BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

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| In the Matter of<br><br>District Business Conduct Committee for District No. 7<br><br>Complainant,<br><br>vs.<br><br>Respondent 1,<br><br>and<br><br>Respondent 2,<br><br>and<br><br>Respondent 3,<br><br>Respondents. | DECISION<br><br>Complaint No. C07960014<br><br>District No. 7<br><br>Dated: November 20, 1997 |

This matter was appealed by respondents Respondent 1, Respondent 2, and Respondent 3 pursuant to Procedural Rule 9310. For the reasons discussed below, we find that Respondent 1 and Respondent 3 violated Article III, Sections 1 and 21(a) of the Rules of Fair Practice (now known as and hereinafter referred to as "Conduct Rules 2110 and 3110(a)") by: 1) conducting a securities business while maintaining insufficient net capital; 2) filing materially inaccurate FOCUS Reports Part I and Part IIA; 3) maintaining inaccurate books and records; and 4) failing to give telegraphic notice of a net capital deficiency. For these violations, we hold that Respondent 1 should be censured, required to requalify as a financial and operations principal ("FINOP"), fined $15,000 (jointly and severally with Respondent 2), and assessed $1,179.50 in costs (jointly and severally with Respondent 2) for the proceedings before the District Business Conduct Committee for District No. 7 ("DBCC"). Due to the unique circumstances of this case, which are discussed below, we do not impose any sanctions on Respondent 3. We also hold that Respondent 2 should be censured, required to requalify as a general securities principal, fined $15,000 (jointly and severally with Respondent 1), and assessed $1,179.50 in costs (jointly and severally with Respondent 1) for conducting a securities business while maintaining insufficient net capital, in violation of Conduct Rule 2110.

Background

Respondent 1 first entered the securities industry in November 1990 as a FINOP, registered with Firm A, a former member of the Association.[1] Respondent 1 served as the Firm's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") at all times relevant to the complaint in this action, and was Firm A's FINOP until July 1994, when he was succeeded by Respondent 3. Respondent 1 has not worked in the securities industry since February 1996.

Respondent 2 first entered the securities industry in April 1990. In January 1991, Respondent 2 joined Firm A and served as its President, and as a general securities representative, options principal, general securities principal and municipal securities principal. Respondent 2 remained with Firm A until July 1995. Respondent 2 has not been employed in the securities industry since February 1997.

Respondent 3 entered the securities industry in May 1994 with Firm A and registered as a FINOP on July 29, 1994. Respondent 3 left Firm A in July 1995. Respondent 3 currently is employed by Firm B in its compliance department.

Facts

The complaint arose from a special financial examination report, which was prompted by DBCC staff's receipt of a telegraphic notice from the Firm of a net capital deficiency in June 1995. Securities Exchange Act of 1934 ("Exchange Act") Rule 15c3-1(a) required Firm A to maintain minimum net capital of $75,000 from February through June 1994 and $100,000 from July 1994 through June 1995. Exchange Act Section 17(a) and the rules thereunder required Firm A to keep current and accurate records and to calculate and report its net capital on a monthly basis to the Securities and Exchange Commission ("SEC" or "the Commission") and to the NASD on the FOCUS Report.

Firm A was an introducing firm that cleared its business on a fully disclosed basis through Company A. The relationship between Firm A and Company A was governed by a written clearing agreement dated October 21, 1991 ("the Clearing Agreement"). Pursuant to paragraph 4(c) of the Clearing Agreement, Firm A was liable to Company A for the unpaid debit balances of its customers. In late 1993 and early 1994, several customers of Firm A had positions in their margin accounts in Company B. In January 1994, the price of Company B dropped dramatically. Customers at Firm A

[1] Firm A was also named as a respondent in this action. The Firm defaulted, however, and on August 22, 1996 the DBCC issued a decision that censured Firm A, imposed a $25,000 fine, and expelled the Firm from membership in the Association. Firm A's membership with the Association had previously been revoked on February 2, 1996 for its failure to file FOCUS Reports.

who held Company B stock saw the equity in their accounts decrease to the point where, by the end of February 1994, they began to carry negative equity balances in their margin accounts.

