

SECURITIES AND EXCHANGE COMMISSION
Washington, D.C.

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 52697 / October 28, 2005

Admin. Proc. File No. 3-11873

In the Matter of the Application of
FOX & COMPANY INVESTMENTS, INC.,

and

JAMES W. MOLDERMAKER

c/o Anthony W. Djinis, Esq.
Pickard and Djinis LLP
1990 M Street, N.W., Suite 660
Washington, D.C. 20036

For Review of Disciplinary Action Taken by

NASD

OPINION OF THE COMMISSION

REGISTERED SECURITIES ASSOCIATION -- REVIEW OF DISCIPLINARY
PROCEEDINGS

Failure to Comply with Net Capital, Recordkeeping, and Reporting Requirements

Conduct Inconsistent with Just and Equitable Principles of Trade

Where (1) member firm of registered securities association conducted, and financial and operations principal permitted member firm to conduct, a securities business without sufficient net capital; (2) member firm maintained, and financial and operations principal caused, materially inaccurate books and records; and (3) member firm filed, and financial and operations principal caused it to file, materially inaccurate FOCUS reports, held, association's findings of violations and the sanctions it imposed are sustained.

APPEARANCES:

Paul J. Bazil and Peter E. McLeod, of Pickard and Djinis LLP, for Fox & Company Investments, Inc. and James W. Moldermaker.

Marc Menchel, James S. Wrona, and Michael J. Garawski, for NASD.

Appeal filed: March 24, 2005

Last brief received: June 28, 2005

I.

Fox & Company Investments, Inc. ("FOX" or the "Firm"), a registered broker-dealer, and James W. Moldermaker, its principal owner and president and, among other capacities, its general securities principal, municipal securities principal, and financial and operations principal ("FINOP"), appeal from NASD disciplinary action. NASD found that: (1) FOX conducted, and Moldermaker permitted it to conduct, a securities business without sufficient net capital; (2) FOX maintained, and Moldermaker caused, materially inaccurate books and records; and (3) FOX filed, and Moldermaker caused it to file, materially inaccurate Financial and Operational Combined Uniform Single ("FOCUS") reports. 1/ For the net capital, recordkeeping, and FOCUS report violations, NASD fined FOX and Moldermaker \$25,000, jointly and severally, and barred Moldermaker from associating with any member firm as a FINOP. On appeal, FOX and Moldermaker (together, "Applicants") challenge only NASD's findings of net capital, recordkeeping, and FOCUS report violations with respect to the failure to book an arbitration liability, and the sanctions imposed for those violations. We base our findings on an independent review of the record.

II.

FOX became an NASD member in 1987. Moldermaker has been registered with FOX in various principal capacities since the Firm's inception. Moldermaker is responsible for computing the Firm's net capital, overseeing preparation of the Firm's books and records, and supervising the preparation and filing of the Firm's FOCUS reports. At the time of the events at issue, FOX was required to maintain \$250,000 in net capital. 2/

In October 1998, five former customers of FOX filed an arbitration claim against

1/ NASD also found that FOX and Moldermaker failed to report to NASD the arbitration claim at issue in this proceeding and failed to file an amended Form U-5 disclosing the allegations raised in the arbitration claim. NASD fined Applicants \$10,000, jointly and severally, and suspended Moldermaker in all supervisory and principal capacities for ten business days for these violations. On appeal, Applicants challenge neither these findings nor those sanctions.

2/ See 17 C.F.R. § 240.15c3-1(a)(2)(i). FOX does not dispute that, at the time of the events at issue, it was a broker-dealer that carried customer accounts and received and held customer funds, thus subjecting it to the \$250,000 minimum net capital requirement.

Moldermaker, FOX, the Firm's clearing broker, and David Gwynn, a former registered representative of the Firm. The arbitration claim alleged, among other things, breach of contract and conspiracy to commit fraud in connection with the failure to execute certain stop-loss orders, among other trading violations.

In January 1999, Moldermaker and FOX filed a claim against the Firm's errors and omissions liability insurance policy and tendered their defense of the arbitration claim to their insurance carrier. On February 23, 1999, the insurance carrier issued to Applicants a "reservation-of-rights" letter acknowledging receipt of the claim, accepting the tender, and indicating that the insurance policy had a \$1 million "limit of liability" (the "Reservation-of-Rights Letter"). ^{3/} The insurance carrier reserved the right not to pay the arbitration claim if the claim did not fall within the scope of the insurance policy. In particular, the Reservation-of-Rights Letter cautioned that the insurance carrier would not pay the arbitration claim if an insured party had admitted liability "without the [insurance carrier's] prior written consent" or "if it is established that [Gwynn] and/or [FOX] benefited from unlawful profits or committed fraud." ^{4/}

On December 27, 2001, an arbitration panel issued an arbitration award against FOX, Moldermaker, and the other respondents in the arbitration case, jointly and severally, in the aggregate amount of \$983,992. A copy of the award was sent by facsimile transmission to Applicants on December 28, 2001, although, due to the holiday weekend, Moldermaker did not see the award until January 2, 2002. In January 2002, FOX's insurance carrier petitioned to vacate the arbitration award on behalf of Moldermaker and FOX, which stayed Applicants' obligation to pay the award. ^{5/}

On January 25, 2002, Moldermaker filed with NASD FOX's FOCUS report for the quarter ending December 31, 2001 (the "December FOCUS report"). Moldermaker did not book the arbitration award as a liability in the Firm's books and records nor include it in his calculation of the Firm's net capital in the December FOCUS report. The December FOCUS report indicated a positive net capital of \$453,985, an excess of \$203,985 over the Firm's net capital requirement of \$250,000. ^{6/}

^{3/} A reservation-of-rights letter is "a notice of an insurer's intention not to waive its contractual rights to contest coverage or to apply an exclusion that negates an insured's claim." Black's Law Dictionary 1334 (8th ed. 2004).

