FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. FCS SECURITIES (CRD No. 40177), and Respondent 2, Respondents.	Disciplinary Proceeding No. 2007010306901 Hearing Officer—Andrew H. Perkins **HEARING PANEL DECISION** May 13, 2009

Respondents failed to file audited annual reports for two years, in violation of SEC Rule 17a-5 and NASD Conduct Rule 2110. Respondents are jointly and severally fined $5,000, and FCS Securities is suspended for four months. At the end of four months, the suspension will convert to an expulsion if Respondents have not at that time filed audited reports for 2006 and 2007. Respondents also are ordered to pay costs.

Appearances

For Complainant: Jeff Kern, Vaishali Shetty, and David M. Jaffe, FINRA, DEPARTMENT OF ENFORCEMENT, New York, NY.

For Respondents: Respondent 2 on behalf of himself and FCS Securities, LLC, New York, NY.

DECISION

I. INTRODUCTION

The Department of Enforcement ("Enforcement") brought this disciplinary proceeding against Respondents FCS Securities ("FCS Securities" or the "Firm") and

Respondent 2 (collectively "Respondents"), alleging that the annual reports Respondents filed with the Securities and Exchange Commission ("SEC") for the years 2006 and 2007 were not audited by an independent public accountant as required by Section 17 of the Securities Exchange Act of 1934 ("Exchange Act") and SEC Rule 17a-5(d)(1)(i).[1] Enforcement filed the Complaint on July 25, 2008.

On September 8, 2008, Respondents filed their Answer and Affirmative Defenses to the Complaint. Respondents admitted that FCS Securities' annual reports for 2006 and 2007 had not been audited by an independent accountant. Respondents asserted that they had relied on the exemption in SEC Rule 17a-5(e)(1)(i), which provides that the financial statements accompanying annual reports need not be audited if the broker's or dealer's business had been limited since the date of the last annual report to "buying and selling evidences of indebtedness secured by mortgage, deed or trust, or other lien upon real estate or leasehold interests, and said broker or dealer has not carried any margin account, credit balance or security for any securities customer."[2]

The Respondents requested a hearing, which was held in New York City on January 27, 2009. The Hearing Panel was comprised of the Hearing Officer and two current members of the District Committee for District 11.

II. BACKGROUND

Respondent 2 entered the securities industry in 1986. Between November 1986 and May 1994, he was associated with New Windsor Associates, L.P., where he held several securities licenses. According to Respondent 2's Central Registration Depository ("CRD") record, between May 1994 and the present, he has been associated with

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[1] SEC Rule 17a-5(d)(1)(i) provides in relevant part: "Every broker or dealer registered pursuant to section 15 of the Act shall file annually, on a calendar or fiscal year basis, a report which shall be audited by an independent public accountant." 17 C.F.R. § 17a-5(d)(1)(i) (2005).

[2] SEC Rule 17a-5(e)(1)(i)(B).

Rockrimmon Securities, LP, although he does not maintain any registrations with that firm.[3] Respondent 2 testified that he spent his entire career in the securities business running a proprietary trading account, and he intended to continue trading exclusively for his own account once FCS Securities began operations.[4] He had no experience as a retail broker.

Respondent 2 formed FCS Securities in 1997 as a sole proprietorship and applied to become a FINRA member firm. However, Respondent 2 was not in a position to commence trading operations because the capital he needed was tied up in litigation that continues to the present.[5] Accordingly, rather than withdraw the membership application for FCS Securities, Respondent 2 entered into a Membership Agreement that limited the Firm's operations to "investment advisory services."[6] Notwithstanding this limitation, Respondent 2 had no intent to provide such services. In his words he accepted the limitation "to get [the] paperwork squared away" and complete his membership application.[7] He testified that he had "never heard of the term investment advisory services. All it was, was a way to change the membership application from principal to something other than principal."[8] He signed the Membership Agreement on April 25, 1997.

Between 1997 and 2004, FCS Securities did little or no securities business. Throughout this period, Respondent 2 was trying to resolve the litigation that had his capital tied up. Because FCS Securities did not appear to be conducting an "investment advisory business," FINRA staff questioned whether FCS Securities was eligible to

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[3] CX-5, at 3.

[4] Tr. 185, 215-16.

[5] Tr. 81-82, 179, 184-86, 206-07, 214-15.

[6] CX-6.

[7] Tr. 185.

