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NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. C02980073
v.	:	Hearing Officer - EBC
Respondents.	:	

ORDER GRANTING ENFORCEMENT'S MOTION FOR LEAVE TO INTRODUCE EXPERT WITNESS TESTIMONY

The Department of Enforcement (Enforcement) has moved for leave to introduce expert witness testimony at the hearing in this proceeding. Respondents _____ have opposed the motion. For the reasons set forth below, Enforcement's motion is granted.

I. Factual Background and the Proposed Expert Witness Testimony

Enforcement's Complaint alleges that, in May and June 1996, _____, acting through _____, charged excessive mark-ups and mark-downs, ranging from 3.89% to 4.74%, on 12 riskless principal transactions (four sales and eight purchases) involving municipal bonds. As a result of their alleged misconduct, Respondents are charged with violating Municipal Securities Rulemaking Board (MSRB) Rule G-30. Rule G-30 requires that retail prices of municipal

securities be "fair and reasonable, taking into consideration all relevant factors."[1] The MSRB thus far has declined to adopt any specific numeric standard for the pricing of municipal securities that is comparable to the NASD's five-percent policy for mark-ups or mark-downs on equity securities.[2]

Enforcement seeks to offer expert witness testimony regarding the fairness and reasonableness of Respondents' pricing decisions on the transactions at issue. More particularly, it proposes offering an expert witness to opine that the mark-ups and mark-downs charged by Respondents were excessive, given: (1) the par value, maturity, rating, and availability of the bonds; (2) the total dollar amount of the transactions; (3) the expense and risk involved, if any, in the transactions; (4) the yield to the customers; and (5) the nature of _____ business. Enforcement also anticipates that its proposed expert witness will testify about the pricing of comparable transactions effected during the same period as the challenged transactions. Finally, Enforcement expects that its proposed expert will offer his opinion as to the appropriate pricing of the transactions under standard industry practice.

II. Ruling

This is the second motion Enforcement has filed seeking leave to introduce expert witness testimony. The Hearing Officer denied Enforcement's initial motion because it had identified as

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[1] Rule G-30(a) states:

> No broker, dealer or municipal securities dealer shall purchase municipal securities for its own account from a customer or sell municipal securities for its own account to a customer except at an aggregate price (including any mark-down or mark-up) that is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction.

[2] See IM-2440.

its expert an individual who is a current member of an NASD Regulation, Inc. (NASDR) District Committee.[3] Pursuant to a resolution adopted by the NASDR Board of Directors, a current District Committee member is prohibited from appearing as an "expert, or consultant in any Association hearing" on behalf of any party.[4] The Hearing Officer, in denying Enforcement's initial motion, did not rule on the broader question of whether, based on Enforcement's proffer, expert witness testimony would be warranted in this proceeding.

In support of its present motion, Enforcement asserts that the application of the factors set forth in Rule G-30 to the transactions at issue is "sufficiently technical" to justify expert witness testimony pertaining to the reasonableness of the mark-ups and mark-downs charged by Respondents. Respondents argue that Enforcement has failed to demonstrate a "compelling rationale" to warrant the use of expert witness testimony in this proceeding; that the matters involved are not technical; and that the Hearing Panel does not require expert assistance to determine whether the transactions at issue were priced in accordance with industry standards. Respondents also object to the introduction of expert witness testimony on the ground that Enforcement has failed to demonstrate that its newly-proposed expert, _____, is qualified to offer expert testimony or an expert opinion on the subjects described in Enforcement's motion.[5]

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[3] See Transcript of February 19, 1999 Pre-Hearing Conference, pp. 6-7.

[4] A copy of the proposed resolution, which was adopted at the January 27, 1997 meeting of the NASDR Board, is attached.

[5] In its present motion, Enforcement indicated that it intended to designate _____ as its expert. On March 17, 1999, Enforcement filed a "Notice of Change of Expert Witness" stating that it intends to designate _____, instead of _____, as its expert. On March 18, Respondents filed papers objecting to Enforcement's designation of _____ as its expert. Enforcement filed a reply on March 18.

