

**FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

RESPONDENT,

Respondent.

Disciplinary Proceeding
No. 2009016159102

Hearing Officer – LBB

**AMENDED HEARING
PANEL DECISION¹**

Dated: August 13, 2013

Respondent acted as the de facto financial and operations principal of a member firm while failing to register as a FINOP for that firm; caused the firm's books and records to be inaccurate; caused the firm's calculations of its required net capital and actual net capital to be inaccurate; caused the firm to conduct a securities business with insufficient net capital; and caused the firm to fail to notify the regulatory authorities that it had insufficient net capital. Respondent is censured for these violations of FINRA Rule 2010.

The Hearing Officer dissents with respect to sanctions, and would suspend Respondent in all principal capacities for 60 days and impose a \$5,000 fine.

Appearances

Jonathan Golomb, Esq., and Gregory R. Firehock, Esq., for the Department of Enforcement.
Respondent, pro se.

DECISION

I. Introduction

Respondent was a consultant to brokerage firms, providing compliance and financial services to the firms. On occasion, some of Respondent's clients asked him to find financial and

¹ The original Hearing Panel Decision has been amended to correct a typographical error in the Hearing Officer's dissent regarding the suggested sanction, clarifying that the Hearing Officer would impose a suspension in all principal capacities, as stated in the summary.

operations principals (“FINOP”) for them. In 2005, one of his longstanding clients, iTradeDirect.com (“iTrade” or “the Firm”), a FINRA member firm, asked Respondent to find a FINOP for the Firm.

Pursuant to iTrade’s request, Respondent retained Richard Novack, a registered FINOP, to act as iTrade’s FINOP. Although Novack was registered as the Firm’s FINOP, he was a subcontractor for Respondent’s consulting firm, rather than an employee of iTrade. Novack did not perform the duties of a FINOP, while Respondent prepared key financial documents and advised the Firm on financial issues. Although Respondent functioned as the Firm’s de facto FINOP, he failed to register as the Firm’s FINOP, in violation of FINRA Rule 2010.

During Respondent’s tenure as the de facto FINOP, iTrade’s books and records were inaccurate, and the Firm violated FINRA and Securities and Exchange Commission (“SEC”) rules relating to net capital. iTrade’s calculation of required net capital was inaccurate because iTrade failed to account for the effect on its required net capital of proprietary trading, which caused its minimum dollar requirement to be \$100,000, rather than \$5,000, the required net capital for an introducing firm that did not engage in proprietary trading. iTrade’s books and records and the calculations of the Firm’s actual net capital were inaccurate because they did not reflect iTrade’s liability for payment of a settlement involving an Illinois regulatory action. The errors in iTrade’s calculations of required and actual net capital caused iTrade to report its net capital inaccurately on its FOCUS reports,² conduct a securities business with insufficient net capital, and fail to report its net capital deficiency to the SEC and FINRA. By failing to ensure that the Firm complied with the recordkeeping and net capital rules, Respondent violated FINRA Rule 2010.

² Financial and Operational Combined Uniform Single (FOCUS) Reports are financial reports that include a member firm’s actual and required net capital. FINRA member firms are required to submit FOCUS reports to FINRA pursuant to Exchange Act Rule 17a-5.

The majority of the Hearing Panel imposes a censure for Respondent's violations. The majority considers a censure appropriately remedial under the facts and circumstances of this case because iTrade is out of business, Respondent has not been registered with a member firm for more than two years, and the majority believes that Respondent is unlikely to engage in similar violations in the future. The Hearing Officer would suspend Respondent in all principal capacities for 60 days and impose a fine of \$5,000, as discussed in a dissenting statement attached to this Decision.

II. Procedural History

The Department of Enforcement filed the Complaint in this disciplinary proceeding on June 20, 2012, asserting five causes of action against Respondent. Respondent answered the Complaint on July 12, 2012, denying most of the allegations in the Complaint. The Complaint included related charges against Novack. By order of the Chief Hearing Officer dated January 28, 2013, the charges against Novack were severed from the charges against Respondent. A default decision has been entered against Novack.³

A two-day hearing was held in Boca Raton, Florida, on April 10 – 11, 2013, and the parties delivered their closing arguments by teleconference on April 16, 2013. The hearing was held before a Hearing Panel composed of a former member of the District 8 Committee, a current member of the District 6 Committee, and a Hearing Officer.

III. Jurisdiction

Respondent was registered with nine FINRA member firms from 1984 to June 22, 2010, with some breaks during which he was not registered with a member firm. He was registered with Maitland Securities, Inc. from November 2009 until June 22, 2010, when he voluntarily

³ See *Dep't of Enforcement v. Novack*, No. 2009016159103.

terminated his employment. He was never registered with iTrade. CX-2. Respondent's primary involvement in the securities business in recent years has been to consult on compliance matters.

Tr. 616-618. Respondent has not been registered with a member firm since June 22, 2010.

CX-2; Stip. 1.

Although Respondent is not currently registered with a member firm, he remains subject to FINRA's jurisdiction for purposes of this proceeding, pursuant to Article V, Section 4 of FINRA's By-Laws, because the Complaint was filed within two years after the termination of his registration with a member firm, and it charges him with misconduct that allegedly commenced prior to the termination of his registration.

