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UNITED STATES OF AMERICA

BEFORE THE UNITED STATES SECURITIES & EXCHANGE COMMISSION

In the Matter of the Application of Wilson-Davis & Co., Inc. (CRD No. 3777), James C. Snow (CRD No. 2761102), and Byron B. Barkley (CRD No. 12469) For Review of Disciplinary Action Taken by FINRA	SEC ADMIN. PROC. FILE NO. 3-19666 FINRA COMPLAINT NO. 2012032731802

OPENING BRIEF FOR APPEAL OF WILSON-DAVIS & CO., INC., JAMES C. SNOW, AND BYRON B. BARKLEY

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Petitioners Wilson-Davis & Co., Inc. ("Wilson-Davis" or the "Firm"), James C. Snow ("Snow"), and Byron B. Barkley ("Barkley") (collectively, "Petitioners") appeal the decision of the National Adjudicatory Council ("NAC") dated December 19, 2019 in FINRA Complaint No. 2012032731802. The NAC found that: (1) Wilson-Davis engaged in short selling in violation of Reg. SHO; (2) Snow and Barkley failed to supervise these short sales; and (3) Wilson-Davis and Snow failed to supervise and establish and implement anti-money laundering ("AML") policies and procedures. The NAC imposed the following sanctions: (1) for short-selling in violation of Reg. SHO, a $350,000 fine and disgorgement of $51,624, plus prejudgment interest; (2) for failing to supervise and implement adequate AML procedures, an additional $750,000 fine and a direction to retain an independent consultant; (3) for failing to supervise and implement adequate AML procedures, Snow was fined $77,000, suspended in all capacities for three months and in his principal and supervisory capacities for one year, and ordered to requalify as a principal; and (4) for failing to supervise the short sale trading, Barkley was fined $52,000, suspended in all capacities for three months and in his principal and supervisory capacities for one year, and ordered to requalify as a principal.

For the reasons discussed herein, the Commission should reverse the NAC's decision or, at a minimum, either vacate or substantially reduce the sanctions imposed.

I. INTRODUCTION

The NAC imposed massive sanctions despite the complete absence of any evidence that: (a) Petitioners engaged in any intentional misconduct; (b) any Wilson-Davis customer, or the market, was harmed by the conduct at issue; (c) Wilson-Davis was being used by its customers to facilitate any illegal or manipulative activity; or (d) Wilson-Davis, in any way, profited from

the alleged misconduct. The NAC's fines and lengthy suspensions, imposed upon a small firm and its principals, are (in large part) for conduct that completely stopped seven years ago, and could for all intents and purposes destroy or cripple the Firm.

Remarkably, the NAC made no effort to explain how these sanctions were remedial, even though the law clearly holds that sanctions must be remedial – not punitive. The U.S. Court of Appeals for the D.C. Circuit has held that it is impermissible to "say, in effect, petitioners are bad and must be punished."[1] But that is exactly what the NAC did here. The D.C. Circuit instructs that as sanctions increase, an explanation must be provided to demonstrate why a "severe, and therefore apparently punitive sanction, is in fact remedial, particularity in light of the mitigating factors."[2] The NAC breaches this requirement as well. For these reasons, as discussed at length herein, the NAC's sanctions are punitive and should be vacated or substantially reduced.

Moreover, the NAC's finding that Wilson-Davis clearly violated Reg SHO cannot withstand scrutiny because the Firm's short selling activity bore indicia of bona fide market making and accomplished the important goal of supplying needed liquidity to markets overwhelmed by buy-side demand. Even if reasonable minds differ as to whether the short sales constituted bona fide market making, neither the regulation, the related guidance, nor Wilson-Davis' alleged failure to comply is so clear-cut as to warrant the massive sanctions imposed, particularly where Wilson-Davis stopped the challenged practice long ago and no finding was made that Wilson-Davis knowingly violated the regulation.

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[1] *Paz Sec. v. SEC*, 494 F. 3d 1059, 1064 (D.C. Cir. 2007)

[2] Id. at 1065.

With respect to the NAC's conclusions regarding AML and supervision, the NAC ignored undisputed evidence and testimony—despite the complete absence of any credibility determinations by the Hearing Panel—establishing that Wilson-Davis was well aware of, and was guarding against, any use of the Firm to facilitate criminal activity both in a firm-wide sense and with respect to the specific trading at issue. The stacking of more than $827,000 in fines, a one-year suspension and an order to requalify for Snow, coupled with an order to retain an independent consultant, cannot possibly be justified as remedial and the NAC nowhere provides the required explanation of why such severe sanctions are remedial rather than punitive. Rather, the lack of any reasoned explanation, along with the evidence that no actual wrongful act occurred at Wilson-Davis (that is, no market manipulation, no Section 5 violation, no wiring money to terrorist havens, etc.) demonstrate that the only possible explanation to nearly triple the Hearing Panel's fine is that the NAC wanted to punish Petitioners. The law does not allow the NAC to do so and the NAC's decision should be reversed or modified.

II. PRELIMINARY OBJECTION–FINRA'S DISCIPLINARY PROCESS IS PATENTLY UNFAIR.

FINRA owes its existence and authority to statute. Specifically, 15 U.S.C. § 78s sets the process by which a self-regulatory organization may become registered and the standards they must satisfy. The Commission has the responsibility to ensure that a self-regulatory organization ("SRO"), like FINRA, adopts and implements fair and appropriate rules governing its members. Moreover, the Commission retains the authority to "abrogate, add to, and delete from … the rules of a self-regulatory organization … as the Commission deems necessary or appropriate to *insure the fair administration of the self-regulatory organization*…." 15 USC § 78s(c) (emphasis added). The Commission has acknowledged its "statutory obligations to ensure

fairness and integrity" to disciplinary proceedings and that "a fundamental principle governing all SRO disciplinary proceedings is fairness." *In re: Jeffrey Hayden*, 2000 SEC LEXIS 946, 54 S.E.C. 651.

The procedures here demonstrate FINRA's failure to comply with this fairness mandate. For example, on October 12, 2018, Petitioners argued their appeal to a two person NAC subcommittee: Ms. Christine Hurt (a law professor) and Jim Williams (an erstwhile member of the securities industry). At this appellate argument, the NAC subcommittee pressed Enforcement on significant issues:

- The NAC Panel inquired of Enforcement: "Why does the SEC go after five stocks and then you go after four? In layman's terms it almost looks like it's double jeopardy." Tr. 53 (R. 8445).
- The NAC Panel asked Enforcement: "I don't want to sound ignorant, but I feel like you're saying they should have looked into [VHMC] because it's suspicious, but you never say it's suspicious of what. Like what is your theory of what was happening? It's like you're saying it was a dark and stormy night, it was a scary house, there was a black cat and then you stop." Tr. 63-64 (R. 8455-56).
- The NAC Panel stated to Enforcement: "It's always troubling to me that FINRA says firms can develop their own procedures and then they come back when something goes wrong and say the procedures aren't good enough. It seems like it's a trap for a lot of people." Tr. 65-66 (R. 8457-58).
- The NAC panel expressed the view: "I don't understand the distinctions in this area. They had procedures, which I would tend to agree, were inadequate, but the remedy seems to be fix your procedures, start documenting the procedures rather than what

the hearing panel sort of came to. And I say the same thing about supervision. . . You could go to 2,000 firms in a day in the country and cite the same thing. The remedy there was fix it, fix your organization, fix your reporting. It almost seems like it's a piling on situation. Tell me why I'm wrong." Tr. 66-76 (R. 8458-59).

- The NAC Panel pushed back on Enforcement's view that the Reg. SHO fine was appropriate: "But it seems like you're saying, then, that the fine is appropriate because the activity that it is targeting generated millions of dollars. But the case is only about four specific instances of this activity. If the rest of the activity was not violative naked shorten selling, then should the fine be based on the tens of millions of dollars or should it be based on these four instances? Because we don't know if all the other trades that Mr. Kerrigone did for two or three years violated Regulation SHO. ... we can't use this as a representative sample and then extrapolate." Tr. 69-70 (R. 8461-62).

Mr. Williams and Professor Hurt, upon information and belief, were tasked with writing the first draft of the NAC opinion, which the entire NAC would then review and reject or approve. But given the extreme length of time between the appeal oral argument (October. 12, 2018) and the issuance of the NAC decision (December 19, 2019), it appears that both members who actually heard the appeal argument were not on the NAC at the time the decision was issued. *See* https://www.finra.org/rules-guidance/oversight-enforcement/decisions/national-adjudicatory-council-nac/members (printed on January 17, 2020, with neither Christine Hurt nor Jim Williams showing as NAC members, attached as Exhibit "A" hereto).

Fundamental principles of fairness are violated when the only persons who actually heard appellate argument for the NAC were not on the NAC when the final decision was made. In any

event, Mr. William and Professors Hurt's hard questions were never adequately answered by Enforcement and subsequently ignored in the NAC's decision.

