BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of Department of Enforcement, Complainant, vs. John D. Kaweske Miami, FL, Respondent.	DECISION Complaint No. C07040042 Dated: February 12, 2007

Respondent failed to return investor funds promptly after an offering did not meet its sales contingency; failed to establish an escrow account for a contingency offering; made fraudulent misrepresentations in connection with the sale of preferred stock; and willfully failed to update his Form U4. Held, Hearing Panel's findings affirmed and sanctions modified.

Appearances

For the Complainant: William Brice La Hue, Esq., Department of Enforcement, NASD

No appearance by or for John D. Kaweske

Decision

Pursuant to NASD Procedural Rule 9311, John D. Kaweske ("Kaweske") appeals a February 10, 2006 Hearing Panel decision. The Hearing Panel found that Kaweske: (1) failed to return investor funds promptly after an offering did not meet its sales contingency; (2) failed to establish an escrow account for a contingency offering; (3) made fraudulent misrepresentations in connection with the sale of preferred stock; and (4) willfully failed to update his Uniform Application for Securities Industry Registration or Transfer ("Form U4"). The Hearing Panel barred Kaweske and ordered him to make restitution to two investors. After a thorough review of the record, we affirm the Hearing Panel's findings and the bars imposed upon Kaweske for the foregoing misconduct. We eliminate, however, the order of restitution imposed by the Hearing Panel and instead impose a $140,000 fine against Kaweske.

I. Background

Kaweske entered the securities industry in December 1992 and first became registered as a corporate securities representative in March 1993. Kaweske subsequently became registered as a general securities representative, general securities principal, and an introducing broker-dealer/financial and operations principal. In July 1993, Kaweske acquired majority ownership of member firm R.K. Grace & Company ("Grace"), and served as CEO and President of Grace. In January 2001, Kaweske sold Grace's assets to member firm Cardinal Capital Management, Inc. ("Cardinal"). Kaweske was registered with both Grace and Cardinal until Grace withdrew its NASD membership in April 2001. Kaweske left Cardinal in March 2003 and is not presently associated with any NASD member firm.

II. Procedural History

On April 20, 2004, NASD's Department of Enforcement ("Enforcement") filed a four-cause complaint against Kaweske. The complaint alleged that Kaweske: (1) failed to return investor funds promptly after an offering did not meet its sales contingency, in violation of Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act"), Exchange Act Rule 10b-9, and NASD Conduct Rule 2110; (2) failed to cause the establishment of an escrow account for a contingency offering as required by Exchange Act Rule 15c2-4, in violation of Conduct Rule 2110; (3) made fraudulent misrepresentations in connection with the sale of preferred stock, in violation of Exchange Act Section 10(b), Exchange Act Rule 10b-5, and Conduct Rules 2120 and 2110; and (4) willfully failed to update his Form U4, in violation of Conduct Rule 2110 and IM-1000-1. Kaweske, through counsel, contested Enforcement's allegations and requested a hearing.

On August 23, 2005, a Hearing Panel conducted a one-day hearing. In a decision dated February 10, 2006, the Hearing Panel found that Kaweske had committed each of the violations alleged in the complaint. The Hearing Panel barred Kaweske in all capacities for failing to return investor funds promptly and failing to establish an escrow account, barred Kaweske in all capacities for making fraudulent misrepresentations, and barred Kaweske in all capacities for willfully failing to update his Form U4. In addition, for failing to return investor funds promptly and failing to establish an escrow account, the Hearing Panel ordered Kaweske to make restitution totaling $140,000 (plus interest) to two customers.

Kaweske's appeal and request for oral argument followed, and Kaweske's attorney filed a brief on Kaweske's behalf. After Enforcement filed its response brief, Kaweske's attorney filed a notice of withdrawal from the case. Thereafter, two notices of the pending oral argument were sent to Kaweske's Central Registration Depository ("CRD"®) address. Neither Kaweske nor an attorney on behalf of Kaweske appeared at oral argument. Pursuant to Procedural Rule 9342, the National Adjudicatory Council ("NAC") Subcommittee appointed to hear this matter

permitted Enforcement to present its argument at the scheduled date and time, and the NAC has considered the matter as to Kaweske solely on the basis of the record.[1]

III. Facts

This case concerns a contingency offering of preferred stock to two investors and Kaweske's failures to update his Form U4 to disclose matters related to the offering and an unrelated customer complaint. The securities at issue were shares of Series A Preferred Stock in R.K. Grace Preferred, Inc. ("Preferred"), an entity created by Kaweske on January 28, 1998. Kaweske created Preferred for the ostensible purpose of investing funds in Grace and to make other appropriate investments. Kaweske signed a new securities account form in the name of Preferred which was held at Grace's clearing firm, and Kaweske was listed as Preferred's only director in its articles of incorporation. During all relevant time periods, Kaweske controlled and acted on behalf of Preferred.

A. Customer RH

Pasquale "Pat" Guadagno ("Guadagno"), a registered representative in New York,[2] introduced RH to Kaweske, and RH opened a securities account with Kaweske at Grace. In late January or early February 1998, Preferred, through Kaweske, commenced an offering of its preferred stock, and Kaweske and Guadagno contacted RH to solicit his investment. Kaweske described Preferred as an "arm" of Grace. Kaweske further informed RH that Preferred would be purchasing shares of Aquagenix, Inc. ("Aquagenix") and that RH could utilize shares of Aquagenix previously acquired by RH to participate in the offering.[3] At Kaweske's recommendation, RH decided to purchase Preferred shares using a portion of his Aquagenix shares as consideration, and on February 10, 1998, RH authorized the transfer of 25,000 shares of Aquagenix stock from his personal account at Grace to Preferred's securities account.

In connection with the Preferred offering, RH signed a subscription agreement which provided that, "[t]he Offer is being conducted on a 'best efforts-all-or-none' basis to the initial 200,000 Shares and on a 'best efforts' basis as to the remaining 200,000 Shares. Share (cash) subscriptions received and collected for the minimum number of Shares offered hereby, will be maintained in an escrow account with [a Fort Lauderdale law firm]." The subscription agreement further provided that the offering would raise a minimum of $2 million (200,000 shares at $10 per share) by February 28, 1998, subject to an extension in Preferred's sole

---

[1] In addition, Kaweske is deemed to have waived any opportunity for oral argument pursuant to Procedural Rule 9342.

[2] Although the record indicates that Guadagno was not registered with Grace, RH understood that Guadagno had moved to Grace. Similarly, Guadagno told customer CR that he planned to open a satellite office of Grace in New York.

[3] RH had expressed a desire to reduce his position in Aquagenix.

discretion.[4] RH understood that his 25,000 shares of Aquagenix were valued at $7 per share at the time of delivery, for a total investment of $175,000 in Preferred. Approximately two weeks after RH transferred his Aquagenix shares to Preferred, Kaweske liquidated the shares for $148,061, none of which Kaweske deposited in escrow. Instead, Kaweske promptly used $80,000 to cover a margin call in Preferred's account. After learning from Guadagno in April 1998 that the Preferred offering failed to reach its minimum,[5] RH requested the return of his $175,000. Kaweske failed to return RH's funds and informed RH that he did not have the funds to repay RH.

In November 1998, RH's attorney demanded that Kaweske return RH's $175,000 based upon the failure of the offering to raise its $2 million minimum. In response, Kaweske claimed that his health was failing, he did not have the funds to repay RH fully, and his ability to repay the funds in the future was uncertain. To resolve the matter, Kaweske offered to convert $150,000 of RH's Preferred shares to Grace shares. RH declined Kaweske's offer, and RH commenced an action against Kaweske, Preferred, and Grace in federal court.

