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FINANCIAL INDUSTRY REGULATORY AUTHORITY[1]
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. 20060042305-01 **HEARING PANEL DECISION** Hearing Officer – SW DATE: April 10, 2008

In his capacity as FINOP, Respondent violated NASD Conduct Rule 2110 by allowing his Firm to conduct a securities business on October 31, 2005, while the Firm failed to meet its minimum net capital requirement. The Hearing Panel imposed a $3,500 fine on Respondent for the violation.

Appearances

Mark A. Graves, Senior Regional Attorney, and John S. Han, Senior Regional Attorney, San Francisco, CA, for the Department of Enforcement.

Respondent, *pro se*.

I. PROCEDURAL HISTORY

A. Complaint and Answer

The FINRA Department of Enforcement ("Enforcement") filed this one-count Complaint against Respondent on May 9, 2007. The Complaint alleges that Respondent, as the registered financial and operations principal ("FINOP") for Security Research Associates, Inc. (the "Firm"), violated NASD Conduct Rule 2110 by permitting the Firm to conduct a securities business on October 31, 2005, while it failed to maintain its

[1] As of July 30, 2007, NASD consolidated with the member firm regulation functions of NYSE and began operating under a new corporate name, the Financial Industry Regulatory Authority (FINRA). References in this decision to FINRA include, where appropriate, NASD.

minimum net capital requirement.

Respondent admits that the Firm conducted a securities business on October 31, 2005, while failing to meet its minimum net capital requirement. In an effort to mitigate his conduct, Respondent argued that although he was the Firm's FINOP, he did not cause the Firm's violation; rather the actions of the Firm's President caused the violation.

B. Hearing

The Hearing Panel, consisting of a current member of the District 1 Committee, a former member of the District 1 Committee, and a Hearing Officer, conducted a Hearing in San Francisco, CA, on November 6, 2007.[2]

The Hearing Panel finds that Respondent, as the Firm's FINOP, violated NASD Conduct Rule 2110 by allowing the Firm to conduct a securities business on October 31, 2005, while failing to maintain its minimum net capital requirement, in violation of SEC Rule 15c3-1.

II. FINDINGS OF FACT AND CONCLUSIONS OF LAW

A. Background

The facts are not in dispute. Respondent is and has been the Firm's FINOP since 1999.[3] (Tr. p. 18). In 2005, the Firm had a minimum net capital requirement of $100,000 because the Firm executed trades for its own account. (Stip. at ¶ 8; Tr. p. 18).

The Complaint alleges that the Firm's net capital was below $100,000 on October 31, 2005. As the Firm's FINOP, Respondent computed the Firm's net capital for the

[2] "Tr." refers to the transcript of the Hearing held on November 6, 2007; "Stip." refers to the Stipulations filed by the Parties on September 26, 2007; "CX" refers to the exhibits submitted by Enforcement; and "RX" refers to the exhibits submitted by Respondent.

[3] Respondent initially became associated with a FINRA member in 1980. (Tr. p. 43). Respondent is also currently registered as the FINOP for several other FINRA member firms. (Tr. pp. 33, 43).

October 2005 FOCUS Report, as of October 31, 2005. (Tr. p. 20). Respondent computed the Firm's net capital using financial statements prepared by the Firm's certified public accountant ("CPA"), which financial statements Respondent generally received two weeks after the end of October 2005, in compliance with the Firm's practices.[4] (Tr. p. 20).

Respondent incorrectly assumed that the Firm was above its $100,000 net capital requirement as of October 31, 2005. Respondent admits that the Firm operated with a net capital deficiency of $26,425.75 on October 31, 2005, in violation of SEC Rule 15c-3 because the Firm did not realize that it had a net capital deficiency. (Stip. at ¶¶ 4, 12).

