BEFORE THE SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Application of LEK SECURITIES CORPORATION, For Review of Action Taken by FINRA	Admin. Proc. File No. 3-17677

LEK SECURITIES CORPORATION'S

APPEAL OF FINRA DECISION

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I. Request for Relief

Lek Securities Corp. ("LSC") appeals the decision of the National Adjudicatory Council ("NAC") dated October 11, 2016 in FINRA Complaint No. 2009020941801. The NAC found that LSC had inadequate anti-money laundering ("AML") policies, procedures and controls and therefore imposed a fine of $100,000. The Commission should reverse the NAC's decision because the evidence – not the unfounded assumptions and incomplete analysis by FINRA's Department of Enforcement ("Enforcement") – demonstrates that the AML policies were robust and that LSC's employees understood them and acted in accordance with them. Indeed, Enforcement repeatedly stipulated that, contrary to its original allegations that prompted the filing of the Complaint, it could not prove the existence of a single manipulative trade that LSC failed to detect or prevent or a single instance where LSC failed to file a necessary suspicious activity report ("SAR"). Accordingly, the Commission should reverse the NAC's decision.

Moreover, even if one were to erroneously conclude that LSC's AML policies were not reasonable, the $100,000 fine should be set aside because it is impermissibly punitive and not reflective of numerous mitigating factors.

II. Relevant Entities

LSC is a small, registered broker-dealer that primarily provides trade execution and clearing services. During the relevant time period, which was January 2008 to October 2010, LSC had approximately 20 employees, nearly all of whom worked in its New York headquarters and were seated closely together in a single room. Samuel Lek is the Chief Executive Officer, Chief Compliance Officer and AML Officer. Caitlin Farrell-Starbuck was the other compliance professional. Together, Mr. Lek and Ms. Farrell-Starbuck handled all of LSC's compliance functions, including AML compliance.

Dimension Securities ("Dimension") was a registered broker-dealer that routed its own customers' orders to LSC for execution and clearing, meaning that Dimension acted as an introducing broker. During the review period, Dimension was LSC's largest customer. Dimension Trading International LP ("DTI") was Dimension's primary customer and conducted the trading at issue in this matter through various subaccounts.[1] DTI's traders utilized day trading strategies, meaning they traded small amounts of liquid stocks throughout the day but generally did not carry overnight positions. Examples of these day trading strategies include making two-sided markets and filling in liquidity gaps. No regulators have filed any charges against Dimension or DTI concerning the conduct at issue in this case.

III. Standard of Review and Relevant FINRA Rules

When a broker-dealer appeals the disciplinary findings of a self-regulatory origination ("SRO"), the Commission conducts an independent review of the record.[2] The Commission must overturn the decision if a preponderance of the evidence does not support the SRO's findings.[3] Even if the Commission affirms the factual findings of the SRO, it may reduce or cancel the sanctions imposed by the SRO.[4]

FINRA Rule 3310 requires each member to "develop and implement a written anti-money laundering program reasonably designed to achieve and monitor the member's compliance with the requirements of the Bank Secrecy Act . . . ."[5] That rule further provides that the AML program shall include "policies and procedures that can be reasonably expected to

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1 A subaccount is a mechanism for a customer to separate traders or trading strategies to enable the customer to better monitor performance of those traders or trading strategies. A single customer may have multiple traders, each with its own subaccount.

2 *In re Lane & Lane*, Exchange Act Rel. No. 74269, 2015 WL 627346, at *5 (S.E.C. Feb. 13, 2015), *In re Cespedes*, Exchange Act Rel. No. 59404, 2009 WL 367026, at *6 (S.E.C. Feb. 13, 2009).

3 *In re Lane & Lane*, 2015 WL 627346, at *5; *In re Cespedes*, 2009 WL 367026, at *6 & n. 11.

4 15 U.S.C. § 78s(e)(2).

5 FINRA Rule 3310 superseded NASD Rule 3011 on January 1, 2010. NASD Rule 3011 contains the same language quoted here.

detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder[.]" There is no one-size fits all approach for complying with these requirements[6] – what is advisable for a large, multi-tiered and geographically dispersed broker-dealer may not be practical or appropriate for a broker-dealer with a handful of employees who sit together in the same room.

A broker-dealer should file a SAR if it identifies customer transactions that constitute, among other things, market manipulation, prearranged or other noncompetitive trading, or wash (or other fictitious) trading or that have no business or apparent lawful purpose.[7] Enforcement itself essentially affirmed the effectiveness of LSC's AML program by its repeated concessions that there was not a single instance of money laundering or a manipulative transaction in the conduct subject to this action.[8] Nor does Enforcement contend that LSC failed to file any necessary SARs.[9]

IV. Introduction

Enforcement began this litigation by claiming that LSC had failed to detect and prevent thousands of manipulative trades that DTI had placed through LSC.[10] As the litigation progressed, however, Enforcement had to ultimately abandon this contention and acknowledge that it could not identify any manipulative trades that had been placed through LSC.[11] Nor has Enforcement alleged that LSC failed to file any required SARs. Instead, Enforcement was left

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6 FINRA Rule 3310(a).

7 *See* FINRA004389 (Ex. CX-28) at Item 30 (listing types of suspicious activity); FINRA004395 (Ex. CX-29) (instructions for completing same).

8 *See, e.g.*, FINRA002718:11-14 ("We will stipulate we have no evidence that we're presenting at this hearing that any trade at issue here was in fact manipulative."); FINRA002849:12-14; FINRA002851:10-13.

9 *See* FINRA002913.

10 *See, e.g.*, FINRA00001, (Complaint) ¶¶ 17 ("This enabled traders of the subaccounts to enter wash trades and other potentially manipulative trades that went undetected by LSC."); 24 (FINRA "advised the firm on multiple occasions of four separate and distinct types of market manipulation in the DTI . . . including wash sales, pre-market canceled orders, marking the close, and improper odd lot trading."); 31 (LSC "fail[ed] to detect and act upon thousands of wash trades within the DTI subaccounts.").

11 *See, e.g.*, FINRA002718:11-14.

clinging to the flimsy theory that LSC's AML policies and procedures were not sufficient to surveil for potentially manipulative trading with respect to three types of trading by DTI: wash sales, marking the close, and pre-market cancelations. The Hearing Panel and the NAC rejected Enforcement's contentions that DTI's trading presented wash sale or marking the close concerns and expressed potential concern about a single set of pre-market cancelations in a very liquid stock which were incapable of artificially impacting the opening price of the stock.[12] With the absence of a single manipulative trade for a nearly three-year period during which LSC handled over 120 million trades, and which Enforcement then investigated for more than additional three years, the inescapable conclusion is that LSC had an effective AML system.

In trying to enable Enforcement to save some face from this deeply flawed prosecution, the NAC: (i) ignored a plethora of uncontroverted evidence demonstrating the reasonableness and effectiveness of LSC's AML policies and procedures; (ii) took excerpts of trial testimony grossly out of context, thereby creating a materially misleading impression of the evidence; and (iii) applied inconsistent reasoning in reaching its conclusions. The Commission should not condone this abuse of the regulatory process.

V. Background

As a very small broker-dealer, LSC consciously established a compliance regime in which there were could be no gaps between trade reviews for general compliance purposes and AML purposes. The same two individuals, Mr. Lek and Ms. Farrell-Starbuck, handled all compliance issues, including AML issues such as evaluating whether to file SARs. As LSC consisted of approximately 20 employees during the relevant time period, that equated to 20% of its personnel being dedicated to compliance activities.

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[12] The Hearing Panel also correctly dismissed Enforcement's cause of action against LSC and Mr. Lek alleging violations of FINRA's portfolio margining rules. That issue is not a part of this appeal.

After doing an exhaustive review that spanned a nearly three-year review period encompassing approximately 120 million trades,[13] followed by an investigation of more than three years,[14] Enforcement did not contend that LSC failed to file any necessary SARs or that LSC's compliance personnel did not understand how to review and analyze trades for SAR filing purposes. With the Hearing Panel and the NAC largely rejecting Enforcement's trade-based arguments, the only sensible conclusion is that LSC's AML policies and procedures were effective.

