. Section 206(1) and (2) provide:

> It shall be unlawful for any investment adviser, by use of the mails or any means or instrumentality of interstate commerce, directly or indirectly--
>
> **(1)** to employ any device, scheme, or artifice to defraud any client or prospective client;
>
> **(2)** to engage in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client;

15 U.S.C. 80b-6.

1. Standard under §206(1)

With regard to the 206(1) allegation, in order to carry its burden of proof, the Division must prove that TRG and Mr. Robare (1) are investment advisers who (2) utilized the mails or instrumentalities of interstate commerce to employ a device, scheme or artifice; (3) the device,

scheme or artifice violated the Firm's fiduciary duty to its clients (4) in that it made false and misleading statements. *S.E.C. v. Merrill Scott,* 505 F. Supp. 2d 1193 (D. Utah 2007). To succeed on its 206(1) claim, the Division must further show that the purported "scheme or artifice" was performed with *scienter,* which is defined as a "mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 185 (1976); *S.E.C. v. Steadman,* 967 F.2d 636, 641 (D.C. Cir. 1992); *S.E.C. v. Moran,* 922 F. Supp. 867, 896 (S.D.N.Y. 1996).[3]

2. Standard under §206(2)

Proving a violation of Section 206(2) requires essentially the same elements as a 206(1) claim. The Division must show that TRG and Mr. Robare engaged in some "transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The conduct alleged here to violate Section 206(2) is the same alleged to have violated 206(1), namely, that TRG and Mr. Robare failed to disclose certain material facts in their dealings with clients. *S.E.C. v. Slocum, Gordon & Co.*, 334 F. Supp. 2d 144, 182 (D.R.I. 2004). Unlike a 206(1) claim, a 206(2) claim does not require a showing of *scienter.* Instead, a negligence standard is imposed, meaning the Division must prove that TRG failed to uphold a duty owed to its clients.

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[3] "Recklessness" can satisfy the scienter requirement. *See David Disner*, 52 S.E.C. 1217, 1222 & n. 20 (1997); *see also S.E.C. v. Steadman*, 967 F.2d at 641-42; *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990). "Recklessness" in this context, however, "is not merely a heightened form of ordinary negligence; it is an ***extreme departure*** from standards of ordinary care, which presents a danger of misleading buyers or sellers." *S.E.C. v. Moran*, 922 F. Supp. 867, 897 (S.D.N.Y. 1996) citing *Steadman*, 967 F.2d 636 at 641-42; *See also, Brandt,* Release No. 289 2005 WL 1584978 (emphasis added) *quoting Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978).

3. Standard under §207

The Division also alleges that in filing TRG's Forms ADV, Messrs. Robare and Jones "willfully" filed an inaccurate report with the Commission. Section 207 of the Act, states:

> It shall be unlawful for any person *willfully* to make any untrue statement of a material fact in any registration application or report filed with the Commission under section 80b-3 or 80b-4 of this title, or *willfully* to omit to state in any such application or report any material fact which is required to be stated therein.

15 U.S.C.A. §80b-7 (emphasis added). In order to carry its burden on this claim, the Division must show that TRG, Mr. Robare and Mr. Jones "willfully" omitted material facts when they cause the Form ADVs to be filed.

For each of the above allegations, if the Division fails to establish any element by a preponderance of the evidence, that claim fails as a matter of law, and the charge must be dismissed. *Steadman,* 450 U.S. at 95.

IV. ARGUMENT

Each and every allegation contained in the OIP requires a finding that TRG failed to make certain material disclosures to its customers regarding the fact that it (1) received compensation from Fidelity; and (2) that the compensation could create a potential conflict of interest. The evidence presented at hearing showed that TRG disclosed both the compensation and the conflict and that it made this disclosure notwithstanding the fact that neither the compensation nor the conflict was material. The fact that the disclosures were made – without more – is sufficient to defeat each and every one of the Division's claims and require an dismissal of the allegations in their entirety.

Yet, the fact of disclosure is merely the first of many the incurable defects in the Division's case. The second major defect is that, even if the Division is correct that there was a failure to disclose (which it is not), a failure to disclose is only actionable if the information

omitted – whether it be a particular fact or a particular conflict – is material. The guidance is clear that only material facts and material conflicts need be disclosed. The Division has failed to prove that either the compensation received or any conflict created by that compensation (if any existed) was material. This failure is likewise fatal to its claims against the Firm.

Third, and finally, the Division failed to present evidence that the Firm acted with the requisite intent in performing the acts at issue in this case, namely: (1) that the Firm acted with *scienter* (required under §206(1)); (2) that the Firm deviated from the duty it owed its clients (i.e., acted negligently) (required under §206(2)); or (3) that Mr. Robare and Jones "willfully" filed false statements with the Commission (required under §207). To the contrary, the unrebutted testimony presented at hearing was that Mr. Robare and Mr. Jones at all times acted in good faith, in the best interest of their clients, and with the intent and belief that their disclosures were complete and accurate.

Accordingly, because the Division has failed to carry its burden in this case, the claims asserted against Respondents should be dismissed.

A. The SEC has Failed to Prove that Mr. Robare or TRG Violated Section 206(1).[4]

The Division has failed to meet its burden of proof that TRG intentionally and with scienter failed to disclose the compensation it received from Fidelity and any potential conflicts created by that compensation. Respondents do not carry the burden of proof in this case and, thus, have no obligation to *disprove* the Division's allegations. Yet the evidence presented did exactly that, establishing that TRG properly disclosed the compensation it received from Fidelity, as well as the fact that such compensation could create a conflict of interest between the

[4] The Commission has not charged Mr. Jones with violating §206. It does, however, charge him with "aiding and abetting" the alleged violations. To the extent the Section 206 allegations are dismissed, the aiding and abetting claims against Mr. Jones fail as a matter of law, and should be dismissed. The aiding and abetting allegation is addressed, in full, in Section IV.D., below.

Firm and its clients. The disclosures occurred in three primary places: (1) the Firm's Form ADV, (2) the Firm's General Information and Disclosure Brochure, which was provided to – and signed by – each and every Firm client; and (3) Fidelity's Customer Agreement with TRG's clients, a document which the Firm considered to be part of the "universe" of disclosures provided to customers.

1. Any Potential Conflict Between TRG and its Customers was not Material.

Based on the testimony presented at hearing in this matter, the parties agree that only material facts and material conflicts of interest are required to be disclosed. Tr. 277:21-279:1; Tr. 829:19-830:13. This understanding is shared by the General Instructions to Part 2 Form ADV, which laid out the Firm's disclosure obligations:

> 3. Disclosure Obligations as a Fiduciary. Under federal and state law, you are a fiduciary and must make full disclosure to your *clients* of all **material** facts relating to the advisory relationship. As a fiduciary, you also must seek to avoid conflicts of interest with your clients, and, at a minimum, make full disclosure of all **material conflicts of interest** between you and your *clients* that could affect the advisory relationship...

DX-90.

Here, both the compensation and its potential to create a conflict were disclosed. Under §206 of the Act, however, only material omissions are actionable. Accordingly, even if there was some defect with the Firm's disclosures, it is not actionable because the Division has failed to establish that the compensation received by Respondents was material. If the compensation was immaterial and need not be disclosed, then any potential conflict created by that compensation must also be immaterial, and need not be disclosed.

As Mr. Robare testified at hearing – and there was no evidence presented to the contrary – the payments from Fidelity amounted to only 2.5% of the Firm's overall revenue.

Tr. 413:18-414:6; Tr. 504:7-18. This small percentage of earnings can hardly be considered to be "material" compensation. If it is not material, the fact of the compensation need not be disclosed. It also follows that if the compensation is not material, and need not be disclosed, the conflict the receipt of that compensation creates is similarly non-material and disclosure is not required.

The materiality of compensation received (and the requirement that it be disclosed) was considered in *Brandt,* Release No. 289 2005 WL 1584978 (Exhibit C) in which the Court held that a $7,500 payment received by the respondent was not material, and that the firm's omission of that amount from its Form ADV did not violate the Advisers Act. In that case, the Division charged respondent ("BKS") with violating §§206(1) and (2) by failing to disclose the fact that it received a $7,500 reimbursement for fees when it transferred its clients' accounts from LPL to TDW. There was no dispute that BKS received the $7,500, or that the Form ADV did not specifically disclose the $7,500. Instead, BKS argued that, in transferring the client accounts, it had disclosed to its clients the material benefits and costs of that transfer, notwithstanding the fact that it did not specifically mention the $7,500 reimbursement. The Court agreed with BKS, concluding:

> [T]here was no misappropriation of client assets and consequently no material misrepresentations or omissions concerning a misappropriation of client assets.... Not only did BKS reimburse clients far more than $7,500, the record shows that BKS and Brandt worked diligently to secure a custodian that would save their clients a substantial amount of money compared to what they had been paying LPL. In sum, there was no scheme to defraud, no material misrepresentations or omissions, and no violation of Sections 206(1) or 206(2) of the Advisers Act.

The Court's reasoning in *Brandt,* recognizing some minimum threshold for materiality with regard to compensation, is echoed by the Commission itself. In fact, the SEC release announcing amended Rule 203-4 (and the amended Form ADV) contains a discussion on the

disclosure of outside business activities (income producing activity that occurs away from the firm). The release explains:

> We are also adopting a *requirement to* disclose other business activities or occupations that the supervised person engages in if they involve a substantial amount of time or pay.
>
> ***
>
> We believe that what *amounts* to "substantial" in many cases depends on particular facts and circumstances, and thus we are not establishing any specific definition of what is and is not substantial. However, we do understand that the concern that there is likely some level at which a source of income or amount of time would rarely interfere or conflict with an adviser's business of providing investment advice. Accordingly, we are allowing advisers to make a presumption that if the other business activities represent less than 10% of the supervised person's time and income, they are not substantial.

RX-124 pp. 60- 61.

Thus, under the most recent guidance, an outside business activity is considered "insubstantial" and need not be disclosed if it constitutes less than 10% of the adviser's income. This guidance suggests, especially when read in conjunction with *Brandt,* that not all compensation received is necessarily material, that a minimum threshold for materiality exists, and that if the compensation received falls below that minimum threshold, it need not be disclosed.

Here, the 2.5% TRG earned under the Fidelity arrangement was simply not material. Not only did the payments represent a very small portion of the Firm's overall earnings, but neither the 2004 Agreement nor the 2012 Agreement had any effect on the particular mutual fund investments TRG selected. Both Mr. Robare and Mr. Jones testified that they were unaware of which of the NTF Funds available on the Fidelity platform were "eligible" under the 2004 Agreement:

Judge Grimes: I'm just going to ask you one question. And I think you addressed this. I just want to make sure we're clear on it. Do you know which non-Fidelity NTF Funds pay fees?

Mr. Jones: We do not.

Tr. 823:21-824:1.

As a result, the Firm was unaware which of the funds did and did not generate the fee, making it impossible for a potential financial incentive, in any way, to impact their fund selection. Thus, the "incentive" which the SEC is concerned about – that TRG may prefer one NTF over another – is entirely academic, as it did not exist in reality.

2. Robare Disclosed the Fidelity Compensation and its Potential Conflict of Interest.

a. Disclosure Standard

Only material conflicts need be disclosed, and only material omissions are actionable. In addition, the Division's claim fails because despite the immateriality of the payments received under the arrangement with Fidelity, the Firm disclosed that arrangement and advised its clients that the relationship could create a conflict of interest.

The primary disclosure document used by investment advisers, including TRG, is the Form ADV. Although the Division focuses solely on the disclosure in Item 13A (later Item 14) in evaluating whether a particular fact was disclosed and how well it was disclosed, the customer disclosures must be viewed in their entirety, instead of limiting the analysis to a particular sentence or phrase. Further, determining whether or not those disclosures were adequate requires them to be viewed in terms of the specific customers to whom they were conveyed. Tr. 271:3-24; Tr. 273: 7-274:1.[5]

[5] *See also,* General Instructions to Form ADV Part 2, included at DX-90.

In determining which disclosures to include in the Form ADV, Firms are cautioned *not* to include every possible conflict of interest that could arise, and are instead instructed to "discuss only conflicts the adviser has or is reasonably likely to have." (Tr. 271:25-272:7). The Division's own witness, Ms. Harke, testified to the same:

> **Q. When an investment advisor is undertaking to disclose his conflicts of interests, does the SEC provide guidance on what the language should be like, how those conflicts should be expressed to the intended reader or prospective reader?**
>
> Ms. Harke: The guidance prior to -- well, since 2010, the guidance on, I'd say, the type of language that you should use or the type of wording you should use would come from the instructions to Form ADV part 2(a), the general instructions to Form ADV, and also the release adopting Form ADV part 2, and basically requires you to provide your disclosures in plain English. You should use concise words or concise statements. Use active voice. ***And really, the point is to make it digestible or understandable by the client to whom you're delivering your brochure....***
>
> And also, there's guidance about how you ***shouldn't do*** what I essentially would say is putting the entire kitchen sink of your potential legal possible pie in the sky type problems into your Form ADV. ***It should be conflicts of interests that you have or reasonably have, and it should describe the business that you have or you reasonably expect to have. It shouldn't be every single thing you can think of.***

Tr. 271:3-18; Tr. 271:25-272:7 (Emphasis added). Further, as Ms. Harke testified, firms are left without guidance as to how to craft these disclosures and, instead of looking to the Commission for guidance, firms should instead focus on finding a way to communicate with their clients given the firm's specific knowledge of who its clients are and what they will understand:

> **Q. Is section 206 of the Advisors Act and Form ADV and Rule 204-3 that you've discussed, are those meant to provide a detailed roadmap to every investment advisor as to exactly how they must disclose their conflicts of interest?**
>
> A. No. That wouldn't be possible. Our rules adopted under the Advisors Act, including Form ADV which is considered a rule, are rules of general applicability. There's such a broad array of investment advisors. They have evolved and changed so much over time and the types of clients to

whom an advisor may be providing services can vary, you know, greatly which is why, you know, the Form ADV has been and continues to be something that you can -- the part 2, I mean -- that you can tailor to individual lines of clients.

The point is to make meaningful disclosure and to bear in mind the financial sophistication of the clients to whom you're reaching. There can't be a roadmap for that. There can be guideposts.

Q. And is that in part because investment advisors act as fiduciaries who are expected to exercise judgment in following the statutes in the guidance?

A. Absolutely. There's no roadmap for being a fiduciary. It's just acting in the best interests of your clients.

Tr. 273:7-274:1.

Prior to 2010, when Form ADV was amended, the primary guidance as to the proper substance of the 13A disclosure was the question itself. Question 13A addressed "Additional Compensation" and directed firms to disclose whether they received compensation from a non-client and, if so, to "describe the arrangement" on its Schedule F. *See, e.g.* RX-6 p. 6.

TRG's small size, perhaps, made it especially adept at drafting disclosures that "described the arrangement" for its particular client base. As Mr. Robare and Mr. Jones testified at hearing, the Firm's client base of approximately 300 households[6] shared several defining characteristics: (1) they came from similar backgrounds as executives or retired executives of the oil and gas industry; (2) they had similar sized accounts of $500,000 to $800,000; and (3) they were intelligent and experienced investors. Tr. 332:5-9; Tr. 302:4-303:20; Tr. 302:19-303:20; Tr. 303:17-20. Further, Respondents maintained frequent contact with their investors, meeting with them at least twice a year, if not more. Tr. 662:9-663:13. Simply put,

[6] Mr. Robare testified that the Firm's client base grew from 150 households in 2002 to 300 households, presently. Tr. 301:23-24; Tr. 301:25-302:3; Tr. 663:14-16.

Mr. Robare and Mr. Jones knew their customers and presented them with information in a manner they knew they would understand.

It is in this context and with this background that TRG's disclosures must be considered – not just *what* the disclosures said, but *with whom* Respondents were communicating. Attached hereto as Exhibit A is a summary of the relevant revisions to Form ADV for the time period at issue in this case. Attached as Exhibit B is a summary of the disclosures found outside of the ADV that made similar disclosures to Firm clients.

The first of the major revisions occurred in 2005, after the execution of the 2004 Agreement, when TRG, with CMC's assistance, amended its Form ADV to reflect the fact that it may receive certain compensation and that the compensation could create a possible conflict of interest. Tr. 676:2-21.

b. Nature of the Compensation Received

Although the Division attempts to shrug off the importance of the nature of the compensation received, its classification is of central importance in this case. Mr. Robare and Mr. Jones both testified that they believed – at all relevant times – that the Fidelity payments were commissions, based on the origin of the payments and the manner in which Respondents were paid. It follows, therefore, that in drafting its disclosures and communicating with its clients, the Firm referred to the Fidelity payments using terms such as "commissions" or "12b-1." The evidence presented at hearing established that from 2004 until April 2013, Fidelity, Triad and TRG *all* considered the payments ultimately received by TRG to be commissions and that TRG reasonably treated them as such when drafting its disclosure documents.

First, the evidence of *how* TRG was paid supports Respondents' conclusion that the payments were, in fact, commissions. Mechanically, under the terms of the 2004 Agreement,

and continuing through April 2013, any amounts TRG earned under the agreement for investments in "eligible" funds were paid by Fidelity directly to Triad. 2.2.15 Stipulations; Stipulation No. 18; RX-1; Tr. 330:20-331:3. Both Mr. Robare and Mr. Jones testified that they understood Triad was included in the 2004 Agreement because the commission payments received from Fidelity – like any commission payment the Firm earned – had to be processed through the broker-dealer (opposed to being paid directly to TRG). RX-17.

Tellingly, Fidelity, Triad and TRG all treated the Fidelity payments as commissions. The payments at issue originated with mutual fund companies for the particular non-Fidelity NTF funds TRG purchased on behalf of its advisory clients. Tr. 30:25-31:13; Tr. 186:9-21; Tr. 349:12-350:12; Tr. 518:12-520:7; Tr. 685:15-17; RX-95. Once Fidelity received those payments from the mutual fund companies, according to Fidelity representative Melissa Morganti Zizza, Fidelity "shared" a portion of the payments it received with Triad and TRG. Tr. 33:13-18; Tr. 36:24-37:1. Ms. Morganti-Zizza's understanding comports with both Mr. Robare's understanding, as well as a 2013 email Mr. Jones received from Fidelity, in which Mr. Fahey stated, in response to Mr. Jones' inquiry as to the source of the payments:

> Fidelity receives a very small portion management fee from the mutual fund companies for distribution through Fidelity's platform, primarily for operational and distribution expense. Under a CSSA agreement, we share a portion of that fee (for certain funds) with certain advisors to cover a portion of related fund distribution expenses.

Tr. 518:12-520:7; RX-92.

Under the terms of the 2004 Agreement, Fidelity computed the amounts owed to TRG on a quarterly basis and remitted that amount to Triad. 2.2.15 Stipulations; Stipulation No. 18; RX-1; Tr. 330:20-331:3. Triad received the payments from Fidelity and, pursuant to the Compensation Agreement with Mr. Robare, Triad retained 10% of the payments and remitted the

remaining 90% to TRG. 2.2.15 Stipulations; Stipulation No. 19; RX-17, RX-18, RX-19. Triad's 10% retention only applied to commissions (not to advisory fees), which is in line with Messrs. Robare and Jones' understanding. RX-16. Then, when the commissions were paid out to Mr. Robare, they appeared on his periodic commission statements. From 2004 until 2010, Triad describe those payments on the commission statements as "Fidelity 12b-1" (RX-29 p. 3, RX-30 p. 3; RX-31 p. 2; RX-32 p. 2; RX-33 p. 15; Tr. 614:4-19) or "Direct Fees." RX-34 and RX-35.

This payment process wholly supports Mr. Robare and Mr. Jones' conclusion that the amounts received under the 2004 Agreement were 12b-1 commissions. Thus, it is unsurprising that the Firm disclosed its receipt of this compensation to its customers as "commissions" and/or "12b-1" fees.

Second, in addition to the mechanics of how the payments were made, the evidence also showed that the parties to the 2004 Agreement shared an understanding as to the nature of those payments. It was up to the mutual fund companies themselves to characterize the nature of the payments, namely, whether they were classified as a commission, 12b-1 fee, distribution expense, or a servicing fee. Tr. 30:25-31:13; Tr. 33:13-18; Tr. 36:24-37:1; Tr. 71:22-73:6; Tr. 186:9-21; Tr. 187:17-25; Tr. 308:14-17; Tr. 352:23-353:5; Tr. 346:2-3; Tr. 349:24-350:12; Tr. 435:7-12. This classification was described in the prospectus for each mutual fund, which were automatically provided to the Firm's clients. Tr. 685:13-19; Tr. 308:14-17; Tr. 352:23-353:5; Tr. 436:2; Tr. 353:16-354:4. According to Mr. Robare, who read the prospectus for each mutual fund in which the Firm invested its clients, the payments made under the 2004 Agreement and 2012 Agreement were "sourced from 12b-1 commissions." Tr. 308:14-17; Tr. 352:23-353:5; Tr. 435:7-20; Tr. 436:2-3.

This understanding comports with the testimony provided by Triad's CCO, Ernest Strauss, at hearing. Specifically, Mr. Strauss testified that Triad's characterization of the payments as "12b-1 commissions" did not originate from Triad. Tr. 619:5-17. Instead, as Mr. Strauss testified, Triad's characterizations of the payments as "Fidelity 12b-1" or "Direct fees," respectively, on Mr. Robare's commission statements were descriptions that originated from Fidelity – Triad simply "transposed" Fidelity's description of the payments it made to Triad onto Triad's commission statements when it forwarded 90% of those payments to Mr. Robare. Tr. 619:5-17.

Based on these facts, Mr. Robare and Mr. Jones acted entirely reasonably in concluding that the payments they received from Fidelity were, in fact, 12b-1 commissions and disclosing them as such to their clients in their disclosure documents.

c. Disclosures

The first of the major revisions to the Firm's Form ADV occurred in 2005, after the execution of the 2004 Agreement, when TRG, with CMC's assistance, amended its Form ADV to reflect the fact that it may receive certain compensation and that the compensation could create a possible conflict of interest (Tr. 676:2-21):

2003 ADV Part II, Item 13A (Pre-Execution)	2005 ADV Part II, Item 13A (Post-Execution)
Mark Robare, Carol Hearn & Jack Jones sell securities and insurance products for sales commissions.	Certain investment adviser representatives of ROBARE, when acting as registered representatives of a broker-dealer, may receive selling compensation from such broker-dealer as a result of the facilitation of certain securities transactions on Client's behalf through such broker-dealer. *** These other arrangements may create a conflict of interest.

Comparing Item 13A of RX-4, left, and RX-6, right.

The above disclosure remained in place for the majority of the time period at issue in this case, in tandem with the 2004 Agreement with Fidelity. The language informed the Firm's clients that their investment adviser may receive compensation from Triad (the Firm's broker-dealer) for facilitating certain securities transactions (including the eligible NTF Funds) purchased on the client's behalf *and* that this compensation could create a conflict of interest. This, of course, is the Fidelity arrangement in a nutshell, as Mr. Jones confirmed in his testimony:

> **Q. At the time the ADV was filed in 2005, did you believe it disclosed the Fidelity relationship?**
>
> A. Yes.
>
> **Q. And how so?**
>
> A. We believed it describes accurately all the elements of the relationship. That certain investment advisors, that would be us, acting as reps of the broker-dealer may receive commission from the broker-dealer, which we did in the form of 12b-1, as a result of facilitation of certain, meaning eligible NTF funds, securities transactions, on our client's behalf through the broker-dealer.

Tr. 677:10-21.

The Firm's initial disclosure of this relationship, although brief, communicates the required information about TRG's relationship with Fidelity to the reader (i.e., the fact of the compensation and potential conflict). Further, as discussed above, the disclosure is part of a larger universe of information provided to the client, which included in-person meetings with Mr. Robare and/or Mr. Jones, receipt of the Firm's General Information & Disclosure Brochure, receipt of Fidelity's new Customer Agreement, and receipt of the prospectuses detailing the specific mutual funds purchased (including a description of the genesis of the payments at issue here). Taken together, during the time period the above language was included in Form ADV,

TRG customers received the following information before ever opening an account with the Firm:

- Certain investment adviser representatives of ROBARE, when acting as registered representatives of a broker-dealer, may receive selling compensation from such broker-dealer as a result of the facilitation of certain securities transactions on Client's behalf through such broker-dealer. RX-6, ADV Item 13A,

- These other arrangements may create a conflict of interest. RX-6, ADV Item 13A

- As an investment advisor we manage your account for a percentage of the assets under our management...Additionally, we may select and monitor other money managers on your behalf. **When we do so, the other money managers pay us a portion of the fees generated by the referred clients – clients do not pay us directly for this service.** General Disclosure Brochure, RX-98, RX-99.

- **You should be aware that a conflict may exist between your interests and those of The Robare Group, Ltd.** and if you elect to act upon any of the recommendations, you are under no obligation to effect the transactions through The Robare Group. *Id.*

- For commission accounts, we recommend our broker/dealer – Triad Advisors, Inc. – and if you implement your securities (or insurance) transactions through it, we may earn sales commissions. *Id.*

- We also may pay your advisor for performing certain back-office, administrative, custodial support and clerical services for us in connection with client accounts for which we act as custodian. These payments may create an incentive for your advisor to favor certain types of investments over others. Fidelity Client Agreement, RX-76, similar language in RX-77-79.

- Fees and compensation charged by specific mutual funds, as provided in those funds' prospectuses. Tr. 186:9-21; Tr. 308:14-17.

The Division (improperly) ignores these other disclosures entirely, and zeros in solely on the words contained in Items 13A and 14, insisting that the Firm should have included more or different language to better communicate the disclosure. Yet, the Division makes this argument without citing the appropriate temporal authority. That is, the Division has *not* argued, for example, that in 2005 the Commission required that disclosures contain certain facts or types of

facts and that TRG failed to include them. Instead, the Division's case flows *backwards*, starting with its ultimate conclusion of what it feels a proper disclosure should look like today and working backwards, deeming each disclosure that does not meet this still-unspecified standard to be "inadequate."

This kind of regulation by hindsight is not merely unfair, it is also contrary to the limited guidance provided to advisers during the time period at issue. Contrary to the Division's position, there was *no* requirement that the Firm specifically name the entity (Fidelity); there was *no* requirement that the Firm include the name of the agreement itself; there was *no* requirement that the Firm disclose that the compensation or the conflict derived specifically from NTF Funds. Instead, the only requirement the Commission imposed on the Firm was to make the disclosure and to make it in a manner that the Firm's specific customers would understand. TRG made that disclosure and, knowing its customers, made the disclosure in a manner they would understand so that they could seek additional information, if necessary, and fully evaluate whether they wished to do business with TRG. Given the Firm's 97% client retention rate (a percentage which includes the time period following the OIP), it can safely be assumed that the Firm's clients were comfortable with TRG's compensation and the manner in which it was disclosed.

Because the Firm's disclosures during the time period at issue disclosed the fact that TRG was receiving compensation from Fidelity and that the compensation could create a conflict of interest, the Division's §206(1) claims fail as a matter of law, and must be dismissed.

3. Mr. Robare and TRG did not Act with Scienter.

Finally, with regard to §206(1), even assuming, *arguendo,* that there was a material conflict requiring disclosure *and* that Mr. Robare and TRG failed to disclose that conflict, the Division's §206(1) claim still cannot succeed. As stated above, a requisite element of this claim is that the SEC prove that Mr. Robare and TRG acted with *scienter,* i.e., an "intent to deceive,

manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 185 (1976); *S.E.C. v. Steadman*, 967 F.2d 636, 641 (D.C. Cir. 1992). There is zero evidence in the record indicating that Mr. Robare or Mr. Jones, individually or on behalf of TRG, acted with scienter. To the contrary, the testimony and evidence presented conclusively show that Mr. Robare and Mr. Jones acted solely with their clients' best interest in mind.

First, there are the disclosures. Mr. Jones testified that the purpose of the language contained in the Firm's ADV was to advise clients of the existence of a potential conflict so that they could evaluate it and determine whether to establish a relationship with TRG. With regard to each Form ADV filed (or deemed filed) during the period at issue in this dispute, Mr. Jones testified that when that document was submitted, the Firm believed the information contained therein accurately disclosed the relationship with Fidelity and the fact that it could create a potential conflict of interest. Tr. 677:10-21; 684:16-20; Tr. 694:10-17; Tr. 717:3-14. In light of this unrebutted testimony, the Commission did not prove this required element of its claim.

Second, and equally indicative of the Firm's mindset in drafting and submitting its Forms ADV, Respondents retained compliance consultants to assist in the disclosure process in an effort to ensure that they complied completely with their disclosure requirements – both in terms of procedure and substance. Each ADV was completed with the advice and counsel of their consultants, first NRS, then CMC and then Renaissance. Renaissance testified at the hearing, through Bart McDonald, that Mr. Robare and Mr. Jones were "very involved and proactive and interested in trying to get [the ADV] right," that they were "forthcoming" and "full frank and timely" in providing the consultants with information. Tr. 557:7-10; 587:8-11.

Third, in addition to the assistance received from its compliance consultants, TRG also relied on the oversight of Triad, which audited the Firm and reviewed the Form ADV annually.

Triad's supervision of TRG included a review of the Firm's Form ADV for the purpose of ensuring that the disclosures contained therein were complete and accurate. As Ernie Strauss, Triad's Chief Compliance Officer, testified at the hearing:

> **Q. Is Robare subject to an annual audit by Triad?**
>
> A. The office is, yes.
>
> **Q. Can you describe for the court, please, what an annual audit of the Robare office entails?**
>
> A. Sure. Per FINRA rules, depending upon what type of branch you are, whether you're what's categorized as a non-OSJ versus an OSJ, the rules dictate a frequency with which an audit must be conducted.
>
> Mr. Robare, because certain functions within his office are able to be approved within his office, is categorized as an OSJ, an Office of Supervisory Jurisdiction. The rules, therefore, require that we audit him on no less than an annual basis. So that annual audit would consist of looking from everything from his blotters to his ADV to customer accounts to, you know, advertising. I mean, just anything that's securities related, anything that's related to outside business activities would be encompassed into this audit.
>
> **Q. You said anything related to outside business activities. In the case of a hybrid like The Robare Group that has an independent RIA, would that annual audit encompass a review of the investment advisory business?**
>
> A. That's correct. It's going to involve looking at things such as maybe corporate bank statements as, you know, minute as that might sound. But it's going to get into all of his client accounts for clients that may not even be a client of Triad Advisors but a client of Robare. And generally, the audit would cover that as well.
>
> **Q. When Triad does an annual audit of an OSJ that is in this hybrid model where there's also an independent investment advisor, does the annual audit encompass a review of the most current Form ADV?**
>
> A. It does, yes.
>
> **Q. What's the point of that being?**

A. The point of it, obviously the ADV is a disclosure document. We review it and part of the audit is to have a conversation with any of our OSJs identify the types of activities that they're involved in, any type of arrangements that have been established with their custodians. And to make sure that those questions on the ADV, the part 1 and the part 2, are answered accurately as well as any sort of disclosure that might need to go on the schedule F.

Tr. 606:5-608:2.

Mr. Strauss further testified that if Triad had identified an issue with the Form ADV (or the disclosures on that form) during these audits, its practice was to bring those issues to the attention of the firm. Tr. 608:3-17:

> **Q. And if during the course of an annual audit, particularly the review of Form ADV, if Triad discovers that there is an issue with the disclosure, whether it's not disclosed at all or the accuracy of something, does Triad bring that to the attention of the subject of the audit?**
>
> A. Oh, absolutely. And then we actually relay that information out on the entire field. If we see something that's affecting one office, if there's a state or some other jurisdiction that feels as though something is not properly disclosed, we make sure other offices are aware of, you know, what these jurisdictions are opining on. And it's just that those changes be incorporated into the appropriate documents such as the ADV.

Triad never identified any issues with the Firm's Form ADV and, as a result, Respondents reasonably continued to believe their disclosures were accurate and in full compliance with the then-existing regulatory requirements. Form ADV. RX-22-27; Tr. 395:13-21; Tr. 612:18-613:1.

The Firm's utilization of compliance consultants and Triad's supervision in this area is indicative of Respondents' good faith intent to comply. In cases involving similar facts, the Commission has found that a firm's retention and utilization of consultants, like those here, is evidence of its lack of scienter. For example, in *Brandt*, discussed above, the Court concluded:

> The putative violation was isolated and scienter is absent. BKS and Brandt even hired an independent compliance expert, NRS, to help them with their compliance responsibilities, including preparation

> of Forms ADV. The record is clear that BKS and Brandt held no information or documents back from NRS and had no intention or motive to hold back documents concerning the $7,500 [payment].

Brandt, Release No. 289 2005 WL 1584978 *8.

Here, TRG not only employed a compliance consultant, as was the case in *Brandt*, but it had an additional layer of supervision, in the Form of Triad. These facts evidence the lack of scienter, a required element of the Division's claim.

Moreover, and as further evidence of the lack of scienter, the ADV disclosures quoted above were in effect in 2008, the exact time when TRG underwent an SEC exam. In connection with that exam, the Commission examiner received and reviewed a copy of the Form ADV containing the above disclosure. RX-93; RX-94. No issues or questions relating to the disclosure were raised by the examiner and the Firm was issued a "no further action" letter, indicating that the examination team found no violations of any law or regulation. RX-95; Tr. 226:22-227:4. As the Division's witness testified at hearing, there is no "better possible result" following an SEC examination than the no further action letter that TRG received from the Commission. Tr. 258:11-17.

To be clear, TRG is not arguing – or even suggesting – that it has somehow transferred to the Commission its obligation to ensure its disclosures were adequate. Yet, the fact that the Firm participated in the exam and received a clean bill of health is evidence that Respondents reasonably believed, in good faith, that their disclosures met whatever standard existed at the time.

Accordingly, the Division's allegation that Mr. Robare and the Firm violated §206(1) should be dismissed in its entirety.

B. The SEC has Failed to Prove that Mr. Robare or TRG Violated Section 206(2).

Section 206(2) prohibits advisers from "engage[ing] in any transaction, practice, or course of business which operates as a fraud or deceit upon any client or prospective client." The United States Supreme Court has interpreted §206(2) as imposing a fiduciary duty on investment advisers, requiring an affirmative obligation of "utmost good faith, and full and fair disclosure of all material facts, as well as an affirmative obligation to employ reasonable care to avoid misleading his clients." *Capital Gains,* 375 U.S.at 191-92,194 (internal punctuation omitted).