In connection with this litigation, RH saw, for the first time, a subscription agreement allegedly signed by RH with a different description of the terms of the Preferred offering than the subscription agreement executed by RH in February 1998.[6] Unlike the agreement executed by RH in February 1998, this second subscription agreement stated that, "[t]he Offer is being conducted on a 'best efforts' basis. Following receipt and acceptance of the proceeds, all proceeds received will be deposited directly to the treasury of the Company." The Hearing Panel found that RH credibly testified that the handwriting on this second subscription agreement was not his, and that Kaweske never advised RH that the Preferred offering was a best efforts offering. RH further testified that Kaweske never advised RH that the terms of the Preferred offering had changed in any way. In May 2000, RH agreed to a settlement with Kaweske, Preferred and Grace in exchange for a cash payment of $80,000. In connection with this settlement, RH executed a broad, general release of any and all claims against Kaweske, Preferred, and Grace. Kaweske failed to update his Form U4 to disclose RH's litigation and the subsequent settlement of such litigation.

---

[4] The subscription agreement also stated that shares in Preferred could be paid for with marketable securities.

[5] The offering raised approximately $656,000, and only one party other than RH and customer CR participated in the offering. Neither RH nor CR ever received stock certificates in connection with Preferred.

[6] In addition, during the course of this litigation RH was shown several letters that Kaweske allegedly sent to RH in February and June 1998 which, among other things, purported to extend the offering's deadline to June 30, 1998. Similar to the second subscription agreement, RH had never seen these letters prior to the commencement of litigation against Kaweske.

B. Customer CR

Similar to RH, Guadagno introduced CR to Kaweske, and CR opened an account at Grace. In late January 1998, Guadagno and Kaweske contacted CR to solicit his investment in the Preferred offering. Kaweske described the Preferred offering as being similar to a mutual fund and mentioned Aquagenix as one company in which Preferred was going to invest.[7] Although CR had expressed reservations concerning an investment in Preferred, on February 4, 1998, pursuant to Kaweske's instructions and prior to CR's receipt of any offering documents, CR wired $125,000 to Preferred's account in connection with the offering. CR understood that he was sending the funds with "no strings attached" and would have an opportunity to review offering documents. In furtherance of CR's understanding, Kaweske told CR that he could get his money back within seven days if he did not like the offering. On the same day that Preferred received CR's $125,000, Kaweske used the $125,000 to cover a margin call in Preferred's account.

Two days after wiring the $125,000 to Preferred, CR received a subscription agreement from Kaweske. This subscription agreement contained terms identical to the agreement that RH had executed in February 1998, and provided that the Preferred offering was being conducted on a best efforts-all-or-none basis as to the initial 200,000 shares. CR did not sign the subscription agreement or complete the attached customer questionnaire, and on February 11, 1998, CR informed Kaweske that he declined to invest in the Preferred offering and requested the return of his $125,000. Kaweske did not return CR's $125,000, and Kaweske refused to take numerous telephone calls from CR. In mid-1998, CR learned from Guadagno that the offering had failed to reach its minimum, and CR wrote a demand letter to Kaweske seeking the return of his $125,000.

In September 1998, Kaweske offered to resolve all matters with CR in exchange for a $100,000 payment to CR, contingent upon Kaweske closing an unrelated transaction. After CR sought clarification of this proposal, CR wrote a letter to Grace's compliance officer. CR's letter confirmed a telephone call in which CR had complained to the compliance officer that his $125,000 had not been returned. Although the compliance officer represented to CR that he would have an NASD examiner review CR's complaint, he did not speak to any NASD staff about CR's complaint, and NASD examiners participating in routine audits of Grace in 1998 had no information regarding CR's complaint. In addition, Kaweske failed to amend his Form U4 to disclose CR's complaint.

In November 1998, Kaweske informed CR that his failing health made the repayment of CR's funds uncertain. In light of these assertions, Kaweske offered to convert $100,000 of CR's Preferred shares to Grace shares. CR declined Kaweske's offer, and after subsequently failing to obtain the return of his $125,000, on March 9, 2000, CR wrote a complaint letter to NASD. Kaweske failed to update his Form U4 to note CR's complaint, despite a letter from NASD to Grace indicating that an amendment to Kaweske's Form U4 may be necessary. In May 2000,

---

[7] CR had previously acquired a position in Aquagenix.

CR agreed to settle the matter with Kaweske, Preferred and Grace in exchange for a cash payment of $80,000 and a release executed in favor of Kaweske, Preferred and Grace. Kaweske failed to update his Form U4 to disclose the settlement with CR.

C. NASD's Investigation

In March 2000, after receiving CR's complaint regarding Kaweske's failure to return his $125,000, NASD began investigating the Preferred offering. In connection with this investigation, NASD staff obtained a second subscription agreement purportedly signed by CR. This second subscription agreement was identical to the second subscription agreement produced in connection with RH's litigation against Kaweske, and provided that the Preferred offering was a best efforts offering instead of a best efforts all-or-none offering with respect to the initial 200,000 shares of Preferred. The Hearing Panel found that CR credibly testified that he had not previously seen this version of the subscription agreement, the handwriting on the agreement was not his, and although the signature on the agreement appears to be his, he did not sign the agreement.

In addition to the events surrounding customers RH and CR, NASD investigated an unrelated complaint against Kaweske from customer RB dated November 18, 1999, that alleged that Kaweske executed unauthorized transactions in RB's account at Grace. Kaweske failed to amend his Form U4 to disclose RB's complaint and failed to disclose a subsequent arbitration proceeding with RB. Further, at the time Kaweske transferred his registrations to Cardinal in 2001 and filed a full Form U4, Kaweske failed to disclose any of the complaints, litigation, or settlements with customers RH, CR, and RB.

IV. Discussion

After reviewing the facts set forth in the record, we affirm the Hearing Panel's findings. We first discuss the violations related directly to the Preferred offering, and then discuss Kaweske's failures to amend his Form U4.

A. The Preferred Offering

The Hearing Panel found that Kaweske failed to return investor funds promptly after the Preferred offering did not meet its sales contingency, and failed to cause the establishment of an escrow account for the offering as required by SEC Rule 15c2-4, in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-9, and Conduct Rule 2110.[8] The Hearing Panel also found that

---

[8] NASD Conduct Rule 2110 requires that NASD members shall, in conducting their business, "observe high standards of commercial honor and just and equitable principles of trade." A violation of another Commission or NASD rule, including Exchange Act Section 10(b) and SEC Rules 10b-9, 15c2-4, and 10b-5, is also a violation of NASD Conduct Rule 2110. *See Terrance Yoshikawa*, Exchange Act Rel. No. 53731, 2006 SEC LEXIS 948, at *30 n.39 (Apr. 26, 2006) (*citing Stephen J. Gluckman*, 54 S.E.C. 175, 185 (1999)). In addition, NASD

[Footnote continued on next page]

Kaweske made fraudulent misrepresentations in connection with the sale of Preferred shares, in violation of Exchange Act Section 10(b), SEC Rule 10b-5, and Conduct Rules 2120 and 2110. For the reasons set forth below, we affirm the Hearing Panel's findings.

1. *Kaweske Failed to Return Investor Funds Promptly and Failed to Establish an Escrow Account*

SEC Rule 10b-9 requires that, in connection with a contingency offering,[9] investor funds be promptly returned if the stated minimum proceeds of the offering are not raised by the deadline specified in the offering.[10] The purpose of SEC Rule 10b-9 is to "ensure that those who invest in a venture under the condition that it will not go forward unless adequately capitalized are not at risk of losing their investment if that condition is not met." *Nat'l P'ship Invs. Corp.*, Exchange Act Rel. No. 38773, 1997 SEC LEXIS 1347, at *9 (June 25, 1997).

SEC Rule 15c2-4 requires that a broker-dealer participating in a contingency offering promptly deposit investor funds into a separate bank account, as agent or trustee for the investors, or a separate escrow account at a bank, until the contingency has occurred.[11] *See*

[cont'd]

Conduct Rule 115 makes all NASD rules, including Conduct Rule 2110, applicable to both NASD members and all persons associated with NASD members.

