

BEFORE THE NATIONAL ADJUDICATORY COUNCIL  
FINANCIAL INDUSTRY REGULATORY AUTHORITY

In the Matter of

Department of Enforcement,

Complainant,

Warren Forest  
Casselberry, FL,

Respondent.

DECISION

Complaint No. 2009016159102

Dated: July 28, 2015

**The Department of Enforcement failed to prove that respondent acted as the de facto financial and operations principal of a member firm while failing to register as a financial and operations principal, and it also failed to prove that respondent was responsible for the member firm's financial books and records and calculations of net capital. Held, findings reversed and complaint dismissed.**

**Appearances**

For the Complainant: Leo F. Orenstein, Esq., Jonathan Golomb, Esq., Department of Enforcement, Financial Industry Regulatory Authority

For the Respondent: Warren Forest, Pro Se

**Decision**

Respondent Warren Forest and the Department of Enforcement ("Enforcement") appeal an August 13, 2013 amended Hearing Panel decision pursuant to FINRA Rule 9311. The Hearing Panel found that Forest violated FINRA Rule 2010 by acting as the de facto financial and operations principal ("FINOP") of a member firm while failing to register as its FINOP, causing the firm's books and records to be inaccurate, causing the firm's calculations of required net capital and actual net capital to be inaccurate, causing the firm to conduct a securities business with insufficient net capital, and causing the firm to fail to notify the regulatory authorities that the firm had insufficient net capital. For the misconduct, the Hearing Panel censured Forest and ordered him to pay costs. After an independent review of the record, we reverse the Hearing Panel's liability findings and sanctions and dismiss the underlying complaint.

## I. Background

Forest first associated with a FINRA member firm in 1988. Forest's last association with a FINRA member firm ended voluntarily on June 22, 2010. He previously has been registered as a FINOP, general securities representative, general securities principal, municipal securities principal, and state law agent.

Forest formed and owns Forest Brokerage Advisors, Inc. ("FBAI"), which provides consulting services to FINRA member firms. Among other things, FBAI assists broker-dealers with membership applications, books and records, accounting functions, filings, and other compliance-related functions. FBAI also helps broker-dealers find and retain FINOPs. As of the hearing in the matter, FBAI had approximately 20 clients.

In or about 1996, FINRA member firm iTradedirect.com ("iTrade" or the "Firm") entered into a contract with FBAI. iTrade was a retail brokerage firm with a principal office in Boca Raton, Florida, and a branch office on Long Island, New York. iTrade was owned by iTRADEnow.com Corp., which was wholly owned by Eric Arlt, iTrade's president. During the relevant period, iTrade had approximately 70 brokers, and Richard Novack was the registered FINOP at iTrade. Forest never was registered with iTrade. On May 27, 2010, iTrade voluntarily filed a Uniform Request for Broker-Dealer Withdrawal ("Form BDW") withdrawing from FINRA membership as of a result of an arbitration award it could not pay.

## II. Procedural History

On June 20, 2012, Enforcement filed the underlying five-cause complaint against Forest and Novack. In causes one through four, Enforcement alleged that Forest and Novack caused the books and records of iTrade to be inaccurate, in violation of Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 17a-3(a)(2), and NASD Rule 3110; caused iTrade to inaccurately record and report its net capital, net capital requirement, and excess net capital, in violation of Section 17(a) of the Exchange Act, Exchange Act Rule 17a-5(a), and NASD Rule 3110; caused iTrade to operate while in net capital deficiency, in violation of Section 15(c)(3) of the Exchange Act and Exchange Act Rule 15c3-1(a); and caused iTrade to fail to comply with the net capital notification requirement pursuant to Section 17(a)-11(b)(1) of the Exchange Act. For each of these causes of action, the complaint alleged that Forest and Novack violated NASD Rule 2110 (for conduct pre-dating December 15, 2008) and FINRA Rule 2010 (for conduct on or after December 15, 2008) for causing the aforementioned recordkeeping and net capital violations.<sup>1</sup> In cause five, Enforcement alleged that Forest performed iTrade's FINOP functions and responsibilities without being registered as a FINOP, in violation of NASD

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<sup>1</sup> On December 15, 2008, NASD Rule 2110 was adopted as FINRA Rule 2010. *FINRA Regulatory Notice 08-57*, 2008 FINRA LEXIS 50, at \*32 (Oct. 2008).

Rule 1021(a) and FINRA Rule 2010. For each of the causes of action, Enforcement alleged that Forest's misconduct occurred during the period September 30, 2009, through April 26, 2010.<sup>2</sup>

By order of the Chief Hearing Officer dated January 28, 2013, the charges against Novack were severed from the charges against Forest.<sup>3</sup>

The parties participated in a two-day hearing on April 10-11, 2013, and delivered closing arguments by teleconference on April 16, 2013. The Hearing Panel issued its amended decision on August 13, 2013.<sup>4</sup> The Hearing Panel found that Forest engaged in the misconduct as alleged in the complaint, and a majority of the Hearing Panel censured him and ordered him to pay costs. In concurrence with issuance of the amended decision, the Hearing Officer issued a dissenting statement with respect to sanctions, stating that he would have suspended Forest in all principal capacities for 60 days and imposed a \$5,000 fine.

Forest appealed the decision in all respects, and Enforcement appealed it with respect to sanctions.

