NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. CHRISTOPHER M. BLOCK (CRD #2073057), Houston, TX and Houston, TX and JEFFREY S. BURKE (CRD #2007369), Houston, TX and Houston, TX and JENNIFER L. GONZALEZ[1] (CRD #2461482), Respondents.	Disciplinary Proceeding No. C05990026 **HEARING PANEL DECISION AS TO RESPONDENTS BLOCK AND BURKE** Hearing Officer - JN September 5, 2000

Digest

The Complaint contains six causes. The First Cause alleges Respondent Block's involvement in improper bookkeeping for Block Trading, Inc., in violation of SEC Rules 17a-3 and 17a-4, and NASD Rules 2110 and 3110. The Second Cause charges Respondents Block and Burke with net capital violations by the firm, in violation of SEC Rule 15c3-1, and NASD

Rule 2110. The Third Cause alleges that Block failed to provide notification that the firm's net capital was below the required minimum, in violation of SEC Rule 15c3-1, and NASD Rule 2110. The Fourth Cause charges Block with filing various inaccurate FOCUS reports, in violation of Rule 2110. The Fifth Cause charges Block with fraud in providing false and misleading financial information to investors, in violation of Rules 2110 and 2120. The Sixth Cause charges supervisory violations by Block and Burke, in violation of Rules 2110 and 3010.

The Hearing Panel found that Respondents Block and Burke were liable as charged in Causes One through Five of the Complaint. As sanctions for Block, the Panel imposed a total of $50,000 in fines and a bar from associating with a member in any principal or supervisory capacity. As sanctions for Burke, the Panel imposed a total of $15,000 in fines, a 30-day suspension from associating with any member in a principal or supervisory capacity, and a requirement that he re-qualify as a General Securities Principal.

A respondent who is liable as a primary violator cannot also be liable for supervisory failures involving that same misconduct. The Panel thus found that Block, already liable for the First through Fifth Causes, cannot also be responsible for those same violations as a supervisor. Had he not been charged as a primary violator in those Causes, the Panel would find, alternatively, that he did violate his supervisory responsibilities with regard to the conduct alleged therein. For such supervisory violations, the Panel would have imposed a fine of $10,000 and a bar from associating with any member in a principal or supervisory capacity.

Burke was not charged in the First, Third and Fourth Causes, and as to those allegations, the Panel found him liable for supervisory failures. As a sanction for these

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[1] Respondent Jennifer Gonzalez, the firm's Financial and Operations Principal (FINOP), settled with

supervisory violations, the Panel fined Burke $5,000 and required that he re-qualify for his Series 24 license. Had he not been charged as a primary violator in the Second Cause, the Panel would find, alternatively, that he was responsible for supervisory failures as to the conduct there alleged. In this event, no additional sanction for that supervisory violation was necessary because Burke was sanctioned for supervisory violations as to the First, Third and Fourth Causes.

Respondents were also jointly and severally assessed $7,339.80 as costs, including $6,589.80 for transcripts and an administrative fee of $750.

Appearances

Ralph J. Veth, Esq. and Mark P. Dauer, Esq., New Orleans, LA and Rory C. Flynn, Esq., Washington, DC, for the Department of Enforcement.

G. Scott Williams, Esq., Houston, TX, for Respondent Block.

Andrew R. Harvin, Esq., Houston, TX, for Respondent Burke.

DECISION

I. Introduction

Respondent Block was the Chief Executive Officer, Chairman, and sole director of Block Trading, Inc., a Houston daytrading firm which ceased operations in September of 1998, due to a net capital deficiency. Respondent Burke was President of the firm.

Although an outside auditor did not discover net capital violations until September of 1998, the firm had operated with net capital below the required minimum since October of

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Enforcement prior to the hearing and appeared as a witness for the Department.

1997. During that time, its monthly deficiencies, hidden from the SEC and NASD, ranged from $192,099 to $1,720,468 (Joint Exhibit 1).

During this period of net capital violations, Block and Burke, co-founders of the firm, who shared joint supervisory responsibility for its operations, fell into serious disagreement. Their deteriorating relationship culminated in Block running the company on a day-to-day basis, while Burke operated a branch office trading floor in another location. While Block relied on Gonzalez, a non-accountant, he nevertheless involved himself in the firm's bookkeeping, including some of the techniques which concealed the net capital violations. An accountant employed by the firm (Mr. S) questioned some of the entries and discussed with Burke his suspicions that the firm was in violation. In June of 1998, Burke conferred with Mr. C, the firm's outside auditor, who, in September of 1998, found that Block Trading was operating without the required minimum net capital. The firm then ceased operations.

The principal issues at the hearing involved the extent to which Block and Burke are culpable for these net capital deficiencies. A Hearing Panel, composed of an NASD Hearing Officer and a current and a former member of District Committee Number 6, conducted hearings in Houston, Texas on April 24, 25, and 26, 2000. After the parties filed briefs, the Panel heard closing statements and arguments on June 16, 2000.

