BEFORE THE NATIONAL BUSINESS CONDUCT COMMITTEE

NASD REGULATION, INC.

In the Matter of District Business Conduct Committee For District No. 10 Complainant, v. Respondent Firm 1 and Respondent 2 Respondents.	DECISION Complaint No. C10950101 District No. 10 Dated: August 5, 1997

This matter was appealed by respondents Respondent Firm 1 (the "Firm") and Respondent 2 pursuant to NASD Procedural Rule 9310. For the reasons discussed below, we hold that the Firm, acting through Respondent 2, failed to maintain minimum net capital of $75,000 in violation of Conduct Rule 2110 (formerly Article III, Section 1 of the Rules of Fair Practice). We order that Respondent 2 and Respondent Firm 1 be fined $2,500 (jointly and severally) and assessed $871.50 in hearing costs and $750 in appeal costs (jointly and severally); and that Respondent 2 requalify by examination as a financial and operational principal ("FINOP") within six months of the decision becoming final, or to cease association in such capacity.

Background. Respondent Firm 1 has been a member of the Association since March 1979. Respondent 2 has been registered with the Association since September 1962 and has been associated with Respondent Firm 1 since 1978. Since 1979, and at all times relevant to this complaint, Respondent 2 has been registered as a FINOP and a general securities principal.

Facts

The complaint in this matter alleged that the minimum net capital requirement for a market maker under SEC Rule 15c3-1 was raised from $50,000 to $75,000 on January 1, 1994 and remained at that level until July 1, 1994 when it was raised to $100,000. The complaint alleged that the Respondent Firm 1, acting through Respondent 2, conducted a securities business on May 31, 1994 and failed to maintain minimum net capital of at least $75,000 as required on that date. The complaint alleged that Respondent Firm 1 maintained only $51,020 in capital, with a deficiency of $23,980, in violation of SEC Rule 15c3-1 and Conduct Rule 2110. The District Business Conduct Committee for District No. 10 ("DBCC") made findings consistent with the complaint.

The Securities and Exchange Commission ("SEC") adopted amendments to SEC Rule 15c3-1 in November 1992. These amendments generally raised the minimum net capital levels for broker/dealers. In order to assist members in understanding the amendments, the Association issued two Notices to Members, 92-72 and 93-30.

The Firm was conducting a securities business and was a market maker on May 31, 1994. The Firm was listed as making markets in four Nasdaq National Market stocks as of May 31, 1994 and in seven Nasdaq Bulletin Board stocks immediately before and after May 31, 1994. The Firm published bid and ask quotations, and updated those quotations during the period of May 25 through June 3, 1994. In addition, in response to a request, the Firm sent the NASD a form, dated October 6, 1993, on which the Firm checked off a box that indicated that the Firm was a market maker. The Firm also filed correct FOCUS reports in October, November, and December of 1993, showing a minimum net capital requirement of $50,000, which was the minimum for a market maker at that time.

Paragraph (a) of SEC Rule 15c3-1 provides that every "broker or dealer shall at all times have and maintain net capital no less than the greater of the highest minimum requirement applicable to its ratio requirement under paragraph (a)(1) of this section, or to any of its activities under paragraph (a)(2) of this section." Paragraph (a) further states that "[e]ach broker or dealer also shall comply with the supplemental requirements of paragraph[ ] (a)(4) . . . of this section."

Paragraph (a)(2)(iii) of SEC Rule 15c3-1 provides that a "dealer shall maintain net capital of not less than $100,000."[1] Pursuant to SEC Rule 15c3-1e (Appendix E to Rule 15c3-1) paragraph (c), the

[1] Paragraph (c)(8) of the Rule states that "the term 'market maker' shall mean a dealer."