Concluding otherwise would require believing that out of the approximately 120 million trades during the review period, LSC was simply lucky that none of those trades were manipulative and that it filed all required SARs. Instead, a reasoned analysis of the evidence and a refusal to accept Enforcement's unsupported speculation leads to the conclusion that LSC's AML program was effective.[15] Accordingly, the Commission should reverse the NAC's decision.

VI. LSC's AML Policies and Procedures Were Clearly Set Forth in the Written Supervisory Procedures and an Additional AML Manual

The relevant policies are contained in two documents: the written supervisory procedures ("WSPs") that address the entirety of the firm's operations, including prohibited securities transactions and AML issues, and an additional manual that further expands on various AML issues. The case against LSC is built upon the faulty premise that the additional AML manual

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13 *See* Complaint ¶¶ 3, 18.

14 FINRA007940, FINRA007942. (FINRA began its investigation in December 2009 and filed a complaint after the completion of its investigation on February 25, 2013).

15 Enforcement's views of what is indicative of potential manipulation are hardly credible. Enforcement had to backtrack its allegations of actual manipulation which were the allegations that certainly prompted the commencement of this litigation in the first instance. Enforcement apparently was unable to find an expert to support its theories about trades raising wash sale and marking the close concerns and the Hearing Panel rejected their flawed analysis. This was a misguided litigation from the start.

and WSPs must be construed in complete isolation of each other. As explained below, that reasoning makes no sense.

Because of the importance of AML, LSC created an additional manual that expanded upon various aspects of the AML portions of the WSPs. Those expanded topics were largely related to monetary movements.[16] According to the NAC, LSC's utilization of an additional AML manual that was primarily focused on money movements means that LSC did not consider the need to file SARs for potentially manipulative trading.[17] That is demonstrably false and utterly devoid of any evidentiary support.

The additional AML manual made abundantly clear that securities trading is an important aspect of the firm's overall AML program. To be sure, the additional AML manual explains that customer transactions are to be monitored "on an ongoing basis with respect to *any* questionable practice, high risk characteristic or suspicious activity."[18] (emphasis added). The additional AML manual explicitly states that securities trading is one of the activities to monitor for suspicious activity.[19] It explains that suspicious activities include "a transaction that has no business or apparent lawful purpose, or . . . where the Firm has no reasonable explanation for the transaction."[20] That necessarily includes potentially manipulative trading activity. And when such activity may have occurred, the additional AML manual requires that "[a]ny employee who becomes aware of suspicious activity (as defined above), or believes such activity may have

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16 LSC does not allow third-party transfers of money or securities into or out of the firm even though such transfers are legally permissible. FINRA003329:3-16. Nor does LSC accept cash or negotiable instruments. *Id.* at 20-23; FINRA003906-7 (Ex. CX-5); FINRA003936, FINRA003964 (Ex. CX-6).. LSC finds more important the added AML protection these practices provide despite the customer inconvenience it causes. FINRA003329:17-23. LSC's AML expert was not aware of a more conservative position in the industry. FINRA003542:20-23.

17 FINRA007938; FINRA007949.

18 FINRA003910 (Ex. CX-5); FINRA003940, FINRA003968 (Ex. CX-6).

19 FINRA003910-11 (Ex. CX-5); FINRA003940, FINRA003968 (Ex. CX-6).

20 FINRA003912 (Ex. CX-5); FINRA003942, FINRA003970 (Ex. CX-6).

occurred, must report such activity to the AML Officer/Compliance Department *immediately*."[21] (emphasis in original).

The plain language of the additional AML manual unquestionably conveys to LSC employees that securities trading can have AML implications and that any potentially illegal trading or trading without an apparent legitimate business purpose must be immediately reported to Compliance. The AML manual also explains the process for filing SARs. The NAC's conclusion that there was no connection between suspicious trade activity and the filing of SARs is false.

LSC also maintains an extensive set of WSPs.[22] Contrary to the suggestion by the NAC and Enforcement, the WSPs address AML issues. For example, like the additional AML manual, the WSPs describe the triggers that Compliance should use for filing SARs, including for transactions that have no business or apparent lawful purpose or have no reasonable explanation after examining the facts.[23] The WSPs also address numerous types of prohibited trading with more specificity than the additional AML manual. For example, the WSPs contain a lengthy list of prohibited securities transactions, including wash trades, prearranged trades, front running, parking and marking the close, which are many of the types of trades that a broker-dealer should be attempting to detect for SAR reporting purposes.[24]

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21 FINRA003912 (Ex. CX-5); FINRA003942, FINRA003970 (Ex. CX-6).

22 FINRA004921 (Ex. RX-505) (version 8 of LSC's WSPs); FINRA005349 (Ex. RX-506) (version IX of LSC's WSPs).

23 *See e.g.*, FINRA004955, FINRA004958, FINRA005024 – 25 (Ex. RX-505); FINRA005383 – 88, FINRA005454 – 56 (Ex. RX-506).

24 FINRA005121 – 24 (Ex. RX-505); FINRA005556 – 59 (Ex. RX-506).

VII. The WSPs and the Additional AML Manual Both Directed Employees to Escalate All Trading Questions to Compliance, Which Reviewed Trades for All Purposes, Including AML

There is a natural overlap between general securities trading compliance and AML compliance with respect to detecting and preventing the types of prohibited trades described in the WSPs. Importantly for purposes of this matter, the WSPs direct employees to contact Compliance if they suspect the existence of any of these prohibited activities.[25] Those Compliance personnel are also responsible for AML compliance, meaning that they are fully aware of the need to review trades for potential SAR reporting purposes.

For inexplicable reasons, however, the NAC held that the WSPs were deficient because they did not direct employees also to consult the additional AML manual after identifying a potentially prohibited transaction.[26] That reasoning ignores the reality that the instruction in both manuals is the same – immediately notify Mr. Lek or Ms. Farrell-Starbuck of the transaction so they can assess whether further action is required. There would be nothing substantive gained from a control standpoint for the WSPs to tell employees to notify Compliance of the suspicious trades and to then consult the additional AML manual so they can read that they must bring the trades to the attention of the same people for review.

To keep the reporting simple and effective, employees outside of Compliance were not required to struggle with whether the potentially suspicious trades raised AML concerns, securities law concerns, or both. That was up to Compliance, which then evaluated the trades with, among other things, SAR reporting requirements in mind. LSC is not a large, dispersed and compartmentalized organization where different subgroups within Compliance handle distinct issues, such that various employee manuals would be needed to spell out in granular

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25 FINRA005122 (Ex. RX-505); FINRA005556 (Ex. RX-506).

26 FINRA007948.

detail which people need to be made aware of particular types of trade activity. Instead, all questions about trade activity are funneled to the same place. As Compliance handled all trading reviews for all purposes, including AML and SAR reporting purposes, there was no gap where questionable trades were not assessed for AML compliance.

VIII. There is no Dispute that LSC Trained Its Employees on How to Identify and Respond to Suspicious Trading Activity

In addition to having clear written directives, LSC further trained its personnel on what constituted suspicious activity and how to respond to such activity.[27] Enforcement acknowledges that it does not take issue with the AML training that LSC provided.[28] As the AML training began prior to, and continued though, the review period, there is no dispute that LSC personnel were taught how to identify and respond to potentially suspicious trading activity during the entirety of the relevant time period. Indeed, LSC presented undisputed testimony that, in accordance with the WSPs and the additional AML manual, LSC personnel regularly brought securities transactions to the attention of Mr. Lek and Ms. Farrell-Starbuck for their review.[29] As Mr. Lek and Ms. Farrell-Starbuck explained, they reviewed all such trades for all compliance purposes, including AML purposes.[30] All of the evidence presented at the hearing corroborated the conclusion that employees knew and acted in accordance with the WSPs and additional AML manual, which is sufficient reason for reversing the decision.[31]

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27 FINRA003916 (Ex. CX-5) (mandatory AML training seminars include how to identify suspicious activities and what to do when suspicious activities are identified); FINRA003946 (Ex. CX-6).

