BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of

District Business Conduct Committee For District No. 8,

Complainant,

VS.

Respondent 1,

Respondent.

DECISION

Complaint No. C8B970010

Dated: August 6, 1999

FINOP allowed firm to violate net capital rule, maintained inaccurate general ledger, and failed to evidence creation of trial balances. <u>Held</u>, findings affirmed, with modifications, and sanctions affirmed.

Respondent 1 has appealed a November 16, 1998 decision of the District Business Conduct Committee for District No. 8 ("DBCC"). After a review of the entire record in this matter, we affirm the findings of the DBCC that Respondent 1 allowed a member firm, Firm A (or the "Firm"), to fail to maintain its required net capital, failed to maintain an accurate general ledger, and failed to evidence creation of trial balances, in violation of Conduct Rule 2110. We affirm the DBCC's sanctions of a censure, a \$2,000 fine, the requirement to requalify by examination as a financial and operations principal ("FINOP"), and costs.

Background

Respondent 1 entered the securities industry in 1992. From April 3, 1996 to August 5, 1997, he was registered as a FINOP and a general securities representative with Firm A, and he was registered as a general securities principal of the Firm from May 20, 1996 to August 5, 1997. Respondent 1 is not currently associated with a member of the Association.

Respondent 1 was the only registered FINOP at KBC while he was associated with the Firm. He was also the Firm's Chief Financial Officer. Although Firm A offices were located in Cincinnati, Ohio, Respondent 1 worked in a separate office in New York City. As the Firm's FINOP, Respondent 1 was responsible for preparing the Firm's balance sheet and general ledger, and he was responsible for computing the Firm's net capital.

In September 1996, approximately five months after Firm A opened for business, staff from the NASD District No. 8 office conducted an on-site examination of the Firm. As part of the examination, NASD staff calculated the Firm's net capital and reviewed the Firm's general ledger and other books and records. As a result of this examination, the DBCC issued a complaint on May 30, 1997 that named the Firm and Respondent 1 as respondents. The Firm negotiated a settlement of the allegations with the NASD, and Respondent 1 proceeded to a hearing before a subcommittee of the DBCC.

Cause One: Firm A's Net Capital Deficiencies

The complaint alleged that Firm A had net capital deficiencies on four dates during which the Firm conducted a securities business.¹ Those dates were July 3, August 2, August 28, and September 4, 1996. The Firm's minimum net capital requirement for each of the four dates was \$5,000.

In conducting the examination, the NASD staff initially reviewed the Firm's records, including accrued expenses. The NASD staff then used those accrued expenses to adjust the liabilities section on the Firm's month-end net capital computations. Where the NASD staff determined that the Firm lacked sufficient net capital, they then reviewed KBC's business to determine if the Firm conducted a securities business at that time. For certain computations, the NASD staff went back days or weeks in order to find a day on which the Firm had conducted a securities business while maintaining insufficient net capital.

At the DBCC hearing, Respondent 1 claimed that on the first two dates, July 3 and August 2, 1996, the Firm actually had excess net capital. Respondent 1 conceded that the Firm was under the required net capital on the last two dates, August 28 and September 4, 1996, but he claimed that this was caused solely by the NASD's failure to approve a subordinated loan. The DBCC dismissed the allegation that the Firm had a net capital deficiency on August 2, 1996. The DBCC concluded, and we agree, that the evidence did not prove that the Firm conducted a securities business on that day. We will discuss the remaining three alleged net capital violations in chronological order.

July 3, 1996 Net Capital Deficiency. For July 3, 1996, the DBCC determined that Firm A had a net capital deficiency of \$1,418.46. The DBCC determined that there were \$2,566.95 in accrued expenses that Respondent 1 did not include on his balance sheet at month end, and that had been accrued as of July 3, 1996. The evidence established that Firm A conducted a securities business on that date.

Based on our review of the evidence, we adjust one item from the liability side of the Firm's balance sheet. We reduce the Firm's short-term loan entry by \$450, because the Firm did not increase its short-term loans until after July 3. Including this adjustment, we find that the Firm had a net capital

The deficiencies were alleged to have violated Securities Exchange Act of 1934 Rule ("SEC Rule") 15c3-1.

deficiency of \$968.46. Accordingly, we uphold the allegation that Respondent 1 allowed the Firm to operate with a net capital deficiency on July 3, 1996.

