FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. SPENCER EDWARDS, INC. (CRD No. 22067), Respondent.	Disciplinary Proceeding No. 2013035865303 Hearing Officer—DW **EXTENDED HEARING PANEL DECISION** March 21, 2017

Respondent facilitated unregistered and nonexempt customer sales of billions of shares of securities in violation of Section 5 of the Securities Act of 1933 and inconsistent with just and equitable principles of trade. It also failed to adequately supervise its brokers and ensure that the firm employed procedures adequate to comply with recordkeeping requirements and its obligation not to participate in unregistered offerings. Respondent is fined $707,000, and suspended from accepting deposits of certificated stock until it adopts adequate procedures. It is also assessed costs.

Appearances

For the Complainant: Gregory R. Firehock, Esq., Perry C. Hubbard, Esq., and Jason W. Gaarder, Esq., Department of Enforcement, Financial Industry Regulatory Authority.

For the Respondent: David A. Zisser, Esq., Jones & Keller, P.C.

DECISION

I. Introduction

"Registered representatives are the gatekeepers of the retail securities market, and as such have a responsibility to safeguard the market's integrity in all of their professional dealings."[1] The Department of Enforcement alleges in this action that Respondent Spencer Edwards, Inc. fell short of this obligation by its failure to implement procedures adequate to detect unlawful sales in the public markets by its customers as part of unregistered offerings. As a result of its

[1] *Andrew Paul Tomasko*, Exchange Act Release No. 40425, 1998 SEC LEXIS 1913, at *6 (Sept. 10, 1998).

inadequate procedures, Spencer Edwards is alleged to have improperly liquidated approximately 4 billion shares of six penny stocks through customer accounts. In answer to the allegations, Spencer Edwards acknowledges its role in customer stock sales, but denies that its procedures were inadequate or that the customer sales were unlawful. This Extended Hearing Panel held a hearing on the allegations in Denver, Colorado.

II. Findings of Fact

A. Background

Spencer Edwards is a retail broker-dealer headquartered in Denver, Colorado, that has been a FINRA member firm since 1988.[2] During the relevant period of January 2011 through December 2012, the firm employed 19 to 26 registered representatives. In 2011 the firm had two branch offices, but none in 2012.[3] During this timeframe Gordon Dihle, the firm's owner, served as Spencer Edwards' President, Chief Executive Officer ("CEO"), and Chief Compliance Officer ("CCO").[4] He also served as the firm's AML Compliance Officer.[5] Dihle was the immediate supervisor of Stephen Biley and Adam Warga, the two brokers responsible for the customer sales at issue in this matter.[6] After Dihle sold the firm and relinquished his managerial roles in mid-2012, his former assistant, Donna Flemming, assumed responsibility as the firm's President, CEO, and CCO.[7] The firm's Operations Manager, Shawna Choate, became head of operations.[8]

B. Spencer Edwards' Penny Stock Business

Spencer Edwards currently derives more than 75 percent of its total revenues from liquidating "penny stocks"[9] from customer accounts.[10] During the relevant period, the firm was

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[2] Joint Factual Stipulations ("Stip.") ¶¶ 2, 3.

[3] Stip. ¶ 4.

[4] Stip. ¶ 9.

[5] Stip. ¶ 11.

[6] Stip. ¶ 10. Prior to the hearing, Dihle, Biley, and Warga each settled charges related to their roles in the violations alleged in this proceeding. Joint Exhibit ("JX-") 247; JX-248; JX-249; JX-250.

[7] Hearing Transcript ("Tr.") at 1297-98 (Flemming).

[8] JX-252, at 3.

[9] "According to the SEC, 'the term 'penny stock' generally refers to low-priced (below $5), speculative securities of very small companies. While penny stocks generally are quoted over-the-counter (such as on the OTC Bulletin Board or in the Pink Sheets) they may also trade on securities exchanges, including foreign securities exchanges." *Absolute Activist Value Master Fund Ltd. v. Florian Homm*, 2010 U.S. Dist. LEXIS 137150, at *1, n.1 (S.D.N.Y. Dec. 22, 2010), *rev'd in part on other grounds*, *Absolute Activist Value Master Fund v. Ficeto*, 2012 U.S. App. LEXIS 4258 (2d Cir. N.Y. Mar. 1, 2012) (citation omitted).

[10] Tr. 1306 (Flemming).

aware of the speculative and high-risk nature of penny stocks; it imposed limitations on its customers' ability to buy the stocks, but imposed no similar limitations on penny stock sales.[11]

Every lawful sale of securities must be made either pursuant to a valid registration statement or subject to an exemption from registration.[12] Registration requirements of the Securities Act of 1933 (the "Act") are not merely technical—they serve to protect investors "by promoting full disclosure of information thought necessary to informed investment decisions."[13] These requirements are of particular import in the penny stock market; "[t]he House Report on the Penny Stock Reform Act of 1990 found that '[b]ecause it is wrapped in secrecy and operates in relative obscurity, the penny stock market lends itself to manipulation far more easily than a market where information is readily available and circulated to investors.'"[14]

In the years leading up to the relevant period, Spencer Edwards' penny stock liquidation business had a troubled history of noncompliance with the registration requirements of the Act. In 2003, the Securities and Exchange Commission ("SEC") found that Spencer Edwards' head trader and one of its registered representatives unlawfully sold unregistered securities on behalf of customers.[15] In 2005, the SEC again found that Spencer Edwards, its president, and two registered representatives violated registration requirements and associated supervisory obligations.[16] In this subsequent action, the SEC found that Spencer Edwards "did not have acceptable procedures in place to prevent or detect unregistered transactions" and "failed to exercise reasonable supervision" over its brokers as they conducted inadequate inquiry into circumstances surrounding unregistered stock sales.[17]

During the period of these actions, Spencer Edwards was purchased by Dihle (the firm's president during the relevant period) who assumed sole responsibility for management of the firm.[18] A subsequent SEC examination in 2009 determined that Spencer Edwards *continued* to facilitate unlawful, unregistered distributions because of its failure to adequately inquire into customer penny stock sales.[19] In response to the examination findings, Dihle and Spencer

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[11] Tr. 1321-22 (Flemming).

[12] *E.g.*, *Earl L. Robbins*, Exchange Act Release No. 6246, 1960 SEC LEXIS 449, at *7-8 (Apr. 26, 1960).

[13] *Ronald S. Bloomfield*, Exchange Act Release No. 71632, 2014 SEC LEXIS 698, at *21 (Feb. 27, 2014), quoting *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953).

[14] *SEC v. China Energy Sav. Tech., Inc.*, 2009 U.S. Dist. LEXIS 133149, at *6-7 (E.D.N.Y. Mar. 9, 2009) quoting H. Rep. No. 101-617 (1990).

[15] *Charles F. Kirby*, 56 S.E.C. 44 (2003); JX-244.

[16] *John A. Carley*, Admin. Proc. File No. 3-11626, Initial Dec. Release No. 292, 2005 SEC LEXIS 1745, *aff'd*, Exchange Act Release No. 57246, 2008 SEC LEXIS 222 (Jan. 31, 2008), *aff'd in part, rev'd in part sub nom. Zacharias v. SEC*, 569 F.3d 458 (D.C. Cir. 2009); JX-245.

[17] JX-245, at 60-62.

[18] Tr. 53 (Biley); JX-253.

[19] Complainant's Exhibit ("CX-") 74.1.

Edwards explained to the SEC that its problematic practices occurred "under prior management" and that the firm was (1) "revising its procedures" to identify red flags that might signal illegal, unregistered distributions; (2) now documenting its inquiry and review process; and (3) providing training to its representatives on its new procedures.[20]

Nevertheless, an October 2011 SEC examination found—once again—that Spencer Edwards facilitated non-exempt unregistered offerings through customer penny stock sales, including certain of the offerings at issue in this case.[21] Spencer Edwards responded to the findings in a letter to the SEC asserting that it had, in fact, conducted a reasonable inquiry into the transactions "and was not aware of or could not have been aware of circumstances indicating that the person for whose account the securities are sold was an underwriter with respect to the securities or that the transaction was a part of a distribution of securities of the issuer."[22] Spencer Edwards emphasized that its policy "considered 5% or greater shareholders to be an affiliate [of the issuers]" and placed certain limitations on such affiliate sales as mandated by SEC Rule 144.[23]

C. Spencer Edwards' Procedures

There is no dispute that the stock sales at issue here were not pursuant to a registration statement.[24] In the absence of registration, Spencer Edwards typically permitted sales of customer securities deposited for public resale only after making a determination that the securities qualified for a registration exemption under the safe-harbor provisions of SEC Rule 144.[25]

Spencer Edwards' written supervisory procedures ("WSPs") in effect during the relevant period explain that "[e]ach registered representative has a duty to make reasonable inquiry under Rule 144 to determine whether the selling security holder acquired the securities to be sold under Rule 144 with distributive intent."[26] Because the Rule imposes volume, timing and other restrictions on sales of "restricted" or "control" securities, the procedures required registered representatives to account for a number of considerations to ensure that a customer selling stock was not in a control relationship with the issuer, or an "underwriter" who acquired his or her

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[20] JX-200.

[21] JX-212.1. A referral following this examination led to the investigation that resulted in this action. Tr. 1389 (Schellhorn).

[22] JX-213, at 5.

[23] JX-213, at 3.

[24] Complaint ("Compl.") ¶ 1; Answer ("Ans.") ¶ 1.

[25] 17 C.F.R. 230.144. Though not itself a statutory exemption from the registration requirements of the federal securities laws, Rule 144's safe harbor provides that where certain requirements are met, qualifying sales are deemed to be within other statutory exemptions provided by the Act.

