

**HARD COPY**

UNITED STATES OF AMERICA  
Before the  
SECURITIES AND EXCHANGE COMMISSION

ADMINISTRATIVE PROCEEDING  
File No. 3-15873

In the Matter of

Thomas R. Delaney II and  
Charles W. Yancey

Respondents.

DIVISION OF ENFORCEMENT'S  
REPLY TO RESPONDENT YANCEY'S  
POST-HEARING BRIEF

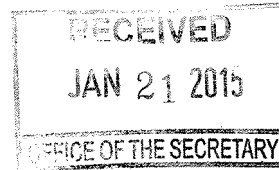


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## I. INTRODUCTION

In its post-hearing brief and proposed findings of fact, the Division outlined how Respondent Bill Yancey, CEO of Penson Financial Services, Inc. (“PFSI”), failed to supervise two key PFSI executives – Michael Johnson, the head of PFSI’s Stock Lending department, and Respondent Tom Delaney, PFSI’s chief compliance officer. More specifically, the Division showed that Yancey was responsible for supervising Johnson, both because he was Johnson’s designated supervisor in PFSI’s procedures and because he did not fully and clearly delegate that responsibility to others. The Division also showed that, despite knowing that a critical report prepared by Delaney for regulators omitted Rule 204 compliance failings that Delaney himself called “massive,” “profound,” and “anomalous,” Yancey took absolutely no steps to follow up on the omission. Under clearly established law, Yancey is liable for failure to supervise.

Despite having the ultimate legal responsibility for supervising PFSI’s employees – and indeed despite admitting at trial that the buck stopped with him – in his post-hearing brief Yancey repeatedly attempts to shirk his responsibilities. His arguments are refuted by the evidence, the law, and by common sense. For example, he argues that his designation as Johnson’s supervisor was a mistake made by a compliance employee, even though he was personally asked to review the designation for accuracy on more than one occasion, and even though the designation was frequently reviewed, revised, and sent to regulators. Similarly, he argues that he “unequivocally” delegated full supervision of Johnson to another executive, Phil Pendergraft, even though Pendergraft plainly testified to the contrary. And he argues that he should be entitled to rely unquestioningly on Delaney’s judgment to exclude the serious Rule 204 compliance

failures from the regulatory report, even though the law requires supervisors to follow up on suspicious circumstances or suggestions of irregularity. At bottom, Yancey's arguments underscore his refusal to understand or take responsibility for the important supervisory responsibilities imposed on CEOs of regulated entities.

Yancey insists that the Division is asking for an "unparalleled and unsupported extension" of supervisory standards, and one that would impose "insurmountable" standards of diligence on CEOs. Not so. Rather, the Division asks – and the law requires – that a CEO of a regulated broker-dealer be held accountable for supervising a key executive who he is assigned to supervise in the firm's policies and procedures, rather than allow that executive to operate with no supervision on regulatory and compliance issues for nearly three years. If a CEO wishes to delegate that responsibility, as Yancey apparently wishes he had here, the Division also asks that he do so clearly, rather than in a way that creates the significant confusion evidenced in this matter. And finally, the Division asks that a CEO take some action in the face of a glaring red flag that his chief compliance officer is concealing "massive," "profound," and "anomalous" compliance issues from regulators. In short, the Division asks for nothing more than the law requires. Yancey's arguments should be rejected, he should be found liable for failing to supervise, and significant sanctions should be imposed.

## II. BACKGROUND

As a clearing firm, PFSI had obligations under Rule 204(a) to close out CNS failures to deliver resulting from long sales no later than market open T+6. (Stip. FoF 6). Two departments had responsibility for PFSI's Rule 204 close-outs. PFSI's Buy-ins department closed-out CNS fails caused by customers. (Div. FoF 38). PFSI's Stock

Loan department was responsible for closing out CNS fails arising from long sales of loaned securities.<sup>1</sup> (Div. FoF 37). From October 2008 until November 2011, two to ten times every day, PFSI failed to close out CNS fails resulting from long sales of loaned securities by market open T+6. (Stip. FoF 7; Div. FoF 40).

### III. YANCEY FAILED TO SUPERVISE JOHNSON

Proper supervision is a critical issue at regulated entities like PFSI. However, despite the irrefutable evidence that Yancey was designated Johnson's supervisor in PFSI's policies and procedures, and the evidence that Yancey did not clearly delegate full supervision of Johnson to anyone else, the evidence also shows that Yancey did not supervise Johnson with respect to critical regulatory and compliance issues, including compliance with Rule 204. (See Div. Br. 27-39). In response to this evidence, Yancey argues vehemently that he should not be held responsible for supervising Johnson. In doing so, Yancey misapprehends both the law and the evidence.

#### A. The Supervisory Matrix is not a Diversionary Tactic, but Rather PFSI's Required Designation of Supervisors.

As explained in the Division's post-hearing brief, PFSI's Written Supervisory Procedures ("WSPs") – and specifically the supervisory matrix incorporated into those WSPs – designates Yancey as Johnson's supervisor. (Div. Br. 29-32). As he did at trial, Yancey continues to try to escape the consequence of this designation by arguing that the document was "erroneous." (Yancey Br. 16-21). Yancey's arguments fail.

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<sup>1</sup> Long sales of loaned securities originated with securities held in customer margin accounts. (See Stip. FoF 7). When a margin customer sold the securities that were out on loan, PFSI issued account-level recalls to the borrowers on T+3, *i.e.*, three business days after execution of the margin customer's sale order. (Stip. FoF 8). When the borrowers did not return the shares by the close of business T+3, and PFSI did not otherwise have enough shares of the relevant security to meet its CNS delivery obligations, PFSI incurred a CNS failure to deliver. (Stip. FoF 8).

