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UNITED STATES OF AMERICA
Before the
COMMODITY FUTURES TRADING COMMISSION

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FILED

In the Matter of:	:	**CFTC Docket No. 95-10**
FIRST COMMERCIAL FINANCIAL GROUP, INC., MARK E. REHN, and JOHN A. HERMANSON,	:	**Administrative Law Judge George H. Painter**
Respondents.	:	

INITIAL DECISION

Opinion of Painter, ALJ

Appearances:

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For Respondent John A. Hermanson:

John A. Hermanson

I. INTRODUCTION

On May 2, 1995, the Commodity Futures Trading Commission ("Commission" or "CFTC") issued a four-count complaint against First Commercial Financial Group, Inc. ("First Commercial"), Mark Rehn, and John Hermanson. In the complaint, the Commission's Division of Enforcement ("Division" or "DOE") alleges that the respondents violated the Commodity Exchange Act ("Act") and Commission Regulations between June 30, 1993, and August 31, 1994.

Count I of the complaint charges that First Commercial, a futures commission merchant ("FCM"), did not maintain the minimum amount of adjusted net capital prescribed in Section 4f(b) of the Act and Commission Regulation 1.17(a)(1). It also charges that during the period when First Commercial was "undercapitalized," it failed to transfer its customer accounts and immediately cease doing business as required by Section 4f(b) of the Act and Commission Regulation 1.17(a)(4).

Count I further contends that Rehn should be held liable as a controlling person for First Commercial's violations, while Hermanson should be held liable as an aider and abetter. Rehn was First Commercial's president, and Hermanson was an associated person ("AP") of First Commercial.

Count II accuses First Commercial and Rehn of violating Section 6(c) of the Act and Commission Regulation 1.10(d)(1) by willfully making false and misleading statements in financial reports filed with the Commission. Count II also names Hermanson as an aider and abetter.

Count III alleges that First Commercial did not comply with Commission Regulations 1.12(a)(1) and (a)(2), which require an FCM to notify the Commission and provide certain financial information when it knows or should know that it is "undercapitalized." Count IV claims that First Commercial violated Commission Regulation 1.12(b) by failing to notify the Commission when it knew or should have known that it was in an "early warning net capital position." Both counts maintain that Rehn controlled First Commercial and is therefore liable for its violations.

The allegations in the complaint stem from financial dealings that First Commercial conducted with Hermanson, Burling Bank, Robert Schillaci, and Dearborn Financial Corporation. At issue is the manner in which First Commercial treated these dealings when it computed its monthly net capital position.

A hearing on this matter was held in Chicago, Illinois from December 16 through December 19, 1996, and from March 19 through March 20, 1997. Hermanson's attendance during the first phase of the hearing was sporadic, and he did not appear at the second phase. All of the parties except for Hermanson filed post-hearing briefs.[1/] This matter is now ready for decision.

1/ Respondents' post-hearing briefs were due by August 9, 1997. On September 5, Hermanson wrote the presiding Administrative Law Judge ("ALJ") to request additional time to file a brief. The ALJ denied his request. (Letter from John Hermanson to ALJ Painter, filed Sept. 8, 1997; Notice and Order, issued Sept. 8, 1997.)

II. FINDINGS OF FACT

A. The Respondents

1. Respondent First Commercial is an Illinois corporation which has been registered as an FCM at all relevant times. (First Commercial Answer ["FC Ans."] ¶ 1; Rehn Answer ["Rehn Ans."] ¶ 1; DOE Exhibit ("DOE Ex.") 112.) Obry Corporation N.V., located in the Netherlands Antilles, is the majority shareholder in First Commercial. Abdullah Taha Bakhsh is the "ultimate owner" of First Commercial. Dearborn Financial Corporation ("Dearborn") represents his financial interests in the United States and holds a minority interest in First Commercial. Dearborn also has power of attorney to act on behalf of Obry. (First Commercial Exhibit ["FC Ex."] 38; Transcript ["Tr."] 176, 834.)

2. Respondent Mark Rehn was First Commercial's president and chief executive officer from April 1993 until December 1994. He managed First Commercial's day-to-day operation and was responsible for its financial, compliance, and back office activities. Rehn has been registered as an AP of First Commercial since at least June 1993. He currently acts as a consultant to First Commercial. (FC Ans. ¶ 2; Rehn Ans. ¶¶ 2, 51, 61, 65; DOE Ex. 113; Tr. 29, 37.)

3. Respondent John Hermanson was registered as an AP of First Commercial from May 20, 1991, until May 10, 1994. He is currently registered as a commodity trading advisor and as an AP of LFG LLC, formerly known as Linnco Futures Group, Inc. (FC Ans. ¶ 3; Hermanson Answer ["Herm. Ans."] ¶ 3; DOE Ex. 114; Tr. 367-368, 407.)

B. Minimum Financial Requirements for an FCM

4. An FCM's "net capital" equals its current assets minus its liabilities. (Commission Regulation 1.17(c)(1).) Its "adjusted net capital" equals its net capital minus certain charges. (Declaration of Walter N. Maksymec ["Maksymec Test."][2/] 3-4; Tr. 118-119.)

5. FCMs must maintain a minimum amount of adjusted net capital. FCMs that fail to do so are "undercapitalized." (FC Ans. ¶ 5; Section 4f(b) of the Act; Commission Regulation 1.17(a).)

6. During the time period covered in the complaint, First Commercial had to maintain adjusted net capital equal to or in excess of the greater of (a) $250,000 or (b) four percent of the customer funds required to be held in segregated and secured accounts. (FC Ans. ¶¶ 4-5; Maksymec Test. 3 & n.1; Commission Regulation 1.17(a) (1994).)

7. There is an "early warning level" of capitalization for an FCM. Falling below the early warning level places an FCM in "early warning status." During the relevant time period, the early warning threshold was the greater of (a) 150% of the adjusted net capital requirements or (b) 6% of the customer funds required to be held in segregated and secured accounts. (Maksymec Test. 5; Commission Regulation 1.12(b) (1994).)

C. Regulatory Implications for an Undercapitalized FCM

8. An FCM that knows or should know that it is undercapitalized must telegraphically notify the Commission within

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2/ The Maksymec Declaration is DOE Exhibit 1.

24 hours. The FCM must also file a statement of financial condition and other financial data. (Commission Regulations 1.12(a)(1)-(2).)

9. An undercapitalized FCM must transfer all customer accounts and immediately cease doing business. (Commission Regulation 1.17(a)(4).)

D. Regulatory Implications for an FCM in Early Warning Status

10. An FCM that knows or should know that it is in early warning status must notify the Commission in writing within five business days. (Commission Regulation 1.12(b).)

E. Form 1-FRs

11. A Form 1-FR-FCM ("1-FR") reports the financial condition of an FCM "as of" a certain date. It includes a statement of the FCM's computation of its minimum capital requirements. A 1-FR must also include any supplemental "information as may be necessary to make the [1-FR] not misleading." (Tr. 110, 534; Commission Regulation 1.10(d)(1).)

12. An FCM must file quarterly unaudited 1-FRs within 45 days of the 1-FR's "as of" date. Within 90 days of the close of its fiscal year, an FCM must file an audited 1-FR that has been certified by an independent public accountant. (Maksymec Test. 4-5; Commission Regulation 1.10(b).)

13. If an FCM's adjusted net capital falls below the early warning level during a month, it must file a 1-FR at the end of that month and continue to file monthly 1-FRs until its adjusted net capital exceeds the early warning level for three successive

months. (Commission Regulation 1.12(b).)

14. First Commercial filed 1-FRs for the "as of" periods ending June 30 through September 30, 1993, and December 31, 1993, through August 31, 1994. (FC Ans. ¶ 24; DOE Exs. 6, 14, 23, 32, 70, 80-87.)

15. Rehn signed each of these 1-FRs on behalf of First Commercial. His signature constituted a certification that the information contained in the 1-FRs was true and accurate to the best of his knowledge. (Rehn Ans. ¶ 24; First Commercial Response to DOE's Request for Admissions ["FC Adm."] ¶ 2; Rehn Response to DOE's Request for Admissions ["Rehn Adm."][3/] ¶ 2; Tr. 37, 101-103, 813; Commission Regulation 1.10(d)(4).)

16. Joe Butzen, the comptroller for First Commercial, prepared the 1-FRs for Rehn's signature. (Tr. 37, 627-628, 694-695.)

17. It is a violation of Section 6(c) of the Act and Commission Regulation 1.10(d)(1) for an FCM or an individual to willfully make any false or misleading statement of material fact in a 1-FR.

F. The Month-End Transfers From Hermanson to First Commercial

18. In 1992, First Commercial began loaning money to Hermanson in the form of advances against his future commissions. At that time, Rehn was First Commercial's vice-president and chief financial officer. (Tr. 34, 120, 746.)

19. In the latter portion of 1992 or in early 1993, Mike

3/ First Commercial's response to the Division's request for admissions is DOE Exhibit 3. Rehn's response is DOE Exhibit 4.