### III. Facts

FBAI had a long-standing relationship with iTrade. In or about 1996, Arlt, iTrade's president, retained FBAI to perform various financial and compliance consulting functions, including compiling the detailed information necessary to prepare the Firm's quarterly Financial and Operational Combined Uniform Single ("FOCUS") reports, pursuant to a books and records contract. In 2005, Arlt asked Forest to find a FINOP for iTrade. Forest retained Richard Novack, a certified public accountant who had been registered as a FINOP since 1983, to act as iTrade's part-time and off-site FINOP. Novack registered as the FINOP of iTrade in February 2005. Novack was an independent contractor for FBAI while he was registered with iTrade. Every month, FBAI invoiced iTrade \$1,300 for the FINOP services of Novack, and FBAI paid Novack \$500 for acting as the FINOP of iTrade. On the same monthly invoice, FBAI also charged iTrade \$400 each month for preparation of financials and net capital computation and \$200 per hour for any consulting services performed by FBAI that month.

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<sup>2</sup> Forest has not been registered with a FINRA member firm since June 22, 2010. Although Forest was not registered with a member firm at the time the underlying complaint was filed, he remains subject to FINRA's jurisdiction for purposes of this proceeding because the complaint was filed with two years after the termination of his registration with a member firm, and it charges him with misconduct that commenced prior to the termination of his registration. *See* FINRA By-Laws, Article V, Section 4.

<sup>3</sup> A default decision was entered against Novack on August 12, 2013 finding him liable for the alleged misconduct.

<sup>4</sup> The Hearing Panel issued an amended decision to correct a typographical error.

Brian Sanders joined iTrade in June 2005. Sanders became the chief compliance officer in October 2005 and ran the Long Island branch office operations. Sanders supervised Novack. Novack and Sanders spoke every couple of months. According to Novack, he spoke to Sanders if there was a problem or he needed access to particular financial data. Novack and Forest, on the other hand, spoke about once a month. Their conversations were largely social, and they specifically discussed iTrade's business in detail on only one or two occasions.

Each month, Sanders referred to a checklist to gather financial information and documents (including bank statements, commissions, accruals), and totaled and coded the amounts based on a coding system created by Forest. Then Sanders faxed the coded information and documents to FBAI. FBAI, through Forest, entered the coded financial information into its computer and prepared iTrade's monthly financial reports, including FOCUS reports, balance sheets, income statements, trial balances, general ledgers, check registers, and net capital computations. Sanders never sent bills or invoices to FBAI but instead would provide totals and the corresponding codes.

The parties stipulated that all FOCUS reports compiled by FBAI were approved by Novack before Forest submitted them to FINRA. It is unclear how Novack received the FOCUS reports for his review prior to their electronic filing with FINRA by Forest. Novack testified he received a compilation of information supplied by Arlt or Sanders and prepared by FBAI. According to Novack, Forest prepared the net capital computations and Novack reviewed and approved them. Sanders testified that for a period of time, Forest sent compiled information to Arlt, and Arlt would send that information to Sanders and possibly to Novack. Forest, on the other hand, testified it was not FBAI's customary practice to send its clients the final FOCUS reports before filing, so he may or he may not have sent iTrade the FOCUS reports prior to filing them.

Novack spent approximately two hours a month acting as iTrade's FINOP. He conducted a cursory review of iTrade's trial balance sheet on a monthly basis and occasionally reviewed iTrade's bank information, statements, and records. According to Novack, his responsibilities as FINOP for iTrade were to review the Firm's FOCUS reports, compare the computations therein to the Firm's trial balance sheets, and ensure that the FOCUS reports were accurate and timely filed. Novack also had access to bank accounts, brokerage statements, clearing statements, bills, and other documents, which he could review if he thought something merited further scrutiny. Novack, however, never asked to look at this documentation. Novack did not review iTrade's general ledger or income statement on a monthly basis. He also never visited iTrade's Boca Raton office and visited iTrade's Long Island office only once during FINRA's 2009 examination of iTrade at the request of FINRA. The only time that Novack looked at iTrade's brokerage records was during the 2009 examination.

FBAI, through Forest, electronically filed iTrade's quarterly FOCUS reports for the fourth quarter of 2008 and the first, second, third, and fourth quarters of 2009.

While Novack served as iTrade's FINOP, Forest continued to provide consulting services to iTrade. According to Sanders, Forest's consulting services went beyond financial issues. Among other things, Forest assisted with the Firm's annual compliance meetings, compliance

questions, and other issues related to the Firm's business. Sanders and Forest typically communicated via telephone and rarely communicated by email. Both Arlt and Sanders testified that they could not recall if Forest charged them every time they called, but both expected Forest to charge for his time.<sup>5</sup>

#### IV. Discussion

The Hearing Panel found that Forest caused iTrade's book and records to be inaccurate; caused iTrade's calculations of required net capital calculations and actual net capital to be inaccurate; caused iTrade to conduct a securities business with insufficient net capital; and caused iTrade to fail to notify the regulatory authorities that it had insufficient net capital. The Hearing Panel further found that Forest acted as the de facto FINOP of iTrade while failing to register as a FINOP. We find iTrade committed the underlying recordkeeping and net capital violations but find that the preponderance of the evidence does not establish that Forest acted as a de facto FINOP of iTrade or can be held liable for causing iTrade's violations. Therefore, we dismiss the complaint against Forest.

##### A. iTrade's Net Capital and Recordkeeping Violations

We first determine whether iTrade committed the recordkeeping and net capital violations allegedly caused by Forest in the complaint. Specifically, the complaint alleges that Forest caused iTrade to inaccurately report its minimum net capital requirement as \$5,000 instead of \$100,000 in the Firm's FOCUS report for the fourth quarter of 2009 ("4Q 2009 FOCUS report"). The complaint further alleges that Forest caused the Firm's net capital calculations in its 4Q 2009 FOCUS report to be inaccurate because the report failed to properly reflect iTrade's liability for a settlement of an Illinois regulatory action. We review these allegations below and conclude that iTrade's 4Q 2009 FOCUS report was inaccurate in both respects.

