FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

Department of Market Regulation and Department of Enforcement, Complainants, v. Wedbush Securities Inc. (CRD No. 877), Respondent.	Disciplinary Proceeding No. 20090206344-01

COMPLAINT

The Departments of Market Regulation and Enforcement allege:

Summary

1. This matter involves egregious and systemic anti-money laundering ("AML") and supervisory violations committed by Wedbush Securities Inc. ("Wedbush" or the "Firm") during the period between January 1, 2008 and August 26, 2013 (the "relevant period") in its business of providing direct market access and sponsored access (together "market access") to broker-dealers and non-registered market participants ("market access customers") to multiple market centers, including NASDAQ Stock Exchange LLC ("NASDAQ"), NYSE Arca, Inc. ("NYSE Arca"), New York Stock Exchange LLC ("NYSE"), BATS Exchange, Inc. ("BZX"), BATS Y-Exchange, Inc. ("BYX"), EDGA Exchange, Inc. ("EDGA"), EDGX Exchange, Inc. ("EDGX"), NYSE MKT LLC ("NYSE MKT"), NASDAQ OMX PSX LLC ("PSX") and NASDAQ OMX BX, Inc. ("BX") (collectively, the "Exchanges").

2. During the relevant period, Wedbush was one of the largest volume market access providers, including through its provision of market access to overseas high-frequency, high-volume, algorithmic day-trading firms and anonymous foreign traders. Without dedicating sufficient resources to ensure appropriate regulatory risk management controls and supervisory systems and procedures, Wedbush enabled its market access customers to flood the Exchanges with thousands of potentially manipulative wash trades, and other potentially manipulative trading activity, such as layering[1] and spoofing.[2] Wedbush reaped millions of dollars from its market access business.

3. Wedbush permitted its market access customers to use third-party market access systems to electronically route orders directly to the Exchanges using a Wedbush-registered market participant identifier ("MPID"). As executing broker, Wedbush was responsible for monitoring and reviewing its market access customers' order flow to detect and report suspicious and potentially manipulative trades, and to ensure that order flow entered via a Firm MPID complied with applicable federal securities laws and regulations and the rules of FINRA and the Exchanges. Despite its obligations, Wedbush largely relied on its market access customers to self-monitor and self-report their own suspicious trades to Wedbush without sufficient oversight and controls.

4. Multiple industry-wide notices and disciplinary decisions published during the relevant period put Wedbush on notice that its market access business posed particular regulatory

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[1] Layering involves a trading pattern in which multiple, non-bona fide, limit orders are entered on one side of the market at various price levels away from the National Best Bid or Offer ("NBBO") in order to create the appearance of a change in the levels of supply and demand, thereby artificially moving the price of the security; an order is then executed on the opposite side of the market at the artificially created price, and the non-bona fide orders are immediately cancelled.

[2] Spoofing involves a trading pattern in which multiple, non-bona fide limit orders are entered generally inside the existing NBBO, with the intention of briefly triggering some type of market movement and/or response from another market participant, followed by cancellation of the non-bona fide orders, and the entry of an order on the opposite side of the market.

and compliance risks. *See, e.g.,* FINRA's 2010 Annual Regulatory and Examination Priorities Letter ("Priorities Letter") (Mar. 1, 2010) (market access providers must ensure that their customers' activities comply with all applicable securities rules and regulations, and that their orders represent bona fide trading interest and are free of errors; market access providers must have appropriate processes for conducting due diligence with respect to approval of market access customers, and must establish controls that systematically limit financial exposure arising from the trading activity of sponsored participants, limit the use of the system to authorized persons, establish checks for validation of order accuracy, and monitor for duplication or retransmission of orders); FINRA's 2011 Priorities Letter (Feb. 8, 2011) (noted FINRA's focus on SEC Rule 15c3-5[3] compliance and FINRA's expectation that firms that generate orders by use of high-frequency models or trading algorithms have written policies and procedures that are reasonably designed to ensure that such trading complies with applicable FINRA rules and federal securities laws and regulations, including anti-manipulation provisions); FINRA's 2012 Priorities Letter (Jan. 31, 2012) (again noted FINRA's emphasis on SEC Rule 15c3-5 compliance, and made clear that market access providers must have post-trade surveillance procedures reasonably designed to identify various potential trading violations such as wash sales, marking, spoofing, layering, quote stuffing and manipulation related to the open and close of trading; the letter also noted FINRA's focus on surveillance of abusive high-frequency trading strategies, including activity initiated from outside of the United States involving momentum ignition strategies, where a market participant attempts to induce others to trade at artificially high or low prices, and set forth FINRA's concern with spoofing strategies related to the open or

[3] The SEC adopted Rule 15c3-5 of the Securities Exchange Act of 1934, as amended ("Exchange Act") in November 2010 to require that brokers or dealers, as gatekeepers to the financial markets, establish, document and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory and other risks related to its market access. 17 C.F.R. § 240.15c3-5, *Risk Management Controls for Brokers or Dealers with Market Access,* 75 Fed. Reg. 69792 at 69792 (Nov. 15, 2010) (Final Rule).

close of regular market hours that involve distorting disseminated market imbalance indicators through the entry of non bona fide orders and/or aggressive trading activity near the open or close); FINRA's 2013 Priorities Letter (Jan. 11, 2013) (again noted FINRA's focus on high-frequency and algorithmic trading abuses intended to bait other market participants to trade at artificially higher or lower prices, and FINRA's focus on activity originating from outside of the United States).[4]

5. In addition, multiple self-regulatory organization ("SRO") examinations beginning in 2007 identified concerns to the Firm relating to its onboarding of new market access customers, identification of authorized traders, inadequate monitoring of activity for potential manipulation, and deficiencies in its written supervisory procedures ("WSPs") with respect to the Firm's market access business. The Firm was informed that multiple SRO investigations involved Wedbush market access customer activity. Those investigations highlighted specific shortcomings in the Firm's market access oversight and WSPs, including with respect to reviews for potential wash trades, pre-arranged trades, and potentially violative odd lot trades.

6. During the relevant period, Wedbush's system of regulatory risk management controls and supervisory procedures were not reasonably designed to manage the risk associated with its market access business. Wedbush's internal reviews were inadequate, and its written description of its risk management controls was insufficient. Moreover, Wedbush's supervisory systems and procedures were not reasonably designed to achieve compliance with federal

[4] See also FINRA's 2008 Priorities Letter (Mar. 24, 2008) (focus areas included AML compliance and supervision); and FINRA's 2009 Priorities Letter (Mar. 9, 2009) (focus areas included AML compliance, order-entry controls, and internal controls, procedures and surveillance practices, including with regard to marking-the-close, to ensure that potential misconduct is identified and reviewed in a timely manner).

securities laws and regulations and FINRA and Exchange rules addressing AML and other potentially manipulative and suspicious trading by the Firm's market access customers, such as layering, spoofing, wash trading, suspicious patterns of order cancellations and odd-lot manipulation.

7. Wedbush failed to develop and implement a written AML program reasonably designed to achieve and monitor compliance with the requirements of the Bank Secrecy Act. During the relevant period, Wedbush maintained written AML procedures and programs that were not tailored to the Firm's market access business. The Firm's AML program did not reasonably take into account its market access customers' trading activities, and in that respect, did not meet minimal regulatory AML requirements. Wedbush's procedures for compliance with its AML obligations, as actually practiced and implemented, were almost non-existent and failed to provide for the monitoring, detection, and reporting of suspicious and potentially manipulative transactions by its direct market access customers.

8. Wedbush did not review its market access customers' trading activities to reasonably determine whether any red flags indicative of suspicious activity were present. In fact, Wedbush routinely ignored alerts from regulators and Exchanges about suspicious and potentially manipulative customer transactions. In addition, the Firm did not have a meaningful process for investigating suspicious activity and filing appropriate suspicious activity reports ("SARs"), as facts and circumstances required.

9. By failing to establish, maintain and enforce adequate AML policies and procedures, and failing to reasonably monitor, detect, and cause the reporting of potentially suspicious and potentially manipulative transactions by its market access customers, Wedbush violated NASD Rules 3011 and 2110 and FINRA Rules 3310 and 2010.

10. By failing to establish, maintain, and enforce supervisory systems and procedures that were reasonably designed to achieve compliance with securities laws, rules and regulations, including FINRA and exchange rules addressing the monitoring, detection, and prevention of suspicious and potentially manipulative trading, Wedbush violated NASD Rules 3010 and 2110 and FINRA Rule 2010.

11. In addition, by failing to establish, document and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the regulatory and other risks of having and providing market access, Wedbush willfully violated Section 15(c)(3) of the Securities Exchange Act of 1934 and Rule 15c3-5 thereunder (beginning on July 14, 2011) and also violated FINRA Rule 2010.

12. By creating incentives that rewarded compliance personnel with monthly compensation based on market access customers' trading volume, for which they had responsibility to oversee, and by failing to monitor and detect thousands of instances of potentially manipulative trading by recidivist customers, despite repeated red flags, Wedbush failed to observe high standards of commercial honor and just and equitable principles of trade, in violation of NASD Rule 2110 and FINRA Rule 2010.

Respondent and Jurisdiction

13. Wedbush Securities Inc. (known as Wedbush Morgan Securities Inc. until April 2010) is headquartered in Los Angeles, California, and has been registered with FINRA since 1955. During the relevant period, the Firm employed over 400 registered representatives in approximately 100 branch offices. Wedbush is also registered with multiple equity and option exchanges, including the Exchanges. FINRA retains jurisdiction over Wedbush because it is currently registered as a FINRA member firm.

Statement of Facts

14. During the relevant period, Wedbush was one of the largest independent brokerage firms, providing a broad range of brokerage and advisory services to institutional and private clients. Wedbush was also one of the largest providers of liquidity as a result of its market access arrangements with a large number of broker-dealers and other market participants. As an example, Wedbush market access customers traded on NASDAQ over 695 million shares daily in 2009. Wedbush collected tens of millions of dollars in revenue from trading activity by its market access customers, who traded through Wedbush more than a billion shares daily on the Exchanges.

15. Despite Wedbush's significant presence in the markets, the Firm assigned an inadequate number of employees to establish, implement and enforce regulatory risk management controls and supervisory systems for its market access business. As a result of Wedbush's supervisory deficiencies, these employees lacked a fundamental understanding of multiple forms of manipulative trading, and failed to take effective steps to understand the Firm's market access customers' trading activity and to implement necessary systems and controls to detect, prevent and report suspicious activity. The Firm's Co-Chief Compliance Officer also lacked a critical understanding of various forms of market manipulation.

16. Wedbush delegated oversight for substantially all supervisory and compliance-related functions related to its market access business, including investigating and responding to regulatory inquiries, reporting suspicious activity to the Firm's AML compliance officer ("AMLCO"), and developing and overseeing post-trade manipulation reviews, to its Senior Vice President of Correspondent Services, who was the Firm's market access

compliance supervisor, but was inadequately trained and grossly understaffed to handle all required compliance tasks delegated to her supervision. This individual, in turn, delegated virtually all reviews of post-trade activity for potentially manipulative wash trades by market access customers to one poorly-trained, unlicensed employee who, in turn, was charged with training another compliance analyst. Both the market access compliance supervisor and her subordinate viewed the designated task of reviewing post-trade reports for potential violative wash trades as largely administrative.

17. In addition to the lack of training and inadequate staffing and resources by Wedbush to achieve compliance with anti-manipulation rules and regulations, Wedbush had in place an incentive compensation system rife with potential conflicts of interest. During the relevant period, the Firm compensated certain employees charged with monitoring trading activity by market access customers for regulatory compliance based, in substantial part, on trading revenue generated by such accounts. This conflict of interest was most significantly highlighted with respect to the Senior Vice President of Correspondent Services, who for certain years during the relevant period, earned more in monthly incentive compensation payments than annual base salary payments.

