

BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD REGULATION, INC.

In the Matter of

Department of Enforcement

Complainant,

vs.

Respondent Firm 1

Respondent 2

and

Respondent 3

DECISION

Complaint No. C8A990071

Dated: April 19, 2001

**Hearing Panel found that firm, acting through its President and FINOP, failed to maintain minimum required net capital, failed to keep accurate books and records as a result of inaccurate trial balances and net capital computations, and filed an inaccurate FOCUS IIA report, and that firm and President also failed timely to respond to Association requests for information. Held, findings affirmed, but sanctions increased.**

Respondent Firm 1 (or "the Firm"), Respondent 2, and Respondent 3 have appealed the sanctions imposed in a September 12, 2000 amended Hearing Panel decision pursuant to NASD Procedural Rule 9310. After an independent review of the entire record in this matter, we affirm the uncontested findings of violations, but modify the sanctions imposed by the Hearing Panel. Thus, the Firm and Respondent 2 are each censured and fined \$20,000, jointly and severally, for the violations alleged in causes one through three of the complaint, and fined \$20,000, jointly and severally, for the violations alleged in cause four. Also in connection with cause four, Respondent 2 is suspended in all principal capacities for 90 days, and thereafter is required to requalify by examination before functioning in any principal capacity. In connection with the violations alleged in causes one through three, we affirm the sanctions imposed below as to Respondent 3, who is thus fined \$1,000 and required to requalify by examination before functioning as a financial and operations principal ("FINOP"). We also

affirm the Hearing Panel's assessment of costs of \$2,334.30, jointly and severally, and assess appeal costs of \$1,000 against the Firm and Respondent 2, jointly and severally.

### Background

The Firm, a \$5,000 fully-disclosed introducing broker, became a member of the NASD in February 1989. At that time, and throughout the periods relevant to the complaint, the Firm was a wholly-owned subsidiary of Firm A. As discussed in greater detail below, on January 24, 1989, Firm A, as an affiliate of the Firm, executed an expense agreement letter representing that it would, among other things, pay the "monthly fixed expenses" of the Firm.

At all relevant times, Respondent 2, who entered the securities industry in September 1981, was President and a registered representative and general securities principal of the Firm, and was also President and controlling shareholder of Firm A. Respondent 2 currently serves in those capacities. At all relevant times, Respondent 3, who entered the securities industry in February 1986, was Vice-President of the Firm, and was a registered representative and general securities principal as well as its part-time registered FINOP. Respondent 3 also currently serves in those capacities. It is undisputed that at all relevant times, Respondent 2 and Respondent 3 shared responsibility for maintaining the Firm's net capital, for ensuring that the Firm's books and records were accurate, and for filing accurate FOCUS Reports.

In overview, this matter concerns an NASD staff inquiry into the respondents' apparent failure to accrue liabilities arising from monetary sanctions imposed in a final NASD disciplinary action, as well as from legal bills incurred in the defense of that action. The liability for monetary sanctions was detected by NASD Regulation, Inc. District staff through communications from internal NASD offices charged with the collection of fines and costs. The liability arising from the legal bills was disclosed to staff by Respondent 2 during conversations about the Firm's annual audit. Thereafter, NASD staff conducted examinations and, beginning on October 14, 1997, issued over the next year numerous letters pursuant to NASD Procedural Rule 8210 ("Rule 8210" or "8210 requests") in order to obtain, among other things, evidence bearing on the proper characterization of these liabilities, as well as to obtain a copy of a videotape made by Respondent 2 of portions of an NASD examination ending on July 1, 1998.<sup>1</sup>

As now admitted on appeal by the respondents, the Firm, through Respondent 2, failed to respond to these requests in a timely manner, exceeding deadlines by anywhere from 55 to 687 days before finally producing all of the requested materials on September 13, 1999. Upon determining that the disputed liabilities should have been, but were not, accrued by the Firm, the staff alleged that as a result the respondents violated numerous financial and operational rules of

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<sup>1</sup> With the staff's permission, Respondent 2 videotaped a portion of his initial conversations with staff during an examination that took place from June 29 through July 1, 1998. Without permission, Respondent 2 recorded a portion of his exit conversation with staff.

the Securities and Exchange Commission ("SEC" or "the Commission") and NASD during the four months of financial and operational violations encompassed in the complaint.

#### Procedural History and Hearing Panel Findings

On October 18, 1999, following examination and investigation by the District No. 8 staff, the Department of Enforcement ("Enforcement") filed the four-cause complaint in this matter. The Hearing Panel granted Enforcement's pre-hearing motion for summary disposition as to cause four (failure to produce all requested information in a timely manner pursuant to Rule 8210). Finding no genuine issue of material fact, the Hearing Panel held that the Firm and Respondent 2 had violated NASD Procedural Rule 8210 and Conduct Rule 2110, as alleged, by failing to produce in a timely manner, among other things, certain bills for legal services and a videotape that the NASD staff properly had requested pursuant to Rule 8210. The Hearing Panel found that Respondent 2 failed to produce videotape pursuant to an 8210 request until September 13, 1999, even though Enforcement had served several 8210 requests for the videotape beginning on July 13, 1998. The Hearing Panel also found that the Firm and Respondent 2 refused to produce copies of legal bills and supporting documentation forming the basis for a contested liability (and at one point denied the existence of such records) notwithstanding repeated 8210 requests dating from October 14, 1997; that the Firm and Respondent 2 did not assert attorney-client privilege with respect to narrative comments appearing on the legal bills until July 1999, and that under the threat of the filing of a formal disciplinary complaint, the Firm and Respondent 2 finally produced redacted copies of the bills on September 13, 1999, pursuant to an agreement with staff.

The Hearing Panel held an evidentiary hearing on both liability and sanctions as to causes one through three, and on sanctions only as to cause four.<sup>2</sup> Cause one alleged, and the Hearing Panel found, consistent with Schedule A to the complaint, that on or about August 1 and August 27, 1997, the Firm violated SEC Rule 15c3-1 and Conduct Rule 2110 by effecting transactions in securities when it failed to maintain its minimum required net capital of \$5,000, and that Respondent 2 and Respondent 3 violated Conduct Rule 2110 by causing or allowing such violations. The Firm's deficiency in net capital was (\$15,677) as of August 1, 1997, and (\$16,811) as of August 27, 1997.

Cause two alleged, and the Hearing Panel found, consistent with Schedule B to the complaint, that the Firm violated SEC Rule 17a-3 and Conduct Rules 3110(a) and 2110 by preparing inaccurate trial balances and net capital computations for July 31, August 29, September 30 and October 31,

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<sup>2</sup> The parties stipulated that Schedules A, B, and C to the complaint, attached hereto, contained accurate representations of the Firm's computations and records as of the dates shown, as well as accurate computations of the staff's reconstruction of what the records and computations should have been (with the exception of the disputed liabilities for the NASD monetary sanction and unpaid legal bills), as well as the differences between the Firm's position and the staff's position. On appeal, the respondents acknowledged the violations supported by the Schedules, and did not contest the accuracy of the Schedules.