This manifest unfairness is then compounded by a disciplinary process that "stacks the deck" against a respondent as: (1) Enforcement is given unlimited power to demand the appearance of witnesses at depositions on little to no notice and then recall a witness an unlimited number of times; while counsel can object during the examination, no neutral decision-maker exists to resolve such objections; (2) a respondent, in turn, never gets the chance to take any discovery[3]; (3) Enforcement has the ability to make an unlimited number of demands for documents and the responding party has no ability to object or refuse to comply because failing to produce is an independent basis for punishment; (4) Enforcement has access to an entire body of hearing officer's written decisions in thousands of disciplinary proceedings that no respondent can access, allowing Enforcement to know in advance of any motion how the particular hearing officer has decided similar motions; and (5) Enforcement knows the identity of each person who has served as an Extended Hearing Panel member for every case that has gone to a decision, while respondents are not provided that information, allowing Enforcement to predict how a particular panel member decided other potentially similar cases while a respondent remains in the dark.

[3] In contrast to the FINRA process, the SEC's Rules of Practice, among other things: (i) grant respondents the right to request the issuance of subpoenas for non-party witnesses to testify at the hearing or, if they cannot appear at the hearing, to sit for a deposition (17 CFR 201.232 and 233); and (ii) provide significant protections to persons compelled to testify as part of an investigative proceeding, including the right to have an order of investigation. *See* 17 C.F.R. 203.7. Moreover, a subpoena may always be challenged in United States District Court.

Petitioners therefore contend that the disciplinary proceedings that FINRA imposes generally, and imposed in this case, are fundamentally unfair and violate the statutory dictate that self-regulatory bodies provide fair procedures for imposing discipline.

III. RELEVANT RULES AND REGULATIONS

Three subject areas are primarily involved in this Petition:

1. Bona fide market making - 17 CFR 232.203, known as Reg. SHO, was promulgated in 2008 and imposes requirements for the short selling of securities, including the obligation to locate stock prior to executing a short sale or have a locate arranged. A primary purpose of Regulation SHO is to curb manipulative naked short selling used to drive down a company's stock price.[4]

   Reg. SHO states that a "bona fide market maker" can engage in short selling without first locating stock to borrow. This is known as the "locate exemption."

   Regulation SHO states that the term "market maker" has "the same meaning as in Section 3(a)(38)" of the Exchange Act, which defines a market maker as one who "holds himself out (by entering quotations or otherwise) as being willing to buy and sell a security for his own account on a regular or continuous basis." The Commission published guidance for Reg. SHO in 2004 and 2008. See Exchange Act Rel. No. 50103, *Short Sales*, 69 Fed. Reg. 48008 (August 6, 2004) and Exchange Act Rel. No. 34-58775, *Amendments to Regulation SHO*, 2008 SEC Lexis 2319, *62 (October 17, 2008).

2. Anti-Money Laundering ("AML") - FINRA Rule 3310 requires each member to "develop and implement a written anti-money laundering program reasonably designed to achieve

[4] RX-34 at 3, footnote 5 and 6 (R.3831).

and monitor the member's compliance with the requirements of the Bank Secrecy Act" and its implementing regulations. Rule 3310 enumerates AML requirements, including the requirement to "[e]stablish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of suspicious transactions required under [the Bank Secrecy Act] and the implementing regulations thereunder."

In turn, 31 C.F.R. 1023.320(a) was promulgated under the Bank Secrecy Act and requires a broker-dealer to file a suspicious activity report ("SAR") when, among other reasons, the broker dealer "knows, suspects, or has reason to suspect" that the action at issue "involves the use of the broker-dealer to facilitate criminal activity."

3. Supervision - NASD Rule 3010(a) requires the establishment and maintenance of a supervisory system "reasonably designed to achieve compliance" with applicable securities laws, regulations, and rules.

IV BACKGROUND AND EXECUTIVE SUMMARY

A. Wilson-Davis & Company.

Wilson-Davis is a small broker-dealer founded in 1968 with its principal office in Salt Lake City. The majority of the trading activity at Wilson-Davis occurs on the OTC market, also known as "the Pink Sheets." Snow joined Wilson-Davis in 1996 and has acted as the Firm's AML officer and President. Barkley joined Wilson-Davis in 1969 and is the Firm's head trader. Lyle Davis, an owner and principal since 1968, assists Snow with AML efforts and helps review trading. Barkley, Snow, and Davis had no regulatory history at the time of the trading at issue. Wilson-Davis' employees and representatives have always sat within twenty feet of the Firm's principals, and the Firm's management and personnel interact constantly throughout each day, Tr. (Snow) at 1136:18-1138:10 (R. 1663-1665).

Wilson-Davis' most serious disciplinary issue in recent years (prior to this matter) related to deposits and trading of a stock in 2006, which resulted in a FINRA complaint in December 2010 ("the FINRA 2010 Complaint") and a hearing panel's conclusion that a Wilson-Davis registered representative, Randy Carlson, facilitated the sale of unregistered securities. CX41, CX-45 (R. 2955, 3015). Wilson-Davis recognized the importance of this issue and did not wait for Enforcement's complaint to start fixing the problem. In early 2010, the Firm (with substantial assistance from outside counsel) completely rewrote its stock vetting and deposit procedures, which have been constantly improved since that time. Tr. (Moore) at 988:9-990:4 (R. 1515-1517) and RX-24 (R. 3679). As a result, Wilson-Davis has completely avoided the Section 5 issues (and related AML concerns) that frequent Enforcement's and the Commission's press releases.[5] *Id.* at 990:5-991:19 (R. 1517-1518). This is not happenstance; Petitioners testified that they take their regulatory responsibilities seriously and provided detailed examples of the steps taken to meet their compliance obligations. *On this point, and many others as discussed below, the Hearing Panel made no credibility finding to the contrary.* In fact, the Hearing Panel did not make any negative or adverse credibility findings regarding Petitioners or any of their witnesses.

B. Wilson-Davis' Market Making Activity In Four Stocks.

[5] *See, e.g.*, (1) Cantor Fitzgerald (fined $7.3 million for selling billions of unregistered microcap shares in violation of federal law), http://www.finra.org/newsroom/2015/finra-sanctions-cantor-fitzgerald-73-million-selling-billions-unregistered-microcap; and (2) Brown Brothers Harriman (fined $8 million for transactions in six billion shares of penny stock, on behalf of undisclosed customers of foreign banks in known bank secrecy havens without verifying that the stocks were free trading), http://www.finra.org/newsroom/2014/finra-fines-brown-brothers-harriman-record-8-million-substantial-anti-money-laundering.

In 2008, Wilson-Davis hired Anthony Kerrigone ("Kerrigone") as a trader.[6] He worked in the Denver office until 2013. Tr. (Kerrigone) at 409:16-24 (R. 935). Kerrigone identified stocks in which he wanted to make a market and then bought and sold to provide liquidity and facilitate market flow. *Id.* at 420:23-421:24 (R. 946-954). Kerrigone received 60 to 70% of the profits from any trading. Tr. (Barkley) at 519:18-24 (R. 1045). Barkley supervised Kerrigone closely, often communicating with him several times a day and making numerous visits to Denver. Tr. (Barkley) at 705:16-706:6, 714:8-715:15 (R. 1231-1232, 1240-1241). Kerrigone focused on newly active Pink Sheet stocks and, when the demand for a stock grew (sometimes due to promotional efforts), Kerrigone became a market maker and engaged in short selling. Tr. (Kerrigone) at 420:23-421:24 (R. 946-947). Enforcement pointed to 122 short sell trades in four Pink Sheet stocks, which occurred over a total of 13 trading days, as instances in which Wilson-Davis was not acting as a bona fide market maker and should have located stock to borrow.

C. Valley High Mining Company ("VHMC").

Wilson-Davis' trading in Valley High Mining Company ("VHMC") occurred over an eight-month period. Trading volume was minimal and VHMC often went days with no activity and, on days when it did trade, the daily volume ranged from a few hundred to a few thousand shares. CX-22 (R. 2301). Wilson-Davis' customers selling VHMC were long time, well known clients, and included well established Salt Lake City businesspeople. Tr. (L. Davis) at 821:13-822:8; RX-14, RX-15 (R. 1348-1349; 3563, 3601). The one Wilson-Davis customer buying VHMC had been a client for close to a decade with no regulatory issues. RX-14 at 21-22 (R. 3563); Tr. (C. Moore) at 1003:5-23 (R.1530). Wilson-Davis knew that certain customers were

[6] At the time Kerrigone was hired, he had very minor regulatory history. Kerrigone executed an AWC and was fined $500.00 in 1997 for using inappropriate language.

occasionally selling VHMC to another customer (that is, engaging in "cross trades" within the Firm) and fully vetted these trades. Tr. (L. Davis) at 809:13-811:11 (R. 1336-1338). But given the totality of the circumstances, including the well-known clients, the lack of any promotion associated with VHMC, and the low daily volume (that is, there was no "pump" and no "dump," among other factors), Wilson-Davis had no reason to believe, and the record is devoid of evidence to suggest, that customers were using Wilson-Davis "to facilitate a crime" or to assist with manipulative activity. Wilson-Davis therefore allowed the trading to occur.

