BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. Fox & Company Investments, Inc., Phoenix, AZ And James W. Moldermaker Scottsdale, AZ, Respondents.	AMENDED DECISION Complaint No. C3A030017 Dated: February 24, 2005

Respondents operated a securities business without sufficient net capital, maintained materially inaccurate books and records, filed inaccurate FOCUS reports, and failed to report certain required information to NASD. Held, Hearing Panel's findings modified and sanctions affirmed.

APPEARANCES

For the Complainant NASD Department of Enforcement: Jacqueline D. Whelan, Esq., Leo F. Orenstein, Esq.

For the Respondents: Anthony W. Djinis, Esq., Paul J. Bazil, Esq., Peter E. McLeod, Esq., of Pickard and Djinis LLP.

DECISION

Fox & Company Investments, Inc. ("Fox" or "the Firm"), a registered broker-dealer, and James W. Moldermaker ("Moldermaker") (together, "respondents") appeal this matter pursuant to Procedural Rule 9311. The Hearing Panel found that Fox, through Moldermaker, conducted a securities business when the Firm failed to meet its net capital requirements; maintained material inaccuracies in the Firm's books and records; and submitted materially inaccurate FOCUS reports. For these violations, the Hearing Panel fined respondents $25,000, jointly and severally, and barred Moldermaker from associating with any member firm as a financial and operations principal ("FINOP"). In addition, the Hearing Panel found that Fox, through Moldermaker, failed to report certain required information to NASD. For this violation, the Hearing Panel fined respondents $10,000, jointly and severally, and suspended Moldermaker in all supervisory and principal capacities for 10 business days. We modify the Hearing Panel's findings and affirm the sanctions.

I. Background

A. Moldermaker's Employment History

Moldermaker entered the securities industry in April 1978. Since Fox became an NASD member in July 1987, and during the time of the alleged misconduct, Moldermaker has been registered with Fox in a number of capacities, including as a FINOP, a general securities principal, a general securities representative, a municipal securities principal, a municipal securities representative, and a registered options principal. Moldermaker is also the president, chief financial officer, and the principal owner of Fox.

B. Procedural History

On June 9, 2003, the Department of Enforcement ("Department") filed a four-cause complaint against Fox and Moldermaker. At the heart of the complaint was the Firm's treatment of a $983,992 arbitration award issued on December 27, 2001, against the Firm, Moldermaker, David Gwynn ("Gwynn"), a former registered representative of Fox, and Southwest Securities, Inc., Fox's clearing firm (collectively, the "arbitration respondents"). Cause one alleged that, on January 31 and February 28, 2002, Fox conducted, and Moldermaker permitted it to conduct, a securities business while below its required net capital of $250,000, in violation of Exchange Act Rule 15c3-1 (the "Net Capital Rule") and Conduct Rule 2110. Cause two alleged that, on or about January 31 and February 28, 2002, Fox and Moldermaker maintained materially inaccurate financial records, in violation of Exchange Act Rule 17a-3 and Conduct Rules 3110 and 2110. Cause three alleged that Fox submitted, and Moldermaker caused it to submit, materially inaccurate Financial and Operational Combined Uniform Single (FOCUS) Reports for the December 2001, January 2002, and February 2002 periods, in violation of Exchange Act Rule 17a-5 and Conduct Rule 2110. Finally, cause four alleged that respondents failed to report certain information to NASD concerning the arbitration matter, in violation of Conduct Rules 2110 and 3070. Such alleged failures included: (i) failing to amend Gwynn's Uniform Termination Notice for Securities Industry Registration ("Form U5") when he was named in the arbitration and when the arbitration award was issued; and (ii) failing to electronically report to NASD the arbitration award as to the Firm and Moldermaker.

On December 30, 2003, the Hearing Panel issued a decision finding respondents liable for all alleged violations, with some evidently inadvertent exceptions.[1] Fox and Moldermaker appealed from the Hearing Panel's decision.[2]

II. Facts

A. The Arbitration Claim

In October 1998, five former customers of Fox filed an arbitration claim before NASD Dispute Resolution against the arbitration respondents. The claim alleged that, in 1995, the arbitration respondents failed to execute instructions to sell stock or place a stop-loss order, and thereby breached a contract, violated fiduciary duties, and failed to act in accordance with standards of care. The former customers also alleged that the arbitration respondents engaged in a conspiracy to defraud them, by churning their accounts and allocating sales proceeds to the accounts of other persons. The former customers sought damages, including losses in excess of $1.8 million. Fox did not file an amended Form U5 notifying NASD of the customers' allegations against former representative Gwynn.

B. Fox's Claim on Its Errors and Omissions Insurance Policy

Based on the arbitration matter, in or around January 1999 Fox and Moldermaker filed a claim on the Firm's errors and omissions liability insurance policy carried by American International Specialty Lines Insurance Company ("AISLIC").[3] In a letter dated February 23,

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1 In making findings with respect to cause two, the Hearing Panel found that respondents violated Conduct Rule 2110, but it did not address the allegations that Fox violated Exchange Act Rule 17a-3 or that respondents violated Conduct Rule 3110. Furthermore, although causes one and three charged only the Firm with violating Exchange Act Rules 15c3-1 and 17a-5, the Hearing Panel found both the Firm and Moldermaker liable for violating those rules.

2 On appeal, respondents moved to introduce into evidence a purported transcript of a February 6, 2002 telephone conversation between Moldermaker and an NASD supervisor. The Department opposed respondents' motion and moved to strike respondents' brief, arguing that it impermissibly referred to the February 2002 transcript. The NAC Subcommittee denied both motions. Pursuant to Procedural Rule 9346, a party may seek leave to introduce evidence that was not introduced below. Because respondents attempted to introduce the February 2002 transcript before the Hearing Panel, the Subcommittee denied respondents' motion. Nevertheless, respondents were permitted to make references to the February 2002 transcript in their brief to argue why the Hearing Panel's decision to exclude the transcript from evidence was erroneous. For this reason, the Subcommittee denied Enforcement's motion to strike the brief.