As an initial matter, Yancey contradicts himself about the importance of the WSPs. When arguing that he should not be deemed Johnson's supervisor, he discounts the WSPs and supervisory matrix as an erroneous and irrelevant document. (Yancey Br. 16-21). However, later, when attempting to take shelter in the affirmative defense to the failure to supervise charge – which requires established, reasonable procedures – he argues that PFSI's WSPs "clearly vested supervisory responsibility in specific individuals." (*Id.* 44). This second argument is correct – the WSPs are important documents and do clearly set out PFSI's supervisory structure. That structure puts Yancey in charge of Johnson.

Further, and contrary to Yancey's claims, the WSPs have independent legal significance – they are not "simply one fact that could evidence supervisory authority." (Yancey Br. 20). NASD Rule 3010(a)(5) requires firms like PFSI to "assign[ ] ... each registered person to an appropriately registered representative(s) and/or principal(s) who *shall be responsible for supervising* that person's activities." (Emphasis added).<sup>2</sup> As Yancey's own witnesses confirmed, the WSPs and supervisory matrix were PFSI's Rule 3010(a)(5) designation. (Div. FoF 258, 265, 267; *see also* Tr. 2607:3-6 (Miller) ("And the Regulatory Supervisor column was the column that dealt with the NASD Rule 3010 supervisor, right? A. Correct."); Tr. 2015:22-25 (Poppalardo) ("And this [designation of supervisors in PFSI's WSPs] is the 3010(a)(5) designation of supervisors; is that right? A. I presume so."); *cf.* Tr. 1163:3-6 (Gardner) ("Do you have any idea what [the Regulatory Supervisor] column means? A. ...I would assume that it's from a compliance

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<sup>2</sup> The version of Rule 3010(a)(5) effective for the relevant time period may be found at [http://finra.complinet.com/en/display/display\\_main.html?rbid=2403&record\\_id=4395](http://finra.complinet.com/en/display/display_main.html?rbid=2403&record_id=4395) (last visited Jan. 12, 2015).

standpoint who the supervisor is.”)). The Division’s expert, David Paulukaitis, reinforced the importance of this WSP designation in his report:

... [W]ritten supervisory procedures provide the foundation for a broker/dealer’s supervisory and compliance system. They not only provide supervisors of a broker/dealer with guidance for how they are to carry out their supervisory responsibilities but they also provide regulators with insight into how supervision within the broker/dealer is supposed to work.

....

Assuming Penson's written supervisory procedures designated Yancey as the supervisor responsible for supervising Johnson, the reasonable presumption would be that Yancey was in fact Johnson's supervisor and that Yancey was supervising Johnson.

(Ex. 238 at 17).<sup>3</sup> In short, Yancey’s designation as Johnson’s supervisor in the WSPs is sufficient to find he had supervisory responsibility for Johnson. See *Kirk Montgomery*, Rel. No. 34-45161, 2001 WL 1618266, \*5 (Dec. 18, 2001) (“We further have held that the individuals identified as having particular supervisory duties in a firm’s written procedures are responsible for discharging those duties.”); cf. *Midas Securities, LLC*, Rel. No. 34-66200, 2012 WL 169138, \*13 (Jan. 20, 2012) (looking to, *inter alia*, the designation of supervisor in the firm’s Supervisory Manual); *Raymond James*, Rel. No. ID-296, 2005 WL 2237628, \*47 (Sept. 15, 2005) (looking to, *inter alia*, the designation of responsibility in the firm’s compliance manual).

Yancey insists he should not be held liable because the WSPs and the supervisory matrix were, he claims, wrong. Yancey seems to blame Kim Miller, the compliance officer responsible for maintaining the supervisory matrix, for the purported error. (See Yancey Br. 17). But in fact, Miller did not make a mistake: she was expressly

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<sup>3</sup> Yancey excerpts a portion of Paulukaitis’ cross-examination to argue that Paulukaitis conceded the WSPs were only one factor in establishing supervisory authority. (Yancey Br. 20). In fact, Paulukaitis’ report makes clear the importance of the WSPs, and the significance of the supervisory designation.



directed to designate Yancey as Johnson's supervisor, and presumed Yancey was aware of that fact. (Div. FoF 275-276). Critically, Miller repeatedly sent copies of the matrix to Yancey and asked him to review for accuracy. (Div. FoF 277-278, 285). This was not a herculean task: fewer than 20 employees were listed under Yancey. (See Ex. 177 at 3; Ex. 196 at 3; Div. FoF 329). Yancey did not propose any changes, responding instead with a simple "Thanks." (Div. FoF 282, 289). Given these facts, Yancey's claim that he was unaware the matrix designated him as Johnson's supervisor rings hollow. Indeed, the fact that he was repeatedly asked to review and correct an important document but apparently failed to do so underscores his lack of appreciation for the supervisory rules that govern regulated entities like PFSI.