Aside from the issue of scienter, the 206(2) allegation fails for the same reasons set forth in Section A, above, which addresses the 206(1) claim. Namely, the evidence presented showed that (1) Respondents were not required to disclose the compensation or its associated potential conflict because it was immaterial; and (2) Respondents nonetheless made the disclosure in TRG's Form ADV and elsewhere. Further, although *scienter* is not required to show a violation of §206(2), the Division is still required to prove negligence, specifically, that Mr. Robare and the Firm failed to uphold a duty owed to its clients. The Division has failed to prove this element.

Instead, the evidence showed the great emphasis Respondents placed on honoring and upholding their fiduciary obligations to their clients. Both Mr. Robare and Mr. Jones testified that their primary consideration in making any investment decision was the best interests of their clients. It is for this reason that the Firm dealt exclusively in NTF Funds. By utilizing NTF Funds, the Firm was free to purchase and sell mutual funds, rebalancing the holdings in its investment portfolios as necessary, without generating outrageous transaction fees to the client. NTF Funds allowed TRG to make these changes with *zero* transaction fees, providing increased

flexibility while keeping clients' costs low and maximizing their return on investment. Tr. 307:11-308:10.

It was also undisputed that the Firm never made any investment decision based on its potential to result in a payment from Fidelity. This is clear from the fact that the Firm continued to invest clients in Fidelity's own NTF Funds – which were specifically excluded from the Fidelity program – throughout the entire time period after the 2004 Agreement was executed. In fact, despite the knowledge that Fidelity funds would not generate a payment, the Firm actually *increased* its clients' holdings in these funds at various times over the years, when it best served its clients' needs. Tr. 336:19-340:3. For example, Mr. Robare testified that during the financial crisis, the Firm moved a substantial amount of its customers' assets in Fidelity Index Funds. Tr. 337:15-338:20. These funds, which would not generate a fee under the 2004 Agreement, were selected by TRG over other non-Fidelity mutual funds because they were cheaper for the Firm's clients. This allowed their clients to stay in the market (and take advantage of the market recovery) while reducing the internal expenses those clients incurred. *Id.*

Additionally, even when the Firm did invest in a non-Fidelity NTF Fund, it did so without knowing whether that fund would result in any payment at all. As Mr. Robare and Mr. Jones testified, the 2004 Agreement only paid on "eligible" NTF funds, but, exactly which funds were "eligible" was never defined or communicated to the Firm. Thus, in selecting non-Fidelity NTF Funds, Respondents never knew whether or not a particular fund would result in a fee; more importantly, they never cared. As Mr. Jones and Mr. Robare testified at hearing, they never made an investment decision based on its potential to generate a fee. Tr. 333:17-334:12; Tr. 335: 15-18; 343:7-17; 671:19-672:4; 752:3-9.

The evidence presented at hearing demonstrated that at all times, Respondents upheld their duty to their clients and acted in their best interest. Accordingly, the Division's allegation that the above disclosures constituted a violation of §206(2) should be dismissed in its entirety.

C. **Respondents did not Violate Section 207.**

The Division has alleged that Respondents violated §207 of the Act, which states:

> It shall be unlawful for any person ***willfully*** to make any untrue statement of a ***material*** fact in any registration application or report filed with the Commission under section 80b-3 or 80b-4 of this title, or ***willfully*** to omit to state in any such application or report any material fact which is required to be stated therein.

15 U.S.C.A. §80b-7. The Division alleges that in filing Form ADV, Messrs. Robare and Jones "willfully" filed an inaccurate report with the Commission. In order to carry its burden on this claim, the Division must show, by a preponderance of the evidence, that Messrs. Robare and Jones "willfully" omitted a "material" fact when they caused the Forms ADV to be filed.

For the reasons set forth above in response to the §206(1) allegations, the §207 claim should likewise be dismissed. That is, if there was no material misrepresentation or omission in the Firm's ADV, the Firm could not possibly have filed a document containing any material misrepresentations or omissions.

Furthermore, even were there some omission in the Forms ADV, the Division has failed to establish that either Mr. Robare or Mr. Jones "willfully" filed a misleading document. The Division must prove that Respondents acted "willfully." Failure to establish "willfulness" is fatal to a §207 claim:

> The language in the ADV Form that the SEC argues compelled this disclosure referred not to bank accounts or to the process by which SG & C facilitated firm trades, but rather asked Defendants to disclose the procedures the firm employed to address conflicts of interest created by engaging in firm trading and client trading simultaneously. Gordon, who prepared the ADV Form for SG & C, testified that he believed SG & C's account structure was

> in compliance with the SEC at the time. This assumption was supported by both the two previous SEC examinations, which failed to note SG & C's account structure as a problem, and the firm's annual surprise examination by independent auditors Deloitte & Touche, which also failed to identify SG & C's account structure as a questionable practice. Indeed, Gordon testified that he believed SG & C's account structure was based on the Gardner and Preston Moss No-Action Letter issued by the SEC in 1982. ... Gordon's testimony on these issues was unrebutted by the Commission, and the Court finds Gordon's reliance on these external evaluations reasonable.
>
> In light of the foregoing, the Court is not persuaded that Gordon knew that the SG & C account structure in place at the time violated federal securities laws. Thus, the Court cannot conclude that he intentionally failed to disclose or willfully omitted this information from the firm's filings. Whether Gordon acted with the requisite mental state for his actions to constitute a violation of the Advisers Act is a question of fact. [] Here, the Court does not find that Gordon intentionally or willfully omitted material facts from his SEC filings. As willfulness is an element of a Section 207 violation… the Court concludes that the Commission failed to meet its burden on this claim, and rules in favor of the Defendants[.]

S.E.C. v. Slocum, Gordon & Co., 334 F. Supp. 2d 144, 181-82 (D.R.I. 2004); *See also Brandt,* 2005 WL 1584978 *7, Release No. 289 (Exhibit C, p. 6).

The Court's analysis in *Slocum* is useful in the context of the §207 allegation, which involves similar circumstances. Mr. Robare and Mr. Jones both testified that when they filed the Forms ADV, they believed the representations contained therein accurately and adequately disclosed both the Firm's compensation and the Firm's actual or potential conflicts of interest. Tr. 677:10-21; 684:16-20; Tr. 694:10-17; Tr. 717:3-14.

Additionally, and as discussed fully above, Mr. Robare and Mr. Jones, like the defendants in *Slocum,* retained compliance consultants to assist them in preparing and submitting their Form ADV and relied on that advice. Also like the defendants in *Slocum,* Mr. Robare and Mr. Jones completed a successful SEC exam in 2008, which included a review of the Firm's Form ADV

and which was closed without issue. RX-94; Tr. 247:12-14; Tr. 409:15-410:1; Tr. 410:13-25; Tr. 680:16-25. Mr. Robare and Mr. Jones relied on these external audits as support for their subjective belief that their disclosures were proper. Tr. 410:13-25; Tr. 680:16-25.

Additionally, going above and beyond the facts of *Slocum,* Respondents here also had Triad, which supervised their RIA and the disclosures made in the Forms ADV. This supervision added another layer of review which likewise failed to raise any concerns with the Firm's disclosures.

Under such circumstances, the Division has failed to carry its burden and establish that Respondents acted "willfully," even if their disclosures are somehow deemed inadequate. For these reasons, the §207 claim should be dismissed.

D. Aiding and Abetting.

Finally, the Division has charged Mr. Jones with aiding and abetting the §206 violations. As with the other allegations, the Division bears the burden of proof on each element of this claim and must prove, by a preponderance of the evidence that (1) TRG and Mr. Robare have committed a primary violation; (2) Mr. Jones had a general awareness that his role was part of an overall activity that was improper; and (3) Mr. Jones knowingly and substantially assisted the principal violation. *Investors Research Corp. v. S.E.C.*, 628 F.2d 168, 178 (D.C. Cir. 1980). It is assumed that scienter is required to establish secondary liability for causing a primary violation that requires scienter. *Brandt,* Release No. 289 2005 WL 1584978 *7 (June 30, 2005).

As noted above, if the §206 allegations against Mr. Robare and TRG fail, the Division will necessarily be unable to establish the first element of this claim, and the aiding and abetting allegations will fail as a matter of law. Irrespective of that determination, however, this allegation must fail because the Division has failed to prove the second and third elements of this claim: that Mr. Jones was aware that his activity was improper and that he provided "substantial

assistance" to the primary violator. The "awareness" element requires a showing that the accused party must at least have been aware of wrongdoing or that he was "extremely reckless" in disregarding the wrongdoing and his role in furthering it. *See Decker v. S.E.C.*, 631 F.2d 1380, 1388 (10th Cir. 1980); *In the matter of Thomas R. Delaney II and Charles Yancey*, Release No. 755 p. 33 (March 18, 2015) (Exhibit D). In the absence of the required knowledge, an aiding and abetting claim fails. *Steadman*, 967 F.2d 636 at 647.

To satisfy the element of "substantial assistance," the Division must prove that Mr. Jones associated himself with the conduct giving rise to the primary violation, that he participated in it "as something he wished to bring about," and that he sought by his action to make it succeed. *SEC v. Apuzzo,* 689 F.3d 204, 212-213 (2nd Cir. 2012); *Delaney,* Release No. 755, p. 33 (March 18, 2015) (Exhibit D).

Here, the unrebutted testimony presented at the hearing was that with each and every Form ADV, Mr. Jones believed the documents to be complete, accurate, and in compliance with the Firm's obligations. Tr. 677:10-21; 684:16-20; Tr. 694:10-17; Tr. 717:3-14. Moreover, in preparing these documents, Mr. Jones engaged the expertise of compliance consultants to assist him and the Firm in drafting the disclosures at issue. Finally, but also indicative of Mr. Jones' lack of intent, the Firm underwent a successful SEC audit in 2008 which resulted in a no action letter. That letter did not identify any issues in the Firm's Form ADV. Based on this successful exam, Mr. Jones continued to believe the disclosures to be accurate.

In light of this evidence, the Division has failed to prove either that Mr. Jones acted with the requisite scienter (knowledge or extreme recklessness) or that he "substantially assisted" in an unlawful venture that he wished to see succeed. *Delaney*. Release No. 755 p. 33 (March 18, 2015) (Exhibit D). For this reason, and those stated above, the aiding and abetting claim fails.

E. The Division's Allegations Relating to Events Occurring Before September 9, 2009 are Time-Barred.

With respect to the Division's allegations for the time period 2003 through 2009, those claims are time barred pursuant to 28 U.S.C.A. §2462[7] which states:

> Except as otherwise provided by Act of Congress, an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced **within five years from the date when the claim first accrued** if, within the same period, the offender or the property is found within the United States in order that proper service may be made thereon.

28 U.S.C.A. §2462 (West) (emphasis added). "Statutes of limitations are intended to 'promote justice by preventing surprises through the revival of claims that have been allowed to slumber until evidence has been lost, memories have faded, and witnesses have disappeared'." *Gabelli v. S.E.C.*, 133 S. Ct. 1216, 1221 (2013), citing *Railroad Telegraphers v. Railway Express Agency, Inc.*, 64 S.Ct. 582, 88 L.Ed. 788 (1944). The Supreme Court, in *Gabelli v. S.E.C.*, laid to rest any questions as to when claims by the Commission "accrue" or whether they are subject to any sort of equitable tolling:

> The same conclusion [allowing tolling of limitations periods for private parties who may be unaware of a legal injury] does not follow for the Government in the context of enforcement actions for civil penalties. The SEC, for example, is not like an individual victim who relies on apparent injury to learn of a wrong. Rather, a central "mission" of the Commission is to "investigat[e] potential violations of the federal securities laws." Unlike the private party who has no reason to suspect fraud, the SEC's very purpose is to root it out, and it has many legal tools at hand to aid in that pursuit. It can demand that securities brokers and dealers submit detailed trading information. It can require investment advisers to turn over their comprehensive books and records at any time. And even without filing suit, it can subpoena any documents and witnesses it deems relevant or material to an investigation.

[7] As the Commission is seeking civil penalties for the alleged conduct, there is no question as to whether §2462 applies to the Commission's claims. *Gabelli v. S.E.C.*, 133 S. Ct. 1216, 1223 (2013).

> ...Charged with this mission and armed with these weapons, the SEC as enforcer is a far cry from the defrauded victim the discovery rule evolved to protect.

Gabelli v. S.E.C., 133 S. Ct. 1216, 1222 (2013) (internal citations omitted). The latest point at which a claim may accrue is the date on which the last act giving rise to the plaintiff's "complete and present cause of action" occurs. *S.E.C. v. Graham*, No. 13-10011-CIV, 2014 WL 1891418 (S.D. Fla. May 12, 2014).

Here, the Division filed its OIP on September 10, 2014. Accordingly, under the above statute, to the extent the Division's claims are based on alleged failures to disclose made on or before September 9, 2009, the Division is barred from seeking civil penalties thereon.

Additionally, in 2008, the Commission conducted an examination of TRG during which it examined its Form ADV. During the course of the exam, the Commission investigated the Firm and had the ability to access any and all information regarding the 2004 Agreement or Robare's commission statements (both of which reflected the commission arrangement). The exam concluded in April 2008 and no disclosure issues were raised or otherwise noted. Accordingly, the five-year limitations period began to run on that date, and has since expired.

To the extent the Division's claims are based on alleged failures to disclose occurring before April 2008, the Division is barred from seeking civil penalties thereon.

V. SANCTIONS ARE NOT WARRANTED

A. Because the Division has Failed to Prove a Violation, Sanctions are not Warranted.

The Division failed to carry its burden of proof and establish that Respondents violated (or aided and abetted the violation of) §§206(1), 206(2) or 207. Respondents therefore request that each of those allegations be dismissed in their entirety and that no sanctions be assessed.

B. Even if There is a Violation, No Sanction is Warranted.

That being said, in the remote circumstance that some unintentional violation is found to have occurred, Respondents feel compelled to set forth the following argument against the imposition of sanctions.

Sanctions are only authorized where, at the close of hearing, the Court concludes that the respondent has:

> (A) willfully violated any provision of the Securities Act of 1933, the Investment Company Act of 1940, or the Investment Advisors' Act of 1940;
>
> (B) willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person.

15 U.S.C. §78u-2(a). As the above language makes clear, an award of sanctions requires a finding of "willfulness." Assuming a finding of willfulness, the appropriateness of any sanction is guided by the public interest factors set forth in *Steadman.*

> (1) the egregiousness of the respondent's actions;
>
> (2) the isolated or recurrent nature of the infraction;
>
> (3) the degree of scienter involved;
>
> (4) the sincerity of the respondent's assurances against future violations;
>
> (5) respondent's recognition of the wrongful nature of his or her conduct; and
>
> (6) the likelihood that the respondent's occupation will present opportunities for future violations.

Steadman v. S.E.C. 603 F.2d 1126, 1140 (5th Cir. 1979), *aff'd on other grounds,* 450 U.S. 92 (1981) ("Steadman factors"). Other factors that have been considered include:

> (7) the age of the violation (*Marshall Melton,* 56 S.E.C. 695, 698 (2003);

(8) the degree of harm to investors and the marketplace resulting from the violation (*Id.);*

(9) the extent to which the sanction will have a deterrent effect (*Schield Mgmt. Co.*, Exchange Act Release No 53201 (Jan 31, 2006), 87 SEC Docket 848, 862);

(10) whether there is a reasonable likelihood of violations in the future (*KPMG,* 54 S.E.C. 1135, 1191 (2001).

The Court should weigh these factors in light of the entire record. No one factor is dispositive. *Id.*

Here, assuming a violation exists, the Steadman Factors militate against the imposition of sanctions. As stated above, there is no indication that Respondents acted with scienter, or with any evil intent whatsoever. To the contrary, at all times they strove to comply with the applicable rules and requirements. To do so, they employed a series of compliance consultants and relied on Triad to advise them as to the propriety of their filings – actions indicative of persons acting in good faith. Additionally, there is no likelihood of future violations. Immediately after TRG learned that the Commission believed its disclosure to be deficient, it further revised the disclosure to comply with the Commission's preferences.

Moreover, in this case, there is no customer harm. Respondents never made any investment decisions with the intention of incurring greater commission payments. All decisions were made solely based on the best interests of their clients. No payments earned by Respondents under the 2004 or 2012 Agreement were paid by customers. The evidence shows that the Firm's customers continue to trust and support the Firm. This is evidenced by (1) the Firm's 97% customer retention rate;[8] (2) the fact that zero customers left the Firm after this proceeding was instituted; and (3) the supportive response by customers to Respondents'

[8] This 97% figure includes the time period after the OIP was filed in this case. Tr. 303:25-304:4.

decision to fight the Division's allegations. Tr. 712:3-24. Under the above factors, the assessment of a sanction is not in the public interest.

Finally, were the Court to contemplate civil penalties (which, again, it should not),[9] the Division has failed to present any evidence that a second or third tier penalty is warranted. Second and third tier penalties are only awarded where the Division establishes the respondent acted with "fraud, deceit, manipulation or deliberate or reckless disregard of a regulatory requirement. (15 U.S.C. §78u-2(c)). Third tier penalties are only awarded where the Division establishes that the acts or omissions at issue resulted in substantial losses (or created a significant risk of substantial losses) or resulted in "substantial" pecuniary gain. Neither occurred here, and those penalties are unwarranted.

C. <u>Cease and Desist Orders are Unnecessary.</u>

In its Pre-Hearing Brief, the Division argued that cease and desist orders are appropriate because, as it promised to show at the hearing, Respondents' conduct was "egregious," performed with a "high degree of scienter" and "to date [they] have not acknowledged any of their wrongdoing." Division's Pre-Hearing Brief p. 30. As already set forth herein, the Division failed to present *any* evidence that Respondents acted with *any* degree of scienter, let alone a high degree. *See* Section A.3., above. Further, the Division's allegation that Respondents have "not acknowledged" wrongdoing is a conclusion that focuses on form and ignores substance. Respondents have denied – and continue to deny – that they violated any law or obligation imposed upon them. That being said, immediately upon learning what the Commission's concerns were with its Form ADV, the Firm *immediately* revised it to conform to those wishes. In fact, even before the Firm learned what the Commission's concerns were, it started

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[9] *See also,* Section IV.E., above, discussing the state of limitations on civil penalties.

implementing revisions, guessing at what the regulators wanted to see. In light of these facts, a cease and desist order is entirely unnecessary, and the Division's request should be denied.

D. Disgorgement is not Warranted.

The Division alleges that the Firm received "more than $530,000" from Fidelity during the time period at issue, yet it failed to present any evidence that the Firm received this dollar amount. In fact, the total amount earned by TRG was much less, largely because of the 10% cut Triad retained on all commissions the Firm earned.

Further, contrary to the Division's contention, the Firm was not "unjustly enriched" in this case. First, the Firm made the required disclosures to its clients, and its clients were aware of, and accepted, the fact that their advisers may earn certain commission payments for recommending certain investments. They were further aware that these payments could create conflicts of interest. They opened and maintained accounts with the Firm armed with that knowledge.

Second, in terms of the management of client accounts, as Mr. Robare and Mr. Jones testified at hearing, they never made a single investment decision based on whether or not it would – or even may – result in commissions from Fidelity. Client investments were selected based on the quality of the particular investment and its cost-benefit to the Firm's clients, period. Thus, any payments earned from Fidelity were earned through transactions the Firm would have carried out *regardless* of whether the 2004 or 2012 Agreements ever existed.

Third, awarding disgorgement in this case will not serve as the deterrent the Division portrays. TRG did everything right in this case: (1) it hired three successive compliance consultants to advise and assist in the ADV drafting and submission process; (2) it had Triad supervise its RIA activity, specifically including its Form ADV, submitted those forms to Triad for review, and received Triad's approval; (3) when anyone – Fidelity, Renaissance, etc. –

suggested that the Firm edit or amend its disclosures, TRG immediately made the requested revisions or additions, all in the interest of maintaining compliance; and (4) most importantly, TRG focused on and strove to serve its clients with every decision the Firm made, whether an individual investment selection or a large-scale business decision. In sum, this is not a fact pattern that preaches a message of deterrence to the industry and no sanctions should be awarded based on the Division's assertions.

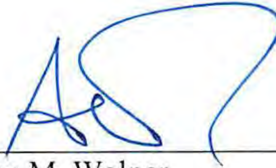
Finally, even if the Division succeeded in proving that Respondents received any illegal commissions, Respondents are entitled to an apportionment of that amount to reflect only the amounts they actually received.

VI. CONCLUSION

For the reasons stated herein, Respondents respectfully request that the allegations against them be dismissed in their entirety. In the alternative, if some violation is found to have occurred, Respondents respectfully request that, in light of the absence of any aggravating factors and in light of the evidence of their good faith attempt to comply, no sanction be assessed against them for the conduct at issue in this dispute.

Respectfully submitted this 20th day of March, 2015.

ULMER & BERNE LLP



Alan M. Wolper
awolper@ulmer.com
Heidi VonderHeide
hvonderheide@ulmer.com
500 West Madison Street, Suite 3600
Chicago, Illinois 60661
(312) 658-6500 – General
(312) 658-6565 – Fax

Counsel for Respondents

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EXHIBIT A

ROBARE CLIENT ADV DISCLOSURES BY TIME PERIOD

2003 ADV Part II, Item 13A	2005 ADV Part II, Item 13A	March 2011 ADV 2A, Item 14	December 2011 ADV 2A, Item 14
Mark Robare, Carol Hearn & Jack Jones sell securities and insurance products for sales commissions.	Certain investment adviser representatives of ROBARE, when acting as registered representatives of a broker-dealer, may receive selling compensation from such broker-dealer as a result of the facilitation of certain securities transactions on Client's behalf through such broker-dealer. *** These other arrangements may create a conflict of interest.	Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation.	Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation. Additionally, we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional compensation does not represent additional fees from your accounts to us.

ROBARE CLIENT ADV DISCLOSURES BY TIME PERIOD

December 2011 ADV 2A, Item 14	March 2012 ADV 2A, Item 14	April 2013 ADV 2A, Item 14
Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation. Additionally, we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional compensation does not represent additional fees from your accounts to us.	We do not receive an economic benefit from a non-client for providing investment advice or other advisory services to our clients. Additionally, we do not have any arrangement under which we, or a related person, directly or indirectly compensate any person, who is not our supervised person, or receive compensation from another for client referrals at this time. Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of compensation. Additionally, we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional	We do not receive an economic benefit from a non-client for providing investment advice or other advisory services to our clients. Additionally, we do not have any arrangement under which we, or a related person, directly or indirectly compensate any person, who is not our supervised person, or receive compensation from another for client referrals at this time. However, certain mutual fund issuers may sponsor and pay for client luncheons, or other events, that Robare hosts. These arrangement may give rise to conflicts of interest, with the firm's clients in connection with Robare's recommendation of certain mutual funds. However, Robare's commitment to its clients and the policies and procedures it has adopted are designed to limit any interference with Robare's independent decision making when choosing the best mutual funds for our clients. Certain of our IARs, when acting as registered representatives of Triad may receive selling compensation from Triad as a result of the facilitation of certain securities transactions on your behalf through Triad. Such fee arrangements shall be fully disclosed to clients. In connection with the placement of client funds into investment companies, compensation may take the form of front-end sales charges, redemption fees and 12(b)-1 fees or a combination thereof. The prospectus for the investment company will give explicit detail as to the method and form of

	compensation does not represent additional fees from your accounts to us.	compensation. Additionally, we may receive additional compensation in the form of custodial support services from Fidelity based on revenue from the sale of funds through Fidelity. Fidelity has agreed to pay us a fee on specified assets, namely no transaction fee mutual fund assets in custody with Fidelity. This additional compensation does not represent additional fees from your accounts to us.

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EXHIBIT B

DISCLOSURES OUTSIDE OF FORM ADV

Client Brochure Disclosure (RX-)	Fidelity Customer Agreement Disclosure (RX-76)
We do investment advising and financial planning. As an investment advisor we manage your account for a percentage of the assets under our management...Additionally, we may select and monitor other money managers on your behalf. **When we do so, the other money managers pay us a portion of the fees generated by the referred clients – clients do not pay us directly for this service.** Mark Robare, Carol Hearn, and Jack Jones are also stockbrokers and insurance agents who may earn sales commissions when you purchase securities and/or insurance products through The Robare Group, Ltd. **You should be aware that a conflict may exist between your interests and those of The Robare Group, Ltd.** and if you elect to act upon any of the recommendations, you are under no obligation to effect the transactions through The Robare Group. *** For commission accounts, we recommend our broker/dealer – Triad Advisors, Inc. – and if you implement your securities (or insurance) transactions through it, we may earn sales commissions.	**How Fidelity Supports Your Advisor** Fidelity provides your investment advisor with a range of services and other benefits to help them conduct their business and serve you... In limited circumstances, we may also make direct payments to your advisor. For example, we may reimburse your advisor for reasonable travel expenses incurred when reviewing our business and practices. **We also may pay your advisor for performing certain back-office, administrative, custodial support and clerical services for us in connection with client accounts for which we act as custodian. These payments may create an incentive for your advisor to favor certain types of investments over others.**

EXHIBIT C

Release No. 289 (S.E.C. Release No.), Release No. ID - 289, 2005 WL 1584978

S.E.C. Release No.
Initial Decision

SECURITIES AND EXCHANGE COMMISSION (S.E.C.)

IN THE MATTER OF BRANDT, KELLY & SIMMONS, LLC, AND KENNETH G. BRANDT

Administrative Proceeding File No. 3-11672
June 30, 2005

*1 BEFORE: Carol Fox Foelak, Administrative Law Judge.

APPEARANCES:
John S. Yun, Sahil W. Desai, and Michael S. Dicke for the Division of Enforcement, Securities and Exchange Commission.
Bradley J. Schram and Brian Witus of Hertz, Schram & Saretsky, P.C., for Respondents Brandt, Kelly & Simmons, LLC, and Kenneth G. Brandt.

INITIAL DECISION

SUMMARY

This Initial Decision dismisses charges brought against a registered investment adviser and its majority owner. The charges concerned Respondents' use of a $7,500 payment received from a broker-dealer to defray expenses incurred when their clients transferred to that broker-dealer from another.

I. INTRODUCTION

A. Procedural Background

The Securities and Exchange Commission (Commission) initiated this proceeding by an Order Instituting Proceedings (OIP) on September 21, 2004. The proceeding was authorized pursuant to Sections 203(e), 203(f), and 203(k) of the Investment Advisers Act of 1940 (Advisers Act).

The undersigned held a two-day hearing on December 8 and 9, 2004, in Detroit, Michigan. Four witnesses, including Respondent Kenneth G. Brandt (Brandt) testified, and eighty-seven exhibits were admitted into evidence. [1]

The findings and conclusions in this Initial Decision are based on the record. Preponderance of the evidence was applied as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91, 97-104 (1981). Pursuant to the Administrative Procedure Act, 5 U.S.C. § 557(c), the following posthearing pleadings were considered: (1) the Division of Enforcement's (Division) January 28, 2005, Proposed Findings of Fact and Conclusions of Law and Post-Hearing Brief; (2) Respondents' March 7, 2005, Proposed Findings of Fact and Conclusions of Law; and (3) the Division's March 21, 2005, Reply. All arguments and proposed findings and conclusions that are inconsistent with this Initial Decision were considered and rejected.

B. Allegations and Arguments of the Parties

This proceeding concerns the use of a $7,500 payment to Brandt, Kelly & Simmons, LLC (BKS), a registered investment adviser, from TD Waterhouse Investor Services, Inc. (TDW), a broker-dealer that was custodian of BKS's client accounts and to

which BKS directed client trades. The OIP alleges that the $7,500 was intended as fee reimbursements for BKS clients but that, instead, BKS used the money to pay its own operating expenses. Thus, the OIP alleges, BKS and Brandt misappropriated client assets in violation of the antifraud provisions of the Advisers Act, Sections 206(1) and 206(2), and failed to disclose its receipt of the money in Part II, Item 13.A. of its Form ADV in violation of Section 207 of the Advisers Act. The OIP also alleges that Brandt violated and aided and abetted and caused BKS's violations of these provisions. The Division requests disgorgement of $5,000, a cease-and-desist order as to both Respondents, and a requirement that BKS hire a compliance consultant. Additionally, the Division requests second-tier civil penalties of $50,000 against BKS and $25,000 against Brandt and a sixty-day suspension against Brandt.

*2 Respondents argue that they reimbursed clients far more than $7,500 in fees and expenses that the clients incurred when Respondents transferred their business to TDW from their previous broker-dealer. They note that the payment was non-recurring and was not connected in any way to the volume of business BKS provided to TDW. They state that they had already decided to select TDW before the $7,500 payment was negotiated. Respondents request that the proceeding be dismissed.[2] In the alternative, if found liable, Respondents argue that no sanctions be imposed in that their actions were neither egregious, repeated, or involved scienter, and that there is no risk of future violations.

II. FINDINGS OF FACT

A. Respondents and Related Entities

Brandt has worked in the securities industry for more than thirty years. Tr. 25-26. He was a registered representative associated with Smith Barney and its predecessors from 1979 to 1996. Tr. 25-26. He was associated with Linsco Private Ledger (LPL), a broker-dealer and registered investment adviser, from 1996 to 2001. Tr. 26-29. In 2001, he and a colleague, Craig Simmons (Simmons), left LPL and established their own investment adviser, BKS. Tr. 34, 91-92, 232. At the time Brandt left LPL, about 90% of his clients were advisory clients and 10% were brokerage clients. Tr. 29-30, 49-50. Brandt currently is 85% owner of BKS. Tr. 84.

Brandt has never been fined or disciplined by the Commission, the NASD, or any other regulatory body. Tr. 90. This proceeding has had a devastating effect on him professionally and personally. Tr. 138-39.

Simmons was born in 1971 and has worked in the securities industry since 1993. Tr. 231-32. He was associated with LPL from 1996 to 2001, when he left to form BKS with Brandt. Tr. 232. He currently has a 9% ownership interest in BKS. Tr. 232. Simmons has never been the subject of a disciplinary action or customer complaint. Tr. 280-81.

BKS is a registered investment adviser; its registration with the Commission became effective and it opened for business in February 2001. Tr. 57. Eventually, about 90% of Brandt's and Simmons's accounts at LPL moved to BKS. Tr. 58. BKS received about $1 million in annual revenue in 2001, 2002, and 2003. Tr. 82-83. BKS had assets under management of about $135 million as of 2003. Tr. 83-84.

B. Brandt and Simmons Establish BKS

Brandt and Simmons decided to strike out on their own because they believed they could offer their clients better service at lower cost than at LPL. Tr. 33-34, 94, 100, 282-83, 288. They believed that at LPL their clients were paying for unneeded services. Tr. 33-34, 282-83. Additionally, LPL planned to become self-clearing, and, based on experience, Brandt and Simmons believed this would cause problems to their clients. Tr. 91-92, 283-84. Also, they believed that the technology that LPL made available to them was inferior to what they might obtain independently. Tr. 92, 282. They understood that they would do less well financially at first, but believed that they would profit in the long run by effecting substantial cost savings for their customers.[3] Tr. 93-94, 100, 288.

*3 BKS needed a custodian and broker-dealer for their clients' brokerage accounts. Tr. 41. Brandt and Simmons considered Schwab, Fidelity, TDW, and others. Tr. 41-42, 236, 284-85. They sought the lowest possible transaction fees and pricing structure for their clients. Tr. 213-14. Eventually they settled on TDW because it offered the lowest fees, technology that met their needs, and good service. [4] Tr. 101-02, 183, 235-36, 285-86. The cost savings to customers included lower or no transaction fees, no annual maintenance fee, and significantly lower 12b-1 fees [5] in the same mutual funds that clients were already holding. Tr. 97-100, 140-41. TDW and BKS estimated that the average account would save more than $500 per year by transferring to TDW. Tr. 98-99, 216, 310; Div. Ex. 5 at TD07553.

Brandt and Simmons hoped that their clients at LPL would follow them to BKS and discussed the benefits and costs of the move with each client. Tr. 56, 110-11, 247-48, 266-67. The costs that a client might incur in transitioning to TDW included IRA termination fees, [6] mutual fund Class B share contingent deferred sales charges (CDSC), [7] bounced check fees, transaction costs from selling stock to put assets under management with BKS - anything related to a customer's transfer from LPL to TDW. Tr. 105-07, 132-33. BKS reimbursed more than $20,000 to clients for their costs of transferring, by giving them credits against their quarterly management fees. [8] Tr. 66, 116-27, 137, 244-46, 298, 300; Resp. Exs. A1-26, D1-5, D7-12, D14-17, D19, D21-24, D27-31. Brandt did not give any fee credits to himself or family members. Tr. 112.

C. $7,500 Fee Reimbursement

After deciding to select TDW, Brandt and Simmons asked TDW for reimbursement of fees that would be incurred by clients transferring from LPL to TDW. [9] Tr. 43-46, 102-03. Brandt's ballpark estimate was that these would amount to about $30,000. Tr. 149, 297; Div. Ex. 14. Brandt and Simmons's principal contact at TDW was Sean Lindenbaum (Lindenbaum); they also had discussions with others, including Lindenbaum's supervisor, Mark Avers (Avers). Tr. 45, 184, 236-37. Eventually BKS and TDW settled on $7,500: on October 10, 2000, Lindenbaum telephoned and left a message for Brandt that TDW would "pay up to $7,500 in term. fees." Tr. 215; Div. Ex. 5 at TD07553. The agreement was memorialized in an October 17, 2000, letter from TDW to Brandt, which stated in reference to this subject, in totality, "TDW is willing to commit up to $7,500 toward account termination fees." [10] Div. Ex. 2 at BKS0020. The amount was not contingent on any particular amount of business or recommendation by TDW. Tr. 103.

The phrase "account termination fees" was not defined in the October 17, 2000, letter or elsewhere. Tr. 208; Div. Ex. 2. The Division argues that "account termination fees" meant, and was restricted to, the $50 fee charged by LPL for closing out IRA accounts. Yet, when TDW refers to IRA accounts, it normally specifies "IRA," because in the securities industry there is a fundamental difference between an IRA and a non-IRA account. Tr. 208-09. Brandt testified that he was never told by TDW and never had any understanding that the $7,500 was for IRA termination fees only, and that he believed that the $7,500 could be used for reimbursement of CDSCs and other charges incurred by clients. [11] Tr. 113, 125. Lindenbaum testified in the Division's direct case that he believed that the $7,500 was only for IRA account termination fees. Tr. 191-92. He testified that he does not remember discussing any fees with BKS other than IRA termination fees. [12] Tr. 196. He testified that entries in his TDW contact detail report referring to "term. fees" and "ind. acct. termination fees" actually referred to IRA termination fees. Tr. 193-94, 229; Div. Ex. 5 at TD07551, TD0553. However, his testimony on cross-examination was inconsistent with this: he testified that he discussed with Brandt and Simmons a wide variety of fees and charges that clients would incur in transferring to TDW. Tr. 223, 318. The undersigned has concluded that Lindenbaum's direct testimony was biased in favor of placing himself and his employer, TDW, in the best possible light with Commission staff. [13] Accordingly, it is found that Lindenbaum's discussions with BKS about fees and charges were not restricted to IRA termination fees and that TDW did not restrict the $7,500 to reimbursement of IRA termination fees only.

