

**FINANCIAL INDUSTRY REGULATORY AUTHORITY**  
**OFFICE OF HEARING OFFICERS**

Department of Enforcement,

Complainant,

v.

Wedbush Securities Inc. (CRD No. 877),

Respondent.

DISCIPLINARY PROCEEDING  
No. 2012033105901

**COMPLAINT**

The Department of Enforcement alleges:

**SUMMARY**

1. On multiple occasions between June 2009 and June 2012, Wedbush Securities Inc. ("Wedbush" or the "Firm") put customer assets at risk in disregard of its obligations under the Customer Protection Rule.
2. During exams in 2009, 2010 and 2011, FINRA found 30 separate instances where Wedbush violated the possession or control requirement of the Customer Protection Rule by creating and/or increasing deficits in the number of securities required to be in the Firm's possession or control. These deficits put approximately 100,000 shares of customer's securities, worth approximately \$7 million, at risk.
3. In 2011 and 2012, Wedbush also violated the customer reserve formula requirements of the Customer Protection Rule on 14 separate occasions by failing to accurately calculate its customer reserve requirement in accordance with the Customer Protection Rule. These 14 violations resulted in Wedbush underfunding its customer

reserve bank account (known as “hindsight deficiencies”) eight times and putting over \$200 million in customer assets at risk.

4. As a result of the foregoing, Wedbush willfully violated Section 15(c) of the Securities Exchange Act of 1934 (“Exchange Act”) and Exchange Act Rules 15c3-3(b)(1) and 15c3-3(e) thereunder, and FINRA Rule 2010.
5. Moreover, despite being on notice from prior FINRA exams as early as 2004 that it had failed to properly protect customer assets, and despite a Letter of Caution on this subject in 2008, from 2009 through 2012, Wedbush failed to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with the requirements of the Customer Protection Rule— in violation of NASD Rules 3010(a) and 3010(b) and FINRA Rule 2010.

#### RESPONDENT AND JURISDICTION

6. Wedbush (known as Wedbush Morgan Securities Inc. until April 2010) is a full-service brokerage firm headquartered in Los Angeles, California. Wedbush, a self-clearing firm, conducts a general securities business through approximately 647 registered individuals in approximately 100 branch offices. Wedbush also provides clearing services for approximately 88 introducing/correspondent broker-dealers. Wedbush has been a FINRA regulated broker-dealer since July 1955 and is subject to FINRA’s jurisdiction pursuant to Article IV, Section 1 of FINRA’s By-Laws.

#### BACKGROUND

7. 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 broker-dealer insolvency, by (1) requiring broker-dealers to maintain physical possession or control of customers' fully paid and excess margin securities (the "possession or control" requirement), and (2) requiring broker-dealers to establish a special reserve bank account for the benefit of customers (the "customer reserve account" or "reserve account") and to fund that account in accordance with Exhibit A to the Rule, which sets forth in detail the computational formula ("customer reserve formula" or "reserve formula") for calculating the required balance (the "customer reserve account" requirement).

8. Over the course of four exams, from 2009 through 2012, FINRA discovered that Wedbush had repeatedly violated both of these requirements by creating or increasing deficits in the number of securities required to be in the Firm's possession or control, and by failing to accurately calculate its customer reserve formula and adequately fund its customer reserve account in accordance with the Customer Protection Rule.

#### **FIRST CAUSE OF ACTION**

#### **(Possession or Control (Exchange Act Section 15(c), Exchange Act Rule 15c3-3(b)(1) and FINRA Rule 2010))**

9. The Department realleges and incorporates by reference paragraphs 1 – 8 above.
10. Exchange Act Section 15(c) and Rule 15c3-3(b)(1) thereunder requires a broker-dealer to promptly obtain and maintain physical possession or control of fully-paid securities and excess margin securities carried for customer accounts. The Rule, along with controlling Rule Interpretation 15c3-3(b)(2)-03, prohibits a firm from delivering or removing securities from its possession or control if doing so would

create or increase a deficiency in the quantity of securities required to be in its possession or control.