3 "An errors-and-omissions policy is professional liability insurance providing a specialized and limited type of coverage as compared to comprehensive insurance; it is designed to insure members of a particular professional group from the liability arising out of a special risk such as negligence, omissions, mistakes and errors inherent in the practice of the

[Footnote continued on next page]

1999, A.I. Management and Professional Liability Claim Adjusters ("A.I. Management"), which was working with AISLIC, acknowledged receipt of the claim, noted that the policy had a "limit of liability of $1 million, $2 million Aggregate (inclusive of defense costs)," and indicated that counsel had been retained to protect Fox's interests. A.I. Management also described a number of factual circumstances that potentially excluded Fox's claim from the scope of the policy's coverage and "reserve[d] all rights and defenses." Respondents' witness Douglas McKinney ("McKinney"), a commercial insurance broker, testified that the February 23, 1999 letter was a typical "reservation of rights letter," which indicated that AISLIC reserved the right not to pay the claim should it not fall within the scope of the policy.[4]

C. The Arbitration Award

On December 27, 2001, an arbitration panel issued an award against the arbitration respondents, jointly and severally, totaling $983,992.[5] NASD Dispute Resolution faxed the award to respondents' attorneys, who faxed a copy of the award to respondents on December 28, 2001. Moldermaker testified that he personally did not see the award until January 2, 2002. Fox did not electronically report to NASD information about the arbitration award. In January 2002, Fox's errors and omissions insurance carrier filed a motion to vacate the arbitration award on behalf of Fox, staying the requirement to pay the award. *See* Code of Arbitration Rule 10330(h).

D. The Filing of Fox's December 2001 FOCUS Report and NASD's Discovery of Fox's Net Capital Problems

In his investigative testimony, Moldermaker explained that he was responsible for approving and submitting the Firm's FOCUS reports, for computing the Firm's net capital, and for overseeing the preparation of the Firm's books and records. On January 25, 2002, Fox submitted its FOCUS report for the period ending December 31, 2001 ("the December 2001 FOCUS Report"), which indicated that Fox's "excess net capital" was $203,985. Fox's December 2001 FOCUS report did not incorporate either the $983,992 arbitration award or Fox's insurance claim.

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professions." 7A John A. Appleman, *Insurance Law and Practice* §4504.01 (Berdal ed., West Publishing Co. 1979); *see also Black's Law Dictionary* 816 (8th ed. 2004). Errors and omissions policies do not cover intentional torts. Appleman at §4504.01 (LexisNexis Supp. 2003).

[4] A reservation of rights letter is a "unilateral notice sent by the insurer to the insured stating that the insurer reserves the right to contest coverage despite its undertaking to investigate the claim and defend the insured." Robert H. Jerry, II, *Understanding Insurance Law* §114[c][3], at 796 (2d ed. 1996); *see also Black's Law Dictionary* at 1334.

[5] The award included compensatory damages (plus 6% interest until the date of payment), attorneys' fees, expert witness fees, and other fees.

On February 5, 2002, Moldermaker called Roger Hogoboom ("Hogoboom"), Regional Counsel in the Department. According to Hogoboom, Moldermaker asked that NASD investigate a "bad broker" who had worked for Fox. As the conversation ensued, Hogoboom learned that the former broker (Gwynn) had been the subject of an adverse arbitration claim and that Moldermaker had "made a strategic decision" not to amend the former broker's Form U5 to reflect the arbitration claim. Hogoboom also learned that the arbitration claim had ripened into an award against Fox, and he informed Moldermaker that he needed to book the arbitration award as a liability. Moldermaker disagreed by stating that he had insurance coverage, but Hogoboom replied that Fox was still required to book the award as a liability and that issues concerning the insurance claim were separate from issues concerning the arbitration award.

According to Hogoboom, Moldermaker never asked whether Fox's insurance coverage could be booked as an asset. Hogoboom did remember, however, that he and Moldermaker might have discussed how the "joint and several" nature of the award affected the award's accounting treatment. Hogoboom acknowledged only that, had Moldermaker specifically asked about the joint and several nature of the award, he would have told Moldermaker to book the entire award. Hogoboom testified that he had never seen either an award that held a firm and its clearing broker jointly and severally liable or the coverage provided by an insurance policy recorded as an asset on a member's balance sheet. Hogoboom immediately informed David Lapham ("Lapham"), the supervisory examiner assigned to Fox, about his conversation with Moldermaker. Lapham had no record of the arbitration award, so he obtained a copy from NASD's Washington office. When he compared the award to the net capital reported on Fox's December 2001 FOCUS report, Lapham became concerned that Fox was not in net capital compliance.

On February 6, 2002, Lapham and Muffie Humphrey ("Humphrey"), an NASD examiner, called Moldermaker. Lapham informed Moldermaker that, according to the *NASD Guide to Rule Interpretations* (1996), the Firm was required to book the arbitration award as a liability at the time the award was made in December 2001 and that, as a result, it appeared that the Firm was not in net capital compliance. Moldermaker again argued about whether he had to book the award, claiming that he had insurance and that the insurance company had appealed the award. According to Humphrey's notes of the conversation, Moldermaker stated that he was "well aware" of the requirement that he book the award but called it "antiquated . . . because it didn't take into account the fact that firms have insurance that covers these matters." Notwithstanding these protests, Lapham informed Moldermaker that he should file a notice pursuant to Exchange Act Rule 17a-11 indicating that NASD had informed the Firm that it was operating out of net capital compliance and should "determine whether . . . he had enough capital to stay in business." On the same day, NASD staff provided to Moldermaker written confirmation of this telephone conversation.

Lapham explained that he had "no discussion [with Moldermaker] about how [specifically] to book anything." Lapham testified that Moldermaker did not ask whether he could book his insurance coverage as an asset. Lapham further testified that, although there was some discussion about the "joint and several" nature of the award, Moldermaker did not ask how that would affect booking the award. Lapham testified that he did not undertake to get back to Moldermaker on any questions.[6] Lapham testified that this was the first time he had encountered an arbitration award potentially covered by insurance and that he was not very knowledgeable about errors and omissions policies. Humphrey's testimony about the conversation with Moldermaker generally corroborated Lapham's testimony.

On February 7, 2002, Moldermaker filed a notice with NASD pursuant to Exchange Act Rule 17a-11, in which he disagreed that Fox lacked sufficient net capital. Moldermaker stated that he "received [a] copy of the [arbitration] award in January 2002" and that Fox's upcoming January 2002 FOCUS filing would "reflect any award, if applicable, as we have done in the past." Moldermaker further wrote, however, that he "still [has] not received the anticipated information from [NASD] on how to do this correctly because it is a fully covered award." Moldermaker claimed he specifically asked NASD staff about how to book the arbitration award, given that he had errors and omissions insurance and that Fox was one of several parties held jointly and severally liable, and about how to "handle" the insurance policy as a "corresponding asset to offset any contingent liability." Moldermaker further claimed that NASD staff did not know how to handle the issues he raised.

E. Fox's January 2002 FOCUS Report and its Aftermath

On February 26, 2002, Moldermaker filed Fox's FOCUS report for the period ending January 31, 2002 ("the January 2002 FOCUS report"). The report indicated that Fox had excess net capital of $393,119 but again did not reflect the arbitration award as a liability. The January 2002 FOCUS report and other Firm records as of January 31, 2002, reflected two other items of significance. First, the records booked two capital contributions totaling $190,000 as among the Firm's assets, even though those contributions were not deposited in Fox's accounts until February 6, 2002. Second, Fox's records booked as an asset and a corresponding liability a

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[6] Respondents' appeal brief quotes from the purported transcript of the February 6, 2002 discussion between Lapham and Moldermaker. The Hearing Officer excluded the transcript from evidence because it was not included in respondents' prehearing submission and because he deemed it irrelevant. We affirm the Hearing Officer's decision to exclude the transcript from evidence. Pursuant to Procedural Rule 9261(c), a party may seek to submit additional evidence at the hearing only for "good cause shown." When the Hearing Officer asked Moldermaker why he had not included the purported transcript in his prehearing submission as required, Moldermaker stated, "I don't know, didn't think I needed to." Moldermaker's ignorance of the procedures governing this disciplinary action is insufficient to demonstrate good cause. In addition, the record contains insufficient evidence and offers of proof to establish the transcript's authenticity. *Cf. Market Regulation Comm. v. Rosen*, Complaint No. CMS970027, 2000 NASD Discip. LEXIS 7, at *6 (NASD Bd. of Governors June 1, 2000) (holding that evidence must be reliable to be admitted); *United States v. Branch*, 970 F.2d 1368, 1371-72 (4th Cir. 1992) (discussing standards for authenticating tape recordings). In any event, Moldermaker was permitted to ask Lapham if the transcript refreshed his recollection about the February 6, 2002 conversation and to read directly from the transcript during his cross examination of Lapham.

$300,000 line of credit, which Moldermaker individually had obtained and "pledged" to Fox in January 2002. As of January 31, 2002, however, respondents had neither obtained nor deposited into Fox's accounts any cash advanced from that line of credit.[7]

On February 28, 2002, NASD staff tried to contact Moldermaker to discuss Fox's second failure to book the arbitration award on its FOCUS report. Moldermaker was not available, so NASD staff spoke with Mary Banicki ("Banicki") (a/k/a Mary Wade), Fox's "head accountant." According to notes of that discussion taken by Cliff Miskell ("Miskell"), an NASD field supervisor who conducts routine examinations of firms, NASD staff explained that Fox was required to carry the entire amount of the arbitration award on the Firm's books as a liability. NASD staff further explained that Fox might have been able, and still might be able, to claim the insurance coverage as an asset provided that the Firm obtained an opinion of legal counsel that the claim was covered and a written acknowledgement from the insurance company that the claim was "due and payable," as required by the section of the Net Capital Rule that sets forth the allowable asset treatment of insurance company receivables (the "insurance claims provision"). Banicki stated that she thought Fox had documents that would satisfy these requirements. That same day, NASD staff faxed to Moldermaker two documents: (i) a rule interpretation published in the *NASD Guide to Rule Interpretations* indicating that a firm must book an adverse arbitration award as an actual liability at the time the award is made, even when it is on appeal; and (ii) a copy of the insurance claims provision.

On March 5, 2002, Moldermaker faxed to NASD a copy of the February 23, 1999 reservation of rights letter from A.I. Management. After evaluating the letter, NASD staff informed respondents that the letter did not express that Fox's insurance claim was due and payable, as required by the insurance claims provision, and would not permit Fox to treat its insurance claim as an asset. Respondents' witness McKinney also testified that there was nothing in the February 23, 1999 letter that indicates that the claim was due and payable.

In a letter dated March 18, 2002, Miskell informed Banicki that "[f]or February 2002, you must . . . show the arbitration award as a liability and classify the insurance receivable as 'non-allowable.'" On the same day, Fox and Moldermaker attempted to provide NASD with a letter that satisfied the due and payable requirement of the insurance claims provision. Specifically, Joseph Inzerillo ("Inzerillo") of AIG Technical Services, Inc. sent NASD a letter describing Fox's coverage under its errors and omissions insurance policy. Among other things, the letter noted that the policy provided "liability limits of $1,000,000 each [l]oss," that the defense costs incurred to date totaled $277,347, and that $722,653 remained "available" to satisfy the arbitration award "subject to further erosion due to continuing defense costs."

In a conference call on March 20, 2002, Department witness Susan DeMando ("DeMando"), Director of Financial Operations in NASD's Department of Member Regulation, informed respondents that Inzerillo's March 18 letter did not meet the requirements of the

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[7] As explained in more detail below, the issues pertaining to the $300,000 line of credit do not pertain to Fox's net capital calculation but to the accuracy of its financial records.

insurance claims provision. Although the letter stated that funds were "available," NASD staff determined that the letter failed to acknowledge that payment would occur should the pending motion to vacate the arbitration award fail.

