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NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. C9B000013
	:	Hearing Officer - JN
v.	:	
	:	**HEARING PANEL DECISION**
	:	July 6, 2001
Respondent.	:	

Financial and Operations Principal found liable under Rule 2110 for firm's net capital violations and fined $2,500.

Appearances

For the Complainant: Michael J. Newman and Rory C. Flynn.

For Respondent: _____ and _____.

DECISION

I. Introduction

Respondent _____ serves as a Financial and Operations Principal (FINOP) for a number of securities firms, including _____, L.L.C. He was responsible for that firm's compliance with the net capital rule (SEC Rule 15c3-1) during a period when the firm failed to maintain its net capital requirement. The Department of Enforcement's Complaint, filed on May 30, 2000, alleged that

_____ was liable under Rule 2110 for the firm's deficiencies. He disputed the charges and requested a hearing.[1]

The Hearing Panel was composed of two current members of the Association's District 9 Committee, both licensed, experienced FINOPs, and an NASDR Hearing Officer. The panel conducted two days of hearings on March 13 and 14 of 2001 in New York City. Enforcement presented twenty-two exhibits ("CX-1" through "CX-22") and testimony from two witnesses. Mr. _____ introduced eight exhibits ("RX-1" through "RX-8") and, with his partner, testified in defense. The parties filed Post-Hearing Memoranda on April 20, 2001.

II. Discussion

A. Factual Background

Mr. _____ has been registered as a FINOP and as a General Securities Principal for many years and functions in those capacities for twenty-eight brokerage firms, including _____ (Stipulation, ¶¶ 5, 6).[2] _____ conducted a securities business while below its required net capital on eleven occasions between May 12, 1999 and June 1, 1999, while Respondent was serving as its FINOP (Id., par. 9; CX-1).

_____ is "primarily engaged in proprietary trading and in agency transactions for a small group of wealthy individuals" (Stipulation, ¶ 2). Its trading and agency transactions typically "involve large 'blue chip' equity securities, and historically the firm's net capital has consistently and substantially exceeded its regulatory requirements" (Id. at ¶ 3). Mr. _____, who owns 90% of the

[1] The Complaint also named _____ as a Respondent. That firm subsequently settled, and the hearing went forward as to Mr. _____ only.

[2] "Stipulation" refers to the Joint Stipulation of Facts, signed by counsel for both parties, and filed on October 10, 2000.

firm, had a clean record of thirty years of industry experience, including service in upper level positions with several prominent firms, and held Series 7, 24, and 63 licenses (Tr. 38-41).[3] The firm also employed another full-time professional, Mr. _____, who was licensed under Series 7, 24, 55, and 63 (Tr. 184; Post-Hearing Memorandum, p. 6).

Respondent and his partner, Mr. _____ (also a licensed and experienced FINOP), provided services to various firms, deciding in each instance upon the appropriate level of necessary supervision. Considering _____'s circumstances, they adopted a level which _____ described as a "two" on a scale of one through ten, with ten reflecting the highest degree of supervision (Tr. 168). They decided that daily oversight of _____ net capital was not necessary and therefore did not receive daily reports as to the firm's positions (Tr. 103, 109, 254-256). Instead they adopted a telephonic system, whereby _____ would keep them informed as to _____'s large positions and any major change in trading positions (Tr. 60-61). _____ acquired information about the firm's positions by telephone calls with _____, who conversed with _____ or _____ at least once a month to furnish monthly position statements. There was a recognized division of labor, whereby _____ would inform _____ of the firm's positions, while the latter would take care of the numbers (Tr. 43, 71, 115, 254-256). Once a month, _____ prepared the firm's FOCUS reports. This system worked well for several years,[4] during which there were no fluctuations in _____ market positions (Tr. 72-73).

In April of 1999, the firm acquired 300,000 shares of Anadarko Petroleum, a holding worth about $8 million (Tr. 46). On May 20, 1999, while reviewing _____ financial data for the prior

[3] "Tr." refers to the transcript of the hearings held on March 13 and 14, 2001.

[4] _____ testified that _____ had been his FINOP since 1992 (Tr. 42, 82). The Stipulation recites that _____ had served as the firm's FINOP since December of 1996 (at ¶ 6).

month, _____ discovered that haircuts and excess concentration charges attributable to that acquisition had lowered the firm's excess net capital from $2.8 million to $163,914 (CX-7, p. 6; Tr. 104-106).[5] _____, aware that the firm's minimum net capital requirement was $100,000, informed _____ (CX-1; Tr. 105, 178, 264). They agreed to alert _____ of the situation (Tr. 264). _____ suggested to _____ that he move some of the Anadarko holding to avoid adverse net capital consequences (Tr. 105). _____ reported to _____ that _____ said, "I will take care of it" (Tr. 267). As a result, _____sold 40,000 of the 300,000 Anadarko shares (Tr. 57-58). Unbeknownst to _____ and _____, the firm was already operating in net capital deficiency at the time of the _____-_____ conversation (CX-1).