Rohlfs discovered that First Commercial had advanced approximately $300,000 to Hermanson. (Tr. 185-186, 838.) Rohlfs is the president and chief executive officer of Dearborn (See Finding of Fact ["FF"] ¶ 1.) and has been on First Commercial's board of directors since 1993. He acts as a liaison between First Commercial and its investors. (Tr. 176-177, 834-836.)

20. Rohlfs told Rehn that First Commercial was not a bank and that Rehn was not to give loans or advances to employees under any circumstances. Rohlfs ordered Rehn to collect the $300,000 from Hermanson. Rehn did so, but then returned the money to Hermanson without ever telling Rohlfs. (Tr. 56-57, 186-188, 746-748, 838-839.)

21. First Commercial continued to advance money to Hermanson after Rehn became president in April 1993. Butzen testified that throughout 1993, he did not know whether the money advanced to Hermanson was greater than the commissions that Hermanson actually earned. (Tr. 46, 120-121.)

22. An expert witness for First Commercial testified that Hermanson owed $200,000 to First Commercial on February 26, 1993, and owed over $1 million by June 1993. If his figures are accurate, then from March through June 1993, First Commercial advanced $800,000 more to Hermanson than he actually earned in commission income. According to the expert witness, from 1991 through April 1994, Hermanson's total earnings at First Commercial were $1.2 million. (Declaration of John P. Garvey ["Garvey Test."] 8-9; Tr. 710-711 (corrected testimony).)

23. In June 1993, First Commercial's adjusted net capital fell below the early warning level. On June 16, it provided written notification to the Commission of its early warning status. (FC Ans. ¶ 16; Rehn Ans. ¶ 16; FC Adm. ¶ 7; Rehn Adm. ¶ 7; DOE Ex. 95; FC Ex. 33; Tr. 508-509, 653-654, 750.)

24. On June 30 and again on the last business day of July through December 1993, Hermanson or someone acting at his direction transferred funds to First Commercial. The amount of money ranged from $275,000 to $1,300,000. First Commercial returned the month-end funds on the first or second business day of the following months. (FC Ans. ¶¶ 25-26; Rehn Ans. ¶¶ 25-26; FC Adm. ¶¶ 10, 13, 16-17, 21, 25, 29, 31-32; Rehn Adm. ¶¶ 10, 13, 16-17, 21, 25, 29, 31-32; Hermanson Response to DOE's Request for Admissions ["Herm. Adm."][4] ¶¶ 3-6, 8, 9, 12-16, 19, 23-25, 32, 34, 37, 41-46, 48-53, 66, 68-69; DOE Exs. 2, 7, 9-13, 15, 17-22, 24, 26-31, 33, 38, 40-41, 44-45, 47, 49, 51-53, 57-58, 60-62, 64-68, 71-73, 75-79, 91; FC Exs. 9a, 10; Tr. 48-50, 58, 64-66, 127-129, 165-167.)

25. The transferred funds came from a one-day loan that Hermanson obtained and from bank accounts in the name of "John Hermanson," "John Hermanson d/b/a Swedes Trading Corporation," and "Swedes Corp."[5] The three accounts from which Hermanson sent month-end checks to First Commercial had insufficient funds to cover those checks. (Id.; Herm. Adm. ¶¶ 19, 24, 37; DOE Exs. 8,

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[4] Hermanson's response to the Division's request for admissions is DOE Exhibit 5.

[5] Hermanson was the president and secretary of Swedes Trading Corporation. (Herm. Ans. ¶ 3.)

16, 25, 34, 46, 48, 59, 63, 74; Tr. 204-206, 209-210, 355-361.)

26. First Commercial counted the month-end transfers as current assets in its monthly capital computations. If First Commercial had not done so, then its 1-FR for the "as of" period ending June 30, 1993, would have disclosed that First Commercial was approximately $300,000 below early warning levels.[6/] (FC Ans. ¶¶ 25, 27; Rehn Ans. ¶¶ 25, 27; Ex. A attached to Maksymec Test.; Tr. 59-60, 71-72, 140, 637, 639-640.)

27. In a January 1995 deposition, Rehn attempted to explain why First Commercial received month-end funds from Hermanson and then returned those funds at the beginning of the following months. Rehn said that at the end of each month, Hermanson would pay a portion of his "debt" to First Commercial with funds from outside sources. Then, according to Rehn, at the beginning of the following months, Hermanson would ask Rehn to cover his month-end checks because his sources had not "come through." (Tr. 47-50.)

28. At the December 1996 hearing, Rehn could not "specifically" recall ever being told by Hermanson that he did not have enough money to cover his month-end checks. But, for the first time, Rehn remembered that Hermanson asked him to "re-loan" the money that Hermanson had provided to First Commercial at month-end. (Tr. 46-47, 51, 58-59, 64-66.)

29. In May or June 1994, Rehn had a conversation with Andrew Gadzinski. (Tr. 314-315, 803.) Gadzinski was a First Commercial

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6/ The effect of the month-end transfers on First Commercial's adjusted net capital for the "as of" periods ending July 31, 1993, through December 31, 1993, will be discussed in conjunction with the Burling Bank loan. (See infra FF ¶ 44.)

employee who had examined the flow of funds between First Commercial and Hermanson. (Tr. 307-309.)

30. Gadzinski testified that Rehn used the terms "kiting" and "plugging" in the conversation. Gadzinski said that Rehn mentioned "kiting" in connection with checks being written by First Commercial and Hermanson at the end of a month and the beginning of the following month. Based on the context of the conversation, Gadzinski surmised that the figures he had examined while reviewing Hermanson's commissions were "plugged." (Tr. 315-321, 332.)

31. Gadzinski was deeply disturbed by his conversation with Rehn. He consulted a lawyer and then recounted the conversation to Mike Rohlfs. (Tr. 188-190, 322-324.)

32. The actions that Gadzinski took after his conversation with Rehn reveal him to be a conscientious and diligent employee. I find Andrew Gadzinski to be a sincere and believable witness.

33. Rehn admitted that he "probably used the term 'plug'" in his conversation with Gadzinski. While Rehn could not "recall" ever using the term "kiting," he said that he "might have" done so. (Tr. 96, 804-805.)

34. I find that in general, Rehn testified in a deceptive manner during the hearing. I find his specific testimony about the month-end transfers to be a complete fabrication.

35. Joe Butzen offered a similar if not equally fanciful story as Rehn did about the month-end transfers. Butzen testified that throughout the month, First Commercial would request that Hermanson pay his "debt" to First Commercial. According to Butzen, Hermanson

would always provide funds on the last day of the month. Butzen said that on the next business day, Hermanson would ask that the funds be returned because the deal that had supposedly provided him with the money had not "come through." (Tr. 127-129, 142-143, 165-167.)

36. I find that Butzen testified in an evasive manner and made no attempt to be forthcoming.

37. Hermanson testified that he provided the month-end funds to First Commercial as a "favor" to Rehn. Hermanson knew that he did not have sufficient funds in his accounts to cover the month-end checks. According to Hermanson, First Commercial promised to cover the checks for him. (Tr. 375-376, 379-381.)

38. In a fit of impromptu candor, Hermanson twice stated that he knew he was "doing something wrong." He just did not know exactly what was "wrong" about it. (Tr. 375-376, 379.)

39. I find that Rehn, with Hermanson's assistance, utilized a check kiting scheme to artificially inflate First Commercial's adjusted net capital. I find that Rehn accepted the month-end funds knowing that First Commercial would be returning those funds to Hermanson in order to cover his overdrafts. I also find that First Commercial and Rehn did not have a good faith belief that the month-end funds could be treated as current assets.

G. <u>The Burling Bank Loan</u>

40. Based on the figures provided by First Commercial's expert witness, Hermanson owed $1,100,000 to First Commercial by July 1993. If his figures are accurate, then from March to July 1993,

First Commercial advanced $900,000 more to Hermanson than he actually earned in commission income. According to the expert witness, from 1991 through April 1994, Hermanson's total earnings at First Commercial were $1.2 million. (Garvey Test 8-9; Tr. 710-711 (corrected testimony).)

41. Rehn testified that Hermanson owed approximately $650,000 to First Commercial by July 1993. (Tr. 757-758, 763.) Hermanson said that he either owed between $200-300,000 to First Commercial, or First Commercial owed him that amount.7/ (Tr. 372-373.)

42. On July 30, 1993, Hermanson and Rehn signed a $650,000 promissory note ("the July 30 note") evidencing Burling Bank loan number 9012. Hermanson signed his name above the designation "borrower," while Rehn signed as First Commercial's president above the designation "co-signer." Rehn co-signed the note at the request of Bill Aldrich, Burling Bank's senior vice-president in charge of lending. (FC Ans. ¶ 30; Rehn Ans. ¶ 30; Herm. Ans. ¶ 30; FC Adm. ¶ 48; Rehn Adm. ¶ 48; DOE Ex. 92; FC Ex. 1; Tr. 83-84, 264-267, 403-404, 755.)

