BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of	**Redacted Decision**
Department of Enforcement,	DECISION
Complainant,	Complaint No. C8A980059
vs.	
Respondent 1	Dated: November 6, 2000
and	
Respondent 2	
Respondents.	

Hearing Panel found that Firm A, acting through its Chairman and FINOP, failed to keep accurate books and records, filed inaccurate FOCUS IIA reports, and failed to maintain minimum required net capital, and that Chairman also (1) operated firm in contravention of restrictive agreement, (2) participated in municipal securities offering while failing to employ registered municipal securities principal, (3) acted as municipal securities principal without being registered as such, (4) operated Firm A without two registered principals, (5) operated firm without registered FINOP, (6) failed adequately and completely to respond to Association requests for information, and (7) failed to report an NASD Regulation, Inc. investigation on his Form U-4. Held, findings affirmed against Chairman and affirmed in part against FINOP, and sanctions modified.

Pursuant to Procedural Rule 9310, Respondent 1 and Respondent 2 have appealed a 1999 decision issued by the Hearing Panel in this matter. This decision was also called for review by the National Adjudicatory Council ("NAC") as to Respondent 2 to examine the findings and to determine whether the sanctions were appropriate in light of the alleged conduct. We find that Firm A ("Firm A" or "the Firm"), acting through Respondent 1, its Chairman, and Respondent 2, its financial and operations principal ("FINOP"), failed to keep accurate books and records[1] and filed inaccurate

[1]We dismiss, however, the allegation as to Respondent 2 relating to the April 30, 1996 recordkeeping violation.

FOCUS IIA reports. We also find that Respondent 1 operated the Firm when the Firm failed to maintain minimum required net capital, operated the Firm in contravention of its restrictive agreement, participated in a municipal securities offering while failing to employ a registered municipal securities principal, acted as a municipal securities principal without being registered as such, operated Firm A without two registered principals, operated Firm A without a registered FINOP, failed adequately and completely to respond to NASD Regulation, Inc. ("NASD Regulation") requests for information, and failed to report an NASD Regulation investigation on his Uniform Application for Securities Industry Registration or Transfer ("Form U-4") and Uniform Termination Notice for Securities Industry Registration ("Form U-5").

We hereby bar Respondent 1 from acting in any principal capacity or having any proprietary interest in a broker-dealer, suspend him for six months in all capacities, fine him $10,000, and assess him $1,995.90 in costs. We hereby fine Respondent 2 $5,000 and assess him $500 in costs.

<u>Background.</u> Respondent 1 entered the securities industry in February 1988 as a general securities representative. He purchased Firm A on August 23, 1995, at the age of 33. Pursuant to its September 1995 restrictive agreement, Firm A was a general securities firm and was required to maintain net capital of at least $100,000. The Firm withdrew its membership from the Association in February 1998.

Respondent 1 was the Chairman, Secretary, and 50-percent owner of Firm A. He became registered as a general securities principal with Firm A in September 1995, and as a municipal securities principal in October 1997. Respondent 1 is presently registered with another member firm. Respondent 1 was based at Firm A's office in Chicago, and he was responsible for the Firm's operations and compliance. Respondent 1's mother, was Firm A's administrator and operations person.

The 49-percent owner and the Firm's President and Treasurer ("the Firm President") was not named in the complaint,.[2] The Firm President, who was registered with Firm A as a general securities principal and municipal securities principal, was based in Kansas City, Missouri. On November 5, 1996, Respondent 1 terminated the Firm President's employment as President of Firm A.

Respondent 2 entered the securities industry as a FINOP in July 1986. He was registered as Firm A's FINOP from August 1995 until October 1997, during which time he worked for Firm A and other broker-dealers from an off-site office. He continues to be employed in the industry as a FINOP.

<u>Facts</u>

The facts are generally undisputed. On September 25, 1995, Respondent 1, on behalf of Firm A, signed a restrictive agreement in which Respondent 1 agreed that the Firm would maintain a minimum net capital of $100,000. Respondent 1 capitalized the Firm with a $125,000 subordinated loan. In response to an NASD Regulation staff ("Staff") suggestion that the Firm should have capital of at least $145,000, Respondent 1 deposited additional capital by means of a $25,000 check, and the Firm

[2]A third individual, who was not named in the complaint, owned one percent of the Firm.

started conducting business. Respondent 1's check was, however, returned for insufficient funds, so the Firm began business with excess net capital of only $25,000.

In mid-June 1996, Respondent 2 reported to Staff that a $65,000 check deposited in Firm A's account by Respondent 1 on May 31 had bounced and was not good capital. Staff reviewed the Firm's financials, discovered that Firm A was operating below its $100,000 minimum net capital requirement, and immediately advised Firm A to file notification with the Securities and Exchange Commission ("SEC") pursuant to SEC Rule 17a-2. In July 1996, Staff examined the Firm's June 30, 1996 financial statements, determined that the Firm was operating below its net capital requirement, and again advised the Firm to file a Rule 17a-2 notification with the SEC.

On July 31, 1996, Respondent 1 borrowed $125,000, which was placed in an account held by the firm at Firm B (the "Firm B Account"). This ostensibly placed the Firm in net capital compliance as of July 31, 1996. Staff, however, determined that the loan was encumbered and, therefore, was not good capital. Staff attempted to obtain further documentation regarding the Firm's financial condition from Respondent 1 from September 6 through September 25, at which time Staff determined to conduct an examination of the Firm. On September 27, 1996, Staff sent Firm A a checklist of items it expected to review. On October 2, 1996, Staff sent Firm A a letter of caution regarding certain deficiencies found during the examination.

During this time, Respondent 1 and the Firm President had been having disagreements, and on November 5, 1996, Respondent 1 terminated her as the Firm President. On November 8, 1996, she sent a letter to Staff alleging that there had been "a fraudulent attempt to disguise the true financial condition of [the Firm], including potential errors in the Firm's net capital computations and undisclosed liabilities." The former president stated that between November 1 and November 4, 1996, he learned that Firm A's corporate American Express account had an outstanding debit balance of approximately $34,000 and was four months overdue; that Firm A had repaid only $40,000 on a $60,000 loan; and that Firm A was four months in arrears in the payment of its equipment lease to Bank 2 and owed Bank 2 $70,000. The former president stated that he spoke to Respondent 1 on November 4 to express his concerns, and that on November 5, Respondent 1 advised him that Firm A's Board of Directors had met on the evening of November 4 and had elected to terminate him.

On November 11 and 12, 1996, Staff confirmed the existence of these liabilities. On November 13, 1996, Staff advised that Firm A did not currently have the minimum required net capital to conduct a securities business. Also on November 13, 1996, Staff sent a request to Respondent 1 pursuant to Procedural Rule 8210 asking him to attend a meeting on November 14 and to bring with him "all documents necessary to compute an accurate net capital computation as of November 14, 1996." Starting on November 18, 1996, and ending in January 1998, Staff had a number of meetings with Respondent 1 and made a series of requests for additional information. Staff's investigation disclosed the facts on which this complaint is based.

Procedural Background

The complaint, issued on August 20, 1998, contained 10 causes.

Cause one alleged that Firm A, acting through Respondent 1 and Respondent 2, conducted business on May 31, June 28, July 31, and September 30, 1996, while failing to maintain the minimum required net capital, in violation of Conduct Rule 2110.

Cause two alleged that Firm A, acting through Respondent 1, failed to comply with the terms of its September 27, 1995 restrictive agreement, in that Firm A failed to conduct its securities business in accordance with SEC Rule 15c3-1(1)(2)(iii) by failing to maintain a minimum net capital of $100,000 on November 30 and December 29, 1995, and on January 31, February 29, March 29, April 30, May 31, June 28, July 31, August 30, September 30, and November 29, 1996, in violation of Conduct Rule 2110.

Cause three alleged that Firm A, acting through Respondent 1 and Respondent 2, prepared inaccurate general ledger, trial balance and net capital computations for the months ended November 30 and December 29, 1995; January 31, February 29, March 29, April 30, May 31, June 28, July 31, August 30, September 30, and November 29, 1996; and January 31, February 28, March 31, April 30, May 30, June 30, July 31, and August 29, 1997, in contravention of SEC Rule 17a-11 and Conduct Rules 2110 and 3110.

Cause four alleged that, in violation of Conduct Rule 2110, Firm A, acting through Respondent 1 and Respondent 2, failed to comply with SEC Rule 17a-5 in that the Firm filed with the National Association of Securities Dealers, Inc. ("NASD") inaccurate FOCUS IIA Reports for the calendar quarters ended December 29, 1995; March 29, June 28, and September 30, 1996; and March 31 and June 30, 1997; which filings were inaccurate as a result of the Firm's inaccurate general ledger, trial balance, and net capital computations.