11. **The quantity of securities required to be in a firm's possession or control is known as the firm's segregation requirement.**
12. **A violation of Exchange Act Section 15(c) and Rule 15c3-3 constitutes a violation of FINRA Rule 2010, which requires firms to "observe high standards of commercial honor and just and equitable principles of trade."**
13. **In exams in 2009, 2010 and 2011, from a sample of securities taken from a two- to four-week period each year, FINRA found 30 separate instances in which Wedbush created and/or increased deficits in its segregation requirement through deliveries or returns of securities.**
14. **In 2009, Wedbush created or increased three deficits, involving approximately 900 shares of stock worth approximately \$12,000. Two of the deficits were caused by stock borrow returns, when the Firm returned shares of stock it had borrowed without having sufficient excess shares above the Firm's segregation requirement. The other deficit was caused by the Firm making a delivery of shares to settle a trade without sufficient excess.**
15. **In 2010, Wedbush created or increased eight deficits, involving over 12,850 shares of stock worth approximately \$360,000. Six of the deficits were caused by stock borrow returns. Two of the deficits were caused by stock loans that the Firm made without having sufficient excess of shares above the Firm's segregation requirement.**

16. In 2011, Wedbush created or increased 19 deficits, involving over 96,600 shares of stock worth approximately \$6.6 million. Seven of the deficits were from stock borrow returns, where the Firm returned shares of stock borrowed without having sufficient excess over its segregation requirement. Five of the deficits were from stock loans, when the Firm loaned shares without having sufficient excess. Four of the deficits were caused by the same day receipt of shares from a returned stock loan and the impermissible redelivery of those shares ("turnaround") and three of the deficits were caused by deliveries through the National Securities Clearing Corporation's ("NSCC") Continuous Net Settlement system ("CNS"), which nets the securities delivery and payment obligations of all NSCC participants. All of the deliveries were made when the Firm did not have sufficient excess of the shares above its segregation requirement.
17. Each of these 30 deficits are specifically identified in the attached Exhibit A, which delineates the date the deficit was created and/or increased, the symbol of the security, the number of shares in deficit, the cause of the deficit, and the value of the deficit.
18. In total, the 30 deficits identified by FINRA involved approximately 100,000 shares of stock worth approximately \$7 million.
19. Each creation or increase of a deficit in the Firm's segregation requirement constitutes a separate and distinct willful violation of Exchange Act Section 15(c), Exchange Act Rule 15c3-3(b)(1) and FINRA Rule 2010.

**SECOND CAUSE OF ACTION**  
**(Customer Reserve (Exchange Act Section 15(c),**  
**Exchange Act Rule 15c3-3(e) and FINRA Rule 2010))**

20. The Department realleges and incorporates by reference paragraphs 1 – 19 above.
21. Exchange Act Section 15(c) and Rule 15c3-3(e) thereunder requires a broker-dealer to maintain a “Special Reserve Bank Account for the Exclusive Benefit of Customers” and to fund the reserve account in accordance with the provisions of Exhibit A to the Rule, which sets forth in detail the computational “Formula for Determination of Reserve Requirement for Brokers and Dealers.”
22. In general, the reserve formula requires a broker-dealer to calculate any amounts it owes customers, called credits, and compare that amount to any amounts its customers owe it, called debits. If credits exceed debits, the broker-dealer must deposit the difference in the customer reserve account. A hindsight deficiency occurs when it is discovered that a customer reserve account funding deficiency existed in the required deposit.
23. From February 2011 through June 2012, the Firm willfully violated Securities and Exchange Act Section 15(c), Exchange Act Rule 15c3-3(e) and FINRA Rule 2010 on 14 occasions by improperly calculating its customer reserve formula, which, on eight occasions, resulted in hindsight deficiencies totaling over \$200 million.