43. Hermanson instructed Burling Bank to disburse the loan proceeds to First Commercial. First Commercial deposited the proceeds into its own account. (FC Ans. ¶ 31; Rehn Ans. ¶ 31; Herm. Ans. ¶ 31; FC Adm. ¶ 54; Rehn Adm. ¶ 54; Herm. Adm. ¶¶ 55, 56; DOE Ex. 119; FC Exs. 5, 9b; Tr. 85, 266, 635, 758.)

44. First Commercial did not count the Burling Bank loan as a

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7/ On November 22, 1993, Hermanson signed a statement which confirmed that he owed $231,396.22 to First Commercial as of September 31, 1993. (FC Ex. 22.)

liability in its net capital computations. If First Commercial had treated the loan as a liability and had not counted the month-end transfers as currents assets, then its net capital computations would have revealed that it was in early warning status for the "as of" periods ending July 31 and August 31, 1993. Its net capital computations would have also revealed that it was undercapitalized for the "as of" periods ending August 31 through December 31, 1993. (FC Ans. ¶ 32; Rehn Ans. ¶ 32; Ex. A attached to Maksymec Test.; Tr. 157-158.)

45. Rehn testified that Hermanson gave the loan proceeds to First Commercial as part of his on-going effort to repay the money that had been "loaned" or "advanced" to him by First Commercial. (Tr. 753.)

46. Hermanson testified that Rehn wanted him to sign the July 30 note because First Commercial needed money to pay legal fees and could not obtain a loan in its own name. Hermanson said that he signed the note as a "favor" to Rehn. (Tr. 371-373.)

47. The July 30 note had a maturity date of September 30, 1993. On that date, Hermanson signed a second promissory note for loan number 9012. The note had a principal amount of $685,000 and a maturity date of June 30, 1994. Rehn signed the second note in February 1994. As with the first note, Hermanson was listed as the "borrower" and First Commercial as the "co-signer." (FC Adm. ¶ 48; Rehn Adm. ¶ 48; Hermanson Response to First Commercial's Request for Admissions ["Herm. Adm. to FC"] ¶ 12; DOE Ex. 93; FC Ex. 2; Tr. 759-761.)

48. On June 30, 1994, Hermanson signed a third promissory note for loan number 9012. This note had a principal amount of $510,000 and a maturity date of March 31, 1995. Although the designation "Cosigner: First Commercial Group, Inc." is typed at the bottom of the note, neither Rehn nor any other First Commercial employee signed the note. (Herm. Ans. ¶ 30; DOE Ex. 94; FC Ex. 4.)

49. A one-page "notice to co-signer" was attached to each note. The notice informed the co-signer that "[y]ou are being asked to guarantee this debt . . . If the Borrower doesn't pay the debt, you will have to . . . The Lender can collect this debt from you without first trying to collect from the Borrower." Rehn, on behalf of First Commercial, signed the notice to co-signer for the first and second notes. (DOE Exs. 92-93; FC Exs. 1-2; Tr. 84-85, 267.)

50. Rehn testified that based on the language in the notice to co-signer and his "understanding" with Bill Aldrich, he believed that First Commercial was a "guarantor" of the loan and not the primary obligor. Rehn said he thought First Commercial had no liability on the loan "whatsoever" because any payments by First Commercial would come from Hermanson's commission income. (Tr. 84, 86-87, 754-757.)

51. Clause 16 of each note's terms and conditions provided that any reference to the "borrower" includes the co-signer. The last sentence of the notice to co-signer read: "This notice is not the contract that makes you liable for this debt." (DOE Exs. 92-93; FC Exs. 1-2; Tr. 86.)

52. Aldrich did not remember if Rehn asked him any questions about First Commercial's obligation on the loan. If Rehn did, then Aldrich advised him that Burling Bank could seek payment from First Commercial without having to first "go after" Hermanson. (Tr. 268-269.)

53. At the hearing, Rehn claimed that when he signed the first note, he was not "clear" about the difference between a co-signer and a guarantor. Yet, on the same day that he signed the first note, Rehn also signed a Burling Bank guaranty agreement for a $300,000 loan to Hermanson and Robert Schillaci. (DOE Ex. 110; Tr. 86-87.)

54. In May or June 1994, Andrew Gadzinski informed Rehn that "if a loan was co-signed . . . you might as well have signed it yourself." (Tr. 309-311, 313, 805.)

55. Rehn did not consult with an attorney or an accountant to determine First Commercial's liability on the loan. Nor did he inform Butzen about the loan. Butzen learned about the loan when Aldrich called him in May 1994 to request that First Commercial make a payment on the loan. After speaking to Aldrich, Butzen "never even thought about" whether the loan should be reflected as a liability. (Tr. 85-86, 147-149, 646, 652, 815.)

56. I find that Rehn contrived his testimony about the circumstances surrounding the loan and about his belief as to First Commercial's liability on the loan.

57. I find that the Burling Bank loan was a primary obligation of First Commercial and at all times should have been included as

a current liability in First Commercial's 1-FRs and net capital computations. (810 ILCS 5/3-419.) I also find that First Commercial and Rehn did not have a good faith belief that the loan was not a current liability.

58. I find that at Rehn's request, Hermanson agreed to act as a nominee borrower for the loan. I find that Rehn wanted Hermanson to be listed as the "borrower" so it would appear that First Commercial was not primarily obligated on the loan.

H. The Hermanson and Schillaci Notes

59. On January 3, 1994, First Commercial returned the $1.3 million that Hermanson had transferred to it at the end of December. (FC Ans. ¶ 35; Rehn Ans. ¶ 35; Herm. Adm. ¶ 61; DOE Exs. 76-79; Tr. 73-74, 174.)

60. Hermanson did not make any more month-end transfers after December 1993. (Tr. 151-152.) In a promissory note dated January 3, 1994, he did, however, agree to pay $1,300,000 to First Commercial. Hermanson pledged his interest in Chicago Double Drive-Thru, Inc. ("CDDT"), to secure his payment of the note. (FC Ans. ¶ 35; Rehn Ans. ¶ 35; Herm. Adm. ¶¶ 58-59, 63; Herm. Adm. to FC ¶ 21; DOE Ex. 99; FC Ex. 25.1; Tr. 174.)

61. First Commercial classified the note as a secured receivable and counted it as a current asset in its net capital computations. If First Commercial had not classified the Hermanson note as a current asset, then its net capital computations would have revealed that it was undercapitalized for the "as of" periods ending January 31 through March 31, 1994. (FC Ans. ¶ 36; Rehn Ans.

¶ 36; Ex. A attached to Maksymec Test.; Tr. 155, 780-781.)

62. Rehn testified that Hermanson signed the note because Rehn wanted him to collateralize his "debt" to First Commercial. (Tr. 773, 777.) Based on the figures provided by First Commercial's expert witness, from July 31, 1993, to January 3, 1994, First Commercial advanced $850,000 more to Hermanson than he actually earned in commission income. From 1991 through April 1994, Hermanson earned a total of $1.2 million for his work at First Commercial. (Garvey Test. 8-9; Tr. 710-711 (corrected testimony).)

63. Hermanson said that he signed the note because Rehn told him that "he was in a bind." Hermanson vigorously disputed that he owed First Commercial as much as it claimed. On November 22, 1993, Hermanson did sign a document that indicated that he owed $231,396.22 to First Commercial as of September 31, 1993. (FC Ex. 22; Tr. 382-383, 386.)

64. Steve Thayer, an attorney for Hermanson, prepared the note and stock pledge agreement after meeting with Hermanson and Rehn. He sent the note and agreement to Rehn on January 31, 1994, which is twenty-eight days after the actual date recorded on the note. The note that Thayer sent was unsigned and had blanks for the interest rate and amount due, as well as the date. (DOE Ex. 122; FC Ex. 23; Tr. 248-250, 253-254, 257, 777, 779.)

65. When Hermanson signed the note, the principal amount had not yet been filled in. Someone at First Commercial eventually typed $1,300,000 onto the note. Rehn said that First Commercial

was "authorized to fill in" the amount. Butzen testified that Hermanson "trusted" First Commercial to fill in the correct number. (FC Adm. ¶ 72; Herm. Adm. ¶ 60; DOE Exs. 99, 122; FC Exs. 23, 24.1, 25.1; Tr. 74-76, 149-150, 154-155, 171-172, 382-383, 663-664.)

66. Although Thayer sent only one note and stock pledge agreement to Rehn, the parties submitted two other notes and stock pledge agreements into evidence. The other notes are dated January 31, 1994, and February 17, 1994. The January 31 note has a principal amount of $1,700,000 and the February 17 note has a principal amount of $1,465,000.[8/] Hermanson's signature appears on these notes, but no determination can be made as to whether he actually signed them or whether someone photo-copied his signature from the January 3 note. (DOE Ex. 99; FC Exs. 24.1, 25.1.)

