

NEW YORK STOCK EXCHANGE LLC

HEARING BOARD DECISION 09-NYSE-01
WEDBUSH MORGAN SECURITIES INC.
MEMBER ORGANIZATION

January 6, 2009

* * *

Violated NYSE Rules 342(a) and (b) by failing to provide for appropriate procedures of supervision and control and establish system of follow-up and review with respect to activities of its Paris branch office; violated NYSE Rule 342(c) by failing to obtain prior consent of NYSE for each office established other than main office; violated NYSE Rule 405 by failing to use due diligence to learn essential facts relative to every customer, supervise diligently all accounts handled by registered representatives in Paris branch office and/or specifically approve opening of accounts prior to or promptly after completion of transaction for accounts of or with customer; violated Rules 17a-4(b)(4) and 17a-4(f) under Exchange Act of 1934 and NYSE Rules 440 and 472(a)(1) by failing to review or approve written or electronic communications and failing to have procedures to maintain such communications in Paris branch office; violated Rule 17a-3(6) under Exchange Act and NYSE Rule 440 by failing to create and maintain order tickets and execution reports of Paris branch office; violated NYSE Rules 342(d) and 345(a) by failing to have qualified persons acceptable to NYSE in charge of branch offices; and/or permitting persons to perform regularly duties customarily performed by registered representative and direct supervisor without such persons being registered with, qualified by, and acceptable to NYSE; violated NYSE Rule 445 by failing to implement policies, procedures and internal controls reasonably designed to achieve compliance with Bank Secrecy Act and implementing regulations thereunder; violated Rule 15c3-3(g) under Exchange Act by making withdrawals from its special reserve account for exclusive benefit of customers when amount remaining was less than amount required to be on deposit pursuant to Rule 15c3-3(e) under Exchange Act, thereby causing hindsight deficiencies – Censure, \$100,000 fine and undertaking.

Appearances:

For the Division of Enforcement
Susan Light, Esq.
Steven F. Korostoff, Esq.
Laura A. Cooper, Esq.
Gerard F. Murphy, Esq.
Jeremy Bloom, Esq.

For Respondent
Steven Young, Esq.
Jason R. Lindsay, Esq.

* * *

A Hearing Panel on behalf of the New York Stock Exchange LLC (“NYSE” or the “Exchange”) considered a Charge Memorandum issued by NYSE Regulation, Inc.’s Division of Enforcement (“Enforcement”) charging Wedbush Morgan Securities, Inc. (“Respondent” or the “Firm”), a member organization, with having:

- I. Violated NYSE Rules 342(a) and (b) by failing to provide for appropriate procedures of supervision and control and establish a system of follow-up and review with respect to the activities of its Paris branch office.
- II. Violated NYSE Rule 342(c) by failing to obtain the prior consent of the NYSE for each office established other than a main office.
- III. Violated NYSE Rule 405 by failing to use due diligence to learn the essential facts relative to every customer, supervise diligently all accounts handled by registered representatives in the Firm’s Paris branch office and/or specifically approve the opening of accounts prior to or promptly after the completion of any transaction for the accounts of or with a customer.
- IV. Violated Rules 17a-4(b)(4) and 17a-4(f) under the Securities Exchange Act of 1934 (the “Exchange Act”) and NYSE Rules 440 and 472(a)(1) by failing to review or approve written or electronic communications in conducting its business as such and failing to have procedures to maintain such communications in the Firm’s Paris branch office.
- V. Violated Rule 17a-3(6) under the Exchange Act and NYSE Rule 440 by failing to create and maintain order tickets and execution reports of the Firm’s Paris branch office.
- VI. Violated NYSE Rules 342(d) and 345(a) by failing to have one or more qualified persons acceptable to the Exchange in charge of one or more branch offices; and/or permitting one or more natural persons to perform regularly the duties customarily performed by a registered representative or a direct supervisor without such persons being registered with, qualified by, and acceptable to the NYSE.

- VII. Violated NYSE Rule 345A(a) by permitting one or more registered representatives to continue to perform duties as a registered person without having complied with the applicable continuing education requirements.
- VIII. Violated NYSE Rule 407(b) by failing to receive and review monthly account statements and confirmation tickets of accounts held at other firms by registered representatives.
- IX. Violated NYSE Rule 445 by failing to implement policies, procedures and internal controls that were reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder.¹
- X. Violated Rule 15c3-3(g) under the Exchange Act by, on one or more occasions, making withdrawals from its special reserve account for the exclusive benefit of customers (“Reserve Account”) when at the time of the withdrawals the amount remaining in the Reserve Account was less than the amount required to be on deposit pursuant to Rule 15c3-3(e) under the Exchange Act, thereby causing hindsight deficiencies.

Respondent filed an Answer on February 8, 2006. On October 19, 2006, Enforcement filed a Motion for Partial Summary Judgment (the “Summary Judgment Motion”). In that Motion Enforcement sought a finding of guilt on Charges I, II, VI, IX and X. After briefing by the parties, the Hearing Officer granted the Summary Judgment Motion only as to Charge X. The opinion supporting the order on the Summary Judgment Motion is attached to this decision as Appendix A.