In June of 1999, while reviewing _____ May data, _____ learned for the first time that the firm had made several other significant stock acquisitions, triggering haircuts and charges which, in turn, had produced net capital deficiencies on eleven instances between May 12 and June 1 of 1999 while the firm conducted a securities business (CX-1; Tr. 109, 112, 114). He informed _____, who, aware only of the Anadarko holding, was shocked to learn of the violations (Tr. 112, 268, 281). On June 23, 1999, _____filed a FOCUS report and requisite notices informing regulatory authorities of the net capital deficiency (Stipulation, ¶ 13). To bring the firm into net capital compliance, _____ sold all of the stock in question, sustaining a $1 million loss (Tr. 73-74).

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[5] As _____ explained, the "haircut" is generally a 15% charge on equities "to allow for the possibility of adverse market fluctuations"; the undue concentration charge (another 15%) is imposed "[b]ecause to the extent you have a great deal of your capital committed to a security, it puts a firm at greater risk...." (Tr. 245-246).

B. _____'s Responsibility and Actions

FINOPs have the duty of "supervision and/or performance of the member's responsibilities under all financial responsibility rules" promulgated under the Exchange Act (Rule 1022(b)).[6] Consistent with that Rule, _____ "Policies and Supervisory Procedures" named _____ as Chief Financial Officer and stated that he had "primary responsibility for supervision of all the financial operations of the firm" (CX-3, p. 22). He was _____ FINOP during the period when the firm operated without the required minimum net capital (Stipulation, ¶¶ 6, 9; CX-1).

Mr. _____ failed to pay sufficient attention to the news that the firm's acquisition of the Anadarko stock caused its excess net capital to decline from several million dollars to $163,914. He acknowledged that the purchase was "like a signal," reflecting a "very, very significant quantum leap in what the firm was doing" (Tr. 262, 351). As expressed by _____, the $8 million Anadarko purchase "stood out as plain as day. It was a position. It was large. [_____] went from three million in excess net capital down to something of hundreds of thousands" (Tr. 118). The resulting decline "significantly" decreased excess net capital and led him to be "concerned" (Tr. 104-105, 118). This decline was particularly significant because it brought _____ April net capital much closer to the $100,000 minimum. "A FINOP must be especially vigilant in ensuring compliance with the net capital rule when . . . his firm . . . is operating near the permissible limits." James S. Pritula, Exch. Act Rel. No. 40647, 1998 SEC LEXIS 2425, at *19-*20 (Nov. 9, 1998) and cases there cited.

[6] _____ objects to Enforcement's mention of that Rule, arguing that it was not set out in the Complaint (Post-Hearing Memorandum, p. 26). "NASD member firms and their FINOPs are charged with knowing the applicable regulations...". In re Litwin Securities, Inc., Exch. Act Rel. No. 38673, 1997 SEC LEXIS 1146, at *14 (May 27, 1997). _____, with extensive FINOP experience, especially should not object to the citation of Rule 1022(b)'s prescription of FINOP duties.

Yet, when confronted with news of this significant decline, rooted in a position which "stood out as plain as day" (Tr. 118), Respondent chose to rely entirely on a belief that _____'s May 20 conversation with _____ would enable the latter to "take care of the problem" (Tr. 281-282). A more thorough inquiry would have revealed that on that very day, the firm was already operating in net capital deficiency (CX-1). _____ failed to follow up on the _____-_____ conversation or ask _____ to do so. He did not attempt to ascertain what _____ had done. Nor did he speak to _____ until the next month, when he learned that additional acquisitions had led the firm into net capital deficiencies. It was not till then that, for the first time, he required daily reports of _____ positions for monitoring net capital compliance (Tr. 103-104).

_____ ultimately sold the stock to bring his firm into compliance and sustained a $1 million loss. He stated that he would have taken similar action on May 20, if he had known that the firm was in net capital deficiency (Tr. 60). Had _____ and _____ pursued the matter when they first learned of the April decline in excess net capital, they would have discovered on-going net capital violations (CX-1), advised _____ accordingly, and effectively reduced the violative period from eleven days to four days.

