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

REPLY BRIEF 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"), by and through their undersigned counsel, hereby submit their reply brief.

INTRODUCTION

The law holds that the Commission "may affirm only FINRA sanctions that are 'remedial' and not 'punitive.'"[1] Remedial sanctions are aimed to prevent the respondent from engaging in similar acts and must be consistent with the Exchange Act's purposes, most commonly defined as protection of investors and the public interest, and maintenance of fair and orderly markets.[2] The law further holds that as sanctions increase in severity, FINRA must provide a clear explanation as to why a "severe, and therefore apparently punitive sanction is, in fact, remedial, particularly in light of the mitigating factors."[3] And while precedent sometimes cannot provide an "apples to apples" comparison, prior decisions reflecting a gross disparity from the pending case are instructive regarding potential bias or desire to punish rather than remediate.[4]

The NAC's decision fails to identify the remedial intent and effect justifying the sanctions, and whether the large fines (which comprise over 30% of the Firm's net capital) and substantial suspensions promote that remedial intent. The NAC's failure is compounded by its unwillingness to address details and facts undercutting the finding of liability or the drastic sanctions. Regulation SHO's guidance, for example, speaks in generalities, not absolutes. And while the Firm understands Enforcement's view that the Firm misinterpreted Reg SHO., the fact

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[1] *In re: Saad*, 2019 SEC LEXIS 2216, *3-4 citing *Sigel v. SEC*, 592 F.3d 147, 158 (D.C. Cir. 2010).
[2] *Standard Inv. Chartered, Inc. v. NASD*, 2007 U.S. Dist. LEXIS 32566, *19 (S.D.N.Y. 2007); *In re: Stock Exchs. Options trading Antitrust Litig.*, 2001 U.S. Dist. LEXIS 1381, *10-11 (S.D.N.Y. 2001).
[3] *Paz Sec. v. SEC*, 494 F.3d 1059, 1066 (D.C. Cir. 2007).
[4] *D'Alessio v. SEC*, 380; F.3d 112, 125 (2 Cir. 2004) ("Perhaps gross disparities in sanctions for similar behavior would at least suggest underlying bias"); *see also, Epstein v. SEC*, 416 Fed. Appx. 142, 2010 U. S. App. LEXIS 24119 (3 Cir. 2010) (same).

remains that the Firm satisfied several of the "indicia" of bona fide market making and provided sell-side liquidity to markets desperately in need of sell-side liquidity. Nor has the Firm engaged in such trading for more than seven years. The $350,000 fine, $51,624 in disgorgement, and the related supervisory fines are not necessary to motivate the Firm to not engage in such conduct, nor do such sanctions protect investors or the market against similar future violations. It is a sanction to punish for past trading, which the law does not allow.[5]

The same is true for the AML and supervisory issues related to VHMC. As NAC Subcommittee member Professor Hurt asked Enforcement during oral argument, "I don't want to sound ignorant, but I feel like you're saying they should have looked into [VHMC] because its suspicious, but you never say its 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, and then you stop." (R. 8455-56). Enforcement never answers the question. Wilson-Davis knew the customers selling VHMC well; they were not unknown individuals in far-away places. The trading was minimal, approximately 3,368 shares per week between $1.00 and $1.50 for most of the relevant time period; a pump and dump (or other manipulative endeavor) this was not. The detailed trade data (that the NAC ignores) demonstrated the buy and sell orders for the purported "matched trades" were entered at separate times for separate amounts, that the market brought these orders together, and that the Firm reviewed these trades. Petitioners understand that supervision or AML violations do not require an underlying violation, but Enforcement examined the Firm for over a three-year period and the only case brought was a stock that did not harm the markets or investors. The NAC does not explain how the massive $750,000 fine is necessary to encourage Wilson-Davis to improve their supervisory or AML systems, or to

[5] *In re Saad*, 2019 SEC Lexis 2216 *19 ("A sanction based solely on past misconduct without regard for the public interest – like the one at issue in Johnson – would be impermissibly punitive, and thus excessive or oppressive.").

protect the public and the market in the future, because no such explanation exists. Even if liability is upheld, significant smaller fines (well less than 30% of the Firm's net capital) and suspensions would be sufficient to match the remedial intent with sanction imposed and more in line with other precedent on these issues.

Accordingly, the NAC's decision should be reversed or remanded.

ARGUMENT

I. The Sanctions are Punitive and the NAC Failed to Explain Why they were Remedial.

Enforcement tries to do what the NAC was required, but failed to do—explain why more than $1.2 million in total fines and sweeping suspensions are remedial and not punitive. But Enforcement does not and cannot alter the fact that: (1) the NAC's failure to explain why the sanctions are remedial renders the decision deficient; and (2) any meaningful analysis demonstrates the sanctions are punitive and were intended to be so.