^{4/} The Reservation-of-Rights Letter indicated that, if Gwynn, who was an insured party, had "made admissions regarding the stop loss order(s) in question," as alleged by the arbitration claimants, such "alleged admission by Mr. Gwynn may have breached" the clause in the insurance policy forbidding the admission of liability.

^{5/} NASD Code of Arbitration Procedure Rule 10330(h) provides that "[a]ll monetary awards shall be paid within thirty (30) days of receipt unless a motion to vacate has been filed with a court of competent jurisdiction." NASD Manual at 7587 (Apr. 2000).

^{6/} NASD did not charge FOX with conducting, and Moldermaker for permitting FOX to

On February 5, 2002, Moldermaker telephoned Roger Hogoboom, an NASD Enforcement attorney, to urge him to investigate Gwynn. During the conversation, Hogoboom learned that FOX was subject to an adverse arbitration award. Hogoboom instructed Moldermaker that FOX should "book the award as a liability consistent with the net capital rule and NASD rule in their interpretation." At the hearing, Hogoboom testified that Moldermaker assured him that the insurance company would pay the arbitration award. According to Hogoboom, Moldermaker did not ask him how to book an arbitration award covered by liability insurance, whether such insurance could be recorded as an asset, nor how to account for the joint and several nature of the award. 7/

Following the telephone conversation, Hogoboom notified David Lapham, the NASD "assigned supervisor" for FOX, of the arbitration award. Lapham then reviewed FOX's December FOCUS report and determined that the arbitration award, which was not reflected in that report, had put the Firm in a negative net capital position. On February 6, 2002, Lapham, together with another NASD staff person, telephoned Moldermaker "to discuss the impact of the arbitration award." Moldermaker informed Lapham that the telephone call was "on a recorded line," and proffered a transcription of the conversation (the "Transcript") into evidence at the hearing. 8/

conduct, a securities business with insufficient net capital on December 31, 2001.

7/ Moldermaker disputes this point, asserting that he specifically asked Hogoboom how to book an arbitration award covered by liability insurance.

8/ Applicants contend that they were prejudiced by the exclusion of the Transcript from evidence at the hearing and argue that the Transcript should be admitted now. The Hearing Officer excluded the Transcript from evidence on the grounds that "it should have been included in the prehearing record" and "[was] irrelevant to the issue before [the hearing panel,]" but permitted Moldermaker to read portions of the Transcript as necessary during his cross-examination of Lapham to refresh Lapham's recollection and to examine Lapham at length about the Transcript. NASD affirmed the Hearing Officer's decision. NASD Procedural Rule 9261(a) requires each party to submit to the other parties and to the Hearing Officer "copies of documentary evidence" expected to be presented at the hearing no later than ten days beforehand. NASD Procedural Rule 9261(c) permits a party, "for good cause shown," to adduce additional evidence at the hearing as the Hearing Officer in his discretion determines "may be relevant and necessary for a complete record." While Hearing Officers have broad discretion in making evidentiary rulings, the Transcript here was clearly relevant: NASD's brief on appeal, in faulting Moldermaker for not attempting to introduce the evidence prior to the hearing, points to the inclusion of Lapham on NASD's witness list and the obvious importance of the February 6, 2002 conversation. We find Moldermaker's statement at the hearing that "he didn't think he needed to" include the Transcript in his pre-hearing submission a plausible explanation by a non-lawyer for the fact that he did not appreciate in advance that Lapham's testimony might deviate from the Transcript. The various factors identified by NASD concerning the ability of Moldermaker to authenticate the

Both the Transcript and the testimony at the hearing make clear that, during this conversation, Lapham advised Moldermaker to book the arbitration award as a liability on the Firm's books and records, as provided in the NASD Guide to Rule Interpretations. Lapham also told Moldermaker that, with the award as a liability, FOX did not appear to have the required net capital with which to conduct business and that, accordingly, Moldermaker should file a notice to that effect with the Commission pursuant to Rule 17a-11 under the Securities Exchange Act of 1934. ^{9/} Moldermaker disagreed with Lapham, arguing both that the award had been appealed and that it was covered by insurance. Moldermaker stated that he was "well aware" of the NASD Guide to Rule Interpretations requirement that an arbitration award be booked as a liability, but described that requirement as "antiquated" because it did not take into account the fact that member firms possess insurance coverage for such liabilities. Lapham advised Moldermaker that, because the grounds for any appeal were narrow, and until the insurance carrier paid for the arbitration award, the award should be booked as a liability.

Following Lapham's discussion with Moldermaker, NASD staff faxed to Moldermaker a letter confirming Moldermaker's obligation "to post the liability resulting from this arbitration award to [FOX's] books and records," directing him to file an Exchange Act Rule 17a-11 notice, and warning him not to "conduct a securities business unless [he had] sufficient capital to meet the requirements of the net capital rule." On February 7, 2002, Moldermaker sent to NASD a letter that he described as an Exchange Act Rule 17a-11 notice "of [NASD's] claim of our deficiency and our position on this issue." In the letter, he promised that FOX's "January 2002 [FOCUS] filing will reflect any award, if applicable, as we have done in the past." ^{10/}

On February 26, 2002, Moldermaker filed with NASD FOX's FOCUS report for the month ending January 31, 2002 (the "January FOCUS report"). Neither the Firm's statement of financial condition nor the net capital computation in that report included the arbitration award as a liability. The January FOCUS report indicated a positive net capital of \$643,119 and excess net capital of \$393,119. Had Moldermaker deducted the \$983,992 arbitration award amount from reported excess net capital, FOX's net capital position on January 31, 2002 would have

Transcript are more pertinent to the probative value of the document than to its admissibility. We evaluate hearsay for its probative value, reliability, and the fairness of its use. Cf. Edgar B. Alacan, Securities Exchange Act Rel. No. 49970 (July 6, 2004), 83 SEC Docket 842, 856-57 (observing that we have held, repeatedly, that "hearsay evidence is admissible in our administrative proceedings" and may constitute the sole basis for findings of fact); Harry Gliksmann, 54 S.E.C. 471, 480 (1999) (internal citations omitted), aff'd, 24 Fed. Appx. 702 (9th Cir. 2001). Since Lapham himself appears to have accepted the veracity of the document, we see no reason why it should not, under the circumstances of this case, be admitted and we accordingly do so. For the reasons discussed below, we have determined to include the Transcript in the record, and include our review of that document in the basis for our findings of fact.

