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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent Firm and Respondent 2 Respondents.	Disciplinary Proceeding No. 2005000316701 Hearing Officer – DRP

ORDER (1) GRANTING COMPLAINANT'S MOTION IN LIMINE; (2) DENYING COMPLAINANT'S MOTION TO SEQUESTER WITNESSES, WITHOUT PREJUDICE; (3) DENYING RESPONDENTS' MOTIONS TO DISMISS; (4) DENYING RESPONDENTS' MOTION TO STRIKE; (5) GRANTING, IN PART, RESPONDENTS' MOTION TO PRECLUDE; (6) DENYING, IN PART, AND DEFERRING, IN PART, RESPONDENTS' MOTION FOR LEAVE TO PRESENT EXPERT TESTIMONY AND (7) DENYING RESPONDENTS' MOTION FOR LEAVE TO FILE A COMPILATION OF MOTIONS, BRIEFS AND RULINGS

1. On May 2, 2006, the Department of Enforcement filed a motion to strike and motion in limine to preclude evidence. In their Answers, both Respondents asserted that, apparently in 2005, Respondent Firm conducted a comprehensive review of mutual fund transactions, refunded money to customers who should have received breakpoints on their mutual fund purchases and modified its internal procedures to better identify transactions eligible for breakpoints. Enforcement argues that Respondents should be precluded from offering evidence to substantiate these assertions because, even if they are true, evidence regarding the Respondent Firm's review of mutual fund transactions,

refunds to customers and modifications to its internal procedures is not relevant or material to the issues presented by the charges in the Complaint.[1]

Respondents argue that the motion should be denied because it is improper under NASD's Code of Procedure and premature, and because evidence regarding the Respondent Firm's actions is relevant and material, at least on the issue of sanctions as evidence of subsequent remedial measures and to show that Respondents did not cause any harm to the public.

None of these arguments is persuasive. Nothing in the Code of Procedure prohibits a party from filing a motion in limine and such motions are common in NASD practice. By clarifying well in advance of the hearing what evidence will or will not be accepted, rulings on in limine motions may substantially simplify and expedite the pre-hearing and hearing process.[2] Of course, a motion in limine may be premature if the issues are not sufficiently developed to permit a determination as to the relevance and materiality of the evidence that is the subject of the motion, but that is not the case here.

The charges in this case relate to the Respondent Firm's responses to NASD's request for a self-assessment of the firm's mutual fund break point practices, including allegations that the firm and Respondent 2 failed reasonably to supervise the preparation and submission of those responses. Evidence relating to a subsequent review of mutual

[1] As Respondent 2 correctly notes in his opposition to Enforcement's motion, the motion is most appropriately characterized as a motion in limine. Respondent 2, however, argues that because this relates to an evidentiary issue, the full Hearing Panel, rather than the Hearing Officer, should decide the motion. On the contrary, under Rule 9235(a)(4), the Hearing Officer alone is responsible for "resolving any and all procedural and evidentiary matters …."

[2] For example, in this case Enforcement has filed a notice indicating that it has issued Rule 8210 requests to Respondents seeking documents relating to their assertions. Granting the motion in limine at this point should obviate the need for those requests.

fund transactions, payment of refunds and modification of internal procedures by the Respondent Firm would have no relevance to the merits of those charges.

Nor would it have any bearing on the appropriate sanctions if the Hearing Panel should find that Respondents violated NASD rules, as charged. For violations of Rule 8210, the Sanction Guidelines list as considerations in setting sanctions the nature of the information requested, as well as whether the requested information has been provided and, if so, the number of requests required, the amount of time the respondent took to respond and the degree of regulatory pressure required to obtain a response. For failure to supervise, the listed considerations are whether the respondent ignored "red flags," the nature of the underlying misconduct and the quality and degree of the supervisor's implementation of the firm's supervisory procedures and controls. Respondents' assertions do not relate to any of these considerations.

The Guidelines also list a variety of considerations that apply to all violations. One consideration is whether the respondent voluntarily employed subsequent corrective measures prior to detection or intervention by NASD. The Respondent Firm's asserted review of mutual fund transactions, payment of refunds and modification of its internal procedures, however, would not fall within this category because none of the Respondent Firm's asserted actions addressed the alleged deficiencies in its responses to NASD. Another consideration is whether the respondent's misconduct caused injury to other parties, including, but not limited to investors. In this case, however, the allegedly injured party is NASD, which claims it did not receive the information it requested; there is no claim that Respondents' alleged violations harmed any investors.

Accordingly, Enforcement's motion is granted; Respondents will be precluded from offering evidence at the hearing regarding the Respondent Firm's review of mutual fund transactions, payments of refunds or revision of its internal procedures relating to breakpoints.

