

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of

The Department of Enforcement,

Complainant,

vs.

Christopher M. Block
Houston, Texas

and

Jeffrey S. Burke
Houston, Texas,

Respondents.

DECISION

Complaint No. C05990026

Dated: August 16, 2001

Where chief executive officer was responsible for net capital, recordkeeping and reporting violations, and for distributing false and misleading financial information, held, findings of Hearing Panel affirmed in part and reversed in part, and sanctions modified. Where firm's president was responsible for net capital and supervision violations, held, findings of Hearing Panel affirmed and sanctions affirmed.

Pursuant to Procedural Rule 9310, Jeffrey S. Burke ("Burke") appealed a September 5, 2000 decision issued by the Hearing Panel in this matter.¹ We also called the decision for review as to Burke and Christopher M. Block ("Block") to examine the findings and to determine whether the sanctions were appropriate in light of the alleged conduct.

¹ Burke filed his appeal on October 3, 2000. On October 10, 2000, he notified NASD Regulation, Inc. ("NASD Regulation") that he had decided to withdraw his appeal. The NAC notified the parties on October 17, 2000 that it had decided to call the decision for review and, therefore, had decided not to rule on Burke's request to withdraw his appeal. Nonetheless, Burke filed an application to reinstate his appeal on October 18, 2000, following the NAC's call for review. We have considered Burke's appeal in our review of this matter.

We affirm the Hearing Panel's findings that Block, the chairman and chief executive officer of Block Trading, Inc. ("Block Trading" or the "Firm"), failed to keep accurate books and records during the relevant period, from October 1997 through September 1998 (cause one); operated Block Trading when the Firm failed to maintain minimum required net capital (cause two); filed inaccurate FOCUS PART IIA reports (cause three); and failed to provide notification that the Firm's net capital was below the required minimum (cause four). We affirm the Hearing Panel's findings that Block induced the purchase of stock by including false and misleading information in a stock purchase agreement (cause five). We reverse the Hearing Panel's findings that Block violated Conduct Rule 2120 by disseminating false and misleading information in a private placement memorandum, but affirm the Hearing Panel's findings of violation of Conduct Rule 2110 (cause five).²

We affirm the Hearing Panel's findings that Burke, the Firm's president, operated Block Trading while the Firm failed to maintain minimum required net capital (cause two); and failed properly to supervise Jennifer Gonzalez ("Gonzalez"),³ the Firm's financial and operations principal ("FINOP") (cause six).

As to sanctions, we affirm the Hearing Panel's determination that Block should be fined \$50,000. We increase the Hearing Panel's imposition of a bar in any principal or supervisory capacity to a bar from association with any member firm in any capacity. We affirm the Hearing Panel's findings that Burke should be fined \$15,000 and required to requalify as a general securities principal, and we affirm the Hearing Panel's determination to suspend Burke for 30 days in any principal or supervisory capacity. Finally, Block and Burke are assessed joint and several costs of \$7,339.80.

Background

Block and Burke entered the industry as general securities representatives in December 1990 and in November 1989, respectively. Block was the founder of Block Trading and became

² Block also was charged under cause six with failing to supervise the Firm's financial and operations principal with respect to the activities described in the first (books and records), third (failure to provide notification of net capital violation), fourth (inaccurate FOCUS filings), and fifth (false and misleading financial information) causes of the complaint. The Hearing Panel found that because Block was "substantively responsible" for the misconduct alleged in the first through fifth causes of complaint, he could not also be responsible "for inadequate supervision with respect to those violations." See Market Surveillance Comm. v. Markowski, Complaint No. CMS920091 at 21 (NAC July 13, 1998), aff'd, Michael J. Markowski, Exchange Act Release No. 43259 (Sept. 7, 2000). We affirm the Hearing Panel's finding and also affirm its dismissal of the supervision allegation in cause six with respect to Block.

³ Gonzalez was a co-respondent in this matter but entered into a settlement with NASD Regulation prior to the hearing in this matter.

registered with the Firm in September 1994 as a general securities representative and a general securities principal. He was the Firm's chairman, chief executive officer, and sole director.

Burke was a co-founder of the Firm and became registered with the Firm as a general securities representative in November 1995 and as a general securities principal in May 1996. At all relevant times, Burke served as the Firm's president.

Block and Burke were shareholders and control persons of the Firm. The Firm ceased operations on September 28, 1998. Neither Block nor Burke is currently associated with another member firm.

Facts

The facts in this matter are generally not in dispute. Block Trading operated as a day-trading firm that held no customer funds or securities and thus was required to maintain net capital of only \$5,000. Block and Burke shared responsibility for the supervision of the Firm.⁴

The Firm grew rapidly, increasing its gross commissions from \$10 million in 1997 to \$25 million in 1998. The Firm began to experience financial difficulties in October 1997 related, at least in part, to the Firm's decision to invest in the development of new trading software. On

⁴ The Firm's supervisory procedures set forth the following:

Supervisory Personnel - will review their areas of responsibility and be responsible for updating any changes or additions to supervisory practice or procedures. The firm has designated supervisory responsibility as indicated.

