NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT Complainant, v. FOX & COMPANY INVESTMENTS, INC. (CRD #18517) Phoenix, AZ JAMES W. MOLDERMAKER (CRD #858894) Scottsdale, AZ Respondents.	Disciplinary Proceeding No. C3A030017 Hearing Officer – DMF **HEARING PANEL DECISION** December 30, 2003

Respondent firm conducted, and respondent individual caused it to conduct, a securities business when the firm failed to meet its net capital requirements, in violation of SEC Exchange Act Rule 15c3-1 and NASD Rule 2110; respondent firm maintained, and respondent individual caused it to maintain, material inaccuracies in the firm's books and records, in violation of NASD Rule 2110; and respondent firm submitted, and respondent individual caused it to submit, materially inaccurate FOCUS reports, in violation of SEC Exchange Act Rule 17a-5 and NASD Rule 2110. For these violations, respondents are fined $25,000, jointly and severally, and respondent individual is barred from associating with any NASD member as a financial and operations principal. In addition, respondent firm failed to report, and respondent individual caused it to fail to report, certain information to NASD in violation of NASD Rules 3070 and 2110. For these violations, respondents are fined $10,000, jointly and severally, and respondent individual is suspended in all supervisory and principal capacities for 10 business days.

Appearances

Jacqueline D. Whelan, Esq., Denver, CO, (Rory C. Flynn, Esq., Washington, DC, Of Counsel) for Complainant.

James W. Moldermaker, pro se and on behalf of Fox & Company Investments, Inc.

DECISION

I. Procedural History

The Department of Enforcement filed a Complaint on June 9, 2003, charging that (1) respondent Fox & Company Investments, Inc. conducted, and respondent James W. Moldermaker caused Fox to conduct, a securities business when the firm failed to satisfy its net capital requirements, in violation of SEC Exchange Act Rule 15c3-1 and NASD Rule 2110; (2) Fox maintained, and Moldermaker caused Fox to maintain, material inaccuracies in the firm's books and records, in violation of NASD Rule 2110; and (3) Fox submitted, and Moldermaker caused Fox to submit, materially inaccurate FOCUS reports, in violation of SEC Exchange Act Rule 15a-5 and NASD Rule 2110. In addition, the Complaint charged that Fox failed to report, and Moldermaker caused Fox to fail to report, certain information to NASD, in violation of NASD Rules 3070 and 2110. Respondents filed an Answer contesting the charges and requested a hearing, which was held in Phoenix, AZ on November 10 and 11, 2003, before a Hearing Panel that included a Hearing Officer, a member of the District 3 Committee, and a former member of the District 3 Committee.[1]

II. Facts

Fox, which is headquartered in Phoenix, Arizona, has been an NASD member since 1987. Moldermaker is Fox's owner, president and chief financial officer. Among

[1] At the hearing, Enforcement presented the testimony of six witnesses and offered Complainant's Exhibits (CX) 1-42, all of which were admitted. Respondents presented the testimony of two witnesses (including Moldermaker) and Respondents' Exhibits (RX) 1-50 and 52-63, all of which were admitted.

other things, he is registered as Fox's financial and operations principal (FINOP). (CX 1, 2; Tr. 21.)

In December 1998, several former Fox customers filed an arbitration claim with NASD Dispute Resolution naming Fox, Moldermaker, Southwest Securities, Inc., Fox's clearing firm, and David Gwynn, a former Fox registered representative, as respondents. The claimants asserted that the respondents were liable for damages as a result of a failure to effect a stop-loss order, asserting that the failure amounted to a breach of contract, a breach of fiduciary duty, and a failure to act in accordance with the standards of care expected from securities brokers. Alternatively, the claimants alleged a conspiracy to defraud the claimants, involving the churning of the claimants' accounts. Fox did not file an amended Uniform Termination Notice for Securities Industry Registration (Form U-5) notifying NASD of the arbitration claim and the allegations against Gwynn. (CX 29, 31; RX 1; Tr. 286-87, 344.)

In January 1999, Fox and Moldermaker made a claim against Fox's errors and omissions ("E&O") insurance carrier, American International Specialty Lines Insurance Company ("AISLIC"), based on the arbitration. On February 23, 1999, AISLIC responded to the claim with a letter in which it acknowledged its receipt of the claim under Fox's policy and undertook to defend the claim, but expressly "reserved all rights and defenses" it might have to liability under the policy. The evidence established that E&O liability insurers frequently issue such "reservation of rights" letters in response to claims. A reservation of rights is neither a rejection of the claim, nor a promise to pay the claim. Instead, it indicates that the insurer has acknowledged a duty to defend the claim under the policy provisions, but that the insurer will continue to investigate and evaluate

the claim to determine whether, ultimately, it will be covered under the policy. (CX 26; RX 4-7; Tr. 356-58, 361, 371-73.)

The arbitration panel issued an award effective December 27, 2001. NASD Dispute Resolution transmitted the award to the attorneys representing Fox and Moldermaker in the arbitration, and those attorneys, in turn, faxed the award to Fox on December 28, 2001. The arbitrators awarded a total of $983,992, including damages, interest, costs and attorneys fees, against Fox, Moldermaker, Southwest and Gwynn, jointly and severally. Fox did not electronically report the arbitration award to NASD as required by NASD Rule 3070. In January 2002, the insurance carrier filed a motion to vacate the award in federal court on behalf of Fox and Moldermaker. Southwest and Gwynn also filed motions to vacate the award. As a result, under NASD Rule 10330(h), their obligations to pay the award were stayed, pending resolution of the motions to vacate. (CX 22, 33; RX 3, 22; Tr. 169-71, 287, 318-20.)