A. The NAC Did Not Explain How the Sanctions are Remedial.

There is a difference between saying sanctions are remedial and explaining why it is so. Here, the NAC pronounces its sanctions remedial but never explains its reasoning. The NAC "made no findings regarding the protective interests to be served by [imposing the sanctions it did] . . ."[6] The NAC leaves it to the Commission to explain how the sanctions are remedial, which, standing alone, demonstrates the inadequacy of the NAC's decision. The Commission cannot, and should not, try to step into the heads of the NAC members and explain their thinking.

The Commission has repeatedly explained that, "it is important that a self-regulatory organization, such as FINRA, clearly explain the bases for its conclusions. If FINRA fails to do

[6] *McCarthy v. SEC* 406 F.3d 179, 189 (2d Cir. 2005).

so, [the Commission] cannot discharge properly [its] review function."[7] Moreover, "[i]f a self-regulatory organization fails to explain itself clearly, applicants are impaired in their ability to defend themselves before us . . ."[8] Thus, where the NAC fails to explain an important aspect of its decision, the Commission routinely remands the matter so that both the respondents and the Commission can assess the propriety of the NAC's conclusions. The Commission should either do so here or, in the alternative, substantially reduce the sanctions to a level that is in fact remedial, not punitive, and in line with sanctions imposed against other industry members for similar violations.

B. The Sanctions Imposed Are Not Remedial.

The record in this case and a review of other relevant decisions establish that the sanctions imposed by the NAC are not remedial. The fact that the dollar value of the sanctions imposed in this case ($1.1 million against the Firm alone) is *double the highest fine imposed in any other case that the Commission has decided in the last half a decade*[9] is telling, particularly where there is no evidence any customer was harmed, the Firm lost more than $2,000,000 from the trading at issue, and the Firm immediately ceased and never resumed the primary violation.

1. <u>Reg. SHO</u>

Despite a $350,000 fine for Reg. SHO violations, the NAC never found that there was any risk that any other Respondent would repeat the conduct at issue. Any such conclusion would be impossible to reach, particularly after Wilson-Davis suffered a large loss, parted ways

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[7] *In re David B. Tysk*, Exchange Act Release No. 80135, at 3.

[8] *Id.* at n. 7 (internal quotations omitted).

[9] Based on a review of the Commission's Appeal decisions from NAC decisions from 2015 forward, the two largest fines the Commission reviewed were $500,000 (*In Re Meyers Associates, LP*, Release No. 86497) and $403,000 (*In Re Newport Coast Securities*, Release No. 88548). Any larger monetary sanction on review by the Commission was either for restitution or disgorgement—not a fine.

with the trader more than five years ago, and never resumed the short-selling practices at issue.[10] In the absence of any threat the action at issue would repeat, the NAC needed to explain how the sanctions were remedial, particularly where the sanctions were a multiple of the established Guidelines. It failed to do so.

In its attempt to divine a remedial purpose for the $350,000 sanction, Enforcement turns to the impact the sanctions might have in deterring others. (Enf. Brief at 38). But characterizing "deterrence of others" as a "remedial" sanction is hopelessly unfair. This would allow the imposition of fines that are ruinous to a small firm, such as Wilson-Davis, even if the firm itself poses no risk of repeating the offense, just to send a message to the industry. In no legal or logical sense is such a sanction "remedial" as it "remediates" nothing. Rather, it is a punitive sanction that destroys one member to hopefully send a message to others. This is why courts have emphasized the relevance of analyzing the "risk of future violations" in distinguishing between remedial and punitive sanctions.[11] Indeed, the Supreme Court in *Kokesh* made this clear: "a pecuniary sanction operates as a penalty only if it is sought for the purpose of punishment, ***and to deter others from offending in like manner***—as opposed to compensating a victim for his loss."[12] "Deter[ing] others from offending" or punishing Wilson-Davis are the only possible reasons for imposing a $350,000 fine that does not "restore the status quo; it leaves the defendant worse off."[13]

Kokesh's holding was important but not groundbreaking. Ten years earlier the D.C.

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[10] Mr. Kerrigone entered into a settlement with FINRA regarding 149 Reg SHO violations. CX-36 (R. 2899). Mr. Kerrigone was fined $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 Mr. Kerrigone settled with the Commission, which accepted a fine of $50,000 against Kerrigone for all Reg SHO violations, even though Kerrigone kept 60-70% of trading profits. *See* CX-37 (R. 2905).

[11] *West v. SEC*, 641 Fed. Appx. 27, *31 (2nd Cir. 2016).

[12] *Kokesh v. SEC*, 137 S. Ct. 1635, 1642 (2017) (emphasis added; internal quotation omitted).

[13] *Id*. at 1642, 1645.