Based on the pleadings, evidence and argument presented at the hearing, the Hearing Panel made the following findings:

Background and Jurisdiction

1. The Firm has been a member organization of the NYSE since 1972. The Firm is a self-clearing organization which engages in investment banking, municipal finance, investment research, retail brokerage activities and correspondent firm services. As of July 2005, the Firm maintained over fifty branch offices, including a number of one-person offices staffed by independent contractors. The Firm has approximately six hundred employees, of which approximately three hundred are registered, including approximately thirty independent contractors.
2. In 2002, the NYSE’s Division of Member Firm Regulation’s (“MFR”) Sales Practice Review Unit (“SPRU”) conducted an examination of the Firm’s supervisory

¹ Prior to the Hearing, Enforcement withdrew those aspects of Charge IX that related to the internal thresholds established by the Firm to detect structuring activities. Charge IX has been conformed herein to reflect that withdrawal by Enforcement.

standards and sales practice procedures. SPRU set forth various exceptions in a written report to the Firm dated March 21, 2002 (the “2002 SPRU Report”). In 2003, SPRU conducted another examination of the Firm’s supervisory standards and sales practice procedures and set forth various exceptions in a written report to the Firm dated October 6, 2003 (the “2003 SPRU Report”). In 2004, MFR conducted an examination of the Firm’s financial, operational and supervisory standards and procedures and set forth various exceptions in a written report dated February 24, 2005 (“2004 Fin/Op Report”). In 2005, MFR’s Qualifications and Registrations department conducted a review of the Firm’s registration of branch offices and found deficiencies as set forth in a letter to the Firm dated March 4, 2005. All matters were referred to Enforcement for investigation.

3. Enforcement notified the Firm that it was investigating certain matters raised in the 2002 SPRU Report and the 2003 SPRU Report.

VIOLATIVE CONDUCT

VIOLATIONS RELATING TO THE FIRM’S OPERATION OF THE PARIS OFFICE

Failure to Register and Failure to Supervise the Paris Office

4. NYSE Rule 342(c) provides: “The prior consent of the Exchange shall be obtained for each office established by a . . . member organization, other than a main office.”
5. NYSE Rule 345(a) provides in relevant part: “No . . . member organization shall permit any natural person to perform regularly the duties customarily performed by (i) a registered representative . . . or (iv) a direct supervisor of [a registered representative] unless such person shall have been registered with, qualified by and is acceptable to the Exchange.”
6. NYSE Rule 342(a) provides in relevant part: “Each office, department or business activity of a . . . member organization . . . shall be under the supervision and control of the . . . member organization establishing it and of the personnel delegated such authority and responsibility.”
7. NYSE Rule 342(b) provides in relevant part: “The general partners or directors of each member organization shall provide for appropriate supervisory control [and appoint a person who will] . . . delegate to qualified principals or employees responsibility and authority for supervision and control of each office . . . [and] establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.”
8. NYSE Rule 342(d) provides in relevant part: “Qualified persons acceptable to the Exchange shall be in charge of: (1) any office of a . . . member organization.”

9. In or about March 2002, the Firm submitted an application to the NYSE for the registration of an office in Paris, France (the "Paris Office"). The application listed two independent contractors, PH and JA, as the registered representatives for the Paris Office.
10. The NYSE rejected the Firm's application for the Paris Office because the NYSE rules in effect at that time did not permit an independent contractor to be the person in charge of a branch office.
11. Subsequent to the NYSE's rejection of the Firm's application, in or about April 2002, PH and JA commenced doing business in the Paris Office as XYZ Finance ("XYZ"), a foreign non-member broker/dealer doing business under the Firm's name. PH and JA serviced approximately thirty customer accounts, most of which were held by institutional customers.
12. PH and JA regularly performed duties customarily performed by registered representatives of the Firm without having been registered with, qualified by and acceptable to the NYSE. No branch office manager or other Firm employee had responsibility and authority for the supervision and control of the Paris Office.
13. The Firm provided the Paris Office with trading execution and supplied it with research reports in exchange for payment of twenty percent of the commissions generated by the Paris Office, less certain expenses. The Paris Office received the remaining eighty percent. During the period of April 2002 to May 2004, the Paris Office received approximately \$579,000 in commissions.
14. The Paris Office was in continuous operation, opening new accounts, accepting customer orders, executing orders through the Firm's institutional equities trading desk and sending customers research reports, during the period of April 2002 to October 2005.
15. The Firm, PH and JA held the Paris Office out to the public as a branch office of the Firm by listing the Paris address as a branch office on the Firm's website, www.wedbush.com, displaying a Firm sign with the Firm's name both inside and outside the Paris Office and listing Paris on the Firm's letterhead and other forms as a city in which the Firm had an office. PH and JA also used the Firm's business cards and e-mail to conduct business.
16. On or about December 4, 2004, MFR informed the Firm that it could not continue to operate the Paris Office without the NYSE's consent.
17. Thereafter, the Firm continued to conduct business through the Paris Office and hold it out to the public as a Firm branch office.
18. As of August 4, 2005, the Firm listed the Paris Office on the Central Registration Depository ("CRD") as a branch office.

19. In or about October 2005, the Firm submitted to MFR a Fully Disclosed Clearing Agreement (“Clearing Agreement”) with XYZ Finance in order to request approval of the Paris Office as a correspondent firm with which the Firm did business. The NYSE verbally approved the Firm’s request.
20. The Firm did not obtain the NYSE’s consent prior to establishing the Paris Office that operated from April 2002 to October 2005.
21. The Firm did not supervise the activities of the Paris Office during the period of April 2002 to October 2005.

Due Diligence As to Customer Accounts

22. NYSE Rule 405, provides in relevant part: “Every member organization is required through a general partner, a principal executive officer or a person or persons designated under the provisions of Rule 342(b)(1) to
 - (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization. . . .
 - (2) Supervise diligently all accounts handled by registered representatives of the organization.
 - (3) Specifically approve the opening of an account prior to or promptly after the completion of any transaction for the account of or with a customer. . . .”
23. NYSE Rule 342.16 provides in relevant part that supervision of registered representatives “[w]ould ordinarily include at least approval of new accounts. . . .”
24. The Firm did not use due diligence to learn essential facts relative to customer accounts opened at the Paris Office. New account documentation was incomplete and lacked information. During the period of March 2003 to January 2004, sixteen accounts were opened without new account documentation and one account was opened with information missing from the new account documentation.
25. The Firm did not review or approve new accounts opened at the Paris Office.