The Division does not, as Yancey suggests, seek to hold Yancey responsible for supervising Johnson based on a one-time error in a document. (See Yancey Br. 17 (claiming the Division's case rests on a "single erroneous document")). Rather, the supervisory matrix was a living document that was routinely updated, frequently reviewed and edited by senior executives, and repeatedly sent to PFSI's regulators. (See Div. FoF 271, 273-275, 278, 285-286, 294-303). Of particular importance, information about Yancey, Pendergraft, and Johnson was often changed in the matrix, and yet Yancey was continuously listed as Johnson's supervisor. For example, between February 2009 and January 2010, several employees were removed from Yancey's supervision and re-assigned to other executives. (*Compare* Ex. 177 *with* Ex. 182; see *also* Div. FoF 330). During that same time period, numerous employees were added to Pendergraft's supervision. (*Id.*). And Johnson's title was updated – from head of Securities Lending for PFSI to Senior Vice President of Securities Lending for PWI – but

he remained listed under Yancey, with Yancey as his regulatory supervisor. (*Id.*). Later, Johnson's information was again updated: the matrix was amended to change Johnson's "Pi Org Chart" supervisor *from Pendergraft to Yancey*. (See Div. FoF 270).

Perhaps most notably, in the various iterations of the matrix several employees were specifically moved from Yancey to Pendergraft – and Johnson was not one of them. For example, when Anne Maxey moved from strategic development with PFSI to strategic development with PWI, she was reassigned – and her Regulatory Supervisor was changed – from Yancey to Pendergraft. (*Compare* Ex. 177 *with* Ex. 182; *see also* Div. FoF 331). Similarly, when Peter Wind moved from marketing with PFSI to Senior Vice President of Sales with PWI, he was also reassigned from Yancey to Pendergraft, and his Regulatory Supervisor changed in the same way. (*Id.*). Johnson, by contrast, was always listed under Yancey, with Yancey as his Regulatory Supervisor, even when he was formally moved from PFSI to PWI. (*Id.*).

In sum, Yancey should not be allowed to walk away from his continuous designation as Johnson's supervisor in PFSI's WSPs.

B. The Evidence Does Not Show "Unequivocal" Delegation of Johnson's Supervision to Pendergraft.

In addition to understating the significance of the WSPs, Yancey overstates the both the law and the evidence regarding Yancey's purported delegation of Johnson's supervision to Pendergraft.

1. The *Gutfreund* Test Is Not Used to Assess Delegation.

As a threshold matter, Yancey misstates the law regarding delegation of supervisory responsibility. Yancey claims that numerous cases have applied the

*Gutfreund* facts-and-circumstances test<sup>4</sup> to determine whether presidents/CEOs have appropriately delegated to others. (Yancey Br. 3 & n.6). Yancey’s claim is, essentially, that courts routinely assess whether another individual is a supervisor per *Gutfreund* and, if so, conclude that a president/CEO has been relieved of supervisory liability. In fact, none of the cited cases stand for that proposition.

Perhaps most notably, *Patricia Ann Bellows*, which Yancey emphatically claims used the test “to conclude that [the] president of [a] broker-dealer had appropriately delegated supervisory authority”, did not involve a president at all. (Yancey Br. n.6 (emphasis in original)). Rather, *Bellows* dealt with whether a compliance officer and vice president should be held liable for failing to supervise a rogue trader. See Rel. No. ID-128, 1998 WL 409445, \*1 (July 23, 1998) (noting that Bellows was a “compliance officer, vice president, and senior registered options principal”); see *also id.* \*7 (rejecting contention that Bellows’ position as compliance officer or member of the firm’s executive committee created supervisory liability).

In *SEC v. Yu*, another case cited by Yancey, the Court also did not use the *Gutfreund* test to find that a president was relieved of responsibility because another individual was acting as a supervisor (the position Yancey urges here). Rather, the issue in *Yu* was whether the president of a broker-dealer had violated a previously-imposed supervisory bar; the Court found that *the president* was acting as a supervisor because of his involvement in hiring and firing decisions. 231 F. Supp. 2d 16, 20-21 (D.D.C. 2002).

Similarly, *Midas Securities* did not find a president had delegated because another individual was acting as a supervisor, but rather concluded that the purported

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<sup>4</sup> See *John H. Gutfreund*, 51 S.E.C. 93, 1992 WL 362753 (Dec. 3, 1992).

delegatee was *not* a supervisor because, among other reasons, he could *not* hire, fire, or approve leave. *Midas Securities*, 2012 WL 169138, at \*13. This analysis makes sense: the *Gutfreund* facts-and-circumstances test is undisputedly used to assess whether individuals *other than the president* are potentially liable as supervisors, whereas the supervisory liability of the president turns directly on whether clear delegation of supervisory responsibility has occurred.<sup>5</sup> In other words, had the *Midas* Court found the purported delegatee was *also* a supervisor under the *Gutfreund* test, it does not follow – and the court did not suggest – that such a finding would have alone proved delegation. Indeed, *Midas* pointed to the lack of control by the purported delegatee as only the last of a number of factors establishing that the president had not delegated supervision. The first two factors the Court emphasized – the purported delegatee’s testimony that he was not the responsible supervisor and the designation of the president as the supervisor in the firm’s procedures – are similar to the evidence here and both strongly support the Division’s position that Yancey did not effectively delegate. See *Midas Securities*, 2012 WL 169138, at \*13.

Finally, and again contrary to Yancey’s suggestion, *Raymond James* was not a case about delegation of supervisory responsibility for an individual employee. Rather, in *Raymond James*, the respondent contended that the CEO had not delegated responsibility for the adoption of the firm’s overall compliance and supervisory procedures; the Court found that fact was irrelevant to whether the respondent was liable for supervising a particular employee. See 2005 WL 2237628, \*46-47. In other

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<sup>5</sup> See *Angelica Aguilera*, Rel. No. ID-501, 2013 WL 3936214, \*24 (July 31, 2013) (noting that the *Gutfreund* test applies to the assessment of supervisory liability of personnel, like a chief legal officer, who “did not become a supervisor ‘solely’ because of his position, *as opposed to the president of the firm*, who ... ‘was responsible for compliance with all of the requirements imposed on his firm,’ pending reasonable delegation.”) (emphasis added).

words, the Court used the *Gutfreund* test to assess the respondent's control, not whether the CEO had reasonably delegated.