- a. CEO and President of the firm share in the ultimate supervision of the firm.
- b. Territorial Managers are Senior Managers reporting to CEO & President.
- c. Regional Managers report to Territorial Managers, directly responsible to the CEO and President for supervision of managers in their assigned region. Regional Managers report directly to the CEO.
- d. Branch Managers are directly responsible for all branch supervision and are directly responsible and report to their Regional Managers.

October 6, 1997, the Firm's Executive Committee⁵ met to discuss the Firm's need for additional capital. Block and Burke agreed to defer receipt of their respective salaries for the month of October in order to fund the development of new trading software.⁶ In addition, the Executive Committee determined it was necessary for Block and Burke to execute subordinated loan agreements in the amount of \$50,000 each to fund the software development program.⁷ During a meeting of the Executive Committee the following day, Gonzalez stated that she expected the Firm to have a net capital problem by the end of the month. In response, Block announced his intention to "challenge" the net capital rule.

Beginning in October 1997, the relationship between Block and Burke became increasingly acrimonious. Burke stopped attending Executive Committee meetings because of his increasing frustration with the committee's tendency to support Block's views over his own ideas. Burke, however, retained his title of president and continued to request and review Block Trading's financial information. Block began to assume more responsibility for the day-to-day operations of the Firm, while Burke focused his attention on the trading operations of one of the Firm's branch offices.⁸

At Block's direction, Gonzalez improperly concealed the Firm's deteriorating financial situation by netting certain accounts receivable (non-allowable assets under the net capital rule) against non-related payables and by booking other Firm expenses to an affiliated entity.⁹ Steve Samples ("Samples"), an accountant who was employed as Gonzalez' assistant, testified that Gonzalez directed him to use the "netting" technique to reduce the Firm's expenses beginning in November 1997.

In December 1997, Block approached Gabriel Alarcon ("Alarcon"), part owner of the DaqCom branch, seeking a loan in the amount of \$600,000 to finance development of the new trading software. On April 24, 1998, following protracted negotiations, Alarcon and his son (together, "the Alarcons") executed an agreement to purchase 25 percent of the stock of Block

⁵ The Firm's Executive Committee was composed of Block, Burke, Gonzalez, and Michael Mogonye ("Mogonye"), the individual in charge of the Firm's computer operations.

⁶ Block and Burke were each paid salaries of \$15,000 per month.

⁷ Block and Burke never funded these loans.

⁸ In January 1997, Burke had moved from the tenth floor, where the Firm's main office was located, to the third floor, where the Firm's DaqCom International, Inc. ("DaqCom") branch was located, to improve the performance of the branch.

⁹ Block admitted that he knew about the "netting" and the transfer of expenses and maintained that he thought it was acceptable. Gonzalez admitted that she also removed liabilities from the Firm's general ledger and then replaced them at the first of the next month (characterized as "reversing" throughout the record). She testified that Block had not directed her to use the improper "reversing" technique.

Trading (contributed equally by Block and Burke) for \$600,000. In order to close the deal, Block gave the Alarcons a copy of the Firm's unaudited quarterly financial statement for the period ending December 31, 1997, which incorporated the misleading accounting practices that Block had directed and that Gonzalez had implemented.

Samples became increasingly nervous as the "netting" continued month after month. Eventually, after seeking advice in February or March 1998 from JC, the Firm's outside auditor, Samples recalculated the Firm's net capital by reconstructing the Firm's financials without the "netting" effect. According to Samples' new calculations, the Firm had a net capital deficit from November 1997 through May 1998.

In late May 1998, Samples told Burke about the accounting irregularities that he had discovered and the Firm's adverse net capital situation. During this meeting, Burke asked Samples how long the activity had gone on and who was involved. Samples told Burke that Block and Gonzalez had used improper accounting methods to hide the Firm's deteriorating financial condition. Samples testified that Burke became extremely upset when he learned about the accounting irregularities and the net capital deficit.

On June 2, 1998, Burke met with outside auditor JC in Dallas to discuss Samples' calculations. Burke asked for an audit as soon as possible. JC was unwilling to begin the audit immediately, however, citing the fact that the fiscal year-end audit was scheduled to begin at the end of July 1998. JC advised Burke that he should not act hastily, and JC questioned whether Burke possessed enough financial information to make an accurate determination about the Firm's net capital.

In early June 1998, Burke also met with Albert Butler ("Butler"), an attorney for the Alarcons. Burke told Butler that the financial information that Block had provided to the Alarcons had been falsified. Butler testified that Burke suspected that Block and Gonzalez were responsible for falsifying the Firm's financial records.