^{9/} 17 C.F.R. §§ 240.17a-11(b) and (g).

^{10/} Moldermaker also noted in the letter that he had "not received the anticipated information from [NASD] on how to [book a joint and several award] correctly because it is a fully covered award."

been approximately negative \$530,873 and resulted in a net capital deficiency exceeding \$780,000. Upon discovering FOX's omission of the arbitration award from the January FOCUS report, NASD staff requested copies of financial records from the Firm. 11/

On February 28, 2002, NASD staff contacted FOX concerning the failure to book the arbitration award. NASD staff informed FOX 12/ that the Firm might have been able, and still might be able, to claim the insurance coverage as an allowable asset, and faxed to the Firm a copy of the net capital rules outlining the conditions under which certain insurance claims could be classified as allowable assets (the "insurance claim provision") 13/ together with a copy of the NASD Guide to Rule Interpretations requirement regarding the treatment of arbitration awards as liabilities.

Under the insurance claim provision, an insurance claim may be classified as an allowable asset if there is an acknowledgment by the insurance carrier that the insurance claim is "due and payable." NASD contacted FOX to request documentation that might contain such an acknowledgment. 14/ On March 18, 2002, NASD staff received a letter from FOX's insurance

11/ In reviewing these records, NASD staff discovered two additional discrepancies. Their analysis of FOX's January 31, 2002 balance sheet revealed that the Firm had recorded a \$190,000 capital infusion, which they traced to two checks which were not deposited into the Firm's bank account until February 6, 2002. These checks were recognized as cash assets in FOX's general ledger on January 31, 2002, identified as "Additional Paid-in Capital" on the Firm's January 31, 2002 balance sheet, included in FOX's net capital computation, and reflected in the January FOCUS report. Moldermaker confirmed at the hearing that the \$190,000 was booked on FOX's general ledger on January 31, 2002. In the proceeding below, NASD found that this improperly-booked amount contributed to the books and records, FOCUS report, and net capital violations. Applicants do not challenge these findings on appeal. NASD staff also identified a \$300,000 line of credit that FOX had booked as an asset and included as a corresponding liability on the Firm's January 31, and February 28, 2002 balance sheets. The line of credit was backed by a promissory note in Moldermaker's name for \$300,000. Moldermaker had obtained the line of credit in his individual name and pledged the \$300,000 to FOX as a "subordinated loan" in January 2002 without obtaining the requisite prior approval from NASD to treat the line of credit as a subordinated loan. The \$300,000 credit line was drawn down and deposited into the Firm's bank account on March 19, 2002. In the proceeding below, NASD found that the \$300,000 was improperly recorded on FOX's books and records. Because a corresponding liability offset the \$300,000 asset, this amount did not contribute to any errors in the net capital calculation in the January and February FOCUS reports, or to the Firm's net capital deficiency. Applicants do not challenge this books and records violation on appeal.

12/ Because Moldermaker was not available, NASD staff spoke with a FOX accountant.

13/ 17 C.F.R. § 240.15c3-1(c)(2)(iv)(D).

14/ In response to NASD's request for such documentation, the Firm provided NASD staff with a copy of the Reservation-of-Rights Letter. NASD staff determined that the Reservation-of-Rights Letter did not satisfy the insurance claim requirements of the net

carrier declaring that defense costs had consumed \$277,347 of FOX's \$1 million insurance coverage, and that only \$722,653 remained available to satisfy the arbitration award "subject to further erosion due to continuing defense costs." NASD staff concluded that this letter failed to satisfy the requirements of the net capital rule because the letter did not state that the claim was "due and payable."

On March 20, 2002, during a conference call among NASD staff, Moldermaker, and the Firm's insurance carrier, NASD staff informed Moldermaker that he could treat FOX's insurance coverage as an allowable asset for net capital computation purposes only if the insurance carrier would represent, without reservation-of-rights, that it would pay the coverage remaining under the insurance policy to satisfy the arbitration award if the award was not set aside. The insurance carrier protested that it could not issue such a guarantee because it would be giving up its right to possible avenues of recourse if it did so. ^{15/}

On March 25, 2002, Moldermaker filed with NASD FOX's FOCUS report for the month ending February 28, 2002 (the "February FOCUS report") and on the same day submitted to NASD an alternative FOCUS report for the same period (the "unofficial FOCUS report"). The February FOCUS report booked the arbitration award as a liability but also included FOX's insurance coverage as an allowable asset, which resulted in a positive net capital computation of \$510,378. ^{16/} The unofficial FOCUS report booked the arbitration award as a liability and treated FOX's insurance coverage as a non-allowable asset, which resulted in a negative net capital of \$212,275 and a net capital deficiency of \$462,275. In his letter accompanying the unofficial FOCUS report, Moldermaker stated that he had "a problem submitting a FOCUS report for February with an obvious net capital violation . . . I hope this will appease everyone involved, especially since the capital has been deposited and any alleged deficiencies are now a moot point." ^{17/}

On June 9, 2003, NASD's Department of Enforcement filed a complaint against

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- capital rule permitting classification of the insurance claim as an allowable asset.
- ^{15/} The insurance carrier later submitted to NASD another letter, dated April 5, 2002, stating 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], James Moldermaker and/or David Gwynn." At the hearing, NASD's Director of Financial Operations for its Department of Member Regulation asserted that the April 5 letter "[c]ame about [ninety] percent close" but ultimately was inadequate because it "didn't say who was going to determine whether or not [FOX] was liable."
- ^{16/} Applicants only booked as an allowable asset the \$722,653 of the insurance claim that remained available. The February FOCUS report again included the \$190,000 in cash assets and the \$300,000 personal line of credit.
- ^{17/} The amount "deposited" to which he was referring was the \$190,000 in checks deposited into FOX's bank account on February 6, 2002 as paid-in capital. Around December 2002, the arbitration claim settled for approximately \$775,000. FOX's insurance carrier contributed \$612,687 toward the settlement amount, the balance of the Firm's insurance policy limits, while Applicants paid the remainder.