In short, the *Gutfreund* facts-and-circumstances test is not used to prove delegation, to determine who, among many, is the exclusive supervisor, or to relieve a president/CEO of supervisory liability. Rather, the *Gutfreund* test is used to expand liability to others outside the normal chain of command. The relevant test here is whether a president/CEO has clearly delegated supervision to another. If not, that president/CEO remains a responsible supervisor. (See Div. Br. 38-39).

## 2. The Evidence of Delegation is Not "Unequivocal."

Yancey strenuously argues that there was no confusion regarding his delegation of complete supervisory responsibility for Johnson to Pendergraft, and that both testimonial and documentary evidence clearly prove this delegation. (Yancey Br. 3-11). Indeed, Yancey repeatedly argues the record shows "unequivocal" delegation of all supervisory responsibility. (See *id.* 1, 3, 5, 7, 13). Of course, Yancey must make this argument, since any confusion over the delegation means he remains liable. (See Div. Br. 32, 36-37). But rhetoric cannot trump evidence, which is far from "unequivocal" about the contours of Johnson's supervision.

Most importantly, contrary to Yancey's claim that "Pendergraft ... unequivocally confirmed" Yancey's full delegation of supervisory responsibility (Yancey Br. 5), Pendergraft's testimony could not have been more clear: he was not responsible for supervising Johnson with respect to PFSI regulatory and compliance matters.

A. Mr. Johnson reported to me or to somebody else at the Penson Worldwide level with respect to his global responsibilities. That meant he largely took his direction from a global executive. When I think of supervision, I think of regulatory and compliance oversight, which would

largely have been a function of the local operating company, the regulated entity.

...

Q. Okay. As to compliance and regulatory oversight, did you have that responsibility for Mr. Johnson as it related to PFSI's stock lending operations?

A. Well, I think compliance is everybody's responsibility. But I was not in the Penson Financial Services regulatory control framework, I did not have any direct regulatory reporting responsibility in the broker-dealer.

Q. Okay. And who would have had that, over Mr. Johnson?

A. Somebody in the Penson Financial Services executive team.

...

Q. Okay. I want you to assume that Mr. Yancey had some supervisory responsibility over Mr. Johnson as it related to PFSI Stock Loan.

A. Yes, ma'am.

Q. And specifically over PFSI Stock Loan's compliance with regulations. Okay?

A. Yes, ma'am.

Q. All right. Assuming that, did you ever come to the understanding that that responsibility had been delegated to you?

A. No, I don't believe I ever had that understanding.

(Tr. 1462:20-1465:16; see also Div. FoF 226-227). Put simply, Pendergraft was unequivocal, but not as Yancey claims – he was unequivocal that he was *not* Johnson's supervisor for regulatory and compliance issues, that such responsibility was *not* given to him by Yancey, and that such responsibility remained with someone at PFSI.

As explained in the Division's post-hearing brief, Pendergraft's testimony alone is sufficient to find Yancey did not delegate regulatory and compliance supervision over

Johnson for either of two reasons: because Pendergraft's testimony should be credited over Yancey's, or because even considering both men's testimony, there was confusion over Johnson's supervision. (Div. Br. 36-37). But even if the Court considers testimony from other PFSI employees, as Yancey urges, that testimony does not save Yancey, for at least three reasons.

*First*, the testimony is not as clear as Yancey suggests. Yancey claims that "[w]itness after witness after witness confirmed that Pendergraft supervised Johnson." (Yancey Br. 9-10). In fact, many of the cited witnesses did not. For example, Yancey cites to testimony by Rudy DeLaSierra. But DeLaSierra testified that he believed Johnson reported to Dan Son, not Phil Pendergraft. (Div. FoF 231.d). Yancey also cites to testimony of Lindsey Wetzig. But Wetzig stated only that it was common for Pendergraft to give instructions to Johnson. Further, he made clear that Pendergraft was always involved in PFSI Stock Loan issues, even when Johnson was a PFSI employee and undisputedly supervised by Yancey. (Div. FoF 235). Thus, Wetzig's observation that Pendergraft gave instructions to Johnson says nothing about the supervisory structure. Yancey further cites to testimony of Dawn Gardner, who was involved in HR functions at PFSI. Gardner admitted, however, that she did not know about Johnson's supervision from a regulatory standpoint. (Tr. 1161:13-24; Div. FoF 332). Similarly, Yancey cites to Kim Miller's testimony. But while Miller did say she perceived Pendergraft to be Johnson's supervisor, she also acknowledged that she may not have been aware if there had been a split in supervision between Yancey and Pendergraft. (Div. FoF 230). Finally, Yancey cites to Delaney's testimony. But as Delaney made clear in his investigative testimony, it made sense to him that Yancey

would be designated as Johnson's supervisor from a compliance standpoint because he expected someone like Johnson, the head of a core function of PFSI, to report in to the CEO of PFSI. (Div. FoF 211; *see also* Ex. 224 at 348:9-349:7).<sup>6</sup>

*Second*, it is not surprising that certain PFSI employees testified to a perception that Pendergraft was Johnson's supervisor. The fact of the matter is that, despite the fact that Yancey did not delegate to Pendergraft supervision over Johnson for regulatory and compliance issues, Pendergraft was the only individual actually exercising *any* oversight over Johnson. Once Johnson became a PWI employee, as a practical matter Yancey left Johnson alone. (See Div. Br. 37-38). Thus, the fact that employees only saw Pendergraft, and not Yancey, interacting with Johnson does not prove Yancey had fully delegated his supervisory responsibilities. To the contrary, it proves that Yancey was not actually exercising the supervisory oversight he was responsible for exercising.