Butler immediately told the Alarcons what he had learned from Burke. Butler called a meeting, which was held on June 15, 1998, with Block, Burke, Gonzalez, and Mogonye in attendance. During this meeting, Burke confronted Block and Gonzalez about the improper accounting entries and the Firm's net capital deficiencies. Butler testified that Block took the position that the Firm maintained one set of financials that allowed management to determine what was "really going on" and another set that complied with regulations. Gonzalez admitted that Block Trading had set up two other affiliates -- Block International Development ("BID") and Amalgamated Services Korporation ("ASK") -- to assume the Firm's software development and other operational costs.¹⁰ Gonzalez represented that the Firm was in good net capital compliance as a result of the transfer of the Firm's expenses to BID and ASK.

¹⁰ Block Trading's technology-related expenses were transferred to BID and its operational expenses were transferred to ASK.

Gonzalez met with Butler shortly after the June 15, 1998 meeting. According to Butler, Gonzalez admitted that the Firm needed \$687,000 to satisfy its minimum net capital requirement. Butler testified that the May 31, 1998 balance sheet that Gonzalez reviewed with him included her hand-written annotations that disclosed the Firm's hidden liabilities. Butler further testified that Gonzalez' annotations characterized certain accounting entries as "doctored" or "super doctored."¹¹ Butler testified that, notwithstanding this evidence, he and Alarcon decided to wait for JC's audit findings to ascertain whether the assignment of the Firm's liabilities to BID and ASK was acceptable, and to determine whether the Firm needed another infusion of capital.

In an eleventh-hour effort to keep the Firm afloat, Block attempted to raise funds by means of a private placement of Block Trading Holdings, Inc., a proposed holding corporation of Block Trading. The sale of all offered shares would have raised \$865,881, which was to be used to purchase 100 percent of the outstanding common stock of Block Trading, ASK, and BID. Block was unable to raise any additional funds for the Firm through this offer.

The Firm's fiscal year-end audit commenced at the end of July 1998. JC determined that the Firm had mid-month net capital deficiencies for May and June 1998.¹² On August 7, 1998, Block notified NASD Regulation and the Securities and Exchange Commission ("Commission") about these net capital deficiencies pursuant to Exchange Act Rule 17a-11.

Block's lack of cooperation delayed the completion of the audit.¹³ On September 28, 1998, JC completed the audit and concluded that the Firm had failed to account for \$800,000 in accounts payable. Pursuant to Exchange Act Rule 17a-11, Block immediately sent notice to NASD Regulation and the Commission notifying them of the net capital deficiency and that the Firm had ceased doing a securities business.

Following receipt of this notice, NASD Regulation commenced a routine "close-out" examination of Block Trading's books and records. NASD Regulation's examination showed that the Firm had operated with a net capital deficit (ranging from \$192,099 to \$1,720,468) from the end of October 1997 until September 28, 1998. The NASD Regulation examiner on site determined that the Firm had employed a number of improper accounting methods that concealed the Firm's true net capital situation from regulators.

¹¹ The balance sheet described by Butler is included in the record and corroborates his testimony.

¹² The exact amounts of these net capital deficiencies are not in the record.

¹³ JC testified that he advised Block that he planned to return to the Firm on August 24, 1998 to complete the audit, and that he needed all invoices in the name of Block Trading. JC also advised Block that he needed a listing of all payments that Block Trading had made subsequent to June 30, 1998. JC further testified that Block delayed giving him the requested information and postponed the appointment several times. Block eventually supplied the requested information to JC, and JC returned to the Firm on September 25, 1998 to complete the audit.

Discussion

In proceedings before the Hearing Panel, Block and Burke stipulated to the accuracy of the information taken from the books and records of Block Trading and to the amount of the net capital deficiencies as calculated by NASD Regulation staff and as set forth in the attached schedule ("Schedule A").¹⁴

Block admitted responsibility for the net capital violations, but disavowed any direct knowledge of the Firm's improper accounting methods. He maintained that he was not responsible for the Firm's financial operations because he had delegated responsibility for this function to Gonzalez, the Firm's FINOP.

Burke argued that he was unaware of the net capital deficit during the period under review because Gonzalez concealed the Firm's net capital deficiency from him. Burke also maintained that he was not responsible for supervising Gonzalez.

We modify the Hearing Panel's findings as to Block and affirm the Hearing Panel's findings as to Burke. We first address the allegations against Block (causes one, two, three, four, and five) and then turn our attention to the allegations against Burke (causes two and six).