[9] A contingency offering, also known as a "minimum-maximum" or a "part-or-none" offering, "is an offering whereby the issuer is required to sell, and receive payment for, a certain minimum number of securities by a certain date. If the minimum is not sold, or payment is not received, by the specified date (and the offering is not properly extended), the existing investors receive a refund of their investment." *Dep't of Enforcement v. Respondents*, Complaint No. C01040001, 2005 NASD Discip. LEXIS 47, at *3 n.1 (NAC Sept. 6, 2005); *see also generally* 8 Louis Loss & Joel Seligman, *Securities Regulation* 3943-47 (Aspen Publishers 3d ed. 2004).

[10] SEC Rule 10b-9 provides, in pertinent part: "It shall constitute a 'manipulative or deceptive device or contrivance,' as used in Section 10(b) of the Act, for any person, directly or indirectly, in connection with the offer or sale of any security, to make any representation . . . (2) to the effect that the security is being offered or sold on any other basis whereby all or part of the consideration paid for any such security will be refunded to the purchaser if all or some of the securities are not sold, unless the security is part of an offering or distribution being made on the condition that all or a specified part of the consideration paid for such security will be promptly refunded to the purchaser unless: (A) a specified number of units of the security are sold at a specified price within a specified time, and (B) the total amount due to the seller is received by him by a specified date."

[11] SEC Rule 15c2-4 provides, in pertinent part: "It shall constitute a 'fraudulent, deceptive, or manipulative act or practice' as used in Section 15(c)(2) of the Act, for any broker . . . participating in any distribution of securities . . . to accept any part of the sale price of any security being distributed unless: . . . (b) if the distribution is being made . . . on any other basis

[Footnote continued on next page]

Robert Tretiak, Exchange Act Rel. No. 47534, 2003 SEC LEXIS 653, at *32 (Mar. 19, 2003). SEC Rule 15c2-4 provides investors with "a high level of assurance that their funds will be promptly returned if the contingency is not satisfied, irrespective of the financial condition of the broker-dealer conducting the offering." *Id.*

As a preliminary defense, Kaweske argues that SEC Rules 10b-9 and 15c2-4 do not govern the offering of Preferred stock to RH and CR because the offering was not a contingency offering but rather an unconditional, best efforts offering.[12] In support of this argument, Kaweske points to the two alternate subscription agreements, allegedly executed by both RH and CR, which provide that Preferred shares would be offered on a best efforts basis and that no sales contingency needed to be satisfied. The record, however, does not support Kaweske's version of the facts. The initial subscription agreements received by both RH and CR in February 1998 (and executed by RH) were identical in that both provided that the offering was contingent upon selling a minimum of 200,000 preferred shares in Preferred at a price of $10 per share. These initial subscription agreements further provided, as required by SEC Rule 15c2-4, for the establishment of an escrow account. RH and CR testified that their review of the subscription agreements in February 1998 revealed that the offering was a contingency offering, and RH testified that he signed this version of the subscription agreement in February 1998.

With regard to the best efforts subscription agreements that surfaced after RH's litigation and NASD's investigation had commenced, RH credibly testified that although the signature on the best efforts subscription agreement appears to be his, the handwriting on this agreement is not his and he first saw this agreement after he commenced litigation against Kaweske in 1999. Likewise, CR credibly testified that he had never seen this version of the subscription agreement prior to NASD's investigation in 2000, and further testified that although the signature on this

---

[cont'd]

which contemplates the payment is not to be made to the person on whose behalf the distribution is being made until some further event or contingency occurs: (1) the money or other consideration received is promptly deposited in a separate bank account, as agent or trustee for the persons who have the beneficial interests therein, until the appropriate event or contingency has occurred, and then the funds are promptly transmitted or returned to the persons entitled thereto, or (2) all such funds are promptly transmitted to a bank which has agreed in writing to hold all such funds in escrow for the persons who have the beneficial interests therein and to transmit or return such funds directly to the persons entitled thereto when the appropriate event or contingency has occurred."

[12] In addition, and with respect to CR, Kaweske argues that because CR did not make an investment in Preferred but rather provided Preferred with temporary funding, SEC Rule 10b-9 does not apply. Kaweske makes this same argument in connection with his SEC Rule 10b-5 violation, and thus we address this issue in Section IV.A.2., *infra*.

agreement appears to be his, he never signed this agreement.[13] Further, in the months after February 1998, Guadagno separately informed both RH and CR that the Preferred offering had failed to meet its contingency, providing further evidence that the Preferred offering was a contingency offering and not a best efforts offering. Thus, based upon the evidence in the record, the February 1998 subscription agreements—not the later, best efforts subscription agreements—governed the Preferred offering, and SEC Rules 10b-9 and 15c2-4 apply.

Having found that SEC Rules 10b-9 and 15c2-4 govern the Preferred contingency offering, we further find that Kaweske violated these rules. First, there is no dispute that Kaweske failed to return funds promptly to RH and CR after the Preferred offering failed to meet its contingency. Despite RH's demands, Kaweske failed to return RH's funds promptly, and Kaweske returned only $80,000 of RH's investment of $175,000 after two years had passed and RH commenced litigation.[14] Likewise, despite CR's demands for the return of his funds beginning in February 1998, Kaweske returned only $80,000 of CR's $125,000 in May 2000—more than two years after CR wired the funds into Preferred's account. Kaweske controlled Preferred, was Preferred's creator, and was intimately involved with every aspect of the offering. Rather than promptly return investor funds in full, Kaweske intentionally engaged in several years of delay before he ultimately made partial repayments to RH and CR. We thus find that Kaweske acted knowingly and with scienter in connection with his failure to return the funds promptly,[15] and we affirm the Hearing Panel's finding that Kaweske failed to return investor funds promptly in violation of SEC Rule 10b-9.[16]

---

[13] As set forth below, we defer to the Hearing Panel's findings that RH and CR were credible.

[14] Kaweske purportedly extended the termination date of the offering from February 28, 1998, to June 30, 1998. Both RH and CR testified that they had no knowledge of any such extension. For purposes of this opinion, it is not necessary to determine whether Kaweske properly extended the offering or precisely when the offering terminated, as Kaweske failed to promptly return investor funds regardless of whether he was required to do so in February 1998 or June 1998. Indeed, the offering was not close to being fully subscribed even by June 30, 1998.

[15] Scienter is required for a violation of SEC Rule 10b-9. *See Tretiak*, 2003 SEC LEXIS 653, at *29; *see also* Section IV.A.2., *infra* (discussing scienter under SEC Rule 10b-5). Scienter is not, however, a requirement for a violation of SEC Rule 15c2-4. *See Dep't of Enforcement v. Gerace*, Complaint No. C02990022, 2001 NASD Discip. LEXIS 5, at *11 (NAC May 16, 2001).

[16] Kaweske also argues, solely with regard to CR, that because CR *wired* his funds prior to receiving the February 1998 subscription agreement, CR did not rely upon the agreement in making his ultimate investment decision and thus Kaweske did not violate SEC Rule 10b-9 with respect to CR. However, reliance on a misrepresentation is not necessary to establish an SEC Rule 10b-9 violation in a disciplinary proceeding. *See Dep't of Enforcement v. Faber*, Complaint No. CAF010009, 2003 NASD Discip. LEXIS 3, at *34-35 (NAC May 7, 2003) (holding that "customer reliance is not an element of a fraud claim when brought by NASD"),

[Footnote continued on next page]

Second, there is no dispute that Kaweske failed to cause the establishment of an escrow account and failed to deposit investor funds into such account. Instead of creating an escrow account and promptly depositing investor funds in such account, Kaweske (on behalf of Grace and Preferred) instructed CR to wire his $125,000 directly into Preferred's securities account, and then immediately used such funds to cover a margin call. With respect to the shares of Aquagenix that RH contributed to the Preferred offering, at Kaweske's instruction, RH transferred such shares to Preferred's account, and Kaweske subsequently sold these shares and promptly used a large portion of the proceeds to cover another margin call. Kaweske made no effort whatsoever to safeguard investor funds pending satisfaction of the contingency despite the requirement that he pay "scrupulous attention" to the requirements of SEC Rule 15c2-4 as an affiliate of Preferred. *See Tretiak*, 2003 SEC LEXIS 653, at *33 n.34; *see also Dist. Bus. Conduct Comm. v. Structured Shelters Sec., Inc.*, Complaint No. CLE-279, 1989 NASD Discip. LEXIS 6, at *32 (Board of Governors Jan. 12, 1989) (finding a violation of SEC Rules 10b-9 and 15c2-4 where investor funds were withdrawn on an as-needed basis prior to meeting contingency). Kaweske subjected investor funds to exactly the financial risk that these rules were designed to prevent. Accordingly, we affirm the Hearing Panel's findings that Kaweske failed to return investor funds promptly after the Preferred offering did not meet its sales contingency and failed to cause the establishment of an escrow account for such funds as required by SEC Rule 15c2-4, in violation of Exchange Act Section 10(b), SEC Rule 10b-9, and Conduct Rule 2110.