Circuit stated: "The Commission did state its view that the sanctions here imposed by the NASD would 'serve as a deterrent to others who may be inclined to ignore NASD's information requests,' but such 'general deterrence' is essentially a rationale for punishment, not for remediation."[14] Although a unanimous Supreme Court reiterated that "deterrence is not a legitimate nonpunitive governmental objective,"[15] Enforcement argues the opposite, asserting that "[a]djudicators must look at deterring future misconduct by the violating firm *and deterring other firms from engaging in similar violations*." (Enf. Brief at 38 (emphasis added)).[16]

Additionally, the distinction between remedial and punitive sanctions evaporates if deterring others is necessarily deemed remedial. Every violation could justify a massive fine simply to ensure others are incentivized not to do the same thing. As Petitioners' opening brief pointed out—and to which Enforcement said nothing—the size of the sanction necessary to deter large firms could be astronomical. Thus, a massive fine could be labeled "remedial" in virtually every case because deterring large firms is at least as important as deterring small firms, and large fines are necessary to deter large firms. The spiral of unfairness to small firms from such a dynamic is manifest, and illustrates why general deterrence and remedial sanctions do not go hand-in-hand.

Enforcement's argument that remedial sanctions may also have a deterrent effect is a red herring. The question is not whether a sanction that is otherwise remedial becomes a penalty

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[14] *Paz Sec. v. SEC*, 494 F.3d at 1066.

[15] *Kokesh*, 127 S.Ct. at 1643 (string cite omitted).

[16] Enforcement also asks the Commission to take note of a May 15, 2019 settlement between Wilson-Davis and the Commission that it had never previously cited or tried to make part of the record. (Enf. Brief at 44 and n. 16). Plainly, the NAC could not have been considering that settlement when it imposed the sanctions and thus it does nothing to inform the question of whether the NAC's decision is appropriate. If Enforcement is now asking the Commission to enhance the sanctions against Wilson-Davis because of the May 15, 2019 settlement, it is clearly punishing Wilson-Davis twice for the same violation, and doing so could not be deemed "remedial" where Wilson-Davis has already done everything the Commission believed was necessary to remediate that alleged misconduct.

merely because it might also deter. Plainly an order suspending a member may well deter others; that does not, standing alone, render the suspension a penalty. The question is whether there is a remedial purpose in the first place, and the NAC was required to identify and explain what the remedial purpose was and why the sanction furthered that purpose. As the magnitude of the sanctions increased, so did the importance of clearly expressing their remedial purpose and how the sanctions served those interests, because the more severe the sanction the more it appears to be punitive. That did not happen here, and the sanctions imposed by the NAC are fatally deficient.

Enforcement also fails to address the massive disparity between the Reg. SHO fines here (amounting to $2,869 per violation) with the $4.56 per violation in *Legacy Trading*. Enforcement retreats to the truism that perfect comparisons between cases are not possible. Petitioners acknowledge the law stating that "the appropriateness of a sanction depends on the facts and circumstances of each particular case and cannot be ***precisely*** determined by comparison with action taken in other proceedings."[17] But the discrepancy in the sanctions imposed in the only two proceedings involving Reg. SHO is not a matter of "precision" but—with a difference of nearly 650 times—is inexplicable. It is the equivalent of one person being imprisoned for two days and another for ***three and a half years*** for the same crime. Enforcement likewise says nothing about the law cited by Petitioners establishing that significant disparities in sanctions evidence bias. *See* Opening Br. at 25.

Furthermore, Enforcement does not even try to explain how factual distinctions between this case and *Legacy Trading* could justify a monetary sanction that is **650 times higher** per

[17] *William J. Murphy*, Exchange Release No. 69923, 2013 SEC LEXIS 1933, at *115-116 (July 2, 2013) (emphasis added).

violation.[18] In every meaningful way, the *Legacy Trading* violations were far more egregious:

- "Legacy almost never posted the inside bid *or* ask in connection with the short sales," whereas Kerrigone was almost always on the inside where the market needed him (as a seller when the market needed supply and as a buyer when the market was flush with sellers);

- The activity at issue in *Legacy Trading* occurred over 14 months, whereas here it was 13 trading days over about nine months;
- The number of Reg. SHO violations was 20 times higher in *Legacy Trading* (2,192) than here (122);

- The short selling in *Legacy Trading* was highly profitable, yielding almost $900,000 in profits whereas here it led to a massive loss.[19, 20]

Enforcement notes the number of trades (122) was deemed to be an aggravating factor, but the NAC never provided any context to explain why the number supports a finding of "egregious" violations. Certainly, the number here pales in comparison to the number of violations found in other proceedings where the sanctions were far less severe.[21]

Finally, Enforcement continues to urge that "[t]he short sales also resulted in monetary gain" despite it being undisputed that Wilson-Davis lost more than $2 million from the short sales that are at issue. Enforcement argues that "the firm's losses in LOTE are not mitigating" and that the Commission should look only at profitable trades. (Enf. Brief at 37, n. 13). The absurdity of this position is manifested by taking it to its logical conclusion. Under

