

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT

Complainant,

v.

Respondent 1

and

Respondent 2

Respondents.

Disciplinary Proceeding
No. C07030065

Hearing Officer – AWH

Corrected Hearing Panel Decision¹

August 11, 2004

Member firm and registered financial and operations principal (FINOP) found liable for (1) filing a late annual audit report; (2) filing a materially inaccurate FOCUS report; and (3) maintaining books and records with inaccurate net capital computations. Member firm fined \$3,000 for filing a late annual audit report. Registered FINOP ordered to requalify by examination within 90 days or face suspension. Member firm and registered FINOP jointly and severally assessed costs of \$750.

Appearances:

Gene E. Carasick, Esq., and Joel R. Beck, Esq.,
for the Department of Enforcement

RM, Esq., for Respondent 1.

CM, Esq., for Respondent 2.

¹ This decision corrects the scope of the possible suspension the registered FINOP might face should he not requalify by examination with 90 days.

DECISION

Introduction

On September 24, 2003, the Department of Enforcement issued a three-cause Complaint in this matter against Respondent 1 (“CSI”) and Respondent 2 (“Respondent 2”), alleging that CSI, through Respondent 2, (1) filed a late annual audit report for the year ending December 31, 2000; (2) filed a materially inaccurate FOCUS report for the quarter ending December 31, 2000, that overstated net capital; and (3) maintained books and records with an inaccurate net capital computation for (a) January 31, 2001, which failed to take a blockage charge and overstated net capital; and (b) February 28, 2001, which failed to take a blockage charge, took an excessive haircut, and overstated net capital. Both CSI and Respondent 2 filed Answers to the Complaint and requested a hearing. A hearing was held in Atlanta, Georgia, on February 10, 2004, before a Hearing Panel, composed of the Hearing Officer and two current members of the District 7 Committee.

Post-hearing matters

At the conclusion of the hearing, the Hearing Panel deliberated, agreeing on findings of fact, conclusions of law, and appropriate sanctions. Thereafter, the Hearing Officer was to draft a written decision embodying those findings, conclusions, and sanctions, and, upon receipt of the hearing transcript, annotate the written decision with references to the transcript and the documentary evidence submitted at the hearing.

On February 27, 2004, the court reporting service advised the Hearing Officer that the court reporter assigned to cover the hearing was incapable of producing a transcript of the hearing from his stenographic notes, and his tape recorded back-up was incomplete,

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

due to a malfunction of the recorder. The Hearing Officer then sent the court reporting service an outline of the hearing, detailing the order of appearance and examination of witnesses, along with the identification of exhibits that had been received during the testimony of the various witnesses. From the audible excerpts of the tape back-up, another court reporter was able to produce a partial transcript. The partial transcript was then reviewed by the Hearing Officer, who edited the transcript to ensure its accuracy.

The parties were notified of the problem with the transcript during a telephone conference that was held on March 25, 2004. The Hearing Officer suggested four possible courses on which to proceed: (1) have the parties submit declarations detailing what they believed was contained in the missing testimony; (2) have the Hearing Panel issue a written decision, based on the documentary evidence, the partial transcript, and the notes of the Hearing Officer; (3) rehear the entire case; or (4) settle the matter on the basis of the sanctions that had been decided by the Hearing Panel.

The parties decided to proceed with the last option, and agreed in principal to settle the matter on the basis of the sanctions agreed upon by the Hearing Panel. However, after Enforcement drafted what it considered to be a standard form settlement agreement that complied with NASD Rules, the Respondents could not accept the format because it read as if it were a unilateral offer of settlement, rather than a joint settlement agreement.

A further telephone conference was held on May 11, 2004, in an attempt to resolve the matter. On May 12, 2004, the Respondents wrote to the Hearing Officer suggesting that the Hearing Panel could (1) issue its decision with an explanation of the problem regarding the transcript; (2) order a new hearing; or (3) dismiss the entire

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

proceeding. Respondents also stated that, “if there is a means to do so and assuming the NASD does the same, the Respondents are prepared to waive any right of appeal on the basis of the incomplete transcript, provided the Hearing Panel’s decision and order is consistent with the terms discussed on March 25th and as set forth in the draft settlement documents. We reserve the right to appeal any increase in the sanctions if the NAC were to do so.” By Reply, dated May 14, 2004, Enforcement took the position that the “only viable alternative” would be to issue the decision without benefit of the full transcript. If that alternative were chosen, Enforcement agreed not to appeal the decision based on the absence of a complete transcript.