Cause five alleged that on September 1, 11, 12, 15, 16, and 18, 1997, Firm A, acting through Respondent 1, conducted a municipal securities business while failing to employ a properly qualified and registered municipal securities principal, in violation of Municipal Securities Regulation Board ("MSRB") Rule G-2.

Cause six alleged that on September 1, 11, 12, 15, 16, and 18, 1997, Respondent 1 acted in the capacity of a municipal securities principal of Firm A without being appropriately qualified and registered in such capacity in violation of MSRB Rule G-3(b).

Cause seven alleged that from September 15, 1997 through November 19, 1997, Firm A, acting through Respondent 1, conducted a securities business while failing to employ two properly qualified and registered general securities principals, in contravention of Membership and Registration Rule 1021(e), and in violation of Conduct Rule 2110.

Cause eight alleged that from January 22, 1998 through February 9, 1998, Firm A, acting through Respondent 1, failed to have a properly qualified and registered FINOP, in contravention of Membership and Registration Rule 1022(b), and in violation of Conduct Rule 2110.

Cause nine alleged that Respondent 1 failed adequately and completely to respond to NASD requests for information sent in accordance with the provisions of Procedural Rule 8210 on November 13, 1996; August 15, August 25, September 3, and September 25, 1997, in violation of Conduct Rule 2110 and Procedural Rule 8210.

Cause 10 alleged that on Forms U-4 and U-5, both filed in February 1998, Respondent 1 failed to disclose that he was the subject of an NASD Regulation investigation, in violation of Conduct Rule 2110.

As more fully described below, Respondent 1 and Respondent 2 stipulated to the facts supporting the Hearing Panel's findings as to causes one through eight and cause 10. Respondent 1 stipulated that he received the Rule 8210 requests for information as alleged in cause nine of the complaint, but he did not stipulate that he failed to provide timely and complete responses to those requests. Respondent 2 denied responsibility for the violations alleged in each of the causes that named him, causes one, three, and four.

Discussion

As a preliminary matter, we have considered Respondent 1's request to adduce additional evidence into the record on appeal.[3] Respondent 1 submitted 34 exhibits, some of which contained more than one document. A substantial number of these exhibits were already in the record, and Respondent 1 withdrew several others. Respondent 1 failed to address why any of these documents were material. As to their availability below, Respondent 1 contended that he did not introduce the proffered documents before the Hearing Panel because, on the advice of counsel, he decided to cooperate with NASD Regulation and concede the allegations of the complaint.

The NAC Subcommittee ("Subcommittee") that heard this matter ultimately considered 11 exhibits and determined to admit the following two exhibits: (1) a letter from Respondent 1 to Staff dated October 3, 1997, in response to a September 30, 1997 request for information; and (2) documents regarding the termination of Firm A employees in July 1997. The Subcommittee concluded that the October 3 letter was material and should be admitted, notwithstanding that it was available in February 1999 when the hearing below took place. The Subcommittee determined to admit the October 3 letter on the basis that the information in the letter was already in the record in another form.

The Subcommittee concluded that none of the remaining documents were material, and that Respondent 1 had not shown good cause for failing to introduce them below. See In re Sidney C. Eng,

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[3]Pursuant to Procedural Rule 9346(b), a party seeking to adduce new evidence must demonstrate that there was good cause for failing to introduce evidence below and also demonstrate why the evidence is material to the proceeding.

Exchange Act Rel. No. 40297 at 24 (Aug. 3, 1998) ("Public policy considerations favor the expeditious disposition of litigation, and a respondent cannot be permitted to gamble on one course of action and, upon an unfavorable decision, to try another course of action") (citing In re David T. Fleischman, 43 S.E.C. 518 (1967)). We affirm the Subcommittee's determination to admit only the two above-described documents.

On its own motion, the Subcommittee requested from the Enforcement Department and placed into the record a copy of the "Wells" letter that placed Respondent 1 on notice that he was being investigated by NASD Regulation.

We have also considered Respondent 1's contention that Staff conducted a "vendetta" against him in an attempt to close down his Firm. We note that Respondent 1 has accepted responsibility for the violations alleged in causes one through eight and cause 10, and that his claim of bias focuses solely on NASD Regulation's investigation of Firm A and Staff's requests for information (as alleged in cause nine) that were part of that investigation. Respondent 1 characterized Staff's requests as "unrelenting" and "duplicative," and he accuses Staff of exceeding its regulatory authority. We reject those claims as wholly unsupported by the record.

After Respondent 1 terminated the Firm President in October 1996, the former President complained to NASD Regulation that Firm A had a number of unreported liabilities. Staff appropriately began an investigation of the Firm, starting with an in-person conference in November 1996, during which Staff asked Respondent 2 and Respondent 1 to disclose all of the Firm's liabilities. Staff's investigation lasted almost until the Firm closed its doors in February 1998.

We find no evidence of overreaching or bias. A review of the requests for information sent to Firm A shows that Staff was attempting to ascertain Firm A's compliance with financial responsibility and registration requirements. Almost one-third of Staff's requests were sent as follow-up letters because Respondent 1 had not responded to a first request. We find that Staff's requests for information were an appropriate response to legitimate concerns about Firm A's compliance with a panoply of regulatory requirements. See e.g., In re Rafael Pinchas, Exchange Act Rel. No. 41816 (Sept. 1, 1999) (general claims of conspiracy and bias on the part of staff unsupported by the record and rejected).

Respondent 1 also contends that The former President was responsible for certain violations but was not named in the complaint. We cannot speculate on the reasons why The former President was not named; however, it is clear that although she was President of Firm A until October 1996, Respondent 1 admittedly was in charge of running the Firm. Respondent 1 hired and supervised Respondent 2, and Respondent 1 was responsible for the operation of the back office. Thus, Respondent 1 was appropriately named in the complaint.

As explained in detail below, we affirm the Hearing Panel's findings as to Respondent 1 and partially affirm the findings as to Respondent 2. We first address the complaint's causes involving both respondents (causes one, three, and four), and then turn our attention to the remaining causes, which name only Respondent 1.

Cause One. Cause one alleged that Firm A, acting through Respondent 1 and Respondent 2, failed to comply with SEC Rule 15c3-1, in that Firm A operated a securities business without sufficient net capital on May 31, June 28, July 31, and September 30, 1996, in violation of Conduct Rule 2110. The Hearing Panel made findings consistent with the complaint. We affirm the Hearing Panel's findings as to Respondent 1 and dismiss their findings as to Respondent 2.

Respondent 1 and Respondent 2 stipulated, and we independently find, that the following liabilities and assets were improperly accounted for on the dates alleged in cause one of the complaint:

(1) Bank 1 $50,000 Loan. On September 15, 1995, Respondent 1, acting on behalf of Firm A, executed a demand note with Bank 1 for $50,000. As of January 31, 1996, the principal balance of the $50,000 loan was $47,000. The note was not paid in full prior to November 1996. On December 12, 1996, Respondent 1 replaced the note with a $50,000 revolving line of credit. Firm A failed to record this loan as a Firm liability on its financial statements submitted to the NASD from November 1995 through November 1996.

(2) Bank 1 $60,000 Sole-Recourse Loan. On December 27, 1995, Respondent 1, acting on behalf of Firm A, executed a second promissory note with Bank 1 for $60,000, due June 3, 1997. This was a sole- recourse loan secured by a pledge of the underwriting receivables that Firm A expected to receive from a clearing firm ("Clearing Firm 1") for participating in a municipal bond offering in November 1995. No payment had been made on the loan as of January 31, 1996. In February 1996, $10,527, a portion of the underwriting receivables, was wired directly to Bank 1, thereby reducing the loan balance to $49,473. Firm A recorded the outstanding loan balance on its books in February 1996, where it remained an outstanding liability until May 1996. On June 4, 1996, Clearing Firm 1 wired $65,827.30, the final amount owed on the underwriting, to Firm A's account at Bank 2. Instead of using those funds to pay of the loan, Respondent 1 transferred $65,000 of those funds to his personal Bank 2 account on June 5 to cover a personal check for $65,000, which he had deposited into the Firm's account on May 31, and which had been returned for insufficient funds.

Thus, instead of using the final Clearing Firm 1 payment to pay off the loan, Respondent 1 deposited $65,000 of the funds into Firm A's account to increase the Firm's capital. Then, Firm A failed to record the outstanding loan balance of $49,473 as a Firm liability on its financial statements submitted to the NASD for the months of June through September 1996. The evidence is not clear as to why Respondent 2 stopped booking the remaining balance. Respondent 1 testified that he did not direct Respondent 2 to take the liability off Firm A's books, but he implied that Respondent 2 knew when the Clearing Firm A check was due. Respondent 1 testified: "If [Respondent 2] inadvertently took it off the books, that's what happened. But nobody directed him to take it off." Respondent 2 stated in correspondence to NASD Regulation that Respondent 1 told him on June 18, 1996, that he had paid the loan off personally on June 5, and that Respondent 2 had inferred that this was the reason the Clearing Firm 1 funds were released to Firm A. Respondent 2 stated that when he was informed that the $49,473 had not been repaid, he adjusted Firm A's books accordingly.

