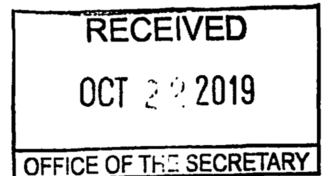

UNITED STATES OF AMERICA
BEFORE THE
SECURITIES AND EXCHANGE COMMISSION

In the Matter of the Application of:

SOUTHEAST INVESTMENTS, N.C., INC. AND FRANK HARMON BLACK

For Review of Disciplinary Action Taken by FINRA

Admin. Proc. File No. 3-19185

APPLICANTS' REPLY BRIEF TO FINRA'S BRIEF IN OPPOSITION TO APPLICATION FOR REVIEW

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INTRODUCTION

FINRA's mantra in its Opposition (the "Opposition") to the Application for Review filed by Southeast Investments N.C., Inc. ("SEI") and Frank Harmon Black ("Mr. Black" or together "Applicants") is basically that the arguments raised on appeal have already been considered and denied by both the Hearing Panel and National Adjudicatory Council ("NAC"). While this is true, it is also true that had either the Hearing Panel or the NAC ruled correctly on the issues before it, this appeal would not have been necessary. That is literally true of every appeal and is no reason to summarily dismiss Applicants' arguments, as FINRA suggests.

Moreover, the issues raised in the Opposition by FINRA do nothing to undercut or diminish Applicants' arguments. With this in mind, Applicants will use this brief to point out the incredible lengths to which FINRA has now gone to in order to justify and excuse the mistakes made in the prosecution of the underlying Enforcement action. Because of this and the other reasons discussed below, the findings and sanctions affirmed by the NAC should be set aside by the Commission.[1]

ARGUMENT

I. APPLICANTS DID NOT PROVIDE FALSE TESTIMONY OR FABRICATE DOCUMENTS

In their Appeal, Applicants demonstrated that the findings that they lied and falsified documents in relation to four particular branch office inspections were erroneous because (1) FINRA relied on biased and unreliable witnesses (in addition to failing to turn over exculpatory evidence relating to said witnesses), (2) the Hearing Panel failed to consider relevant evidence, and (3) because the hearing was not in keeping with the purposes of the Exchange Act. FINRA argued that the result was correct because the NAC affirmed it, made excuses for the mistakes that

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[1] Citations to the transcript of the hearing are abbreviated "Tr. __." Respondents' Exhibits are cited as "RX__." Complainant's Exhibit are cited as "CX_." The March 3, 2017 Decision of the Hearing Panel is referred to as "Decision __." The May 23, 2019 NAC Decision is referred to as "NAC Decision __."

happened during the hearing and its lead up, and argued that the mistakes did not really impact the result of the hearing because the NAC said they did not. Applicants will highlight a few of the fallacies in FINRA's Opposition, which make clear that findings and sanctions related to the falsified documents and false testimony should be vacated.

A. FINRA Cherry-Picked Biased Ex-SEI Employees to Serve as Witnesses.

Common sense dictates that FINRA should have interviewed a mix of current and former SEI employees in order to achieve an accurate sampling to determine if Mr. Black was conducting branch inspections. In its Appeal, Applicants noted that FINRA could have chosen to interview over 100 current and ex-SEI brokers, but instead deliberately interviewed only ex-employees, for the patently absurd reason that it supposedly did not want to disrupt SEI's business by interviewing current brokers.[2]

FINRA defends this decision in a couple of ways. First, it argues that the office inspection checklist produced by Applicants "listed the purported due dates and completion dates of inspections of only 43 Firm Representatives' offices" (FN 23, FINRA Opposition p. 36). Applicants do not grasp FINRA's point. The checklist still had 43 brokers who could have been interviewed and FINRA would have had no problem using its 8210 powers to get the names and contact information of all the other brokers.[3] Even if those other brokers were not on the checklist, FINRA could have asked them if Mr. Black had ever inspected their offices. FINRA argues that such information is irrelevant, "that they may have inspected other offices has no relevance to

[2] This is absurd for at least two reasons. First, FINRA exams are inherently disruptive, yet FINRA conducts hundreds each year, some deliberately without any prior notice, so the notion that FINRA supposedly cares about being disruptive is highly dubious. Second, while the ex-brokers may no longer have been associated with SEI, they were associated with other BDs; thus, the interviews may not have been disruptive to SEI but they certainly were disruptive to the witnesses and the BDs with which they were associated at the time. FINRA's professed concern about being disruptive is nothing but a façade to excuse the deliberately skewed nature of its sample.