Review And Approval of Outgoing and Incoming Correspondence And Maintenance of Books and Records

26. Rule 17a-4(b)(4) under the Exchange Act requires member organizations to maintain “[o]riginals of all communications received and copies of all communications sent . . . by the member . . . (including interoffice memoranda and communications) relating to its business as such” for a period of three years. Rule 17a-4(f) under the Exchange Act requires that, if records are stored electronically, they must be in a non-rewritable, non-erasable format, among other things. NYSE Rule 440 requires that “the record keeping format, medium and retention period shall comply with Rule 17a-4 under the Securities Exchange Act of 1934.”

27. NYSE Rule 472(a)(1) provides that “[e]ach advertisement, market letter, sales literature or other similar type of communication which is generally distributed or made available by a member or member organization to customers or the public must be approved in advance by a member, allied member, supervisory analyst, or qualified person designated under the provisions of Rule 342(b)(1).”
28. NYSE Rule 342.16, provides in relevant part, that supervision of registered representatives “[w]ould ordinarily include at least . . . reasonable procedures for review of registered representatives’ communications with the public relating to their business, and customer accounts and transactions.”
29. From April 2002 to October 2005, the Firm did not review or approve written or electronic communications sent by the Paris Office to its customers.
30. From April 2002 to October 2005, the Firm did not have procedures in place for maintaining written or electronic communications that the Paris Office sent to customers in the conduct of its business.
31. From April 2002 to October 2005, the Firm did not review incoming correspondence at the Paris Office, including correspondence from customers.

Order Tickets and Execution Reports

32. Rule 17a-3(a)(6) under the Exchange Act requires member firms to make and maintain records of customer orders, including the time of entry of the order and the price at which the order was executed, as well as, to the extent feasible, the time of execution.
33. NYSE Rule 440 provides that “every member organization shall make and preserve books and records as the Exchange may prescribe and as prescribed by [Exchange Act] Rule 17a-3.”
34. On one or more occasions, order tickets from the Paris Office did not have the correct date or order times and execution times were not recorded on the order tickets.
35. No one at the Firm reviewed the Paris Office order tickets or execution reports.

VIOLATIONS RELATING TO CONTINUING EDUCATION REQUIREMENTS

36. NYSE Rule 345A(a) provides in relevant part: “No . . . member organization shall permit any registered person to continue to, and no registered person shall continue to, perform duties as a registered person, unless such person has complied with the continuing education requirements. . . .”

37. During the period of January 2002 through September 2004, the Firm permitted four registered representatives who had not complied with the continuing education requirements, including one in the Paris Office, to perform duties as registered persons. Three of the registered representatives improperly earned commissions in an amount totaling approximately \$25,000 while their registrations were inactive. The registered representatives' registrations were inactive for a period of five days, forty-one days and thirty-nine days, respectively.

VIOLATIONS RELATING TO PERSONAL SECURITIES ACCOUNTS HELD BY REGISTERED REPRESENTATIVES OUTSIDE THE FIRM

38. NYSE Rule 407(b) provides in relevant part: "No . . . employee associated with a . . . member organization shall establish or maintain any securities . . . account . . . with respect to which such person has a financial interest or the power, directly or indirectly, to make investment decisions, at another . . . member organization, or a domestic or foreign non-member broker-dealer, investment adviser, bank [or] other financial institution without the prior written consent of another person designated by the . . . member organization under Rule 342(b)(1) to sign such consents and review such accounts." NYSE Rule 407(b) further requires that duplicate confirmations and monthly account statements be sent to the designated supervisor.
39. By letter to MFR dated April 22, 2004, ME, the Firm's Compliance Director, stated that "no employee of the Paris Office holds an outside account."
40. PH of the Paris Office held personal investment accounts at Bank A and Bank B, and JA of the Paris Office held personal investment accounts at Bank C and Bank D. The Firm did not receive duplicate confirmations and monthly account statements for those accounts and did not review the accounts. There was, however, no activity in those accounts.
41. The Firm also failed to receive duplicate confirmations and monthly account statements for accounts held outside the Firm by two registered representatives in the United States. The Firm did, however, receive quarterly account statements for those accounts. There was no activity in either account.
42. The Firm's failure to review personal investment accounts held outside the Firm by registered representatives was a repeat deficiency in the 2002 SPRU, 2003 SPRU and 2004 Fin/Op Reports.

VIOLATIONS RELATING TO FAILURE TO OBTAIN NYSE APPROVAL OF BRANCH OFFICES AND INDEPENDENT CONTRACTORS

43. As set forth above, NYSE rules require (a) prior NYSE approval for the establishment of branch offices and (b) the registration of certain personnel including, *inter alia*, registered representatives and their direct supervisors.

