BEFORE THE NATIONAL ADJUDICATORY COUNCIL

FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of Department of Enforcement, Complainant, vs. Lek Securities Corporation, Respondent.	DECISION Complaint No. 2009020941801 Dated: October 11, 2016

Member firm failed to establish and implement anti-money laundering policies and procedures. Held, findings and sanctions affirmed.

Appearances

For the Complainant: Leo F. Orenstein, Esq., Jeffrey P. Bloom, Esq., and Michael A. Gross, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Kevin J. Harnisch, Esq.

Decision

Lek Securities Corporation ("LSC" or "Firm") appeals a December 30, 2014 Hearing Panel decision pursuant to FINRA Rule 9311. The Hearing Panel found that from January 1, 2008, through October 31, 2010 (the "review period"), the Firm failed to establish and implement Anti-Money Laundering ("AML") policies, procedures, and internal controls that could be reasonably expected to detect and cause the reporting of suspicious transactions and that were reasonably designed to achieve compliance with the Bank Secrecy Act ("BSA"), in violation of NASD Rules 3011(a) and 2110 and FINRA Rules 3310(a) and 2010. After an independent review of the record, we affirm the Hearing Panel's finding and sanctions.

I. Factual Background

A. LSC Corporation

LSC is a small broker-dealer that primarily provides trade execution and clearing services to introducing broker-dealers and institutional clients. It offers automated access to the securities markets to clients who engage in high-volume, high-frequency trading. During the relevant time period, many of the Firm's customers were day traders, and the speed of trade execution was one of the Firm's selling points.

LSC executed millions of transactions during the review period, processing approximately 200,000 trades a day. On average, as many as 500 trades per minute passed through the Firm's automated systems. The Firm generally sought high-speed, high-volume traders, but its clientele was not limited to these traders. Long-term institutional investors, hedge funds, and pension funds accounted for a substantial part of the Firm's business during the review period. Its clientele included institutional trading desks, market makers, exchange specialists, arbitrageurs, and money managers.

Samuel Lek is the majority owner of the Firm, the Chief Executive Officer ("CEO"), the Chief Compliance Officer ("CCO"), and the Firm's AML Officer. During the review period, LSC had approximately 20 employees, and nearly all of them, including Lek, worked in its New York headquarters and were seated near one another in a single room. Because of the size and layout of the Firm's headquarters, Lek expected that any unusual or suspicious activities would be brought to his attention by the Firm's staff. This usually occurred with the LSC employee simply calling out to Lek and drawing his attention to the concerning activity.

During the review period, Caitlin Farrell-Starbuck worked at LSC as a compliance officer, as well as a trading assistant and account opening manager.[1] In addition to these duties, Lek delegated some AML duties to Farrell-Starbuck, as well as to other employees. The discrete compliance and AML duties delegated to Farrell-Starbuck were not specifically defined or memorialized.

B. Dimension Securities and Dimension Trading

Dimension Securities LLC ("Dimension"), a now defunct introducing broker-dealer that cleared through the Firm, was LSC's largest source of transaction business. Dimension accounted for close to half of the trades at the Firm during the review period. Dimension introduced customers on a "fully disclosed" basis, which meant that it disclosed to the clearing firm the name and other characteristics of the account. The clearing agreement between Dimension and the Firm allocated different functions between the introducing broker and the Firm and delegated the Know-Your-Customer obligations to the introducing broker.

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[1] Farrell-Starbuck left LSC in 2010 and is currently employed with another firm.

Dimension Trading International LP ("DTI") was a customer of Dimension and was the Firm's and Dimension's largest account. Dimension introduced DTI to the Firm, DTI opened an account at the Firm, and the Firm agreed to provide margin credit to DTI. DTI was located in the British Virgin Islands and was organized as a master account on LSC's books with over 3,000 subaccounts. During the review period, DTI was the Firm's largest source of transaction business and also constituted over 90 percent of Dimension's business. DTI hired and trained traders offshore to trade in the U.S. securities markets. The business model for DTI was a high-volume, low-margin business. It employed a large number of people who used a variety of different trading strategies. The traders generally used a high-frequency trading strategy. DTI was organized as a limited partnership with a general partner and nine or ten limited partners. Each limited partner had a number of subaccounts in various locations that were associated with that limited partner. The limited partners were described as trading managers.

C. Overview of LSC's Anti-Money Laundering and Written Supervisory Procedures

LSC's AML policies and procedures existed in a separate document from the Firm's general written supervisory procedures ("WSPs"). During the review period, the Firm's AML manual contained little guidance with regard to manipulative trading that might require the filing of a suspicious activity report ("SAR"). Rather, the AML manual focused on money movement issues, such as money laundering. The Firm's AML procedures listed 45 red flags for money laundering that covered account opening and customer account activity. It did not address the high-speed electronic trading services offered by the Firm or the specific type of trading issues that might arise in the Firm's trading business, such as matched trading, wash trading, prearranged trading, spoofing, and layering. In fact, the AML manual was boilerplate, and the only attempt made to specialize the manual was through the use of the small firm template provided by FINRA.

Lek testified that the Firm's AML procedures were concentrated on money laundering and related activities. He emphasized that the Firm did not accept third-party transfers into customer accounts and asserted that it would have complicated the AML manual and confused employees if it were to include information regarding potentially manipulative trading. In fact, only two of the 45 red flags for AML and SAR reporting listed in the AML manual related to securities transactions in any way.

The WSPs, like the AML manual, were not tailored to the Firm's business. The WSPs contained a substantial amount of boilerplate that had little relevance to LSC's business and said very little about the high-speed trading environment at the Firm. The Firm purchased the WSPs from a vendor, and Lek admits that the Firm did not edit the WSPs significantly. While the AML procedures designated Lek as the AML compliance officer, the WSPs also indicated that Lek had delegated several of his responsibilities in the AML procedures to Farrell-Starbuck.