Generally, in NASD disciplinary proceedings, because two of the three Hearing Panelists will have considerable expertise about the securities industry and industry practice, the use of expert witness testimony is far less necessary or routine than it may be in federal court proceedings. Typically, expert witness testimony is not offered in NASD disciplinary matters, unless novel issues or new, complex, or unusual securities products are involved. This is not to say, however, that expert witness testimony may never be appropriate in other circumstances. The fundamental question is whether the proposed testimony would assist the Hearing Panel in understanding the evidence or a fact at issue in the proceeding.

The use of expert witness testimony in this case presents a close question. The SEC has indicated that expert testimony may be helpful, if not necessary, to determine the fairness and reasonableness of the pricing of debt securities, including municipal bonds. See In re First Honolulu Securities, Inc., Exchange Act Release No. 32933, 1993 SEC LEXIS 2422, at * 15 & n.26, at *15 (Sept. 21, 1993) (noting that mark-ups ranging between four and five percent on municipal securities may have been unfair, but that the NASD had failed to introduce expert testimony concerning the mark-ups customarily charged for such securities). The Hearing Officer, however, is not persuaded that the failure to introduce expert testimony on this issue is necessarily tantamount to a failure in proof or that, in every case involving the pricing of municipal bonds, expert testimony will assist the trier of fact. Indeed, in a case involving the fairness of mark-ups of 8 ¼ percent on municipal bonds, the National Business Conduct Committee (NBCC), while noting the SEC's comments in First Honolulu Securities, Inc., denied complainant's request to adduce expert witness testimony regarding customary and usual mark-ups on the type of securities at issue. District Business Conduct Committee No. 4 v. Miller, Johnson, Kuehn, Inc., Complaint No. C04920061, 1994 NASD Discip. LEXIS 51, at * 21-22

(NBCC Feb. 28, 1994). In so doing, the NBCC concluded that it "had sufficient expertise in the municipal bond industry to be able to determine, on the basis of all of the evidence and the relevant factors enumerated by the MSRB in Rule G-30 and the Interpretations thereunder, whether the bonds at issue were priced fairly and reasonably." Id., at * 22.[6]

In this case, which involves the fairness of mark-ups and mark-downs of less than five percent,[7] the Hearing Officer concludes that it is appropriate to allow Enforcement to adduce expert witness testimony on the subjects it has identified, and that such testimony may be of assistance to the Hearing Panel. The industry members of the Hearing Panel of course will bring their own expertise to the matters at issue, and expert witness testimony will not substitute for the Hearing Panel's own analysis and evaluation of whether Respondents fairly and reasonably priced the subject bonds; nor will it be dispositive of any issue in this proceeding. The Hearing Officer also notes that Enforcement's failure to demonstrate that _____ is qualified to offer expert testimony is not, at this time, a basis for excluding his testimony.[8]

Enforcement is reminded that, as a further prerequisite to the introduction of expert witness testimony, it must comply with the December 16 Initial Pre-Hearing Order pertaining to

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[6] See also id., at * 22, n.10.

[7] The SEC and NASD have long held that mark-ups of over five percent in municipal securities are excessive. See, e.g., In re Staten Securities Corporation, 47 S.E.C. 766 (1982); District Business Conduct Committee No. 4 v. Miller, Johnson, Kuehn, Inc., 1994 NASD Discip. LEXIS 51, at * 29.

[8] Pursuant to the December 16 Initial Pre-Hearing Order, Enforcement was not required to furnish any information about its proposed its expert (or even to designate a particular expert witness) with its motion seeking leave to introduce expert witness testimony; that information is not required until Enforcement serves and files its Pre-Hearing Submission, which is due on March 31. Further, as provided in the December 16 Order, a ruling on a motion seeking leave to introduce expert witness testimony is preliminary in nature and does not preclude later challenges based on the detailed information required to be filed with an expert witness designation.

the service and filing of expert witness information. Finally, to enhance the efficiency of the hearing process and to ensure adequate preparation for hearing, the direct testimony of any permitted expert witness shall be introduced in the form of a sworn affidavit, which shall be served and filed on May 3, 1999. The expert shall be made available at hearing for cross and re-direct examinations.

SO ORDERED.

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Ellen B. Cohn
Hearing Officer

Dated: Washington, DC
March 23, 1999