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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. RESPONDENT Respondent.	Disciplinary Proceeding Hearing Officer - JN **HEARING PANEL DECISION** August 19, 2003

Respondent failed to file FOCUS Report in a timely manner, in violation of NASD Conduct Rule 2110 and SEC Rule 17a-5. It is fined $1,000, directed to file a certificate concerning corrective action, and assessed $1,968.74 in hearing costs.

Appearances

For the Complainant: Adam Lipnick, Senior Regional Attorney, New York, NY for the Department of Enforcement.

For the Respondent: Respondent.

Decision

I. Introduction

On January 7, 2003, the Department of Enforcement filed a Complaint against Respondent, a small firm that furnishes investment advice and manages money, operating as a fully-disclosed non-clearing broker. The Complaint alleges that the firm violated NASD Conduct Rule 2110 and SEC Rule 17a-5 by failing to file its December 2001 FOCUS Report in a timely manner. A Hearing Panel composed of two current members of NASD District Committee No. 10 and an NASD Hearing Officer conducted a hearing in New York City on May

22, 2003. The record consists of eight exhibits introduced by Enforcement (CX-1 – CX-8), ten exhibits introduced by Respondent (RX-1 – RX-10) and the hearing transcript ("Tr.").

II. Discussion

A. Liability

Under SEC Rule 17a-5(a)(2)(iii), a member firm such as the Respondent must file its FOCUS Reports with NASD within seventeen business days following each calendar quarter. NASD records show that Respondent's December 2001 FOCUS Report, due January 25, 2002, was not received until February 4, 2002, five business days late (CX-3; Tr. 19, 49, 52; RX-1). Respondent's president, agreed that the filing was late (Tr. 15, 19, 21). The Panel concludes that Respondent thus violated SEC Rule 17a-5 and NASD Rule 2110, as alleged.[1]

B. Sanctions

For non-egregious late filing of FOCUS Reports, the NASD Sanction Guidelines (2001) recommend a fine of $1,000 to $20,000 (p. 76). Enforcement seeks a $1,000 fine. Respondent urged that such a fine would be "harsh," "severe," and "out of proportion" to the misconduct (Tr. 150,186, 188, 190). He sought "the smallest punishment that you can afford to fine," testifying that Enforcement's earlier offer to settle for $500 was too much for the firm (Tr. 41, 141-143, 148).

1.) Circumstances favorable to Respondent

Some aspects of this case support Respondent's arguments for leniency. The Panel has considered the fact that Respondent is a small firm, necessarily dependent upon a part-time accountant to do its financial reporting. The Panel also understands that reports for the last

[1] Making such late filings violates the requirement for adherence to high standards of commercial honor and just and equitable principles of trade. Aristo Investments of America, Exchange Act Rel. No. 31516, 1992 SEC LEXIS 3124 at *4 (November 24, 1992) ("The requirement to file timely FOCUS reports is an important means of monitoring the financial health of broker-dealers and of protecting public investors").

quarter of the year pose practical problems for such accountants, considering their overlapping tax work. The Panel accepts Respondent's testimony that he was caught in a time of transition, involving a new accountant and a new FOCUS reporting system; that the firm serves its clients loyally and well; and that no client had ever complained. Finally, there was no evidence that the late filing was intentional, and Enforcement agreed that the firm's untimeliness did not harm any investor or investments (Tr. 182).

2.) The firm's history of late filing

The most significant countervailing factor lies in the firm's own history. NASD records show that its FOCUS reports were late on five other prior occasions, beginning in May of 1999 and continuing through January of 2001 (CX-2; RX-1). Respondent's suggestion that computer errors somehow rendered NASD's records inaccurate as to the five prior deficiencies is pure speculation. A letter from the firm's computer technicians, stating that transactions might not go through because of slow-downs or bottlenecks in Internet traffic at either end or because of server outages, spoke entirely in generalities and made no reference to any of the specific late filings on the firm's record (RX-2). NASD staff members had received no complaints of inaccuracies in the computerized receipt dates and had no knowledge of any computer errors in this respect (Tr. 52, 109). Moreover, Respondent admitted that he had no documentary evidence showing that he had filed the reports on time (Tr. 135-136). In these circumstances, the Panel accepts NASD records as accurately reflecting the filings as late.[2]

As the Guidelines recognize: "[a]n important objective of the disciplinary process is to deter future misconduct by imposing progressively escalating sanctions on recidivists. For this

[2] Respondent argued that because of "the problems you can have with computers, the Department failed to prove 'beyond a shadow of a doubt'" that his report was late (Tr. 174). The standard of proof is a "preponderance of the evidence" (i.e., more likely than not). There is no requirement for proof "beyond a shadow of a doubt" or by any other higher standard. See Steadman v. SEC, 450 U.S. 91 (1981).

reason, when appropriate, Adjudicators should consider a respondent's relevant disciplinary history in determining sanctions. Relevant disciplinary history may include . . .past misconduct similar to that at issue" (p. 3). See also Howard R. Perles, Exchange Act Rel. No. 45691, 2002 SEC LEXIS 847 at *38 (April 4, 2002). The prior late filings produced several letters, culminating in a Letter of Caution, which asked that the firm detail corrective measures taken to prevent recurrence. After the firm failed to respond, the staff issued a second letter advising the firm that future violations could lead to formal disciplinary charges (CX-7). At no time were fines or other sanctions were imposed. Applying the above Guidelines' principle, some escalation is now necessary.