The Firm's WSPs, unlike the AML manual, did identify pre-arranged trading, wash trading, churning, parking securities, orders at the open or close, and other activities as prohibited transactions. During most of the review period, however, the WSPs gave no guidance as to what should be done if such transactions were identified or who would take action. Toward the end of the review period, in July 2010, a paragraph was added to the WSPs indicating that

"Compliance" was responsible for reviewing potential wash trades, investigating, and documenting its actions. Even with that addition, the WSPs did not establish any connection between the identification of prohibited trading and the process for investigating and determining whether to file a SAR.

Lek believed that, in the context of a firm as small as his, that there is no real distinction between the Firm's AML manual and its WSPs. He testified, "It didn't matter if someone brought a suspicious activity to me because it involved suspicious money movements or suspicious trading, they both got brought to my attention, and I made no distinction whether I thought this was a potential anti-money laundering violation or a potential manipulative activity, they're both investigated." Lek's testimony also evidenced a belief that it really did not matter what is in the AML manual or WSPs, because, ultimately, all significant issues are escalated for Lek to resolve: "The written supervisory procedures are not a description of exactly what in a 20-man firm everybody should do other than call Sam. That's – that's the general thing, let Sam know."

1. The Firm's AML Practices Prior to Summer 2009

During the first half of the review period, from January 1, 2008, through summer 2009, the Firm had no specific automated exception reports for potentially manipulative trading, such as wash trades, pre-open order cancelations, or marking the close. Instead, it relied on its employees sitting at their screens monitoring and reviewing trades in real time and being alert to suspicious trading. The staff would look for suspicious activity as part of the Firm's overall compliance program, without a specific focus on AML issues. This surveillance was guided by AML policies and WSPs that lacked specific guidance regarding how to review and investigate manipulative trading for purposes of determining whether a SAR should be filed. This manual review was not tailored to uncover potential manipulative trading.

While Lek acknowledged at the hearing that it was possible to miss a problem when trades are coming in at a pace of 500 or more a minute, he minimized the danger. Lek asserted that, although they could not catch everything, their controls would stop many common violations. The controls and filters employed by the Firm, however, were not specifically designed to flag potential manipulation. They simply rejected orders that were outside the Firm's authorized parameters, such as credit and size limits or prohibitions against odd lots. To the extent LSC's controls and filters could have been used to analyze for potential manipulation, there was no written guidance establishing such a procedure, and, if there had been a procedure performed to see if there was a pattern of trading, there was no written record memorializing any actual review.

2. Attempted Manipulative Trading and Regulatory Fallout

In August 2009, prior to market opening, a trader in one of the DTI subaccounts placed an order in Goldman Sachs stock and then canceled it and replaced it with a larger order, which he again cancelled and replaced with a still larger order. By repeatedly placing an order and then canceling and replacing it, the trader evaded Dimension's size limit for DTI's orders.[2] Each incremental increase was within DTI's limit and was permitted, but the accumulated total order eventually exceeded DTI's size limit.[3] After detection, the trader admitted that the pre-cancelation orders were an effort to manipulate the market, and he was terminated.

This pre-market activity raised regulatory concerns. NYSE Regulation communicated its concerns to the Firm in a letter dated August 19, 2009. In that letter, NYSE asked the Firm to provide the identity of the account(s) and trader(s) that entered the orders and subsequent cancelations and to provide a detailed explanation as to why the orders were canceled.[4] While the Firm contended that the regulator's concerns were not warranted, and that the practice of entering and quickly canceling orders was commonplace, at the same time, it pressed Dimension, the introducing broker, to make sure that there was not another attempt at manipulating the opening price.

Dimension learned that the trader had intended to affect the opening price by repeatedly entering, canceling, and replacing orders. Dimension discussed the Goldman Sachs trading with Lek. While Dimension modified its software to prevent the problem from arising again, there had been other problem trades that occurred before Dimension became aware of the problem and fixed it.

FINRA's investigation of LSC began in December 2009, following a referral from FINRA examination staff regarding suspicious trading activity at LSC, as well as a second referral from FINRA's Risk Oversight and Operational Regulation concerning portfolio

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[2] In response to NYSE Regulation's inquiries about the activity in question, Dimension explained how the trader was able to evade Dimension's size limitations:

> The trader has admitted to placing these large orders in an effort to influence the opening cross. It was a mystery to us, though, on how he was able to place such larger orders. Our risk management systems indicate that his buying power was limited to $2.5 million. As such, he should not have been able to place an order for 100,000 GS [Goldman Sachs] at a total value of $16 million. After investigating the matter at some length, we discovered that [the trader] exploited an unknown bug in the risk management system that allowed him to cancel and replace an order to progressively higher sizes. Apparently, the risk system was only checking to see if the increased incremental size was within his buying power instead of the total new size, which of course, would've been rejected.

[3] Because the Goldman Sachs trading did not exceed the Firm's own credit or size limits for DTI, LSC did not itself flag that trading as problematic.

[4] Additional pre-open orders and cancelations also piqued regulatory interest. NYSE Regulation contacted the Firm in June 2009 about the entry of large orders in three securities, including Goldman Sachs, and the cancelation of those orders just prior to market open. NYSE Regulation also contacted the Firm several more times about similar conduct through November 2009.

margining. As part of its investigation, FINRA'S Department of Enforcement ("Enforcement") made several FINRA Rule 8210 requests for documents, conducted on the record interviews, and analyzed documents received from the referral sources, as well as from NYSE Regulation.

3. The Firm's AML Practices Summer 2009 Onward

In light of the Goldman Sachs pre-market cancelations and other similar incidents during the summer and fall of 2009, and the subsequent regulatory interest, LSC began to develop new exception reports, including exception reports for potential wash sales, pre-market cancelations of orders, and marking the close.

a. Wash Trades[5]

The first new exception report was a wash trade report that the Firm implemented in August 2009. At first, the Firm ran the report at the DTI customer level, but the report flagged hundreds of potential wash trades. Concluding that many of those were false positives, the Firm changed the parameters of its wash trade report so that it monitored by subaccount trader only. While this significantly reduced the number of possible wash trades, it also limited the Firm's ability to determine whether such trades were going on between different subaccount traders within the same subaccount group.