2. *Kaweske Made Fraudulent Misrepresentations in Violation of SEC Rule 10b-5 and Conduct Rules 2120 and 2110*

Section 10(b) of the Exchange Act makes it "unlawful for any person . . . to use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors." SEC Rule 10b-5 makes it unlawful, in connection with the purchase or sale of any security, "to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading[.]" Conduct Rule 2120 is NASD's antifraud rule and is similar

---

[cont'd]

aff'd, Exchange Act Rel. No. 49216, 2004 SEC LEXIS 277 (Feb. 10, 2004). Kaweske's argument also has no factual basis. At the time CR wired the funds, he understood that he would have an opportunity to review the subscription agreement before any investment became final. CR received the subscription agreement two days after the funds were wired, reviewed it, and based upon his review of the agreement and his general investment preferences, decided not to authorize Kaweske to apply the wired funds to the Preferred investment. Thus, while CR did not review the agreement prior to making the wire transfer, he did rely upon the fact that he would receive the subscription agreement to review in making his ultimate investment decision. And, in fact, CR did rely upon the subscription agreement to decide not to invest in Preferred.

to SEC Rule 10b-5.[17] *See, e.g.*, *Market Reg. Comm. v. Shaughnessy*, Complaint No. CMS950087, 1997 NASD Discip. LEXIS 46, at *24 (NBCC June 5, 1997), *aff'd*, 53 S.E.C. 692 (1998).

To establish a violation of SEC Rule 10b-5, Enforcement must demonstrate by a preponderance of the evidence that Kaweske: (1) made misrepresentations or omissions of material facts; (2) acted with scienter; and (3) made such misrepresentations or omissions in connection with the purchase or sale of a security.[18] *See Dep't of Enforcement v. Apgar*, Complaint No. C9B020046, 2004 NASD Discip. LEXIS 9, at *11 (NAC May 18, 2004) (citing *SEC v. First Jersey Sec., Inc.*, 101 F.3d 1450 (2d Cir. 1996)). A fact is material if "a reasonable man would attach importance in determining his choice of action in the transaction in question." *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (2d Cir. 1968) (en banc). In addition, "scienter refers to a mental state embracing intent to deceive, manipulate, or defraud." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 (1976). A showing of recklessness is sufficient to demonstrate that Kaweske acted with scienter. *See Tretiak*, 2003 SEC LEXIS 653, at *25 (*citing Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990)).[19]

We affirm the Hearing Panel's finding that Kaweske knowingly made fraudulent misrepresentations of material facts in connection with the Preferred offering. First, Kawekse's misrepresentations concerned material facts. Kaweske misrepresented the very nature of the Preferred offering to RH and CR. Through the original subscription agreements received by both RH and CR in February 1998 and through conversations with each investor, Kaweske lead RH and CR to believe that the Preferred offering was a contingency offering whereby their funds would be safeguarded and returned upon the offering's failure (and in the case of CR, returned within 7 days at his sole discretion). In addition, Kaweske misrepresented the purpose of the Preferred offering, informing investors that their funds would be used to purchase Aquagenix

---

[17] Conduct Rule 2120 provides that "[n]o member shall effect any transaction in, or induce the purchase or sale of, any security by means of any manipulative, deceptive or other fraudulent device or contrivance." A violation of Conduct Rule 2120 is also a violation of Conduct Rule 2110. *See Dist. Bus. Conduct Comm. v. Euripides*, Complaint No. C9B950014, 1997 NASD Discip. LEXIS 45, at *19 (NBCC July 28, 1997).

[18] Enforcement must also show that Kaweske used "any means or instrumentality of interstate commerce, or of the mails or of any facility of any national security exchange." SEC Rule 10b-5. There is ample evidence in the record that this element has been satisfied.

[19] "Reckless conduct has been defined as a highly unreasonable misrepresentation or omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." *Dep't of Enforcement v. Abbondante*, Complaint No. C10020090, 2005 NASD Discip. LEXIS 43, at *28 (NAC Apr. 5, 2005) (citations omitted), *aff'd*, Exchange Act Rel. No. 53066, 2006 SEC LEXIS 23 (Jan. 6, 2006), *aff'd*, 2006 U.S. App. LEXIS 30982 (Dec. 12, 2006).

shares. Instead of depositing investor funds in an escrow account, promptly returning investor funds upon the offering's failure, and purchasing shares of Aquagenix, Kaweske immediately used investor funds to cover margin calls in Preferred's account, never established an escrow account, and only begrudgingly returned a portion of RH's and CR's funds after the passage of several years and after litigation had commenced. In connection with a decision to invest in the Preferred offering, a reasonable investor would consider these facts to be crucial and to have altered the total mix of information available. *See TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976). Thus, Kaweske's misrepresentations concerned material facts.

Second, Kaweske acted with scienter. Kaweske, the owner of Grace and the sole director and creator of Preferred, knew at the time he made representations concerning the Preferred offering that such representations were not true. Kaweske controlled Preferred and used CR's funds on the very day Preferred received them to cover a margin call. Likewise, Kaweske promptly used a large portion of the proceeds from the liquidation of RH's shares of Aquagenix to cover a margin call. Kaweske's use of investor funds to cover margin calls, in direct contradiction of the terms of the subscription agreements and his representations to RH and CR, demonstrates that he acted with scienter and knew that such funds would not be used for the stated purposes or placed into an escrow account pending satisfaction of the contingency. At the very least, Kaweske acted recklessly. *See, e.g., Tretiak*, 2003 SEC LEXIS 653, at *26. Thus, the scienter requirement of SEC Rule 10b-5 has been satisfied.

Third, Kaweske made the misrepresentations in connection with the purchase and sale of securities. Kaweske argues, at least with respect to CR, that because CR testified that he ultimately decided not to invest in Preferred, CR did not make an investment in Preferred and thus Kaweske's misrepresentations to CR were not made in connection with the sale or purchase of securities. Kaweske's narrow reading of this requirement of SEC Rule 10b-5 is misplaced.[20] CR wired funds to Kaweske only after Kaweske contacted him regarding an investment in Preferred and only after Kaweske made misrepresentations concerning the Preferred offering. Kaweske urged CR to wire his funds despite CR's reservations about purchasing Preferred shares, with the hope that CR would authorize the application of such funds to the offering after CR reviewed the subscription agreement.[21] Kaweske sent CR the Preferred subscription

---

[20] *See, e.g., Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Dabit*, 126 S. Ct. 1503, 1513 (2006) (holding that when the Court has interpreted the phrase "in connection with" in the context of Exchange Act Section 10(b) and SEC Rule 10b-5, it has espoused a broad interpretation; "[u]nder our precedents, it is enough that the fraud alleged 'coincide' with a securities transaction.").