1997, and that Respondent 2 and Respondent 3 violated Conduct Rule 2110 by causing or allowing such violations. The most significant inaccuracies resulted from the Firm's failure to recognize as liabilities unpaid portions of an NASD monetary sanction and unpaid legal bills.

Cause three alleged, and the Hearing Panel found, consistent with Schedule C to the complaint, that the Firm violated SEC Rule 17a-5 and Conduct Rule 2110 by filing an NASD FOCUS Part IIA Report for the calendar quarter ending September 30, 1997, which inaccurately stated the Firm's net capital, and that Respondent 2 and Respondent 3 violated Conduct Rule 2110 by causing or allowing such violation. The net capital deficiency (of \$6,290) resulted mainly from the Firm's failure to recognize as liabilities unpaid portions of an NASD monetary sanction and unpaid legal bills.

The Hearing Panel found that the violations alleged in causes one through three were attributable primarily to the respondents' failure to accrue NASD monetary sanctions and associated legal fees. The Hearing Panel explained that the disagreement between the respondents and staff in this regard originated in connection with an NASD complaint filed against the Firm and Respondent 2 in 1995. The final decision in the case was issued on January 27, 1997, when the Firm and Respondent 2 were each censured, fined \$5,000, jointly and severally, and assessed costs of \$2,205.63, jointly and severally.<sup>3</sup> The NASD's decision became final, and the monetary sanctions became due and payable, on July 1, 1997, the date on which the SEC dismissed the Firm's and Respondent 2's application for review. As set forth in Schedules A, B, and C to the complaint, the fine and costs (initially \$7,205.63), as well as legal fees incurred by the Firm in connection with that proceeding (\$12,608), which the Firm did not record, accounted in significant part for the unrecorded liabilities responsible for the recordkeeping, computation, and net capital violations alleged in the first three causes of the complaint.

The Hearing Panel rejected the respondents' contention that the Firm had no duty to accrue the liabilities for NASD monetary sanctions and legal bills because of the existence of an expense agreement entered into by the Firm and Firm A, the Firm's parent entity, on January 24, 1989, pursuant to which Firm A purportedly agreed to pay all expenses incurred by the Firm.<sup>4</sup> The Hearing Panel found that the

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<sup>3</sup> District Business Conduct Committee for District No. 8 vs. Respondent Firm 1 and Respondent 2, 1997. The NASD's National Business Conduct Committee ("NBCC") found the Firm and Respondent 2 responsible for a breach of the Firm's restrictive agreement prohibiting receipt of customer funds and for failure to supervise a representative who failed to report an indictment, conditional plea, and criminal conviction on a Form U-4 Uniform Application for Securities Industry Registration or Transfer ("Form U-4"). (On January 16, 1998, as approved by the Securities and Exchange Commission, the National Adjudicatory Council ("NAC") became the successor to the NBCC.)

<sup>4</sup> During membership application proceedings, the NASD staff gave the Firm a directive entitled "Member's Responsibilities for Expenses Paid by Affiliates." The directive applied on its face to "situations where the member indicates that monthly fixed costs will be borne by an affiliated company." In compliance with this directive, the Firm obtained from Firm A a January 24, 1989, letter signed by

scope of the agreement was expressly limited to the "monthly fixed expenses" of the Firm, both according to the written instructions provided by NASD staff in 1989 and the terms of the agreement. The Hearing Panel ruled that Respondent 2's unreasonably "sweeping interpretation" of the scope of the expense agreement was not supported by the respondents' recollection of pre-membership conversations with NASD staff or Respondent 2's personal understanding of the accounting practices of other firms.

In assessing sanctions, the Hearing Panel determined that the net capital, recordkeeping, and FOCUS Report violations set forth in causes one through three could be appropriately considered together based on their common origin, although the underlying rules alleged in the complaint addressed different regulatory concerns. The Hearing Panel dealt with the failures to respond separately. The Hearing Panel also found that, in light of Respondent 3's limited decision-making role within the firm, separate sanctions consisting of a fine of \$1,000 and a requirement to requalify as a FINOP would be appropriate and of sufficient deterrent value as to him.

In its analysis of Respondent 2's responsibility, the Hearing Panel voiced the following concerns about Respondent 2's actions:

In arriving at appropriate sanctions, the Hearing Panel was particularly concerned about Respondent 2's hostile and defiant attitude toward NASD staff, which exacerbated the financial violations, when he rejected the staff's advice in October 1997 that the Firm was required to book the monetary sanctions, and directly led to the failure to timely respond violations. In his closing argument, respondents' counsel admitted that Respondent 2 'has been aggravated for a long while, and as a result he's developed an attitude. We acknowledge it. We acknowledge it, and it's an appropriate thing to be taken into account. It's not an excuse.' [Citation omitted.] During the hearing, at his attorney's urging, Respondent 2 said he 'would very much appreciate a cooperative arrangement' with NASD staff, but he also described the

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Respondent 2, as President of Firm A, which incorporated the specific language required by the directive as follows:

Firm A has agreed [sic] to the following:

1. Firm A. will pay the monthly fixed expenses incurred by Respondent Firm 1 a subsidiary of Firm A.
2. Firm A has informed all creditors that all expenses should be billed directly to Firm A.
3. Firm A does not intend to apportion any of these expenses back to Respondent Firm 1 at the end of the fiscal year or at any other time.

NASD as 'probably the only member organization [in] which all of the member firms hate the establishment.' [Citation omitted.] His demeanor during the hearing reflected clear continuing hostility toward the staff.

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Whatever may have occurred between respondents and the staff prior to the earlier disciplinary proceeding, there is no evidence that the staff's actions relating to this case were in any respect unreasonable or offensive. In October 1997, after learning that the monetary sanctions had become final, the staff called Respondent 2 to confirm that the Firm was properly booking those items. Respondent 2's response was simply to reject out of hand the staff's advice that Investors was required to book these charges. When the staff requested information to confirm Respondent 2's claim that the Firm had no liability for the legal fees, Respondent 2 provided a back-dated note [a promissory note dated December 1, 1996 but actually prepared and signed in November 1997 by Respondent 2 on behalf of Firm A, releasing the Firm from liability for the legal fees], without disclosing that fact, and steadfastly refused to provide copies of the actual bills, which would have shown that they were addressed to Respondent Firm 1, not Firm A. When the staff requested a copy of the videotape Respondent 2 had made, Respondent 2 ignored the requests, except to accuse the staff of lying about [the existence of a formal] NASD taping policy [prohibiting the taping of staff activities]. In short, in this case the record reflects that all of the hostility and antagonism flowed in one direction, from Respondent 2 to staff. [I]n contrast to respondents' obvious hostility toward the staff during the hearing, the Hearing Panel observed no indication that the staff harbors any similar hostility toward respondents.