18. From early in the relevant period, among dozens of market access customers, Wedbush repeatedly identified three particular market access customers as responsible for most of the activity referenced in the regulatory inquiries and daily exchange-generated wash reports, namely: (i) an unregistered foreign-based customer account, its predecessors, affiliates and successor ("Customer W"); (ii) Genesis Securities LLC, a former FINRA broker-dealer that was expelled in 2012 in connection with its failure to monitor manipulative trading activity by overseas day traders, operation of unregistered broker-dealers through master and subaccount

arrangements, and inadequate AML and supervisory procedures; and (iii) Hold Brothers On-Line Investment Services L.L.C., a former FINRA broker-dealer that was fined and then expelled in 2012 in connection with manipulative trading activity, including spoofing, layering, wash trades and pre-arranged trades, committed by overseas day traders via unregistered, non-broker-dealer entities owned and funded by the principals of Hold Brothers, and failing to supervise the foregoing. The traders at Customer W, as well as at the unregistered entities via Genesis Securities, Hold Brothers and other market access customers that engaged in the suspicious trading, were typically foreign, high-frequency, high-volume and algorithmic day traders over which FINRA lacks jurisdiction.

19. Although numerous red flags brought to the Firm's attention by regulators, as well as daily wash trade reports, should have alerted Wedbush to potentially manipulative wash trading, pre-arranged trading, layering, spoofing, excessive quoting and other forms of manipulation by these particular market access customers, Wedbush failed to take reasonable steps to monitor such accounts for potential fraudulent or abusive trading.

20. For example, Wedbush did not track the activity identified in regulatory inquiries and also did not attempt to identify whether any accounts or types of activity were the focus of multiple reviews. Moreover, Wedbush did not adequately review its market access customers' trading outside of responding to FINRA's inquiries, even when the same accounts appeared on multiple FINRA inquiries. In addition, Wedbush did not attempt to determine whether the trading that resulted in regulatory inquiries violated FINRA rules or the securities laws, and its supervisory systems and procedures lacked fundamental reviews to capture potentially manipulative activity.

Wedbush's Failure to Monitor for Layering, Spoofing and Other Forms of Manipulation

21. During the relevant period, Wedbush had no systems or WSPs designed to detect and prevent various forms of market manipulation, such as layering, spoofing and auto-execution manipulation, which is yet another form of manipulation involving the entry of orders with no intention of execution; they are entered simply to entice other buyers and sellers into trading at unfavorable prices. Such conduct continued despite Wedbush's receipt of numerous regulatory inquiries that identified such conduct as potentially violative by the same market access customers of the Firm. Furthermore, prior to and during the relevant period, FINRA, the SEC and other regulators issued guidance and releases discussing layering, spoofing, auto-execution and other manipulative activity involving patterns of order cancellations, and the obligations of firms that provide market access to monitor for such activity.

22. During the relevant period, Wedbush executed for market access customers over 100,000 instances of potential layering, spoofing and auto-execution manipulation, executed in multiple securities across the Exchanges. Wedbush's high-volume, high-frequency trading customers employed aggressive, potentially destabilizing trading strategies in illiquid securities.

23. For example, Wedbush effected approximately 20 instances of apparent spoofing for Customer W in eight illiquid securities in October and November 2008 when Customer W had apparently spoofed another market participant's algorithms and caused that participant to repeatedly buy securities from Customer W at an inflated price and sell back to Customer W at a depressed price.

24. Moreover, until approximately August 2010, Wedbush failed to reasonably monitor for, and had no automated surveillance report to detect, potentially manipulative odd lot

trading, even though Wedbush effected for market access customers numerous potential manipulative odd lot trades.

25. For example, on September 24, 2009, a customer of Genesis Securities, trading via a Wedbush MPID, entered a series of odd lot orders that apparently targeted NYSE Arca odd lot dealers who had been obligated at the time to take the contra-side of odd lot orders at the NBBO. By entering round lot orders on other markets that set the NBBO, the customers achieved favorable executions against the NYSE Arca odd lot dealers who were obligated to execute the customer's odd lot orders at the new NBBO. The customer then repeated the process on the other side of the market.

26. In addition, on February 14 and 15, 2013, Customer W engaged in an apparent manipulative scheme involving cross-market order and trading activity in two securities, in which Customer W, through a Wedbush MPID, was a party to a substantial majority (up to 90%) of the executions in both symbols over ten-minute intervals on both trading days. Customer W initially routed a series of apparent non-bona fide orders on one side of the market to NASDAQ, which set the NBBO; these orders apparently prompted other market participants to enter matching quotes, primarily on BZX Exchange, which then executed against Customer W's bona fide order on the other side of the market at a beneficial (falsely inflated/depressed) price on BZX Exchange. Immediately after it received a beneficial execution, Customer W would cancel its apparent non-bona fide orders, and repeat its trading pattern on the other side of the market. Customer W alternated between executing buy orders at lower prices and sell orders at higher prices; almost every execution followed the entry of a series of apparent non-bona fide orders on the opposite side of the market designed to improve the execution price that a single bona fide order would receive.

27. Five years after the start of the relevant period, Wedbush continued to enable Customer W, through the use of a Wedbush MPID, to trade directly on the Exchanges despite numerous red flags that had specifically identified Customer W as having engaged in this type of manipulative trading.

28. On May 1, 2013, the Firm implemented some surveillance reviews via the NASDAQ SMARTS surveillance system for activity that had passed through certain third-party systems to monitor for activities such as layering, spoofing, market dominance on the open or close of trading, wash trades and marking-the-open/close. However, the Firm assigned only one individual to review these surveillances for potential manipulative activity, and continued to keep the same employee discussed above responsible for wash trade surveillance. Given the volume of trading, it was not reasonable to assign just one person to this task.

29. Moreover, during the period between May 2013 and August 2013, the Firm had yet to review numerous instances of potential manipulative activity by Wedbush market access customers, and had failed to ensure that all order and trade activity by its market access customers was subject to its control and/or processed through its surveillances.

Wedbush's Failure to Reasonably Monitor High-Frequency Trading (HFT) Customers

30. Firms that generate orders by use of HFT models or trading algorithms are required to have in place written policies and procedures that are reasonably designed to ensure that such trading complies with applicable FINRA rules and federal securities laws and regulations, including anti-manipulation provisions.