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[18] The $10,000 fine was consistent with the Guideline then in effect for Reg. SHO violations, which provided for a high end fine of $10,000 in a "first action." Here, this proceeding was unquestionably the "first action" against Petitioners relating to Reg. SHO, and even the 2019 Guidelines provide for a high end fine of $16,000. Yet the $350,000 fine imposed by the NAC for Reg. SHO violations is *nearly 22 times higher than the high end in the Guidelines.* The NAC also failed to explain whether it was imposing—let alone why it would be appropriate to impose—sanctions on a per violation basis. The effect of sanctioning Wilson-Davis $2,869 for each short sale is that even modest transactions yield a massive fine. More than 40 percent of the 122 short sales flagged involved total transaction values under $2,000, dozens of which were well under $1,000. *See* CX-1, CX-6, CX-11, and CX-16 (R. 2175, 2185, 2195, and 2231).

[19] Lyle Davis testified that the firm absorbed a loss of $2.3 million from Kerrigone's trading in LOTE. Transcript (L. Davis) at 802:8-804:1 (R. 1329-1331).

[20] *DOE v. Legacy Trading*, 2010 FINRA Discip. LEXIS 20, at *28, *47.

[21] *See DOE v. Legacy Trading* (2,192 Reg. SHO violations); *DOE v. CL King & Associates* (issued Oct. 2, 2019), Complaint No. 2014040476901, at *2, 138-140 (reducing fine from $450,000 to $292,000 where wrongful conduct occurred over 4 years and involved more than 11 billion shares).

Enforcement's reasoning, if Wilson-Davis made one short sale on one stock that reaped a profit of $1, then made 10,000 other short sales that resulted in a $10 million loss, Wilson-Davis would still be deemed to have received "monetary gain" from its trading. Enforcement choose to aggregate the alleged Reg. SHO violations (both those that made money and those that did not) and cannot now parse them out to create the false conclusion that Wilson-Davis "profited" from the short selling on these four stocks.

Nothing in the record—and certainly nothing in the NAC's decision—explains why the sanctions imposed for the Reg. SHO violations are remedial, and the Commission should either vacate or substantially reduce the sanctions or, in the alternative, remand to the NAC to either modify them or explain why they are remedial.

2. AML and Supervision

The NAC doubled the Hearing Panel's fine for AML and supervision even though the "failures to supervise" related, in part, to the Reg. SHO issues, which—as just discussed—will never repeat. In so doing, the NAC again failed to explain why such a massive fine was "remedial." While the NAC concluded that the $750,000 fine for AML and supervision was appropriate because of five settlements with FINRA between 2010 and 2016, the NAC failed to discuss the nature of those actions, the supervisory procedures at issue, or the magnitude of the settlements. *See* NAC Decision at 27.

If the severity of the sanctions imposed is to be justified as remedial based on past conduct, the nature of that conduct must at least be discussed to justify the sanctions. Plainly, it is not incumbent upon Petitioners or the Commission to divine a justification for the NAC's conclusion that enhanced sanctions are appropriate based on past conduct.

Sanction General Principal No. 2 makes it clear that sanction enhancement is not appropriate just because there are multiple proceedings:

> Adjudicators should consider imposing more severe sanctions when an individual respondent's Disciplinary and Arbitration History:
>
> (a) includes significant past misconduct that is similar to the misconduct at issue; or
>
> (b) shows a pattern of causing investor harm, damaging market integrity, or disregarding regulatory requirements.
>
> ***Pattern***
>
> Adjudicators should draw on their experience and judgment when evaluating if a respondent's Disciplinary and Arbitration History establishes a pattern. In addressing whether disciplinary and arbitration matters establish a pattern, the parties may focus on the nature, severity, and frequency of the matters. Factors that weigh against finding a pattern are the length of time between events, the isolated nature of an event, or other extenuating circumstances.[3]

The NAC's failure to discuss the particulars the prior disciplinary proceedings makes it impossible to assess whether the NAC properly addressed this issue. However, when the particulars of the prior actions are examined, there is no "past misconduct that is similar to the misconduct at issue." With the exception of the Section 5 issues (which resulted in Wilson-Davis fundamentally changing the way it brought stock into the Firm), the settlements were technical issues that in no way suggested deep institutional supervision problems.

The Firm's CRD (JX-19 (R. 8101)) identifies eight matters that were initiated between 2010 and 2016 (the time period identified by the NAC), not including this proceeding. The only such proceeding that even addressed supervisory issues ended in an order entered effective August 14, 2012, and related to events occurring in April 2009—more than six years before the events at issue here. The AWC description of that matter makes clear that any supervisory issues were limited to WSP deficiencies.[22] The total fine for supervisory violations was $10,000.

With respect to the October 5, 2011 settlement, the supervisory issues related only to Section 5 issues from 2006. While Petitioners understand the significance of that proceeding, the activities occurred fourteen years ago, and nine years before the events in question here.