On January 25, 2002, Fox submitted its FOCUS report for the period ending December 31, 2001 to NASD. The report did not include the arbitration award as a liability of Fox. On February 5, 2002, Moldermaker called Roger Hogoboom, an NASD Enforcement attorney in NASD's District 3 Office in Denver, CO, which is responsible for examining Fox. Moldermaker told Hogoboom that NASD should investigate Gwynn, who Moldermaker described as a "bad broker." In response to questions, Moldermaker disclosed the arbitration claim, and that he had not updated Gwynn's Form U-5 when the claim was filed. (Tr. 29-30.)

During the course of the conversation, Moldermaker also disclosed the arbitration award. Hogoboom told him that Fox was required to book the award as a liability.

Moldermaker replied that "my insurance company is going to pay for it," but Hogoboom told him, "You still have to book for it." Hogoboom testified that Moldermaker did not ask him whether he could book the insurance coverage as an asset under SEC rules. He testified that he thought they might have discussed the fact that the award had been issued jointly and severally against Fox, Moldermaker, Southwest and Gwynn, but that he told Moldermaker Fox still had to book the award. He did not recall specifically discussing how much of the award Fox was required to book, but testified that, if Moldermaker asked, his advice would have been that Fox was required to book the entire amount of the award as a liability. (CX 21; Tr. 28-34.)

After speaking to Moldermaker, Hogoboom advised David Lapham, a supervisory examiner in the Denver office who had supervisory responsibility for Fox, that an arbitration award had been issued against Fox. Lapham obtained a copy of the award from NASD Dispute Resolution, noted the large amount of the award, and reviewed Fox's Financial and Operational Combined Uniform Single Report ("FOCUS report") for the period ending December 31, 2001. He determined that the arbitration award was not included as a liability of Fox, and that, if it had been, without any offsetting adjustments to the firm's assets, Fox would have been below its required net capital as of that date. Concerned, Lapham and another NASD examiner called Moldermaker on February 6. (CX 21, 34; Tr. 32-33, 55-62.)

Lapham asked Moldermaker if he was aware of the arbitration award and reminded him that under an SEC staff interpretation, Fox was required to book the award as a liability as of the date it was issued. Lapham also noted that it appeared from the FOCUS report that if Fox had booked the award, it was below its required net capital.

Moldermaker indicated he was aware of the award and of the SEC interpretation, but thought it was an "antiquated" rule that failed to consider that a firm might have insurance coverage for the award. Lapham advised Moldermaker that Fox should book the award; Moldermaker did not ask Lapham whether the fact that the award was joint and several affected how Fox should book the award, or whether Fox could book its insurance claim as an offsetting asset. Lapham testified: "There was no discussion about how to book anything." (CX 34; Tr. 62-64.)

After the call, NASD staff faxed a letter dated February 6 to Moldermaker as president of Fox. In the letter, the staff advised him that Fox was "required to book the liability resulting from this arbitration award to your books and records." The staff pointed out that the award had not been reflected on Fox's December 31 FOCUS report, and that if the award had been included, the net capital computation in the report would have shown a net capital deficit of more than $787,000. The letter again advised Moldermaker that Fox was required to file a notice with the SEC and NASD pursuant to SEC Rule 17a-11, and that it was unlawful under Section 15(c)(3) of the Securities Exchange Act for a securities broker-dealer to conduct a securities business in contravention of the net capital rule. (CX 37; Tr. 65-66.)

On February 7, Moldermaker, as president of Fox, sent NASD staff a letter in which he complained that his February 5 call to Hogoboom had been "in confidence," as a "Good Samaritan." He also contended that he had asked Hogoboom and Lapham for advice on how to book the award, considering that it was a joint and several award and that Fox had insurance coverage, but that neither Hogoboom nor Lapham was able to provide clear guidance on those issues. Moldermaker also complained about the staff's

February 6 letter, including its suggestion that Fox did not meet its net capital requirement, which Moldermaker said was "not true." With regard to the award, Moldermaker stated: "We received our copy of the award in January 2002. The January 2002 FOCUS filing will reflect any award, if applicable, as we have done in the past."[2] (CX 38; Tr. 67-68.)

On February 26, 2002, Moldermaker, on behalf of Fox, filed Fox's FOCUS report for the period ending January 31, 2002. Once again, in spite of the assurance in his February 7 letter, the FOCUS report did not include the arbitration award as a liability of Fox. If the award had been included in Fox's net capital computation without any offsetting increase in Fox's assets, Fox would not have satisfied its net capital requirement as of January 31. (CX 24; Tr. 68-69.)