II. Discussion

A.) Block's liability for financial violations

The First through Fourth Causes of the Complaint charged Block with making improper entries on the firm's books, operating under net capital deficits, failing to report such deficits, and filing false FOCUS reports. Each of these allegations charged a different version of the

same underlying misconduct - the firm's net capital violations. Enforcement's evidence was essentially the same for all of these counts, and Block defended each with the claim that his knowledge of and involvement in the firm's net capital situation were not sufficient to establish liability. For purposes of clarity and of avoiding repetition, the Panel here discusses the four Counts on a combined basis.[2]

1.) Block's activities

Block argues that he was neither involved in nor aware of the accounting misconduct which concealed the net capital violations; that the books were solely the responsibility of Gonzalez, the FINOP, to whom he delegated such duties; and that he, therefore, should not be held liable for the deficiencies in the books and records, the net capital violations, or the failure to report them (Brief, pp. 1-9). The Panel disagrees and concludes that Block - the CEO, Chairman and sole director of the company which bore his name - had close involvement in the net capital violations.

One of the firm's techniques for evading net capital deficits on its books was to treat certain of its liabilities as those of an affiliated management company (Jt. Ex. 1; Tr. 62-63). Block knew about this bookkeeping device; indeed, two of the firm's employees questioned him about the practice. The firm's former compliance officer (Katz) stated that he told Block that such liabilities had to be booked to the firm, not to another entity (CB-33, par. 10). Mr. S, an accountant employed by the firm, testified that he told Block "I will book the entries into [the management affiliate] if you can provide me a letter that stated the arms-length reach between the two companies, or if you would call Jeff Mr. C [the outside auditor] and get his approval to

[2] In the Sanctions section of this Decision, the Panel similarly combines or "batches" these Counts.

book these entries" and that Block refused to make such a call (Tr. 688). Block himself agreed that Mr. S told him "he thought it was illegal" to book the firm's liabilities this way and that he wanted Mr. S to do so anyway because he believed it was permissible (Tr. 562-563).

Gonzalez, the FINOP, testified before investigators that she, together with Block, Burke, and another employee, "decided to use the management company and make those entries" (Tr. 314). She testified at the hearing that booking some of the firm's payables to an affiliate was "probably Chris' idea" (Tr. 430). Minutes of the firm's October 1997 executive committee meeting, referring to Gonzalez' questions about net capital problems, state that Block "proposed the solution of running it through" the management affiliate (CX-21, p. 8774).

A staff supervisor with training and background in analyzing net capital explained "netting," an improper bookkeeping technique which the firm used to understate liabilities. Using this device, the firm would eliminate one of its true liabilities by "netting" it against a "nonallowable asset" (i.e.- an unsecured receivable due to the firm) (Tr. 53-55). After the reporting period ended, the firm would reverse these entries (Id.). As to this device, Gonzalez testified that Block "was aware of the netting procedure because he and I had discussed that at length" and that he "told me to do it," though she did not believe that he knew it was improper (Tr. 315, 356, 430).

Block's involvement with the firm's accounting practices was also shown by Mr. C, the outside auditor. When asked who was "in charge of supervising the accounting department at the firm," he answered: "Well, I always thought Chris. I mean, yeah, Chris did," explaining that Block was his contact at the firm, and that "if I had accounting issues that [Gonzalez] didn't want to answer or were very specific questions, they were always referred to Chris" (Tr. 168).

The record also demonstrates that Block knew of the firm's net capital deficiencies. Gonzalez explained that she, Block and Burke "knew that there was a number every month that we were adjusting or working with every month," a number which "was just whatever we were having to either put off into management companies, or net as far as payables were concerned, to be in capital compliance" (Tr. 314, 315). She testified repeatedly that Block knew "the number" (Tr. 321, 426). Her testimony was corroborated by Mogonye, an employee of the firm and friend of Block, who testified that sometime prior to the summer of 1998, he heard Gonzalez tell Block that the firm needed $600,000 or $700,000 to bring itself into net capital compliance (Tr. 447). The firm had such a deficit in February of 1998, when it was $600,445 below the required minimum (Jt. Ex. 1).

Block's professed belief in the innocence of "netting" and booking the firm's payables to a subsidiary is not persuasive. It is true that Block was not an accountant, but Mr. S, who was a CPA, told him that the latter was illegal. Moreover, Katz had warned him about this practice. In any event, Block's opinion as to the legitimacy of two of the evasive techniques was immaterial. Rules 2110 and 3110, the bases for the Complaint's First, Second, Third, and Fourth Causes, require no showing of specific intent.[3] Block knew of the firm's net capital deficit and used these and other devices to hide it. The firm's books and records were defective, the net capital violations occurred, the required reports were not made, and the FOCUS reports were inaccurate - no matter what he thought about the means used.

The testimony of Mr. S, the employee-accountant, also shows Block's overall awareness of the net capital deficits. He described a meeting with Gonzalez, Block, and others

[3] In re William H. Gerhauser, Exchange Act Rel. No. 40639, 1998 SEC LEXIS 2402 (Nov. 4, 1998).

involving "how to get out of the net capital, and how much money we needed, and how they [Gonzalez and Block] could align the financials to make it look like a profitable company" (Tr. 680). During that meeting, "Chris [Block] asked Jeni [Gonzalez] if you defraud or you fraudulently turn in focus reports to the NASD once or twice, is it bad that you do it a third time, and Jeni referred to, yes, it is, and he said, well, you're just going to have to keep doing it until we can come up with a way to get out of the net cap violation" (Tr. 682).