*Third*, the other PFSI employees did not testify about the *delegation*, as Yancey claims. Nor could they. Yancey himself admitted that he and Pendergraft were the only two individuals present for the conversation where he purportedly delegated supervision

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<sup>6</sup> Yancey also cites to a statement in one of the Division's *Brady* letters that Brian Hall told the Division that Johnson reported to Pendergraft. (Yancey Br. 10). The Division renews its objection to the admission of these letters, particularly on the basis that the letters are admissions by the Division, and urges that the Court give them no weight. (See Tr. 461:12-22 (admitting *Brady* letter in part on that basis)). Other courts have specifically refused to treat *Brady* letters as admissions of the government or to admit them into evidence on other grounds, emphasizing that the government is not vouching for the reliability of statements disclosed pursuant to *Brady* but rather merely fulfilling its obligation to provide all potentially exculpatory evidence. See *U.S. v. Milikowsky*, 896 F. Supp. 1285, 1303 n.34 (D. Conn. 1994) (refusing to admit *Brady* letter as admission of party opponent and noting that "Defendants do not cite, nor can this Court find, any precedent recognizing *Brady* disclosures as nonhearsay admissions of the government"); *U.S. v. Primavera Oil, Inc.*, No. 88-00028, 1988 WL 92863, \*2 (E.D. Pa. Sept. 2, 1988) (refusing to admit *Brady* letter under Fed. R. Evid. 803(24) catchall hearsay exception because doing so would "make the government appear ... as a quasi-guarantor of exculpatory statements it thinks are false," which would not serve the interests of justice); *cf. J.W. v. City of Oxnard*, No. 07-06191, 2008 WL 4810298, \*1-2 (C.D. Cal. 2008) (refusing to admit *Brady* letter to attack witness credibility because the letter was inadmissible hearsay).



of Johnson. (Div. FoF 232). Thus, no one other than Yancey and Pendergraft could offer any testimony on the delegation itself.

Yancey also claims that PFSI's organizational charts "clearly reflect" the delegation of supervisory responsibility from Yancey to Pendergraft. (Yancey Br. 5). In fact, those organizational charts do not show Johnson reporting to Pendergraft. (Div. Br. 36; see *also* Div. FoF 239-241). Whatever evidentiary value the organizational charts have, they do not stand for the proposition Yancey advances.

Finally, Yancey insists that Pendergraft's actions toward Johnson – which Yancey claims show, under the *Gutfreund* facts-and-circumstances test, that Pendergraft had the requisite authority to affect Johnson's conduct – proves that Yancey fully delegated supervisory responsibility to Pendergraft. (Yancey Br. 8-9). But evidence that Pendergraft may have controlled certain of Johnson's activities shows at most that Pendergraft could *also* be Johnson's supervisor, not that he was Johnson's *only* supervisor. As explained in the Division's post-hearing brief, the *Gutfreund* test is not used to limit supervisory liability to one individual, but rather to expand such liability to others outside the normal chain of command. (Div. Br. 38-39). See *also Gutfreund*, 1992 WL 362753 (holding four individuals at brokerage firm – CEO, president, vice chairman, and chief legal officer – all had supervisory responsibility for head of trading desk). What's more, it is not surprising that Pendergraft interacted with Johnson on numerous issues. The Division does not dispute that Pendergraft was, in fact, Johnson's supervisor on certain issues – just not the regulatory and compliance issues involved in this matter. Moreover, there is overwhelming evidence that Pendergraft was significantly involved in PFSI issues, even as to employees he did not supervise. (Div.

FoF 242). In short, evidence that Pendergraft may have *also* acted as Johnson's supervisor is not evidence that Yancey was not Johnson's supervisor.

In conclusion, the evidence is not "clear" or "unequivocal" that Yancey fully delegated supervisory responsibility for Johnson to Pendergraft. Pendergraft himself makes plain that Yancey did not. And even considering all of the evidence, Johnson's supervisory scheme is at best confused. In such circumstances, supervisory responsibility for regulatory and compliance issues remains with Yancey.<sup>7</sup>

3. Pendergraft Did Not Supervise Johnson with Respect to PFSI Regulatory and Compliance Issues.

Yancey also contends the evidence shows Pendergraft practically supervised Johnson as to regulatory and compliance issues, and that any division of supervisory responsibility between business issues and regulatory and compliance issues is illogical and indeed illegal. (Yancey Br. 11-13). Yancey is wrong.

As discussed above, Pendergraft clearly testified that he was not Johnson's supervisor as to regulatory and compliance issues, and that Yancey never delegated him that responsibility. None of the evidence Yancey cites changes this fact. For example, Yancey points to a handful of e-mails between Pendergraft and Johnson that concern regulators. (Yancey Br. 11 & n.46). But Pendergraft had similar e-mails with other employees, including Bart McCain, that were plainly not evidence of a supervisory relationship. (See Ex. 265, 270; see *also* Div. FoF 247-248). Yancey also points to testimony from Johnson that he interacted with Pendergraft on Reg SHO issues. But in

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<sup>7</sup> Yancey also contends that he "routinely and vigorously" followed up on his delegation. (Yancey Br. 14; see *generally id.* 13-16, 24-25). But since Yancey cannot show, as a threshold matter, that he clearly delegated supervisory responsibility for regulatory and compliance issues to Pendergraft, this purported follow-up is irrelevant. Moreover, and tellingly, the issues on which Yancey argues he followed up with Pendergraft are all essentially business and operational issues, *not* regulatory and compliance issues. (See Yancey Br. 15-16 (claiming follow up on performance, personal discipline, budget/compensation, customer relations, business development, firm financing, and expenses)).

fact, Pendergraft interacted with Johnson on Reg SHO issues in 2005 – well before anyone contends Pendergraft was Johnson’s supervisor. (Div. FoF 236). And other evidence, including the testimony of Rudy DeLaSierra, a key Stock Loan executive, underscores that Pendergraft did not have much interaction with Johnson on regulatory or compliance issues. (Div. FoF 312).