##### 1. iTrade's Minimum Net Capital Requirement

Exchange Act Rule 15c3-1 establishes net capital requirements for brokers and dealers. Rule 15c3-1(a)(2)(vi), in the pertinent part, permits a broker-dealer to operate with minimum net capital of \$5,000 if the broker-dealer does not receive or hold customer funds or securities, or carry customer accounts. Rule 15c3-1(a)(2)(iii) nevertheless requires certain "dealers"—including any broker-dealer that effects more than 10 transactions in any one calendar year for its own investment account—to maintain net capital of at least \$100,000. The Commission imposes

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<sup>5</sup> The record includes only three monthly invoices FBAI sent to iTrade dated January 16, 2009, May 16, 2009, and June 16, 2009. Each invoice reflected the \$400 fee for the "preparation of financials and net capital computation" and \$1,300 fee for "FinOp services – Rich Novak." The January 16, 2009 invoice was the only invoice that included a charge for consulting services, which was described as "conversation with [Arlt] regarding PPM and SEC OTR's" for 0.50 hours.

this higher minimum net capital requirement on dealers, in part, in recognition of the risks of a dealer's business, including the potential for severe market volatility. *See William K. Cantrell*, 52 S.E.C. 1322, 1323 (1997). A firm classified as a dealer under this rule continues to be a dealer for the remainder of that calendar year. Exchange Act Rule 15c3-1(a)(2)(iii). Holding securities in a firm's error account overnight before re-selling them constitutes proprietary trading, which causes the firm to be a dealer subject to the \$100,000 minimum net capital requirement if the firm effect more than 10 transactions in a calendar year. *See Cantrell*, 52 S.E.C. at 1325. For the reasons discussed below, we find that iTrade was a dealer in 2009 subject to the \$100,000 minimum net capital requirement.

2. iTrade's 4Q 2009 FOCUS Report Was Inaccurate Because the Firm Effected More Than 10 Proprietary Trades

iTrade maintained an error account at its clearing firm to dispose of securities bought for trades that were cancelled in customer accounts. Approximately 10 percent of iTrade's trades in customer accounts were cancelled. When the prices of stocks in the error account went up, iTrade sold them and kept the profit. When prices of the stocks went down, iTrade sold the stocks and charged the losses to the registered representative. In many instances, the purchases and sales in the Firm's error account took place on different days.

In January 2009, iTrade effected more than 10 proprietary trades in its error account, holding positions overnight or longer. By holding positions overnight, iTrade incurred market risk, which the higher net capital requirement for proprietary traders is designed to protect. *See id.* It is irrelevant whether iTrade intended to engage in proprietary trading. *See id.* at 1326-27. Based on established precedent, the trades in iTrade's error account were proprietary, and the Firm's minimum net capital requirement for the remainder of the 2009 calendar year was required to be reported as \$100,000, not \$5,000. Accordingly, the Firm's 4Q 2009 FOCUS report, which reported its minimum net capital requirement as \$5,000, was inaccurate.<sup>6</sup>

3. iTrade's 4Q 2009 FOCUS Report Was Inaccurate Because It Did Not Account for the Firm's Settlement with the Illinois Securities Department

On May 13, 2009, the State of Illinois Securities Department filed a regulatory action against iTrade, Sanders, and an iTrade registered representative alleging 155 violations and seeking a \$10,000 fine for each violation. As a result, in its 2Q and 3Q 2009 FOCUS reports, iTrade included a \$1.55 million entry for a contingent liability in its aggregate indebtedness.

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<sup>6</sup> iTrade also effected more than 10 proprietary trades in its error account in June 2008, in some instances holding securities for as long as three or four days. As a result of these transactions, iTrade's minimum net capital requirement for the remainder of the 2008 calendar year was \$100,000, not \$5,000. Although outside the relevant period, we discuss the significance of these transactions and iTrade's related net capital filings in Part IV.B.1. *infra*.

In late 2009, iTrade reached a settlement with the customer whose transactions were the subject of the Illinois matter, under which iTrade, Sanders, and the registered representative agreed to pay the customer \$150,000. The release and settlement agreement was dated “as of December 23, 2009,” but the notary public’s certification indicates that Sanders and the registered representative signed the agreement on January 11, 2010. The settlement agreement provided that the matter was being settled by iTRADEnow.com Corp., iTrade’s parent, which the agreement abbreviated as “iTRADE.” Pursuant to the agreement, the customer maintained a securities account at iTRADE, and Illinois had brought a regulatory action against iTRADE. The settlement agreement did not explicitly release iTrade. Pursuant to the settlement agreement, iTRADE was liable for \$75,000, and Sanders and the registered representative each were liable for \$37,500.<sup>7</sup>

iTrade, Sanders, and the registered representative entered into a separate stipulation to enter consent order with the Illinois Securities Department. The stipulation was executed by Sanders and the registered representative on January 11, 2010 and by Arlt, on behalf of iTrade, on “December 5, 2010.”<sup>8</sup> The corresponding consent order, which ordered iTrade, Sanders, and the registered representative to pay the customer \$150,000 in restitution in exchange for a full and unconditional release from the customer, was entered January 13, 2010.

iTrade’s 4Q 2009 FOCUS report correctly removed the \$1.55 million entry for a contingent liability related to the Illinois matter but failed to account for the Firm’s probable and reasonably estimated settlement of the matter as an actual liability. *See Fox & Co. Invs., Inc.*, 58 S.E.C. 873, 885 (2005). iTrade’s 4Q 2009 FOCUS report should have reflected an actual liability in the amount of at least \$75,000 for two reasons.

