SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Release No. 84500 / October 29, 2018

Admin. Proc. File No. 3-17909

In the Matter of the Application of

THADDEUS J. NORTH

For Review of Disciplinary Action Taken by

FINRA

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION—REVIEW OF DISCIPLINARY PROCEEDINGS

Failure to Establish Reasonable Supervisory System for the Review of Electronic Correspondence

Failure to Reasonably Review Electronic Correspondence

Failure to Report Relationship with Statutorily Disqualified Person

Registered representative of FINRA member firm appeals from FINRA disciplinary action finding that he failed to establish a reasonable supervisory system for the review of electronic correspondence, failed to reasonably review electronic correspondence, and failed to report a relationship with a statutorily disqualified person. *Held*, association's findings of violations and imposition of sanctions are sustained.

APPEARANCES:

Constance J. Miller, for Thaddeus North.

Alan Lawhead, *Jante Turner, and Megan Rauch*, for FINRA.

Appeal filed: April 6, 2017

Last brief received: July 28, 2017

Thaddeus J. North, formerly associated with FINRA member firm Southridge Investment Group LLC ("Southridge"), seeks review of FINRA disciplinary action taken against him. FINRA found that North violated FINRA, NASD, and MSRB rules by failing to establish a reasonable supervisory system for the review of electronic correspondence, failing to reasonably review electronic correspondence, and failing to report a relationship with a statutorily disqualified person.[1] FINRA imposed a two-month suspension in all principal and supervisory capacities and a 30-day suspension in all principal and supervisory capacities to run consecutively; fined North $40,000; and ordered North to pay hearing and appeal costs. We base our findings on an independent review of the record and apply the preponderance of the evidence standard.[2] We sustain FINRA's findings of violations and imposition of sanctions.

I. Background

North first associated with a FINRA member firm in 1994. From July 2009 through August 2011, which is the relevant period here, North served as Southridge's Chief Compliance Officer ("CCO") and was responsible for establishing and maintaining its supervisory procedures governing the review of electronic correspondence and for reviewing that correspondence. Southridge had approximately 50 registered representatives in several offices during this time.

A. Southridge's written supervisory procedures lacked details about the criteria for reviewing electronic communications and North reviewed electronic communications either sporadically or not at all.

North was responsible for maintaining Southridge's written supervisory procedures. Southridge's 2008 written supervisory procedures, which were in place when North became CCO and were in effect until November 22, 2010, provided that the CCO was to "maintain and review written procedures" and, "[i]f necessary, modify written procedures." Southridge's 2010 written supervisory procedures, effective November 22, 2010, when North was CCO, specified that "Thaddeus J. North" had the responsibility for "review and amending" of the written

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[1] As a result of the consolidation of the regulatory functions of NASD and NYSE Regulation into FINRA and the development of a new FINRA rulebook, *see* Exchange Act Release No. 56148, 2007 WL 2159604, at *2 (July 26, 2007), North was subject to both FINRA and NASD Rules, depending on the time of the relevant conduct. *See, e.g., KCD Fin., Inc.*, Exchange Act Release No. 80340, 2017 WL 1163328, at *1 n.1 (March 29, 2017) (applying both NASD and FINRA rules, depending on whether conduct occurred before or after consolidation).

FINRA's (and, previously, NASD's) By-Laws also provide that its members and persons registered with members agree to comply with MSRB Rules, and FINRA is authorized to impose sanctions for violations of MSRB Rules. FINRA By-Laws Article IV, § 1(a)(1) (agreement by firms); FINRA By-Laws Article V, § 2(a)(1) (agreement by registered persons); FINRA By-Laws Article XIII, § 1(b) (authorization to impose sanctions for violation of MSRB Rules).

[2] *Robert Marcus Lane*, Exchange Act Release No. 74269, 2015 WL 627346, at *5 (Feb. 13, 2015).

supervisory procedures and that the CCO "must ensure that we have appropriate policies and procedures in effect covering all electronic communications."

North was also responsible for reviewing Southridge's electronic communications. The 2008 written supervisory procedures stated that the CCO was to review correspondence. The 2010 written supervisory procedures stated that the CCO must "monitor the implementation of, and compliance with, our procedures for reviewing public correspondence." Those procedures stated further that the CCO "must ensure that our firm adheres to all requirements regarding internal email, and that all such efforts are appropriately documented." At his hearing, North admitted that he was responsible for reviewing electronic communications.

The firm's electronic communications consisted of firm emails, Bloomberg messages, and Bloomberg chats. North admits in his brief that the Bloomberg communications "comprised eighty-five percent or more of all of the Email [that North] was to review."

Southridge used a vendor, Smarsh, Inc., to archive its communications and provide a platform for reviewing them. According to Southridge's 2008 written supervisory procedures, the firm was to "utilize[] an outsourced email hosting and compliance archiving system through SMARSH" and the CCO was to "review[] a sample of the daily electronic communications by either selecting 'random message' or sometimes by individual [registered representative] mailbox." The 2008 written supervisory procedures did not contain information about the frequency of review or indicate the sample size for review.

The 2010 written supervisory procedures provided that Southridge would employ a "risk-based approach," that the CCO would "[u]tilize [Smarsh] to view random samples of emails to flag electronic communications that may evidence or contain customer complaints" or "conduct inconsistent with FINRA rules [or] federal securities laws," and that Smarsh would "[m]aintain appropriate documentation of electronic communications review." The 2010 procedures also did not specify the frequency of review. As for the sample size, they contained boilerplate language that read: '"[a]n appropriate random sampling (ENTER PERCENTAGE OR OTHER DEFINABLE SAMPLE SIZE) of all copies of email will be reviewed."