Allegations Against Block

1. Inaccurate Books and Records. Cause one alleged that Block failed to ensure the preparation and maintenance of accurate books and records, in violation of Exchange Act Rules 17a-3 and 17a-4 and Conduct Rules 2110 and 3110,¹⁵ in that: (1) for the period from October 31, 1997 through May 31, 1998, month-end journal entries were made on the Firm's general ledger

¹⁴ Block further stipulated that the violations alleged in the complaint in the second cause (insufficient net capital), third cause (failure to provide notification that the Firm's net capital was below the required minimum), fourth cause (inaccurate FOCUS Part II filings), and fifth cause (false and misleading financial information in private placement memorandum and stock purchase agreement) resulted from the accounting irregularities forming the basis of the first cause of complaint (inaccurate books and records). Burke did not join in that stipulation, but offered no evidence challenging it.

¹⁵ Conduct Rule 2110 requires members to observe high standards of commercial honor and just and equitable principles of trade. Conduct Rule 3110 requires members to make and preserve books and records in conformity with all rules of the NASD and as prescribed by Exchange Act Rules 17a-3 (requirement to make and keep books and records, including ledgers reflecting all assets and liabilities) and 17a-4 (requirement to preserve all records required to be made pursuant to Exchange Act Rule 17a-3, paragraphs (1), (2), (3), and (5)). NASD Rule 115(a) states that persons associated with a member have the same duties and obligations as a member under the NASD's rules. Thus, the Conduct Rules cited herein apply to individuals associated with a member as well as to member firms.

that netted amounts payable to certain branch offices against receivables (non-allowable assets) from other branch offices (referred to as "netting" on Schedule A); and (2) for the period from June 1, 1998 through September 28, 1998, certain Firm liabilities were improperly transferred or booked directly to an affiliated, non-member corporation (referred to as "Block Payables Booked to ASK" on Schedule A); and (3) for each month-end period from October 31, 1997 through May 31, 1998, liabilities were removed from the Firm's general ledger and then replaced on the first of the next month (referred to as "reversing" on Schedule A).¹⁶

Independent of Block's claim that he delegated responsibility for the Firm's financial operation to the FINOP, which we reject as unsubstantiated and ineffective as a matter of law,¹⁷ the record supports holding Block responsible for the accounting violations because he directed Gonzalez to account improperly for the Firm's liabilities during the relevant period. Block, who was jointly responsible with Burke for supervising the FINOP's activities, specifically instructed Gonzalez to make the "netting" entries and to transfer Block Trading's payables to ASK.¹⁸

¹⁶ As to cause one, although NASD Regulation Enforcement staff set forth six categories of accounting irregularities in Schedule A, only three of the six categories were alleged as violations in the complaint (the "netting"; the "reversing"; and the improper transfer of Firm liabilities to an affiliated company).

¹⁷ Block admitted that he knew that Gonzalez did not possess a degree in accounting and that she had no previous accounting experience "other than balancing her checkbook." Gonzalez testified that she had taken only three hours of accounting, as a post-graduate. Accordingly, the delegation of responsibility for the Firm's financial operations to Gonzalez was improper. See Kirk A. Knapp, 51 S.E.C. 115, 126 (1992) (the Commission found that "Knapp's reliance on [the FINOP], who he knew had almost no experience, would have been, at best, misplaced.")

The Commission has held that even if there has been an effective delegation of financial compliance responsibilities, a controlling executive who is directly involved in accounting and net capital violations incurs responsibility for those violations. See William H. Gerhauser, 53 S.E.C. 933 (1998) (Commission found the firm's president liable for the net capital violation because he had given the FINOP incorrect information about the firm's net capital obligations); Kirk A. Knapp, supra (Commission found Knapp liable for the firm's net capital and recordkeeping violations because he had proposed many of the violative transactions and, as chief shareholder and executive, he controlled the FINOP and dictated the operations of the firm).

¹⁸ Gonzalez testified that she discussed the "netting" procedure at length with Block and that he directed her to implement the practice. Block admitted that he was aware of the "netting" procedure and testified that the practice made sense to him. Gonzalez further testified that Block instructed her to transfer the Firm's payables to ASK. The minutes of the October 7, 1997 Executive Committee meeting confirm that Block had proposed this practice to the committee. From this evidence, we find that Block directed these practices.

Although Block did not deny that he was aware of the practice of transferring Block Trading's liabilities to an affiliated company, he argued that he reasonably believed that it was acceptable under NASD accounting rules even though the Firm's compliance officer, Donald Katz ("Katz"), JC, and Samples had told him that this practice was unacceptable. We reject Block's contention. There is abundant record evidence showing that Block knew that this accounting practice was improper.¹⁹ Accordingly, we find Block responsible for the Firm's accounting irregularities.

Block argued that he was not liable for the non-disclosure of liabilities at the end of each month and the disclosure of these liabilities at the beginning of the next month. Block claimed that he was not aware of the so-called "reversing" activity and did not participate in the "reversing" activity.²⁰ This contention is irrelevant. Not only did Block fail to ensure that the books and records were properly maintained, the record convincingly demonstrates that Block and Gonzalez were working in concert to conceal from regulators the Firm's true net capital. According to Samples, in a meeting that he had with Block and Gonzalez in June 1998, Block directed Gonzalez to continue filing false FOCUS Part IIA filings until they could "get out of" the net capital violation.²¹ Gonzalez used the "reversing" entries to accomplish Block's stated desire to conceal the Firm's increasing net capital deficits.