**I. Customer Reserve Violations Resulting from Bank Loans Secured by Customer Collateral**

24. Exchange Act Rule 15c3-3a item 2 states that “monies borrowed collateralized by securities carried for the accounts of customers” should be included in the reserve formula as a credit.
25. In early 2011, the Firm began taking out bank loans to fund certain activities, and using customer securities to collateralize those loans.
26. From February to November 2011, the Firm failed, as required, to include the amount of bank loans that were collateralized by customer securities as credits in the reserve formula on eleven occasions, six of which resulted in deficiencies of approximately \$200 million in total, as follows:
- i. February 18, 2011 – failed to include approximately \$15 million in bank loans collateralized by customer securities;
  - ii. March 3, 2011 – failed to include approximately \$47 million in bank loans collateralized by customer securities, resulting in a hindsight deficiency of approximately \$24 million;
  - iii. March 18, 2011 – failed to include approximately \$93 million in bank loans collateralized by customer securities, resulting in a hindsight deficiency of approximately \$77 million;
  - iv. April 21, 2011 – failed to include approximately \$20 million in bank loans collateralized by customer securities, resulting in a hindsight deficiency of approximately \$14 million;
  - v. June 17, 2011 – failed to include approximately \$5 million in bank loans collateralized by customer securities;
  - vi. August 12, 2011 – failed to include approximately \$55 million in bank loans collateralized by customer securities, resulting in a hindsight deficiency of approximately \$44 million;
  - vii. September 20, 2011 – failed to include approximately \$41 million in bank loans collateralized by customer securities, resulting in a hindsight deficiency of approximately \$28 million;
  - viii. September 22, 2011 – failed to include approximately \$9 million in bank loans collateralized by customer securities;

- ix. October 7, 2011 – failed to include approximately \$4.6 million in bank loans collateralized by customer securities;
- x. October 31, 2011 – failed to include approximately \$11.6 million in bank loans collateralized by customer securities; and
- xi. November 11, 2011 – failed to include approximately \$27 million in bank loans collateralized by customer securities, resulting in a hindsight deficiency of approximately \$11 million.

## **II. Customer Reserve Violations Resulting from CNS Fail to Deliver vs. Box**

27. Exchange Act Rule 15c3-3a item 12 and Rule Interpretation 15c3-3 (Exhibit A – Item 12)/081, provides, in pertinent part, that failed to deliver of customers’ securities not older than 30 calendar days that are allocated to a box location—formerly a physical safe-deposit box location, now typically a book-entry type account held at a custodian entity where the securities are segregated by firm—may be included as a debit in the reserve formula if, among other things, the failed to deliver arose from a customer sale transaction. If the failed to deliver did not arise from a customer sale transaction, the contract value should not be included as a debit in the reserve formula.
28. On two occasions in 2011, the Firm erroneously included as debits in the customer reserve formula the contract value of failed to deliver transactions that allocated as “CNS fail to deliver vs. box” but did not arise from customer sale transactions. Specifically, on March 3, 2011, the Firm erroneously included approximately \$22 million as a debit, resulting in a hindsight deficiency of at least \$4 million; and on April 15, 2011, the Firm erroneously included approximately \$16.7 million as a debit, resulting in a hindsight deficiency of \$945,000.

### **III. Customer Reserve Violation from Customer Securities Pledged for Firm Options Clearing Corporation (“OCC”) Requirements**

29. When customer securities are used to collateralize Firm OCC margin requirements, the market value of the securities are required to be included as credits in the customer reserve formula.
30. In 2012, the Firm failed to include as credits in the customer reserve formula the market value of securities that were pledged in support of Firm OCC margin requirements. Specifically, as of June 29, 2012, the Firm failed to include as a credit in the customer reserve formula at least \$1.35 million in customer securities that were allocated as “customer long vs. firm bank loan” and had been pledged in support of Firm OCC margin requirements.
31. Each of the 14 improper calculations of the customer reserve formula, including the eight hindsight deficiencies, constitute separate and distinct willful violations of Exchange Act Section 15(c), Exchange Act Rule 15c3-3(e) and FINRA Rule 2010.