67. A secured loan receivable can be counted as a current asset if it is (1) "secured by readily marketable collateral which is otherwise unencumbered," and (2) the readily marketable collateral is in the possession or control of the FCM, or the FCM has a perfected security interest in it. (Commission Regulation 1.17(c)(3)(i)-(ii).)

68. Commission Regulations incorporate the definition of "readily marketable" found in SEC Rule 240.15c3-1(c)(11). A "ready market" includes "a recognized established securities market in which there exist independent bona fide offers to buy and sell." (Commission Regulation 1.17(c)(2)(iv)(B); CFTC Form 1-FR-FCM

[8/] For the remainder of the decision, all references to the "Hermanson note" will encompass the three promissory notes and stock pledge agreements.

Instructions (Jul. 1989) ["1-FR Inst."] at 2-3.)

69. The CDDT stock which secured the Hermanson note was not "readily marketable" since it was not listed on an exchange. (Tr. 501, 728.)

70. First Commercial never had possession or control of the CDDT stock. (Herm. Adm. ¶ 65; Tr. 77, 155, 780.) Nor did it perfect a security interest in the stock under the then applicable Illinois law. (810 ILCS 5/8-313, -321 (1994).)

71. I find that the Hermanson note was not a current asset. The CDDT stock was not readily marketable collateral, and First Commercial did not have possession or control of it. Nor did First Commercial have a perfected security interest in it. I also find that First Commercial and Rehn did not have a good faith belief that the Hermanson note could be treated as a current asset.

72. I find that the Hermanson note was another attempt by Rehn to artificially increase First Commercial's adjusted net capital. I find that Rehn requested the note because it was less conspicuous than having Hermanson transfer funds at month-end and then having First Commercial return those funds at the beginning of the following months. Rehn knew that the month-end transfers "didn't look too good." (Tr. 804.)

73. On or about February 4, 1994, First Commercial loaned $250,000 to Robert Schillaci. Schillaci used his seat on the Chicago Mercantile Exchange ("CME") as collateral for the loan. (FC Ans. ¶ 38; Rehn Ans. ¶ 38; FC Adm. ¶ 78; Rehn Adm. ¶ 78; DOE Ex. 101; FC Exs. 28, 29; Tr. 77-78, 665, 781-782.) Schillaci was

a First Commercial customer and was also a former executive at First Commercial. He and Hermanson "had a long relationship . . . in the commodities industry and other business ventures." They "were both investors in a venture capital company named Vantage Capital Management, Inc." (Garvey Test. 14.)

74. First Commercial classified the Schillaci note as a secured receivable and counted it as a current asset in its net capital computations. (FC Ans. ¶ 39; Rehn Ans. ¶ 39; Tr. 665-666.)

75. A secured loan receivable can be counted as a current asset if, *inter alia*, it is "secured by readily marketable collateral which is otherwise unencumbered." (Commission Regulation 1.17(c)(3)(i).)

76. The CFTC instruction manual informs FCMs that exchange memberships "are not good collateral for a receivable." Commission Regulation 1.10(d)(1) directs FCMs to complete 1-FRs "in accordance with the instructions to the form." (1-FR Inst. at 2-3 to 2-4; Tr. 493-494, 502.)

77. When Schillaci pledged his CME seat as collateral for the loan from First Commercial, the seat was already encumbered from a prior loan. In June 1993, Schillaci had pledged it as security for a $300,000 loan from Burling Bank to Schillaci and Hermanson. Although Rehn did not "remember" doing so, he guaranteed payment of that loan on behalf of First Commercial. (DOE Exs. 110, 124; Tr. 80-84, 665; see FF ¶ 53.)

78. I find that the Schillaci note was not a current asset. An exchange membership is not readily marketable collateral, and

Schillaci's CME seat was already encumbered when he pledged it as security to First Commercial. I also find that First Commercial and Rehn did not have a good faith belief that the Schillaci note could be treated as a current asset.

79. First Commercial retained Deloitte and Touche ("Deloitte") to prepare a Consolidated Statement of Financial Condition for the time period ending December 31, 1993. On March 28, 1994, Deloitte issued its report. Under the heading of "subsequent event," note 10 of the report read: "In January 1994, the Company extended unsecured demand loans to two individuals totaling $1,615,000." The two individuals referred to are Hermanson and Schillaci. (DOE Exs. 102, 115; FC Ex. 90.)

80. In late March, Rehn read the final report and knew that Deloitte considered the Hermanson and Schillaci notes to be unsecured. Rehn realized that if the notes were unsecured, then First Commercial was undercapitalized. (Tr. 91-92, 788-789.)

81. Rehn did not notify Mike Rohlfs about Deloitte's classification of the notes.[9/] First Commercial continued to reflect the notes as current assets until April 12, 1994, when the National Futures Association ("NFA") ordered it to re-classify the notes as non-current. The NFA was First Commercial's designated self-regulatory organization ("DSRO"). (FC Ans. ¶¶ 4, 42; Rehn Ans. ¶ 42; DOE Ex. 96; Tr. 93, 157, 500-502, 581, 789-790.)

9/ Whenever First Commercial needed a capital infusion, Rehn would speak to Rohlfs. (Tr. 38, 179-180, 839.)

I. The Dearborn Loan

82. On April 12, 1994, Rehn notified the Commission and the NFA that the re-classification of the Hermanson and Schillaci notes had caused First Commercial to fall approximately $963,798 below the minimum net capital requirements. (FC Ans. ¶ 43; Rehn Ans. ¶ 43; FC Adm. ¶ 7; Rehn Adm. ¶ 7; DOE Ex. 96.)

83. On April 14, Mike Rohlfs advised the NFA that Dearborn had added "$1,700,000 in satisfactory regulatory capital" to First Commercial through the transfer of 400,000 shares of Hartmarx stock and $500,000 to First Commercial. Emerson Investment and Atherstone Corporation, the companies that respectively transferred the stock and cash, are controlled by Abdullah Taha Bakhsh, the "ultimate owner" of First Commercial. (FC Ans. ¶ 44; Rehn Ans. ¶ 44; DOE Ex. 105; FC Exs. 38-39.)

84. The transfer of stock and cash created a liability for First Commercial since it was in the form of a loan ("Dearborn loan"). Yet, Joe Butzen told the NFA that the stock and cash were additional paid-in-capital. First Commercial's 1-FR for the "as of" period ending April 30, 1994, also described the stock and cash as additional paid-in-capital. (FC Ans. ¶ 45; Rehn Ans. ¶ 45; DOE Exs. 83, 106-107, 127; FC Exs. 42, 48; Tr. 421, 424-426, 448-452, 515, 524, 881-882, 898.)

85. Commission Regulations permit an FCM to exclude a loan from its liabilities (and thereby increase its adjusted net capital) if the loan is subordinated to the claims of its general creditors, and the subordination agreement is approved by the NFA.

(Commission Regulations 1.17(c)(4)(i), (h)(3)(vi); 1-FR Inst. at 7-1.) An FCM can create a subordinated agreement in "a very short period of time, conceivably even a day," if it uses the NFA's model subordinated loan agreement. First Commercial had prepared other subordination agreements prior to the Dearborn loan. (Tr. 428, 936-937.)

86. On July 27, which was three and one-half months after Dearborn loaned the stock and cash, First Commercial sent subordination agreements to the NFA. (DOE Ex. 108; FC Ex. 50.)

87. On August 2, a CFTC auditor told First Commercial's attorney[10/] that the subordination agreement for the Hartmarx stock was unacceptable. (Tr. 454-455.)

88. On September 2, a First Commercial attorney prepared another subordination agreement for the Hartmarx stock. On September 8, he sent the agreement along with a previously prepared cash subordinated loan agreement to the NFA. The NFA approved the agreements on September 14. (DOE Exs. 100, 103; FC Exs. 43-45, 53-54; Tr. 433-434, 889-891, 901.)

89. I find that the Dearborn loan created a liability for First Commercial until the NFA approved the subordination agreements on September 14, 1994. I also find that prior to September 14, First Commercial and Rehn did not have a good faith belief that they had properly accounted for the loan in First

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10/ Scott Early and Nehad Othman, attorneys at Foley & Lardner, represented First Commercial on the Dearborn loan matter. Early represents First Commercial in the current proceeding, and Othman testified at the hearing. Prior to the hearing, the Division agreed to not call Early as a witness and to not move to disqualify Foley & Lardner. (Tr. 416, 451-452.)

Commercial's net capital computations. If First Commercial had properly accounted for the loan, then its net capital computations would have revealed that it was undercapitalized for the "as of" periods ending April 30 through August 31, 1994. (Ex. A attached to Maksymec Test.)

90. CFTC and NFA regulators sent numerous letters about the Dearborn loan to First Commercial, First Commercial's attorneys, and Dearborn. Rehn received an original or copy of every letter. He also received a copy of every letter sent to regulators by First Commercial's attorneys and Dearborn. (DOE Exs. 100, 103, 105-109, 111, 125; FC Exs. 38-40, 47-50, 52-54.)