We therefore affirm the Hearing Panel's finding that Block violated Exchange Act Rules 17a-3 and 17a-4 and Conduct Rules 2110 and 3110, as alleged in cause one of the complaint.

2. Net Capital Violations. The complaint alleged that Block allowed Block Trading to engage in a securities business when he knew or should have known that the Firm's net capital

¹⁹ In a sworn written statement, Katz declared that he told Block that invoices in the name of Block Trading had to be booked to the Firm and could not be booked to another company. Block and JC both testified that when JC found the mid-month net capital deficiencies for May and June 1998, he instructed Gonzalez that bills had to be in the name of the affiliate if they were to be entered into the books of the affiliate. Block further admitted that he had instructed Samples to enter bills incurred by Block Trading on the books of an affiliate company, but that Samples had refused to do so because he thought it was illegal. Samples testified that Block asked him to make such entries in April or May 1998.

²⁰ Gonzalez testified that the "reversing" was her idea and that she did not know whether Block was aware of the "reversing" entries.

²¹ Samples testified that:

[Gonzalez] was getting concerned at this point that they could not get out of the net capital violation, and [Block] asked [Gonzalez:] "if you defraud or you fraudulently turn in [FOCUS] reports to the NASD once or twice, is it bad that you do it a third time," and [Gonzalez said:] . . . "yes, it is," and [Block replied:] "well, you're just going to have to keep doing it until we can come up with a way to get out of the net cap violation."

was below the required minimum. As set forth above, Block was aware that the Firm was in net capital violation because he directed the activity that concealed the Firm's net capital deficiencies from regulators. See William H. Gerhauser, supra. Block therefore is responsible for the Firm's net capital violations, which are detailed in Schedule A.

Accordingly, we affirm the Hearing Panel's finding that, as alleged in cause two, Block allowed the Firm to engage in a securities business when the Firm's net capital was below the required minimum for the month-end periods of October 1997 through September 1998, in violation of Exchange Act Rule 15c3-1 and Conduct Rule 2110.

3. Failure to Report Net Capital Deficit. Cause three alleged that Block failed to provide notification that the Firm's net capital was below the required minimum, in violation of Exchange Act Rule 17a-11 and Conduct Rule 2110. We reject Block's argument that the Hearing Panel erred in finding that he "knowingly" failed to report the net capital violation. Block admitted in his answer to the complaint that he failed to give the required notice of net capital deficiency and he stipulated that the Firm was operating without its required minimum net capital throughout the relevant period. As noted above, Block was aware of the Firm's net capital deficiencies and he repeatedly concealed those deficiencies from regulators during the relevant period.

Accordingly, we affirm the Hearing Panel's finding that Block failed to provide notification that Block Trading's net capital was below the required minimum during the period from October 31, 1997 through July 29, 1998, in violation of Exchange Act Rule 17a-11 and Conduct Rule 2110, as alleged in cause three of the complaint.

4. Inaccurate FOCUS Reports. Cause four alleged that for the periods ending December 31, 1997, March 31, 1998, June 30, 1998, and September 30, 1998, Block failed to ensure the accurate preparation of FOCUS Part IIA filings, in violation of Exchange Act Rule 17a-5 and Conduct Rule 2110. Block stipulated that Block Trading submitted quarterly FOCUS Part IIA filings with inaccurate information, as set forth in Schedule A, but claims that he was not responsible for those violations because he had no involvement in the preparation and filing of the FOCUS Part IIA reports.

Block's responsibility for the inaccuracy and falsification of the Firm's books and records is clear. Block assumed personal responsibility for the accuracy of these reports. The NASD Regulation examiner testified that all of the Block Trading FOCUS Part IIA reports at issue were filed under the personal identification number assigned to Block, and that pursuant to the NASD's electronic reporting form, "NASDNet: Electronic FOCUS Filing System Personal Identification Number Registration Form," the personal identification number is deemed to be a signature. In addition, the first page of each FOCUS Part IIA report bears Block's name as the "Principal Submitting Form Electronically" and as the "person to contact in regard to this report." The form also includes a boxed notice on each of those pages that states: "The registrant/broker or dealer submitting this Form and its attachments and the person(s) by whom it is executed represent hereby that all information contained therein is true, correct and complete." This

evidence thus demonstrates that Block was the individual directly responsible for ensuring that the FOCUS Part IIA reports contained accurate information.

Thus, we affirm the Hearing Panel's finding of violation and find that Block violated Exchange Act Rule 17a-5 and Conduct Rule 2110 by failing to ensure the accurate preparation of FOCUS Part IIA filings as alleged in cause four of the complaint.

