

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF MARKET
REGULATION

Complainant,

v.

Respondent 1

and

Respondent 2

Respondents.

Disciplinary Proceeding
No. CLG050021

Hearing Officer—Andrew H. Perkins

**ORDER FOLLOWING FINAL PRE-HEARING CONFERENCE
AND RULING ON MOTIONS IN LIMINE**

On April 21, 2006, the Hearing Officer held a final pre-hearing conference at NASD's offices in Washington, DC. At the conference, the Hearing Officer heard argument on the remaining motions in limine filed by the Department of Market Regulation ("Department") and on the motion filed by Respondent 2 to quash the Department's request for the billing records of one of his expert witnesses. This Order sets forth the Hearing Officer's rulings on those motions.¹

I. Respondent 2's Motion to Quash the Department's Rule 8210 Request for Billing Records of Respondent 2's Expert Witness

Respondent 2 moved to quash the Department's request under NASD Procedural Rule 8210 for all of the billing records and time statements submitted by Expert 1, one of

¹ To the extent that this Order contradicts the Hearing Officer's oral rulings at the Final Pre-Hearing Conference, this Order shall govern.

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Respondent 2's designated expert witnesses. Respondent 2 opposed the motion on the grounds that the request was untimely and that Respondent 2 had produced all of the information required by NASD's Code of Procedure regarding his expert witnesses. Specifically, Respondent 2 contended that the Rule 8210 Request constituted expert discovery that was not contemplated by the Scheduling Order.

Following argument, the Hearing Officer granted Respondent 2's motion to quash the Rule 8210 request. The Department did not provide for expert discovery in their proposed pre-hearing schedule, and the Hearing Officer did not include such discovery in the Scheduling Order. Instead, the parties were required to disclose the information required under Procedural Rule 9242(a)(5). Although the Department could have requested additional disclosure regarding the Respondents' proposed experts—and Procedural Rule 8210 is broad enough to permit such discovery—the Department did not make such a timely request.

In addition, the Department failed to demonstrate a compelling need for the records before the Hearing. The Department can cross-examine Expert 1 about the effort he expended on Respondent 2's behalf. If upon cross-examination the Department demonstrates that it needs Expert 1's billing records to cross-examine him effectively, the records can be provided to the Department at that time. Accordingly, Respondent 2 is ordered to have Expert 1's billing records and time statements available at the hearing.²

II. Department's Motion to Exclude Expert 2 from Testifying as an Expert

The Department moved to preclude Expert 2 from testifying as an expert witness. The Department challenged Expert 2's qualifications and argued that his report is flawed for the following reasons:

² Respondent 2 represented that Expert 1 had not yet submitted a bill for his services on this case. Accordingly, Respondent 2 is ordered to request such a statement, which shall reflect all services provided in connection with this proceeding up to the commencement of the Hearing.

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- (1) The Report consists largely of impermissible legal conclusions.
- (2) The Report fails to disclose how Expert 2 used his qualifications (the underlying methodology and analytic approach) in reaching his conclusions.
- (3) The Report fails to articulate the applicable industry standards and customs he used to evaluate the Respondents' conduct.

In conclusion, the Department asserted that Expert 2's testimony would not be helpful to the Extended Hearing Panel.

Respondent 2 pointed out that Expert 2 is uniquely qualified to testify regarding the supervisory issues in this case because he has 30 years relevant industry experience, including experience as head of compliance for a nationwide broker-dealer.

The Hearing Officer took the motion under advisement so that he could consult with the other panelists. Following this consultation, the Hearing Officer denies the Department's motion to exclude Expert 2.

III. Department's Motion to Permit its Expert to Testify by Videoconference

The Department moved to permit its only expert witness to testify by videoconference because he refuses to attend the hearing in person. The Department represented at the Final Pre-Hearing Conference that the expert is fearful of going to New York City because of the terrorist attack on the World Trade Center in September 2001. The Respondents oppose the motion.

The Hearing Officer denied the Department's motion. The Department hired a testifying witness who was not willing to attend the Hearing and then waited until just weeks before the Hearing to request an accommodation to permit him to testify by alternative means. The Department offers no justification for its selection or its lack of diligence in addressing the issue.

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The Department represented that if its expert is required to travel to New York City, he would withdraw from the case. In such a case, the Department would be left with no testifying expert. In an effort to resolve this impasse, the Hearing Officer directed the Department to determine if its expert is willing to travel to Washington, DC for his testimony. The Department shall report its findings to the Office of Hearing Officers and opposing counsel as soon as possible so that appropriate arrangements can be made if his testimony will be heard at a location other than the Hearing in New York City.