[26] JX-201, at 50.

shares from the issuer "with a view to … distribution" prior to executing any sale transaction.[27] The WSPs directed registered representatives to consider, among other factors, how the shares proposed to be sold were acquired, how long they were held, and whether the seller had any arrangement or agreement with others in connection with the sale, or any relationship or connection with the issuer.[28]

The firm's procedures required it and its brokers to undertake substantial diligence before permitting public sale of deposited securities. Indeed, the firm's written policies incorporated a number of procedures provided by FINRA Regulatory Notice 09-05,[29] including requiring brokers to determine how long a customer has held a security; how the customer acquired the security; whether the customer intends to sell the same security through other means; and whether the customer had any arrangement or made any payment to anyone else in connection with the sale.[30] But in practice, the firm's brokers permitted customers to deposit certificated penny stocks and then liquidate the shares unless the customer owned more than 10 percent of the outstanding shares of the issuer.[31] With regard to the transactions at issue here, the firm's brokers made little effort to discern how the customer acquired the stock, or whether the customer had any agreement or other connection with the issuer or others to liquidate the stock.[32] Brokers relied on information provided by the customer on a securities deposit form.[33]

During the relevant period, the firm used a securities deposit form that requested certain customer information.[34] As called for by the firm's procedures, the form gathered information on, among other subjects, the amounts of stock being deposited, total shares of the issuer outstanding, whether other sales were contemplated, and whether the owner is an officer, director, affiliate, control person, or 5 percent owner of the issuer.[35] But significantly, the firm provided no written guidance to its brokers on how to use or evaluate the information. What guidance was provided did not call for additional steps to verify or further inquire into the information the customer provided.[36] Instead, the procedures called for the firm's Compliance Officer to review materials accompanying certificated stock deposits.[37] Spencer Edwards

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[27] JX-201, at 50.

[28] JX-201, at 50.

[29] JX-257.

[30] JX-203, at 51.

[31] Tr. 70-71, 78 (Biley).

[32] Tr. 70-71, 97-98 (Biley); Tr. 971 (Warga).

[33] Tr. 98-99 (Biley); Tr. 974-78 (Warga).

[34] The form was entitled "Deposited Securities Request Form." *See, e.g.*, JX-19, at 5.

[35] JX-28, at 3.

[36] *See* Tr. 98-99 (Biley); 1038 (Warga); JX-203. Later, in September 2011, following almost all of the trading at issue in this matter, Spencer Edwards supplemented its written supervisory procedures to include direction specific to the securities deposit forms. JX-204, at 127.

[37] *See* JX-203, at 51.

presented evidence that Dihle, the firm's Compliance Officer during the relevant period, did review each of the securities deposits now at issue.[38] But there was no evidence that Dihle "document[ed] his review and approval" as expressly required by the firm's procedures, and consequently, there was scant evidence of the nature or extent of Spencer Edwards' review of the circumstances of its customers' securities deposits and subsequent unregistered sales.[39]

D. Trading in Spencer Edwards Customer Accounts Controlled by RD

In January 2011, Spencer Edwards opened trading accounts for three entities, JLP&R Corp., BBC Financing, Inc., and Flash Funding Inc. All three accounts were referred to Spencer Edwards by the same individual, RD. The broker responsible for the accounts, Biley, regarded RD as the principal who controlled the brokerage accounts for each of the three entities, even though RD was not identified as an individual with authority over any of the accounts.[40]

Between January and March 2011, the three entity accounts deposited with Spencer Edwards certificated stock from four penny stock issuers: Encounter Technologies, Inc. (ticker symbol "ENTI"), Strategic Management & Opportunity Corp. ("SMPP"), All-State Properties Holdings, Inc. ("ATPT"), and Green Concepts, Inc. ("LKEN"). Shortly thereafter, the entities liquidated substantially all of these securities through public sales.

The selling activity took place almost immediately after RD made first contact with Spencer Edwards. The same day the entity accounts were opened, RD emailed paperwork to Spencer Edwards in support of a deposit of certificated LKEN stock into the JLP&R account.[41] The next day Spencer Edwards broker Biley corresponded directly with RD when the firm approved the deposit.[42] Within a week, BBC Financing deposited ENTI and ATPT, while JLP&R deposited shares of SMPP.[43]

According to Biley, RD "was very high pressure" and always insisted that securities liquidations and subsequent fund transfers out of Spencer Edwards were "time-sensitive."[44] Notwithstanding account documentation indicating other individuals as principals of the entity accounts (and not reflecting RD's authorization to direct any account activity), the evidence demonstrates that RD exercised control over each of the three entity accounts. RD referred the

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[38] Tr. 1131 (Choate).

[39] JX-203, at 52.

[40] Tr. 177-78; 190-96 (Biley).

[41] JX-87.

[42] JX-88.

[43] JX-19; JX-41; JX-49.

[44] Tr. 176 (Biley).

accounts;[45] he supplied deposit paperwork;[46] he directed the disbursement of funds from the accounts;[47] and he used email addresses associated with each of the three entities.[48] Indeed, when liquidations did not take place quickly, RD threatened to remove the entity accounts from Spencer Edwards and take his business elsewhere.[49]

Not only was the responsible broker, Biley, aware that RD controlled the entity accounts, Dihle, Biley's supervisor—charged with determining whether to approve deposits of securities at the firm—was *also* aware that RD was the principal behind these accounts.[50] Yet Spencer Edwards did nothing to satisfy its obligation to know its customer. It did not obtain even the most basic identification from RD.[51] Instead, it permitted RD to control each of these accounts nominally held in the names of others. Consequently, in determining the percentage of the total float of a particular security held in an entity account, Spencer Edwards did not aggregate the amount of the security held in other entity accounts, despite RD's common control over each of the accounts. Together, the three entities under RD's control liquidated millions of shares of penny stock securities in four of the six issuers. In total, the three entity accounts received $1.6 million in proceeds from the trades, yielding $80,000 in commissions for Spencer Edwards.[52]

1. Encounter Technologies

Encounter Technologies was a Colorado corporation that provided "end-to-end technology and online marketing services."[53] In its 2010 Annual Report the company reported revenues of $25,482 and expenses of $337,766.[54] At the time ENTI stock was deposited with Spencer Edwards, RD was the former CEO of the company, and his brother was the current CEO.[55] Despite RD's past association with ENTI and his brother's current role at the company, there was no evidence presented that either the broker or anyone else at Spencer Edwards made any inquiry as to RD's current role, if any, at the company or his brother's connection, if any, to RD's acquisition of the company's securities.[56]

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[45] Stip. ¶ 14.

[46] JX-85; JX-86; JX-87.

[47] JX-117; JX-124; JX-129; JX-133.

[48] Stip. ¶¶ 17-18; JX-113.

[49] Tr. 176-77 (Biley).

[50] Tr. 195-96 (Biley).

[51] Tr. 668-69 (Biley).

[52] Stip. ¶ 21.

[53] Stip. ¶ 40.

[54] *Id.*

[55] Compl. ¶ 58; Ans. ¶ 58.

[56] *See* Tr. 401-03 (Biley).

Stock certificates for ENTI were deposited into JLP&R, BBC Financing, and Flash Funding accounts along with documentation indicating that the entities acquired the shares after conversion of debt or preferred stock into common stock.[57] Although each of JLP&R, BBC Financing, and Flash Funding controlled less than 10 percent of the outstanding shares of ENTI, the three entities together controlled more than 10 percent of shares outstanding in the aggregate.[58] Under Spencer Edwards' policy of treating any individual or entity controlling 5 percent or more of the outstanding shares of an issuer as an affiliate of the issuer, the firm should not have permitted the entities' unrestricted sales of ENTI.[59] But shortly after accepting the stock for deposit, Spencer Edwards sold ENTI out of the three accounts without limitation into the public markets.[60]

Between January 2011 and April 2011, JLP&R, BBC Financing, and Flash Funding sold almost all[61] of the deposited ENTI shares into the market. The proceeds of the sales were transferred out of the three entity accounts at Spencer Edwards.[62]

2. Strategic Management & Opportunity

Strategic Management & Opportunity was a Nevada corporation headquartered in Clinton, Washington, that purported to be an "internet based marketing and advertising company."[63] In the spring of 2011, SMPP was not current in its public filings.[64]

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[57] Stip. ¶ 41.

[58] Compl. ¶ 63; Ans. ¶ 63. In light of the common control RD exercised over each of the three entity accounts, the percentage of ENTI ownership deposited to each entity account should have been aggregated for purposes of determining the percentage under RD's common control. *SEC v. Kern*, 425 F.3d 143, 150-51 (2d Cir. 2005) (securities "part of a joint scheme to acquire and transfer stock" properly aggregated for purposes of determining common control over an issuer).

[59] That the firm allowed unlimited sales of ENTI by the entities despite the firm's policy of limiting sales of those who own more than 5 percent of an issuer underscores Spencer Edwards' lack of meaningful review of the deposit forms. For instance, BBC Financing responded to a question on the securities deposit form by answering "no" to the question whether it was a 5 percent owner of ENTI. But the form elsewhere reflects that the entity deposited 600 million shares of the company's stock, and that the company had 9,038,548,421 outstanding shares. JX-19, at 5. A straightforward mathematical calculation should have revealed to the firm that the principal of the entity in fact controlled (at least) 6.6 percent of the ENTI's outstanding stock.

[60] CX-8.1.

[61] The only ENTI shares not immediately liquidated were shares transferred from Flash Funding to another Spencer Edwards customer, Belmont Partners, LLC. The principal of Belmont Partners operated a transfer agent that provided services to several penny stock issuers whose stock was liquidated through Spencer Edwards. Belmont Partners' account was opened in February 2011, the ENTI shares were transferred in shortly thereafter; the stock was then liquidated, and the proceeds were transferred out. Stip. ¶¶ 22-26. These sales resulted in an additional $3,000 in commissions for Spencer Edwards. Stip. ¶ 26.

[62] JX-2; JX-4; JX-6.

[63] Stip. ¶ 43.

[64] Tr. 1470-71 (Schellhorn); CX-27.