*4 TDW placed the $7,500 payment in BKS's sundry account at TDW in May 2001. [14] Tr. 60, 244-45; Div. Ex. 7A at 3. TDW annotated the entry in its records as "reimbursement of termination fees," with no mention of "IRA." Tr. 113; Div. Ex.

7A at 3. From there, the funds were wired to BKS's operating account at the Huntington National Bank. Tr. 60-61, 244. BKS did not segregate the $7,500. Tr. 65, 112. It had always expected to reimburse clients in excess of that amount. Tr. 267, 298.

D. BKS's Form ADV

Brandt and Simmons understood that they are ultimately responsible for compliance. [15] Tr. 48, 62, 233, 239. Lindenbaum and Avers referred Brandt and Simmons to several firms that would help them with their compliance obligations. Tr. 47-48, 183-86, 198, 238-39. BKS selected National Regulatory Services (NRS) in November 2000. [16] Tr. 158-60, 237; Div. Exs. 16, 18, 19. NRS undertook to provide full-service turnkey compliance services, including creating and updating BKS's compliance manual, preparation of Forms ADV, and other services. Tr. 128-29; Resp. Ex. C. BKS desired to be in full compliance with all requirements; it provided NRS with all the documentation and information that it requested and held nothing back so that NRS could prepare its Forms ADV with full disclosure. [17] Tr. 80-81, 130.

Forms ADV that BKS filed in February 2001, September 2002, and June 2003 listed, in response to Item 13.A. of Part II, in general terms, benefits that it might receive on an ongoing basis from TDW, but did not mention the $7,500 payment. Tr. 75-77; Div. Exs. 9B at 14-15, 10B at 33-34, 11B at BKS00272-73. The Forms ADV were reviewed and approved by Maria Seedner, TDW's compliance director, who had also reviewed the October 17, 2000, letter that contained the agreement to pay the $7,500. Tr. 205-07, 225-27; Div. Ex. 8 at 1. TDW never told BKS that it should disclose the $7,500 on its Form ADV. [18] Tr. 203, 210-11.

After the Commission began to investigate this matter BKS filed an amendment to Item 13.A. of Part II of its Form ADV that disclosed the $7,500. [19] Tr. 78-79, 162-64, 306; Div. Exs. 20-21.

III. CONCLUSIONS OF LAW

The record shows that BKS and Brandt worked diligently to establish a business plan that would save their clients a substantial amount of money. Did they, however, defraud them as well? It is concluded that the answer is "No" - BKS and Brandt did not violate the antifraud provisions.

A. Advisers Act Antifraud Provisions

BKS and Brandt are charged with willfully violating the antifraud provisions of the Advisers Act. Brandt is also charged with willfully aiding and abetting and causing BKS's violations. Sections 206(1) and 206(2) of the Advisers Act make it unlawful for any investment adviser, by jurisdictional means, to directly or indirectly:

1. employ any device, scheme, or artifice to defraud any client or prospective client, or

2. engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon any client or prospective client.

*5 Section 207 of the Advisers Act makes it unlawful for "any person willfully to make" material misstatements and omissions in applications and reports filed with the Commission under the Advisers Act.

Scienter is required to establish violations of Section 206(1) of the Advisers Act. *SEC v. Steadman*, 967 F.2d 636, 641 & n.3 (D.C. Cir. 1992). It is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976); *see also Aaron v. SEC*, 446 U.S. 680, 686 n.5, 695-97 (1980); *SEC v. Steadman*, 967 F.2d at 641. Recklessness can satisfy the scienter requirement. *See David Disner*, 52 S.E.C. 1217, 1222 & n.20 (1997); *see also SEC v. Steadman*, 967 F.2d at 641-42; *Hollinger v. Titan Capital Corp.*, 914 F.2d 1564, 1568-69 (9th Cir. 1990). Reckless conduct is conduct which is "'highly unreasonable' and ... represents 'an extreme departure from the standards of ordinary care ... to

the extent that the danger was either known to the defendant or so obvious that the defendant must have been aware of it.'" *Rolf v. Blyth, Eastman Dillon & Co.*, 570 F.2d 38, 47 (2d Cir. 1978) (quoting *Sanders v. John Nuveen & Co.*, 554 F.2d 790, 793 (7th Cir. 1977)).

Scienter is not required to establish a violation of Section 206(2) of the Advisers Act; a showing of negligence is adequate. *See SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 195 (1963); *see also SEC v. Steadman*, 967 F.2d at 643 & n.5; *Steadman v. SEC*, 603 F.2d 1126, 1132-34 (5th Cir. 1979), *aff'd on other grounds*, 450 U.S. 91 (1981).

Material misrepresentations and omissions violate Sections 206(1), 206(2), and 207 of the Advisers Act. The standard of materiality is whether or not a reasonable investor or prospective investor would have considered the information important in deciding whether or not to invest. *See SEC v. Steadman*, 967 F.2d at 643; *see also Basic Inc. v. Levinson*, 485 U.S. 224, 231-32, 240 (1988); *TSC Indus. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Investment advisers are fiduciaries and have an affirmative duty of utmost good faith and full and fair disclosure of all material facts. *See Capital Gains Research Bureau, Inc.*, 375 U.S. at 191-92, 194, 201.

***6** BKS is accountable for the actions of its responsible officers, including Brandt. *See C.E. Carlson, Inc. v. SEC*, 859 F.2d 1429, 1435 (10th Cir. 1988) (citing *A.J. White & Co. v. SEC*, 556 F.2d 619, 624 (1st Cir. 1977)). A company's scienter is imputed from that of the individuals controlling it. *See SEC v. Blinder, Robinson & Co.*, 542 F. Supp. 468, 476 n.3 (D. Colo. 1982) (citing *SEC v. Manor Nursing Ctrs., Inc.*, 458 F.2d 1082, 1096-97 nn.16-18 (2d Cir. 1972)). As an associated person of BKS, Brandt's conduct and scienter are also attributed to the firm. *See* Section 203(e) of the Advisers Act.

1. Aiding and Abetting; Causing

In addition to being charged with committing primary violations, Brandt is charged with "aiding and abetting," and with "causing," primary violations of Advisers Act Sections 206(1), 206(2), and 207 by BKS.

For "aiding and abetting" liability under the federal securities laws, three elements must be established: (1) a primary or independent securities law violation committed by another party; (2) awareness or knowledge by the aider and abettor that his or her role was part of an overall activity that was improper; also conceptualized as scienter in aiding and abetting antifraud violations; and (3) that the aider and abettor knowingly and substantially assisted the conduct that constitutes the violation. *See Graham v. SEC*, 222 F.3d 994, 1000 (D.C. Cir. 2000); *Woods v. Barnett Bank of Ft. Lauderdale*, 765 F.2d 1004, 1009 (11th Cir. 1985); *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir. 1980); *IIT v. Cornfeld*, 619 F.2d 909, 922 (2d Cir. 1980); *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 94-97 (5th Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304, 1316-17 (6th Cir. 1974); *Russo Sec. Inc.*, 53 S.E.C. 271, 278 & n.16 (1997); *Donald T. Sheldon*, 51 S.E.C. 59, 66 (1992), *aff'd*, 45 F.3d 1515 (11th Cir. 1995); *William R. Carter*, 47 S.E.C. 471, 502-03 (1981). A person cannot escape aiding and abetting liability by claiming ignorance of the securities laws. *See Sharon M. Graham*, 53 S.E.C. 1072, 1084 n.33 (1998), *aff'd*, 222 F.3d 994 (D.C. Cir. 2000). The knowledge or awareness requirement can be satisfied by recklessness when the alleged aider and abettor is a fiduciary or active participant. *See Ross v. Bolton*, 904 F.2d 819, 824 (2d Cir. 1990); *Cornfeld*, 619 F.2d at 923, 925; *Rolf*, 570 F.2d at 47-48; *Woodward*, 522 F.2d at 97.

***7** For "causing" liability, three elements must be established: (1) a primary violation; (2) an act or omission by the respondent that was a cause of the violation; and (3) the respondent knew, or should have known, that his or her conduct would contribute to the violation. *Robert M. Fuller*, 80 SEC Docket 3539, 3545 (Aug. 25, 2003), *pet. denied*, No. 03-1334, 2004 U.S. App. Lexis 12893 (D.C. Cir. 2004). A respondent who aids and abets a violation also is a cause of the violation under the federal securities laws. *See Graham*, 53 S.E.C. at 1085 n.35. Negligence is sufficient to establish liability for causing a primary violation that does not require scienter. *See KPMG Peat Marwick LLP*, 54 S.E.C. 1135, 1175 (2001), *recon. denied*, 74 SEC Docket 1351 (Mar. 8, 2001), *pet. denied sub nom. KPMG, LLP*, 289 F.3d 109 (D.C. Cir. 2002). It is assumed that scienter is required to establish secondary liability for causing a primary violation that requires scienter. *Id.*

2. Willfulness

The Division requests sanctions pursuant to Sections 203(f), (i), and (k) of the Advisers Act. The Commission must find willful violations to impose sanctions under Sections 203(f) and (i) of the Advisers Act. A finding of willfulness does not require an intent to violate, but merely an intent to do the act which constitutes a violation. *See Wonsover v. SEC*, 205 F.3d 408, 413-15 (D.C. Cir. 2000); *Steadman v. SEC*, 603 F.2d 1126, 1135 (5th Cir. 1979); *Arthur Lipper Corp. v. SEC*, 547 F.2d 171, 180 (2d Cir. 1976); *Tager v. SEC*, 344 F.2d 5, 8 (2d Cir. 1965).

B. Antifraud Violations

The OIP alleges that BKS and Brandt misappropriated $7,500 in client assets by using TDW's $7,500 payment to pay for operating expenses instead of passing on the $7,500 in fee reimbursements to clients and that they failed to inform the clients of the misappropriation, thus violating Sections 206(1) and 206(2) of the Advisers Act. Further, the OIP alleges that BKS and Brandt violated Section 207 of the Advisers Act by failing to disclose the $7,500 payment on Part II, Item 13.A. of its Form ADV.

1. Section 206

The record shows that BKS reimbursed clients for more than $20,000 - far more than $7,500 - for fees they incurred in transferring from LPL to TDW. Thus, there was no misappropriation of client assets and consequently no material misrepresentations or omissions concerning a misappropriation of client assets. [20]

*8 Brandt and Simmons disclosed to each client individually the benefits and costs of changing from LPL to TDW. The Division argues that BKS and Brandt violated Section 206 by offering a $50 reimbursement to IRA account holders who complained about the fee rather than offering $50 to all IRA account holders, whether they complained or not. The OIP does not, however, allege that BKS and Brandt distributed the $50 payments based on impermissible criteria. The OIP alleges that they *misappropriated* the $7,500.

The Division argues that reimbursement of CDSCs paid by clients was a marketing expense that should have been borne by BKS because the clients could have retained their B shares and not paid the CDSCs. However, by this logic, reimbursement of the IRA fees was also a marketing expense since the IRA account holders could have stayed at LPL and not paid the IRA fees.

Not only did BKS reimburse clients far more than $7,500, the record shows that BKS and Brandt worked diligently to secure a custodian that would save their clients a substantial amount of money compared to what they had been paying LPL. In sum, there was no scheme to defraud, no material misrepresentations or omissions, and no violation of Sections 206(1) or 206(2) of the Advisers Act.

2. Section 207

The OIP alleges that BKS and Brandt violated Section 207 of the Advisers Act because they failed to disclose receipt of the $7,500 on Item 13.A. of Part II of BKS's Forms ADV. [21] Item 13.A. of Part II of Form ADV is entitled "Additional Compensation." It asks, "Does applicant or a related person have any arrangements, oral or in writing, where it: is paid cash or receives some economic benefit (including commissions, research, or non-research services) from a non-client in connection with giving advice to clients?" The allegation that Section 207 was violated is based on the assumption that BKS misappropriated the $7,500 so that the funds were compensation to BKS. However, this assumption is inconsistent with the finding that BKS distributed more than $7,500 to clients. BKS was not obligated to disclose the $7,500 payment because it was not compensation to BKS and because BKS did not misappropriate it. The economic benefit of the $7,500 was conferred on clients, not BKS. Accordingly, BKS was not required to disclose the $7,500 payment in response to Item 13.A. [22]

Assuming, *arguendo*, that BKS was required to disclose the payment in response to Item 13.A., its failure to do so was mitigated by its subsequent amendment to disclose the payment when it learned that Commission staff considered that it should be disclosed. Further, considering the *Steadman* factors, no sanction is necessary in the public interest.[23] The putative violation was isolated and scienter is absent. BKS and Brandt even hired an independent compliance expert, NRS, to help them with their compliance responsibilities, including preparation of Forms ADV.[24] The record is clear that BKS and Brandt held no information or documents back from NRS and had no intention or motive to hold back documents concerning the $7,500. The record shows that Brandt sincerely desires to comply with all requirements applicable to investment advisers and considers himself ultimately responsible for BKS's compliance. While BKS and Brandt remain in the investment adviser business, the likelihood of future violations is essentially nonexistent.

IV. ULTIMATE CONCLUSIONS

*9 It is concluded that BKS and Brandt did not violate Sections 206(1), 206(2), or 207 of the Advisers Act. Further, Brandt did not willfully aid and abet or cause violations of Sections 206(1), 206(2), or 207 of the Advisers Act. Accordingly, the proceeding will be dismissed as to both Respondents.

V. RECORD CERTIFICATION

Pursuant to Rule 351(b) of the Commission's Rules of Practice, 17 C.F.R. § 201.351(b), it is certified that the record includes the items set forth in the record index issued by the Secretary of the Commission on March 1, 2005.

VI. ORDER

Based on the findings and conclusions set forth above:

IT IS ORDERED that this administrative proceeding IS DISMISSED as to Brandt, Kelly & Simmons, LLC, and Kenneth G. Brandt.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule 360 of the Commission's Rules of Practice, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule 111 of the Commission's Rules of Practice, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or a motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Carol Fox Foelak
Administrative Law Judge

Footnotes

1 Citations to the transcript will be noted as "Tr. __." The Division's exhibits will be noted as "Div. Ex. __," and Respondents', as "Resp. Ex. __."

2 Respondents also request an award of legal fees, costs, and expenses wrongfully incurred. This request, which is premature, can only be made under the Equal Access to Justice Act (EAJA), 5 U.S.C. § 504, and Sections 201.31-.59 of the Commission's Rules, 17 C.F.R. §§ 201.31-.59. The EAJA and the cited Commission Rules specify the circumstances under which an award of fees and expenses will be made to a party.

3 At LPL, Brandt had annual commission income of about $300,000, and in addition, about $120,000 in trail commissions. Tr. 93. By comparison, his income from BKS was $300-$350 thousand in 2001 and 2002, less in 2003. Tr. 83.

4 Brandt satisfied himself that TDW would make a reasonable profit from BKS's business and thus would have an incentive to render good service. Tr. 102.

5 The 12b-1 fee is authorized by Rule 12b-1 under the Investment Company Act. *See* 17 C.F.R. § 270.12b-1. As adopted in 1980, the rule permits a fund to pay "distribution" expenses, including broker's commissions, and shareholder service expenses from fund assets. For a concise history of the rule, see William P. Dukes and James B. Wilcox, *The Difference Between Application and Interpretation of the Law as It Applies to SEC Rule 12b-1 Under the Investment Company Act of 1940*, 27 New Eng. L. Rev. 9 (1992).

6 LPL charged $50 to close an IRA account. Tr. 47. Many clients were not concerned about the $50 IRA fee, or other small fees, because their savings from transferring to TDW would be so great. Tr. 108-09, 111, 247-48. However, if a client complained about it, BKS offered to reimburse the $50. Tr. 154-55. About 50 of about 200 IRA accounts received the $50 reimbursement. Tr. 47, 67, 248-49. Brandt had originally estimated that he might reimburse as much as $15,000 for IRA fees. Tr. 46.

7 Some clients, who had not been managed clients at LPL, decided to move to BKS and become managed clients, but had Class B shares of mutual funds subject to a substantial CDSC on redemption. Tr. 109. They were offered reimbursement of the CDSC. Tr. 109, 153. The Class B shares theoretically could have been transferred to TDW instead of being redeemed. However, to do so would have been irrational given that the client could transfer to a class of shares that required no sales load and charged lower 12b-1 fees than B shares. At TDW, BKS obtained access to fund classes with no load or load waived and with significantly lower 12b-1 fees than clients were paying in the same funds. Tr. 97-99, 139-41.

8 The actual amount reimbursed was greater than the amount reflected in Resp. Exs. A1-26, D1-5, D7-12, D14-17, D19, D21-24, D27-31. Those exhibits reflect credits that exceeded an account's quarterly fee and were carried over to the next quarter. If the credit was less than the quarterly fee and did not have to be carried over to the next quarter, there was no separate tracking of the reimbursements. Tr. 66, 116, 133, 251-52, 303-04.

9 Schwab and Fidelity also were willing to consider reimbursement of transition costs. Tr. 102-03.

10 Avers provided this language to Lindenbaum, who drafted the letter. Tr. 203-05. TDW's compliance officer, Maria Seedner, reviewed and approved the letter. Tr. 205-07. BKS did not draft any of the language in the letter. Tr. 207.

11 The Division complains that, during the investigation that preceded this proceeding, Respondents did not argue that they had reimbursed charges in addition to IRA fees. However, the Division had notice of Respondents' defense from their prehearing brief.

12 Lindenbaum, the only witness from TDW who testified, had no knowledge of conversations that Brandt or Simmons had with other TDW employees. Tr. 211-12.

13 Official notice is taken, pursuant to 17 C.F.R. § 201.323, of the fact that TDW settled a proceeding related to its actions concerning BKS and two other investment advisers. *TD Waterhouse Investor Servs., Inc.*, 83 SEC Docket 2870 (Sept. 21, 2004). At the hearing Lindenbaum was represented by TDW's attorney, Richard D. Marshall of Kirkpatrick & Lockhart, the predecessor of Kirkpatrick & Lockhart Nicholson Graham LLP. Tr. 196.

14 The sundry account was a holding account for all monies that TDW credited to BKS; funds were transferred from there to BKS's bank account. Tr. 61, 244; Div. Exs. 7A-7H.

15 BKS now has a specific chief compliance officer. Tr. 233-34. This is a requirement of 17 C.F.R. § 275.206(4)-7(c), which became effective February 5, 2004. *Compliance Programs of Investment Companies and Investment Advisers*, 81 SEC Docket 3447, 68 Fed. Reg. 74714 (Dec. 24, 2003).

16 The NRS employee who assisted BKS was Jeremy Johnson. Tr. 158-60; Div. Exs. 16, 18, 19, 20. Johnson, a lawyer, was not working as a lawyer at NRS. Tr. 158, 165-66. His work on the BKS account started shortly after his September 25, 2000, arrival at NRS. Tr. 158, 167-68.

17 Johnson does not recall having the October 17, 2000, letter when he prepared BKS's Forms ADV. Tr. 161-62. BKS, however, had no motive to withhold the letter from NRS.

18 TDW did not have any formal protocols for handling the $7,500 payment; it was an ad hoc arrangement. Tr. 200-01. Later, TDW developed a Sales Incentive Program that included a procedure whereby investment advisers were instructed to disclose any payments from TDW on their Forms ADV. Tr. 200-03.

19 The amendment also disclosed that TDW provided BKS with up to $5,000 for Centerpiece Software consulting and training fees. Div. Exs. 20, 21. The OIP does not allege any violations involving the Centerpiece payment.

20 Since BKS reimbursed the clients with credits against their quarterly fees, it is literally true that BKS used TDW's actual cash payment for its own expenses. To conclude that this was a misappropriation of the $7,500 would mistakenly exalt form over substance.

21 The OIP also alleges that the Forms ADV failed to disclose that BKS misappropriated TDW's $7,500 payment. This allegation is mooted by the conclusion, supra, that BKS did not misappropriate the payment.

22 In its Post-Hearing Brief, the Division also references Item 12.B., which asks, "Does applicant or a related person suggest brokers to clients?" If so, the applicant is directed to describe "the factors considered in selecting brokers and determining the reasonableness of their commissions." The OIP, however, does not allege any deficiency in BKS's response to Item 12.B.

23 When the Commission determines administrative sanctions, it considers:

the egregiousness of the defendant's actions, the isolated or recurrent nature of the infraction, the degree of scienter involved, the sincerity of the defendant's assurances against future violations, the defendant's recognition of the wrongful nature of his conduct, and the likelihood that the defendant's occupation will present opportunities for future violations.

Steadman v. SEC, 603 F.2d at 1140 (quoting *SEC v. Blatt*, 583 F.2d 1325, 1334 n.29 (5th Cir. 1978)).

24 In discussing the cost of new rules for small investment advisers, the Commission referenced, approvingly, the use of independent compliance experts. *Compliance Programs of Investment Companies and Investment Advisers*, 81 SEC Docket 3447, 3458 & n.105, 68 Fed. Reg. 74714, 74724 & n.105 (Dec. 24, 2003).

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EXHIBIT D

INITIAL DECISION RELEASE NO. 755
ADMINISTRATIVE PROCEEDING
FILE NO. 3-15873

UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

In the Matter of THOMAS R. DELANEY II and CHARLES W. YANCEY	INITIAL DECISION March 18, 2015

APPEARANCES: Polly Atkinson, Nicholas Heinke, and Jonathan M. Warner for the Division of Enforcement, Securities and Exchange Commission

Brent R. Baker, D. Loren Washburn, and Aaron D. Lebenta of Clyde Snow & Sessions, P.C. for Respondent Thomas R. Delaney II

Kit S. Addleman, Ronald W. Breaux, Scott M. Ewing, and Sarah S. Mallett of Haynes and Boone, LLP for Respondent Charles W. Yancey

BEFORE: Jason S. Patil, Administrative Law Judge

SUMMARY

This Initial Decision finds that Respondent Thomas R. Delaney II (Delaney) was a cause of Penson Financial Services, Inc.'s (Penson) violations of Rules 204T and 204 of Regulation SHO (Reg. SHO), and orders Delaney to cease-and-desist from causing further violations of Rule 204 of Reg. SHO and to pay a civil money penalty of $20,000. The Initial Decision also finds that Respondent Charles W. Yancey (Yancey) did not fail reasonably to supervise Delaney and a second employee with a view to preventing and detecting their alleged aiding and abetting of Penson's violations.

I. INTRODUCTION

The Securities and Exchange Commission (Commission or SEC) issued an Order Instituting Administrative and Cease-and-Desist Proceedings (OIP) on May 19, 2014, pursuant to Sections 15(b) and 21C of the Securities Exchange Act of 1934 (Exchange Act) and Section 9(b) of the Investment Company Act of 1940 (Investment Company Act). The OIP alleges that: (1) Penson violated Rules 204T and 204 of Reg. SHO; (2) Delaney and the Senior Vice President

of Securities Lending willfully aided and abetted and caused Penson's violations; and (3) Yancey failed reasonably to supervise Delaney and the Senior Vice President with a view to preventing and detecting their willful aiding and abetting. OIP at 16.

I held a hearing in this matter in Dallas, Texas, from October 27, 2014, through November 10, 2014. During the hearing, the Division of Enforcement called ten witnesses, including Delaney and Yancey. Delaney called four witnesses including himself, and Yancey called twelve witnesses including himself. Approximately 600 exhibits were admitted into evidence.[1]

II. FINDINGS OF FACT

I base the following findings of fact and conclusions on the entire record and the demeanor of the witnesses who testified at the hearing, applying preponderance of the evidence as the standard of proof. *See Steadman v. SEC*, 450 U.S. 91, 100-04 (1981). All arguments and proposed findings and conclusions that are inconsistent with this decision are rejected. I find the following facts to be true.

A. Background

1. Penson Financial Services, Inc.

Penson was a North Carolina corporation with a principal place of business in Dallas, Texas. Stipulated FOF No. 3. It was a broker-dealer registered with the Commission, which, from at least 2010 to 2012, was one of the largest clearing firms in the United States as measured by the number of correspondent brokers for which it cleared. *Id.* Penson filed a Form BDW to withdraw its registration from the Commission, which was effective in October 2012, and then declared bankruptcy in January 2013. *Id.* A bankruptcy plan implementing Penson's liquidation was approved in July 2013. *Id.*

Penson was a wholly-owned subsidiary of SAI Holdings, Inc., which in turn was a wholly-owned subsidiary of Penson Worldwide, Inc. (PWI). Stipulated FOF No. 3. PWI was a public company with a number of subsidiaries, including Penson Financial Services, London; Penson Financial Services, Canada; and Nexus Technologies. Stipulated FOF No. 103.

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[1] Citations to the Division's exhibits, Delaney's exhibits, and Yancey's exhibits are noted as "Div. Ex. ___," Del. Ex. ___," and "Yan. Ex. ___," respectively. I will use similar designations in citations to the post-hearing filings, which include post-hearing briefs ("Br.") and replies ("Reply"). Because the Division replied separately to Delaney and Yancey, its reply briefs are designated "Div. Reply to Yan." and "Div. Reply to Del." Citations to the parties' stipulated findings of fact, as ordered on December 17, 2014, are noted as "Stipulated FOF No.___," and citations to the parties' stipulated conclusions of law are noted as "Stipulated COL No. ___." *See Thomas R. Delaney II*, Admin. Proc. Rulings Release No. 2143, 2014 SEC LEXIS 4903 (Dec. 17, 2014). Additional findings of fact and conclusions of law, to which the parties did not stipulate, are cited as "Div. Proposed FOF No. ___" and "Div. Proposed COL No. ___," with similar designations for Delaney's and Yancey's proposed findings and the replies thereto.

2. *Thomas R. Delaney II*

Delaney, age 45, of Colleyville, Texas, was the Chief Compliance Officer (CCO) of Penson from at least September 2008 through April 2011. Stipulated FOF Nos. 1, 12. Delaney gave notice of his resignation as CCO in mid-March 2011, and he left employment at Penson at the end of April 2011. Stipulated FOF Nos. 56, 57. Delaney currently works in compliance at a registered broker-dealer. Stipulated FOF No. 1. He holds Series 4, 7, 24, 27, 53, and 63 licenses. *Id.*

The relevant period (Relevant Period) for the Division's claim against Delaney runs from October 1, 2008, until approximately February 15, 2011. Stipulated FOF No. 58. During the Relevant Period, in addition to his position as CCO, Delaney was a registered representative associated with Penson. Stipulated FOF No. 102; Div. Ex. 241.

3. *Charles W. Yancey*

Yancey, age 58, of Colleyville, Texas, was the President and Chief Executive Officer (CEO) of Penson from at least October 2008 through February 2012. Stipulated FOF No. 2. Yancey was hired as CEO because Penson was growing too large for its founders to continue to manage. Tr. 1456-57. Yancey is currently a Managing Director at a registered broker-dealer. Stipulated FOF No. 2. He holds Series 7, 24, 55, and 63 licenses. *Id.*

4. *Michael Johnson*

Michael Johnson (Johnson), of Dallas, Texas, was the Vice President of Penson's Securities Lending (Stock Loan) department until approximately October 2008, when he became the PWI Senior Vice President for Global Stock Lending, responsible for all of Penson's worldwide stock lending operations. Stipulated FOF Nos. 55, 117; Tr. 514. From October 2008 to June 2012, Johnson was an employee of PWI, the parent company of Penson, and was included on the organizational charts of PWI rather than of Penson. Stipulated FOF No. 9. During the Relevant Period, Johnson was a registered representative associated with Penson. Stipulated FOF No. 102; Div. Ex. 242. He held Series 7, 24, 27, and 63 licenses. Stipulated FOF No. 55. Johnson was charged by the Commission for willfully aiding and abetting the Rule 204 violations at issue in this matter, and has settled his case on a "neither admit nor deny" basis. Stipulated FOF No. 104; *Michael H. Johnson*, Exchange Act Release No. 72186, 2014 SEC LEXIS 1711 (May 19, 2014). Johnson is the "Senior Vice President of Stock Loan" referenced in the OIP, whom the Division alleges Yancey is liable for failing to supervise, in addition to Delaney. *See* OIP at 13-14; Div. Br. at 28.

5. *Other Pertinent Personnel*

Philip Pendergraft (Pendergraft) and Dan Son (Son) were the co-founders of Penson. Tr. 282, 1418; Yan. Ex. 513 at 70. Both were licensed principals and registered representatives associated with Penson. Stipulated FOF Nos. 73, 74; Tr. 1456. From 2008 to 2011, Pendergraft was CEO of PWI and a member of its board of directors. Tr. 1459. Pendergraft was also an executive vice president of Penson during the Relevant Period. Stipulated FOF No. 75.

Richard Barto McCain (McCain) began working at Penson in 2006. Stipulated FOF No. 108. He was Penson's chief administrative officer, and he also served as Penson's chief financial officer for a time. *Id.* In addition to these positions, McCain served as the PWI interim treasurer in 2011 and the interim chief financial officer in 2012. *Id.*

Holly Hasty (Hasty) was, at least until March 2011, the deputy chief of compliance at Penson. Stipulated FOF No. 65. Hasty took over as CCO of Penson in March 2011. Stipulated FOF No. 66.

Eric Alaniz (Alaniz) was a compliance officer at Penson during the Relevant Period. Stipulated FOF No. 62.

Kimberly Miller (Miller) was a Penson compliance department employee from 2000 until 2012. Stipulated FOF No. 107. One of Miller's responsibilities was to provide information in response to requests from regulators and other outside sources. *Id.*

Rudy De La Sierra (De La Sierra) began working at Penson in March 2000 and joined the Stock Loan department in June 2000. Stipulated FOF No. 105. He became Vice President of the Stock Loan department in approximately 2006. *Id.*

Brian Gover (Gover) began working at Penson in April 2007. Stipulated FOF No. 109. Over time, he managed several departments, including the Buy-Ins department. *Id.* In April 2012, Gover moved into the compliance department at Penson. *Id.* He is currently the Chief Compliance Officer of Apex Clearing. *Id.* Gover and De La Sierra signed cooperation agreements with the Division related to this matter. Stipulated FOF No. 93; Tr. 125, 342.

Lindsey Wetzig (Wetzig) began working at Penson out of college in March 2000. Stipulated FOF No. 106. In 2004, he joined the Stock Loan department, and in approximately 2006 or 2007, he was promoted to Operations Manager of the Stock Loan department. *Id.* Wetzig was charged by the Commission for his role in the Rule 204 violations at issue in this proceeding, and settled his case on a "neither admit nor deny" basis. *Lindsey Alan Wetzig*, Exchange Act Release No. 72187, 2014 SEC LEXIS 1712 (May 19, 2014); Tr. 403.

B. The Settlement Process and Rule 204T/204

The Depository Trust and Clearing Corporation (DTCC) operates the National Securities Clearing Corporation (NSCC), a clearing agency registered with the Commission that clears and settles the majority of U.S. transactions in equities. Stipulated FOF No. 5. When NSCC members purchase or sell securities on the exchanges, the exchanges send the trade information to the NSCC, which acts as a central counterparty for clearance and settlement. *Id.* NSCC operates the Continuous Net Settlement system (CNS), which aggregates and nets the trades made each day for NSCC member clearing firms, matching the transactions to available securities. Stipulated FOF No. 5; Tr. 82-83, 1613. The result is a net position, which represents how many shares the NSCC member is either entitled to receive (a net long position) or must deliver (a net short position) based on the trades made that day. Tr. 1613. NSCC member clearing firms receive reports that, as of at least close of business of the trading day plus one day

(T+1), notify the firms of transactions scheduled to clear and settle by close of business T+3. Stipulated FOF No. 5; *see* Tr. 82, 1613. The standard settlement cycle for U.S. equity securities is three business days after the trade day (T+3). Div. Ex. 67 at n.8; Tr. 80-81, 1640-41. CNS also sends reports to the firms listing net fails to deliver in each security as of T+3, which occur when the firms fail to deliver to CNS the shares for which they have a net short position. Stipulated FOF No. 5; Tr. 82-83, 1005.

If a trade fails to settle, there are consequences to the buyer of the shares, and to the market more generally. For example, the buyer does not receive certain rights that come along with owning shares and is exposed to additional risk, and confidence in the market is undermined. Tr. 1005-08, 1677-79; Div. Ex. 260.

In order to address prolonged failures to deliver, the Commission adopted temporary Rule 204T and, later, a permanent Rule 204 of Reg. SHO (collectively, Rule 204T/204). Stipulated FOF No. 4; Div. Ex. 69. In adopting Rule 204T/204, the Commission expressed its concern that delivery of securities was not being made until several days following the standard three-day settlement cycle. Tr. 1642; Div. Ex. 69. Rule 204T became effective on September 18, 2008, and Rule 204, which made most of the provisions of Rule 204T permanent, became effective on July 31, 2009. Stipulated FOF No. 4; Div. Ex. 69. The close-out requirements of Rule 204T were adopted in Rule 204 without modification. Div. Ex. 69 at 8269. Thus, testimony regarding the requirements of Rule 204T at issue in this proceeding applies equally to Rule 204, and vice versa.

Rule 204T/204 requires participants of a registered clearing agency to deliver equity securities to a registered clearing agency when delivery is due; that is, by settlement date (T+3). Div. Exs. 67, 69. For short sales, if the participant does not deliver securities by T+3 and has a failure-to-deliver position at the clearing agency (also referred to as CNS fails/failures to deliver), at market open on the morning of T+4 it must take affirmative action to close out the failure-to-deliver position by purchasing or borrowing securities of like kind and quantity by no later than the beginning of regular trading hours on the settlement day following the settlement date (T+4). *Id.* For long sales, if the participant has a failure-to-deliver position at the clearing agency at market open on the morning of T+6, it must take affirmative action to close out the failure-to-deliver position by purchasing or borrowing securities of like kind and quantity by no later than the beginning of regular trading hours on the third settlement day following the settlement date (T+6). *Id.*

At all relevant times, Penson was a clearing firm, i.e., a participant of a registered clearing agency and a member of NSCC. Stipulated FOF No. 6. No PWI entity other than Penson had close-out obligations under Rule 204T/204. Stipulated FOF No. 111. From October 2008 until November 2011, Penson failed to close out CNS failures to deliver resulting from long sales of loaned securities by market open T+6. Stipulated FOF No. 7. The relevant long sales originated with securities held in customer margin accounts. *Id.* Under the Commission's customer protection rule, Penson was permitted, subject to certain conditions and limitations, to re-hypothecate margin securities to third parties; that is, Penson loaned out securities in the margin accounts to third parties. *Id.*; Tr. 942-44. This was done according to the terms of a

Master Securities Lending Agreement (MSLA) developed by the Securities Industry and Financial Markets Association (SIFMA). Stipulated FOF No. 7.

