NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. JOHN D. KAWESKE (CRD No. 2309807), Respondent.	Disciplinary Proceeding No. C07040042 Hearing Officer – AWH **HEARING PANEL DECISION** February 10, 2006

Registered representative and principal (1) failed promptly to return investor funds upon failure of an offering to meet its sales contingency, in violation of Section 10(b) of the Securities Exchange Act, Rule 10b-9 promulgated thereunder, and NASD Conduct Rule 2110; (2) failed to establish an escrow account for a contingent offering, in violation of NASD Conduct Rule 2110; (3) made fraudulent misrepresentations in connection with the sale of preferred stock, in violation of Section 10(b) of the Securities Exchange Act, Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110; and (4) failed to update his Form U-4 to disclose customer complaints and settlements, in violation of NASD Conduct Rule 2110 and IM-1000-1. Respondent barred in all capacities for each violation, ordered to make restitution to investors, and assessed costs.

Appearances:

William Brice La Hue, Esq., and Joel R. Beck, Esq., for the Department of Enforcement

Stephen A. Mendelsohn, Esq., for John D. Kaweske

DECISION

Introduction

On April 20, 2004, the Department of Enforcement issued the four-cause Complaint in this proceeding, alleging that John D. Kaweske ("Kaweske" or "Respondent") (1) failed promptly to return investor funds when a sales contingency was not met; (2) failed to establish an escrow account for a contingency offering; (3) made misrepresentations and omissions of

material fact in connection with the sale of preferred stock; and (4) willfully failed to update his Form U-4 to disclose customer complaints, civil litigation, and a notice that he was the subject of an investigation by NASD. On May 17, 2004, Respondent filed an Answer and Affirmative Defenses and a request for a hearing. A hearing was originally scheduled to be held in December 2004; however, due to hurricane damage to Respondent's property, the hearing was postponed. The rescheduled hearing was held on August 23, 2005, in Fort Lauderdale, Florida, before a hearing panel composed of the Hearing Officer and two current members of the District 7 Committee. At the end of testimony on that date, the hearing was continued to November 17, 2005, in order to take testimony from Respondent, who was out of the country and did not attend the hearing, and to hear closing arguments by counsel. On November 14, 2005, the parties notified the Hearing Panel that no further oral hearing was necessary because both parties agreed to rest and close the evidence. In lieu of oral argument, they agreed to, and did, submit written memoranda on or before December 15, 2005.

Findings of Fact[1]

Respondent

John D. Kaweske entered the securities industry in December 1992 and first became registered as a corporate securities representative in March 1993. Subsequently, he became registered as a general securities representative, a general securities principal, and an introducing broker-dealer/financial and operations principal. In July 1993, he acquired ownership of member firm R.K. Grace & Company ("Grace") whose main office was located in Miami, Florida. Grace

[1] References to Enforcement's Exhibits are designated as CX_; Respondent's Exhibits, as RX_; Stipulations of Fact, as Stip._; and the transcript of the hearing, as Tr._.

conducted a general securities business, introduced on a fully disclosed basis through another member firm. Kaweske was CEO and President of Grace.[2]

In January 2001, Kaweske sold the assets of Grace to Cardinal Capital Management, Inc. ("Cardinal"), a member firm located in Miami, Florida. Kaweske was employed by Cardinal from January 2001 until March 2003. In April 2001, Grace filed a Form BDW, withdrawing its NASD membership. Prior to the instant proceeding, neither Kaweske nor Grace had any disciplinary action imposed by any self-regulatory organization or governmental body. Kaweske is not currently employed by an NASD member firm.[3]

R.K. Grace Preferred, Inc.

R.K. Grace Preferred, Inc., ("Preferred"), was created by Kaweske to invest funds in Grace and to make other investments as deemed appropriate by its Board of Directors.[4] Preferred was incorporated in Florida on January 27, 1998, with Kaweske listed as its only Director.[5] On January 28, 1998, Kaweske signed a new securities account form in the name of Preferred at Correspondent Services Corporation ("CSC").[6] However, the day before the new account form was signed, Kaweske purchased, on behalf of Preferred, 50,000 shares of Aquagenix, Inc., stock ("AQUX") through CSC. The settlement date for the purchase was February 3, 1998, but CSC refused the trade because there were no funds in the account to pay for the stock.[7]

Also in late January 1998, Preferred, through Kaweske commenced an offering of its preferred stock and sold shares of that preferred stock to only three investors, including CR and

[2] Stip. ¶¶ 1-3, 6-8.
[3] Stip. ¶¶ 4-5, 10-12.
[4] Stip. ¶¶ 13-14.
[5] CX-30.
[6] CX-31.
[7] CX-32; Tr. 168.