44. NYSE Rule 342.11 provides, in relevant part: “With the prior approval of the Exchange, a registered representative may operate from his residence. His home address and telephone number may be advertised in any normal manner . . . but, in such event, the residence address shall be considered as constituting an office of his employer.”
45. Pursuant to NYSE Rule 345(a), as interpreted by NYSE Interpretation Handbook, NYSE Rule 345(a)/02, and NYSE Information Memorandum Number 82-43, “Independent Contractor Registered Representatives,” independent contractor status is permitted for registered representatives, provided that the member organization complies with certain specified requirements, including that the registered representative be treated as an “employee” for purposes of the NYSE’s Constitution and Rules, be supervised and controlled by the member firm and be required to execute a valid consent to jurisdiction of the NYSE. NYSE Rule 345(a), as interpreted by NYSE Interpretation Handbook, NYSE Rule 345(a)/02, also requires that the member firm submit written documentation of compliance with these requirements.
46. Until July 2002, NYSE Rule 345(a), as interpreted by NYSE Interpretation Handbook, NYSE Rule 345(a)/02, required that the registered representative in charge of a single person office be an employee, not an independent contractor. In July 2002, the NYSE’s interpretation of Rule 345(a) was amended to permit “the sole employee in a small office (e.g., residence office)” to be an independent contractor. Under the new interpretation, the member firm was required to affirm in writing that such person was not delegated any supervisory responsibilities, and was further required to implement procedures for special supervision for two months after the office was opened.
47. Until July 2004, NYSE Rule 345(a), as interpreted by NYSE Interpretation Handbook, NYSE Rule 345(a)/02, required that the branch office manager of an office with more than three independent contractors be a Firm employee rather than an independent contractor. In July 2004, the NYSE’s interpretation of Rule 345(a) was amended to permit member firms to designate an independent contractor as the registered representative in charge of an office with more than three independent contractors, so long as the independent contractor was not delegated any supervisory responsibilities. The NYSE’s new interpretation of Rule 345(a) thus required that a branch office manager employed by the Firm supervise offices with more than three independent contractors, even if that individual was not on site.
48. At various points during the period of approximately June 2001 to February 2002, the Firm permitted approximately twenty-six independent contractors to perform regularly the duties customarily performed by a registered representative without having been registered with, qualified by and acceptable to the NYSE.
49. On a rolling basis, the Firm registered nineteen of those independent contractors during the period of September 2001 to February 2002.

50. In addition, the Firm registered a total of twenty-two independent contractors under the wrong address. Between February 2003 and March 2004, the Firm corrected the registration addresses for those individuals.
51. During the period of approximately August 2001 to March 2002, the Firm also operated approximately eleven offices without the NYSE's prior consent.
52. In or about February through May 2002, the Firm submitted applications to register the eleven offices, as well as the Paris Office and a branch office located in Delmar, CA. The NYSE rejected approximately five of the applications, including the Firm's application with respect to the Paris Office, because the offices in question were staffed either by single non-employee independent contractors or by two or more independent contractors without an employed branch office manager. The NYSE's interpretation of NYSE Rule 345(a) had not been amended at that time.
53. The Firm continued to operate the five branch offices that the NYSE did not approve.
54. By Information Memorandum Number 02-54 dated November 26, 2002, the NYSE requested that all member firms submit a list of all of their branch offices.
55. In or about December 2002, the Firm submitted to the NYSE a list of its active branch offices that included offices that the NYSE had not approved.
56. During the period of approximately October 2002 to March 2003, the Firm operated approximately five branch offices for various periods of time without the NYSE's prior consent.
57. In February 2005, the NYSE conducted a review of the status of the Firm's branch offices and noted that the Firm had never submitted an application for the NYSE's prior consent to establish three additional branch offices.
58. By letter dated March 4, 2005, the NYSE notified the Firm of the results of that review.
59. As late as approximately April 2005, the Firm continued to operate five unapproved branch offices, including the Paris Office. The Firm listed several of those offices, including the Paris office, on the Firm's website, www.wedbush.com, as branch offices. The Firm subsequently removed the Paris Office from its website and the CRD. In or about April and May 2005, the Firm registered the remaining branch offices and independent contractors with the NYSE.
60. The Firm operated branch offices without the prior consent of the NYSE. The Firm also permitted individuals who were not registered with, qualified by and acceptable to the NYSE to perform as registered representatives or branch office managers.

61. The number of branch offices for which the Firm failed to obtain prior NYSE consent and the number of independent contractors it failed to timely register, the repeated citation by MFR of such deficiencies over the course of three years of examinations, and the Firm's continued operation of branch offices that the NYSE had previously rejected without correcting the relevant deficiencies, evidenced a systemic failure on the part of the Firm to supervise the registration of branch offices and independent contractors, as well the absence of any system of follow-up and review with respect to that function.

**VIOLATIONS RELATING TO THE FIRM'S ANTI-MONEY LAUNDERING POLICIES
AND PROCEDURES**

62. NYSE Rule 445, which became effective on April 24, 2002, requires member firms to develop and implement a written anti-money laundering program that shall, in relevant part, include: "policies, procedures and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act [31 U.S.C. § 5311, et seq.] and the implementing regulations thereunder. . . ."
63. Section 5318(l) of the Bank Secrecy Act, 31 U.S.C. § 5318(l), as amended by Section 326 of the Patriot Act, and 31 CFR Part 103.122 promulgated thereunder, requires firms to establish a customer identification program ("CIP") which includes the collection of certain information prior to establishing a new account. Under certain circumstances, firms are permitted to rely on a correspondent firm's CIP, as long as that entity is regulated by a "federal functional regulator," is subject to the Bank Secrecy Act, and contractually agrees to annually certify in writing that it has implemented an anti-money laundering program. A firm cannot rely on a foreign correspondent firm that is not subject to the Bank Secrecy Act.
64. During the period of October 1, 2003 to October 30, 2003, the Firm did not collect the required customer identification information for five accounts.
65. The Firm did not collect the required customer identification information for thirteen accounts that were transferred from other broker/dealers via the automated customer account transfer service system ("ACATS"), or for one account opened at the Paris Office.
66. During the period of October 2003 to January 2005, the Firm did not collect the required customer identification information for any new accounts established by correspondent firms.
67. Specifically, the Firm did not verify customer identity and did not receive copies of the information used by the correspondent firms to verify customer identity.
68. The Firm also relied on a Panamanian correspondent firm to collect customer information for three accounts. The Bank Secrecy Act does not permit such reliance on a non-U.S. firm that is not a regulated entity.

69. Pursuant to Section 5318(j) of the Bank Secrecy Act, 31 U.S.C. § 5318(j), as amended by Section 313 of the Patriot Act, a firm must obtain a certification from any foreign bank for which it establishes, maintains, administers or manages a correspondent account in order to ensure that the foreign bank is not using such an account to indirectly provide banking services to a foreign bank that does not have a physical presence in any country.
70. The Firm did not collect the required certification from several foreign banks.