The Hearing Panel noted as aggravating circumstances that the prior NASD action against the Firm and Respondent 2 constituted relevant prior disciplinary history; that the respondents did not take responsibility for and acknowledge the violations herein; that they did not demonstrate reasonable reliance on competent legal or accounting advice; that they did not cooperate with the NASD's investigation, but rather resisted and provided inaccurate and misleading information; and that they continued to refuse to book the liabilities at issue even after being advised by the staff that they were required to do so. Noting that the reduced sanction imposed by the NBCC in the earlier NASD disciplinary proceeding had been interpreted by Respondent 2 as a vindication rather than as a "moderate, corrective deterrent," the Hearing Panel concluded that "more substantial" sanctions as to Respondent 2 and the Firm were needed to deter future violations.

Thus, the Hearing Panel imposed as to the Firm and Respondent 2: censures; an aggregate fine of \$20,000, jointly and severally, for the violations alleged in causes one through three of the complaint; and a fine of \$10,000, jointly and severally, for the violations alleged in cause four. In connection with cause four, the Hearing Panel rejected Enforcement's recommendation that Respondent 2 be suspended in all capacities for one year, because the Hearing Panel was concerned about the effect of such a sanction on the Firm, but determined to suspend Respondent 2 in all principal capacities for 90 days and require him to requalify before functioning in any principal capacity.<sup>5</sup>

### Proceedings on Appeal

By a Notice of Appeal ("Notice") dated September 14, 2000, the respondents, through counsel, appealed the Hearing Panel decision and requested oral argument. The respondents' Notice did not contest the findings of violation set forth in that decision, but did challenge the findings and conclusions as to sanctions.<sup>6</sup> In a letter dated September 18, 2000, NASD Regulation staff acknowledged the scope of the appeal and stated the NAC's scope of review in this matter.

On appeal, counsel for the respondents argued that the Firm, Respondent 2, and Respondent 3 had held a mistaken but good faith belief that the Firm's expense agreement with Firm A allowed the unpaid legal bills and monetary sanctions at issue to remain off its books. Counsel asked for consideration as to sanctions of the fact that during the respondents' pre-membership discussions with a then-NASD Supervisor of Examiners, Respondent 2 discussed his intention to have Firm A pay all of Respondent Firm 1's operating expenses, which Respondent 2 understood were not limited to fixed expenses and would include legal or other professional fees. Counsel cited testimony of Respondent 2 and Respondent 3 to the effect that they had discussed with the Supervisor the ability of the Firm to "upstream commissions and expenses" to Firm A, and that Firm A, a non-broker-dealer, could pay out commissions to the Firm's representatives, and that the Supervisor had confirmed that payroll expenses and annual audit fees could be paid by the parent. Counsel argued that with the exception of one instance, in which staff had questioned Firm A's ability to receive and pay commissions to representatives, NASD examiners had never questioned the absence of expenses flowing through the Firm's income statement.

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<sup>5</sup> The respondents were also assessed costs of \$2,334.30, jointly and severally.

<sup>6</sup> The Notice represented as follows:

Respondents do not take exception to the findings and conclusions that the SEC and NASD Rules set forth in the Decision were violated. Appellants do take exception and appeal on the ground that the factual findings and conclusions regarding sanctions are not supported by the reasonable weight of the evidence, do not give proper credit to the extenuating and mitigating circumstances revealed in the record, and are disproportionately severe in light of the nature of the violations found and the size of the member firm.

Counsel cited Respondent 3's testimony acknowledging his belief, when in receipt of notice of the NASD monetary sanctions, that "the expense agreement deferred everything to Firm A," and counsel argued that Respondent 3 had followed past practice in not booking the liability because he had been taught the importance of consistency in accounting matters. Counsel also argued that the Firm's outside auditors had concurred in the Firm's financial statements and net capital calculation as of June 30, 1997. Those documents did not reflect liabilities for monetary sanctions or legal bills, disclosing instead in footnotes that these items were obligations of Firm A. Counsel offered the foregoing not in support of a contention that the respondents were reasonable in not booking the liabilities, but to rebut the implication in the Hearing Panel decision that the pre-membership discussions were fabrications, that the violations were knowing or intentional, and that the respondents were not motivated by a genuine good faith belief in their accounting practices.

Counsel for the respondents took further exception to the Hearing Panel's apparent imputation of bad faith to the respondents. Counsel noted that the Hearing Panel had held that the February 5, 1996, retainer agreement with his law firm clearly established the Firm's duty to book the liability for legal fees. Although counsel agreed with the Hearing Panel decision that the violations charged in causes one through three could be sustained based on the existence of the NASD monetary sanctions alone, counsel argued that the Hearing Panel's finding that the retainer agreement lacked ambiguity was without legal support and appeared to have influenced the Panel's sanctions determination. Counsel reiterated his argument below that the retainer agreement, which was addressed to Respondent 2 at the address the Firm shared with Firm A, lacked clarity as to the party agreeing to retain and pay the law firm, since Respondent 2's signature on the agreement as Respondent 2, Pres. did not indicate whether he was signing for Firm A or the Firm. Counsel cited Respondent 2's testimony that he had intended, in keeping with his understanding of the expense agreement, for Firm A to be responsible for the liability. Counsel also cited his own testimony that although he had initially looked to Respondent 2 to be responsible for the debts personally and had been indifferent as to the role of any corporate entity, he later recognized that Respondent 2, in signing as he did, had accepted the terms of the retainer on behalf of some unidentified corporate entity. Counsel further observed that although his law firm had billed Respondent 2 at his Firm's address, all the legal bills were paid by Firm A.

Counsel for the respondents argued that although his law firm later had accepted an interest-bearing promissory note from Firm A in satisfaction of the account receivable balance represented by the unpaid legal bills, the Hearing Panel had erred in concluding that the note was given to release a pre-existing obligation of the Firm. Counsel also argued that the Hearing Panel decision erroneously had implied that Respondent 2 had created the note to mislead the NASD staff. Counsel recited that at year-end 1996, when Respondent 2 indicated that he needed more time to pay the bill, which exceeded \$12,000, counsel suggested putting the balance on a promissory note with interest. The topic was not revisited until on or about September 30, 1997, when the Firm's outside auditors asked that documentation be created to confirm that Firm A, not the Firm, was liable for the legal bill. On that date, counsel drafted and faxed to Respondent 2 for immediate execution a promissory note with Respondent 2 and Firm A as makers. Respondent 2 signed and faxed back the note the same day.

Counsel for the respondents explained that on October 14, 1997, NASD staff faxed to Respondent 2a request for, among other things, a copy of any agreements between the law firm to whom the fees are owed, the Firm and Firm A which evidence that the law firm involved has agreed to hold the parent company, Firm A, solely responsible for the \$12,608 obligation. On receipt of the NASD fax, counsel related, Respondent 2 redrafted the note to address more specifically the NASD request by including a recitation on the part of the law firm that all previous invoices for legal services have been paid by Firm A, the parent company of the Firm. According to counsel, Respondent 2 also dated the note "December 1, 1996," to give the law firm the right to interest from the date that the idea of a promissory note had first been discussed. Counsel confirmed the acceptance of the note in a letter dated November 13, 1997. Counsel thus took issue with any implication in the Hearing Panel decision that the "back-dating" of the note was done other than to benefit the law firm, or was created for the purpose of deceiving the staff.