2. On October 6, 2006, the Department of Enforcement filed a motion to sequester witnesses. Enforcement asks for an order requiring that all witnesses be excluded from the hearing when not testifying. Enforcement proposes to exempt from this requirement (i) no more than two corporate designees of the Respondent Firm, (ii) Respondent 2 and (iii) two named Enforcement staff members. Respondents object to any limitation on the number of the Respondent Firm's designees, or to exempting one of the Enforcement staff members from the sequestration requirement.

The motion is denied as premature, since the parties have not yet filed their pre-hearing submissions or identified their proposed witnesses. Enforcement may renew its motion after the parties file their pre-hearing submissions, at which point Respondents will be required to identify any and all witnesses who they wish to designate as corporate representatives, exempt from sequestration. Whether the Enforcement staff will be sequestered will be considered at that time.

3. On October 6, 2006, Respondents filed a joint motion to dismiss this proceeding "on the grounds that the Department of Enforcement cannot sustain its claims that Respondent 2 violated Rules 8210, 3010 and 2110." With respect to the Rule 8210 charge, Respondents argue, first, that NASD's request was not directed to Respondent 2; second, that the request was not valid under Rule 8210; and third, that no violation may

be found based on the Respondent Firm's initial response to NASD's request, because NASD directed the firm to re-do its initial, allegedly deficient response.

As Enforcement points out, under the scheduling order the deadline for filing motions for summary disposition was August 4, 2006; October 6 was the deadline for filing "all other pre-hearing motions." Although Respondents call their filing a motion to dismiss, rather than a motion for summary disposition, the only dispositive motion authorized under NASD's rules is a motion for summary disposition, and Respondents' motion will be treated as such. Therefore, it is untimely and will be denied on that basis.

Moreover, even if it had been timely filed, the motion would be denied because Respondents have failed to make the required showings under Rule 9264 that there is no genuine issue as to any material fact and that they are entitled to summary disposition as a matter of law. As to Respondents' first argument, while NASD's request may not have been addressed to Respondent 2, the Complaint alleges that he was involved in overseeing and approving the firm's response and that he was aware of and approved the submission of inaccurate information. These allegations raise material factual issues as to Respondent 2's potential liability, and therefore preclude summary disposition. See Michael A. Rooms, Exchange Act Rel. No. 51467, 2005 SEC LEXIS 728 at*11 (Apr. 1, 2005), aff'd, 444 F.3d 1208 (10th Cir. 2006) ("On its face, the language of Rule 8210 appears to limit its scope to obtaining information from, and ensuring compliance by, those persons and firms to whom such requests are directed. Liability under the rule may possibly extend to associated persons of a firm who are aware of an 8210 request directed to the firm and seek to falsify or impede the firm's response.").

As to Respondents' second argument, their broad contention that Rule 8210 does not authorize NASD to require member firms to compile and submit data from their records is untenable. The rule authorizes NASD to require member firms "to provide information … in writing" for the purpose of an investigation, complaint, examination, or proceeding authorized by NASD's By-Laws or rules. And as a matter of practice, firms and associated persons are frequently required to compile information or respond to detailed questionnaires.

Respondents rely on a portion of Rule 8210 providing that members may be required to provide information "electronically (if the requested information is, or is required to be, maintained in electronic form)," arguing that this somehow precludes NASD from requiring firms to complete an on-line self-assessment form. When this language was added to Rule 8210, NASD explained that it was a response to the fact that "members have increasingly maintained their trading records in computer-based technology," and as a result, "many members have indicated that they prefer that the staff of the NASD accept such trading information in that form because of increased cost efficiencies." Exchange Act Rel. No. 38468, 1997 SEC LEXIS 724 (April 2, 1997).

In this case, the Complaint alleges that NASD sent a request to the Respondent Firm and other member firms, pursuant to Rule 8210, which required the firms "to sample 800 front-end load Class 'A' share transactions effected between January 1, 2001 and December 31, 2002, and to fill out various spreadsheet fields with information regarding the 800 Class 'A' share transactions, including without limitation NAV data and information on linked or related accounts." The firms were to submit this information on-line, through NASD's website. The Complaint further alleges that, in

response, the Respondent Firm submitted information that was "flawed, inaccurate and incomplete," and that after NASD asked the Respondent Firm to re-submit its data, the firm again submitted "inaccurate, incomplete and otherwise flawed data."

The language on which the Respondent Firm relies does not prohibit NASD from requesting that firms submit data by entering it on a website. Rather, the allegations of the Complaint indicate that NASD simply provided a web-site means for surveyed firms to report the results of their self-assessment, rather than requiring them to fill out and return a paper survey form. On its face, Rule 8210 does not preclude NASD from providing such a means for completing and returning a survey and Respondents have cited no authority in support of their interpretation of the rule.