D. Supervision Generally and Heightened Supervision of Randy Carlson.

The Firm's supervisory structure in 2011 to 2014 was not complex. The only significant change was that Paul Davis, the former supervisor of retail registered representatives, became less involved in 2013 due to personal reasons, and therefore Snow and Lyle Davis increased their supervision over retail activities. Tr. (Snow) at 1139:3-17, (L. Davis) at 735:16-736:18 (R. 1666, 1261-1262). Wilson-Davis, as part of the investigation, presented Enforcement with a "headcount" that incorrectly stated that the registered representatives reported to Snow. However, the testimony established that (1) this was simply an error in a draft document; and (2) everyone knew exactly whom to report notwithstanding the erroneous headcount list. Tr. (L. Davis) at 806:4-807:18 (R. 1333-1334). In addition, the Firm issued a "Heightened Supervision Memorandum" to Randy Carlson, a Wilson-Davis registered representative, as a result of a disciplinary proceeding against him. CX-46 (R. 3033). No evidence exists that problems occurred due to alleged inadequate supervision of Mr. Carlson, or that any Section 5 issues have occurred since Wilson-Davis re-wrote its Section 5 procedures in 2010.

IV. STANDARD OF REVIEW.

In reviewing the NAC's decision, the Commission must independently find that: (1) Petitioners have "engaged in such acts or practices, or ha[ve] omitted such acts, as [FINRA] has found [them] to have engaged in or omitted"; (2) "that such acts or practices, or omissions to act, are in violation of such provisions of this title, the rules or regulations thereunder, the rules of [FINRA] … as have been specified in the determination of [FINRA]; and (3) "that such provisions are, and were applied in a manner, consistent with the purposes of this title." 15 USC § 78s(e). If the Commission so finds, it "shall so declare and, as appropriate, affirm the sanction imposed by [FINRA], modify the sanction in accordance with paragraph (2) of this subsection, or remand to [FINRA] for further proceedings." *Id.* If the Commission, "having due regard for the public interest and the protection of investors, finds after a proceeding … that a sanction imposed by [FINRA] upon such member … imposes any burden on competition not necessary or appropriate in furtherance of the purposes of this title or is excessive or oppressive, the Commission may cancel, reduce, or require the remission of such sanction." *Id.*

A preponderance of the evidence standard is applicable. *See, e.g. In Re Kimberly Springsteen-Abbott*, 2020 SEC LEXIS 394, SEC Release No. 88156, Feb. 7, 2020.

V. WILSON-DAVIS' SHORT SELLING BORE SEVERAL INDICIA OF BONA FIDE MARKET MAKING.

Wilson-Davis claimed the "bona fide market maker" exemption with respect to the four stocks at issue because Wilson-Davis was doing what bona fide market makers are allowed to do: providing pricing efficiency and short-term sell side liquidity to stocks with heavy demand, minimal supply, and upward price volatility. Wilson-Davis incurred risk and its activities bore many indicia of bona fide market making. Moreover, the evidence established —and Enforcement itself acknowledged—that at the time Wilson-Davis was selling short, there was

massive demand for the stocks and minimal supply. The market needed sellers and Wilson-Davis filled that need by selling short.

Wilson-Davis understands that the Commission, given the SEC Order between Wilson-Davis and the Commission on similar issues, will likely disagree.[7] But even if that is the case, the evidence established that Wilson-Davis' trading satisfied several of the guidance's indicia for bona fide market making, and Petitioners believed they were not violating Reg SHO given the regulation's express terms and the limited guidance. Accordingly, for these and the reasons set forth below, and because the imposition of a $350,000 fine is punitive and piling on top of the SEC's prior Reg. SHO fine, the NAC's decision should be reversed or reduced.

A. Wilson-Davis' Activities Evidenced Indicia of Bona Fide Market Making.

The Commission's 2004 and 2008 Reg. SHO guidance sets forth indicia of "what is" and "what is not" indicative of bona fide market making. *See* RX-33 and RX-34 (R. 3803 and 3829). The NAC focused solely on the Commission's guidance that supports the Hearing Panel's conclusion but is virtually devoid of any analysis of the factors or evidence indicating Wilson-Davis was acting (and that lead Wilson-Davis to believe that it was acting) as a bona fide market maker. On this issue, as on other issues, the Hearing Panel made no credibility determinations to explain why testimony supporting Wilson-Davis' interpretation was simply ignored.

First, "a market maker engaged in bona fide market making is a 'broker-dealer that deals on a regular basis with other broker-dealers, actively buying and selling the subject security as well as regularly and continuously placing quotations in a quotation medium on both the bid and

[7] See CX-40.

ask side of the market.'" RX-34 at 30 (R. 3858).[8] Wilson-Davis believed that it satisfied this factor because Wilson-Davis was "actively buying and selling the subject security" from various brokers and constantly posted bid and ask quotes. CX-1, CX-6, CX-11, CX-16 (R. 2175, 2185, 2195, 2231). Although Wilson-Davis carried short positions overnight, Reg. SHO expressly provides market makers with six days to cover a short position (*see* 17 CFR 242.204(a)(3)). *See also* Tr. (Kassar) at 287:24-288:8 (R. 813-814) (guidance provides no time limit for buying and selling "comparable quantities"). If market makers are deemed not to be bona fide because they carry a short position overnight, as the NAC seems to believe, the regulation should be amended or guidance published as, prior this case, nothing existed that would have made that known to Wilson-Davis.

Second, the Commission guidance states that "factors that indicate a market maker is engaged in bona fide market making may include, for example, whether the market maker incurs any economic risk with respect to the securities (e.g., by putting their own capital at risk to provide continuous two-sided quotes in markets)." RX-34 at 31 (R. 3859). Wilson-Davis incurred economic risk in the short sales at issue, a fact evidenced by its multi-million dollar loss in one of the stocks at issue, LOTE, and Wilson-Davis posted "two sided quotes."

Third, and at the *very heart* of Wilson-Davis' belief that it was a bona fide market, is the Commission Guidance stating that "***a market maker engaged in bona fide market making may provide liquidity to a security's market, take the other side of trades when there are short-term buy-and-sell-side imbalances in customer orders, or attempt to prevent excess volatility.***" RX-

[8] In a similar vein, the Commission also stated that "a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity to customers or other broker-dealers" demonstrates bona fide market making. RX-34 at 32 (R. 3860).

34 at 31 (R. 3859) (emphasis added). In a similar vein, the Commission's "Key Points Regarding Regulation SHO" states:

> "Naked" short selling is not necessarily a violation of the federal securities laws or the Commission's rules. Indeed, in certain circumstances, "naked" short selling contributes to market liquidity. For example, broker-dealers that make a market in a security generally stand ready to buy and sell the security on a regular and continuous basis at a publicly quoted price, even when there are no other buyers or sellers. *Thus, market makers must sell a security to a buyer even when there are temporary shortages of that security available in the market. This may occur, for example, if there is a sudden surge in buying interest in that security, or if few investors are selling the security at that time. Because it may take a market maker considerable time to purchase or arrange to borrow the security, a market maker engaged in bona fide market making, particularly in a fast-moving market, may need to sell the security short without having arranged to borrow shares.*

See https://www.sec.gov/investor/pubs/regsho.htm. (emphasis added).

This factor takes center stage as the pattern on each stock is similar: (1) an OTC stock sees dramatic volume and price increase, and (2) Kerrigone addresses the buy-side demand, and in doing so, maintains quotations that are near the inside "ask" but not necessarily near the inside bid, resulting in Wilson-Davis going short and then covering short sales a day or two later when the buying surge wanes.

Enforcement admitted that the Firm's short selling always occurred when there was a demand-side imbalance, with more buyers than sellers: "A. . . . I don't think there's any dispute, his offer was, you know, often close to the inside, you know, during the time that he wanted to sell. Q. Which is when the market needed shares? A. Correct." Tr. (Kassar) at 306:8-14[9] (R. 832). Dr. Blau, a Professor of Finance and Market Structure at Utah State University (and the only expert witness who testified), confirmed the importance of short selling in heated markets:

[9] *See also id.* at 348:17-23 (Kassar) (R. at 874) ("Q. And one of the benefits of short selling is it provides pricing efficiency in the stock. We know that from the 2004 SEC release; correct? A. Okay. Q. Make sense to you? A. Sure.").

> Q. Professor Blau, in a hot stock market where there's dramatic buy side demand, from a market efficiency perspective, what would you want your market maker to do?
>
> A. **Provide as much liquidity as possible on the buy side**. . . . So more liquidity on the buy side is going to be helpful to ensure that prices don't rise faster than they ought to.

Tr. (Blau) at 1310:20 – 1311:17 (R. 1837-38) (emphasis added).