The Firm ran the wash trade report daily after the market close, and Farrell-Starbuck tried to review it every day. The Firm sent the report to Dimension and left it to Dimension to investigate the activity. Farrell-Starbuck kept no records of any follow-up communications with Dimension about any particular questionable trades. If Dimension represented that none of the flagged trades were wash trades, Farrell-Starbuck accepted that statement. She knew that Dimension was developing its own report to identify potential associated subaccounts, and she recalled asking for more information about that in order to make the Firm's report more meaningful.

According to Lek, Dimension ultimately developed its own wash sale report that was better than the Firm's. Lek said that Dimension had the necessary information to know whether a party on one side of a trade was related to a party on the other side of the trade. While the Firm did not know where the traders for the various subaccounts were located or whether they were working together, Lek did have conversations with Dimension's principal about what traders might be working together in conjunction with analyzing potential wash trades.

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[5] Wash trading is the process of buying a security through one broker while selling that same security through a different broker. It may be done by a single investor or by two or more parties conspiring to create artificial market activity in order to profit from a rise in the security's price. It is a form of market manipulation designed to induce other potential buyers into buying the position. *See* http://www.investopedia.com/terms/w/washtrading.asp.

b. Pre-Market Canceled Orders

The Firm implemented a pre-market cancel exception report on October 20, 2009, in response to regulatory inquiries. Farrell-Starbuck testified that she discovered a pattern of pre-market cancels in a DTI trading account and asked Dimension about it. The Firm relied on Dimension to investigate the trading, which was its standard practice with all its introducing brokers. Dimension reported that the trading was inappropriate. Farrell-Starbuck sought to stop the inappropriate trading, but she had to ask Dimension repeatedly from sometime in June through early October 2009 what was being done to stop it. Lek testified that he analyzed the Firm's pre-market cancel exception report to see whether the pre-market cancelations looked like normal business. Lek looked at what the general volume was, how much the trader traded, if the trader eventually bought the stock, and other trades that might be relevant. Lek explained that market circumstances had to be considered in evaluating whether the cancelations were a reaction to some adverse or favorable market move.

c. Marking the Close[6]

The Firm did not have an exception report to monitor for marking the close for most of the review period. LSC finally implemented an exception report in March 2010 for marking the close. The report identified orders placed late in the day that moved the market in the direction of the order and therefore could change the price at which the stock closed. Lek testified that he reviewed the report every day.

II. Procedural History

After the completion of its investigation, on February 25, 2013, Enforcement filed a two-cause complaint against LSC and Samuel Lek. Cause one alleged that LSC's AML policies, procedures, and internal controls were not reasonably designed to achieve compliance with the BSA and the implementing regulations thereunder, in violation of NASD Rules 3011(a) and 2110 and FINRA Rules 3310(a) and 2010. Cause two alleged that both LSC and Lek failed to supervise the portfolio margining of the DTI accounts, in violation of NASD Rules 3010 and 2110 and FINRA Rule 2010. After five days of hearing, the Hearing Panel issued its decision on December 30, 2014, finding that LSC violated NASD Rules 3011(a) and 2011 and FINRA Rules 3310(a) and 2010 by failing to implement policies, procedures, and internal controls that could be reasonably expected to detect and cause the reporting of suspicious transactions and that were reasonably designed to achieve compliance with the BSA. The Hearing Panel dismissed cause two of the complaint. LSC appealed the Hearing Panel's findings and sanctions arising from cause one.

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[6] "Marking the close" is a form of market manipulation. The practice involves attempting to influence the closing price of a security by executing purchase or sale orders at or near the close of normal trading hours. Such activity can artificially inflate or depress the closing price for the security and can affect the price of "market-on-close" orders. *See* http://definitions.uslegal.com/m/marking-the-close

III. Discussion

We have reviewed the record and we affirm the Hearing Panel's findings of violation. We conclude that LSC did not adequately establish AML policies and procedures for monitoring, analyzing, investigating, and reporting suspicious activity associated with its clearing business, in violation of NASD Rules 3011(a) and 2110 and FINRA Rules 3310(a) and 2010.

A. AML Requirements for All Broker-Dealers

In October 2001, Congress passed the Uniting and Strengthening America by Providing Appropriate Tools Required to Intercept and Obstruct Terrorism Act of 2001 ("the PATRIOT Act"). Pub. L. No. 107-56, 115 Stat. 272. Title III of the PATRIOT Act imposes additional obligations on broker-dealers under AML provisions and amendments to the Bank Secrecy Act requirements. *See* 31 U.S.C. §§ 5311 *et seq*. Among other requirements, the PATRIOT Act requires that all broker-dealers establish and implement AML programs designed to achieve compliance with the Bank Secrecy Act and the regulations thereunder, including the requirement that broker-dealers file SARs with the Financial Crimes Enforcement Network ("FinCEN").[7] *See* 31 U.S.C. § 5318(h); 31 C.F.R. § 103.120(c). The SAR identifies 20 types of "suspicious activity" that broker-dealers are required to report to FinCEN, including "Market manipulation," "Money laundering/Structuring," "Prearranged or other non-competitive trading," "Securities fraud," and "Wash or other fictitious trading." *See Suspicious Activity Report by the Securities and Futures Industries* (FinCEN Form 101).[8]

In September 2009, the Commission approved FINRA Rule 3310 that sets forth the minimum standards required for each FINRA member firm's AML compliance program. *See Order Approving Proposed Rule Change to Adopt FINRA Rule 3310 (Anti-Money Laundering Compliance Program) in the Consolidated FINRA Rulebook*, Exchange Act Release No. 60645, 2009 SEC LEXIS 3098 (Sept. 10, 2009). FINRA Rule 3310 is the successor to NASD Rule 3011.[9] *See id.* FINRA Rule 3310 requires that AML programs, at a minimum, "establish and

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[7] The Department of Treasury issued the implementing regulation with respect to the SAR requirement. The regulation provides in part that "[e]very broker or dealer in securities within the United States . . . shall file with FinCEN . . . a report of any suspicious transaction relevant to a possible violation of law or regulation." 31 C.F.R. § 103.19(a)(1). The regulation further requires broker-dealers to report to FinCEN any transaction, alone or in the aggregate, that involves $5,000 in funds or assets and the broker-dealer knows, suspects, or has reason to suspect that the transaction: (1) involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity; (2) is designed to evade the requirements of the Bank Secrecy Act; (3) has no business or apparent lawful purpose or is not the sort in which a particular customer would normally engage; or (4) involves the use of the broker-dealer to facilitate criminal activity. 31 C.F.R. § 103.19(a)(2).