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[22] *See* JX-19 (R. 8101), p.13 of 25 ("The Firm's written supervisory procedures failed to provide for one or more of the above-cited minimum requirements ….").

Moreover, as has been discussed at length, Wilson-Davis successfully revamped its entire Section 5 process and took affirmative steps to ensure against a recurrence of those issues.

Thus, the record relating to disciplinary proceedings reveals two instances in which Wilson-Davis was taken to task for supervisory issues, and the events were entirely unrelated and occurred four years apart and long before the events at issue. Neither the NAC nor Enforcement cites any authority to support the proposition that three settlements touching on supervision, occurring over a span of eight years and involving fundamentally different issues than those present here, justify a sanction more than two times the Guidelines' high end.[23]

Nor does the record support a conclusion (which the NAC never expressly reached) that there is "a pattern of causing investor harm, damaging market integrity, or disregarding regulatory requirements." There was no evidence of any "investor harm," much less a pattern of causing such harm. Nor does the evidence support a finding of any "pattern" of "disregarding regulatory requirements." Where there was a gap of 3 to 4 years between each of the proceedings that touched on supervision, "the length of time between events" "weigh[s] against finding a pattern . . ."[24] The "nature" of the violations charged in the other proceedings also weighs against finding a "pattern" because none addressed Reg. SHO violations.

Enforcement is also silent regarding the magnitude of the difference in the fines imposed for AML and supervision compared to cases involving more egregious misconduct. In *DOE v. Merrimac Corporate Securities, Inc.*, the respondent firm was found to have committed "serious" violations in failing to adopt or implement an adequate AML program, and the NAC

[23] By comparison, in *In Re Meyers Associates, LP*, Release No. 86193 (June 24, 2019), the respondent "had been the subject of 16 final regulatory and disciplinary actions, seven of which involved supervisory failures, since 2000. The Firm had been fined a total of $356,500 for its prior misconduct." Even then, in the face of a much more problematic history, the Commission affirmed an aggregate fine of $500,000 against the firm—far less than the $750,000 imposed here.

[24] *See* FINRA Sanction Guidelines at General Principal No. 2.

found aggravating circumstances in all of the relevant principal considerations.[25] The firm there repeatedly failed to detect significant red flags in customer trading, including the liquidation of large blocks of penny stocks and the customers' disciplinary histories. Yet the firm was fined only $25,000 – the NAC here imposed fines *thirty times greater*.[26]

To the extent that Enforcement seeks to justify $750,000 in fines for AML and supervision because of deficient WSPs[27], the Guidelines undercut that argument. The 2019 Guidelines provide for sanctions in the range of $1,000 to $39,000 for WSP deficiencies. *See* 2019 Sanctions Guidelines at 107.

Another issue raised in Petitioners' opening brief (Opening Br. at 37) that Enforcement ignores was the massive disparity in the ratio of the monetary sanctions imposed versus the Firm's net cap when compared to sanctions imposed against larger firms. And yet the very first "General Principle" in the Guidelines advises that, "Adjudicators should consider a firm's size with a view toward ensuring that the sanctions imposed are remedial and designed to deter future misconduct, but are not punitive." Forcing a small firm like Wilson-Davis to shed nearly a third of its net capital, while larger firms committing more egregious violations have never been assessed fines of greater than 2 to 3 percent of their net capital, makes no logical sense if sanctions are supposed to be remedial. That disparity further demonstrates that trying to justify sanctions as "remedial" on the ground that they can deter the industry as a whole is exceptionally punitive to smaller firms. Catastrophic sanctions against small firms cannot be deemed the price to be paid so that larger firms get the message. The magnitude of the fines imposed compared to

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[25] Complaint No. 2011027666902, decision entered May 26, 2017.
[26] *See, e.g., DOE v. Wood Company, Inc.*, Complaint No. 2011025444501, decision entered March 15, 2017 at *39 (finding egregious AML violations, with "numerous applicable aggravating factors," and imposing fine of $73,000).
[27] *See, e.g.,* Enf. Brief at 33, n.10 ("Without written policies and documents of what steps were taken to scrutinize transactions, an AML program is not reasonably designed to be effective.").

the Firm's net capital is strong evidence of non-remedial "excessive or oppressive" sanctions. 15 U.S.C. § 78s(e)(2).