F. Fox's Official, and Unofficial, February 2002 FOCUS Report

On March 25, 2002, Fox filed an official version and an unofficial version of its February 2002 FOCUS Report. Both versions booked the arbitration award as a liability but treated the insurance receivable differently. In the unofficial version, Fox treated the insurance claim as a "non-allowable asset" and reported a negative "excess net capital" of $462,275. In the official version, however, Fox booked $722,653 of insurance as an "allowable asset" and calculated excess net capital to be $260,378. In addition, the February 2002 FOCUS report and other Firm records as of February 28, 2002, again counted Moldermaker's $300,000 line of credit as an asset and a corresponding liability even though no cash advance had been obtained from that line of credit.[8]

In a cover letter accompanying the two February 2002 FOCUS reports, Moldermaker acknowledged that NASD staff had provided him on February 28, 2002, with the insurance claims provision and had requested on March 21, 2002, that Fox treat its errors and omissions insurance receivable as "an unallowable asset." Moldermaker complained, however, that NASD's advice came "too late" to allow Fox to deposit additional funds to return to net capital compliance for February 2002 and that NASD's determinations concerning the insurance company's letters amounted to an unannounced "policy change." Moldermaker further wrote that "we [have] added additional capital" that "could have been added months before if it was deemed necessary."[9] For these reasons, Moldermaker wrote that he had "a problem submitting a FOCUS report for February with an obvious net capital violation," so he submitted two reports. In doing so, Moldermaker wrote that "I hope this will appease everyone involved, especially since the capital has been deposited and any alleged deficiencies are now a moot point."

G. Events After the February 2002 FOCUS Report

In another attempt to satisfy the insurance claims provision's "due and payable" requirement, on April 5, 2002, Inzerillo wrote to NASD, "[w]e hereby advise that the balance of the policy is due and payable upon the exhaustion of all available appeals processes or similar procedures and a determination of liability against Fox & Company, . . . Moldermaker and/or . . . Gwynn." DeMando testified that NASD staff found that the insurance company's third letter

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[8] The first deposit of cash drawn from the line of credit occurred in March 2002. Specifically, on March 15, 2002, Moldermaker requested Johnson Bank to advance $300,000 from his line of credit and deposit it in Fox's bank account. That deposit was effective March 19, 2002.

[9] The additional capital that Moldermaker referred to included the deposit on March 19, 2002, of $300,000 drawn from his line of credit with Johnson Bank.

again failed to meet the "due and payable" requirement because it "didn't say who was going to determine whether or not Fox . . . was liable." DeMando informed an employee of the insurance company that the April 5, 2002 letter was insufficient. Moldermaker testified, however, that NASD staff did not inform him of their decision until September 2002.

In late 2002 or early 2003, the arbitration matter was settled for approximately $775,000. AISLIC contributed approximately $625,909, the balance of the policy limits. The remainder of the settlement was covered by Fox and/or Moldermaker.

III. Discussion

A. Net Capital Violations

The Hearing Panel found that, on January 31 and February 28, 2002, Fox conducted, and Moldermaker permitted it to conduct, a securities business while below its required net capital. We affirm the Hearing Panel's conclusion.

The Net Capital Rule prohibits broker-dealers from engaging in a securities business if their net capital falls below certain amounts. It "is one of the most important tools that the SEC and NASD use to protect investors because it imposes financial responsibility on the securities industry by: (1) establishing minimum net capital requirements for broker-dealers; and (2) defining the process used by broker-dealers to determine their net capital at all times." *Dep't of Enforcement v. Inv. Mgmt. Corp.*, Complaint No. C3A010045, 2003 NASD Discip. LEXIS 47, at *14 (NAC Dec. 15, 2003). A violation of the Net Capital Rule is also a violation of Conduct Rule 2110. *Id.* at *18.

Fox does not dispute that it was a broker-dealer, received customer funds, and operated a securities business on January 31 and February 28, 2002. Pursuant to minimum requirements set forth by the Net Capital Rule, therefore, Fox was required to maintain a minimum net capital of $250,000 on the two dates at issue. *See* Exchange Act Rule 15c3-1(a)(2)(i). Fox failed to do so. On its January 2002 and February 2002 FOCUS reports, Fox reported that it had net capital well exceeding its required minimum: (i) $643,119 as of January 31, 2002; and (ii) $510,378 as of February 28, 2002. Fox's calculations, however, contained three material errors.

1. $190,000 Deposits

First, the Firm's net capital computation as of January 31, 2002, improperly included as allowable assets two deposits totaling $190,000: (i) a check issued by Moldermaker for $110,000; and (ii) a transfer of $80,000 to Fox from an account that Moldermaker controlled as trustee and that was held at Southwest Securities (the "Spaulding account"). Although Moldermaker's $110,000 check was dated January 31, 2002, it was not deposited in Fox's bank account until February 6, 2002. Likewise, the $80,000 from the Spaulding account was not deposited into Fox's account until February 6, 2002. Although Moldermaker attempted to wire transfer the $80,000 on January 31, 2002, Southwest Securities denied Moldermaker's request to do so. In his investigative testimony, Moldermaker conceded that booking the two deposits as assets on January 31, 2002, was an error.

We reject respondents' current argument that Fox was permitted to book the two deposits as allowable assets on January 31, 2002, pursuant to an SEC interpretation concerning "deposits in transit." According to that SEC interpretation, a "broker-dealer that, as part of its normal business practice, promptly mails deposits to its bank, may include such deposits in transit as allowable assets in its computation of net capital." *See NASD Guide to Rule Interpretations* at 11. The record does not show that respondents mailed, let alone promptly mailed, either deposit to the bank or that it was their normal business practice to do so. In fact, the record demonstrates that it was impossible for the $80,000 deposit to be "in transit" any earlier than February 6, 2002, the day Southwest Securities disbursed the $80,000 from the Spaulding account. Accordingly, respondents improperly counted the $190,000 in deposits as assets as of January 31, 2002.

2. <u>Arbitration Award</u>

Second, the Firm's calculation of its liabilities as of January 31, 2002, failed to include the $983,992 arbitration liability that was awarded against it in December 2001, as well as the accrued interest on that award. "[A] broker-dealer must book an adverse arbitration award as a liability at the time that the award is rendered." *Inv. Mgmt. Corp*., 2002 NASD Discip. LEXIS 47, at *14, *citing Wallace G. Conley,* 51 S.E.C. 300, 302 (1993). Moldermaker, who had previously booked arbitration awards upon their issuance, admitted that he was aware of this requirement.