JLP&R and BBC Financing together deposited and liquidated approximately 780 million shares of SMPP, or at least 16 percent of the company's outstanding shares, through Spencer Edwards between January and March 2011.[65] According to the paperwork supporting the stock deposits, JLP&R acquired its stock from an entity that had a control relationship over SMPP.[66] The documents were signed on behalf of the controlling entity by RD's wife.[67] Despite the fact that the entities together controlled more than 5 percent of SMPP's outstanding shares, Spencer Edwards permitted the two accounts to sell SMPP stock without limitation into the public markets.[68] Immediately after liquidation, cash proceeds of SMPP sales were transferred out of Spencer Edwards.[69]

3. All-State Properties Holdings

All-State Properties Holdings ("ATPT") was a Nevada corporation headquartered in Lexington, Kentucky, that described its business as "attempting to locate and negotiate with eligible portfolio companies to acquire an interest in them."[70] The firm has generated no revenue since at least 2007.[71] As of March 2011, the firm had less than $5,000 in assets.[72] JLP&R and BBC Financing together deposited and liquidated approximately 600 million shares of ATPT through Spencer Edwards between January and March 2011.[73] Securities deposited into Spencer Edwards by BBC Financing were in fact acquired through a purported debt conversion involving JLP&R.[74]

Together, JLP&R and BBC Financing controlled at least 16 percent of the company's outstanding shares.[75] Despite the fact that the entities together controlled more than 5 percent of ATPT's outstanding shares, Spencer Edwards permitted the two accounts to sell SMPP stock without limitation into the public markets.[76] Immediately after liquidation, cash proceeds of ATPT sales were transferred out of Spencer Edwards.[77]

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[65] Stip. ¶¶ 44, 45.

[66] Tr. 592-95 (Biley).

[67] Tr. 592-600 (Biley).

[68] CX-8.1.

[69] JX-2; JX-4.

[70] Stip. ¶ 46.

[71] CX-28.1.

[72] JX-54.

[73] Stip. ¶ 54.

[74] CX-28.1; JX-54.

[75] Tr. 1485 (Schellhorn).

[76] CX-8.1.

[77] JX-2; JX-4.

4. Green Concepts

Based in Fresno, California, Green Concepts "manufactures and distributes a line of … consumer focused inkjet kits."[78] After acquiring ownership of more than 10 percent of the company's outstanding shares,[79] JLP&R and BBC Financing together deposited and liquidated approximately 500 million shares of stock through Spencer Edwards between January and March of 2011, generating more than $788,000 in proceeds.[80]

Once again, notwithstanding the fact that the entities together controlled more than 5 percent of Green Concepts' outstanding shares, Spencer Edwards contravened its own policy by permitting the two accounts to sell Green Concepts stock without limitation into the public markets.[81] Immediately after liquidation, cash proceeds of the sales were transferred out of Spencer Edwards.[82]

E. Trading in Other Spencer Edwards Customer Accounts

In March 2011—about the same time as the trading described above—Spencer Edwards opened trading accounts for two individual customers, JY and KN, as well as a corporate entity, TES Dragon, Inc.[83] A different broker, Warga, was responsible for these accounts.[84] These three accounts similarly deposited certificated penny stock securities with Spencer Edwards only to liquidate those positions shortly thereafter.

1. Healthnostics

Just after opening his account, Spencer Edwards customer JY acquired millions of shares of Healthnostics through a purported debt conversion.[85] Even a cursory review of the public filings of Healthnostics would have revealed that an entity called Carlthon Corporation controlled more than 10 percent of the company,[86] and that Customer JY controlled Carlthon as its CEO.[87] Thus, JY's Healthnostics holdings should have been aggregated with those of Carlthon.[88] Before depositing the Healthnostics shares with Spencer Edwards, JY transferred a

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[78] Stip. ¶ 56.

[79] Stip. ¶ 57.

[80] Stip. ¶ 58.

[81] CX-8.1.

[82] JX-2; JX-4.

[83] Stip. ¶¶ 30, 34.

[84] Stip. ¶¶ 31, 36.

[85] Stip. ¶ 59.

[86] Tr. 1501-02 (Schellhorn); CX-30.

[87] CX-55; CX-56.

[88] Tr. 1025 (Warga).

number of his shares to KN.[89] Together, JY and KN deposited and liquidated approximately 87 million shares of Healthnostics stock through Spencer Edwards between April 2011 and January 2012.[90] Spencer Edwards generated approximately $9,000 in commissions from the sales.[91]

Despite the fact that customer JY controlled more than 10 percent of Healthnostics stock, Spencer Edwards permitted JY to sell the company's stock without limitation into the public markets because it did not identify his role with Carlthon.[92] And despite the limitations otherwise required by Rule 144 on shares acquired from an affiliate, Spencer Edwards imposed no limitations on KN's sales because the firm failed to identify JY as an affiliate.[93]

2. Eastern Asteria

Eastern Asteria, Inc. ("EATR") is a Florida corporation purportedly involved in the "finishing and marketing of gemstone material and finished jewelry."[94] Entity TES Dragon deposited at Spencer Edwards approximately 280 million shares of Eastern Asteria stock in March 2011, and thereafter liquidated the stock by selling the securities to the public through August 2011.[95] Spencer Edwards generated approximately $1,700 in commissions from the sales.[96]

When depositing the stock, TES Dragon represented on the securities deposit form that it had never been "an officer, director, affiliate, control person or 5% owner of the issuer."[97] This representation was false, as TES Dragon did own over 10 percent of EATR prior to a recent share issuance by the company.[98] Warga could not recall an inquiry that he made into the circumstances of TES Dragon's acquisition of Eastern Asteria stock or whether there were arrangements or agreements between the entity and the company despite the fact that the principal of TES Dragon was the son of the EATR's CEO.[99] The company's CEO was also a long-time client of the broker, who was aware of his relationship with TES Dragon's principal.[100]

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[89] Stip. ¶ 60.

[90] Stip. ¶ 62.

[91] Stip. ¶ 33.

[92] Tr. 1021 (Warga).

[93] Tr. 1021 (Warga).

[94] Stip. ¶ 63.

[95] Stip. ¶ 71.

[96] Stip. ¶ 38.

[97] Tr. 1038 (Warga); JX-79.

[98] Stip. ¶ 69.

[99] Tr. 1036-37 (Warga).

[100] Tr. 1028 (Warga).

F. Spencer Edwards Failed to Supervise the Liquidations

Throughout the relevant period, Spencer Edwards' written supervisory procedures required each broker to make reasonable inquiry into penny stock deposits and subsequent sales by its customers. Yet the firm routinely did not follow its procedures in this regard. It failed to identify inconsistent and inaccurate information on securities deposit forms.[101] With respect to legal opinions submitted with securities deposits, the firm failed to recognize that opinions were submitted by the same attorney in connection with ENTI, SMPP, LKEN, and ATPT deposits, despite the fact that the attorney was on the list of "prohibited attorneys" promulgated by OTC Markets Group.[102] In addition, brokers regularly used personal email accounts to conduct firm business in direct contravention of the firm's written supervisory procedures.[103] As a result, the firm failed to preserve emails that constituted business records of the firm.[104]

The failures of Spencer Edwards' brokers were compounded by deficiencies in the firm's supervisory oversight. Dihle, the firm's CCO, reviewed monthly account statements and blotters to monitor the activity in customer accounts, and undertook a personal review of all stock certificates deposited into customer accounts.[105] Nonetheless, Dihle failed to recognize red flags or to conduct "searching inquiry" into unregistered distributions.[106] Dihle did nothing to investigate potential connections or relationships between customers and relevant issuers despite the fact that he knew that the responsible broker similarly made no inquiry.[107]

The firm also failed to satisfy its obligations to prevent money laundering. The firm's policies and procedures contain substantial boilerplate language and descriptions of pertinent regulatory standards and requirements. But the firm's policies were not tailored to the particulars of its business model, which is highly focused on the penny stock liquidation business.[108] The firm relied on its compliance officer's manual review of the pertinent transactions (without any documentation or other memorialization of what procedures were actually performed) while eschewing system-wide exception reports available to it that could have been used to identify red

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[101] *E.g.*, Stip. ¶¶ 67-68 (noting overstatement of shares outstanding of EATR on deposit form). Deposit forms were missing information on market value and average volume (Stip. ¶ 74), as well as the ownership history of the stock (Stip. ¶ 75). Deposit forms for ENTI, SMPP, ATPT and LKEN indicated on their face that the customers owned over five percent of the issuer despite indicating on the form that they did not. Stip. ¶ 76(d). Deposit forms for ATPT indicate that the company had never been a shell company despite SEC filings indicating that it was previously a shell. Stip. ¶ 76(e).

[102] Stip. ¶ 29.

[103] Stip. ¶¶ 90-92.

[104] Stip. ¶ 92.

[105] Stip. ¶¶ 77-78.

[106] Tr. 1138-41 (Choate).

[107] Tr. 193-94 (Biley).

[108] CX-79.1.

flags of violative activity in connection with each of the six issuer offerings at issue here.[109] The firm concedes that during the relevant period, it failed to have any exception reports targeted toward its penny stock business.[110] Nor did the firm generate any exception reports that adequately monitored for patterns of deposits and liquidations of unregistered securities necessary to adequately detect, investigate, and report suspicious activity.[111]

G. Spencer Edwards Failed to Remediate Its Shortcomings

At the hearing, the firm conceded numerous shortcomings in its policies and procedures during the relevant period, but contended that it has made substantial changes that make those shortcomings unlikely to recur.[112] The firm now delegates the review of all customer securities deposits to an attorney outside the firm who makes the determination whether to accept a particular deposit.[113] The firm determined that delegation to outside counsel was necessary because the firm's current Compliance Officer, Flemming, does not believe that she or anyone else at the firm is qualified to adequately review penny stock deposits in a manner adequate to ensure compliance with the securities laws.[114] Although Flemming's signature appears on securities deposit packets reflecting her approval of deposits, the signature was in fact supplied by others at the firm using a signature stamp; Flemming conducted no actual review of the deposits.[115]

As a part of the firm's outside delegation to counsel, the firm provides counsel a securities deposit packet and supporting documentation for each transaction. Counsel then determines whether or not the firm should accept the deposit.[116] The outside counsel conducts his "review" without regard to the firm's written supervisory procedures or its AML policies;[117] he is not provided access to customer trading information;[118] he is not provided access to the client, or even the broker that interacts with the client.[119] The lawyer is compensated by a flat fee of $120 per review.[120] His review [redacted] to any supervision, oversight, or review by anyone

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[109] CX-79.1

[110] Stip. ¶ 89.