#### **THIRD CAUSE OF ACTION**

#### **(Supervision (NASD Rules 3010(a) and 3010(b) and FINRA Rule 2010))**

32. The Department realleges and incorporates by reference paragraphs 1 – 31 above.
33. NASD Rule 3010(a) requires each member to establish and maintain a system to supervise the activities of each registered representative, registered principal, and other associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD and FINRA rules.

34. NASD Rule 3010(b) requires each member to establish, maintain, and enforce written procedures to supervise the types of business in which it engages and supervise the activities of registered representatives, registered principals, and other associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with the applicable NASD and FINRA rules.

35. A violation of NASD Rule 3010 constitutes a violation of FINRA Rule 2010.

36. Wedbush failed to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with both the possession or control requirement and the customer reserve account requirement of the Customer Protection Rule.

**I. Supervision of Possession or Control**

37. At all relevant times during the 2009, 2010 and 2011 exams (the "Relevant Period"), the Firm relied on an improperly designed and improperly implemented manual system to prevent the creation and increase of segregation deficits.

38. The Firm made deliveries and returns of securities manually, outside of Thompson Reuters' BETA system ("BETA"), which the Firm used to calculate the Firm's segregation requirement for each customer and each security on a daily basis. BETA prevents deliveries or returns of securities made through the BETA system if the delivery or return would decrease the Firm's position below its segregation requirement and, thereby, create or increase a deficit.

39. When the Firm made deliveries or returns of securities manually outside of BETA, however, BETA could not and did not prevent, and the Firm had no other systemic

control to prevent, the delivery of shares from the Firm's account at the Depository Trust Company ("DTC") that would create or increase a deficit.

40. Rather, when the Firm made deliveries or returns manually, Firm personnel were supposed to access the Firm's online segregation analysis system ("SEGA"), which would calculate and display the number of shares of a particular security that were in excess of the Firm's segregation requirement. This was the Firm's process for determining whether a particular delivery of securities would create a deficit. This procedure, however, was not adequate to prevent the creation or increase of segregation deficits, as segregation deficits continued to be created or increased during the Relevant Period.
41. Additionally, the Firm had no written procedure in place between January 1, 2009 and September 1, 2011 that required Wedbush personnel to use SEGA to determine if there was an excess of a security prior to making a stock loan.
42. Firm staff were also, in certain situations when the Firm made deliveries or returns manually, supposed to make manual entries at DTC, identified as "hard seg" entries, that would prevent shares being delivered out of DTC if such delivery would create or increase a deficit. This procedure, however, was also not adequate to prevent the creation or increase of segregation deficits, as segregation deficits continued to be created or increased during the Relevant Period.
43. Similarly, the Firm had no system that would automatically prevent the turnaround of stock, that is, the receipt and immediate redelivery of stock, on a stock loan, even if such delivery created and/or increased a deficit.

44. The Firm's manual system was inadequate and not reasonably designed to achieve compliance with the possession or control requirement of the Customer Protection Rule as the Firm created or increased at least 30 deficits, worth approximately \$7 million during the Relevant Period.
45. Given the volume of transactions processed by the Firm, and the size of the Firm's securities lending business, the Firm's manual system was inadequate and not reasonably designed to prevent the creation or increase of deficits for deliveries and returns made outside of the Firm's back-office system.
46. In exams conducted in 2004, 2006, and 2008, FINRA found a total of 15 segregation deficits in the number of securities required to be in the Firm's possession or control and issued a Letter of Caution to the Firm in 2008. Some of the deficits found by FINRA in 2004, 2006, and 2008 were, like in the instant matter, the result of deliveries and returns made outside of the BETA system.
47. Wedbush knew that FINRA had identified possession or control deficit violations. After each exam, the Firm was provided with written examination reports in connection with each exam that delineated the deficits found by FINRA. Moreover, these deficits were discussed orally in exit meetings held between FINRA staff and Firm personnel at the end of each exam.
48. Nevertheless, despite this notice, Wedbush failed to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with the possession or control requirement of the Customer Protection Rule and continued to violate the possession and control requirement of the Customer

Protection Rule. FINRA exams in 2009, 2010 and 2011 continued to identify deficits each year.