Although counsel for the respondents acknowledged that they did not contest the allegations concerning failures timely to respond, counsel offered explanations for Respondent 2's actions with respect to the staff requests for the legal bills and the videotape. According to counsel, the NASD's request for the legal bills placed Respondent 2 in what he considered to be an untenable position. Although the bills were addressed to Respondent 2's attention at the Firm, Respondent 2 had understood and intended that Firm A had retained the law firm and would pay the bills, as it had always done. Respondent 2 therefore considered the bills paid by Firm A to be Firm A's records and thus outside the scope of any Rule 8210 request directed to the Firm. Counsel represented that Respondent 2 was also concerned that the bills contained narrative matter about the defense of the prior disciplinary case with the NASD. Without the advice of counsel, Respondent 2 decided that the Firm had no responsive documents; that the bills in Firm A's possession were not subject to production; that the promissory note evidencing Firm A's liability for the bills was a sufficient response to the NASD's request; and that the bills were no longer relevant. Counsel for the respondents argued that although Respondent 2 had taken an overly technical and legalistic position (which he abandoned when counsel was retained and arranged for the production of redacted copies of the bills), the Hearing Panel's implicit findings of intentional concealment and obstruction were not warranted based on the record.

As to Respondent 2's failure to produce the requested copy of the videotape, counsel for the respondents conceded that Respondent 2 had exercised poor judgment and was "motivated by an overly adversarial attitude," arising from the prior disciplinary proceeding, when he decided to videotape his discussions with NASD staff. Counsel argued, however, that the staff's request for the tape and subsequent disciplinary action over the delay in its production was "equally unwarranted." Counsel noted that the tape consisted of 10 to 15 minutes of an initial background conference taped with staff consent, plus five minutes of an exit exchange, wherein an NASD examiner advised Respondent 2 that NASD policy prohibited such taping and Respondent 2 asked for evidence of such policy. Counsel for the respondents contended that the tape had no relevance to any issues in this proceeding, and was thus outside the scope of any legitimate purpose relating to the examination of the Firm. Counsel claimed that the staff was offended by Respondent 2's taping and demand for evidence of a policy against taping, which policy counsel claimed did not exist until March 2000. Counsel argued that staff had requested the tape "as an expression of that annoyance" rather than any proper purpose. Counsel

argued that Respondent 2 was committed to doing his part to prevent a recurrence of this nature, and that the pettiness of this issue did not warrant a substantial sanction.

Counsel for the respondents also disputed the "aggravating circumstances" cited by the Hearing Panel in support of its sanctions. Counsel asserted that Respondent 2 had genuinely believed that he had been victimized by the poor advice of the NASD staff in the earlier disciplinary proceeding and that he had felt harassed when questioned as to accounting issues he thought had been settled in 1989. Noting that the Firm had implemented revised bookkeeping policies and procedures, counsel represented that Respondent 2 "recognize[d] the necessity that he adopt a more cooperative, responsive and respectful attitude" and ha[d] agreed to "abandon the adversarial stance engendered over the last several years." For these reasons, counsel requested that the NAC reduce the joint and several fine as to the Firm and Respondent 2 for causes one through three to no more than \$10,000, and as to cause four that the Firm and Respondent 2 be fined no more than \$10,000, jointly and severally. Counsel argued that, because Respondent 2 "runs [the Firm] as close to a one-man show from an operational and administrative standpoint," Respondent 2's 90-day suspension in all principal capacities should be reduced to a requirement to requalify before serving in any principal capacity.

In response, counsel for Enforcement contended that the respondents purposefully had ignored staff instructions to book unpaid NASD monetary sanctions, as well as unpaid legal fees incurred in the earlier proceeding, and had failed to comply with Rule 8210 requests for a videotape and for legal bills for extended periods. Enforcement counsel further noted that these materials had been produced only after Respondent 2 was told of staff's intent to commence a disciplinary proceeding. Counsel argued that in light of the admitted violations, no reduction in the Hearing Panel's sanctions was warranted.

Enforcement counsel argued that the Hearing Panel properly had ruled that the Firm's expense agreement did not encompass all expenses. Counsel noted that the express language of the agreement limited it to "fixed expenses" and that the respondents thus should have known that all expenses could not be upstreamed to the parent. Counsel challenged Respondent 2's claimed knowledge of the use of such agreements at other firms where he had worked, particularly in light of his admissions of lack of familiarity with actual accounting practices at those firms. Counsel also argued that respondents' claim of mitigation based on the representations of an NASD Supervisor were also without merit because Respondent 2's construction of the scope of those instructions was without limits and thus unreasonable. Counsel also noted that the Hearing Panel had discredited Respondent 2's testimony concerning a condition precedent to the application of an expense agreement, *i.e.*, that he notified his creditors that all bills should be made out in Firm A's name rather than the Firm, particularly in light of Respondent 2's failure to notify his law firm to look to Firm A for payment. Counsel observed that if respondents' position were accepted, the NASD would be prevented from regulating its member firms, since financial responsibility for NASD monetary sanctions could be shifted to other corporate entities.

Enforcement counsel noted that although the respondents now admitted that the legal fees should have been reported as a liability on the Firm's books and records, the respondents sought mitigation of sanctions because of the "ambiguous" nature of the retainer agreement. Counsel maintained that no ambiguity existed as a matter of law, since the only corporation named in the agreement was the

Firm, and Respondent 2 signed as its President. Counsel argued that the Firm's liability should not have been subject to question, since the law firm had been retained by the Firm and Respondent 2 to represent them before the NASD; the retainer agreement made no mention of Firm A; the law firm's bills were addressed to the Firm, to the attention of Respondent 2, with no evidence of objection; and there was no evidence that the creditor was advised that the bills were liabilities of Firm A until the end of September 1997.

Citing a member's unconditional responsibility to respond to requests made pursuant to Rule 8210, Enforcement counsel noted the invalidity of the explanations offered for the failures to respond. Counsel argued that Respondent 2 had refused to turn over the legal bills because they showed that the Firm owed them, not because they were not in Respondent 2's possession and control. Counsel argued that Respondent 2's claim that the bills were the property of Firm A was based on nothing more than Respondent 2's unilateral determination, and, moreover, that even if it were true, Respondent 2, as controlling shareholder of Firm A, had the authority to produce them. As to Respondent 2's claim of privilege, Enforcement counsel agreed with the Hearing Panel's statement that upon receipt of a request for documents possibly subject to privilege, Respondent 2 should have immediately raised such issues with staff, so as not to delay production.

Counsel for Enforcement challenged Respondent 2's position that he did not intentionally conceal documents or obstruct the staff's investigation. Counsel observed that Respondent 2 lied when he informed NASD staff by letter dated November 18, 1997 that "there [were] no invoices and/or bills from a law firm" when such in fact existed, and instead provided staff with the back-dated promissory note and release, without informing the staff that the note had been recently created. Counsel further noted that Respondent 2, when pressed, claimed that the Firm did not have the requested documents because they were the property of Firm A. Counsel argued that these actions could only be interpreted as an attempt to conceal that the Firm was not accruing all of its liabilities. Counsel maintained that Respondent 2's determination unilaterally to delay production of documents and information throughout his course of dealing with staff was unacceptable and provided no basis for mitigation of sanctions. Observing that greater sanctions were authorized under the Sanction Guidelines and relevant case law, counsel asked that the lenient sanctions of the Hearing Panel be affirmed if not increased.