IV. Respondent's Role in iTrade's Financial Operations

Respondent had a substantial role in the iTrade's financial operations. He prepared key financial documents, including the general ledger, balance sheets, and trial balance, and prepared and filed the Firm's FOCUS reports. When FINRA examiners asked questions about the Firm's finances, or needed copies of financial documents, iTrade turned to Respondent for the answers and documents. Although Novack was iTrade's registered FINOP, he did nothing for iTrade other than a monthly perfunctory review and approval of the FOCUS reports that Respondent prepared and filed.

A. iTrade

iTrade was a retail brokerage firm with its principal office in Florida. Stip. 3. The Firm had about 70 brokers in 2008. iTrade's operations took place in a branch office on Long Island.

Tr. 290-291, 373; Stip. 4. iTrade filed a Form BDW and went out of business in April 2010

because it could not pay an arbitration award, which caused the Firm to have insufficient net capital. Tr. 367-368, 573; Stip. 5.⁴

B. iTrade's Financial Reporting

1. Respondent Prepared Financial Documents, and Prepared and Filed FOCUS Reports

iTrade entered into a contract with ["FBAI"], Respondent's consulting firm, in 1996. FBAI agreed to perform various financial and compliance consulting functions for iTrade, including preparation of a number of financial reports, and compilation of the Firm's FOCUS reports. Stip. 6; RX-1.

In 2005, FBAI retained Novack, as an independent contractor to FBAI, to act as iTrade's FINOP. Novack agreed to review iTrade's FOCUS reports and make certain they were accurate and timely. Tr. 129; Stip. 7. Novack served as iTrade's registered FINOP from February 2005 until April 2010. Stip. 8; Tr. 122-123, 376. iTrade paid FBAI about \$1,200 (or \$2,000) monthly for Novack's services as iTrade's registered FINOP, and FBAI paid Novack \$500 per month. Tr. 129, 578, 642.⁵ Brian Sanders, iTrade's chief compliance officer, was Novack's supervisor. Stip. 9; Tr. 130, 378.

The process of compiling the financial information and preparation of FOCUS reports began at iTrade. Sanders, who was not a FINOP, used a checklist to compile documents and information to be sent to FBAI each month. The documents included check registers, checks, commissions, accruals, lists of accounts receivable and payable, inventory, other liabilities, and other documents. Tr. 369, 374, 376, 378, 463-464, 568; RX-1. Using a coding system that

⁴ iTrade was expelled from FINRA membership in August 2010 for failure to pay fines or costs, and then expelled again based on charges of violations of FINRA's Rules in a default decision issued June 28, 2011. *Dep't of Enforcement v. iTRADEdirect.com*, No. 2009016159101 (O.H.O. June 28, 2011), available on FINRA website through Disciplinary Actions Online at www.finra.org/Industry/Enforcement/DisciplinaryActions/FDAS.

⁵ The former owner of iTrade testified that iTrade paid FBAI \$1,200 per month, but Respondent testified that the monthly payment was \$2,000.

Respondent had designed, Sanders coded the expenses to identify them as rent, commissions, or utilities, for example, and sent the coded information to FBAI. Tr. 567-568, 579, 618-622; Stip. 10.

FBAI entered the coded financial information that Sanders provided into its computer, and prepared iTrade's monthly financial reports, including financial statements, the trial balance, general ledgers, check register, net capital calculations, and FOCUS reports. Tr. 567-568, 579, 618-622, 627-628, 630-631, 650; Stip. 10; RX-1.

After compiling the FOCUS reports, FBAI sent them to Novack for his review and approval. Stip. 11; Tr. 122, 132. As part of his review of the FOCUS reports, Novack conducted a cursory review of a two-page trial balance that FBAI had prepared. The trial balance contained a compilation of iTrade's assets, liabilities, income, and expenses, listed according to the categories that Respondent had developed for financial coding. Tr. 122, 133, 139; RX-2 at 23-25. Novack never saw anything that looked wrong on the FOCUS reports that Respondent prepared. Tr. 134. Respondent filed all FOCUS reports for iTrade during the period that Novack was at iTrade's FINOP. Tr. 143, 178, 630-631, 656. Novack spoke to Respondent about once a month, but the conversations were mostly social, and rarely about iTrade. Tr. 131-132.

Novack worked about two hours per month as iTrade's FINOP. Tr. 123. Novack never requested or reviewed any backup financial documents, nor did he ever prepare any documents. Tr. 134-135, 167. Novack visited the Long Island branch office only once, when FINRA examiners asked that Novack come to the Firm during an examination. Tr. 142. He never visited iTrade's Florida office. Tr. 150. Sanders spoke to Respondent much more often than he spoke to Novack. When Sanders had financial questions, he discussed them with Respondent. Tr. 387-389. Respondent called Sanders about twice a month on financial matters. Tr. 389.

Although Respondent testified that he did not determine the amount of required net capital, the initial determination of iTrade's minimum dollar amount of net capital was not solely the client's responsibility. Respondent's practice was not to rely on his clients' representations to determine the minimum net capital, but to verify the amount of required net capital by looking at documentation, such as the clients' membership agreements, to determine the correct amount of required net capital. Tr. 720-722.

2. Respondent Assisted iTrade with Responding to Financial Issues Raised by FINRA Examiners

FINRA examiners began a routine cycle examination of iTrade in the second quarter of 2009. Tr. 287. Although Novack was iTrade's registered FINOP, he was not on site for most of the examination. Tr. 294. When the examiners asked Sanders technical questions on net capital, he told the examiners he needed to call Respondent. Tr. 295-296. For example, the examiners spoke to Respondent on the telephone when they had questions about iTrade's riskless principal and error accounts. Tr. 299-300. When the examiners asked iTrade to provide net capital computations and supporting documentation, iTrade sent the request to Respondent, not Novack. CX-13, CX-27.