31. The entry and cancellation of numerous orders with few or no executions by HFT or algorithmic trading firms are red flags that warrant further review for potential erroneous orders and potential manipulative trading. During the relevant period, although Wedbush had

multiple HFT and algorithmic market access customers, it conducted no reviews to monitor for patterns of order cancellations by such customers. During the relevant period, Wedbush's HFT and algorithmic market access customers engaged in excessive message activity on numerous trade dates whereby order and cancellation messages flooded the market in a short period of time, with few executions.

32. For example, over a seven-second period in late day trading on April 24, 2012, a Wedbush market access customer entered and cancelled a significant number of orders resulting in a spike in message traffic.

Wedbush's Failure to Reasonably Monitor for Wash Trade Manipulation

33. During the relevant period, Wedbush failed to effectively monitor for potentially violative wash trades (trades with no change in beneficial ownership). Violative wash trades feed false information into the market and can be used to manipulate prices. Intentionally taking both sides of a trade can minimize financial risk for the trading firm while potentially creating a false impression of higher volume in the market. Even wash transactions not undertaken with fraudulent or manipulative intent can create a misimpression of the level of legitimate trading interest and activity in a security. FINRA members have an obligation to have policies and procedures in place to review trading activity to prevent wash sale transactions.

34. Wedbush's WSPs relating to sponsored access during the relevant period stated that wash trades are prohibited. The procedures required the Firm to distribute potential wash sale reports to sponsored participants, and review potential wash sale reports to determine potential violations. If potential wash trades were detected, the Firm was required to obtain representations from the sponsored participants regarding internal wash trade reviews and systems, and maintain records of correspondence. The procedures failed to specify how to

review the wash sale reports to determine whether the transactions may have been executed with the intent to manipulate the market, or when market access should be terminated.

35. Wedbush conducted no reviews of wash trades by market access customers during the period between January 2008 and April 2009. The Firm commenced some reviews of wash trades when it began receiving wash sale reports in or about May 2009 from various exchanges; however, Wedbush essentially stripped out from review significant portions of the exchange-generated wash reports. For example, although the Customer W account was beneficially owned by two principals, it was traded by more than a thousand overseas unregistered traders. Wedbush did not review potential violative wash trades between Customer W traders with multiple trader identifiers ("IDs") who may have been trading with themselves, orders placed by the same trader ID on different exchanges, and orders matched between different traders of Customer W who may have been working in concert, even though these trades resulted in no change in beneficial ownership.

36. With respect to the subset of potential wash trades that Wedbush had determined were worthy of some review, however superficial, Wedbush's reviews were merely administrative, and lacked any meaningful substantive scrutiny for potential manipulation. In essence, Wedbush would e-mail the exchange-generated wash report to its market access customers and ask them to report back on whether any of the transactions were wash trades and, if so, to explain the activity.

37. Wedbush essentially relied on its customers to monitor their own activity and self-report to Wedbush. Moreover, Wedbush generally accepted at face value its customers' explanations, without conducting its own investigation of the potential problematic trades. For example, when Customer W responded that no wash trades were detected, Wedbush would

simply archive the response, without conducting any additional review or requesting supporting documentation. When Customer W acknowledged suspicious activity, rather than insisting that Customer W halt the activity if it did not want its access terminated, Wedbush simply accepted Customer W's response that it had suspended the responsible trader. Wedbush did not track Customer W trader suspensions or disabling of trader IDs. In many instances, Customer W responded within minutes of receiving the wash report stating that none of the trades on the report were problematic, even if it contained over a hundred potential wash trades conducted by multiple different traders, thus evidencing that Customer W did not reasonably review the activity on the report and did not take seriously its obligation to prevent manipulative trading. Further, Wedbush received responses to only about half of the wash trade inquiries it had sent to Customer W, and Wedbush failed to follow up with Customer W concerning those unanswered inquiries. In addition, Wedbush did not conduct any analysis to identify the market impact of the potential wash trades that appeared on the daily wash trade reports, or whether they may have been manipulative.

38. Even though Wedbush received and forwarded wash trade reports from several exchanges, Wedbush conducted absolutely no reviews for potential wash trades on the NYSE, nor did Wedbush conduct any cross-market reviews for wash trades that had arisen from orders entered on one market center but executed on another.

39. Further, although Wedbush could have enabled wash trade prevention software to prevent wash trades by its market access customers at the MPID level, it did not take reasonable steps to ensure that such controls had been enabled and functioning for all such customers, including Customer W. The few controls that were implemented by Wedbush, such as prohibitions of wash sales only at the trader ID level, were insufficient and not reasonably

designed to detect and prevent violative wash trades. Although Wedbush allowed anti-internalization controls to be disabled for some customers, Wedbush did not place such customers under heightened supervision or conduct reviews to identify customers whose controls may not have been properly enabled.

40. Moreover, Wedbush executed for its market access customers on NYSE Arca thousands of wash trades using mid-point passive liquidity ("MPL") orders (*i.e.*, un-displayed limit orders priced at the midpoint of the Protected Best Bid/Offer) in an apparent attempt to collect liquidity rebates.[5]

41. For example, in March and April 2010, Customer W, through approximately 250 traders, entered approximately 20,000 wash trades in the MPL order type, totaling over 19 million shares, and generating potential profit of almost $40,000. Wedbush did not conduct any reviews to detect potential abuse of the MPL order type, including through the use of wash trades.

42. The Firm's deficient supervision in the monitoring of wash trading enabled its market access customers to execute more than 100,000 potentially violative wash trades in hundreds of securities across multiple exchanges during the relevant period.

Wedbush's Failure to Monitor for Pre-arranged Trading

43. Although Wedbush's WSPs prohibited pre-arranged trades, Wedbush conducted no reviews for pre-arranged trades even though Wedbush effected hundreds of instances of apparent pre-arranged trades for its market access customers in numerous different securities across multiple market centers, and even where there were patterns of trades between Customer W traders at the same location (*i.e.*, wash trades which Wedbush had excluded from review).