North used a Smarsh Management Console ("SMC") when reviewing Southridge's electronic communications. That system archived Southridge's email, Bloomberg messages, and Bloomberg chats into three separate repositories. North had to access each repository separately to review each category of communications. The Smarsh system automatically recorded the user's identity, search history, message review history, date range of search, number of messages located through a search, and number of messages reviewed by the user. North relied exclusively on this system to record his review of Southridge's electronic communications.

North admits that, from July 1, 2009, through September 1, 2011, he did not review the SMC repositories containing the firm's Bloomberg messages or chats. At his hearing, North testified that he "didn't focus on Bloomberg." When asked at the hearing about his lack of focus on Bloomberg and if he had previously described it as boring, North testified that "all email review is boring." The SMC email repository's data showed that North reviewed the firm's emails only sporadically. From June 2010 through August 2011, for example, North reviewed emails only six times. There were significant stretches (ranging from three to five months) in which he failed to review any emails. North reviewed no emails in 13 of the 26 relevant months. North has provided no explanation for not reviewing emails more often.[3]

B. North did not report to FINRA that a Southridge representative entered into a business relationship with a statutorily disqualified individual.

Sometime before July 2009, Southridge CEO William Schloth considered hiring Leslie King and Todd Cowle as registered representatives. King and Cowle worked together previously at another FINRA member firm. Schloth requested that North run a report on Cowle in the Central Registration Depository.[4] The report indicated that Cowle was subject to a statutory disqualification as a result of FINRA's finding that he had willfully failed to disclose federal tax liens on his Uniform Application for Securities Industry Registration or Transfer ("Form U4").[5] Schloth decided not to hire Cowle because doing so would have required sponsoring him through FINRA's process for employing statutorily disqualified individuals.[6] Schloth hired King instead, and she became a registered representative in Southridge's Plano, Texas office in July 2009.

That same month, King and her husband formed King Asset Management ("KAM"), which King disclosed to Southridge as an outside business entity. On July 15, 2009, King, on behalf of KAM, entered into a service agreement with a company that Cowle owned called Ultimate Tier Advisors, LLC ("UTA"). UTA promised to introduce KAM to street brokers in the securities industry and to provide consultation, instruction, and training in exchange for payment as an independent contractor by KAM. King signed the service agreement on behalf of KAM, but Cowle's name did not appear anywhere on the contract. Between July 2009 and September 2011, KAM paid UTA approximately $600,000 for various services.

FINRA performed a routine examination of Southridge in March 2010. After FINRA staff requested financial information about Southridge's Plano, Texas branch, North obtained invoices from UTA that showed KAM had paid it more than $150,000. North gave the invoices to Schloth, who then produced them to FINRA. FINRA subsequently requested any agreements relating to the invoices, which led North to see the service agreement for the first time. The

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3 At the hearing, North testified that he spent "a lot" of time responding to FINRA's inquiries. North does not argue that this prevented him from reviewing emails. In any case, FINRA did not start examining Southridge until March 2010.

4 *See* Investor Publication, Protect Your Money: Check Out Brokers and Investment Advisers ("The Central Registration Depository (CRD) is a computerized database that contains information about most brokers, their representatives, and the firms they work for."), *available at* http://www.sec.gov/investor/brokers.htm.

5 *See* Exchange Act Section 3(a)(39), 15 U.S.C. § 78c(a)(39) (defining a "statutory disqualification" to include any person who has been found to have willfully made a false or misleading statement of material fact, or omitted to state a material fact required to be disclosed, in any application or report filed with a self-regulatory organization).

6 *See* FINRA Rules 9520 through 9527 (setting the parameters of eligibility proceedings).

service agreement was only one page, was not executed by anybody on behalf of UTA, and did not identify anyone associated with that company. The invoices issued under the agreement also provided only a vague description of the services provided—such as "consultations," "trainings," and "introductions." Despite these circumstances, North admitted at the hearing that he did not question King about the agreement or invoices or investigate further.

In December 2010, FINRA began investigating Southridge based on a tip that King and another person were paying Cowle for client referrals and other activities. In response to a request for more information about King's and Cowle's relationship, Schloth procured additional KAM/UTA invoices from after FINRA's March 2010 examination. Schloth and North discussed that Cowle was involved in UTA, and North claims that Schloth told him that King was not engaging in any misconduct through her relationship with UTA.[7] North neither reported King's relationship with UTA and Cowle to FINRA nor conducted an independent examination of the relationship despite knowing that Cowle was subject to a disqualification based on the CRD report he ran for Schloth when Schloth previously considered hiring Cowle and King.

C. FINRA found that North violated FINRA, NASD, and MSRB rules.

On July 15, 2013, FINRA's Department of Enforcement charged North with (1) failing to report King's relationship with a statutorily disqualified person, in violation of NASD Rule 3070(a)(9)[8] and FINRA Rules 4530(a)(1)(H) and 2010; (2) failing to establish and maintain a supervisory system reasonably designed to achieve compliance with applicable securities laws related to the review of electronic correspondence, in violation of NASD Rule 3010(a) and (d)[9] and FINRA Rule 2010, and in willful violation of MSRB Rules G-27(b) and (e) and G-17; and (3) failing to adequately review electronic correspondence, in violation of NASD Rule 3010(b) and FINRA Rule 2010, and in willful violation of MSRB Rules G-27(a) and (c) and G-17.[10]

After a hearing, a FINRA Hearing Panel issued a decision finding that Enforcement proved the charged violations, with the exception of the allegation that North's failure to report King's relationship with a statutorily disqualified person violated FINRA Rule 4530. The Hearing Panel imposed a 30-business-day suspension in any principal capacity followed by an

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7 Although Schloth was available to testify at the hearing, North did not call him as a witness.

