

CORRECTED¹
FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2016049183302

TO: Department of Enforcement
Financial Industry Regulatory Authority ("FINRA")

RE: Ace Diversified Capital, Inc., Respondent
Member Firm
CRD No. 41768

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent Ace Diversified Capital, Inc. submits this Letter of Acceptance, Waiver and Consent ("AWC") for the purpose of proposing a settlement of the alleged rule violations described below. This AWC is submitted on the condition that, if accepted, FINRA will not bring any future actions against Ace alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Ace Diversified Capital, Inc. ("Ace" or the "firm") hereby accepts and consents, without admitting or denying the findings, and solely for the purposes of this proceeding and any other proceeding brought by or on behalf of FINRA, or to which FINRA is a party, prior to a hearing and without an adjudication of any issue of law or fact, to the entry of the following findings by FINRA:

BACKGROUND

Ace has been a FINRA member since July 1997. The firm employs 12 registered representatives, who are located in its headquarters in San Gabriel, California and a branch office in Los Angeles. Ace has no relevant disciplinary history.

OVERVIEW

From July 2013 through August 2015 (the "Relevant Period"), Ace failed to reasonably supervise a former representative's sale of non-traditional exchange-traded funds ("ETFs") and exchange-traded notes ("ETNs") to his customers. The firm also failed to establish a supervisory system, including written supervisory procedures, reasonably designed to detect potential excessive trading. The firm also failed to establish and

¹ This "Corrected" AWC reflects the following corrections to the AWC originally issued on September 11, 2019: (i) a corrected date of August 28, 2015, for the commencement of interest to be paid by Respondent (*see* p. 7, ¶ 1) and (ii) a corrected restitution amount of \$7,506 due to customer OG in the third bullet listing sanctions (*see* p. 6, Section B). The correct restitution amount due to customer OG, \$7,506, was accurately reflected on p. 3, ¶ 6 and on p. 7, ¶ 1 in the original AWC.

maintain a reasonable supervisory system, including written supervisory procedures, concerning the approval of options accounts. Based on the foregoing, the firm violated NASD Rules 3010(a) and (b) (before December 1, 2014), FINRA Rules 3110(a) and (b) (for conduct on or after December 1, 2014), and FINRA Rule 2010.²

During the Relevant Period, the firm also accepted options orders in an account that was not approved for options trading by a Registered Options Principal or a Limited Principal-General Securities Sales Supervisor. That account was located in a branch office with more than three registered representatives and whose principal supervisor (the branch manager) was not qualified to supervise an options business. The firm's written procedures were unreasonable because they did not require the branch's principal supervisor to obtain the necessary qualifications to supervise the branch's options business. Accordingly, the firm violated FINRA Rules 2360(b)(16)(A), (20)(A), and (20)(B), as well as FINRA Rule 2010.

FACTS AND VIOLATIVE CONDUCT

The firm's supervisory failures were identified during a sales practice examination conducted by FINRA's Los Angeles District Office. The examination was initiated based upon a customer complaint made against a former firm registered representative.

Failure to Supervise a Former Representative's Recommendation of Non-Traditional ETFs and ETNs

FINRA Rule 3110(a) and, for conduct occurring before December 1, 2014, NASD Rule 3010(a) require each member firm to "establish and maintain a system to supervise the activities of each associated person that is reasonably designed to achieve compliance with . . . applicable FINRA [and NASD] rules," and provide that "[f]inal responsibility for proper supervision shall rest with the member."

FINRA Rule 3110(b) and, for conduct occurring before December 1, 2014, NASD Rule 3010(b) require each member firm to "establish, maintain, and enforce written procedures to supervise the types of business in which it engages and the activities of its associated persons that are reasonably designed to achieve compliance with . . . applicable FINRA [and NASD] rules." Violations of FINRA Rule 3110 and NASD Rule 3010 constitute violations of FINRA Rule 2010.