[5] On NYSE Arca at the time, firms that supplied liquidity using MPL orders received a rebate of $0.20 per 100 shares, but were not charged a fee for taking liquidity.

44. For example, in March and April 2010, Wedbush executed numerous apparent pre-arranged trades for a market access customer which had used MPL orders in an apparent attempt to collect exchange liquidity rebates. The customer's trades comprised over 50% of the total daily consolidated volumes of the securities. Given the inverted nature of this order type's rebate structure, Wedbush should have been alerted by the exceptional volume by its customer using MPL orders; however, Wedbush failed to detect this activity. Wedbush also effected for market access customers numerous instances of potential pre-arranged trades during post-core sessions, with low liquidity, in penny stocks and at prices significantly outside the normal trading pattern of the securities involved. Wedbush did not detect or conduct reviews for any of these types of activity.

Wedbush's Failure to Monitor Authorized Trader IDs

45. Although certain market access customer accounts traded via numerous overseas, unregistered traders, Wedbush made no effort to ensure that each authorized trader was only issued one trader ID or to terminate inactive trader IDs. The Firm failed to establish and implement effective controls relating to the deactivation and sharing of trader IDs, the assignment of multiple trader IDs to a single trader and trading suspensions of disciplined traders.

46. The lack of control over both the issuance of trader IDs and the deactivation of inactive trader IDs enabled its market access customers to potentially use multiple trader IDs to circumvent surveillance monitoring conducted at the trader ID level, and to potentially have access to higher trading limits through the use of multiple IDs. It also allowed market access customers to have the same person potentially continue trading under a different trader ID after that person's original trader ID had been terminated. Moreover,

Wedbush failed to ensure that it had restricted trading to only those persons who had been approved and authorized by Wedbush. As a result, for example, on January 10, 2012, an inactive Customer W trader ID had been used to conduct unauthorized trading in one security on NYSE Arca.

Wedbush's Failure to Monitor for Marking-the-Close

47. Marking-the-close involves the practice of repeatedly executing transactions in a stock at or near the end of the trading day in order to affect the stock's closing price. Such activity sends false signals to the market about the value of the security. It has long been recognized that firms are required to maintain adequate systems to detect potential instances of marking-the-close. Despite Wedbush's WSPs and regulatory notices, which made clear that marking-the-close is prohibited, Wedbush had no surveillance in place until May 2013 to monitor market access customers' trading based on the time of execution, including for potential instances of marking-the-close.

Potential Conflict of Interest with Employee Incentive Compensation

48. During most of the relevant period, until early 2013, Wedbush had in place a monthly incentive compensation system rife with potential conflicts of interest, whereby the Firm compensated employees charged with monitoring trading activity by market access customers for compliance with applicable federal securities laws and regulations and FINRA and Exchange rules based, in substantial part, on trading revenue generated by such accounts. As a result, for several years during the relevant period, the market access compliance supervisor earned more in monthly incentive compensation payments than in annual base salary payments.

49. Since approximately half of the market access compliance supervisor's compensation was based upon the revenue generated by the trading volume of accounts that her

staff was responsible to monitor, such arrangement presented a serious conflict of interest, which could have discouraged rigorous review of the potential manipulative trading activity identified in the dozens of regulatory inquiries received by the Firm throughout the relevant period.

Wedbush's Inadequate WSPs

Anti-Money Laundering WSPs

50. Wedbush's WSPs state that the AMLCO is responsible for developing policies, procedures and internal controls to achieve compliance with AML rules and regulations. During the relevant period, the AMLCO had just one supporting analyst at any one time. The AML procedures require the Firm to file SARs for transactions that may be indicative of money laundering activity, and refer to the 25 red flags or risk indicators of money laundering.

51. In deciding whether or not to file a SAR, the AMLCO should, pursuant to the procedures, "review transactions and accounts identified for potential suspicious activity" and "determine whether the activity constitutes suspicious activity requiring reporting." The Firm's procedures identify a number of tools to identify suspicious activity, including education of Firm personnel, review of wire transfers, and employee reports of potential suspicious activity forwarded to the AMLCO.

52. In addition to its WSPs, Wedbush also maintained separate written AML procedures titled "Anti-Money Laundering Transaction Review Procedures." These were updated nearly annually, and contained 25 red flags indicative of possible money laundering. The AML procedures focused on how to monitor for suspicious money transactions. The AML procedures did not adequately address suspicious trading activity, despite the fact that trading was a core component of the Firm's business.

53. In practice, Wedbush failed to review trading by its market access customers for potentially suspicious activity transactions and potentially manipulative transactions. The AMLCOs during the relevant period developed what Wedbush called a "transaction alert report," which was the leading tool that the AMLCOs relied on to help ensure AML compliance. As used, the transaction alert report altogether failed to identify suspicious securities trading activity by market access customers. The report was generated monthly and was used to track primarily money (and some securities) movements by customers. The report effectively kept a running chronological record of alerts, based on the rules that the AMLCO had programmed into it.

54. Among other rules, the report incorporated "risk scores" (weighted, from low to high, from 1 to 4) depending on the geographic location of the account, the institutional type of account, and the type of transaction. For example, Canada had a low country risk score of 1, while Yemen had a risk score of 4 (as did the Cayman Islands and China). IRA accounts, for example, had an "institutional" risk score of 1; domestic LLP and LLC accounts and foreign individual accounts had a score of 4. Different transactions were rated from "lowest risk" (1) to "high risk" (4), and allocated a corresponding score. The report generated an alert only when a significant transaction of some kind (usually money movement) occurred in the customer's account. Also, the bulk of the resulting alert score was based on the type of transaction involved. If a customer engaged in no significant money movement transactions in a given month, it would not appear on the transaction alert report.

55. Significantly, Customer W appeared on the report every month, and consistently ranked high on the scoring system primarily, if not only, because it had engaged in frequent money movements or wires, and not as a result of its trading practices. With respect to Customer W, for example, the AMLCO or analyst made frequent entries like "account activity is consistent"

or "nothing unusual noted for this Professional Trading account." The entry for activity for March 2010 stated, "Activity is closely monitored by CSD [Correspondent Services Department] Management." For June 2010, the entry for Customer W read, "Journal and trading activity do not seem suspicious."