[111] *Id.*

[112] Tr. 74-77 (Biley); Tr. 1295-1301 (Flemming).

[113] Tr. 1335-36 (Flemming).

[114] Tr. 1308-09 (Flemming).

[115] Tr. 1207-08 (Choate).

[116] Tr. 1335-36 (Flemming).

[117] Tr. 1858-59 (Sawyer).

[118] Tr. 1335-36 (Flemming).

[119] Tr. 1839-41 (Sawyer).

[120] Tr. 1844 (Sawyer).

at the firm.[121] The firm has never sought to obtain from counsel any records or the attorney's notes documenting his reviews of securities deposits.[122] The firm undertakes this procedure notwithstanding its awareness that under the pertinent regulatory regime, it is not permitted to contract its supervisory and compliance obligations away from its direct control.[123]

The firm today relies exclusively on counsel's review for deposits of certificated penny stocks. Following its receipt of preliminary findings of SEC staff in 2012 that identified numerous deficiencies in its procedures associated with its penny stock business, current management conducted no internal investigation or other inquiry into the shortcomings identified by the SEC;[124] never spoke to the brokers involved regarding the conduct at issue;[125] never reviewed the firm's response to the SEC;[126] and did nothing to ascertain the truth of the findings or implement procedures to remediate potential issues identified by the SEC staff.[127]

III. Conclusions of Law

A. Spencer Edwards' Evidentiary Objections Are Overruled

At the hearing, Spencer Edwards made a general objection to unspecified portions of the evidence offered by Enforcement, contending that the firm was being required to defend against what it asserted were facts beyond the scope of the allegations of the Complaint. The Hearing Panel directed the firm to make a written submission where it was to "identify the facts in evidence that you believe are beyond the scope of the allegations in the complaint and explain why you think they are beyond the allegations in the complaint."[128]

In its submission, the firm claims that Enforcement "argued and elicited evidence … such as the failure to do google searches on customers, training of registered representatives, using attorneys on the OTC Markets prohibited list, customers having accounts at other firms, information on forms being whited out and written over, signatures being copied, increases in shares issued by various issuers, customer signatures predating the opening of accounts,

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[121] Tr. 1336 (Flemming).

[122] Tr. 1848 (Sawyer).

[123] Tr. 1337 (Flemming).

[124] Tr. 1311 (Flemming).

[125] Tr. 1312 (Flemming).

[126] Tr. 1312-13 (Flemming).

[127] Tr. 1312-15 (Flemming).

[128] Tr. 2040. The Hearing Officer notes that most of the facts in dispute pertain to proof of exemptions from registration, which are in the nature of affirmative defenses that must be proven by respondent. The law is clear that a complainant is not required to plead facts that negate all (or any) conceivable affirmative defenses. *E.g.*, *Rosen v. Brookhaven Capital Mgmt. Co.*, 194 F. Supp. 2d 224, 227-28 (S.D.N.Y. 2002) ("[A] complaint should contain allegations that support [any asserted] claim, but a plaintiff has no obligation to anticipate and refute potential affirmative defenses.").

aggregating the shares of TES Dragon with the chief executive officer of Eastern Asteria because they were father and son, a customer entering into a transaction before the customer was formally formed as an entity, and whether Healthnostics was a shell company."[129]

FINRA Rule 9212(a) requires that a Complaint "specify in reasonable detail the conduct alleged to constitute the violative activity and the rule, regulation, or statutory provision the Respondent is alleged … to have violated." To meet this standard, Enforcement need not include evidentiary details in the Complaint,[130] and the "complaint need not specify all details regarding a case against a respondent."[131] The Complaint's allegations need only "provide a respondent sufficient notice to understand the charges and adequate opportunity to plan a defense."[132]

Here, we conclude that the detailed, 33-page, 214-paragraph Complaint gave Spencer Edwards adequate notice of the claimed misconduct. Spencer Edwards knew from the Complaint's allegations precisely the transactions at issue; and it knew that Enforcement alleged that it had not properly taken into account the factual circumstances surrounding the specific transactions in considering the applicability of exemptions from registration, as reflected in its own books and records. The Complaint adequately detailed the misconduct.[133]

We further note that by and large, our factual findings rest on allegations beyond the scope of the firm's objection and clearly set forth in the Complaint. Of the multitude of factual circumstances Spencer Edwards objected to, the only challenged fact reflected in our findings above relates to the firm's reliance on an attorney opinion letter despite the fact that the attorney appeared on the OTC Markets prohibited list. As Spencer Edwards *stipulated* to this fact in a joint pre-hearing submission, it cannot now be heard to complain that it is somehow surprised by our consideration of the evidence.[134] Spencer Edwards' objection is overruled.

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[129] Spencer Edwards' Post-Hearing Brief, pp. 7-8.

[130] OHO Order 09-05 (2008012955301) (Dec. 16, 2009) at 3, http://www.finra.org/sites/default/files/OHODecision/p121082_0_0_0.pdf.

[131] *Dep't of Enforcement v. Zenke*, No. 2006004377701, 2009 FINRA Discip. LEXIS 37, at *11 n.7 (NAC Dec. 14, 2009) (citing *Wanda P. Sears*, Exchange Act Release No. 58075, 2008 SEC LEXIS 1521, at *11 (July 1, 2008)).

[132] OHO Order 09-05 at 2 (quoting *Dist. Bus. Conduct Comm. v. Euripides*, No. C9B950014, 1997 NASD Discip. LEXIS 45, at *10 (NBCC July 28, 1997)); OHO Order 10-04 (2008014621701) (July 12, 2010) at 3, http://www.finra.org/sites/default/files/OHODecision/p122653_0_0_0_0.pdf ("The standard is whether the Complaint discloses enough information to enable a respondent to plan his or her defense.").

[133] See *Murray Sec. Corp.*, 37 S.E.C. 780, 782 (1957) ("[T]he period covered in the order for proceedings is sufficiently short that the registrant, once apprised of the names of the securities, should be able to derive other needed information, such as the identity of the persons by and to whom the representations were made, from its books and records and its own personnel.").

[134] *See* Stip. ¶ 29. *Dep't of Enforcement v. Berry-Shino Sec., Inc.*, No. C3A030001, 2003 NASD Discip. LEXIS 61, at *32-33 (OHO Dec. 10, 2003) ("Even if a charge is not clearly articulated in the Complaint, it may be adequately clarified during the pre-hearing process and a respondent may be held liable if it is clear that the respondent had adequate notice of the charge and a fair chance to defend.").

B. Spencer Edwards Violated FINRA Rule 2010 by Selling Unregistered Securities in Violation of Section 5 of the Securities Act

1. Enforcement Established a Prima Facie Case for a Violation of Section 5 of the Securities Act

Sections 5(a) and (c) of the Act prohibit the "sale" and "offer for sale" of any security unless a registration statement is in effect or there is an applicable exemption from registration requirements. The purpose of the registration requirement is to "protect investors by promoting full disclosure of information thought necessary to informed investment decisions."[135] A violation of Section 5 of the Act constitutes a violation of FINRA Rule 2010.[136]

Prima facie proof of a Section 5 violation requires a showing that (1) no registration statement was in effect as to securities; (2) Respondent sold the securities; and (3) interstate transportation or communications were used in connection with the sale.[137] Proof of scienter is not required because "[t]he Securities Act of 1933 imposes strict liability on offerors and sellers of unregistered securities."[138]

Liability under Section 5 extends not only to those who engage in the actual sale of securities, but also those who engage in significant steps in the distribution process. Anyone who is a "necessary participant" or a "substantial factor" in the unlawful transaction, including a selling broker, violates Section 5.[139]

The facts here sufficiently establish a *prima facie* case—Spencer Edwards sold unregistered shares of each of the six different issuers on behalf of its customers using means or instruments of transportation or communication in interstate commerce without registration statements in effect.[140]

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[135] *SEC v. Ralston Purina Co.*, 346 U.S. 119, 124 (1953).

[136] *Alvin W. Gebhart, Jr.*, Exchange Act Release No. 53136, 2006 SEC LEXIS 93, at *54 n.75 (Jan. 18, 2006) *rev'd and remanded in part on other grounds*, 255 F. App'x 254 (9th Cir. 2007) ("Further, because we have consistently held that a violation of a Commission or NASD rule or regulation is inconsistent with just and equitable principles of trade, we find that the [Respondents'] sale of the unregistered [] notes also constitutes a violation of NASD Conduct Rule 2110."); *Stephen J. Gluckman*, Exchange Act Release No. 41628, 1999 SEC LEXIS 1395, at *185 (July 20, 1999); *see William H. Gerhauser*, 1998 SEC LEXIS 2402, at *20-21 (Nov. 4, 1998).

[137] *Rodney R. Schoemann*, 2009 SEC LEXIS 3939, at *20-21 (Oct. 23, 2009); *Gebhart*, 2006 SEC LEXIS 93, at *53.

[138] *Schoemann*, 2009 SEC LEXIS 3939, at *22, n.13 (citing *Swenson v. Engelstad*, 626 F.2d 421, 424 (5th Cir. 1980)); *SEC v. Calvo*, 378 F.3d 1211, 1215 (11th Cir. 2004).