The Hearing Panel agreed to issue the decision in the absence of a complete transcript, consistent with its deliberations following the hearing. In greater detail, the following are the findings, conclusions, and sanctions that were communicated to the parties during the March 25, 2004, telephone conference:

Findings of Fact²

I. The Respondents

Since March 1996, and at all times relevant to the Complaint, Respondent CSI has been an NASD member. CX 20. Respondent 2 first became registered with NASD in 1983. He has been associated with CSI since September 1995, and, since March 1996, has been registered through CSI as a general securities principal and as a financial and operations principal (“FINOP”). CX 21; Respondent 2 Answer, at ¶ 2. Since May 1999, Respondent 2 has been the president and chief financial officer of CSI, and DM has been

² References to Enforcement’s exhibits are designated as CX_; Respondents’ exhibits, as RX_; and the transcript of the hearing, as Tr_. References to affidavits, that were attached to Enforcement’s Motion for Summary Disposition and Respondents’ Opposition thereto, are designated by the name of the Affiant followed by Aff. _.

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

the chairman and chief executive officer of CSI. CX 20.

II. Filing of the Annual Audited Report

A. The two years preceding the 2000 annual audited report filing at issue

CSI's 1998 annual audited report, which was due on March 2, 1999, was timely tendered to NASD, but was rejected because the auditor's state license had not been renewed. Tr. 96-97; CX 9; DM Aff., at ¶ 11. On July 6, 1999, CSI's NASD membership was suspended for failing to file the annual audited report. CX 10. On August 20, 1999, CSI notified NASD that it had engaged another auditor to complete the annual report. After the report was filed, NASD challenged the amount of a haircut taken on some stock held by CSI. Tr. 98-99. As a result, the 1998 annual audited report was finally accepted by NASD 311 days after the date it was originally due to be filed. At that time, CSI's suspension was terminated, and CSI received a Letter of Caution concerning the late filing. CX 9.

On April 12, 2000, CSI's membership was suspended for failure to timely file its 1999 annual audited report. CX 11. Again, there was a dispute between NASD and the auditor over an amount included in the report. DM Aff., at ¶ 13. The suspension continued for 22 days, until the report was accepted by NASD.

B. The 2000 annual audited report filing and events leading up to that filing

In March 2000, CSI hired RD "as its CFO to oversee the preparation of its FOCUS reports and financial statements."³ Tr. 100; DM Aff., at ¶ 18. In the "latter part" of 2000, RD became "severely ill, to the point he could not be contacted." Tr. 104; DM Aff., at ¶ 19. In his absence, an office employee of CSI "inadvertently" filed the September FOCUS report, using the same information developed by RD for the June

³ The CRD record in evidence shows only Respondent 2 as the designated CFO. CX 20.

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

2000 FOCUS report. Tr. 105; DM Aff., at ¶ 22. The NASD supervisor of examiners, Richard Nichols, reported the error to CSI by letter dated December 11, 2000. RX 5. On January 10, 2001, DM wrote Nichols, informing him that he had hired a CPA who specializes in broker-dealers. RX 6. At some time unspecified by Respondents, CSI hired CPA RF to prepare and file the FOCUS reports. Tr. 107; DM Aff., at ¶ 19. RF prepared and filed an amended and corrected September 2000 FOCUS report. DM Aff., at ¶ 22.

At some time unspecified by Respondents, before the December 2000 FOCUS report was due to be filed, DM was searching for a replacement for RD and was concerned that the December 2000 FOCUS report could not be prepared on time “because no one else had the knowledge, experience or information that Mr. RD had.” *Id.*, at ¶ 24. On January 30, 2001, DM wrote to Clint Johnson, the NASD field supervisor assigned to examine CSI, asking for an extension of time to file the December 2000 FOCUS report to coincide with the filing of the annual audited report “which [CSI was] currently preparing”, and noting that he was unaware that the September FOCUS report, prepared by CSI’s “independent CPA,” did not match its Balance Sheet. RX 7. Mr. Nichols denied the request for an extension, finding that DM cited no “unusual circumstances which fall beyond the control of the firm which would prevent the firm from filing a timely report.” RX 8.