The account with the biggest debit balance belonged to Customer AA. According to Customer AA's monthly account statement, as of February 28, 1994, the equity in his account was negative $259,936. Customer AA did not pay that balance in February. As a result of a continued drop in the price of the Company B stock in Customer AA's account, and his failure to pay off his balance, the negative equity balance grew to $411,057 by the end of March. Customer AA did not pay the balance in March. In April 1994, the remaining positions in Customer AA's account were sold out. By that time, however, Company B stock was trading at less than $2 per share. Therefore, even after the proceeds from those sales were applied to the debit balance, the April month-end equity balance in Customer AA's account was negative $580,495.[2]

In June 1995 (pursuant to instructions from DBCC staff), Firm A took a charge against its capital for the amount of the negative equity balance in Customer AA's account. When Firm A's net capital computation is adjusted to reflect the amount of the negative equity balance in Customer AA's account, Firm A shows insufficient minimum net capital from February 1994 through July 28, 1995.

Respondents have raised several arguments in their defense.[3] First, they assert that Company A, not Firm A, was responsible for the negative equity balance in Customer AA's account (and as a result, Firm A did not need to take a charge for that liability). Second, they maintain that, notwithstanding who was the real cause for Customer AA's negative equity balance, Company A contractually agreed to assume that responsibility (again, operating to relieve Firm A from that financial liability). The issue in this case, therefore, is whether the respondents met the responsibilities that were triggered as a result of the negative equity balance in Customer AA's account.

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[2] Interest continued to accrue on that balance through October 1994, at which time it was capped by Company A at negative $601,417, where the balance remained. If the amount of the equity balance in Attar's account is subtracted from Firm A's claimed net capital, Firm A had insufficient net capital to meet its minimum requirement (initially $75,000, which increased to $100,000 in July 1994) to operate as a broker/dealer from February 1994 through June 1995.

[3] These arguments are presented by Respondents 1 and 2. As discussed below, Respondent 3's main arguments related to the fact that he was not the FINOP at when the debit balances occurred, and that he was specifically informed by Respondent 2, the Firm's President, that Company A had undertaken the responsibility to account for the debit balance in its own records and that therefore did not need to take a charge against its net capital.

Discussion

Firm A Was Responsible For The Negative Equity Balance in Account

Cause One - Respondent 1 and Respondent 2 Were Responsible For The Firm's Failure To Maintain Adequate Net Capital. We find that Firm A was responsible for the negative equity balance in Customer AA's account, and that by operating a securities business while neglecting to take the appropriate charge against the Firm's net capital and to make other adjustments to maintain adequate net capital, Respondent 1 and Respondent 2 violated SEC Rule 15c3-1 and Conduct Rule 2110.[4] Specifically, we find that Respondent 1 was responsible as CEO, CFO, and FINOP for Firm A (on month-end dates February 28, March 31, April 29, May 31, and June 30, 1994) and that Respondent 2 was responsible as the President and general securities principal of Firm A (on month-end dates July 29, August 31, September 30, October 31, November 30, and December 31, 1994, as well as on January 31, February 28, March 31, April 28, May 31, and June 26, 1995). Since we have determined to reverse the findings against Respondent 3, we discuss him in a separate section of this decision. Although we also find that Respondent 3 was responsible under causes one through four for the period during which he served as FINOP, we discuss him in a separate section of this decision as we have determined not to impose sanctions on him.

There is no dispute that the negative equity balance in Customer AA's account rose from negative $259,936 as of February 28, 1994 to a total of $601,417 by October 1994, where it remained through June 1995. There is also no dispute that Firm A did not reflect this amount by taking a charge against its net capital from February 28, 1994 through July 28, 1995. The proper calculation of Firm A's net capital during this period demonstrates that the Firm was operating a securities business in net capital deficiency on February 28, March 31, April 29, May 31, June 30, July 29, August 31, September 30, October 31, November 30 and December 31, 1994, as well as on January 31, February 28, March 31, April 28, May 31 and June 26, 1995.