II. Heightened Supervision

The lengths Enforcement is willing to go in order to prop up the punitive sanctions is well illustrated by the way it characterizes Petitioners' alleged failures regarding Randy Carlson's heightened supervision. Enforcement, like the NAC, disregards what actually happened after the Section 5 issues came to the Firm's attention, ignoring the undisputed evidence that Wilson-Davis did not wait until a complaint was filed to fundamentally rewrite its procedures for bringing stock into the firm. Enforcement's own witness acknowledged that in early 2010—years before a heightened supervision plan was ordered by the prior panel—the Firm completely rewrote its stock vetting and deposit procedures, which have been constantly improved since that time.[28] Enforcement looked but could not identify a single instance of any Section 5 issues arising from January 1, 2011 to April 30, 2014.[29]

Rather than acknowledge this proactive approach, and positive result, the NAC punishes Wilson-Davis for it. By this logic, Wilson-Davis would have been better served by changing the stock intake procedures only for Randy Carlson; as doing so would have given Wilson-Davis the ability to say it implemented a comprehensive plan to address the issues that, at that point, had only directly impacted Mr. Carlson. The NAC and Enforcement ignore such efforts and instead offer revisionist history in which Wilson-Davis ignored Randy Carlson's issues and did nothing to address any Section 5 issues, when the opposite is true.

Enforcement also claims—without citation to record evidence—that the heightened supervision plan was "ineffective." (Enf. Brief at 29.) In fact, the record demonstrated that

[28] Tr. (Moore) at 988:9-990:4 (R. 1515-1517) and RX-24 (R. 3679).
[29] *Id.* at 990:5-991:19 (R. 1517-1518).

Enforcement did not find a single Section 5 issue—or any other compliance problem—tied to Randy Carlson in the more than 5-year period after FINRA filed its complaint. And it was not for lack of looking. (R. 1517-1518). If Wilson-Davis is going to be sanctioned on the basis of an "ineffective" plan, the NAC or Enforcement should at least point to some evidence in the record of how the issues were repeated or were likely to have been repeated.

Enforcement reaches even farther by arguing that a delay of six days between when a formal heightened supervision plan should have been in place and when it actually was in place was an "egregious" failure. "In a legal context, the term *egregious* refers to actions or behaviors that are staggeringly bad, or obviously wrong, beyond any reasonable degree."[30] Particularly in the context of this case—where Wilson-Davis began addressing the issues that led to the charges against Randy Carlson years before the plan was required to be in effect—a six day (four trading day) delay is not an "egregious" failure, and there were no egregious consequences.

Enforcement contends that Randy Carlson was not effectively supervised because the manner in which he was supervised differed from what was set forth in the Firm's WSPs. (Enf. Brief at 30.) But Enforcement again ignores unrebutted testimony—about which the Panel made no credibility finding—that Randy Carlson was the most heavily scrutinized representative at the Firm, and that the actual supervision was even more robust than the plan specified.

III. AML and Supervision

Enforcement largely ignores the evidence relevant to the AML and supervision claims. It remains undisputed Snow trained Wilson-Davis's staff annually regarding red flags for suspicious trading and potential money laundering (and currently outside counsel helps with these efforts as well).[31] Snow testified that, when conducting the training, he would speak for

[30] https://legaldictionary.net/egregious/ (last accessed June 9, 2020).
[31] *See* CX-49 at 12-13, 23-24, 44-45, 70-71 (R. 3092-93, 3103-04, 3124-25, 3150-51).

close to an hour and cover far more than what is mentioned in the slides.[32] The unrebutted testimony of Trudy Evans, Josh Carlson, and Lyle Davis—none of which the Panel found to be lacking credibility—established that Wilson-Davis employees knew to watch for red flags such as cross-trading and that all proposed cross-trades were vetted before execution.[33] It was also undisputed that Wilson-Davis's WSPs contained comprehensive discussions of the firm's AML program[34] and detailed discussions of "prohibited transactions and practices," including market manipulation, prearranged trades, and wash transactions.[35] Finally, Wilson-Davis demonstrated that it has completed a thorough and independent annual review of its AML program.[36]

Moreover, the undisputed testimony, which the Hearing Panel did not find was lacking in credibility, established that cross-trades were vetted. But Enforcement again asks the Commission to completely ignore the undisputed evidence of what actually happened at Wilson-Davis and conclude that, in fact, none of it happened because it was not documented. (Enf. Brief at 33 "While the report appears to have permitted Davis to consider the possibility of a cross trade in the case of VHMC, there is no documented evidence that he did anything further to investigate."). Enforcement seems to contend that testimony by percipient witnesses of matters within their own knowledge is irrelevant unless documentation exists to back it up. This is not

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[32] Transcript (Snow) at 1075:19-25 (R. 1602), 1163:6-24 (R. 1690).

[33] *See* Opening Br. at 17, citing all relevant testimony. Most significant was Lyle Davis's unrebutted testimony that he vetted all cross-trades. *See* Transcript at 812:1-814:5 (R. 1339-41).