28 FINRA003293-94.

29 FINRA002242; FINRA002407-08.

30 *Id.*

31 *Dep't of Enforcement v. Sterne, Agee & Leach, Inc.*, OHO Dec. No. E052005007501, 2010 WL 3598592, at *15 (O.H.O. March 5, 2010) (in dismissing the case, the Hearing Panel noted that Enforcement did not show that employees "had any difficulty in understanding what would constitute a red flag that should be brought to the attention of their supervisors or the AML compliance officer.").

If employees had contrary information, Enforcement could have compelled them to testify at the hearing (or during the three-year investigation) but there were no such witnesses. The inescapable conclusion is that Enforcement did not provide any contrary evidence because there is no such evidence.

In an attempt to justify its incorrect conclusions, the NAC held that LSC did not review trading with AML in mind.[32] The NAC based this conclusion on Enforcement and the initial Hearing Panel taking an excerpt of Ms. Farrell-Starbuck's testimony grossly out of context. When asked whether anyone at LSC was "monitoring trading activity for AML purposes[,]" Ms. Farrell-Starbuck responded, "Not specific to AML, no."[33] Enforcement and the Hearing Panel touted this statement as being tantamount to some sort of admission that trades were not reviewed with AML considerations in mind.[34] That is a complete mischaracterization of her testimony. Ms. Farrell-Starbuck was merely acknowledging that LSC did not have compliance personnel dedicated solely to AML issues. Mr. Lek and Ms. Farrell-Starbuck reviewed potentially suspicious trades for all compliance purposes, including SAR reporting obligations. Indeed, on the very same page of her testimony, Ms. Farrell-Starbuck noted that the WSPs identified prohibited transactions and trading that would warrant escalation, "and that was part of our overall compliance program. AML was part of our compliance program."[35] Ms. Farrell-Starbuck's entire answer conclusively refutes the NAC's position. Not considering the totality of her answer is an egregious effort to create a misleading impression of that testimony.

In sum: (i) the WSPs and the additional AML manual instructed employees on what to do if they observed potentially suspicious trading activity; (ii) LSC further trained its personnel

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32 FINRA007939.
33 FINRA007473 (citing FINRA002052:8-10).
34 FINRA007473; FINRA007939.
35 FINRA002052.

on how to identify suspicious activities and what to do when such trading is identified; (iii) employees understood their responsibilities as evidenced by the uncontroverted testimony that they regularly brought trades to the attention of Compliance for reviews; (iv) both documents provided guidance on the considerations and processes for filing SARs; and (v) when Compliance reviewed trades, it did so for AML purposes. The logic of these conclusions is buttressed by the lack of any allegations of LSC (i) executing or clearing any allegedly manipulative or otherwise illegal trades; (ii) not filing any necessary SARs; or (iii) not properly training its employees on AML issues.

IX. LSC's Policies Provided Guidance With Respect to Trade Reviews

The NAC held that LSC's AML policies were deficient because they did not explain the details about how transactions should be reviewed.[36] To the contrary, the additional AML manual explains that Compliance will gather relevant information to enable it to evaluate potentially suspicious activity.[37] Similarly, the WSPs explained that employees were required to refer any suspicious activity to the AML Compliance Officer, who was responsible for reviewing potential suspicious activity and determining whether to file a SAR.[38] Imposing a requirement to include more granular detail in the written procedures has been flatly rejected as "operational detail that [is] unnecessary for the written AML procedures."[39] This is especially true in circumstances like this where Enforcement has not proven (or even attempted to prove) that employees "had any difficulty in understanding what would constitute a red flag that should be brought to the attention of their supervisors or the AML compliance officer."[40] There is not a

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36 FINRA007939.
37 FINRA003896 (Ex. CX-5); FINRA003928 (Ex. CX-6).
38 FINRA004958.
39 *Sterne, Agee & Leach*, 2010 WL 3598592, at * 15.
40 *Id.*

shred of evidence that any employees failed to properly elevate a trade for additional Compliance review.

Moreover, the manner in which Compliance analyzes a given set of trades will necessarily depend on the circumstances. Trying to map out every potential permutation in a manual is neither practical nor required. In fact, flexibility is needed and should be encouraged. Compliance needs the ability to consider factors based on an ever-changing set of circumstances. Limiting the manner of their review to specific approaches set forth in a manual does not achieve greater investor protection. Instead, that approach actually creates the opposite effect by risking the establishment of an environment in which reviewers will limit their analysis to the specifics of what is on the piece of paper. A principles-based approach is more effective than having reviewers put on blinders to marry their review process to the specific limited steps in whatever the current version of a manual may be.

In the context of a case like this, where there is no longer any contention that any of the approximately 120 million trades over a nearly three-year time period, and that were the subject of an additional three-year investigation, were manipulative or that LSC's reviews missed something suspicious for which a SAR should have been filed, there is no practical basis for concluding that LSC's policies did not provide sufficient direction on what to do when reviewing trades.

X. Enforcement's Expert Supports the Conclusion that the Collective Substance of the WSPs and the Additional AML Manual Satisfied Regulatory Requirements

The NAC held that the WSPs and the additional AML manual were not tailored to LSC's business because LSC purchased the WSPs from a vendor without making significant changes, and only two of the forty-five red flags in the additional AML manual related to securities

trading.[41] Of course, it is not only legal, but quite common, for small broker-dealers to use vendors for constructing their manuals. And in doing so, firms must pick from among a panoply of various components as to what to include in their own manual. They make that decision based upon which of those components best fits with their business. So, by definition, there is tailoring happening in the initial construction of the form of the manual. And then the firm makes any additional adjustments that are necessary. LSC, indeed, made such additional adjustments. The fact that Mr. Lek made one characterization about the type of changes to the vendor's work product as not being significant, that does not equate to the AML procedures being unreasonable.[42] Similarly, the NAC's criticism of the additional AML manual's red flags not containing additional securities trading-related red flags ignores the fact that the WSPs contained more extensive information about prohibited securities transactions.

There is no rule specifying how much tailoring is required when utilizing policies that are purchased from a vendor or derived from a template constructed by knowledgeable people. After all, it is the substance that should matter and not an artificial number of changes. The two cases the NAC cites where the broker-dealer did not tailor its policies and procedures involved situations where the respondents made no changes at all to the templates.[43] With respect to *Dimension*, that firm not only made no changes, but the firm actually stated in its manual that many of the AML red flags it was including had no relationship to its business yet did not even identify which of those red flags were inapplicable. Here, by contrast, there is no dispute that LSC made changes to the WSPs and to the small firm template that was included in the additional AML manual, thereby reflecting thought and analysis as to what was changes were necessary to make those documents reflective of LSC's business. Whether the changes were

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41 FINRA007938, FINRA007945 n. 10, FINRA007946.
42 FINRA007938.
43 FINRA007946.

"significant" or numerous is of no particular moment as it is the substance of the final documents that matters.

Indeed, Enforcement's own expert undermines any attempt to conclude that the collective substance of the two manuals was deficient. Specifically, Ms. Fox opined that her concerns about LSC's AML policies could have been addressed if the additional AML manual simply cross-referenced the prohibited transactions section of the WSPs.[44] In other words, the reasonableness of LSC's AML policies comes down to whether LSC's additional AML manual should have cross-referenced the prohibited transaction section of the WSPs. This is the epitome of elevating form over substance.

XI. LSC Enhanced Its Trade Surveillance as Trading Speeds Increased

The NAC also found fault with LSC's AML policies because they did not specifically address the high-speed trading environment at the firm.[45] That argument is a red herring. Potentially manipulative trading, like the types of trades set forth in the prohibited transactions section of the WSPs, are not a function of trade speed. For example, analyzing whether trades raise improper wash sale issues is not dependent on the speed at which the trades were made. The same is true for canceling orders prior to the market open as well as for analyzing whether a trader was trying to mark the close. The NAC's criticism was no more than a conclusory statement without any factual foundation designed to manufacture supposed support for the desired outcome.