[21] *See, e.g., Dep't of Enforcement v. Galasso*, Complaint No. C10970145, 2001 NASD Discip. LEXIS 2, at *36-37 (NAC Feb. 5, 2001) (holding that where respondent made statements to brokers meant to encourage them to persuade customers to purchase stock, such statements were made in connection with the purchase and sale of securities), *aff'd in part and rev'd in part on other grounds, John Montelbano*, Exchange Act Rel. No. 47227, 2003 SEC LEXIS 153 (Jan. 22, 2003).

agreement in furtherance of his scheme, and CR reviewed the agreement and decided not to invest. Despite CR's instructions to the contrary, Kaweske applied CR's funds to the Preferred offering. Clearly, Kaweske made misrepresentations to CR to induce him to purchase Preferred shares, and Kaweske made such misrepresentations in connection with the sale and purchase of Preferred shares.

Moreover, while CR may have believed that the funds he wired would be returned to him with "no strings attached" if he chose not to invest in Preferred and that the wire transfer was not an investment in Preferred because he ultimately decided not to invest, at all times Kaweske treated CR's wire transfer as an investment in Preferred and treated CR as an investor in Preferred. In fact, Kaweske referred to CR's wire transfer as an investment in Preferred on numerous occasions, and at the hearing before the Hearing Panel, Kaweske stipulated that he sold Preferred shares to CR and that CR invested $125,000 in the Preferred offering. Thus, Kaweske is estopped from now asserting otherwise.[22] Finally, regardless of whether CR made an investment in Preferred, RH unquestionably invested in Preferred, and Kaweske does not argue otherwise. Thus, because Kaweske knowingly made misrepresentations of material facts in connection with the purchase and sale of Preferred shares, we affirm the Hearing Panel's findings that Kaweske violated Exchange Act Section 10(b), SEC Rule 10b-5, and Conduct Rules 2120 and 2110.[23]

B. Kaweske's Failures to Update Form U4

The Hearing Panel found that Kaweske willfully failed to update his Form U4 in violation of Conduct Rule 2110 and IM-1000-1. We affirm the Hearing Panel's findings.

Form U4 is utilized by NASD "to monitor and determine the fitness of securities professionals." *Rosario R. Ruggiero*, 52 S.E.C. 725, 728 (1996) (*citing Thomas R. Alton*, 52

---

[22] The Hearing Panel accepted these stipulated facts in connection with its ruling, and Kaweske cannot now take an inconsistent position. *See, e.g.*, *Cadle Co. v. Schlictmann, Conway, Crowley & Hugo*, 338 F.3d 19, 22-23 (1st Cir. 2003) (holding party estopped from arguing it was the agent of a note's owner where it had previously argued in same proceeding that it was the owner of the note); *Abbondante*, 2006 SEC LEXIS 23, at *10 n.12 ("Stipulated facts serve important policy interests in the adjudicatory process, including playing a key role in promoting timely and efficient litigation; we will honor stipulations in the absence of compelling circumstances."). Further, in addition to Kaweske's stipulation before the Hearing Panel, Kaweske referred to CR as an investor in Preferred when he offered to exchange CR's shares in Preferred for shares in Grace in November 1998, in the May 2000 settlement agreement with CR, and in a May 2000 letter to the SEC in connection with an SEC examination.

[23] In addition, and as further support for his argument that he did not violate SEC Rule 10b-5 with respect to CR, Kaweske argues that CR did not rely on the subscription agreement. However, in a disciplinary proceeding, proof of investor reliance is unnecessary to establish a violation of SEC Rule 10b-5. *See Tretiak*, 2003 SEC LEXIS 653, at *24 n.26.

S.E.C. 380, 382 (1995)). A Form U4 that is inaccurate or incomplete so as to be misleading, or the failure to correct such filing after notice thereof, may be deemed to be conduct inconsistent with just and equitable principles of trade. *See* IM-1000-1; *Alton*, 52 S.E.C. at 382. Article V Section 2(c) of NASD's By-Laws requires that every application for registration filed with NASD be kept current, and further requires that amendments to applications be filed no later than 30 days after learning of the facts or circumstances giving rise to the amendment. The responsibility for maintaining the accuracy of a Form U4 lies with each registered representative. *Dep't of Enforcement v. Howard*, Complaint No. C11970032, 2000 NASD Discip. LEXIS 16, at *31-32 (NAC Nov. 16, 2000), *aff'd*, 55 S.E.C. 1096 (2002), *aff'd*, 77 F. App'x 2 (1st Cir. 2003).

In this case, Kaweske undisputedly failed to file amendments to his Form U4 in connection with each of the following events: (1) RH's November 1998 demand letter to Kaweske in connection with the Preferred offering; (2) RH's suit against Kaweske, Grace and Preferred filed in February 1999; (3) RH's May 2000 settlement with Kaweske, Grace and Preferred; (4) CR's October 1998 letter to Grace's compliance officer complaining that Kaweske had failed to return CR's $125,000; (5) CR's complaint letter to NASD dated March 9, 2000, which NASD promptly forwarded to Kaweske; (6) CR's May 2000 settlement with Kaweske, Grace and Preferred; (7) customer RB's written complaint to NASD dated November 18, 1999, which NASD promptly forwarded to Kaweske, alleging that Kaweske executed unauthorized transactions in his account at Grace; and (8) RB's initiation of an arbitration proceeding against Kaweske and Grace in 2001. Further, there is no dispute that Kaweske was required to disclose each event on his Form U4.

Despite Kaweske's obligation to update his Form U4 to disclose these events, he failed to do so. Kaweske was intimately involved with each of the events requiring disclosure, and NASD staff sent reminder letters regarding Kaweske's obligation to amend his Form U4 in connection with CR's complaint and RB's complaint.[24] Moreover, NASD first asked Kaweske specific questions concerning his failures to amend Form U4 in July 2000 during an on-the-record interview. Despite NASD's reminders to update his Form U4 and direct questioning in connection with these events, Kaweske did nothing with regard to his Form U4. Indeed, in 2001 when Kaweske filed a full Form U4 in connection with his move to Cardinal, Kaweske again failed to disclose any of these events. Kaweske's failures violated Conduct Rule 2110 and IM-1000-1. Further, we find that Kaweske's failures to amend his Form U4 were willful. *See Dep't of Enforcement v. Zdzieblowski*, Complaint No. C8A030062, 2005 NASD Discip. LEXIS 3, at *14 (NAC May 3, 2005) ("A willfulness finding is predicated on [a respondent's] intent to commit the act that constitutes the violation -- completing the Form U4 inaccurately."). Accordingly, we affirm the Hearing Panel's findings that Kaweske willfully failed to update his Form U4 in violation of Conduct Rule 2110 and IM-1000-1.

---

[24] During certain relevant periods, including December 1999 when NASD staff sent Grace's compliance director the letter regarding RB's complaint, Kaweske served as Grace's compliance director. During those times when Kaweske did not serve as compliance director, the compliance director reported directly to Kaweske.

C. The Witnesses Were Credible

Kaweske attempts to undermine the Hearing Panel's findings by attacking the credibility of RH and CR. The Hearing Panel expressly found both RH and CR to be credible witnesses. "Credibility determinations of the initial fact-finder, which are based on hearing the witnesses' testimony and observing their demeanor, are entitled to considerable weight and deference and can be overcome only where there is substantial evidence for doing so." *Dep't of Enforcement v. Gebhart*, Complaint No. C02020057, 2005 NASD Discip. LEXIS 40, at *51 n.18 (NAC May 24, 2005), *aff'd*, Exchange Act Rel. No. 53136, 2006 SEC LEXIS 93 (Jan. 18, 2006).