Yancey also claims that “the law does not allow” supervision to be split between operational matters and regulatory and compliance matters. (Yancey Br. 13). Tellingly, Yancey does not cite a single case for this purportedly legal proposition. This is not surprising, since the law gives firms significant flexibility in how they choose to structure supervision. *See, e.g., E.F. Hutton*, SEC No-Action Letter, 1985 WL 54261 (May 4, 1985) (“Both the SROs and the Commission recognize that effective supervisory procedures will vary among firms depending on factors such as structure and business mix and for that reason do not prescribe a particular system of supervision.”). (See also Ex. 238 (Paulukaitis Report) at 10). The only support Yancey can muster for his position is the testimony of his retained expert, who says simply that she had never heard of that sort of division. However, this testimony is contradicted by the testimony of Kim Miller – a PFSI compliance official and Yancey’s own witness – who explained that, at least as Person, such division would not be inappropriate. (Div. FoF 228). Indeed, PFSI’s own supervisory matrix evidences a division of supervision between business and regulatory issues: that is the point of a “Pi Org Chart” supervisor (for HR purposes) and a “Regulatory Supervisor” (for compliance/regulatory purposes). (Div. FoF 264-265, 268).

Other evidence further confirms that PFSI was often creative in its division of supervision. For example, another of Yancey’s witnesses, Bart McCain, conceded that

he was supervised by Yancey with respect to his PFSI broker-dealer responsibilities and by Pendergraft with respect to overall firm financing responsibilities. (Div. FoF 229). Similarly, Yancey admitted that two PWI employees – Sean Malloy and Dan Weingarten – reported to him rather than to anyone at PWI. (Tr. 1852:16-24; Div. FoF 333). Put simply, division of supervisory responsibility in myriad ways may be done as a matter of law, and was done at Penson as a matter of fact. The law does not preclude dividing supervisory responsibilities between operational and regulatory/compliance issues.

Finally, and again contrary to Yancey's claims, the division of responsibility between Yancey and Pendergraft does not "def[y] common sense." (Yancey Br. 13). To the contrary, leaving supervision of regulatory and compliance issues at the broker-dealer level makes perfect sense. Regulatory and compliance issues only applied to PFSI the broker-dealer, not PWI the parent company. (See, e.g., Div. FoF 226; see also Tr. 1462:23-1463:1 (Pendergraft) ("When I think of supervision, I think of regulatory and compliance oversight, which would largely have been a function of the local operating company, the regulated entity.")). Thus, Pendergraft's assumption of operational supervision of Johnson at the parent company level, while leaving regulatory and compliance supervision at the broker-dealer level, is a logical and reasonable system.

C. Johnson was Unsupervised with Respect to Regulatory and Compliance Functions.

Yancey also insists the evidence shows Johnson was reasonably supervised, including on regulatory and compliance issues. (Yancey Br. 23-24). Yancey goes so far as to claim that "this is not a case where an employee was left on his own unsupervised." This claim is refuted by overwhelming evidence. Pendergraft disclaims that he had the responsibility for regulatory or compliance oversight. Nor did Yancey

provide such oversight: he did not exercise any supervision of Johnson once Johnson became a PWI employee. (Div. FoF 304-305). Rudy DeLaSierra confirmed that he did not see anyone interacting with Johnson on regulatory or compliance issues. (Div. FoF 312). And Johnson himself explained that PFSI Stock Loan was essentially left alone – that they had to “run on the fly and make it.” (Div. FoF 313-314). In light of this evidence, Yancey’s claim that Johnson was reasonably supervised strains credulity.

D. Yancey Cannot Take Shelter in Section 15(b)(4)(E)’s Affirmative Defense.

The securities laws provide an affirmative defense to a failure to supervise charge if the firm has established procedures (and a system for applying those procedures) that would be expected to detect and prevent the underlying securities law violations, and the respondent has followed those procedures. See 15 U.S.C. § 78o(b)(4)(E); *Michael Bresner*, Rel. No. 517, 2013 WL 5960690, \*116 (Nov. 8, 2013). It is unclear whether Yancey is asserting this affirmative defense with respect to his supervision of Johnson. (See Yancey Br. 42-48 & Table of Contents (discussing affirmative defense under heading of Division’s failure to supervise claims regarding Delaney)). Assuming he is, the defense fails.

Perhaps the most damning fact is that Yancey did *not* follow PFSI’s procedures regarding Johnson’s supervision. As Yancey himself concedes, PFSI’s procedures were contained in the firm’s WSPs, which “clearly vested supervisory responsibility in specific individuals.” (Yancey Br. 44). The Division agrees. As discussed in detail above, the WSPs “clearly vested” supervisory responsibility for Johnson in Yancey. And yet it is undisputed that Yancey did not exercise any supervision over Johnson once Johnson

became a PWI employee. (Div. FoF 304-305). For this reason alone, Yancey cannot show that he reasonably followed PFSI's procedures.