Furthermore, the conclusion that LSC did nothing from a compliance perspective in light of the high-speed trading by some customers is wrong and inconsistent with the evidence in the record. Indeed, Mr. Lek testified without contradiction that he created and implemented an

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44 FINRA002890-91.
45 FINRA007946.

exception report designed to detect potential wash trades as a direct result of observing customer trades on opposite sides of the market being executed within one second of each other.[46] The process was difficult and imperfect as LSC did not have information reflecting the contra-parties on trades (which would show if orders for the same customer actually crossed).[47] Mr. Lek asked various exchanges for that information but his requests were denied.[48] Nevertheless, Mr. Lek proceeded to use the information available to LSC to design a program that essentially recreated the trading book for a particular customer (at either the master account or subaccount level) by sequencing orders in a manner that showed where an order had the potential to interact with another open order from the same customer.[49] These steps demonstrate significant efforts to enhance surveillance techniques as a result of the increased speed of customer trading.

XII. LSC Used Automated Exception Reports as Part of Its Trade Surveillance

The Hearing Panel found LSC's trade surveillance unreasonable because of the faulty conclusion that LSC used a completely manual approach prior to the summer of 2009 and then was only semi-automated after that point, suggesting that trade reviews consisted of little more than mindlessly staring at a computer screen.[50] The notion that LSC did not utilize any type of automated reviews prior to the middle of 2009 is incorrect. For example, Exhibit RX-501 identifies over 70 electronic exception reports that were already in existence and operational by July 2009, and therefore were already in use long before that date.

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46 FINRA007373; FINRA003374:17-23.

47 FINRA003376:24 - FINRA00338:6. Available information about execution times was of limited value because those times were rounded to the nearest second. As orders often are placed and executed within milliseconds, a buy and sell at the same price at what was listed as the same time did not mean that the orders actually crossed. FINRA003141:23-FINRA003142:9, FINRA003347:20-FINRA003348:19.

48 FINRA003374:17 - FINRA003375:3.

49 FINRA003375:4-20.

50 FINRA007497.

A. The Opinion of Enforcement's AML Expert is not Reliable Because She did not Review LSC's Numerous Exception Reports

Enforcement's AML expert, Aaron Fox, did not review a single one of LSC's numerous types of electronic exception reports.[51] She rationalized not reviewing any of those exception reports because Enforcement did not identify them as being part of LSC's overall AML program even though she acknowledged that an exception report need not be listed in the AML manual to be considered part of the overall AML program.[52] Ms. Fox's opinion did not consider that important, highly relevant information that LSC used to help detect and prevent potentially manipulative trades, which are the very types of trades that LSC would evaluate for AML and SAR reporting purposes. Although the NAC ignored this glaring hole in Enforcement's case, the Commission should not.

B. LSC's Use of Technology-Assisted Manual Review Provided an Additional Layer of Trade Surveillance

While LSC is a technology-driven firm, it recognizes that effective surveillance should not be limited to automated computer programs. Having experienced personnel observe and analyze trading activity is critical to flagging potentially suspicious trading that may be conducted outside the parameters of any given exception report.[53] Instead of embracing this logical and proactive approach, the NAC derides it and inaccurately characterizes this additional layer of surveillance as people mindlessly staring at a computer screen while trading information flashes by.[54]

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51 FINRA002840; FINRA002865; FINRA002880 - 88; FINRA004201 (Ex. CX-14); FINRA006089 (Ex. RX-541); FINRA004917 (Ex. RX-501).

52 FINRA002862; FINRA002888.

53 FINRA003510 ("No matter how many reports you have, paying attention is critical.").

54 FINRA007945.

That false conclusion ignores the uncontroverted witness testimony. Instead of passively observing information, LSC's trading desk personnel used ROX's[55] multi-faceted functionality to filter and sort information by certain variables so they could more closely analyze trading activity.[56] For example, LSC personnel used electronic filtering tools to organize orders for symbols or traders of interest in sequential order to determine whether there were buys and sells at the same price.[57] LSC personnel also performed more focused analysis on trading in stocks with large price movements, stocks in the news, and through doing periodic customer reviews.[58] This additional layer of technology-assisted human review was described during the hearing as being similar to having a real-time exception report that resulted in employees identifying and escalating issues for review.[59] Ms. Farrell-Starbuck also explained how she performed her own trade queries to identify potential issues and then conducted additional follow up when appropriate.[60]

There is no evidentiary basis for ignoring the uncontroverted testimony of Mr. Lek and Ms. Farrell-Starbuck regarding the human analytical component of LSC's surveillance, and instead putting forth the false narrative that during the early portion of the review period, LSC's surveillance solely consisted of nothing more than staring at a computer screen. Based on relevant precedent, when there is no evidence that this type of review missed suspicious transactions that a purely automated review would have caught, the respondent must prevail.[61]

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55 ROX is LSC's proprietary electronic trading platform.

56 FINRA003367 - 68.

57 FINRA003404:24-FINRA003405:7.

58 FINRA003489 - 90.

59 FINRA002143 - 44.

60 FINRA002029 - 30.

61 *Dep't of Enforcement v. Sterne, Agee & Leach, Inc.*, OHO Dec. No. E052005007501, 2010 WL 3598592, at *14 (decision in favor of respondent because FINRA "did not establish that Respondent's mix of manual and automated monitoring missed suspicious transactions that an automated system would have caught.").

In order to create the false impression that Mr. Lek agreed that LSC's approach to trade surveillance was deficient, the NAC misleadingly repeats a snippet from Mr. Lek's testimony when he acknowledged that LSC's manual reviews were not going to catch everything.[62] Specifically, here is the excerpt from that portion of Mr. Lek's testimony at the hearing: "Q: How is it humanly possible for anybody on a timely basis to respond to what may be out of order? A: I'm not suggesting that we're going to catch everything."[63] Tellingly, the NAC ignored the next two sentences from Mr. Lek's answer that address LSC's use of both pre and post-trade controls to prevent and detect potentially manipulative trades: "In – and that's why we have ex-post exception reports. Primarily we have controls built into the system that would stop the typical violations that are determinable from the single order itself."[64] Despite the NAC's refusal to acknowledge the facts, the Commission must consider the testimonial and documentary evidence demonstrating the reasonableness of LSC's use of electronic exception reports that supplemented a filtered and technology-assisted manual review.

C. Enforcement Provided No Evidence About Whether and How the AML Software on the Market During the Review Period was Different from LSC's Surveillance Tools

The notion that LSC's securities trading surveillance methodology was unreasonable because it was not completely automated by January 2008 is a conclusion devoid of supporting facts. While Ms. Fox said that trade surveillance software was available in the market in 2008, that observation alone is not sufficient to impose liability because Enforcement failed to adduce information about numerous critical variables, such as whether and how that software was

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62 FINRA007948.
63 FINRA003488:22-25, FINRA003489:1-2.
64 FINRA003489:3-8.

substantively different from the tools that LSC was utilizing.[65] Nor could she have made those necessary comparisons because Enforcement did not permit her to review the exception reports that LSC had implemented during the relevant time period. Without that crucial information, there is no evidentiary basis to conclude that purchasing such software would have changed the substance of what LSC already was doing.

Moreover, saying that LSC would have had sufficient trade surveillance by simply purchasing a vendor's software package certainly undercuts the NAC's reasoning that LSC's WSPs were deficient because LSC had purchased them from a vendor without making significant revisions. The NAC and Enforcement cannot have it both ways.

XIII. LSC's Monitoring of Specific Types of Trades

A. LSC Routinely Followed Up on Potentially Suspicious Trades

The NAC's finding that LSC inadequately implemented its AML polices was premised on the incorrect conclusion that LSC did not document any of its trade reviews or follow up with Dimension. LSC had numerous exception reports, including some that were developed or modified during the review period, and the uncontroverted testimony was that Compliance reviewed and analyzed those reports and conducted additional follow up if warranted.[66] Thus, those reports certainly reflect trades that were reviewed. As Mr. Lek testified, he also developed a computer program that could re-create a customer's order book at the master and subaccount levels.[67] Moreover, there are numerous emails reflecting instances of follow up with Dimension, further corroborating the fact that LSC was regularly communicating with Dimension regarding

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65 FINRA007945 n. 10; FINRA000746-7.