Here, substantial evidence does not exist for reversing the Hearing Panel's findings of credibility, and we will not disturb the Hearing Panel's findings. The testimony of both customers was consistent with the declarations executed by each of them during NASD's investigation, and their testimony was generally mutually corroborative. *See Galasso*, 2001 NASD Discip. LEXIS 2, at *28 (finding that witnesses were credible based upon their consistent and mutually corroborative testimony). Despite Kaweske's assertions to the contrary, the fact that both customers continued to trade in their Grace accounts for several months after the Preferred offering does not make their testimony incredible. Nor does each customer's alleged failure to explain why only three persons invested in Preferred have any relevance or bearing on their credibility. Likewise, RH's motivation for investing in Preferred—to reduce his holdings in Aquagenix—has no bearing on RH's credibility. And Kaweske's assertion that both RH and CR testified that they were unsophisticated despite their familiarity with and trading in small cap stocks is unsupported by the record and, even if true, is insufficient evidence to reverse the Hearing Panel's findings of credibility. Finally, Kaweske's claim that the testimony of RH and CR was biased because they knew that the Hearing Panel might order Kaweske to make restitution is without merit. Kaweske has failed to identify any evidence of bias or unreliability in the testimony of RH and CR in connection with the potential for restitution, or with regard to any other matter. Therefore, we will not disturb the Hearing Panel's findings that RH and CR were credible.

D. The Proceeding Below Was Fair

Kaweske argues that NASD's delay in bringing this proceeding renders the proceeding fundamentally unfair. We disagree.

Under Section 15A(b)(8) of the Exchange Act, NASD disciplinary proceedings must be conducted in accordance with fair procedures. *See Mark H. Love*, Exchange Act Rel. No. 49248, 2004 SEC LEXIS 318, at *14 (Feb. 13, 2004); *Jeffrey Ainley Hayden*, 54 S.E.C. 651, 653 (2000). In determining whether a delay in bringing a disciplinary action violates Section 15A(b)(8), we have previously held that there are no bright-line rules or mechanical tests concerning the impact of a delay on a disciplinary proceeding's fairness. *See Dep't of Enforcement v. Morgan Stanley DW, Inc.*, Complaint No. CAF000045, 2002 NASD Discip. LEXIS 11, at *24 (NAC July 29, 2002); *see also Love*, 2004 SEC LEXIS 318, at *15. Fairness is determined by examining the entirety of the record. *Love*, 2004 SEC LEXIS 318, at *16. While earlier SEC cases such as

Hayden and *William D. Hirsh*, 54 S.E.C. 1068 (2000), focused on several different time periods[25] to assess the impact of a delay on the fairness of a proceeding, "[i]n subsequent cases the SEC has emphasized that the proponent of a Hayden/Hirsh defense must demonstrate that he or she was prejudiced by the allegedly undue delay." *Apgar*, 2004 NASD Discip. LEXIS 9, at *25 (*citing Feeley & Willcox Asset Mgmt. Corp.*, Exchange Act Rel. No. 48607, 2003 SEC LEXIS 2396, at *8 (Oct. 9, 2003)).

We reject Kaweske's argument that the delay in bringing this disciplinary proceeding renders the proceeding fundamentally unfair. First, although a mechanical analysis of the time periods identified in earlier cases does not, in and of itself, determine whether a proceeding is fundamentally unfair, the relevant time periods in this case are generally shorter in duration than those cases where adjudicators found the delay in question to be unfair. For example, with regard to the time between NASD's discovery of the misconduct and filing the complaint, NASD first learned of Kaweske's misconduct in March 2000,[26] and filed the complaint in April 2004. This period of time (four years, one month) is almost one year less than the same period in *Hayden* (five years) and one year, nine months less than *Morgan Stanley* (five years, 10 months), both cases in which adjudicators found the delay to be unfair.[27]

---

[25] In such earlier decisions, adjudicators examined the following time periods in determining whether a proceeding violated the Exchange Act's fundamental fairness requirement: (1) the time between the self-regulatory organization's discovery of the alleged misconduct and the filing of the complaint; (2) the time between the first alleged misconduct and the filing of the complaint; (3) the time between the last alleged misconduct and the filing of the complaint; and (4) the time from the commencement of the investigation by the self-regulatory organization to the filing of the complaint. *See Hirsh*, 54 S.E.C. at 1077.

[26] Kaweske alleges that NASD first learned of CR's allegations concerning the Preferred offering in May 1998 and again in October 1998. In support of these allegations, Kaweske points to a May 1998 NASD memo in which NASD staff refers generally to funds wired to Preferred in connection with Grace's potential violations of net capital rules, and CR's October 1998 letter to Grace's compliance officer. The May 1998 memo, however, does not discuss or even mention CR's complaint, RH's complaint, or any of the allegations of wrongdoing described herein. Further, the record indicates that Grace's compliance officer did not contact NASD staff in October 1998 (or any other time) concerning CR's complaint, and NASD examiners had no record of CR's complaint as alleged by Kaweske. Thus, we find that NASD first learned of the alleged misconduct in this case in or around March 2000.

[27] Although the four year, one month period from NASD's discovery of the misconduct to the filing of the complaint was longer than the same period in *Love* (three years, eight months) and *Hirsh* (one year, eight months), both of which held that the delays in question did not render the proceedings unfair, a review of the other relevant time periods generally supports a finding that the proceeding was fair. For example, the period of time from Kaweske's first misconduct to the filing of the complaint was six years, two months, less than each of the cases cited by Kaweske and Enforcement (*Hayden* (13 years, nine months), *Morgan Stanley* (eight years), *Hirsh* (eight years, 11 months) and *Love* (six years, 10 months)). Similarly, the period of time

[Footnote continued on next page]

Second, Kaweske has not demonstrated that any delay by NASD has harmed his ability to defend himself in this action or caused him any prejudice. Although Kaweske describes the witnesses' memories as "foggy" due to the length of the delay, the Hearing Panel found both witnesses' testimony to be credible and consistent with declarations they executed in 2000. Kaweske did not identify any specific documents or witnesses that had become unavailable due to the passage of time,[28] nor did Kaweske testify before the Hearing Panel despite several opportunities to do so.[29] Further, Kaweske shares in the blame for any delays in this proceeding, as an NASD examiner testified that Kaweske did not provide certain documents that the examiner had requested and Kaweske failed to disclose customer complaints on his Form U4, which caused NASD's delay in concluding its investigation and discovering Kaweske's misconduct. Under the circumstances of this case and based upon the entirety of the record, the proceeding against Kaweske does not violate Section 15A(b)(8) of the Exchange Act.

Finally, Kaweske suggests that RH's telephonic testimony rendered the proceeding unfair. We do not agree. Although it may be preferable to have a witness appear in person so that the trier of fact can observe his or her demeanor, NASD does not have subpoena power and cannot require non-members (such as RH) to appear at a disciplinary hearing. *See Dep't of Enforcement v. Patel*, Complaint No. C02990052, 2001 NASD Discip. LEXIS 42, at *22 (NAC

[cont'd]

from Kaweske's last misconduct to the filing of the complaint in this case was five years, 10 months, again less than each of the cases cited by Kaweske and Enforcement (*Hayden* (six years, seven months), *Morgan Stanley* (seven years), *Hirsh* (eight years), and *Love* (six years, five months)). Finally, the period of time from the start of NASD's investigation to the filing of the complaint was four years, one month, less than *Morgan Stanley* (four years, 10 months) and more than *Hayden* and *Love* (each three years, six months), and *Hirsh* (one year). Thus, although a comparison of these time periods is not determinative, they generally weigh against a finding of fundamental unfairness when considering the entirety of the record.

[28] As evidence of prejudice, Kaweske points generally to SEC and NASD rules, which require that certain customer documents be maintained for three years. Kaweske, however, does not allege that he destroyed or purged any documents in reliance on these rules. Further, NASD's investigation commenced in March 2000, well before the expiration of three years from the date of Kaweske's misconduct, and NASD promptly notified Kaweske of the investigation. We note that the destruction of relevant documents with the knowledge that NASD is conducting an investigation violates Conduct Rule 2110. *See Stratton Oakmont, Inc.*, 52 S.E.C. 1170, 1173 (1997) (finding violation of member's obligation to observe high standards of commercial honor and just and equitable principles of trade where respondent impeded an NASD investigation).

[29] After requesting and receiving a postponement of the original hearing date, on the eve of the continued hearing date Kaweske again sought to postpone the hearing. Although the Hearing Panel denied this request and proceeded with the hearing, it set a continued hearing date for Kaweske to testify. Just days before the continued hearing date, Kaweske notified the Hearing Panel that the parties had agreed that the evidence was closed and that he would not testify.