[8] Tr. 186.

remain a FINRA member. In addition, FINRA staff questioned FCS Securities' ability to rely on the exemption in SEC Rule 17a-5(e)(1)(i) from having an independent accountant perform an annual audit.[9] In 2004, FINRA staff completed a routine examination of FCS Securities, which resulted in a Letter of Caution being issued against FCS Securities on January 11, 2005, for its failure to file audited financial statements for 2001, 2002, and 2003.

Despite the Letter of Caution, FCS Securities again sought to claim the same exemption for 2005. After repeated discussions with Respondent 2, FINRA staff concluded that the Firm's activities in 2005 still did not qualify it to claim the exemption. Nonetheless, because the rule in question is an SEC rule, FINRA staff arranged a conference call with Respondent 2 and a representative of the SEC's Division of Market Regulation. The conference call was held on February 10, 2006. During the call, FINRA and SEC staff advised Respondent 2 that in their opinion FCS Securities did not qualify for the exemption and that it would have to file an audited annual report for 2005.[10] They further advised Respondent 2 that "investment advisory services" do not fall within the scope of the exemption contained in SEC Rule 17a-5(e)(1)(i).[11] Although Respondent 2 disagreed, he nonetheless filed an audited report for 2005.[12]

After he filed the audited 2005 report, Respondent 2 continued to ask FINRA staff how FCS Securities could qualify for the exemption. In effect, Respondent 2 wanted to find some business activity FCS Securities could undertake in 2006 that would permit it to remain registered but not be obligated to incur the costs of an annual audit.[13] FINRA staff advised Respondent 2 that he would need to modify his membership application if

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[9] Tr. 28.

[10] CX-14, at 2.

[11] Tr. 42, 48, 52; CX-14 (letter from FINRA staff to Respondent 2 dated December 12, 2006).

[12] Tr. 52.

[13] Tr. 179.

he intended to change FCS Securities' business model.[14] Respondent 2 elected not to request a change to FCS Securities' Membership Agreement.

III. FINDINGS OF FACT

The relevant facts are not disputed. FCS Securities filed unaudited annual reports for 2006 and 2007.[15] In each case, Respondent 2 certified that FCS Securities was exempt from filing an audited report because its business for each year was limited to "buying and selling evidences of indebtedness secured by … [a] lien upon real estate." For the reasons set forth below, the Hearing Panel determined that FCS Securities did not qualify for the exemption for either year. Indeed, the Respondents failed to show that FCS Securities conducted any securities business in 2006 and 2007.

The Respondents rest their exemption claims on a loan FCS Ventures, Inc. ("Ventures"), a corporation controlled by Respondent 2, made five years earlier to CA and AA, Respondent 2's sister and brother-in-law.[16] Respondent 2 is Venture's sole officer, director, and common shareholder.[17] Respondent 2's sister is one of approximately 10 to 12 preferred shareholders. Respondent 2 operated FCS Securities and Ventures out of his apartment in New York City. The loan was evidenced by a promissory note dated April 16, 2001, and secured by a financing statement on CA and AA's residence in Ohio.[18] Respondent 2 testified that the loan agreement required CA and AA to send their monthly payments to an account at Fidelity Investments titled in the name of Ventures, CA, and AA.[19]

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[14] CX-10.

[15] CX-2; CX-3.

[16] Tr. 35-36, 41.

[17] Tr. 180-81.

[18] CX-11; RX-27.

[19] Tr. 182, 198.

A. The 2006 Activity

Respondent 2 claimed that by 2006, CA and AA had defaulted in making the monthly payments due on the loan with Ventures. He testified that CA and AA had not made monthly payments for "a couple of years or a substantial period of time" although he could not recall what months they missed.[20] Nonetheless, Respondent 2 did not want to sell his sister's home to pay the loan.[21] Accordingly, Respondent 2 wanted to "restructure" the loan so that they could keep their home.[22] At the same time, Respondent 2 needed to come up with some securities business for FCS Securities that did not violate the restrictions in its Membership Agreement and that would allow the Firm to claim an exemption from the requirement to file an audited statement for 2006.[23] He testified, "I perceived that I had to do some sort of role in [an] advisory capacity, but I also perceived that the objective was to be a broker and so my role that I actually did was to have multiple hats with FCS Ventures and FCS Securities."[24]

Respondent 2 concluded that he could meet the definition of "buying and selling evidences of indebtedness secured by … [a] lien upon real estate" if he transferred the "risk" of default from Ventures to another person in connection with the restructuring of the terms of CA and AA's home loan.[25] Significantly, however, Ventures never endorsed the promissory note to a new holder, nor did Respondent 2 introduce any evidence that Ventures (or any of its shareholders) received anything of value from the purported transfer of the risk associated with the promissory note.

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[20] Tr. 182.