CSI’s 2000 annual audited report was due to be filed on March 1, 2001. At some time “just prior” to the due date, CSI’s auditor resigned, telling DM that “it was too much bother to deal with the NASD for such a small amount.” DM Aff., at ¶ 14. On March 20, 2001, CSI was notified of a possible suspension of its NASD membership for failure

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

to file its 2000 annual audit report. CX 7, at 4. On March 23, 2001, DM wrote to Johnson, noting that his mother had passed away on March 6⁴, and that he had been out of town dealing with her funeral and estate. In that letter, DM asked for an extension of time to file the annual audited report. He stated, “Our auditor has informed us (while I was out of town) that because of his backlog he will be unable to finish our audit until after the first of May.”⁵ CX 5. Citing a Questions and Answers section of SEC Rule 17a-5, on March 26, 2001, Nichols denied the request for an extension because it was not received prior to the date upon which the annual audited report was due. Tr. 114-17; CX 6, CX 6A.⁶ A hearing on the possible suspension of CSI’s NASD membership was scheduled for May 25, 2001. CX 7, at 4. CSI’s annual audited report for the year 2000 was filed on May 18, 2001, 78 days late. CX 4. On May 23, 2001, the Department of Member Regulation moved to dismiss the suspension proceeding against CSI, based on the fact that the 2000 annual audited report had been filed. CX 7, at 4. The suspension hearing was canceled and the proceeding dismissed on May 24, 2001. CX 7, at 2.

III. The December 31, 2000 FOCUS Report

CSI filed its FOCUS Part IIA Report for the quarter ending December 31, 2000, on February 28, 2001, 34 days after it was due to be filed.⁷ CX 1. Pursuant to a Letter of Acceptance, Waiver and Consent, CSI paid a fine of \$1,000 for filing the FOCUS Report

⁴ DM’s affidavit states that her date of death was March 5, 2001. DM Aff. ¶ 15.

⁵ It is not clear from the record whether this auditor with the backlog is the same auditor who had resigned before the audited report was due to be filed on March 1, 2001. As discussed below, FVB was engaged as CSI’s auditor on April 17, 2001.

⁶ The Questions and Answers that refer to Rule 17a-5 are available on the NASD Manual Online at <http://cchwallstreet.com/nasd/>. The printed version of Rule 17a-5 that appears in the Code of Federal Regulations does not contain the Questions and Answers section. 17 CFR § 240.17a-5.

⁷ As noted previously, on January 30, 2001, five days after the December FOCUS report was due, CSI requested an extension of time to file the December FOCUS report. That request was denied.

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

late. CX 2. The December 2000 FOCUS Report stated that CSI's net capital was \$15,067; its minimum net capital requirement was \$5,000. CX 1. The Report was prepared by RF, using, as a model, information from the prior Reports prepared by RD. DM Aff., at ¶ 24.

After the December 2000 FOCUS report was filed, NASD's FOCUS system generated an exception report finding that CSI had a significant decrease in revenue items and a decrease in excess net capital from \$240,000 to \$10,000. Accordingly, the report also noted a "cumulative loss alert." CX 3. The exceptions were due to the decline in the price of 50,000 proprietary shares of Speedlane.com, Inc. stock ("SPDL") from \$7 to \$.25 per share. Johnson Aff., at ¶ 5. Johnson reviewed the exception report but decided not to request any backup documentation from CSI at that time. Rather, he decided to wait until he received CSI's annual audited report so that he would have audited financials with which to work. *Id.* at ¶ 6. As more fully discussed below, the 2000 annual audited report, which was filed on May 18, 2001, concluded that CSI's actual net capital as of December 31, 2000, was \$2,959, not \$15,067 as CSI had reported on its December 2000 FOCUS Report. CX 4.

IV. The Effect of a Blockage Charge on CSI's Net Capital Computations

In the course of reviewing CSI's net capital computations for January and February 2001, which were submitted to NASD on April 17, 2001, supervisor Johnson noticed that CSI failed to deduct a marketplace blockage charge⁸ attributable to the 50,000 share proprietary position CSI had in SPDL. CX 12. The NASD Guide to Rule

⁸ A blockage charge, or blockage haircut, applies to that portion of large blocks of securities that are, because of their size, considered to be non-marketable, and, therefore, are not considered part of a firm's net capital. NASD INTRODUCTION TO SEC RULES 15C3-1 AND 15C3-3, at 55 (1995).