[8] http://www.fincen.gov/forms/files/fin101_sar-sf.pdf.

[9] NASD Rule 3011 was adopted without substantive change into the Consolidated FINRA Rulebook as FINRA Rule 3310 (AML Compliance Program).

implement policies and procedures that can be reasonably expected to detect and cause the reporting of" suspicious transactions; "[e]stablish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act" and its implementing regulations; provide independent testing by qualified persons of the AML program; designate and identify to FINRA an individual responsible for implementing and monitoring the AML program; and "[p]rovide ongoing training for appropriate personnel." FINRA Rule 3310(a)–(e).

In implementing an AML system that is in compliance with FINRA Rule 3310, FINRA members were advised to note the difference between "systems" and "written procedures." *See, e.g.*, *NASD Notice to Members 09-45*, 1999 NASD LEXIS 20 (June 1999). Written procedures "are a critical part" of an overall system. *Id.* at *4.

> For example, a supervisory system may include elements such as automated exception reports and surveillance programs that monitor for unusual trading activity in customer accounts. The written supervisory procedures would instruct the supervisor on which reports produced by the surveillance system the supervisor is to review as part of his or her responsibilities, including a description of how often these reports should be reviewed, the steps to be taken if suspicious activity is discovered, and how to document the supervisor's oversight activities. *Id.*

Compliance with Rule 3310 requires *both* adequate systems and written procedures. *See, e.g.*, *Dep't of Enforcement v. Domestic Sec., Inc.*, Complaint No. 2005001819101, 2008 FINRA Discip. LEXIS 44, at *14–18 (FINRA NAC Oct. 2, 2008); *Dep't of Enforcement v. N. Woodward Fin. Corp.*, Complaint No. E052005007501, 2014 FINRA Discip. LEXIS 11, at *47–52 (FINRA OHO May 16, 2014), *aff'd*, 2014 FINRA Discip. LEXIS 32 (FINRA NAC July 21, 2014).

B. <u>LSC Violated FINRA Rule 3310(a)</u>

FINRA Rule 3310(a) required that LSC develop and implement policies and procedures "that can be reasonably expected to detect and cause the reporting of" suspicious activity and transactions. FINRA emphasized to its members that to be effective, AML procedures "must reflect the firm's business model and customer base." *NASD Notice to Members 02-21*, 2002 NASD LEXIS 24, at *17 (Apr. 2002). Members were advised that "in developing an appropriate AML program," it should consider factors such as its "business activities, the types of accounts it maintains, and the types of transactions in which its customers engage." *Id.* at *20. Firms must also "establish and implement controls and written procedures that explain the procedures that must be followed, the person responsible for carrying out such procedures, how frequently such procedures must be performed, and how compliance with the procedures should be documented and tested. *Id.* at *21. FINRA further advised that "[a]ppropriate" red flags must be described in each firm's written AML procedures." *Id.* at *42.

The Hearing Panel concluded that the Firm's AML program was not reasonably designed to achieve compliance with its AML responsibilities and the applicable SAR reporting requirements and that the Firm did not adequately implement its AML program. We agree.

1. LSC's Inadequate AML Policies and Procedures

Until summer 2009, the Firm relied on an improvised manual review of its customers' trades as roughly 500 trades per minute came across the staff's computer screens. Identification of patterns of potential market manipulation in this fast-moving environment was difficult, if not impossible. The inadequacy of the system was exacerbated by the lack of any guidance in the Firm's AML manual and WSPs connecting potential manipulative trading and the Firm's duty to file a SAR in certain circumstances.

While the Firm started to add some automated exception reports to its system of surveillance for potentially manipulative trading in summer 2009, its AML program was still inadequate. Although the exception reports generated lists of trades, beyond creating a list, the Firm did not institute any particular procedures for investigating the items identified in the exception reports or for determining whether to file a SAR. As Enforcement's AML expert testified, merely generating a list of potentially suspect trades does not satisfy the AML requirements. For most of the review period, the Firm also did not document any AML review or investigation that may have been performed. Both Enforcement's AML expert and LSC's AML auditor testified that documentation is required for a sound AML program.[10]

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[10] The Hearing Panel's decision considered and adopted the expert testimony of Aaron Fox, an AML expert who testified for Enforcement. She testified that a technologically advanced firm like LSC should have used an automated system for surveillance and that software for such surveillance was affordable and commonly used by 2008. Fox further testified that given the Firm's technologically advanced business, its lack of automated transaction monitoring systems constituted a "complete failure." She explained why LSC's written procedures were not consistent with industry standards, noting, among other things, that there were no specific red flags identified for securities-related activity —only two of the 45 red flags listed on LSC's AML manual refer to securities trading. Fox also pointed to additional flaws in LSC's AML procedures, such as its failure to create any kind of record that documented its AML investigations. Fox testified that it is essential for a firm to document that AML reviews have been performed. We find no basis to overturn the Hearing Panel's adoption of Fox's testimony and agree with her conclusion that LSC's AML program was incomplete and not properly implemented.