IV. Department's Motion in Limine to Preclude Evidence of Unprofitable Trades

According to the Department, the issue in this case is whether the Respondents violated NASD Rules 2110 and 3010 by failing to comply with their respective supervisory obligations, and whether, as a consequence, [the Trader], one of [the Firm]'s institutional traders, was able to employ a fraudulent scheme. The Department submitted proposed exhibits concerning 64 instances that are illustrative of this alleged fraudulent scheme. In response, Respondent 2 submitted proposed exhibits that he claimed show that the Trader lost money on other trades.

The Department moved to exclude Respondent 2's proposed evidence of losses or small gains on other trades. The Department contended that such evidence is "irrelevant, immaterial, and unduly repetitious." The Department further pointed out that it did not allege that every transaction the Trader executed for his institutional customers in 1999 and 2000 was part of his fraudulent scheme.

Respondent 2 argued that the evidence of trades on which the Trader lost money is relevant because the Department based its Complaint on the theory that the Trader engaged in a "pattern" of fraudulent trading. Respondent 2 argued that he should be allowed therefore to adduce evidence to show that such a "pattern" did not exist.

The Hearing Officer concluded that the Department's motion is premature. The Hearing Officer cannot determine if evidence of unprofitable trades is or is not relevant

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and material from the existing record. Such a determination can only be made in light of the evidence presented at the Hearing. Accordingly, the Department's motion is denied. The Department is granted leave to renew its motion at the appropriate time.

V. Department's Motion to Preclude Respondent 2's Demonstrative Exhibits

The Department moved to exclude all of Respondent 2's proposed demonstrative exhibits that were "prepared by [Respondent 2's] counsel or their minions" because the underlying data were not produced on time. Respondent 2 has since produced the underlying data, but the Department contended that it is prejudiced by the delay. In addition, the Department contended that the proposed demonstrative exhibits should be excluded because they are "improperly embellished with biased and argumentative titles and comments."

The Hearing Officer denied the Department's motion. First, the admissibility of the demonstrative exhibits is dependent on the testimony of the sponsoring witness and other evidence at the Hearing. Accordingly, the admissibility of the demonstrative evidence should be determined at the Hearing in light of this other evidence. Second, the Hearing Officer finds that the Department has sufficient time to review Respondent 2's proposed demonstrative exhibits. In this regard, the Respondents are ordered to cooperate in providing additional information that the Department may reasonably request regarding the source of the data summarized by the demonstrative exhibits. Third, the Hearing Officer finds that the proposed demonstrative exhibits do not contain unduly argumentative and biased titles and comments. The panelists will be able to separate arguments from evidence.

VI. Department's Motion to Disqualify Expert 1

The Department filed two motions to Expert 1 from testifying as an expert witness in this case. Expert 1 is the Department's former Vice President and Chief Counsel. The Department filed the first motion before Respondent 2 disclosed the nature

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of Expert 1's proposed testimony. The Department argued in that motion that Expert 1 obtained confidential information while employed at NASD, including information about "strategies, policies, and procedures concerning examinations, investigations, and litigation."³ In addition, the Department argued that Expert 1 had been extensively involved in the various examinations of the Firm between 1997 and 2000, "including reviews of the firm's trading and market making activities and its written supervisory procedures in effect in 1997, 1998, 1999, and 2000."⁴ The Department argued that Expert 1's expected testimony in this case necessarily will be intertwined with the confidences and privileges NASD entrusted to him during his employment, and, thus, his testimony "will presumably relate to either the Department's trading analyses concerning the underlying fraudulent activity or the Respondents' failure to properly supervise or both."⁵

After ordering Respondent 2 to submit a summary of Expert 1's proposed testimony and permitting the Department to file a Reply Supporting Disqualification, the Hearing Officer denied the Department's motion to disqualify Expert 1. Instead the Hearing Officer entered a Protective Order that limited the scope of Expert 1's testimony.⁶ The Hearing Officer found from the summary Respondent 2 submitted that it was likely that Expert 1's testimony would involve NASD confidential information. Accordingly, the Hearing Officer ordered that Expert 1 would be prohibited from testifying about the Firm's supervisory practices and procedures and the operation of the Firm's institutional sales desk. In addition, the Hearing Officer granted the Department leave to renew its motion to disqualify Expert 1 if his report discusses or is based on NASD confidential information.