Block's argument that he had no involvement in the filing of FOCUS reports (Brief, p. 9) ignores Mr. S's' testimony and is contrary to other evidence in any event. His reported remark about filing "fraudulent" FOCUS reports is corroborated by the reports themselves. For quarters ending December 31, 1997, March 31, 1998, and June 30, 1998, the firm's reports incorporated the accounting irregularities and failed to disclose net capital deficiencies (Jt. Ex. 1, Schedule A and par. 9; CX-26, pp. 9176-9205).

Each FOCUS report was transmitted to the NASD under a PIN number assigned to Block (Tr. 112). The keypunch operator for the reports relied wholly on financial data given him by Gonzalez, who was Block's appointee and with whom Block discussed accounting matters. Block effectively signed the FOCUS reports themselves. The first page of each bears his name as the "Principal Submitting Form Electronically" and as the "person to contact in regard to this report" (CX-26, pp. 9176, 9186, 9196). A boxed notice on each of those pages states: "[t]he registrant/broker or dealer submitting this Form and its attachments and the person(s) by whom it is executed represent hereby that all information contained therein is true, correct and complete" (Id.).

2.) Block's delegation to Gonzalez

Gonzalez, who held a Series 27 license, was the firm's Limited Principal-Financial and Operations (FINOP). Under Rule 1022(b)(2), her duties included "final approval and responsibility for the accuracy of financial reports" and "final preparation of such reports." Block, who lacked a FINOP license, argues that he delegated "final" responsibility for the books and records to Gonzalez and thus could not be liable under the First through Fourth Causes of the Complaint, citing In re Everest Securities, Inc., Exchange Act Rel. No. 37600, 1996 SEC LEXIS 2272 at *17-*18 (August 26, 1996).[4]

As stated in Everest Securities, "[t]he president of a brokerage firm is responsible for the firm's compliance … unless or until he or she reasonably delegated a particular function to another person in the firm, and neither knows nor has reason to know that such person is not properly performing his duties" (Id.). That Gonzalez was a licensed FINOP is not dispositive of the reasonableness of the delegation. See In re Kirk A. Knapp, Exchange Act Rel. No. 31556, 1992 SEC LEXIS 2971, at * 26 (December 3, 1992), where Knapp, the firm's chief shareholder and executive, "claim[ed] he is not responsible … because he was not licensed as a financial principal, and necessarily relied on [the firm's] FINOP." The SEC concluded that Knapp was responsible for net capital and other financial violations, notwithstanding the delegation, stating, "[w]e agree with the NASD that Knapp's reliance on [the FINOP] who he knew had almost no experience, would have been, at best, misplaced."[5]

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[4] Br., pp. 3-4; Tr. 857-859.

[5] See also In re Charles L. Campbell, Exchange Act Rel. No. 26510, 1989 SEC LEXIS 174, at *10 (February 1, 1989), where the FINOP's inability to balance trial balances "gave an immediate demonstration" that Respondent "could not reasonably rely on her to carry out her responsibilities."

Block's reliance on Gonzalez was similarly misplaced. She had an undergraduate degree in history, with a minor in Spanish, and three hours of accounting during some post-graduate work (Tr. 288-290). As Block admitted, he knew that Gonzalez did not possess a degree in accounting and she had no previous accounting experience, "other than balancing her checkbook" (Tr. 485). She passed her Series 7 while working as a "[g]opher, secretary" and was employed by Block Trading to write tickets and enter trades on a computer (Tr. 288-289). After two months she became "bookkeeper/accountant/controller, sort of all at once" (Id., at 289).

When a panelist asked her "[o]n what basis do you feel you are qualified to become the controller …?", she replied: "I do not think I was qualified. I was grossly underqualified, and when I'm not somewhat ashamed, I'm amused by the amount of things that we sort of all figured out as we went. Accounting happened to be my given area, and I figured it out somewhat" (Tr. 420). Mr. C, the outside auditor, described Gonzalez as "kind of learning as she went" and stated that "early on" in the firm's operations, he told Block that "due to the, size of the organization and the complexity, ... a degreed accountant would be appropriate for his firm" (Tr. 139, 140)[6]. Mr. C explained Block's delegation to Gonzalez in these terms: "[a]ccounting enlists a sense of trust, and I think he trusted Jeni [Gonzalez], and sometimes people put people in positions of trust over skill. They may not have the skills but, they have the trust part" (Tr. 181-182).

[6] The firm grossed $10 million in 1997 and $25 million in 1998 (Tr. 508).

Block's installation of this admittedly "grossly underqualified" non-accountant as FINOP of a multimillion dollar firm, in disregard of the outside auditor's advice, was unreasonable and cannot be the predicate for a "delegation" defense.

Second, Block was not the pure delegator he claims to be. The record shows his close involvement with the firm's accounting and related net capital problems. Block instructed Gonzalez to net certain receivables and payables; he had conversations with Gonzalez and Mr. S, the in-house accountant, about booking the firm's liabilities to an affiliated management company ("probably Chris' idea"); he knew the monthly "number" necessary to bring the firm into net capital compliance; he was the person to whom Gonzalez referred the outside auditor's questions; and his name appeared on the FOCUS reports as the person making the submission and the person to contact, recitals which made him the guarantor of their accuracy.