[139] *Zacharias*, 569 F.3d at 467 (finding Spencer Edwards broker who accepted customer orders, completed Rule 144 forms, and ensured that proceeds were wired to clients was a "substantial factor" in Section 5 violation); *see also Calvo*, 378 F.3d at 1215; *SEC v. Murphy*, 626 F.2d 633, 649-52 (9th Cir. 1980); *SEC v. Universal Express, Inc.*, 475 F. Supp. 2d 412, 422 (S.D.N.Y. 2007), *aff'd sub nom. SEC v. Altomare*, 300 F. App'x 70 (2d Cir. 2008) (per curiam) (unpublished), *cert. denied*, 129 S. Ct. 2745 (2009); *Owen v. Kane*, 48 S.E.C. 617, 621 (1987).

[140] Stip. ¶¶ 82-84.

2. Spencer Edwards Failed to Establish that the Transactions Were Exempt from Registration

Once *prima facie* proof of a violation is shown, the burden shifts to Spencer Edwards to demonstrate that the questioned transactions qualify for an exemption.[141] "Exemptions from registration are affirmative defenses that must be established by the person claiming the exemption."[142] And any exemption must be "construed narrowly 'in order to further the purpose of the Act: To provide full and fair disclosure of the character of the securities, and to prevent frauds in the sale thereof.'"[143] Evidence supporting a claimed exemption must be "explicit, exact, and not built on mere conclusory statements."[144]

Spencer Edwards contends that the relevant transactions were exempt from registration under Sections 4(a)(1) and (4) of the Securities Act.[145] The first of these exemptions, Section 4(a)(1), exempts from registration any transaction by a person other than an "issuer, underwriter, or dealer." Spencer Edwards claims to have relied "on the safe harbor established by Rule 144, which establishes requirements that, if met, creates a 'safe harbor' in which the seller of securities is deemed not to be an 'underwriter' for purposes of Section 4(a)(1)."[146] The firm also claims to be entitled to the broker's exemption provided by Section 4(a)(4), which exempts transactions by "brokers who have made a sufficient inquiry to determine whether a transaction executed on a customer's order which is not solicited."[147]

(a) Spencer Edwards Is Not Entitled to the Section 4(a)(1) Exemption

We find at the outset that Spencer Edwards cannot rely upon the Section 4(a)(1) exemption. This exemption—sometimes referred to as "the exemption for nonprofessionals"[148]—is "intended to exempt routine trading transactions between individual investors with respect to securities already issued and not to exempt distributions by issuers or acts of other individuals who engage in steps necessary to such distributions."[149] Notwithstanding its claim that its customers were not "issuers" or "underwriters" as contemplated by Section 4(a)(1), the exemption applies only to persons "other than an issuer,

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[141] *Gebhart*, 2006 SEC LEXIS 93, at *53; *SEC v. Cavanagh*, 1 F. Supp. 2d 337, 361-63 (S.D.N.Y. 1998), *aff'd*, 155 F.3d 129 (2d Cir. 1998); *Carley*, 2005 SEC LEXIS 1745, at *87 (citing *Swenson*, 626 F.2d at 425).

[142] *Carley*, 2008 SEC LEXIS 222, at *24.

[143] *SEC v. Platforms Wireless Int'l Corp.*, 617 F.3d 1072, 1086 (9th Cir. 2010) (citing *SEC v. Murphy*, 626 F.2d 633, 641 (9th Cir. 1980)).

[144] *Robert G. Weeks*, 56 S.E.C. 1297, 1322 (2003).

[145] Spencer Edwards Pre-Hr'g Br., p. 1.

[146] Spencer Edwards Pre-Hr'g Br., p. 6.

[147] *Id.*

[148] Thomas L. Hazen, THE LAW OF SECURITIES REGULATION, § 4.26 at p. 207 (5th ed. 2005).

[149] *Carley*, 2008 SEC LEXIS 222, at *26.

underwriter, *or dealer*." Whether or not its clients fell within the statutory definition of an issuer or underwriter, Spencer Edwards was a dealer in the context of the relevant transactions, as it acted as a broker offering its customers' securities for sale.[150] The law is clear that a broker like Spencer Edwards may not avail itself of the Section 4(a)(1) exemption.[151]

(b) Spencer Edwards Is Not Entitled to the Section 4(a)(4) Exemption

While Spencer Edwards may not invoke the Section 4(a)(1) exemption, its contention that its customers were exempt because they were not issuers or underwriters bears on the firm's claim that the transactions at issue were ordinary market transactions that it facilitated as broker pursuant to the Section 4(a)(4) exemption for "brokers' transactions executed upon customers' orders on any exchange or in the over-the-counter market but not the solicitation of such orders."[152]

The Section 4(a)(4) exemption, designed to exempt ordinary brokerage transactions, "is not available to a registered representative if he knows or has reasonable grounds to believe that the selling customer's part of the transaction is not exempt from Section 5 of the Securities Act."[153] The exemption is available only if the broker conducts an inquiry adequate to determine if the securities may be sold lawfully. The SEC explained a broker's duty to investigate in a widely cited 1962 release:

> The amount of inquiry called for necessarily varies with the circumstances of particular cases. A dealer who is offered a modest amount of a widely traded security by a responsible customer, whose lack of relationship to the issuer is well known to him, may ordinarily proceed with considerable confidence. On the other hand, when a dealer is offered a substantial block of a little-known security, either by persons who appear reluctant to disclose exactly where the securities came from, or where the surrounding circumstances raise a question as to whether or not the ostensible sellers may be merely intermediaries for controlling persons or statutory underwriters, then searching inquiry is called for.

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[150] *See* Securities Act § 2(a)(12) ("The term 'dealer' means any person who engages either for all or part of his time, directly or indirectly, as agent, broker, or principal, in the business of offering, buying, selling, or otherwise dealing or trading in securities issued by another person.").

[151] *Quinn & Co., Inc.*, 44 S.E.C. 461, 467 (1971), *aff'd*, 452 F.2d 943 (10th Cir. 1971) ("Clearly the exemption in Section 4(1) was not available to [the broker], for it was in any event a dealer as defined in the Act. Accordingly, it must find its exemption, if any, under the provisions of Section 4(3) or Section 4(4) providing exemptions for dealers and brokers."). Though the Act provides two distinct exemptions for brokers and dealers, Spencer Edwards asserts only that the relevant transactions qualified for the brokers' exemption found in Section 4(a)(4).

[152] *See* Hazen, THE LAW OF SECURITIES REGULATION, § 4.26[1] at p. 208 ("[S]ection 4(1) must be read in tandem with section 4(3)'s exemption for most dealers' transactions and section 4(4)'s exemption for unsolicited brokers' transactions.").

[153] *Carley*, 2008 SEC LEXIS 222, at *34; *Jacob Wonsover*, 54 S.E.C. 1, 26 (1999), *petition for review denied*, 205 F.3d 408 (D.C. Cir. 2000).

> The problem becomes particularly acute where substantial amounts of a previously little known security appear in the trading markets within a fairly short period of time and without the benefit of registration under the Securities Act of 1933. In such situations, it must be assumed that these securities emanate from the issuer or from persons controlling the issuer, unless some other source is known and the fact that the certificates may be registered in the names of various individuals could merely indicate that those responsible for the distribution are attempting to cover their tracks.[154]

Precedents considering the applicability of the broker's exemption emphasize that "[a] broker relying on Section 4(4) cannot merely act as an order taker, but must make whatever inquiries are necessary under the circumstances to determine that the transaction is only a normal 'brokers' transaction' and not part of an unlawful distribution."[155] Although brokers are not required to be "finished scholars in the metaphysics" of the Securities Act, "familiarity with the rudiments is essential."[156]

We are not persuaded by Spencer Edwards' showing that it was entitled to the broker's exemption. As set forth above, the evidence established that for each of the transactions at issue, Spencer Edwards' customers controlled at least 10 percent of the issuer's outstanding stock at the time of sale, supporting at least a reasonable inference that the customers were "affiliates" of the issuer, necessitating careful scrutiny of the transaction for potential control relationships between the customer and issuer for purposes of determining whether the transactions were exempt.[157] Spencer Edwards dismisses such control as inadequate to confer affiliate status, noting that an "affiliate" is defined as someone who directly or indirectly controls, or is controlled by, or is under common control with the issuer.[158] The firm argues that nothing in this definition provides

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[154] Distribution by Broker-Dealers of Unregistered Securities, Exchange Act Release No. 6721, 1962 SEC LEXIS 74, at *4-5 (Feb. 2, 1962). The standards set forth in this 1962 release have been cited in numerous cases involving sales of unregistered securities by registered representatives. *See, e.g.*, *Geiger v. SEC*, 363 F.3d 481, 485 (D.C. Cir. 2004); *Wonsover*, 205 F.3d at 415; *see also* FINRA Regulatory Notice 09-05, at 4 (Jan. 2009), http://www.finra.org/industry/notices/09-05.

[155] *Robert G. Leigh*, 50 S.E.C. 189, 193 (1990); *see also* Sales of Unregistered Securities by Broker-Dealers, Exchange Act Release No. 9239, 1971 SEC LEXIS 19, at *7-8 (July 7, 1971).

[156] *Paul L. Rice*, 45 S.E.C. 959, 961 (1975); *see also Leigh*, 50 S.E.C. at 193; *Robert Stead*, Admin Proc. No. 3-1958, 1971 SEC LEXIS 3977, at *98 (Dec. 21, 1971) ("Indeed, such a professional has a duty to be familiar with the registration requirements of the Securities Act as well as the circumstances under which an exemption from such requirements is available."); *Quinn & Co.*, 44. S.E.C. at 469; *Stone Summers & Co.*, 45 S.E.C. 105, 109 (1972) ("We have previously emphasized that broker-dealers have a responsibility to be aware of the requirements necessary to establish an exemption from the registration requirements of the Securities Act and should be reasonably certain such an exemption is available.").