Nor do Yancey's other arguments show that PFSI had reasonable procedures for detecting and preventing the underlying violations – Stock Loan's repeated violations of Rule 204(a). Yancey claims PFSI's WSPs addressed "all elements" of Rule 204 and "set out procedures to be followed." (Yancey Br. 44). But in fact, while the WSPs restated the rule that long sales must be closed out by T+6, they contained no actual discussion of the procedures Stock Loan should follow to do so. (See Div. FoF 119-121). Similarly, as multiple Stock Loan employees testified, the Compliance department did not, as Yancey claims, provide effective guidance on how Stock Loan should comply with the Rule. The Compliance department did not explain how Stock Loan could resolve the conflict between its practice of closing out in the afternoon on T+6 and the Rule's requirement of closing out by the morning on T+6, or how Stock Loan could comply with the Rule by recalling shares on T+2 rather than T+3. (See Div. FoF 62, 130-135). Finally, PFSI's Rule 3012 testing, which Yancey also relies on, did not address Stock Loan's compliance with Rule 204. (See Div. FoF 109).

At bottom, Yancey's arguments boil down to a claim that PFSI had some general processes and procedures in place to give guidance on and test compliance with the securities laws. But the affirmative defense requires processes and procedures aimed at preventing the actual violations at issue – here, Johnson's and Stock Loan's serial non-compliance with Rule 204. See 15 U.S.C. § 78o(b)(4)(E)(i) (affirmative defense where there are procedures to detect and prevent "such violation by such other person"); *Gutfreund*, 1992 WL 362753, at n.20 (affirmative defense did not apply

because no procedures to detect and prevent “the violations”). Since there were no such policies and procedures in place, the affirmative defense does not apply.

#### IV. YANCEY FAILED TO SUPERVISE DELANEY

Yancey also contends that he did not fail to supervise Delaney because there were no “red flags” concerning Delaney’s misconduct. As detailed in the Division’s post-hearing brief, Yancey had a duty to follow up, not just on actual knowledge of wrongdoing, but on “suspicious activities” or “suggestions of irregularity.” (Div. Br. 39-40). Here, Yancey’s failure to investigate Delaney’s omission of any mention of PFSI’s Rule 204 compliance issues from the report accommodating PFSI’s annual CEO certification – including the disastrous results of the Compliance department’s December 2009 Rule 204 audit – meets this standard.

##### A. The December 2009 Audit Revealed Critical Compliance Problems.

Yancey argues that the December 2009 Rule 204 audit was not such a big deal, since it only found that 112 securities transactions out of the millions of trades cleared violated the rule. (Yancey Br. 31). This argument mischaracterizes the audit. The audit evaluated the total number of transactions that required close-outs as a result of fails to deliver, and identified 113 such transactions. (See Div. FoF 111). Out of that total, it found that 112 transactions – in other words, *all but one of the transactions tested* – failed to comply with the Rule. (See *id.*). Eric Alaniz, the compliance official who conducted the audit, described the findings as a failure rate of 99% – although he was later instructed by Delaney to remove this language from the report. (Tr. 779:8-21; Div. FoF 334). Alaniz noted this was one of the most significant failures he had ever found,

and Delaney characterized the failures as “massive,” “profound,” and “anomalous.” (Div. FoF 112-114). Put simply, the audit revealed incredible Rule 204 compliance issues.

Yancey also seeks to minimize the audit by arguing it tested only Buy-Ins’ compliance with Rule 204, not Stock Loan’s compliance. (Yancey Br. 29-31). But this argument misses the point. The critical red flag to Yancey was the omission of any reference to PFSI’s Rule 204 compliance issues in the Rule 3012 Summary Report that accompanied PFSI’s annual CEO certification. While Yancey was not aware of all of PFSI’s Rule 204 compliance issues – namely, Stock Loan’s practice of violation, which Delaney concealed from Yancey – he was certainly aware of some significant compliance problems. Yancey admits he reviewed the audit in December 2009, and then repeatedly discussed that compliance issue in multiple quarterly meetings with the Compliance department. (See Div. FoF 167, 182-189). The Summary Report’s complete silence about Rule 204 should have suggested to Yancey that Delaney was not being forthcoming with regulators about PFSI’s Rule 204 compliance problems. (Div. Br. 42; see also OIP ¶¶ 80). It was that red flag that demanded vigorous inquiry and follow-up, and yet Yancey did nothing. (Div. Br. 41-42).

B. Omission of Rule 204 from the CEO Certification Was a Red Flag.

Yancey argues that omission of any mention of Rule 204 compliance issues from the Rule 3012 Summary Report was not a red flag because (1) Delaney had discretion about what issues to include in the Report, (2) the audit results were not a key compliance issue, (3) the identified issues were being remediated, and (4) the results were not, in fact, concealed from regulators. (Yancey Br. 36-39). These arguments should be rejected.



The Division does not contest that Delaney had discretion to determine what to include in the Summary Report. But that does not mean exclusion of the results was not a red flag. To the contrary, it underscores why the omission was suspicious. Delaney's determination to exclude the "massive," "profound," and "anomalous" Rule 204 violations, or indeed any reference to PFSI's Rule 204 compliance issues, should have put Yancey on notice that Delaney was exercising his "discretion" in a way that was concealing important information from regulators.