³ Department's Mot. to Disqualify Expert 1 as a Potential Expert Witness at 4.

⁴ *Id.* at 5.

⁵ *Id.* at 6.

⁶ Order Partially Granting Complainant's Mot. to Disqualify Expert Witness (Mar. 17, 2006).

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Respondent 2 filed Expert 1's expert report on March 22, 2006, and the Department renewed its motion to disqualify Expert 1 on April 4, 2006.

In the Department's second motion to disqualify Expert 1, the Department argued that Expert 1 should be disqualified as an expert because his report "contains numerous opinions and detailed discussions concerning the operation of the Firm's institutional sales desk and analytic methods purportedly used by the Department in examining the operations of the Firm's institutional sales desk, including the Trader's institutional trading."⁷ Further, the Department argued that Expert 1's opinions and conclusions, including those concerning purported applicable industry standards, are based primarily upon knowledge and experience he gained while working on privileged and confidential matters as Chief Counsel to the Department.⁸ Thus, in the Department's view, Expert 1 will have to reveal confidential information to defend his opinions.⁹

The Hearing Officer heard argument on the second motion to disqualify Expert 1 at the Final Pre-Hearing Conference. At the conference, the Department clarified that Expert 1 never worked on the investigation that led to the filing of the Complaint in this proceeding and that he had no role in the Department's decision to bring this disciplinary proceeding. Thus, this case does not involve any possible misuse of confidential information that is peculiar to this case. In other words, this case does not fall within the class of cases where a confidence may be breached because a testifying expert switches sides in the same case.

To the contrary, the Department argued that in his report Expert 1 assumed a position regarding the interpretation of NASD Notice to Members 97-57, NASD Interpretations of SEC Order Handling Rules, NASD Limit Order Protection Rules, and

⁷ Department's Renewed Mot. to Disqualify Expert 1 at 2.

⁸ Id.

⁹ Id.

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Member Best Execution Responsibilities, which Expert 1 helped draft while he was employed at NASD.¹⁰ The Department argued that to cross-examine Expert 1 effectively it will have to inquire into “the reasons why NASD included or excluded certain statements contained in the Notice and what NASD intended in making such statements,” which is privileged and confidential information.¹¹ The Department also argued that it would have to cross-examine Expert 1 about another case to show that Expert 1 is biased and this line of questions would require inquiry into confidential information.

As a starting point, the Hearing Officer thoroughly reviewed Expert 1's report and found that it did not reveal NASD confidential information. In summary, Expert expressed the following opinions in his report: (1) the Trader's institutional customers instructed him to execute their orders at a net price that the customers knew included the Firm's compensation; (2) industry practice and NASD interpretations left the level and manner of compensation for such transactions to the discretion and private arm's-length negotiations of the broker-dealer and its institutional customers; (3) as a matter of industry practice institutional customers were not informed of the amount of profit a broker-dealer made on such transactions; (4) there were no industry standards or arbitrary limitations on the amount of compensation that could be earned on the type of trades that are the subject of this proceeding; and (5) the Trader executed the trades in question in conformance with all applicable laws, rules, and regulations.¹² Expert 1 based his opinions on published regulatory guidance and his general experience as a regulator at NASD and the Securities and Exchange Commission. Expert 1 did not rely on NASD confidential information.

¹⁰ *See Id.* at 6.

¹¹ *Id.*

¹² Expert 1 Report at 1-2.

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The Department did accurately point out that Expert 1 criticized the analytic approach the Department applied in this case. Expert 1 disagreed with the Department's use of industry customs regarding the amount of commissions typically charged by broker-dealers in 1999 and 2000.¹³ But in so doing Expert 1 did not apply non-public material. Indeed, Expert 1 expressly limited his opinion to industry standards and NASD published guidance.

Nonetheless, the Department intimates that Expert 1 may have taken a contrary position on another case while he was the Department's Chief Counsel.¹⁴ The Department would like to bring that prior inconsistency to the Extended Hearing Panel's attention through cross-examination to show that Expert 1 is biased. However, the Department argued that to make such a showing it will have to question Expert 1 about confidential information concerning the other case. Similarly, the Department challenged the basis for Expert 1's statement that NTM 97-57's guidance on broker-dealers' best execution obligations is based on NASD's recognition that "as a matter of standard industry practice, an institutional customer placing a not-held order voluntarily substitutes his own order handling instructions for the generic order handling presumptions implied by the duty of best execution."¹⁵ Here also, the Department contended that it would have to explore non-public information to cross-examine Expert 1 regarding the reasons underlying NTM 97-57. Accordingly, the Department urges the Hearing Officer to disqualify Expert 1 from testifying in this proceeding.