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

Interpretations states that the “number of shares held by the broker/dealer that exceeds the aggregate of the most recent four-week interdealer trading volume should be considered non-marketable and subject to a 100 percent deduction from net worth.” CX 13 at 5.

The applicable four-week trading volume for SPDL in January 2001 was 200 shares; for February 2001, it was 100 shares. CX 14-15. Accordingly, the blocked volume of SPDL for January 2001 was 49,800 shares, and for February 2001, it was 49,900 shares. In calculating the blockage charges to be taken, Johnson multiplied the blocked volume by the then current price of \$1.031 per share, and arrived at a blockage charge of \$51,343.80, for January 2001, and \$51,446.90, for February 2001. CX 16.

Applying those blockage charges instead of the smaller haircut that CSI took on SPDL,⁹ Johnson concluded that CSI’s actual net capital was \$2,898 for January 2001, and \$1,834 for February 2001; CSI had overstated its January net capital by \$24,310, and its February net capital by \$24,398. Johnson Aff., at ¶ 11. In May 2001, CSI filed amended net capital computations for January and February 2001, reflecting the appropriate blockage charges, and a Rule 17a-11 notification for the resulting net capital deficiencies for those months.¹⁰ CX 17–19.

At the present time, CSI’s net capital is based on cash that has been deposited in a

⁹ FVB, CSI’s independent auditor since April 2001, testified and stated in his affidavit that he would have taken a 15 percent haircut with an undue concentration addition on the SPDL stock held by CSI. FVB Aff., ¶ 13. The undue concentration was not specified. Moreover, he could provide no basis for his opinion on the haircut or the undue concentration addition. Accordingly, the Hearing Panel gives no weight to his opinion.

¹⁰ On the notifications, DM wrote the following:

I have had a standing bid for this stock for three and one-half months from an independent party, which included December 2000 and January and February 2001, at a price which puts me in capital compliance. I object strongly to having to file this letter as I don’t believe I am in violation of my net capital requirements.

CX 19.

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

bank. Its net capital includes no securities. Tr. 88-89.

Discussion

Late Filed Annual Audit Report

Exchange Act Rule 17a-5(d)(5) requires broker-dealers to file an annual audited financial report not more than 60 days after the date of the financial statements contained in such report. CSI's 2000 audited financial report was due to be filed on March 1, 2001. After the due date, CSI requested an extension of time to file the 2000 annual audited report. That request was denied, and CSI was notified that a hearing would be held on May 25, 2001, to determine whether its membership should be suspended for failing to file that annual audited report. The hearing was never held because, on May 18, 2001, CSI filed its annual audited report, 78 days after it was due. By failing to file the report by March 1, 2001, CSI, acting through Respondent 2, the firm's Chief Financial Officer, violated Exchange Act Rule 17a-5. A violation of an Exchange Act Rule is also a violation of NASD Conduct Rule 2110 which requires adherence to "just and equitable principals of trade." *See, e.g., William H. Gerhauser*, Exchange Act Rel. No, 40,639, 1998 SEC LEXIS 2402 at *20 (Nov. 4, 1998).

Materially Inaccurate FOCUS Report

Exchange Act Rule 17a-5(a)(2)(iii) requires broker-dealers who neither clear customer transactions nor carry customer accounts to file FOCUS Report Part IIA on a quarterly basis. Inherent in that requirement is that the FOCUS Reports must be materially accurate. The filing of an inaccurate FOCUS Report is a violation of NASD Conduct Rule 2110. *See, e.g., DBCC No. 1 v. L.H. Alton & Company et al.*, Nos. C01960003 and C01960024, 1997 NASD Discip. LEXIS 60 (NAC Dec. 17, 1997); *aff'd.*,

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

Exch. Act Rel. No 40,886, 1999 SEC LEXIS 17, at *9 (Jan. 6, 1999).

On February 28, 2001, CSI filed its FOCUS Part IIA Report for the quarter ending December 31, 2000, showing its net capital as \$15,067. However, CSI's audited financial statements for 2000 showed that its net capital as of December 31, 2000, was actually \$2,959. Accordingly, CSI's quarterly FOCUS Report overstated its net capital by approximately \$12,000, and its net capital was actually below its \$5,000 minimum requirement. By filing a materially inaccurate FOCUS Report, CSI, acting through Respondent 2, violated NASD Conduct Rule 2110 and Exchange Act Rule 17a-5.