Respondents incorrectly argue that Code of Arbitration Rule 10330(h), which stays the requirement to pay an arbitration award if a motion to vacate the award has been filed, freed Fox from the obligation to book the arbitration award as a liability. As we recently confirmed, "an award should be booked when it is rendered, not when a court confirms it." *Id.* at *16; *see also NASD Guide to Rule Interpretations* at 35 (stating that "a broker/dealer that is the subject of an adverse award in an arbitration proceeding should book the award as an actual liability at the time the award is made, even though the appeal process has not been exhausted, because grounds for appeal are very limited").

Respondents have not expressly challenged the Hearing Panel's conclusion that the joint and several nature of the arbitration award did not permit Fox to book less than the full amount of the award as a liability. The Hearing Panel's conclusion in this regard was correct. "The purpose of the net capital rule is 'to ensure that broker-dealers have sufficient liquid capital to protect the assets of customers and to meet their responsibilities to other broker-dealers.'" *L.H. Alton & Co.*, 53 S.E.C. 1118, 1121 (1999) (*quoting Lowell H. Listrom,* 50 S.E.C. 883, 886 (1992), *aff'd*, 975 F.2d 866 (8th Cir. 1992) (Table)), *pet. for review denied,* 229 F.3d 1156 (9th Cir. 2000) (Table). For purposes of the net capital rule, a firm that is jointly and severally liable for an arbitration award must book the full amount of the award as a liability because it is a defined, enforceable obligation against the firm. *See* Financial Standards Accounting Board, Statement of Financial Accounting Concepts No. 6, at ¶¶ 35, 36, 39. We find nothing in the record that would change this result in this case. To the contrary, there was evidence that Fox had indemnified Southwest Securities against losses such as the arbitration award. Accordingly, Fox was required to book the entire amount of the arbitration award as a liability.

3. Errors and Omissions Insurance Claim

Third, the Firm's calculation of its net capital as of February 28, 2002, improperly included its errors and omissions insurance coverage as an allowable asset. The Net Capital Rule provides that a firm's calculation of net capital must "deduct[ ] fixed assets and assets which cannot be readily converted into cash," including the following insurance claims:

> [1] Insurance claims which, after seven business days from the date the loss giving rise to the claim is discovered, are not covered by an opinion of outside counsel that the claim is valid and is covered by insurance policies presently in effect; [2] insurance claims which after 20 business days from that date the loss giving rise to the claim is discovered and which are accompanied by an opinion of outside counsel described above, have not been acknowledged in writing by the insurance carrier as due and payable; and [3] insurance claims acknowledged in writing by the carrier as due and payable outstanding longer than 20 business days from the date they are so acknowledged by the carrier.

Exchange Act Rule 15c3-1(c)(2)(iv)(D) ("the insurance claims provision"). The plain language of the insurance claims provision provides that a narrowly defined set of insurance claims may be booked as assets during a narrow range of time.[10]

It is undisputed that Fox did not obtain an opinion of counsel indicating that its insurance claim was valid. Assuming *arguendo* that an opinion of counsel letter is not always required more than seven business days after the loss is discovered,[11] Fox could have booked its insurance claim as an asset pursuant only to prong 1 and/or prong 3 of the insurance claims provision: *i.e.*, for seven business days after December 28, 2001 (the day respondents discovered the arbitration award) and/or for 20 business days from the date its insurance company acknowledged its claim as due and payable.[12] Because respondents are charged with conducting, or causing to conduct, a

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[10] The regulatory history of the insurance claims provision reflects that the SEC did not intend to permit firms to book insurance claims as assets for extended, indefinite periods of time.

[11] Because the Firm did not obtain timely, satisfactory letters from its insurance company, we do not have to address whether prong 3 of the insurance claims provision is to be read independently of the other two prongs or, instead, in conjunction with the other two prongs as conditions precedent, which would thereby require an opinion of counsel letter and limit that prong's effectiveness to, at most, 40 business days after the discovery of the loss.

[12] This discussion also assumes *arguendo* that the Net Capital Rule's insurance claims provision, based on its plain language, applies to claims on errors and omissions policies. We note, however, that the regulatory history of the Net Capital Rule reflects that the SEC may not have intended the provision to apply so broadly. In 1974, the SEC proposed a revised version of the insurance claims provision that was substantially similar to the version that was ultimately

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securities business when the Firm failed to meet its net capital requirements only on January 31 and February 28, 2002, we need only address whether Fox obtained a letter from its insurance company that satisfied prong 3 of the insurance claims provision.

None of the three letters from Fox's insurance carrier satisfied the "due and payable" requirement in prong 3 of the insurance claims provision. The 1999 reservation of rights letter—written 34 months before the arbitration award was issued—itemized a number of factors that could *prevent* payment. As for the insurance company's March 18, 2002 or April 5, 2002 letters, such acknowledgments were too late to affect Fox's net capital as of January 31 or February 28, 2002. The effective date of an acknowledgment of a claim as due and payable is the date the claim is "so acknowledged by the carrier." Exchange Act Rule 15c3-1(c)(2)(iv)(D). Accordingly, Fox was not permitted to book its insurance claim as an asset on either January 31 or February 28, 2002.[13]

Respondents argue that it is not necessary to comply with the technical requirements of the insurance claims provision, and they cite as support a no-action letter issued by the SEC's Division of Market Regulation, *Securities Settlement Corp.*, 1980 SEC No-Act LEXIS 4103 (Dec. 12, 1980). Respondents' reliance on *Securities Settlement Corp.*, however, is misplaced. First, the circumstances in *Securities Settlement Corp*. are significantly different than those presented here. In *Securities Settlement Corp.*, the SEC's Division of Market Regulation granted no-action relief to a broker-dealer that requested permission to include an insurance claim in its net capital computation beyond the time constraints in the insurance claims provision. The size and nature of the broker-dealer's $9.8 million insurance claim precluded its insurance company from reviewing the claim within the required time limits. In addition, the broker-dealer in *Securities Settlement Corp.* complied with the insurance claims provision to the extent it could by obtaining an opinion of counsel that its insurance claim would be covered. In contrast, there is no evidence that respondents' insurance company was unable to review the errors and omissions claim in a timely manner. And unlike the broker-dealer in *Securities Settlement*

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adopted. *Notice of Revisions to Proposed Rule 15c3-1*, Exchange Act Rel. No. 11094, 1974 SEC LEXIS 2342, at *43-44 (Nov. 11, 1974); *see also Adoption of Amendments to Rule 15c3-1*, 1975 SEC LEXIS 2517, at *45 (June 26, 1975) (final rule). In explaining its proposal, the SEC stated that "[i]n many instances broker-dealers have insurance claims which relate to *losses of securities* which have been resolved." Exchange Act Rel. No. 11094, 1974 SEC LEXIS 2342, at *23 (emphasis added). In singling out losses of securities, it is unclear whether the SEC intended the provision to cover other types of insurance claims, such as Fox's errors and omissions insurance claim. It is unnecessary for us to resolve the substantive reach of the insurance claims provision, however, given that respondents did not otherwise meet its requirements.