Applicants. NASD found that, on January 31, and February 28, 2002, FOX conducted a securities business without sufficient net capital, in violation of Exchange Act Rule 15c3-1 and NASD Conduct Rule 2110. NASD also found that Moldermaker, as FOX's president and FINOP, permitted FOX to conduct a securities business on those two dates without sufficient net capital, in violation of NASD Conduct Rule 2110. Specifically, NASD determined that FOX avoided reporting a net capital deficiency on January 31, 2002 by failing to account for the arbitration award as a liability and by recognizing, prematurely, cash assets of \$190,000 on its January 31, 2002 balance sheet. ^{18/} NASD also determined that, despite booking the arbitration award as a liability on February 28, 2002, FOX improperly offset that liability by classifying its insurance claim as an allowable asset. NASD found further that, on or about January 31, and February 28, 2002, FOX maintained materially inaccurate books and records in violation of Exchange Act Rule 17a-3 and NASD Conduct Rules 3110 and 2110. In addition, NASD found that Moldermaker caused material inaccuracies in those required books and records in violation of NASD Conduct Rules 3110 and 2110. ^{19/} NASD also found that FOX submitted materially inaccurate FOCUS reports for the December 2001, January 2002, and February 2002 reporting periods, in violation of Exchange Act Rule 17a-5 and NASD Conduct Rule 2110. NASD found further that Moldermaker caused the submission of those materially inaccurate FOCUS reports, in violation of NASD Conduct Rule 2110.

III.

A. Net Capital Violations

The principal purposes of the net capital rule are to protect customers and other market participants from broker-dealer failures and to enable those firms that fall below the minimum net capital requirements to liquidate in an orderly fashion without the need for a formal proceeding or financial assistance from the Securities Investor Protection Corporation. ^{20/} The

^{18/} Applicants challenge neither the finding that they recognized the \$190,000 in cash assets as paid-in capital in error on FOX's January 31, 2002 balance sheet nor the finding that they included Moldermaker's personal credit line as an asset, offset by a corresponding liability, on the Firm's January 31, and February 28, 2002 balance sheets.

^{19/} Violations of NASD rules such as NASD Conduct Rule 3110 constitute conduct inconsistent with the just and equitable principles of trade provisions of NASD Conduct Rule 2110. See, e.g., E. Magnus Oppenheim & Co., Exchange Act Rel. No. 51479 (Apr. 6, 2005), 85 SEC Docket 475, 478 (holding that a violation of another NASD rule is also a violation of NASD Conduct Rule 2110); Chris Dinh Hartley, Exchange Act Rel. No. 50031 (July 16, 2004), 83 SEC Docket 1239, 1244 (same); Stephen J. Gluckman, 54 S.E.C. 175, 185 (1999) (same).

^{20/} Rel. No. 34-48690 (Oct. 24, 2003), 81 SEC Docket 1719, Alternative Net Capital Requirements for Broker-Dealers That Are Part of Consolidated Supervised Entities, Proposed Rule, 68 Fed. Reg. 62872 (Nov. 6, 2003). See also Paul Joseph Benz, Exchange Act Rel. No. 51046 (Jan. 14, 2005), 84 SEC Docket 2631, 2634; Lowell H. Listrom, 50 S.E.C. 883, 886 (1992), aff'd, 975 F.2d 266 (8th Cir. 1992) (Table).

net capital rule requires a broker-dealer to use the accrual method of accounting in calculating its net worth, in accordance with generally accepted accounting principles. 21/ All accrued liabilities must be included unless specifically excluded by the net capital rule or an interpretation. 22/ As we stated in Wallace G. Conley, "losses that are contingent upon the happening of a future event must be accrued as liabilities where the loss can be reasonably estimated, and . . . the contingency is probable." 23/

Here, FOX's loss could be estimated reasonably as the total arbitration award amount of \$983,992. Moreover, the contingency that the arbitration award would occur was probable. The NASD Guide to Rule Interpretations provides that a "broker/dealer that is the subject of an adverse award in an arbitration proceeding should book" the 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." 24/ Therefore, FOX and Moldermaker should have accounted for the arbitration award in the calculation of FOX's net capital for January 31, 2002.

While FOX booked the arbitration award as a liability on its February 28, 2002 balance sheet, it offset that liability by treating its insurance coverage as an allowable asset, which contributed to a positive net capital computation for the Firm on that date. However, pursuant to the net capital rule, "assets which cannot be readily converted into cash" must be deducted from a broker-dealer's net worth for purposes of calculating net capital. Such deductible assets include:

[1] Insurance claims which, after seven (7) 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; [2] insurance claims which after twenty (20) business days from the date the loss

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- 21/ Troy A. Wetter, 51 S.E.C. 763, 765 (1993). See also Rel. No. 34-18737 (May 13, 1982), Net Capital Requirements for Brokers and Dealers, 47 Fed. Reg. 21579 (May 20, 1982).
- 22/ Wetter, 51 S.E.C. at 765.
- 23/ Wallace G. Conley, 51 S.E.C. 300, 302 (1993) (noting that, given the narrowness of grounds for appeal, confirmation of arbitration award was "virtually certain"). See also FASB Statement of Financial Accounting Standards No. 5, ¶¶ 3 and 8 (2001/2002).
- 24/ Accord, see Conley, 51 S.E.C. at 302. The standard of review for an arbitration award is "extremely narrow" and a court may vacate an arbitration award "only upon a showing of one of the statutory grounds listed in the Arbitration Act, . . . if the arbitrators acted in manifest disregard of the law, . . . or if the award is incomplete, ambiguous, or contradictory" Transit Cas. Co. v. Trenwick Reinsurance Co., Ltd., 659 F. Supp. 1346, 1350-51 (S.D.N.Y. 1987) (internal citations omitted), aff'd, 841 F.2d 1117 (2d Cir. 1988) (Table); Denver & Rio Grande W. R.R. v. Union Pac. R.R., 119 F.3d 847, 849 (10th Cir. 1997) (describing the courts' powers of review over arbitration awards as being so limited as to be among the narrowest known to the law).