At the examiners' insistence, Novack came to iTrade's Long Island office to meet with the examiners once during the 2009 examination. When an examiner asked Novack questions about iTrade's financial matters, he found that Novack was not knowledgeable about the issues. Tr. 297. For example, Novack was not aware of trades in an error account or a riskless principal account. Tr. 297-298, 300. In response to some of the examiners' questions, Novack stated that he needed to discuss the matters with Respondent. For example, Novack said he needed to talk to Respondent about accruals and the trading in the error account. Tr. 300-301.

V. iTrade's Net Capital and Recordkeeping Violations

The Complaint charges Respondent with causing iTrade to commit recordkeeping and net capital violations. Thus, it is necessary to determine whether iTrade committed the violations before the Hearing Panel can determine whether Respondent caused them. The evidence establishes that iTrade committed the violations alleged in the Complaint. Its books and records were inaccurate due to the failure to properly record the liability for the Illinois settlement as a liability. Its net capital and net capital requirements were calculated and reported incorrectly on its FOCUS reports. The Firm effected securities transactions while it had insufficient net capital. It failed to file a notice with the SEC and FINRA when it had a net capital deficiency.

A. iTrade's FOCUS Report for December 31, 2009, Was Inaccurate Because iTrade's Proprietary Trading Caused It to be a \$100,000 Dealer Rather than a \$5,000 Broker, as Reported in the FOCUS Report

The Complaint alleges that Respondent is responsible for two inaccuracies in iTrade's net capital calculations on its December 31, 2009 FOCUS report. First, the Complaint charges that iTrade inaccurately reported that its net capital requirement was \$5,000, the requirement for an introducing broker, when in fact iTrade's net capital requirement was \$100,000 as a result of proprietary trading, causing iTrade to be classified as a dealer for net capital purposes. Second, as discussed in the next section of this decision, the Complaint charges that the net capital calculations for iTrade were inaccurate because the Firm failed to include the effect of its liability for the Illinois settlement in the calculation of its actual net capital.

1. iTrade's Trading in Its Error Account

iTrade maintained an error account to dispose of securities bought for trades that were cancelled in customer accounts. Tr. 341, 414, 516-517. Approximately 10% of the Firm's trades in customer accounts were cancelled. Tr. 518. When the prices of stocks in the error account went up, the Firm sold them and kept the profit. When prices of the stocks went down, the Firm

sold the stocks, but charged the losses to the registered representative in charge of the account. Tr. 518. In many instances, the purchases and sales in the error account took place on different days. Tr. 517; CX-28, CX-29.

2. Expert Testimony on the Effect of Trading in the Error Account on Required Net Capital

Andrew Labadie, Enforcement's expert witness, explained the effect of the trading in the error account on iTrade's net capital requirement.⁶ Labadie explained that the minimum net capital for a member firm is established by two separate determinations, and the required minimum net capital is the higher of the two amounts. The calculation that is relevant to this matter is the minimum dollar requirement, which is determined by the nature of the activities in which a firm engages. Tr. 44-47.⁷

The minimum dollar requirement for a firm whose business is limited to introducing customers is \$5,000. Tr. 46, 48. If a firm engages in more than ten proprietary trades in a calendar year, the firm becomes a dealer. A dealer's minimum net capital, using the minimum dollar requirement, is \$100,000 for the remainder of each calendar year in which the firm has made more than ten proprietary trades. Tr. 46, 50. A trade in an error account of a position that is held overnight or longer is considered a proprietary trade. Tr. 73, 75.

In June 2008, iTrade effected more than ten proprietary trades in the error account. In some instances, iTrade sold securities that it held as long as three or four days. CX-28; Tr. 56.

⁶ Labadie is Associate Director of Financial Operations, Risk Oversight and Operational Regulation, FINRA Department of Member Regulation. He is a CPA with years of experience in dealing with net capital issues, at FINRA, a member firm, and at public accounting firms. Tr. 26-35; CX-1. The Hearing Panel found that his testimony was credible and persuasive.

⁷ A firm must also calculate its required net capital using a ratio. The required net capital is the higher of the ratio calculation and its minimum dollar requirement. For some periods, iTrade reported its minimum required net capital based on a ratio. The ratio that is relevant to iTrade's net capital calculations is based on aggregate indebtedness. Tr. 44-47. No violations are charged with respect to the ratio calculation.

As a result, the Firm undertook market risk with respect to these transactions, and had a minimum dollar net capital requirement of \$100,000 for the rest of 2008. Tr. 56-57; CX-1.

In January 2009, iTrade effected more than ten transactions in its error account in which the securities were held overnight or longer. Because these trades are considered proprietary trades, iTrade should have reported its minimum dollar requirement for the balance of 2009 as \$100,000. CX-29, CX-1; Tr. 69-70.

3. Respondent Revises iTrade's FOCUS Report for December 2008 Due to Proprietary Trading and Files an "Early Warning Notice" of iTrade's Weak Net Capital Position

By not later than the middle of 2009, Respondent was aware of the issue of the effect of proprietary trading in the error account on iTrade's required net capital. During a FINRA cycle examination in mid-2009, and in a follow-up e-mail on June 29, 2009, FINRA's examiners told Sanders that the FINRA staff believed the trades in iTrade's error account were proprietary trades, and that the proprietary trading had caused iTrade's net capital requirement to increase to \$100,000. Tr. 299-300; CX-12, CX-13. Sanders told the examiners that he would work with Respondent on the matter and correct iTrade's net capital filings. Tr. 306.