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[4] The complaint alleges that Firm A failed to comply with SEC Rule 15c3-1 from February 1994 through June 26, 1995. (Respondent 1 is alleged to be responsible from February 1994 through July 28, 1994 and Respondent 2 is alleged to be responsible from July 29, 1994 through June 26, 1995). The record, however, does not contain net capital computations and order tickets with accompanying customer confirmation slips for each day during that period. Rather, the record contains such evidence only for the last business day of each month during that time. Thus, we confine our findings of net capital deficiencies to the actual month-end dates for which the record contains net capital computations, order tickets, and customer confirmation slips. In re Arthur Stelmack, Exchange Act Rel. No. 35100 (December 13, 1994) (SEC set aside finding of net capital violation because the evidence did not show that the firm had effected securities transactions on the date when the net capital violation allegedly occurred and for which the net capital computations were performed).

When a net capital deficiency arises, the reason for the deficiency is not significant; the focus, rather, must be on whether the member firm responded to the deficiency in a proper manner. A firm may choose to infuse additional capital, narrow the scope of its functions in order to qualify for a lower minimum net capital, or cease doing business until the deficiency has been remedied. A firm also is required to account properly for the deficiency in its own books, as well as in the various financial reports required to be filed with the Association. In the instant matter, we find that Respondent 1 and Respondent 2 failed in all respects to carry out these responsibilities.

Section 4(c) of the Clearing Agreement provides:

> You [(Firm A)] shall be responsible for assuring that each Introduced Account (i) deposits by settlement date sufficient and adequate initial margin in connection with any margin transaction; and (ii) promptly deposits sufficient and adequate maintenance margin upon [Company A's] request and in the event of a failure of an Introduced Account to do any of the foregoing you agree to pay us [(Company A)] promptly the full amount of any loss or expense incurred by us as a result thereof.[5]

There is no provision in the Clearing Agreement that states that the accounts were the responsibility of Company A and not Firm A; therefore Firm A was responsible for the Customer AA account and its negative equity.

The SEC has taken the position in precisely these circumstances that deficits in introduced accounts must be deducted <u>by the carrying broker/dealer and the introducing broker/dealer.</u> In a verbal interpretation given in August 1988 by SEC Staff to the New York Stock Exchange ("NYSE"), the SEC determined that "deficits in unsecured and partly secured introduced accounts shall be deducted by the carrying broker/dealer <u>and</u> the introducing broker/dealer when the clearing agreement states that such deficits are the liability of the introducing broker/dealer."[6] NASD Guide to Rule Interpretations, p.

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[5] The phrase "loss or expense" is defined in the Clearing Agreement at section 9(i) to include "all costs, damages, liabilities, interest expense and attorneys fees and expenses incurred in connection with such matters."

[6] There is no merit to the argument of Respondent 1 and Respondent 2 that they cannot be held to the standard of this SEC Interpretation because it was not included in the 1989 version of the NASD Guide to Rule Interpretations. First, the fact that the Interpretation was not printed in a pamphlet assembled by the NASD to be helpful to its members does not absolve members and associated persons of their responsibility for knowing and following the rules of securities regulation between publication dates. <u>In re Litwin Securities, Inc.</u>, Exchange Act Rel. No. 38673, p. 8 (May 27, 1997) ("NASD member firms and their FINOPS are charged with knowing the applicable regulations,

8 (1994 - Net Capital and Customer Protection Rules). Since section 4(c) of the Clearing Agreement specifically states that deficits are the liability of the introducing broker/dealer, it is clear that Firm A was financially liable to Company A as a result of Customer AA's failure to satisfy the unpaid negative balance in his account. Firm A therefore should have taken a charge to its net capital to reflect the situation with the Customer AA account.

This conclusion is not effected by the charge that Company A took against its own net capital for the debit balance. The Interpretation makes it clear that Company A was required to take that charge because the SEC had determined that the net capital rule mandates that both Company A, as the clearing firm, and Firm A, as the introducing firm, take the charge. It was the responsibility of Respondent 1 and Respondent 2 as principals of Firm A to ensure that their Firm was in compliance with all pertinent rules and regulations. This responsibility cannot be foisted onto others, including Company A, outside counsel, or the NASD.[7]

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including rules governing the computation of net capital . . . "); In re Jeffrey D. Field, 51 S.E.C. 1074, 1076 (1994) (participants in the industry must take responsibility for their compliance with applicable regulatory requirements and cannot be excused for lack of knowledge, understanding, or appreciation of these requirements). Second, we note that the 1994 version of the NASD Guide to Rule Interpretations did include this Interpretation, at page 8, and that the 1994 version was published in May 1994, during the period relevant to this action. Moreover, there is no indication in the record that Respondent 1 and Respondent 2 attempted to consult with SEC or NASD staff to determine the appropriate treatment of Attar's negative equity balance, which may have led them to the proper result.