First, iTrade’s attempt to shift its liability to its parent was ineffective. To remove a liability from a broker-dealer’s books by shifting the liability to a third party, the following five criteria must be satisfied:

- a. If the expense results in payment owed to a vendor or other party, the vendor or other party has agreed in writing that the broker-dealer is not directly or indirectly liable to the vendor or other party for the expense;
- b. The third party has agreed in writing that the broker-dealer is not directly or indirectly liable to the third party for the expense;

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<sup>7</sup> The settlement agreement was executed by the parties separately. Although also notarized, it is not clear what day the other parties—i.e., Arlt, in his capacity as president and CEO of iTradenow.com Corp., and the customer—executed the settlement agreement.

<sup>8</sup> It is unclear when Arlt executed the stipulation, but it undoubtedly was not December 5, 2010. In the copy of the stipulation signed by Arlt, the year “2009” was crossed out and “2010” was handwritten.

- c. There is no other indication that the broker-dealer is directly or indirectly liable to any person for the expense;
- d. The liability is not a liability of the broker-dealer under GAAP; and
- e. The broker-dealer can demonstrate that the third party has adequate resources independent of the broker-dealer to pay the liability or expenses.

*See NASD Notice to Members 03-63*, 2003 NASD LEXIS 76, at \*8-9 (Oct. 2003). There was no written agreement that iTrade was no longer liable for the Illinois matter because the settlement agreement did not release iTrade.<sup>9</sup> Pursuant to the stipulation to enter consent order, the Illinois Securities Department required iTrade to make the payments required by the settlement agreement and revoked iTrade's Illinois license when it failed to do so. Further, iTRADEnow.com Corp. arguably also did not have adequate resources to pay the liability because it failed to make the requisite payments.<sup>10</sup>

Second, as of December 2009, when the settlement agreement was drafted, based on emails with counsel, iTrade knew the settlement was probable and could have reasonably estimated the loss. Indeed, iTrade itself understood that the Illinois matter was no longer a contingent liability in December 2009 when it removed it from its calculation of contingent liabilities for the calculation of required minimum net capital in the 4Q 2009 FOCUS report. Accordingly, the Firm's 4Q 2009 FOCUS report, which did not include the Illinois matter settlement as an actual liability, was inaccurate.

B. Forest's Interactions and Conduct Related to iTrade's Net Capital Violations

Having determined that iTrade committed the underlying recordkeeping and net capital violations related to the Firm's 4Q 2009 FOCUS report, we next determine whether Forest is responsible for those violations. To do so, we must first review Forest's interactions and involvement with iTrade related to the violations. Some of these interactions precede the relevant period but are relevant for our purposes because they relate to Forest's knowledge of underlying issues relevant to the 4Q 2009 FOCUS report.

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<sup>9</sup> The settlement agreement also conflates iTrade with its parent, which suggests that the customer did not intend to release iTrade. For example, it provides that the customer opened an account with "iTRADE" and references Illinois's action against "iTRADE."

<sup>10</sup> Arlt testified that iTrade's parent paid the customer \$100,000, and the remaining amount was obligated to be paid by Sanders and the registered representative. The Illinois Securities Department expelled iTrade from membership because the settlement was a joint and several obligation.



During the second quarter of 2009, FINRA staff began a routine examination of iTrade, reviewing the time period April 2008 through May 2009. Sanders was FINRA staff's primary contact on financial and net capital issues. When Sanders was uncomfortable with technical questions on net capital issues, he told FINRA staff that he would have to talk to Forest. Sanders never told FINRA staff he needed to talk to Novack. Novack was not on site at iTrade's branch office at the beginning or during the majority of the examination. At one point during the examination, FINRA staff requested Novack to come to iTrade's branch office.<sup>11</sup> According to FINRA staff, Novack was not knowledgeable about the Firm's financial statements or issues, and it appeared as though Novack was seeing certain documents for the first time. In response to some of the examiners' questions, Novack stated he needed to discuss the matters with Forest before providing a response.

1. iTrade's Trading in the Firm's Error Account

During the examination, FINRA staff noticed that in June 2008 iTrade had more than 10 proprietary trades in its error account and held trades overnight or longer even though iTrade purported to operate as a broker-dealer subject to a \$5,000 minimum net capital requirement. FINRA staff testified that, when Novack came to iTrade's branch office during the examination, Novack was unaware that iTrade had trades in its error account that were held overnight. FINRA staff spoke to Sanders about the issue, and Sanders called Forest and put him on speakerphone.<sup>12</sup> FINRA staff explained to Forest that they believed iTrade's trading in its error account impacted the Firm's net capital calculation because it was proprietary trading. Forest said he disagreed with the classification at the time.

As a result of FINRA staff's concerns, on June 29, 2009, Sanders emailed FINRA staff that iTrade was not aware of the effect of positions held overnight in its inventory and error accounts and, as a policy going forward, would ensure that positions were not held overnight in the accounts. In a separate email later that same day, Sanders stated that iTrade would re-characterize itself as a broker-dealer with a \$100,000 minimum net capital requirement for the 4Q 2008 FOCUS report and recalculate its financials. On July 1, 2009, Forest filed an amended 4Q 2008 FOCUS report. That same day, Forest, pursuant to Exchange Act 17a-11(c)(3), also

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<sup>11</sup> In advance of Novack's appearance, Sanders emailed Forest with the subject line "Novack visit" and inquired, "Anything else he should know." Forest responded, "[H]e should let them know that he is up to speed with the financials, as he is and course u can go over everything with him beforehand...anything that you or he do not know or are unsure of, email me and [my wife] or I will get back to u asap." When asked why it was necessary for Sanders to go over financials with Novack, Sanders testified that Novack may have not been up to speed with what was going on in the examination at the time.