### Discussion

Following our consideration of the entire record in this proceeding, including the arguments of the parties on review, we accept respondents' waiver of objection to the findings and conclusions of the Hearing Panel as to their violations of the SEC and NASD rules set forth in the Hearing Panel decision, and the findings of fact supporting them, except as to sanctions. We have thus confined our independent review to the issues raised by the respondents with respect to the sanctions imposed in this proceeding, and we thus affirm the findings set forth in the Hearing Panel's decision. As to the contested facts relating to sanctions, based on our independent review, we concur with the determinations made in the Hearing Panel decision, except to the extent stated herein.

Any consideration of sanctions in NASD disciplinary proceedings begins with the NASD Sanction Guidelines. As noted below, the range of discretion conferred by the Guidelines for causes one through three is broad. Under the relevant Guideline for the net capital violations, the recommended fine per violation ranges from \$1,000 to \$50,000, and adjudicators may consider suspending firms in some or all capacities or even expulsion in egregious cases.<sup>7</sup> The respondents do not contest that consistent with Schedule A to the complaint, on or about August 1 and August 27, 1997, the Firm violated SEC Rule 15c3-1 and NASD Rule 2110, and Respondent 2 and Respondent 3 violated Rule 2110 by causing or allowing the net capital violations. The Guideline for the recordkeeping and computation violations suggests a fine of \$1,000 to \$10,000, and in egregious cases, up to \$100,000, with discretion to suspend firms and individuals up to 30 business days, and in egregious cases, to suspend for longer periods or to expel or bar them.<sup>8</sup> The respondents do not contest that consistent with Schedule B to the complaint, the Firm violated SEC Rule 17a-3 and NASD Rules 3110(a) and 2110 by preparing inaccurate trial balances and net capital computations for July 31, August 29, September 30 and October 31, 1997, and that Respondent 2 and Respondent 3 violated Rule 2110 by causing or allowing such violations. Finally, the Guideline for filing an inaccurate FOCUS Report recommends a fine of \$10,000 to \$50,000, and permits consideration of a suspension of up to two years for an individual and suspension of solicited retail activity for a firm for 30 days or until all deficiencies are corrected.<sup>9</sup> Finally, the respondents do not contest that consistent with Schedule C to the complaint, the Firm violated SEC Rule 17a-5 and NASD Rule 2110 by filing an NASD FOCUS Part IIA Report for the calendar quarter ending September 30, 1997, that inaccurately stated the Firm's net capital, and that Respondent 2 and Respondent 3 violated Rule 2110 by causing or allowing such violation.<sup>10</sup>

Although SEC case law and NASD practice suggest that sanctions generally be assessed per cause, we concur with the Hearing Panel's determination that the financial and operational violations alleged in causes one through three were attributable to a common underlying cause, the failure to book legal and regulatory liabilities, and thus should be addressed in a unitary sanction. For the reasons set forth in the Hearing Panel decision, we affirm the Hearing Panel's imposition of a \$20,000 joint and several fine under those causes. Having given due weight to the respondents' initiation of corrective action and admission of liability and responsibility in this proceeding, we believe that a joint and several fine of \$20,000 is necessary to effect appropriate remediation and deterrence with respect to these violations as to Respondent Firm 1 and Respondent 2. We also concur with the Hearing Panel's determination to impose separate sanctions as to Respondent 3 for these violations, and we agree for

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<sup>7</sup> NASD Sanction Guidelines (1998 ed.) ("Guidelines") at 27 (Net Capital Violations).

<sup>8</sup> Guidelines at 28 (Recordkeeping Violations).

<sup>9</sup> Guidelines at 64 (FOCUS Reports).

<sup>10</sup> NASD Rule 115 indicates that persons associated with a member shall have the same duties and obligations under the NASD's Rules as members. Thus, the ethical standards imposed on members in Rule 2110 apply equally to persons associated with a member.

the reasons set forth in the decision below that his fine of \$1,000 and requirement to requalify by examination as a FINOP are appropriately remedial.<sup>11</sup>

We have considered respondents' claim that they had no intention of committing the financial and operational violations and held a misplaced but good faith belief in their interpretation of the expense agreement's purportedly comprehensive scope.<sup>12</sup> We agree with the Hearing Panel that respondents' construction of the agreement was unreasonable.<sup>13</sup> Although we acknowledge respondents' concession on appeal that they were mistaken as to their construction,<sup>14</sup> we accept the respondents' claims of good faith only to the point that NASD staff began active questioning of the Firm's accounting practices with regard to the NASD monetary sanctions and associated legal fees. Particularly as to the requirement to

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<sup>11</sup> We find the requalification requirement particularly fitting in order to impress upon Respondent 3 the duties and obligations of a FINOP. See, e.g., In re Gilad J. Gevanyahu, 51 S.E.C. 710 (1993) (FINOP held responsible for carrying out attendant duties and obligations notwithstanding that he maintained his own practice and worked for the firm only on a part-time basis). See also In re George Lockwood Freeland, 51 S.E.C. 389 (1993) (same); In re Wallace G. Conley, 51 S.E.C. 300 (1993) (same).

<sup>12</sup> In connection with the respondents' claim of good faith, we note that intent does not enter into the determination of whether a financial or operational violation occurred. See In re Kirk L. Ferguson, 51 S.E.C. 1247, 1250 n.14 (1994) (intent not relevant with respect to a net capital violation).

<sup>13</sup> We do not doubt that pre-membership discussions with an NASD Supervisor took place, but we concur with the Hearing Panel's credibility determinations and factual analysis, as well as its conclusion that those discussions, and the fact of subsequent NASD examinations, could not estop necessary NASD regulatory action. The actions or representations of NASD staff concerning compliance obligations do not bind the NASD. See In re JJFN Servs., Inc., Exchange Act Rel. No. 39343, at 8 (Nov. 21, 1997) (holding that statements made by Nasdaq staff with respect to an application for listing on the automatic quotation system did not bind NASD); In re Peter T. Higgins, 51 S.E.C. 865, 868 n.10 (1993) (stating that erroneous advice from NASD staff did not alter the respondent's obligation to pay an arbitration award). The SEC has also emphasized that "a securities dealer cannot shift its compliance responsibility to the NASD. A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation." In re W.N. Whelen & Co., 50 S.E.C. 282, 284 (1990). See also In re Thomas C. Kocherhans, 52 S.E.C. 528, 531 (Dec. 6, 1995) ("[w]e have repeatedly held that a respondent cannot shift his or her responsibility for compliance with applicable requirements to . . . the NASD."); In re Lowell H. Listrom & Co., 48 S.E.C. 360, 366 (1985) (same), aff'd, 803 F.2d 938 (8th Cir. 1986); In re Melvin Y. Zucker, 46 S.E.C. 731, 733-34 (1976) (same).