These failures constitute serious matters. As explained by the SEC, "prompt receipt of accurate FOCUS and annual audit reports is critical. It provides the NASD and the Commission with an important means of timely oversight of the financial health of broker-dealers and of protecting public investors."[3] "[C]ompliance with the requirements of Rule 17a-5 'is a keystone of the surveillance of registered broker-dealers with which [the Commission is] charged in the interest of affording protection to investors . . .'"[4] See also Aristo, supra, at *4.

The firm's prior record also should have led Respondent to be more careful. Member firms receive regular notice of the FOCUS report due dates (CX-4, CX-5), and Respondent gave the accountants "filing instructions . . .by providing the filing date and repeating to them that it had to be filed on time" (Tr. 11). Given the firm's past late filings and its ongoing transitional difficulties with accountants and reporting systems, Respondent should have checked with the accountant as to the prospect for timely filing of the Report due in January of 2002. This step

[3] Clinger & Co., Exch. Act Rel. No. 33375 (December 23, 1993), 1993 SEC LEXIS 3524 (1993).

[4] Philip Greifeld, CPA, Exch. Act Rel. No. 38316 (Feb. 20, 1997), 1997 SEC LEXIS 408 (1997) (quoting W.E. Leonard & Co., Inc., Exch. Act Rel. No. 6197 (March 3, 1960), 1960 SEC LEXIS 413 (1960)).

should have alerted him to the need for an extension from NASD staff. Respondent said that he never took that step because he had no advance knowledge that the accountant would be late (Tr. 11-12, 116-117, 174-175). A simple question to the accountant, however, would have given him that knowledge.

The Respondent firm is a recidivist in an important regulatory area and, as such, warrants a sanction greater than the "smallest" conceivable one.

The February 1, 2002 Letter of Caution asked for a response "setting forth in detail the actions taken to correct the deficiency and to prevent a recurrence" (CX-7). Respondent filed no such response because, as he testified, the future is unknown and he could not guarantee the timeliness of future reports (Tr. 138, 149, 176). That contention also fails. Under Respondent's theory, no one ever need respond to such an NASD inquiry because no one knows the future. In any event, a list of actions taken "to prevent a recurrence" is not the same thing as a guarantee against recurrence. Respondent is an intelligent and articulate person who could have made clear that a description of corrective measures did not necessarily embody guarantees. As expressed by NASD's District 10 Deputy Director, who supervises financial surveillance in New York, "[i]t is just very rare for us not to receive a response [to a Letter of Caution] because firms are . . .generally pleased that the matter is resolved informally; and there is no downside to the firm, why would you not want to respond?" (Tr. 99). The failure to respond is an aggravating circumstance.[5]

[5] Respondent raised a question about notes of telephone conversations between him and the staff (Tr. 78-79). The Hearing Officer noted that any exculpatory materials should not be withheld, and the Panel directed Enforcement to file a report concerning the notes or the notes themselves within one week after the hearing closed (Tr. 81-82, 198-200). The Department submitted the notes while arguing that they were irrelevant and subject to the work product privilege. Respondent responded. The Panel finds that the notes shed little light on any issue. None of them dealt with the lateness that was the subject of the Complaint. None was exculpatory. Some lines were illegible. Insofar as the notes have any relevance, it would be unfair to both sides to consider them without testimony from and cross-examination of the note-takers. In these circumstances, the Panel decided not to re-open the hearing and gave the notes no weight.

3.) Respondent's other arguments for leniency

That the untimely filing of a FOCUS report can be treated under the NASD's Minor Rule Violation Plan does not warrant leniency here. The staff exercised its discretion by attempting initially to handle the instant violation that way. It offered a $500 settlement under that Plan, but Respondent rejected the offer as too high (Tr. 41, 42, 103). That unsuccessful effort does not somehow preclude the instant Complaint. Indeed, the Plan specifically states that "[t]he NASD retains the discretion to bring full disciplinary proceedings for any violation of a rule included in the Plan, including situations where: . . .there is a history or pattern of repeat violations; . . ." (Notice to Members No. 01-54, 2001 NASD LEXIS 59 at 4-5 (August, 2001). The Respondent firm has precisely such a history.

Respondent repeatedly alleged that the staff attempted to pressure him into settlement by saying that the stakes would be higher if he went to hearing (Tr. 13, 14, 45-46). As the SEC stated, "we have frequently pointed out that pragmatic considerations justify lesser sanctions in negotiated settlements" than in cases that go to hearing.[6] "[S]anctions stemming from a settlement are typically less than fully litigated cases because the parties forgo the cost of litigation. This is generally referred to as a settlement discount."[7] Telling Respondent that the "settlement discount" disappears if the case goes to hearing is consistent with conventional practice and creates no reason for leniency.