When a margin customer sold the hypothecated securities that were out on loan, Penson issued account-level recalls to the borrowers of the securities on T+3, i.e., three business days after execution of the margin customer's sale order. Stipulated FOF No. 8. When the borrowers did not return the shares by the close of business T+3, and Penson did not otherwise have enough shares of the relevant security to meet its CNS delivery obligations, Penson incurred a CNS failure to deliver. *Id.*

Rule 204T/204 contains a "safety valve" in the form of a concept called the penalty box. Tr. 140, 2061-62. If a participant of a registered clearing agency is unable to close out a CNS failure to deliver, it must place the security in question on a list, called the penalty box, and cannot lend any of the shares on that list. Tr. 140. Because no system can guarantee perfect settlement, the penalty box allows the capital markets to continue operations related to short selling. Tr. 2061-63.

C. The Stock Loan Department and its Rule 204T/204 Violations

Penson's Stock Loan department had several different functions. Tr. 90. It generated revenue by lending out securities in its customers' margin accounts to counterparties, who generally paid a "rebate" to borrow the securities in order to meet their customers' delivery obligations, and by borrowing securities to assist with Penson customers' short selling, charging a mark-up to its customers for the cost of the borrow to satisfy the obligation to settle the short sale trade on T+3. Tr. 90-91, 206-09, 211-12, 355-56, 944-45. The Stock Loan department also supported Penson customers' short selling by providing "locates" on shares – affirmative determinations that the shares would be available – before the customer engaged in the short sale, and charging a rate for that service. Tr. 205-06, 346; 945-46. The Stock Loan department generated significant profits through these lending, borrowing, and locating activities. Tr. 212-13, 944-46. Penson also used the Stock Loan department's lending capabilities to obtain working capital for the firm, by pledging the securities to a counterparty in exchange for a percentage of the securities' value paid in cash. Tr. 209-11, 943-44, 1502-03. This way of obtaining financing for Penson was advantageous compared to financing through a bank loan because Penson received more value for the stock pledged as collateral and paid a lower interest rate. Tr. 209-11, 943-944, 1831-32, 2165-66.

Penson's Stock Loan department was responsible for closing out CNS fails arising from long sales of securities which had been loaned out by Penson. Tr. 173, 235, 305-06. By contrast, Penson's Buy-Ins department had the responsibility to close out CNS fails caused by customers, e.g., customers who sold short or customers who sold long and failed to provide the shares to Penson by settlement date. Stipulated FOF No. 17; Tr. 173, 231-32, 235, 305-06. In such circumstances, the cost of the buy-in (i.e., borrowing or buying before market open), and the attendant market risk, was borne by the customer or broker causing the fail, not by Penson. Stipulated FOF No. 17; Tr. 87-90. Where CNS failures to deliver were not caused by the action of any customers, as was the case for long sales of loaned securities, there was no one other than Penson to absorb the cost of closing out the fails. Stipulated FOF No. 18.

Members of the Stock Loan department, which included Johnson, at all times knew that Rule 204T/204 required them to close out all long sale transactions at or before market open on T+6. Stipulated FOF No. 70. Stock Loan initially attempted to comply with this requirement for long sales of loaned securities by recalling loans at the account level on T+3 and buying in the borrowers at market open T+6. Stipulated FOF No. 10. However, because the MSLA gave the borrowers three full days (until close-of-business T+6) to return the shares, the borrowing counterparties pushed back against Penson's attempted market open T+6 buy-ins. *Id.*

Due to this difficulty in buying in the shares, at least on some occasions, the Stock Loan department allowed CNS failures to deliver resulting from long sales of loaned securities to persist beyond market open T+6 and did not take steps, such as purchasing or borrowing securities, in order to close out Penson's CNS failure-to-deliver position. Stipulated FOF No. 11.

As head of the Stock Loan department, Johnson had primary authority and responsibility for its operational practices and for the department's Written Supervisory Procedures (WSPs), which were incorporated into Penson's WSPs. Stipulated FOF No. 41. Johnson was also the individual with primary responsibility in the Stock Loan department for compliance with Rule 204T(a)/204(a) procedures. Stipulated FOF No. 38. He knew that Rule 204T(a)/204(a) required Penson to close out CNS failures to deliver for long sales, including long sales of loaned securities, by market open T+6, and he ultimately made the decision that the Stock Loan department would use procedures by which fails to deliver were not closed out until the afternoon of T+6. Stipulated FOF No. 41; Tr. 389. From October 2008 through November 2011, Johnson knew Penson was at times violating Rule 204T(a)/204(a) in connection with long sales of loaned securities. Stipulated FOF No. 41.

Between October 2008 and October 2011, there were at least 1,500 Rule 204T(a)/204(a) violations by Penson relating to long sales of loaned securities.[2] Stipulated FOF No. 49; Del. Ex. 454 at 33-34. During this time, Penson cleared at least one billion securities transactions, of which 83.6 million were long sale transactions by Penson that were potentially associated with loaned shares. Stipulated FOF Nos. 50, 51. Of these 83.6 million long sale transactions, only 0.12 percent were potentially associated with a negative CNS position that was a Rule 204(a)/204T(a) violation. Stipulated FOF No. 51. The 1,500 Rule 204T(a)/204 negative CNS positions identified as violations represented only approximately 0.68 percent of the total number of Penson's CNS net sale settling positions potentially associated with loaned shares. Stipulated FOF No. 52. It is not surprising that only a small percentage of all trades Penson cleared violated Rule 204, because the vast majority of all trades settle within the standard three-day settlement cycle. Tr. 1018-19, 1640-41.

[2] For the alleged violations of Rule 204T/204 for long sales of loaned securities in this case, the Division of Enforcement is not alleging that a failure to recall on T+2 or a failure to close out at any time prior to market open on T+6 is a violation. Stipulated FOF No. 59.

The Stock Loan department's revenue was approximately $77 million during this period. Stipulated FOF No. 79. The only specifically quantified benefit Penson gained from not timely closing out fails to deliver at market open on T+6 is $59,000. Stipulated FOF No. 53.

D. The Compliance Department's Role

During the Relevant Period, Penson's compliance department, under the direction of Yancey and Delaney, grew to over twenty-three employees. Stipulated FOF No. 72. On average, the compliance department received between approximately 1,100 and 1,500 regulatory requests and state agency subpoenas per year. Stipulated FOF No. 99.

Penson's general implementation process for new rules and regulations was as follows: in response to a new rule, the compliance department often held initial meetings with the affected business units and management to determine what procedural changes, development efforts, technology resources, or training was required, as well as to create a roadmap for compliance deadlines and testing, and also distributed special compliance memorandums both internally and externally to keep employees and correspondents abreast of the recent regulations. Tr. 1246-50, 1707-08, 1715, 1718-20. Penson also provided web-based compliance training to its employees, including training on Reg. SHO and Rule 204T/204. Tr. 1710-11, 1718, 1740-42; Del. Ex. 384.

Delaney participated in Penson's efforts to implement procedures in response to Rule 204T in October 2008 and to Rule 204 in July 2009. Stipulated FOF No. 14. On or around September 25, 2008, Delaney received and read guidance from the law firm Morgan, Lewis & Bockius LLP (Morgan Lewis) discussing the Commission's issuance of emergency orders on temporary close-out requirements on short sales. Stipulated FOF 85; Tr. 1245-46; Del. Ex. 422a. The guidance noted that a clearing broker had until market open T+6 to close out fails to deliver due to long sales. Del. Ex. 422a at 4. It also discussed the impact of the interim rules on securities lending practices. *Id.* at 4-5. In October 2008, Morgan Lewis issued updated guidance about Rule 204T, which again noted the close-out requirements for long sales and included information regarding how securities lending practices would be affected. Div. Ex. 255 at 3-5. The guidance also linked to the Rule 204T adopting release, which discussed Rule 204T's requirements for failures to deliver resulting from long sales. *Id.* at 5; *see* Div. Ex. 67 at 1713.

It was Delaney's practice to review Morgan Lewis's guidance carefully. Tr. 1400. Rule 204T/204 was among the most significant rule changes during Delaney's more than fifteen years in the industry. Tr. 1228-30; 1240-41; *see* Del. Ex. 302 at pp. 0936, 0939. Delaney was aware of the potential tension between the close-out requirements of Rule 204T and securities lending practices in the industry. Div. Ex. 224 at 404. He also understood at all relevant times that Rule 204T/204 required Penson to close out CNS failures to deliver resulting from long sales by market open T+6. Stipulated FOF No. 14.

Beginning in October 2008, two Stock Loan officials engaged in sparing conversations with Delaney about the challenges of Rule 204T compliance. Tr. 227, 236-37, 517-20, 524-25. There is no evidence that other Stock Loan personnel had similar discussions with Delaney. *Cf.* Tr. 402-03; Del. Ex. 446 (July 2014 Brady Letter). Both Johnson and De La Sierra testified that they warned Delaney that Penson counterparties pushed back against being bought in by market

open on T+6 because they viewed it as a violation of both the MLSA and Penson's recall letters, which gave the counterparties a full three days to return the securities after Penson recalled them on T+3. Tr. 225-27, 272, 517-21. Johnson also recalled "putting pressure" on Delaney in August 2009, around the time Rule 204 was adopted, "for answers ... because [Johnson] was concerned about complying with the rule." Tr. 524-25. Johnson testified that he made it clear to Delaney what the Stock Loan department's problem was with complying with Rule 204T/204. Tr. 525. Johnson was a vocal and direct personality; he was not afraid to raise issues and was direct if he needed something. Tr. 2226-27. Though Johnson was also a prolific emailer, no email was ever identified from Johnson to Delaney regarding counterparty pushback or requesting guidance on how to handle it. *See* Stipulated FOF No. 119; *see, e.g.,* Yan. Exs. 521, 638, 667-68, 707. Nor were any emails introduced from anyone else in the Stock Loan department to anyone in the compliance department on the issue of counterparty pushback.

Johnson and De La Sierra testified that they raised this issue with Delaney so that he would provide them guidance on how to comply with Rule 204T/204. Tr. 239-41, 517-18. On one occasion, rather than provide guidance to the Stock Loan department on how it could comply with Rule 204T/204, Delaney told Johnson to "write [his] congressman" if he had problems with the rule. Tr. 1192-93, 1404-05. Similarly, De La Sierra testified that within the first two weeks of Rule 204T's inception, he had a conversation in which Delaney asked whether the Stock Loan department was still having issues with market open buy-ins, and De La Sierra told him that Stock Loan had not resolved the issues, to which "Delaney simply said 'okay.'" Tr. 238. According to De La Sierra, Delaney did not instruct him or the Stock Loan department to buy in by market open on T+6, and neither Delaney nor anyone from compliance got back to the Stock Loan department with guidance on how to comply with the rule. Tr. 237-40, 242-43. However, Delaney and other officials did provide guidance on Reg. SHO to the Stock Loan department in conjunction with the adoption of Rule 204T and Rule 204. *See, e.g.*, Del. Ex. 360 (email to Johnson and others highlighting differences between Rule 204T and Rule 204); Tr. 1710-12, 1740 (testimony that compliance department made "several" Reg. SHO trainings available to Penson employees); *see also* Del. Ex. 386 (email conveying praise to Delaney for his deputy's "terrific help" with the Buy-In department's Rule 204T/204 compliance issues); Yan. Ex. 533 (Delaney providing same-day response to Johnson for guidance on emergency order contemporaneous with Rule 204T). Furthermore, each rule and its associated guidance was available to all Stock Loan department personnel electronically, publicly posted on the internet by the SEC, FINRA, and other reliable sources. *See* Tr. 1941, 2054-56, 2077; Del. Ex. 301 at 0018-0124 (downloaded materials on Rule 204T/204).

On December 13, 2008, Johnson forwarded Delaney an email from other industry participants regarding Rule 204T's "negative unintended consequences on broker-dealer financing and stock market volatility." Div. Ex. 160. The email noted that Rule 204T applied to both long and short sales, and observed that "the timelines set by the rule do not match the timelines in the securities lending markets." *Id.* at 5527. The email encouraged recipients to write a comment letter to the Commission with recommendations on how Rule 204T might be changed to mitigate this problem. *Id.*

On December 15, 2008, Delaney received a draft comment letter written by SIFMA concerning Rule 204T. Yan. Ex. 541. This letter contained a whole section on the impact of

Rule 204T on securities lending practices. *Id.* at 2613-15. The section noted that the MLSA and market practice gave borrowers a certain amount of time to return securities after they were recalled but, in order to comply with Rule 204T, some firms experienced situations in which they had to purchase the securities before the end of the delivery period in order to close out by market open T+6. *Id.* at 2614.

In July and August 2009, Delaney reviewed additional guidance from Morgan Lewis and another law firm on the adoption and substance of Rule 204. Del. Exs. 422a, 424, 425a; Tr. 1245-46. 1251, 1254-55. The guidance provided links to the adopting release for Rule 204. Del. Exs. 424 at 1, 425a at 3. Delaney testified that it was his practice to review the links in such guidance. Tr. 1245-46, 1252-55. The adopting release for Rule 204 specifically discussed the "effect of the close-out requirements of temporary Rule 204T on securities lending" and noted the conflict between the "completion of the securities lending cycle" and the requirements of the rule. Div. Ex. 69 at 38270. Nonetheless, in the next paragraph of the release, the Commission reiterated that despite the impact on securities lending, the Commission would keep the close-out requirements of Rule 204T. *Id.*

On August 10, 2009, Delaney sent an email[3] in which he passed along guidance from Morgan Lewis regarding Rule 204 that stated that close-outs of fail positions needed to occur on T+6 without specifying at what point during the day the close-outs must occur. Tr. 586-87; Div. Ex. 125. The email did not discuss the conflict between the securities lending cycle and the rule. Tr. 586-87; Div. Ex. 125. Nor did it provide any specific guidance on how the Stock Loan department should comply with Rule 204's requirement to close out at market open T+6 in the face of counterparty pushback on being bought in at market open T+6. Tr. 243-44, 586-87; Div. Ex. 125. Johnson interpreted "T+6" as the full day and did not think it resolved the issue of the Stock Loan department closing out after market open on T+6. Tr. 523-24. De La Sierra agreed that the email failed to provide effective guidance on how the Stock Loan department could comply with Rule 204, and he believed Delaney was aware at this time that the Stock Loan department was not buying in to close out fails to deliver until the afternoon of T+6. Tr. 243-44. There is no indication that De La Sierra or Johnson responded to Delaney's email in any way.

E. NASD Rule 3012 and FINRA Rule 3130

1. December 2009 NASD Rule 3012 Audit

National Association of Securities Dealers (NASD)[4] Rule 3012 (Rule 3012), in effect during the Relevant Period, required NASD members to establish, maintain, and enforce policies

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[3] Div. Ex. 125 does not indicate the distribution list of Delaney's email, but it is addressed to "All" and was received by both Johnson and De La Sierra. Tr. 243, 522-23, 586; Div. Ex. 125; *cf.* Del. Ex. 349.

[4] NASD was the predecessor to the Financial Industry Regulatory Authority (FINRA). Tr. 435. By order dated July 26, 2007, the Commission approved the NASD's and New York Stock Exchange Regulation's proposed consolidation of their respective member regulatory operations under a single organization: FINRA. Self Regulatory Organizations, Exchange Act Release No.

and procedures that tested and verified the members' compliance with securities laws and regulations and NASD rules. Tr. 108-09; Rule 3012; *see* Yan. Ex. 828 at 12. The rule also required the creation of an annual report, to be presented to the member's senior management, detailing the policies and procedures, test results, and any amended procedures created in response to the test results. Rule 3012; *see* Tr. 171-72.

Alaniz had primary responsibility at Penson for conducting the testing required by Rule 3012 during the Relevant Period, and he was the one who primarily conducted such testing. Stipulated FOF No. 63. He was experienced and well-trained in compliance. Tr. 720-21, 832-34. In his compliance role at Penson, Alaniz created and administered a wide-ranging and vigorous Rule 3012 testing program. Tr. 705-07, 832; Yan. Ex. 828 at 12-13. As part of its Rule 3012 testing process, Penson's compliance department identified specific regulatory issues and/or problems, and the business units proposed solutions. Tr. 784-85, 794-95, 846. This was a collaborative process, which required Alaniz to rely on the business units as the "subject matter experts" or "specialists" in each department. Tr. 726, 784, 838, 846, 851.

The compliance department performed Rule 3012 tests, also referred to audits, on approximately twenty topics per year. Tr. 714, 739. Alaniz came up with topics for the audits based on his understanding of what areas FINRA and SEC regulators were interested in at the time. Tr. 705; Div. Ex. 134. He and Delaney then collaborated to create a list of topics, and shared that list with Yancey, updating it as needed to reflect Yancey's feedback. Tr. 705.

In December 2009, the compliance department completed a Rule 3012 audit of Penson's Rule 204T/204 close-out procedures, which had been in place at Penson from October 2008 forward. Stipulated FOF No. 15. In preparing for the audit, Alaniz spoke with both the Stock Loan and Buy-Ins departments to verify that he correctly understood the requirements imposed by Rule 204. Tr. 706, 864-65. During these initial meetings with Stock Loan department personnel, no one from the Stock Loan department told Alaniz that the department was deliberately failing to comply with Rule 204. *See* Stipulated FOF No. 60. Nor am I am aware of any evidence that anyone from the Stock Loan department told Alaniz that they were inadvertently failing to comply. After these discussions with the Stock Loan and Buy-Ins departments, Alaniz decided how to test Rule 204 compliance within Penson. Tr. 743. No limitations were placed on him in making this decision, and he did not recall whether he discussed the decision with Delaney. Tr. 743-44.

In order to test Penson's Rule 204T/204 procedures, compliance personnel sampled 113 CNS failures to deliver between November 16 and December 11, 2009, resulting from both long sales and short sales in the Buy-Ins department. Stipulated FOF No. 15; Div. Ex. 70. The audit found that the Buy-Ins department's procedures resulted in Rule 204(a) violations for 112 out of the 113 securities sampled. Stipulated FOF No. 15; Div. Ex. 70. This result constituted one of the most significant failures in Alaniz's Rule 3012 testing for that timeframe. Tr. 708.

56145, 2007 WL 5185330, at *1 (July 26, 2007). FINRA is responsible for regulatory oversight of all securities firms that do business with the public. *Id.*

The December 2009 Rule 204T/204 audit related exclusively to the Buy-Ins department. Stipulated FOF No. 78; Tr. 635-36. As noted above, the Buys-Ins department only handled close-outs of CNS failures to deliver resulting from transactions initiated by customers. Stipulated FOF No. 17. Alaniz did not look at CNS fails related to loaned securities, the province of the Stock Loan department. Tr. 717. The Stock Loan and Buy-Ins departments were separate – one was located on the 14th floor, the other on the 19th floor – and a problem in one department did not necessarily mean that there was an issue in the other department. Stipulated FOF No. 86; Tr. 173-75, 855-56, 1348-49. Delaney understood that the audit had revealed failures relating to the Buy-Ins department's Rule 204(a) procedures that were anomalous during his tenure as CCO. Stipulated FOF No. 15.

Alaniz prepared a memorandum, dated December 21, 2009, summarizing the results of the December 2009 audit. Div. Ex. 70. The memorandum was reviewed and edited by Delaney. Tr. 708-09. According to the memorandum, the Buy-Ins department's Rule 204(a) close-outs of short sales occurred "anywhere from 30 minutes to a 1 hour and 15 minutes after the market open" and the department's Rule 204(a) close-outs of long sales occurred "anywhere from 4 hours from the market open to up until 11 minutes of the market close." Stipulated FOF No. 25; Div. Ex. 70. The memorandum also noted that the failure to comply with close-out requirements placed 112 out of the 113 securities tested into the penalty box.[5] Div. Ex. 70 at 6755. The memorandum was sent to both the Buy-Ins and Stock Loan departments. Div. Ex. 70; Del Ex. 345. On February 23, 2010, Brian Hall (Hall), who worked in the Stock Loan department, sent Alaniz and De La Sierra the Stock Loan department's response to the memorandum, copying Johnson and Delaney. Tr. 93; Del. Ex. 345 at 2. Hall's response indicated that the Stock Loan department agreed with the memorandum's findings and noted that the Stock Loan department, by contrast, "borrows for 204 securities daily *prior to market open* and will monitor those borrows to ensure proper settlement of CNS fails." *Id.* at 7 (emphasis added). The Buy-Ins department also responded to the memorandum, noting, among other things, that:

> The T+4 report has been reviewed and reworked to capture all required accounts per Rule 204. It is now in the QA Department pending testing. Until a more complete report can be created, tested, and perhaps fully automated, we are manually reviewing fails on the T+4 and T+6 reports to comply with the "closeout" requirements. Since our discussions we have had a high success rate at meeting the "close-out" requirement. We will continue to work with the Securities Lending Department to minimize any and all violations.
>
> The T+6 report will be reviewed and reworked as necessary for compliance with Rule 204 to ensure that all account(s) that may have been missed in the past are included in the report going

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[5] Alaniz's initial draft characterized this as a "99 percent failure rate," but Delaney asked him to remove that language to avoid confusion about what the numbers represented. Tr. 779, 1299-1301.

> forward. Executions are now being done at or before the market open.

Div. Ex. 70 at 6761.

Penson undertook substantial remediation efforts following Alaniz's testing of Penson's Rule 204 compliance, beginning at least as early as January 2010. Stipulated FOF No. 64; Div. Ex. 134. In June 2010, Alaniz did follow up testing on Rule 204 compliance. Tr. 709. The June 2010 test only analyzed compliance with the T+4 requirement for short sales, not the T+6 requirement for long sales, and again related only to the Buys-Ins department. Stipulated FOF No. 78; Div. Ex. 85; Tr. 709, 797-98. The June 2010 test showed improvement in both the number of fails and the timing of the fails (i.e., how long after market open the close-outs occurred). Tr. 172, 859-60. Alaniz also later conducted a spot check with Summer Poldrack (Poldrack), an employee in the Buy-Ins department, and the results indicated 100% compliance in the Buys-Ins department. Stipulated FOF No. 110; Tr. 860-61.

2. *Rule 3012 Meetings and FINRA Rule 3130 Certification*

FINRA Rule 3130 (Rule 3130) requires a member's designated CEO to meet with its designated CCO at least once annually to discuss the processes in place to ensure compliance with FINRA rules and federal securities laws and regulations, and to certify that those processes and tests are reasonably designed to achieve compliance. FINRA Rule 3130; Tr. 835. Penson's WSPs, effective as of March 31, 2010, contained a section titled "Annual CEO Certification (RULE 3130): CEO and CCO Mandated Meeting." Stipulated FOF No. 45. The procedures identified Yancey, as CEO/President, and Delaney, as CCO, to be the relevant designated supervisory principals. *Id.* The procedures contained the following requirement:

> The CCO will prepare and provide the CEO (or equivalent officer) with an Annual Report that includes a review of [Penson]'s Supervisory System and Procedures and key compliance issues. The CCO will meet with the CEO to discuss and review the report and will meet at other times, as needed, to discuss other compliance matters.

Id. The procedures required Yancey to certify, among other things, that "[c]ompliance processes are evidenced in a written report reviewed by the CEO, CCO, and other appropriate officers and submitted to the Board of Directors and Audit Committee, if any." *Id.*

Yancey held quarterly meetings to review the results of the Rule 3012 testing, exceeding FINRA's annual requirement. Stipulated FOF No. 90; Tr. 835; *see* Div. Ex. 134. Yancey was attentive during these meetings and asked detailed questions. Tr. 837; *see* Yan. Ex. 692. The meetings provided Yancey an executive-level summary of the testing process and results. Tr. 836-37. Delaney, Alaniz, and other members of the compliance department were more knowledgeable than Yancey regarding the Rule 204 testing. Tr. 1352.

On January 28, 2010, Delaney and Alaniz had a quarterly meeting with Yancey. Div. Ex. 134; Tr. 710. At that meeting, the December 2009 Rule 204 audit was one of two items discussed. Div. Ex. 134; Tr. 711, 895. Delaney and Alaniz explained the results of the audit and pointed out that 112 out of 113 items tested failed. Div. Ex. 134; Tr. 709-10. Yancey was also told that the compliance department was receiving cooperation from the Buy-Ins department for Rule 204 remediation. Tr. 845, 1354, 1879-80; *see* Div. Ex. 134 (January 28, 2010 email from Alaniz to Yancey stating Rule 204 is now the focus of "prompt remediation"). When Yancey suggested to Alaniz that Johnson be brought into the conversation to discuss the December 2009 Rule 204 audit, Alaniz told him it was unnecessary because it was a Buy-Ins department issue. Tr. 613, 762-63, 1354, 1878-79; Div. Ex. 224 at 329.

On March 31, 2010, another Rule 3012 meeting was held. Stipulated FOF No. 113. Alaniz and the compliance department decided who to invite to the March 2010 meeting, and Alaniz distributed the invitation list for the meeting. Stipulated FOF No. 96; Tr. 714, 1881-82; Div. Ex. 99; Yan. Ex. 674. A representative from the Stock Loan department attended the March 2010 meeting. Tr. 539; Div. Ex. 224 at 350-51. Johnson was invited but did not attend; he testified that he did not refuse to attend the meeting but, as a general rule, he did not attend meetings that occurred during the trading day. Tr. 538-39; Yan. Ex. 674. The Division did not ask Johnson any questions regarding his non-attendance at the March 2010 meeting. Tr. 513-568.

At the March 31, 2010, quarterly meeting, the compliance department presented the annual report required by Rule 3130 (Annual Report). Stipulated FOF No. 21. Per Penson's WSPs, the report was to discuss Penson's "key compliance problems" for the period April 1, 2009, through March 31, 2010. *Id.* Consistent with this requirement, the Annual Report contained a section titled "identification of significant compliance problems." Stipulated FOF No. 46. However, neither in this section of the report nor elsewhere in the report were Penson's Rule 204 deficiencies discussed. *Id.*; Tr. 857; *see* Div. Ex. 135. The Annual Report also contained no mention of the results of the other items tested in the Rule 3012 audit. Tr. 857, 1303; *see* Div. Ex. 135.

The preparation of the Annual Report was a group effort by the members of the compliance department, including Delaney. Tr. 1361. Alaniz prepared the initial draft of the Annual Report, using a template and filling out certain substantive portions of the report. Tr. 826, 856-57. Once he did so, he sent the report on to Delaney to complete. Tr. 826. Alaniz testified that he received direction on what to include in the report from Delaney, and that it was ultimately Delaney who decided whether items would be listed as significant compliance problems. Tr. 719, 857. Alaniz did not include any of the Rule 3012 audit results in the Annual Report, and he did not recall telling Delaney that the results should be included. Tr. 826, 856-58.

Though not included in the Annual Report, the Rule 204 test was discussed at the March 2010 meeting. Stipulated FOF No. 21. A specific item of discussion was the Rule 204(a) violations resulting from the Buy-Ins department's procedures – a compliance failure that Delaney years later characterized as "massive," "profound," and "anomalous." *Id.*; *see* Div. Ex. 224 at 389, 415, 428. The ongoing remediation efforts were discussed for approximately fifteen minutes. Tr. 851-52.

At the conclusion of the March 31, 2010, meeting, Yancey signed the CEO certification required by Rule 3130. Stipulated FOF No. 46; *see* Div. Ex. 135. The Annual Report was appended to the certification. Stipulated FOF No. 46. Yancey was aware that the CEO certification and Annual Report were sent to regulators. Stipulated FOF No. 115. Both Delaney and Yancey testified that Yancey had no reason to overrule the judgment of the compliance department regarding the contents of the report. Tr. 1362-63, 1887-88; *see* Yan. Ex. 828 at 18. Following both the January 2010 and March 2010 meetings, Yancey was told that the Rule 204 testing results were the subject of prompt remediation and that the relevant departments were cooperating. Stipulated FOF No. 77.

On March 31, 2010, Delaney personally emailed the CEO certification and Annual Report to FINRA in response to its specific request for the documents. Stipulated FOF No. 33. That same day, Penson's compliance personnel uploaded the documents to Penson's FINRA gateway and separately emailed the Annual Report to other FINRA personnel. *Id.* On April 1, 2010, compliance personnel sent the Annual Report to the Chicago Board Options Exchange (CBOE). *Id.* Several months later, in September 2010, compliance personnel sent the Annual Report to the National Stock Exchange, Inc., in response to an information request. *Id.* While not included in the Annual Report, files containing all Rule 3012 testing results were retained to be made available to regulators upon request. Tr. 804-05; *see* Div. Ex. 135 at 0006 (stating that Rule 3012 test results were "available in the Compliance dept.").

F. Updates to WSPs and Submission to FINRA

In January 2010, Penson compiled WSPs for delivery to FINRA as part of a FINRA Rule 1017 application.[6] Stipulated FOF No. 19. FINRA had been very clear with Delaney that they were going to be "poring over the WSPs with a fine-tooth comb." *Id.* On January 25, 2010, Delaney forwarded a set of WSPs to Alaniz for comment before delivering the WSPs to FINRA. *Id.* Alaniz responded that the WSPs Delaney sent him did not expansively address Reg. SHO as it pertained to Rule 204. *Id.*; Div. Ex. 82. Among other things, Alaniz recommended that "[a]s much as they can, I'd recommend to consolidate [the WSPs] and include how Sendero will adjust for T+4's and T+6's close-out requirement" of Rule 204 and to "[i]nclude close-out requirement procedures in the WSPs."[7] Div. Ex. 166.

A relevant WSP section had two parts: one titled "Close-Out Requirements for Fail (sic) to Deliver (SEC Rule 10b-21; Regulation SHO Rule 204)," and a subsequent part titled "Procedures Adopted in Accordance With Rule 204." Stipulated FOF No. 20. The first part correctly articulated the regulatory requirement that CNS failures to deliver resulting from long sales had to be closed out by market open T+6. *Id.* The section detailed the Stock Loan

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[6] FINRA Rule 1017 requires an application to be submitted when one member firm merges with another member firm. Tr. 800. Penson acquired the clearing accounts of another firm, Broadridge, in approximately 2009. Tr. 86, 113, 527.

[7] Sendero was a system used by Penson to track locates and to generate reports of CNS fails. Tr. 215, 229-30. Penson used Sendero to determine which department had responsibility for closing out the fails. Tr. 229-30.

department's procedures for maintaining a list of easy-to-borrow securities and providing locates that were relevant to Penson's compliance with Rule 203, not Rule 204. *Id.* The second part finished with a brief description of procedures designed to ensure close-outs of CNS failures to deliver resulting from short sales by T+4. *Id.*

In June and July 2010, Delaney coordinated with his staff to formally approve an updated version of Penson's WSPs. Stipulated FOF No. 27. Both Penson's March 31, 2010, WSPs, which Delaney specifically reviewed and approved, and December 30, 2010, WSPs, did not contain expanded procedures for how to close out long sales by T+6. Tr. 654-55, 659-60; Div. Ex. 188 at 9762-63; Div. Ex. 191; Div. Ex. 211 at 12. However, the WSPs stated: "If Stock Loan does not have a counterparty to pass the Buy-In to, then the Buy-In is forwarded to the customer Buy-In department." Div. Exs. 188 at 9753, 211 at 4. Delaney was copied on at least one email from Penson's compliance department delivering the WSPs to FINRA as part of Penson's Rule 1017 application. Stipulated FOF No. 20.

G. Regulators Raise Concerns About Penson's Rule 204T/204 Compliance

1. OCIE Examination

The Commission's Office of Compliance Inspections and Examinations (OCIE) began conducting a review of Penson's Rule 204T procedures in November 2008. Stipulated FOF No. 28. On April 8, 2010, OCIE informed Penson that it had learned Penson was having problems executing close-outs at market open and asked for an explanation. Stipulated FOF No. 34. On April 14, 2010, a junior Penson compliance officer asked OCIE to clarify how it had learned about the potential close-out problems. *Id.* That same day, OCIE sent the junior compliance officer and Delaney the following clarification and request for information:

> During staff's review of fails to deliver and conversations with the firm regarding 204T compliance, Penson represented and in documents produced evidenced that the firm did not always buy-in to close-out a fail to deliver position at the market open. The reason the firm provided for not buying-in at the open was because of manual processes and system limitations. Q. What is the system limitations that prevent the firm from executing buy-ins at the market open? Has the firm fixed the system limitations and manual processes to now execute buy-ins at the market open? If so, please provide the date the firm corrected this issue.

Id.

On April 22, 2010, a Penson compliance officer named Doug Gorenflo (Gorenflo) sent Penson's response to OCIE. Stipulated FOF No. 23; Div. Ex. 171. The response stated: "[Penson] would like to note that the majority of any Regulation SHO buy-ins are and have been covered by stock borrow or executing closing trades prior to the market open." Stipulated FOF No. 23; Div. Ex. 171 at 0001. The response continued: "For those instances where we were unable to complete buy-ins prior to market open, buy-ins were typically executed within 15 minutes of market open." Stipulated FOF No. 24; Div. Ex. 171 at 0001. On May 10, 2010,

Hasty forwarded the April 22, 2010, response to Delaney, stating "Tom, Attached is a copy of the most recent response, as well as a link to the examination folder." Stipulated FOF No. 26; Div. Ex. 171.

In October 2010, OCIE issued Penson a deficiency letter reporting that OCIE had found Rule 204T(a) violations. Stipulated FOF No. 28. The findings reported to Penson in the deficiency letter included FINRA's conclusion, detailed below, that Penson had violated Rule 204T in connection with short sales. *Id.* At this time, Gorenflo forwarded the April 22, 2010, response to Delaney as part of Delaney's efforts to respond to the OCIE deficiency letter. Stipulated FOF No. 26.

On November 8, 2010, Gover, then a supervisor in the Buy-Ins department, emailed Delaney and Yancey, among others, a short draft letter of selected responses to OCIE's findings. Stipulated FOF Nos. 30, 47. Gover's draft contained the language: "Penson feels that the processes and procedures employed to close out positions that were in violation of Rule 204T were effective and performed as designed." Stipulated FOF No. 30. On November 15, 2010, Miller, the compliance officer shepherding the drafting process, emailed Delaney a full draft of Penson's responses to OCIE. Stipulated FOF No. 31; Div. Ex. 206. That draft contained the same language from the November 8 draft regarding the effectiveness and performance of Penson's Rule 204T processes and procedures. Stipulated FOF No. 31; Div. Ex. 206 at 7.