8 FINRA Rule 4530, effective July 1, 2011, superseded NASD Rule 3070. *See Regulatory Notice 11-06*, 2011 FINRA LEXIS 8, at *1-7 (Feb. 2011).

9 FINRA Rule 3110, effective December 1, 2014, superseded NASD Rule 3010. *See Regulatory Notice 14-10*, 2014 FINRA LEXIS 17, at *1-14 (Mar. 2014).

10 Enforcement's complaint also included claims against Schloth and King, but they later settled. *See* Order Accepting Offer of Settlement, *William E. Schloth*, Disciplinary Proceeding No. 2010025087302 (Sept. 10, 2013); Order Accepting Offer of Settlement, *Leslie L. King*, Disciplinary Proceeding No. 2010025087302 (March 24, 2015), *available at* http://www.finra.org/industry/finra-disciplinary-actions-online.

additional two-month suspension in any principal capacity; fined North $40,000; and censured him.

North appealed to FINRA's National Adjudicatory Council ("NAC"). On March 15, 2017, the NAC affirmed the Hearing Panel's findings of liability except that it reversed the finding that North violated MSRB Rule G-17. The NAC also affirmed the sanctions except that it reversed the Hearing Panel's imposition of a censure and modified the suspensions imposed to be in all principal and supervisory capacities. North timely filed this appeal.[11]

II. Analysis

Under Exchange Act Section 19(e)(1), we review FINRA disciplinary action to determine whether the applicant engaged in the conduct FINRA found, whether such conduct violates the statutes and rules FINRA found it to have violated, and whether FINRA's rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.[12] We sustain FINRA's disciplinary action in this case.

A. North failed to establish and maintain a reasonable supervisory system for the review of electronic correspondence and to reasonably review that correspondence.

We find that North failed to establish and maintain a supervisory system reasonably designed to achieve compliance with rules related to the review of electronic correspondence in violation of NASD Rule 3010(a) and (d), FINRA Rule 2010, and MSRB Rule G-27(b) and (e). We also find that North failed to reasonably review electronic correspondence in violation of NASD Rule 3010(b), FINRA Rule 2010, and MSRB Rule G-27(a) and (c). We further find that these rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.

1. North failed to establish and maintain a reasonable supervisory system.

NASD Rule 3010(a) required members to "establish and maintain a system" that is "reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules."[13] NASD Rule 3010(d)(1) required members to "establish procedures . . . for the review by a registered principal of incoming and outgoing written and electronic correspondence of its registered representatives with the public relating to the

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11 We note that after North associated with another member firm in 2011, FINRA found that he failed to enforce supervisory procedures for the review of electronic communications at that firm. *See Enforcement v. North*, Complaint No. 2012030527503, 2017 WL 3412462 (Aug. 3, 2017). North has also filed an application for review of that decision. *See Thaddeus J. North*, Exchange Act Release No. 81867, 2017 WL 4548279 (Oct. 12, 2017) (ordering the filing of briefs).

12 *See* 15 U.S.C. § 78s(e)(1).

13 NASD Rule 3010(a).

investment banking or securities business of such member."[14] NASD Rule 3010(d)(2) required members to develop "written procedures that are appropriate to its business, size, structure, and customers for the review of . . . electronic correspondence with the public relating to its investment banking or securities business. . . ."[15] A violation of any NASD rule also constitutes a violation of FINRA Rule 2010.[16] MSRB Rule G-27 is effectively the same as NASD Rule 3010, but applies to dealers of municipal securities.[17] We sustain FINRA's finding that North engaged in conduct while Southridge's CCO that violated these rules.

North acknowledges that he was responsible for establishing and maintaining Southridge's written supervisory procedures. NASD Rule 3010 gives firms wide latitude in "establish[ing] and maintain[ing] a system" to review electronic communication and recognizes that a firm's policies and procedures will reflect its "business, size, structure, and customers."[18] The 2008 written supervisory procedures were not reasonably designed because they completely failed to specify even the most basic parameters for reviewing electronic communications, e.g., the frequency of review, the methodology to be used in selecting communications to be reviewed, whose electronic communications were going to be reviewed, the number of communications to be reviewed, or how to document actions taken as a result of reviews. In substance, Southridge's written supervisory procedures identified a system to be used in reviewing electronic communications, i.e., Smarsh, but provided no guidance as to how the system should be used to conduct those reviews.

It is true, as North claims, that the 2008 written supervisory procedures were in effect when North became CCO in July 2009, but he did not amend them until November 2010. The 2010 procedures North ultimately adopted did not remedy any of the deficiencies in the 2008 procedures. Indeed, North made the written supervisory procedures worse in one respect. When he revised the procedures in 2010, he failed to replace the bracketed boilerplate placeholder language with any program requirements. Contrary to North's assertion that this omission was "a single scrivener's error," FINRA correctly concluded that North utterly failed to establish and maintain a reasonable supervisory system for the review of electronic correspondence by not amending the 2008 written supervisory procedures and not establishing reasonable procedures in 2010 in violation of NASD Rule 3010, FINRA Rule 2010, and MSRB Rule G-27.[19]

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[14] NASD Rule 3010(d)(1).