49. In September 2011, the Firm finally began using an automated system for preventing shares from being delivered out of DTC if such delivery would create or increase a segregation deficit. No possession or control deficits were identified by FINRA in the 2012 and 2013 exams, after the automated system was adopted.

50. Accordingly, from at least January 2009 to September 2011, Wedbush violated NASD Rules 3010(a) and 3010(b) and FINRA Rule 2010 by failing to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with the possession or control requirement of the Customer Protection Rule.

## **II. Supervision of Customer Reserve Formula**

51. From February 2011 to June 2012, the Firm also failed to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with the customer reserve account requirement of the Customer Protection Rule. Specifically, the Firm failed to have a system that required certain Firm departments, including the Cash Management Department, to provide, or the Accounting Department to consider, all relevant information, which would result in the accurate calculation of its customer reserve formula.

52. From February 2011 to June 2012, the Wedbush Accounting Department calculated the customer reserve formula for the Firm every Monday and on the first business day of every month using allocation reports from BETA, the Firm's general ledger, trial balance and cash reconciliation reports. These reports were collected from several

other departments at Wedbush, including Credit, Cash Management, Street Settlement, and Internal Controls and Audit.

**A. Supervision related to Customer Bank Loans**

53. From February to November 2011, the Firm's systems and procedures did not require the Cash Management Department to provide notice to the Accounting Department when customer securities were used to secure Firm obligations. Thus, during that period, the Cash Management Department failed to notify the Accounting Department to include the value of bank loans secured by customer securities as credits in the customer reserve formula, leading to customer reserve account violations.
54. Only after the Firm was notified of a problem with its customer reserve formula in late 2011 did the Firm put a system in place that required the Cash Management Department to notify the Accounting Department when it used customer securities as collateral for bank loans.
55. The Firm did not have a final written procedure memorializing that system, however, until 2013.
56. The procedure the Firm used to address the bank loan issue, however, only addressed customer securities used as collateral for bank loans and was insufficient to prevent the Firm from violating the Customer Protection Rule by failing to include as credits in the customer reserve formula the market value of securities used to collateralize Firm OCC margin requirements, which FINRA identified as a violation in the 2012 exam.

**B. Supervision related to CNS Fail to Deliver vs. the Box**

57. From March to May 2011, the Firm's systems and procedures did not require the Accounting Department to consider whether items in the "CNS fail to deliver vs. box" allocation were customer-related. Thus, during that period, the Firm erroneously included non-customer transactions as debits in the customer reserve formula on at least two occasions.

**C. Supervision related to Firm OCC Margin Requirements**

58. From at least December 2011 to June 2012, the Firm did not have a process for, or written procedures requiring, Cash Management to notify Accounting when it was using customer securities as collateral for Firm OCC requirements, even though by that time it had put a procedure in place for Cash Management to notify Accounting when it was using customer securities to secure Firm bank loans.

59. Thus, although Accounting received a report showing a "customer long vs. firm bank loan" allocation that included the value of customer securities used to support the Firm's OCC margin requirements, Accounting disregarded this report when calculating its customer reserve formula.

60. As a result, on June 29, 2012, the Accounting Department failed to include at least \$1.35 million in customer securities that allocated as "customer long vs. firm bank loan" and had been pledged in support of Firm OCC margin requirements as credits in the customer reserve formula and additionally failed to determine whether the remaining \$4.7 million in customer securities that allocated as "customer long vs.

firm bank loan” were required to be included as credits in the customer reserve formula.