J. Conclusions

91. I find that Rehn controlled First Commercial.

92. I find that for the "as of" periods ending September 30, 1993, through August 31, 1994, First Commercial maintained less than the prescribed amount of adjusted net capital, operated while undercapitalized, and failed to transfer all customer accounts and immediately cease doing business as an FCM. (FC Ans. ¶ 15; Rehn Ans. ¶ 15; Ex. A attached to Maksymec Test.)

93. I find that Rehn did not act in good faith and knowingly induced the violations described in the previous finding.

94. I find that for the "as of" periods ending September 30, 1993, through August 31, 1994, First Commercial knew or should have known that it was undercapitalized. I also find that except for April 12, 1994, First Commercial did not provide telegraphic notice to the Commission that it was undercapitalized. (FC Ans. ¶¶ 16,

59-60; Rehn Ans. ¶¶ 16, 59-60.)

95. I find that Rehn did not act in good faith and knowingly induced the violations described in the previous finding.

96. I find that First Commercial's adjusted net capital was below early warning levels for the "as of" periods ending June 30, July 31, and August 31, 1993. (Ex. A attached to Maksymec Test.) I also find that First Commercial knew or should have known that it was in early warning status during those time periods.

97. I find that First Commercial failed to provide the Commission with written notice of its early warning position for the "as of" periods ending July 31 and August 31, 1993. (FC Ans. ¶ 16; Rehn Ans. ¶ 16.)

98. I find that Rehn did not act in good faith and knowingly induced the violations described in the previous finding.

99. I find that for the "as of" periods ending June 30 through September 30, 1993, and December 31, 1993, through August 31, 1994, First Commercial and Rehn willfully filed false and misleading 1-FRs that overstated First Commercial's adjusted net capital.

100. I find that Hermanson willfully aided and abetted First Commercial in operating while undercapitalized and in filing false and misleading 1-FRs.

III. DISCUSSION

A. Count I: Failure to Meet Minimum Capital Requirements

1. The Month-End Transfers

Rehn told the truth when he spoke to Andrew Gadzinski and used the term "kiting" to describe the month-end transfers. From June through December 1993, Hermanson wrote or directed others to write month-end checks to First Commercial from accounts that had insufficient funds to cover those checks. First Commercial accepted these funds knowing that it would be returning them to Hermanson in order to cover his overdrafts. (Rehn Ans. ¶ 26.)

At the hearing, Rehn provided an implausible version of events. He testified that at month-end, for seven consecutive months, Hermanson provided funds to First Commercial from various outside business deals in order to pay off his "debt" to First Commercial. Rehn said that at the beginning of the following months, First Commercial "re-loaned" the funds to Hermanson because the deals that had supposedly produced the funds had not "come through."

The only "deal" involved in the month-end transfers was that First Commercial would cover Hermanson's checks. Rehn's account of the transfers was nothing more than an unartfully contrived cover story. For seven straight months, First Commercial did not "re-loan" funds to Hermanson because some deal had not worked out. It returned the funds to Hermanson so he could cover the checks that he had just written to First Commercial.

Some of the month-end funds provided to First Commercial came

from a one-day loan of $350,000 from Burling Bank to Hermanson. (DOE Ex. 91.) On June 30, 1993, Hermanson had the bank issue a check for the loan proceeds directly to First Commercial (DOE Ex. 9.). First Commercial repaid the bank on July 1 (FC Ex. 10.). Hermanson would not have taken out a one-day loan for that amount of money unless he had a prior agreement with Rehn that First Commercial would pay off the loan. First Commercial's acceptance of the loan proceeds and repayment on the following day establishes that First Commercial never intended to keep the loan proceeds beyond the end of the June reporting period. It also proves that Rehn knew that Hermanson's outside business ventures were not the source of his month-end funds.

The seven month pattern of payments between Hermanson and First Commercial provides a sufficient basis from which to infer a scheme to artificially inflate First Commercial's adjusted net capital. The inference of wrongdoing becomes a virtual certainty when one considers Gadzinski's "kiting" conversation with Rehn, the one-day loan of $350,000, Rehn's lack of credibility, and Hermanson's admission that he acted in a dishonest manner. First Commercial never intended to make use of the month-end funds and should not have classified them as current assets.[11/]

2. The Burling Bank Loan

a. First Commercial's status

In a memorandum of law filed before its case-in-chief, First

11/ A current asset is an asset "which [is] reasonably expected to be . . . consumed within a year or within the normal operating cycle of the entity." (Patrick R. Delaney ET AL., GAAP 96 (1990) (emphasis added).)

Commercial contended that it acted as a "guarantor" of the Burling Bank loan and therefore did not have to report it as a current liability. (First Commercial Memorandum of Law on Burling Bank Loan, filed Feb. 20, 1997.) The ALJ issued a preliminary finding in response to the memorandum which held that First Commercial was not a guarantor of the loan. (Notice Regarding Burling Bank Loan ["Burling Bank Notice"], issued Mar. 11, 1997.) In its post-hearing brief,[12] First Commercial once again asserts that it acted as a guarantor.[13] (First Commercial Post-Hearing Brief ["FC PHB"] 11-13.) Its post-hearing argument is not any more persuasive than its earlier memorandum.

A party who signs a note in the capacity of a guarantor is an "accommodation party." (See Godfrey State Bank v. Mundy, 90 Ill. App. 3d 142, 147 (1980).) The Illinois Commercial Code defines an accommodation party as one who signs an instrument "for the purpose of incurring liability on the instrument without being a direct beneficiary of the value given for the instrument." (810 ILCS 5/3-419(a).) The Official Comment to Section 3-419 gives an example in which party X co-signs a note for another party. The Comment concludes that "X is an accommodation party if no part of the loan was paid to X or for X's direct benefit."

12/ Rehn's post-hearing brief "adopts and incorporates" First Commercial's brief. (Rehn Post-Hearing Brief 1.)

13/ First Commercial's brief states that the ALJ's preliminary finding characterized First Commercial as an "absolute guarantor" of the Burling Bank loan. (FC PHB 12 & n.6.) First Commercial's attorneys must have misread the finding. The finding never held that First Commercial was an absolute guarantor. It only noted that even if one assumed for the sake of argument that First Commercial were a guarantor, its guaranty was an absolute one, and First Commercial still had to report the loan as a liability. (Burling Bank Notice.)

First Commercial was not a guarantor of the Burling Bank loan because it did not meet the statutory definition of an accommodation party. An accommodation party cannot be "a direct beneficiary of the value given for the instrument." (810 ILCS 5/3-419(a).) First Commercial was a "direct beneficiary" of the loan; it received $650,000 from it. Since "part of the loan was paid to" First Commercial (Official Comment to 810 ILCS 5/3-419.), First Commercial was not an accommodation party or a guarantor.

As a non-accommodation party, First Commercial was a primary obligor on the loan, and its obligation to repay the loan was absolute and unconditional.[14/] (See Landmark KCI Bank v. Marshall, 786 S.W.2d 132, 136 (Mo. Ct. App. 1989) (stating that a co-signer's liability is "unconditional and absolute"); Krumme v. Moody, 910 P.2d 993, 996-997 (Okl. Sup. Ct. 1995) (holding that a non-accommodating co-signer is a primary obligor).) First Commercial should have listed the loan as a current liability.

First Commercial's post-hearing brief makes no attempt to reconcile the statutory definition of an accommodation party with First Commercial's contention that it acted as a guarantor. The brief simply declares that as a guarantor, First Commercial did not have to report the loan as a current liability until Burling Bank declared a default. (FC PHB 14.) Since the loan was not in default during the time period relevant to the complaint, First Commercial maintains that it did not commit a violation by failing

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14/ First Commercial and Hermanson were jointly and severally obligated. (Clause 16 of each note's "Terms and Conditions.")

to report it as a liability. (Id.)

In support of its position, First Commercial quotes an Illinois appellate court decision which held that "no liability may be imposed upon [a party] unless and until the principal debtor has defaulted." (FC PHB 12-13, quoting Hensler v. Busey Bank, 231 Ill. App. 3d 920, 927 (1992).) Whether a party is legally liable to pay a bank after a principal debtor defaults has no relevance to the current matter. The charges in the complaint concern First Commercial's failure to treat the loan as a liability in its net capital computations. They do not involve First Commercial's liability to repay the loan after Burling Bank declared a default.