[15] NASD Rule 3010(d)(2).

[16] *Michael Pino*, Exchange Act Release No. 74903, 2015 WL 2125692, at *10 n.31 (May 7, 2015).

[17] *Compare* MSRB Rule G-27(b) and (e) *with* NASD Rule 3010(a) and (d).

[18] NASD Rule 3010(a) and (d)(2).

[19] *See Castle Sec. Corp.*, Exchange Act Release No. 52580, 2005 WL 2508169, at *3 (Oct. 11, 2005) (finding that firm's "written supervisory procedures lacked necessary provisions detailing the supervisory oversight to be accorded [to certain of the firm's] transmissions"

(continued…)

2. North failed to reasonably review electronic correspondence.

NASD Rule 3010(b) required members to "establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives, registered principals, and other associated persons."[20] MSRB Rule G-27(a) and (c) are effectively identical to that rule.[21] Southridge's written supervisory procedures required North to review Southridge's electronic communications. We sustain FINRA's finding that North's review of Southridge's electronic communications violated NASD Rule 3010(b), FINRA Rule 2010, and MSRB Rule G-27(a) and (c).

North admits that he never reviewed the SMC repositories containing the firm's Bloomberg messages or chats, which he further admits were 85% of the firm's electronic correspondence. This failure alone is sufficient to sustain FINRA's findings.

North claims that he did not understand the Smarsh system and did not realize that he had to search a separate repository to review the firm's Bloomberg communications. But Southridge's written supervisory procedures made North responsible both for reviewing the firm's electronic communications and for using the Smarsh system to do so. North's failure to understand the system he was charged with using to fulfill his responsibilities to review the firm's communications only underscores the extent to which he acted unreasonably.

North also argues that he should not be found liable for inadequate supervision because Smarsh lacked the ability to archive Southridge's emails and did not host or control the underlying technology required to produce the SMC reports. The underlying emails, however, are not the basis for North's liability, as North's failure to conduct any review of the firm's Bloomberg communications was plainly not reasonable. Based on these facts, we find that North failed to reasonably review the firm's electronic correspondence in violation of NASD Rule 3010(b), FINRA Rule 2010, and MSRB Rule G-27(a) and (c).

3. NASD Rule 3010, FINRA Rule 2010, and MSRB Rule G-27 are, and were applied in a manner, consistent with the purposes of the Exchange Act.

Because we have "'long emphasized that the responsibility of broker-dealers to supervise their employees is a critical component of the federal regulatory scheme,'"[22] and because FINRA's application of NASD Rule 3010 and MSRB Rule G-27 was appropriate in this case

(…continued)

because they "contained no information with respect to the manner, method, frequency, or documentation of any review that [the firm] might conduct").

20 NASD Rule 3010(b).

21 *Compare* NASD Rule 3010(b) *with* MSRB Rule G-27(a) and (c).

22 *KCD Fin. Inc.*, Exchange Act Release No. 80340, 2017 WL 1163328, at *10 (Mar. 29, 2017) (citation omitted).

given the unreasonableness of the written supervisory procedures and North's review of the electronic correspondence, we find that NASD Rule 3010 and MSRB Rule G-27 are, and were applied in a manner, consistent with the purposes of the Exchange Act. FINRA Rule 2010 also is consistent with the Exchange Act's purposes because it reflects the mandate of Exchange Act Section 15(b)(6) that FINRA design its rules to "promote just and equitable principles of trade."[23] The application of Rule 2010 to North's failure to maintain a reasonable supervisory system furthered the objective of promoting just and equitable principles of trade.[24]

4. North acted willfully and is therefore subject to a statutory disqualification.

Under Section 3(a)(39) of the Exchange Act, a person who willfully violates MSRB rules is subject to a statutory disqualification from the securities industry.[25] A willful violation of the securities laws means "'that the person charged with the duty knows what he is doing.'"[26] Such a finding does not require that the respondent "also be aware that he is violating one of the Rules or Acts"; it simply requires the voluntary commission of the acts themselves.[27] Here, North acted voluntarily in failing to establish reasonable written supervisory procedures and in failing to reasonably review electronic correspondence. We find, and North does not contest on appeal, that his violation of MSRB Rule G-27 was willful and subjects him to statutory disqualification.

North argues that his willful use of a template and inclusion of "a single scrivener's error" in the supervisory procedures do not warrant "such harsh punishment" as a statutory disqualification. But a statutory disqualification is neither a punishment nor a sanction. Where, as here, there is a willful violation of MSRB rules "a person is subject to statutory disqualification by operation of Exchange Act Section 3(a)(39)(F)."[28]

B. North failed to report King's relationship with a statutorily disqualified person.

We find that North failed to report King's relationship with a statutorily disqualified person, that by doing so he violated NASD Rule 3070(a)(9) and FINRA Rule 2010, and that those rules are, and were applied in a manner, consistent with the purposes of the Exchange Act.

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[23] 15 U.S.C. 78o-3(b)(6).

[24] *Kenny Akindemowo*, Exchange Act Release No. 79007, 2016 WL 5571625, at *7 n.16 (Sept. 30, 2016).

[25] *See* 15 U.S.C. § 78c(a)(39), 15 U.S.C. § 78o(b)(4)(D).