On February 28, after reviewing the January 31 FOCUS report, NASD staff attempted to contact Moldermaker. He was unavailable, so the staff spoke to Mary Banicki, Fox's "head accountant." The staff explained that Fox was required to book the amount of the award as a liability. They also advised her that, under the SEC's Net Capital Rule, Fox might be able to book its E&O coverage for the claim as an asset if it had the documentation required under the Rule. The staff then faxed Moldermaker an excerpt from NASD's Guide to Rule Interpretations concerning the booking of arbitration awards, as well as the portion of the SEC's Net Capital Rule that addresses the

[2] As noted above, both Hogoboom and Lapham credibly testified that Moldermaker did not ask for advice on how to book the award, and the evidence establishes that Fox received the award in December 2001, not January 2002. The record establishes, and the Hearing Panel concludes based on its opportunity to observe Moldermaker at the hearing, that his recollections and descriptions of events are frequently inaccurate and, therefore, not credible. Furthermore, again based on the Panel's observation of Moldermaker, it is far more likely that Moldermaker made his own determinations about the appropriate treatment of the award and the insurance coverage than it is that he asked the staff for advice, or that he would have heeded any advice that he received.

circumstances under which an insurance claim may be allowed as an asset for net capital purposes. (CX 39; Tr. 71-72.)

On March 5, 2002, apparently after further discussions, Moldermaker faxed AISLIC's February 23, 1999, reservation of rights letter to NASD staff. They reviewed the letter, but concluded that under the specific requirements set forth in the Net Capital Rule, it did not provide a basis for Fox to book its insurance claim as an asset. The District 3 staff then consulted with other NASD staff, respondents, SEC staff and AISLIC in an effort to help Fox obtain a letter that would satisfy the requirements of the Net Capital Rule. On March 18, 2002, AISLIC faxed a letter to NASD staff in which it explained that Fox's policy "provides liability limits of $1,000,000 each Loss," from which the costs of defense were deducted. AISLIC stated that "[t]he Defense Costs … as of this date are $277,347," and "[a]ccordingly, $722,653 is available to satisfy the [arbitration] award subject to further erosion due to continuing defense costs." NASD staff concluded, however, that these statements were not sufficient under the Net Capital Rule to allow Fox to book the insurance coverage as an allowable asset for net capital purposes, and advised Moldermaker of that determination. (CX 26, 27; Tr. 77-79; 224-25.)

On March 25, Moldermaker sent the staff a letter complaining that, as to the February FOCUS report, the staff "failed to advise us the correct way to treat [the insurance] asset until it was too late to rectify and deposit additional funds to return to net capital compliance in February." He stated that he had relied on "the SEC exemption specifically designed for member firms with the insurance we have. The exemption has reference to a letter we had already received years ago from our insurance carrier" – i.e.,

AISLIC's February 23, 1999, retention of rights letter. He complained that it was not until early March that he had learned from NASD staff that "somehow the internal NASD/SEC policy had changed not allowing what had been allowed for more than a decade." Until then, he asserted, "the standard operating procedure coverage letter … had sufficed for years." He complained that the staff had advised him that the March 18 letter from AISLIC "is still not enough," which further demonstrated that "there had been a policy change … without any communication …." (CX 41.)

Moldermaker stated that, having learned of the policy change, "we added additional capital. This capital could have been added months before if it was deemed necessary." He included two different FOCUS reports for Fox as of February 28, 2002. In one, Fox reported the arbitration award as a liability, but also reported the insurance coverage as an allowable asset, resulting in Fox meeting its net capital requirement; in the other, Fox reported the award as a liability but did not report the insurance as an asset, resulting in Fox not meeting its net capital requirement. Moldermaker indicated that he hoped including both FOCUS reports would "appease everyone involved, especially since the capital has been deposited and any alleged deficiencies are now a moot point." Fox actually submitted as its official FOCUS report the version that listed both the award as a liability and the insurance claim as an offsetting asset, for net capital purposes. (CX 25; 41; Tr. 82-85, 156.)

After further discussions among NASD staff, SEC staff, Moldermaker and AISLIC, on April 5, 2002, AISLIC sent another letter to NASD staff regarding Fox's insurance coverage. In that letter, AISLIC reiterated that, as of March 18, $722,653 was available to satisfy the award, subject to further erosion due to continuing defense costs,

and stated: "We hereby advise that the balance of the policy is due and payable upon the exhaustion of all available appeals processes or similar procedures and a determination of liability against Fox & Company, James Moldermaker and/or David Gwynn." NASD staff concluded that this letter "came about 90 percent close" to satisfying the requirements of the Net Capital Rule, but did not fully commit AISLIC to paying the claim, and therefore requested some additional clarification, which AISLIC refused to provide. By that time, however, Fox had received additional capital. Enforcement does not contend that Fox failed to meet its net capital requirement after February 28. (CX 28, 36; Tr. 234-41, 247, 253-54.)

In late 2002 Fox, Moldermaker and Southwest settled with the arbitration claimants. AISLIC contributed the then-remaining insurance coverage amount of approximately $612,000 to the $775,000 settlement, with Fox paying the balance. Southwest did not contribute to the settlement. (RX 34, 35, 36; Tr. 350-51.)

On further review of Fox's financial records and FOCUS reports, NASD staff noted that as of January 31 and February 28, 2002, Fox's records reflected a $300,000 line of credit as an asset, which it included in its net capital computations in its January 31 and February 28 FOCUS reports. The line of credit, however, was issued to Moldermaker personally, not Fox, and as of those dates Fox had neither the $300,000 nor the right to obtain it under the line of credit. In addition, Fox booked two capital contributions totaling $190,000 as of January 31, and included that amount in the net capital computation in its January 31 FOCUS report. In fact, however, the funds were not deposited into Fox's bank account until February 6, 2002. (CX 13-20, 24-25; Tr. 164-67, 322-35.)