<sup>12</sup> This was the only time FINRA staff spoke to Forest during the examination. FINRA staff testified that, of all the people they dealt with regarding iTrade's financials, Forest seemed to be the most knowledgeable. At the hearing, Forest testified when he spoke to Sanders, he did not know who else was in the office at the time.

filed an early warning notice with FINRA that iTrade's net capital was less than 120 percent of the Firm's required net capital.

During the examination, FINRA staff also noticed that iTrade in January 2009 had more than 10 proprietary trades in its error account and held trades overnight or longer. In iTrade's 2Q and 3Q 2009 FOCUS reports, iTrade correctly reported that it was subject to a \$100,000 minimum net capital requirement. iTrade's 1Q and 4Q 2009 FOCUS reports, however, incorrectly reported that iTrade was subject to a \$5,000 minimum net capital requirement. It is unclear from the record whether FINRA staff or anyone at iTrade explicitly discussed this trading with Forest. It is also unclear whether FINRA staff and iTrade ever discussed iTrade's need to amend its 1Q 2009 FOCUS report to reflect that the Firm was operating as a dealer and subject to a \$100,000 minimum net capital requirement as a result of the proprietary trading in 2009.

Sanders testified he never sent to Forest iTrade's clearing firm's error account activity statement for June 2008 or January 2009, and Forest testified he never saw them. At the hearing, Novack testified that, as far as he was aware, iTrade never was subject to a \$100,000 minimum net capital requirement. He never saw an error account statement and, prior to his visit, never saw the firm's riskless principal account statement. Novack also testified that he never knew that in July 2009 iTrade filed an amended 4Q 2008 FOCUS report or the early warning notice. Forest, on other hand, testified that he thought he told Novack about the amended FOCUS report and early warning notice and believes Novack's recollection is wrong.

## 2. The Illinois Matter

During the examination, FINRA staff also reviewed the Illinois Securities Department's regulatory action filed against iTrade in May 2009. At the time, iTrade's work papers and financial documents did not reflect the Illinois matter as a contingent liability. FINRA staff asked Sanders whether iTrade had acquired a legal opinion on the action that the claim was frivolous, so that iTrade did not need to report it as a contingent liability on its financial statements. Sanders indicated that he had not received an opinion from counsel and would check with Forest regarding the impact of the Illinois matter on iTrade's financials. Sanders later told FINRA staff that he spoke to Forest, and iTrade was going to update its quarterly FOCUS filing accordingly.<sup>13</sup> iTrade's 2Q and 3Q 2009 FOCUS reports correctly reported the Illinois matter as a contingent liability.

At the hearing, Sanders could not recall if he ever discussed with Forest whether the Illinois matter could be removed from the 4Q 2009 FOCUS report. Arlt testified that he never told Forest or FBAI about the Illinois matter settlement. Arlt testified that it was his opinion, after consulting with outside counsel (not Forest), that the settlement did not need to be booked as a liability because the settlement was with iTrade's parent. Novack testified that he did not

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<sup>13</sup> Forest acknowledged that he provided advice to iTrade on how the contingent liability should be recorded.

become aware of the Illinois matter until he came to iTrade's office during FINRA's 2009 examination.

3. FINRA's 8210 Requests to iTrade

In conjunction with its 2009 examination, FINRA sent to iTrade at least two FINRA Rule 8210 requests requesting various financial information and documentation related to the Firm's net capital calculation. Sanders forwarded portions of the FINRA Rule 8210 requests to Forest. Sanders testified that he probably had the requested information, but it "was just easier to get it from [Forest]." Sanders did not send the request to Novack because Forest compiled and produced all the reports, so Forest probably could better access the requested information.

C. The Evidence Is Insufficient to Establish that Forest Was the De Facto FINOP

After reviewing Forest's interactions and involvement with iTrade related to the Firm's underlying recordkeeping and net capital violations, we find that the evidence, while troubling, does not meet the burden of establishing that Forest acted as iTrade's de facto FINOP and therefore failed to register as a FINOP with iTrade. Whether an individual can be held liable for acting as a de facto FINOP is a novel issue which has not been previously considered. For purposes of the analysis below, we assume that someone other than a firm's registered FINOP may be liable as the de facto FINOP under appropriate circumstances. *Cf. Dep't of Enforcement v. Gallagher*, Complaint No. 2008011701203, 2012 FINRA Discip. LEXIS 61 (FINRA NAC Dec. 12, 2012) (finding that respondent acted as an unregistered principal and was liable for the firm's supervisory failures). We, however, find the evidence is insufficient to reach such a conclusion in this instance.

The Hearing Panel found that Forest functioned as a de facto FINOP based on "the overall scope of [his] activities." The Hearing Panel reasoned that Forest's agreement with Novack for Novack to act as iTrade's FINOP was structured so that Forest would perform the duties of the FINOP. The Hearing Panel was troubled that Novack's duties were to review and approve, but not to prepare, the FOCUS reports. The Hearing Panel further reasoned that FBAI's \$500 monthly payment to Novack was far too little compensation if Novack was expected to do anything more than the perfunctory review that he agreed to do. The Hearing Panel was also troubled that, in addition to the preparation and filing of iTrade's FOCUS reports, Forest responded to questions from the Firm on financial issues, included responding to questions raised by FINRA examiners during the 2009 examination and providing documents to the Firm when the regulators requested them. The Hearing Panel concluded that Forest's collective roles caused him to be iTrade's FINOP.