Finally, as shown infra in the discussion of supervisory failures, there were several "red flags" which should have alerted Block to the underlying net capital deficiencies He ignored these signs, allowing (and even encouraging) the violations. His failure to act appropriately in response to the situation at the firm should be considered as "part of the equation" in determining that Block was a primary actor in Causes One through Four.[7]

The argument that Block was so distant or remote from the firm's books as to be somehow insulated from liability for their entries and net capital consequences is not supported by this record. The Panel finds that the evidence directly links Block to the improper accounting, to the net capital violations, to the failure to report them, and to the inaccurate FOCUS reports. He is thus liable under the First, Second, Third, and Fourth Causes.

B.) Burke's liability for the net capital violations

The Complaint's Second cause charged Burke with allowing the firm to operate under net capital deficits from October of 1997 to September of 1998.

Burke was the President of Block Trading, with a salary equal to Block's (Tr. 757). The firm's compliance manual provided that he and Block "share in the ultimate supervision of the firm" (CB-21, p. 2). He was present at the firm's Executive Committee meeting in October of 1997, where Gonzalez warned about likely net capital problems at the end of the month and Block suggested "running" certain liabilities through an affiliated company (Tr. 293-294, 305-306). Gonzalez testified that Burke had discussed some of the on-going improper accounting techniques and that he was among those who knew "the number" (Tr. 298, 314).

During sometime in May or June of 1998, Mr. S, the firm's in-house accountant, told Burke of his concerns about net capital violations and gave him materials showing net capital violations from November of 1997 (Tr. 675-676, 678, 695, 697, 708; CX-16, p. 7263). Burke's handwritten note, reflecting what Mr. S told him, said "$564,000 in net capital violation and have been in net cap violation since October of last year" (Tr. 779; CX-16, p. 7283).

On the basis of Mr. S'' materials, Burke went to Dallas to confer with Mr. C, the outside auditor, telling him in a June 2, 1998 meeting that he "had concerns about the [firm's] accounting" (Tr. 141, 165-167). Burke believed that the firm might be in violation and raised net capital questions with the executive committee at a June 15, 1998 meeting, but did not pursue the matter further because he had no "conclusive evidence" and because Mr. C had told him to be cautious - advice which Mr. C corroborated (Tr. 170, 742-743, 746).

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[7] See Market Surveillance Comm. v. Markowski, No. CMS920091, 1998 NASD Discip. LEXIS 35, at *52 (NAC,

In January of 1998, Burke first attempted to sell his ownership share of the firm (JB-3; Tr. 384-386). In a later agreement, executed after the June 15, 1998 meeting (where Burke raised questions about the firm's net capital), Block agreed to buy Burke's shares for $1 million (Tr. 594, 733-744).[8] These two Respondents were the firm's principal stockholders and shared an obvious economic interest in keeping the firm going; although the million dollar sale fell through, Burke acknowledged that the firm's continued operation was important to the value of his stock (Tr. 767).

Burke challenges Gonzalez' credibility, suggesting that her testimony was a product of her promise to cooperate with Enforcement (Tr. 940-941, 953-954). The Panel finds nothing in this contention which justifies exonerating Burke. First, her testimony was not critical to his liability. Burke's presence at the October 1997 meeting, where net capital was discussed, is shown by the minutes of that meeting, as well as by his own admission (CX-21, pp. 8770, 8774; Tr. 769). Even if he did not know the "number" earlier (as Gonzalez testified), he nevertheless suspected net capital problems as early as April of 1998, when he called Mr. S to his office to discuss them (Tr. 673, 675). Burke's counsel had ample opportunity to explore any relationship between Gonzalez' "cooperation" with Enforcement and her testimony during cross-examination, but chose not to do so. Her testimony reflected understandable memory lapses, considering the passage of time since the events. Her overall caution was consistent with a reluctance to admit that her performance as FINOP, of which she was already "ashamed"

July 13, 1998).

[8] Burke claims that he had no knowledge of net capital violations when he first proposed to sell his stock (Br. p. 3). But he was certainly not ignorant of them at the time of the million dollar agreement in June of 1998.

(Tr. 420), was even worse. Finally, many aspects of her testimony were corroborated. The Panel saw and heard Gonzalez and concludes, on balance, that her testimony was truthful.

The totality of the evidence shows that Burke knew of the net capital violations, but never took his concerns beyond the company and its auditor. This inaction came during the time when he decided to sell his interest in the firm and was consistent with a desire to avoid action which might depress the selling price. The Panel concludes that though Burke did not cause or direct the particular accounting irregularities, he nevertheless knowingly acquiesced in them and thus may be held liable for the net capital violations.

The Panel recognizes that Burke's involvement differed from Block's; his conduct involved omissions rather than commissions. That distinction, while relevant to the questions of sanctions, does not create a defense. In the Panel's view, the evidence sufficiently links Burke to the net capital violations. Respondent Burke notes Enforcement's statement that "[t]he Department of Enforcement does not contend that Burke was an active participant in the manipulation of the firm's records" (Brief, p. 14) and asks the Panel to find that he was not such a participant. The Panel agrees that Burke was not an active participant in the manipulation of the records of Block Trading Inc., a factor which will be considered in determining an appropriate sanction.