The logical consequence of a market maker providing liquidity in a hot market is that a firm's short-term selling correlates to the dramatic, new buy-side demand. Indeed, it would do no good for a market maker to sell short if it were required to more or less simultaneously buy the same quantity of the same stock *thereby taking the very liquidity just provided.* But even if ultimately found to be incorrect, Wilson-Davis reasonably believed that short selling (while executing no or limited buys) into an incredibly active Pink Sheet market with a demand-side imbalance was indicative of bona fide market making.

The NAC also failed to recognize Reg. SHO's policy concerns. Reg. SHO was established to target abusive short selling, primarily in situations where traders engaged "in massive 'naked' short selling that flooded the market with [an issuer's] stock, and depressed its price." RX-34 at 3, footnotes 5 and 6 (R. 3831). Wilson-Davis did *not* engage in this type activity. To the contrary, Wilson-Davis' trading seemed to provide salutary benefits:

> According to the SEC, short selling provides the market with at least two important benefits: market liquidity and pricing efficiency. For example, market professionals, such as market makers may provide liquidity by naked short selling to offset temporary imbalance in the buying and selling interests of securities.[10]

The NAC ignored the "important benefits" that Wilson-Davis provided.

[10] *See* GAO Report "Recent Actions Appear to Have Initially Reduced Failures to Deliver, But More Industry Guidance is Needed" GAO 09-483 at 31. *See* https://www.gao.gov/assets/290/289477.pdf.

B. The Evidence Weighing Against a Finding of Bona Fide Market Making Was Not As One-Sided as the Decision (and the Sanctions Imposed) Suggests.

Enforcement's evidence focused almost exclusively on answering a single question: what percentage of time was Wilson-Davis more than 10% off of the inside of the bid, the offer, or both. *See* CX-4, CX-9, CX-14, and CX-19 (R. 2181, 2191, 2227, and 2295). But the 10% "standard" is a creature of Enforcement's creation specifically for this matter, chosen "because in some ways it might be applied in other markets" such as the NASDAQ or NYSE markets, markets which behave very differently than the Pink Sheets. Tr. (Kassar) 288:22-289:5 (R. 814-815). Neither FINRA nor the Commission ever advised that 10% is the relevant "bona-fide market making" standard. Indeed, before FINRA could impose a 10% requirement as the basis for what is (and is not) bona fide market making, it would have to go through rule making. Rule 240.19b-4(c) presumes that any change in an SRO's interpretation, policy, or practice is a "rule change" under the applicable legislation. Yet FINRA would purport to hold Petitioners liable for failing to maintain bids and offers within 10 percent of the inside without ever even announcing that standard, let alone going through rule making. See *General Bond & Share Co. v. SEC*, 39 F.3d 1451 (10th Cir. 1994) ("The establishment of a new standard of conduct … must be considered a rule change under any common sense definition of that term."). "Due process requires that an NASD [FINRA] rule give fair warning of prohibited conduct before a person may be disciplined for that conduct." *Rooms v. SEC*, 444 F.3d 1208, 1214 (10th Cir. 2006). Here a "standard" was decided upon and used against Petitioners that was never articulated anywhere.[11]

[11] It is also evident that an across-the-board 10% threshold is nonsensical. If 10% is always the standard, a market maker would be bona fide with short sales of Amazon stock—which had recently traded at around $1,800 per share—even while maintaining a $170 spread on either side of the best bid/offer. Conversely—and more apropos—

Yet Enforcement and the NAC looked principally at Wilson-Davis's compliance with the non-existent "10% rule" while ignoring pertinent questions of where Wilson-Davis stood vis-à-vis the dozens of other market makers. In this case "the leading market maker" was NITE "who was far and away the most active" market maker in LOTE[12], but there were more than 40 other market makers trading in LOTE. *Id.* at 1233:24-1234:3, 1311:18-24 (R. 1760-61, 1838). Dr. Blau concluded that Wilson-Davis' quoted prices "were at least as competitive as the average market maker." *Id.* at 1233:18-21 (R. 1760) and RX-32 at page 15 of 24 (R. 3793).[13] This expert testimony was unrebutted and the Panel made no finding that it lacked credibility.

The NAC ignores the reality of a human trading these stocks as well. The inside quotes in these stocks were incredibly active. There were 53,116 inside quotes for LOTE and 133,209 updated quotes. RX-32 at page 14 of 24 (R. 3792). There were more than 136 inside quotes per minute in LOTE. CX-18 (R. 2293). Likewise, CNCT's inside quote updated every 2 seconds. RX-32 at 14 of 24 (R. 3792). A human trader has no ability to be on the inside every second of the trading day, particularly where a stock price is moving hundreds of times a minute.

The NAC was also demonstrably inaccurate when it found that Kerrigone always began selling into markets with "relatively inactive stocks" (NAC at 14) and thus there was no "trade

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a market maker providing liquidity to a fast-selling stock trading at $.20 per share could be within $.03 of the best offer and be found not be a bona fide market maker.

[12] Knight Capital Americas, LLC (aka "NITE") is a large broker dealer. As stated in NITE's SEC settlement, in 2011-2012, NITE's "aggregate trading (both for itself and for its customers) generally represented approximately ten percent of all trading in listed U.S. equity securities." *See* Exchange Act Release No. 70694 (dated October 16, 2013). The Commission Order details NITE's "automated, high speed algorithmic router that sends orders into the market for execution." NITE was therefore always at the inside due to its massive order flow and computerized trading. Wilson-Davis had neither of these advantages.

[13] The best illustration of how much more active NITE was than other market makers in each of the stocks at issue is found in the first three lines of Exhibit 4 to Dr. Blau's report (RX-32 at page 15 (R. 3793)). NITE updated its quotes in LOTE 12,208 times during the relevant time period, while the average market maker updated its quotes 3,330 times.

imbalance or lack of liquidity in any of the Stocks when Kerrigone began short selling." With respect to LOTE (which constituted a majority of the challenged trades), Kerrigone started making a market on April 23, 2013. The day before Kerrigone entered the market LOTE opened at $2.35 and closed at $2.74 on substantial volume of 434,000 shares. RX-25 (R. 3749). Trading activity in LOTE had increased each trading day before that, with volume rising from about 284,000 shares on April 18th to 434,455 shares on April 22nd. Thus, Kerrigone found LOTE as an active stock with rising interest and few sellers—precisely the kind of market that often needs liquidity to stabilize pricing.

Moreover, the NAC largely looked at the challenged trades and quotes in a vacuum and refused to acknowledge how quickly prices where changing, particularly with LOTE. The NAC also disregarded the fact that, even when Enforcement tried to make it appear that Kerrigone was far off the inside offer (*e.g.,* 122 percent off for about 45 minutes in CNCT), Enforcement was ignoring activity on the electronic securities exchange ARCA. Tr. (Kassar) at 301:1-11 (R. 827). For example, the NAC pointed out that Kerrigone would accumulate "a short position in the stock while posting bid quotations for Wilson-Davis that were significantly away from the inside bid, sometimes by more than 250 percent." NAC at 13. But the NAC made no mention of what was happening on ARCA, [14] which activity has to be factored in, because market making includes "any dealer who, with respect to a security, holds himself out (by entering quotations in an inter-dealer quotation system *or otherwise*) as being willing to buy and sell such security for his own account on a regular or continuous basis." Yet Wilson-Davis' ARCA offers were regularly executed, making it clear that the market was aware of those offers.

[14] ARCA is an ECN that Wilson-Davis (and others) could use to place an anonymous bid or ask quote. Wilson-Davis was never told, during numerous FINRA audits, than using ARCA was somehow improper.

In sum, the NAC's findings that these violations were so egregious as to justify the massive sanctions imposed cannot withstand scrutiny and should be rejected because: (1) the short selling activity met many of the indicia of bona fide market making; (2) the markets needed sellers when Wilson-Davis was selling short and by selling into these markets, Wilson-Davis was doing what the market needed it to do; (3) the application of its previously unannounced "10 percent rule" is arbitrary and improper; (4) many of the NAC's factual findings are demonstrably erroneous; and (5) the record is devoid of any evidence that the trading negatively impacted anyone other than Wilson-Davis.

VI. THE SANCTIONS IMPOSED FOR WILSON-DAVIS' SHORT SELLING ARE PLAINLY PUNITIVE AND NOT REMOTELY REMEDIAL.

FINRA, the Commission, and the Courts have all stated that enforcement sanctions must be "remedial and not punitive."[15] The D.C. Circuit has explained that, it is not enough to "say, in effect, petitioners are bad and must be punished" and, as the sanctions increase in severity, an explanation is needed to establish why a more "severe, and therefore apparently punitive sanction, is in fact remedial, particularity in light of the mitigating factors."[16]

The NAC ignores this legal mandate and inexplicably fails to even discuss how the $350,000 fine for Reg SHO violations—which is unprecedented in its magnitude for a small firm—was determined or why it is "remedial." The NAC uses the word "remedial" only once (other than when quoting from authority), and then only in a completely conclusory statement

[15] *See* FINRA Sanction Guideline at 3 (March 2017); *In re: Elgart,* 2017 SEC LEXIS 3097, *27-28 ("In making this assessment, we must consider any aggravating or mitigating factors, and whether the sanctions are remedial and not punitive.").