<sup>14</sup> The fines, costs, and legal bills associated with the earlier NASD disciplinary action were not fixed or recurring, were supported by documentation identifying Investors as the entity owing the expense, and were thus required to be recognized as liabilities.

book NASD disciplinary fines and costs as a liability, an obvious source of justifiable regulatory concern with a clear basis in generally accepted accounting principles ("GAAP"),<sup>15</sup> case law,<sup>16</sup> and longstanding interpretation,<sup>17</sup> the respondents should have sought guidance from the NASD at their earliest opportunity. Similarly, once alerted to the NASD staff's concerns about liability for legal bills, respondents should have immediately communicated with staff to resolve the issue.<sup>18</sup> Instead, as noted by the Hearing Panel, the respondents resisted booking the liabilities even after the staff explained to them the regulatory basis for the NASD's position.

It is clear that the respondents' failure to seek and heed the guidance of the NASD or to cooperate with the staff's inquiries support the Hearing Panel's sanctions for causes one through three. Separately, we find that the respondents' protracted failure to respond to Rule 8210 requests in a timely manner as alleged in cause four of the complaint requires increased sanctions to address and properly remediate these egregious violations.

Our analysis as to the sanctions with respect to cause four commences with an observation that the relevant Sanction Guideline, as well as case law, supports sanctions far greater than those imposed by the Hearing Panel in this proceeding.<sup>19</sup> Respondent 2 repeatedly failed to respond in a timely manner

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<sup>15</sup> See FASB Statement of Financial Accounting Standards No. 5, Paragraph 8 (1997) (losses that are contingent upon the happening of a future event must be accrued as liabilities where (1) the loss can be reasonably estimated, and (2) the contingency is probable).

<sup>16</sup> See In re Walter G. Conley, *supra* (consistent with GAAP, adverse arbitration award should have been treated as a broker-dealer liability from the date of the award).

<sup>17</sup> See NASD Guide to Rule Interpretations (1996), p. 35 ("A court judgment adverse to a broker/dealer is, at a minimum, a contingent liability of the firm and included in the calculation of aggregate indebtedness unless an opinion of counsel indicates otherwise. If the broker/dealer has exhausted its remedies, the liability must be booked. Each situation must be analyzed on the particular facts present in the matter." *Letter from SEC Staff of Division of Market Regulation to NASD, February 8, 1978*).

<sup>18</sup> We concur with the Hearing Panel's analysis that the legal bills should have been accrued as a liability by the Firm. This objective determination is supported by the unambiguous retainer agreement for the joint representation of the Firm and Respondent 2 signed on February 5, 1996, by Respondent 2 as President; the legal bills addressed to the Firm, to the attention of Respondent 2; and the fact that the law firm was not instructed to look to Firm A for payment until after the staff began to question this accounting treatment.

<sup>19</sup> Guidelines at 31 (Failure to Respond). The relevant fine range for failure to respond in a timely manner is from \$2,500 to \$25,000, and an adjudicator may suspend the responsible individual in any or all capacities for up to two years. The principal considerations specific to that Guideline include the nature of the information requested, the number of the requests, and the degree of regulatory pressure required to obtain a response. In addition, we, like the Hearing Panel, have considered with respect to

(responding anywhere from 55 to 687 days after deadline) to numerous Rule 8210 requests dating from October 14, 1997, which were not finally satisfied until September 13, 1999, following staff's steps toward the initiation of formal disciplinary proceedings. Like the Hearing Panel below, we find that Respondent 2's explanations for these delays are uniformly without merit. Similarly, we cannot condone Respondent 2's intentional interference with the staff's inquiries, which included falsely stating to staff in writing that he had no responsive documents tending to establish the existence of the legal bills associated with a prior NASD disciplinary action.

Respondent 2 had an unqualified duty to produce responses as directed and to avoid providing incomplete and misleading answers to the staff's investigative inquiries. See In re Michael Markowski, 51 S.E.C. 553, 557 (1993) (upon registration with the NASD, registrant agreed to abide by its rules, which are unequivocal with respect to the obligation to cooperate with the NASD). The crucial importance of the Association's ability to enforce timely, complete, and truthful compliance with its investigatory requests has been repeatedly recognized. In re Brian L. Gibbons, 52 S.E.C. 791, 794 (1996), aff'd, 112 F.3d 516 (9th Cir. 1997); In re John A. Malach, 51 S.E.C. 618, 621 (1993), and cases cited therein. Because the NASD lacks subpoena power, failure to comply with Rule 8210 subverts the NASD's ability to carry out its regulatory responsibilities, and must be viewed as a serious violation. In re Charles R. Stedman, 51 S.E.C. 1228, 1232 (1994). As the SEC has stated, "[a]ny problems or concerns that a member firm or its associated persons might have in responding to an information request in a timely or complete manner should be raised, discussed and resolved with the NASD in the cooperative spirit and prompt manner contemplated by [Rule 8210]." In re Richard J. Rouse, 51 S.E.C. 581, 584, n. 9 (1993). Because of Rule 8210's regulatory importance, "[t]he NASD should not have to bring a disciplinary proceeding . . . in order to obtain compliance with its rules. . . ." In re Sundra Escott-Russell, Exchange Act Re. No. 43363 (September 27, 2000).

We reject and find no mitigation in Respondent 2's claim that he had no access to or legal authority to provide the requested legal documentation, because he had at all times the ability, whether in his individual capacity as a client of the law firm or as President and controlling shareholder of both the Firm and Firm A, to obtain and produce them. We agree with Enforcement that Respondent 2 was not entitled to make a unilateral determination that the NASD had no need for copies of the legal documentation.<sup>20</sup> Similarly, Respondent 2's delay in responding is not excused because of his concerns

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all causes the general principal considerations of the Sanctions Guidelines including prior disciplinary history, acknowledgment of the violations, lack of reliance on competent legal or accounting advice, failure to cooperate with the staff's investigation, and refusal to follow staff instructions. With the exception of the respondents' acknowledgment of responsibility and admission of the violations for purposes of this proceeding, we agree that these considerations support our affirmance of the sanctions as to causes one through three and our increase in the sanctions as to cause four.

<sup>20</sup> Our observation with respect to the legal documentation applies equally to Respondent 2's unilateral determination that staff was not entitled to a copy of the videotape at issue, which we believe staff was fully within its rights to request. As the Commission has stated:

as to confidentiality, because he had an overriding duty to comply pursuant to Rule 8210. Cf. In re Darrell Jay Williams, 50 S.E.C. 1070, 1072 (1992) (pendency of related litigation no excuse for failure to respond to NASD investigative demands). Respondent 2's unilateral decision first to deny the existence of such documents and thereafter to refuse their production until subjected to the threat of disciplinary action is but one of the circumstances supporting the imposition of sanctions greater than those imposed by the Hearing Panel.<sup>21</sup>

We find that the controversy resulting in this disciplinary action came about not because of overzealous staff efforts or a failure of communication, but because of an experienced securities professional's inexcusable failures to comply with important regulatory obligations. In terms of the number of requests, the cumulative delays, the regulatory importance of the information requested, and the pressure required to effect compliance, this matter stands as an extreme aberration when compared with the cooperative regulation practiced daily between the NASD and thousands of other NASD member firms. We believe that Respondent 2's continuing lack of appreciation of the gravity of his misconduct demonstrates the necessity for increased remedial sanctions as to cause four.