[157] For purposes of the registration requirements of the Act, an affiliate is regarded as the functional equivalent of the issuer itself. *SEC v. Cavanagh*, 445 F.3d 105, 111 n.12 (2d Cir. 2005).

[158] An "affiliate" is "a person that directly, or indirectly through one or more intermediaries, controls, or is controlled by, or is under common control with, [an] issuer." 17 C.F.R. § 230.144 (a)(1).

that "control" exists, or is even presumed to exist, where a person merely owns 10 percent or more of an issuer's outstanding shares.[159]

Spencer Edwards claims that it was in fact Enforcement's burden to demonstrate that firm customers exercised actual control over the pertinent issuers, irrespective of the percentage of customer ownership, in order to raise an inference that the customers were issuer affiliates. It argues that as to certain transactions, "persons not alleged to have any relationship with [firm customer RD] own controlling interests in those issuers far in excess of any amount of shares" attributed to the RD-controlled entities.[160] Spencer Edwards maintains that it need not "disprove every fact or circumstance which might obviate the existence of an exemption," and need only "demonstrate the facial requirements of an exemption" before the burden returns to Enforcement to show that the transactions were not exempt.[161]

But the firm never explains how it demonstrates even the "facial requirements" of an exemption applicable only where its customers were *not* issuers or affiliates—the burden was "clearly upon [the firm] to prove" its customers were within the scope of the exemption.[162] This means that "[w]here … the critical factor determining the availability of an exemption is whether the shares in question emanated from a person in a control relationship with the issuer, *one asserting the exemption must show the absence of control*."[163] Where a customer of the firm controls 10 percent or more of the outstanding securities of a company, such control is, at a minimum, a "fact which must be taken into consideration" in determining whether the customer may be an affiliate of the company.[164]

Spencer Edwards did not prove that it took into meaningful consideration the degree of control its customers exercised over the relevant companies.[165] It conducted no documented review or assessment of the surrounding facts that might be probative of control, even in the face of substantial customer ownership of each of the relevant securities. And its failure occurred after the firm specifically represented to the SEC in response to its 2009 examination that in light of past problems it would maintain "documentation of the reasonable inquiry and the review process."[166] Its after-the-fact suggestion that others may "own controlling interests" in the

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[159] *But see Cavanagh*, 445 F.3d at 113 n.19 ("Although there is no bright-line rule declaring how much stock ownership constitutes 'control' …, some commentators have suggested that ownership of something between ten and twenty percent is enough, especially if other factors suggest actual control.").

[160] Spencer Edwards Pre-Hr'g Br., p. 8.

[161] Spencer Edwards Pre-Hr'g Br., p. 5, citing *Busch v. Carpenter*, 827 F.2d 653, 657 (10th Cir. 1987).

[162] *Quinn & Co.* 452 F.2d at 946.

[163] *Wittow & Co.*, 44 S.E.C. 666, 671-72 (1971) (emphasis supplied).

[164] *American Standard No-Action Letter*, 1972 SEC No-Act LEXIS 3787, at *1 (Oct. 11, 1972).

[165] The firm stipulated that the three RD-controlled entities collectively controlled more than 10 percent of each of the relevant issuers, and that TES Dragon controlled more than 10 percent of EATR. Stip. ¶¶ 20, 44, 69; Compl. ¶¶ 63, 91; Ans. ¶¶ 63, 91.

[166] JX-200, at 2.

relevant issuers did not relieve the firm of its duty to inquire into the circumstances of the transactions, including the degree of corporate control possessed by its clients.[167] Indeed, its own internal policies *required* Spencer Edwards to treat a customer controlling 5 percent or more of a company's securities as an "affiliate."[168] And for each of the transactions at issue, it did not do so. The firm never explained why it failed to follow its own policies.[169]

Spencer Edwards' failure to carefully scrutinize the transactions is compounded by numerous red flags that suggested the existence of control or an otherwise collusive relationship[170] between the firm's clients and the issuers, or called into question whether the securities acquisition transactions were arms-length, including (a) a close familial relationship between customer RD and the CEO of ENTI; (b) customer RD's wife serving as a director to an entity with a control relationship with SMPP; (c) a close familial relationship between the principal of the entity TES Dragon and the CEO of EATR; and (d) customer use of legal opinion letters in connection with securities deposits for ENTI, SMPP, LKEN, and ATPT from an attorney on the OTC Markets Group "prohibited attorney" list.

Indeed, the firm does not dispute that the multitude of red flags surrounding the transactions warranted careful scrutiny. It instead argues that the red flags were "irrelevant," because Spencer Edwards "treated all deposits of stock as potentially involving an illegal distribution."[171] It claimed to have "implemented rigorous requirements" such as collecting customer documentation that "included not only opinions of counsel regarding the existence of an exemption, but copies of the documents reflecting how [the firm's] customers (or potential customers) had obtained the shares so that the factual bases for a claimed exemption could be

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[167] *See Wittow & Co.*, 44 S.E.C. at 671 (fact that another individual controlled 70 percent of company's shares by proxy did not negate potential "control" of 10.6 percent owner; broker violated Section 5 by failing to make "careful inquiry" into the relationship). There was no proof that Spencer Edwards' brokers were even aware of relative percentages of ownership, given their lack of inquiry across each of the relevant transactions. Tr. 77 (Biley); Tr. 1017-18 (Warga).

[168] The evidence was unclear as to whether in practice the firm policy applied to 5 percent owners or 10 percent owners during the relevant period. *See* Tr. 86-95 (Biley). Because the customers here owned more than 10 percent of the relevant issuers' outstanding shares, the disregarded policy should have limited the relevant customer sales under either formulation.

[169] *See* Tr. 1140-41 (Choate).

[170] Section 4(a)(1) also excludes transactions by "underwriters," defined as those who either obtain securities from an issuer "with a view to distribution," or directly or indirectly offer or sell for an issuer. Section 2(a)(11). Respecting almost all of the transactions at issue, Spencer Edwards never investigated the possibility that its customers, even if not in a "control" relationship with an issuer, worked in concert with the issuer as part of an unregistered issuer distribution. With regard to the Healthnostics shares sold by customer JY, Spencer Edwards argues that based on the date of JY's acquisition, the stock had "come to rest" with him such that he did not acquire the stock with a "view toward distribution." Spencer Edwards Pre-Hr'g Br., pp. 11-12. But Spencer Edwards never persuasively explained why JY—who controlled more than 10 percent of Healthnostics stock—was not an affiliate of the company. It therefore failed to establish that JY's sales—or the sales of customer KN who acquired his Healthnostics stock from JY, a 10 percent owner shortly before public sales—were exempt.

[171] Spencer Edwards Pre-Hr'g Br., p. 3.

verified."[172] But the firm never "verified" anything. For instance, the stock deposit documents for the four issuers sold through the RD entity accounts purport to identify the entities as owners of the stock, *but the firm never identified RD*, who controlled the three accounts despite the fact that he is nowhere reflected as an owner of the accounts. Having failed to even identify the individual controlling the accounts selling the securities, Spencer Edwards cannot show that it conducted a "searching inquiry" into whether this individual had a control relationship with the relevant issuers.[173]

We regard Spencer Edwards' approach to these transactions as little more than papering its file with a checklist of customer-provided documents without undertaking any genuine review of the significance of the information found in the documents, or verification of these materials to determine whether its clients had a connection with the relevant issuers that potentially undermined an exemption. Its failure to carefully scrutinize or assess its customers' statements in connection with the relevant transactions is fatal to its current assertions. The law is clear that "[w]hen a broker is faced with recurring red flags suggesting that its customer is engaging in unregistered distributions of securities, it cannot satisfy its reasonable inquiry obligations by relying on the mere representations of its customer, the issuer, or counsel for the same, without reasonably investigating the potential for opposing facts."[174]

Consequently, we conclude that for each of the relevant securities sales, Spencer Edwards failed to adequately satisfy its obligation to make searching inquiry into the existence of a valid exemption from registration. Accordingly, the firm did not meet its burden of proving that it was entitled to rely on the brokers' exemption provided by Section 4(a)(4) of the Act.

Spencer Edwards' unregistered sales of securities for its customers in each of the six issuers were not subject to any valid exemption. Accordingly, the sales were in violation of Section 5 of the Act and therefore inconsistent with just and equitable principles of trade in violation of FINRA Rule 2010.

C. Spencer Edwards Violated NASD Rule 3010 and FINRA Rule 2010 by Failing to Reasonably Supervise Its Penny Stock Liquidation Business

The second cause of action alleges that Spencer Edwards violated NASD Rule 3010 and FINRA Rule 2010 by failing to establish and maintain a supervisory system, including WSPs, reasonably designed to ensure compliance with Section 5 of the Act.

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[172] *Id.*

[173] Spencer Edwards also argues that its sales of ENTI for Belmont Partners were exempt, but concedes that this conclusion is predicated upon the conclusion that customer RD—who transferred the shares to Belmont Partners shortly before its public sales—was not an "affiliate" of ENTI. Spencer Edwards Pre-Hr'g Br., p. 9. As set forth above, Spencer Edwards has failed to demonstrate that RD was not an affiliate.

[174] *E*Trade Sec., LLC*, Exchange Act Release No. 73324, 2014 SEC LEXIS 3846, *19 (Oct. 9, 2014).

NASD Rule 3010 (a) requires firms to "establish and maintain a system to supervise activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." Under NASD Rule 3010(b), these systems must be documented in the firm's WSPs. The procedures also must be tailored to the business lines in which the firm engages.[175] In addition, the procedures must set out mechanisms for ensuring compliance and for detecting violations, not merely set out what conduct is prohibited.[176]

The evidence established that Spencer Edwards failed to devise and maintain supervisory systems adequate to ensure that the firm complied with the requirements of Section 5 of the Act, even though a substantial proportion of its business involved liquidating shares of penny stocks deposited in certificated form. Despite its written supervisory procedures that required the firm to gather adequate information to identify its customers, Spencer Edwards failed to gather any information at all verifying the identity of RD, who exercised control over the three entity accounts described above that engaged in unlawful trading. Notwithstanding the fact that RD exercised control over accounts responsible for millions of dollars of penny stock sales, firm policies regarding the acceptance of instructions regarding account trading and disposition of funds received from third parties were disregarded.