In June 2009, FINRA issued Regulatory Notice 09-31, which reminded firms of their obligation to supervise the sale of non-traditional ETFs. The notice explained that non-traditional ETFs are securities that "offer leverage or that are designed to perform inversely to the index or benchmark they track—or both" and "are highly complex financial instruments that are typically designed to achieve their stated objectives on a daily basis." Further, "[b]ecause of the effects of compounding, their performance over longer periods of time can differ significantly from their stated daily objective." Firms

² FINRA Rule 3110 superseded NASD Rule 3010 effective November 30, 2014.

were warned that non-traditional ETFs “typically are not suitable for retail investors who plan to hold them for more than one trading session.”

Due to these risks, the guidance reminded firms that they must establish written supervisory procedures to ensure that their recommendations of non-traditional ETFs are suitable and are otherwise designed to comply with FINRA’s rules. The guidance emphasized the need for firms to fully understand these securities, including the impact of the customer’s holding period on their performance.

Firms were also reminded that they “must train registered persons about the terms, features and risks of all ETFs that they sell.” In the case of non-traditional ETFs, “that training should emphasize the need to understand and consider the risks associated with such products, including the investor’s time horizons, and the impact of time and volatility on the fund’s performance.” Because non-traditional ETNs and ETFs have similar holding period risks, the guidance in Regulatory Notice 09-31 also applies to ETNs.³

During the Relevant Period, a former representative of Ace had three customers—OG, MS and EO. OG was an appliance salesperson with an annual income of \$85,000 and a liquid net worth of \$50,000. MS was a high school teacher with an annual income of \$50,000 to \$100,000 and a liquid net worth of \$20,000. EO was a personal trainer with an annual income and a liquid net worth that were both in the \$50,000 to \$100,000 range. None of the customers had experience investing in complex securities. Each customer indicated a “moderate aggressive” risk tolerance on their new account forms.

Despite his three customers’ limited financial means, lack of sophistication, and, risk tolerance, the firm permitted a former representative to recommend 65 non-traditional ETF and ETN purchases, with a total value of \$262,867, for their accounts. Moreover, notwithstanding the risks associated with holding periods longer than a day, the accounts held overnight positions in these securities for an extended period of time. For example: OG’s account had an overnight long position in the Direxion Daily Natural Gas Related Bull 3X Shares (GASL)—a tripled-leveraged ETF—for 85 consecutive days; the accounts of MS and EO were long GASL for 94 and 122 consecutive days, respectively.

Customers OG and EO suffered \$7,506 and \$1,882 in losses, respectively, in connection with the non-traditional ETF/ETN recommendations. Customer MS did not suffer any losses related to his non-traditional ETF/ETN holdings.

During the Relevant Period, the firm failed to establish and maintain any supervisory system, written supervisory procedures or training to ensure the suitability of non-traditional ETF and ETN recommendations to its customers or monitor the risks associated with holding non-traditional ETFs and ETNs for extended periods of time. Ace’s training on these products was likewise unreasonable in that its training materials were limited to a brief, one-paragraph overview of leveraged and inverse ETFs. Because

³ See FINRA Investor Alert: Exchange-Traded Notes—Avoid Unpleasant Surprises (July 10, 2012).

of these failures, the accounts of the three customers were improperly allowed to hold overnight positions in non-traditional ETFs and ETNs, sometimes for months at a time.⁴

Accordingly, during the Relevant Period, the firm failed to establish a reasonable system to supervise a former representative's recommendations of non-traditional ETFs/ETNs, in violation of FINRA Rule 3110(a), and for conduct occurring before December 1, 2014, NASD Rule 3010(a). By virtue of these violations, the firm also violated FINRA Rule 2010.