First Commercial's attorneys are well aware of the distinction between a party's liability to repay a loan in default and a party's classification of a loan in its accounting records. After Burling Bank declared a default on the loan, it sued First Commercial and the Circuit Court of Cook County held that First Commercial was liable for the repayment of the loan.15/ (Judgement Order, dated Aug. 14, 1997 (No. 94 L 14334).) Based on the Cook County judgement, the Division filed a motion seeking issue preclusion on First Commercial's failure to include the loan as a liability in its net capital computations.16/ (Motion Seeking Issue Preclusion Based Upon Summary Judgement, filed Dec. 11, 1997.) In its opposition papers, First Commercial chastised

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15/ First Commercial is appealing the Cook County judgement. (Memorandum in Opposition to DOE's Motion to Supplement the Record ¶¶ 7, 9, filed Oct. 17, 1997.)

16/ The ALJ denied the Division's motion. (Tr. 7-9.)

the Division for failing to recognize that "the issues presented" in the Cook County matter and the current matter "are different in all material respects." First Commercial went on to state that:

> The issue in [the Cook County] case, therefore was whether First Commercial was liable for repayment as a co-signer, after the note went into default. By contrast, the issue with respect to the Note in the present case is whether First Commercial had any obligation to carry the Note on its books as a current liability during the time period . . . prior to the declaration of default . . . . The [Cook County] case involved a determination of what liability First Commercial had to repay the loan after default by John Hermanson. The [Commission complaint] . . . involves the accounting treatment, if any, that was required for that same note prior to default.[17]

(Response to Issue Preclusion 3-4, filed Dec. 13, 1996 (emphasis in original).)

As First Commercial's attorneys stated so cogently, First Commercial's liability to repay the loan after Burling Bank declared a default is of no interest to this proceeding. First Commercial's post-hearing argument to the contrary has no merit.

b. The second and third notes

Hermanson signed three separate notes for Burling Bank loan number 9012. First Commercial insists that under no circumstances did it have to report the second note as a liability until Rehn signed it in February 1994. First Commercial also asserts that it did not have any obligation to report the third note as a liability because Rehn never signed it. (FC PHB 13 & n.8, 14.)

The fact that Rehn did not immediately sign the second note

17/ In his closing argument, First Commercial's counsel reiterated that the issue with respect to the loan was not First Commercial's legal liability after default, but how First Commercial "account[ed]" for the loan. (Tr. 960-961.)

and never signed the third note does not absolve First Commercial from its failure to report these notes as liabilities. Bill Aldrich testified that the second and third notes were "renewal" notes which merely extended the time for repayment of the loan.[18] (Tr. 284-286.) A party that fails to sign a renewal note is not discharged from its obligation on the original note unless all the parties intend otherwise. (See State Bank v. Winnetka Bank, 245 Ill. App. 3d 984, 991 (1993); see also Farmers Union Oil Co. v. Fladeland, 287 Minn. 315, 319 (1970); Landmark KCI Bank v. Marshall, 786 S.W.2d 132, 143 (Mo. Ct. App. 1989); Commerce Union Bank v. Burger-in-a-Pouch, 657 S.W.2d 88, 90 (Tenn. Sup. Ct. 1983); Annotation, Renewal Note Signed by One Comaker as Discharge of Nonsigning Comakers ["Annotation"], 43 A.L.R.3d 246, 252 (1972).) Burling Bank's conduct after Hermanson signed the second and third notes indicates that it did not intend for these notes to discharge First Commercial from its liability on the first note.

The bank treated First Commercial as a primary obligor. It accepted loan payments from First Commercial before Rehn signed the second note and after Hermanson signed the third note.[19] (FC Exs. 153b, 153f, 153j, 153m; Tr. 647-652, 922-923.) On September 28, 1994, after Hermanson had signed the third note, the bank

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[18] First Commercial's request for admissions from Hermanson refers to the second note as a "renewal note." (First Commercial Requests to Admit Propounded to Hermanson ¶ 12.)

[19] First Commercial continued to make payments on the loan even after Hermanson had stopped working there. (Maksymec Test. 14; Tr. 88, 574.) In total, Burling Bank obtained approximately $225,000 from First Commercial prior to filing suit for the loan balance and interest. (Maksymec Test. 14; Tr. 572.)

demanded that First Commercial pay the outstanding principal and accrued interest within five days. (FC Ex. 8.) The next day it faxed a copy of the loan history to Rehn. (DOE Ex. 98.) On October 14, the bank notified First Commercial that the loan was in default. (FC Ex. 81.) In December, it seized $40,000 from a First Commercial account at the bank and applied that money towards the loan. (FC Ex. 153o, Tr. 573, 652.)

The fact that Bill Aldrich asked Rehn to sign the renewal notes (FC Ex. 81; Tr. 286, 761.) is further evidence that the bank never intended to release First Commercial from its obligation on the first note. (See Commerce Union Bank, 657 S.W.2d at 91 (asking party to sign renewal note demonstrated bank's intent not to discharge party).) It is inconceivable that Aldrich, who knew that Hermanson had a dubious credit history (Tr. 270, 274.), intended to discharge First Commercial by accepting the renewal notes without Rehn's signature.

Not only did Burling Bank not intend to discharge First Commercial, but First Commercial also agreed to remain liable on the first note if the bank extended Hermanson's time to repay the loan. Clause 10 of the first note's "Terms and Conditions" stipulated that any modification of Hermanson's obligations would not affect First Commercial's obligations. Clause 10 acted as First Commercial's consent to a renewal or extension of the first note without a discharge of its obligations. First Commercial has no defense based on Rehn's delayed signing of the second note and his failure to sign the third note. (See American Nat'l Bank v.

Warner, 127 Ill. App. 3d 203, 206-07, 208 (1984) (finding non-signing party liable on renewal note due to contract provision about renewals and extensions contained in the signed notes); see also (Krumme v. Moody, 910 P.2d 993, 998 (Okl. Sup. Ct. 1995) (refusing to release party from its obligation on the first note when it agreed in advance to its renewal or extension); Annotation at 252 (consenting to renewal prevents party from claiming a discharge due to its failure to sign a renewal note).) First Commercial should have listed the loan as a current liability at all times.

3. The Hermanson and Schillaci Notes

On or about January 31, 1994, Hermanson signed a promissory note and stock pledge agreement in favor of First Commercial. He pledged his interest in CDDT stock as security for the note. First Commercial classified the note as a secured receivable and counted it as a current asset.

The Hermanson note did not qualify as a current asset. It was not secured by "readily marketable" collateral since CDDT stock was not listed on an exchange. Furthermore, First Commercial did not possess or control the stock. Nor did it perfect a security interest in the stock.

First Commercial contends that it perfected a security interest in the CDDT stock when Steve Thayer, Hermanson's attorney, received the security agreement. (FC PHB 18-19.) The provision under which First Commercial claims a perfected security interest, Section 8-313(1)(h)(ii) of the 1994 Illinois Commercial Code, only

applied if the person who received the security agreement, in this case Thayer, also possessed the stock. (See generally 810 ILCS 5/8-321 (1994) (providing that a security interest in a security is perfected if transferred pursuant to a provision of Section 8-313(1).) Thayer, however, never had possession of the stock. Nor did he ever tell Rehn or any other First Commercial employee that he had possession.[20/] (Tr. 250, 251-252.) First Commercial therefore, did not have a perfected security interest in the CDDT stock.

On February 4, 1994, First Commercial loaned $250,000 to Robert Schillaci. Schillaci gave First Commercial a security interest in his CME seat as collateral for the loan. First Commercial classified the loan as a secured receivable and counted it as a current asset.

The Schillaci note did not satisfy the regulatory criteria for a current asset. The CME seat pledged as collateral was already encumbered from a prior loan to Schillaci. Furthermore, exchange seats are not "readily marketable" collateral.

4. The Dearborn Loan

On April 14, 1994, Dearborn arranged for stock and cash to be loaned to First Commercial. The loan created a liability for First Commercial until the NFA approved the subordination agreements for

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20/ First Commercial's attorneys gratuitously cast aspersions on Thayer by insinuating that it was "unusual" and maybe "unethical" for Thayer to meet with Hermanson and Rehn. (FC PHB 18 n.11.) When Thayer, Hermanson, and Rehn met to discuss the note and stock pledge agreement, Thayer informed Rehn that he represented Hermanson's interests, and he suggested that First Commercial obtain its own lawyer. (Tr. 253, 255.) Thayer did nothing even remotely "unusual" or "unethical."

the loan on September 15. From April 14 through September 15, First Commercial should have treated the loan as a liability in its net capital computations.

5. Conclusion

For the "as of" periods beginning on June 30, 1993, and ending on August 31, 1994, First Commercial overstated its adjusted net capital by improperly classifying the month-end transfers, the Burling Bank loan, the Hermanson and Schillaci notes, and the Dearborn loan. From September 30, 1993, through August 31, 1994, First Commercial's actual adjusted net capital was below the minimum requirements. During that time period, First Commercial violated the Act and Commission Regulations by maintaining less than the prescribed amount of adjusted net capital, operating while undercapitalized, and failing to transfer all customer accounts and immediately cease doing business as an FCM.