May 23, 2001). Further, "telephonic testimony frequently is used in NASD disciplinary proceedings, and neither the Commission nor the courts have found the use of such testimony to be unfair." *Ronald W. Gibbs*, 52 S.E.C. 358, 364 (1995). Here, although RH testified via telephone, RH testified under oath and Kaweske had ample opportunity to cross-examine (and in fact his attorney did cross-examine) RH. Consequently, we find that the telephonic testimony of RH did not render the proceeding unfair.

V. Sanctions

The Hearing Panel barred Kaweske in all capacities in connection with his failure to promptly return investor funds and failure to establish an escrow account, barred Kaweske for his fraudulent misrepresentations, and barred Kaweske for his willful failures to update his Form U4. The Hearing Panel further ordered Kaweske to make restitution to RH in the amount of $95,000 and to CR in the amount of $45,000, each with interest, in connection with his failure to return investor funds promptly and failure to establish an escrow account. Finally, the Hearing Panel imposed $2,270.25 in costs against Kaweske. In determining sanctions, the Hearing Panel found that Kaweske's conduct was egregious and part of an orchestrated scheme, and also found that the losses suffered by Kaweske's customers and Kaweske's failure to express any contrition or remorse were aggravating factors.

After a thorough review, and in order to protect the investing public, we affirm the Hearing Panel's bars of Kaweske for the foregoing misconduct, although we have considered the first three causes of the complaint in the aggregate for purposes of assessing sanctions because the violations are related and arise from the same underlying misconduct.[30] With respect to the Hearing Panel's order that Kaweske make restitution to RH and CR, we find that under the circumstances an order of restitution is not appropriate, and instead impose a $140,000 fine upon Kaweske.

Our discussion below first addresses sanctions assessed for violations related directly to the Preferred offering. We then address sanctions in connection with Kaweske's failures to amend his Form U4.

---

[30] *See Dep't of Enforcement v. J. Alexander Sec., Inc.*, Complaint No. CAF010021, 2004 NASD Discip. LEXIS 16, at *69 (NAC Aug. 16, 2004).

A. The Preferred Offering

1. *A Bar Is Appropriate*

For a failure to return investor funds promptly after an offering does not meet its sales contingency in violation of SEC Rule 10b-9, NASD's Sanction Guidelines ("Guidelines") recommend a suspension of up to two years in egregious cases.[31] For a failure to establish an escrow account in connection with a contingency offering in violation of SEC Rule 15c2-4, the Guidelines recommend a suspension of up to 30 business days in egregious cases.[32] For a fraudulent misrepresentation of material fact in violation of SEC Rule 10b-5 and Conduct Rules 2120 and 2110, the Guidelines recommend a suspension of 10 business days to two years in cases involving intentional or reckless misconduct, and a bar in egregious cases.[33]

In imposing sanctions, we have also considered the specific principal considerations for each of these rule violations,[34] as well as the Principal Considerations in Determining Sanctions and the General Principles applicable to all sanctions determinations.[35] Consideration of these and other aggravating factors weigh heavily against Kaweske, and we find that Kaweske's intentional and willful conduct was egregious and part of a scheme designed to defraud RH and CR. Although Kaweske did not personally retain any compensation in connection with the Preferred offering, Kaweske—acting on behalf of Preferred—belatedly returned only $80,000 of RH's $175,000 and only $80,000 of CR's $125,000. Kaweske was intimately involved with the Preferred offering and controlled Preferred and Grace during all relevant time periods. Kaweske never established an escrow account for investor funds; rather, he immediately utilized CR's $125,000 to cover a margin call and utilized a large portion of RH's funds in a similar fashion. Kaweske exposed investor funds to complete risk of loss, and Kaweske fell far short of the $2 million in proceeds specified as the offering's minimum. Moreover, in furtherance of Kaweske's scheme, subscription agreements allegedly executed by RH and CR (which purported to change the contingent nature of the Preferred offering) surfaced after the offering failed to reach its minimum.

---

31 *NASD Sanction Guidelines* 24 (2006), http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf (hereinafter *Guidelines*).

32 *Id.*

33 *Id.* at 93. The Guidelines also suggest a fine of $5,000 to $50,000 for a violation of SEC Rule 10b-9, a fine of $1,000 to $10,000 for a violation of SEC Rule 15c2-4, and a fine of $10,000 to $100,000 for intentional or reckless misrepresentations. *Id.* at 24, 93.

34 *Id.* at 24. The Guidelines do not list any specific principal considerations for violations of SEC Rule 10b-5 and Conduct Rules 2120 and 2110. *Id.* at 93.

35 *Id.* at 2-7.

Simply put, Kaweske orchestrated the Preferred offering to obtain the investors' funds, which he then intentionally and knowingly used for purposes unrelated to the Preferred offering and for purposes other than those communicated to investors. Kaweske purposely misled RH and CR both before and after their investments in Preferred, in virtually identical fashion. Kaweske has not expressed any remorse for his actions or for the $140,000 in losses suffered by his customers. To the contrary, Kaweske characterizes RH's receipt of $80,000 in settlement proceeds as a windfall. Consideration of these factors supports the Hearing Panel's bar of Kaweske for his egregious misconduct.

Kaweske suggests that even if he violated SEC Rules 10b-9 and 15c2-4, such violations are not sufficiently serious to warrant the sanctions imposed. Violations of SEC Rules 10b-9 and 15c2-4, however, "are serious breaches of the duty owed by issuers, underwriters and broker-dealers to the investing public." *Gerace*, 2001 NASD Discip. LEXIS 5, at *15-16 (*citing* Exchange Act Rel. No. 11532 (July 11, 1975)). Moreover, such an argument ignores Kaweske's fraudulent misrepresentations in violation of SEC Rule 10b-5 and Conduct Rule 2120, which are themselves serious matters that warrant severe sanctions in addition to his violations of SEC Rules 10b-9 and 15c2-4. Kaweske's "clean disciplinary record" does not lessen the seriousness of such violations, as the lack of a disciplinary record is generally not mitigating. *See Rooms v. SEC*, 444 F.3d 1208, 1214 (10th Cir. 2006).

We also reject Kaweske's argument that the settlements with RH and CR are mitigating. Kaweske only settled with RH and CR after two years had passed and after NASD had commenced its investigation and RH had initiated litigation. Further, the settlements provided less than the full return of investor funds. Moreover, Kaweske's alleged cooperation and forthrightness with NASD is contradicted by the record. Kaweske delayed NASD's investigation into these matters through his failures to properly disclose his wrongdoings, and then delayed the proceedings through several requests for continuances. Kaweske's attendance at three on-the-record interviews does not, in and of itself, demonstrate cooperation with NASD. This is particularly true because Kaweske did not fully cooperate during the course of such interviews. Finally, Kaweske suggests that the sophistication of RH and CR is mitigating. The fact that RH or CR may have been experienced investors does not give Kaweske license to make fraudulent representations, and we do not consider this factor to be mitigating under the circumstances. *See Lester Kuznetz*, 48 S.E.C. 551, 554 (1986). In light of the numerous aggravating factors discussed above, and in order to deter such misconduct in the future, we bar Kaweske in all capacities for his failure to return investor funds promptly, failure to establish an escrow account, and fraudulent misrepresentations.

2. *A Fine Rather Than Restitution Is Appropriate Under the Circumstances*

The Hearing Panel ordered that Kaweske pay a total of $140,000 in restitution to RH and CR (i.e., the total amount remaining unpaid to RH and CR after consideration of Kaweske's previous payments of $80,000 to each customer). The Hearing Panel also ordered that Kaweske pay interest on RH's $95,000 from the date RH's attorney demanded the return of his funds (November 2, 1998) until paid, and interest on CR's $45,000 from the date CR first demanded the return of his funds (February 11, 1998) until paid. Under the unique facts and circumstances of this case, and in light of the prior voluntary settlement and release agreements executed by the

customers in May 2000, restitution is inappropriate. Accordingly, we eliminate the Hearing Panel's order of restitution. However, we impose a $140,000 fine (comprised of the total amount that Kaweske failed to return to RH and CR) to deprive Kaweske of his ill-gotten gain.