**VIOLATIONS RELATING TO THE FIRM'S SPECIAL RESERVE ACCOUNT FOR
THE EXCLUSIVE BENEFIT OF CUSTOMERS**

71. Rule 15c3-3(g) promulgated under the Exchange Act provides that “a broker dealer may make withdrawals from its Reserve Bank Account if and to the extent that at the time of the withdrawal the amount remaining in the Reserve Bank Account is not less than the amount then required” according to a specific formula in Rule 15c3-3(c).
72. The Firm withdrew assets from its Reserve Account, leaving an amount remaining in the Reserve Account that was less than the amount then required according to Rule 15c3-3(c) on the following days, in the following approximate amounts, and thereby caused hindsight deficiencies:

Date	Approximate Hindsight Deficiency
February 6, 2002	\$24 Million
February 13, 2002	\$42 Million
February 13, 2002	\$34 Million
February 20, 2002	\$93 Million
February 20, 2002	\$37 Million
January 28, 2003	\$41 Million
May 11, 2004	\$26 Million

73. The February 6, 2002 deficiency was caused by the entry of an instruction to withdraw \$50 million par value of U.S. Treasury Bonds from the Reserve Account. At the time of the withdrawal, the amount remaining in the Reserve Account was less than the amount then required to be on deposit. The hindsight deficiency lasted for approximately nine minutes.
74. On February 13, 2002, there were two hindsight deficiencies in the Reserve Account that were caused by the withdrawal of securities from the Reserve Account for deposit into another account. At the time of the withdrawals, the amount remaining in the Reserve Account was less than the amount then required to be on deposit. The

first hindsight deficiency lasted approximately one minute and the second, approximately two hours and fifty-seven minutes.

75. On February 20, 2002, there were two hindsight deficiencies as a result of the withdrawal of securities from the Reserve Account prior to the deposit of adequate collateral into the Reserve Account. At the time of the withdrawals, the amount remaining in the Reserve Account was less than the amount then required to be on deposit. The first hindsight deficiency lasted approximately three minutes and the second approximately thirteen minutes.
76. The January 28, 2003 deficiency occurred when a Firm employee failed to follow Firm procedure with respect to ensuring that sufficient collateral was deposited in the Reserve Account prior to the withdrawal of assets. At the time of the withdrawal, the amount remaining in the Reserve Account was less than the amount then required to be on deposit. The hindsight deficiency lasted approximately two minutes.
77. The May 11, 2004 deficiency was caused by the entry of an instruction to withdraw assets from the Reserve Account prior to the deposit of assets in the Reserve Account. At the time of the withdrawal, the amount remaining in the Reserve Account was less than the amount then required to be on deposit. The hindsight deficiency lasted approximately seven minutes.

DECISION

The Hearing Panel found Respondent guilty of Charges I, II, III, IV, V, VI, IX and X, and not guilty of Charges VII and VIII.

The Paris Office

The question of whether the Paris Office comprised a branch office of the Firm was relevant to the Hearing Panel's decision on Charges I, II, III, IV, V and VI.

The Firm, which was based in Los Angeles, was eager to portray itself as having an international reach. It entered into discussions with two individuals, PH and JA, who were previously registered with the NYSE as employees in the Paris office of a separate NYSE member firm. PH and JA were setting up a small French brokerage firm but were eager to retain their NYSE registrations.

As a result of those discussions, the Firm agreed to register PH and JA with the NYSE, and entered into a representative office agreement with them on behalf of their firm in November 2001. That agreement provided that the Firm would execute transactions on behalf of the Paris Office established by PH and JA, and would also supply that office with research and permit it to use the Firm's name to do business. In exchange, PH and JA would pay the Firm twenty percent of the Paris Office's commissions.

At the time the Firm entered into the representative office agreement with PH and JA, the NYSE Rules only permitted member firms to do business through branch offices or correspondent firms

whose trades were cleared by the member firm. When the Firm attempted to register PH and JA with the NYSE as registered representatives of the Firm, it became apparent that the Firm did not know how to properly characterize the Paris Office under the NYSE Rules.

The Firm's witnesses testified that they sought guidance from the NYSE on this point, but that their calls were not returned by NYSE representatives. Rather than persisting in such attempts to obtain the necessary guidance, the Firm chose to submit an electronic application to the NYSE which characterized the Paris Office as a branch office of the Firm. The application was rejected in April 2002 because the Paris Office was under the supervision of PH and JA, who were both independent contractors and were thus not permitted to supervise a branch office under the NYSE Rules in effect at that time. Nevertheless, the Paris Office commenced doing business under the terms of the representative office agreement in April 2002.

Firm management testified at the Hearing that they never intended to create a branch office in Paris by virtue of entering into the representative office agreement with PH and JA. They claimed that, had they understood the requirements of the NYSE Rules, they would have requested that the NYSE treat the Paris Office as a correspondent firm. However, as a member organization of the NYSE, the Firm was obligated to comply with the NYSE Rules. If the Firm was unable to understand what was required of it under those Rules, it was obligated to obtain the necessary guidance from the NYSE and refrain from taking action until it did so. Instead, the Firm sought the NYSE's consent to establish the Paris Office as a branch office of the Firm, and continued to do business through that office even after such consent was denied. It was only after the NYSE brought the problems regarding the operation of the Paris Office to the Firm's attention that the Firm entered into a correspondent agreement with XYZ Finance in 2005.

While Firm management may not have intended to create a branch office by entering into the representative office agreement with PH and JA, that fact was not apparent to either the NYSE or the public. The Firm registered the Paris Office with the CRD as a branch office of the Firm. It also listed Paris, France as a city in which the Firm maintained an office on Firm letterhead, Firm forms and the Firm's website. Thus, for the purposes of these charges, the Paris Office will be considered a branch office of the Firm.