[26] *Wonsover v. SEC*, 205 F.3d 408, 414 (D.C. Cir. 2000) (quoting *Hughes v. SEC*, 174 F.2d 969, 977 (D.C. Cir. 1949)).

[27] *David Adam Elgart*, Exchange Act Release No. 81779, 2017 WL 4335050, *4 (Sept. 29, 2017).

[28] *E.g., Michael Earl McCune*, Exchange Act Release No. 77375, 2016 WL 1039460, at *9 (Mar. 15, 2016).

1. North's failure to report King's relationship with Cowle violated FINRA rules.

NASD Rule 3070 required members to report to FINRA "not later than 10 business days after the member knows or should have known" that one of its associated persons was "associated in any business or financial activity with any person who is subject to a 'statutory disqualification.'"[29] Southridge's 2008 and 2010 written supervisory procedures specified that North, as CCO, was responsible for Southridge's compliance with NASD Rule 3070's reporting requirements. Here, North ignored clear red flags in connection with King's association with UTA. North knew that King had "worked with [Cowle] for years." Around July 2009, when Schloth was considering hiring both King and Cowle, North discovered that Cowle was statutorily disqualified. As a result, Schloth decided to hire only King, and King began working for Southridge in July 2009. That same month, KAM (King's company) entered into a service agreement with UTA. By March 2010, North knew about the service agreement with UTA and that KAM had paid UTA approximately $150,000 under the service agreement between July 2009 and February 2010. North reviewed the unsigned service agreement between KAM and UTA pursuant to which money was paid and saw that no one had signed it on behalf of UTA, and that no one was identified as performing services under the agreement on behalf of UTA. Yet North did not question King about the agreement or invoices or investigate further. Nor did FINRA's requests about the UTA invoices prompt North to inquire about King's relationship with UTA. We agree with the NAC that these facts should have led North to inquire about that relationship. Accordingly, North violated NASD Rule 3070 and FINRA Rule 2010 because he did not report King's and Cowle's relationship to FINRA although he should have known about it.

North argues that he should not be held liable for the Rule 3070 violation because the applicable rules applied only to the firm, Schloth had determined that there was no misconduct in King's and Cowle's relationship, and FINRA was supposedly aware of the relationship already. But the rules applied to associated persons as well as member firms,[30] North was responsible for reporting a registered representative's relationship with a statutorily disqualified individual regardless of whether the relationship involved misconduct, and North should have known about the relationship by March 2010 yet there is no evidence FINRA knew about it by that date.

2. NASD Rule 3070 and FINRA Rule 2010 are, and were applied in a manner, consistent with the purposes of the Exchange Act.

NASD Rule 3070 required member firms to file with FINRA information that could be used to identify risks and initiate investigations. This is consistent with the Exchange Act's requirement that FINRA design rules to "protect investors and the public interest."[31] FINRA's

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29 NASD Rule 3070(a)(9) & (b).

30 *See* FINRA Rule 0140(a).

31 15 U.S.C. § 78o-3(b)(6).

application of this rule to North's conduct furthered these objectives because North's failure to report King's relationship with Cowle frustrated FINRA's ability to monitor its members. As discussed above, FINRA Rule 2010 is consistent with the Exchange Act's requirement that FINRA promote just and equitable principles of trade.[32] FINRA's application of this rule to North's conduct furthered the objective of promoting just and equitable principles of trade.

A common thread through our analysis of the application of the FINRA, NASD and MSRB rules discussed above is that they are designed, and have been applied in this matter, in a manner consistent with the Exchange Act, including that they promote just and equitable principles of trade. In the case of a CCO, such application generally requires a matter-specific analysis of the facts and circumstances.

Compliance officers play a vital role in our regulatory framework. That role in many instances has increased in complexity, and there are circumstances where the role presents difficult challenges. In making determinations about CCO liability, the protection of investors and the public interest are at the forefront of our minds. The principles of fairness and equity, applied in context, also shine brightly in our decisions. For example, we have held that "[e]mployees of brokerage firms who have legal or compliance responsibilities do not become 'supervisors' . . . solely because they occupy those positions."[33] We have also dismissed proceedings alleging supervisory failures where the respondent conducted his own independent investigation in response to indications of wrongdoing and recommended responsive action.[34] We have further dismissed proceedings against an individual with compliance responsibilities that alleged liability for causing his firm's violations of the securities laws where another official at the firm had responsibility for overseeing the relevant activities and the respondent was never asked to evaluate the relevant regulatory issues.[35] We also have found a compliance director's failure to respond to NASD's requests for information mitigated by the "extraordinary demands on the compliance group" during the relevant time.[36]

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32 *Lane*, 2015 WL 627346, at *6 n.20.

33 *John H. Gutfruend*, Exchange Act Release No. 31554, 1992 WL 362753, at *15 (Dec. 3, 1992). *See also* Division of Trading and Markets, *Frequently Asked Questions about Liability of Compliance and Legal Personnel and Broker-Dealers under Section 15(b)(4) and 15(b)(6) of the Exchange Act* (Sept. 30, 2013), *available at* http://www.sec.gov/divisions/marketreg/faq-cco-supervision-093013.htm (stating that "compliance and legal personnel do not become 'supervisors' solely because they have provided advice or counsel concerning compliance or legal issues to business line personnel, or assisted in the remediation of an issue").

34 *James Arthur Huff*, Exchange Act Release No. 29017, 1991 WL 296561, at *4 (Mar. 28, 1991).