[7] Respondent 1 and Respondent 2 argue that their conclusion that Firm A was not liable for the debit balance in Customer AA's account was based on advice received from their lawyer. We note that in order to sustain the defense of reliance on the advice of counsel, a respondent must prove that he or she: (1) made a complete disclosure to counsel of the intended action; (2) requested counsel's advice as to the legality of the contemplated action; (3) received counsel's advice that such action would be legal; and (4) relied in good faith on that advice. In re John Thomas Gabriel, 51 S.E.C. 1285, 1292 (1994). Respondent 1 and Respondent 2 do not meet these requirements.

Further, we note that the "reliance-on-counsel" defense usually is not available when intent is not an element of the violation. Gabriel at 1292, n.31. There is no scienter requirement in net capital violations. In re First Heritage Investment Co., 51 S.E.C. 953, 957 at n.15 (1994). Thus the intent, or lack thereof, of Respondent 1 and Respondent 2 is not a consideration, except with regard to the choice of sanctions for the offense.

As to Respondent 1 and Respondent 2's argument that the NASD, during its examinations, had failed to inform them of the incorrect net capital computations, we note that the record indicates that there was no NASD examination of Firm A during the period at issue. Further, even if that were not the case, the Commission repeatedly has held that members cannot shift their responsibility for compliance

There is no merit to the argument of Respondent 1 and Respondent 2 that Company A was responsible for the negative equity balance in Customer AA's account because Company A unduly delayed liquidating the positions in that account. Respondents 1 & 2 have stated that if Company A had sold out the Customer AA account sooner, when the negative balance was not so high, Firm A could have remained in business even if Firm A ultimately was responsible for that debt. As we have previously noted, the net capital rules do not require a finding as to who caused the deficiency; it is the member's responsibility to follow proper procedures to account for and correct the deficiency, regardless of fault. Further, this argument presupposes that Company A had sole discretion to sell out the positions in Customer AA's account.[8] Respondent 1, however, admitted at the DBCC hearing that Firm A also had the ability under the Clearing Agreement to sell out securities, but did not do so in this case because Respondent 1 and Respondent 2 believed that Company A was negotiating directly with Customer AA.

The Clearing Agreement Was Not Amended To Provide That Company A Was Solely Responsible To Account For The Negative Equity Balance In Customer AA's Account. There is no support for the argument of Respondents 1 and 2 that the Clearing Agreement, which specifically provides at section 4(c) that Firm A was responsible for its customers' unpaid debts, was amended to make Company A responsible for the debit balance in Customer AA's account. Respondent 1 and Respondent 2 have asserted three different theories by which they maintain that the Clearing Agreement had been amended. The record demonstrates that none of these alleged amendments was accomplished.

First, Respondent 1 and Respondent 2 contend that the parties entered into a letter agreement, signed by both Firm A and Company A, dated March 17, 1994 (the "Letter Agreement") that rendered Company A contractually liable for Firm A's unpaid customer debits. Yet there is absolutely no provision in the Letter Agreement that makes such a statement. The Letter Agreement begins by stating that it "confirms [the] proposal relative to the collateralization of the unsecured debit balances of the thirteen (13) Introduced Accounts listed" and sets forth the plan for Firm A to deposit $200,000 with

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to the NASD. In re Prime Investors, Inc., Exchange Act Rel. No. 38487 (April 8, 1997); Litwin, supra at 8; citing In re Thomas C. Kocherhans, Exchange Act Rel. No. 36556 (December 6, 1995); In re G. K. Scott & Co., Inc., 51 S.E.C. 961, 966 n.21 (1994), aff'd, No. 94-1161 (D.C. Cir. 1995) (unpublished opinion).