[13] We acknowledge that an argument can be made that, going forward, the March 18 and April 5, 2002 letters would have satisfied prong 3's due and payable requirement. Because the Department has not alleged net capital violations any later than February 28, 2002, we need not, and do not, resolve such issues here.

Corp., Fox did not obtain an opinion of counsel that its claim would ultimately be covered. Second, no-action letters reflect only the advisory expressions of the Commission's staff and do not represent the official views of the Commission. *Bacardi Corp.*, 50 S.E.C. 136, 141 n.27 (1989).

Accounting for the three errors discussed above, Fox operated a securities business on both January 31 and February 28, 2002, with net capital that was well below its required $250,000 minimum, in violation of Exchange Act Rule 15c3-1 and Conduct Rule 2110.[14] As president and FINOP of Fox, Moldermaker was responsible for ensuring that Fox complied with its net capital obligations. Membership and Registration Rule 1022(b)(2)(E) (FINOP is charged with the duty to supervise and/or perform the member's responsibilities "under all financial responsibility rules promulgated pursuant to the provisions of the [Exchange] Act"). His failure to do so violated Conduct Rule 2110. *Dep't of Enforcement v. Block*, Complaint No. C05990026, 2001 NASD Discip. LEXIS 35, at *16 n.17, 19 (NAC Aug. 16, 2001); *James Pritula*, 53 S.E.C. 968, 976-77 (1998).

B. <u>Inaccurate Books, Records and FOCUS Reports</u>

The Hearing Panel also found that, on or about January 31 and February 28, 2002, Fox and Moldermaker maintained material inaccuracies in the Firm's records, and that respondents submitted materially inaccurate FOCUS Reports for the December 2001, January 2002, and February 2002 periods. We affirm the Hearing Panel's findings.

"The SEC has repeatedly held that the duties to maintain records and file reports require that such records and reports be true and correct." *Inv. Mgmt. Corp.*, 2003 NASD Discip. LEXIS 47, at *20, *citing Hutchinson Fin. Corp.*, 51 S.E.C. 398, 399 (1993). Failing to maintain accurate books and records is a violation of Exchange Act Rule 17a-3 and Conduct Rules 3110 and 2110. *Id.* at *20-21. Failing to file accurate FOCUS reports is a violation of Exchange Act Rule 17a-5 and Conduct Rule 2110. *Block*, 2001 NASD Discip. LEXIS 35, at *20-22.

The three errors in the Firm's net capital computation also were reflected in the Firm's records and FOCUS reports. Specifically: (i) Fox incorrectly booked the two deposits totaling $190,000 as assets on its FOCUS report, balance sheet, and general ledger dated January 31, 2002;[15] (ii) Fox failed to book the arbitration award as a liability on its December 2001 FOCUS report; and (iii) Fox incorrectly booked its insurance claim ($722,653) as an allowable asset on its February 2002 FOCUS report.

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[14] Not accounting for any accrued interest for which Fox was liable, on January 31 and February 28, 2002, Fox had negative net capital of ($530,873) and ($212,275), respectively.

[15] Fox's general ledger reflected "paid in capital" of $110,000 from Moldermaker and $80,000 from "Spaulding."

In addition to these errors, Fox incorrectly booked a $300,000 line of credit as an asset on its January and February 2002 FOCUS reports and its balance sheets and general ledgers dated January 31 and February 28, 2002.[16] The $300,000 line of credit was Moldermaker's personal line of credit, not Fox's, and therefore was not an asset that Fox could readily convert into cash.[17] *Cf. Kirk L. Ferguson*, 51 S.E.C. 1247, 1249-50 (1994) (holding that checks issued from FINOP's personal line of credit but not deposited into broker-dealer's account were not among firm's allowable assets).

Accordingly, Fox violated Exchange Act Rules 17a-3 and 17a-5 and Conduct Rules 3110 and 2110. As president and FINOP of Fox, Moldermaker had responsibility to maintain accurately Fox's books and records and to ensure the accuracy of the Firm's FOCUS reports, and he is therefore liable for violating Rules 3110 and 2110. Membership and Registration Rule 1022(b)(2); *Block*, 2001 NASD Discip. LEXIS 35, at *21; *James Pritula*, 53 S.E.C. at 976-77.

C. <u>Failure to Report Information</u>

We also affirm the Hearing Panel's finding that respondents failed to report certain information to NASD concerning the arbitration case and award, in violation of Conduct Rules 2110 and 3070. Respondents failed to do so on two occasions.

First, respondents failed to file an amended Form U5 regarding former representative Gwynn when he was named as a respondent in the arbitration matter. Member firms are required to notify NASD through Form U5 of the termination of an associated person and to file an amended Form U5 within 30 days "in the event that the member learns of facts or circumstances causing any information set forth in [Form U5] to become inaccurate or incomplete." NASD By-Laws Art. V, Sec. 3(b). Failing to file an amended U5 is a violation of Conduct Rule 2110. *Dist. Bus. Conduct Comm. v. Respondent 1*, Complaint No. C8A960052, 1998 NASD Discip. LEXIS 63, at *14-15 (NAC Oct. 13, 1998). Question 7E of Form U5 asks whether the terminated individual has been named in any investment-related, consumer-initiated arbitration that alleged that the terminated individual was involved in one or more sales practice violations. Therefore, when the arbitration matter was filed against Gwynn, Fox was required to amend Gwynn's Form U5 with that information no later than 30 days after learning of the arbitration. Respondents failed to file such an amendment.

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[16] On Fox's balance sheets and general ledgers, the $300,000 was reflected as "Johnson Bank CC" in the assets column and included in the "due to shareholder" line item in the liability column. The total assets and liabilities reported on these records were substantially the same totals reported on Fox's FOCUS reports.