56. Although the AMLCO, during most of the relevant period, knew that Customer W had an estimated 1,000 traders at any one time, most of whom were in China, the AMLCO did not know Customer W's trading strategy, how Customer W selected its traders or whether Customer W had performed any due diligence on them. The transaction alert report did not generate, nor did the AMLCO or the analyst otherwise review, instances of possible manipulative activity, including wash trades, spoofing, marking-the-close or open, or matched trades. The AMLCO relied on Correspondent Services to alert him of suspicious trading activity that should be reviewed by the AMLCO. However, no such instances appeared on the transaction alert report.

57. Although the AMLCO relied on Correspondent Services to conduct reviews and report instances of suspicious trading activity to the AMLCO, the AMLCO failed to ensure that Correspondent Services had conducted meaningful reviews to determine if Wedbush's market access customers had executed potential violative wash trades and other forms of unlawful manipulative trading. In fact, the AMLCO had no knowledge of any reviews or findings of potential manipulation by Correspondent Services. Even though Customer W regularly appeared on the AMLCO's transaction alert reports, if only as a result of its money movements, the Firm and the AMLCO conducted no independent reviews of Customer W's trading activity, and had no understanding of what, if any, reviews had been conducted by Correspondent Services. Correspondent Services did little, if any, meaningful review of the Firm's market access customers' trading activity.

58. Wedbush accordingly failed to conduct its own monitoring of potentially suspicious trading and it had little idea of what measures, if any, its market access customers took to monitor trading by its own traders.

Market Access WSPs

59. Wedbush's WSPs for its market access business did not require review of market access customers' orders for potentially manipulative activity, and Wedbush did not implement any such reviews until May 2013. Wedbush's market access WSPs contained no procedures to monitor for various types of price manipulation, including layering, spoofing, pre-arranged trading, auto-execution, excessive order entry and cancellations, and marking-the-close.

60. Wedbush's WSPs also contained fundamental flaws with respect to established reviews, such as for wash trades. The WSPs identified the individual responsible for conducting daily reviews for wash or pre-arranged trades, and required that the designated person review potential wash sale reports and distribute the reports to sponsored participants; however, the procedures failed to indicate the steps for reviewing the wash sale reports and made no mention of how to reasonably monitor for potential pre-arranged trading activity. According to the WSPs, if potential wash transactions were detected, the designated reviewer was required to obtain representation from sponsored participants regarding internal wash trade reviews and systems. The procedures did not indicate what, if any, subsequent review or action was required. No reviews were conducted by Wedbush to detect potential pre-arranged trades.

61. Wedbush updated its WSPs as of July 14, 2011, to coincide with the effective date of Rule 15c3-5; however, the updated WSPs failed to specify reviews to ensure that Wedbush: (1) prevent the entry of orders that exceeded appropriate pre-set credit or capital thresholds or that appeared to be erroneous; (2) prevent the entry of orders unless there has been compliance

with all regulatory requirements that must be satisfied on a pre-order entry basis; (3) prevent the entry of orders that the customer was restricted from trading; (4) restrict market access technology and systems to authorized persons; and (5) assure appropriate surveillance personnel receive immediate post-trade execution reports, and assure appropriate reviews would be conducted to ensure compliance with the foregoing. The updated WSPs continued to lack procedures to monitor for various types of price manipulation, including layering, spoofing, pre-arranged trading, auto-execution, excessive order entry and cancellations, and marking-the-close.

62. In addition, Wedbush did not have an adequate written description of its risk management controls as part of its books and records. Wedbush's WSPs lacked procedures regarding how regulatory risk controls were to be utilized or the identity of the responsible individuals to monitor such controls. Moreover, despite Rule 15c3-5's requirement that the Firm's market access systems be under the Firm's exclusive control at all times, Wedbush failed to have adequate WSPs and controls to ensure that it had direct and exclusive control over regulatory risk management systems and financial controls with respect to order management systems used by its market access customers. Wedbush's WSPs also failed to set forth the steps by which due diligence reviews would be conducted prior to approving new market access customers.

63. Moreover, Wedbush did not adequately review its business activity in connection with its market access to assure the overall effectiveness of its risk management controls and supervisory procedures, including with respect to any allocated regulatory responsibilities to broker-dealer clients.

64. In sum, the Firm's market access procedures were not tailored to its high-volume trading market access business, including high-frequency and algorithmic trading entities, and

could not reasonably have been expected to detect, prevent and cause the reporting of suspicious activity. The Firm's market access procedures did not address how to monitor overseas day traders for suspicious activity, and the Firm inadequately monitored the activity by its market access customers, which represented millions of shares traded daily on the exchanges using a Firm MPID. The Firm failed to establish procedures to perform effective monitoring in light of the location of the traders and heightened risk. The Firm also failed to perform heightened monitoring of the activity in those accounts. The Firm ignored extensive red flags suggesting that its accounts had engaged in manipulative or otherwise unlawful activity. The Firm did not attempt to determine whether the trading activity that resulted in regulatory inquiries had violated FINRA rules or the securities laws.

65. Despite receiving numerous regulatory inquiries, and the fact that the same accounts were repeatedly identified in response to those inquiries, the Firm did not place any of the accounts under heightened supervision. The Firm also did not track the activity identified in regulatory inquiries to determine if any accounts or types of activity were the focus of multiple reviews. The Firm failed to establish and implement policies and procedures that could have been reasonably expected to detect, prevent and cause the reporting of suspicious activity, or otherwise were reasonably designed to achieve compliance with securities laws and exchange rules prohibiting manipulative trading practices.

