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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. CAF030014 Hearing Officer—Andrew H. Perkins

ORDER PARTIALLY GRANTING THE RESPONDENT'S MOTION TO RECONSIDER DISCOVERY REQUESTS

Respondent now seeks reconsideration of two orders denying various discovery requests. On July 17, 2003, the Respondent filed a motion to compel production of documents (the "Discovery Motion"), and on November 21, 2003, the Respondent moved, pursuant to NASD Procedural Rule 9252, that NASD issue a Request for Production of Documents to 22 member firms (the "Rule 9252 Motion"). The Hearing Officer denied these motions by orders dated October 6, 2003, (the "Discovery Order") and March 24, 2004 (the "Rule 9252 Order").[1] The Respondent seeks reconsideration at this point because the Department of Enforcement (the "Department") has since filed expert witness reports that demonstrate that the requested information is material and exculpatory.

[1] This is the Respondent's second motion for reconsideration of the order denying the Rule 9252 Motion.

The Respondent's various discovery requests have been the subject of considerable briefing and argument. Accordingly, the Hearing Officer will not address again in this Order all of the issues surrounding these requests. Instead, the Hearing Officer will focus on whether the Department's proposed expert opinion testimony necessitates further disclosure under Procedural Rule 9251 and the doctrine enunciated in *Brady v. Maryland*[2] (the "Brady Doctrine").

The Department opposes the Respondent's motion for reconsideration and each of the Respondent's discovery requests. The Department reasserts that the document requests exceed the scope of its obligations under Code of Procedure Rule 9251(a)(1) and that much of the requested material is privileged under Code of Procedure Rule 9251(b)(1). In addition, the Department objects to the Respondent's delay in moving for reconsideration. The Department contends that its experts' reports do not inject new contentions that merit reconsideration of the Hearing Officer's previous rulings.

For the reasons discussed below, the Hearing Officer grants the Respondent's motion in part.

I. Introduction

The Complaint alleges that, between October 1999 and March 2000, the Respondent participated as a member of the selling group in more than 50 initial public offerings ("IPOs"). Frequently, the IPOs were "hot issues"—shares that traded immediately in the aftermarket at a significant increase from the initial offering price.

[2] 373 U.S. 83 (1963).

The central charge in the Complaint is that the Respondent, in connection with the allocation of hot issues, engaged in "profit sharing" with its institutional customers in violation of NASD Conduct Rule 2330(f).[3] The Department alleges that the Respondent allocated hot issues to its best customers—those that paid the most commissions—and that this policy induced its customers to pay Respondent inflated and unjustified commissions, which the Respondent accepted although it knew, or should have known, that acceptance of these inflated and unjustified commissions amounted to impermissible profit sharing in its customers' accounts.[4] Specifically, the Department contends that some customers engaged in the following practices to increase the likelihood that Respondent would allocate them hot issues. First, the Department contends that customers paid inflated and unjustified commissions on agency transactions in liquid securities. Second, the Department contends that some customers paid excessive and unjustified commissions to Respondent when they immediately sold or "flipped" the hot IPO shares they received, thereby paying a portion of their profit on those sales to Respondent. Third, the Department contends that some customers engaged in trades of liquid securities solely to increase the amount they paid in commissions to Respondent. The Department further contends that these customers often paid inflated and unjustified commissions on both the purchase and sale of the securities.

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[3] With limited exceptions not applicable here, Rule 2330(f)(1)(A) permits sharing in the profits and losses in a customer's account only in direct proportion to the financial contributions made to such account by the member.

[4] The Respondent argues, and the Department concedes, that Respondent's customers set the commission rates they paid, without any demand from Respondent.

Hedging its bet that the foregoing conduct violates Conduct Rule 2330(f), the Department alleges in the Second Cause of Action that the Respondent violated NASD Conduct Rule 2110[5] by "receiv[ing] inflated commissions and permit[ing] its customers to try and influence [Respondent] to allocate IPO shares to them."[6] Essentially, the Department advances this theory as an alternative to the more detailed allegations of profit sharing set forth in the First Cause of Action.