C.) Block's Liability for the Stock Purchase Agreement and the Private Placement Memorandum

1.) the stock purchase agreement

In April of 1998, the firm, Block, and Burke executed a stock purchase agreement whereby two investors purchased shares of Block Trading stock for $600,000 (CX-27, pp. 2583-2597). The agreement, signed by Block and Burke (Id., at 2597), recites the delivery to

the investors of a financial statement which "present[s] fairly the financial condition" of the firm as of December 31, 1997 (Id., at p. 2587). The agreement further states that all information furnished to the investors "do[es] not … omit to state any material fact" (Id., at 2592). As of that date, the firm had a net capital deficit of over $300,000 and had been in a net capital deficit situation for the preceding two months (Jt. Ex. 1). Block admitted that the financial statement supplied to the investors did not disclose the net capital violation and that if he were investing in Block Trading, he would want to know if the company was in net capital violation (Tr. 654).

The Fifth Cause alleged that Block induced the purchase of the stock by providing financial information which he knew or should have known was false and misleading, in violation of Rules 2110 and 2120. Rule 2120 is the NASD's anti-fraud rule, which parallels SEC Rule 10b-5. "To find a violation of Conduct Rule 2120 and Rule 10b-5, there must be a showing that: (1) misrepresentations and/or omissions were made in connection with the purchase or sale of securities; (2) the misrepresentations and/or omissions were material; and (3) they were made with the requisite intent, i.e. scienter." District Business Conduct Committee v. Michael R. Euripides, 1997 NASD Discip. LEXIS 45, at *18 (NBCC, July 28, 1997).

Those requirements are satisfied here. The financial information furnished to the investors was false and misleading; it falsely understated liabilities and also failed to disclose that the company was in a net capital deficit. "The test for materiality is whether the reasonable investor would consider a fact important in making his or her investment decision." In re Martin R. Kaiden, Exchange Act Rel. No. 41629, 1999 SEC LEXIS 1396 (July 20, 1999), citing TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 444 (1976). The misrepresentation and the omission were material. The correct total of a firm's liabilities is plainly material when, as

here, such a statement would establish the existence of a net capital deficiency, which would trigger immediate disclosure to the SEC and NASD (SEC Rule 17a-11) and could cause the firm to cease operations. Any reasonable investor considering putting money into such a firm would want to know of an adverse net capital situation. As noted, Block himself acknowledged that if he were investing, he would have wanted to know of the net capital violation.

Rule 2120 requires proof that Block acted with scienter (knowingly intending to deceive or acting recklessly).[9] As to this element, Respondent argues that he did not know that the financial statements were inaccurate and that, in any event, the investors did not rely on the statements in them (Brief, pp. 9-10). Neither contention has merit. As shown supra, there is ample evidence that Block knew of the accounting irregularities and had personal involvement in some of them. Finally, in enforcement cases, "it is well established that reliance need not be shown to establish a violation of the antifraud rules." In re New Allied Development Corporation, Exchange Act Rel. No. 37990, 1996 SEC LEXIS 3262, at *20 (November 26, 1996)(citations omitted).

The Panel concludes that Block is liable under Rule 2120 for failing to disclose the firm's true net capital status to the investors.

2.) the private placement memorandum

The Fifth Cause also alleges that the firm's September 1998 private placement memorandum similarly concealed the company's true net capital deficit status, in violation of Rules 2110 and 2120. This memorandum described Block as "Chairman, Director, CEO and Acting President [Burke having resigned by this time], and COO" (CX-28, p. 6760).

He was the sole management official listed in it (Id., at 6771). Block was the addressee for subscription notices, subscription agreements, and purchaser questionnaires, and he was the signatory for acceptance of any subscription agreement (Id., at 6831, 6837, 6842, 6844). The memorandum was in essence a communication from Block to prospective investors.

Attached to it were financial statements for periods ending December 31, 1997 and March 31, 1998 (CX-28, pp. 6805-6806, 6810-6811). In a representation not challenged by Block, Enforcement states that "[t]he staff compared the information contained in these financials … to information contained in the [false] FOCUS IIA filings of the firm for the same time periods and noted that the information is identical" (Brief, p. 8). The December 31, 1997 balance sheet, attached to the memorandum, while not precisely identical, is virtually the same as the FOCUS report for that period, which erroneously represented a positive net capital (CX-26, pp. 9177-9178; CX-28, pp. 6806-6807). The Panel concludes that the private placement memorandum failed to disclose the firm's true net capital situation and, as shown supra, that Block knew of the deficits. In these circumstances, his circulation of the memorandum constituted fraud.

D.) Supervisory violations

The Complaint's Sixth Cause alleges that Block and Burke failed to exercise reasonable supervision of Gonzalez, the firm's FINOP, with regard to concealment of the firm's net capital deficiencies, as alleged in the First, Third and Fourth Causes. However, a respondent who is "substantively responsible" for misconduct alleged in specific causes of a Complaint cannot also be responsible "for inadequate supervision with respect to those violations." Market

[9] See, e.g., Department of Enforcement v. Levitov, No. CAF970011 (NAC, June 28, 2000) and cases there

Surveillance Comm. v. Markowski, No. CMS920091, 1998 NASD Discip. LEXIS 35, at *52-*53 (NAC, July 13, 1998), and authorities there cited.