The Hearing Panel also considered testimony from Frank Calimano, LSC's independent AML consultant, who was not qualified as an AML expert at the hearing. Although Calimano ultimately concluded that LSC's AML program had "no material deficiencies," he recommended that LSC create and maintain a record of its AML investigations. Calimano made this recommendation in his 2007-2008 audit report of LSC, but did not repeat his recommendation in later audit reports. Although we disagree with Calimano's ultimate conclusion about LSC's

[Footnote Continued on Next Page]

Furthermore, LSC failed to tailor its AML manual to its business. It purchased an AML manual mostly consisting of boilerplate language and slightly modified it to include parts of FINRA's Small Firm AML Template. This was insufficient. To comply with FINRA Rule 3310, a FINRA member must tailor its AML program to its business. *See id*. at *19. Boilerplate and "one-size-fits-all" AML compliance procedures do not suffice. *Id.* The inclusion of parts of FINRA's Small Firm Template into LSC's AML manual does not secure compliance with Rule 3310 because the Small Firm Template is only a generalized tool that must be customized to the firm's business. *See N. Woodward*, 2014 FINRA Discip. LEXIS 11, at *47–52 (finding that the firm violated FINRA Rule 3310 when it added its company name to FINRA's Small Firm AML Template, using it without further modification, and purchased boilerplate WSPs and used them without modification.); *Domestic Sec.*, 2008 FINRA Discip. LEXIS 44, at *17-18 (explaining how the template itself explicitly warns its users that "following this template does not guarantee compliance with those [AML] requirements or create a safe harbor from regulatory responsibility"); *Anti-Money Laundering Template for Small Firms* ("The language in this template is provided only as a **helpful starting point** to walk you through developing your firm's program." (emphasis in original)).[11] Only two out of the 45 red flags for AML and SAR reporting listed in LSC's AML manual related to securities transactions. In addition, although LSC operates in a high frequency trading environment that processes more than 500 trades per minute, no reference to high frequency trading was made in its AML manual. As Lek himself conceded, LSC's AML manual was focused on money-movement issues rather than manipulative trading issues.

It is well established that FINRA Rule 3310 mandates written procedures that cover money-movement issues as well as the detection and reporting of manipulative trading practices and that AML procedures be customized to a firm's business. *See, e.g.*, *Domestic Sec.*, 2008 FINRA Discip. LEXIS 44, at *16 ("AML requirements encompass the detection and reporting of a broad range of unlawful financial activities . . . including market manipulation, prearranged or other noncompetitive trading, and wash or other fictitious trading."). Because LSC failed adequately to address both of these, its AML procedures were deficient.

2. <u>LSC's Delegation to Dimension</u>

We also find that LSC's reliance on Dimension for some of its AML compliance functions, while allowed, at times exceeded the scope of permissible delegation, further weakening LSC's AML policies and procedures.

Introducing and clearing brokers that choose to work together in complying with AML regulations still have *independent* compliance responsibilities. *See NASD Notice to Members 02-*

[Continued]

AML program, we agree with his recommendation in the 2007-2008 audit report that LSC should have maintained a record of its AML investigations.

11 http://www.finra.org/industry/anti-money-laundering-template-small-firms

21, 2002 NASD LEXIS 24, at *15 ("Any such allocation [between introducing and clearing brokers] . . . would not relieve either party from its independent obligation to comply with AML laws."); *cf. Wedbush Sec., Inc.*, Exchange Act Release No. 73652, 2014 SEC LEXIS 4463, at *45-46 (Nov. 2014); *NASD Notice to Members 05-48* (July 2005) (explaining that a member may "never [outsource] its supervisory and compliance activities away from its direct control" to a third party).

Farrell-Starbuck relied on Dimension to investigate suspected wash trades, did nothing but accept Dimension's evaluation of those trades at face value, and kept no records of any follow-up communications with Dimension. LSC failed to take affirmative action, but instead repeatedly asked Dimension to take action when Dimension detected suspicious cancelations in the pre-trading hours. Delegation in general, while allowed, does not absolve LSC of liability. In this case, the Firm's practices not only involve a delegation of its compliance functions, but also an abdication of responsibility.

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We therefore affirm the Hearing Panel's finding that LSC did not establish adequate AML policies and procedures, and is in violation of FINRA Rule 3310(a).

C. <u>LSC's Defenses to Liability</u>

In its briefs and at oral argument, LSC's overarching defense was that based on the size of the Firm, the technology available during the review period, and the realities of how LSC was run, the Firm's AML policies and procedures, while not perfect, were reasonable and adequate and thus not violative of FINRA rules. We disagree.

1. <u>LSC's Misplaced Reliance on Its WSPs</u>

LSC argues that the Hearing Panel "improperly divorced the contents of the WSPs from its analysis of the AML policies and procedures." The Firm argues that the practical distinction between the Firm's AML manual and its WSPs is meaningless in the context of a small firm such as LSC.[12] We disagree and have rejected similar arguments in the past. *See Domestic Sec.*, 2008 FINRA Discip. LEXIS 44, at *16–18. To be considered as a component of a firm's AML program, that firm's warnings to its employees about manipulative trading practices must be specifically presented in the AML context. *Id.* In *Domestic*, we held that a firm's AML manual did not sufficiently incorporate by reference its "Capital Markets Manual" because "there was no expectation that the [f]irm's employees, when faced with a potentially suspicious activity, would also reference the [AML] manual for direction and guidance." *Id.*

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[12] For example, the Firm contends that its WSPs direct its employees to contact "Compliance" if they suspect activities that involve a prohibited securities transaction have occurred, including wash trades, prearranged trades, and marking the close. The Firm believes this was sufficient to discharge its AML duties because the Compliance personnel in the WSPs were also responsible for AML compliance.

The same reasoning applies here. LSC does not claim that its AML procedures addressed potentially manipulative trading. Instead, it claims such provisions were included in its WSPs. Yet those provisions were not included or even referenced in the AML procedures, nor did they direct employees to the AML procedures in the event such activity was detected. In addition, the Firm's AML procedures and WSPs did not describe in what way review of trading activity should be documented. They gave no guidance on what records, if any, should be maintained to demonstrate that a review had been conducted and the conclusions reached instructed supervisors on which reports to review or the steps to be taken if suspicious activity is detected. We conclude that LSC's AML policies were deficient, in violation of FINRA and NASD Rules.