[8] Respondents 1 and 2 have cited section 4(b) of the Clearing Agreement in support of this argument. Section 4(b), however, provides only that if Company A made the determination to sell out an account, it did not have to consult with or obtain authorization from Firm A. Section 4(b) does not state that Firm A was prevented by the Clearing Agreement from also selling out customer accounts, and Respondent 1's testimony shows that Firm A did, indeed, participate in selling out customer accounts.

Company A and for Company A to begin selling out the accounts (with the exception of the Customer AA account). Moreover, in provision number four of the Letter Agreement, Firm A and Company A expressly agree that they will "continue to perform all of their respective obligations and duties as outlined in [the Clearing Agreement]." The clear implication of provision number four is that Firm A would remain liable for the unpaid debit in Customer AA's account as set forth in section 4(c) of the Clearing Agreement, and the Letter Agreement is silent on the issue of the appropriate treatment of Customer AA's debit for net capital purposes.

The second theory of amendment is that a "series of correspondence," between Firm A and Company A, taken together, operated to amend the Clearing Agreement. These documents, however, are merely proposals by either Firm A or Company A to address the situation regarding the outstanding debit balance. None of the three documents contained in the "series" was signed by both Firm A and Company A, and there is no indication in these documents that any agreement existed between the parties.[9] Further, section 9(a) of the Clearing Agreement provides that it could be amended "only in writing signed by both parties . . . and approved by the NYSE." NASD Conduct Rule 3230 also requires that amendments to clearing agreements be submitted to the Association for its review. Accordingly, these documents could not be construed as an amendment to the Clearing Agreement, as none of the documents was signed by both Firm A and Company A and there is no evidence that the alleged amendment was approved by the NYSE, or submitted to NASD Regulation.

The requirement that any amendment to the Clearing Agreement be in writing also defeats Respondents 1 and 2's third theory of amendment -- Respondent 1's assertion that he had a "handshake agreement" with the former managing director of Company A,[10] pursuant to which Company A allegedly agreed not to hold Firm A responsible for the debit balance. Although the record contains no corroborating evidence to support this contention, it is clear that even assuming, arguendo, that such an agreement existed, it did not operate as an effective amendment to the responsibilities established by the Clearing Agreement.

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[9] In the only document in that series authored by Company A (a letter dated February 23, 1994, Complainant's Exhibit 19), Company A proposes that Firm A provide a promissory note to collateralize the customer accounts with unpaid and unsecured debit balances, including the Customer AA account. We note that this is inconsistent with the argument of Respondents 1 and 2 that Company A had assumed sole responsibility for those debits, because if Company A had agreed to release Firm A from responsibility for those debits, Company A would not have had reason to seek such security from Firm A.

[10] The former managing director did not testify at the DBCC hearing. A different individual who served as the managing director of Company A at the time of the DBCC hearing was scheduled to testify as a staff witness, but was not permitted to do so when respondents objected, asserting that his testimony might be damaging to any potential arbitration or civil litigation on these issues between Firm A and Company A.

In view of these findings, we conclude that Firm A had insufficient minimum net capital on each of the month-end dates on which staff prepared net capital calculations from February 1994 through June 1995. The record clearly reflects that Firm A, in fact, conducted a securities business on each of those days. By virtue of their respective positions with Firm A, both Respondent 1 and Respondent 2 were aware, from the very beginning, of the conflict with Company A over the debit balance in Customer AA's account, and they had the responsibility to ensure that the Firm's net capital, books and records, and financial reports properly reflected Firm A's liability for that deficit. Accordingly, we find that Respondent 1 and Respondent 2 failed to comply with SEC Rule 15c3-1, in violation of Conduct Rule 2110, as alleged in cause one of the complaint.