5. False and Misleading Financial Information in Private Placement Memorandum and Stock Purchase Agreement. Cause five alleges that Block used false financial statements in two attempts to raise capital for the Firm.²²

As to the stock purchase agreement, in April 1998, Block induced the Alarcons to invest a total of \$600,000 in Block Trading in exchange for a 25 percent ownership interest in Block Trading. The stock purchase agreement, dated April 24, 1998, represented that the Firm's December 31, 1997 unaudited financial statements had been delivered to the Alarcons. Block signed the stock purchase agreement as chief executive officer of Block Trading and he attested to the accuracy of the representations contained in the agreement.

Conduct Rule 2120 prohibits a member from effecting any transaction in, or inducing the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance. An allegation under Conduct Rule 2120 requires a showing that the respondent acted with "scienter" (a "mental state embracing intent to deceive, manipulate, or defraud"). See Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193, n. 12 (1976).²³ Scienter may be established by demonstrating intentional or reckless conduct. See Meyer Blinder, 50 S.E.C. at 1229, n. 64. We find that Block acted with the requisite scienter. As detailed above, Block was well aware of the Firm's accounting irregularities when he distributed false financial information in connection with the April 24, 1998 stock purchase agreement. Thus, we find that Block violated Conduct Rules 2110 and 2120.

We also find that Block violated Conduct Rule 2110 in connection with the private placement memorandum that he distributed to 14 individuals on September 23 through 28, 1998. The private placement memorandum included unaudited financial information for the months ending December 31, 1997 and March 31, 1998. The information contained in those financial statements is identical to the inaccurate information contained in the Firm's FOCUS Part IIA filings for the same periods. Moreover, the net capital calculations in the relevant FOCUS Part IIA reports are the same as the Firm's net capital calculations that Block stipulated were inaccurate. We therefore conclude that the financial statements that were included in the private placement memorandum contained false and misleading information about the Firm's net capital position.

²² Block stipulated that the information in the financial statements was false and misleading.

²³ Scienter is often established by circumstantial evidence. See Blech Sec. Litig., 961 F. Supp. 569, 582 (S.D.N.Y. 1997); Meyer Blinder, 50 S.E.C. 1215, 1229-30 (1992).

The record indicates that none of the private placement offerees purchased stock, which led to the offering's being withdrawn and the closing of Block Trading. We reverse the Hearing Panel's finding that Block violated Conduct Rule 2120 based on our finding that Block did not consummate any sales in connection with his distribution of the private placement memorandum.

Allegations Against Burke

1. Net Capital. The complaint alleged that Burke allowed Block Trading to engage in a securities business when he knew or should have known that the Firm's net capital was below the required minimum. The record indicates that Burke was the president of the Firm until he resigned that position on August 17, 1998. Burke shared responsibility for supervision of the Firm with Block pursuant to the Firm's written supervisory procedures. The Commission has stated that "the president of a brokerage firm is responsible for his firm's compliance with all applicable requirements unless or until he or she reasonably delegates a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his duties." Everest Securities, Inc., 52 S.E.C. 958 (1996). Burke never claimed that he delegated any of this responsibility to Gonzalez, and early on had reason to believe that she was not properly performing her duties.

It is well settled that presidents of securities firms bear a heavy responsibility to ensure that broker-dealers comply with all applicable rules and regulations. See Hutchison Financial Corporation, 51 S.E.C. 398 (1993) (despite warning signs, president took no steps to assure firm's ongoing net capital compliance and was only remotely involved in monitoring of firm's net capital); Kirk A. Knapp, *supra* ("[O]nce a president accepts that title, he was required to fulfill the obligations attached to his office, for so long as he occupied the position."); Joseph Elkind, 46 S.E.C. 361, 362 (1976); see also James Michael Brown, 50 S.E.C. 1322 (1992), *aff'd*, Brown v. SEC, 21 F.3d 1124 (11th Cir. 1994) (table cite) (rejecting defense that president of firm should be excused because he lacked a meaningful role in firm's management); William H. Prince, 45 S.E.C. 963 (1975) (rejecting respondent's "conditional president" concept, the Commission held that "[t]o acquit Prince of responsibility for [the firm's] derelictions in these circumstances 'would encourage ethical irresponsibility by those who hold themselves out as active operating heads and who in the very nature of the corporate setup should be primarily responsible.'" (citation omitted)).