On July 1, 2009, Respondent filed a revised FOCUS report for iTrade for the period ending December 31, 2008, correcting the required net capital calculation. The revised filing showed the required minimum dollar amount of net capital as \$100,000, rather than \$5,000, as in the original filing. CX-10; Tr. 66. iTrade reported its net capital requirement as \$100,000 because the FINRA examiners had requested it. Respondent did not advise the Firm as to whether it was required to report its net capital requirement as \$100,000. Tr. 659- 662.

When a broker-dealer's net capital falls below 120% of the required minimum net capital, the broker-dealer is required to file an "Early Warning Notice" with FINRA. Tr. 52-53.

Respondent filed an Early Warning Notice with FINRA on July 1, 2009, reporting that iTrade's

net capital from December 15 to December 31, 2008, had been less than 120% of the Firm's required minimum net capital. CX-11.

Novack never saw the amended FOCUS report or the Early Warning Notice that Respondent filed. Tr. 152, 154, 158-161, 165.

4. iTrade Conducts Proprietary Trading in 2009 but Respondent Files a FOCUS Report that Fails to Report iTrade's Net Capital as \$100,000

On January 27, 2010, Respondent filed a FOCUS report for iTrade as of December 31, 2009. Respondent reported iTrade's net capital requirement as \$11,004, based on the ratio calculated using iTrade's aggregate indebtedness. As Mr. Labadie testified, Respondent should have reported iTrade's net capital requirement as \$100,000, because iTrade had effected more than ten proprietary trades in the error account in January 2009. CX-9; Tr. 179-181.

5. iTrade Violated FINRA's Rules When Respondent Filed a FOCUS Report with an Inaccurate Calculation of Required Net Capital

The case law and regulations support the conclusions of Enforcement's expert witness. A broker-dealer that does not receive or hold customer funds or securities and does not carry customer accounts is required to maintain net capital of not less than \$5,000.⁸ Under Exchange Act Rule 15c3-1(a)(2)(iii), a firm is classified as a dealer if it effects more than ten transactions in any one calendar year for its own investment account, and continues to be a dealer for the remainder of that calendar year. The Rule requires a dealer to maintain net capital of not less than \$100,000. The SEC imposed the higher net capital requirement on dealers, in part, in recognition of the risks of a dealer's business, including the potential for severe market volatility.⁹ The SEC has affirmed a FINRA decision finding that holding securities in a firm's

⁸ Exchange Act Rule 15c3-1(a)(2)(vi).

⁹ *William K. Cantrell*, Exchange Act Rel. No. 38570, 1997 SEC LEXIS 990, at *3 (May 5, 1997).

error account and then re-selling constituted proprietary trading, causing the firm to be a dealer subject to the \$100,000 net capital requirement.¹⁰

iTrade effected more than ten proprietary transactions in January 2009. It held the positions overnight or longer, incurring the market risk against which the higher net capital requirement for proprietary traders is designed to protect. iTrade's net capital requirement was thus \$100,000, and not \$5,000, as reported in the FOCUS report that Respondent filed for December 31, 2009. By filing an inaccurate FOCUS report, iTrade violated FINRA Rule 2010.¹¹

B. iTrade's Books and Records and Net Capital Calculations for a FOCUS Report that Respondent Filed Were Inaccurate Because of the Exclusion of the Liability for a Settlement with the Illinois Securities Department

In late 2009, iTrade settled a regulatory action that had been filed by the Illinois Securities Department. iTrade tried to avoid recognizing the effect on the Firm's financial statements by attempting to shift the liability for the settlement payments to its parent firm, whose sole asset was iTrade. iTrade should have considered the settlement payment as an iTrade liability both on its financial statements and in its net capital calculations. The financial documents that Respondent prepared, including the net capital calculation in a FOCUS report that Respondent filed shortly after the settlement was negotiated, improperly excluded the liability.

1. Respondent Correctly Reports the Effect of the Filing of the Illinois Action in iTrade's Required Net Capital in 2009

The State of Illinois Securities Department filed a regulatory action against iTrade, two of its representatives, and its president on May 13, 2009. The Notice of Hearing sought a \$10,000 fine for each of 155 alleged violations, or a total fine of \$1,550,000. CX-16.

¹⁰ *William K. Cantrell*, 1997 SEC LEXIS 990, at *4-12.

¹¹ *Cf. Fox & Co. Inv., Inc.*, Exchange Act Rel. No. 52697, 2005 SEC LEXIS 2822 (Oct. 28, 2005) (filing FOCUS report with inaccurate calculation of actual net capital violated NASD Rule 2110).

When Novack was at iTrade during the 2009 examination, he learned about the issue of the effect of the filing of the Illinois action on iTrade's required net capital. Tr. 146-148. Novack discussed the Illinois action with Respondent, which was the only time Novack ever had a substantive conversation with Sanders or Respondent about iTrade's business. Tr. 146-148. When the examiners raised the issue, Sanders and Respondent exchanged e-mails about the effect of the Illinois action on iTrade's financial reporting, and Respondent told Sanders that the result would be an increase in iTrade's required net capital. Sanders told the examiners that he had discussed the matter with Respondent. CX-14; Tr. 311-312.