(c) American Express Corporate Account Outstanding Balances of $34,637, $7,774, $28,235, $31,527, and $32,335 for the Months of May through September 1996, Respectively. We find that Firm A made an error in failing to book these American Express bills as liabilities between May and September 1996. The Firm President applied for an American Express corporate account on November 22, 1995, with himself as the authorized agent, and he obtained cards for himself, Respondent 1, and Respondent 1's mother. Respondent 1 obtained an opinion from an attorney dated April 10, 1997, which stated that the American Express indebtedness was Respondent 1's responsibility, not Firm A's. Respondent 2 stated in a letter to Staff that it was explained to him that Firm A did not have corporate cards, and that its management was individually responsible for their charges, and Firm A was responsible for paying "itemized transaction[s] that were accountable to the company." Thus, Respondent 2 stated, he did not book the American Express bills as liabilities.

We disagree with the Hearing Panel that Respondent 2 reasonably viewed the American Express liability as a contingent liability of the Firm that should not be booked as a liability until the contingency became probable. Under the terms of the account, Firm A agreed to be liable for all charges on the account, notwithstanding the fact that individual users were expected to pay their own balances. Thus, the charges should have been included in the calculation of the Firm's aggregate indebtedness until paid. See In re Townsley Associates & Company, Inc., 50 S.E.C. 755 (1991) (finding that liabilities that have been incurred must be included in the firm's net capital computation).

(d) Bank 2 Lease Agreement. In January 1996, Firm A, acting through Respondent 1, entered into an agreement with Bank 2 to lease office furniture and equipment. In May 1996, pursuant to this agreement, Firm A, acting through Respondent 1, executed a lease payment schedule creating a principal balance of $59,126. Firm A failed to record this capitalized lease on its financial statements submitted to the NASD for the months of May through October 1996. Respondent 2 failed properly to account for Firm A's $59,000 obligation under the Bank 2 lease because he never saw the January 1996 lease agreement until Staff showed it to him in November 1996. He relied on a bank debit memo sent to him by Respondent 1's Mother that merely said "Rent furniture and fixtures" and on Respondent 1's opinion that Firm A's monthly payments were rental payments.

The parties stipulated, and we independently find, that the following were non-allowable assets on the relevant dates in 1996:

(e) Payment-for-order-flow Receivables Received by Firm A from Clearing Firm 2 in the amounts of $1,540, $17,086, $1,050, $150, $5,010, $6,306, $5,963, $12,244, and $2,412 in November and December 1995, January through March 1996, and May through August 1996, Respectively.

Firm A incorrectly included these payments as allowable assets on its financial statements. Staff notified Respondent 1 in June 1996 that the Firm could not include payment-for-order-flow as an allowable asset.[4] During the June 1996 examination, Staff reclassified $5,015 in payment-for-order-

[4]Payment for order flow fees receivable are unsecured receivables, which should be treated as nonallowable assets pursuant to SEC Rule 15c3-1(c)(2)(iv) (assets not readily convertible into cash). See NASD Regulatory & Compliance Alert (April 1995).

flow receivables as non-allowable, and, on June 3, 1996, Respondent 1 signed the examination exit conference form that noted that payment-for-order-flow receivables were non-allowable. Firm A discontinued booking payments from one broker-dealer, but continued to book payments from Clearing Firm 2 through October 1996 on the basis that Firm A had changed its arrangement with Clearing Firm 2 and was now receiving payments in the form of "rebates receivables" in the amount of 50 percent of the spread.

In correspondence dated October 23, 1996, Respondent 1 asked Staff for clarification of whether a receivable from a broker-dealer less than 30 days old should have allowable treatment. Staff advised Respondent 1 that changing the form of payment from what Respondent 1 characterized as "rebates" to "a give up basis" did not change the status of these payments, which were non-allowable for net capital purposes.

(f) <u>$65,000 Personal Check Deposited by Respondent 1 on May 31, 1996.</u> As noted above in the discussion of the Bank 1 sole-recourse loan, Respondent 1 deposited a personal check for $65,000 into the Firm's checking account at Bank 1 on May 31, 1996, to make sure that Firm A had sufficient capital as of that date. Respondent 1 knew when he wrote the check that he did not have sufficient funds in his account to cover the check. Respondent 1 planned to cover the check with funds that he expected to arrive at the Firm by May 31, but the funds did not arrive as expected, and the check bounced. Respondent 1 nonetheless allowed Respondent 2 to book the $65,000 check as good capital as of May 31, 1996. On June 4, 1996, Clearing Firm 1 wired $65,926.91 into Firm A's account at Bank 2. On June 5, 1996, Respondent 1 transferred $65,000 from Firm A's Bank 2 account to his personal account and put his $65,000 check through a second time, at which point it cleared.

Money that has not been tendered for deposit into a firm's account cannot be considered good capital for purposes of calculating the firm's net capital. Thus, Respondent 1's $65,000 check was not good capital on May 31, 1996, because the $65,000 needed to cover the check had not yet been deposited. <u>In re James S. Pritula</u>, Exchange Act Rel. No. 40647 at 4 (Nov. 9, 1998) (check that is returned for insufficient funds not good capital).

(g) <u>$125,000 Firm B Account.</u> Firm A opened an account at Firm B on July 31, 1996. The Firm President signed the account application as the Firm's President. Attached to the application was a document entitled "Certified Copy of Certain Resolutions Adopted by the Board of Directors Whereby the Establishment and Maintenance of Securities Cash Accounts Have Been Authorized." This document, among other things, empowered "the President/CEO or any Vice President of [Firm A]," or other authorized agents to establish the account with Firm B and to deposit or withdraw funds from the account. Two names were listed as authorized agents: "[Employee 1]" and Respondent 1. On the same date, Respondent 1 obtained a personal loan of $125,000 from Employee 1, who transferred $125,000 into the account. Firm A booked the $125,000 deposit as good capital for Firm A from July through October 1996.

As an authorized agent on the Firm A account, however, Employee 1, who was not an officer or employee of Firm A, had the authority to withdraw funds from the account. Thus, the $125,000 could not be considered an allowable asset for Firm A so long as Employee 1 remained an "authorized agent" on the account. After discussions with Staff, Respondent 1 arranged to remove Employee 1's name as authorized agent in November 1996, and the funds then became good capital for purposes of calculating Firm A's net capital. In re L.H. Alton & Company, Exchange Act Rel. No. 40886 at 4 (Jan. 6, 1999), aff'd, Lewis H. Alton and L.H. Alton & Company v. S.E.C., No. 99-70383 (9th Cir. July 14, 2000) (unpublished decision) ("A bank account from which a person who is not associated with the broker-dealer is authorized to withdraw funds is not an allowable asset for the purposes of [the] net capital rule").

Although Firm A's restrictive agreement required the Firm to maintain a minimum net capital of $100,000, Staff calculated the Firm's net capital on the dates alleged on the basis of a $5,000 net capital requirement.[5] Firm A had the following net capital deficiencies on the following four dates, as alleged in the complaint:

(a) On May 31, 1996, Firm A had a net capital deficiency of $64,849. Among other things, the $65,000 check that was returned for insufficient funds, a $6,306 payment-for-order-flow receivable, and $29,653 (one-half of the capitalized $59,126 lease liability)[6] were non-allowable. Also, Firm A failed to book as liabilities the $47,000 Bank 1 loan and $34,637 owed to American Express.

(b) On June 28, 1996, Firm A had a net capital deficiency of $44,103. On this date, Firm A failed to report not only the $47,000 Bank 1 loan, but also the sole-recourse loan, which had an outstanding balance of $49,473. Firm A continued to include a payment-for-order-flow receivable ($45,963) as an asset and also failed to book one-half of the capitalized lease liability ($29,563) and an American Express balance of $7,774.

(c) On July 31, 1996, Firm A had a net capital deficiency of $162,196. Firm A failed to book its lease liability and the two Bank 1 loans; and Firm A wrongly included $12,244 in payment-for-order-flow receivables and the $125,000 Firm B deposit, which was encumbered on that date, in its net capital computation.

(d) On September 30, 1996, Firm A had a net capital deficiency of $136,289. Firm A continued to fail to book its lease liability, the two Bank 1 loans, and a $32,335 American Express bill. Firm A also continued to include as an asset in its net capital computation the encumbered $125,000 Firm B deposit.

[5]The record does not specifically indicate why Staff calculated Firm A's net capital on the basis of a $5,000 net capital requirement, but the Firm on those dates was acting solely as an introducing broker-dealer. See SEC Rule 15c3-1(a)(2)(vi). Nonetheless, the terms of Firm A's restrictive agreement required the Firm to maintain a minimum net capital of $100,000 on those dates.