Yancey also claims that the audit results were not a key compliance issue. This argument misapprehends the evidence and ignores common sense. Yancey argues that Alaniz testified he did not believe the results rose to the level of a key compliance issue, and that Alaniz did not think the results needed to be included in the Report. (Yancey Br. 37). In fact, Alaniz testified only that he *did not recall* whether or not he suggested to Delaney that the results be included, and further confirmed that it was Delaney who determined what would be included as a significant compliance problem. (See Tr. 857:22-858:2; Div. FoF 159, 335). Moreover, as noted above, Alaniz testified the results were some of the worst he had seen. Alaniz's testimony gives Yancey no cover. Yancey also cites to Delaney's trial testimony, in which Delaney attempted to explain away the omission of the results by claiming there were remediation efforts underway. But in fact, in his investigative testimony, Delaney gave a far more credible explanation: he conceded that he could not explain the omission, and confirmed he "would have expected there to be some reference to it ... as a testing item or a specific compliance problem." (Div. FoF 163). This explanation makes sense, given Delaney's description of the failures uncovered by the testing as "massive," "profound," and

“anomalous.” In light of this evidence, it defies common sense to argue the results were not a “key compliance issue,” or that Rule 204 was not a significant compliance problem for PFSI.

Yancey also argues that he was not bothered by the Report’s silence about Rule 204 issues because he knew those issues would be remediated. (Yancey Br. 38). This argument fails for two reasons. First, the Summary Report was retrospective, designed to inform regulators of compliance issues in the prior year. (See Div. FoF 153-154). That an issue was going to be remediated in the future was not a reason to exclude it from the Report. Second, as Yancey himself acknowledged, *every single one* of the items included in the Summary Report were described as being remediated. (Div. FoF 165). In short, whatever the import of remediation, it is certainly not a basis for excluding items from the Summary Report.

Finally, Yancey argues that the audit results “were not concealed from regulators.” (Yancey Br. 39). More specifically, he argues that all results of PFSI’s 3012 testing were available to regulators in boxes housed in the Compliance department. As a threshold matter, Yancey ignores the evidence that the audit results were not only omitted from the Summary Report, they were also omitted from the remediation tracking logs that were specifically requested by and sent to FINRA. (Div. FoF 166). That evidence strongly suggests the results were, in fact, concealed. What’s more, whether PFSI stored the audit results such that regulators could retrieve and review them is irrelevant to Yancey’s failure to supervise, for two reasons. First, even if the December 2009 audit results had been buried among the myriad documents in the boxes of test results kept by the Compliance department, that does not make the exclusion of the

results (and indeed the entire subject of Rule 204) from the Summary Report – which is intended to highlight key compliance issues – any less suspicious. Second, Yancey points to no evidence that he knew, at the time he signed the CEO certification, the Compliance department kept testing results on hand. The argument that exclusion of the results was not a red flag because the results were otherwise available is nothing more than a *post-hoc* justification, which should be rejected.

At bottom, Yancey’s argument is that he should be entitled to rely wholesale on Delaney’s discretion as to what to include in the Summary Report, and thus cannot be liable for failure to supervise him. But justified reliance can only go so far. The evidence shows that one of the most significant compliance issues at PFSI was excluded from an important regulatory report intended to highlight key compliance problems – a report Yancey carefully reviewed and attached to his personal annual CEO certification. Such an omission was plainly a suspicious circumstance, and yet Yancey took no steps to follow up. (Div. Br. 39-42). This inaction constitutes a failure to supervise.<sup>8</sup>

#### V. YANCEY SHOULD BE SANCTIONED

Yancey argues that even if the Court finds him liable for failing to supervise, neither a bar nor monetary sanctions should be imposed. (Yancey Br. 48-50). Yancey claims he was “diligent and engaged” with those he supervised, and is a “clear champion for compliance.” To the contrary, the evidence shows that Yancey ignored and continues to ignore his clear designation as Johnson’s supervisor in PFSI’s

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<sup>8</sup> For similar reasons, Yancey cannot take advantage of the affirmative defense to a failure to supervise claim: that PFSI had established procedures for preventing and detecting violations and that Yancey followed those procedures. PFSI’s procedures – its WSPs – specifically required disclosure of “key compliance problems” in the Summary Report. (Div. FoF 153). Since PFSI’s Rule 204 compliance issues were omitted from the Summary Report – and Yancey knew they were omitted – he cannot argue that he followed PFSI’s procedures. Further, as discussed above, PFSI did not have procedures in place for detecting Stock Loan’s Rule 204(a) violations.

procedures. Moreover, Yancey's failure to supervise Johnson – a key executive and head of a core function of PFSI – allowed Johnson and Stock Loan to operate with no regulatory or compliance supervision, and in so doing violate Rule 204 every day for nearly three years. Similarly, despite obvious signs that Yancey's chief compliance officer was concealing information from regulators, Yancey did nothing. These are not the actions of an executive committed to complying with the law.

Yancey also argues that future violations are unlikely because he currently only oversees two individuals. But the fact is that Yancey remains in the industry, and remains a supervisor. Such a position plainly creates the opportunity to commit future violations. For these reasons, as well as those reasons outlined in the Division's post-hearing brief, sanctions against Yancey are appropriate and in the public interest.

## VI. CONCLUSION

Respondent Yancey – a former CEO of a regulated broker-dealer who is currently supervising employees in the securities industry – continues to misunderstand or ignore the basic rules and duties of supervision in the industry. Those duties are that the CEO bears ultimate responsibility for supervision unless and until he clearly delegates that responsibility, and that the CEO (like other supervisors) must vigorously follow up on red flags and suspicious circumstances. Yancey failed in his duties. He must be held liable.

DATED: January 20, 2015.

A handwritten signature in black ink, appearing to read 'P. Atkinson', written over a horizontal line.

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