As found, supra, Respondent Block is liable for the violations alleged in the First through Fifth Causes of the Complaint, and Respondent Burke is liable for the misconduct alleged in the Second Cause. Each cannot also be liable for supervisory failures regarding such violations. However, if Block had not been charged as a primary violator, the Panel would conclude that he was liable for supervisory failures pertaining to the misconduct alleged in the First through Fifth Causes. Similarly, if Burke had not been charged as a primary violator under the Second Cause, the Panel would conclude that he committed supervisory violations pertaining to that misconduct.

1.) Block

As shown supra, Block's attempt to avoid supervisory violations by virtue of his delegation to Gonzalez has no merit. Despite the advice of the firm's outside auditor, Block delegated responsibility for the financial aspects of a multi-million dollar company to a person who was not a certified public accountant, had no accounting degree, and admitted that she was grossly unqualified for the position. In those circumstances, his delegation was unreasonable and cannot be the basis for avoiding supervisory liability.[10]

Block's assertion that he saw no supervisory "red flags" until the meeting of June 15, 1998 (Tr. 509-510) is not persuasive. As far back as June of 1997 (when he hired Mr. S),

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cited.

[10] In re J.B. Hanauer & Co., Exchange Act Rel. No. 41832, 1999 SEC LEXIS 1773, at *20 (September 2, 1999); Market Regulation Committee v. La Jolla Capital Corp., 1998 NASD Discip. LEXIS 26, at *16-*17, *21-*22 (NAC, February 27, 1998), aff'd, In re La Jolla Capital Corp., Exchange Act Rel. No. 41755, 1999 SEC LEXIS 1642 (August 18, 1999).

Block realized that Gonzalez was "overwhelmed" by the firm's accounting work (Tr. 509, 662). He installed Gonzalez as the FINOP, knowing, as he admitted, that she "didn't have a degree in accounting, ... was not a CPA, and she had no prior accounting experience, probably other than balancing her checkbook" (Tr. 485). From "early on" in the firm's operations, the outside auditor recommended to Block that because of the firm's size and complexity, its FINOP should be an accountant (Tr. 140, 181). He ignored that recommendation.

Block knew from Gonzalez' report in October of 1997 that the firm might have a forthcoming net capital violation. As she explained, thereafter there was a monthly "number," known to Block, which was necessary to bring the firm into net capital compliance (Tr. 315). Mr. C, who was "always" concerned about the firm's need to avoid net capital deficiencies, talked to Block about that subject "in the past" (Tr. 153). In April or May of 1998, Mr. S questioned the booking of certain liabilities to the management company. Gonzalez said that she would discuss the matter with Block and then returned, telling Mr. S that she would take over this aspect of the work (Tr. 669-671). Prior to June of 1998, Katz, who had compliance responsibilities at the firm and whom Block trusted, told him that obligations of the firm could not be booked to another entity (CB-33, par. 10).

There were thus a number of "red flags" which should have alerted Block to the need for careful supervision.

Finally, Block's reliance on the hiring of Mr. S as supposedly illustrating his sensitivity to supervisory responsibility is wholly without merit (Brief, p. 13). After Mr. S questioned one of the accounting techniques which enabled the firm to conceal its net capital deficits, Block participated in reducing his responsibilities, putting him on vacation, and ultimately obtaining his

resignation (Tr. 671, 687-689). Far from reflecting meaningful supervision, these actions suggest Block's own complicity in the accounting irregularities.

2.) Burke

Burke was the firm's President during eleven of the twelve months at issue (Jt. Ex. 1; Tr. 745, 751). He and Block were the principal stockholders and drew equal salaries, and the firm's supervisory manual provided that they "share in the ultimate supervision of the firm" (CB-21, p. 2). That Burke may have become a "de facto" branch manager, and not a "functional" President (Br. 3; Tr. 959, 962, 964), is no defense. The manual's provision for his share of "ultimate" supervisory responsibility is dispositive. See In re William H. Prince, Exchange Act Rel. No. 11680, 1975 SEC LEXIS 741, at *7 (September 26, 1975) (a "conditional president," who held himself out as chief executive, was nevertheless responsible for the firm's misconduct).[11]

Burke's contention that he cannot be liable because Block told Gonzalez not to give him financial information (Br. p. 15) also lacks merit. See In re George Lockwood Freeland, Exchange Act Rel. No. 32192, 1993 SEC LEXIS 878, at *7-*8 (April 22, 1993), where the Commission rejected a FINOP's contention that he was not liable for supervisory misconduct involving net capital violations because the firm's president refused to provide him with necessary information. Freeland's reasoning applies a fortiori to Burke here: "Freeland [the FINOP] was aware at the time that Barham [the president] was withholding information from

[11] See also In re Joseph Elkind, Exchange Act Rel. No. 12485, 1976 SEC LEXIS 1581, at *3 (May 26, 1976) ("We have consistently rejected the notion that the president of a broker-dealer firm can be a mere figurehead, able to disclaim responsibility for his firm's compliance with regulatory requirements"); In re Management Financial, Inc., Exchange Act Rel. No. 12098, 1976 SEC LEXIS 2427, at *25 (February 11, 1976) ("His assertion that he 'was acting president only because there were no other officers' does not aid him")(citing Prince).