[6]In addition, the Staff increased the Firm's total assets by adding in the furniture and equipment as assets and adjusted the Firm's liabilities by including the principal balance of the lease. The adjustment that affected the Firm's net capital computation, however, was the non-allowance of one-half of the amount of the capitalized lease liability, which equaled $29,653.

As the SEC has often stated, "[t]he net capital rule is designed to ensure liquidity. A broker or dealer must have sufficient assets that are readily convertible to cash to cover its indebtedness to customers and other broker-dealers in case of financial difficulty." James S. Pritula, supra. See also In re Lowell H. Listrom, 50 S.E.C. 883, 886 (1992) ("The primary purpose of Rule 15c3-1 is to ensure that broker-dealers have sufficient net capital to protect the assets of customers and to meet their responsibilities to other broker-dealers."), aff'd, 975 F.2d 866 (8th Cir. 1992). The record demonstrates that Firm A operated with insufficient capital on May 31, June 28, July 31, and September 30, 1996.

We next consider the responsibility of Respondent 1 and Respondent 2 for these net capital deficiencies. We find, based on our review of the evidence, that Respondent 1 is liable for all of the deficiencies. Before the Hearing Panel, Respondent 1 accepted full responsibility for the violations alleged in the complaint (with the exception of the failure-to-respond violation, cause nine). He nonetheless argued to the Hearing Panel that he was not responsible for the Firm's net capital compliance because "the functions of financial record keeping and accounting were not a part of [his] duties, and [he] did not perform them."

As Firm A's Chairman and Executive Representative located in Firm A's main office, Respondent 1 was admittedly responsible for the Firm's administration and operation and "the other aspects of regulatory (sic) and compliance."[7] He was also the Firm's compliance officer. Respondent 1 testified that Firm A "was ultimately my firm anyway, and so I did both production and the administration and compliance." The SEC has long held that "[t]he president of a corporate broker-dealer is responsible for compliance with all of the requirements imposed on his firm unless and until he reasonably delegates particular functions to another person in that firm, and neither knows nor has reason to know that such person's performance is deficient." See, e.g., In re William H. Gerhauser, Sr., Exchange Act Rel. No. 40639 at p. 9 (Nov. 4, 1998).

Respondent 1 ostensibly delegated financial compliance responsibilities to Respondent 2. Respondent 1, however, either knew or had reason to know that Respondent 2 could not perform his duties adequately because Respondent 1 withheld critical information from Respondent 2 concerning the Firm's financial obligations. For example, in September 1995, Respondent 1 borrowed $50,000 on behalf of the Firm. Respondent 1 failed to disclose the existence of this loan either to Respondent 2 or Firm A's auditors from November 1995 through November 1996. As of January 31, 1996, the principal balance of the $50,000 loan was $47,000. Even when Staff specifically asked Respondent 1 in November 1996 whether there were any liabilities that he had not yet disclosed, he failed to disclose the existence of this loan. On December 12, 1996, Respondent 1 replaced the $47,000 note with a $50,000 revolving line of credit, but he did not tell Respondent 2. Respondent 2 did not learn of the loan until it was discovered by Firm A's auditors during the Firm's audit for the period ending December 31, 1996. In correspondence to Staff in May 1997, Respondent 1 represented to Staff that he did not consider the loan to be a Firm liability.

[7]We have also considered Respondent 1's contention that the Firm President, as 49 percent owner and President and Treasurer of the Firm until October 1996, must bear some responsibility. We note, however, that the former President was not named in the complaint. Accordingly, we have not considered what, if any, responsibility she bears for the violations at issue.

Respondent 1 also knew that he did not have sufficient funds in his personal checking account on May 31, 1996, to cover the $65,000 check that he deposited into Firm A's account on that date. Respondent 1 testified that he asked the bank to pay the check pending receipt of funds. The bank not only did not cover the check, it sent Firm A a "non-sufficient funds" notice. Respondent 1 told none of this to Respondent 2, and he allowed Respondent 2 to include the $65,000 in the Firm's net capital computation as of May 31, 1996.

In January 1996, Respondent 1 entered into an agreement with Bank 2 on behalf of Firm A to lease office furniture and equipment. Pursuant to this agreement, Respondent 1 executed a lease payment schedule in May 1996, creating a principal balance of $59,126. Respondent 1 concluded that the lease did not have to be capitalized, and he did not inform Respondent 2 of the lease arrangements. Instead, Respondent 1's Mother faxed Respondent 2 a bank debit memo that said "Rent furniture and fixtures," and Respondent 2 continued to treat the monthly payments as rent until Staff showed him a copy of the lease, at which time Respondent 2 agreed that the lease should be capitalized.

We now address Respondent 2's responsibility for Firm A's May 31, June 28, July 31, and September 30, 1996 net capital violations. A FINOP's responsibilities are established in Membership and Registration Rule 1022(b). Respondent 2's responsibilities were not modified or changed in any way because he worked for Firm A off-site and on a part-time basis. The duties and responsibilities of a FINOP set forth in Rule 1022(b) apply to all FINOPs, regardless of whether they are employed on-site or off-site and whether they work full-time or part-time.

Under Rule 1022(b), a FINOP is charged with the member firm's compliance with all applicable financial reporting and net capital requirements, including final preparation of such reports; supervision of individuals who assist in the preparation of such reports; 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; supervision and/or performance of the member's responsibilities under all financial responsibility rules promulgated pursuant to the provisions of the Securities Exchange Act of 1934; overall supervision of and responsibility for the individuals who are involved in the administration and maintenance of the member's back office operations; and any other matter involving the financial and operational management of the member. Further, a FINOP is responsible for the accuracy of financial reports submitted to any duly established securities industry regulatory body. James S. Pritula, supra, at 6 n.13 (FINOP responsible for ensuring his firm's net capital compliance).

Once an individual agrees to serve as a firm's FINOP, and for as long as he retains that position, he is responsible for carrying out the duties and obligations of a FINOP as described in Rule 1022(b). In re Gilad J. Gevaryahu, 51 S.E.C. 710 (1993) (finding that part-time FINOP was responsible for carrying out his attendant duties and obligations for as long as he retained that position, notwithstanding that he maintained his own practice and worked for the firm only on a part-time basis). See also In re George Lockwood Freeland, 51 S.E.C. 389 (1993) (same); In re Wallace G. Conley, 51 S.E.C. 300 (1993) (same).

Further, a FINOP is responsible for the accuracy and timeliness of all reports regardless of whether the president or owner of the firm is cooperative. In George Lockwood Freeland, supra, the FINOP denied responsibility for various net capital and reporting violations on the basis that the firm's president had prevented him from performing his duties by refusing to provide information that he needed to do his job. The Commission found that "[e]ven if [the president] did not cooperate with Freeland, Freeland was responsible as FINOP for the Firm's compliance with applicable financial reporting and net capital requirements." Id. at 392. A FINOP is required to insist on his employer's cooperation and compliance with applicable requirements or resign. Id. Thus, as long as Respondent 2 remained Firm A's FINOP, he was responsible for the performance of his duties. See also Wallace G. Conley, supra (incorrect instructions from firm's president do not relieve FINOP of his responsibilities). Moreover, a FINOP's duty to assure compliance with net capital requirements is particularly important, and a FINOP must pay even greater attention, when, as in the instant matter, the firm has been experiencing financial difficulties and is operating close to permissible limits. See George Lockwood Freeland, supra; Wallace G. Conley, supra; and In re Hutchison Financial Corporation, 51 S.E.C.398 (1993), aff'd, 22 F.3d 846 (9th Cir. 1993).

Thus, Respondent 2 cannot limit his obligations as Firm A's FINOP by claiming that he was not Firm A's Chief Financial Officer, that he did not have any management responsibility or authority, that the terms of his contract with Firm A limited his responsibilities, or that Respondent 1 did not cooperate with him. A FINOP is responsible for knowing the net capital rule and for applying its provisions properly regardless of whether he or she is a full-time on-site employee, and regardless of whether the president and/or owner of the firm cooperates. Nevertheless, under the particular facts and circumstances before us, we have concluded that Respondent 2 should not be held responsible for certain of the incorrect net capital calculations.[8]

At the outset, we note that Respondent 2 showed a commitment to report all assets and liabilities correctly, regardless of the effect on the Firm's ability to remain in capital compliance, and that after the November 1996 meeting with staff, Respondent 2 made every effort to correct all of the deficiencies pointed out by Staff. We are cognizant of the fact that notwithstanding what the president of a firm may tell the FINOP, the FINOP has an obligation independently to review the underlying documentation to determine whether a liability exists. William H. Gerhauser, supra, at 16 n.40. Nevertheless, we find that Respondent 1's withholding of information regarding certain significant liabilities, which, if reported, would have placed the Firm in net capital deficiency, literally made it impossible for Respondent 2 to discover and report those liabilities.[9]

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[8]We distinguish the facts in this case from the facts in Gilad J. Gevaryahu, supra, in which the FINOP was held responsible for a net capital violation. In that case, the FINOP was aware that a substantial liability that recurred monthly was being omitted from the firm's financial statements and that the creditor had demanded payment of that item. The FINOP made no effort to investigate the matter further or obtain supporting documentation, even though he knew that including this item would have caused a net capital deficiency. Instead, he accepted the word of the firm's president that there was no liability. The FINOP complained that his relationship as a part-time FINOP was an "inherently weak one," since he got most of his information "second hand," but the SEC found that the FINOP's action "amounted to a total abdication of his responsibilities as FINOP." Id. at 4-5.

