

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of

District Business Conduct Committee
For District No. 8,

Complainant,

vs.

Respondent Firm 1

and

Respondent 2

Respondents.

DECISION

Complaint No. C8A960081

District No. 8

Dated: October 22, 1998

Pursuant to Procedural Rule 9310, Respondent Firm 1 and Respondent 2 have appealed an 1997 decision issued by the District Business Conduct Committee for District No. 8 ("DBCC"). After a review of the entire record in this matter, we find that Respondent Firm 1, acting through Respondent 2, in violation of Conduct Rule 2110, failed promptly to amend and file with the Association a Uniform Application for Broker-Dealer Registration ("Form BD") to reflect a Delinquent Tax Warrant ("the Tax Lien") issued by the State on November 6, 1995, failed to maintain a general ledger, checkbook, bank statements, canceled checks, bank reconciliations, and copies of the Firm's Form BDs; prepared inaccurate trial balances and net capital computations for December 31, 1995; filed inaccurate FOCUS Part I and Part IIA Reports for month-end December 1995; and failed to respond fully to NASD Regulation, Inc. ("NASD Regulation") staff requests for information.

We hereby censure Respondent 2 and Respondent Firm 1, impose a joint and several \$5,000 fine, and require Respondent 2 to requalify by examination as a financial and operations principal ("FINOP") within six months of the date of this decision. We also require Respondent 2 to establish within 90 days of the date of this decision a system for maintaining Respondent Firm 1's required books and records that meets the satisfaction of Association staff. We also affirm the joint and several assessment of costs of the DBCC hearing in the amount of \$1,079.25.

Background. From January 1978 to August 1983, Respondent Firm 1 was registered with the SEC as a "Securities and Exchange Commission Only" ("SECO") firm. In August 1983, became a member of the NASD. Respondent Firm 1 conducts a general securities business on a fully disclosed basis through Firm A. During the relevant time, Respondent Firm 1 was a Subchapter S Corporation under the Internal Revenue Code. As a Subchapter S Corporation, the Firm distributed its income directly to Respondent 2, its sole shareholder, and did not pay any corporate income tax.

When Respondent Firm 1 became an NASD member in August 1983, Respondent 2 was granted a waiver from the general securities representative, general securities principal, municipal securities principal, registered options principal, and FINOP examinations and became registered in those capacities with Respondent Firm 1. Respondent 2 is currently registered with Respondent Firm 1 and is the Firm's sole employee.

Facts

The facts relevant to this complaint were developed as the result of an NASD on-site examination of Respondent Firm 1 on January 24 and 25, 1996.

During the course of the examination, it became apparent to the NASD examiner that Respondent Firm 1 was not maintaining certain required books and records. Prior to the examination, the examiner had sent Respondent Firm 1 a checklist of certain documents that would be reviewed in the course of the examination, but Respondent 2 did not have all of those documents on site for the examiner's review. When asked to provide a general ledger and cash receipts and disbursements record, Respondent 2 told the examiner that he did not maintain these records for Respondent Firm 1 because he paid all of the Firm's expenses out of a personal checking account except for licensing and bond costs, and the only money the Firm received each month was one check from Firm A.

Respondent 2 was also unable to provide the examiner with amendments to written supervisory procedures; Firm A's settlement statement for December 31, 1995; Form BD amendments; a copy of the Firm's fidelity bond; new account information for Customer HHE; and materials pertaining to the firm element of Respondent Firm 1 continuing education program. In the "Exit Conference Summary Form" ("the Exit Form") prepared by the examiner on January 25, 1996, at the conclusion of the examination, the examiner listed these items as "open items" to be filed with the District office by February 8, 1996.

The examiner discovered during the course of his examination that Respondent 2 was not using the Firm's checking account to pay Firm expenses because there was a lien on the account. When he questioned Respondent 2 about the small balance in the account at the end of December 1995 -- approximately \$40 -- Respondent 2 told him that he had not used the account since the preceding June because there was a lien on the account, and some money had already been garnished out of the account. Respondent 2 indicated that he was paying the Firm's bills out of a personal checking account that was held jointly in his and his deceased mother's name. The source of the lien was not established

during the course of the examination, but the examiner believed that the lien arose out of an Internal Revenue Service ("IRS") matter. The examiner did not request a copy of the account statements for Respondent 2's personal account.

The Exit Form indicated, among other things, that Respondent Firm 1: (1) had not designed the firm element portion of the Firm's continuing education program; (2) had failed to maintain a general ledger and cash receipts and disbursements blotter; (3) had overstated its net capital by approximately \$385 as of December 31, 1995; and (4) because of this last error, had also filed an inaccurate FOCUS Report for December 31, 1995. The Exit Form also gave Respondent 2 until February 7, 1996 to provide the missing documents. The examiner repeated the request for documents, except for the Form BD and amendments, in correspondence dated February 13, 1997, and he gave Respondent 2 until February 23, 1996 to comply.