C. FINOP Liability Under Rule 2110 and Respondent's "Good Faith" Defense

It is well settled that FINOPs are generally responsible for a firm's compliance with the net capital requirements of SEC Rule 15c3-1 and may be held liable under Rule 2110 when the company operates in violation of them. Joseph S. Barbera, Exch. Act Rel. No. 43528, 2000 SEC LEXIS 2396, at *1-*2 (Nov. 7, 2000) (sustaining NASD's conclusion that "Barbera was responsible for [the firm's] conducting . . . a securities business while it failed to maintain the minimum net capital required by Rule 15c3-1 . . . and thereby violated NASD Conduct Rule 2110"); Pritula, 1998 SEC LEXIS 2425, at

*20 ("We conclude that Pritula was responsible for the Firm's failure to comply with Exchange Act Rule 15c3-1" and "thereby violated" Rule 2110's predecessor); William H. Gerhauser, Sr., Exch. Act Rel. No. 40639, 1998 SEC LEXIS 2402, at *16-*17 (Nov. 4, 1998) (Respondent "was liable under [Rule 2110's predecessor] for … the period during which there was a net capital deficiency and he was the firm's FINOP"); Gilad J. Gevaryahu, Exch. Act Rel. No. 33038, 1993 SEC LEXIS 2791 at *1 (Oct. 12, 1993) (sustaining NASD finding that FINOP was "responsible for the firm's failure to comply with net capital" requirements and "accordingly" violated Rule 2110's predecessor). See also Department of Enforcement v. Webb, No. C8A980059 (NAC, Nov. 6, 2000)[7] (finding a FINOP liable under Rule 2110 for a firm's operations while in net capital deficiency).

Arguing that Rule 2110 reflects an ethical standard, _____ urges that he did nothing unethical and acted in good faith at all times (Post-Hearing Memorandum, pp. 16-24). The same argument was rejected in Gerhauser, 1998 SEC LEXIS 2402, where, as here, the FINOP was charged with violating the Association's requirement for observance of "high standards of commercial honor and just and equitable principles of trade" by virtue of his firm's violation of SEC Rule 15c3-1's net capital requirements.[8] There, as here, the FINOP urged that the above requirement was "an ethical standard requiring a showing of bad faith" (Id. at *20). The Commission's response in that case is dispositive of Mr. _____'s arguments:

> We agree with applicants that [the "high standards" Rule] reflects a broad ethical standard of conduct. Here Applicants are charged under [that Rule] based upon infractions of various rules under the Exchange Act. We have consistently maintained that a violation of another SEC or NASD rule or regulation constitutes a violation of the requirement to adhere to "just and equitable principles of trade" embodied in the

[7] http://www.nasdr.com/pdf-text/nac1100_01red.pdf (redacted version)

[8] Gerhauser involved former Article III, Section 1 of NASD's Rules of Fair Practice, now codified verbatim in Rule 2110.

> NASD Rules ... and does not require a finding of intent or scienter. This is particularly true with respect to violation of the net capital rule.

(Id. at *20-*21; citations omitted). See also Fundclear, Inc., Exch. Act Rel. No. 34735, 1994 SEC LEXIS 2956, at *11 ("We reject Applicants' defense that they were acting in good faith and did not intend to violate the net capital rules. Rule 15c3-1 has no scienter requirement.").

As explained in Department of Enforcement v. Shvarts, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *12-*13 (NAC, June 2, 2000), offenses under Rule 2110 fall into two categories:

> [S]ome types of misconduct, such as violations of federal securities laws and NASD Conduct Rules, are viewed as violations of Conduct Rule 2110 without attention to the surrounding circumstances because members of the securities industry are expected and required to abide by the applicable rules and regulations. E.g. In re L. H. Alton & Co., et al., Exch. Act Rel. No. 40886 at 5 (Jan. 6, 1999) (violations of the net capital rule were violations of Conduct Rule 2110) . . . Other types of violations . . . are viewed as violations of Conduct Rule 2110 only if the surrounding facts or circumstances indicate that the conduct was unethical. The concepts of excuse, justification, and 'bad faith' may be employed to determine whether conduct is unethical in these cases.

"Good faith," though relevant to sanctions (Webb, No. C8A980059, slip op. at 25 (NAC, Nov. 6, 2000)), is, therefore, not a defense to charges of FINOP liability under Rule 2110.