III. Discussion

A. Net Capital, Financial Records and Reporting Violations

Fox is a broker/dealer member of NASD. SEC Rule 15c3-1 (the Net Capital Rule) establishes minimum net capital requirements for broker/dealers and sets out the methods for calculating net capital. Section 15(c) of the Securities Exchange Act prohibits broker/dealers from engaging in a securities business if their net capital falls below the amounts required by Rule 15c3-1. SEC Rule 17a-3 and NASD Rule 3110 require broker/dealers to keep accurate books and records. SEC Rule 17a-5 requires NASD members to submit periodic reports of their financial condition (FOCUS reports) to NASD, and Rule 2110 requires that FOCUS reports be accurate.

Moldermaker is Fox's FINOP, as well as its president. NASD Rule 1022(b) provides that a FINOP's duties include, among other things, "final approval and responsibility for the accuracy of financial reports submitted to any duly established securities industry regulatory body," as well as "supervision of and responsibility for individuals who are involved in the actual maintenance of the member's books and records from which such reports are derived," and "supervision and/or performance of the member's responsibilities under all financial responsibility rules promulgated pursuant to the provisions of the [Securities Exchange] Act."

Enforcement contends that Fox transacted a securities business while it was below its required net capital on January 31 and February 28, 2002; that its books and records were inaccurate as of January 31 and February 28, 2002; and that it filed inaccurate FOCUS reports for the periods ending December 31, 2001, January 31, 2002 and

February 28, 2002. Enforcement also contends that, as Fox's FINOP, Moldermaker was responsible for these violations.

1. Net Capital

To establish a net capital violation, Enforcement had to prove that Fox conducted a securities business on January 31 and February 28, 2002, while its net capital was below its required minimum. The parties agreed that Fox conducted a securities business on those dates, and that its minimum net capital requirement on those dates was $250,000. (Tr. 162, 165; CX 6-11.) Whether Fox met that requirement on those dates turns primarily on whether it was (i) required to record the arbitration award as a liability for net capital computation purposes, and (ii) permitted to record its insurance claim as an offsetting asset for net capital purposes.[3]

The NASD Guide to Rule Interpretations explains to NASD members that the SEC has determined that, for purposes of the Net Capital Rule, "[a] broker-dealer that is the subject of an adverse award in an arbitration proceeding should book said award as an actual liability at the time the award is made, even though the appeal process has not been exhausted and no judgment has been rendered, because grounds for revision on appeal are very limited." (CX 23.) The National Adjudicatory Council recently confirmed that NASD members are required to follow this direction. Department of Enforcement v.

[3] According to Fox's net capital calculation in its January FOCUS report, which did not include either the award as a liability or the insurance claim as an asset, Fox's net capital on January 31 was $643,119, or $393,119 in excess of its $250,000 required minimum. Thus, if Fox was required to include the $983,992 as an additional liability, without any offsetting amount for the insurance claim, Fox was well below its required minimum on January 31. According to Fox's February FOCUS report, which included both the award as a liability and the insurance claim as an asset, Fox's net capital on February 28 was $508,625, or $258,625 in excess of its minimum. If Fox were required to exclude amount of the insurance claim ($722,653), it was again well below its required minimum net capital. In contrast, the $300,000 line of credit did not have any impact on Fox's net capital computations because Fox's computation included an offsetting liability entry in the same amount, and even if the $190,000 capital contribution was deducted from the assets Fox claimed in its January FOCUS report, if there were no adjustment for the arbitration claim, Fox would have satisfied its net capital requirement. (CX 3, 4, 24, 25; Tr. 158-59.)

Investment Management Corp., No. C3A010045 (Dec. 15, 2003). Moldermaker admitted that he was aware of this obligation, and in fact, had booked arbitration awards in the past. (Tr. 316-17.)

Moldermaker argued, however, that the requirement was unclear as applied to this arbitration award, because it was issued jointly and severally against Fox, Moldermaker, Southwest and Gwynn. The Panel rejects this argument. The concept of joint and several liability is well understood. "A liability is said to be joint and several when the creditor may demand payment or sue one or more of the parties to such liability separately, or all of them together at his option." Black's Law Dictionary (6th ed. 1990), at 837. In other words, in their discretion, the arbitration claimants could have demanded the entire amount of the award from any of the arbitration respondents, including Fox. For that reason, Fox was required to book the entire amount of the award as a liability.

Moldermaker understood this; he testified that he had prior experience with joint and several arbitration awards and had booked the entire amount of those awards as liabilities. (Tr. 321.) He argued that those awards had not involved another NASD member, but the liability principle is exactly the same regardless of the identities of the joint and several obligors – the arbitration claimants were free to demand the entire amount of the award from Fox.[4] Further, the Panel rejects Moldermaker's complaint that, when he consulted them, NASD staff could not tell him how to book such an award. The Panel credits the staff's testimony that Moldermaker did not ask how to book the award,

[4] Moreover, Moldermaker's argument appears disingenuous. During the hearing, Moldermaker complained that Fox had paid Southwest's defense costs, and had paid the full amount of the eventual settlement with the arbitration claimants that was over and above the amount available under the AISLIC policy, without any contribution from Southwest. He explained that Fox's clearing agreement with Southwest included a provision requiring it to indemnify Southwest. Therefore, Moldermaker surely knew that, regardless of the fact that Southwest was jointly and severally liable under the award, Fox, rather than Southwest, would have to pay it. (Tr. 428, 431.)

or that, if he did, they advised him, correctly, to book the entire amount. In any event, as Fox's FINOP, Moldermaker was responsible for ensuring that Fox met its net capital requirements, and could not transfer that responsibility to NASD staff.