Charge I

Because the Paris Office was a branch office of the Firm, the Firm was obligated to supervise, review and approve its activities. It failed to do so. The Firm did not review or otherwise supervise the opening of new accounts, or the emails and orders that went through the Paris Office. While orders from the Paris Office were routed through a trading desk in Los Angeles, the fact that orders were subject to general supervision at that trading desk did not overcome the absence of any supervision at the Paris Office. The evidence presented at the Hearing demonstrated that orders at the Paris Office were routinely processed with crossed-out time stamps and incomplete order tickets, and were submitted for execution on an untimely basis. The Firm's supervision of the Paris Office was not only inadequate, it was non-existent. The Panel, therefore, found Respondent guilty of Charge I.

Charge II

Charge II alleges that the Firm violated NYSE Rule 342 (c) by operating the Paris Office as a branch office without the prior approval of the NYSE. As set forth above, the Firm's application for approval of the Paris Office as a branch office was rejected by the NYSE because it identified PH and JA, the individuals in charge of the Paris Office, as independent contractors rather than Firm employees. The NYSE Rules that were in effect at that time did not permit independent contractors to supervise branch offices.² The Firm continued to operate the Paris Office as a branch office despite that rejection.

The Firm also failed to obtain the prior consent of the NYSE before establishing approximately eleven offices in the United States. Those offices were established after the Firm agreed to take over the offices of a correspondent firm client that was having financial difficulties in order to protect the correspondent firm's customers. Most of the offices the Firm thus acquired were single-broker offices; however, the brokers at those offices were registered to a single office of supervisory jurisdiction where none of them actually worked. When the Firm discovered this discrepancy, it attempted to register the offices with the NYSE but was unable to do so because the brokers in question were independent contractors who were not permitted to supervise branch offices under the NYSE Rules. Nevertheless, the Firm continued to operate the majority of the branch offices on an unregistered basis from August 2001 through March 2002.

The Firm established the Paris Office as well as several branch offices in the United States without the prior consent of the NYSE. The Panel, therefore, found Respondent guilty of Charge II.

Charge III

Charge III charges the Firm with violating NYSE Rule 405 by failing to learn the essential facts relative to customer accounts in the Paris Office, and by failing to supervise and approve the opening of those accounts. When NYSE examiners reviewed the files of thirty-three accounts in the Paris Office they found that seventeen of them were missing required new account documentation or information. Thus, even if the Firm had attempted to comply with its obligation under NYSE Rule 405 to supervise and approve the opening of those accounts, it would not have been able to do so, given the missing information.

The Panel, therefore, found Respondent guilty of Charge III.

Charge IV

Charge IV charges the Firm with violating NYSE Rule 472(a)(1) by failing to approve written or electronic communications that were distributed to customers of the Paris Office. The Charge further charges that the Firm failed to establish procedures to maintain and preserve such communications, as required by Exchange Act Rules 17a-4(b) and 17a-4(f) and NYSE Rule 440.

² While the Firm, at one point, identified a management employee in Los Angeles as the supervisor of the Paris Office, that individual testified that he did not believe that the Firm was responsible for supervising the Paris Office and that he did not perform any supervisory function with respect to that office.

Senior management of the Firm testified at the Hearing that the Firm did not review emails or faxes that were sent to customers of the Paris Office. An examination by the NYSE found that certain of those communications contained excerpts of Firm research reports that were sent to customers of the Paris Office without the prior approval of the Firm. This failure was significant because, unlike the complete research reports that were properly approved by the Firm, excerpts of research reports had the potential to present customers with an unbalanced picture of the matters contained in the original reports.

The Panel also found that, while the Firm had procedures to maintain and preserve written and electronic communications, it did not apply those procedures to the Paris Office.

The Panel, therefore, found Respondent guilty of Charge IV.

Charge V

Charge V charges the Firm with violating Exchange Act Rule 17a-3(6) and NYSE Rule 440 by failing to create and maintain order tickets and execution reports at the Paris Office.

The Paris Office failed to create and maintain accurate records of orders and executions. Some records were missing, others were altered. Tickets were sometimes time-stamped the day after the order was received, and the date was subsequently crossed out and changed.

The Panel, therefore, found Respondent guilty of Charge V.

Charge VI

Charge VI alleges that the Firm violated Exchange Act Rules 342(d) and 345(a) by failing to have one or more qualified persons acceptable to the NYSE in charge of one or more branch offices, and by permitting one or more individuals to perform regularly the duties customarily performed by a registered representative or direct supervisor without such persons being registered with, qualified by and acceptable to the NYSE.

As set forth above, the Firm permitted independent contractors to supervise branch offices in violation of the NYSE Rules in effect at that time. In addition, during the period of June 2001 to February 2002, approximately twenty-six independent contractors performed regularly the duties customarily performed by a registered representative or supervisor without having been registered with, qualified by and acceptable to the NYSE. A total of twenty-two independent contractors were registered under the wrong address.

The Panel, therefore, found Respondent guilty of Charge VI.

Charge VII

Charge VII charges the Firm with violating NYSE Rule 345A(a) by permitting one or more registered representatives to continue to perform their duties without having complied with the applicable continuing education requirements.

At the Hearing, Enforcement presented evidence establishing that four individuals at the Firm performed their duties as registered representatives while they were not in compliance with the continuing education requirements of the NYSE Rules. One of the registered representatives in question was PH of the Paris Office. The Firm argued, and the Panel accepted, that the Firm was not at that time aware that PH was subject to those requirements. PH also did not earn any commissions during the period at issue. The Panel thus found that the evidence presented at the Hearing did not conclusively demonstrate that the Firm violated NYSE Rule 345A(a) by permitting PH to continue to perform his duties as a registered representative without fulfilling his continuing education requirements.

At the Hearing, Enforcement withdrew the charges relating to a second registered representative who was prevented by personal circumstances from complying with the continuing education requirements until six days after the deadline for such compliance had passed.