Failure to Supervise Quantitative Suitability

Under FINRA Rule 3110 and NASD Rule 3010, each FINRA member's supervisory system, including its written procedures, must be reasonably designed to achieve compliance with, among other rules, FINRA Rule 2111(a). FINRA Rule 2111(a), known as the suitability rule, requires, among other things, that a recommended transaction be quantitatively suitable for a customer. According to the supplementary materials to the suitability rule:

Quantitative suitability requires a member or associated person who has actual or *de facto* control over a customer account to have a reasonable basis for believing that a series of recommended transactions, even if suitable when viewed in isolation, are not excessive No single test defines excessive activity, but factors such as the turnover rate, the cost-equity ratio, and the use of in-and-out trading in a customer's account may provide a basis for a finding that a member or associated person has violated the quantitative suitability obligation.

See FINRA Rule 2111.05(c).

In May 2012, FINRA issued Regulatory Notice 12-25, which provided detailed guidance on the excessive trading metrics discussed in the supplementary materials to the suitability rule. For instance, the guidance provided the calculations for turnover rate and cost-to-equity ratio, and when their results may be indicative of excessive trading.⁵ It also explained the meaning and import of in-and-out trading.

During the Relevant Period, Ace failed to detect that the former representative's trading in his customers' accounts reached levels that are indicative of excessive trading. For example, the turnover rates ranged between 11.01 and 23.40 and the cost-to-equity ratios ranged between 25.32% and 30.53% in those accounts. The firm's written procedures recommended that supervisors look at the "profit and loss or change of equity" and "turnover" when reviewing an actively traded account. The written procedures did not

⁴ Ace has amended its written procedures to prohibit the solicitation or recommendation of non-traditional ETF and ETN transactions.

⁵ As set forth in Regulatory Notice 12-25, a turnover rate and cost-to-equity ratio as low as three and 8.7%, respectively, have been considered indicative of excessive trading in litigated cases.

explain how to make these calculations or when their results may be indicative of excessive trading. Nor did the written procedures state whether they were the same or similar to the metrics discussed in FINRA's guidance. The written procedures did not address in-and-out trading at all.

Accordingly, the firm failed to establish a supervisory system, including written procedures, that was reasonably designed to detect potential excessive trading and, therefore, achieve compliance with the requirement that the firm's recommendations are quantitatively suitable. By virtue of these failures, the firm violated FINRA Rules 3110(a) and (b) and, for conduct occurring before December 1, 2014, NASD Rules 3010(a) and (b). By virtue of these violations, the firm also violated FINRA Rule 2010.

Failure to Approve and Supervise a Former Representative's Options Trading in Customer OG's Account

Under FINRA Rule 2360(b)(16)(A), a firm may not accept options orders in an account unless that account has been approved for options trading. FINRA Rule 2360(b)(16)(B) permits a branch manager to approve an account for options trading, but if the branch manager is not a Registered Options Principal ("ROP"), then the account must be approved by a ROP within 10 days.⁶

The manager of the firm's Los Angeles branch office approved customer OG's account for options trading in August 2011. The Los Angeles branch manager, however, was not qualified as a ROP. Therefore, the branch manager's approval was sufficient for only 10 days under FINRA rules. Starting in November 2011, the firm permitted a former representative to execute 103 options trades in OG's account without approval from any ROP at the firm. Customer OG did not suffer any losses related to the options trading in his account.

Under FINRA Rule 2360(b)(20)(A), "[e]ach member that conducts a public customer options business shall ensure that its written supervisory system policies and procedures . . . adequately address the member's public customer options business." Under FINRA Rule 2360(b)(20)(B), "[n]o branch office of a member shall transact an options business unless the principal supervisor of such branch office accepting options transactions has been qualified as . . . a Registered Options Principal . . . ; provided that this requirement shall not apply to branch offices in which no more than three registered representatives are located, so long as the options activities of such branch offices are appropriately supervised by . . . a Registered Options Principal."