[9]During the appeal hearing, Respondent 1 attempted to introduce hearsay testimonial evidence regarding Respondent 2's knowledge of certain loans. Respondent 1 failed to request prior to the appeal hearing that the

Specifically, we find that Respondent 2 was not responsible for the failure to report the $47,000 Bank 1 loan. Respondent 1 concealed the existence of this loan not only from Respondent 2, but also from the accountants who performed the Firm's audit for the 1995 fiscal year. Moreover, Respondent 1 failed to disclose the existence of the loan when asked by Staff at the November 16 meeting whether Firm A had any additional liabilities. We do not believe that Respondent 1's failure to report the loan to Staff was an oversight, since he renegotiated the loan only a few weeks later. When Firm A's auditors reported the loan to Respondent 2 in 1997, Respondent 2 reported it immediately to the NASD .

We also do not hold Respondent 2 responsible for misreporting Respondent 1's $65,000 check as good capital as of May 31, 1996. There is no way that Respondent 2 could have known on May 31 that the check was not good capital. Respondent 1 purposefully did not tell Respondent 2 on May 31, 1996, that he did not have sufficient funds in his personal account to cover the check. Respondent 1 decided on his own that because he could cover the check and redeposit it on June 5 that it was "good capital" as of May 31. So, on June 14, when Respondent 2 was given information to prepare the May 1996 financials, he was neither told about the bounced check nor given the notice from the bank showing that the check had bounced. Respondent 2 submitted the Firm's financial statements on June 17, based on bank statements dated May 31, 1996, which did not reflect the June transactions. When Respondent 2 accidentally discovered the insufficient funds notice from the bank on Respondent 1's Mother's desk on June 18, he immediately reported the deficiency to Staff.

We also do not hold Respondent 2 responsible for incorrectly reporting the $125,000 in Firm A's Firm B account as good capital in July and September 1996, because he did take steps to document with Firm B that the deposit was good capital. Specifically, Respondent 2 spoke to an individual at Firm B, who told Respondent 2 that the money had come from Employee 1 and who faxed him an internal Firm B statement showing that $125,000 had been deposited in an HKS account. Respondent 2 also asked for copies of all of the new account documents, but he never received them. When Staff inquired about the loan in August 1996, Respondent 2 sent Staff a copy of the statement he had received from Firm B. Because Respondent 2 never received the new account documents from Firm B, he did not see the signature card bearing Employee 1's name until it was shown to him at the hearing below. We find that Respondent 2 made a good faith effort to confirm the deposit by speaking to a Firm B representative and requesting supporting documentation, and that he had no reason to believe that the account was encumbered.[10]

We do hold Respondent 2 responsible for his failure to report and include in his net capital calculations the $60,000 non-recourse loan (paid down to $49,473) on June 28, July 31, and September 30, 1996. Firm A expected to receive the final Clearing Firm 1 receivable at the end of May 1996. This receivable, which collateralized the loan, was to have been used to pay off the loan.

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individuals who purportedly had such knowledge be permitted to testify. The Subcommittee determined that it would not consider such evidence, and we affirm that determination.

[10]We note on the signature card that the initials "[Respondent 1’s initials]" were signed under Employee 1’s name. Respondent 1 disputed that the initials were in his handwriting; nevertheless, he admitted having seen the document before.

When the $65,000 receivable had not arrived by May 31, Respondent 1 wrote a check for that amount from his personal account, hoping that the receivable would arrive in time to cover his check. When the receivable arrived on June 4, Respondent 1 used it to cover his check, which he used, not to pay off the loan, but to pay other Firm obligations.

Respondent 2 was aware of the $60,000 non-recourse loan and had booked it as a liability from February through May 1996,[11] but he failed to record the $49,473 remaining balance as a Firm liability on its financial statements submitted to the NASD for the months of June through September 1996. Respondent 2 knew that Clearing Firm 1 had wired the $65,000 receivable directly to Firm A, rather than the bank. Thus, the loan could only have been paid off if Firm A wired the funds or wrote a check to Bank 1. Respondent 2 neither asked for nor was given any documentation that Firm A paid off the loan. Instead, Respondent 2 relied on a verbal representation from Respondent 1 that Respondent 1 had paid off the loan on June 5, 1996. When Firm A borrowed $125,000 from Employee 1, Respondent 2 credited $65,000 of that sum on Firm A's books as a return of Respondent 1's $65,000 advance.

Respondent 2 had no basis to discontinue booking the loan. He relied solely on Respondent 1's representation to him that the loan had been repaid, and he failed to request and review documentation that the loan had been repaid. As a result, Respondent 2 failed to report the outstanding $49,473 balance on the loan as a liability on June 28, July 31, and September 30, 1996. When Respondent 2 learned the truth, he re-entered the liability on the Firm's books and records.

We also hold Respondent 2 responsible for the failure to capitalize the Bank 2 lease, a liability of approximately $59,000. Respondent 1 decided on his own that the lease did not have to be capitalized because he considered it a "rental agreement." When Respondent 2 asked Respondent 1 for supporting documentation regarding the monthly payments, Respondent 1's Mother gave him only monthly bank debit memos that reflected "rental payments" to Bank 2 for furniture and fixtures. Respondent 2 should not, however, have relied merely on debit memos. He should have asked to see the underlying loan documents themselves. We believe he would have properly capitalized the lease had he seen the underlying documentation, because when Staff showed him the lease in November 1996, Respondent 2 agreed with Staff that it should be capitalized. Respondent 2 testified: "After I reviewed the documents, I saw that it was a bargain purchase of a dollar at the end. According to [GAAP] accounting, it should be capitalized."

We also hold Respondent 2 responsible for incorrectly booking payment- for- order-flow receivables as allowable assets. In June 1996, Staff advised Respondent 2 that payment-for-order-flow receivables were unsecured and, therefore, were not allowable. Respondent 2testified that he was confused about it at the time and was still confused about it. Nonetheless, after June 1996, Respondent 2 ceased to book Trade Tech rebates as allowable assets. Starting in May 1996, Clearing Firm 2 changed its clearing arrangement with Firm A, recharacterizing the payments as "give-ups," and Respondent 2 incorrectly continued to book those amounts as allowable assets until NASD Regulation staff advised him to cease the practice some months later. We find that Respondent 2 was on notice

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[11]Respondent 2overstated the outstanding loan balance in February and March 1996 by approximately $10,000.

that payment-for-order-flow receivables were not allowable assets. The new arrangement with Clearing Firm 2 merely recharacterized those payments. Respondent 2 should, therefore, have reviewed the Clearing Firm 2 arrangement with Staff to determine whether those payments were allowable.

We further find that Respondent 2 incorrectly failed to book amounts owed to American Express on Firm A's account. There was no uncertainty that these liabilities had been incurred on Firm A's corporate account and had not been timely repaid by the individuals who incurred the charges.

Firm A's restrictive agreement required the Firm to maintain $100,000 minimum net capital. For purposes of this action, however, Staff calculated the Firm's net capital requirement at $5,000, since it was acting solely as an introducing broker on the dates alleged in the complaint. We find that Respondent 2 was not responsible for causing the Firm's net capital deficiency on May 31, 1996. On that date, Respondent 2 misreported the $47,000 Bank 1 loan and Respondent 1's $65,000 bounced check, for which we have found he was not responsible. Although Respondent 2 made other errors on that date, it was Respondent 1's concealment of these items that caused the Firm's net capital deficiency. Further, because we do not hold Respondent 2 responsible for misreporting the Firm B account and the $47,000 Bank 1 loan, we also find that he was not responsible for causing the Firm's net capital deficiency on July 31 and September 30, 1996. We do, however, hold Respondent 2 responsible for the Firm's operating below its $5,000 minimum net capital requirement on June 28, 1996. Respondent 2's misreporting of Firm A's $7,774 American Express bill, $59,126 lease liability, $49,473 sole-recourse loan, and $5,963 in payments-for-order-flow on June 28, 1996, were sufficient to cause a net capital deficiency on that date.