The underlying goal of NASD sanctions is to deter future misconduct and to remediate misconduct, and "[t]oward this end, Adjudicators should design sanctions that are significant enough to prevent and discourage future misconduct by a respondent, to deter others from engaging in similar misconduct, and to modify and improve business practices."[36] The Guidelines recommend that we consider ordering restitution where appropriate to remediate misconduct, and that we "may order restitution when an identifiable person, member firm or other party has suffered a quantifiable loss as a result of a respondent's misconduct, particularly where a respondent has benefited from the misconduct."[37] Like all sanctions, an order of restitution is discretionary. *See, e.g.*, *Dist. Bus. Conduct Comm. v. Holbert*, Complaint No. C3A930012, 1994 NASD Discip. LEXIS 219, at *12 (NBCC May 18, 1994) (stating that NASD has "considerable discretion" in its choice of sanctions).

Enforcement argues that, irrespective of the customers' voluntary settlements with Kaweske pursuant to which they released Kaweske from any further financial liability in exchange for cash payments, the Hearing Panel's bar and order of restitution should be affirmed. Enforcement further argues that any result short of the imposition of a bar and an order of restitution would contravene the purposes served by the Guidelines. We agree that in addition to the bars, Kaweske should not be permitted to return only a portion of the funds to customers while enjoying the benefits of the remainder. We find that in light of the customers' prior settlement and release agreements with Kaweske, however, a fine rather than restitution to customers is appropriate.

We acknowledge that where the identity of customers is known and such customers suffer quantifiable losses, it is preferable to order that a respondent pay restitution directly to injured customers instead of making payment to NASD in the form of a fine. *See NASD Notice to Members 99-86* (Oct. 1999) (stating that NASD will generally order restitution where there is quantifiable customer harm or respondent has been unjustly enriched); *see also Toney L. Reed*, 51 S.E.C. 1009, 1013 (1994) ("In addition to the policy of depriving the wrongdoer of his ill-gotten gains is our desire to see that monetary amounts assessed by the NASD be turned over to wronged customers where they are identifiable."). In this case, however, both customers voluntarily released Kaweske from any and all further monetary liability well before the commencement of this proceeding. While a customer's release of a member firm or associated person is not legally binding on NASD, as a matter of sanctions policy RH's and CR's settlement and release agreements are highly significant in connection with our consideration of whether to

---

36 *Guidelines*, at 2 (General Principles Applicable to All Sanction Determinations, No. 1).

37 *Id.* at 4 (General Principles Applicable to All Sanction Determinations, No. 5).

award restitution to RH and CR.[38] Absent a finding that a customer's settlement with a member or an associated person was procured by fraud, we will not second guess whether a settlement was insufficient or unwise by ordering the payment of additional funds to a settling customer. Here, the customers were represented by counsel and voluntarily released Kaweske from any further monetary liability in exchange for payment. In essence, an order of restitution in this case would supersede the May 2000 settlement and release agreements and render them moot. This might jeopardize the prospect for future settlements with customers by creating uncertainty and discouraging members and associated persons from voluntarily executing settlement agreements and making voluntary payments to customers. Accordingly, we reverse the Hearing Panel's order to make restitution.[39]

Kaweske, however, should not be permitted to enjoy the benefits of the customers' funds that he did not return. The Guidelines provide that, "where appropriate to remediate misconduct, Adjudicators may require the disgorgement of such ill-gotten gain by fining away the amount of some or all of the financial benefit derived, directly or indirectly."[40] As set forth above, Kaweske engaged in a scheme whereby he made fraudulent misrepresentations to customers and belatedly returned only a portion of the funds obtained through his scheme. Indeed, of the $300,000 invested by RH and CR, Kaweske returned only $160,000. In order to deprive Kaweske of his ill-gotten gain, and to deter such misconduct in the future, we impose a $140,000 fine upon Kaweske (which represents the total amount that he failed to return to RH and CR). This sanction preserves the integrity of the prior customer settlements while advancing the underlying goals of the Guidelines.

---

[38] We emphasize that customers do not have the authority to limit in any way the sanctions NASD may order in a disciplinary proceeding.

[39] In response to Kaweske's argument that an order of restitution would undercut the finality of settlement agreements, Enforcement cites to a number of state court cases for the proposition that restitution is appropriate despite a previous settlement agreement. These cases, however, generally involve state statutes that provide for restitution in connection with criminal sentencing and the impact of a civil settlement on criminal restitution. Because NASD proceedings are not criminal proceedings, these cases are inapposite. *See Mkt. Regulation Comm. v. Zubkis*, Complaint No. CMS950129, 1997 NASD Discip. LEXIS 47, *18 (NBCC August 12, 1997), *aff'd*, 53 S.E.C. 794 (1998) (stating that NASD proceedings are not criminal proceedings).

[40] *Guidelines*, at 5 (General Principles Applicable to All Sanction Determinations, No. 6). The Guidelines further provide that, "[w]hile restitution is an appropriate method of depriving a respondent of his or her ill-gotten gain, where appropriate to remediate misconduct, the amount of some or all of the respondent's ill-gotten gain also may be used to determine the amount of a disciplinary fine." *Id.* at 5 n.4.

B. Kaweske's Failures to Amend His Form U4

For a failure to amend Form U4, the Guidelines recommend a suspension of up to 30 business days, and in egregious cases, a suspension of up to two years or a bar.[41] The Guidelines provide examples of egregious cases, which include those involving repeated failures to file or the failure to disclose a customer complaint.[42] The Hearing Panel considered Kaweske's willful failures to amend and failures to disclose three customer complaints on his Form U4 to be egregious and barred Kaweske in all capacities for such violations.

We affirm the Hearing Panel's sanction. Kaweske's failures to amend were repeated, willful, and occurred over a several-year period. Additionally, Kaweske failed to disclose three separate customer complaints involving serious allegations of wrongdoing. Kaweske had notice of each and every event that necessitated an amendment to his Form U4, and NASD staff even reminded Kaweske that amendments to his Form U4 might be necessary, yet he failed to take any action. Kaweske intentionally failed to amend his Form U4, which delayed NASD's investigation into allegations concerning CR and RH. We find Kaweske's failures to be egregious. Thus, we affirm the Hearing Panel's sanction in connection with Kaweske's failures to amend his Form U4 in violation of Conduct Rule 2110 and IM-1000-1.

VI. Conclusion

We find that Kaweske failed to return investor funds promptly after a contingency offering did not meet its sales contingency, failed to establish an escrow account for a contingency offering as required by SEC Rule 15c2-4, and made fraudulent misrepresentations in connection with the Preferred offering, in violation of Section 10(b) of the Exchange Act, SEC Rule 10b-9, SEC Rule 10b-5, and Conduct Rules 2110 and 2120. We further find that Kaweske willfully failed to update his Form U4 in violation of Conduct Rule 2110 and IM-1000-1.

---

41 *Guidelines*, at 73-74.

42 *Id*.

Accordingly, we bar Kaweske in all capacities for his failure to return investor funds promptly, his failure to establish an escrow account, and for his fraudulent misrepresentations, and bar Kaweske in all capacities for his willful failure to update his Form U4.[43] We find, however, that the Hearing Panel's order of restitution was not warranted, and therefore eliminate the Hearing Panel's sanction with regard to restitution and instead impose a $140,000 fine upon Kaweske. We also affirm the Hearing Panel's imposition of $2,270.25 in costs.[44]

On Behalf of the National Adjudicatory Council,

_____

Marcia E. Asquith, Vice President and Deputy Corporate Secretary

---

[43] The bars are effective as of the date of this decision.

[44] We have also considered and reject without discussion all other arguments advanced by the parties.