66. The Firm updated relevant sections of its WSPs as of May 1, 2013, to coincide with its implementation of various SMARTS anti-manipulation surveillances; however, the May 2013 WSPs lacked any references to such surveillances. After the relevant period, the Firm updated its WSPs as of October 11, 2013, and referenced its use of SMARTS to monitor for various activities including layering, spoofing, market dominance on open/close, ramping, wash

trades and marking-the-open/close; however, the October 2013 WSPs still failed to identify the specific reports implemented, the parameters of such reports, the frequency of reviews, how such reviews should be conducted and documented, or what actions may or should be taken by the Firm. Moreover, between May 2013 and August 2013, substantially all of the alerts that had been generated for review for potential manipulative activity had not been reviewed by the Firm's one designated reviewer.

First Cause of Action
Supervisory Deficiencies
NASD Rules 3010 and 2110 and FINRA Rule 2010

67. Market Regulation and Enforcement re-allege and incorporate by reference each preceding paragraph.

68. As described above, Wedbush's supervisory systems and procedures governing market access were deficient in numerous ways, including the following: (i) the Firm did not conduct adequate reviews for potentially manipulative trading activity; (ii) the Firm did not subject to appropriate review accounts that posed heightened risk, including when an account's trading was the subject of multiple regulatory inquiries; (iii) the Firm allocated insufficient resources and unqualified personnel to monitor its market access business and ensure compliance with applicable securities laws, rules and regulations; and (iv) the Firm delegated compliance reviews to personnel to monitor transactions for accounts when their compensation was directly tied to the level of trading activity in the accounts.

69. During the relevant period, and despite numerous red flags that should have alerted Wedbush to the types of potential manipulation by its market access customers, Wedbush's WSPs continued to lack reasonable or any procedures and reviews for various types of price manipulation, including layering, spoofing, pre-arranged trading, auto-execution, excessive order

entry and marking-the-close, and contained fundamental flaws with respect to established reviews.

70. Wedbush failed to establish, maintain and enforce WSPs reasonably designed to supervise the types of business in which it was engaged and to supervise the activities of registered representatives, registered principals and other associated persons that were reasonably designed to achieve compliance with applicable securities laws, regulations and FINRA Rules, including Rule 15c3-5.

71. As a result of the foregoing conduct, Wedbush violated NASD Rule 3010(a), by failing to have a supervisory system reasonably designed to achieve compliance with the securities laws and FINRA rules, and NASD Rule 3010(b), by failing to establish, maintain and enforce written procedures to supervise the types of business in which it engaged. The supervisory deficiencies also constituted violations of NASD Rule 2110 (for misconduct before December 15, 2008) and FINRA Rule 2010 (for misconduct beginning December 15, 2008).

Second Cause of Action
Anti-Money Laundering Deficiencies
NASD Rules 3011 and 2110 and FINRA Rules 3310 and 2010

72. Market Regulation and Enforcement re-allege and incorporate by reference each preceding paragraph.

73. Since 2002, the United States Department of the Treasury has required suspicious transaction reporting by broker-dealers pursuant to the Bank Secrecy Act of 1970, 31 U.S.C. section 5311, *et seq.*, as amended. The implementing regulation, 31 C.F.R. § 1023.320 (re-codified from 31 C.F.R. §103.19 on March 1, 2011) requires that "[e]very broker or dealer in securities within the United States . . . file with [the Financial Crimes Enforcement Network] . . .

a report of any suspicious transaction relevant to a possible violation of law or regulation." The regulation further provides that:

> A transaction requires reporting . . . if it is conducted or attempted by, at, or through a broker-dealer, it involves or aggregates funds or other assets of at least $5,000, and the broker-dealer knows, suspects, or has reason to suspect that the transaction (or a pattern of transactions of which the transaction is a part):
>
> > (i) Involves funds derived from illegal activity or is intended or conducted in order to hide or disguise funds or assets derived from illegal activity (including, without limitation, the ownership, nature, source, location, or control of such funds or assets) as part of a plan to violate or evade any Federal law or regulation or to avoid any transaction reporting requirement under Federal law or regulation;
> >
> > (ii) Is designed, whether through structuring or other means, to evade any requirements of this chapter or of any other regulations promulgated under the Bank Secrecy Act;
> >
> > (iii) Has no business or apparent lawful purpose or is not the sort in which the particular customer would normally be expected to engage, and the broker-dealer knows of no reasonable explanation for the transaction after examining the available facts, including the background and possible purpose of the transaction; or
> >
> > (iv) Involves use of the broker-dealer to facilitate criminal activity.

74. In 2002, FINRA adopted amendments to NASD Conduct Rule 3011 (n/k/a FINRA Rule 3310) to require, among other things, members to develop and implement an AML compliance program and designate persons responsible for AML compliance. FINRA also issued detailed guidance to the industry regarding broker-dealer monitoring and reporting requirements. In Notice to Members ("NTM") 02-21, FINRA emphasized that each broker-dealer has a duty to detect red flags that may indicate money laundering or other violative activity and where detected, "to perform additional due diligence before proceeding with the transaction." In NTM 02-47 and subsequent guidance, FINRA further advised broker-dealers of their duty to file a SAR for certain suspicious transactions.

75. NASD Rule 3011(a), and FINRA Rule 3310(a) beginning January 1, 2010,

requires each member to "establish and implement policies and procedures that can be reasonably expected to detect and cause the reporting of transactions required under 31 U.S.C. 5318(g) and the implementing regulations thereunder."

76. During the relevant period, Wedbush failed to develop and implement AML policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations promulgated thereunder. Although the Firm had AML policies and procedures in place, they were not tailored to its market access business and therefore could not reasonably be expected to detect and cause the reporting of suspicious transactions, as required by NASD Rule 3011(a) and FINRA Rule 3310(a).

77. As alleged above, Wedbush missed or otherwise failed to investigate numerous red flags of suspicious activity related to its market access business and clients. This failure was at least partly the result of the Firm's failure to adopt clear lines of responsibility for AML compliance regarding the market access business.

78. By failing to establish, maintain and enforce adequate AML policies and procedures, coupled with its failure to reasonably monitor, detect, and cause the reporting of potentially suspicious activity by its market access customers, Wedbush violated NASD Rule 3011(a) (for misconduct before January 1, 2010) and FINRA Rule 3310(a) (for misconduct beginning on January 1, 2010), as well as NASD Rule 2110 (for misconduct before December 15, 2008) and FINRA Rule 2010 (for misconduct beginning on December 15, 2008).