[16] *Paz Sec.,* 494 F. 3d at 1064-66.

that the sanctions are "remedial." NAC at 24. The D.C. Circuit has made it clear that the NAC's failure is reversible error. *Paz Sec. v. SEC*, 494 F. 3d 1059, 1061 (D.C. Cir. 2007) (reversing SEC order because "it did not identify any remedial – as opposed to punitive – purpose for the sanctions it approved").

Moreover, a remedial sanction is one that reduces the risk that the particular offender will repeat his unlawful acts; when the purpose strays to discouraging others from doing the same, the sanction clearly becomes punitive. *See Kokesh v. SEC*, 137 S. Ct. 1635, 198 L. Ed. 2d 86 ("[A] pecuniary sanction operates as a penalty only if it is sought for the purpose of punishment, and to deter others from offending in a like manner—as opposed to compensating a victim for his loss."). The very first sentence in General Principle No. 1 in FINRA's Sanction Guidelines states: "The purpose of FINRA's disciplinary process is to protect the investing public, support and improve the overall business standards in the securities industry, and decrease the likelihood of recurrence of misconduct **by the disciplined respondent**." (emphasis added).[17]

The Commission should therefore first ask whether the offending activity is likely to recur and, if so, what sanction is necessary to ensure it does not. Here, it is undisputed that, even before Enforcement started looking into the trades at issue, Wilson-Davis stopped the short-selling activity and never resumed it. This is clearly not a case where the Firm needed (or still needs) some external force to stop the offending behavior. Rather, the Firm suffered a large loss and Kerrigone, the only one who ever traded in this manner, left the firm *seven years ago*. *See*

[17] The idea of using monetary sanctions against a specific respondent to try to deter violations by other FINRA members is inherently unfair, particularly to smaller broker-dealers. The magnitude of the fine that would have to be imposed to deter a broker-dealer with billions in market capital from taking actions that may reap them substantial business or monetary gain is obviously enormous. A much smaller broker-dealer like Wilson-Davis should not have to bear the cost of deterring wrongdoing by other FINRA members. This is part of why the deterrent effect of sanctions should be measured against only the respondents themselves—that is, what is necessary to discourage the respondents themselves—not the world at large—from repeating the sanctioned conduct.

West v. United States SEC, 641 Fed. Appx. 27 *31 (2nd Cir. 2016) (noting that the "risk of future violations" is relevant in considering whether a sanction is remedial or punitive). Thus, a $350,000 fine is not necessary to ensure against future short selling where there is no chance the "misconduct by the disciplined respondent" will ever be repeated.

The Commission's decision in *Saad*, Release No. 86751/August 23, 2019, does not compel a different conclusion. There, the Commission addressed whether the sanction of a bar on the individual member was punitive, rather than remedial. The Commission specifically noted that, in declining to extend the holding of *Kokesh* to the sanction at issue, "it makes no sense to extend this compensation-based test to *non*pecuniary sanctions—which by their nature do not compensate victims—lest we render all noncompensatory sanctions penalties." *Saad*, SEC Release No. 86751 at 3. The Commission made clear in *Saad* that "[t]he inquiry is objective and focuses on the purpose of the [sanction], as opposed to the subjective impact on the respondent." *Id.* at 5.

The Commission also illustrated the distinction between remedial and punitive sanctions by comparing the decisions in the two *Paz v. SEC* cases, 494 F.3d 1059 (*Paz I*) and 566 F.3d 1172 (*Paz II*). In *Paz I*, the D.C. Circuit remanded the bar where nothing in the record supported the sanction and the Commission was merely saying "in effect, petitioners are bad and must be punished." 494 F.3d at 1064. In *Paz II*, the same court affirmed the bar where the Commission reasonably found that petitioners "posed a clear risk of future misconduct" and the bar was therefore "necessary to protect investors." 566 F.3d at 1176. The *Paz II* court again stressed that "a sanction may be used to protect investors but not to punish a regulated person or firm." *Id.* at 1065. ***No such finding was made here, nor could it have been.***

Instead, the NAC simply parrots the FINRA Sanction Guidelines. But this analysis, even if allowed and it is not, is fatally flawed. The FINRA Sanction Guidelines recommend a fine of no more than $16,000 for a "first action," $77,000 for a "second action," and $155,000 "for subsequent actions." This was the first action ever taken against Wilson-Davis by FINRA for alleged Reg SHO violations. Thus, the upper limit of the recommended fine is only $16,000. Yet the NAC imposed a fine **22 times higher**. The NAC acknowledged there was "no basis" in the record for the sanction imposed by the Hearing Panel "so far in excess of the Guidelines," yet the NAC makes this same error. NAC at 24.

Furthermore, the "aggravating factors" identified by the NAC are largely absent or overstated. First, the NAC cites the number of trades at issue, which was 122. The NAC provides no basis for comparing this number of trades with those at issue in other cases, or in any way explains why that number is "aggravating"—it simply says so. Yet in cases involving substantially higher trade volumes, the penalties imposed on appeal were far less severe. For example, in *CL King*—a NAC decision issued only two months before the decision in this matter —the respondents' AML failures resulted in their sale of more than *11 billion shares* of dozens of penny stocks over a four-year period. *See* NAC Decision in *DOE v. CL King & Associates, Inc.*, Complaint No. 2014040476901, at 53. And in that case the NAC *reduced* the fine imposed by the hearing panel from $450,000 to $292,000—while acknowledging that the fine was "at the top end, rather than outside, the" relevant Guidelines.

The NAC also cites the duration of the alleged unlawful trading as an aggravating factor, claiming it took place "over a period of close to a year." But the evidence demonstrates that characterization is flatly wrong:

- Trading in LOTE (which constituted the vast majority of the challenged short sales) started on April 24, 2013 and ended on April 29, 2013 – a period covering only 4 trading days (CX-16 (R. 2231));

- Short sales in PVTA started July 9, 2012 and ended on July 12, 2012, a period only 3 trading days (CX-1 (R. 2175));

- Short sales in CNCT started on February 21, 2013 and ended on February 25, 2013, a period covering only 3 trading days (CX-11 (R. 2195)); and

- Short sales in PMEA started November 12, 2012 and ended November 14, 2012 and covered only 3 trading days (CX-6 (2185)).

Thus, at most the trading at issue began July 12, 2012, and ended on April 29, 2013—a total duration of about nine months, but over that time there were ***only 13 days*** on which challenged trades were made. To characterize this as being wrongful activity occurring "over a period of close to a year" reflects how far the NAC was willing to go to punish Petitioners.

The NAC also makes the incredible assertion that "[t]he short sales also resulted in monetary gain for the firm" (NAC at 24) despite, later in the same page, acknowledging Wilson-Davis' "suffered losses in excess of $4.2 million on Kerrigone's LOTE trading." The fact that there was any uncertainty on this point is perplexing. The Firm's net revenue number from the trading at issue was indisputably a massive loss. Thus, Principal Consideration No. 16 does not favor a more significant sanction. This fact also is relevant to the question of what constitutes a proper remedial sanction. What will it take to ensure the violations do not repeat? A multi-million dollar loss helps ensure that Wilson-Davis will never again engage in the short-selling activity at issue here, or anything like it. Moreover, the passage of seven years with no suggestion the challenged activity has or ever will recur is, to say the least, compelling evidence that a massive fine is unnecessary to ensure against future violations.

The NAC also concludes—without any supporting evidence—that the short sales "affected other market participants." NAC at 24. To the extent other market participants were affected, it was in the form of profits at Wilson-Davis' loss.

In an unsuccessful attempt to support its sanction the NAC cites to *Legacy Trading*. **[CITE]** But does not explain how the $350,000 fine imposed here could be appropriate where the fine in that case was $10,000 for more than 2,000 Reg SHO violations. Although Petitioners understand that it is not possible to make "apples to apples" comparisons between cases, appellate courts recognize that "[p]erhaps gross disparities in sanctions for similar behavior would at least suggest underlying bias" and give a reviewing court pause. *D'Alessio v. SEC*, 380 F.3d 112, 125 (2nd Cir. 2004); *Epstein v. SEC*, 416 Fed. Appx. 142, 2010 U. S. App. LEXIS 24119 (3rd Cir. 2010) (same).