The deficiency was not discovered until after the Firm's October 2005 FOCUS Report was filed because Respondent inaccurately calculated the Firm's net capital using an incorrect percentage to compute undue concentration charges on the Firm's equity inventory position and incorrectly applied a charge to the Firm's money market funds held at two banks.[5] (Stip. at ¶ 11). Respondent reported on the Firm's October 2005 FOCUS Report that the Firm's net capital as of October 31, 2005, was $103,189.09, when its actual net capital on that date was $73,574.25.[6] (Stip. at ¶¶ 10, 12, 14). The FINRA staff discovered the error and correctly calculated the Firm's net capital. (Stip. at ¶¶ 12, 13).

To explain, in part, his failure to recognize that the Firm was in danger of failing to meet its net capital requirement, Respondent presented evidence that in July 2005, the

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[4] All reports, bank statements, trading reports, payroll, etc., were typically received by the 15th of the month. (Tr. p. 20).

[5] A 7.5% undue concentration charge was applied to the Firm's equity inventory positions, when it should have been a 15% undue concentration charge. (Stip. at ¶ 11).

[6] The Complaint did not charge Respondent with submitting an inaccurate FOCUS Report.

Firm's net capital was approximately $212,000, *i.e.*, the Firm had excess capital of $112,000. (RX-7, p. 3; Tr. p. 50). In August 2005, the Firm's net capital was approximately $217,000, and the Firm's President took $45,000 in advances. (RX-7, p. 5; Tr. pp. 50-51). In September 2005, the Firm's net capital was approximately $233,000, *i.e.,* excess capital of $133,000, and the Firm's President took another $30,000 in advances. (RX-7, p. 7; Tr. p. 51).

Respondent credibly testified that, in the months prior to October 2005, he had no concern that the Firm might have a net capital problem; nevertheless, he warned the President to be careful about taking money out of the Firm.[7] (Tr. pp. 36, 46, 55-57). Respondent described the Firm as being "in good shape for net capital." (Tr. p. 47). Ultimately, the reason that the Firm failed to meet its net capital requirement was because the President unexpectedly increased the securities in the Firm's proprietary inventory account from zero in July 2005, to $568,000 in October 2005, and the particular securities that were purchased required significant concentration haircuts. (Tr. p. 54).

Respondent stated that the Firm's President, with over thirty years experience in the securities business, was very aware of the financial condition of the Firm. (Tr. p. 57). It was Respondent's experience with the Firm's President, over the previous five years, that the President maintained a rough estimate of the Firm's capital at all times, and had "the knowledge and ability to understand" how to avoid using up the Firm's excess capital. (Tr. p. 40).

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[7] The President was taking money out of the Firm in anticipation of adding partners to the Firm, who would add capital to the Firm. (Tr. pp. 54-55).

The Firm's net capital violation did not expose the public to any harm because the Firm does only an institutional stock brokerage business, not retail, and was a fully disclosed introducing broker acting through its clearing firm, Wedbush Morgan. (Stip. at ¶ 15; Tr. pp. 47, 59). When the Firm realized that it was below its net capital requirement, the Firm took immediate steps to remedy the violation by selling some of its inventory to bring it back into compliance. (Tr. pp. 52-53).

Arguing that the President created the problem by his actions, Respondent stated that he should not be held responsible for the Firm's violation.[8] (Tr. p. 58).

B. As the Firm's FINOP, Respondent has the Responsibility for the Firm's Compliance with the Net Capital Rule

NASD Membership and Registration Rule 1022 requires that each FINRA member designate a qualified FINOP. Subsection (b) of the Rule provides that the FINOP is responsible for the financial matters of a broker dealer.[9]

Rule 1022(b) provides, in part, that a FINOP's duties include:

> (E) supervision and/or performance of the member's responsibilities under all financial responsibility rules promulgated pursuant to the provisions of the Act; (F) overall supervision of and responsibility for the individuals who are involved in the administration and maintenance of the member's back office operations; or (G) any other matter involving the financial and operational management of the member.