2. Distinguishing *Sterne, Agee & Leach*

LSC cites to *Dep't of Enforcement v. Sterne, Agee & Leach*, Complaint No. E052005007501, 2010 FINRA Discip. LEXIS 18 (FINRA OHO Mar. 5, 2010), and claims that it, like Sterne, sufficiently complied with Rule 3310 because it used manual and semiautomatic supervisory systems to monitor trades. We disagree.

First, Sterne had 400 employees and had different divisions to supervise ongoing trades.[13] *See id.* at *5. In addition, most of the misconduct at issue in Sterne occurred in 2002-2005, when automated supervisory systems were not as readily available or advanced. In contrast, LSC should have used an automated system for surveillance and that software for such surveillance was affordable and commonly used by 2008. Moreover, LSC has about 20 employees and a loosely organized reporting system of "calling Sam" when an employee detected suspicious activity. LSC's high-frequency business environment only worsens its position. LSC relied on a primarily manual (prior to Summer 2009) and semi-automated (from Summer 2009) system to supervise 500 trades per minute, when, as Lek himself implied, it was not humanly possible for LSC to "catch everything."

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[13] Sterne's system included:

> manual reviews by employees in the Central Cashiering Department to monitor all deposit activity; in the Margin Department to monitor wire activity, journal activity, and fund disbursements; in the Cash Management Department to monitor incoming wires; and in the New Accounts Department to monitor foreign accounts and new accounts. The Margin Department, Central Cashiering Department, and New Accounts Department were within the Risk Division, which was part of the Operations Department. The Operations Department was supervised by the chief operations officer. The risk division manager reported to the chief operations officer, and managers of the departments within the Risk Division reported to the risk division manager.

Id. at *15.

Second, Sterne's AML compliance officer prepared monthly activity reports for wire transfers and later added a daily review of all trades over 25,000 shares. *See id.* at *8. Unlike Sterne's documentation practices, LSC did not create a record of any of its AML investigations. Instead, LSC delegated some responsibility to Dimension, its introducing broker, and did not keep any records of any follow-up communications with Dimension. Third, the Hearing Panel found that Sterne's written procedures adequately described how to identify and review suspicious transactions and how to escalate red flags. *See id.* at *12–13. In contrast, LSC continued to use an AML manual that did not discuss how the Firm should detect and investigate suspicious trading, and that provided no guidance as to the process for determining in a timely fashion whether to report suspect trading with a SAR. In addition, testimony describing how the Firm's AML manual procedures worked in practice illustrates that LSC clearly failed to implement a system that could have been reasonably expected to detect and cause the reporting of suspicious activity.[14]

3. <u>Use of Exception Reports</u>

LSC contends that its exception reports were adequately employed to detect manipulative trading patterns. In its briefs, LSC notes that it used over 70 electronic exception reports that were already operational as of July 2009. As an example, in the wash trade context, LSC argues that it had automated controls that addressed variables typically associated with potential wash trades, such as limitations on order sizes (as percentage of trading volume is an important factor when analyzing for potentially manipulative wash trades) and reports flagging trades in stocks with significant market movements. LSC concedes that it did not have an exception report exclusively dedicated to potential wash trades until mid-2009, but maintains that "the functionality of what was done must drive the analysis, not the particular name given to a report." LSC further contends that it has steadily improved these systems. While Enforcement does not contest the supervisory systems' improvements, it views those even those improved systems as generally inadequate for AML compliance purposes.

We find that these exception reports are not a satisfactory proxy for the effective AML policies and procedures required by FINRA rules. None of the exception reports referenced by LSC either monitored or were designed to detect potentially suspicious trading activity. In any event, the sophistication of LSC's electronic systems is only one factor in evaluating whether it established and maintained an AML program in compliance with FINRA Rule 3110(a). Even if we were to credit LSC's assertion that its exception reports were sophisticated enough to detect wash trades and other manipulative trading practices, LSC is still not exculpated from liability in light of its other AML shortcomings.

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[14] In practice, Lek and his staff all sat closely in a single room. If an employee saw something suspicious on his or her computer screen, Lek testified that, "All they have to do is turn their head and [say], 'Sam, look at this, this is what I'm seeing.'" Lek would also stand up and shout out to his employees to look out for certain trading activity. We find that this system falls short of the requirements of Rule 3310(a).

4. Pre-Market Cancelations

LSC contends that the Hearing Panel erred when it concluded that pre-market cancelations could result in market manipulation, such as spoofing.[15] LSC argues that Enforcement, upon whom the burden of proof falls, failed to present any evidence, testimonial or otherwise, upon which the Hearing Panel could have based its adverse findings regarding pre-market cancelations. LSC maintains that its expert on market manipulation, Dr. Stewart Mayhew, the only expert to testify on the matter, opined that there was no reason to be concerned that pre-market cancelations could lead to market manipulation.[16]

On the contrary, we find that Enforcement did provide a basis for the Hearing Panel's determination concerning pre-market cancelations. In August 2009, a DTI trader attempted to manipulate the market in Goldman Sachs stock through the use of pre-market orders and cancelations, with the express intent of market manipulation. Therefore even if most pre-market cancelations do not affect the market, and there are certainly non-manipulative reasons to enter and cancel pre-market bids, we agree with the Hearing Panel that to accept that these cancelations *never* affect the market "would mean that the entire process of pre-market bids and offers was meaningless and that market participants engage in it for no reason. This defies common sense."

5. No Evidence of Actual Market Manipulation

LSC maintains that its AML policies and procedures were effective because "there was not a single instance of money laundering or a manipulative transaction subject to this action," and no allegations that the Firm failed to file an appropriate SAR. This argument fails because both FINRA and the Commission have consistently held that a determination that a respondent has violated FINRA's supervisory rules is not dependent on a finding of an underling violation. *Cf. Robert J. Prager*, 58 S.E.C. 634, 662 (2005) (citing NASD Notice to Members 98-96 (Dec.