[34] *See, e.g.,* JX-3 (2011 WSPs) at 155-191 (R. 5009-5045). Wilson-Davis's preliminary AML section makes it clear that AML includes not only money laundering but has been "interpreted to mean suspicious activities of other financial crimes" and that "[c]rimes, money laundering, or suspected financial crimes by individuals (whether associated with the Firm, a customer, or prospective customer) are required to be reported to Jim Snow . . . ." *Id.* at 42 and 46 (R. 4896 and 4900). Section 7, entitled "AML Program," explained that suspicious activities include a wide range of questionable activities, including "trading that constitutes a substantial portion of all trading for the day in a particular security . . . late day trading . . . heavy trading in late day securities . . . ." *Id.* at 167 (R. 5021). The Firm likewise identified, in Section 7, reports to assist the AML officer with "matched or crossed trades as well as transfers of securities between accounts within the firm." *Id.* at 155 (R. 5009).

[35] *See, e.g.,* JX-3 at 299-300 (R. 5153-54).

[36] Transcript (Renza) at 1399:9-1421:8 (R. 1926-1948).

the law. Again, if Petitioners are faulted for failing to document their efforts, so be it—but that is very different from disregarding what Petitioners testified they did to investigate these trades.

Enforcement also claims, without a supporting citation or any reasoning, that a firm's knowledge of the customer trading in a stock "does not outweigh the numerous red flags present in this case." The facts here demonstrate why such a definitive rule would be absurd. The customer who made the initial sales of VHMC stock was Wallace Boyack, a well known Wilson-Davis customer who had an unblemished history with the Firm and dedicated a decade of his life to enforcing securities laws as a SEC attorney and Assistant U.S. Attorney. Boyack had been looking to sell his VHMC shares for months before he finally found someone willing to buy them. What purpose would there be in asking Boyack why he was willing to sell the shares?

Enforcement also contends (again without a citation to the record) there was a missed "red flag" because "there was publicly available information indicating familial affinities between the Firm's customers and the individual who was once the sole director of VHMC…." (Enf. Brief at 16-17). Enforcement is vague on this issue because the evidence established that the "insider" at issue—J. Michael Coombs[37]—resigned from all positions with VHMC ***years before*** the trading occurred.[38] Enforcement further contends that Wilson-Davis ignored a red flag because the price of the stock "rose to approximately $4.95 per share," but ignores the fact that the stock price was between $1.00 and $1.50 per share during the overwhelming majority of

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[37] *See* Transcript (Moore) at 926:5-8 (R. 1453) ("At one point he [J. Michael Coombs] was the sole director of VHMC.").

[38] *See* RX-18 at 3 (R. 3613) (VHMC Sch. 14F-1 Statement), identifying Michel Van Herreweghe as the sole officer and director of the company as of April 12, 2012, who replaced John Thomas Hickey, the sole VHMC officer and director from March 4, 2010 through April 12, 2012; *id.* at 10 (Andrew Helsey becomes the sole officer and director as of Oct. 31, 2012).

the trades at issue and the average trading volume was a sparse 3,368 shares per week.[39] Next, Enforcement refers—again without citation—to "numerous instances of apparent pre-arranged trades and matched orders," but Petitioners thoroughly debunked those allegations at the hearing, and neither the NAC nor Enforcement points to a single instance of an actual pre-arranged trade or matched order.[40] Again, the NAC deals in generalities rather than address specific evidence.

IV. Regulation SHO

Enforcement urges that the presence of certain indicia of bona fide market making does not, standing alone, demonstrate that the trades at issue were part of bona fide market making. But that argument addresses a straw man of Enforcement's own creation, because Petitioners have never argued that any single factor carries the day. Petitioners consistently argue that the presence of a number of bona fide market making indicia undermine any conclusion that Reg. SHO violations were egregious, and demonstrate Petitioners' effort to comply with the regulation based on the available published guidance.

Enforcement talks in circles when trying to explain why the "10 percent" rule is not

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[39] Almost all of the VHMC sales involving Wilson-Davis customers were made between April 13, 2012 and August 27, 2012, when the price of the stock fluctuated between a low of $0.75 per share and a high of $2.00 per share. RX-22 (R. 3675). The overwhelming majority of transactions occurring during that time period were between $1.00 and $1.50 per share. *Id.* *See* CX-22 (R. 2301) in regard to trading volume.

[40] No red flags existed regarding order quantity because the orders were rarely placed for the same quantity. *See* RX-22 (R. 3675) (showing in the "Matched Volume" column the vast majority of trades executed did not match the volume offered or bid). For example, in the very first trade, Wallace Boyack had offered 16,000 shares at $0.40 per share. Six months after those shares were first offered, Prominence Capital put in a bid to purchase up to 2,500 shares of VHMC at up to $0.51 per share. RX-21 at page 13 (R. 3635) (first line reflects the "buy" order); Tr. at 1337:20-1338:20 (R. 1864-1865). Three days later Prominence Capital purchased 1,500 shares at $0.78 per share and another 1,500 shares at $1.04 per share, while three Wilson-Davis customers sold a total of 7,000 shares at price ranging between $1.01 and $1.19 per share. These were not executions where a buyer and seller frequently came in at the same quantity. There were also no red flags regarding the timing of the orders. The time elapsing between bids or offerings being posted and hit ranged from a low of 8 minutes to a high of 4 months, with more than three hours passing in 17 of 31 trades. *Id.* (first column showing time between bid/offer post and execution). Moreover, in many cases, Wilson-Davis customers would offer shares at prices that generated no interest from any buyers, and thus had to reduce their offer price to obtain execution. Tr. (Evans) at 1339:1-1341:6 (R. 1866-68).