August 28, 1996 Net Capital Deficiency. For August 28, 1996, the DBCC determined that Firm A had a net capital deficiency of \$17,897.37. The DBCC determined that there were \$4,070.07 in accrued expenses that Respondent 1 did not include on his balance sheet at month end, and that had been accrued as August 28, 1996. The evidence established that on August 28, 1996, Firm A conducted a securities business.

After reviewing the record, we adjust two items of accrued expenses and one item in the checking account balance. We eliminate the accrued expense of \$300 payable to WCIN because the invoice was dated only one day before August 28,² and we reduce the Tele-Communications Inc. invoice from \$734.44 to \$183.61, the amount stated on the face of the invoice. We increase the Firm's checking account balance by \$524.25 because a check in this amount was not disbursed until August 29, 1996. After making these adjustments, we find that the Firm had a net capital deficiency of \$16,522.29. Accordingly, we uphold the allegation that Respondent 1 allowed the Firm to operate with a net capital deficiency on August 28, 1996.

<u>September 4, 1996 Net Capital Deficiency.</u> The DBCC determined that on September 4, 1996, Firm A had a net capital deficiency of \$21,158.84. The DBCC also found that the Firm conducted a securities business on that date.

Based on our review of the evidence, we adjust several of the accrued expenses. Our conclusion is that the Firm had a net capital deficiency of \$18,455.29 on September 4, 1996. We eliminate four of the accrued expenses because the invoices were dated September 3 or later. We do not eliminate any of the invoices dated September 1 or earlier. Consequently, we find that the Firm's accrued expenses as of September 4 were \$1,028.99, not \$3,732.54, as found by the DBCC. Accordingly, we uphold the allegation that Respondent 1 allowed the Firm to operate with a net capital deficiency on September 4, 1996.

As a defense to the allegations of net capital violations on August 28 and September 4, 1996, Respondent 1 argued that beginning in May 1996, he attempted to obtain a subordinated loan for Firm A in order to keep the Firm sufficiently capitalized. To that end, Respondent 1 solicited his own family and others to lend money to the Firm. On August 12, 1996, Respondent 1 submitted to the NASD for its approval, a subordinated debt loan agreement. According to Respondent 1, the agreement was based on a Form SL-1 that the NASD staff had provided to Respondent 1 in May 1996, after he

When evaluating the date on which the Firm should book invoices that were mailed to it, the DBCC allowed the Firm one or two days leeway from the date printed on the invoice because the Firm may not have received the invoice until that time. In the context of this case we consider this ruling to be reasonable and, for the purpose of consistency, we follow the DBCC's practice when we compute the Firm's net capital.

informed the NASD staff of the Firm's need for a subordinated loan. Thereafter, between August 12 and September 19, 1996, Respondent 1 determined, after speaking with NASD staff, that the SL-1 debt subordinated loan application would not resolve Firm A's net capital problems because the Firm's proposed subordinated loan was for equity capital. On September 19, 1996, the NASD staff provided Respondent 1 with a copy of a Form SL-5, which is a subordinated loan agreement for equity capital.

Respondent 1 admits that the original application was incomplete and contained some errors. He nonetheless claims that the NASD was at fault for providing the wrong form initially and then not acting timely once the original subordinated loan agreement was submitted. Respondent 1's argument, however, is irrelevant to the issue of whether the Firm operated while violating the net capital rule. Respondent 1's responsibility was to ensure that the Firm had adequate capital, not merely to start a process of requesting approval for a subordinated loan. Because Respondent 1 failed to complete successfully the subordinated loan approval process, he remained liable for allowing the Firm to operate while it had net capital deficiencies.

Accordingly, we find that on July 3, August 28, and September 4, 1996, Firm A conducted a securities business while failing to maintain the required minimum net capital. We find Respondent 1 liable for these violations as Firm A's FINOP, and therefore find that he violated Conduct Rule 2110.