[21] Tr. 187.

[22] Tr. 188.

[23] Tr. 194.

[24] Tr. 186-87.

[25] Tr. 187.

Respondent 2's testimony regarding what happened was convoluted, vague, contradictory, and nonsensical. Respondent 2 began by stating that he could not help his sister and brother-in-law unless he obtained the approval of Venture's preferred shareholders despite the fact that he had complete voting control of the corporation.[26] Nonetheless, he used that premise as the rationale for FCS Securities' involvement in what otherwise appears to have been a private transaction principally involving family and family friends.

Respondent 2 described the multi-step transaction as follows. First, he claimed that he needed to "step aside" from his officer and director roles at Ventures to avoid the appearance of a conflict of interest that could arise if he acted as the controlling person for both Ventures and FCS Securities.[27] Thus, he had his parents assume those roles so that they would be the neutral party to negotiate the restructuring of their daughter's and son-in-law's loan.[28] Respondent 2 considered them free of all conflicts notwithstanding their close family relationship because they did not own any Ventures stock. Respondent 2 reasoned that the undocumented delegation of authority to his parents left him free to "broker" the sale of the risk associated with CA and AA's promissory note.[29]

The next step according to Respondent 2 was the sale of the preferred shareholders' individual interests in the promissory note to Ventures.[30] Respondent 2 assumed that the preferred shareholders owned transferrable interests in the promissory note despite the fact that Ventures was the sole payee and the holder of the promissory note. However, he presented no evidence or legal authority to support his assumption.

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[26] Respondent 2 presented no evidence that the preferred shareholders had any voice in the company's operations.

[27] Tr. 188.

[28] Tr. 189.

[29] Tr. 189.

[30] Tr. 189.

Then, the final step was a sale "between FCS Ventures and a partnership of Respondent 2 and KK."[31] Under this arrangement, the risk that the preferred shareholders had transferred to Ventures was now to be transferred to the new partnership. Respondent 2 identified KK as a family friend for the past 50 years.[32] Respondent 2 selected KK because she had sufficient finances and as a close family friend she would be discrete. Respondent 2 did not want his sister's dire financial situation to become public knowledge.[33] Respondent 2 testified that it took him between two and three months to convince KK to help.[34] Respondent 2 further testified that after he selected KK, he, acting as FCS Securities, had to negotiate with his parents to get Ventures' approval of KK as Respondent 2's partner.[35]

Respondent 2 testified that all of the foregoing was undertaken to make it easier for him to speak to his sister and brother-in-law about their financial difficulties, particularly about their non-payment of their home loan with Ventures.[36] He felt that it put him in a better position to "start turning the screws" on his sister and brother-in-law.[37] Ultimately, it appears that what Respondent 2 meant by this is that he told them they had to live within their means and not incur more consumer debt.[38] Respondent 2 did not specify whether these negotiations were conducted in 2006 or later.

Respondent 2 submitted an exhibit that he claimed was the documentation evidencing the sale of the "risk" of the promissory note on December 27, 2006.[39] But the

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[31] Tr. 190.

[32] Tr. 190.

[33] Tr. 190.

[34] Tr. 197.

[35] Tr. 192, 196.

[36] Tr. 198.

[37] Tr. 198, 199-200.

[38] Tr. 201.

[39] RX-21.

terms of the document actually accomplished nothing. In the first paragraph it recites that Ventures is buying all of his parent's interest in the note, while the second paragraph recites that his parents are buying the same interests from Ventures. Read in its entirety, the net result is that nothing changed as a result of the document.[40] Furthermore, at all times CA and AA continued to make their payments to the account at Fidelity Investments in their and Ventures' names. Accordingly, the Hearing Panel concluded that Respondent 2 had created a fictional transaction in an attempt to demonstrate that FCS Securities qualified for the exemption from filing an audited annual report for 2006.

In early 2007, Respondent 2 filed FCS Securities' annual report and financial statement.[41] The financial statement shows that FCS Securities received no revenue from investment advisory services in 2006. The only revenue the Firm reported was interest income of $315.[42]

B. The 2007 Activity

In 2007, Respondent 2 was again presented with the dilemma of how to demonstrate that FCS Securities had conducted securities business that qualified for the exemption from filing an audited annual report. Respondent 2's solution was to undo the fictional 2006 transactions involving Ventures' loan to his sister and brother-in-law and have them execute a new promissory note.

Respondent 2 testified that after the 2006 transaction was complete, Ventures' preferred shareholders decided that they "wanted to attempt to do the right thing and take some of the burden and so they decided that they wanted to try and buy back this thing that was restructured to get [CA and AA] the best chance of getting out of this in one

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[40] Rx-21.