<u>Causes Three and Four.</u> We find that Firm A, acting through Respondent 1 and Respondent 2, failed to comply with Exchange Act Rule 17a-3, as alleged in cause three, in that it prepared inaccurate general ledgers, trial balances, and net capital computations for the 20 months ended November 30 and December 29, 1995; January 31, February 29, March 29, April 30, May 31, June 28, July 31, August 30, September 30, and November 29, 1996; and January 31, February 28, March 31, April 30, May 30, June 30, July 31, and August 29, 1997, in violation of Conduct Rules 2110 and 3110.

We also find as to cause four, that Firm A, acting through Respondent 1 and Respondent 2, failed to comply with SEC Rule 17a-5, in that it filed inaccurate FOCUS IIA filings for the six calendar quarters ended December 29, 1995; March 29, June 28, and September 30, 1996; and March 31 and June 30, 1997, in violation of Conduct Rule 2110. These filings were inaccurate as a result of the Firm's inaccurate general ledger, trial balances, and net capital computations.

Firm A's inaccurate books and records and inaccurate FOCUS IIA reports reflected the undisclosed liabilities and non-allowable assets discussed in reference to cause one as well as the following debts to vendors, which were not recorded timely on Firm A's financial statements in 1997:

(a) Bloomberg L.P. ("Bloomberg") billed Firm A for unpaid balances in the months of January through August 1997 in the amounts of $6,855.38, $13,787.78, $13,787.78, $13,787.78, $20,720.18, $20,720.18, $20,720.18, and $27,938.93, respectively.

(b) Transworld Systems, Inc., a collection agency, sent a written notification to Firm A in August 1997, stating that Firm A owed Vedder Price Kaufman, a law firm, $6,928.45.

(c) In August 1997, Firm A received an invoice from MidCom, a telecommunications company, for $888.56 for services provided to Firm A in July 1997. In September 1997, Firm A received an invoice from MidCom for $2,321.03, which included the prior unpaid balance of $888.56 and $1,432.47 for services provided in August 1997. Firm A failed to record the $2,321.03 on its August 1997 financial statements submitted to NASD Regulation.

(d) As of August 1997, Firm A owed $5,143.95 to United Parcel Service ("UPS"). Firm A failed to record this balance on its August 1997 financial statements submitted to NASD Regulation.

We find that Respondent 1 is responsible for the violations alleged in causes three and four. Respondent 1 caused the inaccuracies in Firm A's books and records and FOCUS reports by withholding pertinent materials from Respondent 2 and by refusing to address problems that Respondent 2 brought to his attention. For example, when Respondent 2 came to Respondent 1 in 1997 and told him that he would not be able to prepare FOCUS reports any more because he and the accountant Respondent 1 hired in January 1997 ("the Accountant"), did not agree on how certain payables should be booked, Respondent 1 chose not to get involved. He testified: ". . . I had to ultimately go in and talk to them, but the reality of it was you guys are both CPAs. Figure this out. Why do I got (sic) to get involved here." Thus, whether or not Respondent 1 hid liabilities from Respondent 2, or merely chose not to get involved in the accurate reporting of Firm A's liabilities, he is nonetheless responsible because he knew that Respondent 2 did not have accurate information and he chose not to get involved.

As alleged in cause three, we find that Respondent 2 is responsible for the books and records violations that occurred in 19 of the months, i.e., on November 30 and December 29, 1995; January 31, February 29, March 29, May 31, June 28, July 31, August 30, September 30, and November 29, 1996; and January 31, February 28, March 31, April 30, May 30, June 30, July 31, and August 29, 1997. We dismiss the finding that he was responsible for the April 30, 1996 violation. On April 30, the only inaccuracy was the failure to report the $47,000 Bank 1 loan, for which we have not held Respondent 2 responsible.

As Firm A's FINOP, Respondent 2 was responsible for keeping accurate books and records. Except for the alleged April 30, 1996 violation in cause three, his errors, whether or not material enough to cause the Firm to operate without sufficient net capital, caused the Firm's financial documents to be inaccurate. As the SEC stated in In re Palm State Equities, Inc., 52 S.E.C. 333 at 7 (1995):

> Exchange Act Rule 17a-3 requires that a broker-dealer keep and maintain current books and records. It does not permit a broker-dealer to avoid this requirement merely because, in retrospect, the resulting adjustments prove to be immaterial. Simply put, until the actual reconciliation is performed, the broker-dealer cannot know whether any resulting adjustment will be material.

Thus, although we find that Respondent 2 was not responsible for failing to report certain liabilities in 1995 and 1996, we find, as demonstrated in the record, that on each date alleged in cause three, except for April 30, 1996, Respondent 2 made certain reporting errors, and that these errors caused him to file inaccurate FOCUS reports. These errors include inaccurate reporting regarding payments for order flow (November 30 and December 29, 1995 and January 31, February, March 29, May 31, July 31, and August 30, 1996); taking the $60,000 sole-recourse loan off the books (January 31, 1996); overstating the sole-recourse loan (February 29 and March 29, 1996); misreporting a deposit in transit (February 29, 1996); misreporting underwriting receivables (March 29, 1996); and failing to report Firm A's American Express liability (May 31, June 28, July 31, August 30, and September 30,1996). We also find Respondent 2 responsible for failing to report numerous unbooked liabilities from Bloomberg, Vedder Price Kaufmann, MidComm, and UPS as of month-end from January 1 through August 29, 1997.

The record shows that Respondent 2 knew that he was not getting accurate information from Any in 1997. When asked: "Did you have any trouble getting documents from the Accountant to prepare the FOCUS reports?" Respondent 2 responded: "Yeah. I got his financials, but they would never give accounts payable detail which I asked him about every month." Respondent 2 testified that the Accountant was too busy and Respondent 1 was out of town, so he "would book manually based off of Peter Any's calculations and then add to the FOCUS report and try to do things as accurate as possible." Respondent 1 testified that Respondent 2 complained to him that his differences with the Accountant as to how payables should be booked were having an impact on his ability to prepare FOCUS reports.

Cause Two. We find that, as alleged in cause two of the complaint, Respondent 1 is responsible for Firm A's failure to abide by the Firm's restrictive agreement, which required Firm A to maintain a minimum net capital of $100,000 in accordance with the requirements of SEC Rule 15c3-1(a)(2)(iii), in violation of Conduct Rule 2110. Firm A failed to maintain the required net capital on November 30 and December 29, 1995; January 31, February 29, March 29, April 30, May 31, June 28, July 31, August 30, September 30, and November 29, 1996. Although Firm A calculated its net capital at between approximately $119,000 and $150,000 during the months alleged, the Firm, in fact, had incorrectly booked assets, incorrectly included certain items as assets, or failed to record certain liabilities, which brought the Firm's net capital below the required $100,000 on the dates alleged.

Cause Five. We find that, as alleged in cause five, Respondent 1 caused Firm A to conduct a municipal securities business while failing to employ a properly qualified and registered municipal securities principal. MSRB Rule G-3(ii)(D) provides that an individual who is qualified as a general securities representative or general securities principal is not required to have taken and passed the Municipal Securities Principal Qualification Examination ("Examination") prior to being qualified as a municipal securities principal for the first 90 days after becoming a municipal securities principal, provided that such person takes and passes the Examination within that period.

The following facts are undisputed. Employee 2, Firm A's registered municipal principal, terminated her registration with Firm A on June 6, 1997. Respondent 1 assumed that responsibility, but he was not registered as a municipal principal on that date. As provided in MSRB Rule G-3(ii)(D), Respondent 1 had 90 days -- until September 5, 1997 -- to take and pass the Examination, during which time he could act as a municipal securities principal. Respondent 1 did not become registered as a municipal securities principal until October 1997, nor did Firm A employ a registered municipal securities principal between June 6 and October 1997.

On September 1, 1997, Firm A participated as a co-manager in the City of Chicago Water Revenue Bonds ("Chicago") offering. The date of issue of the bonds was September 1, 1997; the date of the prospectus was September 10, 1997; and the bonds were delivered on September 24, 1997. Firm A made five sales of the bonds on September 11, 12, 15, 16, and 18. Therefore, Firm A, acting through Respondent 1, conducted a municipal securities business on September 11, 12, 15, 16, and 18, 1997, while failing to employ a properly qualified and registered municipal securities principal in violation of MSRB Rule G-2. We reverse the finding as to the September 1, 1997 violation, on the basis that Respondent 1 was allowed to act as a municipal securities principal until September 5, 1997.

Cause Six. We find that, as alleged in the complaint, Respondent 1 acted in the capacity of a municipal securities principal of Firm A on September 11, 12, 15, 16, and 18, 1997, notwithstanding that he did not register as a municipal securities principal until October 1997. Staff had advised Respondent 1 that Firm A could not conduct a municipal securities business after September 6 without a registered municipal securities principal. We find no merit in Respondent 1's contention that he believed that he was properly acting as a municipal securities principal because the date of issue of the Chicago bonds was September 1, 1997, within 90 days of Employee 2's resignation. The Chicago bond deal did not close until the end of September, and Firm A continued to sell the Chicago bonds between September 11 and 18 without a registered municipal securities principal.