[3] FINRA could have even used Broker Check!

testifying falsely that they inspected the Four Testifying Representatives' offices..." (FN 25, FINRA Opposition p. 39). FINRA is wrong on two counts. First off, the testifying witnesses all had past issues with Mr. Black; if other brokers with more harmonious relationships with Mr. Black testified that he inspected their offices, it might have indicated the testifying witnesses had ulterior motives and that their testimony was not true.

More importantly, as will be discussed below, Mr. Minor, one of the ex-broker witnesses, testified not only that Mr. Black had not visited *his* office, but that Mr. Black had never gone to visit *any other* branches. Thus, information from other brokers would have weighed directly on the credibility of Mr. Minor, who turned out to be a critical witness, and whose credibility was central to the findings. FINRA's decision to cherry-pick only biased witnesses reverberated throughout the hearing in the form of inconsistent testimony that was not credible.

FINRA also defends the one-sided composition of its sample of SEI RRs by acknowledging – but perhaps not overtly embracing, for fear of looking ridiculous once its pleading became public – the legal notion that while FINRA *disciplinary hearings* must be fair, that concept does not extend to FINRA *exams*. In other words, even if FINRA's decision during the exam to restrict the sample of RRs interviewed to ex-SEI RRs was unfair because it was not representative of the overall population of SEI RRs, it is somehow irrelevant to the Commission's consideration of the appeal and should be disregarded. This is typical of the disdain for the process that FINRA exhibited throughout this case.

B. FINRA's Witnesses were not Credible and Consistent.

Because the NAC conceded that the credibility of the ex-broker witnesses "is the key issue" (NAC Decision p. 14), FINRA was forced to characterize their testimony as "credible and consistent" (FINRA Opposition p. 1). But simply repeating over and over that the testimony was

credible and consistent does not make it so. A couple of examples from the Appeal make this self-evident.

First up is consistency. Mr. Ravella is an ex-SEI broker with a history of work related disputes with Mr. Black. He testified under oath that he had never met or even seen Mr. Black prior to the hearing (Tr. 125-126). Mr. Black, of course, testified to the opposite, that he had, in fact, met Mr. Ravella on prior occasions (Tr. 963), which forced the hearing panel to resolve that issue of fact. As the FINRA documents produced after the hearing clearly showed,[4] Mr. Ravella was far from "consistent" on the issue of his prior meetings with Mr. Black. In fact, contrary to his sworn testimony at the hearing – testimony that was specifically highlighted in the FINRA decisions in support of the conclusion that Mr. Black was not credible – Mr. Ravella had previously told FINRA personnel that he met Mr. Black once a year. This is but one example; the record is replete with inconsistent testimony from Mr. Ravella and the other witnesses.

Despite FINRA's reassurances to the Commission, the record indicates that the witnesses were not only not consistent (*see* above), they were also not credible (*see* below). Again, Applicants will highlight just one example to demonstrate that FINRA's star witnesses were not quite what FINRA has made them out to be (although Mr. Ravella's "inconsistent testimony" as demonstrated above is also a fine example of the credibility problem with FINRA's witnesses).

Mr. Minor was another ex-SEI broker with a history of disputes with Mr. Black and SEI. According to FINRA's own documents – not produced until after the hearing – Mr. Minor told a staff member that not only had Mr. Black never been to his office to make an inspection, but that "he had never gone to any other branches." At the time, SEI had well over 100 registered representatives. Realistically, Mr. Minor could not have had knowledge about whether or not Mr.

[4] These documents will be discussed in greater detail below in response FINRA's argument that they do not constitute exculpatory material.

Black visited the other offices, but that did not stop him from telling FINRA that no visits occurred. A credible witness is one that can be believed and Mr. Minor's statement is unbelievable; thus he is not credible and neither is his testimony. The same can be said for each and every one of the testifying ex-brokers.

C. The Inconsistencies were not "Immaterial" to the Case.

In light of the facts highlighted above, FINRA reluctantly conceded that some inconsistencies might have existed. But, no worries! "[A]ny inconsistencies identified by Applicants had no material impact on FINRA's credibility findings and the findings that Black and the Firm lied and fabricated documents." (FINRA Opposition p. 3). As this one sentence makes rather clear, the basis for FINRA's conclusion is simply that the NAC and Hearing Panel said so. We already know, however, that the OHO was wrong on numerous issues in this matter (since the NAC reversed it on certain findings and sanctions). And the NAC, too, is commonly reversed on appeal by the Commission. Thus, to say that the Commission should find that inconsistencies were immaterial merely because the NAC "said so" is simplistic to the point of absurdity.