66 *See, e.g.*, FINRA001995; FINRA002072-73; FINRA002311

67 Contrary to Ms. Fox's statement, Mr. Lek confirmed that LSC maintained records of reviews using this program. FINRA003378:7-17. Ms. Fox made no requests of LSC and only reviewed the selected information the Department provided to her, which did not include LSC's exception reports. FINRA002840:15-25, FINRA002845:13 – FINRA002846:9. Therefore, she had no basis upon which to claim that LSC did not maintain these records.

the explanations for various trades.[68] Just because those follow up emails were not centralized in a single location does not mean that follow up did not occur. In addition, by at least February 2010, Ms. Farrell-Starbuck began keeping a log that reflected her follow up inquiries.[69] The firm has long since now formalized a process for documenting its reviews in a centralized manner.[70]

In addition, third party testimony confirmed that LSC regularly followed up with Dimension about DTI's trading.[71] Specifically, Phil Potter, Managing Member of Dimension, which was no longer a customer of LSC by the time of the hearing and had ceased doing business, corroborated Mr. Lek's and Ms. Farrell-Starbuck's testimony that they regularly followed up with Dimension.[72] Mr. Potter explained that he frequently spoke with Mr. Lek about trading questions while Ms. Farrell-Starbuck was regularly on phone calls with Keith Fortier or himself with respect to follow up questions.[73] Enforcement did not present any witnesses who contradicted this testimony.

B. In Addition to Asking Dimension for Explanations of Trades, LSC Also Performed Its Own Trade Analysis

The NAC incorrectly characterized LSC's Compliance efforts as doing no analysis of the exception reports and improperly delegating the review to Dimension and taking any feedback from Dimension at face value.[74] That characterization, however, is inconsistent with the actual evidence.

There was extensive testimony on how LSC reviewed trades for potential wash trades, pre-market manipulation and marking the close. Mr. Lek reviewed the reports reflecting

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68 *See, e.g.*, FINRA004243 (Ex. CX-20); FINRA004263 (Ex. CX-21); FINRA004293 (Ex. CX-24).

69 FINRA002060; FINRA002174-75; FINRA007101 (Ex. RX-706).

70 FINRA003477.

71 LSC coordinated with Dimension as Dimension was the introducing broker with the direct relationship with DTI. As Enforcement's expert acknowledged, it would have been improper for LSC to communicate directly with DTI. FINRA002974-78.

72 FINRA003050 – 51.

73 FINRA002118; FINRA002155.

74 FINRA007941; FINRA007947.

potential wash trades for patterns suggestive of potential manipulation at both the master account and subaccount level, and reviews were also further refined by particular traders, symbols, and time periods of interest.[75] Those reviews showed that the potential wash sales were statistically random, leading to the conclusion that any actual wash trades were unintentional and coincidental.[76] This conclusion was further supported by the fact that the executions were at or inside the National Best Bid and Offer so there was no potential to improperly influence the market.[77] Moreover, the trades were such a small percentage of the trading volume for the relevant stocks that they could not have presented a misleading view of the market activity for those stocks.[78] Accordingly, LSC did not have a basis for disagreeing with the explanations that Dimension provided about DTI's trading that appeared on potential wash sale reports.[79]

With respect to pre-market cancelations, in addition to reviewing DTI's explanations, Mr. Lek had determined that approximately 55% of DTI's pre-opening orders were canceled, which was a smaller percentage than DTI's cancelations during normal market hours, and certainly a significantly lower percentage than described by the SEC and the NYSE as being commonplace (approximately 95% – 98%).[80] As manipulation necessarily requires, among other things, the

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75 FINRA003288:15-19; FINRA003370:7-18.

76 FINRA003370:24 - FINRA003371:7. Consequently, LSC began to focus more (but not all) of its analysis on potential wash trades within the same subaccounts. This was a reasonable allocation of its resources and was consistent with FINRA's own position that trades emanating from different traders within a single institution that cross with each other are presumed to be legitimate. FINRA005946 (RX-521) ("Wash sale transactions that originated from unrelated algorithms or separate or distinct trading strategies, trading desks or aggregation units would not be considered non-*bona fide* wash sale transactions for purposes of the rule.").

77 FINRA003370:24 - FINRA003371:7.

78 *Id.*

79 As the introducing broker with the direct relationship with DTI, Dimension had the initial responsibility for understanding DTI's trading strategies and then using that knowledge to detect and prevent potentially improper trades. FINRA005925 (RX-513) (NYSE Rule 382); FINRA005927 (RX-514) (NASD Rule 3230); FINRA006059 (RX 534) (Clearing Agreement). Accordingly, Dimension also had its own systems in place to monitor for wash trades, which it had explained in detail to LSC. FINRA002341:25- FINRA002342:6, FINRA003057:3-16; RX-555. Although Dimension sought to detect and prevent improper wash trades, it never found patterns suggestive of such trades by DTI. FINRA003143:10-25. While LSC would still need to follow up on red flags indicating potential impropriety – and LSC did so – it is important to consider that another registered broker-dealer (*i.e.*, Dimension) with its own set of wash trade controls also concluded that there were no indicia of manipulation.

80 FINRA003388:5-22.

supposed manipulator to do something that impermissibly benefits one of its positions,[81] LSC also reviewed DTI's trading in order to determine whether the pre-opening cancelations may have benefitted other positions.[82] Mr. Lek's analysis did not reveal any such benefit. Thus, these observations regarding DTI's pre-market cancelations and related trading gave added credence to the explanations provided to LSC.

With respect to marking the close, DTI had no incentive to mark the close because its traders were generally prohibited from having overnight positions (it was a day trading firm).[83]

Consistent with Mr. Lek's conclusions, Enforcement's own AML expert acknowledged that she could not identify any transactions that did not have a reasonable business purpose, which is the threshold for filing a SAR.[84] In other words, LSC carefully reviewed the trading on the reports, received reasonable explanations from DTI that were consistent with LSC's own trade analysis, and not even Enforcement's expert was able to reach different conclusions about the trades. This all supports the effectiveness of LSC's AML controls.

C. LSC's Monitoring of Potential Wash Trades

LSC has always prohibited wash trades.[85] As would be expected, the manner in which LSC has monitored for potential wash trades has evolved over time as the nature of its customers' trading has changed and technology has advanced. The NAC incorrectly concluded that LSC was not monitoring for wash trades prior to August 2009 (which covered

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81 *In re Sheehan*, Exchange Act Rel. Nos. 33-8208 & 34-47521, 2003 WL 1222597 (S.E.C. March 18, 2003), *SEC v. Shpilsky*, Lit. Rel. No. 17221, 2001 WL 1408740, at *2 (S.E.C. Nov. 5, 2001).

82 FINRA002114:24-FINRA002116:2; FINRA002160:2-FINRA002161:25.

83 FINRA003398: 7-18.

84 FINRA002848 – 50; FINRA002859.

85 FINRA005123 (Ex. RX-505); FINRA005557 (Ex. RX-506) (both listing "wash transactions" among the WSPs prohibited transactions).

approximately half of the review period) because LSC did not develop an electronic exception report solely and exclusively dedicated to potential wash trades until that time.[86]

This overly simplistic view ignores how several of the then-existing exception reports worked collectively to prevent and detect this very type of activity. For example, one of the purposes of LSC's automated credit control limits was to minimize the ability of a customer to take large positions that could dominate the market in a stock, which is a prerequisite for manipulative wash trades.[87] LSC also utilized an automated control that prevented repeated orders in rapid succession, which among other things, could be indicative of a customer trying to create an inaccurate impression of the demand in a stock.[88] Thus, just because LSC did not have an automated report entitled "Wash Trades" for part of the relevant period does not mean that LSC did not have electronic controls in place to detect and prevent potentially manipulative wash trades. LSC, in fact, had been controlling for key factors that necessarily would need to exist for manipulative wash trades to occur.

The NAC's refusal to acknowledge this basic point is yet another attempt to elevate form over substance. In fact, the effectiveness of LSC's methods for surveilling for wash trades is demonstrated by the Hearing Panel's rejection (which the NAC did not disturb) of Enforcement's arguments that thousands of trades it had identified were suggestive of manipulative wash trades. Enforcement's underlying rationale for bringing this case was flawed from the start.