[41] CX-2.

[42] CX-2, at 6.

piece."[43] Respondent 2 referred to this process as a "round robin."[44] And FCS Securities' role was "taking the restructured note and sending it back.[45]

This time, the first step involved having CA and AA execute a new promissory note dated December 29, 2007, for the identical principal amount as the original promissory note dated April 16, 2001.[46] In addition, as with the original note, the payee and designated holder of the new promissory note was Ventures, not any of the people Respondent 2 claimed owned an interest in the loan at the time. The 2007 note also was secured by a financing statement on CA and AA's residence. The only change in the new note is a revised monthly payment schedule.

To complete the reversal of everything that Respondent 2 put together in 2006, he had the relevant people sign another document dated December 30, 2007.[47] Respondent 2 prepared this document to show that FCS Securities qualified for the exemption from filing an audited annual report for 2007. As with the similar 2006 document, this one made no sense and accomplished nothing. According to the first paragraph of the document, Respondent 2's parents purchased Ventures interest in the December 2007 promissory note, while in the second paragraph Respondent 2 and KK sold the same interest to Ventures. Respondent 2 claimed the he, operating as FCS Securities, brokered the sale or sales involving the "interest" in the 2007 promissory note. At no point did Respondent 2 present any evidence the persons identified as buyers ever paid anything to the persons identified as sellers.

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[43] Tr. 203.

[44] Tr. 204.

[45] Tr. 205.

[46] RX-22.

[47] RX-23.

Based on the totality of the evidence, the Hearing Panel concluded that Respondent 2 again had created a fictional transaction in an attempt to demonstrate that FCS Securities qualified for the exemption from filing an audited annual report for 2007.

In early 2008, Respondent 2 filed FCS Securities' annual report and financial statement for 2007.[48] The financial statement shows that FCS Securities received revenue of $2,000 from investment advisory services in 2007.[49] Those fees were paid to FCS Securities in connection with the preparation of the promissory note dated December 29, 2007.

IV. CONCLUSIONS OF LAW

SEC Rule 17a-5(d)(1)(i) provides that "[e]very broker or dealer registered pursuant to section 15 of the [Exchange] Act shall file annually, on a calendar or fiscal year basis, a report which shall be audited by an independent public accountant." FCS Securities is registered pursuant to section 15 of the Exchange Act and therefore is required to make an annual filing of a financial statement audited by an independent public accountant. Failure to timely file a report as required by Rule 17a-5 is a violation of NASD Rule 2110.[50]

As found above, FCS Securities did not file audited financial statements for 2006 and 2007. Nor was it exempt from that requirement under SEC Rule 17a-5(e)(1)(i). To qualify, it was incumbent upon Respondent 2 to show that FCS Securities had engaged in the buying and selling of evidences of indebtedness secured by a mortgage, deed or trust, or other lien upon real estate in 2006 and 2007. However, he failed to do so. Although Respondent 2 engaged in an elaborate subterfuge in an attempt to generate qualifying activity, in the end the transactions he described bore no economic reality. Importantly,

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[48] CX-3.

[49] CX-3, at 6.

[50] *Magnus Oppenheim & Co.*, Exchange Act Rel. No. 51479, 2005 SEC LEXIS 764, at *7 (Apr. 6, 2005).

the real economic interests of the obligors and the holder of the promissory notes never changed. At all times, Respondent 2's sister and brother-in-law were indebted to Ventures, and Ventures never negotiated the promissory notes, which Respondent 2 admitted. Accordingly, he cannot claim that FCS Securities engaged in the buying and selling of the promissory notes, which are the evidences of CA and AA's debt to Ventures. Although Respondent 2 claimed that he facilitated the sales of the "risk" under the first promissory note, these sales or transfers cannot qualify because "risk" is not an "evidence of indebtedness." Further, Respondent 2's personal role in helping members of his family through a difficult financial situation does not qualify him for the exemption from filing audited annual statements under the unusual facts and circumstances of this case.

In conclusion, the Hearing Panel found that the transactions Respondent 2 devised in 2006 and 2007 were not bona fide sales of purchases of evidences of indebtedness and therefore FCS Securities was not exempt from the requirement that it file annual audited statements for those years. Accordingly, the Respondents violated SEC Rule 17a-5 and NASD Conduct Rule 2110.