On November 19, 2010, Delaney emailed Miller, stating "Attached is my re-draft with a couple of additional notes." Stipulated FOF No. 32; Div. Ex. 208. Delaney's re-draft provided edits to the draft letter of November 15, 2010. *Id.* On November 24, 2010, Delaney and Yancey were copied on an email seeking their final review of the letter before delivery to OCIE. Stipulated FOF Nos. 35, 47. That draft of the letter, as well as the final letter delivered to OCIE later that day, contained the exact language from Delaney's November 19 re-draft. Stipulated FOF No. 35. Yancey allowed the letter to be delivered to OCIE without making any edits to it. Stipulated FOF No. 48.

Delaney did not alter the language in the original draft of the letter authored by Gover relating to Penson's Rule 204T processes and procedures. Div. Ex. 208 at 9777. Thus, the letter delivered to OCIE on November 24, 2010, stated:

> Penson believes that the reasonable processes employed to close out positions that were allegedly in violation of rule 204T were effective and performed as designed. Our current procedures as they relate to Rule 204 are effective and designed to ensure that all short sales and sales not long are covered either through stock borrow or market action prior to the open on S+1.

Stipulated FOF No. 29; Div. Ex. 101 at 8.

Gover believed that this language was accurate, both when he drafted it and as of the date that he testified at the hearing. Stipulated FOF No. 61. The Division did not ask Gover any questions at the hearing regarding his use of this language in the OCIE response letter. Tr. 74-

199. Hasty also believed that Penson's November 2010 OCIE response letter, which she signed, was accurate, and Alaniz agreed that he believed the language regarding Penson's "effective" and "reasonable" processes was correct at the time. Tr. 828-29, 1738-39; Div. Ex. 101 at 12. Delaney explained that he did not think the response was inconsistent with the December 2009 Rule 204 test results because he believed the problems identified in that test were being effectively remediated. Tr. 1284-85.

2. FINRA

FINRA conducts annual examinations, known as cycle exams, which evaluate clearing firms' compliance with FINRA rules. As part of the cycle exams, FINRA examiners went to Penson's offices and met with Penson's senior leadership and business unit heads. Tr. 1261-63. For its 2010 cycle exam, FINRA notified Penson that the exam would be focused on Reg. SHO and anti-money laundering. Tr. 1287.

On or around May 11, 2010, FINRA requested the remediation tracking logs related to, and referenced in, the March 31, 2010, CEO certification. Div. Ex. 194 at 7039; *see* Div. Ex. 135 at 0006. Alaniz maintained the remediation tracking logs to chart the progress of the persons in relevant business units who were working to cure the identified compliance problems. Tr. 1305-06. The logs provided to FINRA did not mention Rule 204T, Rule 204, or Alaniz's testing of Rule 204 compliance. Div. Ex. 194.

On May 17, 2010, Delaney was copied on an email between Gover and Miller regarding FINRA's conclusion that Penson had failed to close out eight long sales by T+6. Div. Ex. 168. The email did not indicate whether the long sales were loaned securities or customer-caused fails. *Id.* Delaney did not personally follow up on this information. *See* Tr. 596-98.

FINRA completed its examination of Penson in October 2010 and sent Penson an exit meeting report summarizing the results of its examination. Div. Ex. 40. Delaney received a copy of the report on October 21, 2010, which he forwarded on to Yancey, McCain, Gover, Hasty, Pendergraft, and others. *Id.* at 4660; Tr. 603-604. The report stated that FINRA had reviewed ten CNS failures to deliver between February 1, 2010, and March 31, 2010, and found that Penson failed to recall or borrow securities to close out the ten fails in compliance with the T+4 requirement for short sales and the T+6 requirement for long sales. Div. Ex. 40 at 4668. The report concluded that this was a violation of Rule 204 and therefore NASD Rule 3010. *Id.*

On February 24, 2011, FINRA sent a second examination report to Penson. Div. Ex. 89. The report again noted the ten failures to deliver between February 1, 2010, and March 31, 2010, and concluded that Penson was not in compliance with Rule 204 and NASD Rule 3010. *Id.* at 0030. Penson responded to this report in a letter dated March 18, 2011 (the March 2011 FINRA Letter), which stated with respect to the Rule 204 violations:

> While the Firm feels the procedures and policies around the handling of Reg SHO Rule 204 are generally effective we have taken steps to ensure that all items subject to Reg SHO Rule 204 are covered either by borrow or buy-in by the required date for

> each transaction type. We would note that of the items identified as being subject to buy in yet a buy-in did not occur we find 3 items which should have been bought in. The aggregate value of those transactions was <$10,000.

Id. The letter also stated:

> With regards to the timing of long-sale closeouts, the Firm does not believe it is industry practice to close out long sales prior to the market open on T+6. Not once has the Firm ever had a borrow closed out by a lending counterparty at the open. Conversely, the Firm's borrowing counterparties will not accept a closeout price on a stock loan at the market open. Thus, the Firm executes closeouts versus long sales at the conclusion of the DTCC trading window at approximately 3:00 EST daily, as is universally practiced. Closing out loans at the market open would put the Firm at a competitive disadvantage and ultimately hinder the Firm's ability to cover its customers' delivery obligations.

Id. at 0031. Delaney testified that the March 2011 FINRA Letter was drafted by Penson's subject matter experts. Tr. 572.

H. Other Penson Discussions Regarding Compliance with Rule 204

Gover testified that sometime in the spring of 2010, he had a meeting with Delaney, Johnson, and Hasty, perhaps also including Hall and De La Sierra, at which the Stock Loan department's problems complying with Rule 204 were discussed. Tr. 103-06, 117-18. He testified that given the passage of several years, he could not "reliably say" precisely when the meeting occurred. Tr. 118, 140-41. He recalled that the compliance problem was not resolved in the meeting, but that it was decided to obtain the advice of outside counsel. Tr. 106.

On July 15, 2010, Delaney was copied on email discussions between compliance and operational personnel about the Stock Loan department's procedures for close-outs of CNS failures to deliver resulting from long sales of loaned securities. Stipulated FOF Nos. 16, 39; Div. Ex. 158; *see* Tr. 113-17. On July 26, 2010, Alaniz responded to the email, continuing to copy Delaney, indicating that fails attributable to Penson's Stock Loan department "should be flat by the end of the day or have a surplus" and "[p]referably this should be completed prior to or at market open." Stipulated FOF No. 39; Div. Ex. 158.

On August 2, 2010, Delaney met with Yancey to discuss the status of the efforts to remediate the Buy-Ins department's Rule 204(a) deficiencies regarding short sales. Stipulated FOF No. 40. Delaney and Yancey did not discuss whether there were Rule 204(a) violations relating to long sales of loaned securities. *Id.*

On August 20, 2010, Delaney was copied on an email from Alaniz attaching guidance concerning Rule 204. Del. Ex. 328. The guidance repeated a portion of the July 2009 adopting

release for Rule 204, and two of the nine paragraphs in the guidance discussed the conflict between securities lending practices and Rule 204's requirements. *Id.* at 1, 3; *see* Div. Ex. 69.

On October 13, 2010, De La Sierra was forwarded an email chain discussing Rule 204's close-out requirements, which noted that "[i]n the event your short is the result of a bona-fide long sale you have the option of arranging a borrow via our Stock Loan Department." Div. Ex. 26 at 9046. De La Sierra responded, copying Johnson and Hall, stating that "[w]e do not borrow for long sales . . . we'll just wait for shares to be received rather than incur the cost of borrowing." *Id.* at 9045. The email was escalated to Gover for his approval of this description of the close-out process for customer-caused failures of long sales, and Gover in turn copied Delaney on his response, noting that he was "[b]ringing Compliance (Tom Delaney and Tom Textor) into the discussion." *Id.* at 9044.

Delaney maintains that he did not know about the Stock Loan department's practice of noncompliance with Rule 204 until early 2011. Tr. 1200; Del. Reply at 9-11. He testified that in February 2011, Johnson came into Delaney's office to discuss a proposal, involving the use of the penalty box, to resolve the counterparty pushback the Stock Loan department was experiencing. Tr. 1199, 1308-09, 1323-24. In response, Delaney arranged a meeting between the Stock Loan department and Penson's outside counsel. Stipulated FOF No. 68; Tr. 1322-23. During the meeting, which took place by telephone, outside counsel informed the Stock Loan department that its proposed solution did not comply with Rule 204. Tr. 1324-25. The testimony of Gover, De La Sierra, and Wetzig regarding this meeting is consistent with Delaney's. Tr. 144, 273, 402-03. The Stock Loan department did not change its Rule 204 close-out practices after the February 2011 meeting, and violations of Rule 204 by the Stock Loan department continued after the meeting, and after Delaney left Penson. Stipulated FOF Nos. 67, 68, 91. Delaney did not have the power to discipline, hire, or fire members of the Stock Loan department. Stipulated FOF No. 69.

In approximately the fall of 2011, the Stock Loan department became aware of a provision in Rule 204's adopting release that suggested that compliance with Rule 204 could be achieved by issuing recalls of loaned stock on T+2. Tr. 247, 331-32; *see* Div. Ex. 69 at 38270 n. 55. At that time, the Stock Loan department reprogrammed its Sendero system to issue recalls on T+2, which allowed it to comply with both Rule 204 and the MSLA. Tr. 247-48, 331-33, 372-75. By recalling on T+2, the Stock Loan department could buy-in a counterparty three days after the recall, or at the close of business on T+5, and still close out the fail to deliver before market open on T+6. Tr. 333. The re-programmed system was extremely accurate in allowing the Stock Loan department to recall shares that were going to be in a fail position. Tr. 247-48, 372-75. The reprogramming of Sendero was done in house, and took approximately one week. Tr. 373-74. Prior to this time, no one from compliance alerted the Stock Loan department to the provision in Rule 204's adopting release that suggested issuing recalls on T+2. Tr. 242, 333-34. It is not clear whether anyone from the Stock Loan department read the adopting release before then.

I. Penson's Management Structure

1. Supervision of Delaney

Yancey had approximately nine to ten direct reports during the Relevant Period, one of whom was Delaney. Yan. Exs. 503, 570-71 (organizational charts). Yancey had supervisory responsibility for Delaney and met with him routinely. Stipulated FOF Nos. 95, 112. Yancey also conducted weekly group and one-on-one meetings with all of his direct reports, including Delaney. Tr. 1339, 1840, 2178.

Yancey was an accessible and engaged supervisor. Tr. 176-77, 423-24, 837, 1339-40, 1701-02, 2178. Yancey believed Delaney was a conscientious, qualified, and engaged CCO. 1908-10. This belief was echoed by other witnesses at the hearing. Tr. 831, 1582-83, 1585, 1588, 1757-58, 1762, 1766-67, 2200. Other than the current action, Delaney has a clean record and Form U4. *See* Thomas Richard Delaney BrokerCheck Report at 9, available at http://brokercheck/finra.org (last visited Mar. 13, 2015).[8]

2. Supervision of Johnson

At some point prior to the implementation of Rule 204T, Johnson became the PWI Senior Vice President for Global Stock Lending, responsible for all of Penson's worldwide stock lending operations. Stipulated FOF No. 117. Until Johnson was promoted to this position, Yancey was Johnson's supervisor and Penson's organizational charts listed Johnson as a Penson employee reporting to Yancey. Stipulated FOF No. 118; Yan. Ex. 555.

According to several witnesses, in August 2008, Yancey delegated supervision of Johnson to Pendergraft. Tr. 951, 1149-51, 1902-03, 2181-82; *see also* Tr. 1332. Yancey testified that this change was suggested by Pendergraft, who wanted to develop a global role for Penson's stock lending activities and make Johnson his direct report. Tr. 947-48, 1902-03. McCain echoed this understanding, and Pendergraft confirmed that he and Yancey discussed making Johnson Pendergraft's direct report around this time. Tr. 1512, 2181-82. On August 14, 2008, Pendergraft directed Penson's Vice President of Human Resources, Dawn Gardner (Gardner), to move Johnson from Penson's payroll to PWI's. Yan. Ex. 608; Tr. 1150-51.

Johnson believed he reported to Pendergraft at PWI during the Relevant Period, and he told Penson employees that he did so. Stipulated FOF No. 83; Tr. 1152, 1338, 1743-44, 2182-83. Pendergraft agreed that he supervised Johnson during this time, but testified that he did so only with regard to Johnson's PWI responsibilities, not with respect to his regulatory and compliance responsibilities for the Stock Loan department. Tr. 1461-64. Pendergraft testified that someone on the Penson executive team, not the PWI team, would have had supervisory responsibility over Johnson as to regulatory and compliance issues pertaining to the Stock Loan department. Tr. 1463. Pendergraft never testified who that person was (quizzically, the Division counsel did not ask him, perhaps because they knew that Pendergraft would not directly implicate Yancey). According to several other witnesses, however, Pendergraft accepted

[8] Official notice, pursuant to 17 C.F.R. § 201.323, is taken of this record.

supervision of Johnson unconditionally, including both his stock lending and non-stock lending activities and both his operational and compliance responsibilities. Tr. 948, 1152, 1745-46, 1846; *see also* Tr. 1334-36. Gardner, Hasty, and Johnson himself also disputed Pendergraft's claim that Johnson had more than one supervisor. Tr. 537-38, 1151; 1745. After August 2008, Penson's organizational charts listed Johnson on the same level as Yancey, underneath Pendergraft, Son, and Roger J. Engemoen, Jr., the then Chairman of the Board.[9] Tr. 2192-93; Yan. Exs. 503, 513-14, 570, 588, 629, 644, 677.

Pendergraft had sufficient knowledge and experience to supervise Johnson. Stipulated FOF No. 82. As a Series 27 license-holder, Pendergraft was particularly well-qualified to supervise Johnson and stock lending activities. Tr. 1343-44, 1961-63. He interacted with Johnson on a regular basis during the Relevant Period. Stipulated FOF No. 81. During the period in 2008 to 2011 during which Johnson reported to Pendergraft, Pendergraft communicated with and instructed Johnson with respect to the following: performance (Yan. Ex. 565); adherence to internal policies (Yan. Ex. 668); payroll, compensation, and bonuses (Yan. Exs. 608, 639, 646, 662, 684, 809); budget and spending (Yan. Exs. 502, 506, 517, 550, 590, 591); staffing (Yan. Exs. 655, 664, 678); decision-making and customer relations (Yan. Exs. 707, 741, 783, 788, 790, 793, 794, 795, 801); Penson financing and lending balances (Yan. Exs. 515, 607, 780, 790, 803, 804, 806); Stock Loan revenue and expenses (Yan. Exs. 611, 627, 791, 797); and leave and work schedule (Yan. Exs. 548, 557, 605, 688, 709, 710). *See also* Tr. 1513, 1521, 1529-34. These interactions included discussions between Johnson and Pendergraft regarding Reg. SHO. Tr. 541-44. Johnson also updated Pendergraft on the status of FINRA examinations (Yan. Exs. 563, 638) and it was not uncommon for Pendergraft to be invited to meetings with regulators. Tr. 1729, 1840.

Virtually every Penson employee who testified at the hearing understood that Johnson reported to and was supervised by Pendergraft. Tr. 302-03, 1150, 1153-54, 1217, 1336, 1743, 1745, 2181, 2194, 2585; *cf.* Del. Ex. 446 ("Brian Hall told the Division that Michael Johnson reported to Phil Pendergraft."). They observed Pendergraft supervising and giving direction to Johnson, including on issues related to Penson's stock lending activities. Tr. 287, 302-03, 416-17, 1153, 1217, 1794-95, 2195. De La Sierra, after initially testifying that he believed Johnson reported to Son, agreed that he was supervised by Pendergraft, including on Johnson's Penson activities. Tr. 286, 302-03.

Yancey and Pendergraft agreed that Yancey routinely checked in with Pendergraft regarding Pendergraft's communications with Johnson on payroll, compensation, budget, leave and work schedule, and the other issues identified above, including periodic updates on Johnson's performance. Pendergraft maintained a desk inside Yancey's office during the Relevant Period; Yancey testified that this was done at his suggestion so that the two could find

[9] In addition to showing Johnson under these three executives, many of the organizational charts note next to Johnson's name "(Reporting to Son)." *See, e.g.*, Yan. Ex. 513. at 425. This did not change any witnesses' opinion that Johnson in fact reported to Pendergraft; one witness explained his understanding that because Johnson was a "high-maintenance individual," Son was assigned to pay extra attention to Johnson and "make him feel like he was an important part of the firm." Tr. 2193. During the Relevant Period, Pendergraft and Son shared an office. Stipulated FOF No. 87.

more time to communicate in person. Stipulated FOF No. 76; Tr. 948-49. Pendergraft believed Yancey acted reasonably in ensuring that the Stock Loan department and Johnson were properly conducting business. Stipulated FOF No. 88; Tr. 1537, 1540, 1859. Yancey was not aware that Penson's Stock Loan department was violating Rule 204, and he took no steps regarding how the Stock Loan department's Rule 204 procedures may have been contributing to Penson's Rule 204 deficiencies. Stipulated FOF Nos. 43, 44.

Emails sent and received by Pendergraft suggest that he had the authority to promote, hire, and fire Johnson and other Stock Loan department personnel. *See* Yan. Exs. 526, 549, 664, 678, 711, 824. Johnson was qualified and experienced with respect to his role at Penson. Stipulated FOF No. 55 (Johnson held Series 7, 24, 27, and 63 licenses); Tr. 1862 (Johnson was "well equipped" and "had a real strong background"). Other than the current action, Johnson has a clean record and Form U4. *See* Michael Haynes Johnson BrokerCheck Report at 9, available at http://brokercheck/finra.org (last visited Mar. 13, 2015).[10]

NASD Rule 3010 requires each registered representative be appropriately assigned to a registered principal, e.g., an individual who holds a Series 24 or Series 27 license. Stipulated FOF No. 98; *see* Tr. 1950-51; 2588-89; FINRA, Conduct Rule 3010 (Supervision), *available at http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=4395* (last visited March 13, 2015). In order to keep track of Penson's compliance with this requirement, Miller maintained a document called the Registered Representative Supervisory Matrix (RRSM) which identified each registered representative and his or her supervisor.[11] Tr. 2589-90; *see* Stipulated FOF No. 100. Penson's WSPs incorporated by reference the RRSM. *See* Div. Ex. 213 at 11. For each employee, the RRSM had columns labeled "Company," "Department," "PI Org Chart," and "Regulatory Supervisor." Div. Ex. 177. Miller testified that the designation of Regulatory Supervisor did not mean that the supervisor was the registered representative's day-to-day manager or boss, nor that they controlled the representative's activities. Tr. 2591. Instead, she testified that the person listed in the column titled "PI Org Chart" was the person who directed the activities of the employee. *Id.*

From 2009 to 2011, the RRSM listed Yancey under the column titled "Regulatory Supervisor" with regard to Johnson. Stipulated Finding of Fact No. 37. A 2009 version of the RRSM listed Pendergraft in the "PI Org Chart" column. Div. Ex. 177. A 2010 version of the RRSM listed Yancey in both the "Regulatory Supervisor" and "PI Org Chart" columns. Div. Ex. 201 at 19.

According to Miller, however, the RRSMs maintained during this period were inaccurate in a number of respects. The 2009 RRSM listed Johnson's company as "Penson US," when Miller knew him to be a PWI employee. Div. Ex. 177; Tr. 2593-94. She also testified that it was Pendergraft, not Yancey, who should have been listed as Johnson's regulatory supervisor in the 2009 RRSM. Tr. 2594-95. She explained that because Pendergraft held a Series 24 license, "the regulatory supervision piece would not have transferred to Bill" and instead "would have

[10] Official notice, pursuant to 17 C.F.R. § 201.323, is taken of this record.

[11] At Penson, the employee that dealt with licensing and registration was also the individual responsible for keeping and maintaining the RRSM. Stipulated FOF No. 100.

remained [with] Phil [Pendergraft]." Tr. 2594. She recalled being instructed to replace Pendergraft with Yancey in this column, but could not remember when or why this occurred. Tr. 2595. Miller testified that the 2010 RRSM was also incorrect; while Johnson was correctly identified as a PWI employee, Miller believed someone else had changed the RRSM to put Yancey's name in both columns, which was not correct. Tr. 2601-02. Hasty agreed that the RRSM was inaccurate and should not have listed Yancey under either "Regulatory Supervisor" or "PI Org Chart." Tr. 1794-95. Other witnesses identified additional inaccuracies in the RRSM. Tr. 1929-30, 2190-91.

Miller testified that the inaccurate RRSM was sent to regulators. Tr. 2596-97. According to Miller, however, this did not mean that Penson personnel actually used the document to determine supervisory relationships. Tr. 2597. Other witnesses agreed that the RRSM was not used within Penson for this purpose; they consulted organizational charts when seeking information on supervisory relationships. Tr. 862, 1164-65, 1215-16, 1345, 1747-48, 1837-39, 2188. The provision of the RRSM to regulators did not change the actual, day-to-day supervisory responsibilities at Penson. Tr. 1795, 2041.

J. Responsibilities of the Compliance Department

The compliance department and Delaney, as Penson's CCO, had a number of responsibilities during the Relevant Period. Delaney was responsible for establishing and maintaining Penson's supervisory system policies and procedures, other than financial and operations procedures. Stipulated FOF No. 36. This included responsibility for making sure that Penson had policies and procedures designed to prevent or detect violations of rules. Div. Ex. 224 at 352. Penson's compliance department should have determined whether Penson's policies and procedures complied with Rule 204. Div. Ex. 224 at 101.

When Penson received an examination notification from a regulator or prepared an exam response, the compliance department's typical practice was as follows: the compliance department distributed the notification to the business units, senior management, and the legal department; held an initial meeting with the recipients of the notification to determine assignments for the response among the business units; compiled a response draft document with input from, and substantive sections drafted by, the business units by assignment; circulated responses internally among the compliance department, business unit heads, senior management, the legal department and sometimes outside counsel; and, once a final consensus was reached, sent the response to the regulatory entity. Stipulated FOF No. 101.

When a new rule, such as Rule 204T and Rule 204, is adopted, the CCO is partly responsible for designing a program for complying with the rule. Tr. 1868. If the rule is complex, it is reasonable for a registered person to consult FINRA, the Commission, or another regulator; consult interpretive guidance; and/or consult with industry groups, such as SIFMA. Tr. 191-92. Often, when new rules came out, Penson's compliance department would have meetings, analyze technologies, and develop a road map to ensure compliance. Tr. 1707-08.

Delaney was a compliance official with responsibility related to Rule 204T/204. Tr. 1769-70. Delaney was also a compliance official responsible for interfacing with the Stock Loan department. Tr. 1770. Part of the role of a compliance officer is to give guidance on rules and

assist business units in complying with new rules. Tr. 725 -26, 2029-30. Delaney cannot recall any specific meetings about the implementation of Rule 204. Tr. 1238-39. Nor was any technology designed or modified to enable the Stock Loan department to comply with Rule 204T/204 at the time the rules were adopted. Tr. 2028.

As Penson's CCO, if Delaney learned that associated personnel were not following the securities laws, he was required to take reasonable steps to investigate and report his findings to members of senior management where those persons reported. Stipulated FOF No. 13. Delaney never informed Yancey that Penson was following a perceived industry practice to close out in the afternoon of T+6, rather than following Rule 204T/204's requirement to close out by market open on T+6. Tr. 941, 1926; Div. Ex. 224 at 270.

K. Delaney's Wells Submission

During the Division's investigation of this matter, Delaney's lawyers submitted a Wells submission containing numerous statements related to the events underlying this proceeding. Tr. 1228; *see* Div. Ex. 157. Delaney testified that he reviewed and approved the submission of the document. Tr. 573. However, he explained that his lawyers drafted it with "limited information" and he has since indicated that the submission is not an appropriate reflection of his understanding of events. Tr. 1409.

L. Yancey's Character Witnesses

Yancey was uniformly praised as honest, ethical, and a person of integrity in the securities profession, including during his tenure as Penson's CEO, according to sworn testimony of Delaney (Tr. 1328); William Felder, who worked at Southwest Securities for 33 years, serving as CEO and Chairman (Tr. 2113-14, 2117); John Gisea, the President and CEO of the U.S.-based Securities Traders Association (Tr. 2131, 2135, 2137-38); Gover (Tr. 176-77), Bart Green, a senior vice president manager of equity trading at Wells Fargo Advisors, LLC (Tr. 2248, 2253-54); Hasty (Tr. 1753); Miller (Tr. 2603);[12] John Muschalek, a vice chairman of First Southwest Company, with more than 25 years of experience (Tr. 2130); Pendergraft (Tr. 1483-84, 1487-88); and Wetzig (Tr. 423-24).

M. Delaney's Character Witnesses

Delaney is overwhelmingly regarded as an honest man of exemplary character and integrity by all Penson employees who testified and were asked to express an opinion about his character, including Alaniz (Tr. 831), Gardner (Tr. 1155), Hasty (Tr. 1757-58, 1766-77), McCain (Tr. 2201), Pendergraft (Tr. 1588), and Yancey (Tr. 1909-10). Delaney's supervisors, among other key officials, view Delaney as an effective CCO who never hides compliance problems from management or regulators and instead, routinely escalated compliance issues to supervisors and regulators. Tr. 1439-41, 1448-50, 1757, 1766, 1834, 1908, 2200. Delaney's current

[12] Miller explained that "[a]ny conversation that I ever had with Bill [Yancey] was always about doing the right thing. There was never a conversation that I had with him where he even missed a beat on making the right decision. He's a good man." Tr. 2603.

employers think so highly of Delaney's character and skill as a compliance officer that they continue to employ him in the compliance area notwithstanding the Division's allegations. Tr. 1440, 1449, 1453.

N. **Expert Testimony**

The parties agreed that each expert's report would be considered his or her direct testimony. Tr. 31.

1. Dr. Lawrence Harris

Lawrence Harris (Harris) is a Professor of Finance at USC Marshall School of Business. Div. Ex. 239 at 3. He served as Chief Economist of the Commission from July 2002 through June 2004. *Id.* at 4. He received a Ph.D. in Economics from the University of Chicago in 1982. *Id.* at 3. The Division's contract with Harris in this proceeding, paying up to half a million dollars, was to provide expert testimony that "[p]rovides a characterization of the extent of Penson's Rule 204 violations" and "[e]stimates the benefit that Penson obtained to close out certain fails to deliver in a timely manner." *Id.* at 5; Tr. 1099.

Harris calculated the purported "benefit" to Penson from Rule 204T(a)/204(a) violations as approximately $6.2 million. Div. Ex. 239 at 9, 42, and Ex. 1. Delaney's expert, Dr. Erik Sirri (Sirri), subsequently established that the $6.2 million figure resulted from a calculation error that caused Harris to overstate the purported benefit by a factor of 100. *See* Del. Ex. 454 at 26. Harris acknowledged this "quite embarrassing" error when he testified. Tr. 1002. The Division subsequently conceded that the only specifically quantified benefit to Penson from not timely closing out at market open on T+6 over the entire three-year period at issue was $59,000, less than one percent of the $6.2 million figure originally reported by Harris. Stipulated FOF No. 53.

Harris testified that there would have been substantial, unquantified costs to Penson if it had "bought" shares at market open T+6, without being able to pass those costs on to customers. Tr. 1028-1030. Harris testified that he is "capable of providing crude estimates" of such costs to Penson, but that "[his] understanding was it wasn't necessary to quantify everything, so [he] didn't bother." Tr. 1030.

Harris testified that when a trade fails to settle, there are consequences to the buyer of the shares and to the market more generally. For example, the buyer does not receive certain rights that come along with owning shares. Tr. 1005-08. Harris's report purported to identify between 1,631 and 1,766 Rule 204T(a)/204(a) violations, but he subsequently admitted these numbers were exaggerated because he mistakenly conflated "settlement days" and "trading days." Div. Ex. 239 at 8; Tr. 1002-03.

Harris testified that it is not surprising that only a small percentage of all trades Penson cleared violated Rule 204T/204, because the vast majority of all trades settle on time. Tr. 1019. In discussing footnote 55 to the adopting release of Rule 204, Harris testified that "the rule does not require that you recall on T+2. Accordingly, if you don't recall on T+2, you haven't violated

any rule." Tr. 1114-15. Harris agreed that the reason the Commission adopted Rule 204T(a)/204(a) is not relevant to this case. Tr. 1072-73.

2. David Paulukaitis

David Paulukaitis (Paulukaitis) is the Managing Director of Mainstay Capital Markets Consultants, Inc., a consulting firm with expertise in the securities industry and regulatory agencies. Div. Ex. 238 at 22. He previously served for twenty-three years with NASD, including eleven years as an Associate District Director, and roughly ten years supervising a NASD district office's routine examination, "cause" investigation, financial surveillance, and membership programs. *Id.* at 22-23.

The Division retained Paulukaitis to address various issues including broker-dealer supervision (Div. Ex. 238. at 5-7), reasonable delegation of supervisory responsibilities (*Id.* at 8-9), written supervisory procedures (*Id.* at 9-12), and a broker-dealer's compliance department (*Id.* at 12-14). Paulukaitis was then asked to offer select opinions (*Id.* at 15-18), predicated on the truth of four specific assumptions: (1) "the Stock Loan Department of Penson acted in violation of Rule 204," (2) "by at least February 2010, Delaney was aware that Penson's Stock Loan Department was violating Rule 204," (3) "Penson's written supervisory procedures assigned the responsibility to supervise Johnson to Yancey," and (4) "Yancey was the assigned supervisor for Johnson." *Id.* at 15. The first assumption is supported by the evidence and agreement of the parties, but the other assumptions are not. However, his report also addresses a number of other issues relevant to the proceeding.

a. Compliance

Paulukaitis discussed the duties and responsibilities of compliance personnel, including the CCO. Div. Ex. 238 at 13. Paulukaitis noted that the following SEC guidance that compliance personnel should follow up potential misconduct – not just so-called red flags – is consistent with guidance from the Securities Industry Association (SIA) (now known as SIFMA):

> *[C]ompliance* and legal *personnel should* inform direct supervisors of business line employees about conduct that raises red flags and continue to *follow up in situations where misconduct may have occurred to help insure that a proper response to an issue is implemented by business line supervisors. Compliance and legal personnel may need to escalate situations to persons of higher authority if they determine that concerns have not been addressed.*

Id. at 14 (citation omitted) (emphasis added). However, Paulukaitis, quoting a former SEC Commissioner, noted that the standard for supervision of a firm's regulatory compliance "doesn't require perfection . . . [i]n the context of 10,000 transactions a day, reasonableness must allow some questionable transactions to slip through undetected." *Id.* at 6.

b. Supervision and Delegation

Paulukaitis agreed that the delegation of supervisory responsibility is reasonable if the delegatee is qualified to perform supervision in a satisfactory manner, and the delegator takes reasonable steps to follow up on that delegation. Tr. 482. Paulukaitis agreed that follow up on delegation is reasonable where the delegator meets with the person to whom supervision had been delegated about the performance of the individual for whom supervisory responsibility was delegated. Tr. 485.

Paulukaitis's written expert report does not cover dual supervision, i.e., the Division's theory based on Pendergraft's testimony and the RRSM that Pendergraft supervised Johnson as to business issues and Yancey supervised him as to regulatory and compliance issues. Tr. 476-77; *see* Div. Reply to Yan. at 15-16. I permitted him to testify on this subject, however, because the dual supervision issue was "a reasonable inference or extrapolation from [Paulukaitis's] underlying report." Tr. 441, 929. Paulukaitis testified that a person might have more than one supervisor; however, he was unable to substantiate the Division's theory in this instance. Tr. 442-43.

c. Written Supervisory Procedures

Paulukaitis noted the importance of the designation of supervisors in the WSPs, and opined that, if "Penson's written supervisory procedures designated Yancey as the supervisor responsible for supervising Johnson, the reasonable presumption would be that Yancey was in fact Johnson's supervisor and that Yancey was supervising Johnson." Div. Ex. 238 at 17. However, at the hearing, Paulukaitis testified that a firm's NASD Rule 3010 supervisory designation in its WSPs is only one relevant fact, among many, that establishes supervisory authority. Tr. 485-89.

3. Marlon Paz

Marlon Paz (Paz) is a partner at Locke Lord LLP, whose practice focuses on securities matters. Yan. Ex. 829 at 1. He is also an adjunct law professor at Georgetown University Law Center, where he teaches securities law courses, including regulation of broker-dealers. *Id.* During six years of service at the Commission as an attorney, he "was significantly involved in the rulemaking process for Rule 204T/204(a)." *Id.* at 3. He "helped write the rule, revise and edit the rule, solicit comment and feedback, and analyze whether the rule was in the public interest." *Id.*

Yancey retained Paz to offer two principal opinions. Paz's first opinion is that "Rule 204T/204(a) is a highly technical rule that was adopted primarily to curb the abusive practice of naked short selling, an issue not present in this case." Yan. Ex. 829 at 4-13. Paz testified that Rule 204 is a complex, technical, and ambiguous rule. Tr. 2053-54. He testified that Rule 204 contains a "safety valve" in the form of the penalty box because no system can guarantee perfect settlement, and the penalty box allows the capital markets to continue operations. Tr. 2061-63.

Paz's second opinion is that none of the "red flags" advanced by the Division would have alerted Yancey to systemic or intentional violations of Rule 204T/204(a) for long sales of loaned securities. Yan. Ex. 829 at 19-24. Paz opined that the December 2009 audit of the Buy-Ins department could not have been a red flag to Yancey regarding Rule 204 violations of long sale of loaned securities, given the context of the high volume of trades that Penson was successfully clearing and the prompt assurances he received that remediation efforts were underway. *Id.* at 19-22; *see also* Stipulated FOF Nos. 61, 64, 77; Div. Ex. 134 (email stating SEC Rule 204 is now the focus of "prompt remediation"). Paz determined that Yancey was entitled to rely on the representations that the Rule 204 issues that arose in the December 2009 audit were being remediated. Div. Ex. 829 at 21-22.