In reaching this determination, we have fully considered, and reject Respondent 1 and Respondent 2's argument that the staff may have proved the existence of a net capital violation, but that without proof of bad faith by Respondent 1 or Respondent 2, no finding of violation of Conduct Rule 2110 may ensue. This position is simply incorrect. The Commission has required a demonstration of bad faith under Conduct Rule 2110 only where the misconduct alleged does not constitute the violation of another SEC or NASD rule or regulation and does not involve the respondent's activities as a registered person.[11] The SEC has consistently upheld NASD findings of violation of Conduct Rule 2110 based solely on the finding of a violation of SEC Rule 15c3-1. <u>See</u> <u>Litwin</u>, <u>supra</u> at 9 ("Because intent is not relevant here, we sustain the NASD's findings that applicants violated [Conduct Rule 2110] when . . . [the firm] . . . conducted a securities business while failing to maintain the minimum net capital"); <u>In re Whelen & Co., Inc.,</u> 50 S.E.C. 282, 286 (1990) ("Proof of intent to violate is unnecessary to establish net capital violations . . . the firm cannot shift its responsibility for compliance with regulatory requirements to the NASD. While the circumstances to which applicants refer may be considered in mitigation, they are not a defense to the NASD's charges"); <u>In re Hutchison Financial Company And Thomas A. Mace</u>, 51 S.E.C. 398, 404 (1993) (Affirming NASD's finding of violation of Conduct Rule 2110 for net capital violation and stating "[O]fficers of securities firms bear a heavy responsibility in ensuring that the firm complies with all applicable rules and regulations. This includes the duty of ensuring that the firm comply with the net capital requirements"). Conduct Rule 2110 does not require a showing of improper purpose or motive, but instead merely requires a showing that the respondent acted in a manner inconsistent with his or her obligation to "observe high standards of commercial honor and just and equitable principles of trade." Proper observance of the SEC's net capital rule clearly falls squarely within this area.

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[11] <u>See</u>, <u>e.g.</u>, <u>In re George R. Beall, Jr.</u>, 50 S.E.C. 230 (1990) (deliberately passing bad checks to employer firm violates Conduct Rule 2110); <u>In re Robert J. Jautz</u>, 48 S.E.C. 702 (1987) (borrowing money from a customer does not alone violate Conduct Rule 2110, unless unethical conduct is shown); <u>In re William D. George</u>, 47 S.E.C. 368 (1980) (failing to reimburse customer pursuant to indemnity agreement does not violate Conduct Rule 2110 unless respondent acted in bad faith).

Causes Two Through Four - Respondent 1. Based on our finding as to his responsibility in connection with the net capital violation in cause one, findings of liability as to Respondent 1 necessarily follow as to causes two through four, for the period during which he was alleged to be responsible (February 1994 until July 1994).[12] Firm A's reported net capital from February 1994 through May 1995 should have been reduced by the amount of the debit balance in Customer AA's account. Thus, each FOCUS Report filed by the Firm during the time period for which Respondent 1 was responsible was materially inaccurate, as alleged in cause two. Similarly, Firm A's net capital computations and trial balances for the same time alleged as to Respondent 1 were materially inaccurate due to the same omission, as alleged in cause three. Finally, Firm A should have filed telegraphic notice of its net capital deficiency in February 1994, when the situation first arose, and not in June 1995, when it did so upon advice from District staff. Accordingly, we find that Respondent 1 violated Conduct Rules 2110 and 3110 for the periods alleged against him in causes two, three, and four.

Respondent 3 - Causes One Through Four. We have determined to affirm the DBCC's findings of violation as to Respondent 3 in causes one through four of the complaint, but our finding applies to the entire period during which he served as the Firm's FINOP (July 29, 1994 through June 26, 1995), and only for the net capital violations on month-end dates July 29, August 31, September 30, October 31, November 30, and December 31, 1994, as well as on January 31, February 28, March 31, April 28, May 31, and June 26, 1995.[13] Based upon the circumstances in this case, however, we have determined not to impose sanctions on Respondent 3.

Respondent 3 has conceded that he was Firm A's FINOP during a portion of the period alleged in the complaint, from July 1994 through June 1995. Respondent 3 also concedes that the Firm was not in net capital compliance during that period due to Firm A's failure to account for the debit balance in Customer AA's account by taking a charge against its net capital. We conclude that Respondent 3 should be held responsible for the net capital violations which occurred while he was the Firm's FINOP, since he should have been aware of the legal standards which would have put him on notice of the risks represented by the Customer AA debit balance, and because he failed to obtain appropriate contractual and regulatory assurances concerning the debit balance before he signed inaccurate FOCUS Reports and filed them with the Association.