Cause Seven. We find that, as alleged in cause seven, Respondent 1 caused Firm A to conduct a securities business from September 15 through November 19, 1997, while failing to employ two properly qualified and registered general securities principals, in contravention of Membership and Registration ("Registration") Rule 1021(e) and in violation of Conduct Rule 2110. Registration Rule 1021(e) requires each applicant for membership in the Association, except a sole proprietorship, to have at least two officers or partners become registered as principals with respect to each aspect of the applicant's investment banking and securities business. Rule 1021(d)(1) gives any registered representative whose duties are changed by his firm so as to require registration in any principal classification 90 calendar days to become so registered.

On June 16, 1997, Employee 3, a general securities principal for Firm A, terminated his registration with the Firm. This left Firm A with Respondent 1 as the sole general securities principal. Respondent 1 was thus required either to hire an additional principal or to require a registered representative to qualify as a principal within 90 days. Respondent 1 was Firm A's sole principal during those 90 days, from June 16, 1997 until September 15, 1997, and he continued to function as Firm A's sole registered principal until November 11, 1997, when Employee 3 returned to the Firm.

Respondent 1 argued that he believed that Firm A's FINOP could serve as the Firm's second general securities principal and that he sought clarification on this issue from the Staff. Staff responded that Firm A was in violation of the two-principal rule from June 16, 1997 until November 11, 1997. We do not credit Respondent 1's contention that he misunderstood the parameters of a FINOP's function. Membership Rule 1022 clearly sets forth the parameters of a FINOP's responsibilities. Rule 1022(b) makes clear that the duties and powers of a FINOP relate to a member firm's financial and operational management. Rule 1022(b)(5) provides that a person registered as a FINOP "shall not be qualified to function in a principal capacity with responsibility over any area of business activity not prescribed in" Rule 1022(b)(2). Rule 1022(b)(2) clearly states that a FINOP who is not otherwise registered as a general securities principal is limited to those activities described in that Rule. See In re Harry Gliksman and William J. Gallagher, Exchange Act Rel. No. 42255 at 13 (Dec. 20, 1999) (noting that Rule 1022(b)(5) states that a person registered as a FINOP "shall not be qualified to function in a principal capacity with responsibility over any area of business activity not prescribed in" Rule 1022(b)(2)).

Cause Eight. We find that Respondent 1 failed to employ a FINOP from January 22, 1998 through February 9, 1998, as required by Registration Rule 1022(b), in violation of Conduct Rule 2110. Rule 1022(b) requires every member of the Association, unless exempted, to designate a FINOP. Firm A was not exempted from that requirement. Respondent 2 was Firm A's FINOP from August 1995 until he terminated his employment with Firm A on October 23, 1997. Firm A then had 90 days in which to hire a FINOP, and the Firm failed to do so. Accordingly, Firm A failed to have a properly qualified and registered FINOP from January 22 through February 9, 1998, when the Firm's membership was terminated. Although Respondent 1 contended that Firm A was essentially out of business during that time, he had not yet filed the Firm's Uniform Request for Broker-Dealer Withdrawal ("Form BDW"); therefore, Firm A was not excused from the requirement to employ a FINOP during that time.

Cause Nine. The Staff sent Respondent 1 Rule 8210[12] requests on November 13, 1996, and August 15, August 25, September 3, and September 25, 1997, requesting that he provide, on behalf of Firm A, certain documents and information. Each of these requests was properly served on Respondent 1, and Respondent 1 admitted that he received each of these requests. We find that Respondent 1 failed adequately and completely to respond to each of the requests for documents and information as alleged, in violation of Conduct Rules 8210 and 2110.

November 13, 1996 Request. In this letter, the Staff asked Respondent 1 to meet at an NASD District Office the following day and to bring with him all bank statements/reconciliations, clearing account statements/reconciliations, and Firm A's most current statements from all creditors, including the Bank 2 lease, the American Express bills, and the $60,000 Bank 1 loan. In addition, Staff asked Respondent 1 to bring "all documents necessary to compute an accurate net capital computation as of November 14, 1996." In a meeting with Staff on November 15, 1996, Respondent 1 provided information concerning the Bank 2 lease, the American Express bills, and the $60,000 recourse loan.

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[12]Rule 8210, among other things, gives Staff the right to require a member or person associated with a member to provide information and to inspect and copy the books, records, and accounts of such member or person with respect to any matter involved in an investigation or examination.

Respondent 1 did not disclose the existence of the second Bank 1 loan, which had an outstanding balance of $47,000.

August 15, 1997 Request. In this letter, Staff asked Respondent 1 to provide principal account statements and firm account statements provided to Firm A by his clearing firm(s) from November 1, 1995 through November 29, 1996, indicating any and all transactions in which Firm A acted in a risk-based, principal capacity; firm account statements provided to Firm A by its clearing firm from November 1, 1995 through November 29, 1996; the American Express contract/agreement and the opinion from counsel regarding the American Express liabilities; Firm A agreements with Clearing Firm 2; personal guarantees on the $60,000 sole-recourse loan and an explanation as to why this liability was taken off the Firm's books in January 1996 and subsequently put back on the Firm's books in February 1996; and Firm A's original net capital computation, trial balance, balance sheet, general ledger, and general journal for the last business day of the months of November and December 1995 and January through November 1996. No date was given by which Respondent 1 was required to respond.

August 25, 1997 Request. When Respondent 1 did not respond to the August 15 letter by August 25, Staff sent him a follow-up letter advising him that Staff had not received the information requested in the August 15 letter, and giving him until August 29, 1997 to respond.

September 3, 1997 Request. This letter advised Respondent 1 that Staff had not received the information requested in the August 15 letter, and gave him until September 10, 1997 to respond.

Respondent 1 responded to the August 15 letter on September 10, 1997. Respondent 1 responded to all seven questions, but he did not provide all of the requested information. Respondent 1 responded that Firm A had already supplied Staff with copies of all firm account statements from Firm A's clearing firm for the period indicated, as well as Firm A's original net capital computation, trial balance, balance sheet, general ledger, and general journal for the last business day of the months of November and December 1995 and January through November 1996. An NASD Regulation Compliance Examiner testified, however, that Respondent 1 had previously provided payout calculations evidencing the commissions receivable from the clearing firm, but not the back-up documentation showing transactions and dates of transactions. As to the request for American Express documents, Respondent 1 responded that Firm A did not have a "contract/agreement" with American Express when, in fact, there was such an agreement.

September 25, 1997 Request. The Compliance Examiner testified that Firm A's creditors had complained to NASD Regulation, and he was looking for documentation of those liabilities, which Respondent 1 had never reported. Accordingly, the Complinace Examiner's September 25 letter asked Respondent 1 to provide invoices, correspondence and/or bills relating to its accounts with Bloomberg, UPS, MidComm, MCI, and Vedder Price Kaufman. In addition, Staff asked for Firm A's telephone lease agreements, tax return for the year ended March 31, 1997; supervisory procedures manual; checks receipt and delivery blotter and securities receipt and delivery blotter; trial balance, balance sheet, and net capital computations for the period January through August 1997 with back-up documentation for all allowable assets and liabilities; sales literature, brochures, and advertising used from January 1996 through the present; order tickets, confirmations, and trade blotters for all trades executed during September 1997; a list of all current registered and unregistered employees and associated persons; and a list of all underwritings in which the Firm participated from October 1995 to the present. The letter also asked for a written statement indicating the name of the last individual employed by the Firm, other than Respondent 1, who was registered as a general securities principal, and the action the Firm was taking to comply with the requirement to employ two general securities principals.

Respondent 2 sent the Compliance Examiner a letter via facsimile on September 25, 1997, in which Respondent 2 stated that he had paged Respondent 1 and had spoken with representatives of Firm A, who told him that the Bloomberg invoices had been paid and that the information in the Compliance Examiner's September 25 letter was "wrong or exaggerated."

On September 30, 1997, the Compliance Examiner sent a second request to Respondent 1 for the Bloomberg, UPS, MidComm, MCI, and Vedder Price Kaufman documentation. On October 3, Respondent 1 responded to the September 25 letter, indicating the outstanding balances on the accounts in question, and also stating that the Complianace Examiner had already been given certain other documents during a visit to Firm A's office. Respondent 1 failed to provide UPS documentation as well as one MidComm invoice.

Accordingly, we find that the evidence fully supports a finding that Respondent 1 failed adequately and completely to respond to each request for information as alleged.