D. _____'s Other Contentions

Relying on _____ to "take care of" the matter cannot suffice. A FINOP has an independent responsibility to assure the firm's compliance with financial requirements and cannot shift those duties to the firm or its officers. Barbera, 2000 SEC LEXIS 2319, at *19; Gerhauser, 1998 SEC LEXIS 2402, at *33, fn. 40; Gevaryahu, 1993 SEC LEXIS 2791, at *7-*8; Arthur Stelmack, Exch. Act Rel. No. 35100, 1994 SEC LEXIS 4049, at *8, fn. 10 (Dec. 13, 1994) (off-site FINOP); Wallace G. Conley, Exch. Act Rel. No. 31913, SEC LEXIS 367, at *6 (Feb. 24, 1993); Webb, No. C8A980059, slip op. at 13 (NAC, Nov. 6, 2000).

Narrow exceptions to FINOP liability, articulated in Webb, No. C8A980059, slip op. (NAC, Nov. 6, 2000), are inapplicable here. This is not a case where _____ or his firm withheld information which "made it impossible for [_____] to discover and report" (Id. at 14). There is no evidence that anyone hid anything from _____ or _____. Nor is this a case where the FINOP is excused because he made inquires and took steps to document the legitimacy of an item which turned out to be a non-allowable asset (Id. at 15). On the contrary, _____ failed to make inquiries, a circumstance which supports his liability as a FINOP for the firm's net capital violations.

_____ contends that his decision that _____required only a limited degree of supervision was reasonable because the firm had been well-capitalized in the past, it did not engage in significant trading, and _____ and another experienced securities professional provided daily oversight (Post-Hearing Memorandum, pp. 4-8). Perhaps that judgment was appropriate when made, several years before the events at issue. However, it does not justify _____'s inattention in May of 1999, after learning that the firm's excess net capital had suddenly declined from several million dollars to $163,914 because of an acquisition which "stood out plain as day," and which _____ himself recognized as a "very, very significant quantum leap in what the firm was doing." At that point, the limited level of supervision, however reasonable and successful in the past, needed to be increased.

Mr. _____ argues that the acquisitions which led to _____ net capital violations were unforeseeable, and that the equally unforeseeable illness of _____'s mother prevented _____ from notifying _____ of those positions (Post-Hearing Memorandum, pp. 1, 13-15, 20, 23, 25). These contentions are not defenses.

Nothing in the cases makes FINOP liability turn on the concept of foreseeability. Moreover, even if some events were wholly unforeseeable, _____ nevertheless learned of the Anadarko position

and the firm's resulting decline in excess net capital on May 20, 1999. He could have then advised _____ fully about the adverse net capital consequences of this or any future acquisition of that magnitude and would have likely headed off many of the firm's net capital violations.

Citing Richard J. Rouse, Exch. Act Rel. No. 32658, 1993 SEC LEXIS 1831, *12, fn. 14 (July 19, 1993), Respondent urges that "highly extraordinary extenuating circumstances" here preclude a finding of a violation of Rule 2110. In Rouse, the Commission found Respondent liable for submitting late responses to staff requests, but set aside a finding that he violated the "high standards" rule, noting the "highly extraordinary extenuating circumstances" (Id.). Rouse functioned under a "crisis atmosphere," which required 16 to 18 hour work days responding to various requests and ultimately left him as the firm's sole compliance employee (Id.). If "extraordinary extenuating circumstances" excuse FINOP liability—and no case so holds—such circumstances were not shown here. There was no "crisis" atmosphere surrounding _____ or _____. Nor is there any claim that _____ and his staff were so overworked that they could not have reacted timely to the warnings inherent in the discovery of a significant change in _____ trading pattern and the resulting decline in excess net capital.

_____ argues that _____'s pre-occupation with his mother's illness constituted an extraordinary extenuating circumstance because it prevented _____ from communicating with _____ (Post-Hearing Memorandum, pp. 24-26). In the Panel's view, _____'s liability cannot be excused on the ground that _____'s mother was ill. Though the illness was distressing and time-consuming, _____ testified that during that time, he nevertheless went to work on certain days, kept abreast of what was happening at the firm, and monitored _____ trading positions (Tr. 69). He was certainly not incommunicado or incapable of acting. During the time in question, he participated in

_____'s May 20 telephone conversation about the Anadarko holding and decided to sell 40,000 of the shares (Tr. 57-58, 70). There is no reason why _____ or _____ could not have at least attempted to follow up on _____'s initial alert. In light of the information available regarding the impact of the Anadarko position, _____, as the firm's FINOP, was obliged to follow up affirmatively. He cannot blame either _____ or _____'s mother's illness for his failure to do so.