In fact, FINRA's own actions are the best evidence of the materiality of the inconsistencies. Mr. Firley specifically highlighted, both at the oral argument and in written briefs, testimony from Mr. Ravella that he had never met Mr. Black prior to the hearing; testimony that Mr. Firley knew or should have known to be false. FINRA attempts to dismiss Mr. Firley's conduct by doubling down on the "immateriality argument": "contrary to Applicants' assertion, Enforcement was not required to correct inconsistent witness testimony on immaterial facts[5]" (FINRA Opposition

[5] FINRA continues, "especially, when Applicants could have cross-examined the witnesses on these discrepancies or elicited direct testimony to the contrary." (*Id.).* As will be demonstrated in Section E, below, Applicants were denied the opportunity to effectively cross examine the witnesses. Further, Applicants did elicit direct testimony to the

p. 38). Thus, FINRA would have the Commission believe, for example, that Mr. Ravella testifying falsely under oath that he had never met Mr. Black when FINRA's own (albeit late produced) records show that he had, in fact, met Mr. Black multiple times is somehow immaterial.

It is curious, then, that Mr. Firley chose to highlight this supposedly "immaterial" fact at the oral argument, emphasizing to the panel that Mr. Ravella testified "that he had never seen Mr. Black before. Didn't even know what he looked like until he walked into the hearing to testify." (Oral Argument p. 96).[6] FINRA is talking out of both sides of its mouth. On the one hand, FINRA went out of its way to stress Mr. Ravella's (false) testimony at the hearing and on appeal due to its importance to the outcome, yet, when confronted with the undeniable fact that such testimony was flatly inconsistent with what he told FINRA during the exam, FINRA then claims it was somehow not material, and argues that it had no impact on the outcome.[7]

FINRA chose its star witnesses, witnesses whose credibility has been deemed to be the key to the findings that are on review. Now that FINRA's own documents reveal that those witnesses were hardly the acme of "consistency and credibility" that FINRA has maintained, it defends the findings by pleading "immateriality."[8] It should not be allowed.

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contrary, but, as will be shown, the efficacy of the testimony was limited without exculpatory evidence to directly refute the FINRA witnesses.

[6] Further, Mr. Firley went so far as extoll Mr. Ravella's virtue as a testifying witness: "he was very calm, very soft spoke and very credible." (Tr. 980), even as he was telling the Hearing Panel information that Mr. Firley knew or should have known to have been at odds with FINRA's own documents., Mr. Firley went even further: "Mr. Ravella testified clearly...he had never seen or met Mr. Black until he walked into this hearing three days ago (*Id.).* Despite this, FINRA continues to argue with a straight face that Applicants received a fair hearing.

[7] By highlighting the false and inconsistent testimony, FINRA bolstered the credibility of their witnesses before the panel, when they were, in reality, lacking credibility.

[8] Moreover, given that the numerous inconsistences were, in fact, material, FINRA's argument that it had no duty to correct testimony that it knew or should have known to be false falls flat.

D. The FINRA Notes that were Not Produced were Exculpatory Evidence.

It comes as no surprise that FINRA argues that the Emails and Memo[9] that it failed to produce prior to the hearing were not exculpatory evidence; indeed, what choice does FINRA have, for to concede they were exculpatory mandates the conclusion that the hearing was unfair and the findings be vacated? FINRA terms them as "so-called 'exculpatory' documents"(FINRA Opposition p. 27) as if to make light of Applicants' argument when, in fact, the only thing that is silly are the excuses FINRA offers up as to why it did not produce the documents until ordered to do so.

First off, it is undisputed that FINRA either lost or destroyed the original Notes taken by Ms. Arnold during her phone conversations with the ex-brokers (*see* argument on spoliation below), which means nobody will ever know what the witnesses actually said. Equally problematic, it also means that no one, neither the Hearing Panel, nor the NAC, nor the Commission, has the ability to evaluate the overt decision that Mr. Firley admitted was his, *not* to produce the Notes (Tr. 301-2): "the decision not to produce the notes had nothing to do with Ms. Arnold, that was my decision." (Tr. 305). Oddly, that decision, with its *Brady* implications, was made despite testimony from Ms. Arnold that Enforcement never asked for or received copies of the Notes[10] from her (Tr. 303-4).[11]

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[9] The NAC issued an Interim Order to FINRA ordering it to turn over notes (the "Notes") from interviews of ex-SEI brokers taken by FINRA staff. On July 2, 2018, FINRA DOE produced declarations of Ms. Arnold and Mr. Firley representing that the Notes could not be located. In lieu of producing the Notes, FINRA DOE provided (1) several e-mails from Ms. Arnold to Mr. Ray Palacios, written six days after the telephone conversations with FINRA's witnesses (the "Emails"), that purportedly "summarized the information from [her] notes into the emails," and (2) Mr. Palacios' memorandum to the file (the "Memo").