Moreover, regardless whether NASD was entitled to insist that the Respondent Firm submit data through the website, according to the allegations in the Complaint, the Respondent Firm did submit its responses in that manner, and the charges in the Complaint concern the quality of its responses. Indeed, even assuming that Rule 8210 did not apply to the firm's responses, the Complaint's allegations, if proven, might support a finding of a violation and the imposition of sanctions under Rule 2110. See Michael A. Rooms, 2005 SEC LEXIS 728 at *12-14.

Respondents' contention that NASD is estopped from disciplining Respondents for filing an initial deficient report because NASD directed the firm to correct and re-submit its response is also untenable. Again, Respondents offer no authority to support their argument. Moreover, in advancing this argument Respondents urge that imposing liability would be inappropriate "when the firm had complied with the Rule 8210 request to the best of its ability and submitted its response two days prior to the initial deadline."

But this simply confirms that there are material issues of fact in this case concerning Respondents' actions in connection with the firm's responses. Moreover, those factual issues will require a full evidentiary hearing.

Respondents also argue that Respondent 2 cannot be held liable for any violation of Rule 3010. But Respondents' arguments are, once again, premised on factual assertions concerning his role that Respondents have not shown to be undisputed, as required by Rule 9264. To determine whether Respondent 2 fulfilled his supervisory responsibilities, the Hearing Panel will have to hear and consider all relevant and material evidence.

On October 6, Respondents filed an additional motion to dismiss this proceeding, as arbitrary, capricious and the product of a process depriving Respondents of fundamental rights. More specifically, Respondents argue that Enforcement has changed its allegations, preventing Respondents from preparing their defense.[3]

As Enforcement points out in its response to the motion, the charges set forth in the Complaint have not changed. Enforcement alleged and continues to allege that Respondents submitted inaccurate data to NASD and failed reasonably to supervise the process by which the data was prepared and submitted. Enforcement has, however, revised the schedules setting forth its specific objections to Respondents' submissions. Enforcement should have settled on those objections before filing the Complaint. Nevertheless, Respondents have failed to demonstrate that Enforcement's post-Complaint preparation and revision of its schedules has, to this point, deprived Respondents of a fair

[3] Respondents also assert that Enforcement threatened to conduct an "audit" into the Respondent Firm's asserted breakpoint refunds and revised procedures if Respondents did not withdraw their attempt to raise those issues in their defense. Since Enforcement's motion in limine to preclude evidence on those topics has been granted, as set forth above, this issue is effectively moot.

hearing. Therefore, the motion is denied. As set forth below, however, Enforcement will be required to provide final schedules setting forth all of Enforcement's objections to Respondents' submissions well before the hearing.

4. On October 6 Respondents also filed a motion to strike paragraphs 41 and 43 from the Complaint. Those are the charging paragraphs alleging that Respondents' conduct, as alleged in the balance of the Complaint, violated certain NASD rules. Accordingly, granting the motion would effectively amount to a dismissal of the Complaint. Once again, therefore, under NASD's rules this motion is effectively a motion for summary disposition, and for reasons set forth above, it is therefore untimely and it will be denied on that basis.

Moreover, even if it had been timely filed, the motion would have been denied. Respondents object to the allegation that Respondents' conduct, as alleged in the Complaint, "constitutes separate and distinct violations" of designated NASD rules. Relying on criminal law case authority, Respondents contend that NASD cannot find separate violations and impose separate sanctions for each alleged inaccuracy in the Respondent Firm's responses to NASD's request. Enforcement, however, disclaims any intention to argue for such determinations. Instead, Enforcement states that it is simply asserting that each of the Respondent Firm's two responses to NASD's request for a self-assessment, containing alleged inaccuracies, constitutes a separate and distinct violation. It will be for the Hearing Panel to determine, after hearing the evidence, whether Enforcement has proven its allegations, but at this point Respondents have failed to establish that there is no genuine issue as to any material fact and that they are entitled to summary disposition as a matter of law.

5. On October 6, Respondents also filed a motion to preclude Enforcement from making further amendments to its schedules, to compel Enforcement to designate its final schedules by October 20, 2006, and to preclude Enforcement from entering any prior schedules, or errors identified in prior schedules, into evidence.

In the Complaint, Enforcement alleges that both the Respondent Firm's original submission in response to NASD's request for information and the Respondent Firm's second submission in response to the request were inaccurate. After filing the Complaint, Enforcement provided schedules purporting to identify its objections to the Respondent Firm's submissions. Enforcement has subsequently revised and corrected those schedules on several occasions. Respondents argue that Enforcement should be required to finalize its schedules so Respondents can adequately prepare for the hearing.