Accordingly, as the Firm's FINOP, Respondent is responsible for the supervision and/or performance of the Firm's obligations under the financial responsibility rules, including SEC Rule 15c3-1, the net capital rule promulgated under the provisions of the Securities Exchange Act of 1934. In particular, the FINOP is responsible for calculating

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[8] Respondent testified that the Firm's President acknowledged that his actions resulted in the net capital violation. (Tr. p. 59).

[9] There is no prohibition on the president of a firm also being a firm's FINOP.

the Firm's net capital accurately to ensure that it meets the required minimum at all times while conducting a securities business.[10]

"The principal purposes of the net capital rule are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation."[11] A firm that engages in the securities business while in violation of the net capital rule violates NASD Conduct Rule 2110, and a FINOP that allows a firm to do so also violates NASD Conduct Rule 2110.[12]

Respondent argued that the Firm is not willing to pay him to check the Firm's financial statements every day, especially when there is no obvious reason to do so, and that, despite the FINRA staff's view, there should be some lesser responsibility for a part-time FINOP.[13]

However, the case law is clear that Rule 1022(b) applies whether the FINOP is a full-time or a part-time FINOP.[14] FINRA issued a Regulatory and Compliance Alert to Members in 1999 explicitly stating that FINOPs, whether they are full-time or part-time, are responsible for each duty outlined in NASD Rule 1022(b).[15] Accordingly, a FINOP must take whatever steps are necessary to meet the requirements of Rule 1022(b).

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[10] *James S. Pritula*, Exch. Act Rel. No. 40,607, 1998 SEC LEXIS 2425, at *10, n.13 (Nov. 9, 1998).

[11] *Fox & Company Investments, Inc.*, Exch. Act Rel. No. 52,697, 2005 SEC LEXIS 2822, at *18 (Oct. 28, 2005) (citations omitted).

[12] *Id.* at *27, n.29.

[13] Respondent bills the Firm $300 per month for three to five hours of work. (Tr. pp. 33-34).

[14] *See Gilad J. Gevaryahu*, 51 S.E.C. 710, 710 (Oct. 12, 1993).

[15] *NASD Regulatory & Compliance Alert*, Volume 13, Number 4, Winter 1999, pp. 15-16.

Respondent argued that he relied on a team consisting of an experienced president, who had been in the securities business for 34 years without regulatory incident, and an experienced CPA to alert him of any significant events that would require an interim calculation of net capital.[16] (Tr. pp. 26, 38, 40, 48). While such reliance, if reasonable, may be mitigating, under Rule 1022(b), the FINOP bears primary responsibility for the firm's compliance with the net capital rule.[17] Here, although Respondent knew that the Firm's President could substantially increase the amount of the Firm's proprietary account, he made no specific arrangements to be kept abreast of the President's trading. (Tr. pp. 36, 56).

Accordingly, the Hearing Panel finds that Respondent, as FINOP, is responsible for the Firm's failure to comply with SEC Rule 15c3-1, and thereby Respondent violated NASD Conduct Rule 2110.

III. SANCTION

For net capital violations, the FINRA Sanction Guidelines suggest that adjudicators impose fines ranging from $1,000 to $50,000, and consider suspending the financial principal in any or all capacities for up to 30 business days, with consideration of a lengthier suspension of up to two years or a bar in egregious cases.[18] The principal

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[16] For example, when the Firm acted as a co-manager of an underwriting in 2007, which it had not done before, Respondent was alerted and prepared an interim net capital calculation for the Firm. (Tr. pp. 100-102).

[17] A firm president may also be liable for a net capital violation if he or she has notice of and does not prevent the firm from engaging in a securities business. However, a president's liability under Rule 1022(b) does not exonerate the FINOP; both the president and the FINOP may be liable. *See Paul Joseph Benz*, Exch. Act Rel. No. 51,046, 2005 SEC LEXIS 116, at *10 (Jan. 14, 2005).