The Complaint also contains a number of charges directly related to Respondent's IPO practices. The Third Cause of Action charges that Respondent failed to comply with NASD's corporate finance rules. Specifically, the Complaint alleges that Respondent failed to adequately describe the underwriting arrangements, terms, and conditions by omitting information about Respondent's alleged profit-sharing practices, in violation of NASD Conduct Rules 2710(b)(1) and 2710(b)(5)(a)(ii). The Fourth Cause of Action charges that Respondent failed to maintain accurate books and records that reflected that Respondent shared in its customers' profits, in violation of Section 17(a) of the Securities Exchange Act of 1934, Exchange Act Rules 17a-3(a)(1), (2), and (6), and NASD Conduct Rules 3110 and 2110. The Fifth Cause of Action charges that Respondent supervisors failed to properly follow up on numerous red flags that Respondent's customers were sharing a portion of their IPO profits with Respondent, or that its customers were paying inflated commissions to try and influence Respondent to allocate

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[5] Conduct Rule 2110 requires members to observe high standards of commercial honor and just and equitable principles of trade. The Rule "is not limited to rules of legal conduct but rather … it states a broad ethical principle." (*Timothy L. Burkes*, 51 S.E.C. 356 (1993), *aff'd mem*., *Burkes v. SEC*, 29 F.3d 630 (9th Cir. July 24, 1994)).

[6] Compl. ¶ 50.

IPO shares to them. The Department alleges that Respondent thereby violated NASD Conduct Rules 3010(a) and 2110. Finally, the Sixth Cause of Action charges that Respondent failed to maintain and enforce an adequate supervisory system and written supervisory procedures that were reasonably designed to achieve compliance with applicable laws and rules relating to the allocation of IPO shares, the receipt of commissions, and the supervision of Respondent employees involved in the allocation process, in violation of NASD Conduct Rules 3010(a) and 2110.

Respondent admits that it allocated hot issues to its best customers based on the amount of commissions they paid Respondent. However, Respondent argues that the practice by underwriters of allocating IPO shares to their best customers is a widely followed practice in the securities industry. In addition, Respondent distinguishes this case from one involving an unlawful "quid pro quo" on the grounds that its customers voluntarily set their commissions, taking into consideration the Firm's highly sophisticated services and proven record of success. Respondent further points out that it has consistently employed the same policies for almost 30 years. For these reasons, Respondent asserts it lacked fair notice that any of its activities could be construed to violate NASD Conduct Rules 2110 and 2330(f). Respondent vehemently complains that the instant charge constitutes a radical departure from existing policies and standards, which NASD was obligated to submit to the Securities and Exchange Commission (the "Commission") for its approval as a "rule change" under Section 19(b)[7] of the Securities

[7] 15 U.S.C. § 78s(b)(1).

Exchange Act of 1934 and Exchange Act Rule 19b-4. Having failed to do so, Respondent argues that the case must be dismissed.

II. Expert Reports

On September 15, 2004, the Department filed reports prepared by six proposed expert witnesses. Among them is the report prepared by Joseph E. Price ("Price"), Vice President in charge of the NASD Corporate Financing Department (the "Financing Department"). Price also is offered as a fact witness regarding what bearing Respondent's disclosure of information regarding "its profit sharing, inflated rate commission receiving practices" would have had on the Financing Department's review of underwriting terms and conditions.[8] Assuming the allegations in the Complaint are true, Price states that Respondent's inflated commissions, had they been disclosed to the Financing Department, would have been "material" to its underwriting review process. Thus, the Department squarely puts in issue NASD's underwriting review process and its interpretation of the rules applicable to that process. Accordingly, the Respondent requests that the Hearing Officer reconsider his prior ruling that had denied the Respondent access to a number of categories of documents related to NASD's internal review process on the grounds that the documents were protected from discovery by Procedural Rule 9251(b)(1).

The Department also filed reports prepared by JC, former Chief Operating Officer of Nasdaq and President of Nasdaq U.S. Markets; DG, a retired trader and supervisor at NASD member firms, and ER, an industry professional with experience managing

[8] *See* Price Report at 1 & n.1.

institutional investment portfolios. In summary, each of these experts, among other points, is offered for their opinion testimony that, for the services Respondent offered its institutional customers, commissions of 5 to 7 cents per share were reasonable during the applicable period. In addition, DG states in his report that commissions of 20 cents or more were unjustifiable under the facts and circumstances of this case. The Department also filed a report prepared by JB, the founder and former Chairman and Chief Executive Officer of The Vanguard Group, which states that Respondent acted unethically when it accepted excessive commissions.