Enforcement replies that Respondents' motion amounts to a premature objection to exhibits, before they are due under the pre-hearing schedule, and that Respondent's have adequate notice from the Complaint that they are charged with submitting inaccurate information. Neither point is entirely persuasive. Enforcement has charged Respondents with submitting inaccurate information; to prepare their defense, they are entitled to know what specific deficiencies in the submissions Enforcement will attempt to prove at the hearing. While pre-hearing submissions are not yet due, as a matter of fairness, Respondents are entitled to sufficient notice to allow them to prepare their defense. Given that NASD received the allegedly inaccurate submissions in 2003, that the Complaint was filed in January 2006, and that Enforcement has already revised its schedules several times, it is appropriate to require Enforcement to settle on a final schedule of all alleged inaccuracies or other flaws in Respondents' responses to NASD's

requests by December 15, 2006. Because the hearing is now scheduled for March 2007, Respondents will have adequate time to review any material changes in Enforcement's final schedules, as compared to earlier versions.[4]

6. On October 6, Respondents also filed a motion for leave to present expert testimony from three proposed expert witnesses. One of Respondents' proposed experts previously served in executive capacities with several NASD members, including as Chairman and CEO of two firms in the 1990s, the second is a law professor who has written and taught on the topics of securities regulation, broker-dealer regulation, corporate supervision and corporate governance, Respondents' third proposed expert formerly served as vice president of regulatory affairs at the New York Stock Exchange, where he had a wide variety of responsibilities. Respondents represent that all of these witnesses would testify "regarding Respondent 2's supervisory responsibilities as CEO and the steps he took to satisfy those responsibilities, including the supervisory delegation needed and the appropriate level of follow-up that was required under the circumstances," and that they "anticipate that the experts will testify that Respondent 2 satisfied the standard of reasonable supervision required of CEOs."

Expert testimony is not received as a matter of course in NASD proceedings, because the members of the Hearing Panel have substantial expertise themselves. While expert testimony may be allowed when it appears that the proposed testimony could be helpful to the Panel on an unusual or technical issue, no such issue is presented in this case. Rather, the Complaint alleges that Respondent 2 failed reasonably to supervise the preparation and submission of the Respondent Firm's responses to NASD's requests, based on quite specific allegations concerning his role in that process. The Panel's

[4] Plainly, the final version will supersede earlier versions, and those earlier versions will not be admissible.

resolution of the supervision charge, therefore, will require it to determine, first, whether the evidence adduced by Enforcement substantiates any or all of Enforcement's factual allegations, and, then, based upon such allegations as Enforcement may be able to substantiate, whether Respondent 2's supervision was reasonable.

There is no reason to believe that the members of the Panel will be unable to make these determinations without input from the proposed experts. Although Respondents insist that Panelists must be apprised of "all the duties of a CEO, including the demands a CEO faces when undergoing a conversion of the magnitude [Respondent 2] was experiencing," as noted above the allegations in this case are quite specific—there is no general charge that Respondent 2 failed to exercise reasonable supervision as a CEO.

Nevertheless, as Respondents point out, the members of the Panel have not yet been appointed, and it is at least conceivable that the Panelists would find it helpful to hear from Respondents' proposed expert who previously served in executive capacities with several NASD members, including as Chairman and CEO of two firms. Therefore, as to that expert, a ruling on Respondents' motion will be deferred pending appointment of the Panel. In that regard, Respondents must submit as part of their pre-hearing submission a report prepared and signed by the expert containing the information required under Fed. R. Civ. P. 26(a)(2), as well as the information required by Rule 9242(a)(5). At the discretion of the Hearing Panel, if the testimony of the expert is allowed, the report may serve as the expert's direct testimony at the hearing, but in such case Enforcement and the Panel will have an opportunity to question the witness.

On the other hand, testimony from a law professor who, according to Respondents' motion, has never worked in the industry, and a former NYSE regulator, who has not been employed by a broker-dealer, would not be helpful. In any event, such testimony would be cumulative and unduly repetitious. Therefore, as to those proposed experts, Respondents' motion is denied.

7. On October 23, 2006, Respondents filed a motion for leave to prepare and file a compilation of motions, briefs and rulings for the benefit of the Hearing Panel, suggesting that all the Panelists should be aware of the motions that have been filed and the rulings on those motions. It is the Hearing Officer's responsibility, however, to advise the other Panelists regarding the course of the proceeding. Respondents also note that some courts require that motions regarding evidentiary issues be renewed at trial, suggesting that submitting their proposed compilation would somehow eliminate the need for them to do that in this case. NASD practice, however, is governed by NASD rules, which do not require, or allow re-arguing pre-hearing motions at the hearing. Moreover, even at the hearing, resolution of procedural and evidentiary issues is the responsibility of the Hearing Officer, not the full Panel. Accordingly, Respondents' motion is denied.

SO ORDERED.

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David M. FitzGerald[5]
Deputy Chief Hearing Officer

Dated: November 16, 2006

[5] The Deputy Chief Hearing Officer issues this Order pursuant to Rule 9235(b).