Freeland concerning the Firm's finances, correspondence, and transactions. Freeland was required to insist on Barham's cooperation and compliance with applicable requirements or to resign. As long as Freeland remained FINOP and a registered securities principal, he was responsible for the performance of his duties."

Despite the friction between the two men, Burke remained as President of the firm throughout most of the twelve-month net capital deficiency period, and its compliance manual continued to provide that he and Block "share in the ultimate supervision of the firm" (CB-21, p. 2). NASD is entitled to look to persons holding themselves out as supervisors, and may properly conclude that they are responsible for the firm's conduct.

E.) Sanctions

1.) Causes One through Four: Block

As noted, the misconduct alleged in the Complaint's first four Causes arises out of the firm's net capital violations. Each cause depends upon the same underlying misconduct, the existence and attempted concealment of net capital deficits. The NASD Sanction Guidelines (1998) recognize that violations can sometimes be aggregated or "batched" for sanctions purposes (at p. 5). Block's counsel urged that the Panel take such an approach for the first four counts, and Enforcement agreed as to three of them (Tr. 994). The Panel concludes that it will aggregate Causes One through Four for sanctions purposes.[12]

The Guideline for net capital violations recommends a fine of $1,000 to $50,000 and, in egregious cases, a suspension of thirty days to two years, or a bar (Guidelines, supra, p. 27).

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[12]Enforcement sees the First Cause (bookkeeping violations) as somehow distinct from the net capital violations (Tr. 994). The Panel disagrees. The bookkeeping violations had no independent significance or purpose; they were simply tools for concealing the net capital violations (Jt. Ex. 1).

The Panel finds that there were egregious circumstances. The violations occurred over many months and involved substantial deficits. Block allowed the firm to continue in operation, while knowing the true "number," and attempted to conceal the deficiencies by various bookkeeping devices.

There are also mitigating circumstances. As stipulated, Block "fully cooperated with the NASD in its investigation … [and] provided NASD regulators with unrestricted access to all books and records of Block Trading" (Id., at par. 8). Similarly, during the hearing, Block (and Burke) acknowledged the existence of the net capital violations (Jt. Ex. 1) and did not seek to hide them by providing inaccurate or misleading testimony.[13]

Enforcement seeks a bar in all capacities. The Panel will limit the bar to principal or supervisory activities. Block's conduct reflected his failures as a principal, but not necessarily as a Series 7 registered representative. As stipulated, there was no evidence of any sales practice misconduct on his part or at his direction.

On balance, the Panel concludes that the appropriate sanctions for Block's net capital violations (the First through Fourth Causes) are: a fine of $25,000 (midway on the recommended range) and a bar from associating with any member of the Association in any principal or supervisory capacity.

2.) Cause Five (Block)

The Panel found that Block committed fraud in using financial statements which failed to reflect the firm's true net capital deficits. These statements were part of an unsuccessful private placement memorandum and a stock purchase agreement which culminated in a $600,000 sale

[13] See "Principal Consideration," number 12, Guidelines, at p. 9.

of the stock to two investors. For such conduct, the Guidelines recommend a fine of $10,000 to $100,000 and a suspension for ten days to two years, or a bar in egregious cases (at p. 80).

Attempting to deceive potential investors by hiding the firm's precarious financial condition is serious misconduct. But as to the private placement memorandum, no one was injured, as it failed to raise any money. The stock purchase agreement victimized only two persons, whose representative testified that Block "put a lot of effort" into making the investment good (Tr. 218-219, 255). Again, this misconduct occurred in Block's capacity as the firm's principal, and did not involve any of its customers.

As appropriate sanctions for this offense, the Panel imposes a fine of $25,000 and bars Block from associating with any member firm in any principal or supervisory capacity.

3.) Second Cause (Burke)

As noted, the recommended sanctions for net capital violations are a fine of $1,000 to $50,000 and a suspension of up to thirty days, or a lengthier suspension or bar in egregious cases (Guidelines, supra, p. 27). For Burke's allowing the firm to operate while in net capital violation, Enforcement seeks a fine of $25,000, a three-month suspension in all capacities, and a six-month suspension in functioning as a principal (Tr. 1013).

Burke, the President, unquestionably allowed the firm to operate while in substantial net capital deficiencies which persisted for many months. But, as noted, his role differed sharply from that of Block, the person primarily responsible for the net capital violations. Burke's acts were those of omission, not commission. Enforcement "does not contend that Burke was an active participant in the manipulation of the firm's record" (Brief, p. 14), and the record shows that he was not such a participant.

It is true that he did not take sufficient action to address the deficiencies when he learned about them, and that silence or inaction by Burke would preserve the value of the stock he was trying to sell to Block. But, Burke's approach was also consistent with the outside auditor's advice that he should proceed cautiously. Finally, the stipulation's recital of full cooperation with NASD investigators also applies to Burke; and he (like Block) acknowledged the net capital violations and did not seek to conceal them by providing inaccurate or misleading testimony (Jt. Ex. 1).