RH.[8] At the time they were offered the preferred stock, both CR and RH held large positions in AQUX that they had purchased through Pat Guadagno, a registered representative in New York, not associated with Grace, who introduced both CR and RH to Kaweske.[9]

The Offering, The Purchasers, and The Flow of Their Funds

Customer CR

After Guadagno introduced him to Kaweske, CR opened a securities account with Kaweske at Grace. In late January 1998, Kaweske told CR about Preferred, describing it as an offering "similar to a mutual fund" in which he was looking for people to invest.[10] One company that Kaweske mentioned as an investment for Preferred was AQUX, a stock in which CR had acquired a position a few weeks earlier though Guadagno.[11] Pursuant to Kaweske's instructions, on February 4, 1998, prior to his receipt of any offering documents, CR invested in the offering by wiring $125,000 to the investment account of Preferred.[12] On that same day, the $125,000 that CR had wired to Preferred's account was used to cover a margin call.[13]

Although CR agreed to wire the $125,000 with "no strings attached," he understood that he would have an opportunity review the Preferred Subscription Agreement, and, if he decided he did not like it, his money would be returned to him within seven days.[14] Kaweske sent CR the Subscription Agreement which stated:

> The Offer is being conducted on a "best efforts-all-or-none" basis to the initial 200,000 Shares and on a "best efforts" basis as to the remaining 200,000 Shares. Share (cash) subscriptions received and collected for the

[8] Stip. ¶¶ 15-16; Tr. 160.
[9] Tr. 49-50, 85. Guadagno told CR that he planned to open a satellite office of Grace in New York. Tr. 40. RH was under the impression that Guadagno had "moved over to Mr. Kaweske's firm." Tr. 84.
[10] Tr. 26.
[11] Tr. 27, 49-50.
[12] Stip. ¶¶ 17-18; CX-1; Tr. 27-28.
[13] CX-19; Tr. 163.
[14] Tr. 28, 41.

> minimum number of Shares offered hereby, will be maintained in an escrow account with [a Fort Lauderdale law firm].[15]

CR did not sign the Subscription Agreement or fill out the investor questionnaire that was attached to it. On February 11, 1998, CR informed Kaweske that he declined to invest in the Preferred Offering, and he requested the return of his $125,000. Kaweske failed to return the funds as requested.[16]

At the hearing, CR was shown another copy of the Preferred Subscription Agreement with a different description of the terms of the offering. The second page states:

> The Offer is being conducted on a "best efforts" basis. Following receipt and acceptance of the proceeds, all proceeds received will be deposited directly to the treasury of the Company.

This Subscription Agreement is purportedly signed by CR, and offers to purchase 12,500 shares at a purchase price of $10.00 per share; moreover, it states that, if the offer is accepted, the shares will be paid for by the delivery of "$125,000 by money wire."[17]

CR credibly testified that (1) he had not seen this version of the Subscription Agreement until 2000 when NASD staff sent it to him during the course of its investigation; (2) the handwriting, which filled in blanks for the number of shares, the share price, and the total amount to be paid, and included the words "money wire," is not his; and (3) although the signature looks like his, he did not sign that document.[18] CR was never advised that the offering was on a best efforts basis.[19] CR never received any Preferred stock certificates.[20]

[15] CX-2, p. 2.
[16] Tr. 29, 41-42.
[17] CX-3, pp. 2, 8.
[18] Tr. 29-30.
[19] Tr. 31.
[20] Tr. 33.

After Kaweske refused to take numerous phone calls from him, CR wrote to Kaweske on June 22, 1998, demanding the return of his $125,000.[21] On October 15, 1998, CR wrote to Jaime Annexy, the person identified to him as the Compliance Officer at Preferred, confirming a telephone call in which CR complained about "embezzlement" of his $125,000. Annexy had represented to CR that he would have a NASDAQ (sic) examiner review CR's file and complaint, and then Annexy would contact CR after the review. However, CR did not hear anything further from Annexy with regard to a review by an examiner.[22] Annexy did not speak to any NASD staff about CR's complaint, nor did any examiner participating in a routine audit of Grace have any information about CR's complaint.[23]

In September and again in November 1998, Kaweske offered to settle CR's demand for the return of his money, but CR did not agree with the terms of the proposed settlement.[24] Having failed to effect the return of his investment, on March 9, 2000, CR wrote a letter of complaint to NASD.[25] In May 2000, CR agreed to a settlement with Kaweske for $80,000.[26]

Customer RH

RH acquired a "significant amount" of AQUX stock at the recommendation of Pat Guadagno prior to opening an account at Grace. In 1997, RH opened an account at Grace, which included his shares of AQUX. Kaweske was the broker of record on that account.[27] In late January or early February 1998, RH was told about Preferred during a phone call with both Kaweske and Guadagno. RH was told that Preferred was going to be an arm of Grace and was

[21] CX-1, pp. 4-5.
[22] CX-1, p. 9; Tr. 36-37.
[23] Tr. 149, 151.
[24] CX-1, p. 6, CX-4.
[25] CX-1.
[26] CX-5; Tr. 39.
[27] Tr. 84-85, 108-09.

an investment opportunity through which RH could get rid of his AQUX stock.[28] As RH testified, Kaweske and Guadagno, through Preferred:

> . . . were going to be buying Aquagenix stock, which they felt was undervalued at the time, but they could margin it four times and that would basically make the market very liquid and allow me, which was my goal, to get rid of my Aquagenix stock.
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> * * *
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> . . . part of the purpose of R.K. Grace Preferred was to raise this money for the purpose of buying more Aquagenix stock.[29]

At Kaweske's recommendation, on February 10, 1998, RH authorized the transfer of 25,000 shares of his AQUX stock from his personal account at Grace to the Preferred account.[30] The stock was delivered to the Preferred account on February 17, 1998.[31] On March 3 and 6, 1998, those shares were liquidated for $148,061.04. Of that amount, $80,000 was used to cover a margin call.[32]

RH also signed a Subscription Agreement for the Preferred stock on February 10, 1998. The Subscription Agreement was identical to the one Kaweske sent to CR, in that it also stated:

> The Offer is being conducted on a "best efforts-all-or-none" basis to the initial 200,000 Shares and on a "best efforts" basis as to the remaining 200,000 Shares. Share (cash) subscriptions received and collected for the minimum number of Shares offered hereby, will be maintained in an escrow account with [a Fort Lauderdale law firm].[33]

The Subscription Agreement also noted that shares may be paid for with marketable securities, and if so, the securities were to be delivered "to R.K. Grace Preferred, Inc., together with an executed stock power…."

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[28] Tr. 85-86.
[29] Tr. 86-87.
[30] Stip. ¶¶ 19-20; CX-7, CX-19.
[31] CX-8, CX-19; Tr. 89, 163.
[32] CX-19; Tr. 163-64.
[33] CX-9, p.1; Tr. 89-90.

As was the case with CR, at the hearing, RH was shown another copy of the Preferred Subscription Agreement with a different description of the terms of the offering. The second page states that the "Offer is being conducted on a 'best efforts' basis." This agreement is purportedly also signed by RH on February 10, 1998, and offers to purchase 14,875 shares at a purchase price of $10.00 per share, to be paid for by the delivery of 25,000 shares of AQUX. RH credibly testified that he did not see this second Subscription Agreement in February 1998; rather, he saw it for the first time later when he was involved in litigation against Kaweske.[34] Moreover, RH was never advised that the Offer was a "best efforts" offering, or that the closing of the offering had been extended from the end of March 1998 until the end of June 1998.[35] RH never received any Preferred stock certificates.[36]

When RH tendered his shares of AQUX to Preferred, he thought that his shares were going to be sold to raise $175,000 that was going to be held in escrow, pursuant to the terms of the Subscription Agreement he signed.[37] RH understood that his 25,000 shares of AQUX were valued at $7.00 per share at the time he tendered them to Preferred.[38] On November 2, 1998, through his attorney, RH demanded the return of his $175,000.[39] After rejecting an offer to convert Preferred shares to Grace shares, RH filed suit against Kaweske in a federal district court, and, in May 2000, settled for a payment of $80,000 from Kaweske.[40]

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[34] Tr. 91-93; CX-10.
[35] CX-12; Tr. 94-95.
[36] Tr. 95.
[37] Tr. 127.
[38] Tr. 87. RH's understanding of the $7.00 per share valuation is bolstered by a letter from Kaweske, addressed to RH, dated February 19, 1998, indicating the $175,000 valuation, but subtracting a 15 percent "NASD haircut," for a net valuation of $148,750. CX-11. RH never received the letter, nor did he know what an "NASD haircut" was. Tr. 94, 139.
[39] CX-14.
[40] CX-15, CX-16, CX-17.

Form U-4 Amendments

CR's Complaint

As noted above, on October 15, 1998, CR submitted a written complaint to Preferred, with a copy to Kaweske, alleging embezzlement of his funds sent to Preferred in February of that year. Having failed to achieve the return of his funds, on March 9, 2000, CR wrote a letter of complaint to NASD about Grace and Kaweske. A copy of that letter was sent to Grace by NASD staff shortly after its receipt.[41] In the transmittal letter, NASD staff reminded the firm that it had an obligation to determine whether Kaweske must update his Form U-4 to disclose the complaint. As noted previously, Kaweske settled CR's complaint in May 2000. No amendment to Kaweske's Form U-4 was ever filed to disclose CR's complaint or its resolution.[42]

RH's Complaint

As noted above, on November 2, 1998, RH's attorney sent Kaweske a demand letter for the return of RH's $175,000 investment. After rejecting a settlement offer from Kaweske, RH filed suit against him in a federal district court, and, in May 2000, RH settled for a payment of $80,000 from Kaweske. No amendment to Kaweske's Form U-4 was ever filed to disclose RH's complaint, his civil action, or the resolution of the civil action.[43]

Complaint of Customer RB

On November 18, 1999, NASD staff received a written complaint from RB, alleging that Kaweske executed unauthorized transactions in his account at Grace. On December 2, 1999, NASD staff forwarded RB's complaint to the Director of Compliance at Grace.[44] Kaweske,

[41] CX-20, CX-26.
[42] Stip. ¶ 23; CX-21.
[43] Stip. ¶ 26; CX-21.
[44] CX-25.

Grace's Director of Compliance at that time, received the complaint and handled it, but did not amend his Form U-4 to disclose the complaint.[45]

On May 21, 2001, RB submitted to NASD Office of Dispute Resolution a Statement of Claim in the amount of $46,835.12 against Kaweske and Grace, alleging sales practice violations including unauthorized transactions.[46] Kaweske did not amend his Form U-4 to disclose this arbitration proceeding. In addition, when he filed a full Form U-4 to transfer his registration to Cardinal, he failed to disclose this arbitration proceeding or the complaints or suits by CR and RH.[47]

Discussion

Timeliness of the Complaint

Kaweske argues that, because of the delay between the date of the last alleged misconduct and the date of the Complaint in this matter, the Complaint is untimely and should be dismissed. Kaweske's argument is based upon the fundamental fairness standard found to have been violated in the *Hayden* case[48] and the *Morgan Stanley* case.[49] Kaweske argues that NASD has exceeded some of the time periods analyzed in those cases, while the other time periods are close. However, the SEC has held that there is no bright line rule about the impact of the length of delay in filing a complaint on the fairness of a disciplinary proceeding; rather, the determination of fairness is based on the entire record.[50]

As the parties have stipulated, Preferred commenced the offering of preferred stock in February 1998. The Complaint was filed on April 20, 2004, six years and two months after CR

[45] CX-40, CX-41; Tr. 247-48.
[46] CX-22.
[47] CX-21; Tr. 184-85.
[48] *Jeffrey Ainley Hayden*, Exchange Act Release No. 42,772, 2000 SEC LEXIS 946 (May 11, 2000).
[49] *Department of Enforcement v. Morgan Stanley DW Inc.*, No. CAF000045, 2002 NASD Discip. LEXIS 11 (NAC July 29, 2002).
[50] *Mark H. Love*, Exchange Act Release No. 49,248, 2004 SEC LEXIS 318, **14-16, (Feb. 13, 2004).

and RH made their investments in the offering. However, that delay is less than those in *Hayden* and *Morgan Stanley*, where the delay was found to be unfair, and less than those in *Hirsh*[51] and *Love*, where the delay was not found to be unfair.[52]

NASD first learned of the sales practices at issue in March 2000 when it received CR's letter of complaint. The Complaint in this case was filed four years and one month later. That delay is less than the delay between the discovery of the misconduct and the filing of the Complaint in *Hayden* and *Morgan Stanley*, and longer than in *Hirsh* and *Love*.[53] However, the crucial consideration is whether, as a factual matter, any delay in filing the Complaint against Kaweske harmed his ability to mount an adequate defense.[54] The Hearing Panel concludes that it did not. Both customers testified at the hearing, and their testimony was consistent with the declarations they signed early in the investigation. Kaweske had the opportunity to testify, but did not. Finally, there has been no allegation that any documentary evidence or witness that might have had a material affect on the issues in the case is missing or unavailable. Accordingly, the Hearing Panel concludes that any delay in the filing of the Complaint has not prejudiced Kaweske, and that, therefore, the Complaint should not be dismissed on that ground.

Failure to Return Investors' Funds and Failure to Establish an Escrow Account

The First Cause of Complaint charges that Kaweske violated Section 10(b) of the Securities Exchange Act, Rule 10b-9 and NASD Rule 2110 by failing promptly to return

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[51] *William D. Hirsh*, Exchange Act Release No. 43,691, 2000 SEC LEXIS 2703 (Dec. 8, 2000).

[52] In *Hayden*, the delay between the first misconduct to the filing of the complaint was 13 years, 9 months; the delay between the last misconduct and the filing of the complaint was 6 years, 7 months. In *Morgan Stanley*, the delay between the first misconduct to the filing of the complaint was 8 years; the delay between the last misconduct and the filing of the complaint was 7 years. In *Hirsh*, the delay between the first misconduct to the filing of the complaint was 8 years, 11 months; the delay between the last misconduct and the filing of the complaint was 8 years. In *Love*, the delay between the first misconduct to the filing of the complaint was 6 years, 10 months; the delay between the last misconduct and the filing of the complaint was 6 years, 5 months.

[53] The delay was 5 years in *Hayden*, and 5 years, 10 months in *Morgan Stanley*. The delay in *Hirsh* was 1 year, 8 months, and, in *Love*, 3 years, 8 months.

[54] *Mark H. Love*, 2004 SEC LEXIS 318, *16.

investor funds when Preferred did not raise the minimum proceeds from the offering by the deadline stated in the Subscription Agreement. The Second Cause charges that Kaweske violated SEC Rule 15c2-4 and Rule 2110 by failing to cause Grace to establish an escrow account for the Preferred offering.

These two charges are closely related. "Rule 10b-9 requires that a ['minimum/maximum'] offering must provide that investor funds will be returned if the required minimum proceeds are not raised by the stated offering deadline."[55] Rule 15c2-4 is designed to effectuate the obligation imposed by Rule 10b-9 by "impos[ing] an obligation on broker/dealers to safeguard investor funds and ensure that they are not disbursed to the issuer before the contingency is met."[56] The Preferred offering failed to raise the minimum $2 million by June 30, 1998, the extended date of the offering. Nevertheless, the investors' funds were not promptly returned, nor were any stock certificates issued. In fact, prior to the original closing date of the

[55] *Richard H. Morrow*, Exchange Act Release No. 40,392, 1998 SEC LEXIS 1863, **9-10 (Sept. 2, 1998). Rule 10b-9 provides, in relevant part: "It shall constitute a 'manipulative or deceptive device or contrivance' … for any person, directly or indirectly, in connection with the offer or sale of any security, to make any representation: … (2) To the effect that the security is being offered or sold on any … basis whereby all or part of the consideration paid for any such security will be refunded to the purchaser if all or some of the securities are not sold, unless the security is part of an offering … being made on the condition that all or a specified part of the consideration paid for such security will be promptly refunded to the purchaser unless: (A) a specified number of units of the security are sold at a specified price within a specified time …."

[56] *District Business Conduct Committee for District No. 9 v. Covato/Lipsitz, Inc.*, No. C9A920043 (NBCC Mar. 15, 1994). Rule 15c2-4 provides, in relevant part: "It shall constitute a 'fraudulent, deceptive or manipulative act or practice,' … for any broker … participating in any distribution of securities … to accept any part of the sale price of any security being distributed unless: … (b) If the distribution is being made on … any … basis which contemplates that payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs: … (1) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (2) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred."

offering, Kaweske, through Preferred, expended those funds to satisfy margin calls. Both customers finally obtained the return of a portion of their invested fund almost two years after the extended closing date of the offering. Kaweske was not only the architect of the offering, but he was the owner of Grace and the only person registered through Grace who participated in the offering, as well as the creator and alter ego of Preferred. By failing to cause the return of the investors' funds promptly upon failure of the offering to sell the specified minimum amount of securities, Kaweske violated Section 10(b) of the Securities Exchange Act, Rule 10b-9 promulgated thereunder and NASD Conduct Rule 2110, as alleged in the First Cause of the Complaint.

The Preferred offering was a contingency offering that required investors' funds to be deposited in a separate escrow account, consistent with the requirements of SEC Rule 15c2-4, pending satisfaction of the contingency. Kaweske failed to establish such an escrow account on behalf of Preferred and, accordingly violated NASD Conduct Rule 2110, as alleged in the Second Cause of the Complaint.

Fraudulent Misrepresentations and Omissions

Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rule 2120 all "proscribe fraudulent conduct in connection with the purchase or sale of securities."[57] To establish that Kaweske violated the antifraud provisions of the federal securities laws and NASD rules as charged, Enforcement must prove by a preponderance of the evidence that he made misrepresentations or omissions

[57] *Leslie E. Rosello*, Exchange Act Release No. 43,650, 2000 SEC LEXIS 2632, at **6-7 (Dec. 1, 2000).

of material facts, in connection with the purchase, sale, or offer of securities, and that he acted with scienter.[58] Recklessness suffices to show scienter.[59]

The standard for materiality is objective. An omitted fact is material if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having significantly altered the total mix of information available.[60] Material facts include those that may affect whether an investor will buy, sell, or hold a company's securities.[61] Moreover, in a disciplinary proceeding, proof of investor reliance is not necessary to establish a violation of the antifraud provisions involving misrepresentation or omissions of material facts.[62]

Kaweske misrepresented to customers that the offering would be conducted on a minimum/maximum basis, and that their funds would be deposited in an escrow account. He misrepresented to CR that, if he asked for his money back, it would be returned within seven days; and he misrepresented to RH that his money would be returned if the offering failed to achieve its minimum by the end of March 1998.

Those misrepresentations concerned material facts that would have been considered highly important by the investors in connection with their decisions to invest in Preferred's offering. The investors were told orally and in writing that their funds

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[58] *Dane S. Faber*, Exchange Act Release No. 49,216, 2004 SEC LEXIS 277, at **13-14 (Feb. 10, 2004). Scienter is "a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n.12 (1976).

[59] *See, e.g.*, *Hollinger v. Titan Capital Corp*., 914 F.2d 1564, 1568-69 (9th Cir. 1990), *cert. denied*, 499 U.S. 976 (1991); *Kevin Eric Shaughnessy*, Exchange Act Release 40,244, 1998 SEC Lexis 1507, *9 (July 22, 1998). Recklessness has been defined as highly unreasonable conduct involving not merely simple or excusable negligence but an extreme departure from the standards of ordinary care. *See Market Regulation Committee v. Jawitz*, No. CMS960238, 1999 NASD Discip. Lexis 24, at **19-20 (NAC July 9, 1999) (citing *Hollinger*, 914 F.2d at 1568-69 and cases there cited), *aff'd, Michael B. Jawitz*, Exchange Act Release No. 44,357, 2001 SEC Lexis 1042 (May 29, 2001).

[60] *Time Warner Securities Litigation*, 9 F.3d 259, 267-68 (2d Cir. 1993), *cert. denied*, 511 U.S. 1017 (1994).

[61] *SEC v. Hasho*, 784 F. Supp. 1059, 1008 (S.D.N.Y. 1992).

[62] *See Robert Tretiak*, Exchange Act Release No. 47,534, 2003 SEC LEXIS 653, at *24 n.26 (Mar. 19, 2003).

would be securely held in an escrow account and would be returned upon a failure to sell the minimum amount of stock as provided in the Subscription Agreement. Any reasonable investor, under the circumstances, would consider it important to know that the funds would not be placed in an escrow account, but would be deposited immediately into Preferred's account and disbursed. The fact that the customers' funds were disbursed to cover a margin call in Preferred's account almost immediately after receipt demonstrates that Kaweske must have known, at the time he made those representations to CR and RH, that they were untrue. Moreover, Kaweske's intimate involvement in the structure and sale of the offering, as well as his control of the issuer, also satisfy the scienter requirement for a Rule 10b-5 violation.[63] He therefore violated Section 10(b) of the Securities Exchange Act of 1934, Rule 10b-5 thereunder, and NASD Conduct Rules 2120 and 2110.[64]

Failure to Amend Form U-4

Article V, Section 2(c), of NASD's By-Laws obligates registered representatives to keep their application for registration current by filing supplementary amendments. Form U-4 mandates that registered persons "update this form by causing an amendment to be filed on a timely basis whenever changes occur to answers previously reported."[65] Such amendments shall be filed with NASD within 30 days after learning of the facts or circumstances giving rise to the amendment.[66] NASD Membership and Registration Requirements provide that the filing of information that is incomplete or inaccurate so as

[63] *Id.*, at **25-26.
[64] A violation of Rule 10b-5 and Conduct Rule 2120 also violates Conduct Rule 2110. *See generally DBCC v. Euripides*, No. C9B950014, 1997 NASD Discip. Lexis 45, at **16-23 (NBCC July 28, 1997); *Shaughnessy*, 1997 NASD Discip. Lexis 46, at **24-27.
[65] *See* NTM 98-27 (March 1998).
[66] Article V, Section 2(c), NASD By-Laws.

to be misleading, or the failure to correct such filing after notice thereof, may be deemed to be conduct inconsistent with just and equitable principles of trade, and, when discovered, may be sufficient cause for disciplinary action.[67] Both the SEC and NASD have stated that the responsibility for maintaining the accuracy of the Form U-4, by updating the information as necessary, lies with the registered representative.[68]

Kaweske failed to amend his Form U-4 to disclose CR's written complaint after NASD forwarded a copy of the complaint to Grace and Kaweske, reminding them that they should consider filing an amended Form U-4 for Kaweske. After he settled CR's complaint for $80,000 in May 2000, Kaweske again failed to amend his Form U-4.

RH sent Kaweske a demand letter for the return of his funds, initiated a civil action against Kaweske for the return of those funds, and eventually settled the matter for $80,000. Kaweske failed to amend his Form U-4 to disclose the complaint, the litigation, or the settlement.

Customer RB also filed a written complaint with NASD, which was forwarded to Grace. Kaweske acknowledged receipt of the complaint, admitted that he was the compliance officer at that time, and admitted that he took no action to amend his Form U-4 to disclose the complaint. Kaweske also failed to amend his Form U-4 when RB filed a statement of claim, alleging damages of over $40,000 and sales practice violations that included unauthorized transactions.

Finally, Kaweske filed a full Form U-4 when he transferred his registrations to Cardinal. However, he failed to disclose any of the above-mentioned complaints, litigation, or settlements.

The Hearing Panel concludes that his failures to properly update his Form U-4 were willful. He had personal knowledge of the events that triggered the obligation to amend his

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[67] NASD Rule IM-1000-1.

[68] *Frank R. Rubba*, Exchange Act Release No. 40238, 1998 SEC LEXIS 1499, at *8 (July 21, 1998); *Dep't of Enforcement v. Howard*, 2000 NASD Discip. LEXIS 16, at **31-32 (NAC Nov. 16, 2000) *aff'd.* 2002 SEC LEXIS 1909 (July 26, 2002).

Form U-4. As the Chief Operating Officer and President of Grace, and, from time to time, its compliance officer, he had the responsibility for insuring that those material events were disclosed on his Form U-4. Because he "knew or reasonably should have known under the particular facts and circumstances that his conduct was improper," his misconduct was willful.[69]

Sanctions

The NASD Sanction Guidelines for violations of the contingency offering rules suggest a fine of $5,000 to $50,000 and a suspension of up to two years for egregious cases.[70] For escrow violations, the Guidelines suggest a fine of $1,000 to $10,000 and, in egregious cases, a suspension for up to 30 business days.[71] For intentional or reckless misrepresentations and omissions, the Guidelines suggest a fine of $10,000 to $100,000 and, in egregious cases, consideration of a bar.[72] Finally, for failing to file forms, the Guidelines suggest a fine of $2,500 to $50,000 and a suspension of up to 30 business days, or, in egregious cases, consideration of a suspension of up to two years or a bar.[73]