Paz found that given the large number of regulatory inquiries that Penson received, it is reasonable that the technical violations identified in the December 2009 audit would not warrant inclusion on a list of "key compliance issues" in the CEO's Annual Report. Div. Ex. 829 at 23. According to Paz, Yancey, as CEO, reasonably relied on the determination of his key compliance officials that the December 2009 Rule 3012 audit did not rise to the level of a "key compliance issue." *See id.*

4. Judith Poppalardo

Judith Poppalardo (Poppalardo) is the managing partner of Financial Industry Service Group LLC, which provides regulatory consulting services to broker-dealers. Yan. Ex. 828 at 26. Poppalardo previously served as Associate General Counsel at SIA. *Id.* Prior to joining SIA, she served nearly ten years at the Commission in the Division of Market Regulation and in OCIE, where she oversaw the Commission's broker-dealer examination program. *Id.* at 26-27. She also served as Assistant General Counsel at the NSCC, where she ensured compliance with federal laws and regulations governing clearing corporation operations. *Id.* Overall, she has "almost 30 years of experience in the financial services industry with a focus on supervision and supervisory controls." *Id.* at 1. Yancey retained Poppalardo "to review the [Penson] supervisory system and state an opinion as to whether it was reasonably designed and whether [Yancey] appropriately and reasonably carried out his supervisory responsibilities under that system." *Id.*

a. Supervision and Delegation

Poppalardo found that during the pertinent period, Penson had reasonably designed supervisory systems and procedures, under which business units were supervised by appropriately qualified individuals, reasonable written policies and procedures were in place, and the firm was subject to regular testing to ensure that supervisory procedures were being carried out effectively. Yan. Ex. 828 at 7-13. She found that Penson's supervisory system assigned qualified experts over each line of business and included written policies and procedures designed to prevent and detect violations of the securities laws. *Id.* According to Poppalardo, Yancey reasonably supervised Delaney and properly delegated supervisory responsibility within this system. Yan. Ex. 828 at 13-15. In Poppalardo's view, a contrary conclusion would unreasonably suggest that Yancey could not rely on business line supervisors and properly qualified licensed individuals and experts, including supervisory delegatees, to perform their duties. Yan. Ex. 828 at 4, 16.

Poppalardo indicated, consistently with Paulukaitis, that "[i]n a financial services firm, supervision rests, initially, with the CEO, unless and until he reasonably delegates supervisory responsibility by assigning experienced, qualified individuals to supervise the business activities of the firm." Yan. Ex. 828 at 6. Poppalardo agreed that, in 2010, Penson provided an RRSM to select regulators that reflected that Yancey was Johnson's supervisor. Tr. 2015.[13] However, Poppalardo testified, also consistently with Paulukaitis, that no one piece of evidence – including the supervisory matrix – is dispositive in identifying a person's supervisor, and that a supervisory matrix is simply one fact that could evidence supervisory authority:

> Q: Ms. Atkinson asked you about several supervisory matrices. Do you believe those matrices are determinative of who is a supervisor?
> A: No, I don't, and I think it's clear based on administrative decision, case law that it's a fact and circumstances determination.
> Q: If a supervisory matrix is given to FINRA or CBOE designating, as these do, of regulatory supervisors, what does that say about who has day-to-day responsibility for supervision?
> A: It doesn't say anything. It fulfills the requirement that FINRA has in its rules that say you have to have a designated supervisor over each business line.
> Q: And is that matrix that's given to the regulator determinative of who is a supervisor for day-to-day purposes?
> A: No. Again, it would depend on a lot of other things.

Tr. 2040-41.

Poppalardo testified, that as a practical matter, supervision includes supervision of regulatory compliance, and in her entire career, she had never heard of a delegation along the lines of what Pendergraft described (in which he attempted to disclaim, in pertinent part, supervision of Johnson's Rule 204 compliance):

> Q: Have you ever heard of a delegation along the lines of what Mr. Pendergraft described, which is a delegation of operations and business functions, but not regulatory and compliance functions?
> A: . . . I feel really strongly that—that you just can't parse the business activities from the regulatory requirements. It's a highly regulated industry. Just about everything is regulated right down to time off. There's, you know, a requirement that . . . traders have to take a certain amount of time off. So it's really very hard to parse those two.

[13] I note that Poppalardo had already testified and been excused long before Miller, the author of the RRSM, admitted that the matrix inaccurately reflected Yancey as Johnson's supervisor, and that it instead should have reflected Pendergraft as Johnson's supervisor.

Q: And my question is really about your industry experience as well. Have you seen that before? Is that common?
A: I've never seen it. No, no. I've never seen it.

Tr. 1999. Poppalardo testified that an individual with a Series 27 license, like Pendergraft, is best qualified to supervise Johnson and Stock Loan department activities. Tr. 1962. Poppalardo agreed that follow up on delegation is reasonable where the delegator meets with the delegatee about the performance of the individual for whom supervisory responsibility was delegated and receives no indication of wrongdoing. Tr. 1990-91. Poppalardo also agreed that if there is actual confusion about delegation, the president of the broker-dealer retains the supervisory responsibility, though she did not find actual confusion in this case. Tr. 2038-39.

b. Compliance

According to Poppalardo, if a business line official asks a CCO how to comply with a new rule, the CCO should bring together, as a group, the individuals necessary "to make sure that" the firm was "able to comply." Tr. 2029-30. Indeed, Delaney agrees "Poppalardo would have expected a CCO, to the extent a problem came to his attention, to work with the business line and figure out how to address the problem." Del. Reply to Div. Proposed FOF at ¶ 89; *see* Yan. Reply to Div. Proposed FOF at ¶ 89 (substantially similar agreement to Delaney's).

c. Testing

Poppalardo testified that Penson's Rule 3012 testing was "very robust" in light of industry practice. Tr. 1995; *see also* Yan. Ex. 828 at 12-13. Poppalardo testified that Penson was not required to explicitly reference the December 2009 Rule 204 audit of the Buy-Ins department in the Annual Report attached to the CEO certification. Tr. 1959–60; Yan. Ex. 828 at 18. According to Poppalardo, it was Delaney's responsibility as CCO to determine whether an issue rose to the level of a "key compliance issue," such that, pursuant to Penson's WSPs, it would be included in the Annual Report, and that Yancey was entitled to rely on Delaney's determination. Yan. Ex. 828 at 18; Tr. 1959-60. Poppalardo agreed with Delaney and Alaniz's determination that the December 2009 audit results were not worthy of inclusion in the report. Yan. Ex. 828 at 18.

Poppalardo noted that Yancey acted reasonably in part because he confirmed that the issues identified in the December 2009 audit were the focus of prompt remediation efforts. Yan. Ex. 828 at 15-16. Poppalardo found that Yancey was entitled to rely on these representations regarding remediation. *Id.* Poppalardo observed that a CEO cannot operate effectively if he must continually second-guess the information communicated to him by his direct reports. Yan. Ex. 828 at 4, 16. Given the representations he received, she opined that the December 2009 audit could not have been a red flag to Yancey regarding Rule 204(a) violations of long sale of loaned securities. Yan. Ex. 828 at 15-16.

Poppalardo testified that if a small testing sample showed a huge failure rate, she would "absolutely" test a larger sample, and, in so doing, test the part "that was the most problematic."

Tr. 2035. Poppalardo agreed that in retrospect, Penson's "automated system was, in fact, not recalling in sufficient time to close out those fails to deliver." Tr. 2028.

d. Written Supervisory Procedures

Poppalardo determined that Penson's Rule 204 procedures were adequate and typical of the industry, and included procedures for closing-out long sales, including long sales of loaned securities. Yan. Ex. 828 at 9-12; Tr. 1993–94, 2039–40; *see also* Div. Exs. 66 at 396-97; 183 at 337-39. She found that Penson's Reg. SHO and Rule 204 policies and procedures addressed (1) all elements of the rule, (2) set out specific procedures to follow, and (3) identified individuals and supervisors responsible for compliance. Yan. Ex. 828 at 10-12; *see* Div. Ex. 211 at 3-14; Yan. Exs. 540 at 383-99; 746 at 325-41. She opined that contrary to the Division's contention, the section titled "House Buy-Ins" contained within the "Securities Lending (Stock Loan) – Dallas Office II – Rule 204" section of Penson's WSPs pertained to buy-ins of securities that Penson had borrowed to cover its customers' short sales *and* securities that Penson had loaned to its counterparties. Tr. 2039-40; *see also* Tr. 398-401; Div. Ex. 66 at 387-88.

Poppalardo presumed that a portion of the WSPs pointed to by the Division at the hearing were Penson's NASD Rule 3010 designation. Tr. 2015. She agreed that Penson's WSPs did not include any organizational charts. Tr. 2028-29.[14]

5. Dr. Erik Sirri

Sirri served as the Director of the Commission's Division of Trading and Markets from 2006 to 2009. Del. Ex. 454 ¶ 2. He served as the Commission's Chief Economist from 1996 to 1999. *Id.* ¶ 3. From 1989 to 1995, he was an assistant professor of finance at Harvard Business School. *Id.* ¶ 1. From 1999-2006, and 2009-present, he was a finance professor at Babson College. *Id.*

Delaney retained Sirri, in pertinent part, "to evaluate and respond to certain analysis and opinions presented by Professor Lawrence Harris." Del. Ex. 454 ¶ 7. As noted above, Sirri corrected a major error that caused Harris to overstate the purported benefit to Penson from Rule 204T(a)/204 violations by a factor of 100. *Id.* ¶¶ 74-78. After Sirri's corrections, the parties agreed that there were at least 1,500 violations during the pertinent three-year period; and the only quantified benefit to Penson of those violations was $59,000 (on average, less than $40 per violation). Stipulated FOF Nos. 49, 53.

Sirri agreed that when Rule 204T was adopted, "the vast majority of all trades settle[d] by T+3." Tr. 1640. Sirri agreed with the Division that he had previously written the following language on the Commission's concern about the failure to deliver securities:

[14] Notwithstanding Poppalardo's testimony, I note that Penson's WSPs do reference its organizational chart for reporting purposes. *See* Div. Ex. 188 at 9615 (directing team members to the organizational chart to determine reporting chain for senior management).

> The Commission was concerned about the harmful effects on the markets of failing to deliver securities. Failing to deliver a share converts ownership of a security into a forward contract, causing the buyer (or a clearing agency) to be exposed to the credit risk of the seller. It can also create problems with respect to the voting of shares as a buyer might not be in possession of the security at the required time and thus would lose the ability to vote.

Div. Ex. 260 at 524; Tr. 1677-79. However, Sirri testified that isolated fails to deliver have minimal effect on systemic risk, in part due to the design of CNS and the NSCC. Tr. 1609-10.

III. CONCLUSIONS OF LAW

A. Delaney Did Not Willfully Aid and Abet Penson's Rule 204T/204 Violations

1. Legal Standard for Aiding and Abetting

To establish that Delaney willfully aided and abetted Penson's violations of Rule 204T/204, the Division must show that: (1) a primary securities law violation was committed by Penson; (2) Delaney acted with the requisite scienter; and (3) Delaney provided substantial assistance to Penson, the primary violator. *See Graham v. SEC,* 222 F.3d 994, 1000 (D.C. Cir. 2000). The scienter requirement for aiding-and-abetting liability may be satisfied by evidence that the respondent knew of, or was extremely reckless in disregarding, the wrongdoing and his role in furthering it. *Eric J. Brown*, Exchange Act Release No. 66469, 2012 WL 625874, at *11 (Feb. 27, 2012); *Howard v. SEC*, 376 F.3d 1136, 1143, 1149 (D.C. Cir. 2004). Extreme recklessness may be found if the alleged aider and abettor encountered "red flags," or "suspicious events creating reasons for doubt" that should have alerted him to the improper conduct of the primary violator.[15] *Graham*, 222 F.3d at 1006; *see also Wonsover v. SEC*, 205 F.3d 408, 411 (D.C. Cir. 2000).

To satisfy the substantial assistance element of aiding and abetting, the Division must show that Delaney in some way associated himself with the venture, that he participated in it as something that he wished to bring about, and that he sought by his action to make it succeed. *SEC v. Apuzzo*, 689 F.3d 204, 212-13 (2d Cir. 2012). In addition, the primary violation must be a direct or reasonably foreseeable result of the aider and abettor's conduct.[16] *SEC v. Grendys*, 840 F. Supp. 2d 36, 46 (D.D.C. 2012).

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[15] I reject Delaney's argument that *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004), stands for the proposition that Delaney must have had actual knowledge of the Stock Loan department's violations in order for him to have aided and abetted those violations. Del. Reply at 8. The court in *Howard* rejected the Commission's aiding and abetting claim because it concluded that the Commission had established at best ordinary negligence, while simultaneously acknowledging that extreme recklessness can support an aiding and abetting claim. *See Howard*, 376 F.3d at 1143-44, 1149.

[16] The parties do not dispute this legal standard for substantial assistance. *See* Stipulated COL Nos. 7-8.

2. *The Primary Violation*

The parties have stipulated that Penson violated Rule 204T/204 at least 1,500 times between October 1, 2008, and October 31, 2011, due to Penson's failure to deliver to CNS on long sales of loaned securities by market open on T+6. Stipulated FOF Nos. 49, 54; *see* Del. Ex. 454 at 33-34. Thus, the Division has satisfied its burden of demonstrating that a primary securities law violation occurred.

3. *Failure to Prove Actual Knowledge*

The Division has failed to show that Delaney acted with the requisite scienter, and therefore its aiding and abetting claim against Delaney fails. As an initial matter, I note that the Division is unable to articulate or substantiate a plausible theory as to why Delaney would want to aid and abet Penson's violations of Rule 204T/204. While the Division correctly argues that motive is not a mandatory element of an aiding and abetting claim, numerous courts have noted its absence when finding that scienter has not been proven. *See, e.g., S.E.C. v. Steadman*, 967 F.2d 636, 642 (D.C. Cir. 1992) (reversing the finding of scienter where there was no evidence of "any motive" for the defendants to not register their shares under state Blue Sky laws and observing that "[a]ny accusation of bad faith would seem unfounded, because [defendants] had little, if anything to gain from discontinuing Blue Sky registration."); *Warren v. Reserve Fund, Inc.*, 728 F.2d 741, 746 (5th Cir. 1984) (declining to find scienter, in part, because there was no evidence of "any motive which would lead the [defendant] Fund to misrepresent the earnings," where "[t]he Fund neither retained nor gained any benefit at the expense of its shareholders."); *Barker v. Henderson, Franklin Starnes and Holt*, 797 F.2d 490, 492 (7th Cir. 1986) (noting that proof of actual knowledge requires "some reason to conclude that the defendant has thrown in his lot with the primary violators.").

Delaney would have had "everything to lose" as CCO of a major broker-dealer by knowingly aiding and abetting the primary violations of Rule 204T/204. *See Barker*, 797 F.2d at 497 (determining there was "no sound basis," as a matter of law, to conclude that the defendant aided and abetted a primary violation where the defendants "had nothing to gain and everything to lose"). The Division also failed to establish that Delaney had anything to gain from the alleged misconduct. The Division's original theory was a wildly exaggerated belief that Penson's Rule 204T/204 violations resulted in millions of dollars of additional profits. *See* OIP at 3 (Delaney was "[m]otivated by financial considerations"); Div. Ex. 239 at 9, 42, and Ex. 1 (Harris expert report quantifying the benefit to Penson at approximately $6.2 million). The Division was forced to abandon that theory, and in the end agreed that the "only specifically quantified benefit" to Penson of the at least 1,500 violations was a meager $59,000. Stipulated FOF Nos. 49, 53. I do not find that sum would have given Delaney any motive to aid and abet the Stock Loan department's violation, as it constituted only 0.08 percent of the Stock Loan department's total revenue of $77 million during this period. *See* Stipulated FOF Nos. 79-80. As CCO, Delaney had nothing to gain, and virtually everything to lose, by aiding and abetting violations of Rule 204T/204.

Although the Division also argues that there would have been "substantial costs to [Penson] if it had bought shares at market open T+6," and that such purchases "could expose the

firm to significant losses," the Division produced no evidence to quantify the costs or losses, and the testimony to which the Division points is general and speculative. *See* Div. Proposed FOF Nos. 43, 45. Indeed, Wetzig acknowledged the possibility that any shares purchased by Penson to comply with the close-out obligations could go up in value and be sold at a profit, not a loss. Tr. 427-28. Rule 204T/204 also allowed Penson to borrow shares to close out positions, thus avoiding purchasing risks. *See* Rule 204(a)(1); *see also* Tr. 426-27 (testimony by Wetzig confirming that the Stock Loan department "could have borrowed" to close out a position). As the Division did not provide any evidence quantifying the purported costs or losses, I am unable to determine whether there were any. If the data supported the existence of any such additional benefits to Penson, I assume that the Division would have had Harris calculate these benefits, but they did not. Tr. 1030. More telling, however, is the lack of any indication that Delaney would have decided that these were reasons to support a violation of a rule.

a. Delaney's Wells Submission

The Division's claim that Delaney had actual knowledge of the Rule 204T/204 violations depends, in part, on its contention that he is lying. *See* Div. Br. at 7-9; Div. Reply to Del. at 3-4. However, I disagree with the Division's conclusion that "Delaney has not been honest or truthful" and "[i]nstead . . . has been evasive and inconsistent." Div. Br. at 7. The Division's primary evidence for this alleged dishonesty are statements made in Delaney's Wells submission. The Division argues, "either the statements Delaney approved about his knowledge and actions were lies to the Commission in his Wells submission or his repudiation of those statements are lies to the Court now." Div. Br. at 8-9.

As I indicated previously, I do not rely on Delaney's Wells submission to decide the claims and defenses in this case. *See Thomas R. Delaney II*, Admin. Proc. Rulings Release No. 2220, 2015 SEC LEXIS 167 (Jan. 15, 2015). Based on my careful review of that document, I conclude that it is primarily comprised of argument by counsel and grounded in incomplete information. *See* Tr. 1228, 1409-10; Div. Ex. 157 at 2 n.2 ("The Staff elected to provide an abridged investigative record as part of its discretionary pre-Wells process."). It is based not just on Delaney's understanding at that time, but on his counsel's characterization of other evidence selectively provided to Delaney by the Division. *See id.* In contrast to that argumentative submission, Delaney testified five times under oath, including at the hearing. *See* Div. Ex. 157 at 5 n.9. I find that Delaney's testimony was overwhelmingly consistent, and the handful of inconsistencies alleged by the Division in such testimony either do not exist or are easily explained by the circumstances, as discussed below. Over time, Delaney's testimony consistently reflected his lack of knowledge of the Stock Loan department's policy to violate Rule 204T/204 until early 2011, when Delaney discovered and disclosed that practice to FINRA.

None of the assertions in the Wells submission regarding Delaney's knowledge of the Stock Loan department's noncompliance with Rule 204T/204 are specific as to a date, except with respect to the aforementioned disclosure to FINRA in March 2011 and the discussions that closely preceded it. If Delaney were aware of such violations before early 2011, one would reasonably expect that the Wells submission would have noted *when* he had such knowledge, or that the Division would have some concrete, credible evidence as to when Delaney had such

knowledge. However, as discussed below, none of the testimony elicited at the hearing established that Delaney had actual knowledge prior to early 2011.

My decision to deemphasize reliance on the Wells submission is supported by the Division's claim that Delaney knew the Stock Loan department was violating Rule 204T/204 based on that submission's statement that "Delaney knew that the closeout issue *might* begin with Stock Lending." Div. Ex. 157 at 16 (emphasis added); *see* Div. Proposed FOF No. 63. The preceding statement does not refer to when Delaney first knew the problem "might" relate to the Stock Loan department. I also note that the statement simply paraphrases some of Delaney's investigative testimony. Thus, on the key issue of Delaney's knowledge of the Stock Loan department's involvement, the Wells submission does nothing more than characterize testimony that the Division already took, and tells us nothing new. I find that Delaney's testimony, taken as a whole (rather than an attorney's characterization of one instance of that testimony), represents the evidence on which I should rely.

The Wells submission also states that after the Rule 3012 testing, Delaney "required that representatives from each of the business units involved with closing out short sales were present to discuss the results and create accountability." Div. Ex. 157 at 21. The Division claims this is contradicted by Delaney's investigative testimony, in which he stated that he and Alaniz told Yancey that it was not necessary to have a Stock Loan representative in the first meeting at which the Rule 3012 testing was discussed, in January 2010. Div. Reply to Del. at 11; see Div. Ex. 224 at 329. Alaniz testified that it was he who told Yancey that Johnson did not need to be present because the Stock Loan and Buy-Ins departments were being helpful in remediating the issue. Tr. 762-63. He further testified that if he had known that the Stock Loan department had a policy of not closing out he would have invited Johnson to the meeting to explain why they were not complying. Tr. 763-63. Delaney's testimony is consistent with that of Alaniz: that they told Yancey that the Stock Loan department did not need to attend the first meeting discussing the December 2009 Rule 204 testing because, at that point, they did not think there was an issue with the Stock Loan department, but rather, with the Buy-Ins department. Tr. 611-14. That Delaney's account is supported by Alaniz is further proof that this particular Wells submission is not a reliable indicator of the facts in this case.

The other purported admissions by Delaney in the Wells submission do not indicate whether they are based on Delaney's actual or direct knowledge and are presented in the legal argument section of the submission. For example, the argument section states that Rule 204T/204 issues were "raised many times – both routinely and extraordinarily – with Mr. Yancey." Div. Ex. 157 at 32. However, there is no indication in the submission as to who raised these issues with Yancey, or to what extent they related to the Buy-Ins department, as opposed to the Stock Loan department.[17] *Id.* The only concrete example of Rule 204T/204 compliance issues referenced are those with respect to the Buy-Ins department, and all the parties agree that

[17] Furthermore, even in the view of the Division, Yancey did not know during the Relevant Period about any violations of Rule 204T/204 by the Stock Loan department, which is yet another convincing reason it seems the Wells submission is not reliable. *See* Stipulated FOF No. 43.

those issues were in fact raised to Yancey and then subject to prompt remediation. *Id.* at 31-32; Stipulated FOF Nos. 17, 21.

In this case, where Delaney testified multiple times under oath at the Division's request, as did other witnesses, I have decided to base my decision on that testimony and other documents in the record, which I find more probative than past characterizations made by Delaney's counsel. *See Keith L. Mohn,* Exchange Act Release No. 42144, 1999 SEC LEXIS 2442, at *14 n.16 (Nov. 16, 1999) ("[Respondent]'s brief, however, attaches pleadings filed in that suit, not testimony. Argument of counsel is not evidence."). Though the Wells submission is Delaney's, in some instances it identifies Delaney's understanding and in others, references other sources to support a legal argument drafted by counsel. I do not accept the Division's insistence that everything in the document, particularly the statements in the legal argument section, should be taken, in essence, as testimony of Delaney. As such, though I have admitted the Wells submission, I give it sparing weight because it is an unspecific and unreliable indicator of what took place.

b. Alleged Inconsistencies in Delaney's Testimony

To the extent that Delaney's testimony could be at all be characterized as "evasive" or "inconsistent," Div. Br. at 7, it may be because he lacks a completely clear recollection of what took place years ago regarding his alleged conduct. Delaney credibly and convincingly explained that his initial testimony was given with virtually no preparation or opportunity to review documents, thus preventing him from having a full and fair recollection of the events he was asked about. Tr. 1200-01. While his conduct with respect to Rule 204T/204 is especially important in the present action, at the time of such conduct, Delaney was in the business of putting out "fires," Tr. 725, and Rule 204T/204, though undeniably important, was most assuredly not the top priority for the compliance department. *See* Tr. 728-29. Instead, a substantial number of people in the compliance department, including Delaney, were focused on anti-money laundering compliance as a top priority, among several other challenging and complex issues. *See* Tr. 727-30, 1291-96. In contrast with officials in the Stock Loan department, who addressed Rule 204T/204 compliance issues on a daily basis, Delaney dealt with it much less, and often relied on representations by his staff that they were handling relevant issues. *See* Tr. 101-02, 729-30, 749-50, 1292-93.

The inconsistencies alleged by the Division in Delaney's testimony either do not exist, or are subject to reasonable explanation. First, neither Delaney nor his current employer ever had the chance to explain the purported inconsistency between Delaney's testimony at the hearing that "he was no longer acting as a Chief Compliance Officer" and his current employer's testimony that "he serves as the CCO." Div. Br. at 9; *see* Tr. 1212-13, 1447. The parties are in agreement that Delaney works in the compliance department of his new employer. Stipulated FOF No. 1. His employer was not asked whether or why Delaney does not technically hold the title of CCO during the pendency of this administrative proceeding. If the Division wanted to prove an inconsistency, they should have squarely asked Delaney and his employer about it. The fact that they did not do so, and the very fact that they focus on this issue as an inconsistency, demonstrates, in my mind, that there is not much to criticize in Delaney's lengthy testimony.

Second, the Division claims that "Delaney denied that it was the practice of [Penson]'s Stock Loan department to close-out long sales at market close rather than market open." Div. Br. at 9; *see* Tr. 572. However, I do not think his testimony on this point is inconsistent. Delaney's testimony is that he did not know of such a practice until early 2011. Tr. 1199-1200. Him denying that he knew about it before he actually knew about it (even though it was apparently taking place) is not discrepant, but simply reflects that his knowledge as to the existence of the practice changed over time.

Third, the Division argues that "Delaney *quibbled* about whether he had seen the release [for Rule 204T] in the same exact format as that in the exhibit used at the hearing and during his testimony." Div. Br. at 9 (emphasis added). Several exhibits copy or link to the text of the releases for Rule 204T and Rule 204, with the appearance and formatting of each differing dramatically from the way the text of such releases is ultimately arranged in the printed version of the Federal Register, the document Delaney was shown at the hearing. *See* Div. Exs. 67, 69, 255 at 5; Del. Ex. 301 at 0025-0100; Del. Ex. 328. When someone is testifying about a document that may not look anything like the version he had read, it is not "quibbling" to explain that one has never seen something that looks like the exhibit. I in fact thought that the Federal Register version of the releases looked considerably different from the other copies and would have been hesitant to say I had read the exhibit without first looking it over.

Fourth, the Division argues that "although ultimately admitting that there was only one test of the Stock Loan department's Rule 204 procedures, Delaney originally denied that fact." Div. Br. at 9; *see* Tr. 637-38. My perception of Delaney's testimony on this point was that he was becoming exasperated by the Division's questions, and he made the general point that, while at Penson, the compliance department carried out a robust testing regime. Indeed, Alaniz tested and re-tested the Buy-Ins department until it achieved complete compliance with Rule 204. Tr. 860-61. Despite his exasperation at the Division's repeated insinuations that he was lying, I found Delaney a credible and convincing witness. My perception, that his hours of testimony were sincere and truthful, is consistent with the attestation of all the hearing witnesses regarding Delaney's honesty and integrity.

Finally, the Division asserts that Delaney contradicted himself because, on the one hand, in August 2012 he did not recall being concerned about the contents of the March 2011 FINRA Letter and, on the other hand, in July 2013 he testified that a disclosure in that letter would be a big deal for Penson. Div. Br. at 7-8; *see* Div. Ex. 224 at 267-68, 489-92. However, because Delaney was asked somewhat different questions on the two different occasions (as opposed to being asked the same question on both occasions), his answers were consistent. In August 2012, Delaney was asked whether he was concerned about the letter, not the conduct at issue. Div. Ex. 224 at 267-68. When asked about the purported contradiction at the hearing, Delaney reasonably explained that he was not concerned about the letter disclosing the conduct, which was accurate as he understood it, but at the same time was concerned about the underlying rule violations.[18]

[18] To put the March 2011 FINRA Letter in context, two final points are worth considering: first, like letters Delaney frequently issued to regulators, this letter set forth over a dozen issues, including many that Delaney spent dramatically more time on. Div. Ex. 89; Tr. 1290-96. The Division did not posit a plausible explanation for why Delaney, who routinely disclosed issues of

Tr. 1297-98. Even assuming, for the sake of argument, that Delaney's testimony in August 2012 and July 2013 was contradictory, it is a collateral issue. *See United States v. Williamson*, 202 F.3d 974, 979 (7th Cir. 2000) (observing that attempts to "impeach by contradiction on a 'collateral or irrelevant matter,'" to be "impermissible.") (internal citation omitted).

It is telling that the Division, who has had Delaney testify so often, seizes on such minor supposed contradictions. I find all of the purported inconsistencies identified by the Division are either immaterial or have been adequately explained by Delaney. I found, on the whole, Delaney's testimony to be credible, with the exception, noted previously, that he may not recall comparatively minor events and discussions that took place up to six years before the hearing.

c. Other Evidence of Actual Knowledge

In addition to the alleged inconsistencies in Delaney's testimony, the Division also points to De La Sierra's testimony as evidence of Delaney's actual knowledge, specifically his statement that he believed Delaney knew about the Stock Loan department's practice to close out failures to deliver in the afternoon of T+6 because he and/or Johnson told Delaney that the Stock Loan department was experiencing counterparty pushback on attempts to close out at or before market open. Div. Br. at 13; *see* Tr. 202, 337-38. De La Sierra admitted, however, that merely informing Delaney that the Stock Loan department was experiencing counterparty pushback did not mean that the department was necessarily violating Rule 204T/204 (indeed, there would only be pushback if the Stock Loan department was attempting to enforce the rule); he agreed that counterparties did not prevent the Stock Loan department from buying in at market open. Tr. 272. Given this, I am not persuaded that De La Sierra's unsubstantiated belief that Delaney knew about the violations in 2008 should be given much weight.

Despite voluminous exhibits, there are no documents establishing that Delaney had actual knowledge of the Stock Loan department's Rule 204T/204 violations before early 2011. The strongest possible evidence that the Division might have to establish that Delaney had actual knowledge of Rule 204T/204 violations before early 2011 was the testimony of Gover, who suggested that at least he, Delaney, and Johnson had a meeting about it in early 2010. Tr. 103-06, 117-18. However, Gover acknowledged that he "would not be able to reliably say" when the meeting occurred, which is unsurprising given that the meeting in question took place several years before the hearing, although he believed he could narrow it to a period of several months in 2010. Tr. 117-18, 140. Yet, no one else testified that such a meeting took place in 2010; indeed, both Delaney and Johnson, the other alleged attendees of the meeting, directly contradicted this testimony. Tr. 568, 1308. Instead, based on the balance of testimony by various witnesses, it seems more likely that Gover instead recalled a meeting in early 2011, which others do remember, that shortly led to a meeting with outside counsel on the issue. *See* Tr. 273-74, 402, 1322-23. Gover himself testified that the meeting he remembered culminated in a meeting with outside counsel. Tr. 106. While it is possible that there was an identical meeting a year earlier,

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extraordinary significance, would conceal the comparatively lesser issue of Rule 204T/204 violations. Second, the Division's allegation that Delaney strove to conceal the Stock Loan department's Rule 204T/204 violations from regulators is further undermined by Delaney's disclosure of just such violations in the letter.

there is no documentary evidence to suggest that there was. Indeed, as discussed below, the documentation regarding Penson's Rule 204T/204 practices in 2010 suggests that the Stock Loan department was telling the compliance department (and the Buy-Ins department) at this time that the Stock Loan department was in compliance with the rule. For example, the language regarding Penson's "effective" Rule 204T/204 procedures in the November 2010 OCIE letter, which Gover drafted and continues to believe is true, is a very strong indication that the meeting he referenced at which he learned of Stock Loan's non-compliance did not take place until 2011 – not early to mid-2010. *See* Stipulated FOF No. 61. If such a meeting had taken place earlier, then Gover would have drafted a false response to OCIE. I find that the Division has failed to prove that Delaney had actual knowledge of the Stock Loan department's practice of violating Rule 204T/204 prior to February 15, 2011.[19]

4. Failure to Prove Extreme Recklessness

Notwithstanding Delaney's lack of actual knowledge, the Division might nonetheless prevail if it can show that Delaney acted with extreme recklessness. *See Howard*, 376 F.3d at 1143. However, the Division has failed to establish that there were "an abundance of red flags and suggestions of irregularities [that] demanded inquiry." *Id.* at 1149 (internal quotation marks and citation omitted). While the evidence adduced at the hearing demonstrates Delaney's negligence, as discussed below, it does not rise to the level of extreme recklessness.

Several pieces of evidence militate against a finding of extreme recklessness. First, the compliance department provided guidance, training, and conducted testing with respect to Rule 204T/204. Delaney did not just receive rules and guidance from authoritative sources; he passed guidance on to the business units, like the Stock Loan department. *See, e.g.*, Div. Ex. 125. His department made web-based training available, including on Rule 204T/204. *See* Tr. 1710-11, 1718, 1740-42; Del. Ex. 384. However, it is not clear whether Stock Loan officials bothered, for example, to review the guidance or take any relevant training. I do not agree with the Division's contention that Delaney was reckless for failing to convene meetings with relevant personnel when Rule 204T was implemented. Div. Br. at 18. Delaney believed that meetings might have been held at this time, but he could not recall the attendees or specifics because there was a great deal of communication and coordination going on simultaneously. Tr. 1238-39. As noted above, the record reflects that he passed along guidance on Rule 204T/204, and multiple meetings were later held to discuss Rule 204 compliance after the December 2009 audit. While his behavior does not rise to the level of extreme recklessness, it is clear that when faced with an important new rule like Rule 204T, it would have been prudent for Delaney to follow Penson's common practice and convene a meeting with relevant personnel, analyze any pertinent technologies, and develop a road map to ensure compliance with Rule 204T. *See* Tr. 1707-08, 1714-15, 2029-30; *see also* Del. Reply to Div. Proposed FOF at ¶ 89. Delaney's failure to do so represents a missed opportunity that a prudent CCO would have taken, and it is an example of his negligence, as discussed below.

With respect to the December 2009 audit, Delaney and Alaniz decided to conduct Rule 3012 testing of Penson's Rule 204T/204 compliance, but Delaney did not tell Alaniz which

[19] The Division acknowledges that it does not seek to hold Delaney liable for aiding and abetting from approximately February 15, 2011, on. *See* Stipulated FOF No. 58.

departments to test or how. *See* Tr. 705, 743-44, 864-65. Giving Alaniz maximum flexibility in devising how best to test Rule 204T/204 compliance, after consulting with both the Stock Loan and Buy-Ins departments, not only indicates that Delaney was not knowingly involved in the Stock Loan department's rule violations, but also supports that he was not reckless with respect to Rule 204T/204 compliance issues. Notably, in the course of Alaniz's Rule 3012 testing of Penson's Rule 204T/204 compliance, he actively engaged the Stock Loan department, and in early 2010 received their assurances in writing that the Stock Loan department had procedures in place to ensure proper settlement of CNS fails. Tr. 705-06; Del. Ex. 345. The Buy-Ins department responded with similar assurances, noting that, among other remediation efforts, Buy-Ins was "manually reviewing fails on the T+4 and T+6 reports to comply with the 'close-out' requirements" and would "continue to work with the Securities Lending Department to minimize any and all violations." Div. Ex. 70 at 6761. At least some of these assurances were communicated to Delaney. Del. Ex. 345 at 2. And the assurances may also have reasonably dissuaded Alaniz from suggesting Rule 204T/204 testing of the Stock Loan department. The Stock Loan and Buy-Ins departments were the business line experts, and employees in those departments were required to know the regulations and to develop procedures to comply with the laws. Tr. 391, 396, 1944-45; *see* Stipulated FOF No. 41. Although, in retrospect, the assurances made by the Stock Loan and Buys-Ins departments were not complete and correct, that does not mean that, at the time, Delaney, Alaniz, and the rest of the compliance department were reckless in relying on such clear, written representations from these departments on the Rule 204T/204 issue.[20]

Secondly, the only documents the Division is able to point to in order to demonstrate Delaney's recklessness are a handful of email exchanges that do not, on their face, relate to the Stock Loan department's Rule 204T/204 violations with respect to long sales of loaned securities. Because these documents do not address the Stock Loan department's Rule 204T/204 compliance, and are generally raised in the context of one of Delaney's subordinates resolving the issue presented, the overall flow of information establishes that Delaney was not reckless with respect to the Stock Loan department's Rule 204T/204 issues.