[17] According to Fox's January 2, 2002 corporate minutes, Moldermaker "pledged" the line of credit to Fox as a "subordinated loan." There is nothing in the record, however, that demonstrates that the line of credit was converted from Moldermaker's personal line of credit to Fox's line of credit.

Second, respondents failed to electronically report through the Rule 3070 reporting system the issuance of the $983,992 arbitration award against Fox. Conduct Rule 3070(a)(7) requires member firms to "promptly report" to NASD an adverse securities-related arbitration award that exceeds $15,000. Respondents failed to do so, in violation of Conduct Rules 3070 and 2110. *See Inv. Mgmt. Corp.*, 2003 NASD Discip. LEXIS 47, at *21-23 (holding broker-dealer and its president liable for failing to report arbitration award).

Respondents argue that there was no evidence that Moldermaker was personally responsible for filing the amended Form U5 or for filing required reports under Rule 3070. As president of Fox, however, Moldermaker was "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." *William H. Gerhauser*, 53 S.E.C. 933, 940-41 (1998). There is no evidence that Moldermaker delegated to anyone the responsibility for filing required reports under Conduct Rule 3070. While there is evidence that Moldermaker delegated responsibility to file amended Forms U5, the record demonstrates that Moldermaker personally decided not to file an amended Form U5 for Gwynn out of a concern that Gwynn otherwise might not provide favorable testimony in the arbitration matter. Given Moldermaker's personal intervention with respect to Gwynn's Form U5, any alleged delegation of authority by Moldermaker would not have been effective.

Accordingly, Fox and Moldermaker failed to file required information with NASD in violation of Conduct Rules 2110 and 3070.

IV. Sanctions

For respondents' failure to maintain sufficient net capital and to maintain accurate books and records, the Hearing Panel fined respondents $25,000, jointly and severally, and barred Moldermaker from associating with any member firm as a FINOP. For respondents' failure to file an amended Form U5 or report the arbitration award to NASD, the Hearing Panel fined respondents $10,000, jointly and severally, and suspended Moldermaker in all supervisory and principal capacities for 10 business days. We affirm the Hearing Panel's sanctions.

A. Sanctions for Net Capital, Recordkeeping, and FOCUS Report Violations

The Hearing Panel appropriately assessed a single set of sanctions for respondents' net capital, recordkeeping, and FOCUS report violations. Although SEC case law and NASD practice strongly suggest that sanctions be assessed per cause, where multiple, related violations arise as a result of a single underlying problem, a single set of sanctions may be more appropriate to achieve NASD's remedial goals. *Inv. Mgmt. Corp.*, 2003 NASD Discip. LEXIS 47, at *27-28. In this case, respondents' net capital and recordkeeping violations primarily arose out of respondents' improper accounting treatment of the arbitration award, the insurance claim, and the $190,000 deposits, making a single set of sanctions for these violations appropriate.

In deciding upon an appropriate sanction, we have considered both the principal considerations and the specific considerations concerning respondents' net capital, recordkeeping, and FOCUS report violations set forth in the NASD Sanction Guidelines (2001 ed.) ("Guidelines"). *See* Guidelines at 9-10 (Principal Considerations), 33 (Net Capital Violations), 34 (Recordkeeping Violations), and 76 (FOCUS Reports—Late Filing; Failing to File; Filing False or Misleading Reports). Such considerations demonstrate that respondents' violations were egregious.

The inaccurate information on respondents' January 2002 and February 2002 FOCUS reports was material, given that it masked the fact that the Firm maintained net capital at levels that were hundreds of thousands of dollars below its required minimum and inaccurately reflected that the Firm maintained substantially more assets than it actually did. And clearly, respondents' decision to continue operating its business despite maintaining insufficient net capital resulted in the potential for their monetary gain. Respondents also engaged in a pattern of misconduct, failing over three consecutive months to properly book numerous items.

Respondents argue that a variety of factors demonstrate that they acted reasonably and in good faith, which they contend should mitigate their conduct. For example, respondents claim that: (i) the net capital issues were novel and unprecedented; (ii) Moldermaker initiated and engaged NASD staff in discussions concerning these net capital issues and reasonably believed that NASD staff would ultimately deem Fox's insurance coverage as an allowable asset; (iii) Moldermaker reasonably doubted the correctness of instructions from NASD staff, who had initially "leaped to the conclusion" that Fox maintained insufficient net capital without considering whether Fox had an allowable insurance asset; and (iv) NASD staff failed to timely advise respondents how to calculate the Firm's net capital.

We find, however, respondents had no reasonable basis for their net capital treatment of the arbitration award and the insurance claim. Respondents did not secure competent advice, such as a legal or accounting opinion, that their conduct was appropriate. Nor did respondents ultimately secure no-action relief from the SEC or approval of their conduct from NASD staff. Absent any basis for their actions other than Moldermaker's personal preference and his distrust of NASD staff, respondents fail to show that their conduct resulted from a good faith misunderstanding of their obligations.

Instead, the preponderance of the evidence shows that respondents' violations were intentional. Moldermaker was aware that an arbitration award had been issued against Fox, that he had not obtained a letter from outside counsel indicating that Fox's errors and omissions claim was due and payable, and that the Firm's insurance company had not acknowledged Fox's insurance claim as due and payable prior to the day for which he booked the insurance claim as among the Firm's assets. And while specific awareness of applicable legal requirements is not required to find that a respondent's violations were intentional, respondents calculated net capital in ways that they knew conflicted with applicable legal requirements. Specifically, Moldermaker admitted that he was aware of the requirement to immediately book arbitration awards as liabilities for net capital purposes and that he had previously booked arbitration awards immediately upon issuance. Viewing that requirement as "antiquated," however, Moldermaker chose to ignore it, even after NASD staff instructed him that Fox was required to book the arbitration award as a liability. Likewise, Moldermaker admitted that he was familiar with the steps the insurance claims provision required before booking an insurance claim as an asset, and

NASD staff warned him that booking Fox's insurance claim as an asset would contravene that provision. Moldermaker again, however, ignored the applicable rule and NASD staff's instructions. Respondents' booking the two deposits totaling $190,000 also was at least reckless. Although respondents assert that booking the $190,000 as an asset was a mistake and a clerical error, the fact that respondents erroneously booked not one but two deposits undermines that assertion.