B. Count II: Filing False 1-FRs

Count II of the complaint alleges that First Commercial and Rehn willfully filed false 1-FRs in connection with the month-end transfers, the Burling Bank loan, and the Dearborn loan. A party willfully files a false 1-FR if the party knows the 1-FR is false or acts with reckless disregard for its truth or falsity. (In re Squadrito, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,262 at 38,828 (CFTC Mar. 27, 1992).) First Commercial and Rehn maintain that any errors on First Commercial's 1-FRs were made in good faith and therefore cannot be considered "willful." (FC PHB 31-32; Rehn Post-Hearing Brief ["Rehn PHB"] 29.)

1. The Month-End Transfers

First Commercial and Rehn "consciously sought to mislead the Commission" by filing 1-FRs that reported the month-end transfers as current assets. (Squadrito at 38,828.) The transfers were sham transactions designed to puff up First Commercial's capital position. Rehn's revisionist explanation of the transfers was feeble. (See supra at 26-27.) First Commercial and Rehn willfully filed false 1-FRs concerning the month-end transfers.

2. The Burling Bank Loan

Rehn claimed that he thought First Commercial had no liability on the loan "whatsoever" because any payments by First Commercial would be taken from Hermanson's commission income. If Rehn truly thought that Hermanson's commission income was sufficient to pay off the loan, then there would have been no need for Hermanson to obtain the loan in the first place. First Commercial could have simply applied Hermanson's commission income directly to his "debt" with First Commercial instead of applying it to the loan. Or to put it another way, if Hermanson could not pay off his "debt" to First Commercial with his income from commissions and outside sources, then Rehn had no reason to think that Hermanson could pay off the Burling Bank loan with just his commission income. Rehn knew that First Commercial funds would be used to pay off the loan.

Rehn testified that he did not consider First Commercial to be "primarily obligated" on the loan. (Tr. 757.) Yet, Andrew Gadzinski told Rehn that First Commercial's obligation was no different than if it had been the only party who signed the loan.

Rehn also testified that he considered First Commercial to be a guarantor of the loan because the notice to co-signer stated that First Commercial was "being asked to guarantee" the loan. The last sentence of the notice, however, declared that "[t]his notice is not the contract that makes you liable for this debt." Furthermore, Rehn knew what a Burling Bank guaranty agreement looked like. He signed one on the same day that he signed the notice to co-signer for the first note. The agreement had small lettering, filled an entire page, had the word "guaranty" in the upper left hand corner, and did not require the guarantor to co-sign the note. The notice to co-signer had bigger print and was merely nine sentences long.

Rehn concocted his testimony about the loan in an attempt to cloak his actions with good faith. He wanted the loan in Hermanson's name so it would appear that Hermanson was the party primarily liable for its repayment. The fact that Rehn's plan was ill-conceived does not make it any less illegal.

It is foolhardy for First Commercial to assert that it had a good faith belief that the loan was not a liability when one considers that Butzen, the person who prepared its 1-FRs, did not even know about the loan for ten months. When he did become aware of the loan, he never even thought about whether it should be reflected as a liability. Butzen's carefree attitude towards First Commercial's duty to file accurate 1-FRs is not fodder for a finding of good faith. First Commercial and Rehn willfully filed false 1-FRs concerning the Burling Bank loan.

3. The Dearborn Loan

First Commercial blames its failure to properly account for the Dearborn loan on indifferent regulators who "failed to respond to [its] documentation and delayed months at a time." (FC PHB 25.) First Commercial's cry of victimization does not play well.

Commission dictates could not be more straightforward. A loan to an FCM must be treated as a liability in its net capital computations unless the loan is subordinated to the claims of the FCM's general creditors, and the NFA has approved the subordination agreement. In its 1-FRs for the "as of" periods ending April 30 through August 31, 1994, First Commercial excluded the Dearborn loan from its liabilities even though it had not received NFA approval of the subordination agreements.[21/] Moreover, its 1-FR for the "as of" period ending April 30, 1994, classified the loan as additional paid-in-capital. First Commercial and Rehn willfully filed false 1-FRs concerning the Dearborn loan.

C. Counts III and IV: Failure to Notify the Commission

1. Early warning status

Count IV of the complaint charges that First Commercial violated Commission Regulation 1.12(b) by failing to provide the Commission with written notice when it knew or should have known that its adjusted net capital was below early warning levels.

First Commercial was in early warning status for the "as of" periods ending June 30 through August 31, 1993. During this time

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21/ First Commercial did not even file subordination agreements until July 27, 1994.

frame, First Commercial willfully misclassified the month-end transfers and the Burling Bank loan to make it appear that its adjusted net capital was above early warning levels. (See supra at 37-38.) Therefore, for the "as of" periods ending June 30 through August 31, 1993, First Commercial knew or should have known that its actual adjusted net capital was below early warning levels.

In June, First Commercial notified the Commission of its early warning status. First Commercial contends that its June notice was still "in effect" throughout July and August "and continued to satisfy the purpose of the regulation." (FC PHB 51.) Commission Regulation 1.12(b) requires an FCM to notify the Commission if it knows or should know "at any time" that it is in early warning status. First Commercial therefore should have provided separate notices of its early warning status for July and August.

2. Undercapitalization

Count III of the complaint alleges that First Commercial violated Commission Regulation 1.12(a)(1) by not providing the Commission with telegraphic notice when it knew or should have known that its adjusted net capital was below the minimum levels.

First Commercial was undercapitalized for the "as of" periods ending September 30, 1993, through August 31, 1994. During this time frame, First Commercial willfully misclassified the month-end transfers, the Burling Bank loan, and the Dearborn loan in order to make it appear that its adjusted net capital was above early warning and minimum capitalization levels. (See supra at 37-39.) If First Commercial knew or should have known that the Hermanson

note was not a current asset, then based on its willful misclassification of the other transactions, First Commercial knew or should have known that its actual adjusted net capital was below the minimum requirements for the September 30, 1993, through August 31, 1994 periods.[22/]

First Commercial knew that it could not treat the Hermanson note as current asset since the CDDT stock which secured the note was not listed on an exchange and was therefore not "readily marketable." First Commercial also knew that it could not treat the note as a current asset since it did not have possession or control of the stock, or have a perfected security interest in it. First Commercial's post-hearing argument that it had a perfected security interest under Section 8-313(1)(h)(ii) of the 1994 Illinois Commercial Code is a desperate after-the-fact attempt by its attorneys to provide legal support for First Commercial's decision to classify the note as a current asset. Not only did First Commercial not satisfy the requirements of Section 8-313(1)(h)(ii) (See supra at 34-35.), but also its attorneys did not, needless to say, elicit testimony from Rehn or Butzen about how they believed that First Commercial had a perfected security interest based on their reading of Section 8-313(1)(h)(ii).

First Commercial knew or should have known that it was undercapitalized for the "as of" periods ending September 30, 1993,

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22/ The Schillaci note is not at issue because even if the $250,000 value of the note were subtracted from First Commercial's purported adjusted net capital, First Commercial would still have been above the early warning and minimum capitalization levels. (FC PHB 20.)

through August 31, 1994. Except for one occasion, First Commercial failed to notify the Commission that it was undercapitalized.

D. Controlling Person Liability of Rehn

The Division seeks to hold Rehn liable as a controlling person for First Commercial's failure to maintain the required amount of net capital (Count I). It also seeks to hold Rehn liable as a controlling person for First Commercial's failure to notify the Commission of its early warning status and its undercapitilization (Counts III and IV).

Rehn controlled First Commercial. As president and chief executive officer, he possessed "the power to direct or cause the direction of [First Commercial's] management and policies." (In re Spiegel, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,103 at 34,765 n.4 (CFTC Jan. 12, 1988).) Rehn also controlled how First Commercial classified the transactions at issue for purposes of its net capital computations. First Commercial's classification of these transactions is the predicate for its violations of the Act and Commission Regulations. (See In re First National Trading Corp., [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,142 at 41,787 (CFTC Jul. 20, 1994) (finding control when the respondent controlled the specific activity which formed the basis for the primary violations).)

Rehn, as a controlling person of First Commercial, is liable for its violations if he knowingly induced the acts constituting the violations or did not act in good faith. (Section 13(b) of the Act.) "Knowing inducement" is established by showing that the

controlling person had actual or constructive knowledge[23/] of the core activities constituting the violations and allowed them to continue. (In re Spiegel at 34,767.)

Rehn had actual or constructive knowledge that First Commercial contravened Commission directives when it classified the transactions at issue for its net capital computations. At the hearing, he feigned that he had an honest belief that First Commercial properly accounted for the transactions. Rehn is liable as a controlling person for First Commercial's violations of Sections 4f(b) of the Act and Commission Regulations 1.17(a)(1), 1.17(a)(4), 1.12(a)(1), 1.12(a)(2), and 1.12(b).

E. Aiding and Abetting Liability of Hermanson

The Division asserts that Hermanson's participation in the month-end transfers and the Burling Bank loan aided and abetted First Commercial in filing false 1-FRs, operating while undercapitalized, and maintaining less than the minimum amount of adjusted net capital. (DOE Proposed Findings of Fact ¶¶ 182, 191.)