$100,000 minimum net capital requirement for a dealer, which included a market maker, was phased in over time, as follows:

Minimum	**Effective Date**
$25,000	Until June 30, 1993
$50,000	July 1, 1993--December 31, 1993
$75,000	January 1, 1994--June 30, 1994
$100,000	July 1, 1994 forward

The supplemental requirement for a market maker in paragraph (a)(4) of SEC Rule 15c3-1 provides that a "market maker as defined in paragraph (c)(8) of this section shall maintain net capital in an amount not less than $2,500 for each security in which it makes a market." Paragraph (a)(4) further provides that "[u]nder no circumstances shall [a market maker] have net capital less than that required by the provisions of paragraph (a) of this section, or be required to maintain net capital of more than $1,000,000 unless required by paragraph (a) of this section." Since the Firm made markets in fewer than 15 stocks, paragraph (a)(4) did not operate to make the Firm's minimum net capital greater than that provided in paragraph (a) of SEC Rule 15c3-1. Thus, according to paragraph (a)(2)(iii) and Appendix E, on May 31, 1994, the Firm's net capital requirement was $75,000.

It was undisputed that in early 1994, acting upon the advice of its accountant, the Firm began filing FOCUS reports as an introducing broker, instead of as a market maker. The minimum net capital for an introducing broker at that time was $35,000, compared to $75,000 for a market maker. The Firm filed FOCUS reports for five months using the incorrect minimum.[2] On May 31, 1994, according to its FOCUS report, the Firm computed its net capital to be $55,000 with an excess of $20,000 over a minimum requirement of $35,000. At that time, based on the Firm's status as a market maker, its minimum net capital requirement actually was $75,000. Therefore, the Firm's net capital was $20,000 below the minimum.

The Firm's accountant worked on the Firm's annual financial statements, but not on its monthly FOCUS reports. The accountant reviewed the November 1992 changes in the net capital rules and advised the Firm that its net capital should be calculated as that of an introducing broker, rather than as that of a market maker. The accountant gave this advice although he was aware that the general import

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[2] The Firm's net capital as reported in its FOCUS reports for the first four months of 1994 was, respectively, $66,000, $60,000, $70,000 and $59,000. The Firm reported its minimum net capital during that period as $35,000, the appropriate amount for an introducing broker that was not a market maker.

of the changes in the net capital rules was to increase the minimum net capital for firms. He advised the Firm that its minimum net capital was reduced from $50,000 (the minimum for a dealer or market maker between July 1, 1993 and December 31, 1993) to $35,000 (the minimum for an introducing broker between January 1, 1994 and June 30, 1994).

In June 1994, the Association staff contacted Respondent 2 and informed him that he was in violation of the net capital rule. Although he did not understand and disagreed with that conclusion, Respondent 2 caused the Firm to withdraw from market making, thus bringing the Firm into compliance with Rule 15c3-1.

At the DBCC hearing, Respondent 2 and the Firm's accountant explained that they had calculated the Firm's minimum net capital as an introducing broker, since that seemed more appropriate to them in light of the fact that, in their view, the Firm's market-making activity was not extensive. In addition, they believed that a market maker only had to meet the per-stock requirements set forth in the beginning of paragraph (a)(4) of SEC Rule 15c3-1, and not (as explained later in paragraph (a)(4)) the requirements set forth in paragraph (a)(2).[3] The Firm's accountant did not understand that as a market maker, the Firm had to satisfy the requirements of both paragraphs (a)(2) and (a)(4) of the rule. During the DBCC hearing, the accountant stated that he had come to understand that his original interpretation of the Rule had been incorrect.

The changes to the net capital rule raised questions in the minds of Respondent 2 and the accountant. The accountant was particularly concerned, since he knew that the Firm was reducing its minimum net capital at a time when the general effect of the changes in SEC Rule 15c3-1 was to increase minimum net capital levels. Nonetheless, neither Respondent 2 nor the accountant called anyone at the NASD, nor did they consult with anyone outside of the accounting firm.