<u>Cause Ten.</u> In a letter dated February 10, 1997, Staff advised Respondent 1 that based upon the NASD's current investigation into his activities while employed at Firm A, he was required to answer "yes" to the question on the Form U-4 asking whether he had been notified in writing that he was the subject of an investigation that could result in findings being entered against him and to complete a Disclosure Reporting Page ("DRP"). Staff stated that a review of the Form U-4 recently processed by the Central Registration Depository ("CRD") indicated that he had failed to answer "yes" to this item and failed to complete a DRP disclosing the investigation. By letter dated February 23, 1998, Respondent 1 directed all further inquiries relating to Firm A to his attorney. By letter dated March 3, 1998, Staff advised Respondent 1 that he had still not updated his Form U-4 to reflect the NASD's investigation and, pursuant to Rule 8210, asked Respondent 1 to explain why he had not done so. Respondent 1 amended his Form U-4 on March 16, 1998 to reflect the NASD's investigation. Respondent 1 testified that he made full disclosure of "exactly what had transpired" to his new firm, but he maintained that he had not received any correspondence from the NASD that stated that he was under formal investigation.

Form U-4 instructions define the term "investigation" as including "NASD Regulation, Inc. investigations after the "Wells" notice has been given <u>or</u> after a person associated with a member, as defined in the NASD By-Laws, has been advised by the Staff that it intends to recommend formal disciplinary action . . ." (emphasis added). A "Wells Submission" is the process by which NASD Regulation staff notifies a respondent that a recommendation of formal disciplinary charges is being considered, and gives the respondent the opportunity either to settle the matter or to submit a written statement explaining why such charges should not be brought. See Notice to Members 97-55 (Aug. 1997).

In this case, Staff sent Respondent 1 a "Wells" notice on January 12, 1998. This letter informed Respondent 1 that Staff was considering recommending formal action, described the proposed causes of action, and gave Respondent 1 an opportunity to respond. Accordingly, Respondent 1 was required to report on his Form U-4 that he was the subject of an investigation. In failing to do so, Respondent 1 violated Conduct Rule 2110.

Sanctions

After considering all of the facts in this matter, we impose the following sanctions. As to Respondent 1, we bar him in all principal, supervisory, and proprietary capacities. We set aside the requalification requirement imposed by the Hearing Panel, reduce the two-year suspension in all capacities to six months, and reduce the $250,000 fine to $10,000. As to Respondent 2, we impose a $5,000 fine and set aside the 30-day suspension imposed by the Hearing Panel.

Respondent 1 was Firm A's Chairman, Secretary, and 50-percent owner, and the person responsible for the Firm's operations and compliance. The Commission has previously held that "[o]fficers of securities firms bear a heavy responsibility in ensuring that the firm complies with all applicable rules and regulations . . . [including] the net capital requirements." William H. Gerhauser, Sr., supra, at 12 (citing Hutchinson Financial Corp., supra, at 403-04). Nevertheless, in his quest to keep Firm A open, Respondent 1 purposefully ignored myriad rules over an extended period of time. We find that Respondent 1's conduct makes him unfit to have a proprietary interest in a broker-dealer or to act in any principal capacity.

As early as July 1995, Respondent 1 withheld from Respondent 2 the fact that he had bounced a $25,000 check. During the Winter of 1995, Respondent 1 borrowed $50,000 on behalf of Firm A, which he neither reported on the Firm's financial statements nor disclosed to Respondent 2. Auditors discovered the loan during an audit in 1997. When Staff attempted in November 1996 to get an accurate picture of Firm A's financial status, Respondent 1 did not reveal that Firm A still owed $47,000 on that loan because, he testified, "They hadn't asked me." Respondent 1 wrote a personal check to Firm A for $65,000 on May 31, 1996, to keep the Firm in ostensible net capital compliance, knowing that he did not have sufficient funds in his account to cover the check. When Firm A received $65,827.30 in receivables from Clearing Firm 1on June 4, he used $65,000 of that amount to cover his check, notwithstanding that those funds had been pledged as collateral for one of Firm A's outstanding loans.

When Firm A's municipal principal resigned, Respondent 1 participated in a municipal securities offering, notwithstanding that he had not yet qualified as a municipal securities principal. When one of his principals left Firm A, he operated the Firm with only one principal, in contravention of the two-principal requirement. When Respondent 2 resigned, he operated without a FINOP. When Staff tried to ascertain the Firm's financial status, Respondent 1 did not respond timely and completely to Staff requests for information. Respondent 1 closed the Firm after Staff advised the SEC on January 28, 1998 that Staff was unable to determine Firm A's net capital position, and that Firm A was conducting a securities business despite being advised by Staff not to conduct a securities business while not in compliance with the net capital rule.

Respondent 1 also hindered Staff's attempts to ascertain Firm A's true financial condition by failing adequately and completely to respond to each of Staff's requests for documents and information. Respondent 1 did not disclose the Bank 1 loan when he met with Staff in November 1996, notwithstanding Staff's request that Respondent 1 bring to the meeting "all documents necessary to compute an accurate net capital computation as of November 14, 1996." Respondent 1 also failed to respond to an August 15, 1997 request for information until September 10, 1997, at which time he failed to include the American Express contract and certain requested documentation. As the SEC stated in In re Brian L. Gibbons, 52 S.E.C. 791, 794 (1996), aff'd, 112 F.3d 516 (9th Cir. 1997), a person associated with a member has a duty to give Staff "full and prompt cooperation when the request for information [is] made. Otherwise the NASD would be unable to carry out its regulatory functions."

The evidence is overwhelming that Respondent 1 flouted SEC and NASD rules repeatedly in order to keep Firm A in business. He withheld pertinent financial information from Respondent 2, Firm A's auditors, and NASD Regulation, and allowed Firm A to conduct a securities business while in net capital deficiency. Although there is no evidence that Firm A's customers suffered financial loss, Respondent 1's actions clearly subjected them to undue risk. As the SEC has stated, "[t]he exposure of customers to the risk posed by violations of the [net capital rule] is in itself the abuse at which the Rule is aimed." Townsley Associates & Company, Inc., supra. (citations omitted). Respondent 1's pattern of activity evidences his deliberate intent to conceal Firm A's financial condition from NASD Regulation. Respondent 1 has amply demonstrated that the preservation of his Firm was more important to him than compliance with applicable regulatory requirements.

Based on the foregoing, we conclude that Respondent 1 should be barred in all principal, supervisory, and proprietary capacities. We have also concluded that Respondent 1 should be additionally suspended in all capacities for his failure adequately and completely to respond to Staff requests for information. We have concluded, however, that a six-month suspension in all capacities, in addition to the bar in any principal or proprietary capacity, is sufficiently remedial to address this misconduct. We set aside the requirement to requalify by examination imposed by the Hearing Panel. Inasmuch as most of Respondent 1's misconduct took place in connection with his position as owner and principal of Firm A, we do not find it necessary to require Respondent 1 to requalify in a representative capacity. Based on Respondent 1's demonstrated inability to pay the full amount of the fine imposed below, we have also reduced the $250,000 fine to $10,000.

As to Respondent 2, we find that his misconduct warrants a $5,000 fine, but we set aside the 30-day suspension imposed below. In making this modification, we have considered that Respondent 2 generally made a good faith effort to report accurately, to keep Firm A in net capital compliance, and to keep the Firm from doing business when its net capital computation was in question. We have also considered that it was Respondent 2 who asked for a meeting with Staff in 1995 after Respondent 1's $25,000 check bounced. It was also Respondent 2 who, upon receipt of a letter from Staff in September 1997 stating that the Firm should not conduct a securities business until Respondent 1 could show that the Firm was in net capital compliance, instructed Firm A's clearing firm, Clearing Firm 3, to cease doing business with Firm A. Nonetheless, as Firm A's FINOP, Respondent 2 must be sanctioned for the violations for which he was responsible. As Firm A's FINOP, Respondent 2 had a duty to be "especially vigilant in ensuring compliance with the net capital rule," knowing as he did that Firm A was experiencing financial difficulties. James S. Pritula, supra, at 19. We have concluded that a $5,000 fine is an appropriately remedial sanction for these violations.

Accordingly, we bar Respondent 1 in all principal, supervisory, and proprietary capacities (including having any proprietary interest whatsoever in a broker-dealer), suspend him for six months in all capacities, fine him $10,000, and affirm the Hearing Panel's imposition of costs of $1,995.90 as to Respondent 1. The bar shall become effective as of the date of this decision. We fine Respondent 2 $5,000 and affirm the Hearing Panel's imposition of $665.80 in costs as to Respondent 2.[13]

On Behalf of the National Adjudicatory Council,

____

Alden S. Adkins, Senior Vice President and General Counsel

[13]The sanctions are within the ranges recommended in the applicable NASD Sanction Guideline. See NASD Sanction Guidelines ("Guidelines") (1996 ed.) at 27 (Net Capital Violations); 28 (Recordkeeping Violations); 31 (Failure to Respond); 42 (Member Agreement Violations); 43 (Registration Violations); 64 (FOCUS Reports); and 65 (Forms U-4/U-5).

We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

Pursuant to NASD Procedural Rule 8320, any member who fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.