Moldermaker's contention that *he* initiated the discussions with NASD staff concerning the net capital issues is disingenuous and does not mitigate his conduct. The record demonstrates that Moldermaker initially contacted NASD to complain about Gwynn, not to inquire about how to book the arbitration award or the insurance claim. And respondents' attempts to shift the blame for their own actions to NASD staff is an aggravating factor, not a mitigating one, because it demonstrates that respondents have not accepted responsibility for their actions. *See Dep't of Enforcement v. Tretiak*, Complaint No. C02990042, 2001 NASD Discip. LEXIS 1, at *57 (NAC Jan. 23, 2001), *aff'd*, *Robert Tretiak*, Exchange Act Rel. No. 47534, 2003 SEC LEXIS 653 (Mar. 19, 2003).

Accordingly, we find that respondents' violations are serious enough to bar Moldermaker from serving as a FINOP for any member firm and to impose on Moldermaker and Fox, jointly and severally, a $25,000 fine.[18] We therefore affirm without modification the single set of sanctions imposed by the Hearing Panel.[19]

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18 Respondents argue that barring Moldermaker as a FINOP is unduly harsh when compared to sanctions imposed in other cases. The appropriateness of sanctions, however, "depends on the particular facts of each case and cannot be determined with any exactness by comparison with the action taken in other cases." *Dist. Bus. Conduct Comm. v. Mohn*, Complaint No. C8A960063, 1999 NASD Discip. LEXIS 2, at *41 n.12 (NAC Jan. 22, 1999) (quoting *Donald W. Collins*, 46 S.E.C. 642, 647 (1976)), *aff'd*, *Keith L. Mohn*, 54 S.E.C. 457 (1999).

19 This single set of sanctions is within the range recommended in the Guidelines. For egregious net capital violations, the Guidelines recommend that we impose a fine between $1,000 to $50,000, consider suspending the firm for up to two years or expelling it, and consider suspending the financial principal or responsible party in any or all capacities for up to two years or imposing a bar. *See* Guidelines (2001 ed.) at 33 (Net Capital Violations). For egregious recordkeeping violations, the Guidelines recommend that we consider imposing a fine of $10,000 to $100,000, consider suspending the firm up to two years or expelling it, and consider suspending the financial principal or responsible party in any and all capacities for up to two years or imposing a bar. Guidelines (2001 ed.) at 34 (Recordkeeping Violations). For filing false or misleading FOCUS reports, the Guidelines recommend that we impose a fine between $10,000 and $50,000, consider suspending the firm from all solicited retail business for up to 30 business days and thereafter until the firm corrects all deficiencies, and consider suspending the financial principal or other responsible principal in any and all capacities for up to two years. Guidelines (2001 ed.) at 76 (FOCUS Reports).

B. Sanctions for Reporting Violations

The recommended ranges of sanctions for failing to update a Form U5 and failing to report a reportable event under Conduct Rule 3070 are similar: the imposition of a fine on the responsible principal and/or firm between $5,000 and $100,000 and a suspension of the responsible principal in all supervisory capacities for 10 to 30 business days.[20]

The record demonstrates that respondents' failure to file a Form U5 for Gwynn was intentional. Moldermaker testified that he understood that Fox had an affirmative obligation to keep Forms U5 current with amendments. Yet, according to both Hogoboom and Miskell, Moldermaker stated that he made a "strategic decision not to" file a Form U5, to ensure that Gwynn would provide favorable testimony in the arbitration matter. Moreover, during NASD's investigation, Moldermaker informed NASD staff that "[o]nly after adjudicating the two arbitrations did it become my opinion that Mr. Gwynn's egregious behavior needed to be reported to you." Moldermaker's actions in this regard reflect an intent to violate the Firm's reporting obligations.

As for respondents' failure to report to NASD the issuance of the arbitration award, Moldermaker appeared to be ignorant of the requirement that he do so. Ignorance of NASD requirements, however, is no excuse for violative behavior. *Thomas C. Kocherhans*, 52 S.E.C. 528, 531 (1995). Moreover, Moldermaker essentially admitted that this was not the first time that he failed to comply with Rule 3070, testifying that, as a result of the last three routine examinations of the Firm, NASD had issued three Letters of Caution concerning Rule 3070 violations. Such repeated misconduct demonstrates to us that sanctions stronger than Letters of Caution are needed to deter future failures to comply with Rule 3070.

The sanctions imposed by the Hearing Panel for respondents' reporting violations are appropriate. Accordingly, for failing to report required information to NASD, we fine Fox and Moldermaker $10,000, jointly and severally, and we suspend Moldermaker in all supervisory and principal capacities for 10 business days.

V. Conclusion

Accordingly, we find that Fox operated with insufficient net capital, failed to maintain accurate records, submitted materially inaccurate FOCUS reports, and failed to report certain information to NASD concerning the arbitration matter, in violation of Exchange Act Rules 15c3-1, 17a-3, and 17a-5 and Conduct Rules 2110, 3070, and 3110. For causing such violations, Moldermaker violated Conduct Rules 2110, 3070, and 3110. For the net capital, recordkeeping

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[20] Guidelines (2001 ed.) at 77 (Forms U4/U5 – Failing to File Forms or Amendments), 82 (Reportable Events Under Conduct Rule 3070). The Guidelines contain additional recommendations for egregious failures to report, which are not pertinent to this aspect of the case.

and FOCUS report violations (causes one, two, and three), we fine the Firm and Moldermaker $25,000, jointly and severally, and we bar Moldermaker from associating with any member firm as a FINOP. For the respondents' failure to report information concerning the arbitration matter (cause four), we fine respondents $10,000, jointly and severally, and we suspend Moldermaker in all principal and supervisory capacities for 10 business days. We affirm the Hearing Panel's imposition of $2,938.03 in costs against respondents, jointly and severally, and we assess on respondents appeal costs of $2,353.70, jointly and severally.[21]

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney, Senior Vice President
And Corporate Secretary

[21] We have considered and reject without discussion all of respondents' other arguments.

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