Respondents argue that, if Fox was required to recognize the award as a liability for net capital purposes, it should also have been entitled to claim its insurance coverage as an offsetting asset. The Net Capital Rule specifically addresses the circumstances under which an insurance claim may be an allowable asset for net capital purposes. SEC Rule 15c3-1(c)(2) provides that, in calculating a firm's net capital, the firm must adjust its net worth by deducting "assets which cannot readily be converted into cash … including, among other things":

> D. Insurance claims which, after seven business days from the date the loss giving rise to the claim is discovered, are not covered by an opinion of outside counsel that the claim is valid and is covered by insurance policies presently in effect; insurance claims which after 20 business days from the date of the loss giving rise to the claim is discovered and which are accompanied by an opinion of outside counsel described above, have not been acknowledged in writing by the insurance carrier as due and payable; and insurance claims acknowledged in writing by the insurance carrier as due and payable outstanding longer than 20 business days from the date they are so acknowledged by the carrier[.]

It is clear that under these standards Fox could not have treated its insurance claim for the arbitration award as an allowable asset for net capital purposes in its January or February FOCUS reports. Fox did not obtain, or even seek, an opinion of outside counsel that its claim for coverage of the award was valid and covered by its insurance policy within seven business days after the award was issued, or ever. Further, Fox did not ask AISLIC to acknowledge in writing that Fox's claim for coverage of the award was due

and payable, and AISLIC did not provide such an acknowledgment within 20 business days or pay the claim within 20 business days after acknowledging it.[5]

Respondents argue that the reservation of rights letter that Fox received from AISLIC in February 1999 should have been acceptable as AISLIC's written acknowledgement under the Net Capital Rule. Moldermaker pointed out that such letters are standard practice in the insurance industry for claims under E&O policies. Respondents' own insurance agent witness, however, testified that AISLIC's reservation of rights letter only committed AISLIC to defend the claim. AISLIC expressly reserved its rights to deny coverage under any of the various exclusions in the policy if it discovered that an exclusion applied. (Tr. 371-72.)

Respondents contend that reservation of rights letters have been accepted for many years under the Net Capital Rule, but they offered no evidence whatsoever to support that contention. In contrast, NASD staff testified that in their experience, the circumstances of this case were unprecedented. They were unaware of any prior instance in which an NASD member had sought to claim insurance coverage for an arbitration award as an asset for net capital purposes. In addressing this novel situation, they applied the explicit provisions of the Net Capital Rule; they did not ignore or change any existing practice. As explained above, the reservation of rights letter clearly did not satisfy the requirements of the Rule.

[5] Although the Rule requires payment of the claim within 20 days after it is acknowledged, recognizing that respondents' obligation to pay the award was stayed pending a ruling on the motion to set aside the award, pursuant to NASD Rule 10330(h), and after consulting with SEC staff, NASD staff agreed that it would be sufficient if AISLIC provided an unconditional assurance that it would pay the claim if and when the award was sustained. (Tr. 228-30.) There is no need for the Panel to determine whether that would have been appropriate under the Rule, because AISLIC gave no such assurance during the period relevant to the alleged violations. See n. 6, infra.

Respondents also pointed out that, by the time the award was issued, AISLIC had spent more than $250,000 defending the arbitration, and argued that this justified an inference that AISLIC would pay the claim. The SEC's Net Capital Rule, however, is very explicit. It does not permit a firm to book an insurance claim as an allowable asset based on an inference that the insurance carrier will pay. Rather, the Rule requires an opinion of counsel, followed by a prompt written acknowledgment from the carrier that the claim is due and payable, followed by prompt payment. As of January 31 and February 28, 2002, Fox did not have any of these things. Therefore, it could not include insurance coverage for the award as an allowable asset for net capital purposes.

Respondents also pointed out that the AISLIC coverage was NASD-sponsored, and argued that it was unfair for NASD to deny the adequacy of a product it promoted. The issue, however, had nothing to do with the adequacy of the coverage afforded under the AISLIC policy; indeed, AISLIC ultimately paid the remainder of the policy limits in settlement of the arbitration award. Instead, the issue was whether Fox had satisfied the requirements imposed by the SEC in the Net Capital Rule. NASD staff were not free to ignore or modify the Rule's requirements just because the insurance in question was an NASD-sponsored product. Because respondents never even attempted to satisfy the requirements plainly set forth in the Rule, they have no cause for complaint.[6]

Finally, the Hearing Panel notes that respondents' failure to follow the clear directives of the Net Capital Rule was not a mere technical violation. Indeed, this case

[6] As explained above, AISLIC issued letters on March 18 and April 5, 2002, that NASD staff concluded were not adequate to satisfy the requirements of the Net Capital Rule. Because those letters were not issued until after the dates on which Enforcement charged, and the Hearing Panel finds, Fox operated while below its required net capital, the Panel finds it unnecessary to determine whether the letters met the requirements of the Rule.