As the speed of customer trading quickened and customers' use of subaccounts increased, LSC began seeing customer trades on opposite sides of the market being executed within one

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86 FINRA007474. Enforcement also contended that LSC failed to follow up on supposed red flags that Enforcement believed were indicative of wash trades. The Hearing Panel correctly disagreed and the NAC did not disturb that conclusion. FINRA007490.

87 FINRA003595.

88 FINRA003590.

second of each other.[89] To address that new development, LSC designed and implemented an automated exception report for the specific purpose of identifying those trades for further compliance review.[90] As described in Section VIII above, Mr. Lek reviewed the reports for patterns suggestive of potential manipulation.[91]

With additional technological advancements since the review period, LSC has developed a pre-trade control that blocks an order from reaching the market if there is a possibility that the order could interact with an open order for the same customer on the opposite side of the market. This evolution in monitoring for and preventing potentially manipulative wash trades demonstrates how LSC enhances its processes as circumstances change and new technology emerges. That is exactly what FINRA should be encouraging its members to do.

D. LSC's Monitoring of Pre-Market Cancelations

The NAC faulted LSC for not monitoring DTI's pre-market cancelations for potential manipulation until after examiners began asking about the topic in June 2009. Unlike how the NYSE has a rule prohibiting cancelations of market on close orders, there are no rules prohibiting or limiting pre-market cancelations. Moreover, because of the manner in which specialists calculate opening prices and the rapid dissemination of pre-market order imbalance information, Mr. Lek, Ms. Farrell-Starbuck and Mr. Potter all testified that prior to the examination requests, they had no reason to believe that pre-market cancelations could impact the opening price of a stock. Dr. Stewart Mayhew, former Deputy Chief Economist at the SEC, confirmed that view and Enforcement had no experts who provided a contrary opinion.

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89 FINRA003374.

90 *Id.* The report was imperfect because LSC did not have contra-party information for the trades – despite Mr. Lek requesting such information from the exchanges – which would show if orders for the same customer actually crossed. FINRA003374 - 78.

91 FINRA003288; FINRA003370.

1. Pre-Market Cancellations do not Impact Opening Stock Prices

Specialists use a mathematical formula to establish the opening price of a stock, and that formula is based on open orders, not orders that have already been canceled.[92] To ensure that all market participants have current pre-market information, updated imbalance information is circulated every 15 seconds after 9:20 a.m. until the opening.[93] Indicative opening price information is also included with the imbalance information after 9:28 a.m.[94] The marketplace pays close attention to the rapidly changing imbalance information as additional orders and cancelations are entered up until the time that the specialist opens the stock. There is no expectation that the imbalance remains static and that people do not adjust their orders up until the last possible moment in light of those changes, including cancelations. Thus, as Dr. Mayhew explained, pre-market cancelations, even as late as 9:28 a.m. or 9:29 a.m., will not impact the price of a stock because these safeguards ensure that the market has sufficient time to react to updated imbalance information.[95] As Dr. Mayhew further explained, if a specialist nevertheless has concern about whether market participants have had an adequate opportunity to react to the updated imbalance information, the specialist is supposed to delay the opening of the stock.[96] Enforcement presented no documents or testimony – not even a single specialist – to attempt to rebut Dr. Mayhew's expert analysis.

Neither the Hearing Panel nor the NAC disagreed with the substance of Dr. Mayhew's analysis but instead tried to sidestep it by reasoning that LSC's position meant that "the entire process of pre-market bids and offers was meaningless and that market participants engage in it

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92 FINRA003400 - 01.

93 Order imbalance information is disseminated every five minutes from 8:30 a.m. – 9:00 a.m.; every minute from 9:00 a.m. – 9:20 a.m.; and every 15 seconds from 9:20 a.m. until the opening. Exchange Act Release No. 34-57862 (May 23, 2008).

94 *See* NYSE Open and Closing Auctions, *available at* http://www.readbag.com/nyse-pdfs-fact-sheet-nyse-open-close.

95 FINRA003613 - 14.

96 FINRA003614 - 15.

for no reason."[97] That statement, however, completely misses the mark by incorrectly stating LSC's position. Indeed, Dr. Mayhew described the purpose of placing pre-market orders as a search for liquidity in a stock that becomes very dynamic in the last few minutes before the opening.[98] It is precisely this dynamic activity, coupled with other safeguards, that led all of the fact witnesses and the sole expert witness who testified on the issue to be of the view that there was no reason to be concerned that pre-market cancelations could result in manipulation of the opening price.

The NAC attempted to rebut these logical conclusions by citing a settlement between the SEC and a non-broker-dealer trading firm and one its traders for the proposition that pre-market cancelations can raise spoofing concerns.[99] Aside from the fact that is a settlement with no precedential value and from five years after LSC's review period, there are several important facts about that settlement that keep it from having any relevance to this matter. Specifically, the pre-market orders at issue in that case were used to create imbalance information that the trader used to get a better execution in another market center that was open for trading, after which he canceled his pending pre-market orders. As described above, however, there were no such executions in other markets and that is something that Mr. Lek was looking for once LSC created the exception reports. Also of note, the SEC did not charge the broker-dealer through which the respondents placed the orders. After the three-year investigation and significant regulatory attention devoted to this set of orders and cancelations, it would be perverse for LSC to be charged for deficient procedures while no charges of any kinds have been brought against the actual firm and individual that did the trading.

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97 FINRA007493.

98 FINRA003638.

99 FINRA007950 n. 15 (citing SEC Press Release, SEC Charges Firm and Owner with Manipulative Trading (Oct. 8, 2015), *available at* https://www.sec.gov/news/pressrelease/2015-236.html).

2. Once Examiners Began Asking Questions About Pre-Market Cancellations, LSC Quickly Developed an Exception Report

Despite any differences of opinion at the time about whether pre-market cancellations could impact the opening price of a stock, once examiners expressed concerns about DTI's pre-market cancels, LSC designed and implemented an exception report and followed up with customers to get explanations for the cancelations in order to be comfortable that they were not for nefarious purposes.[100] LSC implemented the exception report in October 2009, which was before Enforcement had begun an investigation.[101] Implementing a control after examiners had expressed an interest in a type of trading is the epitome of reasonableness. LSC also encouraged Dimension to cease the pre-market cancelations in light of the requests it received from examiners so as to reduce the likelihood that LSC would receive additional requests about those types of cancelations.[102]

3. A Single DTI Trader's Hope that He Could Impact the Opening Price of a Stock does not Render LSC's Entire AML Control System Unreasonable

Despite all of the above, the NAC attempted to justify its finding of insufficient surveillance because of a single instance in which one of DTI's several hundred traders had hoped that his pre-market orders and cancelations on a single day in a highly liquid stock (Goldman Sachs) would influence the opening price of the stock. There are several reasons why that single event cannot lead to the conclusion that LSC had unreasonable controls in place.

First, LSC had strict controls on order size limits that, among other things, guarded against the possibility of somebody manipulating a stock because he would be prevented from

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100 FINRA002311. *See, e.g.*, FINRA007007 (Ex. RX-657); FINRA007023 (Ex. RX-665); FINRA007097 (Ex. RX-700).

101 FINRA007919.

102 Contrary to the Decision (at FINRA007477-78), LSC did not encourage Dimension to stop the pre-market cancelations because LSC thought they were manipulative. Instead, LSC no longer wanted such order flow because of the multiple regulatory inquiries it was receiving about pre-market cancelations, regardless of the merits of those inquiries. *See* FINRA002159.

dominating the market in the stock. The Goldman Sachs orders did not exceed those limits.[103] Second, Dimension never told LSC that it learned that the trader had hoped to influence the opening price so LSC was unaware of that information.[104] Third, a trader's hope of influencing the opening price does not equate to his conduct actually having the ability to achieve that result. Clearing and execution firms' controls are necessarily based on the risks posed by orders they receive. If an order does not pose a risk of manipulation, which the Goldman Sachs pre-market orders and cancelations did not for the reasons described above, the firm cannot be penalized for somehow not knowing the subjective intent of one of the thousands of traders that place otherwise unremarkable orders through its systems on any given day – firms like LSC can only react to and control for objective information. Fourth, notwithstanding the first three reasons, a single, isolated instance for which remedial action was taken (the trader was terminated) does not render an entire control structure unreasonable.[105]

4. Enforcement Did Not Offer Any Evidence About How DTI's Pre-Market Cancelations Supposedly Were Indicative of Potential Manipulation

Enforcement did not present any actual proof upon which the Hearing Panel or the NAC could appropriately find that DTI's pre-market cancelations had indicia of potential efforts to manipulate opening stock prices. Enforcement's entire case on this issue consisted of having a FINRA employee introduce the pre-market orders and cancelations, claim that unidentified specialists had complained about the cancelations, and simply asserted that the cancelations were

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[103] As DTI had several hundred active traders at any given time, Dimension and DTI placed limits on the order sizes for individual traders. When aggregated together, their orders could not exceed the overall size limitations that LSC placed on DTI as a whole. While the trader in question circumvented Dimension's size limitations on him personally, the size of his trades did not meet or exceed LSC's overarching size limitations on DTI, which prevented a customer from dominating the market in a stock. DTI terminated the trader and Dimension revised its policies and procedures to address the flaw the trader had exploited. FINRA003132.