Discussion

Procedural Issues. On appeal, respondents object to the fact that the DBCC denied respondents' request to require the testimony of an Examiner, a former NASD employee. Respondents intended to have the former NASD employee testify about a conversation he had with Respondent 2 on January 17, 1995, in which the former NASD employee allegedly acknowledged that the net capital rules were complex and that he knew of four or five other firms who were experiencing difficulties similar to those of the Firm. We agree with the DBCC's decision not to require the former NASD employee's testimony. Even assuming the former NASD employee would have testified as respondents

[3] Notice to Members 93-30, however, clearly specified that a "firm that engages in more than one type of business will be required to maintain a minimum net capital equal to the highest requirement for any business conducted."

represented he would, that testimony would not change the outcome in this case. Therefore, respondents were in no way prejudiced by the DBCC's refusal to require the former NASD employee to testify.

Substantive Issues. We agree with the DBCC that respondents' reliance on the advice of the Firm's accountant is not a defense to a net capital violation. First, it was not appropriate for the Firm to rely upon its accountant to determine whether the Firm was a market maker or an introducing broker. The type of business in which the Firm is engaged is something the Firm should know. Second, the Commission consistently has held that reliance upon the advice of accountants does not shift the ultimate burden of compliance. In re Kirk L. Ferguson, 51 S.E.C. 1247 (1994); In re Livada Securities Co., 45 S.E.C. 578 (1974). As FINOP for the Firm, Respondent 2 was responsible for knowing how to comply with the net capital requirements. In re Kirk L. Ferguson, at 1249 n. 12.

Respondents argue that the Association did not question the fact that the Firm filed six FOCUS reports from January through May 1994 using the $35,000 minimum net capital level. We find that although this may be considered as a mitigating factor for sanctioning purposes, it is not a defense to the net capital violation. The Commission has held that a firm cannot shift to the NASD its responsibility for compliance with regulatory requirements. In re Sherman, Fitzpatrick & Co., Inc., 51 S.E.C. 1048 (1994); In re Troy A. Wetter, 51 S.E.C. 763, 766 n. 16 (1993). "[A] securities dealer cannot shift its compliance responsibility to the NASD. A regulatory authority's failure to take early action neither operates as an estoppel against later action nor cures a violation." In re William N. Whelan, Jr., 50 S.E.C. 282, 284 (1990).

In its decision, the DBCC ordered that Respondent 2 and Respondent Firm 1 be fined $2,500 (jointly and severally) and assessed $871.50 in hearing costs (jointly and severally); and that Respondent 2 be ordered to requalify by examination as a FINOP within six months of the decision becoming final. We agree with the DBCC that it is appropriate to require Respondent 2 to requalify as a FINOP to guard against similar problems in the future. We also agree with the DBCC's decision not to impose a censure. Finally, we affirm the $2,500 fine. This is the minimum fine recommended by the applicable NASD Sanction Guideline ("Guideline").[4] The minimum fine is appropriate in this case because of the following mitigating factors: (i) neither Respondent 2 nor the Firm acted with intent or in bad faith; (ii) we accept Respondent 2's explanation that he was confused by the net capital rule amendment; (iii) we also take note of Respondent 2's years of securities experience with no disciplinary history; and (iv) when informed that the Firm was in violation of the net capital rule, Respondent 2 caused the Firm to withdraw from market making, thus bringing the Firm into compliance with Rule 15c3-1. Nonetheless, the net capital rule is a strict liability rule and therefore we affirm the DBCC's finding of a violation and imposition of sanctions.

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[4] See Guidelines (1993 edition) at 30 (Net Capital Violations).

Accordingly, the Firm and Respondent 2 are fined $2,500 (jointly and severally) and assessed $871.50 in DBCC hearing costs and $750 in appeal costs (jointly and severally); and Respondent 2 is required to requalify by examination as a financial and operations principal within six months of the date of this decision becoming final, or to cease association in such capacity.[5]

On Behalf of the National Business Conduct Committee,

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Joan C. Conley, Corporate Secretary

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

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