Cause Two: Recordkeeping

The second cause of action alleged that Respondent 1 failed to comply with SEC Rules 17a-3 and 17a-4, in that he failed to maintain an accurate general ledger for the Firm and he failed to evidence creation of trial balances. The DBCC found that the Firm's general ledgers for April, May, June, and July were inaccurate and that Respondent 1 had not created trial balances for those months. The NASD staff had testified that checks issued by the Firm were not recorded in the general ledger and Respondent 1 did not accrue invoices on the Firm's books and records.

Based on our review of the evidence, we affirm the DBCC's findings that Respondent 1 maintained an inaccurate general ledger for April, June, and July 1996. We reverse the DBCC's finding as to the May general ledger because the exhibit in support of this allegation contained an invoice dated June 14, 1996, which does not demonstrate an inaccuracy in the May general ledger. We affirm the following findings made by the DBCC: The April 1996 general ledger failed to include two checks written in April, with a total value of \$900. The June general ledger failed to include the remaining balance of \$200.94 for an invoice and failed to include an expense of \$183.61. The July general ledger failed to include five invoices, which totaled \$2,566.95.

Turning to the issue of trial balances, SEC Rule 17a-3(a)(11) requires member firms to make and keep current:

A record of the proof of money balances of all ledger accounts in the form of trial balances, and a record of the computation of aggregate indebtedness and net capital, as of the trial balance date Such trial

balances and computations shall be prepared currently at least once a month.

SEC Rule 17a-4 requires that "[e]very such broker and dealer shall preserve for a period of not less than three years . . . [a]ll trial balances" We uphold the DBCC's finding that Respondent 1 failed to evidence creation of the Firm's trial balances for April, May, June, and July 1996. The NASD staff testified that Respondent 1 told them that he did not create trial balances for those months. In his closing statement at the DBCC hearing, Respondent 1 contended that the Firm's general ledger could provide the information contained in a trial balance and that having a report entitled "trial balance" was "getting stuck on ceremony." We affirm the DBCC's finding that Respondent 1 failed to evidence creation of trial balances.

Accordingly, we find that Respondent 1 failed to comply with SEC Rules 17a-3 and 17a-4, in that Respondent 1 failed to maintain an accurate general ledger and failed to evidence creation of trial balances, in violation of Conduct Rule 2110.

Procedural Issues and Objections

Motion to Adduce Additional Evidence. Respondent 1 made a motion to the National Adjudicatory Council ("NAC") subcommittee that presided over the appeal hearing ("Subcommittee") to adduce additional evidence in the form of 13 proposed new exhibits. The Subcommittee denied this motion, and we affirm that denial. Procedural Rule 9346(b) requires that parties seeking to introduce additional evidence satisfy the burden of demonstrating that: (1) there was good cause for failing to adduce the evidence before the DBCC; and (2) the evidence is material to the proceeding.

Respondent 1 offers several reasons as good cause for failing to introduce the additional evidence at the DBCC hearing, including: asserting that he did not anticipate that witnesses called by the regional attorney for District No. 8 would testify as they did, that the DBCC hearing panel did not understand SEC Rule 17a-3, and that the DBCC hearing panel disagreed with one of Respondent 1's points.³ None of these reasons constitutes good cause for failing to introduce evidence at the DBCC hearing. Respondent 1 heard the testimony of the complainant's witnesses, had the opportunity to cross-examine them, and also had the opportunity to put on witnesses himself. Allowing him to introduce his proposed new evidence on appeal would undermine the role of the initial fact-finder and would eliminate the incentive for all parties to prepare thoroughly for a hearing.

Respondent 1 requested that he be allowed to introduce six audiotaped telephone conversations, but he offered no reason why the recordings were not introduced at the DBCC hearing. All of the telephone calls took place several months before the DBCC hearing. Therefore, we deny Respondent 1's motion as to these items because Respondent 1 failed to satisfy the good cause requirement of Rule 9346.

In addition, we find that Respondent 1 has failed to demonstrate the materiality of these proposed additional pieces of evidence, except for items three and four. As for the remaining 11 items, they relate to Respondent 1's claim that the Firm had net capital deficiencies in addition to the ones alleged in the complaint, Respondent 1's claim that he could not ascertain proper information from the Firm's President, and exploratory settlement discussions between Respondent 1 and the NASD staff. None of these matters are material to either the violations or the sanctions imposed by the DBCC. Because Respondent 1 failed to show good cause and materiality, we deny his motion to adduce additional evidence.