Respondent calculated the effect of the contingent liability for the Illinois action on required net capital for iTrade's FOCUS report. Tr. 150. In the FOCUS report as of September 30, 2009, which Respondent filed on October 23, 2009, iTrade correctly reported that the filing of the Illinois action had caused the Firm's net capital requirement to increase by \$104,000 as a result of the increase in contingent liabilities. CX-8; Tr. 84-86.

2. iTrade Incorrectly Excludes the Settlement of the Illinois Action from Its Trial Balance and Calculation of Its Actual Net Capital for the FOCUS Report for December 31, 2009

iTrade and the two iTrade representatives who were respondents in the Illinois Securities Department action entered into a settlement with the customer whose transactions were the subject of the action. Although the agreement was signed in January 2010, it was dated "as of December 23, 2009." The settlement agreement stated that the matter was being settled by iTRADEnow.com Corp., which was iTrade's parent. The abbreviated name for the parent in the agreement was "iTRADE." The agreement stated that the customer maintained a securities account at "iTRADE" and that Illinois had instituted an administrative proceeding against "iTRADE," thus referencing matters that related to iTrade, the broker-dealer, rather than the parent. There was nothing in the agreement that explicitly released iTrade, and the agreement

did not mention that the subsidiaries of iTrade's parent are among those released. CX-17; Tr. 598.

iTrade entered into a consent order with the Illinois Securities Department dated January 13, 2009. CX-19. The consent order recited that iTrade and its two registered representatives had agreed to pay \$150,000 to the aggrieved customer, and ordered iTrade and the representatives to make the payments. The consent order did not mention iTRADEnow.com, the parent of iTrade. CX-19. iTrade's registration with the State of Illinois was revoked in September 2010 for failure to make payments pursuant to the settlement agreement with the customer and the consent order with the Illinois Department of Securities. CX-37; Tr. 529-530.

Labadie testified that under the applicable accounting rules, a liability is considered "probable" when there is an agreement to settle litigation. As a result, the accounting rules require that the amount of the settlement should be recorded as an actual liability, and the amount of the demand in the complaint, i.e., the \$1,550,000 in the Illinois complaint, is no longer included in contingent liabilities. iTrade correctly ceased reporting the Illinois matter as a contingent liability for the FOCUS report for December 31, 2009. Tr. 93. iTrade failed to include the settlement of the Illinois matter on its trial balance, where it should have been listed as a liability. RX-2; Tr. 195-196.

iTrade's December 31, 2009 FOCUS report should have reflected the Illinois settlement, because iTrade knew in December 2009 that the payment was probable. Because it was liable for half the settlement under the agreement with the customer, it should have accrued a liability of at least \$75,000 as of December 31, 2009, for purposes of its net capital calculations for its FOCUS report. Tr. 93, 95, 172, 174-175, 184-190; CX-1, CX-9, CX-35, CX-36. The FOCUS report that Respondent filed as of December 31, 2009, did not include the contingent liability and

reported a substantially reduced net capital requirement as a result. The actual liability was not considered in iTrade's net capital calculation or as an accrued expense item. Enforcement's expert testified that, as a result, its reported net capital was overstated by at least \$75,000. CX-1, CX-9; Tr. 184-190.

According to accounting principles, iTrade's attempt to shift the liability to iTrade's parent by purporting to substitute the parent for iTrade in the settlement with the customer was invalid. The applicable accounting rules, as well as guidance from the SEC and FINRA, did not permit iTrade to remove the liability from its capital calculations and books and records. Tr. 104-105.

3. iTrade Violated FINRA Rule 2010 Because Its Net Capital Was Incorrectly Calculated on Its FOCUS Report for December 31, 2009

As Labadie testified, iTrade's attempt to take the liability for the Illinois settlement off its books, and exclude it from its net capital calculations, was improper. FINRA issued a Notice to Members in October 2003, informing member firms of the SEC's guidance on the treatment of expense sharing agreements.¹² 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;
- 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 expense.

¹² See NTM 03-63(Oct. 28, 2003).

iTrade's attempt to shift the liability to its parent did not satisfy these criteria. There is no writing that indicates that iTrade did not remain liable for the payment. In fact, the settlement with the customer nowhere mentions a release of iTrade. The language of the settlement suggests that the customer did not intend to release iTrade, because the agreement refers to the account the customer opened with "iTRADE," and references an action by the Illinois Securities Department against "iTRADE." In addition, the Illinois Securities Department required iTrade to make the payments required by the customer settlement in the consent order that iTrade signed, and revoked iTrade's Illinois license when iTrade did not make the payment. The liability should have been reported by iTrade under accounting principles. The parent corporation apparently did not have the resources to satisfy the liability, because it failed to do so. Pursuant to the guidance from the SEC and FINRA, the liability clearly should have stayed on iTrade's books for net capital purposes.

Respondent argued at the hearing that even if the liability for the settlement should have been considered an iTrade liability, the liability would not affect net capital until January 2010, when the settlement agreement was signed. However, Labadie testified, and the SEC has held, that a loss should be recorded as a liability when the loss is probable and can be reasonably estimated.¹³ In fact, iTrade itself understood that the liability no longer was properly a contingent liability in December 2009, by removing the potential liability from its calculation of contingent liabilities for the calculation of required net capital as of December 31, 2009. The loss should have been recognized for the December 31, 2009 FOCUS report, but was not.

By filing an inaccurate FOCUS report, iTrade violated FINRA Rule 2010.

¹³ *Fox & Company Inv., Inc.* 2005 SEC LEXIS 2822, at *19.