Although we agree with the underlying factual conclusions of the Hearing Panel, we do not find that these facts, absent additional evidence regarding Forest's role and involvement in iTrade's management, caused him to be iTrade's de facto FINOP or liable for causing iTrade's underlying violations.

1. Forest's Relationship With iTrade and Novack Does Not Make Forest iTrade's FINOP

Based on the record before us, we cannot conclude, in light of Novack's failure to discharge his duties, that Forest's relationship with iTrade and Novack is sufficient to make Forest iTrade's de facto FINOP. NASD Rule 1022(c) requires that each person associated with a member who performs the duties of a FINOP to register with FINRA as a FINOP. A FINOP is defined as an associated person whose duties include:

- (A) final approval and responsibility for the accuracy of financial reports submitted to any duly established securities industry regulatory body;
- (B) final preparation of such reports;
- (C) supervision of individuals who assist in the preparation of such reports;
- (D) supervision of and responsibility for individuals who are involved in the actual maintenance of the member's books and records from which such reports are derived;
- (E) supervision and/or performance of the member's responsibilities under all financial responsibility rules promulgated pursuant to the provisions of the Act;
- (F) overall supervision of and responsibility for the individuals who are involved in the administration and maintenance of the member's back office operations; or
- (G) any other matter involving the financial and operational management of the member.

NASD Rule 1022(c)(2).<sup>14</sup>

It is beyond question that Novack failed to properly perform his duties as FINOP of iTrade, and Novack's final review of the FOCUS reports was utterly deficient. *See, e.g., Cantrell*, 52 S.E.C. at 1327 (finding FINOP who failed to recognize his firm's trading in error account made the firm a dealer required to maintain \$100,000 minimum net capital responsible for the firm's net capital violations); *Fox & Co. Invs., Inc.*, 58 S.E.C. at 889 (finding president and FINOP who failed to properly account for an reasonably estimated arbitration award liable for firm's net capital violation); *Arthur Stelmack*, 52 S.E.C. 103, 106 (1994) (rejecting lackadaisical FINOP's "suggestion that the fact that he was a part-time employee of [the firm]

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<sup>14</sup> Although its decision cited the applicable rule, the Hearing Panel did not elucidate on how Forest's role corresponded to the duties provided in NASD Rule 1022(c). Enforcement argued that Forest performed many of the duties set forth in NASD Rule 1022(c), particularly items (B), (E), and (G). At oral argument, Enforcement argued that Forest essentially had "final approval" of financial reports because Novack never had any questions and there was no one supervising the preparation of the financial reports.

who visited the firm just once a month should excuse any dereliction of his FINOP duties” and finding him responsible for the firm’s net capital violations). As previously noted, FINRA brought a disciplinary action against Novack for these deficiencies. Novack willingly “agreed to serve as the firm’s FINOP, and for as long as he retained that position, he was responsible for carrying out its attendant duties and obligations.” *Gilad J. Gevanyahu*, 51 S.E.C. 710, 712-13 (1993). Novack had access to iTrade’s books and records, but he only visited the Firm once at the request of FINRA staff and, at a minimum, consistently failed to inquire and review iTrade’s ongoing liabilities, contingent liabilities, and activities related to a proper net capital calculation during the relevant period. *See NASD Notice to Members 06-23*, 2006 NASD LEXIS 23, at \*6-10 (May 2006) (instructing part-time and off-site FINOPs to conduct a minimum number of on-site visits each year and inquire about and review the firm’s books and records when conducting examinations on site).

Enforcement argues that because Novack failed to discharge his duties as FINOP, Forest essentially had “final approval” of iTrade’s financial reports and FOCUS reports. Based on the record before us, we disagree. There is insufficient evidence that Forest had independent or final approval of the Firm’s FOCUS reports, even if he had raised issues to Novack, Sanders, or Arlt. *See NASD Rule 1022(c)(2)(A), (B)*. And as both parties stipulated, and as Novack, Sanders, and Arlt testified, Novack reviewed and approved every FOCUS report.

The financial relationship among iTrade, Forest, and Novack, moreover, does not support a finding that iTrade intended to engage Forest, and not Novack, for the “final preparation” of such reports. *See NASD Rule 1022(c)(2)(B)*. We disagree with the Hearing Panel’s finding that the portion of the compensation for Novack’s FINOP services that FBAI retained—\$800 per month—may be characterized, solely by virtue of its relative size, as payment for Forest’s “responsibilities for financial recordkeeping and reporting.” Neither Sanders nor Arlt testified that they knew FBAI retained a significant portion of Novack’s compensation. Further, FBAI’s invoice to iTrade included a separate line item for FINOP services, the preparation of financials and net capital computation, and consulting services. Considering that Sanders only provided totals and the corresponding codes to FBAI, the relatively smaller amount on FBAI’s invoice for the preparation of financials and net capital computation may well have corresponded to the ministerial nature of the compilation of iTrade’s FOCUS reports.

We likewise do not believe there is sufficient evidence to conclude, as the Hearing Panel did, that Novack’s \$500 per month compensation “was far too little compensation if Novack had been expected to do anything more than a perfunctory review that he agreed to do.” Novack previously functioned as a part-time FINOP for other firms, and he agreed to be paid \$500 per month by FBAI for serving as iTrade’s FINOP. Nothing in the record leads us to conclude that Novack’s compensation somehow dictated or controlled the amount of time he planned to serve as iTrade’s FINOP. In fact, Novack was unaware that FBAI kept the majority of iTrade’s

payment to FBAI for Novak's FINOP services.<sup>15</sup> Moreover, Enforcement did not present evidence that \$500 was less compensation than Novack or other FINOPs received for serving as part-time FINOPs at other firms.