Notably, *Legacy Trading* is the only other matter Petitioners could identify where sanctions were imposed for Reg SHO violations. In that case, the respondent was fined **a total of $10,000** despite committing **2,192 Reg SHO violations** under egregious circumstances. *DOE v. Legacy Trading, Co*, No. 2005000879302, 2010 FINRA Discip. LEXIS 20, at *48-49. The NAC here effectively imposed fines of $2,869 per violation—fines that are **650 times higher than those imposed in *Legacy***. Yet in every way that the two cases could be compared, it is *Legacy*—not this case—where a higher fine could be justified. In *Legacy,* there was no evidence of any significant loss to the firm in the trading at issue, but here that evidence is undisputed. In *Legacy*, the firm "almost never posted the inside bid or ask in connection with the short sales," and "when the market moved towards Legacy's quote it often moved its quote away"—circumstances that never occurred here. *Id.* at *28. The NAC concluded in *Legacy* that the respondents "acted willfully and that their violations ... regarding short sales were egregious."

Id. at *48. Moreover, the firm at issue "made false statements to FINRA...." *Id.* at *9. Despite having 20 times more violations and numerous aggravating circumstances and bad faith credibility findings, the panel imposed a fine of only $10,000 or $4.56 per violation.

Additionally, the NAC incorrectly believed that "Wilson-Davis required Kerrigone to reimburse the firm for its LOTE losses," suggesting that Wilson-Davis itself suffered no loss. NAC at 7. That is, at the very least, incomplete. The record states that Kerrigone covered less than half of Wilson-Davis' loss. *See* Tr. 803:20-804:1 (R. 1220-1331) (Lyle Davis testifying that $2.3 million of the "$4.2 million loss in LOTE" was "absorbed by the firm").

Additional mitigating factors are present that make the sanctions imposed punitive. Wilson-Davis was fined by the Commission for the same type of activity. The Commission already imposed a $75,000 fine for such trading and ordered disgorgement of $208,645.71. *See* CX-40 at 14 (R. 2952). Although the Commission's complaint covered different stocks, "the conduct at issue before [the Commission] was essentially identical" to the conduct at issue here: whether Wilson-Davis was engaged in "bona fide market making activity." *See* CX-40 (R. 2939). FINRA General Sanction Principle six states: "Where appropriate, Adjudicators should consider sanctions previously imposed by other regulators . . . based on the same conduct." The Panel did the opposite – the sanctions increased due to Wilson-Davis' SEC settlement.[18]

[18] It is also worthy of note that **Kerrigone was fined only $10,000 by FINRA and $50,000 by the Commission for his involvement in the exact same conduct.** In fact, Kerrigone entered into a settlement with FINRA regarding 149 Reg SHO violations—27 more than are at issue here. CX-36 (R. 2899). Kerrigone was fined only $10,000 for all 149 violations and suspended for six months with no disgorgement. *See id.* at 2 (R. 2900). That settlement was reached as of September 24, 2015. More than a year later Kerrigone settled with the Commission, which accepted a fine of $50,000 against Kerrigone for all Reg SHO violations. *See* CX-37 (R. 2905). The NAC's Decision would impose upon Wilson-Davis a fine that is six times greater than FINRA and the Commission combined imposed on the individual who directly engaged in the activity, even though he kept 60-70% of trading profits.

Finally, in *Kokesh v. SEC*, 137 S. Ct. 1635, 198 L. Ed. 2d 86, a unanimous Supreme Court held that disgorgement is a punitive—rather than a remedial—sanction where the money disgorged is not used to compensate a specific victim. The Court noted that, "[s]anctions imposed for the purpose of deterring infractions of public laws are inherently punitive . . . ." *Id.* at 1633 (internal quotation omitted). The Court went on to explain more generally that, "a pecuniary sanction operates as a penalty only if it is sought for the purpose of punishment, and to deter others from offending in a like manner—as opposed to compensating a victim for his loss." *Id.* Applying these same standards, a fine of $350,000 for Reg SHO violations is necessarily punitive because it does not compensate any alleged victim—indeed, in this proceeding there was not a single "victim" ever identified. Nor does the imposition of the fines levied in this case "restore the status quo; it leaves the defendant worse off," much worse off in this instance. *Kokesh*, 137 S. Ct. at *1465.

Because the sanctions imposed for Reg SHO violations are punitive and, in any event, the NAC decision fails to explain why or how such sanctions are remedial, those sanctions should be vacated or substantially reduced.

VII. AML COMPLIANCE

Enforcement acknowledged at the hearing that knowing who is involved in trading is relevant when looking for possible red flags (Tr. (Kassar) 354:9-355:10 (R. 880-881)):

> Q. If it's a long-time client with no history of any issues, does that affect whether or not the trade might be considered a red flag?
>
> A. That could potentially be a mitigating factor, yes.

The undisputed evidence was that the persons trading in VHMC were long-time Wilson-Davis customers with no history of issues. Wally Boyack, whose early trades in the stock seemed particularly concerning to Enforcement, testified but his testimony was not even acknowledged or mentioned by either the Hearing Panel or the NAC. The Hearing Panel learned what Wilson-Davis already knew—that Mr. Boyack is an attorney licensed to practice law for more than 45 years (Tr. 1487 (R. 2015)), who spent the first 13 years of his career working for the Commission and as an Assistant United States Attorney (Tr. 1487-88 (R. 2015-16)), and who had been a Wilson-Davis customer for over a decade (Tr. 1489-50 (R. 2017-18)). Given Enforcement's acknowledgement that a broker-dealer's knowledge of its customers can mitigate potential red flags, Mr. Boyack's background was highly relevant. The NAC's complete omission of his name is telling and is consistent with the NAC's desire to ignore evidence that did not support its narrative.

In fact, the NAC completely ignored who the customers were and how that might have impacted an analysis of possible red flags and Wilson-Davis' AML obligations. Enforcement acknowledged they found ***no evidence of any actual manipulation or other criminal activity***. Tr. 1590:4-8 (R. 2118). So the only evidence presented was that Wilson-Davis knew its customers and had no reason to suspect any use of the Firm to perpetrate a crime. Yet the NAC imposed lengthy suspensions and then substantially increased the Hearing Panel's fine.

The NAC also disregarded the testimony and evidence about the investigations that were going on in real time in which every cross trade was verified even though the Panel again made no finding whatsoever that this testimony lacked credibility. Joshua Carlson testified that registered representatives would have no way of knowing if a trade was a cross-trade when it came across, but the trading desk would catch cross-trades and have to approve it. He

specifically recalled one instance in which a VHMC cross trade came across the trading desk and had to be approved. Tr. 1375-1379 (R. 1902-1906). Lyle Davis also followed up on any cross trades the following day, as explained in more detail below. With no finding by the Hearing Panel that any of this testimony was not credible, and where no contradictory testimony was adduced, the NAC had to conclude that Wilson-Davis did exactly what the witnesses said it did, which undercuts the factual basis for finding sweeping AML failures with respect to VHMC.

VIII. SUPERVISION

The NAC's findings unreasonably elevate form over substance in terms of Wilson-Davis' supervisory framework. This is perhaps best illustrated by the NAC's focus on the inaccuracy of a "head count" document, which the evidence showed had never even been circulated within the firm, let alone relied upon. Tr. 741-742 (R. 1267-68). At the same time the NAC seemed largely to disregard the undisputed testimony—which the Panel did not find was lacking in credibility—about what was actually happening on a day-to-day basis at Wilson-Davis.

For example, the NAC points out that "while Snow is explicitly designated as the individual responsible for the reasonable implementation of the firm's AML program, he maintains that he did not have the responsibility for detecting suspicious activity, nor did he delegate that responsibility to anyone else at the firm." NAC at 9. The NAC thus concluded no one at Wilson-Davis was responsible for "detecting suspicious activity," but the undisputed evidence presented at the hearing demonstrates this was patently untrue.[19]

Lyle Davis, among other things, reviewed all cross-trades for any transactions that might be suspicious. Tr. 808-809 (R. 1335-36). He also testified that every morning he received a

[19] Mr. Snow also made it clear that he understood Mr. Barkley was responsible for supervising trading, but that, ultimately "we're all responsible as a management team." Tr. 1048 (R. 1575).

report of "all customer trades," and acknowledged the firm's "responsibility to review all customer trades." He explained:

> When I would receive this report, I would look at the significant trades, and any trades that I needed to review further, and I would investigate from this report customer trades of the previous day. And so this was part of what I did every morning to supervise customer trades.

When he was asked specifically about his notations that trades in VHMC were "okay," he explained:

> That indicates that as I review this report, I'm looking for cross trades, wash sales, any trades that might be out of the ordinary market orders that are done on the – in the marketplace. And so this particular one, as I come down the report, I see there's 2,500 shares bought, 2,500 shares sold, has the potential of being a matched trade or a cross trade. And so with that in front of me, I could call out on the computer, see who the trades were done by, who the salesmen were involved. And then I would go – it was my practice to go and talk to the salesmen, talk to Trudy [Evans], to see if this had been approved prior to it. If it had come to me, I wouldn't have to go to them, because generally before a trade is crossed we discuss it and to make sure that it's meeting the proper circumstances on the trade. And so with this report I would identify cross trades, matched trades, wash trades.