35 *Scott G. Monson*, Investment Company Act Release No. 28323, 2008 WL 2574441, at *5 (June 30, 2008).

36 *Richard J. Rouse*, Exchange Act Release No. 32658, 1993 WL 276149, at *5 (July 19, 1993).

These decisions reflect the principle that, in general, good faith judgments of CCOs made after reasonable inquiry and analysis should not be second guessed. In addition, indicia of good faith or lack of good faith are important factors in assessing reasonableness, fairness and equity in the application of CCO liability.

While matters involving the determination of CCO liability are facts and circumstances specific, there are matter types where determinations of individual liability generally are straightforward. For example, absent unusual mitigating circumstances, when a CCO engages in wrongdoing, attempts to cover up wrongdoing, crosses a clearly established line, or fails meaningfully to implement compliance programs, policies, and procedures for which he or she has direct responsibility, we would expect liability to attach. In contrast, disciplinary action against individuals generally should not be based on an isolated circumstance where a CCO, using good faith judgment makes a decision, after reasonable inquiry, that with hindsight, proves to be problematic. When the facts and circumstances of matters fall outside these relatively clear examples of where liability should or should not attach, liability determinations will require matter-specific analysis and informed judgment.

With that perspective, in this instance, on the record before us, it is clear that North failed to make reasonable efforts to fulfill the responsibilities of his position.[37] It is the evidence of North's actions and failures to act that is the basis for his liability.[38] North's failure to fulfill his own responsibilities was egregious. Here, North ignored red flags and repeatedly failed to perform compliance functions for which he was directly responsible. Under these facts and circumstances, FINRA's disciplinary action was clearly appropriate.

In reaching this conclusion, we recognize that North was not the only person at Southridge whose performance may have been deficient with respect to the written supervisory procedures and review of electronic communications.[39] The Commission has held repeatedly that the "chief executive officer of a brokerage firm is responsible for compliance with all of the requirements imposed on his firm 'unless and until he reasonably delegates particular functions to another person in the firm and neither knows nor has reason to know' that a problem has arisen."[40] Although Schloth may have delegated the compliance functions with respect to

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[37] *See Robert A. Grunburg*, Exchange Act Release No. 36182, 1995 WL 522993, at *3 (Sept. 1, 1995) (finding that chief compliance officer, who was "responsible for final approval of the firm's advertising," violated NASD rules by failing "to conduct a careful review of the advertisements").

[38] *See, e.g.*, *SEC v. Universal Major Indus. Corp.*, No. 73-3626, 1975 WL 400, at *3, 20 (S.D.N.Y. July 14, 1975) (stating that corporate counsel's "liability is based not upon his title, but upon the acts which he performed"), *aff'd*, 546 F.2d 1044 (2d Cir. 1976).

[39] FINRA's settlement with Schloth involved only Schloth's supervisory failures regarding King's relationship with Cowle. *See supra* note 10.

[40] *Michael J. Markowski*, Exchange Act Release No. 43259, 2000 WL 1264292, at *4 (Sept. 7, 2000) (quoting *Thomas F. White*, Exchange Act Release No. 34398, 1994 WL 389903,

(continued...)

establishing and maintaining adequate written procedures and reviewing electronic correspondence to North, that did not end his responsibilities. "It is not sufficient for the person with overarching supervisory responsibilities to delegate supervisory responsibility to a subordinate, even a capable one, and then simply wash his hands of the matter until a problem is brought to his attention. . . . Implicit is the additional duty to follow-up and review that delegated authority to ensure that it is being properly exercised."[41] The record does not indicate what actions Schloth took to monitor whether North was reviewing electronic communications, and we are troubled by the possibility that North could have abdicated his own responsibilities to review those communications without Schloth knowing.

Finally, it is not clear from the record why FINRA did not charge Southridge, although we take official notice of the fact that Southridge terminated or withdrew its registration over a year prior to FINRA instituting its action here.[42] "A firm . . . can act only through its agents, and is accountable for the actions of its responsible officers."[43] We think it important to make it clear to firms—by holding them responsible when there are problems—that it is in their interest to have effective, diligent compliance officers to help them remain in compliance with their obligations. Further, as we have said previously, "broker-dealers must provide effective staffing, sufficient resources and a system of follow-up and review to determine that any responsibility to supervise delegated to compliance officers, branch managers and other personnel is being diligently exercised."[44] Indeed, in some cases it may be more appropriate to hold the firm liable rather than the compliance officer. In this case, we agree with FINRA that its disciplinary action against North was warranted.

(…continued)

at *2 (July 19, 1994)), *reconsideration denied*, *Michael J. Markowski*, Exchange Act Release No. 43503, 2000 WL 1656276 (Nov. 1, 2000); *see also FAQs*, supra note 33 (stating that the "Commission has stated that ultimately the responsibility for a broker-dealer's compliance resides with its chief executive officer and senior management") (citations omitted).

41 *Castle Sec. Corp.*, Exchange Act Release No. 39523, 1998 WL 3456, at *4 (Jan. 7, 1998) (citations omitted).

42 https://brokercheck.finra.org/firm/summary/45531 (showing termination or withdrawal on September 23, 2011). *See generally* FINRA By-Laws Article IV, Section 6 (stating that a "resigned member or a member that has had its membership canceled or revoked shall continue to be subject to the filing of a complaint . . . based upon conduct which commenced prior to the effective date of the member's resignation . . . or the cancellation or revocation of its membership" provided that the complaint "be filed within two years after the effective date of resignation, cancellation, or revocation").