demonstrates quite clearly the importance of the Net Capital Rule's requirements. Moldermaker repeatedly insisted that his problems were attributable to the staff's ignorance regarding insurance. Yet he also testified that when the award was issued, he was not worried because he "had $2 million of insurance to cover this thing," which was far in excess of the award. But in March, when at the staff's insistence AISLIC was finally asked for an acknowledgment under the Net Capital Rule, Moldermaker "was in shock" when he learned that he had only $1 million in coverage, and that, because of defense costs, only about $722,000 of that amount remained – more than $250,000 less than the amount of the award. In the end, AISLIC contributed what remained of the policy limits, about $612,000, and Fox was required to pay an additional $162,000 to complete the settlement.[7] (Tr. 310, 350.) Thus, Moldermaker's blind assumption that there was no need to book the award because he had ample insurance coverage was unfounded; if he had followed the directives in the Rule, he would have learned much earlier that Fox had very substantial exposure on the award, over and above its potential insurance coverage.

The Hearing Panel, therefore, finds that Fox conducted a securities business on January 31 and February 28, 2001, while below its required net capital, in violation of SEC Rule 15c3-1(c)(2)(D) and NASD Rule 2110. Further, the Panel finds that Moldermaker, as Fox's president and FINOP, was responsible for Fox's violations, and therefore violated Rule 2110.

[7] Moldermaker's own insurance agent testified that he had no doubt that the policy's coverage for the arbitration award was limited to $1 million, not $2 million. (Tr. 380-81.)

2. Books and Records and FOCUS Reports

Fox's books and records indicated that, as of January 31 and February 28, 2002, its assets, and allowable assets for net capital purposes, included a $300,000 line of credit. They also indicated that, as of January 31, its assets, and allowable assets for net capital purposes, included $190,000 that purportedly had been deposited into Fox's bank account on January 31, 2002. In fact, the line of credit was in Moldermaker's name, personally, not Fox's, and no funds had been transferred to Fox from the line of credit as of January 31 or February 28. Further, the $190,000 was not actually deposited into Fox's bank account until February 6, 2002.

Respondents argued that the line of credit was properly counted as an asset of Fox because Moldermaker obtained it to provide funding for Fox, and always intended that it would be used for that purpose. Nevertheless, as of January 31 and February 28, the line of credit represented simply a potential source of funds for Moldermaker; Fox had neither the funds nor any right of its own to obtain them. Moldermaker also argued that he "pledged" the line of credit to Fox "as a subordinated loan," as reflected in an entry in Fox's Corporate Minutes dated January 2, 2002. (RX 41.) Under the Net Capital Rule, however, a subordinated loan must meet certain specific requirements and must be approved by NASD before it can be treated as an asset for net capital purposes. See SEC Exchange Act Rule 15c3-1d. Moldermaker's pledge of the line of credit was not, and would not have been, approved by NASD as a subordinated loan under the standards set forth in the Net Capital Rule. (Tr. 154-55.) The Hearing Panel, therefore, finds that the letter of credit was not an asset of Fox on those dates. Respondents conceded that the

$190,000 capital contribution was not an asset of Fox as of January 31.[8] Therefore, the Panel concludes that Fox maintained, and Moldermaker as its president and FINOP caused it to maintain, inaccurate books and records, in violation of NASD Rule 2110, as charged.

Fox failed to include the arbitration award as a liability in its FOCUS report for the period ending December 31, 2001, which was filed on January 25, 2002. The award was issued on December 27, and Fox received notice of the award on December 28. Therefore, it should have been included as a liability in the FOCUS report. Fox's FOCUS report for the period ending January 31, 2002, which was filed on February 24, 2002, included the line of credit and the purported capital contributions described above as assets of the firm, and as allowable assets for net capital purposes. For the reasons set forth above, this was improper. Finally, Fox's FOCUS report for the period ending February 28, 2002, also included the line of credit as an asset and an allowable asset, which was improper, and included the insurance claim as an asset, which was also improper, for the reasons set forth above. Therefore, the Hearing Panel concludes that Fox submitted inaccurate FOCUS reports for those dates, in violation of SEC Rule 17a-5 and NASD Rule 2110, and that Moldermaker caused Fox to submit the inaccurate reports, and thereby violated Rule 2110, as charged.

[8] Moldermaker described the failure to deposit the funds by January 31 as a "clerical error." (Tr. 334-35.) The evidence showed, however, that Moldermaker wrote a check for $110,000 to Fox that was dated January 31, 2002, but not deposited in Fox's account until February 6, and that Moldermaker attempted to transfer an additional $80,000 to Fox from an account he controlled on January 31 by wire transfer, but was advised that the funds could not be transferred by wire, resulting in those funds also not being deposited into Fox's account until February 6. (CX 17-20.)

B. Form U-5 and Rule 3070 Violations

When Gwynn left Fox, Fox filed a Form U-5 notifying NASD of the termination, pursuant to Art. V, § 3(a) of NASD's By-Laws. (CX 29.) Among other things, a Form U-5 asks whether the terminated individual has been named in any consumer-initiated arbitration. Article V, § 3(b) of NASD's By-Laws requires an NASD member to file an Amended Form U-5 within 30 days if it learns "of facts or circumstances causing any information set forth in [the original Form U-5] to become inaccurate or incomplete." Therefore, Fox was required to file an Amended Form U-5 for Gwynn when the arbitration was filed in December 1998 naming Gwynn as one of the respondents. Fox failed to file an Amended Form U-5, and Moldermaker, as president of Fox, was responsible for ensuring that it did. Therefore, the Hearing Panel concludes that Fox and Moldermaker violated Rule 2110.