In May of 1994, Respondent 3 entered the securities industry with Firm A. On July 29, 1994, he registered as Firm A's FINOP. Respondent 3 performed an independent review of the Firm's records in his preparation to become the FINOP, and he noticed debit balances in certain customer accounts. When Respondent 3 asked the Firm's President, Respondent 2, about those balances, he

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[12] Respondent 2 was not named in causes two through four, and the findings against Respondent 3 are discussed separately herein.

[13] The DBCC had determined that Respondent 3 was liable beginning in November 1994, following his attendance at a meeting with Respondent 2 and representatives from Company A.

was told that everything had been "taken care of" and that Firm A did not need to take any action because Company A was taking a charge against its own net capital for the debits.[14]

Despite Respondent 2's assurances to Respondent 3, however, the record shows that the situation had not been "taken care of" and that Firm A and Company A had been involved throughout the Spring of 1994 in ongoing discussions in an effort to determine how and when Firm A would pay the debit balances. Respondent 1 and Respondent 2 were fully aware of these discussions, and thus Respondent 2 had no basis in July 1994 for instructing Respondent 3, the Firm's new FINOP, that Firm A did not have to take any action on its books and records with regard to the debit balance in account. If Respondent 2 had explained the circumstances properly, Respondent 3 might have been able to take steps sooner to advise the Association of Firm A's net capital deficiency.

Although the DBCC determined that Respondent 3 should be held responsible as FINOP for the allegations in causes one through four beginning only in November 1994, we do not find that Respondent 3's knowledge of the understanding between Firm A and Company A changed significantly at that time to justify any adjustment to our finding that he was liable for the violations as soon as he became the Firm's FINOP. The record shows that Respondent 3 attended a meeting in New York in November 1994, which was also attended by Respondent 2 and representatives of Company A. There was discussion at this meeting as to which firm would be responsible for payments of the liabilities stemming from the debit balance in Customer AA's account. Yet Respondent 3 testified that when he heard this discussion, he believed that Company A was trying to "rewrite history" by attempting to change the terms of an already existing agreement with Firm A that Company A would be responsible for the debit balance. Respondent 3 stated that he thought that Company A was trying to "change[] [its] story," and "go back on the agreement." He did not, however, believe that Company A had managed to achieve this purpose, and he did not question the word of Respondent 2, who assured him that Firm A did not have to make an adjustment to its net capital.

We find that the facts in this case are supported by those in <u>In re Wallace G. Conley</u>, 51 S.E.C. 300 (1993), in which the SEC determined that the FINOP's responsibilities as to his firm's net capital were not relieved by virtue of erroneous instructions given to the FINOP by the firm's president. Conley was held to be liable, censured, fined $2,000, and assessed costs. Yet we find the facts in <u>Conley</u> to be distinguishable, from a sanctions standpoint, from the instant action, which contains

[14] We do not mean to imply that Respondents 1 and 2 deliberately "lied" to Respondent 3; indeed the record more likely indicates that they were stating their own, albeit erroneous, understanding of the situation. Respondent 2 testified that he had informed Respondent 3 that there was an ongoing dispute with Company A, but Respondent 3 denied this. The DBCC found Respondent 3 more credible on this point, and we do not find any reason to disturb this credibility finding of the DBCC. <u>In re Falcon Trading Group, Ltd.</u>, Exchange Act Rel. No. 36619 at 5 n.10 (December 21, 1995) ("the credibility determinations of an initial fact-finder are entitled to considerable weight and deference").

extremely mitigating circumstances. In Conley, the FINOP was actually employed by his firm at the time of the violation and therefore had reason to know of irregularities signaling his firm's net capital violation. In the instant matter, however, Respondent 3 arrived on the scene long after the occurrence of the problem which led to the net capital violation, and after specific inquiry of his supervisors, was misinformed by Respondent 2 as to Firm A's obligations and compliance with the net capital requirements.