In correspondence dated March 18, 1996, the examiner again requested that Respondent 2 submit a copy of the fidelity bond, new account information for Customer HHE, and a copy of the firm element for continuing education. In addition, the examiner noted that the NASD had learned that the State, Department of Revenue had placed a \$2,645.52 lien against the Firm on November 6, 1995, for unpaid corporate taxes for 1993. The examiner requested documentation of the Tax Lien as well as documentation of the June 1995 IRS lien. In addition, the examiner asked for copies of the amended Form BDs that reflected the Tax Lien, and explanations for not including the Tax Lien in the Firm's balance sheet as of December 31, 1995.

Staff repeated these requests in correspondence dated April 1 and April 12, 1996. The examiner also had several conversations with Respondent 2 during this time in which Respondent 2 indicated that he was sending the requested information.

On April 26, 1996, Respondent 2 submitted to NASD Regulation staff the Firm's State "Tax-Option (S) Corporation Franchise or Income Tax Return" for 1992, 1993, and 1994; the Firm's "U.S. Income Tax Return for an S Corporation" for 1992, 1993, and 1994; his "U.S. Individual Income Tax Return" for 1992 and 1993; and his state income tax returns for 1992 and 1993. The returns showed that Respondent Firm 1 had operated at losses of approximately \$25,000 and \$30,000 in 1992 and 1993, respectively. All of these returns were signed in April 1996. Respondent 2 also submitted a copy of a note that he had submitted to the State on April 23, 1995. The note stated: "Based on the 92-94 corp. tax returns and payments applied, the judgements & warrants numbered as follows: [number redacted] will be satisfied in the near future."

The examiner called Respondent 2 on May 2, 1996, to remind him that he had not fully replied to the staff's requests for information. Respondent 2 agreed to provide the information by May 6, 1996, but he did not do so. The DBCC issued the instant complaint on November 15, 1996. The Supervisor of Examiners sent a follow-up request on November 21, 1996.

Following the issuance of the complaint, Respondent 2 contacted the State and obtained a release of the Tax Lien. By letter dated November 21, 1996, Respondent 2 advised District staff that the Tax Lien had been withdrawn. The notice from the State stated:

Our records indicate that this warrant(s) has been previously satisfied. However, since this warrant(s) should not have been issued in the first place, we are requesting that both the warrant(s) and the subsequently filed satisfaction(s) be withdrawn and stricken from the docket.

In correspondence dated December 3, 1996, Respondent 2 explained the circumstances under which he had been doing business. He stated that his mother had been his sole employee since approximately 1971 until her last illnesses, and that in the years before her death in 1994, he had spent all of his time taking care of her to the detriment of his business. He stated that the non-registered person that he had hired in 1992 to take care of his bookkeeping and to pay bills had embezzled funds from him. Respondent 2 stated that she had written checks to herself, had shown him bogus worksheets, and had destroyed checks. Respondent 2 stated that he did not file taxes during this time because he had not had time to sort out what she had done.

Respondent 2 contended that the State had filed the Tax Lien simply because he had not filed his tax returns, but that he knew that Respondent Firm 1 did not owe money to the State because Respondent Firm 1 was operating at a loss and had accumulated a \$100,000 net operating loss carry forward. Respondent 2 indicated that in response to the NASD's inquiry, he had made it a priority to piece together his expenses and have his accountant prepare his tax returns. Respondent 2 attached to this letter statements from Firm A showing that the Firm had maintained a \$6,000 cash balance during 1995, a statement of accounts, a copy of the Firm's fidelity bond, an income statement and balance sheet, a net capital computation, and a list of checks that his employee had embezzled.

Discussion

We find that the violations alleged in the complaint are established by the record evidence. We therefore affirm the DBCC's findings as to all four causes of complaint. As to cause one, the existence of the November 6, 1995 Tax Lien is undisputed, and we find that Respondent 2 should have reported its existence on an amendment to the Firm's Form BD. Question "7I" of the Form BD required Respondent Firm 1 to report whether it had "any unsatisfied judgments or liens against it." As a registered principal, it was Respondent 2's responsibility to know and to carry out applicable regulatory requirements. See, e.g., In re Jeffrey D. Field, 51 S.E.C. 1074 (1994) (participants in securities industry required to take responsibility for their compliance with applicable regulatory requirements).

The Firm should also have accounted for the Tax Lien as a liability in its net capital calculation and on its books and records. Respondent 2's failure to do so, and his overstatement of commissions receivable, caused Respondent Firm 1's FOCUS Reports for month-end December 1995 to be inaccurate, as alleged in cause three. We do not credit Respondent 2's contention that he was not

required to report the Tax Lien on the Firm's books and records because the Firm did not actually owe any taxes to the State.