If _____ had tried to follow up, he could have obtained the relevant information notwithstanding the illness. _____ Managing Director, Mr. _____, an experienced licensed securities principal and trader, shared responsibility for daily review and approval of the Firm's securities transactions (CX-3, p. 26). _____, who recognized that _____ and _____ were "responsible for what was going on" at the firm, said that _____ knew that "large positions generate large haircuts," and believed that he could make net capital calculations (Tr. 251, 253-254). _____'s presence at the firm was so significant that _____ furnished it as one of the bases underlying the limited oversight plan (CX-3, p. 22; Tr. 241, 250-253, 303).

Even if his mother's illness had temporarily taken _____ out of the firm (which it did not), Mr. _____ was still present. There is no claim that _____'s mother's illness had any impact on _____, and the record reflects no reason why _____ or _____ could not have pursued net capital matters with him.

Finally, _____'s argument for the "clear and convincing" standard of proof also lacks merit (Post-Hearing Memorandum, p. 18, fn. 8). It is well settled that the "preponderance of the evidence" is the standard of proof in NASD disciplinary proceedings. Steadman v. S.E.C., 450 U.S. 91, 96 (1981) (S.E.C. administrative proceeding); Gerald James Stoiber, Exch. Act Rel. No. 39565, 1998 SEC LEXIS 103 (Jan. 22, 1998). See also District Bus. Conduct Comm. v. Lawrence P. Bruno, 1998

NASD Discip. LEXIS 51, at *8 (NAC, July 8, 1998) (rejecting the "clear and convincing" standard). In any event, the facts establishing the instant violations were largely undisputed and liability is clear under either standard.

III. Sanctions

The NASD Sanctions Guidelines (2001) for net capital violations recommend a fine of $1,000 to $50,000 and a suspension of up to 30 days, or a longer suspension or bar in egregious cases (p. 33). Enforcement recommends a censure and a $7,500 fine (Tr. 397). The Panel finds several mitigating circumstances and concludes that a lower fine with no censure is the appropriate sanction.

Respondent's arrangement for limited oversight of _____was reasonable when it was adopted, considering the firm's history, nature, and personnel. According to _____, such tailoring of FINOP supervision to the circumstances of a particular firm accords with industry practice (Tr. 353).[9]

The Anadarko and other acquisitions, which led to _____ net capital deficiencies, represented a significant departure from the firm's historic trading pattern. Once he learned of the Anadarko acquisition, Respondent promptly directed _____, a CPA and experienced FINOP, to discuss it with _____. Respondent's mistake was in simply accepting the report that _____ would "take care of it" without following-up and inquiring about any other departures from the firm's historical trading practices.

There is no suggestion that _____ intentionally allowed _____(or any other client) to operate in net capital deficiency, or that he booked unallowable assets, concealed liabilities, or "parked" items. He said that he was in "shock" when he learned of _____ difficulties (Tr. 281), and the

[9] Enforcement objected to a later question about industry practice, arguing that _____ was a respondent and not an expert (Tr. 376-377). In fact, he had many times testified as an expert on FINOP matters (Tr. 236-237). Moreover, Enforcement made no objection when _____ was first asked about industry practice (Tr. 353). The Panel recognizes Respondent's self interest, but sees no reason to disregard his testimony.

circumstances corroborate that testimony. _____ did not attempt to conceal his errors; on the contrary, as soon as he learned of the deficiency, he had _____file notices alerting the appropriate authorities. The misconduct produced no monetary or other gain for him-indeed, it threatens to jeopardize his career.

The Panel has considered the important purposes of the net capital rule (see, e.g., Gerhauser, 1998 SEC LEXIS 2402, at *9), but concludes, on balance, that _____'s misconduct deserves a fine of $2,500, a number at the low end of the recommended range. As to a censure, the Sanction Guidelines state that "[a]djudicators generally should not impose censures" for net capital violations, where the total monetary sanctions are $5,000 or less (at pp. 12, 110-111). The Panel sees no reason to depart from that policy here.

Finally, the Panel directs that Respondent pay total costs of $3,966.58, reflecting $3,216.58 for transcripts, plus $750, the standard administrative fee.

IV. Conclusion

Respondent is liable under Rule 2110 for _____ Group's operations while in net capital deficiency. As a sanction he shall pay a fine of $2,500, plus a total of $3,966.58 in costs.[10]

HEARING PANEL

_____
Jerome Nelson
Hearing Officer

Dated: Washington, D.C.
July 6, 2001

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