61. Accordingly, from February 2011 to June 2012, Wedbush violated NASD Rules 3010(a) and 3010(b) and FINRA Rule 2010 by failing to establish and maintain a supervisory system, including written procedures, reasonably designed to achieve compliance with the customer reserve account requirements of the Customer Protection Rule.

### **RELIEF REQUESTED**

WHEREFORE, the Department respectfully requests that the Panel:

- A. make findings of fact and conclusions of law that Respondent committed the violations charged and alleged herein;
- B. order that one or more of the sanctions provided under FINRA Rule 8310(a), including monetary sanctions, be imposed;
- C. order that Respondent bear such costs of proceeding as are deemed fair and appropriate under the circumstances in accordance with FINRA Rule 8330; and

- D. make specific findings that Respondent Wedbush Securities Inc. willfully violated  
Section 15(c) of the Exchange Act and Exchange Act Rule 15c3-3.

**FINRA DEPARTMENT OF ENFORCEMENT**

Date: 5/27/16



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**Exhibit A**  
**Segregation Deficits Created or Increased by Wedbush**

No.	Date of Deficit	Security	Number of Shares	Cause of Deficit	Approximate Value
1.	April 14, 2009	CLFC	500	Stock Borrow Return	\$2,000
2.	April 14, 2009	HSP	300	Stock Borrow Return	\$9,600
3.	April 16, 2009	RVSN	100	Delivery	\$700
4.	February 8, 2010	COF	6,659	Stock Borrow Return	\$230,601
5.	February 9, 2010	KBE	3,586	Stock Borrow Return	\$78,569
6.	February 12, 2010	MHPI	384	Stock Borrow Return	\$13,248
7.	February 12, 2010	MHPI	100	Stock Borrow Return	\$3,450
8.	February 12, 2010	SBH	1,047	Stock Borrow Return	\$8,355
9.	February 12, 2010	SBH	200	Stock Borrow Return	\$1,595
10.	February 5, 2010	UNS	235	Stock Loan	\$7,174
11.	February 10, 2010	XLP	640	Stock Loan	\$16,806
12.	March 14, 2011	ELNK	803	Stock Borrow Return	\$6,335
13.	March 15, 2011	ADBE	2,101	Stock Borrow Return	\$69,417
14.	March 15, 2011	PAYX	713	Stock Borrow Return	\$22,830
15.	March 18, 2011	SPY	10,200	Stock Borrow Return	\$1,251,624
16.	March 18, 2011	SPY	3,600	Stock Borrow Return	\$441,749
17.	April 5, 2011	A	500	Stock Borrow Return	\$16,362
18.	April 5, 2011	A	300	Stock Borrow Return	\$9,817
19.	March 10, 2011	XLV	9,609	Stock Loan	\$313,157
20.	March 11, 2011	BRFS	237	Stock Loan	\$4,185
21.	March 17, 2011	SPY	3,599	Stock Loan	\$460,132
22.	March 18, 2011	HUM	1,600	Stock Loan	\$103,856
23.	March 21, 2011	SPY	12,923	Stock Loan	\$1,670,000
24.	March 8, 2011	AMB	185	Turnaround	
25.	March 11, 2011	XLV	9,609	Turnaround	\$313,157
26.	March 11, 2011	XLV	1,600	Turnaround	\$52,143
27.	March 18, 2011	SPY	9,800	Turnaround	\$1,252,048
28.	March 11, 2011	UDR	7,399	CNS Delivery	\$175,134
29.	April 4, 2011	CMC	13,999	CNS Delivery	\$245,682
30.	April 8, 2011	TTM	7,900	CNS Delivery	\$224,913
<b>TOTAL:</b>			<b>110,428</b>		<b>\$7,004,639</b>