[10] Ms. Arnold testified, at best, that they "discussed" the Notes. (Tr. 304).

[11] This would also seemingly contradict the NAC's finding that, "Enforcement represents that it had Arnold's notes in its possession earlier in the proceeding and reviewed them in connection with its initial document production." (NAC Decision p. 22), prior to losing them. Again, there are conflicting stories from FINRA but the Applicants are the ones being punished.

Faced with its inability to produce the missing documents, FINRA has no choice but to argue that "the Notes were irrelevant to whether Black and the Firm lied about inspecting offices" (FINRA Opposition FN 22, p. 34), because of the Emails and Memo that were created days after the missing contemporaneous Notes were prepared. In other words, FINRA argues that the Emails and Memo are the functional equivalent of the Notes, but this forces FINRA to ignore the fact that unlike the original Notes, the Emails contained only that information which Ms. Arnold deigned to include, which may or may not have been important to the Applicants' defense. Whatever additional exculpatory evidence that might have been contained in the original Notes, but not captured in the Emails and Memo, has been lost forever. Indeed, given Ms. Arnold's testimony she did not even provide the Notes to Enforcement for review (Tr. 304), it unclear how FINRA has any basis to argue that the Memo and Emails are equivalents for the Notes, apart from the argument by Mr. Firley – who was not a witness, not subject to cross examination, and whose credibility was not weighed by the Hearing Panel. In short, Applicants have been penalized because of FINRA's conduct in losing the Notes, whether accidental or intentional.

Putting aside for the moment (or forever, actually, since FINRA caused them to disappear) the lost Notes, FINRA still argues that the Emails and Memo that were produced after the hearing did not contain exculpatory evidence. In its Appeal, Applicants showed that the concern of the Supreme Court in *Brady* was in relation to the introduction of false testimony. In other words, that a witness might testify about something while the government had in its possession documents relevant to the witness's credibility on that same topic. The ex-brokers here testified about branch audits, but FINRA failed to turn over documents in its possession that showed, or could have showed, that testimony to be false, thus, impacting the credibility of those ex-brokers.[12] FINRA

[12] FINRA argues that "there is not a shred of evidence that FINRA's Enforcement lawyers personally knew that any statements of the Four Testifying Representatives were untrue." (FINRA Opposition p. 38). However, in light of the

can spin this however it wants (although, it mostly just argues that the documents are not exculpatory because the NAC said so), but the Emails and Memo are exculpatory and the failure to produce them was not harmless error. FINRA's Opposition did nothing to undermine the arguments presented in the Appeal.

E. Applicants were Denied the Opportunity to Defend Themselves.

Applicants' Appeal demonstrated that counsel was unable to properly cross examine the FINRA witnesses because of its failure to produce evidence until it was ordered to do so *after* the hearing had concluded. In other words, when FINRA witnesses lied under oath, Applicants' counsel could not impeach them because FINRA failed to produce the documents needed to accomplish that, i.e., documents which would have clearly demonstrated the inconsistencies between the witnesses' testimony at the hearing and what they said to FINRA during the exam.

In defense of its conduct, FINRA seems to have adopted the old strategy of victim blaming. Using the example of Mr. Ravella, FINRA writes, "Black could have testified that he met Ravella before the hearing" (FINRA Opposition p. 31), as if that would have had the same impact on the hearing panel's consideration of Mr. Ravella's credibility as confronting him with FINRA's own documents revealing that Mr. Ravella's sworn testimony at the hearing was directly at odds with what he had previously told the FINRA examiner. In the latter scenario, the hearing panel would have had evidence to conclude that Mr. Ravella was an unreliable witness without any need to contrast his testimony with Mr. Black's, which is the analytical dynamic to which FINRA repeatedly, but over simplistically, returns. In other words, there never would have been a

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information contained in the Emails and Memo, it is reasonable to conclude that some of the broker testimony was untrue (even with a generous reading, it was inconsistent), which makes the Memo and Emails exculpatory documents since they weigh negatively on witness credibility. Moreover, in Enforcement's Opposition to Motion to Compel from March 8, 2016, Enforcement affirmatively stated, "further, none of the documents that have been withheld from production under Rule 9251(b) contain *Brady* material." (FN 2, p. 2), which indicates they reviewed the documents and either knew or should have known about the inconsistent/false testimony.

credibility judgement as was required in this "he said/she said" situation because FINRA's own documents would have shown conclusively that Mr. Ravella was not reliable. FINRA's failure to produce the documents with which Mr. Ravella could have been directly and potentially dramatically impeached cannot, under anyone's definition of the word, be deemed "harmless" error.