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15 LSC maintains that pre-market cancelations cannot be spoofing. We disagree and find that pre-market cancelations can raise spoofing concerns. *See* https://www.sec.gov/news/pressrelease/2015-236.html (in which the Commission found, in relevant part, that respondent used his firm account to place multiple, large, non-bona fide orders on the NYSE before the exchange opened for trading at 9:30 a.m. and that these non-bona fide orders impacted the market's perception of demand for the stocks it spoofed and often the prices of the stocks).

16 The Hearing Panel Decision did not address Dr. Mayhew's testimony or make any credibility determinations as to his statements or opinions concerning pre-canceled trades. In other instances, however, the Hearing Panel did credit Dr. Mayhew's testimony concerning, among other things, potential wash sales. Hearing Panel Decision pp. 33-34. We, like the Hearing Panel, find no need to address or weigh Dr. Mayhew's testimony concerning pre-order cancelations since the record facts alone support the conclusion that such cancelations have the potential for market manipulation.

1998) (stating that a violation of Rule 3010 can occur in the absence of an underlying rule violation)).

In addition, LSC's related argument that "a single, isolated instance for which remedial action was taken (the trader was terminated) does not render an entire control structure unreasonable" also lacks merit. We agree with LSC that the adequacy of the Firm's entire control structure does not hinge upon the Firm's failure to detect one DTI trader's attempted manipulation of a stock price; however, we do find LSC's control structure was deficient because its boilerplate AML manual was not sufficiently tailored to its business and did not institute any particular procedures for investigating the items identified in the exception reports or for determining whether to file a SAR.

Finally, LSC contends that it should not be penalized because "there was no evidence of any improper impact at all on any opening prices or even the opening process."[17] This argument tries to infer the absence of manipulative practices from a lack of its visible effects. We reject this argument. Manipulation can be illegal solely because of the actor's purpose to manipulate. *See, e.g.*, *Koch v. SEC*, 793 F.3d 147, 153–54 (D.C. Cir. 2015) (citing *Markowski v. SEC*, 274 F.3d 525, 529 (D.C. Cir. 2001)).

IV. Sanctions

The Hearing Panel fined LSC $100,000 for failing to establish and implement AML procedures in compliance with NASD Rules 3011(a) and 2110 and FINRA Rules 3310(a) and 2010. We affirm.

There is no specific Sanction Guideline for failing to establish and implement AML procedures. Therefore the Hearing Panel considered what it found to be the most closely analogous Guideline—i.e., the Guidelines for deficient WSPs.[18] For deficient WSPs, the Guidelines provide for fines ranging from $1,000 to $37,000.[19] In egregious cases, the

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[17] LSC maintains that:

> there was no evidence about how the imbalances or indicative prices changed after DTI's order placements or after their cancelations. Similarly, there was no evidence regarding whether DTI's orders and cancelations influenced others' trading decisions or any evidence demonstrating that DTI's cancelations were not reactions to other orders and/or cancelations. Finally, there was no evidence as to whether traders other than DTI also canceled their orders, and if so, how those cancelations compared in time sequence and quantity to DTI's cancelations. In sum, there was no evidence of any improper impact at all on any opening prices or even the opening process.

[18] *See FINRA Sanction Guidelines* 104 (2015) (Deficient Written Supervisory Procedures), http://www.finra.org/sites/default/files/Sanctions_Guidelines.pdf [hereinafter *Guidelines*].

[19] *Id.*

Guidelines recommend suspending the firm with respect to any or all relevant activities for up to 30 business days and thereafter until the supervisory procedures are amended to conform to rule requirements.[20] For the reasons discussed below, we do not find the deficient WSP guideline to be sufficiently analogous.

A. LSC's Violation is Egregious

We find LSC's violation to be egregious because of the presence of several aggravating factors and the absence of any mitigating factors. First, LSC engaged in a pattern[21] of misconduct for an extended period of time.[22] Despite regulators' warnings, as well as evidence of attempted manipulation, LSC failed to establish and implement an AML program in compliance with FINRA Rule 3310(a).[23] In addition, we find that LSC's conduct was reckless.[24] We address specific aggravating factors below.

First, LSC continued to use a deficient AML program despite FINRA's warnings. At least from January 1, 2008, to October 2010, LSC did not have an AML program that satisfied the requirements of FINRA Rule 3310(a). Only two of the 45 red flags listed on LSC's AML manual related to securities trading, and its AML manual made no reference to the high-speed trading environment in which it operates. As Lek himself testified, the Firm's AML manual was focused more on money movement rather than securities trading issues. Despite regulatory inquiries from FINRA and NYSE, LSC continued to use its deficient AML manual. Lek's testimony, coupled with the Firm's myriad AML shortcomings, evidence LSC's disregard and failures to acknowledge the import of AML rules.

Second, the fact that LSC ignored regulators' warnings and demonstrated a disregard for its AML responsibilities supports a finding that its AML compliance failures were reckless. The Commission defines recklessness as an "extreme departure from the standards of ordinary care,

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[20] *Id.* The Guideline provides two principal considerations specific to deficient WSP violations: (1) whether the deficiencies allowed violative conduct to occur or to escape detection; and (2) whether the deficiencies made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance. *Id.* We conclude that neither of the principal considerations for this analogous Guideline are applicable to this matter. First, the purpose of an AML program is to detect and report suspicious activity. A firm must report suspicious activity regardless of whether any violative misconduct occurred. Second, the issues here do not involve a difficulty determining *who* at LSC was responsible for AML issues (Lek or Farrell-Starbuck), but rather involves lack of guidance on the part of the Firm as to *what* employees needed to do to comply with AML requirements and *how* to do it.

[21] *Id.* at 6 (Principal Considerations in Determining Sanctions, No. 8).