Despite Spencer Edwards' purported reliance on SEC Rule 144's safe-harbor provisions to permit its penny stock sales, the firm's supervisory systems lacked adequate procedures to ensure its compliance with the Rule. The firm relied upon customer answers to a questionnaire on stock certificate deposit forms as a primary means of obtaining information about penny stock deposits, but failed to undertake any meaningful review of those answers even in the face of red flags suggesting further inquiry. And despite its stated policy of treating any person holding more than 5 percent of an issuer's outstanding stock as a control person—and thus an affiliate—of the company whose stock sales should have been subject to limitations, it repeatedly permitted unrestricted selling by individuals and entities that controlled more than 5 percent of outstanding issuer stock. The firm permitted certificated stock to be deposited where certain of the information requested from the customer on the deposit form was left blank. It failed to identify inconsistent and inaccurate information on securities deposit forms. And after a security was deposited, it conducted no review or analysis to satisfy itself that subsequent sales were exempt. The firm's procedures, as implemented, were inadequate for the needs of its business and directly resulted in its registration violations.

In particular, Dihle, the firm's CCO, reviewed monthly account statements and blotters, and oversaw all stock certificates deposited into customer accounts. Thus, Dihle had notice that Biley's and Warga's customers deposited large quantities of shares in each of the six issuers for immediate liquidation. He also knew that each company was a penny stock that had minimal

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[175] *See* NASD Membership and Registration Rule Interpretive Material ("IM") 3010-1, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=4396.

[176] *See Gary E. Bryant*, 51 S.E.C. 463, 471 (1993); *John A. Chepak*, 54 S.E.C. 502, 506 (2000); *A.S. Goldmen & Co.*, 55 S.E.C. 147, 166 (2001).

public trading before the shares were deposited with Spencer Edwards. Dihle further knew that Biley's and Warga's customers began selling the stock and immediately wiring out proceeds from those sales from the relevant accounts. Indeed, activities of this sort comprised a majority of Spencer Edwards' business. Nonetheless, Dihle failed to recognize red flags associated with the transactions, and failed to conduct adequate inquiry regarding the unregistered distributions of each of the six issuers. Dihle failed to adequately investigate the source of relevant securities despite the fact that he was aware that brokers in charge of the accounts similarly made no inquiry. Despite the firm's history of substandard diligence, and its awareness of regulatory expectations as a result of prior examinations and enforcement actions, Dihle and Spencer Edwards abdicated responsibility for assessing sales activities in connection with the relevant liquidations.

Spencer Edwards' supervisory failures were not limited to its non-compliance with the registration requirements of the federal securities laws. It also failed to ensure that proper records were maintained as a result of its employees transacting substantial firm business using personal email accounts. Both Biley and Warga transacted firm business using personal email accounts. Biley in particular used a personal email account systematically during the relevant period, including communications to his supervisor, Dihle. Upon receiving emails from a personal email address, Dihle was on notice that Spencer Edwards' policies that required brokers to use a firm email address at all times were being violated. He nevertheless took no action to enforce firm policies requiring business-related communications to be transacted through firm email accounts.

In light of the foregoing, we conclude that Spencer Edwards violated NASD Rule 3010 and FINRA Rule 2010 by failing to establish and maintain a supervisory system reasonably designed to ensure compliance with recordkeeping requirements, as well as compliance with Section 5 of the Act by failing to prevent the unregistered, non-exempt securities offerings.

D. Spencer Edwards' AML Policies and Procedures Were Inadequate

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 (2001). Title III of the PATRIOT Act imposes added obligations on broker-dealers under AML provisions and amendments to the Bank Secrecy Act requirements.[177] In April 2002, the SEC approved NASD Rule 3011, now FINRA Rule 3310, that sets forth the minimum standards required for each FINRA member firm's AML compliance program.[178] FINRA Rule 3310(b) requires that AML programs, at a minimum, "establish and implement policies, procedures, and internal controls reasonably designed to achieve compliance with the Bank Secrecy Act and the implementing regulations."[179]

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[177] *See* 31 U.S.C. §§ 5311 et seq.

[178] *See* Order Approving Proposed Rule Changes Relating to Anti-Money Laundering Compliance Programs, Exchange Act Release No. 45798, 2002 SEC LEXIS 1047 (Apr. 22, 2002).

[179] FINRA Rule 3310(b).

As early as 2002, FINRA emphasized to its members that to be effective, AML procedures "must reflect the firm's business model and customer base."[180] Members were advised that "in developing an appropriate AML program …, [a firm] should consider factors such as its … business activities, the types of accounts it maintains, and the types of transactions in which its customers engage."[181] The firm's procedures must address a number of areas, including "monitoring of account activities, including but not limited to, trading and the flow of money into and out of" accounts.[182]

Spencer Edwards' AML program was not adequately designed to achieve compliance with its AML responsibilities and the applicable suspicious activity reporting ("SAR") requirements. Nor did the firm adequately implement its AML program.

The firm's policies and procedures contain substantial boilerplate language and descriptions of pertinent regulatory standards and requirements. But conspicuously absent from the firm's policies is any tailoring to the particulars of its business model, which is highly focused on the penny stock liquidation business. The firm relied on its compliance officer's manual review of the pertinent transactions (without any documentation or other memorialization of what procedures were actually performed) while eschewing system-wide exception reports available to it that could have been used to identify red flags of violative activity in connection with each of the six issuer offerings at issue here. The firm offered no justification or reasonable explanation for its failure to use available exception reports.

In light of its failures in this regard, we conclude that Spencer Edwards violated FINRA Rules 3310(b) and 2010 by failing to develop and implement adequate AML policies and procedures.[183]

E. Spencer Edwards Failed to Retain Electronic Communications

A member firm's responsibility to retain electronic records such as emails relating to its business is well established.[184] Section 17(a)(1) of the Exchange Act requires broker-dealers to "make and keep for prescribed periods" such records as the SEC prescribes by rule as necessary or in the public interest. Under Exchange Act Rule 17a-4(b)(4), broker-dealers are required to "preserve for a period of not less than 3 years, the first two years in an accessible place . . . [o]riginals of all communications received and copies of all communications sent . . . by the

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[180] NASD Notice to Members 02-21, at 4 (Apr. 2002), http://www.finra.org/industry/notices/02-21.

[181] *Id.*

[182] *Id.* at 5.

[183] *Dep't of Enforcement v. Domestic Sec., Inc.*, No. 2005001819101, 2008 FINRA Discip. LEXIS 44, at *17-18 (Oct. 2, 2008) (holding that respondent did not establish adequate AML policies and procedures when it failed to tailor the FINRA Small Firm Template to fit the firm's business).

[184] *See* NASD Notice to Members 03-33, at 344-45 (July 2003), http://www.finra.org/industry/notices/03-33; *Dep't of Enforcement v. Legacy Trading Co.*, No. 2005000879302, 2009 FINRA Discip. LEXIS 12, at *54-55 (OHO Mar. 12, 2009).

member, broker or dealer (including inter-office memoranda and communications) relating to its business as such." In addition, Rule 17a-4(f) requires that broker-dealers that employ electronic storage media must preserve these records "exclusively in a non-erasable and non-rewritable format." FINRA Rule 3110, in turn, requires its members to preserve records in accordance with the SEC rule. Electronic communications fall within the ambit of Rule 3110, and failing to preserve emails that relate to a broker-dealer's business violates the Rule.[185]

As explained above, Dihle failed to ensure that Spencer Edwards had an effective system in place to retain electronic communications, as Spencer Edwards brokers routinely used personal email accounts bypassing any system of surveillance or monitoring utilized by the firm.

We conclude that during the relevant period Spencer Edwards failed to ensure that employee business emails were preserved as required pursuant to Section 17(a)(1) of the Exchange Act, Rule 17a-4(b)(4) thereunder, and therefore violated NASD Conduct Rules 3110 and 2110.

IV. Sanctions

A. Selling Unregistered Securities

In determining the appropriate sanction we first considered FINRA's Sanction Guidelines ("Guidelines") for the sale of unregistered securities,[186] as well as the Principal Considerations in Determining Sanctions.[187] The Guidelines recommend an order of disgorgement, as well as a fine of between $2,500 and $73,000.[188] In egregious cases, the Guidelines recommend that we consider a more substantial fine or suspending the firm with respect to any or all activities or functions for up to 30 business days or until procedural deficiencies are remedied.[189]

The Guidelines recommend that in cases of unregistered stock sales, principal consideration should focus on: (1) whether the firm attempted to comply with an exemption from registration; (2) whether the firm sold before the effective date of registration statement; (3) the share volume and dollar amount of transactions involved; (4) whether the firm implemented reasonable procedures to ensure that it did not participate in an unregistered distribution; and (5) whether the firm disregarded "red flags" suggesting the presence of an unregistered distribution.[190]

In light of these considerations, Spencer Edwards' conduct was aggravated in a number of respects. We find that the firm did not attempt in good faith to determine the *bona fide*

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[185] *See* NASD Notice to Members 03-33, at 344-45.

[186] *See* FINRA Sanction Guidelines 24 (2016), http://www.finra.org/industry/sanction-guidelines.

[187] Guidelines at 6.

[188] *Id.* at 24.