Throughout the Relevant Period, Ace's Los Angeles branch had at least five registered representatives. No options trading should have taken place at that branch unless the individual who was its branch manager and principal supervisor was qualified as a ROP. But the Los Angeles branch manager was not and never has been qualified in that

⁶ FINRA Rules 2360(b)(16)(A) and (20)(B) also permit approval and supervision of options accounts by a Limited Principal-General Securities Sales Supervisor. The firm did not have anyone functioning in that capacity during the Relevant Period.

capacity. Nevertheless, the firm permitted options trading to take place in OG's account at its Los Angeles branch.

The firm's supervisory system and written procedures were unreasonable because they did not require the branch manager (*i.e.*, the principal supervisor) of the Los Angeles branch to qualify as a ROP when the Los Angeles branch had more than three registered representatives and conducted an options business.

Thus, the firm permitted options trading to take place in an account that was not approved by a ROP in violation of FINRA Rule 2360(b)(16)(A). The firm violated FINRA Rule 2360(b)(20)(B) by permitting options trading to take place in an account that was located at a branch office, with more than three registered representatives, whose principal supervisor was not a ROP. The firm also failed to establish written procedures requiring the principal supervisor of a branch office to qualify as a ROP if that branch had more than three registered representatives and conducted an options business, in violation of FINRA Rules 2360(b)(20)(A) and 3110(a) and (b), and, for conduct occurring on or before November 30, 2014, NASD Rules 3010(a) and (b). By virtue of the above violations, the firm also violated FINRA Rule 2010.

B. Ace also consents to the imposition of the following sanctions:

- a censure;
- a total fine amount of \$20,000;⁷
- restitution in the amount of \$7,506 plus interest to customer OG;
- restitution in the amount of \$1,882 plus interest to customer EO; and
- an undertaking to revise the Firm's supervisory systems, including its written procedures, to address the deficiencies described in this AWC as they relate to quantitative suitability and options trading. Within 30 days of this AWC being accepted by the National Adjudicatory Council ("NAC"), or such additional period of time as agreed to by a FINRA staff member in writing, a registered principal on behalf of Ace shall submit to Carolyn Craig, Senior Director, at the address set forth below, or by e-mail from a work-related account of the registered principal of Ace to EnforcementNotice@FINRA.org, a signed, dated letter providing the following: (1) a reference to this matter; (2) a representation that the firm has revised its supervisory systems, including its written procedures, to

⁷ Pursuant to the *General Principles Applicable to All Sanction Determinations* set forth in the Sanction Guidelines, FINRA imposed a lower fine in this case after it considered, among other things, the firm's revenues, financial resources, and ability to pay. See also Notice to Members 06-55 (Sept. 2006).

address the deficiencies referenced in this paragraph; and (3) the date the revisions were implemented.

Restitution is ordered to be paid to customer OG in the total amount of \$7,506 and to customer EO in the total amount of \$1,882, with both amounts to be paid plus interest at the rate set forth in Section 6621(a)(2) of the Internal Revenue Code, 26 U.S.C. 6621(a)(2), from August 28, 2015 until the date this AWC is accepted by the NAC. Ace may offset such restitution by any amounts paid by its former representative to customers OG and EO. Restitution payments to customers shall be preceded or accompanied by a letter, not unacceptable to FINRA staff, describing the reason for the payment and the fact that the payment is being made pursuant to a settlement with FINRA and as a term of this AWC.

A registered principal on behalf of Ace shall submit satisfactory proof of payment of restitution or of reasonable and documented efforts undertaken to effect restitution. Such proof shall be submitted to Carolyn Craig, Senior Director, 300 South Grand Avenue, Suite 1600, Los Angeles, California 90071, either by letter that identifies Ace Diversified Capital, Inc. and FINRA No. 2016049183302, or by e-mail from a work-related account of the registered principal of Ace to EnforcementNotice@FINRA.org. This proof shall be provided to the FINRA staff member listed above no later than 30 days after acceptance of the AWC.