Moreover, contrary to FINRA's suggestion that Applicants failed to highlight the differences in recollections between the witnesses, Mr. Black *did* testify that Mr. Ravella's sworn statement at the hearing about never having met him before the hearing was false and that Mr. Ravella was lying. (Tr. 963-4). In other words, Applicants did exactly what FINRA suggested Applicants should have done. But, the evidence actually adduced at the hearing required the hearing panel to compare Mr. Ravella's testimony with Mr. Black's to decide if Mr. Ravella was being truthful, rather than allowing the panel to compare Mr. Ravella's own inconsistent statements. This just drives home Applicants' argument about the importance of producing the missing documents for impeachment purposes and the inherent unfairness of Applicants' hearing.

Even FINRA, quick to excuse its own errors and blame Applicants, conceded that Applicants' testimony could not possibly have cured the failure to turn over the exculpatory documents on certain issues: "it is true that without the Emails, Applicants were unable to question Minor on the statement in the Emails that Black did not inspect any branch offices and how Minor might have known that." (FN 20, FINRA Opposition p. 32).[13] In other words, in a case where

[13] Incidentally, one of the ex-brokers that FINRA did interview, Gregg Kucher, indicated that he did have his branch inspected and that he met Mr. Black approximately 20 times, which flies in the face of Mr. Minor's testimony. Of course, FINRA failed to produce the Email reflecting that interview until after the hearing. Consider then, that FINRA failed to produce the document containing Mr. Minor's outlandish statement AND the document directly refuting that outlandish statement only then to argue that neither document was exculpatory evidence and that they had no impact on the hearing. Moreover, Ms. Arnold testified that the ex-brokers FINRA spoke with, as found on CX-11, told FINRA that nobody from SEI had been to their respective locations in terms of inspections (Tr. 263-4). This is at odds with the Memo where Mr. Kucher, who appears to be part of the group that Ms. Arnold was referring to, indicated

witness credibility is key, FINRA denied Applicants the opportunity to cross examine – and impeach – a witness on a claim so outlandish it would have likely rendered his credibility blown and his testimony moot.

F. The Findings Should be Vacated Because due to Evidence Spoliation.

Applicants' hearing was unfair for other reasons. Applicants demonstrated in the Appeal that the findings that they lied and provided false documents should be vacated because of evidence spoliation. FINRA argues that the NAC correctly found that Applicants failed to show that FINRA acted with a culpable state of mind. "Where a party seeks a severe sanction, such as dismissal or an adverse inference, the movant must show: (1) that the spoilating party had control over the evidence and an obligation to preserve it at the time of destruction or loss; (2) that the party acted with a culpable state of mind upon destroying or losing the evidence; and (3) that the missing evidence is relevant to the movant's claim or defense." *Harkabi v. SanDisk Corp.*, 275 F.R.D. 414, 418 (S.D.N.Y. 2010) (*citing Residential Funding Corp. v. DeGeorge Fin. Corp.*, 306 F.3d 99, 107 (2d Cir. 2002)). "'[T]he culpable state of mind factor is satisfied by a showing that the evidence was destroyed knowingly, even if without intent to breach a duty to preserve it, or *negligently*.'" *Harkabi*, 275 F.R.D. at 418 (*quoting Residential Funding Corp.*, 306 F.3d at 108) (emphasis in original).

FINRA argues Applicants assumed negligence and that "the record does not show that FINRA acted intentionally" to lose or destroy the notes. (Opposition Brief p. 35). FINRA has misstated the applicable standard here. It is important to understand that *either* negligently losing the documents *or* knowingly losing or destroying the documents (even without the intent to breach a duty) satisfies the second prong. Thus, for example, if FINRA intentionally shipped the

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that a branch inspection occurred. FINRA failed to correct this testimony, which appears to be false and weighs directly on witness credibility and is, thus, material.

documents to another office, without the intent to deprive Applicants access to them, the second prong is still satisfied. It is also satisfied if a FINRA employee destroyed them by negligently spilling coffee on them. FINRA's arguments on the second prong fail.