Accordingly, we affirm the findings of violation against Respondent 3 as to the specific dates set forth above in connection with causes one through four, but we eliminate the sanctions imposed on him by the DBCC. We reach this determination based upon the specific circumstances of this action. Specifically, Respondent 3: was not the FINOP during the operative period which led to the debit balances in the customer accounts; was not a party to the original discussions of responsibility with Company A; and was misled by his superior, Respondent 2, the Firm's president, that an agreement was in effect that made Company A solely responsible for accounting on its records for the liability raised by the debit balance in the Customer AA account.

This Case Involved No Procedural Irregularities

There is no support for the argument of Respondent 1 and Respondent 2 that Company A had "manipulated the NASD into using the instant proceeding to gain an advantage over Firm A in subsequent arbitration or litigation." The record shows that Company A cooperated with staff in this case, but no "manipulation" was demonstrated. The Company A managing director was willing to testify for staff, but was not permitted to do so when respondents objected.[15]

Further, the DBCC's reference to issues in the dispute between Firm A and Company A was necessary, as the respondents had raised those issues in their defense, arguing that Company A was

[15] Respondent 1 and Respondent 2 allege that staff counsel telephoned the managing director immediately upon the conclusion of the DBCC hearing. On appeal, the regional counsel for the DBCC asserted that he had made this call, from a public telephone, only because the managing director (and his lawyer) had been waiting by the telephone for some time to see if his testimony would be needed as part of the staff's rebuttal case. When the DBCC hearing panel concluded, at the close of the respondents' case, that rebuttal would not be necessary, the hearing panel moved directly to closing arguments. Thus, the regional counsel telephoned the managing director immediately after the hearing concluded as it was his first opportunity to advise the managing director that he was not needed to testify. Although the respondents' allegation that staff operated as a "stalking horse" for Company A is unfounded, we note that even if staff had been biased in favor of Company A, "such bias . . . would not render the proceedings invalid . . . NASD staff does not decide cases and, therefore, the allegations of bias . . . do not suggest that the fairness of the hearing itself was compromised." In re Dillon Securities, Inc., 51 S.E.C. 142, 150 n.29 (1992) (citations omitted).

solely liable for the debit balance in Customer AA's account. Accordingly, the DBCC's references, as well as our own, to arguments regarding the alleged amendment of the Clearing Agreement pertain only to the facts of this case, and do not have a bearing on the dispute between Firm A and Company A as to which firm may ultimately be liable monetarily for the situation that occurred.

Sanctions

As stated, we eliminate the sanctions imposed on Respondent 3 by the DBCC. As to Respondent 1 and Respondent 2, we affirm the censures and requirement that each requalify by examination (Respondent 1 as a FINOP and Respondent 2 as a general securities principal) before acting in such capacities or cease acting in such capacity until so requalified. We reduce the fine, however, from $15,000 per respondent, to $15,000, jointly and severally. Due to our elimination of the sanctions against Respondent 3, we also eliminate the DBCC's assessment of costs as to Respondent 3 and impose $1,179.50 in DBCC costs jointly and severally on Respondent 1 and Respondent 2.

In reaching these sanctions, we have considered the applicable NASD Sanction Guideline for net capital violations.[16] We find that the $15,000 joint and several fine is remedial and consistent with the Guideline's direction to impose a joint and several fine for first violations, and individual sanctions in repeat violations. We also conclude that the requalification requirements are particularly appropriate in this situation where Respondents 1 & 2 admitted their ignorance of the applicable rules.[17]

Thus, Respondent 1 is censured, required to requalify as a FINOP, fined $15,000 (jointly and severally with Respondent 2), and assessed $1,179.50 in DBCC costs (jointly and severally with Respondent 2). Respondent 2 is censured, required to requalify as a general securities principal, fined

[16] The recommended sanctions are consistent with the applicable NASD Sanction Guidelines ("Guidelines"). See Guidelines (1993 ed.) at 30 (Net Capital Violations).

[17] We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will be summarily suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will be summarily revoked for non-payment.

$15,000 (jointly and severally with Respondent 1), and assessed $1,179.50 in DBCC costs (jointly and severally with Respondent 1). All sanctions and costs imposed on Respondent 3 are eliminated.

On Behalf of the National Business Conduct Committee,

Joan C. Conley, Corporate Secretary