4. iTrade Failed to Maintain Accurate Books and Records by Failing to Record the Liability for the Illinois Settlement

The First Cause of Action charges Respondent with causing iTrade's books and records to be inaccurate from September 30, 2009, through April 26, 2010. iTrade's books and records were inaccurate because iTrade failed to record in its books and records its liability for the settlement with the State of Illinois that required iTrade to pay restitution to customers.

Exchange Act Rule 17a-3 requires broker-dealers to maintain "ledgers (or other records) reflecting all assets and liabilities . . . and a record of the proof of money balances of all ledger accounts in the form of trial balances, and a record of the computation of aggregate indebtedness and net capital, as of the trial balance date" NASD Conduct Rule 3110 requires members to maintain books and records as prescribed by Exchange Act Rule 17a-3. Requirements to maintain records encompass the requirement that such records be accurate.

Because its books and records were inaccurate, iTrade violated Exchange Act Sec. 17(a), Exchange Act Rule 17a-3(a)(2), NASD Rule 3110, and FINRA Rule 2010.

C. iTrade Conducted a Securities Business with a Net Capital Deficiency, in Violation of Exchange Act Rule 15c3-1 and FINRA Rule 2010

The Third Cause of Action charges Respondent with causing iTrade to effect securities transactions when it had insufficient net capital, in violation of FINRA Rule 2010. When a FINRA member firm effects securities transactions while the firm has a net capital deficiency, the firm operates a securities business, in violation of Exchange Act Rule 15c3-1, and therefore violates FINRA Rule 2010.¹⁴

iTrade's FOCUS report for December 31, 2009, reported that the Firm had excess net capital of \$143,940. When the corrections are made for the improper treatment of the

¹⁴ *Paul Joseph Benz*, Exchange Act Rel. No. 51046, 2005 SEC LEXIS 116, at *10 (Jan. 4, 2005).

proprietary trading in the error account in the calculation of required net capital, and the failure to consider the Illinois action in the calculation of actual net capital, iTrade actually had a net capital deficiency of \$20,066. Tr. 190-193; CX-1, CX-9. iTrade conducted a securities business on December 31, 2009, effecting securities transactions for customers. CX-30; Tr. 526-527.

By effecting securities transactions when it had a net capital deficiency, iTrade violated Exchange Act Rule 15c3-1 and FINRA Rule 2010.

D. iTrade Failed to Notify FINRA and the SEC that It Had Insufficient Net Capital, in Violation of FINRA Rule 2010

Under Exchange Act Rule 17a-11, “Every broker or dealer whose net capital declines below the minimum amount required pursuant to § 240.15c3-1 shall give notice of such deficiency that same day”¹⁵ Failure to file the required notice with the SEC and FINRA constitutes a violation of FINRA Rule 2010.¹⁶ The Fourth Cause of Action charges Respondent with causing iTrade to fail to file the required notice when iTrade’s net capital was less than the required amount, in violation of FINRA Rule 2010.

Enforcement did not offer direct evidence that iTrade failed to file the notice of its net capital deficiency. Nevertheless, the evidence is sufficient to establish that the notice was not filed, because the FOCUS reports that Respondent filed report that iTrade had substantial excess net capital, while the Firm actually had a net capital deficiency. iTrade violated FINRA Rule 2010 by failing to file the notice required by Exchange Act Rule 17a-11 despite having insufficient net capital on December 31, 2009.

¹⁵ 17 C.F.R. § 240.17a-11(b)(1).

¹⁶ *Dist. Bus. Conduct Comm. v. First Heritage Investments*, No. C02910081, 1992 NASD Discip. LEXIS 47, at *9-10 (N.B.C.C. Dec. 9, 1992); *Fundclear, Inc.*, Exchange Act Rel. No. 34735, 1994 SEC LEXIS 2956, at *2 n.2, and *11 (Sept. 28, 1994).

VI. Respondent's Violations of FINRA Rule 2010

A. Respondent Violated FINRA Rule 2010 by Acting as iTrade's De Facto FINOP, but Failing to Register as the Firm's FINOP

Because Respondent can be liable for the first four causes of action, relating to the calculation of iTrade's net capital, net capital requirements, and liabilities only if he was acting as a FINOP for iTrade, the Hearing Panel first considered whether Respondent functioned as a de facto FINOP for iTrade while failing to register as a FINOP. The Hearing Panel concludes that Respondent essentially "rented a license" by agreeing to provide Novack's services to iTrade as the nominal FINOP, while Respondent was the Firm's actual FINOP, and thereby violated FINRA Rule 2010, as alleged in the Fifth Cause of Action.

NASD Rule 1022(c) requires that each person associated with a member who performs the duties of a FINOP must register with FINRA as a FINOP.¹⁷ Rule 1022(c)(2) defines a FINOP 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.

¹⁷ NASD Rule 1022 requires that persons who perform FINOP duties must qualify by first passing an examination, either the "Financial or Operations" (Series 27) or "Introducing Broker-Dealer/Financial and Operations" (Series 28). The type of registration that is required depends upon the net capital requirements of the member firm. SEC Rule 15c3-1(a). Respondent had the licenses necessary to be a FINOP. CX-2.