FINRA also argues that even if Applicants did show a culpable state of mind they failed to prove the other two prongs. Incredibly, but consistently, for what that is worth, FINRA argues that the Notes "were irrelevant to whether Black and the Firm lied about inspecting offices" (FINRA Opposition p. 34) because of the Emails and Memo that were created a few days later (which, of course, FINRA also failed to produce). The Emails and Memo, however, do not encompass the content of the original Notes and the FINRA employee admitted that they were merely synopses of what she felt was important (possibly omitting information important to the defense). Thus, the Notes were entirely relevant. Moreover, FINRA controlled the documents, and had a duty to preserve them (FINRA seems to have abandoned its ludicrous argument that it had no duty preserve relevant evidence).[14] Applicants satisfied all three prongs, which means the findings should be dismissed.

From the above, it is clear that Applicants have been deprived a fair hearing. FINRA cherry-picked biased witnesses and then shrugged and argued "immaterial" when, predictably, it turned out that those ex-employees with axes to grind failed to testify in a credible and consistent manner. Worse, FINRA purposefully denied Applicants access to the very exculpatory documents they could have used to demonstrate the failings of the witnesses to the panel during the hearing. Again, FINRA shrugs this off as "immaterial," but at some point, it becomes clear that FINRA's actions denied Applicants a fair hearing. The arguments raised in FINRA's Opposition do nothing

[14] FINRA previously argued that it did not have a duty to preserve the evidence because counsel had not requested copies of the documents when they were lost (FINRA's Brief Addressing Findings in the Extended Hearing Panel's August 31, 2018 Order, p. 4).

to cure the problems raised in the Appeal. Because of this, the findings that Applicants gave false testimony and fabricated documents in relation to branch inspections, and the corresponding sanctions, should be vacated.

II. APPLICANTS' EMAIL SUPERVISION SYSTEM WAS REASONABLE

FINRA's Opposition also missed the point on the issue of email supervision. FINRA concedes, as it must, that the adequacy of email supervision is based on a reasonableness standard. (FINRA Opposition p. 42). In other words, a system that is bad for one broker-dealer might be fine – reasonable – for another. As will be shown below, FINRA did nothing but repeat its misguided arguments about SEI's email supervision system.

In layman's terms, the crux of FINRA's argument is that SEI's email supervision was bad or unreasonable because, to some degree, it involved the so-called "honor system."[15] It is, however, undisputed by FINRA that the honor system is acceptable in certain situations and, therefore, not *per se* bad (Oral Argument p. 83). This means that the honor system *can* be reasonable; thus, the issue is whether or not the honor system was reasonable ***for SEI***, in light of its business model. Because it was reasonable, the findings of the NAC should be vacated.

A. The Use of Third-Party Email Addresses was Specifically Allowed by FINRA.

The NAC took issue with the fact that "SEI permitted its representatives to use their own private email accounts for the purposes of conducting SEI business." (NAC decision p. 26). In its Opposition, FINRA did the same: "the record shows, and Applicants do not dispute that, during the relevant period they permitted the Firm's registered representatives to use personal email for Firm-related business." (FINRA Opposition p. 43). The problem is that FINRA realized there

[15] SEI previously maintained a procedure whereby those associated persons who utilized e-mail for communication with customers were permitted to use their personal e-mail addresses, however, they were required to copy Mr. Black on all such correspondence. The communications were then kept in written or electronic form. That procedure, as Mr. Black testified, was originally suggested to SEI by FINRA Examination Manager DePorres Cormier

would be instances where employees, such as those working at SEI, would "communicate via email through means other than their member-issued email addresses" (Regulatory Notice 07-59 p. 8), and specifically allowed for it: "if a member permits employees to communicate with customers through...other non-member employee addresses, the member is required to supervise and retain those communications" (*Id.*). In other words, FINRA had the ability in 2007 to outright prohibit the use of personal emails for firm business, but declined to do so. Instead, FINRA stated explicitly that "[t]he guidance neither creates new supervisory requirements nor requires the review of every communication."

Mr. Black testified that after Mr. Cormier's suggestions during FINRA's 2008 exam, SEI initiated a requirement that representatives copy SEI on their emails and, further, SEI began retaining those emails in either paper or electronic form (Tr. 802). SEI brokers who used their personal email addresses were required to forward all customer correspondence to Mr. Black, where the correspondence was reviewed and retained. Thus, in formulating their procedures, Applicants followed verbal recommendations from FINRA staff and formal written guidance from FINRA (Regulatory Notice 07-59). In its Opposition, FINRA totally ignores its own guidance and, instead, repeatedly argues, without explanation, that the use of third-party email addresses is inherently unreasonable. FINRA should not be allowed to put out guidance and then punish members who follow it.