These reports put in sharper focus the Department's theories and proof. With the benefit of this further information, the Hearing Officer has reviewed the Respondent's discovery requests and found that some additional disclosure is appropriate under the Brady Doctrine, which encompasses impeachment evidence as well as exculpatory evidence.[9]

III. The Discovery Motion

Respondent's Discovery Motion sought the production of documents in 14 broad categories, including all exculpatory material relating to the Department's claim that excessive commissions and profit sharing with customers in connection with the distribution of the offerings was information that would have had a bearing on NASD's review of underwriting terms and arrangements.[10] The Respondent also requested all documents indicating that commissions or other fees generated by third parties (other

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[9] *United States v. Bagley*, 473 U.S. 667, 676 (1985). *See also Giglio v. United States*, 405 U.S. 150, 154–55 (1972).

[10] Doc. Req. No. 2. *See* Compl. ¶ 54.

than the underwriter or its agents), or profit sharing, ever related to the NASD's review of underwriting terms and arrangements.[11]

In light of Price's proffered expert testimony, the Hearing Officer modifies the Discovery Order dated October 6, 2003, with respect to the Respondent's Request No. 2[12] and directs the Department to produce all materially exculpatory evidence relating to Price's testimony that otherwise is not available to the Respondent. However, to constitute materially exculpatory evidence, the subject documents must bolster the defense's case or impeach the Department's witnesses.[13] Applying that standard, the Hearing Officer finds that the Brady Doctrine does not require the production of "manuals, guidelines or examination modules" used by NASD staff in conducting underwriting reviews during the period in question except to the extent that they contain facts that would tend to impeach Price's testimony. If the Department has questions about the application of the Brady Doctrine to the documents responsive to Request No. 2, it may submit them to the Hearing Officer for *in camera* review.

Except to the extent modified by this Order, the Discovery Order remains in effect.

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[11] Doc. Req. No. 4.

[12] Request No. 2 asked for:

> All Documents relating to the assertion that Respondent's allegedly "excessive commissions and profit with customers in connection with the distribution of the offering was information that would have had a bearing on NASD's review of underwriting terms and arrangements" (Compl. ¶ 54), including any manuals, guidelines or examination modules for such reviews utilized during the period covered by the Complaint (or otherwise) that indicate how such NASD review would take into account the customers' commissions and profits in connection with distribution of offerings.

[13] *Giglio*, 405 U.S. 150, 154-55.

IV. The Rule 9252 Motion

Respondent's Rule 9252 Motion requested NASD to issue requests for information to 22 member firms to obtain sections of their compliance and supervisory manuals relating generally to their IPO allocation practices and their receipt of commissions. The Rule 9252 Order dated March 23, 2004, denied the Respondent's motion. Respondent now seeks reconsideration of that order because of the nature of the Department's proposed expert testimony.

In consideration of the Department's expert witness reports, the Hearing Officer now agrees that he should grant a limited portion of Respondent's Rule 9252 Motion. Many of the Department's experts have offered their opinion that the prevailing commission rate for the relevant period was 5 to 7 cents per share. In support, ER attached a copy of Schwab Institutional's commission rate schedule dated November 1999. In part, Respondent wants to obtain similar commission rate schedules from other member firms. The Hearing Officer concludes that such evidence may be relevant to the issues framed by the Department's witnesses. Accordingly, the Hearing Officer orders the Department to issue as soon as possible Rule 8210 Requests to 10 member firms to be identified by the Respondent from among the firms listed in its Rule 9252 Motion. The Rule 8210 Requests shall direct the firms to provide copies of their applicable commission rate schedules for the period of October 1999 through March 2000. The member firms shall be directed to produce the requested documents to the Department and Respondent's counsel not later than 14 days following the date of the Rule 8210 Requests.

The Respondent is ordered to limit the use of the information and documents it receives pursuant to this Order to the defense of this disciplinary proceeding. The

Respondent shall not release the information and documents to any third party who is not involved directly as a member of the defense team.

IT IS SO ORDERED.

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Andrew H. Perkins
Hearing Officer

October 4, 2004