Tr. at 810 (R. 1337).[20]

Other witnesses likewise testified that Wilson-Davis would not allow any cross-trades to be executed unless and until they were cleared by Lyle or the trading desk. *See* Tr. 1377:9-1378:6 (R. 1904-05). Given all of this evidence, none of which was found to lack credibility, the most that could be said is that Wilson-Davis did not adequately document its efforts to watch for signs of manipulative or unusual trading, including more documented details regarding its review and approval of the non-manipulative cross-trades here. This evidence makes the NAC's

[20] Under further examination from the Hearing Officer, Mr. Davis explained in detail what his investigation would entail, which included talking to the salesmen and asking probing questions, including "how the number of shares were arrived at" and "[h]ow did you arrive at a price." If he did not receive adequate answers he "would think that it was suspicious." Tr. at 812:22-814:4 (R. 1339-41).

suggestion that Wilson-Davis did not watch for or take steps to prevent suspicious trading indefensible.

The NAC also found that Snow's annual AML trainings "provided no instruction on red flags related to matched orders, wash sales, or the particular concerns of the firm's penny stock liquidation business." NAC at 9. But again it was clear that the persons responsible for executing trades and reviewing them post-hoc knew precisely what to look for in terms of suspicious trading and regularly undertook efforts to guard against the use of the Firm to facilitate criminal activity. It is also again important to note that Enforcement did not even allege, let alone prove, that any manipulative matched or wash trades or other manipulative activities *were actually taking place*, either in regard to VHMC or any other trading. Moreover, in focusing on only the few items that the AML training materials did not address, the NAC ignored the nearly two dozen other "red flag" and AML items that were covered annually. CX-49 at 12-13, 23-24 (R. 3092-93, 3103-04).

Yet the NAC fixated on whether or not Snow himself was reviewing any of the trading at issue and ignored that Snow—like most competent supervisors—was relying on others within his organization to do so. The "team" approach that Snow testified about was working as it was supposed to. The evidence is unrebutted and undisputed that the trading at issue was being closely reviewed throughout the relevant time period.

With respect to supervision of Kerrigone, Barkley was interacting with Kerrigone on at least a daily (and sometimes hourly) basis and was regularly watching his trading activity. Tr. (Barkley) at 705:16-706:6, 714:8-715:15 (R. 1231-1232, 1240-1241). To the extent Barkley's supervision was called into question because he allowed the short selling at issue to occur, Kerrigone's short selling activity bore many indicia of bona fide market making as discussed

above. Any contention that Barkley must (or should) have known it was improper is not as clear-cut as the NAC would suggest.

In the final analysis, the record is devoid of evidence supporting the NAC's conclusions regarding AML and supervision. The NAC painting of a picture of a firm that was devoid of leadership, supervision, and active monitoring of trading for any suspicious activity is belied by the hearing evidence. Petitioners acknowledge they can always do better, but perfection is not the standard, and they respectfully contend that the NAC's findings of AML and supervisory violations should be vacated.

IX. THE SANCTIONS FOR SUPERVISION AND AML ARE MANIFESTLY EXCESSIVE AND PUNITIVE.

Despite a complete absence of evidence of any intentional wrongdoing or actual harm to the investing public (let alone Wilson-Davis customers), the NAC *increased* the fines imposed by the Hearing Panel for "failures to supervise and implement adequate AML procedures . . . ." NAC at 28. Specifically, the NAC more than doubled the fine on Wilson-Davis from $300,000 to $750,000, and imposed a fine of $75,000 and lengthy suspensions on Snow. *Id.*

Nowhere does the NAC explain how more than doubling an already large sanction is remedial. Moreover, the evidence shows that Wilson-Davis did certain things right. Wilson-Davis was well-acquainted with the customers trading in VHMC thereby satisfying the "know your customer" obligations. Wilson-Davis identified illegal distributions of unregistered shares as a primary concern given its business model and tailored its supervision and WSPs on that issue. Enforcement's investigation therefore found no evidence of Section 5 issues despite investigating numerous stocks for any such violations. Wilson-Davis developed a report to help

the Firm identify and, if need be, report suspicious cross-trades. And while Wilson-Davis remains convinced that Enforcement's argument (and the NAC's findings) greatly mischaracterize the day-to-day VHMC trading as it was occurring in real time, the sanctions imposed are not remedial given that the trading in VHMC was (at most) a few thousand shares a week, no evidence exists of harm to the limited number of customers involved, and there is no evidence of any intentional wrongful act by the Firm—or anyone else for that matter.[21] The Firm's $750,000 sanction and Mr. Snow's $77,000.00 sanction and year-long suspension in a supervisory capacity are intended to punish and again, the word "remedial" appears nowhere in the NAC's discussion of the AML sanctions.

The conclusion that the "failure to timely and appropriately devise a plan of heightened supervision for Randy Carlson was an alarming supervisory failure" relies on an incomplete and misleading version of the facts. The NAC contends that Wilson-Davis "waited two months after the Hearing Panel's decision to put in place a deficient plan," demonstrating "blatant disregard for the firm's own procedures and a FINRA order...." NAC at 26. The NAC fails to mention that the prior hearing panel order provided Wilson-Davis with 6 ½ weeks to develop and implement the plan as the Hearing Panel order was not "final," and that the plan was implemented six trading days after the date the order became final. Wilson-Davis therefore did not "wait two months;" rather, the order specifically granted Wilson-Davis 6 ½ weeks to implement while the order was "not final." Specifically, Randy Carlson "needed to be put on

[21] Such considerations are undeniably relevant to the sanction for alleged systematic supervisory failures. *See* Sanction Guideline at 77. Factors to be considered are: (1) whether the deficiencies allowed violative conduct to escape detection – here, even Enforcement admits that they are not alleging a manipulation occurred in regard to VHMC; (2) whether identified deficiencies were not timely corrected – here there was no such evidence; and (3) the number of customers and the dollar value of the transaction – here, the number of customers was very small and the dollar amount was minimal.

heightened supervision for Section 5 issues" by "July 26, 2012" (Tr. 983-986 and RX-26 (R. 1510-13 and 3751)) and the date of his plan was August 6, 2012—six trading days. The NAC never explains how a delay of six days constitutes an "alarming supervisory failure" or "blatant disregard for a FINRA order."

Petitioners presented unrebutted testimony about the impact the heightened supervision had on Randy Carlson, the stock his customers brought in, and his own business. Joshua Carlson testified that, as a person responsible for compliance with the heightened supervision plan, the plan was strictly enforced and resulted in many customers taking their stock elsewhere. Tr. 1364-1372 (R. 1891-1899). He also testified that Paul Davis paid extra attention to Randy's stock intake even below the $75,000 threshold, and that Paul would sometimes reject deposits even where attorneys approved. Tr. 1379-1381 (R. 1906-1908). Under questioning from Hearing Officer Williams, Joshua Carlson testified in depth about the extensive process worked for deposits over $75,000. Tr. 1389-1393 (R. 1916-1920).

The NAC also suggests that Wilson-Davis did nothing to address the Section 5 issues until then, but in so doing ignores the massive changes made firm-wide to ensure the Section 5 issues did not recur—changes that even Enforcement acknowledged. Tr. 986-987 (R. 1513-1514). Joshua Carlson testified (Tr. 1364, 1372 (R. 1891, 1899) that the process for vetting stock in August of 2012 "was very different than it was in 2008, 2007 when the … alleged violations involving Randy occurred." Moreover, Enforcement has not brought a single Section 5 claim against the Firm in the last decade, despite constant looking. Tr. 990-991 (R. 1517-1518). Petitioners took their Section 5 issues seriously and did exactly what they should have done to fix the problems that led to Randy Carlson's discipline in the first place.

In *In Re William H. Murphy & Co., Inc.*, Complaint No. 2012030731802 (issued Oct. 11, 2018), the NAC recognized that a firm's relatively small size, and the fact that the individual charged "served in multiple operational and administrative rolls at" the firm, must be factored in when assessing sanctions for supervisory failures. There the NAC found "egregious" supervisory failures but only fined the firm and the individual $50,000 jointly and severally with a suspension of only six months. In *In Re C.L. King & Assocs.*, Complaint No. 2014040476901 (issued Oct. 12, 2019), the Hearing Panel fined the firm $450,000 for AML-related violations and NAC specifically acknowledged that "a reduction in the fine for supervisory failures "is appropriate given that we direct the firm to retain an independent consultant. Good compliance is critical to the business of the firm. . . . An independent consultant should assist the firm in establishing a successful supervisory program going forward." Id. at 57.

Here, by contrast, the NAC both required the firm to retain an independent consultant *and increased the fines*. But the NAC did not stop there. It also suspended Snow and Barkley in all capacities for three months, in supervisory capacities for a year, *and* required them to be requalified. The stacking of sanction upon sanction is punitive and intended to keep Snow and Barkley out of the industry—and thereby cripple Wilson-Davis—far longer than necessary for any, albeit unidentified, remedial purpose. If the goal of FINRA adjudicators is, as FINRA has long professed, "ensuring that the sanctions imposed are remedial and designed to deter future conduct, but are not punitive," the suspensions and other sanctions imposed in this proceeding fall far from the mark.