As to cause two, it is undisputed that Respondent 2 failed to maintain the books and records required under SEC Rule 17a-4. We do not credit Respondent 2's argument that a complete set of books and records was not necessary because of the Subchapter S status of the Firm. It is the obligation of every broker/dealer to maintain the books and records necessary to allow the NASD and other regulators to determine the Firm's compliance with the SEC's net capital and reporting requirements. Further, it was Respondent 2's duty as the Firm's FINOP to perform Respondent Firm 1's responsibilities under all financial responsibility rules promulgated pursuant to the provisions of the Securities Exchange Act of 1934. NASD Rule 1022(b)(E). See In re Gilad J. Gevaryahu, 51 S.E.C. 710 (1993) (FINOP responsible for firm's recordkeeping violations). Respondent 2's system of maintaining records was not sufficient for these purposes.

As to cause four, Respondent 2's failure to provide the NASD with all of the requested information on a timely basis is also well supported in the record. As a result of the NASD examination and requests for information, Respondent 2 worked with his accountant to file all relevant tax returns, and thereby to extinguish the Tax Lien. He also asked Firm A and his insurer to provide the NASD with copies of settlement statements and the blanket fidelity bond, respectively. He did not, however, advise NASD staff that he was taking these steps, or provide this documentation on a timely basis.

Sanctions

Notwithstanding our affirmance of the DBCC's findings of violation, we have concluded that a modification of the sanctions imposed by the DBCC is warranted by the circumstances of this case. The DBCC censured Respondent 2 and the Firm, fined Respondent 2 and the Firm \$10,000, jointly and severally, and barred Respondent 2 from association with any member of the NASD in any principal or supervisory capacity. We affirm the censures of Respondent 2 and Respondent Firm 1, but we reduce the joint and several fine to \$5,000 (\$1,000 each for causes one, two, and three, and \$2,000 for cause four), and we eliminate the bar of Respondent 2 in any principal or supervisory capacity. In lieu of the bar, we require Respondent 2 to requalify by examination as a FINOP within six months of the date of this decision and also require Respondent 2 to establish within 90 days of the date of this decision a system for maintaining Respondent Firm 1 required books and records that is satisfactory to Association staff.

Based on the facts before us, we believe that a \$3,000 fine for causes one, two, and three (\$1,000 per cause) is appropriate. In imposing these sanctions, we have considered that the respondents' regulatory deficiencies did not result in any customer complaint or any customer injury. We have also considered that Respondent 2 managed to run his Firm without any difficulty (with the exception of two late FOCUS reports in 1985 and 1986)¹ until his mother became too ill to work any

¹ The NASD fined \$100 in 1985 and \$100 in 1986 for filing late FOCUS Reports.

longer, at which time he ignored his obligations at the Firm in order to take care of her. Respondent 2's difficulties during this time were compounded as the result of his employee's embezzlements and destruction of records.

Although Respondent 2 did not respond promptly and fully to the NASD's inquiries, he did attempt during this time to correct the situation that had caused the State to issue the Tax Lien and to gather the documents that had been requested. Respondent 2 retained his accountant and filed all delinquent tax returns for the Respondent Firm 1 and for himself, thereby causing the Tax Lien to be lifted. He also obtained from Firm A and his insurance company documents that staff had requested. Although Respondent 2's proper course of conduct would have been to keep NASD staff apprised of his actions, he did not. Nonetheless, he did not ignore the situation, and he took what he believed to be reasonable steps to rectify the situation. Because he did eventually respond, and because the facts underlying the Tax Lien and the books and records problems were known to NASD staff, we believe that a \$2,000 fine for this violation is appropriately remedial.

We have concluded, however, that in order to stay in business, Respondent 2 must face up to his regulatory obligations. His decision to operate under the Subchapter S provision of the Internal Revenue Code does not relieve him of the responsibility to maintain required books and records. We therefore believe that it is appropriately remedial for Respondent 2 to requalify by examination as a FINOP within six months and also to establish a system for maintaining required books and records that meets the satisfaction of Association staff. We give Respondent 2 90 days to accomplish this. If he fails to establish a system to maintain adequate books and records in 90 days, he shall be suspended from doing business until this task is accomplished.²

² In determining appropriately remedial sanctions, we have considered the Sanction Guidelines (1996 ed.) for false or inaccurate reports (FOCUS or other) to the NASD, recordkeeping violations, and failure to respond completely and timely to requests for information, as well as the particular facts of this case.

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 summarily be 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 summarily be revoked for non-payment.

Accordingly, we hereby censure Respondent 2 and Respondent Firm 1, impose a joint and several \$5,000 fine, and require Respondent 2 to requalify by examination as a FINOP within six months of the date of this decision. We also require Respondent 2 to establish within 90 days of the date of this decision a system for maintaining Respondent Firm 1 required books and records that meets the satisfaction of Association staff or be suspended from doing business until this task is accomplished. We also affirm the joint and several assessment of costs of the DBCC hearing in the amount of \$1,079.25.

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary