

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of	
District Business Conduct Committee for District No. 1,	<u>AMENDED DECISION</u>
Complainant,	Complaint No. C01970012
vs.	District No. 1
Respondent Firm 1	Dated: July 9, 1998
and	
Respondent 2	
Respondents.	

This matter was called for review pursuant to NASD Procedural Rule 9312.¹ After a review of the entire record in this matter, we affirm the DBCC's findings that Respondent Firm 1 and Respondent 2 violated Conduct Rules 2110 and 3010 by failing to have supervisory procedures and plans to address the continuing education requirements (cause one); and, as a consequence of the entry of an arbitration award of \$103,000 against the respondents, violated Conduct Rule 2110 and various other requirements with respect to net capital (cause two), telegraphic notice (cause three), and Form BD, Form U-4, and Form U-5 update requirements (cause four). Based on our review, we affirm the DBCC's issuance of a Letter of Caution concerning continuing education deficiencies as to cause one, as well as the DBCC's sanctions as to the remaining violations. Respondent Firm 1 and Respondent 2 are thus each censured; fined \$3,750, jointly and severally; and assessed costs of \$769.90, jointly and severally; and Respondent 2 is ordered to requalify as a financial and operations principal ("FINOP") within 60 days of the date of this decision.

¹ The National Business Conduct Committee ("NBCC") of NASD Regulation, Inc. ("NASD Regulation") called this case for review, to examine whether the low sanctions imposed by the District Business Conduct Committee for District No. 1 ("DBCC") were warranted in light of the findings of violations. This matter was decided by the National Adjudicatory Council, which, as approved by the Securities and Exchange Commission, became the successor to the NBCC on January 16, 1998.

Background

Respondent Firm 1, a \$5,000 broker/dealer engaging primarily in the retail sale of mutual funds, has been a member of the NASD since May 1, 1985. Since May 1, 1985, Respondent 2 has been the president and sole owner of Respondent Firm 1. Respondent 2 is the Firm's general securities principal and designated FINOP, which registrations remain currently effective.

Facts

The four-cause complaint, based on information discovered by the examination staff, was issued on May 6, 1997.

Cause One - Supervision (Failure to Have Continuing Education Plans). Cause one alleged, and the DBCC found, that from July 1, 1995, through December 1996, Respondent Firm 1, acting through Respondent 2, failed to complete a needs analysis; design and implement training plans appropriate to the size, scope and complexity of its operations; and revise and update its supervisory procedures to address the continuing education requirements for its registered persons, in contravention of Membership and Registration Rule 1120 and Conduct Rules 2110 and 3010.

In their answer, the respondents stated that Respondent Firm 1 did have a continuing education program at the time of the examination, acknowledged that "[a]t the time of the inspection, the text of only a small portion of the continuing education program was being completed," and explained that the NASD Regulation examiner had offered to help Respondent 2 complete it. The answer stated that this occurred during Respondent Firm 1's first examination since the continuing education requirement had become applicable.

The Examiner, now no longer a NASD Regulation examiner, testified at the September 30, 1997 DBCC hearing that he had examined Respondent Firm 1 on December 4, 1996. The Examiner testified that in order to comply with the continuing education requirements, the respondents had purchased a generic package of compliance materials, but had not customized this generic package to the Firm's operations. The Examiner testified that Respondent Firm 1 had not performed an individualized needs analysis or customized the procedures to address the continuing education requirements.

At the April 28, 1998 review hearing before a subcommittee of the National Adjudicatory Council, Respondent 2 acknowledged that at the time of the examination, the continuing education plans were "still in the process of being formalized." He asserted that "a majority" of the plans had been finished at that point, although he admitted that he had

asked the examiner for help or guidance as to complete them, since he had never prepared such plans before.

Cause Two - Net Capital. Cause two alleged, and the DBCC found, that on October 31 and November 29, 1996, as a result of an arbitration award entered on October 22, 1996 against Respondent Firm 1, Respondent 2, and Employee A in the amount of \$100,000 with forum fees of \$3,000, Respondent Firm 1, acting through Respondent 2, utilized the instrumentalities of interstate commerce to engage in a securities business while failing to maintain minimum net capital of \$5,000, as set forth in schedules to the complaint, in contravention of the net capital rule, Securities and Exchange Commission ("SEC") Rule 15c3-1 and in violation of Conduct Rule 2110.

In their answer, the respondents admitted that the arbitration award had been issued as alleged, but they stated that they had been unaware that they were required to book the award as an offset to net capital, and that when the matter was brought to their attention they immediately made the proper notifications and ceased conducting a securities business until they were able to meet the requirements of the net capital rule.

The Examiner testified before the DBCC concerning his net capital computations for Respondent Firm 1 for October 31 and November 29, 1996. These computations showed that on October 31, the Firm had a net capital deficiency of \$78,474, and that on November 29, the deficiency was \$75,675. The only difference between the Examiner's net capital computations and Respondent Firm 1's was the staff's inclusion of the amount of the arbitration award as a liability.

Cause Three - Telegraphic Notice. Cause three alleged, and the DBCC found, that Respondent Firm 1, acting through Respondent 2, failed to give prompt telegraphic notice to the SEC and to NASD Regulation of the net capital violations described in cause two, in contravention of SEC Rule 17a-11, and in violation of Conduct Rule 2110.

In their answer, the respondents admitted that since they had been unaware of the net capital violations, they did not know to report them as required by SEC Rule 17a-11.

Cause Four - Failure to Update Required Filings. Cause four alleged, and the DBCC found, that Respondent Firm 1, acting through Respondent 2, failed to amend Respondent Firm 1 Form BD and Respondent 2's Form U-4² to reflect the arbitration award described in cause two, and failed to disclose that award on a Form U-5 for Employee A, in contravention of Article IV, Sections 2 and 3 of the By-Laws, and in violation of Conduct Rule 2110.

² Although the complaint and DBCC decision referred to Respondent 2's "Form U-5," staff noted during the review proceedings that this was a typographical error, and should have referred to "Form U-4" in both instances. The respondents did not amend their

The respondents' answer referred to their response under cause two, essentially stating that since the respondents did not know of the net capital violations, they did not report them on the required forms. It stated, ". . . we were unaware of our violation, and when we were notified, we complied."³

Discussion

After a careful, independent consideration of the entire record, including the proceedings on review, we affirm the findings and sanctions of the DBCC.

Cause One - Continuing Education Requirements. Cause one alleged that Respondent Firm 1, acting through Respondent 2, failed to complete a needs analysis; design and implement training plans appropriate to size, scope and complexity of its operations; and revise and update its supervisory procedures to address the Firm Element of the continuing education requirements for its registered persons, in contravention of Membership and Registration Rule 1120, and in violation of Conduct Rules 2110 and 3010. Membership and Registration Rule 1120(b)(2) provides that each member must maintain a continuing and current education program for its covered registered persons to enhance their securities knowledge, skill, and professionalism. This rule provides that, at a minimum, each member annually shall evaluate and prioritize its training needs and develop a written training plan.⁴

Although Respondent 2 maintained that he had purchased a commercial package of continuing education materials and had completed some, but not all of the needs analysis, the record supports the DBCC's finding that the respondents failed to complete the

answer's general admission as to the allegations of cause four, and did not challenge the staff's revision. Further, notwithstanding the typographical error, we observe that Respondent 2 does not appear to have been misled. The complaint identifies Respondent 2 as having failed to update a personal filing to reflect the issuance of the arbitration award; further, Respondent 2 would not have had an occasion to file any updated Form U-5, since he did not have any Form U-5 in effect.

³ The staff treated the respondents' answer as to causes two through four as admitting the allegations of the complaint, and the staff did not present evidence as to cause four. Respondent 2 affirmed during the review hearing that the allegations of causes two through four were admitted in the respondents' answer.

⁴ In Special NASD Notice to Members 95-13 (March 8, 1995), the NASD announced the addition to the NASD By-Laws of continuing education requirements. Included as part of the Notice to Members was an article that discussed guidelines for Firm Element training. See also Notice to Members 95-86 (October 1995).

materials required under the rules that were specific to the needs of the Firm. The Examiner testified that the Firm's training manual was generic and contained materials that were not relevant or specific to the Firm's size and type. He did not find anywhere at Respondent Firm 1 any evidence of customization or specificity in a training needs analysis or written training plans. In sum, the evidence established that Respondent Firm 1 did not have the required needs analysis, did not have written training plans, and had not implemented training plans. Therefore, we find that Respondent Firm 1 and Respondent 2 failed to comply with Membership and Registration Rule 1120, in violation of Conduct Rules 2110 and 3010.

Cause Two - Net Capital. Cause two alleged that Respondent Firm 1, acting through Respondent 2, utilized the instrumentalities of interstate commerce to engage in the securities business while failing to maintain net capital of \$5,000, in contravention of SEC Rule 15c3-1. The arbitration award was issued on October 22, 1996. On December 10, 1996, NASD staff discovered that Respondent Firm 1 was in violation of the net capital rule and requested that Respondent Firm 1 voluntarily cease business. On December 12, 1996, Respondent 2 responded that Respondent Firm 1 had ceased operations on December 10 and was in negotiations with the claimant. On December 20, 1996, Respondent 2 informed NASD staff that Respondent Firm 1 had obtained a release from the award and was in compliance with the net capital rule as of December 19, 1996. Respondent Firm 1 thereafter recommenced its securities business.

Respondent Firm 1 and Respondent 2 do not dispute that on October 31 and November 29, 1996, Respondent Firm 1's minimum net capital requirement was \$5,000;⁵ that the staff's net capital computations are accurate; or that Respondent Firm 1's failure to comply with the net capital requirement on those dates was due to the issuance of the \$103,000 arbitration award and the failure of Respondent 2, the Firm's FINOP, to recognize that the amount of the award had to be immediately booked as a liability.

The net capital rule is designed to ensure that a broker/dealer has sufficient liquid assets to satisfy its indebtedness, particularly the claims of customers. In re Lowell H. Listrom Company, Inc., 47 S.E.C. 270 (1980). Central to the net capital computation is the prompt and accurate recordation of liabilities. Under generally accepted accounting principles, losses that are contingent upon the happening of a future event must be accrued as liabilities where (1) the loss can be reasonably estimated; and (2) the contingency is probable. In the instant case, the respondents were aware of the exact size of the liability and knew or should have known that it was immediately due and payable under NASD rules. See IM-10100 (Failure to Act Under Provisions of Code of Arbitration Procedure) (awards are payable in full in cash on receipt or when stated in the award).

⁵ The record showed that Respondent Firm 1 conducted a securities business on these dates.

In September 1988, the staff of the SEC Division of Market Regulation provided the following guidance to the NASD:

A broker/dealer that is the subject of an adverse award in an arbitration proceeding should book said award as an actual liability at the time judgment is rendered, even though the appeal process has not been exhausted, because grounds for revision on appeal are very limited.

NASD Guide to Rule Interpretations, at 33 (1994). This interpretation was cited with approval by the Commission in In re Wallace G. Conley, 51 S.E.C. 300 (1993).

Respondent 2 contends that although he had not been aware of his responsibility to book the award immediately, he did not deliberately violate the net capital rule. This is not a defense to the violations, since intent does not enter into the determination of whether a net capital violation occurred. In re Kirk L. Ferguson, 51 S.E.C. 1247, 1250 n.14 (1994). We find that Respondent Firm 1 and Respondent 2 violated the net capital rule and Conduct Rule 2110 on October 31 and November 29, 1996, as alleged.

Cause Three - Net Capital. Cause three alleged that Respondent Firm 1, acting through Respondent 2, failed to give prompt telegraphic notice to the SEC and the NASD of the net capital violations described in cause two, in contravention of SEC Rule 17a-11, and in violation of Conduct Rule 2110. The respondents admitted that since they were unaware of the net capital violations, they did not know to report them as required by SEC Rule 17a-11.

SEC Rule 17a-11 requires, among other things, that any broker or dealer whose net capital declines below the minimum amount required by SEC Rule 15c3-1 must give notice of the deficiency to the SEC (in its Washington, D.C. and appropriate regional office) and its designated examining authority (in this instance the NASD) by telegram or facsimile within 24 hours of discovery of the deficiency. This rule is intended to provide regulators with early warning of financial or operational difficulties experienced by a firm so that immediate remedial action can be undertaken. In this instance, the respondents admittedly failed to give the required notice of the net capital deficiencies, thus exposing their customers to prolonged risk and frustrating the ability of their regulators to respond.

Cause Four - Failure to File Updated Forms. Cause four alleged that Respondent Firm 1, acting through Respondent 2, failed to amend various forms to reflect the arbitration award described in cause two, in contravention of Article IV, Sections 2 and 3 of the By-Laws, and in violation of Conduct Rule 2110. The respondents admitted in their answer that they unaware of their violations, but complied when notified.

Form BD is the form prescribed by the NASD for broker/dealer member registration; Form U-4 is the corresponding form for individual registration. Article IV, Section 2 of the NASD By-Laws requires that these forms be kept current at all times by supplementary amendment within 30 days of the facts or circumstances giving rise to the amendment (10 days if such amendment involves a statutory disqualification). We take administrative notice of the fact that Forms BD and U-4 require that significant events such as arbitration awards against the applicant be listed therein, and similarly require that they be updated when such events occur. We thus accept the respondents' admission that they did not file updated Forms BD and U-4 after learning of the arbitration award.

Form U-5 is the form prescribed by the NASD for termination of individual registrations with broker/dealer members. Article IV, Section 3 of the NASD By-Laws requires member firms to file this form within 30 days of terminating the employment of an individual, and to file an amendment to the form whenever the member learns of facts or circumstances causing any information set forth in the form to become inaccurate or incomplete. Since the issuance of the arbitration award as to Employee A made the Firm's earlier notice incomplete, we find that the respondents were required to update the notice, even though Employee A had left Respondent Firm 1 about two years before the issuance of the award. Since the respondents have not disputed that they did not file an updated Form U-5 for Employee A, we conclude that they acted in violation of Conduct Rule 2110 in failing to update the Firm's Form BD, Respondent 2's Form U-4, and Employee A's Form U-5.

Sanctions

Based on the foregoing, we affirm the sanctions imposed by the DBCC. Respondent Firm 1 and Respondent 2 are thus each censured; fined \$3,750, jointly and severally; and assessed costs of \$769.90, jointly and severally; and Respondent 2 is ordered to requalify as a FINOP within 60 days of the date of this decision.

We also affirm the imposition upon the respondents of a Letter of Caution as to cause one. Although the sanction for this violation is less than the minimum recommended by the applicable Sanction Guideline, and would not be appropriate for similar prospective violations, we find it to be sufficiently remedial under the unique circumstances of this case.

While the respondents have argued that the continuing education requirements are new and not well understood, we find that the requirements have been the subject of extensive publicity. The NASD Regulation staff noted that as to the Firm Element, Respondent Firm 1 was required to complete a needs analysis and training plans no later than July 1, 1995, and to implement its plans no later than January 1, 1996. We thus cannot excuse a failure to have had required plans and procedures in place by December 1996, the date of the Firm's first examination after the effective date of the requirements.

The SEC has emphasized that net capital violations are serious offenses. A firm's failure to maintain its required net capital means that the firm does not have sufficient liquid assets to satisfy its indebtedness, particularly the claims of its customers. In re Wallace G. Conley, *supra*. Respondent 2 was responsible for the Firm's compliance with applicable financial reporting and net capital requirements. Respondent 2's hopes that his counsel would effect a settlement of the arbitration matter did not excuse him from booking the award as a liability and otherwise carrying out his responsibilities as FINOP. See, e.g., In re George Lockwood Freeland, 51 S.E.C. 389 (1993); In re James Michael Brown, 50 S.E.C. 1322 (1992), aff'd without opinion, No. 92-9165 (11th Cir. April 19, 1994).

We note in mitigation, however, that the respondents have no previous disciplinary history and that the violations were rectified when they were brought to the respondents' attention by the NASD Regulation staff.

Accordingly, Respondent Firm 1 and Respondent 2 are thus each censured; fined \$3,750, jointly and severally; and assessed costs of \$769.90, jointly and severally; and Respondent 2 is ordered to requalify as a FINOP within 60 days of the date of this decision or else to cease operating in this capacity until he has requalified as such. In addition, this decision shall serve as a Letter of Caution as to cause one.⁶

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Corporate Secretary

⁶ 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.