Respondent urges a light sanction because Rule 17a-5 is "flawed" in that it contains no flexibility for the small firm caught up in the practical difficulties of making a filing within seventeen business days (Tr. 129, 149, 151-152, 159, 174, 178, 181). Though the Rule is written

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[6] Perles, supra, 202 SEC LEXIS 847 at *34 (citation omitted).

[7] Dep't of Enforcement v. Wendell D. Belden, No. C05010012, 2002 NASD Discip. LEXIS 12 at *27 (August 13, 2002), sustained, Exchange Act Rel. No. 47859, 2003 SEC LEXIS 1154 (May 14, 2003).

in broad uniform terms, particular circumstances may warrant extensions, which the staff can grant (Tr. 116-117). In addition, a disciplinary panel may, as here, consider mitigating circumstances. That the SEC chose to require all brokers or dealers in a certain category to file their reports within 17 business days after the quarter's end is not itself a reason for leniency.

4.) The asserted inability to pay a $1,000 fine

Respondent rejected Enforcement's offer to settle the dispute for $500 because, according to him, he could not afford to pay that much (Tr. 41, 142). He testified that he "would have to think about" his ability to pay any fine higher than $15 (Tr. 145). The record shows that the firm and/or Respondent's President could easily pay a $1,000 fine. His assertions to the contrary reflect his perceived need to conserve money and not an actual inability to pay the fine.

As to the existence of money, the firm has over $126,000 in liquid assets, including over $70,000 in cash, while carrying what Respondent himself described as "very little" in liabilities (CX-8; Tr. 140-141, 146). He further acknowledged ownership of a mortgage-free apartment with a value of at least $600,000 (Tr. 195). He also admitted, "I suppose I could borrow if I wanted to go into debt" (Tr. 196).[8]

The record also shows that the asserted inability to pay even a $1,000 fine reflected a desire to retain the money for possible future need, not any lack of means. Respondent made clear that he was choosing not to spend money on a fine because his business was not now profitable and he preferred to save for an unknown future (Tr. 143, 150, 156). He acknowledged that paying a $1,000 fine would not put the firm out of business "tomorrow," but insisted that "I need every cent in contingency" and "I need working capital. I don't know how business is

[8] A successful inability-to-pay defense requires proof that the Respondent "has no ability to borrow the necessary monies." William J. Gallagher, Exchange Act Rel. No. 47501, 2003 SEC LEXIS 599 at *12 (March 14, 2003) (citation omitted).

going to be" (Tr. 143, 150). A panelist asked, "you do have the ability to, for example, write a check up to a thousand dollars, but you would feel it would not be prudent to pay that amount, is that your understanding?" and Respondent answered, "[e]xactly" (Tr. 156). A respondent whose financial position "hinges more on his own asset-allocation choices than a genuine inability to pay" has failed to carry the burden of establishing the defense. Milton R. Barnes, 1998 NASD Discip. LEXIS 55, at *13 (NASD Board of Governors, June 26, 1998).

With the record in this posture, the Panel agrees with Enforcement that Respondent has not shown (and cannot show) a good faith inability to pay and that no useful purpose would be served by continuing the hearing to receive a financial disclosure form and review its contents. The undisputed facts show that he has the money to pay this comparatively small fine and that his claimed inability is the product of asset allocation choices.

5.) The appropriate sanctions

The Panel has considered all of the circumstances. Balancing the favorable factors discussed above against the firm's history of late filings, it concludes that the appropriate sanctions for the untimely filing of the FOCUS report for the last quarter of 2001 shall include a fine of $1,000. See Aristo supra, sustaining a $2,000 fine for such a late filing, where the firm had a prior history of such deficiencies.

The Panel further concludes that the firm should file a certificate, signed by an officer, "setting forth in detail the actions taken to correct this deficiency and to prevent a recurrence" (CX-7), i.e., responding to the staff's request in the Letter of Caution. This should not be burdensome, considering Respondent's belief that he now has the untimeliness problem "under control" (Tr. 149, 189). The certificate would not constitute a guarantee of the future, but would address only what has been done and what can reasonably be expected.

C. Conclusion

For filing its FOCUS report late, in violation of SEC Rule 17a-5 and NASD Rule 2110, Respondent is fined $1,000 and required to submit to Enforcement the certificate described above. Finally, Respondent is directed to pay a total of $1,968.74 in costs, reflecting $1,218.74 for the hearing transcript and the standard $750 administrative fee.[9]

These sanctions shall become effective on a date set by the Association, but no earlier than 30 days after this Decision becomes the final disciplinary action of the Association.[10]

HEARING PANEL

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Jerome Nelson
Hearing Officer

Dated: August 19, 2003
Washington, DC

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[9] During a pre-hearing conference, the Hearing Officer advised Respondent that failing to prevail at a hearing could result in the imposition of transcript costs plus the $750 fee (March 26, 2003, Tr. 14-15). He elected to go forward.

[10] The Hearing Panel considered all of the arguments of the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.