The evidence presented at the Hearing demonstrated that the two remaining registered representatives only became subject to the continuing education requirements after a regulatory action concerning their previous firm eliminated their prior exemption from those requirements. The Panel found that there was some question as to whether the Firm received notice from the CRD system of the change in the registered representatives' status. The Panel also found that the evidence did not conclusively demonstrate that the registered representatives failed to timely satisfy their continuing education requirements.

The Panel, therefore, found Respondent not guilty of Charge VII.

Charge VIII

Charge VIII alleges that the Firm violated NYSE Rule 407(b) by failing to receive and review monthly account statements and confirmation tickets for accounts held at other firms by four registered representatives of the Firm.

Two of the representatives in question, PH and JA, held inactive accounts at other firms that were not traded. The Panel accepted the Firm's argument that it was not aware of its obligation to review those accounts.

CG was a registered representative with the Firm who was formerly employed by Firm X. CG retained an account at Firm X that contained only a single worthless security. Because the security was worthless, CG had difficulty closing the account or transferring the position to the Firm.

RA, formerly with Firm Y, wanted to maintain a checking account at his former firm because it offered certain benefits such as tax free interest and a Visa card that earned airline miles that were not available from the Firm. RA thus requested permission from the Firm's compliance department to keep the account. That permission was denied.

The Firm's compliance department wrote to both Firm X and Firm Y in order to obtain copies of the monthly statements for the accounts of CG and RA. The compliance department also requested that Firm Y close RA's account, but it took two years for Firm Y to do so. No securities were traded in either account while CG and RA were employed by the Firm.

The Panel found that the Firm's failure to review the monthly account statements and confirmation tickets for the accounts of CG and RA was caused in part by operational difficulties over which the Firm had no control. The Panel, therefore, found Respondent not guilty of Charge VIII.

Charge IX

Charge IX charges the Firm with violating NYSE Rule 445 by failing to implement policies and procedures designed to prevent money laundering.

Prior to the Hearing, Enforcement withdrew those aspects of the Charge that related to the internal thresholds used by the Firm to determine whether a suspicious activity report had to be filed. The remainder of Charge IX relates to the Firm's lapses regarding its obligation to perform customer identity verification and obtain foreign bank certifications.

Section 5318(l) of the Bank Secrecy Act and the implementing regulations thereunder required the Firm to perform customer identity verification on new accounts by 1) verifying the identity of every new customer through documentary evidence such as a driver's license or passport or by other non-documentary means such as comparing information provided by the customer with information obtained from a consumer reporting agency, public database or other source, and 2) comparing that customer's name against lists of known or suspected terrorists or other potentially dangerous individuals.

The Firm employed an outside vendor to perform customer identity verification for its new accounts through non-documentary means. The Firm was obligated to ensure that the vendor performed both elements of the customer identification process – verifying the identity of new customers in the first instance, and comparing the names of those customers against lists of known or suspected terrorists or bad actors. The Firm failed to do so. In fact, the outside vendor was only performing the second step of the two-step customer identity verification process.³

The Firm was also a clearing broker for a number of correspondent firms. Section 5318(l) of the Bank Secrecy Act and the implementing regulations thereunder permitted either the Firm or the correspondent firms to perform customer identity verification for new customers of those firms. However, a correspondent firm could only perform customer identity verification pursuant to a

³ During the Hearing, the Firm commenced discussions with the vendor to obtain customer identification verification services that satisfied both steps.

written agreement allocating responsibility for that function, and the correspondent firm was also required to submit an annual certification to the Firm affirming that it was, in fact, conducting customer identity verification. From approximately October 2003 to January 2005, the Firm did not obtain annual certifications from its correspondent firms. Thus, all new accounts that were established by correspondent firms during that period were not in compliance with the anti-money laundering requirements. The Firm also relied on a Panamanian correspondent firm that was not subject to the Bank Secrecy Act to perform customer identity verification on three customer accounts.

In addition, fourteen accounts were not subjected to customer identity verification. One of the accounts in question originated in the Paris Office; the other thirteen were accounts that were transferred to the Firm from other broker/dealers via ACATS. While the Firm argued that it did not understand that it was required to perform customer identity verification on accounts transferred to the Firm by other broker/dealers, the Panel found that the Firm was not thereby relieved of its obligations under the Bank Secrecy Act.

In addition to failing to perform adequate customer identity verification on new accounts, the Firm also failed to collect from several foreign banks the certification required under the Bank Secrecy Act to ensure that the banks were not foreign shell banks. The Firm argued that this was caused by the Firm's failure to identify several foreign banks when it searched its customer lists without using all foreign language variations of the word "bank." However, the Panel found that this error did not excuse the Firm's failure to comply with Section 5318(j) of the Bank Secrecy Act.

The Panel, therefore, found Respondent guilty of Charge IX.

Charge X

For the reasons set forth in the summary judgment opinion, Respondent was found guilty of Charge X.

Charge X charges the Firm with making withdrawals from its Reserve Account on seven occasions when, at the time of the withdrawals, the amount remaining in the Reserve Account was less than the amount required to be on deposit pursuant to Rule 15c3-3(c) under the Exchange Act. The withdrawals caused hindsight deficiencies that ranged in amount from from \$24 million to \$93 million and lasted for periods of one minute to just under three hours. Five of the seven deficiencies lasted fewer than 10 minutes.

The summary judgment decision noted:

The purpose of the Rule is to ensure that customer funds are protected in the event of a bankruptcy, since a bank normally has a right of set-off against funds deposited by the broker-dealer, except to the extent that the funds are established as special accounts or in trust for a special purpose. See Dowden v. Cross County Bank, 97 B.R. 503, 508 (Bankr. E.D. Ark.1987)

In its defense, the Firm asserted that it had sufficient funds in other accounts to cover the deficiencies. As noted below in the summary judgment opinion the Hearing Officer found this defense wanting:

There is no evidence that, in the event of bankruptcy, Respondent's bank would have been required to treat the unidentified "other account" referred to in the Answer as a special account or one containing funds being held in trust for customers. In any event, the Rule makes clear that the Reserve Bank Account must be kept separate and apart from any other accounts maintained by the broker-dealer. This requirement is not a mere formality, but rather, is an explicit and essential obligation of federal law.