For example, Delaney was courtesy copied on an email from Miller to Gover on May 17, 2010, regarding FINRA's observation that Penson failed to close out eight long sales in accordance with Rule 204. Div. Ex. 168. However, Delaney is correct that "there is no indication that the eight long sales referenced involved long sales of loaned securities, as opposed to fails from customer-caused long sales," which would be the province of the Buy-Ins department, in which Gover worked, not the Stock Loan department. Del. Reply at 16. Nor is there any suggestion in the email that the issue identified was not being appropriately handled by Miller and Gover. Another "red flag" alleged by the Division is that Delaney was courtesy copied on an October 13, 2010, email chain (along with ten other Penson employees) in which, earlier in the chain, De La Sierra stated: "We do not borrow for long sales." Div. Ex. 26. In the

[20] For this reason, I also reject the Division's claim that follow up testing should have been conducted on a larger sample and should have tested close-outs of long sales. Div. Br. at 19-20. Given the assurances of the Stock Loan and Buy-Ins departments, Delaney and Alaniz acted reasonably in electing not to expand the follow up testing to another department, as opposed to the Buy-Ins department, which was retested on two occasions.

portion of the chain on which Delaney was first copied, Gover noted that he is "[b]ringing Compliance . . . into the discussion" and stated his understanding that "for Ridge Customers[,] although we can borrow to cover a failing long sale, we will not do so unless the correspondent contacts Stock Loan to arrange the borrow and agree the rate." *Id.* The Division did not ask any witnesses at the hearing about this exhibit, and on its face the email chain appears to relate to the language used by Penson when notifying customers of customer-caused long sales. *Id.* It is, in other words, irrelevant to the violations here.

As another example, the Division points to the July 26, 2010, email from Alaniz to Poldrack, copying Delaney, regarding the Stock Loan department's close-out procedures. Div. Br. at 17; Div. Ex. 91. I disagree that this email either escalated a Rule 204T/204 issue to Delaney or represented a red flag. According to its author, Alaniz, who was unquestionably credible, the email exchange did not escalate a compliance issue to Delaney for action. Tr. 824-25. While one line of the email chain, from a lower level Stock Loan employee, stated the understanding that the Stock Loan department was not to be bought in, the portion of the chain on which Delaney was copied shows that the issue was addressed, and resolved, through the responses of compliance personnel that in part pledged to engage higher-level Stock Loan officials. Tr. 816; Div. Ex. 91. As with the other evidence cited by the Division, this email fails to rise to the level of a red flag sufficient to put Delaney on notice of the Stock Loan department's violations. In other words, each documentary "red flag" alleged by the Division would give Delaney no reason to have been alerted to the Stock Loan department's practice of noncompliance with Rule 204T/204 for long sales of loaned securities, and fails to demonstrate that he was reckless with respect to the Stock Loan department's violations.

The third factor weighing against a finding of recklessness is the uncontroverted expert testimony of Yancey's expert, Poppalardo, that the Reg. SHO procedures in Penson's WSPs were adequate and typical of the industry. Yan. Ex. 828 at 9-12; Tr. 1993-94, 2039-40. The WSPs detailed the requirements of Rule 204T/204 and expressly directed the Stock Loan department to not only buy-in recalls if necessary to satisfy CNS obligations, but, when "Stock Loan does not have a counterparty to pass the Buy-In to," to "forwar[d] [the Buy-In] to the customer Buy-In department." *See* Tr. 2039-40; *see, e.g.,* Div. Ex. 188 at 9753, 9762. While the Division contends that Penson's WSPs could have done more than that, I credit the expert testimony that Penson's Rule 204T/204 procedures were sufficient and consistent with appropriate industry standards, and find that Delaney was not reckless in believing the WSPs adequately reflected the requirements of Rule 204T/204. I also reject the Division's allegation that Delaney recklessly ignored Alaniz's recommendation to include more detailed procedures for Rule 204T/204 compliance in the WSPs. Div. Br. at 20-21. As part of the Rule 3012 testing follow up process, Alaniz directly liaised with the business units, and one of the issues he followed up on with them was their practices and procedures for Rule 204T/204 compliance. Tr. 782-83, 805-07. The business units, including the Stock Loan department, generated their own WSPs. Tr. 308; 1758-59; *see* Stipulated FOF No. 41. As the "experts . . . day-to-day" it was "absolutely necessary to have the business owners be the original people who are drafting those WSPs." Tr. 1758-59. No one in the compliance department had "the level of sophistication with regard to Stock Loan to be able to write Stock Loan substantive WSPs." Tr. 1759. Furthermore, there is no evidence that Delaney prevented or discouraged Alaniz from addressing his suggestions to the Stock Loan department so that they could modify the WSPs accordingly.

Finally, when Delaney ultimately had actual knowledge of the Stock Loan department's rule violations in early 2011, he quickly escalated the issue first to in-house, and then to outside counsel to determine whether Johnson's proposed solution was viable under Rule 204.[21] Tr. 1309-11. This decision is not consistent with the Division's claim that he was reckless with respect to Rule 204 compliance. *See* Del. Reply at 11.

In light of the foregoing factors, and after considering each of the "red flags" alleged by the Division, I do not find that Delaney was reckless with regard to the Stock Loan department's Rule 204T/204 compliance. Though the Stock Loan department did not actually comply with Rule 204T/204 during the Relevant Period, the record does not substantiate that there were "red flags" sufficient to adjudge Delaney's conduct to be reckless as opposed to simply negligent. Because the Division has failed to satisfy the scienter requirement of aiding and abetting, its aiding and abetting claim against Delaney fails.[22]

5. Failure to Prove Substantial Assistance

The Division's aiding and abetting claim also fails because Delaney's conduct did not provide "substantial assistance" to Penson's violations. *See Graham,* 222 F.3d at 1000. The OIP alleges that Delaney committed four acts that substantially assisted Penson's violations: (1) agreeing with the Stock Loan department to continue implementing non-compliant procedures; (2) intentionally omitting the Stock Loan department's non-compliant procedures in Penson's WSPs; (3) intentionally concealing the non-compliant procedures from regulators and Yancey; and (4) exploiting a "Supervisory System" in order to allow Johnson to remain unsupervised so he could continue the practice of intentionally violating Rule 204T/204. *See* OIP at 3, 8-13. Each of these allegations is predicated on Delaney's actual knowledge of the Stock Loan department's noncompliant practices, which the Division has failed to prove existed before early 2011.

In its post-hearing briefs, the Division also argues that Delaney substantially assisted the violations by "repeatedly disregard[ing] red flags of suspicious activities" and not disclosing those red flags to either Yancey or regulators. Div. Br. at 21; Div. Reply to Del. at 16.

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[21] Although the record establishes that Delaney escalated the Stock Loan department's Rule 204 compliance problems to outside counsel, Delaney did not attempt to satisfy the requirements for an advice of counsel defense, and the privilege holder, Penson, has not waived privilege over the substantive communications on the Rule 204T/204 issue. Tr. 127-28. To raise the advice of counsel defense, Delaney must show that he: (1) made a complete disclosure of the relevant facts of the intended conduct to counsel; (2) sought advice on the legality of the intended conduct; (3) received advice that the intended conduct was legal; and (4) relied in good faith on counsel's advice. *Rodney R. Schoemann*, Securities Act of 1933 (Securities Act) Release No. 9073, 2009 SEC LEXIS 3939, at *46 & n.41 (Oct. 23, 2009). Because it was not perfected, any such defense has been waived.

[22] Because I do not find that Delaney aided and abetted Penson's violations, I need not address the parties' dispute about whether he did so willfully. *See* Div. Br. at 11; Del. Br. at 8-9.

However, for the reasons set forth above, I have found that Delaney was not faced with repeated red flags of suspicious activities sufficient to establish that he was reckless. In particular, I reject the Division's argument that Delaney misled regulators and/or Yancey by not ensuring that Penson's Rule 204T/204 violations were disclosed in the Annual Report or the November 2010 OCIE letter. Div. Br. at 24-26. With respect to the Annual Report, neither Alaniz, who prepared the initial draft of the report, nor Delaney, elected to include the Rule 204T/204 testing. Tr. 856-58, 1362. By the time of the report, both Delaney and Alaniz believed the issues with Rule 204T/204 were being effectively remediated by the business units.[23] Tr. 793-95, 1361-62; Del. Ex. 321. Poppalardo's expert opinion supports their determination to exclude it. *See* Yan. Ex. 828 at 18. Indeed, none of the Rule 3012 tests performed that year were included in the Annual Report. Tr. 857, 1303; *see* Div. Ex. 135. Instead, all testing materials, including those related to the Rule 204T/204 audit, were made separately available to regulators for review. Tr. 804-05; *see* Div. Ex. 135 at 0006 (stating that 3012 test results were "available in the Compliance dept.").

I also reject the allegation that I should find the fact that Delaney removed language regarding a "99 percent failure rate" from the Annual Report to be evidence of his culpability. *See* Div. Proposed FOF No. 334. The Division notes that Alaniz testified that in his original draft of the Rule 3012 testing summary memorandum, 112 out of 113 securities tested had failed, which he had indicated equaled a 99 percent failure rate. Tr. 779. He was later asked to remove the reference to that percentage. Tr. 779. Delaney testified that he asked Alaniz to remove the reference to a 99 percent failure rate because it was potentially misleading and confusing. Tr. 1300-01. The December 2009 Rule 204 audit results did reflect that "the failure to comply with the close-out requirement placed 112 out of 113 securities in the 'Penalty Box.'" Div. Ex. 70. Gover's testimony supports the contention that given Penson's trading volume and the small sample of securities tested, labeling the audit results as a "99 percent fail rate" could be misleading. Tr. 169-70. On January 28, 2010, Delaney and Alaniz had a quarterly meeting with Yancey where they informed him 112 of the 113 securities tested failed. Tr. 709-10. Furthermore, Alaniz would have had the opportunity to use the phrase "99 percent failure rate" with Yancey if he wanted to, though Alaniz did not recall employing that phrase in that meeting. Tr. 710, 844-45. While the Division seems to imply that Delaney acted nefariously by removing the 99 percent failure rate language, because he retained the raw numbers regarding the 112 of 113 securities tested and the failure was reported to Yancey, I do not find that he did anything inappropriate. Tr. 780. The fact that Delaney and Alaniz reported the fails to Yancey in writing and verbally shows they were working as a team to convey the correct information.

With respect to the November 2010 OCIE letter, I do not agree that the response establishes a failure on the part of Delaney or an attempt to mislead regulators. Div. Br. at 25-26. Gover, not Delaney, drafted the letter, and Gover confirmed that he believed his response was accurate both when he wrote it and at the time of the hearing. *See* Stipulated FOF Nos. 30, 61; Tr. 147-48. Tellingly, the Division never attempted to question Gover regarding the disputed sentence in the letter on Penson's "effective" Rule 204T processes and procedures, which appear in context to be related to the procedures and processes for short sales, not long sales. Tr. 74-198, 827-28; Div. Ex. 101 at 8. At the hearing, Alaniz and Hasty also stood by the accuracy of

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[23] I am unpersuaded by the Division's suggestion that I should credit, over his explanation at the hearing, a snippet of Delaney's investigative testimony in which he stated that he would have thought the Rule 204T/204 audit results would be included in the Annual Report. Div. Br. at 24.

the representations made in the letter. Tr. 828-29, Tr. 1738-40. Delaney had no reason to second-guess the accuracy of Gover's statement, the assessment of his own personnel, or the understanding that remediation of the Rule 204T/204 compliance problems revealed in the December 2009 audit was underway. *See* Tr. 1285, 1792-93. The Division identified no evidence that Delaney's edits to the letter were anything other than stylistic. Tr. 1283-84. And the letter was later signed and issued by Hasty, not Delaney. Div. Ex. 101 at 12. I have determined, with respect to the November 2010 OCIE letter, that Delaney's reliance on the subject matter expert – Gover – and his official in charge of Rule 204T/204 testing – Alaniz – was reasonable. The potential exception to this, to what extent Delaney may have addressed the October 2010 FINRA report, is discussed below with regard to the issue of negligence.

After carefully considering each act by Delaney that may have assisted Penson's violations, I conclude that none of those acts substantially assisted the violations. Thus, even had Delaney acted with the requisite scienter, the Division's aiding and abetting claim against Delaney still fails.

B. Delaney's Alleged Liability for Causing Penson's Violations

To establish liability for "causing" violations in the absence of aiding and abetting, the Division must prove three elements: (1) a primary violation; (2) an act or omission by the respondent that was a cause of the violation; and (3) that the respondent knew, or should have known, that his conduct would contribute to the violation. *See Robert M. Fuller*, Exchange Act Rel. No. 48406, at *4 (Aug. 25, 2003), *pet. for review denied*, 95 F. App'x 361 (D.C. Cir. 2004). Negligence is sufficient to establish "causing" liability under Exchange Act Section 21C(a), unless the person is alleged to "cause" a primary violation that requires scienter. *Howard v. SEC*, 376 F.3d 1136, 1142 (D.C. Cir. 2004). The primary violations at issue here, Penson's violations of Rule 204T/204, are technical violations that do not require scienter.[24] Thus, because the evidence supports that Delaney contributed to Penson's violations and should have known he was doing so, I find that he caused the Rule 204T/204 violations.

Delaney acknowledges that "[n]egligence is defined as: [t]he failure to exercise the standard of care that a reasonably prudent person would have exercised in a similar situation; any conduct that falls below the legal standard established to protect others against unreasonable risk of harm, except for conduct that is intentionally, wantonly, or willfully disregardful of others' rights. The term connotes culpable carelessness." Del. Reply to Yan. Proposed COL at ¶ 26 (internal quotation marks omitted). Delaney also acknowledges that "[t]he reasonable person acts sensibly, does things without serious delay, and takes proper but not excessive precautions." *Id.* at ¶ 27.

As such, I have considered what a reasonable prudent person would have done in Delaney's situation. The notion that expert testimony is necessary to establish a breach of the

[24] Delaney admits that Rule 204T/204 is a "technical rule," but claims that because the OIP is largely focused on intentional violations of Rule 204T/204, scienter is required. Del. Reply at 21. I reject this argument, as the fact that the OIP describes intentional violations of Rule 204T/204 does not imbue this technical rule with a scienter requirement.

standard of care arises from a line of cases where fact-finding is conducted by a lay jury, whose common knowledge and experience may not, without expert testimony, be sufficient to appreciate such a breach. However, "there is no categorical rule requiring expert testimony in a securities case." *S.E.C. v. Ginder*, 752 F.3d 569, 575 (2d Cir. 2014). While expert testimony as to industry practice is generally relevant in a securities case to show the standard of care, the standard is ultimately one of reasonable prudence. *See Vernazza v. S.E.C.*, 327 F.3d 851, 861-62 (9th Cir. 2003) (upholding Commission's exclusion of purported expert testimony on the standard of care). Although Delaney chose not to call his compliance expert, Greg Florio, and withdrew Mr. Florio's previously admitted expert report, Tr. 1432-33, other experts and fact witnesses with expert knowledge of compliance, including Delaney, testified at length concerning the standard of care for compliance in that situation. Most important of these is Paulukaitis's undisputed testimony that according to SEC guidance, in situations "where misconduct may have occurred"– as opposed to "conduct that raises red flags" – compliance officers should follow up to facilitate a proper response. Div. Ex. 238 at 14. This view was echoed by Poppalardo, who, like Hasty (Delaney's deputy and ultimate successor), opined that coordinated engagement was the appropriate way to deal with new, challenging rules. Tr. 1707-08, 2029-30.[25] I have applied the preceding principles in making my findings regarding negligence here.

Since the time that Rule 204T was adopted in the fall of 2008, Delaney should have known that Penson's Stock Loan department may well face challenges complying with the rule. Delaney admits that he "received email newsletters indicating Rule 204T/204 applied to long sales and could create difficulty for the stock lending industry" but asserts that "it is difficult to understand how the receipt of bulletins that Rule 204 could create difficulty for the stock lending <u>industry</u> should have alerted Delaney that Penson's Stock Loan Department had instituted a policy or practice to violate the Rule." Del. Reply at 14 (emphasis in original). While I agree that none of the newsletters would have alerted Delaney that the Stock Loan department had instituted a policy to violate Rule 204T/204, they should have alerted him as to the potential difficulties of Rule 204T/204 compliance in the field of securities lending. On their own, such newsletters and guidance materials would not have required Delaney to take any particular action, but, in this case, they were followed with comments from Stock Loan department employees, which underscored that compliance was in fact challenging.[26]

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[25] In select respects, Poppalardo's testimony was quite helpful to Delaney, supporting the reasonableness of his conduct with respect to the Annual Report (Tr. 1959-60; Yan. Ex. 828 at 18) and the adequacy Penson's WSPs related to Rule 204T/204 (Tr. 1993-94, 2039-40; Yan. Ex. 828 at 9-12).

[26] Notably, at least two key Penson Stock Loan officials never asked Delaney for guidance on Rule 204T/204 until 2011. Wetzig testified that he did not have any conversations with Delaney about Rule 204T/204 compliance until the early 2011 call with outside counsel. Tr. 402-03. And, according to the July 2014 Brady Letter, Hall told Division staff that he did not ask for legal or compliance help with Rule 204T/204 until the beginning of 2011. Del. Ex. 446.

While I credit Delaney's claims that he did not have "knowledge that Stock Loan had a practice or policy of violating Rule 204T/204" in 2008, he recalled a couple brief verbal exchanges with Johnson and potentially De La Sierra around the time Rule 204T was adopted regarding "counter-party pushback" as a result of the Stock Loan department's attempts to comply with Rule 204T. Tr. 1192-94; Del. Reply at 10-11. As Delaney testified, his interpretation of this situation was that such pushback indicates that Stock Loan was enforcing Rule 204T. Tr. 1195; *see* Del. Reply at 10-11.

In this case, neither De La Sierra nor Johnson testified that they expressly told Delaney that the Stock Loan department was routinely violating Rule 204T/204. *See* Tr. 272-73, 517-20. De La Sierra's testimony reflects that he assumed that Delaney knew about the violations because he was told about the counterparty pushback. Tr. 272. Similarly, Johnson testified that he sought Delaney's help on reconciling industry practice, which was to close out long sales in the afternoon, with the requirements of Rule 204T/204. Tr. 517-18. However, I disagree with Delaney's characterization that Johnson "at most . . . 'communicated' to Delaney that there was a conflict between 'the rule and the *industry* practice,' not the practice at Penson." Del. Reply at 9 (emphasis in original). There would be no reason for Johnson to bring up a conflict with industry practice and Rule 204T/204 were Penson, a member of the relevant industry, not also having challenges complying. It was not reasonable for Delaney to presume full compliance without follow up once explicitly informed by a department head that counterparties were pushing back on a rule that was known (or should have been known) to be difficult to comply with. Delaney's oral exchanges with Stock Loan department officials regarding the challenges of Rule 204T/204 compliance reasonably obliged him, in his capacity as CCO, either by himself or through his staff, to make further inquiry to ascertain the nature and extent of the compliance challenges. Delaney's failure to ask whether the Stock Loan department was complying with (or violating) Rule 204T/204 in the face of counterparty pushback was a missed opportunity. Dismissively telling Johnson that if he was having trouble with the rule, he should "write [his] congressman," falls short of reasonable prudence. Tr. 1193, 1405.

While Delaney placed commendable reliance on Alaniz in establishing Rule 3012 testing for Penson, including with respect to Rule 204T/204, because Delaney did not advise Alaniz of his exchanges with the Stock Loan department officials on the rule, Alaniz was deprived of the full and complete information he needed in order to design an appropriate test to gauge Penson's Rule 204T/204 compliance. Delaney is correct that either the Stock Loan or Buy-Ins departments could also have notified Alaniz that the Stock Loan department had different close-out procedures for long sales. Del. Reply at 20. This does not absolve Delaney of responsibility, however – Delaney and Alaniz worked together to come up with a list of topics for the Rule 3012 testing, and at no point did Delaney inform Alaniz about his knowledge of the particular challenges faced by the Stock Loan department with respect to Rule 204T/204 compliance. Tr. 705. It was unreasonable of Delaney to remain silent rather than sharing this pertinent information with Alaniz.

The Stock Loan department's response to the December 2009 audit memorandum, in early 2010, may have provided comfort to the compliance department, including Delaney, about Penson's Rule 204T/204 compliance and might have decreased, as a matter of priority, looking into such compliance issues by the Stock Loan department. However, a few months later, Delaney was again confronted with evidence that Penson was having trouble complying with

Rule 204. On October 21, 2010, Delaney sent an email attaching a FINRA exit meeting report which concluded, from a review of ten CNS failures to deliver between February 1, 2010, and March 31, 2010, that Penson "failed to recall securities from stock loan or borrow securities to close out all 10 of these fails, which resulted in the fails being consistently outstanding beyond Trade date +4 for short sale FTD's and Trade date +6 for long sale FTD's." Div. Ex. 40 at 4668. While I agree with Delaney that these ten failures "is tiny compared to the tens of millions of transactions cleared by Penson during that period," Del. Reply at 16-17, since each such failure represented a potential violation of Rule 204, with at least ten violations in the two-month period surveyed by FINRA, the report suggests that there may well be sixty violations a year at that rate if the violative practices were not stopped. While it is certainly plausible that, by October 2010, the chance of future violations could have been limited, or extinguished, by remedial efforts or actions undertaken after the December 2009 audit, it is not necessarily the case that it would have. A reasonable person upon receipt of such a report would have followed up with the concerned departments, including the Stock Loan department, to ascertain whether such problems with Rule 204 compliance continued.

Unlike the OCIE response, which was followed up on by one of Delaney's compliance officers, who engaged the business unit and addressed, to everyone's satisfaction, the issue, by contrast, Delaney's handling of the FINRA exit report does not reflect assigned follow up by Delaney, or anyone else in the compliance department, nor any of the business units that could be responsible. While the exit report does not necessarily implicate the Stock Loan department, the plain language suggests that the Stock Loan department might be involved, and as such, some form of follow up was within the scope of Delaney's duties and responsibilities as CCO. I do note that it is plausible that because the FINRA exit report involved a two-month period earlier that year, and because of the subsequent remediation efforts, he may have assumed that this was taken care of, but, to do so was imprudent. The distinction between my different findings on the two October 2010 notices of Rule 204T/204 violations – one from OCIE, one from FINRA – is that there was prudent follow up in response to the first, and no evidence of such follow up in response to the second.

Delaney argued in his prehearing brief that "the evidence will establish that [he] acted reasonably in fulfilling his duties as CCO," and in his post-hearing brief, he concluded that this was indeed shown by the evidence adduced in this proceeding. Del. First Am. Prehearing Br. at 36; Del. Reply at 21. After careful consideration of the evidence in the record, I disagree. When Delaney was presented with authoritative guidance and oral comments from Stock Loan department officials indicative of the difficulties of complying with Rule 204T/204, he was negligent in the following respects:

- Delaney failed to convene a meeting of relevant personnel to ensure effective steps were taken to comply with Rule 204T;
- Delaney assumed, incorrectly, that the Stock Loan department was fully compliant with Rule 204T/204, rather than asking any logical follow up questions to assess compliance;
- Delaney did not mention the challenges of Rule 204T/204 compliance faced by the Stock Loan department to Alaniz, who was charged with testing on that issue; and
- Delaney did not conduct any follow up with the Stock Loan department regarding the

FINRA exit report he forwarded in October 2010 reflecting potential noncompliance by the Stock Loan department with the rule.

Each of these acts and omissions was a cause of Penson's ongoing primary violations, and Delaney should have known that his behavior would contribute to that result.

Delaney raises three primary defenses to the Division's allegations that he negligently caused Penson's violations. First, he argues that he did not have proper notice that the Division intended to pursue a "causing" claim.[27] Del. Br. at 46; Del. Reply at 3, 21. As the Commission recently affirmed, the standard for determining whether notice is adequate in administrative proceedings is "whether the respondent understood the issue and was afforded full opportunity to justify [his] conduct during the course of the litigation." *John P. Flannery*, Exchange Act Release No. 73840, 2014 SEC LEXIS at *131-32 (internal quotation marks omitted). While Delaney argues he should not be found liable on a negligence theory because the Division focused its case primarily on allegedly intentional misconduct, his prehearing brief simultaneously contended that

> even if this Court were to permit the Division to proceed on a pure negligence theory at hearing . . . there will be no credible evidence adduced at trial to support such a theory. Rather, the same evidence detailed above . . . would preclude a finding that Delaney acted negligently or otherwise caused or contributed to any violations of Rule 204T(a)/204(a).

Del. First Am. Prehearing Br. at 36.

Delaney does not dispute that "causing" was a charge alleged in the OIP. *Id.* at 21-22; Del. Reply at 46. And while he claims that he focused his efforts at the hearing on intentional conduct rather than recklessness or negligence because of the inadequacy of the OIP, Del. Reply at 4, Delaney submitted after the hearing a proposed conclusion of law on the issue of negligence, contradicting his argument that the Division abandoned at the hearing any claim grounded in that standard. *See* Del. Proposed COL No. 17; Del. Br. at 46. The Division did not offer a new set of facts or body of evidence in support of its negligence claim – as Delaney acknowledged, the facts and evidence are the same, whether the conclusion is that Delaney acted intentionally, acted recklessly, or acted negligently. Del. First Am. Prehearing Br. at 36. Nonetheless, on January 23, 2015, I provided Delaney with the opportunity "to identify, with specificity, any and all additional evidence that he would have otherwise presented to defend himself on the issue of negligence." *Thomas R. Delaney II*, Admin. Proc. Rulings Release No.

[27] Delaney alleges that this lack of notice violated his constitutional right to due process. Del. Reply at 3. As noted herein, I find that he had a full and fair opportunity to defend himself in this proceeding and thus reject this argument and his other arguments related to the adequacy of the notice provided by the OIP and the Division's prehearing briefs. Other than his arguments regarding notice and his causation argument, discussed *infra*, Delaney failed to assert in his post-hearing briefs any of the other affirmative defenses raised in his Answer. *See* Del. Answer at 14-17. The rest of his affirmative defenses were therefore abandoned, and, in any event, are without merit.

2254, 2015 SEC LEXIS 279 (January Order). In response, Delaney contends that he would have hired different experts, asked different questions, and talked more about his overall responsibilities as a CCO, but did not show, with any specificity, how the substance of his defense against the charges and violations in this case would have been materially different. Del. Resp. at 6-10. Delaney repeatedly testified about compliance generally at Penson, and thus presented, in substance, the type of evidence he now claims he would have introduced. *See, e.g.*, Tr. 1223-27 (discussing the general environment in the compliance department), 1228-30 (discussing various new rules and rule implementations), 1230-32 (discussing how compliance challenges at Penson were different than compliance challenges at other firms), 1290-96 (walking through numerous compliance issues to show "a day in the life of [Delaney] at Penson"). Other witnesses were asked similar questions. *See, e.g.*, Tr. 159-63 (Gover questioned on numerous regulations that applied to broker-dealers), 1704-06 (Hasty questioned about overall role of compliance department).

After reviewing Delaney's response to my January Order, I am confident in concluding that there was no actual prejudice here. I find that the OIP was adequate as to both recklessness and negligence. Delaney had ample opportunity to defend on the issue of recklessness and negligence, and, while he was not ultimately successful on the issue of negligence, it does not undercut the fact that he carried out a robust defense of his conduct with respect to the Stock Loan department's Rule 204T/204 compliance.

Second, Delaney argues that for the Division to pursue a negligence theory, "it needed to offer evidence establishing what a reasonable CCO's duties are in providing guidance or in ensuring compliance," and that such evidence must involve expert testimony on the issue of standard of care. Del. Reply at 19; Del. Resp. at 5-6. However, as noted above, the cases cited by Delaney on the issue of expert testimony are inapposite, and in any event, there is sufficient evidence in the record on both Delaney's compliance responsibilities and the facts and circumstances with which he was presented to determine whether he exercised reasonable prudence as CCO of Penson.

Finally, Delaney argues that, "[u]nder established principles of negligence, 'intentional misconduct' by a third party is a superseding cause that breaks a causal chain and relieves a party from possible negligence." Del. Reply at 22 (citing *Rupert v. Daggett,* 695 F.3d 417, 426 (6th Cir. 2012); *United States v. Speakman,* 594 F.3d 1165 (10th Cir. 2010); Restatement (Second) of Torts § 448); Del. Answer at 16-17. However, there is an exception to this rule where "the actor at the time of his negligent conduct . . . should have realized the likelihood that such a situation might be created, and that a third person might avail himself of the opportunity to commit such" intentional misconduct. Restatement (Second) of Torts § 448. Delaney should have known that, by not acting with reasonable care to understand, report, and remedy Penson's Rule 204T/204 violations, he contributed to the circumstances where particular personnel could commit such violations. Delaney asserts that "[w]here members of Penson's Stock Loan knew of and decided to intentionally violate Rule 204T/204, no further advice that Delaney could provide, or procedures he could have put into place, would have changed the outcome." Del. Reply at 22. I disagree. If Delaney had asked the previously described follow up questions about the Stock Loan department's Rule 204T/204 compliance, and informed Alaniz of what he knew, he would have found continuing violations, which would have (or should have) been reported up the organizational chain of command and to regulators when they asked for that

information. This is sufficient to establish that Delaney's oversights were a cause of the violative conduct at Penson.[28]

C. Yancey's Alleged Liability for Failure to Supervise

1. Failure to Supervise Delaney

Section 15(b)(4)(E) of the Exchange Act authorizes the Commission to impose sanctions on an associated person of a broker-dealer if that person "has failed reasonably to supervise, with a view to preventing violations of [the federal securities statutes, rules, and regulations], another person who commits such a violation, if such other person is subject to his supervision." 15 U.S.C. § 78*o*(b)(4)(E). The supervised person must have "willfully aided, abetted, counseled, commanded, induced, or procured" the securities law violation. *Id.* Willfulness is shown where a person intends to commit the act that constitutes a violation. *See, e.g., Wonsover*, 205 F.3d at 414.

It is undisputed that Yancey and Delaney were associated persons of Penson during the Relevant Period, and that Yancey was responsible for supervising Delaney. Stipulated FOF Nos. 2, 42, 102, 112. However, as detailed above, I have not found that Delaney "willfully aided, abetted, counseled, commanded, induced, or procured" a securities law violation. 15 U.S.C. § 78*o*(b)(4)(E). Instead, I have found that Delaney was negligent in causing Penson's Rule 204T/204 violations. Without a predicate aiding and abetting offense committed by Delaney, the Division's failure to supervise claim with respect to Delaney must fail.

Even had I found that Delaney willfully aided and abetted Penson's Rule 204T/204 violations, however, the Division has failed to show that Yancey did not reasonably supervise Delaney. The parties do not dispute that Yancey was unaware that the Stock Loan department was violating Rule 204T/204. Stipulated FOF No. 43. However, "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." *Dennis S. Kaminski*, Exchange Act Release No. 65347, 2011 WL 4336702, at *8 (Sept. 6, 2011) (internal quotation marks omitted); *see also Banc of America Inv. Servs., Inc.*, Exchange Act Release No. 60870, 2009 WL 3413048, *6 (Oct. 22, 2009) ("Red flags and suggestions of irregularities demand inquiry as well as adequate follow up and review. When indications of impropriety reach the attention of those in authority, they must act decisively to detect and prevent violations of federal securities laws.") (internal quotation marks and citation omitted). On the other hand, "[a] firm's president is not automatically at fault when other individuals in the firm engage in misconduct of which he has no reason to be aware." *Swartwood Hesse, Inc.*, Exchange Act Release No. 31212, 1992 WL 252184, at *6 (Sept. 22, 1992) (quoting *Juan Carlos Schidlowski*, 48 S.E.C. 507, 509 (1986)).

The record shows that Yancey exercised consistent, robust supervision over all his direct reports, including Delaney. *See* Stipulated FOF No. 95 (Yancey met routinely with Delaney);

[28] Delaney's observation that the "violations continued after Delaney left," Del. Reply at 22, is not decisive as to his liability because this case does not address his successor's knowledge and conduct. In addition, there is no dispute that the Rule 204T/204 violations, which had persisted at Penson for years, ceased within a few months of Delaney's departure. *See* Stipulated FOF No. 7 (Penson's violations continued until November 2011).

Tr. 423-24 (Yancey was compliance-minded, approachable, engaged, and honest), 1338-40 (Yancey was an engaged supervisor who met with his direct reports routinely), 1701-02 (Yancey was very engaged and "very interested in what was going on in [the] Compliance Department"), 1840 (Yancey held both one-one-one and group meetings on at least a weekly basis with each direct report), 1918-19 (Yancey asked his direct reports for updates and encouraged participation in meetings), 2178 (Yancey was "a very involved manager" and routinely met with his supervisees). As outlined in my fact findings, Yancey's character witnesses also uniformly praised him as honest, ethical, and a person of integrity in the securities industry.

I am unconvinced that Yancey was confronted with any "red flags" requiring follow up that he failed to take. The Division alleges that the absence of an explicit reference to the Rule 3012 testing of the Buys-Ins department's Rule 204T/204 procedures in the Annual Report, appended to Yancey's March 2010 CEO certification, was a "red flag" and that Yancey should have followed up on with respect to why the test results were not included in the certification.[29] Div. Br. at 39-42. I disagree, in part for the same reasons that I concluded above that Delaney was not at fault for failing to ensure those results were included. Yancey repeatedly received assurances that the Rule 204T/204 testing results were the focus of prompt remediation. Stipulated FOF No. 77. Alaniz testified that he specifically told Yancey that he was receiving cooperation from departments for remediation and that Yancey seemed reassured by that fact. Tr. 845; *see also* Div. Ex. 134. Yancey confirmed that this occurred. Tr. 1879-80. Yancey also specifically asked whether Johnson should join the January 28, 2010, meeting, at which the Rule 204T/204 test results were first discussed, and was assured that his attendance was not necessary. Tr. 1354. I also credit the expert opinions of Poppalardo and Paz that as CEO, Yancey was entitled to rely on the determination that the December 2009 testing did not rise to the level of a "key compliance issue" that needed to be included in the report. *See* Yan. Exs. 828 at 16-18, 829 at 22-24. Yancey had no reason to believe that any "red flags" or "irregularities" were occurring at Penson that were not already the subject of prompt remediation. Given the absence of such evidence, I find that the Division did not prove that Yancey failed reasonably to supervise Delaney, even were such a claim viable here.