We conclude that had Burke not abdicated his responsibilities as president, Block and Gonzalez might not have been able to engage in the misconduct at issue here. The evidence establishes that Burke failed to take an active role in managing the Firm, notwithstanding his duty to do so as president of the Firm. Burke knew as early as October 1997 that the Firm was experiencing financial problems and that Block had decided to challenge the net capital rule.²⁴

²⁴ In October 1997, Burke became aware that the Firm was in a precarious net capital situation and that it would likely have net capital problems by the end of the month. Burke attended the Executive Committee meetings on October 6 and 7, in which net capital problems were discussed, but offered no evidence that he did anything to determine whether the Firm was in or approaching net capital deficiency. Block announced at the October 7 meeting that it was his goal to "challenge" the net capital rule. Apart from attempting to sell his interest in the Firm

In short, Burke elected to retain his position of authority but made no attempt to assure the Firm's ongoing net capital compliance during the relevant period. See Hutchison Financial Corporation, supra. The conclusion is inescapable that Burke knew that the Firm had serious capital problems but failed to take sufficient corrective measures. Instead, his response was to attempt to sell his shares to Block on two separate occasions. We agree with the Hearing Panel that it is likely that Burke's failure to take appropriate remedial action was related to his desire to maximize the value of his investment in the Firm.

Accordingly, as alleged in cause two of the complaint, we find Burke responsible for allowing Block Trading improperly to engage in a securities business when the Firm's net capital was below the required minimum, as set forth in Schedule A, in violation of Exchange Act Rule 15c3-1 and Conduct Rule 2110. We thus affirm the Hearing Panel's finding of violation.

2. Failure to Supervise. According to the Firm's written supervisory procedures, Block and Burke were responsible for the "ultimate supervision of the firm." The evidence demonstrates that Block was responsible for the Firm's day-to-day operations, but that Burke had abdicated any meaningful management role by the end of October 1997 and, thereafter, focused his attention on the DaqCom branch.

Burke was aware of a series of irregularities that put him on notice that an investigation and immediate remedial action were necessary. When there is evidence of illegal acts, irregularities, or "red flags," a president is required to discharge his supervisory responsibilities with respect to misconduct that comes to his attention. See, e.g. John H. Gutfreund, 51 S.E.C. 93, 111 (1992) (finding that president took no meaningful action to respond to misconduct and that he retained his supervisory responsibilities as president of the firm and failed to discharge those responsibilities); see also Christopher J. Benz, 52 S.E.C. 1280 (1997), *aff'd*, Benz v. SEC, 168 F.3d 478 (3d Cir. 1998) (finding that president of firm ignored "red flags"); Houston A. Goddard, 51 S.E.C. 668, 672 (1993) (sustaining sanctions imposed on principal and compliance officer who failed to adequately follow up on red flags); Edwin Kantor, 51 S.E.C. 440, 447 (1993) ("Red flags and suggestions of irregularities demand inquiry as well as adequate follow-up and review.") Once Burke became aware of the "red flags,"²⁵ he should have taken immediate action to determine the extent of Gonzalez' misconduct and to undertake the steps that were necessary to limit her activities.

Accordingly, as alleged in cause six of the complaint, we find that Burke was derelict in discharging his supervisory responsibilities because he failed to take necessary action after

(continued)

to Block in January 1998, Burke showed no interest in learning how Block and Gonzalez intended to address the Firm's financial and operational problems.

²⁵ Burke was aware of the first "red flag" as early as October 1997 when he learned that the Firm was having financial and operational difficulties. He became aware of another "red flag" at the end of May 1998 when Samples told him about the Firm's accounting irregularities and adverse net capital situation.

becoming aware of net capital problems beginning in October 1997. We therefore affirm the Hearing Panel's finding that Burke failed properly to supervise Gonzalez during the period alleged in the complaint, in violation of Conduct Rules 2110 and 3010, as alleged in cause six.

Sanctions

In determining sanctions, we have carefully considered the entire record in this proceeding, including the arguments of the parties on review and all evidence presented in mitigation and aggravation.

Sanctions as to Block. As to Block, the Hearing Panel below determined to aggregate causes one through four for purposes of determining sanctions. We agree with that approach since each of those causes related to the same underlying misconduct -- the existence and attempted concealment of net capital deficiencies.

The NASD Sanction Guideline for net capital violations recommends a fine of \$1,000 to \$50,000 and, in egregious cases, a suspension of 30 days to two years, or a bar.²⁶ We consider this to be an "egregious" case because Block engaged in a scheme over a 12-month period to conceal a net capital violation in an attempt to deceive regulatory authorities²⁷ and permitted the Firm to continue in business while he knew of the deficiencies and accounting inaccuracies. We disagree with the Hearing Panel's characterization of Block's cooperation with NASD investigators as a mitigating factor for purposes of assessing sanctions. The fact that Block gave access to the Firm's records as required and did not hinder the staff's investigation cannot be characterized as a mitigating factor under the circumstances of this case.