Recordkeeping Violations

Exchange Act Rule 17a-3(11) requires registered firms to make and keep current, on a monthly basis, a "record of the proof of money balances of all ledger accounts in the form of trial balances, and a record of the computation of aggregate indebtedness and net capital, as of the trial balance date" The failure to maintain accurate books and records violates that Rule, as well as NASD Conduct Rule 2110. *See, e.g., Dep't of Enforcement v. Christopher M. Block et al.*, No. C05990026, 2001 NASD Discip. LEXIS 35 (NAC Aug. 16, 2001).

In its January and February 2001 net capital computations, CSI overstated its net capital by approximately \$24,000, due to its failure to deduct the appropriate marketplace blockage charges attributable to a 50,000 share proprietary position in SPDL. Its actual net capital for those months was below its minimum requirement. When it was brought to CSI's attention by the NASD examiner, CSI filed amended net capital computations reflecting the correct blockage charge, and submitted a Rule 17a-11 notification for the net capital deficiency. By failing to maintain books and records that accurately stated its

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

net capital, CSI, through Respondent 2, violated Exchange Act Rule 17a-3 and NASD Conduct Rule 2110.

Sanctions

The Department of Enforcement does not consider the violations in this case to be egregious, and, therefore, it does not seek any suspensions, bars, or expulsions. In fact, Enforcement concedes that (1) the violations were not intentional, (2) there was no customer exposure as a result of the violations, and (3) CSI did not conduct a securities business on those days that it had net capital deficiencies and, therefore, did not violate the net capital rule. Finally Enforcement notes that CSI hired an independent contractor to prepare its financial statements and reports in order to ensure that these types of violations do not recur. In view of the foregoing, Enforcement requests that Respondents be censured and fined \$7,500, jointly and severally, for the violations alleged in all three causes of complaint, with the fine broken down as follows:

- (1) \$2,500 for the inaccurate December 2000 FOCUS Report;
- (2) \$3,000 for the late 2000 annual audited report, taking into account that 2000 was the third consecutive year CSI filed its audited report late; and
- (3) \$2,000 for the inaccurate January and February, 2001, net capital computations.

The Hearing Panel agrees that for the reasons articulated by Enforcement, this is not an egregious case. Moreover, the Hearing Panel finds that a number of sudden personnel and personal difficulties experienced by DM – who was, in the absence of Respondent 2’ active participation in the firm, responsible for the filings – contributed to the problems CSI had in filing fully accurate financial reports, and led to strained

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

relations between DM and NASD staff over the denial of CSI's requests for extensions of time to file reports. Nevertheless, Respondent 2, who had little to do with the events in this case, but remained as FINOP, is liable for any violations because he remained as CSI's FINOP, responsible for financial filings. However, as noted in their May 12, 2004, letter, Respondents "anticipate that Mr. Respondent 2 will retire as FinOp of Chadbourn Securities, Inc., in the next few weeks and does not intend to maintain his license."

Under the unique circumstances of this case, the Hearing Panel agrees that, as requested by Enforcement, CSI should be fined \$3,000 for filing a late annual report. In view of CSI's retention of an independent contractor to prepare its financial reports, and Respondent 2' intention not to maintain his license, the Hearing Panel does not believe that fines for the inaccurate FOCUS report or the inaccurate net capital computations would be remedial. However, the Hearing Panel determines that, to insure that any further continuation of Respondent 2' activity as a FINOP is consistent with his regulatory responsibilities, he should requalify by examination as a FINOP within 90 days or be suspended in that capacity until he so requalifies. Finally, Respondents, jointly and severally, will be assessed costs in the amount of \$750, an administrative fee. There have been no charges for the incomplete transcript.

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision C07030065.

Conclusion

CSI, is fined \$3,000 for filing a late annual audit report for the year ending December 31, 2000, in violation of Exchange Act Rule 17a-5 and NASD Conduct Rule 2110. Respondent 2, is ordered to requalify by examination as a financial and operations principal within 90 days or be suspended in that capacity until such time as he so requalifies. CSI and Respondent 2 jointly and severally, are assessed an administrative fee in the amount \$750.

The sanctions shall become effective on a date determined by NASD, but not sooner than 30 days from the date this Decision becomes the final disciplinary action of NASD.

SO ORDERED.

Alan W. Heifetz
Hearing Officer
For the Hearing Panel