B. The Honor System was a Reasonable System to Supervise Emails.

In its Opposition, FINRA again argued repeatedly, and without explanation, that the honor system was unreasonable even though Enforcement counsel conceded during oral argument that the honor system involving a limited number of brokers "maybe...fine." (Oral Argument p. 83). There are two issues with this assertion. First, and most obvious, FINRA has never offered any guidance that even suggests the ability to rely on the honor system is somehow pegged to the size

of the firm. Indeed, in Regulatory Notice 07-59, FINRA addressed the question whether it was appropriate to subject "small firms with limited resources" to the same supervisory requirements as big firms, and concluded that size does not matter; what does matter is that "the principles-based guidance generally allows firms" – regardless of size – "the flexibility to design supervisory review procedures for electronic communications that are appropriate to each firm's business model." Given this, counsel's concession during oral argument was, simply, wrong.

Second, even assuming that there is some legitimacy to the notion that an honor system does not work for bigger firms, FINRA painted a false picture of SEI in its attempt to demonstrate that it was too large reasonably to rely on an honor system, describing SEI as supposedly having "numerous registered representatives scattered across the country" (FINRA Opposition p. 45). This was simply not the case. In June 2013, Mr. Black wrote to FINRA in response to the SEI 2012 Cycle Exam (RX. 52) and specifically noted that "we surveyed all of our brokers regarding their use of email to communicate with clients and the number was 28 out of a then total 126 reps in 2011." (RX 52 p. 13). Notably, 28 refers to ***any*** broker using ***any*** email; the number of brokers using their personal emails was likely even lower. Mindful that the total number of SEI employees using personal email is small and, therefore, manageable, FINRA resorts to citing percentages in its attempt to add some gravitas to its argument, i.e., 28 of 126 reps "still represents nearly 25 percent of the Firm's registered representatives." (FINRA Opposition p. 45). By that logic, 25 percent of a four-broker office using ***any*** email to communicate with clients would make the honor system unreasonable. It is just not so.

FINRA also argued that the system was unreasonable because SEI "was not doing anything to confirm that its representatives" (*Id.*) were actually complying with the honor system. The NAC, however, conceded that "respondents also 'require[d] each employee to certify in writing,

on at least an annual basis, that they were complying with SEI's procedure for copying' the home office 'on all electronic communications.'" (NAC Decision p. 27). Once again, FINRA's Opposition misses the mark.

C. Regulators' Alleged Warnings about the System.

FINRA argues repeatedly that Applicants were warned that they needed to change their email supervision system. As explained in the Appeal, the source of the warning cited exclusively to a FINRA Press Release, which, as a FINRA employee conceded during the hearing, is not a regulation (Tr. 379). Mr. Black also testified that he did not believe that the Press Release was a binding regulation (Tr. 818). Mr. Black was correct. In fact, very recently, President Trump issued an "Executive Order on Promoting the Rule of Law Through Improved Agency Guidance Documents"[16] that requires "that agencies treat guidance documents as non-binding both in law and in practice." In other words, despite what FINRA might argue, Applicants cannot be held liable for violating a press release.

Even assuming there were other warnings about other violations, the Commission can still find, for the reasons outlined above and described in Applicants' Appeal, that the system employed was reasonable for a brokerage full of "old fogies" (RX-115 p. 11) that were not as reliant on technology (i.e., email) as the typical entity that FINRA regulates. Moreover, FINRA conceded in its Opposition that "a supervisory system does not have to be perfect" (FINRA Opposition p. 46). SEI's system was not perfect, but it was reasonable, in light of the brokers employed and the manner in which they communicated with their customers.[17] Because of this, FINRA failed to

[16] https://www.whitehouse.gov/presidential-actions/executive-order-promoting-rule-law-improved-agency-guidance-documents/ (last visited October 21, 2019)

[17] FINRA argues that Applicants cannot dispute that SMARSH was more likely to ensure regulatory compliance than the honor system. However, Mr. Dale conceded that SMARSH would not capture emails from a broker who elected to use a personal email addresses not registered with the system or old-fashioned paper letters or correspondence

prove by a preponderance of the evidence that the SEI failed to establish and maintain a reasonable supervisory system and failed to establish, maintain and enforce reasonably designed written supervisory procedures to ensure the retention and review of business-related emails.[18] Thus, the findings and sanctions should be vacated.