The Hearing Panel barred Block from association with any member in any principal or supervisory capacity and imposed a \$25,000 fine. Considering the egregious circumstances cited above and the gravity of the violations, we have determined to increase the level of the sanctions. We order that Block be barred from association with any member firm in all capacities. We affirm the imposition of a \$25,000 fine. We disagree with the Hearing Panel's characterization of Block's misconduct as reflecting only on his failures as a principal, and with his claim that a suspension as a general securities representative would be inappropriate because "no customers of Block Trading lost money, or were otherwise injured, as a result of his alleged conduct." As the Commission has stated: "Net capital violations are serious. The uniform net capital rule is designed to insure that a broker-dealer will have sufficient liquid assets to satisfy its indebtedness, particularly the claims of its customers." Edward B. Daroza, Jr. 50 S.E.C. 1086 (1992). Block's violations thwarted the purpose of the net capital rule, put investors and creditors at risk, and misled the Firm's regulators.

²⁶ See Guidelines (1998 ed.) at 27 (Net Capital Violations).

²⁷ Schedule A shows that by September 1998, the Firm had a net capital deficiency of \$1,720,468.

With respect to cause five (Block's use of fraudulent financial statements to effect the Alarcon's stock purchase and his attempt to effect sales through a misleading private placement memorandum), we look to the Guideline for misrepresentations or material omissions of fact (intentional or reckless misconduct), which recommends a fine of \$10,000 to \$100,000 and a suspension for 10 days to two years, or a bar in egregious cases.²⁸ We consider Block's misconduct to be egregious. Clearly, any investor putting capital into a broker-dealer would want to know the Firm's true financial condition. We conclude that Block's actions were calculated to mislead the Alarcons, who did in fact invest, as well as the potential purchasers in a private placement offering. The Hearing Panel determined to bar Block from association with any member firm in any principal or supervisory capacity and to impose an additional fine of \$25,000. Because of the gravity of the misconduct alleged in cause five, we have determined to increase the level of sanctions imposed by the Hearing Panel to a bar from association with any member in all capacities. We affirm the Hearing Panel's imposition of a \$25,000 fine.

Sanctions as to Burke. Burke's role differed sharply from Block's in that Block and Gonzalez were actively involved in the concealment of the Firm's net capital deficits, while Burke did not actively engage in the manipulation of the Firm's books and records in order to conceal the Firm's net capital deficiency. Rather, as Block Trading's president, Burke ignored the red flags concerning net capital problems and accounting irregularities that came to his attention, and he abdicated his supervisory responsibilities at a time he knew that the Firm was experiencing serious problems.

In determining sanctions, we have taken into account the fact that Burke did not assist in implementing the improper accounting practices that concealed the Firm's net capital deficiencies. Additionally, he challenged Block and Gonzalez about the accuracy of the Firm's financial records, albeit not until June 15, 1998, at which point the misconduct had been going on for approximately nine months. Finally, we have considered that Burke eventually brought his concerns about the Firm's accounting irregularities and net capital problems to Alarcon and his attorney.

The recommended sanction for a net capital violation is a fine of \$1,000 to \$50,000 and a suspension of up to 30 days, or a lengthier suspension or bar in egregious cases. Based on the nature of Burke's involvement in the net capital violations, we find that lesser monetary sanctions than those imposed on Block are appropriate. We therefore affirm the Hearing Panel's imposition of a 30-day suspension in any principal or supervisory capacity and \$10,000 fine, and find these sanctions to be sufficiently remedial.²⁹

With respect to Burke's responsibility for failing to supervise Gonzalez under cause six, we recognize that after Burke became aware of the "red flags," he took no formal steps -- such as initiating an outside audit which would have been appropriate under the circumstances -- to determine the extent of Gonzalez' activities. But for Burke's abdication of his supervisory

²⁸ See Guidelines (1998 ed.) at 80 (Misrepresentations or Material Omissions of Fact).

²⁹ See Guidelines (1998 ed.) at 27 (Net Capital Violations).

responsibilities, the financial and operational violations might have been detected and prevented. Nonetheless, given the nature of Burke's misconduct and his attempt, however belated, to confront the Firm's financial problems, we believe that the sanctions imposed by the Hearing Panel in this regard are sufficiently remedial. We thus affirm the Hearing Panel's determination to require Burke to re-qualify as a general securities principal and to pay a fine of \$5,000. We agree with the Hearing Panel that these sanctions are sufficient to impress upon Burke the importance of his supervisory responsibilities.³⁰

In summary, Block is barred from association with any member firm in any capacity (causes one through five); and fined \$50,000 (\$25,000 for causes one through four and \$25,000 for cause five). Burke is suspended for 30 days from association with any firm in any principal or supervisory capacity (cause two); fined \$15,000 (\$10,000 for cause two and \$5,000 for cause six); and required to requalify by examination as a general securities principal within 90 days of the date of this decision (cause six). Finally, costs of the proceeding below of \$7,339.80 are assessed on Block and Burke, jointly and severally.³¹

On Behalf of the National Adjudicatory Council,

Jeffrey S. Holik
Vice President and Acting General Counsel

³⁰ See Guidelines (1998 ed.) at 89 (Supervision – Failure To Supervise).

³¹ 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 therein.

Pursuant to NASD Procedural Rule 8320, any member that 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.