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 [3] insurance claims acknowledged in writing by the carrier as due and payable outstanding longer than twenty (20) business days from the date they are so acknowledged by the carrier[.] 25/

It is undisputed that at no time did FOX have an opinion of outside counsel attesting to the validity of its insurance claim and that the claim was covered by policies then in effect. Thus, the first and second tests outlined above are inapplicable here. Applicants do not dispute this point.

The only other basis on which the claim could be included as an allowable asset is if, as of the applicable net capital calculation dated February 28, 2002, FOX's insurance claim was acknowledged in writing by its insurance carrier as "due and payable" and, if so, the claim was outstanding less than twenty days from the date it was so acknowledged by the insurance carrier. None of the three letters from FOX's insurance carrier provided FOX with the right to include the claim as an allowable asset under the insurance claim provision.

The Reservation-of-Rights Letter simply noted receipt of the claim, the financial limits of the policy, and circumstances under which the claim would not be due and payable. The second and third letters were not received until after the two dates of noncompliance with the net capital rule at issue here, January 31, and February 28, 2002, and therefore could not be used to include the claim as an allowable asset on those dates. Moreover, the March 18, 2002 letter represented that only \$722,653 of coverage remained available to satisfy the arbitration award and indicated that even that amount was "subject to further erosion" due to litigation costs, raising the very real possibility that the insurance policy would not have sufficient funds remaining to pay the award. The letter did not acknowledge that payment of any funds remaining at the conclusion of the litigation was "due and payable" as required by the insurance claim provision. 26/ Accordingly,

25/ 17 C.F.R. § 240.15c3-1(c)(2)(iv)(D) (the "insurance claim provision").

26/ Indeed, as discussed above, the March 20, 2002 conference call with FOX's insurance carrier made clear that this omission was not an oversight. Because an insurer's duty to defend a claim is broader than its duty to indemnify, the insurer may be obligated to defend against actions which are not actually covered under its policy. See Tews Funeral Home, Inc. v. Ohio Casualty Ins. Co., 832 F.2d 1037, 1042 (7th Cir. 1987). Of particular concern here were the allegations of fraud and the possibility that Gwynn had breached a clause in the insurance policy proscribing the admission of liability, a finding of either of which would have invalidated the insurance claim.

We do not reach a determination as to whether the April 5, 2002 letter would have satisfied any of the tests set forth in the insurance claim provision because the letter was issued well after the February FOCUS report.

we conclude that FOX's insurance claim was not an allowable asset for purposes of its February 28, 2002 net capital calculations. 27/

Applicants contend that the NASD interpretation, which is based on a 1988 Commission staff interpretation, is superseded by the net capital rule and by NASD Code of Arbitration Procedure Rule 10330(h), approved by the Commission in 1992, which provides that a member firm need not pay a "monetary award" where, as here, a "motion to vacate" was pending. 28/ This argument ignores our 1993 decision in Wallace G. Conley, which reaffirms NASD's rule interpretation and makes clear that, given the extremely narrow grounds on which a motion to vacate might succeed, the contingency should be treated as probable from the date of the award.

Applicants also claim that, because the net capital rule does not address errors and omissions insurance explicitly, FOX's insurance coverage may be treated as an allowable asset. Applicants are mistaken. The net capital rule addresses insurance claims generally; Applicants offer no reason, and we can see none, why an errors and omissions insurance policy should be treated differently for purposes of determining whether to include a claim against such a policy as an allowable asset. The factors articulated in the net capital rule do not address the type of coverage provided by an insurance policy, but rather the extent to which the insurance company has committed to paying a particular claim.

Applicants contend that NASD failed to consider the "novel and unprecedented" facts of this case, NASD staff's inexperience in this area, and the "lack of authoritative legal guidance." Applicants claim that it is impossible to violate net capital rules where there is "substantial uncertainty" concerning how to apply them. As discussed above, there is ample legal precedent mandating the accounting treatment of an arbitration award as a liability. Moreover, the net capital rule is clear that an insurance claim is not an allowable asset for net capital purposes unless it qualifies as such under the insurance claim provision of the rule. Both Hogoboom and Lapham delivered consistent advice to Moldermaker when they insisted that he book the arbitration award as a liability regardless of his insurance coverage. The only "uncertainty" Moldermaker has identified is his own disagreement with existing policy. We find that, on

27/ Applicants' unofficial FOCUS report correctly treated the insurance claim as a non-allowable rather than as an allowable asset, and therefore, correctly calculated the Firm's net capital and net capital deficiency. However, the unofficial FOCUS report still incorrectly included the \$300,000 as both an asset and a liability, the Firm's books and records still incorrectly included the insurance claim as an allowable asset, and the Firm was still in net capital deficiency, on the date of the filing of the February FOCUS report. Thus, the unofficial FOCUS report did not cure all of Applicants' violations.