43 *A.J. White & Co. v. SEC*, 556 F.2d 619, 624 (10th Cir. 1977).

44 *Stuart K. Patrick*, Exchange Act Release No. 32314, 1993 WL 172847, at *3 (May 17, 1993) (citation omitted), *petition denied*, 19 F.3d 66 (2d Cir. 1994).

C. North's remaining arguments are unavailing.

1. North's claims about the exclusion of evidence concerning the Southridge emails underlying the Smarsh reports are irrelevant to his liability.

North contends that the Hearing Officer and a NAC subcommittee erroneously excluded evidence about Southridge emails that FINRA allegedly "spoliated" and that the Smarsh system improperly archived.[45] As discussed above, the Southridge emails underlying the Smarsh reports are irrelevant to our decision to sustain FINRA's finding of violations. North's complete failure to review the firm's Bloomberg communications establishes his liability.

2. Neither the Hearing Officer nor a NAC subcommittee demonstrated bias.

North argues that the Hearing Officer was biased because he "participated either directly or indirectly" in Cowle's 2007 disciplinary proceeding and issued evidentiary rulings in this proceeding that were "intended to favor FINRA in prosecuting anyone who may have had contact with [Cowle]." But the record does not establish that the Hearing Officer participated in Cowle's disciplinary proceeding. The record establishes only that the Hearing Officer previously worked in Enforcement and was copied on FINRA's decision finding that Cowle willfully failed to disclose information on his Form U4. In any case, North's only evidence of bias is the Hearing Officer's evidentiary rulings. Adverse rulings alone do not establish bias.[46]

North also argues that a NAC subcommittee was biased against him when it denied his motion to introduce additional evidence in order to "avoid confronting FINRA's and Smarsh's illegal conduct." Again, North's only evidence of bias is the NAC subcommittee's rulings against him. These rulings, which we found fully supported by the record, do not establish bias.

3. North's claims of a conspiracy against him are meritless.

North claims that FINRA conspired with Smarsh to illegally intercept and fabricate emails from North and other Southridge brokers and "made up" or altered exhibits, including the

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[45] On April 6, 2015, North filed an action against FINRA and Smarsh in federal district court alleging that the data Smarsh produced to FINRA was spoliated and tampered with. The district court dismissed the action on December 4, 2015, finding that North "was highly unlikely to succeed on the merits of [his] negligent spoliation claim," that the court lacked jurisdiction to review or enjoin FINRA's disciplinary actions, and that FINRA was absolutely immune from suit. *See North v. Smarsh*, 160 F. Supp. 3d 63, 86-88 (D.D.C. 2015).

[46] *AutoChina Int'l Ltd.*, Exchange Act Release No. 79010, 2016 WL 5571626, at * n.21 (Sept. 30, 2016) (citing *Liteky v. United States*, 510 U.S. 540, 555 (1994) and *Marcus v. Dir., Office of Workers' Comp. Programs*, 548 F.2d 1044, 1051 (D.C. Cir. 1976)). North also vaguely alleges that FINRA's lead prosecutor and deputy hearing officer were biased because of their prior involvement with the Cowle matter, but he does not explain how this improperly affected FINRA's decision. In any case, we find no evidence of improper bias on their part.

Smarsh Reports and written supervisory procedures, to pursue allegedly frivolous disciplinary cases in violation of the Maloney Act,[47] the Electronic Communications Privacy Act,[48] the Y2K Act,[49] and the Fourth Amendment to the U.S. Constitution.[50] We find no basis for those claims. As explained above, Southridge's underlying emails are not relevant to finding North liable here. North also does not specify how FINRA's alleged conduct violated these provisions beyond vague allegations about a broad, unlawful conspiracy against him. Finally, we can find no evidence in the record to support those allegations.

III. Sanctions

Under Exchange Act Section 19(e)(2), we must sustain FINRA's sanctions unless we find, having due regard for the public interest and the protection of investors, that the sanctions are excessive or oppressive or impose an unnecessary or inappropriate burden on competition.[51] In doing so, we must consider any aggravating or mitigating factors.[52] We also consider whether the sanctions are remedial or punitive.[53] Although we are not bound by FINRA's Sanction Guidelines, we use them as a benchmark in conducting our review.[54] North does not challenge the sanctions other than to claim that they are unreasonable because FINRA allegedly obtained evidence illegally and was biased—claims that are either irrelevant or unsupported.

A. The sanctions for failing to establish a reasonable supervisory system and reasonably review electronic correspondence are neither excessive nor oppressive.

FINRA's Sanctions Guidelines recommend a fine between $1,000 and $37,000 for deficient written supervisory procedures.[55] We agree with the NAC that North's failure to establish adequate written supervisory procedures was serious. "Assuring proper supervision is a

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47 *See* Maloney Act of 1938, Pub. L. No. 75-719, 52 Stat. 1070.

48 *See* 18 U.S.C. §§ 2510–22.

49 *See* 15 U.S.C. §§ 6601–17.

50 The Fourth Amendment does not apply to FINRA proceedings. *See Sheen Fin. Resources, Inc.,* Exchange Act Release No. 35477, 1995 WL 116484, at *5 (Mar. 13, 1995) (observing that the Fourth Amendment was not applicable to FINRA's predecessor NASD).

51 15 U.S.C. § 78s(e)(2). The record does not show that FINRA's sanctions impose an unnecessary or inappropriate burden on competition.