Respondent 1's Motion To Appeal Document Request. On the day of the DBCC hearing, Respondent 1 handed the DBCC hearing panel a "Motion to Compel Discovery Request." The DBCC hearing panel denied the motion, and we affirm that ruling. The complaint in this matter was filed on May 30, 1997. Under the Code of Procedure that was in effect at the time, a respondent was not entitled to discovery. See In re Steven B. Theys, 51 S.E.C. 473, 480-81 (1993). Here, Respondent 1 did receive the documents to which he was entitled under the Code of Procedure. In accordance with the rules that were in effect at the time, Barbera received a copy of all of the exhibits that the regional attorney would be using during her case-in-chief more than five days before the DBCC hearing. Respondent 1 was entitled to nothing more. Accordingly, we uphold the DBCC hearing panel's denial of Respondent 1's discovery request.

Other Objections. Respondent 1 has made a series of objections to the procedures used by the DBCC and on appeal. For the following reasons, we find no merit in any of these objections. The use of an attorney-advisor by both the DBCC and the NAC subcommittees was proper. See In re Jonathan Garrett Ornstein, 51 S.E.C. 135, 138 n.5 (1992); In re Arthur W. Weisberg, 50 S.E.C. 643, 645 (1991). The order of the closing arguments at the DBCC hearing and the order of the oral arguments before the NAC subcommittee was proper. See Wm. Bruce Hoff, Jr. and Kenneth J. Jurek, 3 Federal Litigation Guide, at 36-16 ¶36.03[3] (1990) (party with the burden of proof is entitled to speak last in closing arguments); Cf. Fed. R. App. P. 34(c) (appellant is entitled to open oral argument). The time allowed to respondent at the NAC subcommittee hearing was proper. Cf. SEC Rules of Practice 451(c) ("Unless the Commission orders otherwise, not more that one half-hour per side will be allowed for oral argument.") Finally, Barbera's many assertions that events at the DBCC hearing were unfair are not supported by the record. See In re Strathmore Securities, Inc., 42 S.E.C. 993, 999 (1966) (denying allegation of an unfair hearing when respondent did not show specific prejudice).

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See Notice to Members 97-55 at 438 (August 1997).

Sanctions

The DBCC imposed sanctions of a censure, a \$2,000 fine, a requirement to requalify as a FINOP, and costs. These sanctions are consistent with, and on the low end of, the range recommended by the NASD Sanction Guidelines,⁵ which suggest a fine of between \$1,000 and \$20,000.

In determining sanctions we have considered Respondent 1's disciplinary history, which involves no other formal disciplinary actions. We also note, however, that: "[n]et capital violations are serious offenses. By failing to maintain sufficient capital, [a firm] subject[s] its customers to the risk that it w[ill] not have sufficient liquid assets to satisfy its indebtedness." In re James S. Pritula, Exchange Act Rel. No. 40647, p. 11 (Nov. 9, 1998). We adopt the DBCC's apportionment of \$1,000 of the fine for the net capital violation and \$1,000 of the fine for the recordkeeping violation.

We affirm the requalification requirement because Respondent 1 has demonstrated a lack of understanding of the rules relevant to the job of a FINOP. By requiring requalification, we intend to reinforce the importance of the rules, including the net capital rule and the obligation to create and maintain trial balances and accurate ledgers.

Accordingly, Respondent 1 is censured, fined \$2,000, required to requalify by examination as a FINOP before functioning again in that capacity, assessed DBCC hearing costs of \$2,597, and assessed appeal costs of \$1,000 plus the cost of the transcript.⁶

On Behalf of the National Adjudicatory Council,

Joan C. Conley, Senior Vice President and Corporate Secretary

Pursuant to NASD Procedure 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 sanctions, after seven days' notice in writing, will summarily be revoked for non-payment.

⁵ <u>See</u> NASD Sanction Guidelines ("Guidelines") (1996 ed.) at 35 & 40 (Net Capital and Recordkeeping Violations).

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.