Rule 3070 requires member firms to report promptly any award against the firm in excess of $25,000, or against any person associated with the firm in excess of $15,000, issued in any securities or commodities-related arbitration. Fox did not report the arbitration award as required under Rule 3070, and Moldermaker, as president of Fox, was responsible for ensuring that it did. Therefore, the Hearing Panel concludes that Fox violated Rules 3070 and 2110 and that Moldermaker violated Rule 2110, as charged.

IV. Sanctions

A. Financial Records and Reporting Violations

The Sanction Guidelines recommend that adjudicators impose fines of $1,000 to $50,000 for net capital violations; $1,000 to $10,000, or up to $100,000 in egregious cases, for books and records violations; and $10,000 to $50,000 for false or misleading

FOCUS reports. In addition, for all three types of violations, the Guidelines recommend that adjudicators consider imposing a suspension of up to 30 business days on the firm and the FINOP, and in egregious cases consider imposing longer suspensions of up to two years, or even expelling the firm or barring the FINOP. NASD Sanction Guidelines (2001 ed.) at 33, 34, 76. Enforcement requested that the Hearing Panel fine the respondents, jointly and severally, $10,000 for the net capital violation, $10,000 for the books and records violation, and $20,000 for the FOCUS report violation, for a total fine of $40,000, and bar Moldermaker as a FINOP for the violations collectively.

Ordinarily, it is appropriate to impose separate sanctions for each violation, but "where multiple, related violations arise as a result of a single underlying problem, a single set of sanctions may be more appropriate to achieve NASD's remedial goals." Department of Enforcement v. Investment Management Corp., at 11. In this case, the net capital, books and records and FOCUS reports violations were all caused by respondents' failure properly to account for the arbitration award, the related insurance claim, the line of credit and the capital contribution, which affected the firm's books and records, its FOCUS reports based on those records and the net capital computations in the FOCUS reports.

There was no justification for Fox's failure to recognize the arbitration award as a liability in its December 2001 FOCUS report and its January 2002 net capital calculations. Moldermaker knew about the SEC interpretation requiring firms to book arbitration awards as liabilities when issued, and admitted Fox had done that in the past. Initially, he claimed in his communications with NASD staff that Fox did not book the award as a liability in December 2001 because it did not receive the award until January

2002, but at the hearing he was forced to concede that Fox actually received the award on December 28, 2001. More importantly, the SEC interpretation requires that arbitration awards be booked as of the date they are issued.

Moldermaker also said that he was uncertain how to book the award because it was joint and several, yet he admitted this was not the first joint and several award that had been issued against Fox. Although this was the first such award in which another firm was one of the joint obligors, the principles are the same regardless of the identity of the joint obligors. If Moldermaker had any doubt about that, he should have contacted NASD staff promptly and asked for assistance. Instead, he did not contact the staff until February, and did so in order to complain about Gwynn, not to seek advice about how to book the award. Moldermaker simply decided, on his own, that, because he mistakenly thought he had adequate insurance coverage, he did not need to book the award at all. Even after NASD staff reminded him that he was required to book the award, and he promised to do so in Fox's January FOCUS report, he omitted it from Fox's liabilities in the report, and instead calculated Fox's net capital as though the award did not exist.

Similarly, there was no basis for his treatment of the insurance claim. The requirements for booking an insurance claim as an asset are set forth explicitly in the Net Capital Rule, yet Moldermaker made no effort to comply with them. Instead, he decided that the reservation of rights letter should be adequate, even though it did not commit AISLIC to pay the claim, and that, because AISLIC had paid the costs of defense, it was appropriate to assume that it would also pay the award. Because he did not attempt to follow the requirements of the Rule, Moldermaker was "shocked" when he discovered that Fox's remaining coverage was substantially less than the amount of the award.

Moldermaker's treatment of the line of credit and the capital contributions reflects the same cavalier attitude toward the requirements that NASD members maintain accurate books and records, submit accurate financial reports and ensure that they do not transact business while below their net capital requirements. There was no basis for Fox to claim a line of credit issued to Moldermaker personally as an asset of the firm, but Moldermaker decided it was sufficient that he intended to use the line as a source of funds for the firm, if needed. And it should have been equally clear that capital contributions that were not deposited to Fox's account until February could not be included in its January records and FOCUS report, yet Moldermaker did so anyway, apparently on the theory that only a "clerical error" had prevented the funds from being deposited in January.

The Sanction Guidelines explain:

> The overall purpose of NASD Regulation's disciplinary process and NASD Regulation's responsibility in imposing sanctions are to remediate misconduct and to protect the investing public. Toward this end, Adjudicators should design sanctions to prevent and discourage future misconduct by a respondent, to deter others from engaging in similar misconduct, and to improve overall business standards in the securities industry.

Sanction Guidelines at 3.

In this case, the Hearing Panel agrees with Enforcement that to accomplish those goals, Moldermaker must be barred from serving as a FINOP. The violations show a pattern of Moldermaker simply deciding not to follow the applicable rules in accounting for the arbitration award, the insurance coverage, the line of credit and the capital contributions because, for one reason or another, he did not think they should apply. Even at the hearing, he did not acknowledge or accept responsibility for his own actions,

but rather continued to blame NASD staff. There is no reason to believe that anything short of a bar would deter him from similar misconduct in the future if he were allowed to continue as Fox's FINOP.