In determining to increase the level of sanctions as to cause four, we have considered, in addition to the foregoing, the Firm's and Respondent 2's single previous disciplinary action and the concept of progressive discipline, as well as the size of the Firm and the nature of its business. In light of Respondent 2's central role in the operations of the Firm, we have determined not to increase his 90-day suspension in all principal capacities. Recognizing that Respondent 2's recalcitrance precluded the Association from conducting a timely investigation and hampered its self-regulatory efforts, we find that

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Failure to provide information fully and promptly undermines the NASD's ability to carry out its regulatory mandate. Borth and Jones, as registered representatives, each had a clear obligation to supply the information that the NASD requested. Borth's decision not to respond because he did not believe that the NASD continued to need the information provides no excuse for his failure to provide it. The Rules do not permit second guessing the NASD's requests.

In re Michael David Borth, 51 S.E.C. 178, 180-181 (1992).

<sup>21</sup> We agree with the Hearing Panel that Respondent 2 provided a misleading response to investigative questions going directly to significant regulatory issues when he submitted a copy of a promissory note and release dated December 1, 1996, that he actually executed after mid-October 1997. The Hearing Panel did not determine precisely why Respondent 2 created the back-dated note. Even if we accept the explanation for the back-dating Respondent 2 offered in this appeal, we agree with the Hearing Panel's determination that by submitting the note, without explanation, coupled with his failure to produce the requested legal documentation, Respondent 2 misled the staff and thus obstructed its investigation.

an increase in the respondents' joint and several fine for cause four from \$10,000 to \$20,000 is necessary to effect remediation, given the need for specific and general deterrence demonstrated by the circumstances of the violations.

The violations alleged in this case, namely failures to respond to staff investigatory requests in a complete and timely manner and to maintain accurate books and records, net capital, and accurate required financial and operational calculations are serious in that they go to the responsibility of each member to self-regulate by adhering to established accounting principles, and they undermine the Association's ability to detect and prevent misconduct on the part of its members without delay. Violations of this nature challenge the ability of the membership, operating through the NASD as the front-line regulator of the securities industry, to police itself. Moreover, the duty of prompt cooperation and the requirement to maintain the integrity of financial and operational records and reports are essential to preserve public confidence in the securities industry.

Accordingly, the Firm and Respondent 2 are each censured<sup>22</sup> and fined \$40,000, jointly and severally (\$20,000 for the violations alleged in causes one through three, and \$20,000 for the violations alleged in cause four). Also, in connection with cause four, Respondent 2 is suspended in all principal capacities for 90 days and is required to requalify by relevant examination before functioning in any principal capacity. In connection with the violations alleged in causes one through three, we impose as to Respondent 3 a fine of \$1,000 and require him to requalify by examination before again functioning as a FINOP. We also affirm the assessment of costs of the proceeding below of \$2,334.30 as to the Firm, Respondent 2, and Respondent 3, jointly and severally, and we order the assessment of appeal costs of \$1,000 as to the Firm and Respondent 2, jointly and severally.<sup>23</sup>

On Behalf of the National Adjudicatory Council,

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Joan C. Conley, Senior Vice President and Corporate Secretary

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<sup>22</sup> Notwithstanding the imposition of a 90-day suspension as a principal as to Respondent 2, we expressly affirm the Hearing Panel's censure of Respondent Firm 1 and Respondent 2.

<sup>23</sup> The foregoing sanctions are within the ranges suggested by the relevant Sanction Guidelines.

We have considered all of the arguments of the parties. They are rejected or sustained to the extent that they are inconsistent or in accord with the views expressed herein.

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

Staff Comparative Schedule of Net Capital Computations  
For Respondent Firm 1

|                                | As of August 1, 1997 |                 |               | As of August 27, 1997 |                 |               |
|--------------------------------|----------------------|-----------------|---------------|-----------------------|-----------------|---------------|
|                                | Per<br>Firm          | Per<br>Staff    | Adjustments   | Per<br>Firm           | Per<br>Staff    | Adjustments   |
| Total Assets                   | 9,492                | 9,492           | 0             | 8,358                 | 8,358           | 0             |
| Total Liabilities              | <u>0</u>             | <u>(19,814)</u> | 19,814 (a)    | <u>0</u>              | <u>(19,814)</u> | 19,814 (a)    |
| Net Worth                      | 9,492                | (10,322)        | 19,814        | 8,358                 | (11,456)        | 19,814        |
| Non-allowable Assets           | <u>0</u>             | <u>0</u>        | 0             | <u>0</u>              | <u>0</u>        | 0             |
| Tentative Net Capital          | 9,492                | (10,322)        | 19,814        | 8,358                 | (11,456)        | 19,814        |
| Haircuts & Undue Concentration | <u>(588)</u>         | <u>(355)</u>    | (233) (b)     | <u>(588)</u>          | <u>(355)</u>    | (233) (b)     |
| Net Capital                    | 8,904                | (10,677)        | 19,581        | 7,770                 | (11,811)        | 19,581        |
| Minimum Requirement            | <u>(5,000)</u>       | <u>(5,000)</u>  | 0             | <u>(5,000)</u>        | <u>(5,000)</u>  | 0             |
| Excess (Deficient) Net Capital | <u>3,904</u>         | <u>(15,677)</u> | <u>19,581</u> | <u>2,770</u>          | <u>(16,811)</u> | <u>19,581</u> |

Notes:

(a) Firm failed to book NASD Fine (\$7,206) and legal fees payable (\$12,608). Staff noted that the legal fees were related to the firm's defense in an NASD disciplinary proceeding. Staff was provided a promissory note dated December 1, 1996 from the firm parent company to the law firm assuming this debt. Staff, however, noted that a letter from the law firm discharging the debt was dated November 14, 1997. Staff requested additional documentation from the firm regarding this debt (invoices, bills, etc.), but none were provided.

(b) Firm took a 30% haircut on a mutual fund, while staff applied a 15% haircut.