A FINOP's role is to "[ensure] investor protection by being responsible for the Firm's compliance with applicable net capital, recordkeeping and other financial and operational rules."¹⁸ In addition, "the review and understanding of the computations and the ability to explain the mechanics and rationale of the computations to FINRA staff ... [resides] with the Firm's properly registered associated person vested with authority and responsibility for this function."¹⁹ A part-time or off-site FINOP has the same responsibilities as a full-time FINOP who is employed by a member firm.²⁰

Because FINRA's registration requirements provide "an important safeguard in protecting public investors," strict adherence to its registration requirements is essential.²¹ In determining whether registration is required, FINRA will look at the overall scope of the individual's activities. Even if no single responsibility would require registration, a combination of functions may require registration.²²

Respondent's agreement with Novack for Novack to act as iTrade's FINOP was structured so that Respondent would perform the duties of the FINOP. He received source documents from iTrade, prepared a variety of monthly financial reports and the monthly FOCUS reports, and sent Novack only the completed FOCUS report and the trial balance that Respondent had prepared.

¹⁸ NTM 06-23; see also NTM 01-52.

¹⁹ Reg. Notice 11-14 at 5, discussing clearing or carrying firms' restrictions and obligations regarding outsourced activities.

²⁰ *Dep't of Enforcement v. Respondent 1*, No. C8A980059, 2000 NASD Discip. LEXIS 21, at *31 (N.A.C. Nov. 6, 2000).

²¹ *Eric J. Weiss*, Exchange Act Rel. No. 69177, 2013 SEC LEXIS 837, at *27 (Mar. 19, 2013); *Dep't of Enforcement v. Hedge Fund Capital Partners*, No. 2006004122402, 2012 FINRA Discip. LEXIS 42, at *27 (N.A.C. May 1, 2012).

²² *Dennis Todd Lloyd Gordon*, Exchange Act Rel. No. 57655, 2008 SEC LEXIS 819, at *24-35, 32 (Apr. 11, 2008).

Novack's duties were to review and approve, but not to prepare, the FOCUS reports. He had no duties with respect to preparation of the monthly reports. FBAI's \$500 monthly payment to Novack was far too little compensation if Novack had been expected to do anything more than the perfunctory review that he agreed to do. In fact, Respondent kept the majority of each payment for FINOP services, consistent not only with receipt of a finder's fee, but with his responsibilities for financial recordkeeping and reporting.

In addition to preparation of financial reports, and preparation and filing of the FOCUS reports, Respondent responded to questions from the Firm on financial issues. He also handled questions raised by FINRA examiners during the 2009 examination, including the effect on net capital of the filing of the Illinois action, and provided documents to the Firm when the regulators requested them.

Collectively, Respondent's various roles caused him to be iTrade's FINOP. The Hearing Panel finds that Respondent acted as the de facto FINOP for iTrade, but was never registered as iTrade's FINOP. By acting in a capacity that requires registration but failing to register, Respondent violated FINRA Rule 2010.²³

B. As iTrade's De Facto FINOP, Respondent Violated FINRA Rule 2010 by Causing the Firm's Net Capital and Financial Recordkeeping Violations

A FINOP may be held responsible when a firm fails to comply with a firm's recordkeeping and net capital requirements.²⁴ FINOPs have been held liable for a member

²³ See *Dep't of Enforcement v. Gallagher*, No. 2008011701203, 2012 FINRA Discip. LEXIS 61 (N.A.C. Dec. 12, 2012); *Dep't of Enforcement v. Cotto*, No. 2005001305701, 2008 FINRA Discip. LEXIS 45 (N.A.C. Oct. 6, 2008).

²⁴ *Avello v. SEC*, 454 F.3d 619, 624 (7th Cir. 2006) (citing *Davrey Fin. Servs. Inc.*, Exchange Act Rel. No. 51780, 2005 WL 1323032, at *4 n.13 (June 2, 2005); *William H. Gerhauser*, Exchange Act Rel. No. 40639, 1998 WL 767091, 53 S.E.C. 933, 938-40 (Nov. 4, 1998); *Gilad J. Gevaryahu*, Exchange Act Rel. No. 33038, 1993 SEC LEXIS 2791 (Oct. 12, 1993); *George Lockwood Freeland*, Exchange Act Rel. No. 34-32192, 51 S.E.C. 389, 390 (Apr. 22, 1993); *Dep't of Enforcement v. Respondent 1*, 2000 NASD Discip. LEXIS 21, at *31. ("[A] FINOP is charged with the member firm's compliance with all applicable financial reporting and net capital requirements....").

firm's failure to keep accurate books and records²⁵ and for net capital violations,²⁶ including failure to file notices of net capital deficiencies.²⁷ The duties of a FINOP who is a contractor and has other businesses are the same as a FINOP who is a full-time employee.²⁸

Although Enforcement has not cited any cases in which someone was held to be a de facto FINOP,²⁹ FINRA has held that one who acts as a de facto principal may be liable for a firm's violations.³⁰ Respondent similarly is responsible for the violations charged in the Complaint. Respondent set up the arrangement for Novack to be the registered FINOP, retaining Novack as an independent contractor for FBAI while keeping the majority of the payments. In addition to performing the overall duties of a FINOP, Respondent was aware of the specific issues that are the subject of the Complaint. He was aware of the issue raised by the effect of the trading in the error account on required net capital because he filed an amended FOCUS report and Early Warning Notice for June 30, 2008, but did not ensure that the effect of the trading was properly reported in 2009. He was aware of the Illinois litigation because he advised iTrade of the effect of the filing of the Illinois complaint on iTrade's contingent liabilities and required net capital, but did not follow through to be sure the Firm properly accounted for the settlement. These failures caused iTrade's books and records and net capital reporting to be inaccurate. As a

²⁵ *Avello*, 454 F.3d at 626 (FINOP liable for failure to book liabilities); *Gevaryahu*, 1993 SEC LEXIS 2791; *Fox & Co. Investments*, 2005 SEC LEXIS 2822; *Dep't of Enforcement v. Cohen*, No. EAF0400630001, 2010 FINRA Discip. LEXIS 12 (N.A.C. Aug. 18, 2010), *aff'd sub nom. Dennis S. Kaminski*, Exchange Act Rel. No. 65347, 2011 SEC LEXIS 3225 (Sept. 16, 2011).