problematic. According to Enforcement, the fact that the "10 percent" rule was not the sole basis for the NAC's finding, and that the NAC was not "endorsing" a "10 percent" rule, should fully resolve Petitioners' concern that a previously unarticulated rule was being used against them. But in the same paragraph Enforcement acknowledges that "10 percent is a reasonable measure of quotes being away from the inside so as to be considered not near the market." (Enf. Brief at 26). In other words, while Enforcement may have adopted the "10 percent" rule for purposes of finding Petitioners in violation of Reg. SHO, there is no concern because the NAC did not pronounce it as a "rule" for all time. But again, Petitioners were held to a standard they could not possibly have known they would be held to. Enforcement is also tellingly silent in response to Petitioners' argument that a "10 percent" rule is both over-inclusive and under-inclusive, particularly with very low priced stocks (like those at issue here) where 10 percent can be a matter of a penny or two and the price moves rapidly.

Enforcement likewise failed to respond to Petitioners' argument that where a stated purpose of the exception is to provide liquidity in a rapidly moving market, requiring a market maker to immediately take up the very sale-side liquidity he or she just provided by engaging in purchases would be decidedly counterproductive. Nor has Enforcement ever countered the argument that Kerrigone was doing exactly what market makers are supposed to do by providing shares when the market needed sellers and then taking up shares when the market needed buyers. Enforcement repeatedly conceded this point at the hearing:

> Q. Now, that's the first day of trading, and if you looked at the data on Exhibit RX-25, we know the price went up on the first day of trading, so it makes sense that Mr. Kerrigone would be near the ask; correct? Near the offer?
>
> A. If he's trying to sell, correct, yes.
>
> Q. And the market, when it's going up, wants him to sell; correct?

A. Correct.

(Tr. at 297:6-16 (R. 823)).

Q. But the price is going upward, so there are more buyers than sellers?

A. Sure.

Q. It's the supply and demand balance the SEC talks about, and in that situation you'd expect Mr. Kerrigone, as a market maker, to sell; correct?

A. I'd expect him to provide liquidity on the sell side, correct.

(Tr. at 299:12-20 (R. 825)).

Thus, to the extent that Kerrigone's short selling into a market that needed sellers "affected other market participants" as Enforcement contends—but provides no evidentiary support—the effect was positive as it substantially reduced market volatility and put appropriate opposite side pressure on these stocks. The Commission itself has noted the important role that naked short selling plays in "contribut[ing] to market liquidity" when there is a surge in interest in thinly-traded stock, pointing out that

> 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. This is especially true for market makers in thinly traded, illiquid stocks as there may be few shares available to purchase or borrow at a given time.[41]

Thus, the available guidance suggests—and Enforcement's own witness confirmed—that Kerrigone was behaving very much the way a bona fide market maker would be expected to behave when he supplied liquidity to fast-moving markets that were short on supply.

Petitioners again acknowledge that reasonable minds can differ on whether Petitioners

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[41] "Key Points About Regulation SHO," found at https://www.sec.gov/investor/pubs/regsho.htm.

carried their burden to show that each of the challenged short sales was part of bona fide market making. But neither Enforcement nor the NAC seems capable of acknowledging that the question was at least debatable, or that the short selling at issue in fact bore numerous indicia of bona fide market making. While such acknowledgement may not change the analysis of whether the exception was satisfied, it affects the assessment of whether the sanctions imposed were punitive or otherwise excessive or oppressive.

CONCLUSION

For the foregoing reasons, the NAC's decision should be reversed, remanded to the NAC for further findings regarding why the sanctions it imposed are remedial, or the sanctions and suspensions imposed should be substantially reduced.

Respectfully submitted this 10th day of July, 2020.

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ATTORNEY CERTIFICATION

Pursuant to 17 CFR §201.450, I hereby certify that the foregoing brief contains 6,887 words, exclusive of the tables of contents and authorities, caption, and signature block, which is less than the 7,000 word limit. This word count was generated using the "word count" function in the word processing program used to prepare this brief.

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CERTIFICATE OF SERVICE

THE UNDERSIGNED CERTIFIES that on this 10th day of July, 2020, a true and correct copy of the foregoing **PETITIONERS' REPLY BRIEF** was filed via email (pursuant to Securities Act Release No. 10767 and the parties' Joint Notice of Waiver of Paper Service) upon the following:

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