Staff Comparative Schedule of Net Capital Computations  
For Respondent Firm 1

|                                | As of July 31, 1997 |                 |               | As of August 29, 1997 |                 |               | As of September 30, 1997 |                 |                 | As of October 31, 1997 |                 |               |
|--------------------------------|---------------------|-----------------|---------------|-----------------------|-----------------|---------------|--------------------------|-----------------|-----------------|------------------------|-----------------|---------------|
|                                | Per Firm            | Per Staff       | Adjustments   | Per Firm              | Per Staff       | Adjustments   | Per Firm                 | Per Staff       | Adjustment<br>s | Per Firm               | Per Staff       | Adjustments   |
| Total Assets                   | 14,492              | 14,788          | (296) A       | 12,710                | 12,719          | (9) D         | 12,110                   | 12,165          | (55) F          | 15,403                 | 16,075          | (672) H       |
| Total Liabilities              | <u>(4,683)</u>      | <u>(24,780)</u> | 20,097 B      | <u>(1,195)</u>        | <u>(21,009)</u> | 19,814 E      | <u>0</u>                 | <u>(18,067)</u> | 18,067 G        | <u>(2,410)</u>         | <u>(21,148)</u> | 18,738 I      |
| Net Worth                      | 9,809               | (9,992)         | 19,801        | 11,515                | (8,290)         | 19,805        | 12,110                   | (5,902)         | 18,012          | 12,993                 | (5,073)         | 18,066        |
| Non-allowable Assets           | <u>0</u>            | <u>0</u>        | 0             | <u>0</u>              | <u>0</u>        | 0             | <u>0</u>                 | <u>0</u>        | 0               | <u>0</u>               | <u>0</u>        | 0             |
| Tentative Net Capital          | 9,809               | (9,992)         | 19,801        | 11,515                | (8,290)         | 19,805        | 12,110                   | (5,902)         | 18,012          | 12,993                 | (5,073)         | 18,066        |
| Haircuts & Undue Concentration | <u>(588)</u>        | <u>(231)</u>    | (357) C       | <u>(603)</u>          | <u>(364)</u>    | (239) C       | <u>(655)</u>             | <u>(388)</u>    | (267) C         | <u>(652)</u>           | <u>(379)</u>    | (273) C       |
| Net Capital                    | 9,221               | (10,223)        | 19,444        | 10,912                | (8,654)         | 19,566        | 11,455                   | (6,290)         | 17,745          | 12,341                 | (5,452)         | 17,793        |
| Minimum Requirement            | <u>(5,000)</u>      | <u>(5,000)</u>  | 0             | <u>(5,000)</u>        | <u>(5,000)</u>  | 0             | <u>(5,000)</u>           | <u>(5,000)</u>  | 0               | <u>(5,000)</u>         | <u>(5,000)</u>  | 0             |
| Excess (Deficient) Net Capital | <u>4,221</u>        | <u>(15,223)</u> | <u>19,444</u> | <u>5,912</u>          | <u>(13,654)</u> | <u>19,566</u> | <u>6,455</u>             | <u>(11,290)</u> | <u>17,745</u>   | <u>7,341</u>           | <u>(10,452)</u> | <u>17,793</u> |

Notes:

(A) Differences due to (1) (\$1) posting error in the amount of money in the firm's checking account, (2) \$13 change in NAV of mutual fund between 7/25/97 and 7/31/97, and (3) firm's apparent failure to accrue commissions receivable from Coltrane amounting to \$284.

(B) Differences due to firm's apparent failure to book (1) fine payable to the NASD (\$7,206), (2) legal fees payable (\$12,608), and (3) \$284 commissions payable owed to reps.

(C) Firm took a 30% haircut on mutual fund rather than 15% used by staff.

(D) \$9 difference due to pricing. Firm apparently used NAV as of 8/25/97 rather than 8/29/97.

(E) Difference due to (1) the firm's apparent failure to book fine payable to the NASD (\$7,206) and (2) legal fees payable (\$12,608)

(F) Firm apparently failed to accrue commissions receivable from Employee 1 (\$55).

(G) Firm apparently failed to (1) book remaining balance (\$5,404) of fine payable to the NASD (\$1,802 was paid by the firm on 9/22/97), (2) book legal fees payable (\$12,608), and (3) accrue commissions payable (\$55).

(H) Differences due to firm's apparent failure to accrue commissions receivable amounting to \$726 and change in NAV from 10/27/97 to 10/31/97 (\$54).

(I) Differences due to the firm's apparent failure to book (1) balance of fine payable (\$5,404) to the NASD, (2) failure to accrue commissions payable of \$726 and (2) failure to book legal fees payable amounting to (\$12,608).

| Respondent Firm 1<br>Firm Records, FOCUS, and Staff Net Capital Reconciliation<br>September 30, 1997 |            |            |                     |
|------------------------------------------------------------------------------------------------------|------------|------------|---------------------|
| Description                                                                                          | FOCUS      | Staff      | Differences         |
| Cash                                                                                                 | \$4,223    | \$4,224    | \$1 <i>a</i>        |
| Other Securities                                                                                     | \$1,775    | \$7,887    | \$6,112 <i>b</i>    |
| Receivables from non-customers                                                                       | \$0        | \$55       | \$55 <i>c</i>       |
| Other Assets                                                                                         | \$6,112    | \$0        | (\$6,112) <i>b</i>  |
| TOTAL ASSETS                                                                                         | \$12,110   | \$12,165   | \$55                |
| Payables to non-customers (NASD fine)                                                                | \$0        | (\$5,404)  | (\$5,404) <i>d</i>  |
| Accounts payable, accrued liabilities,<br>expenses and other                                         | \$0        | (\$12,663) | (\$12,663) <i>e</i> |
| TOTAL LIABILITIES                                                                                    | \$0        | (\$18,067) | (\$18,067)          |
| Common Stock                                                                                         | (\$1,000)  | (\$1,000)  | \$0                 |
| Additional Paid-in Capital                                                                           | (\$48,050) | (\$48,050) | \$0                 |
| Retained Earnings <Deficit>                                                                          | \$36,940   | \$36,940   | \$0                 |
| Staff Adjustments                                                                                    | \$0        | \$18,012   | \$18,012            |
| TOTAL OWNERS' EQUITY                                                                                 | (\$12,110) | \$5,902    | \$18,012            |
| TOTAL LIABILITIES & OWNER'S<br>EQUITY                                                                | (\$12,110) | (\$12,165) | (\$55)              |
| Total Assets                                                                                         | \$12,110   | \$12,165   | \$55                |
| (Total Liabilities)                                                                                  | \$0        | (\$18,067) | (\$18,067)          |
| Owner's Equity                                                                                       | \$12,110   | (\$5,901)  | (\$18,011)          |
| (Less: NAA)                                                                                          | \$0        | \$0        | \$0                 |
| TNC                                                                                                  | \$12,110   | (\$5,901)  | (\$18,011)          |
| Haircuts on Securities                                                                               | (\$655)    | (\$389)    | \$267 <i>f</i>      |
| Net Capital                                                                                          | \$11,455   | (\$6,290)  | (\$17,745)          |
| (Less: REQ NC)                                                                                       | (\$5,000)  | (\$5,000)  | \$0                 |
| ENC or <Deficiency>                                                                                  | \$6,455    | (\$11,290) | (\$17,745)          |

*Notes:*

*a* Difference due to rounding.

*b* Firm classified money market balance of \$6,112 as "other assets." Staff classified this same balance as an "other security."

*c* Firm failed to accrue commissions receivable of \$55 from Employee 1..

*d* Firm failed to book NASD Fine payable of \$5,404.

*e* Firm failed to book legal fees payable of \$12,608 and commissions payable in the amount of \$55.

*f* Firm took a 30% haircut on a mutual fund balance of \$1,775. Staff applied a 15% haircut on this same security.