²⁶ *Gevaryahu*, 1993 SEC LEXIS 2791; *Dep't of Enforcement v. Respondent 1*, 2000 NASD Discip. LEXIS 21, at *32-33.

²⁷ *Dist. Bus. Conduct Comm. v. First Heritage Inv.*, No. C02910081, 1992 NASD Discip. LEXIS 47 (N.B.C.C. Dec. 9, 1992) (Respondent was president and operations principal, violated FINRA Rules by failing to file notice); *Whiteside & Co.*, Exchange Act Rel. No. 26187, 1988 SEC LEXIS 2063 (Oct. 14, 1988) (same).

²⁸ *Gevaryahu*, 1993 SEC LEXIS 2791, at *6-7.

²⁹ Respondent, defending himself, did not file a pre-hearing brief.

³⁰ *Gallagher*, 2012 FINRA Discip. LEXIS 61, at *35-36. (unregistered firm president violated FINRA Rules by supervisory failures).

result, iTrade effected securities transactions while having insufficient net capital, and failed to notify the SEC and FINRA of its net capital deficiency.

Respondent violated FINRA Rule 2010 by causing iTrade to maintain inaccurate books and records, calculate and report its required and actual net capital inaccurately, operate with insufficient net capital, and fail to file the required notices with the SEC and FINRA of iTrade's net capital deficiency.

VII. Sanctions (Majority of the Hearing Panel)

The Hearing Panel considers the five violations as a group because they are all attributable to a common underlying cause.³¹ The root cause of all the violations was that Respondent believed he was not a FINOP because Novack was registered as the Firm's FINOP, and that as a consultant, Respondent had no duty to ensure that the Firm's reports were accurate or that the Firm complied with the rules relating to net capital.

The majority of Hearing Panel believes that no remedial purpose would be served by a fine or suspension. iTrade is out of business, and Respondent has not been registered with a FINRA member firm for more than two years. In addition, the majority finds that Respondent acted in good faith, believing that he was rendering his services in the same manner as other consultants do. Respondent appeared quite sincere in his commitment to compliance with FINRA's Rules. The majority believes that Respondent is unlikely to commit a similar violation when he understands that he assumed the duties of a FINOP when he set up an arrangement under which he performed the actual duties while the registered FINOP worked for him as a token FINOP.

³¹ See FINRA Sanction Guidelines, General Principal at 5 (2011) (General Principles Applicable to All Sanctions Determinations No. 4) (*available at* www.finra.org/sanctionguidelines.) Enforcement recommended a two-month suspension in all principal capacities and a fine of \$20,000 for Respondent's failure to register as a FINOP, and a suspension of 20 business days in all principal capacities and a fine of \$10,000 for the net capital and recordkeeping violations.

Having considered all of the foregoing, the majority of the Hearing Panel imposes a censure for Respondent's violations.

CONCLUSION

Respondent violated FINRA Rule 2010 by acting as the de facto FINOP of a member firm while failing to register as a FINOP for that firm; causing the Firm's books and records to be inaccurate; causing the Firm's calculations of required net capital calculations 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 it had insufficient net capital.

Respondent is censured for these violations, and ordered to pay costs in the amount of \$6,920.34, which includes a \$750 administrative fee and the cost of the transcript.

Hearing Panel.

Lawrence B. Bernard
Hearing Officer

Hearing Officer's Dissenting Statement with Respect to Sanctions

I dissent because I believe the sanction imposed by the majority of the Hearing Panel is not sufficiently remedial. Respondent left iTrade essentially financially defenseless. Respondent retained Novack to be a figurehead FINOP, providing little more value than his signature. Respondent was aware that the Firm had issues with the impact of the trading in the error account and the Illinois litigation on the Firm's net capital, yet he prepared and filed FOCUS reports that were inaccurate due to the failure to account for these issues correctly. Respondent should have been diligent in determining whether the proprietary trading in the error account continued into 2009, and should have inquired about the status of the Illinois action until it was resolved.

FINRA's Sanction Guidelines recommend a fine of \$1,000 to \$50,000, and a suspension for up to 30 business days, for net capital violations.³² For recordkeeping violations, the Guidelines recommend a fine of \$1,000 to \$10,000, and a suspension in any or all capacities of up to 30 days. For registration violations, the Guidelines recommend a fine of \$2,500 to \$50,000, and a suspension of up to six months.³³ The Guidelines recommend greater sanctions for egregious violations.

Respondent's violations were not egregious. Like the majority of the Hearing Panel, I find that Respondent did not knowingly violate FINRA's Rules. I also find, however, that he should have known that the arrangement left iTrade without a functioning registered FINOP, and that nobody was ensuring that iTrade's financial recordkeeping and reporting were accurate.

I would suspend Respondent in all principal capacities for 60 days, and impose a fine of \$5,000.

³² FINRA Sanction Guidelines at 28.

³³ FINRA Sanction Guidelines at 45.