The one year suspension is particularly egregious considering it was coupled with a requirement that both Snow and Barkley requalify before reentering the industry. Although Petitioners contend that this requirement is punitive and unnecessary, if Snow and Barkley

demonstrate their ability to qualify by passing the requisite examinations, what possible remedial effect would come from forcing them to then sit out for an additional period of time? If they are qualified, it necessarily means they are ready to reenter the industry. General Principle No. 8 recognizes this, noting that "[t]he remedial purpose of disciplinary sanctions may be served by requiring an individual respondent to requalify by examination as a condition to continued employment in the securities industry. If the Commission concludes that Snow and Barkley—despite their decades of experience and lack of disciplinary record—lack familiarity with key rules and laws, then requiring them to requalify should be more than sufficient to remediate any alleged failures. Keeping them out of the industry, or out of a supervisory capacity, long after they have requalified would serve no remedial purpose.

Moreover, in *CL King* the total AML fine was $292,000—less than half of what was imposed here—yet the facts that were substantially more egregious than those presented here. In that case, the NAC concluded the respondents had "systemic supervisory failures" that "were significant and persisted for more than four years." *DOE v. C.L. King*, Complaint No. 2014040476901, 2019 FINRA DISCIP. LEXIS 43, at *126. The respondents started liquidating penny stock but "failed to tailor the firm's AML program to address" that new line of business. The respondents in *CL King* also "egregiously failed to respond reasonably to many conspicuous red flag warnings." As a result of all this wrongdoing, the NAC concluded the firm in *CL King* "at least acted recklessly." Due to these failures, two customers "sold over ***11 billion shares*** in securities of companies with little or no histories of operations or revenue," generating sales proceeds of $19 million, and commissions of "over $574,000." *Id.* at *127. Despite all of that, the NAC in that case also reduced the suspension of the principal at issue from six months to three months in all principal and supervisory capacities. Yet here the NAC would keep Snow

and Barkley out of the industry entirely for a year. Surely the acts and omissions here are not four times more egregious than those at issue in *CL King*.

Finally, the punitive nature of the fines imposed by the NAC is demonstrated by the relationship between those fines and Wilson-Davis' net capital. Wilson-Davis is a small broker dealer with a 2018 net capital of $3,570,053.[22] The NAC fine for the AML violations alone is $750,000, and is $1,100,000 for the AML and Reg SHO violations combined, representing a staggering 21 percent and 31 percent respectively of Wilson-Davis' net capital. By comparison, in 2017, Morgan Stanley was fined $10 million for multiple alleged AML violations including, but not limited to, failing to conduct adequate surveillance of "tens of billions of dollars of wire and foreign currency transfers, including transfers to and from countries known for having high money laundering risk."[23] The fine represented .3 percent of Morgan Stanley's net capital, which was $3,455,000,000.[24] In 2018, Industrial and Commercial Bank of China ("ICBC") was fined $5.3 million,[25] and UBS was fined for $5 million[26] for similar alleged wide-sweeping AML violations. Those fines represented 1.2 percent and .07 percent, respectively, of ICBC's and

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[22] *See* Wilson-Davis' Form X-17A-5 at 18, available at: https://www.sec.gov/Archives/edgar/vprr/1800/18006567.pdf

[23] FINRA AWC No. 2014041196601, available at: https://www.finra.org/sites/default/files/Morgan_Stanley_AWC_122618.pdf

[24] *See* Morgan Stanley Smith Barney LLC's Consolidated Statement of Financial Condition as of December 31, 2018 at 17, filed with the SEC on March 1, 2019, available at: https://www.sec.gov/Archives/edgar/data/1457496/000145749619000006/mssbpublic.pdf

[25] FINRA AWC No. 2015045550801, available at: https://www.finra.org/sites/default/files/fda_documents/2015045550801%20Industrial%20and%20Commercial%20Bank%20of%20China%20Financial%20Services%20LLC%20CRD%20131487%20AWC%20va%20%282019-1563400160067%29.pdf

[26] FINRA AWC No. 2012034427001, available at: https://www.finra.org/sites/default/files/UBS_AWC_121718.pdf

UBS' net capitals.[27,28] Most recently, in October 2019, BNP Paribas was fined $15 million for alleged AML violations, including but not limited to, processing more than 70,000 wires worth $233 billion, and at least 834 customer accounts associated with high-risk jurisdictions or foreign currency-denominated wire transfer activity purchased and sold penny stocks.[29] The $15 million fine issued by FINRA represented .7 percent of BNP's net capital.[30]

The largest fine levied by FINRA for AML violations to date was against Raymond James.[31,32] Notably, this was Raymond James' second AML violation, having been previously fined in 2012.[33] The violations alleged in 2016 were significant, including that Raymond James "did not have a single written procedures manual describing its AML procedures."[34] The $17 million fine represented 3.2 percent of Raymond James' net capital.[35]

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[27] At December 31, 2018, ICBC had net capital of $434,151,374. *See* ICBC's Form X-17A-5 at 13, filed with the SEC on March 13, 2019, available at: https://www.sec.gov/Archives/edgar/vprr/1901/19010387.pdf

[28] The UBS entities (UBS Financial Services and UBS Securities LLC) had 2018 net capitals of $1,094,602,000 and $5,790,390,000, for a total combined net capital of $6,884,992,000. *See* UBS Financial Services Inc.'s Notes to Consolidated Statement of Financial Condition at 35, filed with the SEC on March 1, 2019, available at: https://www.sec.gov/Archives/edgar/data/200565/000020056519000008/sofnotes.pdf; UBS Securities LLC's Notes to Consolidated Statement of Financial Condition at Section 15, filed with the SEC on March 1, 2019, available at: https://www.sec.gov/Archives/edgar/data/230611/000023061119000006/sofcnotesab.pdf

[29] FINRA AWC No. 2016051105201, available at: https://www.finra.org/media/fdafile/542911

[30] *See* BNP Paribas Securities Corp.'s Statement of Financial Condition as of December 31, 2019 at 20, filed with the SEC on February 26, 2020, available at: https://www.sec.gov/Archives/edgar/data/753835/000075383520000017/bnpps2019public.pdf

[31] *See* FINRA AWC No. 2014043592001, available at: https://www.finra.org/sites/default/files/fda_documents/2014043592001_FDA_JMX2873.pdf

[32] "The fine is [FINRA's] largest ever for anti-money laundering compliance violations said FINRA spokeswoman Michelle Org." https://www.reuters.com/article/us-raymond-james-fi-finra-idUSKCN0Y91ZW

[33] *Id.* at 2.

[34] *Id.* at 5.

[35] As of Sept 30, 2016, the two involved Raymond James entities (Raymond James & Associates and Raymond James Financial Services, Inc.) had net capitals $512,594,000 and $27,013,000, respectively, for a combined net capital of $539,607,000. *See* Raymond James & Associates, Inc.'s Form X-17A-5 at 26, filed with the SEC on

Contrast these relatively low percentages with the excessively high percentage of Wilson-Davis' net capital represented by the NAC fine. There is no legitimate basis for a fine so beyond the ordinary range of .07 percent to, at most, 3.2 percent levied on larger firms whose alleged conduct was worse and involved much higher amounts and farther-reaching potential consequences than Wilson-Davis' alleged conduct. Indeed, the percentage of Wilson-Davis' fine is between ***6 to 10 times greater than*** the percentage of even the largest AML fine ever levied by FINRA (against repeat violator Raymond James). Again, Petitioners appreciate that "apples to apples" comparisons between cases are not always possible, but large firms committing allegedly more egregious misconduct received fines that are essentially insignificant to their bottom line, further supporting the conclusion that the sanctions here are punitive.

X. CONCLUSION

For the foregoing reasons, Petitioners respectfully request that the NAC's decision be reversed, vacated, and/or modified.

Respectfully submitted this 20th day of March 2020.

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November 25, 2016, available at: https://www.sec.gov/Archives/edgar/vprr/1602/16022300.pdf; Raymond James Financial Services, Inc.'s Form X-17A-5 at Note 7, filed with the SEC on November 25, 2016, available at https://www.sec.gov/Archives/edgar/vprr/1602/16022299.pdf

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ATTORNEY CERTIFICATION

Pursuant to Rule 154 of the Commission's Rules of Practice, I hereby certify that the foregoing document contains 12,575 words, exclusive of the tables of contents and authorities. This word count was generated using the "word count" function in the word processing program used to generate the document.

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CERTIFICATE OF SERVICE

THE UNDERSIGNED CERTIFIES that on this 20th day of March 2020, a true and correct copy of the foregoing OPENING BRIEF FOR APPEAL was filed via facsimile and overnight Federal Express (signature requested) upon the following:

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