28/ Alternatively, Applicants contend that, because the motion to vacate was pending, the payment of the arbitration award by the insurance carrier was not "outstanding" and therefore could not have been outstanding longer than twenty days as specified in Exchange Act Rule 15c3-1(c)(2)(iv)(D). This reasoning is flawed. The rule refers to claims that are outstanding twenty days from the date the insurance carrier acknowledges them as due and payable, not from the date of the arbitration award.

January 31, and February 28, 2002, FOX conducted a securities business without sufficient net capital in violation of Exchange Act Rule 15c3-1, and that its violation of the net capital rule was also a violation of NASD Conduct Rule 2110. 29/

As FOX's president and FINOP, Moldermaker was responsible for computing the Firm's net capital on the dates in question. Officers of securities firms "bear a heavy responsibility in ensuring that the firm complies with all applicable rules and regulations[.]" including "the duty of ensuring that the firm comply with the net capital requirements." 30/ At the hearing, Moldermaker testified that he had booked previous arbitration awards against the Firm as liabilities upon their issuance. Moldermaker thus was aware of the negative impact that the arbitration award would have on FOX's net capital. FOX received notice of the arbitration award on December 28, 2001. Moldermaker neglected to account for the arbitration award and permitted FOX to conduct a securities business on January 31, and February 28, 2002, even though he knew that the Firm was not in net capital compliance. NASD staff advised Moldermaker repeatedly of the proper accounting treatment for the arbitration award, in one-on-one telephone conversations, conference calls, and written communications. 31/ On February 28, 2002, NASD staff faxed to the Firm a copy of the net capital rules addressing the classification of insurance claims as allowable assets and a copy of the Commission interpretation regarding the treatment of arbitration awards. Nonetheless, Moldermaker permitted FOX to operate its securities business without sufficient net capital. Accordingly, we find that Moldermaker permitted FOX to conduct a securities business without sufficient net capital on January 31, and February 28, 2002, in violation of NASD Conduct Rule 2110.

B. Recordkeeping Violations

As relevant here, Exchange Act Rule 17a-3 requires broker-dealers to maintain "[l]edgers (or other records) reflecting all assets and liabilities . . ." and 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

29/ We have held previously that a violation of a Commission rule is a violation of NASD Conduct Rule 2110. See Davrey Fin. Servs, Inc., Exchange Act Rel. No. 51780 (June 2, 2005), __ SEC Docket __; Pacific On-Line Trading & Secs., Inc., Exchange Act Rel. No. 48473 (Sept. 10, 2003), 81 SEC Docket 106, 111.

30/ Hutchison Fin. Corp., 51 S.E.C. 398, 403-04 (1993).

31/ Under cross-examination at the hearing, Moldermaker admitted that he was aware that he was required to book the amount of the arbitration award as a liability, that he had done so in the past, and was familiar, at the time he received the arbitration award, with the insurance claim provision. When NASD counsel asked Moldermaker whether he had booked the insurance policy as an allowable asset "because you decided to book it that way, you yourself[.]" Moldermaker replied, "[t]hat's correct." When NASD counsel asked Moldermaker whether he had "made the decision to include [the insurance] as a capital asset, not the auditors[.]" Moldermaker responded that, "[b]ased on the information received, that's correct."

aggregate indebtedness and net capital, as of the trial balance date" 32/ NASD Conduct Rule 3110 requires members to maintain books and records as prescribed by Exchange Act Rule 17a-3. Requirements to maintain records encompass the requirement that such records be accurate. 33/

There is no dispute that FOX did not book the arbitration award as a liability in its January 31, 2002 books and records. 34/ While FOX booked the arbitration award as a liability

32/ 17 C.F.R. § 240.17a-3(a)(2) and (11).

33/ See, e.g., James S. Pritula, 53 S.E.C. 968, 976 (1998) (accurate statement necessary to reliably ascertain accuracy of net capital computation); Dillon Secs., 51 S.E.C. 142, 147 (1992) (same).

34/ In charging Applicants with recordkeeping violations, NASD's complaint did not specifically allege Applicants' failure to book the arbitration award as a liability in FOX's January 31, 2002 books and records as one of the inaccuracies supporting the alleged recordkeeping violations. Our review of the record makes clear, however, that Applicants understood this issue and were afforded full opportunity to litigate it at the hearing. See Jonathan Feins, 54 S.E.C. 366, 378 (1999) (holding that "[a]dministrative due process is satisfied where the party against whom the proceeding is brought understands the issues and is afforded a full opportunity to meet the charges during the course of the proceeding"). See also Jesse Rosenblum, 47 S.E.C. 1065, 1070 (1984) (finding, in the context of a Commission administrative proceeding, that a particular charge against respondent "was encompassed by the allegations in the order for proceedings"); KPMG Peat Marwick, Exchange Act Rel. No. 44050 (Mar. 8, 2001), 74 SEC Docket 1351, 1354 (holding that, "[a]s long as a party to an administrative proceeding is reasonably apprised of the issues in controversy and is not misled, notice is sufficient") (citing Aloha Airlines v. CAB, 598 F.2d 250, 262 (D.C. Cir. 1979) ("notice is sufficient if the respondent 'understood the issue' and 'was afforded full opportunity' to justify its conduct during the course of litigation.")), petition denied, 289 F.3d 109 (D.C. Cir. 2002); William C. Piontek, Exchange Act Rel. No. 48903 (Dec. 11, 2003), 81 SEC Docket 3044, 3054 and n.23 (finding that respondent who "understood the issue[s]" and "was afforded full opportunity to litigate" them had sufficient notice of the charges against him).