With regard to monetary sanctions, although the amounts requested by Enforcement might be reasonable if the violations had been independent, in fact they were different manifestations of Moldermaker's failure to properly account for the award, the insurance claim, the line of credit and the capital contributions. Therefore, the Hearing Panel concludes that a single fine, in the amount of $25,000, coupled with the bar against Moldermaker continuing to serve as Fox's FINOP, will fully accomplish NASD's remedial goals.

B. U-5 and Rule 3070 Violations

For failure to file a Form U-5, the Sanction Guidelines recommend that adjudicators fine the responsible principal and/or the firm $5,000 to $100,000 and consider suspending the responsible principal in all supervisory capacities for 10 to 30 business days. The recommendations are the same for violations of Rule 3070. Sanction Guidelines at 77-78, 82. Enforcement requests that respondents be fined $5,000, jointly and severally, for each violation, and that Moldermaker be suspended in all principal capacities for 10 business days.

Hogoboom testified that during their telephone conversation on February 5, 2002, Moldermaker told him that he had made "a strategic decision" not to update Gwynn's Form U-5 when the arbitration claim was filed, because he needed Gwynn to testify favorably, and another NASD examiner testified that Moldermaker made a similar comment during an examination of Fox. (Tr. 29-30, 47, 168-69.) During the

investigation, NASD staff asked Moldermaker to confirm that, and he replied in a letter dated April 23, 2002: "We received the arbitrations after his voluntary resignation. Only after adjudicating the two arbitrations did it become my opinion that Mr. Gwynn's egregious behavior needed to be reported to you." (CX 31.) The Hearing Panel, therefore, concludes that the Form U-5 violation was deliberate, and warrants substantial sanctions. (Tr. 192-96.)[9]

It appeared from Moldermaker's testimony that the Rule 3070 violation was attributable to his ignorance of the requirements of the Rule. (Tr. 198-202.) Ignorance is not, however, an excuse, particularly since Moldermaker stated that Fox had received three letters of caution for other types of Rule 3070 violations as a result of its last three NASD examinations. (Tr. 315-16.) Moldermaker thought this was mitigating, complaining that none of the letters of caution advised Fox that it was required to report arbitration awards. In fact, however, the letters of caution should have led him to study carefully all the requirements of Rule 3070 to avoid any future violations of any sort. Plainly, more serious sanctions are required to accomplish that goal.

Taking all these circumstances into consideration, the Hearing Panel agrees that the sanctions requested by Enforcement are appropriate to accomplish NASD's remedial purposes. Therefore, for these violations, respondents will be fined a total of $10,000, jointly and severally, and Moldermaker will be suspended in all supervisory and principal capacities for 10 business days.

[9] Gwynn testified on behalf of Enforcement that when the arbitration claim was filed, he asked Moldermaker to report the claim to NASD, and that Moldermaker told him Fox would do so. (Tr. 205-06; CX 30.) Gwynn, however, was not a credible witness in any respect. In any event, the Panel finds that Moldermaker's statements in his April 23, 2002 letter to the staff are reliable evidence that he deliberately refrained from filing an Amended Form U-5 for Gwynn.

V. Conclusion

Respondent Fox & Company Investments, Inc. conducted, and respondent James W. Moldermaker caused it to conduct, a securities business when Fox failed to meet its net capital requirements, in violation of SEC Exchange Act Rule 15c3-1 and NASD Rule 2110; Fox maintained, and Moldermaker caused it to maintain, material inaccuracies in the firm's books and records, in violation of NASD Rule 2110; and Fox submitted, and Moldermaker caused it to submit, materially inaccurate FOCUS reports, in violation of SEC Exchange Act Rule 17a-5 and NASD Rule 2110. For these violations, respondents are fined $25,000, jointly and severally, and Moldermaker is barred from associating with any NASD member as a financial and operations principal.

In addition, Fox failed to file, and Moldermaker caused it to fail to file, a required amendment to a Form U-5, in violation of NASD Rule 2110, and Fox failed to report, and Moldermaker caused it to fail to report, an arbitration award, in violation of NASD Rules 3070 and 2110. For these violations, respondents are fined $10,000, jointly and severally, and Moldermaker is suspended in all supervisory and principal capacities for 10 business days. In addition, respondents, jointly and severally, are ordered to pay costs in the amount of $2,938.03, which includes an administrative fee of $750 and hearing transcript costs of $2,188.03.

These sanctions shall become effective on a date set by NASD, but not sooner than 30 days after this decision becomes NASD's final disciplinary action in this matter, except that if this decision becomes NASD's final disciplinary action, the bar shall become effective immediately, and Moldermaker's suspension in all supervisory and

principal capacities shall commence with the opening of business on March 1, 2004, and conclude at the close of business on March 12, 2004.[10]

HEARING PANEL

_____

By: David M. FitzGerald
Hearing Officer

Copies to:

Fox & Company Investments, Inc. (via overnight and first class mail)
James W. Moldermaker (via overnight and first class mail)
Jacqueline D. Whelan, Esq. (electronically and via first class mail)
Rory C. Flynn, Esq. (electronically and via first class mail)

[10] The Hearing Panel has considered all of the arguments of the parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.