Therefore, the Hearing Officer found that Enforcement was entitled to judgment as a matter of law on Charge X and found the Respondent guilty of that Charge.

PENALTY

In determining a penalty that would be reasonable and appropriate, the Panel was mindful of the factors that the Second Circuit Court of Appeals, in the McCarthy case, held should be taken into account:

The seriousness of the offense, the corresponding harm to the trading public, the potential gain to the [respondent] for disobeying the rules, the potential for repetition in light of the current regulatory and enforcement regime, and the deterrent value to the offending [respondent] and others are all relevant factors to be considered in deciding whether the sanction is appropriately remedial and not excessive and punitive.

McCarthy v. SEC, 406 F.3d 179, 190 (2d Cir. 2005).

Enforcement requested that the Panel impose a censure, a fine of \$600,000 and an undertaking. The undertaking would require the Firm to hire an independent outside consultant to review and make recommendations with respect to the Firm's registration and filing policies and procedures and anti-money laundering policies and implementation, as well as the Firm's supervisory structure, delegation of supervisory responsibilities and fulfillment of those responsibilities.

Respondent urged the Panel to impose only a fine of less than six figures. If the Panel imposed an undertaking, Respondent requested that it be narrow and precise.

Enforcement cited a number of cases in support of its requested penalty; Respondent challenged those citations and cited cases in which much more modest fines were imposed. The Hearing Panel chose not to simply add up the penalties imposed for similar violations in the cases cited by the parties. Rather, the Hearing Panel found that this case and a previous one, Wedbush Morgan Securities, Inc. Decision 06-196 (NYSE Hearing Board, Apr. 9, 2007), modified in part by the Board of Directors Wedbush Morgan Securities, Inc., Decision 06-196 (NYSE March 12, 2008), were two chapters out of the same book.

The Hearing Panel found that, in both cases, the underlying factor or cause of the violations at issue was the Firm's understaffed legal and compliance departments. Evidence presented during the Hearing of this matter indicated that the Firm has undertaken measures to address this issue. Such measures must continue for the Firm to establish effective internal compliance policies and procedures that are taken seriously by both the Firm and its staff. The implementation of such policies and procedures will benefit the Firm, its officers, employees and customers. The funds expended by the Firm in payment of the legal fees for these two cases, along with the resulting fines, would have been better spent improving the Firm's compliance function in the first instance, an investment that likely would have obviated the need for these prosecutions.

The fact that the Firm committed certain violations with respect to its anti-money laundering, Reserve Account, and other obligations does not mean that those aspects of the Firm's business were entirely out of order. The Exchange's expert witness on anti-money laundering procedures praised certain aspects of the Firm's program while agreeing that the Firm dropped the ball with respect to other, specific issues. Likewise, certain of the Firm's violations with respect to maintaining a Reserve Account occurred during a change in bank systems, and were promptly detected and remedied by Firm supervision or, in one instance, by back-up supervision. We took the positive aspects of the Firm's performance, as well as the negative, into account in assessing a reasonable and appropriate penalty.

In view of the above findings, the Hearing Panel imposed the penalty of a censure, a fine of \$100,000, and an undertaking as follows:

- a. Within 30 days from the date on which this decision becomes final, Respondent shall hire an outside consultant (the "Consultant"), not unacceptable to the NYSE, to perform a review and prepare a report (the "Report"), that – taking into consideration Respondent's size, number of customers, business and product mix, and financial resources – contains recommendations concerning the adequacy of Respondent's regulatory and compliance resources, including without limitation, Respondent's controls over, procedures for and supervision of the registration of individuals and branch offices, including the obtaining of prior consent from the appropriate self-regulatory authority for the establishment of branch offices; Respondent's policies, procedures and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations thereunder; and Respondent's supervisory structure and delegation of supervisory authority.
- b. Within 180 days of being retained, the Consultant shall provide Respondent's Board of Directors and Enforcement with a copy of the Report.
- c. Respondent shall adopt and implement all policies, procedures, practices, and staffing levels recommended in the Report; provided, however, that as to any recommendation which Respondent, with the consent of its Board of Directors, determines is, in whole or in part, inappropriate, unnecessary, or unduly burdensome, Respondent may propose to the Consultant alternative policies, procedures, practices, and staffing levels that are designed to achieve the same objective or purpose as those recommended in the Report (the "Alternatives").

- d. In the event that Respondent proposes Alternatives to the Consultant as referred to above, Respondent shall provide Enforcement with a written representation that such Alternatives have been presented to the Consultant with a description of how such Alternatives achieve the same objective or purpose as the Report's original recommendation.
- e. In the event that the Consultant is not satisfied that such Alternatives achieve the same objective or purpose as the Report's original recommendations, Respondent shall implement the policies, procedures, practices, and staffing levels recommended in the Report.
- f. Within 60 days of delivery of the Report to the Respondent's Board of Directors, Respondent shall submit to Enforcement a written representation, signed by the Chief Executive Officer, setting forth the details of Respondent's implementation of the recommendations contained in the Report, or the Alternatives, if agreed to by the Consultant.
- g. The parties may agree to change any of the dates above provided that notice is given to the Hearing Officer. The parties may agree, with the prior permission of the Hearing Officer to combine the undertaking process of this case with that of Hearing Panel Decision 06-196 as modified on review.

For the Hearing Panel

Vincent F. Murphy – Hearing Officers
Panelists:
Lois Cox
James Clifton