[18] *FINRA Sanction Guidelines*, p. 29 (2007), available at *http://www.finra.org/web/groups/enforcement/documents/enforcement/p011038.pdf*.

considerations are (1) whether the firm continued its business with knowledge of its net capital deficiency, and (2) whether there was an attempt to conceal the deficiencies.[19]

Enforcement recommended that Respondent be fined $5,000 and suspended for 10 business days. Enforcement recommended these sanctions based, in part, on Respondent's prior disciplinary history. In fact, Enforcement argued that Respondent was a "recidivist" because the Firm's failure to meet its net capital was the result of an issue with its proprietary account, which Enforcement contended was similar to a net capital violation by a different client in May 2004.[20]

In arriving at the appropriate sanction, the Hearing Panel considered, first, that the two specific aggravating considerations listed in the Guidelines are not present in this case. The Firm did not continue its business with knowledge of its net capital deficiency, and there was no attempt to conceal the deficiency.

Second, the Hearing Panel considered several relevant general considerations in the Guidelines.[21] The Hearing Panel finds that, as suggested by Enforcement, it is aggravating that Respondent has been previously disciplined for a net capital violation. However, the Hearing Panel rejects Enforcement's characterization of Respondent as a "recidivist," and the argument that Respondent's current violation is exactly the same as the prior violation. In the 2004 case, the net capital violation did not arise from Respondent's failure to monitor the firm's net capital closely. Instead, Respondent was aware of a possible net capital deficiency and explicitly instructed the president to either

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[19] *Id.*

[20] In a June 18, 2004 offer of settlement, Respondent and his client, for which he provided FINOP services, were fined $5,000 jointly and severally, for the client's violation of the net capital rule. (Stip. at ¶ 16).

[21] *Guidelines* at 6-7.

put more money into the firm or sell inventory to avoid the deficiency. Respondent was cited for a violation when he did not remove himself from the firm after he was unable to persuade the president to take action to avoid the anticipated net capital violation. Accordingly, although the Hearing Panel finds that the prior violation is an aggravating factor, it is not as aggravating as if the prior violation had involved exactly the same behavior as the current violation.

In addition, the Hearing Panel finds that a number of other aggravating factors are not present in this case.[22] Respondent did not engage in the misconduct over an extended period of time. Respondent did not attempt to conceal his misconduct or to lull into inactivity, mislead, deceive or intimidate a customer, regulatory authorities, or his member firm. To the contrary, Respondent provided assistance to Enforcement during its investigation. Enforcement stipulated that Respondent had been cooperative. In addition, Respondent's misconduct did not result in injury to other parties.

Respondent's misconduct was not the result of an intentional or reckless act. Knowing that the Firm previously had significant excess capital, Respondent did not view the Firm as operating near permissible capital limits or experiencing financial difficulties, and Respondent had no expectation that the President, who was familiar with the net capital rule, would fail to heed his general warnings. And, Respondent's misconduct did not result in the potential for Respondent's monetary or other gain.

Finally, the Hearing Panel considered and found somewhat mitigating that Respondent relied upon a team consisting of an experienced president, who had been in the securities business for 34 years without regulatory incident, and an experienced CPA,

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[22] *Id.*

to alert him of any significant events at the Firm that might impact capital and require an interim calculation to assure compliance. However, the Hearing Panel did not give great weight to this factor because there were no explicit written procedures in place requiring Respondent to be notified of any Firm actions that could significantly impact net capital.

The Hearing Panel finds that, under these circumstances, a suspension and a fine five times the minimum fine, as recommend by Enforcement, would be punitive rather than remedial. Accordingly, the Hearing Panel concludes that a $3,500 fine with no suspension is an appropriate remedial sanction for Respondent's violation of NASD Conduct Rule 2110.

IV. CONCLUSION

Therefore, the Hearing Panel, having considered all of the evidence, fines Respondent $3,500. Additionally, Respondent shall pay the costs of the Hearing in the amount of $1,695.75, which includes an administrative fee of $750 and transcript costs of $945.75. The fine and the costs shall become payable on a date set by FINRA, but not less than 30 days after this Decision becomes the final disciplinary action in this matter.[23]

HEARING PANEL.

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By: Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
April 10, 2008

[23] The Hearing Panel has 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.