The Panel has weighed the aggravating and mitigating factors as to Burke and concludes that the appropriate sanction for his allowing the firm to operate while in net capital deficiency is a fine of $10,000 and a thirty-day suspension from acting in any principal or supervisory capacities.

4.) Sixth Cause (supervisory violations as to Block and Burke)

a.) Block

As noted, if Block had not been charged as a primary violator under the First through Fifth Causes, the Panel would conclude that he committed supervisory violations as to the misconduct there alleged.

As to sanctions for such supervisory violations, the Guidelines recommend a fine of $5,000 to $50,000 and a suspension of up to thirty days, or, in egregious cases, a suspension of up to two years or a bar (Guidelines, supra, p. 89). The Department recommends that Block be barred, or, in the alternative, fined $50,000 (Brief, p. 14). If sanctions for supervisory failures were necessary, the Panel believes that the appropriate remedial sanction does not require a total bar. The Department did not spell out a relationship between the supervisory misconduct

and a bar in all capacities. The Panel sees no apparent link between Block's supervisory defects and his remaining in the industry as a Series 7 representative, particularly on a record which contains no evidence of any sales practice misconduct. Considering the principle that disciplinary actions should be remedial (Guidelines, supra, p. 3), the Panel would bar Block from associating with any member firm in a principal or supervisory capacity, and would fine him $10,000.

b.) Burke

The following conclusions as to sanctions apply to Burke's supervisory failures involving the misconduct alleged in the First, Third and Fourth Causes (where he was not named as a violator).

Burke's supervisory situation was obviously different from Block's. It is true that he retained the title of "President" and the firm's manual gave him joint supervisory responsibility. But for sanctions purposes, additional considerations are relevant. Personal difficulties between Burke and Block effectively left Burke running a branch office, while Block ran the firm. It was Block, not Burke, who trusted the unqualified Gonzalez, installed her as FINOP, and supervised her on a day-to-day basis. In addition, the record shows that Block himself was involved in certain details of the net capital violations, while Burke, as noted earlier, was not an active participant in the manipulation of the firm's records. Indeed, Enforcement's recommendation (a three-month suspension in all capacities, a six-month suspension in principal capacities and a $25,000 fine) reflects these differences.

To impress upon Burke the importance of supervisory responsibility, the Panel imposes a requirement that he re-qualify for a Series 24 license. Finally, a fine at the low end of the range is appropriate for him, and the Panel accordingly imposes a fine of $5,000.[14]

III. Conclusion

A.) Block

Respondent Block committed the following violations involving Block Trading, Inc.'s net capital: first, failing to ensure the maintenance of proper books and records for Block Trading Inc. (Rules 2110 and 3110); second, allowing that firm to conduct a securities business while its net capital was below the required minimum (Rule 2110); third, failing to provide the required notification that the firm's net capital was below the required minimum (Rule 2110); and fourth, filing inaccurate FOCUS reports (Rule 2110). He also violated Rules 2110 and 2120 by using false and misleading financial information in a private placement memorandum and in a stock purchase agreement. If Block were not charged as a primary violator, as found above, the Panel would conclude that he violated Rules 2110 and 3010 by failing to exercise supervisory responsibility.

The Panel aggregated the first four violations for sanctions purposes and, for them, imposed a fine of $25,000 and a bar from associating with any member of the Association in any principal or supervisory capacity. For the misleading financial information, the Panel imposed a fine of $25,000 and a similar bar. For the supervisory violations, the Panel would impose a fine of $10,000 and a similar bar.

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[14] Had Burke not been charged as a primary violator under the Second Cause, the Panel would have found him liable for supervisory failures pertaining to that misconduct. But, considering the above imposed re-qualification and fine, it would not assess any further sanction.

In connection with a defense of inability to pay, Block submitted a financial disclosure statement for which he sought confidentiality. He withdrew the defense when the Hearing Officer explained that some aspects of the statement might appear in a Panel decision and that in any event, he could not assure confidentiality in an appeal to the SEC or the courts (Tr. 1007-1008). That withdrawal should not prevent Block from seeking permission to pay the fines assessed on an installment basis. See Notice to Members 99-86.

B.) Burke

Respondent Burke allowed Block Trading, Inc. to conduct a securities business while its net capital was below the required minimum, in violation of Rule 2110. He also violated Rules 2110 and 3010 by failing to exercise supervisory responsibility, with respect to the firm's books and records.

For the net capital violation, the Panel imposed a fine of $10,000 and a thirty-day suspension from functioning in any principal or supervisory capacities. For the supervisory violation, the Panel imposed a $5,000 fine and a requirement that Burke re-qualify for his Series 24 license.

Respondents shall jointly and severally pay costs of $7,339.80, reflecting $6,589.80 for transcripts plus the standard administrative fee of $750.[15]

These sanctions shall become effective on a date set by the Association, but not earlier than 30 days after the final disciplinary action of the Association. If this decision becomes the final disciplinary action of the association, the suspension as to Respondent Burke shall become

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

effective with the opening of business on Monday, November 6, 2000 and end at the close of business on Monday, December 18, 2000.

HEARING PANEL

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Jerome Nelson
Hearing Officer

Dated: Washington, DC
September 5, 2000

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