Knowing participation in a primary party's unlawful conduct is sufficient to establish aiding and abetting liability. (See In re Richardson Securities, Inc. [1980-1982 Transfer Binder] Comm. Fut. L. Rep. ¶ 21,145 at 24,646 & n.14 (CFTC Jan. 25, 1981).) Hermanson participated in the month-end transfers and the Burling Bank loan as a "favor" to Rehn. He avowed that his participation in the month-end transfers was wrong. He also assuredly knew that his

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23/ A person who consciously seeks to avoid knowledge of an activity has constructive knowledge of that activity. (In re Spiegel at 34,767 n.11.)

Burling Bank "favor" was also improper.

Hermanson knowingly associated himself with deceptive transactions that permitted First Commercial to overstate its net capital on its 1-FRs and continue operating as an FCM. His conduct establishes that he "knowingly participated" in the month-end transfers and the Burling Bank loan. He is liable as an aider and abetter for First Commercial's violations of Section 4f(b) of the Act and Commission Regulation 1.17(a)(4), as well as its violations of Section 6(c) of the Act and Commission Regulation 1.10(d)(1).[24/]

24/ Hermanson did not violate Commission Regulation 1.17(a)(1) which requires an FCM to maintain a minimum amount of net capital. He did not assist First Commercial in falling below the minimum capital requirements.

IV. CONCLUSIONS OF LAW

A. Count I

The Division has proved by a preponderance of the evidence that First Commercial violated Section 4f(b) of the Act and Commission Regulations 1.17(a)(1) and (a)(4) for the "as of" periods ending September 30, 1993, through August 31, 1994.

The Division has proved by a preponderance of the evidence that Rehn is liable as a controlling person for First Commercial's violations.

The Division has proved by a preponderance of the evidence that Hermanson willfully aided and abetted First Commercial's violations of Section 4f(b) of the Act and Commission Regulation 1.17(a)(4). The Division has failed to meet its burden as to the charge that Hermanson willfully aided and abetted First Commercial's violations of Commission Regulation 1.17(a)(1).

B. Count II

The Division has proved by a preponderance of the evidence that First Commercial and Rehn violated Section 6(c) of the Act and Commission Regulation 1.10(d)(1) for the "as of" periods ending June 30 through September 30, 1993, and December 31, 1993, through August 31, 1994.

The Division has proved by a preponderance of the evidence that Hermanson willfully aided and abetted First Commercial's violations.

C. Count III

The Division has proved by a preponderance of the evidence

that except for one occasion, First Commercial violated Commission Regulations 1.12(a)(1) and (a)(2) for the "as of" periods ending September 30, 1993, through August 31, 1994.

The Division has proved by a preponderance of the evidence that Rehn is liable as a controlling person for First Commercial's violations.

D. Count IV

The Division has proved by a preponderance of the evidence that First Commercial violated Commission Regulation 1.12(b) for the "as of" periods ending July 31 and August 31, 1993.

The Division has proved by a preponderance of the evidence that Rehn is liable as a controlling person for First Commercial's violations.

V. SANCTIONS

A. Cease and Desist Order

A cease and desist order is appropriate for all of the respondents. Their conduct was not a case of isolated wrongdoing.

B. Revocation of Registration

For fourteen months, Rehn, acting on behalf of First Commercial, deceived regulators about First Commercial's financial condition. Rehn conspired with Hermanson to raise assets through a check-kiting scheme, and he used Hermanson as a nominee borrower to obtain an additional $650,000 in assets from Burling Bank. Rehn then falsely categorized the Hermanson note as a secured receivable in another attempt to boost First Commercial's net capital. Rehn also falsely categorized the Dearborn loan as additional paid-in-capital so First Commercial would appear to be above the minimum capital requirements.

Rehn signed his name to thirteen 1-FRs which contained false and misleading information. Each 1-FR reminded him of his obligation to ensure its accuracy to the best of his knowledge. Thirteen times Rehn knowingly breached this obligation. His conduct demonstrated a stunning contempt for his responsibilities as the president and chief executive officer of an FCM.

First Commercial permitted itself to fall below the minimum capital requirements. It chose deceit over disclosure as its response. Rehn permitted First Commercial to operate outside regulatory boundaries. He chose disdain over deference as his attitude towards Commission requirements. First Commercial's and

Rehn's systematic fraud on the Commission and NFA is tantamount to a fraud on the investing public. The registrations of First Commercial and Rehn are revoked.

Hermanson willfully assisted First Commercial's fraud by participating in a check-kiting scheme and by arranging for the Burling Bank loan in his own name. His actions reflect a fundamental lack of integrity. His registration is revoked.

C. Monetary Penalty

Adherence to capital requirements is critical to the stability of the futures industry. The requirements serve as the "primary financial protection for public customers who must entrust their funds to commodity professionals." (In re Premex, [1987-1990 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 24,165 at 34,891 (CFTC Feb. 17, 1988).) For fourteen months, First Commercial and Rehn knowingly abrogated this protection and created the false impression that the accounts of First Commercial's customers were not at risk.

First Commercial and Rehn have shown no appreciation for the severity of their wrongdoing. They believe their violations, if any, were technical and caused by Hermanson's treachery. (FC PHB 1-4, 53-54; Rehn PHB 5, 28-29.) First Commercial's post-hearing brief asserts that Hermanson "defraud[ed] Mark Rehn and First Commercial." (FC PHB 3.) Rehn's post-hearing brief adds: "[t]here was only a plan by Hermanson to bilk [First Commercial] through his manipulation of Rehn." (Rehn PHB 5.)

First Commercial and Rehn are not being sanctioned for their

poor judgement regarding Hermanson. Rather, it is their concerted attempt to cover up First Commercial's capital deficiencies that merits a monetary penalty. The fact that those deficiencies may have been caused by First Commercial's imprudent decision to "loan" or "advance" funds to Hermanson is not a mitigating factor.

The pleas of good faith by First Commercial and Rehn cannot be taken seriously. (FC PHB 4; Rehn PHB 29.) An FCM and its president do not act in good faith by participating in juryrigged transactions at month-end for the sole purpose of overstating the FCM's net capital. Nor do they act in good faith by obtaining $650,000 for the FCM under the guise of a loan to an employee. Finally, an FCM and its president do not act in good faith by classifying two promissory notes as current assets and one loan as additional paid-in-capital without any regard for the Commission Regulations that clearly prescribe how these transactions should be treated.

Rehn's plea of good faith is particularly hollow when juxtaposed with his belief that his background "creates a presumption of ignorance." (Rehn PHB 11.) If Rehn truly did not grasp the elementary accounting issues involved in this case,[25/] then he certainly did not demonstrate good faith by choosing to rely on his own "accounting" judgement instead of consulting with regulators.

First Commercial's and Rehn's conduct did not have disastrous

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25/ Rehn's profession of ignorance seems dubious when one considers that he is a certified public accountant and lawyer with 17 years experience in the futures industry. (Tr. 30-31.)

consequences. First Commercial's customers did not lose any funds as a result of its failure to maintain adequate net capital. First Commercial, however, did suffer monetarily because it was forced to repay the Burling Bank loan.

Based on the factors mentioned in In re Grossfeld, First Commercial is assessed a monetary penalty of $200,000, and Rehn is assessed a monetary penalty of $200,000. (In re Grossfeld, [Current Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,921 at 44,467-68 (CFTC Dec. 10, 1996).) Hermanson was not involved in all of the transactions and did admit that his month-end dealings with First Commercial were wrong. He is assessed a monetary penalty of $50,000.

ORDER

First Commercial is **ORDERED** to cease and desist from violating Sections 4f(b) and 6(c) of the Act and Commission Regulations 1.17(a)(1), 1.17(a)(4), 1.10(d)(1), 1.12(a)(1), 1.12(a)(2), and 1.12(b). It is further **ORDERED** to pay a monetary penalty of $200,000 within 30 days of the date that this decision becomes final. Its registration is hereby **ORDERED** revoked.

Mark Rehn is **ORDERED** to cease and desist from violating Sections 4f(b) and 6(c) of the Act and Commission Regulations 1.17(a)(1), 1.17(a)(4), 1.10(d)(1), 1.12(a)(1), 1.12(a)(2), and 1.12(b). He is further **ORDERED** to pay a monetary penalty of $200,000 within 30 days of the date that this decision becomes final. His registration is hereby **ORDERED** revoked.

John Hermanson is **ORDERED** to cease and desist from violating

Sections 4f(b) and 6(c) of the Act and Commission Regulations 1.17(a)(4) and 1.10(d)(1). He is further **ORDERED** to pay a monetary penalty of $50,000 within 30 days of the date that this decision becomes final. His registration is hereby **ORDERED** revoked.

Issued October 27, 1997

George H. Painter
Administrative Law Judge

Attorney-Advisor:
Anthony Saler