III. THE CUMULATIVE EFFECT OF THE ERRORS

The Commission has in the past vacated findings and sanctions because the cumulative effect of errors created an unfair hearing. *In the Matter of the Application of U.S. Associates, Inc.*, 1993 WL 469130 at *5. Similarly, in its Appeal, Applicants demonstrated that the cumulative effect of the errors, some by FINRA, some by the hearing panel, created an unfair hearing which demands the findings and sanctions in the instant matter be vacated. FINRA attempts to distinguish *U.S. Associates* from the instant matter for several reasons, all of which fail.

For instance, FINRA argues that the cases are different because in *U.S. Associates*, FINRA did not produce the bulk of documents it intended to introduce at hearing until the night before the hearing (FN 26, FINRA Opposition p. 41). FINRA's argument fails because Applicants' situation is actually worse, i.e., Applicants never got the exculpatory documents that they would have used in their own defense until well ***after*** the hearing. Moreover, in *U.S. Associates*, after respondents objected to the late production of documents, "the NASD staff attorney responded that the vast majority of the materials were the firm's own records." *U.S. Associates at *3.* Thus, in that matter, respondents would have at least had some familiarity with the documents at issue, as well as the opportunity to have reviewed them in preparation for the hearing. In the instant matter, however, Applicants could not possibly have reviewed the Emails and Memo, as they were created and

(Tr. 381-383), making it, too, ultimately reliant on the honesty of the brokers. Thus, Applicants can and do dispute FINRA's assertion that SMARSH was some kind of panacea or superior to the honor system.

[18] As noted in the Appeal, there are not, nor have there ever been allegations of fraudulent conduct in relation to a broker having failed to forward a customer email to the home SEI office.

controlled by FINRA. Indeed, Applicants did not even know they existed until well after the conclusion of the hearing.

The Opposition also argues that *U.S. Associates* is distinguishable because in that matter respondents were denied the opportunity to put on their full case because the hearing panel refused to extend the length of the hearing. (FN 26, FINRA Opposition p. 41). However, SEI and Mr. Black were denied the opportunity to put on their full case because they did not have exculpatory documents to cross-examine the ex-SEI brokers and demonstrate inconsistencies and the lack of credibility in their testimony. The Opposition argues that the instant matter is distinguishable because "Applicants had ample opportunity to present their case and defend themselves" *(Id.)*, but this misses the point. Mr. Black and SEI could have had a year-long hearing and it would not have mattered because FINRA did not produce the exculpatory evidence they needed to properly cross examine FINRA's witnesses and defend themselves.

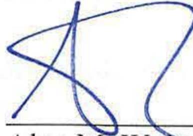
Finally, FINRA attempts to parse the slightest difference between the two cases, arguing that any difference, however slight, means that Applicants' case is distinguishable and therefore, their hearing was fair. Applicants have pointed to some of the similarities in the cases, but what ultimately matters is that there were a multitude of errors in the hearing in both. As the Commission found in *U.S. Associates*, "perhaps some of the objections (considered in isolation) might be dismissed, but together they demonstrate unfairness." *U.S. Associates at *5*. Applicants have demonstrated multiple errors that extinguished any opportunity they had for a fair hearing. Thus, the Commission should apply the same logic from *U.S. Associates* and vacate the findings and sanctions against Applicants.

CONCLUSION

For the foregoing reasons, Applicants request that the findings and sanctions affirmed by the NAC be vacated.

Respectfully submitted this 21st day of October, 2019.

ULMER & BERNE LLP



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CERTIFICATE OF SERVICE

I hereby certify that APPLICANTS' REPLY BRIEF TO FINRA'S BRIEF IN OPPOSITION TO APPLICATION FOR REVIEW has been sent to the following parties entitled to notice as follows:

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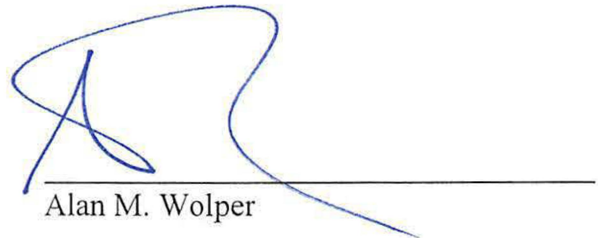
This 21st day of October, 2019.



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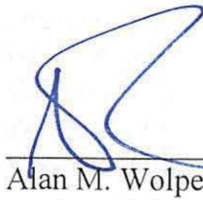
Certification pursuant to Rule 450(c)

I certify that this document conforms to the requirements of SEC Rules of Practice 450(c). The length of this brief, excluding the cover page, table of contents, table of authorities and signature blocks is 6,356 words.



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