[104] Phil Potter of Dimension did not recall providing that information to LSC, and Mr. Lek was certain that he had not been informed. FINRA003078; FINRA002323 - 24.

[105] FINRA's own AML rules do not require perfection. Instead, a firm's AML program must be "reasonably designed to achieve compliance." FINRA Rule 3310(b).

suspicious without providing any other additional information about the pre-market activity surrounding DTI's orders and cancelations. In other words, Enforcement unilaterally proclaimed the pre-market cancelations were suspicious and improperly shifted the burden to LSC to prove Enforcement wrong.

Despite predicating their concern on the supposed basis that specialists had complained about pre-market cancelations routed through LSC,[106] Enforcement did not call a single specialist as a witness. Courts do not allow trials to proceed based on anonymous allegations that deprive defendants from cross-examining those individuals or otherwise prevent them from being able to probe the accuracy and motives for those allegations.[107] LSC should not be afforded less protections in this forum.

Nor did Enforcement introduce any evidence about the overall pre-market activity surrounding DTI's pre-market orders and cancelations so that the cancelations could be evaluated in context and not in isolation. For example, there was no evidence about how the imbalances or indicative prices changed after DTI's order placements or after their cancelations. Similarly, there was no evidence regarding whether DTI's orders and cancelations influenced others' trading decisions or any evidence demonstrating that DTI's cancelations were not reactions to other orders and/or cancelations (*i.e.*, updated order imbalance information). Finally, there was no evidence as to whether traders other than DTI also canceled their orders, and if so, how those cancelations compared in time sequence and quantity to DTI's cancelations.

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106 FINRA002559 – 60.

107 *In re Bear Stearns Cos., Inc., Sec., Derivative, & ERISA Litig.*, No. 08 CIV. 2793, 2012 WL 259326, at *2-4 (S.D.N.Y. Jan. 27, 2012) (court compelled plaintiff to identify the confidential witnesses in the discovery phase, even after the plaintiff stated that it did not intend to call any of the confidential witnesses at trial); *Fort Worth Emp. Ret. Fund v. J.P. Morgan Chase & Co.*, No. 09 Civ. 3701, 2013 WL 1896934, at *1 (S.D.N.Y. May 7, 2013) (granting application for the disclosure of confidential informant identities); *In re Am. Int'l Grp., Inc. 2008 Sec. Litig.*, No. 08 Civ. 4772, 2012 WL 1134142, at *3, *5 (S.D.N.Y. Mar. 6, 2012) (rejecting the plaintiff's request to only disclose identifies of those confidential witnesses it noticed for depositions or place on a witness list for trial, and instead requiring the disclosure of all confidential witnesses).

In sum, there was no evidence of any improper impact at all on any opening prices or even the opening process.

Enforcement, not LSC, had access to all of this information yet failed to provide any of it. These are basic questions and one can only conclude that had the answers to those questions supported Enforcement's theory, Enforcement would have introduced it. When the party with the burden of proof fails to call witnesses with relevant information, it must be presumed that such testimony would have been unfavorable to that party.[108] Thus, the only reasonable conclusion is that any specialist testimony and the overall context of the pre-market activity surrounding DTI's cancelations do not support the conclusion that the cancelations were for the purpose of impacting the opening price. The NAC did not address any of this. The Commission should not overlook these important issues.

E. LSC's Monitoring for Marking the Close

Although Enforcement alleges that LSC's AML procedures were unreasonable because LSC did not sufficiently monitor for the possibility that DTI would mark the close, the Hearing Panel correctly refrained from citing the firm's marking the close procedures as a basis for its decision. The NAC did likewise, and so should the Commission. Marking the close occurs when a money manager purchases shares shortly before the close of the market to artificially affect the closing price of a stock.[109] As Enforcement's own AML expert acknowledged, marking the close is generally something smaller funds do with illiquid or thinly traded stocks with the intent of increasing the price in order to create another financial benefit to them, such as

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[108] *Thomas E. Snyder Sons Co. v. Comm'r*, 288 F.2d 36, 39 (7th Cir. 1961); *see Reynolds v. Octel Commc'n Corp.*, 924 F. Supp. 743, 748 (N.D. Tex. 1995) (party failed to meet burden of proof because it failed to call any witnesses).

[109] *See, e.g., In re Wanger & Wanger Inv. Mgmt., Inc.* Exchange Act Rel. No. 66053, 2011 WL 6541416 (S.E.C. Dec. 23, 2011) (hedge fund manager marked the close of several illiquid stocks at the end of months and quarters to boost performance figures for marketing purposes and to receive higher management fees).

increased quarterly fees.[110] As DTI was a day-trading firm whose traders rarely carried overnight positions, marking the close was not a meaningful risk for that customer.

Nevertheless, LSC's WSPs explicitly prohibited marking the close and LSC took steps to make sure such trading did not happen.[111] LSC not only utilized an electronic report that identified orders exceeding certain volume percentages near the market close, but it conducted post-hoc reviews and queries for significantly successful orders prior to the close.[112] LSC also implemented a specific exception report for marking the close in March 2010. As the Southern District of New York has explained, unless "the only possible purpose" for doing large trades at the end of the day is to artificially impact the price an executing broker like LSC has no reason to conclude that the trades were done for a manipulative purpose.[113] Unlike Enforcement, LSC also presented expert testimony regarding its marking the close processes. Enforcement's presentation on this issue consisted of Enforcement staff examiners, with no first-hand knowledge of any of the trades and without any evidence about what similarly situated broker-dealers do to monitor for marking the close, simply argued that LSC's approach was not sufficient. The Hearing Panel and the NAC correctly declined to adopt Enforcement's approach. The Commission should do likewise.

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110 FINRA002832; Jason Zweig and Tom McGinty, *Fund Managers Lift Results With Timely Trading Sprees*, The Wall Street Journal, Dec. 6, 2012 (The risk of marking the close is greatest at month-end or quarter-end because money managers may be tempted to "bid aggressively for more shares of a stock they already own, which drives up the value of their entire position in the stock. That, in turn, boosts their performance at the very moment when they report results, making their funds look more appealing to potential investors . . . and earn higher fees.").

111 *See, e.g.*, FINRA005558 – 59 (Ex. RX-506).

112 FINRA002180 - 82. LSC often conducted the post-hoc reviews in conjunction with customer requests to withdraw funds. FINRA002182 - 83.

113 *SEC v. Masri*, 523 F. Supp. 2d 361, 370 and 375 (S.D.N.Y. 2007).

XIV. The $100,000 Fine Imposed is Impermissibly Punitive and Failed to Account for Numerous Mitigating Factors

A. The $100,000 Fine is Impermissibly Punitive

FINRA sanctions must be remedial, not punitive.[114] The NAC did not explain at all why this large fine against such a small firm that has completely addressed the issues that were investigated is remedial. "A remedial sanction is designed to correct the harm done by respondent's wrongdoing and to protect the trading public from any future wrongdoing the respondent is likely to commit."[115] Where processes have been reformed in the aftermath of the conduct at issue, the absence of specific findings that the trading public would receive additional protection from sanctioning the respondent renders the sanctions excessive and punitive.[116]

The $100,000 fine does not protect the public or provide any meaningful deterrence against future misconduct because LSC has continued to enhance its surveillance controls and corresponding procedures. For example, as previously described, LSC has used previously unavailable information now provided by the NSCC and new technology to block potential wash trades before they reach the market. LSC also has developed a system to affirmatively document its follow up with respect to exception reports and potentially suspicious activity. Given these circumstances, a $100,000 fine is punitive, not remedial. This conclusion is further bolstered when one considers the very small size of LSC.