2. *Failure to Supervise Johnson*

It is undisputed that Johnson was a registered representative associated with Penson during the Relevant Period. Stipulated FOF No. 102. It is also clear that he willfully aided and abetted Penson's violations. Johnson had primary responsibility in the Stock Loan department for compliance with Rule 204T/204 procedures and for the department's operational practices. Stipulated FOF Nos. 38, 41. He knew that Rule 204T/204 required the Stock Loan department to close out CNS failures to deliver for long sales by market open T+6, yet permitted the Stock Loan department to violate this requirement by closing out later in the day. Stipulated FOF No. 41; Tr. 515. It is clear that Johnson acted with the requisite scienter and substantially assisted in Penson's violations. *See Graham,* 222 F.3d at 1000.

[29] The Division did not pursue other purported red flags, including Johnson's absence from the March 31, 2010, meeting and the absence of a specific reference to the Buy-Ins department's Rule 204T/204 issues in Penson's November 2010 OCIE response. *Compare* OIP at 14-16 *with* Div. Br. at 39-42 *and* Div. Reply to Yan. at 20-24.

Yancey does not appear to challenge the fact that Johnson willfully aided and abetted Penson's Rule 204T/204 violations. *See* Yan. Br. at 2-24; Yan. Reply at 2-15. Yancey persuasively disputes, however, that Johnson was subject to his direct supervision. With respect to who had supervisory responsibility over Johnson, as an initial matter, a president of a firm "is responsible for the firm's compliance with all applicable requirements unless and until he or she reasonably delegates a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his or her duties." *John B. Busacca III,* Exchange Act Release No. 63312, 2010 SEC LEXIS 3787, at *37 (Nov. 12, 2010) (internal citations omitted). Paulukaitis testified, and the parties agree, that the delegation of supervisory responsibility is reasonable when (1) the person to whom the responsibilities are delegated possesses sufficient knowledge and experience to perform those functions in a satisfactory manner, and (2) the person who has delegated supervisory responsibilities to another takes reasonable steps to ensure that the functions delegated are being performed in reasonable manner. Tr. 482-85; Stipulated COL No. 9.

The parties agree that, prior to Johnson's promotion to Senior Vice President for Global Stock Lending at PWI, Yancey was Johnson's supervisor. Stipulated FOF No. 118. Yancey argues that at or around the time of Johnson's promotion, Yancey delegated supervisory responsibility to Pendergraft and thereafter Johnson was no longer subject to his supervision. Yan. Br. at 4. It is Yancey's burden to submit "reliable evidence" showing that he delegated supervisory responsibility over Johnson to Pendergraft. *See SEC v. Yu*, 231 F. Supp. 2d 16, 21 (D.D.C. 2002). The parties do not agree, however, on what evidence should be used to evaluate whether such a delegation occurred.

The act of delegation need not be formal or written. *See In the Matter of Thomas F. White*, Exchange Act Release No. 34398, 1994 WL 389903, at *2-3 (July 19, 1994) (finding CEO reasonably delegated supervisory authority where CEO "assigned" supervisee's responsibilities to the delegatee); *Swartwood Hesse, Inc.*, 1992 WL 252184, at *5 ("[t]he fact that there was no written documentation to support this division of authority is not dispositive of the issue" of whether supervisory authority was delegated). Yancey would use the test developed in *John H. Gutfreund*, Exchange Act Release No. 31554, 1992 WL 362753, at *15 (Dec. 3, 1992) (*Gutfreund*), to determine whether supervisory responsibility has been appropriately delegated. Yan. Br. at 3. The Commission in *Gutfreund* held that

> if a particular person is a "supervisor" depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue.

Gutfreund at *15.

The Division insists that the delegation must be "clear" to be effective, Div. Br. at 32, and disputes that the test articulated in *Gutfreund* is applicable to determining whether delegation has occurred, Div. Reply to Yan. at 7-10. The Division argues that I should simply look at the RRSM and should find, "[o]n this basis alone," that Yancey retained supervisory responsibility over Johnson. Div. Br. at 32. It is clear, however, that courts consider the facts and circumstances surrounding a purported delegation, as established through both testimonial and documentary evidence, to be relevant in determining whether supervision was in fact reasonably

delegated. *See Yu*, 231 F. Supp. 2d at 20-21 (looking at actions and responsibilities of president to determine whether he retained supervisory power in violation of a prior Commission bar); *Midas Securities, LLC*, Exchange Act Release No. 66200, 2012 WL 16138, at *13 (considering "the weight of the evidence" to determine whether president reasonably delegated his supervisory duties); *White*, 1994 WL 389903, at *2-3 (reviewing evidence of job responsibilities and testimony of supervisee to determine whether supervision was delegated); *Swartwood*, 1992 WL 252184, at *5-6 (relying on testimony of firm employees regarding division of responsibilities after purported delegation to determine whether delegation occurred).

I find that Yancey is not liable for Johnson's intentional misconduct because the record supports that Yancey reasonably delegated supervisory responsibility over Johnson to Pendergraft, one of the founders of Penson, at Pendergraft's own invitation, and then followed up reasonably. In August 2008, Pendergraft explicitly directed Gardner to move Johnson out of Yancey's organization, Penson, and into Pendergraft's organization, PWI. Yan. Ex. 608; *see also* Yan. Ex. 698. Yancey, Gardner, Delaney, and McCain confirmed that in August 2008 Yancey delegated supervision of Johnson to Pendergraft, with Pendergraft serving as Yancey's supervisor from that point forward.[30] Tr. 951, 1149-51, 1332, 1902-03, 2182-83. Miller and Hasty also testified that Pendergraft was Johnson's supervisor during this time. Tr. 2594-95, 1743-46. While De La Sierra first testified that he thought Johnson reported to Son, he later agreed that Pendergraft was supervising Johnson. Tr. 286, 302-03. I find that the foregoing testimony, which was frankly overwhelming, represents "reliable evidence of supervisory control by another individual" which establishes that Yancey delegated supervisory responsibility over Johnson to Pendergraft. *See Yu*, 231 F. Supp. 2d at 22.

As reflected in my factual findings, there was also considerable documentary evidence corroborating that Pendergraft was in fact actively supervising Johnson's activities. The Division accurately notes that similar documents exist in the record between Johnson, on the one hand, and other top Penson officials, on the other, and that they are not also his supervisors; however, this argument misses the mark. Div. Reply to Yan. at 15. As noted above, the overwhelming testimony at the hearing was that Yancey delegated supervision of Johnson to Pendergraft and Pendergraft in fact supervised Johnson. In addition to that testimony, there is considerable documentary evidence consistent with Pendergraft supervising Johnson. While there is other correspondence between Johnson and top Penson officials, I find that the nature and extent of the communications and correspondence between Johnson and Pendergraft is completely consistent with the supervisory relationship that virtually every witness testified to. While such documentary evidence could possibly exist in the absence of supervision – though I think it would be much more limited and directive in nature – here the most plausible explanation is that it exists because of that supervisory relationship.

The Division relies on two things in an unsuccessful attempt to rebut this overwhelming evidence that Yancey delegated supervisory authority over Johnson to Pendergraft. First, the Division argues that Penson's RRSM listed Yancey as Johnson's regulatory supervisor. *See* Div. Br. at 29-32. However, I find that the RRSM was inaccurate based on the testimony of Miller, the author of the document. Miller testified that with regard to the various versions of the

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[30] Johnson confirmed that he had only one supervisor from late 2008 on, and that it was either Pendergraft or Son, not Yancey. Tr. 537-38; *see* Stipulated FOF No. 84.

document, the RRSM inaccurately reflected Yancey as Johnson's regulatory supervisor, and Johnson should have been listed under Pendergraft because Pendergraft was his supervisor. Tr. 2594-95, 2601-03, 2623. Miller was "[v]ery clear" that the RRSM was wrong with respect to the supposed supervisory relationship of Yancey to Johnson. Tr. 2595. Miller explained that that she allowed the error to persist in the document because she did not look at it carefully:

> Q: But just to be clear, you knew that Bill Yancey was not the regulatory supervisor?
>
> A: I know that Bill Yancey was not Mike Johnson's regulatory supervisor. I don't know that I gave it any thought with regard to this document. It just wasn't a big part of my job. I didn't look at it that often.

Tr. 2597.

I find no reason to reject Miller's testimony that the RRSM was wrong; Miller was an objectively neutral witness who testified with great sincerity. Her testimony on this point was corroborated by other witnesses who also testified that the RRSM was inaccurate in this and other respects. Tr. 1794-95, 1929-30, 2190-91. Miller was firm that notwithstanding the inaccurate RRSM, Johnson "reported to Phil Pendergraft" – not Yancey. Tr. 2585-86. Miller testified that she was never asked during her investigative testimony questions about the RRSM or who Johnson's supervisor was. Tr. 2585.

I do not agree with the Division's suggestion that Yancey had supervisory responsibility over Johnson, as a matter of law, merely because the inaccurate supervisory matrix was sent to regulators. Div. Br. at 30-31. The apparently mistaken submission does not make Yancey Johnson's supervisor, nor does it make him liable for failing to supervise Johnson. As Poppalardo testified, sending an inaccurate document to a regulator does not render the mistaken information in that document accurate. Tr. 2041. And the Division's own expert, Paulukaitis, made clear that the supervisory matrix was just one fact and circumstance that needed to be balanced against all of the other evidence when determining whether a person is a supervisor or not.[31] Tr. 486-87. The Division argues that the matrix was updated by Miller, and Yancey himself had a few opportunities to review it. Div. Br. at 30-31. However, the fact that Yancey received copies of the RRSM and apparently did not correct its inaccuracies does not make the document accurate. At most, the Division's argument establishes that Yancey, who, like virtually everyone else at Penson did not use that document, did not take the time to carry out a detailed review of the document. It is not clear that such in-depth review was a priority, since Penson employees uniformly did not use the RRSM to determine who supervised whom; they testified unequivocally that they consulted Penson's organizational charts when seeking information on supervisory relationships. Tr. 862, 1164-65, 1215-16, 1345, 1747-48, 2188. After 2008, those charts reflect that Johnson no longer reported to Yancey.[32] *See, e.g.,* Yan. Ex.

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[31] At the time Paulukaitis testified, no testimony had been adduced to the effect that the RRSM was inaccurate, such as the testimony of Miller.

[32] That the organizational charts reflect that Son assisted or shared Pendergraft's supervisory role does not undermine the evidence of Yancey's delegation. Similarly, I do not find De La Sierra's

503. Notably, Miller, the author of the RRSM, testified that she did not give the supervisory matrix "much thought," that it "wasn't a big part" of her job, and that she "didn't look at it that often." Tr. 2597. Miller testified that she thinks that she provided the matrix to Yancey a couple of times. Tr. 2591-92. For example, in February 2009, Miller sent Yancey, and others, a copy of the RRSM. Div. Ex. 177. Miller's email asked the recipients if she needed to make additional changes. *Id.* Yancey responded "Thanks" to the email. Div. Ex. 263. He admitted that he did not look at the RRSM closely. Tr. 1837-39. A year later, when Miller sent the matrix to Yancey again, neither she nor Yancey could recall if he replied. Tr. 963, 2618. While in retrospect it is regrettable that Yancey, Miller, or others, did not more carefully review and correct this document with respect to Yancey and Johnson, that oversight does not make Yancey the supervisor of Johnson.

In addition to the RRSM, the Division relies on Pendergraft's testimony to support the claim that even if Yancey did delegate responsibility for supervising Johnson with respect to some aspects of his job, Yancey did not delegate responsibility for supervising Johnson "as to regulatory and compliance issues." Div. Br. at 34. I do not agree with the Division's argument that I should credit Pendergraft's testimony on this point. *Id.* As a preliminary matter, I found Pendergraft's testimony as it relates to who was supervising Johnson's Rule 204T/204 compliance to be the least credible testimony at the entire hearing. For context, Pendergraft disappeared to Hawaii notwithstanding the subpoena I issued commanding his attendance at the hearing in Dallas. Tr. 38-42. He was unable to return during the Division's case in chief, and his testimony had to be taken out of turn. Tr. 43-44. When he did finally take the stand, for good reason, he appeared extremely apprehensive of incriminating himself. As Johnson's supervisor, Pendergraft's answers were so cautious, self-serving, and hair-splitting that it seemed he was wording things however possible to prevent incriminating himself in any way as opposed to providing useful information. While Pendergraft denied serving as Johnson's supervisor as to regulatory and compliance issues, stating that "[s]omebody in the Penson Financial Services executive team" would have had responsibility for Johnson with respect to the Stock Loan department's regulatory compliance, he admitted that he supervised Johnson in other areas and "provided direction" to Johnson on Stock Loan issues. Tr. 1460-64.

The Division unconvincingly argues that "Yancey himself vouched for Pendergraft's credibility" by "urging the Division to take his testimony during the investigation in order to properly understand the supervisory structure over Johnson." Div. Br. at 34. However, Yancey did not vouch for Pendergraft's credibility – he urged the Division to take Pendergraft's testimony in the hope that Pendergraft would admit what nearly every other witness in this case has confirmed – that he was Johnson's supervisor. As Yancey points out, "had the Division not taken Pendergraft's testimony ***after*** Yancey had already received a Wells notice, ***after*** Pendergraft was aware of the potential charges that he could face with an admission of his role, ***after*** he had the opportunity to review the transcripts of other witnesses, and ***after*** his counsel advised him on the risks of admitting his supervision," the testimony from Pendergraft may have

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testimony that he believed Johnson reported to Son to be probative of any disputed issue. Tr. 286. For unknown reasons, the Division elected not to present Son as a witness, or to meaningfully explore, with Pendergraft, Son's duties and responsibilities, if any, with respect to Yancey.

been different. Yan. Reply at 10-11 (emphases in original). Pendergraft's testimony is also contradicted by the documentary evidence noted above, including email correspondence between Johnson and Pendergraft on regulatory and compliance issues such as Reg. SHO and FINRA examinations. Tr. 541-44; Yan. Exs. 563, 638. The Division's argument that De La Sierra's testimony is meaningful on this issue is thus unpersuasive. *See* Div. Proposed FOF Nos. 309, 312. De La Sierra testified that he did not observe interactions between Johnson and Pendergraft on compliance issues, including on Reg. SHO and Rule 204T/204. However, De La Sierra agreed that Pendergraft supervised Johnson and regardless of what he personally observed, that supervision clearly involved regulatory and compliance issues.[33] Tr. 302-03. Indeed, no one else who testified at the hearing, including Johnson, believed a division of supervisory duties had occurred. Tr. 537-38, 948, 1151-52, 1745-46, 1846; *see also* 1334-36. Poppalardo also testified that such a division of supervision over business activities and regulatory requirements would not have been common in the industry.[34] Tr. 1999.

The Division also argues that Johnson remained heavily involved in the Stock Loan department and therefore was "closely associated" with Penson even after his promotion, such that it would make sense for him to continue to be supervised by Yancey with respect to Penson-related issues. Div. Br. at 33-34. I am unconvinced, however, that his continued duties in Stock Loan would have prevented him from being fully supervised by Pendergraft with respect to those duties. McCain testified that Pendergraft routinely visited Stock Loan's offices to talk with Johnson, and it is undisputed that Pendergraft interacted with Johnson on a regular basis during the Relevant Period. Stipulated FOF No. 81; Tr. 2195. There is nothing in the record that convinces me that Pendergraft could not have supervised Johnson in his performance of Penson-related duties simply because Pendergraft was associated with the parent company. For the same reason, I do not find persuasive the Division's suggestion that because Gover and Johnson testified that the Stock Loan department reported directly to Yancey as CEO of Penson, Yancey must also have supervised Johnson. *See* Div. Proposed FOF No. 199. There is no reason to conclude that even if certain Stock Loan personnel reported up the Penson chain to Yancey, Johnson was necessarily among them.

I find that, notwithstanding the Division's characterization of the RRSM, Pendergraft's testimony, and the continuing involvement of Johnson and Yancey with the Stock Loan department, the overwhelming evidence is that Yancey effectively delegated all supervision of Johnson to Pendergraft in August 2008. The Division's contention that there was "confusion" concerning the delegation is unpersuasive. Div. Br. at 36-37. With the exception of Pendergraft's highly questionable testimony, De La Sierra's limited observation that he personally did not see Pendergraft interact with Johnson on regulatory issues, and an inaccurate matrix that was not relied on in the organization even by its author, more than half a dozen witnesses clearly understood that Yancey delegated supervision of Johnson to Pendergraft.

[33] While De La Sierra's testimony may suggest that Pendergraft's supervision of Johnson on regulatory and compliance issues could be more robust, the cited testimony does not establish that Yancey failed in his duties.

[34] The Division's expert on the issue of delegation and supervision, Paulukaitis, did not discuss the concept of dual supervision in his expert report. Tr. 476-77. He testified only that it was generally possible for a person to have more than one supervisor. Tr. 442-43.

Having observed all this testimony and reviewed the documentary evidence, I have the utmost confidence that, within Penson, this was clearly appreciated and understood by everyone.

Having found that Yancey delegated supervisory responsibility to Pendergraft, I must determine whether such delegation was reasonable. *See John B. Busacca III,* 2010 SEC LEXIS 3787, at *37. With respect to the requirement that a delegator follow up to ensure that the delegated functions are performed reasonably, follow up is adequate where the president has in-person or other meetings or communications with the delegatee, and receives no indication of wrongdoing. *See Swartwood,* 1992 WL 252184, at *5 (delegator not liable for failing to supervise when "the record does not show that, during the relevant period, [president] had the slightest indication of any irregularity in [supervisee's] activities, that any irregularity was brought to his attention, or that he had reason to believe he could not trust [delegatee] to perform his functions in a proper manner"); *Universal Heritage Invs. Corp.*, 1982 WL 525157, *2, *5 (1982) (finding no failure to supervise where president of broker-dealer delegated supervisory authority to another and "met with [delegatee] several times a month to discuss the firm's operations").

First, the parties have stipulated that Pendergraft had sufficient knowledge and experience to supervise Johnson. Stipulated FOF No. 82. Furthermore, as the preceding factual findings show, Yancey undertook consistent and robust follow up of Pendergraft's supervision of Johnson. Yancey met regularly with Pendergraft, discussed Johnson's performance with him, and monitored Pendergraft's supervision of Johnson's activities. Stipulated FOF No. 88; Tr. 1537, 1540, 1859-60. In addition, Yancey also attended weekly telephonic meetings with Pendergraft and Johnson, which allowed Yancey to receive updates regarding Johnson's activities. Tr. 948-50, 1498. I note that Pendergraft maintained a desk in Yancey's office, further opening their line of communication with respect to Johnson and other issues. Stipulated FOF No. 76; Tr. 948-49. Pendergraft himself admitted that Yancey checked in with him routinely regarding Pendergraft's communications with Johnson regarding performance, compensation, budget and spending, leave and work schedule, and other issues. Tr. 1536-37. Pendergraft also believed that Yancey acted reasonably in ensuring that Johnson and Stock Loan were properly conducting business in accordance with the securities laws. Tr. 1537. It is undisputed that Yancey had no actual knowledge of Stock Loan's Rule 204T/204 violations. Stipulated FOF No. 43. Neither did he receive any indication of wrongdoing in Johnson's activities or reason to doubt that Pendergraft was supervising him properly. *See Swartwood,* 1992 WL 252184, at *5. I therefore find that Yancey's delegation of full supervisory authority over Johnson to Pendergraft was both effective and reasonable.

Because Johnson was not subject to Yancey's supervision, Yancey cannot be liable under Exchange Act Section 15(b)(4)(E). The Division's claim against Yancey for failing reasonably to supervise Johnson also fails.[35]

[35] Because I find Yancey not liable for failing to supervise either Delaney or Johnson, I need not reach Yancey's argument that Penson had procedures in place to prevent and detect violations of laws and regulations, which appears to be an attempt to assert an affirmative defense under Exchange Act Section 15(b)(4)(E). *See* Yancey Br. at 42-47; 15 U.S.C. § 78*o*(b)(4)(E).

IV. SANCTIONS

Having found that the Division did not establish that Yancey failed to supervise Delaney and Johnson, I do not impose any sanctions as to Yancey. With respect to Delaney, I impose a cease-and-desist order and a civil penalty of $5,000 for each of the four acts and omissions I have found were a cause of Penson's violations, totaling $20,000.

A. Cease and Desist Order

Section 21C of the Exchange Act authorizes the Commission to issue a cease-and-desist order against a person who has caused the violation of any provision of the Exchange Act or rules or regulations thereunder. 15 U.S.C. § 78u-3(a). In deciding whether to issue a cease-and-desist order, I must consider: (1) whether future violations are reasonably likely; (2) the seriousness of the violations at issue; (3) whether the violations are isolated or recurrent; (4) the respondent's state of mind; (5) whether the respondent recognizes the wrongful nature of his conduct; (6) the recency of the violations; (7) whether the violations caused harm to investors or the marketplace; (8) whether the respondent will have the opportunity to commit future violations; and (9) the remedial function [a] cease-and-desist order would serve in the overall context of any other sanctions sought in the same proceeding. *Gordon Brent Pierce*, Securities Act Release No. 9555, 2014 SEC LEXIS 4544, *82-83 (Mar. 7, 2014); *Joseph John VanCook*, Exchange Act Release No. 61039, 2009 SEC LEXIS 3872, at *63 (Nov. 20, 2009), *pet. denied*, 653 F.3d 130 (2d Cir. 2011).

"Absent evidence to the contrary," a single past violation ordinarily suffices to establish a risk of future violations. *KPMG Peat Marwick LLP*, Exchange Act Release No. 43862, 2001 SEC LEXIS 98, at *102 (Jan. 19, 2001), *recon. denied*, Exchange Act Release No. 44050, 2001 SEC LEXIS 422 (Mar. 5, 2001), *pet. denied*, 289 F.3d 109 (D.C. Cir. 2002); *see id.* at *102-03 ("evidence showing that a respondent violated the law once probably also shows a risk of repetition that merits our ordering him to cease and desist"). The showing necessary to demonstrate the likelihood of future violations is "significantly less than that required for an injunction." *Id.* at *114. A determination "that a violation is egregious 'raises an inference that it will be repeated.'" *Joseph John VanCook*, 2009 SEC LEXIS 3872 at *63.

Although it was not established that any one of the Rule 204T/204 violations was particularly serious, I find that the large number of violations – at least 1,500 – associated in some way with Delaney's negligence, makes this an exponentially more serious matter than a matter in which a compliance officer's failure to exercise reasonable care resulted in only one violation. The violations were not an isolated occurrence, but recurred over time. Similarly, Delaney's conduct, over time, was a cause of the continued violations.

I acknowledge that Delaney did not intentionally or recklessly cause the violations. However, his conduct was negligent, and having a cease-and-desist order in place, as a continuing reminder to follow the standard of care, seems reasonable. Had Delaney acknowledged his failure to follow the standard of care in relevant respects, apologized, and expressed remorse, it would have militated against the need for such an order. Although in some instances Delaney, through counsel, has indicated that Delaney, "could be . . . negligent," that falls short of acceptance of responsibility. *See* Del. Br. at 35.

Delaney's conduct is comparatively recent. The negligence and the related Rule 204T/204 violations took place over a two-and-a-half-year period that did not end until early 2011. Only a few years have elapsed since this period.

While Delaney's negligence and the related Rule 204T/204 violations did not directly harm investors, and a specific harm to the marketplace was not quantified, Delaney's expert witness, Sirri, acknowledged that in adopting Rule 204T/204

> [t]he Commission was concerned about the harmful effects on the markets of failing to deliver securities. Failing to deliver a share converts ownership of a security into a forward contract, causing the buyer (or a clearing agency) to be exposed to the credit risk of the seller. It can also create problems with respect to the voting of shares as a buyer might not be in possession of the security at the required time and thus would lose the ability to vote.

Tr. 1678-79; Div. Ex. 260 at 2, 9. Thus, while it may be difficult to quantify the extent of the harm, Rule 204T/204 was designed to protect the marketplace, and failures to deliver securities in violation of the rule do harm, or potentially harm, the marketplace.

Delaney may have the opportunity to commit future violations because he continues to work as a securities compliance official, holds select securities licenses, and will likely work in the industry for the foreseeable future. *See* Stipulated FOF No. 1. Delaney did not explain his assertion that "the prospect that Mr. Delaney could cause future violations is non-existent," Del. Br. at 47, but I take it to mean that his current firm does not engage in securities lending, so Rule 204 is not at issue. But, that is merely his current employer and he could easily work somewhere else where Rule 204 compliance is as much or more important than it was at Penson.

While Delaney correctly contends that a cease-and-desist order is not automatic,[36] in light of each of the preceding factors, and because the other means to remedy or sanction Delaney's conduct are relatively limited, I find that the actual effect on Delaney, and deterrent effect on other potential violators, of this order would best serve the public interest.

B. <u>Bar</u>

Exchange Act Section 15(b)(6)(A)(i) authorizes the Commission to impose an associational bar on a respondent associated with a broker or dealer, who has willfully aided and abetted the violation of the securities laws, if it is in the public interest. 15 U.S.C. §§

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[36] *KPMG Peat Marwick LLP*, 2001 SEC LEXIS 422, at *20-22; *WHX Corp. v. SEC*, 362 F. 3d 854, 859 (D.C. Cir. 2004).

78o(b)(6)(A)(i), 78*o*(b)(4)(E). Having found that Delaney did not willfully aid and abet Penson's violations of Rule 204T/204, I am without authority to impose a bar on Delaney.[37]

C. **Civil Penalty**

Exchange Act Section 21B(a)(1)(B) authorizes the Commission to impose a civil money penalty in a case instituted under Exchange Act Section 15(b) if a respondent has willfully aided and abetted a violation of the securities laws. *See* 15 U.S.C. § 78u-2(a)(1)(B). Exchange Act Section 21B(a)(2)(B) authorizes the Commission to impose a civil money penalty in a case instituted under Exchange Act Section 21C if a respondent caused the violation of a regulation issued under the Exchange Act. *See* 15 U.S.C. § 78u-2(a)(2)(B). Six factors may be considered in determining whether a penalty is in the public interest. These include: (1) whether the violation involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement; (2) the resulting harm to other persons; (3) any unjust enrichment and prior restitution; (4) the respondent's prior regulatory record; (5) the need to deter the respondent and other persons; and (6) such other matters as justice may require. 15 U.S.C. § 78u-2(c).

Because I have found that Delaney did not willfully aid and abet a violation of the securities laws, I am without authority to impose a civil penalty on Delaney under Exchange Act Section 21B(a)(1)(B). I have authority, however, to impose civil penalties on Delaney under Exchange Act Section 21B(a)(2)(B),[38] given my finding that he caused Penson's violations of Rule 204T/204.

I find that imposing a civil penalty against Delaney under 15 U.S.C. § 78u-2(a)(2)(B) is in the public interest. Delaney's negligence did not involve fraud, deceit, manipulation, or deliberate disregard of a regulatory requirement. As a result, the maximum penalty that may be imposed for each act or omission causing the violation is $6,500 for violations occurring after February 14, 2005, and $7,500 for violations occurring after March 3, 2009. 15 U.S.C. § 78u-2(b)(1)-(3); 17 CFR §§ 201.1003, .1004 (adjusting the statutory amounts for inflation). Within any particular tier, the Commission has discretion to set the amount of the penalty. *See Brendan E. Murray*, Advisers Act Release No. 2809 2008 SEC LEXIS 2924, at *42 (Nov. 21, 2008); *The Rockies Fund, Inc.*, Exchange Act Release No. 54892 2006 SEC LEXIS 2846, at *25 (Dec. 7, 2006). "[E]ach case has its own particular facts and circumstances which determine the appropriate penalty to be imposed" within the tier. *SEC v. Murray*, No. OS-CV-4643 (MKB), 2013 WL 839840, at *3 (E.D.N.Y. Mar. 6, 2013) (quotation omitted); *see also SEC v. Kern*, 425 F.3d 143, 153 (2d Cir. 2005).

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[37] The OIP also authorized the imposition of penalties under Section 9(b) of the Investment Company Act of 1940. OIP at 17. Because the Division not seek any penalties under this provision, I do not consider it here.

[38] That section provides that "[i]n any proceeding instituted under section 21C against any person, the Commission may impose a civil penalty, if the Commission finds, on the record after notice and opportunity for hearing, that such person . . . (B) is or was a cause of the violation of any provision of [the Exchange Act], or any rule or regulation issued under [the Exchange Act]."

The Division did not show how investors were directly harmed by Delaney's negligence. The general harm to the marketplace of Rule 204T/204 violations is discussed above. As a cause of Penson's violations, Delaney's negligence harmed other individuals at that organization, like Yancey, who would have been far better off in the absence of such violations. In addition, while Delaney was not unjustly enriched, Penson was to the tune of $59,000 from its rule violations. Delaney has not previously been found to have violated securities laws or rules, and notwithstanding his negligence, he appears to be a person of good character. However, given that I have found that his negligence was a cause of at least 1,500 violations, there is a need to deter him, and others like him, from such failures in the future. The cease-and-desist order, alone, would lack a sufficient deterrent function, and thus, some civil penalty is appropriate to satisfy the public interest in ensuring that Delaney and others comply with the appropriate standard of care and do not cause such violations in the future. Based on the foregoing factors, I have determined that a first-tier civil penalty of $5,000 for each of the four violations I have found – totaling $20,000 – is warranted to punish Delaney's negligence with respect to Penson's Rule 204T/204 compliance.

D. <u>Disgorgement</u>

Exchange Act Section 21B authorizes the Commission to order disgorgement in any proceeding in which a penalty may be imposed. *See* 15 U.S.C. § 78u-2(e). Disgorgement is equitable in nature and is intended to prevent unjust enrichment and to act as a deterrent. *SEC v. First City Fin. Corp.*, 890 F.2d 1215, 1230 (D.C. Cir. 1989).

The Division correctly contends that "disgorgement need only be a reasonable approximation of the profits *causally connected* to the violation." Div. Br. at 49; *Montford and Co., Inc.*, Advisers Act Release No. 3829, 2014 SEC LEXIS 1529, *94 (May 2, 2014) (citing *SEC v. Patel*, 61 F.3d 137, 139 (2d Cir. 1995)) (emphasis added). At that point, "the burden shifts to the respondent to show that the amount of disgorgement is not a reasonable approximation." *Id.* It is thus the case that "[t]he risk of uncertainty in calculating disgorgement . . . fall[s] on the wrongdoer whose illegal conduct created that uncertainty." *Id.*

I have opted not to order disgorgement in this case, because the amount at issue is negligible. The Division contends, in effect, that Delaney must pay back the portion of his $40,000 in bonuses during the relevant time period that arose from the Rule 204T/204 violations. The quantified benefit of the violations, $59,000, is approximately 0.008 percent of Penson's revenue during that period. *See* Stipulated FOF Nos. 53, 80 (reflecting the parties' agreement that the violations accounted for .08 percent of the Stock Loan department's revenue during the pertinent period); Tr. 2164 (the Stock Loan department's revenue represented seven to ten percent of Penson's revenue). Even if all of Delaney's bonuses were based on Penson's performance (which, they are not, since the parties seem to be in general agreement that such performance was only one of three factors in bonuses), based on the preceding figures, the percentage of Delaney's bonuses tied directly to the quantifiable benefit of Rule 204T/204 violations (0.008 percent of $40,000) is three dollars and twenty cents. Even accounting for prejudgment interest, a disgorgement order is unwarranted.

V. RECORD CERTIFICATION

Pursuant to Rule of Practice 351(b), 17 C.F.R. § 201.351(b), I certify that the record includes the items set forth in the Revised Record Index issued by the Secretary of the Commission on February 24, 2015.

VI. ORDER

I ORDER that, pursuant to Section 21C of the Securities Exchange Act of 1934, Thomas R. Delaney II shall CEASE AND DESIST from causing any violations or future violations of Rule 204(a) of Regulation SHO.

I FURTHER ORDER that, pursuant to Section 21B of the Securities Exchange Act of 1934, Thomas R. Delaney II shall PAY A CIVIL MONEY PENALTY in the amount of $20,000.

I FURTHER ORDER that the proceeding against Charles W. Yancey is DISMISSED.

Payment of civil penalties shall be made no later than twenty-one days following the day this Initial Decision becomes final, unless the Commission directs otherwise. Payment shall be made in one of the following ways: (1) transmitted electronically to the Commission, which will provide detailed ACH transfer/Fedwire instructions upon request; (2) direct payments from a bank account via Pay.gov through the SEC website at http://www.sec.gov/about/offices/ofm.htm; or (3) by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order, payable to the Securities and Exchange Commission.

Any payment by certified check, United States postal money order, bank cashier's check, wire transfer, or bank money order shall include a cover letter identifying the Respondent and Administrative Proceeding No. 3-15613, and shall be delivered to: Enterprises Services Center, Accounts Receivable Branch, HQ Bldg., Room 181, AMZ-341, 6500 South MacArthur Bld., Oklahoma City, Oklahoma 73169. A copy of the cover letter and instrument of payment shall be sent to the Commission's Division of Enforcement, directed to the attention of counsel of record.

This Initial Decision shall become effective in accordance with and subject to the provisions of Rule of Practice 360, 17 C.F.R. § 201.360. Pursuant to that Rule, a party may file a petition for review of this Initial Decision within twenty-one days after service of the Initial Decision. A party may also file a motion to correct a manifest error of fact within ten days of the Initial Decision, pursuant to Rule of Practice 111, 17 C.F.R. § 201.111. If a motion to correct a manifest error of fact is filed by a party, then that party shall have twenty-one days to file a petition for review from the date of the undersigned's order resolving such motion to correct a manifest error of fact. The Initial Decision will not become final until the Commission enters an order of finality. The Commission will enter an order of finality unless a party files a petition for review or motion to correct a manifest error of fact or the Commission determines on its own initiative to review the Initial Decision as to a party. If any of these events occur, the Initial Decision shall not become final as to that party.

Jason S. Patil
Administrative Law Judge