The Hearing Panel considers this to be an egregious case. Kaweske orchestrated a scheme to obtain investor funds by misrepresenting the circumstances under which he intended to use them, and failed to return those funds as he represented that he would. By repeatedly failing to report the complaints of those investors, contrary to representations he made to one of them, he delayed an NASD investigation into those complaints. Two investors failed to recover a total of $140,000 that they invested in Preferred. Kaweske failed to testify at the hearing and has not expressed any contrition or remorse.

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[69] *See Christopher LaPorte*, Exchange Act Release No. 39,171, 1997 SEC LEXIS 2085, at *8 n.2 (Sept. 30, 1997).
[70] NASD SANCTION GUIDELINES, at 24 (2005 ed.).
[71] *Id.*
[72] *Id*., at 93.
[73] *Id.*, at 73-74.

In looking at the principle considerations in determining sanctions under the Guidelines for violations of the contingency and escrow rules, the Hearing Panel finds that (1) Kaweske was intimately affiliated with the issuer of the contingency offering; (2) investor funds were released almost immediately after they were received; (3) those funds were exposed to complete risk or loss; and, (4) the contingency was never close to becoming satisfied. The violations were aggravated by his misrepresentations to the investors, his efforts to conceal them by failing disclose them on his Form U-4, and his failure to fully reimburse the investors. Accordingly, to tailor sanctions to respond to the misconduct at issue, the Hearing Panel believes they should be above the range recommended by the Guidelines.[74]

For his violations of Section 10(b) of the Securities Exchange Act, Rule 10b-9 promulgated thereunder, and NASD Conduct Rule 2110, and to protect the investing public, the Hearing Panel will bar Kaweske in all capacities, and order him (1) to pay to customer CR his quantifiable loss of $45,000, plus interest, calculated in accordance with Section 6621 of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from February 11, 1998, the date he demanded the return of his investment, until paid; and (2) to pay to customer RH his quantifiable loss of $95,000, plus interest, calculated in accordance with Section 6621 of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from November 2, 1998, the date he demanded the return of his investment, until paid.

For his violations of Section 10(b) of the Securities Exchange Act, Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110, the Hearing Panel will bar Kaweske in all capacities. For repeatedly failing to update his Form U-4 to disclose customer complaints and settlements, in violation of NASD Conduct Rule 2110 and IM-1000-1, the Hearing Panel will bar Kaweske in all capacities. In addition, the Hearing Panel will order

[74] SANCTION GUIDELINES, General Principle 3, at p.3.

Kaweske to pay total costs of $2,270.25, consisting of an administrative fee of $750, plus a transcript fee of $1,520.25.

Conclusion

John D. Kaweske is barred from associating with any member firm in any capacity for (1) failing promptly to return investor funds upon failure of an offering to meet its sales contingency; in violation of Section 10(b) of the Securities Exchange Act, Rule 10b-9 promulgated thereunder, and NASD Conduct Rule 2110; (2) failing to establish an escrow account for a contingent offering, in violation of NASD Conduct Rule 2110; (3) making fraudulent misrepresentations in connection with the sale of preferred stock, in violation of Section 10(b) of the Securities Exchange Act, Rule 10b-5 promulgated thereunder, and NASD Conduct Rules 2120 and 2110; and (4) failing to update his Form U-4 to disclose customer complaints and settlements, in violation of NASD Conduct Rule 2110 and IM-1000-1. He is also ordered to make restitution (1) to customer CR in the amount of $45,000, plus interest, calculated in accordance with Section 6621 of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from February 11, 1998, until paid; and (2) to customer RH, in the amount of $95,000, plus interest, calculated in accordance with Section 6621 of the Internal Revenue Code, 26 U.S.C. § 6621(a)(2), from November 2, 1998, until paid. He is also assessed total costs of $2,270.25. The bars shall become effective immediately if this Decision becomes the final disciplinary action of NASD.

SO ORDERED.

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Alan W. Heifetz
Hearing Officer
For the Hearing Panel

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