Third Cause of Action
Market Access Violations
Section 15c(3) of the Exchange Act, Rule 15c3-5 Thereunder, and FINRA Rule 2010

79. Market Regulation and Enforcement re-allege and incorporate by reference each preceding paragraph.

80. Wedbush failed to appropriately control the risks associated with providing its customers with market access so as not to jeopardize the Firm's and other market participants' financial condition and the integrity of the trading on the securities markets, as required by SEC Rule 15c3-5.

81. In its capacity as a provider of "market access," as the term is defined in Rule 15c3-5, Wedbush failed to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of providing market access, as required by Rule 15c3-5(b).

82. Wedbush failed to ensure, as required by Rule 15c3-5(c), that it had in place appropriate regulatory risk management controls and supervisory procedures so as to: (i) prevent the entry of orders unless there was compliance with all regulatory requirements; (ii) prevent the entry of orders if the customer or trader is restricted from trading; (iii) restrict access to trading systems and technology to persons pre-approved and authorized by Wedbush; and (iv) assure appropriate surveillance personnel receive immediate post-trade execution reports that result from market access.

83. Wedbush failed to ensure that it had adequate risk management controls to prevent the entry of erroneous orders, by rejecting orders that exceed appropriate price or size parameters, on an order-by-order basis or over a short period of time. The Firm's price and size parameters did not take into account the current market price, NBBO or trading volume of a security. For example, in January 2012, for one of the Firm's market access customers, the price and size parameters did not prevent the entry of orders at prices less than $999, with sizes less than 100,000 shares, and a notional order value less than $1,000,000.

84. Wedbush failed to ensure that its regulatory risk management controls and supervisory procedures were under its direct and exclusive control, as required by Rule 15c3-5(d). Wedbush failed to reasonably allocate, by written contract, after a thorough due diligence review, control over specific regulatory risk management controls and supervisory procedures to a broker-dealer customer. Wedbush was not relieved of any of its obligations to establish, document, and maintain a system of risk management controls and supervisory procedures reasonably designed to manage the financial, regulatory, and other risks of market access. The Firm failed to adequately review the performance of broker-dealers to whom it has allocated certain regulatory responsibilities.

85. Wedbush failed to establish, document and maintain a system for regularly reviewing the effectiveness of the risk management controls and supervisory procedures as required by Rule 15c3-5(e).

86. As detailed above, by failing to establish, document and maintain a system of risk management controls and supervisory procedures reasonably designed to systematically manage the regulatory and other risks of providing market access, Wedbush willfully violated Section 15(c)(3) of the Exchange Act, and Rule 15c3-5 thereunder (for misconduct beginning July 14, 2011), and violated FINRA Rule 2010.

Fourth Cause of Action
Violations of Just and Equitable Principles of Trade
NASD Rule 2110 and FINRA Rule 2010

87. Market Regulation and Enforcement re-allege and incorporate by reference each preceding paragraph.

88. As described above, Wedbush established a compensation system rife with potential conflicts of interest whereby certain personnel who performed compliance oversight

functions received monthly incentive compensation based on the profitability of the Correspondent Services Division, which depended largely on the trading volume of Wedbush's market access customers, including high-volume, high-frequency, and algorithmic trading entities. Wedbush thereby knowingly and deliberately created a disincentive for its employees to conduct rigorous and effective monitoring and curtail potential violative activity.

89. Moreover, despite its receipt of numerous regulatory inquiries as well as exchange-generated reports identifying hundreds of wash trades on a daily basis, Wedbush eliminated from review significant quantities of wash trades, relied on its customers to monitor and self-report their own wash trades, and took no steps to curtail wash trades. Through such knowing and deliberate conduct, Wedbush enabled artificially elevated, distorted and misleading trading volumes of multiple securities across the Exchanges.

90. Further, as described in detail above, Wedbush handsomely profited from its abject failure to reasonably monitor and detect thousands of instances of potential manipulative activity by the same recidivist customers, despite repeated red flags. The tremendous volume generated from these unregistered, foreign, anonymous traders substantially contributed to Wedbush's status as a leading liquidity and volume provider as well as Exchange rebates and reduced fees.

91. By virtue of the foregoing, in the conduct of its business, Wedbush failed to observe high standards of commercial honor and just and equitable principles of trade, in violation of NASD Rule 2110 (for misconduct before December 15, 2008) and FINRA Rule 2010 (for misconduct beginning on December 15, 2008).

Relief requested

Wherefore, the Departments of Market Regulation and Enforcement respectfully request that the Panel:

A. make findings of fact and conclusions of law that Respondent committed the violations charged herein;

B. make specific findings that Respondent wilfully violated Section 15(c)(3) of the Exchange Act and Rule 15c3-5 thereunder;

C. order that one or more of the sanctions provided under FINRA Rule 8310(a), including monetary sanctions, be imposed;

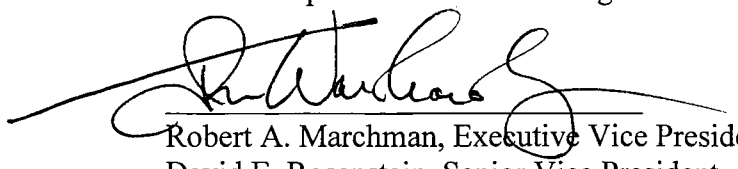
D. order that Respondent retain at its own expense one or more qualified independent consultants (the "Consultants") not unacceptable to FINRA staff to conduct a comprehensive review of Respondent's supervision of its direct market access business, including its compliance with AML rules and regulations and SEC Rule 15c3-5; and

E. order that Respondent bear such costs of the proceeding as are deemed fair and appropriate under the circumstances in accordance with FINRA Rule 8330.

Dated: August 18, 2014

Respectfully submitted,

FINRA Department of Market Regulation



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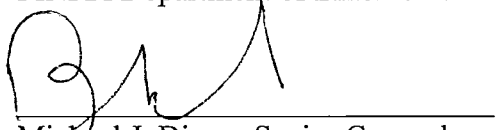

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