If for any reason Ace cannot locate OG or EO after reasonable and documented efforts within 60 days from the date the AWC is accepted, or such additional period agreed to by a FINRA staff member in writing, Ace shall forward any undistributed restitution and interest to the appropriate escheat, unclaimed property or abandoned property fund for the state in which the customer is last known to have resided. Ace shall provide satisfactory proof of such action to the FINRA staff member identified above and in the manner described above, within 14 days of forwarding the undistributed restitution and interest to the appropriate state authority.

Ace has specifically and voluntarily waived any right to claim an inability to pay at any time hereafter the monetary sanction(s) imposed in this matter.

The imposition of a restitution order or any other monetary sanction herein, and the timing of such ordered payments, does not preclude customers from pursuing their own actions to obtain restitution or other remedies.

Restitution payments to customers shall be preceded or accompanied by a letter, not unacceptable to FINRA staff, describing the reason for the payment and the fact that the payment is being made pursuant to a settlement with FINRA and as a term of this AWC.

The sanctions imposed herein shall be effective on a date set by FINRA staff.

II.

WAIVER OF PROCEDURAL RIGHTS

Ace specifically and voluntarily waives the following rights granted under FINRA's Code of Procedure:

- A. To have a Complaint issued specifying the allegations against it;
- B. To be notified of the Complaint and have the opportunity to answer the allegations in writing;
- C. To defend against the allegations in a disciplinary hearing before a hearing panel, to have a written record of the hearing made and to have a written decision issued; and
- D. To appeal any such decision to the NAC and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Ace specifically and voluntarily waives any right to claim bias or prejudgment of the Chief Legal Officer, the NAC, or any member of the NAC, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including acceptance or rejection of this AWC.

Ace further specifically and voluntarily waives any right to claim that a person violated the ex parte prohibitions of FINRA Rule 9143 or the separation of functions prohibitions of FINRA Rule 9144, in connection with such person's or body's participation in discussions regarding the terms and conditions of this AWC, or other consideration of this AWC, including its acceptance or rejection.

III.

OTHER MATTERS

Ace understands that:

- A. Submission of this AWC is voluntary and will not resolve this matter unless and until it has been reviewed and accepted by the NAC, a Review Subcommittee of the NAC, or the Office of Disciplinary Affairs ("ODA"), pursuant to FINRA Rule 9216;
- B. If this AWC is not accepted, its submission will not be used as evidence to prove any of the allegations against Ace; and
- C. If accepted:

1. this AWC will become part of Ace's permanent disciplinary record and may be considered in any future actions brought by FINRA or any other regulator against it;
2. this AWC will be made available through FINRA's public disclosure program in accordance with FINRA Rule 8313;
3. FINRA may make a public announcement concerning this agreement and the subject matter thereof in accordance with FINRA Rule 8313; and
4. Ace may not take any action or make or permit to be made any public statement, including in regulatory filings or otherwise, denying, directly or indirectly, any finding in this AWC or create the impression that the AWC is without factual basis. Ace may not take any position in any proceeding brought by or on behalf of FINRA, or to which FINRA is a party, that is inconsistent with any part of this AWC. Nothing in this provision affects Ace's (i) testimonial obligations; or (ii) right to take legal or factual positions in litigation or other legal proceedings in which FINRA is not a party.

D. Ace may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Ace understands that it may not deny the charges or make any statement that is inconsistent with the AWC in this Statement. This Statement does not constitute factual or legal findings by FINRA, nor does it reflect the views of FINRA or its staff.

The undersigned, on behalf of Ace, certifies that a person duly authorized to act on its behalf has read and understands all of the provisions of this AWC and has been given a full opportunity to ask questions about it; that Ace has agreed to its provisions voluntarily; and that no offer, threat, inducement, or promise of any kind, other than the terms set forth herein and the prospect of avoiding the issuance of a Complaint, has been made to induce Ace to submit it.

11/18/2019
Date (mm/dd/yyyy)


Ace Diversified Capital, Inc.

Accepted by FINRA:

12/02/2019

Date

Signed on behalf of the
Director of ODA, by delegated authority



Carolyn Craig
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