Moreover, a comparison to one of the very few litigated cases on AML procedures, and upon which Enforcement and the NAC heavily relied– *In re Domestic Securities*[117] – demonstrates the unreasonable and punitive nature of the $100,000 fine. In *Domestic Securities*, which involved a broker-dealer that was more than twice the size of LSC, the AML policy

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114 *Dep't of Enforcement v. Leopold*, 2012 WL 641038, at *7 n.15 (NAC Decision, Feb. 24, 2012).
115 *Id.* (citing *McCarthy v. SEC*, 406 F.3d 179, 188 (2d Cir. 2005).
116 *McCarthy*, 406 F.3d at 189-90.
117 2008 WL 4490637 (N.A.S.D.R. Oct. 2, 2008).

merely copied all of the red flags in FINRA's small firm template and then included a statement in its AML manual that many of the red flags listed were inapplicable to the firm and did not identify which of these red flags did not apply. Thus, unlike the situation with LSC, there was absolutely no guidance anywhere about what employees should look for. Nevertheless, the fine imposed was $10,000, or 10% of the fine the NAC assessed against LSC. There is no non-punitive justification for the fine against LSC.

The NAC argued that it would be inappropriate to compare the instant case with *Domestic Securities* "because a sanction determination depends on the facts and circumstances specific to each case."[118] That generalized statement may be true, but the NAC failed to explain what facts and circumstances make LSC's conduct ten times greater than the violation in *Domestic Securities* where the facts in that case appear to be more egregious than the comparable facts here.

Consequently, to the extent the Commission upholds the findings of liability, the fine imposed should be reduced significantly, or entirely eliminated, because the size of the fine serves no remedial purpose and can only be viewed as punitive under the totality of the circumstances.

B. The NAC Ignored Numerous Mitigating Factors and Improperly Found Aggravating Factors

In addition to being punitive, the NAC improperly determined the amount of the fine by ignoring numerous mitigating factors and improperly finding aggravating factors. Those are additional reasons why the Commission should eliminate or significantly reduce the fine.

Although the NAC disagreed with the methodology the Hearing Panel used to calculate the fine, the NAC nevertheless upheld the amount by incorrectly concluding that there was a

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[118] FINRA007954.

complete absence of any mitigating factors for the violations while simultaneously finding the existence of several, largely unexplained, aggravating factors.[119] The Commission should not make the same mistake.

According to FINRA's Sanction guidelines, the factors that may be considered aggravating or mitigating include:

1. Whether the member firm voluntarily employed subsequent corrective measures, prior to detection or intervention by a regulator, to revise general and/or specific procedures to avoid recurrence of misconduct;

2. Whether the member firm demonstrated reasonable reliance on competent legal or accounting advice;

3. Whether, at the time of the violation, the member firm had developed adequate training and educational initiatives; and

4. The number, size and character of the transactions at issue.[120]

Based on the four criteria above, there are numerous mitigating factors for which the NAC did not account.

With respect to the first factor, LSC continuously enhanced its trade surveillance processes based on observance of new trade practices (*e.g.*, development of new exception report after observing executions on opposite sides of the market within one second of each other), as it obtained new data feeds from NSCC (*e.g.*, enabling LSC to create a control to block orders from reaching the market that could have the potential of interacting with an open order for the same customer), and in response to questions posed by examiners (*e.g.*, creation and implementation

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119 FINRA007952-3 ("We find LSC's violation to be egregious because of the presence of several aggravating factors and the absence of any mitigating factors.").

120 FINRA Sanction Guidelines at 6-7, FINRA (Oct. 2016), *available at* https://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf.

of an exception report for pre-market cancelations). LSC implemented its initial potential wash trade and pre-market cancelation exception reports before Enforcement began its investigation.[121] In addition, although Ms. Farrell-Starbuck had begun the process of documenting the follow up she performed with customers, LSC has now formalized a system for recording and tracking such follow up efforts. LSC has also done a complete overhaul of its AML policies.

With respect to the second factor, each year LSC retained an independent AML auditor to examine LSC's AML systems and controls. Each year, the AML auditor certified that LSC did not have any material deficiencies in its AML program.

With respect to the third factor, it is undisputed the LSC provided AML training to its employees. That training included how to identify and respond to suspicious trading activity. Enforcement acknowledged that it did not take issue with LSC's AML training.

With respect to the fourth factor, Enforcement no longer contends that any manipulative trades were done through LSC. Similarly, Enforcement has not alleged that LSC failed to file any necessary SARs. The Hearing Panel specifically rejected Enforcement's views about what constituted indicia of potential wash sales or risks regarding marking the close. Of the more than 120 million trades during the review period, the NAC and Hearing Panel had concerns about a single set of pre-market orders and cancelations in one highly liquid stock and for which the only expert testimony concluded that the activity could not have manipulated the opening price.

In light of the above facts, which were never even referenced in the NAC's sanctions analysis, the NAC's conclusion that there were no mitigating factors to even consider is facially wrong.

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121 FINRA007940 ("FINRA's investigation of LSC began in December 2009.").

With respect to aggravating factors, the NAC simply said that LSC was "obstinate."[122] Defending oneself does not render a person or entity obstinate and worthy of enhanced sanctions. Indeed, the DC Circuit has explicitly held that the SEC cannot consider a violation serious on the basis that the respondent did not agree with the interpretation of SEC staff members because staff members can be wrong.[123] The same rationale should apply with respect to analyzing aggravating factors for purposes of FINRA sanctions. The NAC penalized LSC for defending the reasonableness of its AML programs in the face of serious allegations about manipulative trading that Enforcement ultimately withdrew only after Enforcement had already filed charges against LSC. LSC's attempt to defend itself cannot be properly considered an aggravating factor for sanctions purposes.

In light of the numerous mitigating factors that the NAC failed to consider, and the NAC's improper finding of aggravating factors, the Commission should set aside or significantly reduce the $100,000 fine.

XV. Conclusion

An objective review of the totality of the evidence supports the conclusion that LSC's AML policies and procedures were reasonable and effective. All of the testimony demonstrated that LSC's employees understood their responsibilities and that Compliance reviewed all trades brought to their attention, whether through escalation or exception reports, for all compliance related purposes, including AML purposes. Thus, it is not surprising that Enforcement did not identify any instances where LSC failed to file a required SAR or that Enforcement ultimately

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122 FINRA007953.

123 *See e.g.*, *WHX Corp. v. SEC*, 362 F.3d 854 (D.D.C. 2004) ("[f]inding a violation 'serious' and 'willful' simply because of a failure to comply immediately with the staff's interpretation effectively punishes parties who make Wells submissions that are ultimately unsuccessful. To do so is arbitrary and capricious, at least in the absence of a more compelling explanation than the SEC offered in its Opinion.").

withdrew its core allegations about LSC having executed manipulative trades on behalf of DTI. LSC understood its AML responsibilities and it complied with them.

Based on the foregoing, the Commission should reverse the NAC's decision.

Date: February 10, 2017

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE WITH RULE 450(C)

I hereby certify that this brief complies with the length limitation set forth in Rule 450(c) and contains 11,433 words, exclusive of pages containing the table of contents, table of authorities, and any addendum that consists solely of copies of applicable cases, pertinent legislative provisions, or rules and exhibits, but inclusive of pleadings incorporated by reference.

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CERTIFICATE OF SERVICE

I hereby certify that on February 10, 2017, I caused the foregoing to be served by first class mail, return receipt requested, on the following:

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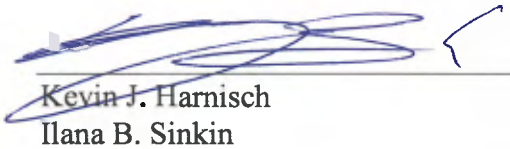

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