V. SANCTIONS

The FINRA Sanction Guidelines ("Guidelines") do not contain a specific guideline for failure to file annual audited financial statements. However, the Guideline for late filing of FOCUS reports is instructive.[51] It recommends a fine between $10,000 and $50,000, a suspension of the firm for 30 business days, or until the firm files the report, and a suspension of the responsible principal for up to two years. The Guideline further sets out two principal considerations for determining the appropriate sanction

[51] FINRA Sanction Guidelines 72 (2007), available at www.finra.org/oho (then follow "Enforcement" hyperlink to "Sanction Guidelines").

within the recommended ranges.[52] First, the adjudicator should consider the number of days late the reports were filed. Second, the adjudicator should consider whether the respondent delayed filing the report to prevent disclosure of a record-keeping, operational, or financial deficiency.[53]

Prompt receipt of annual audit reports is integral in facilitating oversight of broker-dealer firms' financial health and in protecting investors' funds.[54] Here, although FCS Securities conducted little or no business in 2006 and 2007, it nonetheless was obligated to comply with SEC Rule 17a-5. The rule does not provide an exemption for firm's with *de minimis* revenue.

Taking into consideration FCS Securities' size, Enforcement requested imposition of a $10,000 fine, the minimum recommended under the Guidelines for late filing of a FOCUS report. Enforcement did not request a suspension of either Respondent 2 or FCS Securities.

The Hearing Panel took other factors into consideration in addition to the Firm's size and revenue. First, the Respondents have a long history of refusing to file compliant annual reports. As noted above, in January 2005, FINRA issued a Letter of Caution to Respondents for their failure to file audited financial statements for 2001, 2002, and 2003. Furthermore, staff representing both FINRA and the SEC advised Respondent 2 in February 2006 that he was required to file audited financial statements for 2005 and that FCS Securities did not qualify for the same exemption Respondent 2 relied upon for the years in question here. Respondent 2 cannot therefore claim in good faith that he misunderstood that he needed to file audited statements for 2006 and 2007. Nonetheless, he refused to comply with the rule.

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[52] *Id.*

[53] Sanction Guidelines 72.

[54] *Clinger & Co.*, Exchange Act Release No. 33375, 1993 SEC LEXIS 3524, at *5 (Dec. 23, 1993).

The Hearing Panel also considered Respondent 2's stated motive for devising artifices in 2006 and 2007 to support his exemption claims. Respondent 2 demonstrated complete understanding of the applicable legal principles, yet he intentionally engaged in obfuscation in his efforts to avoid the expense of filing audited annual reports. As Respondent 2 admitted, he never intended to conduct the securities business permitted by FCS Securities' Membership Agreement, but he also did not want to incur the cost of withdrawing the application and re-filing when he was ready to engage in his intended business, which was proprietary trading. In effect, Respondent 2 wanted FINRA to allow FCS Securities to remain a dormant member until he could capitalize it adequately.

Based upon these unique facts, the Hearing Panel determined that Respondent 2 and FCS Securities jointly and severally shall be fined $5,000, and FCS Securities shall be suspended for four months, which suspension shall convert to an expulsion if, at the end of four months, it has not filed audited financial reports for 2006 and 2007 that are acceptable to FINRA Staff in District 10.

VI. ORDER

Respondent 2 and FCS Securities are jointly and severally fined $5,000, and FCS Securities is suspended for four months, which suspension shall convert to an expulsion if, at the end of four months, it has not filed audited financial reports for 2006 and 2007 that are acceptable to FINRA Staff in District 10. In addition, Respondent 2 and FCS Securities are jointly and severally ordered to pay the costs of this proceeding in the amount of $2,017.15, which includes a $750 administrative fee and the cost of the hearing transcript.

The fines and costs shall be payable on a date set by FINRA, but not less than 30 days after this decision becomes FINRA's final disciplinary action in this matter. If this decision becomes FINRA's final disciplinary action, the suspension shall commence on July 6, 2009, and end at the close of business on November 5, 2009, if FCS Securities has

filed audited financial reports for 2006 and 2007 in compliance with SEC Rule 17a-5(d)(1)(i) by that date. In the event FCS Securities does not file audited annual financial statements that comply with SEC Rule 17a-5(d)(1)(i) before November 5, 2009, the suspension shall convert to an expulsion.[55]

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Andrew H. Perkins
Hearing Officer
For the Hearing Panel

Copies to:

Respondent 2 (by electronic and first-class mail)
FCS Securities, LLC (by electronic and first-class mail)
Vaishali Shetty, Esq. (by electronic and first-class mail)
Jeff Kern, Esq. (by electronic and first-class mail)
David R. Sonnenberg, Esq. (by electronic mail)

[55] The Hearing Panel has considered and rejects without discussion all other arguments of the parties.