[22] *Id.* (Principal Considerations in Determining Sanctions, No. 9).

[23] *Id.* at 7 (Principal Considerations in Determining Sanctions, No. 15).

[24] *Id.* (Principal Considerations in Determining Sanctions, No. 13).

and which presents a danger . . . that is either known to the [actor] or is obvious that the actor must have been aware of it." *In re Ernst & Young, LLP*, 2004 SEC LEXIS 831, at *152–153 (Apr. 16, 2004). While FINRA does not require perfect supervision procedures, LSC's AML policies and procedures, or lack thereof, fell far below the minimum standard. Lek's testimony that it was not humanly possible for LSC to "catch everything" prior to the summer of 2009 shows us his awareness of the deficiencies with LSC's reliance on manual reviews. Moreover, the potential for missed trading violations was quite high considering that LSC is a clearing firm that processes hundreds of thousands of trades a day. Yet LSC still failed to tailor its AML program to its business even after regulatory inquiries in the summer of 2009. Although Lek touted LSC's systems as very advanced, Enforcement's AML expert testified that the industry was employing software tools to assist in the detection of AML violations during the period that the Firm was still relying on ad hoc, manual surveillance. Even after developing automated exception reports to identify potential problems, the Firm did not develop procedures for using them and did not document its use of the exception reports. We agree with the Hearing Panel that:

> Lek's testimony conveyed the sense that, although the Firm did improve its surveillance for potentially manipulative trading during the Review Period, the Firm did not fully embrace the need to develop a coherent AML program for investigating and reporting suspicious trading. The Firm continued to use an AML manual that did not discuss how the Firm should detect and investigate suspicious trading, and that provided no guidance as to the process for determining in a timely fashion whether to report suspect trading with a SAR. The WSPs that Lek argued were sufficient for AML purposes did not link AML concerns or SAR reporting to the prohibited activities discussed elsewhere in the WSPs. Given that the WSPs were over 200 pages and covered many different topics, it is unreasonable to expect a reader to make that connection without more guidance. Finally, during the Review Period, the need to document any AML reviews was largely ignored by Lek and his staff. Hearing Panel Decision at 43-44.

Therefore, we find that LSC's violation was reckless.

The presence of these aggravating factors is accompanied by the absence of any mitigating factors. Prior to detection, LSC did not acknowledge its misconduct to a regulator,[25] voluntarily employ corrective measures,[26] or reasonably attempt to remedy the misconduct.[27] Indeed, LSC remained obstinate, in the face of regulatory inquiries and the instant disciplinary action, that its AML policies and procedures were reasonable and adequate.

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[25] *Guidelines*, at 6 (Principal Consideration No. 2).

[26] *Id.* (Principal Consideration No. 3).

[27] *Id.* (Principal Consideration No. 4).

Taking all of the foregoing factors into careful consideration, we find that LSC's misconduct was egregious.

B. The Fine Imposed is Not Punitive

LSC argues that the $100,000 fine is punitive because it drastically departs from the Guidelines and LSC "had many electronic systems to monitor for potentially manipulative trades in July 2009 and has continued to improve those supervision systems." The Firm also cites to the decision in *Domestic Securities* in support of its position for lower sanctions. We disagree. First, as previously discussed, LSC's deficiencies were contained not only in its monitoring systems but also in its AML program overall. For example, LSC failed to tailor its AML manual to its high-speed trading business, and the AML manual itself contains only minimal information about manipulative trading practices. Second, it is not appropriate to compare the instant case with *Domestic Securities* because a sanction determination depends on the facts and circumstances specific to each case and the appropriate sanction to be imposed in a particular case cannot be determined by reference to the facts of another case. *See Dep't of Enforcement v. Nicolas*, Complaint No. CAF040052, 2008 FINRA Discip. LEXIS 9, at *80 (FINRA NAC Mar. 12, 2008) (rejecting objection of respondents that others received lesser sanctions for related conduct, noting that "[t]he Commission has repeatedly rejected attempts by respondents to compare the sanctions imposed against them to the sanctions imposed against others").

We acknowledge that the sanction imposed by this decision would fall outside a range suggested by the guideline for WSP violations. That guideline, however, was not crafted to address the violations here, a deficient AML program, including deficient policies and procedures. In fact, deficiencies in AML policies and procedures are far more serious than most deficiencies in written supervisory procedures. AML laws are intended to safeguard financial institutions from the abuses of financial crime, including money laundering, terrorist financing, and other illicit financial transactions—crimes with potentially devastating social and financial effects.

We are mindful that adjudicators should impose sanctions that are remedial and not punitive. The sanctions should protect the public and not penalize brokers, and prevent the violating firm or individual from causing future harm to the public. We also consider whether the sanction imposed is sufficiently stringent to deter the Firm and others from engaging in this serious misconduct, without being punitive in nature.[28] The facts and circumstances presented in this case, as discussed above, warrant a sanction that appropriately reflects the seriousness of LSC's violation. This does not alone render the sanction punitive. We believe that a significant fine and censure are necessary to communicate to LSC and other firms the importance FINRA places on adequate AML policies and procedures.

Therefore, in light of the egregiousness of LSC's misconduct, we find that a fine of $100,000 is appropriately remedial.

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[28] *Guidelines*, at 2 (General Principles Applicable to All Sanction Determinations).

V. Conclusion

We affirm the Hearing Panel's finding that LSC failed to establish and implement AML policies, procedures, and internal controls that could be reasonably expected to detect and cause the reporting of suspicious transactions and that were reasonably designed to achieve compliance with the Bank Secrecy Act, in violation of NASD Rules 3011(a) and 2110 and FINRA Rules 3310(a) and 2010. We also affirm the $100,000 fine and censure imposed by the Hearing Panel. Finally, we affirm the Hearing Panel's order that the Firm pay $14,776.34 in hearing costs and also order the Firm to pay $1,678.34 in appeal costs.

On Behalf of the National Adjudicatory Council,

Marcia E. Asquith
Senior Vice President and Corporate Secretary