Finally, Forest did nothing to prevent or relieve Novack from properly performing his duties as FINOP, and there is insufficient evidence that Forest was aware that Novack was not properly performing his duties, for us to conclude that Forest assumed "supervision of and responsibility for" Novack or any other individual assisting in the preparation of iTrade's reports or involved in the maintenance of iTrade's books and records. *See* NASD Rule 1022(c)(2)(C) & (D). Through his consulting role, Forest was privy to certain, but incomplete, confidential and proprietary information relevant to iTrade's FOCUS report and might have had reason to suspect that iTrade did not provide FBAI with accurate figures for the 4Q 2009 FOCUS report.<sup>16</sup> Nevertheless, Forest did not have the same rights or responsibilities as a FINOP would to review iTrade's books and records and did not purport to exercise any such rights or responsibilities for iTrade's benefit.

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<sup>15</sup> It does not appear that FBAI and Forest tried to hide from Novack the fact that FBAI kept a significant portion of the payment for Novack's FINOP services because Novack had access to iTrade's books and records, which likely would include contracts for services and invoices.

<sup>16</sup> Due to FBAI's books and records and consulting contract with iTrade, Forest was aware that iTrade effected proprietary trading in its error account in 2008 because he filed the amended 4Q 2008 FOCUS report and the early warning notice. As a result, Forest might have had reason to suspect that iTrade did not provide FBAI with accurate figures for the 4Q 2009 FOCUS report. iTrade's 2Q and 3Q 2009 FOCUS reports also provided the Firm's minimum net capital requirement as \$100,000, which seems to suggest that FBAI had sufficient information from which Forest could infer that a similar problem might have arisen in 2009. Forest, however, testified he never saw the Firm's January 2009 error account activity statement, and Sanders testified he never provided it (or the June 2008 statement) to Forest. Forest also testified that the officers at iTrade never asked him whether the Firm was subject to a \$5,000 or \$100,000 minimum net capital requirement, and he merely entered the information as coded by Sanders.

Due to FBAI's books and records and consulting contract with iTrade, Forest also was aware of the Illinois matter and the corresponding contingent liability because he counseled iTrade on how to report it when asked. The uncontroverted record provides, however, that Forest was not privy to iTrade's settlement negotiations or the ultimate settlement. Nonetheless, as a result of the removal of the contingent liability from the 4Q 2009 FOCUS report, Forest might have had reason to suspect that an actual liability should have been reported.

2. The Hearing Panel Did Not Give Appropriate Weight to Sanders's and Arlt's Responsibility for the 4Q 2009 FOCUS Report

Even if we were to disregard Novack's status as the registered FINOP, to find Forest liable as the de facto FINOP would seemingly overlook Sanders's and Arlt's responsibility for causing iTrade to file the erroneous 4Q 2009 FOCUS report. It is undisputed that Sanders was charged with supervising Novack. It is also beyond question that Sanders and iTrade, as a whole, failed to do so properly. Sanders testified that he himself "didn't know anything about . . . doing FOCUS reports or any of that stuff. So really [his] only job was to get together all the bits of information that [iTrade] needed every month to put into those reports . . ." He further testified that "[he] [didn't] know what [FBAI] sent to Mr. Novack or what he did with it." Although Sanders said that Novack approved of the filing of the FOCUS reports, iTrade and Sanders did not have a specific system by which they ensured that Novack did so.<sup>17</sup>

Such an indifferent and cavalier approach is in direct contravention of FINRA guidance to members employing part-time and off-site FINOPs. *See NASD Notice to Members 06-23*, 2006 NASD LEXIS 23, at \*10-11 (explicitly urging members to "establish procedures that describe the FINOP's duties and thoroughly outline the FINOP's responsibilities" and to "conduct ongoing assessments of its FINOP's ability to perform his or her duties"). Sanders failed to supervise Novack, and iTrade failed to fulfill the duties of a member firm employing a part-time and off-site FINOP. *See id.*

Based on the preponderance of the evidence, we cannot conclude that Forest was in a position to exercise final approval and final preparation of the relevant FOCUS reports or supervisory authority over Novack, the de jure FINOP. Indeed, both Sanders and Arlt as Novack's direct supervisor and the president of the Firm, were in a better position than Forest to supervise and otherwise control Novack. Novack was an associated person at iTrade; Forest's uncontroverted testimony was that he could not fire Novack. In contrast, Sanders and Arlt undoubtedly had the ability to fire Novack. While Forest filed iTrade's FOCUS reports as an operational matter, it was Sanders who gathered the relevant information to prepare the reports and maintained iTrade's books and records from which the FOCUS reports were derived. *See NASD Rule 1022(c)(2)(A), (B), (D), (F)*. Despite Forest's considerably greater experience with the duties of a FINOP, Forest's role, as a whole, was seemingly clerical and more akin to an administrative function in this instance. For each of FBAI's books and records clients, Forest testified that he entered the data as transcribed and coded by the client. Forest asserted that he did not inquire further about particular matters unless specifically asked by his clients per their consulting arrangement because he was not the FINOP. Forest argued that if he were to do anything more than his purposeful hands-off approach, he indeed would have to register as a FINOP. With respect to iTrade, Forest testified he never advised iTrade whether it was subject to a \$5,000 or \$100,000 minimum net capital requirement because the officers at iTrade never

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<sup>17</sup> Sanders testified that Novack did not necessarily call Sanders to approve of the filing, but it was possible Novack may have told Arlt.

asked him to do so. When asked why he changed iTrade's minimum net capital requirement to \$5,000 from \$100,000 for the 4Q 2009 FOCUS report, Forest did not directly answer the question. Instead, he testified "it's a computer function. I filed the FOCUS reports, I'm not putting the stuff together . . . every one of my clients has a FINOP. They make their call. They would tell me." Forest further contended that it was not his job to determine whether iTrade continued to hold overnight positions in its error account in 2009.