in its February 28, 2002 books and records, it offset the award by recognizing, improperly, the amount of its liability insurance coverage as an allowable asset on that date. The record demonstrates further that, in its ledgers, balance sheet, and other financial statements on or about January 31, 2002, FOX included as assets of the Firm, and as assets for net capital purposes, the \$300,000 line of credit and \$190,000 in checks described above. The checks totaling \$190,000 were not deposited into FOX's bank account until February 6, 2002. Moldermaker's \$300,000 credit line was not drawn down and deposited into the Firm's bank account until March 19, 2002. Consequently, FOX's books and records on January 31, 2002 were materially inaccurate because the Firm did not recognize the arbitration award, and the \$300,000 credit line and the \$190,000 were prematurely credited as assets on that date. ^{35/} The record also indicates that FOX carried the \$300,000 credit line on its books and records as an asset of the Firm, and as an asset for net capital purposes, on February 28, 2002. As a result, FOX's books and records on February 28, 2002 were materially inaccurate. As FINOP, Moldermaker was responsible for ensuring that FOX's books and records were accurate. By failing to provide an accurate statement of the Firm's trial balances and net capital computations on January 31, and February 28, 2002, Moldermaker caused FOX to maintain materially inaccurate books and records. We sustain NASD's finding that FOX maintained materially inaccurate books and records in violation of Exchange Act Rule 17a-3 and NASD Conduct Rules 3110 and 2110. We also sustain NASD's finding that Moldermaker caused material inaccuracies in FOX's required books and records in violation of NASD Conduct Rules 3110 and 2110.

^{35/} See supra note 11. Nor were the checks so-called "deposits in transit." A deposit in transit is a check that has been transmitted for deposit but that has not yet appeared on the most recent bank statement. See Pritula, 53 S.E.C. at 973; Vincent Musso, 48 S.E.C. 1, 3 (1984). The NASD Guide to Rule Interpretations permits a broker-dealer to include certain deposits in transit as allowable assets for net capital computations where the broker-dealer, as part of its normal business practice, promptly mails deposits to its bank. We agree with NASD's finding that the record does not show that Applicants promptly mailed those checks to their bank or that it was their normal business practice to do so.

C. FOCUS Report Violations

Exchange Act Rule 17a-5 requires broker-dealers like FOX to file monthly and quarterly FOCUS reports with NASD. 36/ Violation of Exchange Act Rule 17a-5 constitutes a violation of NASD Conduct Rule 2110. 37/

The material inaccuracies in FOX's books and records were incorporated into the Firm's December, January, and February FOCUS reports. The December FOCUS report failed to account for the arbitration award and, as a result, materially understated the Firm's liabilities. The January FOCUS report also failed to account for the arbitration award but, in addition, overstated the Firm's assets by including as Firm assets the \$190,000 in checks that had yet to be deposited and Moldermaker's \$300,000 personal line of credit. This inflated the Firm's net capital to approximately \$643,119, and its excess net capital to approximately \$393,119, on January 31, 2002. The February FOCUS report not only included the \$300,000 credit line as an asset, but also booked the Firm's then \$722,653 insurance claim as an allowable receivable. This overstated FOX's assets and resulted in an inflated net capital computation. As FINOP, Moldermaker was responsible for ensuring the filing of accurate FOCUS reports. 38/ For the reasons discussed above, we sustain NASD's findings that FOX submitted materially inaccurate FOCUS reports for the December 2001, January 2002, and February 2002 reporting periods in violation of Exchange Act Rule 17a-5 and NASD Conduct Rule 2110. We also sustain NASD's finding that Moldermaker caused the submission of those materially inaccurate FOCUS reports, in violation of NASD Conduct Rule 2110.

IV.

The only sanctions Applicants challenge are those imposed by NASD for the net capital, recordkeeping, and FOCUS report violations. For these violations, NASD fined Applicants \$25,000, jointly and severally, and barred Moldermaker from associating with any member firm as a FINOP. We review sanctions imposed by NASD to determine whether they are excessive or oppressive or impose an unnecessary or inappropriate burden on competition. 39/ We have consistently held that the appropriate sanction depends on the facts and circumstances of each case and cannot be determined by comparison with action taken in other proceedings. 40/ Applying this standard, we see no basis for reducing the sanctions.

NASD determined that Applicants' net capital, recordkeeping, and FOCUS report violations were egregious. It imposed a single set of sanctions for these violations because it

36/ 17 C.F.R. § 240.17a-5.

37/ E. Magnus Oppenheim & Co., 85 SEC Docket at 478.

38/ See Pritula, 53 S.E.C. at 976; Dillon Secs., 51 S.E.C. at 147.

39/ Exchange Act Section 19(e)(2), 15 U.S.C. § 78s(e)(2). Applicants do not assert, and the record does not show, that NASD's action imposes an undue burden on competition.

40/ See, e.g., Butz v. Glover Livestock Comm'n Co., 411 U.S. 182, 187 (1973); Davrey, ___ SEC Docket at ____.

determined that these violations "primarily arose out of respondents' improper accounting treatment of the arbitration award, the insurance claim, and the \$190,000 deposits, making a single set of sanctions for these violations appropriate." 41/

Applicants contend that, in assessing sanctions for the net capital, recordkeeping, and FOCUS report violations, NASD failed to consider Moldermaker's "good faith" efforts to comply with the net capital requirements. They claim that Moldermaker did not attempt to conceal his actions or deceive the authorities, but rather, "brought the issue to [NASD's] attention." The record, however, shows that Moldermaker telephoned Hogoboom only to urge him to investigate Gwynn. It was his questioning of Moldermaker that led Hogoboom to discover the arbitration award. Nor did Moldermaker seek in good faith to comply with the net capital rule. The hearing panel credited the testimony of Hogoboom and Lapham, finding that they "credibly testified that Moldermaker did not ask for advice on how to book the award." 42/ Applicants argue that Moldermaker had "numerous discussions" with NASD staff about booking the arbitration award and substantially assisted the staff in its investigation. While there is no dispute that Moldermaker had numerous discussions with NASD staff, NASD found him to be intransigent rather than helpful. The hearing panel determined, based on its observation of Moldermaker, that "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 [NASD] staff for advice or that he would have heeded any advice he received." 43/

Applicants argue that NASD failed to properly consider the following mitigating factors:

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- 41/ For net capital violations, the NASD Sanction Guidelines (the "Guidelines") recommend a fine of \$1,000 to \$50,000 and, in egregious cases, a suspension of up to two years or expulsion for the firm, and a suspension of up to two years or a bar for the FINOP. NASD Sanction Guidelines (2001 ed.) at 33. For recordkeeping violations, the Guidelines recommend in egregious cases a fine of \$10,000 to \$100,000, a suspension of up to two years or expulsion for the firm, and a suspension of up to two years or a bar for the FINOP. NASD Sanction Guidelines at 34. For filing false FOCUS reports, the Guidelines recommend a standard fine of \$10,000 to \$50,000, consideration of a suspension of the firm for up to thirty days and beyond until it corrects all deficiencies, and consideration of a suspension of the FINOP in any or all capacities for up to two years. NASD Sanction Guidelines at 76.
- 42/ Credibility determinations of an initial fact-finder are entitled to considerable weight and deference because they are based on hearing the witnesses' testimony and observing their demeanor. *See, e.g., Dane S. Faber*, Exchange Act Rel. No. 49216 (Feb. 10, 2004), 82 SEC Docket 530, 540; *Litwin Secs., Inc.*, 52 S.E.C. 1339, 1342 n.13 (1997).
- 43/ As noted above, the Transcript of the February 6, 2002 conversation supports this interpretation of the record. For example, after Lapham insisted during that conversation that "the net capital rule requires you to book that award in its entirety until it is paid[,]" Moldermaker responded "[w]ell, that's where I disagree." When Lapham explained that it was his "obligation . . . to advise you of what the rules say . . ." Moldermaker replied, "[o]kay. Very good. Thank you for your advisement."

that Moldermaker's conduct never jeopardized the Firm's liquidity, that there was no pattern of misconduct, and that they did not engage in the alleged misconduct over an extended period of time. Applicants are mistaken. In assessing sanctions, NASD appropriately considered both the principal and specific considerations associated with Applicants' violations as set forth in the NASD Sanction Guidelines. ^{44/} These considerations led NASD to conclude that Applicants' misconduct was "egregious." NASD determined that Applicants concealed their net capital deficiency by providing inaccurate information in the January and February FOCUS reports. NASD reasoned that operating a securities business despite insufficient net capital resulted in potential monetary gain to Applicants by enabling them to continue to generate income from their business without interruption. NASD considered that three consecutive months of accounting irregularities, as reflected in the December, January, and February FOCUS reports, constituted a pattern of misconduct over an extended period of time. NASD concluded that Applicants's misconduct was intentional because they failed repeatedly to book the arbitration award as a liability and insisted on recognizing the insurance claim as an allowable asset, despite the contrary advice of NASD staff.

Applicants assert that the \$25,000 fine and the FINOP bar against Moldermaker are "much too onerous and oppressive." They contend that no customers were injured by Moldermaker's alleged misconduct. ^{45/} The net capital rule involves "fundamental safeguards imposed for the protection of the investing public on those who wish to engage in the securities business." ^{46/} As such, the net capital rule is "one of the most important weapons in the Commission's arsenal to protect investors." ^{47/} The question is not whether actual injuries or losses were suffered by anyone. ^{48/} By conducting business when the Firm was not in compliance with net capital requirements, FOX and Moldermaker subjected the Firm's customers to undue risks. ^{49/} In addition to the net capital violations, FOX and Moldermaker were responsible for recordkeeping and reporting violations. As we have held previously, these "rules are not technical but involve fundamental safeguards imposed for the protection of the investing public on those who wish to engage in the securities business." ^{50/} Consequently, broker-dealers, "in conducting their business and safeguarding the funds entrusted to them by customers [must] maintain accurate books and records." ^{51/} We do not conclude that the sanctions assessed by NASD are excessive or oppressive.

^{44/} The considerations include questions of whether Applicants engaged in a pattern of misconduct, whether they concealed the misconduct or withheld information from NASD, the potential for monetary gain, and whether the misconduct was intentional. NASD Sanction Guidelines at 9-10.

^{45/} See Conley, 51 S.E.C. at 303.

^{46/} Listrom, 50 S.E.C. at 888; Robert S.C. Peterson, Inc., 48 S.E.C. 800, 800-01 (1987).

^{47/} Blaise D'Antoni & Associates, Inc., 289 F.2d 276, 277 (5th Cir. 1961).

^{48/} Id. at 277.

^{49/} Conley, 51 S.E.C. at 303.

^{50/} Listrom, 50 S.E.C. at 888.

^{51/} Wetter, 51 S.E.C. at 766 n.16.

An appropriate order will issue. 52/

By the Commission (Chairman COX and Commissioners GLASSMAN, CAMPOS, and NAZARETH); Commissioner ATKINS not participating.

Jonathan G. Katz
Secretary

52/ We have considered all of the contentions advanced by the parties. We have rejected or sustained these contentions to the extent that they are inconsistent or in accord with the views expressed in this opinion.

UNITED STATES OF AMERICA
before the
SECURITIES AND EXCHANGE COMMISSION

SECURITIES EXCHANGE ACT OF 1934
Rel. No. 52697 / October 28, 2005

Admin. Proc. File No. 3-11873

In the Matter of the Application of
FOX & COMPANY INVESTMENTS, INC.,

and

JAMES W. MOLDERMAKER

c/o Anthony W. Djinis, Esq.
Pickard and Djinis LLP
1990 M Street, N.W., Suite 660
Washington, D.C. 20036

For Review of Disciplinary Action Taken by

NASD

ORDER SUSTAINING DISCIPLINARY ACTION TAKEN BY REGISTERED SECURITIES
ASSOCIATION

On the basis of the Commission's opinion issued this day, it is

ORDERED that the disciplinary action taken by NASD against Fox & Company
Investments, Inc. and James W. Moldermaker be, and it hereby is, sustained.

By the Commission.

Jonathan G. Katz
Secretary