

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
LETTER OF ACCEPTANCE, WAIVER AND CONSENT
NO. 2017054054101**

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

RE: Electronic Transaction Clearing, Inc., Respondent
Member Firm
CRD No. 146122

Pursuant to FINRA Rule 9216 of FINRA's Code of Procedure, Respondent Electronic Transaction Clearing, Inc. (ETC or the Firm) 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 Respondent alleging violations based on the same factual findings described herein.

I.

ACCEPTANCE AND CONSENT

- A. Respondent 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

The Firm has been a FINRA member since 2009. It provides high volume execution and clearing services to broker-dealers and non-broker dealers. The Firm has approximately thirty-five registered representatives in two branch offices.

RELEVANT DISCIPLINARY HISTORY

In December 2015, the Firm was censured and fined \$75,000 by FINRA for submitting incorrect blue sheets to FINRA and the SEC. The inaccuracies were caused by a coding error in the Firm's systems. The Firm also failed to maintain a required audit system, insofar as it had no procedures for validating blue sheets for accuracy or completeness before submission. See AWC No. 2014039947501.

In December 2016, the Firm was censured and fined \$150,000 by the CBOE for, among other things, improperly calculating customer reserve amounts, and failing to supervise its compliance with margin requirements and calculation of customer reserve amounts. See OFR, File No. 16-0013, STAR No. 20150460041.

OVERVIEW

During the period of April 1, 2015 through June 30, 2017, ETC failed to satisfy its customer protection requirements for its customer and proprietary business, including hindsight deficiencies in two instances; adhere to capital withdrawal rules specific to clearing firms in two instances; and, comply with its recordkeeping and supervision requirements. In particular:

When calculating reserves in customer and proprietary accounts of broker-dealers (PAB), the Firm failed to make required reductions to certain debit balances. This caused the Firm's customer and PAB reserve accounts to be underfunded, resulting in hindsight deficiencies of \$19.3 million and \$23 million in the customer reserve account and \$46.8 million and \$12.8 million in the PAB reserve account, as of March 31, 2016 and August 26, 2016, respectively. The Firm also failed to timely notify the SEC and FINRA of these deficiencies. In addition, from February 2016 to April 2017, the Firm improperly overstated debits in its customer reserve calculations when it included an amount that was doubtful of collection. As a result, the Firm violated Rule 15c3-3 of the Securities Exchange Act of 1934 (Exchange Act) and FINRA Rule 2010.

In November and December 2016, the Firm made unsecured advances to its parent company that exceeded 10% of the Firm's excess net capital for that period, without obtaining written permission from FINRA prior to doing so. As a result, the Firm violated FINRA Rule 4110 and FINRA Rule 2010.

In 2016-2017, the Firm failed to comply with recordkeeping rules requiring the creation and maintenance of certain business records. Between January and June 2017, the Firm did not maintain an index of electronic records, store electronic records in the proper format, maintain an audit system for electronic records, or provide required notices and undertakings regarding its electronic records. Separately, throughout 2016, the Firm did not comply with recordkeeping requirements regarding payments made to its affiliated entities. As a result, the Firm violated Exchange Act Rule 17a-3 and 17a-4, and FINRA Rules 4511 and 2010.

During the period April 1, 2015 through June 30, 2017, the Firm relied on proprietary electronic systems to help it calculate reserves, track margin calls, generate customer statements, and maintain position reconciliations. Although the Firm was aware of deficiencies in its electronic systems, it failed to replace or improve them. The Firm, as part of its supervisory system, at times developed back-up manual processes in an attempt to satisfy its obligations. However, these manual processes did not result in accurate calculations and records, given the volume of trading and number of accounts at the Firm, and the Firm failed to reasonably monitor these manual processes to ensure that they complied with regulatory requirements. The Firm also failed to reasonably supervise its affiliate that was operating the Firm's electronic storage systems and failed to reasonably supervise intercompany transfers between the Firm and its affiliates. It also failed to reasonably address deficiencies with respect to its margin model. Accordingly, the Firm failed to establish and maintain a supervisory system reasonably designed to achieve

compliance with the securities laws and FINRA rules in violation of FINRA Rules 3110(a) and 2010.

FACTS AND VIOLATIVE CONDUCT

This matter originated from FINRA's 2016 and 2017 cycle examinations of ETC.

Customer and PAB Reserve Calculations

Exchange Act Rule 15c3-3, also known as the "Customer Protection Rule," protects customer assets from being improperly used by a broker-dealer for its own purposes, and ensures the prompt return of customer assets in the event of a broker-dealer's insolvency. It requires broker-dealers: (i) to maintain a reserve account for the benefit of customers, and a second PAB reserve account for proprietary accounts of other brokers-dealers; and (ii) to fund the customer and PAB reserve accounts in amounts determined by using the calculation contained in the Rule.

The Rule requires a broker-dealer to calculate any amounts it owes customers, called credits, and compare that amount to any amounts customers owe it, called debits. The formula for this calculation is set forth in Rule 15c3-3a – Exhibit A (Exhibit A). If credits exceed debits, the broker-dealer must deposit the difference in the reserve account. A hindsight deficiency occurs when a broker-dealer discovers that it previously failed to make a sufficient deposit in one of its reserve accounts.

Pursuant to Exhibit A, Note E(5), in performing the calculation, the broker-dealer must reduce debit balances in margin accounts by the amount that any customer's debit balance exceeds 25% of the broker-dealer's tentative net capital, unless the broker-dealer can demonstrate that the debit balance is directly related to credit items in the reserve formula.

Between March 31, 2016 and August 26, 2016, the Firm improperly calculated the customer and PAB reserve amounts. For both calculations, the Firm failed to reduce debit balances relating to a number of margin accounts where the debit balance exceeded 25% of the Firm's tentative net capital. Instead, the Firm concluded that no reduction was required, even though it did not perform any analysis to demonstrate that the debit balances were directly related to credit items in the reserve formula. As a result, the Firm included debits that should not have been included. This resulted in hindsight deficiencies of \$19.3 million and \$23 million in the customer reserve account and \$46.8 million and \$12.8 million in the PAB reserve account, as of March 31, 2016 and August 26, 2016, respectively. The Firm also did not provide prompt written notification to the SEC and FINRA of these hindsight deficiencies.

Exhibit A, Note E(1) also requires that in calculating the reserves, the broker-dealer must reduce debit balances in margin accounts by the amount by which a specific security which is collateral for margin accounts exceeds in aggregate value 15 percent of the aggregate value of all securities which collateralize all margin accounts receivable. The Firm failed to do so with respect to its customer and PAB reserve calculations as of

March 31, 2016 and August 26, 2016.

Exhibit A, Item 10 further requires that in performing the customer reserve calculations, the broker-dealer must exclude accounts doubtful of collection from debit balances. Between February 2016 and April 2017, the Firm overstated debits in its customer reserve calculation by approximately \$180,000 when it improperly included an amount doubtful of collection. This amount consisted of a stock loan margin interest charge the Firm incorrectly believed a third party was financially responsible for, which in fact the Firm was responsible for covering itself.

By virtue of the foregoing, the Firm violated Exchange Act Rule 15c3-3 and FINRA Rule 2010.

Unauthorized Capital Withdrawals

FINRA Rule 4110(c)(2) prohibits a clearing firm from making any unsecured advance to an affiliate, where such advances in the aggregate, in any 35 rolling calendar day period, on a net basis, exceed 10% of its excess net capital, absent written permission from FINRA. This requirement is part of a set of rules that seeks to promote the financial responsibility of broker-dealers.¹

In November and December 2016, the Firm made unsecured advances to its parent company that totaled approximately \$1 million, an amount greater than 10% of its excess net capital at that time. The Firm, however, failed to obtain the required written permission from FINRA before doing so. By virtue of the foregoing, the Firm violated FINRA Rule 4110(c)(2) and FINRA Rule 2010.

Storage of Electronic Records

FINRA Rule 4511(a) requires FINRA regulated broker-dealers to make and preserve books and records as required under the Exchange Act and the applicable Exchange Act rules. Between January and June 2017, the Firm failed to comply with five separate Exchange Act recordkeeping requirements relating to the storage of electronic records. The Firm's electronic storage systems were operated and maintained by an affiliate of the Firm.

Exchange Act Rule 17a-4(f)(3)(iv) requires broker-dealers to organize and index accurately all information maintained on electronic storage media. The Firm did not maintain such an index of all electronic records.

Exchange Act Rule 17a-4(f)(2)(ii)(A) requires broker-dealers, with respect to records stored in electronic storage media, to "preserve the records exclusively in a non-rewritable, non-erasable" or WORM format. Rule 17a-4(f)(3)(iii) requires broker-dealers to store a duplicate copy of such records in a format authorized by the Rule. The Firm

¹ FINRA Regulatory Notice 08-23, *Proposed Consolidated FINRA Rules Governing Financial Responsibility*, at 2 (May 2008).

failed to maintain the original or duplicate copies of customer statements, stock records, trade confirmations, trade blotters, and other transaction records in WORM format; and also stored electronically, but not in WORM format as required, compliance records, personnel records, bank statements, reconciliations, net capital records, and reserve formula computations.

Exchange Act Rule 17a-4(f)(3)(v) requires broker-dealers to have in place an audit system providing for accountability regarding of records maintained in electronic format. The Firm did not have an audit system for those records it maintained in electronic format.

Exchange Act Rule 17a-4(f)(2)(i) requires FINRA-regulated broker-dealers to notify FINRA 90 days prior to employing electronic storage media other than optical disk technology. The Firm utilized a system for storage of electronic records other than optical disk technology, but did not file a notice with FINRA to that effect.

Exchange Act Rule 17a-4(f)(3)(vii) requires each broker-dealer to provide an undertaking from at least one independent third party relating to records preservation issues. Such undertaking represents that the third party shall provide to regulatory authorities requested electronic records if the member firm is unable to do it itself. The Firm designated two affiliated entities as third parties responsible for records preservation. However, these entities were not independent third parties, but were rather affiliates commonly controlled by the Firm's parent company.

By virtue of the foregoing, the Firm violated Exchange Act Rule 17a-4(f) and FINRA Rules 4511 and 2010.

Recordkeeping of Intercompany Expenses

Pursuant to Exchange Act Rules 17a-3 and 17a-4, a broker-dealer must make and keep current records reflecting each expense incurred relating to its business and any corresponding liability. NASD Notice to Members 03-63 specifies that this obligation also applies when a third party has paid, agreed to pay, or agreed to assume responsibility for the expense of the broker or dealer. It further specifies that the broker-dealer must also maintain a written expense sharing agreement between itself and any such third party. The agreement must identify which party is obligated to pay each expense, whether the broker-dealer has any obligation to reimburse any party for paying the expense, and the method of allocating expenses.² These provisions are intended to ensure that a firm's liabilities are accurately recorded, for the purposes of assessing profitability and capital compliance, and to ensure the availability of records.

Throughout 2016, the Firm obtained business-related services from its parent and two affiliates; and, the parent transferred certain funds received from the Firm to the affiliates in connection with such services. The Firm maintained an expense sharing agreement

² NASD Notice to Members 03-63, *SEC Issues Guidance on the Recording of Expenses and Liabilities by Broker/Dealers*, at Parts 1, 6, 7 (October 2003).

with the parent, but that agreement did not specify, and the Firm did not maintain records showing, how the affiliates were indirectly compensated through the parent. In addition, the agreement with the parent in effect between January and May 2016 did not accurately reflect the monthly payment amounts sent from the Firm to the parent during this period, understating the monthly base amount by approximately \$5,000, and failing to account for another approximately \$10,000 also transferred during this period. Finally, the expense sharing agreement did not specify the method of allocation pursuant to which the amounts paid from the Firm to the parent were determined.

By virtue of the foregoing, the Firm violated Exchange Act Rules 17a-3 and 17a-4, and FINRA Rules 4511 and 2010.

Supervision

FINRA Rule 3110(a) requires broker-dealers to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable FINRA Rules. This supervisory obligation includes the duty to respond to red flags suggesting that the system is not reasonably designed.

The Firm's Electronic Systems and Back-Up Manual Processes Were Not Reasonably Designed to Achieve Compliance with the Securities Laws and FINRA Rules

From April 1, 2015 through June 30, 2017, ETC relied, in substantial part, on a proprietary electronic system ("PES") to meet its regulatory obligations related to Customer Protection Rule reserve calculations, Regulation T margin requirements, and recordkeeping rules. The Firm knew that PES did not, at times, produce accurate records and calculations. To address this, the Firm at times employed manual workarounds, but those were unable to generate accurate calculations and records due to the large volume of trading and number of customer accounts at the Firm, and the Firm failed to reasonably monitor those manual back-up processes. Despite knowledge that the Firm's electronic and manual systems fell short of meeting regulatory requirements, the Firm did not establish a system to supervise the calculations and records in a way designed to achieve compliance with applicable securities laws and regulations. In particular:

The Firm used PES to assist it with Customer Protection Rule calculations, but this system was unable to perform certain of these calculations automatically. Although the Firm attempted to perform these calculations manually, it was unable to do so given the large number of accounts at the Firm. The Firm knew that its automated system could not perform the calculations and that the Firm could not perform accurate calculations manually, but failed to take reasonable action to correct its deficient systems.

The Firm used PES to identify required Regulation T margin calls between April and December 2016. However, the automated records generated were often unreliable and did not properly track required margin calls. Because of this known deficiency, the Firm was forced to implement a manual margin call process during this period. However, the

manual process also did not properly track required margin calls, given the large amount of trades at issue, and the Firm did not reasonably monitor the manual process used. Although the Firm knew that its automated system and manual back-up process were not capable of tracking required margin calls, it failed to take reasonable action to bring its systems and processes into compliance.

The Firm also used PES to generate monthly account statements issued to customers, as well as its internal position reconciliations. However, the Firm established no supervisory system or procedures to check customer statements for accuracy after they were generated by the automated system and before they were issued to customers, and also failed to reasonably monitor the automated system's preparation of position reconciliations. These failures led to inaccurate customer statements between January and April 2016, and again in December 2016 and January 2017, as well as inaccurate position reconciliations in November and December 2016 that were not compliant with recordkeeping rules.

The Firm Failed to Establish and Maintain Reasonable Supervisory Systems With Respect to the Monitoring of Its Affiliates and Intercompany Transfers to Them

If a member outsources activities that otherwise would be the subject of the Firm's own supervisory system, the member must perform due diligence to determine whether its third-party service providers are capable of performing the outsourced activities, and must have policies and procedures to assess the service provider's continued ability to perform the activities.³

The Firm outsourced the operation and maintenance of the Firm's electronic storage of records to an affiliate. However, the Firm did not reasonably oversee, supervise, and monitor the affiliate's processes for carrying out this activity, leading to the recordkeeping violations described above. Thus, the Firm failed to reasonably determine whether affiliate was capable of performing the outsourced activities concerning the Firm's electronic storage of records consistent with regulatory requirements.

The Firm also failed to reasonably supervise recordkeeping concerning intercompany transfers between it and its affiliates. The Firm had no system to account for services provided by its affiliates, failed to accurately document payments that were in fact made, failed to employ a reasonable methodology to support the intercompany transfer amounts, and failed to review or test the intercompany money movements.

The Firm Failed to Reasonably Supervise Margin

The Firm failed to establish and maintain a supervisory system reasonably designed to comply with the Firm's margin obligations under the securities laws and FINRA rules.

³ NASD Notice to Members 05-48, *Members' Responsibilities When Outsourcing Activities to Third-Party Service Providers* at 3 (July 2005).

From April 2016 through March 2017, the Firm failed to implement a supervisory system to place required restrictions on margin accounts for customers with certain recurrent liquidations.⁴ The Firm also had no supervisory system in place to identify or conduct reviews of irregular margin calls. As a result, the Firm issued and collected an \$800,000 margin call from a customer in December 2016, then reduced the margin amount and returned the money the next day without any justification, and without following any standards or process. Additionally, in May 2017, the Firm failed to designate, as part of its supervisory system, an appropriately registered person to carry out supervisory responsibilities over margin calls. The Firm also did not reasonably respond to unmet margin calls in January 2017, failing to take reasonable steps to address this issue such as by following-up with the relevant customers. Finally, the Firm failed to implement, as part of its supervisory system, the Option Clearing Corporation's Theoretical Intermarket Margining System ("OCC TIMS") to compute end of day margin requirements in portfolio margin accounts from April 2015 to October 2016. The Firm was aware that use of the OCC TIMS model was required, but declined to purchase and make available the model for use.

By virtue of the foregoing, the Firm violated FINRA Rules 3110(a) and 2010.

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

1. A censure; and
2. A fine in the amount of \$450,000; and
3. Certification: Within 60 days of Notice of Acceptance of this AWC, the Firm shall certify to FINRA in a submission signed by an officer and registered principal of the Firm that, as of the date of the certification, the Firm has established and implemented policies, procedures, and internal controls reasonably designed to address and remediate the issues identified in this AWC. The certification shall be addressed to Elissa Meth Kestin, Senior Director, FINRA Department of Enforcement, 200 Liberty Street, New York, NY 10281, elissa.methkestin@finra.org. Upon written request showing good cause, FINRA staff may extend the procedural date set forth above.

Respondent agrees to pay the monetary sanction upon notice that this AWC has been accepted and that such payment is due and payable. Respondent has submitted an Election of Payment form showing the method by which it proposes to pay the fine imposed.

Respondent specifically and voluntarily waives any right to claim an inability to pay, now or at any time hereafter, the monetary sanction imposed in this matter.

⁴ FINRA expects broker-dealers to restrict portfolio margin accounts to funds on hand for 90 calendar days if the customer has certain recurrent position liquidations to cover margin deficiencies within a twelve-month period, unless a waiver is granted by the firm after review. See FINRA Rule 4210(g)(10)(E) & Interpretation .02.

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

II.

WAIVER OF PROCEDURAL RIGHTS

Respondent 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 National Adjudicatory Council (NAC) and then to the U.S. Securities and Exchange Commission and a U.S. Court of Appeals.

Further, Respondent 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.

Respondent 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

Respondent 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 Respondent; and

C. If accepted:

1. this AWC will become part of Respondent's permanent disciplinary record and may be considered in any future action brought by FINRA or any other regulator against Respondent;
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. Respondent 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. Respondent 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 Respondent'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. Respondent may attach a Corrective Action Statement to this AWC that is a statement of demonstrable corrective steps taken to prevent future misconduct. Respondent 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 the Respondent Firm, 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 it has agreed to the AWC's 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 it to submit it.

Electronic Transaction Clearing, Inc.
Respondent

5/26/2020
Date

By: Wishnivetski

Print Name: Eli Wishnivetski

Title: CCO

Accepted by FINRA:

6/5/2020
Date

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



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