Unlike Forest, Sanders and Arlt were directly aware of iTrade's business and affairs and had access to information regarding iTrade's overnight positions in the Firm's error account and the Illinois matter. Sanders and Arlt also were in a better position than Forest to identify and forward to Novack information relevant to iTrade's net capital calculations.<sup>18</sup> By contrast, Forest did not have access to the primary sources of financial information that comprised the calculations for iTrade's FOCUS reports. Sanders chose what financial information to convey to FBAI when he provided compiled totals and corresponding codes and by asking specific questions pursuant to iTrade's consulting contract with FBAI.

The fact that Sanders spoke with Forest more frequently than Novack regarding financial matters does not make Forest responsible for iTrade's financial reporting and therefore the de facto FINOP. Sanders testified that, due to iTrade's consulting relationship with FBAI, he called Forest "all the time and asked him all kinds of questions." Sanders testified he spoke very little to Forest or Novack about net capital because the subject only came up a few times. Other than Forest's compilation of iTrade's FOCUS quarterly reports, the record demonstrates that Forest was involved in issues related to the Firm's net capital computation on only a few occasions when specifically asked questions by iTrade.

Likewise, the fact that Forest provided documents for the Firm to produce in response to the FINRA Rule 8210 requests and responded to questions raised by FINRA examiners during the 2009 examination also does not make Forest responsible for the "performance of [iTrade's] responsibilities under all financial responsibility rules." NASD Rule 1022(c)(2)(E). Sanders's request to Forest to help gather iTrade's financial information for the FINRA Rule 8210 requests does not suggest that Forest and FBAI exercised control over such information on behalf of the Firm. As Sanders testified, he probably had all requested information, but "[i]t was just easier to get it from [Forest]" because Forest compiled and produced all the reports. Moreover, as FINRA staff testified, it is not inappropriate for a member firm to confer with an outside consultant or counsel prior to answering questions during an examination, which seemingly is what Sanders intended in this matter. While Forest undoubtedly realized that his participation in iTrade's FINRA examination could bring his consulting relationship with iTrade under scrutiny, it was Sanders who involved Forest in these matters due to his own inexperience and supervisory

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<sup>18</sup> Even if Sanders was not familiar with FOCUS reports and net capital calculations, he was undoubtedly aware that iTrade's trades in its error account in June 2008 were an issue and could have forwarded to Novack information regarding the same trading being effected in January 2009.



failures. Based on these facts and circumstances, the evidence does not support that Forest assumed the requisite degree of responsibility to make him the de facto FINOP.

D. The Evidence Did Not Establish that Forest Possessed the Requisite Control over the Firm's Financial Management to Render Him Liable for the Firm's Financial Recordkeeping and Net Capital Violations

We also find that the evidence does not establish that Forest possessed the requisite level of control or authority over the Firm's financial management, independent of the allegations that he operated as the de facto FINOP, to render him liable for causing the Firm's financial recordkeeping and net capital violations. The Commission has found that an officer or executive at the firm may be liable for a firm's recordkeeping and net capital violations when circumstances provide the opportunity to control the firm's financial recordkeeping and net capital reporting and those responsible for the firm's financial recordkeeping and net capital reporting. *See William H. Gerhauser*, 53 S.E.C. 933, 941 (1998) (finding the firm's president liable for the net capital violation because he gave the FINOP incorrect information about the firm's net capital obligations); *Kirk A. Knapp*, 51 S.E.C. 115, 126 (1992) (finding the chief shareholder and executive liable for the firm's net capital and recordkeeping violations because he had proposed many of the violative transactions and controlled the FINOP and dictated the operations of the firm); *Dep't of Enforcement v. Block*, Complaint No. C05990026, 2001 NASD Discip. LEXIS 35, at \*16 (NASD NAC Aug. 16, 2001) (finding chief executive officer responsible for the firm's net capital violation because he co-supervised the FINOP and "directed [the FINOP] to account improperly for the Firm's liabilities").

In light of the record before us, we do not need to reach the question whether an individual other than the FINOP, officer, or executive at the firm may be held liable for such violations, for example, based on the ability to assert control over relevant information or to otherwise exercise influence over the financial or operational management of a firm. As we have explained, there is insufficient evidence to conclude that Forest had final authority, final approval, supervisory authority, or the requisite responsibility for iTrade's duties under all financial reporting rules. And although we find Forest's inaction based on his knowledge of certain issues relevant to the 4Q 2009 FOCUS report disconcerting, we nonetheless cannot find that he is liable for causing iTrade's recordkeeping and net capital violations because the evidence did not establish he possessed the requisite control and authority over the Firm's financial management. Thus, based on the totality of the circumstances present in this record, we cannot hold Forest liable for iTrade's recordkeeping and net capital violations.

V. Conclusion

Enforcement failed to prove by a preponderance of the evidence that Forest acted as the de facto FINOP at iTrade while failing to register as a FINOP or was responsible for its books and records and calculations of net capital. Accordingly, we dismiss the complaint.

On Behalf of the National Adjudicatory Council,

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Marcia E. Asquith,  
Senior Vice President and Corporate Secretary