[189] *Id.*

[190] *Id.*

availability of an exemption from registration. It failed to undertake the "reasonable inquiry" required to rely on the brokers' exemption found in Section 4(a)(4) of the Securities Act. The relevant companies had little or no business history and thinly traded stock, and the pertinent transactions involved requests by unknown customers to immediately liquidate large quantities of certificated shares. The situation mandated a "searching inquiry" into the facts and circumstances surrounding the transactions. However, the inquiry conducted by Spencer Edwards was far from searching and largely non-existent; it constituted little more than a check-the-box business model that was at least reckless in overlooking clear red flags and without meaningful inquiry as to the availability of an exemption from registration when selling securities.[191]

We further note that billions of shares were sold on the market to members of the investing public. The firm sold more than four billion shares, yielding for its customers total sales proceeds of approximately $2 million. Through its conduct the firm generated over $107,000 in commissions.[192] This volume of sales and the dollar amounts involved created the potential for significant harm to investors.[193]

Another factor we find significantly aggravating is the firm's history of failures in this area, as chronicled by, among other things, prior enforcement actions against the firm and its brokers for selling unregistered stock prior to the conduct at issue.[194] As a result of these actions, including the firm's censure by the SEC for failing to prevent its brokers from engaging in conduct violative of Section 5 of the Act, Spencer Edwards was on clear notice of its obligations. But its present violations leave us convinced that even after being on notice, the firm failed to take its gatekeeper obligations seriously. To the contrary, its egregious facilitation of unlawful penny stock offerings continues to be a substantial component of the firm's ongoing business model. In this regard, Spencer Edwards' current protests[195] of its inability to pay any substantial

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[191] Guidelines at 24 (Principal Considerations, Nos. 1, 4, 5).

[192] CX-1.

[193] Guidelines at 24 (Principal Considerations, No. 3).

[194] Guidelines at 2, General Principles Applicable to All Sanction Determinations, No. 2 ("Adjudicators also should consider imposing more severe sanctions when a respondent's disciplinary history includes significant past misconduct that: (a) is similar to that at issue; or (b) evidences a reckless disregard for regulatory requirements, investor protection, or market integrity.").

[195] We note that in *Carley*, as here, Spencer Edwards disavowed any ability to pay a sanction due to its precarious financial condition. In light of the firm's representations, the sanction in that matter was lowered from $959,204 (including disgorgement, prejudgment interest, and a $200,000 fine) to a total sanction of $25,000. The reduced sanction had little apparent deterrent effect. We note our obligation to take into account here the firm's purported weakened financial condition in assessing sanctions (Guidelines at 5), and, as explained below, decline to reduce the sanction we impose.

sanction ring hollow.[196] Sanctions should not be calculated to be a mere cost of doing business—they should deter future violations.[197] That Spencer Edwards has not yet been convinced of the need to obey the law given its current conduct in light of its regulatory history counsels in favor of a substantial sanction to ensure future compliance with the registration requirements of Section 5 of the Act.[198]

We identified no mitigating factors, nor did Spencer Edwards suggest any in its prehearing submissions or at the hearing.[199] Accordingly, and in the absence of any mitigating factors, and taking into account that Spencer Edwards earned more than $107,000 in commissions on the transactions at issue here, we will impose disgorgement in that amount, along with a fine of $50,000 for each of the six issuer offerings facilitated by the firm, resulting in the total sanction of a $407,000 fine for Spencer Edwards' violations of Section 5 of the Act and FINRA Rule 2010.

We note in addition that the firm presently takes the position that it may delegate its ongoing responsibilities related to determining the existence of a valid exemption outside the firm to outside legal counsel. This is improper.[200] Although the firm may engage counsel or others to assist in the exercise of its responsibilities, the firm may not completely abdicate its responsibility for complying with its obligations and ultimately must determine within the firm, in concert with any third party evaluation, whether its customer sales are exempt. Until the firm adequately conducts its due diligence responsibilities with respect to certificated stock

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[196] We find no merit to Spencer Edwards' claimed inability to pay. Despite its protest of poverty, its unlawful unregistered penny stock liquidation business is lucrative. While the firm asserts that its earnings are minimal (*see* Tr. 1862-65 (Flemming)), the firm in fact generates hundreds of thousands of dollars in revenue each month, offset in substantial part by the commissions it pays its brokers. (Respondent's Exhibit ("RX-") 5; RX-6). Biley, responsible for the customer sales in the majority of the issuer offerings at issue here, earned between $250,000 and $350,000 per year during the relevant period. Tr. 52-53 (Biley). He earned 65 percent of the firm's commissions in connection with the relevant transactions. Tr. 52-53 (Biley). The firm derives significant revenues from its willingness to stand in the role of gatekeeper without actually keeping the gate. And it has made no showing that it could not reasonably satisfy the sanction imposed here by taking appropriate steps to restructure its business as necessary to comply with the securities laws and regulatory provisions pertinent to conducting this line of business. *Dep't of Enforcement v. Merrimac Corp. Sec., Inc.*, No. 2007007151101, 2012 FINRA Discip. LEXIS 43, at *44 (Bd. of Governors May 2, 2012) ("A respondent claiming an inability to pay must show that—in seeking to pay a fine—it is unable to obtain the needed funds by, among other things, reducing expenses and salaries, raising capital, or borrowing money."). We therefore reject its assertion that it cannot pay an appropriate sanction.

[197] Guidelines at 2, General Principles Applicable to all Sanctions No. 1.

[198] *Id.*, General Principles Applicable to all Sanctions No. 2.

[199] *See ACAP Financial v. SEC*, 783 F.3d 763, 767 (10th Cir. 2015) (limiting its analysis of mitigating factors to those actually pursued by respondents). The only arguments made by Spencer Edwards relative to sanctions relate to its claimed inability to pay addressed above.

[200] *See* JX-257, at 9 (FINRA Regulatory Notice 09-05, noting that "FINRA, the SEC and the courts have repeatedly held that firms cannot rely on outside counsel, clearing firms, transfer agents, issuers or issuer's counsel to discharge their obligations to undertake an inquiry.").

liquidations, its liquidation activities must cease.[201] Accordingly, we will suspend the firm with respect to accepting for deposit or liquidating previously deposited certificated securities until such time as an independent consultant retained by the firm (and not unacceptable to Enforcement) determines that Spencer Edwards has implemented procedures adequate to reasonably ensure that it is not participating in unregistered offerings of securities.

B. Deficient Supervisory Procedures and Supervision

In cases involving a member firm's failure to supervise, the Sanction Guidelines recommend a fine of between $5,000 and $73,000, and if the failures are systemic, suspending the firm with respect to any or all activities or functions for up to two years or expulsion of the firm.[202]

The Guidelines recommend that in addition to the Principal Considerations in Determining Sanctions,[203] our sanctions determination should focus on (1) whether the firm disregarded "red flags" that should have resulted in additional scrutiny; (2) the nature, extent, size, and character of the underlying misconduct; and (3) the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls.[204]

In applying the Guidelines to the conduct at issue, we determined to aggregate Spencer Edwards' supervisory and AML violations because they stemmed from a common problem at the firm—its decision to assemble a checklist of materials never critically reviewed by anyone at the firm, coupled with the firm's failure to conduct meaningful inquiry into the source and origin of deposited securities.[205] We find that the violations were egregious and that Spencer Edwards knowingly failed to implement procedures tailored to its business. Instead, the firm uncritically executed customer orders without asking appropriate questions regarding the origin of the stock deposited for liquidation. And none of those responsible for supervision at Spencer Edwards conducted sufficient inquiry into any of the six transactions at issue, or recognized red flags in the accounts of the customers selling shares. We also find the nature, extent, size, and character of the transactions aggravating. As discussed in detail above, the firm sold billions of shares of unregistered securities to the public, yielding for its customers total sales proceeds of approximately $2 million. This activity posed a significant risk of harm to investors.

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[201] Guidelines at 3, General Principles Applicable to all Sanctions No. 3 ("Adjudicators may impose sanctions that … require a respondent firm to retain a qualified independent consultant to design and/or implement procedures for improved future compliance with regulatory requirements.")

[202] *Id.* at 102.

[203] *Id.* at 6-7.

[204] *Id.* at 102.

[205] *Dep't of Enforcement v. North Woodward Fin.*, No. 2011028502101, 2016 FINRA Discip. LEXIS 35, at *48 n.43 (NAC July 19, 2016) (aggregating or "batching" violations of supervisory requirements and AML requirements for purposes of imposing sanctions).

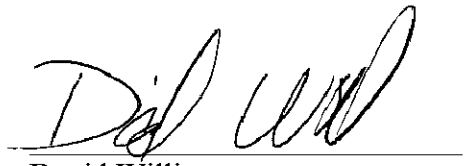
Taking all of the foregoing factors into careful consideration, we find that the appropriate sanction for Spencer Edwards' failures to supervise is $50,000 for each of the six offerings that it failed to carry out its supervisory responsibilities, for a total fine of $300,000.[206]

V. Order

For its sales of unregistered securities in violation of Section 5 of the Act and FINRA Rule 2010, Spencer Edwards is fined $407,000. Spencer Edwards is also suspended with respect to accepting for deposit or liquidating previously deposited certificated securities until such time as an independent consultant (not unacceptable to Enforcement) determines that the firm has adopted and implemented supervisory procedures adequate to reasonably ensure that it is not participating in unregistered offerings of securities.

For its failures to supervise in violation of NASD Conduct Rules 3010 and FINRA Rule 2010, Spencer Edwards is fined an additional $300,000. Accordingly, the total fine imposed against Spencer Edwards is $707,000.

Spencer Edwards is ordered to pay costs in the amount of $16,813.43, which includes a $750 administrative fee and the cost of the hearing transcript, $16,063.43. The fines and costs shall be payable on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final disciplinary action in this matter.[207]



David Williams
Hearing Officer
For the Extended Hearing Panel

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[206] As discussed above, we took into consideration the firm's prior disciplinary history in concluding that greater sanctions were needed to prevent future misconduct and to protect the investing public.

[207] The Extended Hearing Panel considered and rejected without discussion all other arguments of the parties.