52 *Saad v. SEC*, 718 F.3d 904, 906 (D.C. Cir. 2013) (citing *PAZ Sec., Inc. v. SEC*, 494 F.3d 1059, 1065 (D.C. Cir. 2007)).

53 *McCarthy v. SEC*, 406 F.3d 179, 188–191 (2d Cir. 2005).

54 *See, e.g.*, *John Joseph Plunkett*, Exchange Act Release No. 69766, 2013 WL 2898033, at *11 (June 14, 2013).

55 FINRA Sanctions Guidelines at 103 (2016).

critical component of broker-dealer operations."[56] The Guidelines also identify as a Principal Consideration whether the deficient written procedures allowed violative conduct to occur or to escape detection.[57] As the NAC observed, North's failure to establish reasonable written supervisory procedures allowed violative conduct to continue because it contributed to North's unreasonable review of electronic correspondence. As the NAC stated, North "may not have been so haphazard" if the procedures had not been deficient because specific guidelines and review procedures could have dictated his review. We also agree it was aggravating that the deficient written supervisory procedures were in effect for over two years and involved both the 2008 and 2010 written supervisory procedures.

We recognize that the $10,000 fine is in the Guidelines' lower range. We also recognize that the fine will help secure North's compliance with FINRA's rules governing written supervisory procedures in the future. Given these factors, we find that FINRA's imposition of the $10,000 fine is a remedial sanction and is neither excessive nor oppressive.

FINRA's Sanction Guidelines further recommend a fine of $5,000 to $73,000 and a suspension in all principal capacities for up to 30 business days for failing to establish and maintain such reasonable supervisory procedures and, in egregious cases, recommend imposing a longer suspension in all capacities or barring the responsible individual.[58] In determining the appropriate sanctions, the Guidelines provide three Principal Considerations: (1) whether the individual ignored "red flag" warnings that should have resulted in additional supervisory 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.[59] North admits that over a two-year period he never reviewed the firm's Bloomberg communications. North's failure to reasonably review electronic correspondence was egregious. We therefore agree with the NAC that North's misconduct "warrants significant sanctions."

We recognize that the NAC tailored North's suspension to his misconduct. North's violation was a failure to supervise as he was responsible for the review of electronic correspondence. As a result, the NAC suspended North in all principal and supervisory capacities only. The suspension and fine will protect the public by encouraging North to take any responsibility to review electronic communications in a supervisory capacity in the future more seriously. The suspension and fine are also relatively lenient given the sanctions that the guidelines recommend for egregious cases. Thus, we find that FINRA's imposition of a two-month suspension in all principal and supervisory capacities and a $20,000 fine are remedial sanctions and are neither excessive nor oppressive.

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[56] *World Trade Fin. Corp.*, Exchange Act Release No. 66114, 2012 WL 32121, at *11 (Jan. 6, 2012) (quoting *Ronald Pellegrino*, Exchange Act Release 59125, 2008 WL 5328765, at *10 (Dec. 19, 2008)), *petition denied*, 739 F.3d 1243 (9th Cir. 2014).

[57] FINRA Sanctions Guidelines at 103.

[58] FINRA Sanctions Guidelines at 102.

[59] *Id.*

B. The sanctions FINRA imposed on North for failing to report a relationship with a statutorily disqualified person are neither excessive nor oppressive.

FINRA's Sanction Guidelines for a failure to report a relationship with a statutorily disqualified person recommend a fine of $5,000 to $146,000 and a suspension of the responsible principal in all supervisory capacities for 10 to 30 business days.[60] In egregious cases, the Guidelines recommend suspending the responsible individual in all capacities for up to two years or barring the responsible principal in all supervisory capacities.[61] The NAC's imposition of a 30-business-day suspension in all principal and supervisory capacities and a $10,000 fine is within these Guidelines, and we find that these sanctions are not excessive or oppressive.

We agree with FINRA that aggravating factors are present. The Guidelines advise adjudicators to consider whether the unreported event would have established a pattern of potential misconduct.[62] Had North investigated KAM's relationship with UTA in March 2010, he would have discovered that Cowle, whom he knew was statutorily disqualified, owned UTA—and thus could have reported that information to FINRA. North's failure to investigate and report the relationship allowed King to continue inappropriately doing business with Cowle, without FINRA knowing, for several months. North's failure to report the relationship thus deprived FINRA of important regulatory information.

As discussed above, the NAC tailored North's suspension to his misconduct by suspending him in principal and supervisory capacities only. The suspension and fine will impress upon North the need to report a relationship with a statutorily disqualified person to

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60 *Id*. at 73.

61 *Id*.

62 *Id*.

FINRA so that he reports such important information in the future. For these reasons, we find that FINRA's imposition of a 30-business-day suspension in all principal capacities and a $10,000 fine are remedial sanctions and are neither excessive nor oppressive.[63]

An appropriate order will issue.[64]

By the Commission (Chairman CLAYTON and Commissioners STEIN, JACKSON, PEIRCE and ROISMAN).

Brent J. Fields
Secretary

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[63] We also sustain FINRA's imposition of costs.

[64] We have considered all of the parties' contentions. We have rejected or sustained them to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Release No. 84500 / October 29, 2018

Admin. Proc. File No. 3-17909

In the Matter of the Application of

THADDEUS J. NORTH

For Review of Disciplinary Action Taken by

FINRA

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY FINRA

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action taken by FINRA against Thaddeus J. North be, and it hereby is, sustained.

By the Commission.

Brent J. Fields
Secretary