The Department failed to establish that Expert 1 used confidential information as a basis for his opinions. Indeed, the thrust of his opinion is that the Firm's practices were

¹³ See *Id.* at 33.

¹⁴ The Department did not provide any details regarding the nature of the other case or the alleged inconsistent position the Department attributes to Expert 1.

¹⁵ Department's Renewed Mot. to Disqualify Expert 1 at 7.

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consistent with widely accepted industry standards. This opinion is not dependent on NASD confidential information.

The Department's argument that Expert 1's cross-examination will result in the disclosure of confidential information is based on an erroneous view of the permissible scope of cross-examination. First, the history of NTM 97-57 is not relevant to the issues in this case. Accordingly, the Department's argument that it will need to cross-examine Expert 1 about NASD's reasons for issuing the Notice is a red herring. Moreover, the Department cannot introduce collateral evidence to show bias. Thus, even if Expert 1's advice as an attorney in connection with the drafting of the Notice were relevant, the Department could not introduce collateral evidence to show that his position on the issues in the Notice were different when he was employed by NASD.

In addition, whatever confidential information Expert 1 possesses about the drafting and issuance of NTM 97-57 are not "so intertwined with [this case] as to make the confidential information relevant to his proposed testimony."¹⁶ NTM 97-57 contains "interpretative advice regarding a member's best execution obligations when handling a customer order, especially in light of the SEC's Order Handling Rules¹⁷ and the NASD's Limit Order Protection Rules."¹⁸ The Notice contains a series of 12 specific questions and answers that NASD developed after consulting with the staff at the SEC.¹⁹ Two of the questions address discretionary or working orders; the remaining questions and answers do not apply to the trades in this case.

The Department failed to show how Expert 1's participation as an attorney in drafting interpretative advice regarding the SEC's Order Handling Rules is relevant. The

¹⁶ *Bristol-Myers Squibb Co. v. Rhone-Poulenc Rorer, Inc.*, 2000 U.S. Dist. LEXIS 321, at *15 (S.D.N.Y. Jan. 20, 2000).

¹⁷ Exchange Act Rules 11Ac1-4 and 11Ac1-1.

¹⁸ Notice to Members 97-57, 1997 NASD LEXIS 75, at * 1 (Sept. 1997).

¹⁹ *Id.*

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Notice states that it is the NASD's interpretative advice and that NASD developed the advice after consulting the staff at the SEC. The Department failed to establish how Expert 1's professional advice under these circumstances is relevant to his proposed testimony in this case.

In conclusion, the Hearing Officer found that the Department failed to establish that Expert 1's report disclosed or that his proposed testimony will disclose NASD confidential information. Accordingly, the Hearing Officer denied the Department's renewed motion to disqualify Expert 1 from testifying as an expert in this case.²⁰

Alternatively, the Department moved to disqualify Expert 1 because his report violated the terms of the protective order the Hearing Officer issued on March 17, 2006.²¹ The Protective Order prohibited Expert 1 from testifying "regarding the Firm's supervisory practices and procedures, including Respondent 2's delegation of supervisory responsibilities, and the operation of its institutional sales desk." The Hearing Officer issued the Protective Order without the benefit of Expert 1's report.

Upon consideration of Expert 1's report and the Department's arguments, the Hearing Officer has determined that the Protective Order needs to be clarified. The Protective Order was intended to limit Expert 1's testimony regarding *NASD confidential information*. For example, the Department had raised the concern that his testimony would challenge the Department's investigatory methods or analysis. The Hearing Officer agreed with the Department that this was not the proper subject of expert opinion under the facts and circumstances of this case. On the other hand, the Hearing Officer did not intend to prohibit Expert 1 from testifying about industry custom and practices or about information he obtained from other non-confidential sources about the Firm's

²⁰ The Hearing Officer granted the Department leave to file a further submission to demonstrate the specific portions of Expert 1's report that the Department claims is based on confidential information.

²¹ Order Partially Granting Complainant's Mot. to Disqualify Expert Witness (Mar. 17, 2006).

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operations. Accordingly, the Hearing Officer found that Expert 1's report does not violate the terms of the Protective Order.

VII. Opening Statements

At the Final Pre-Hearing Conference the Hearing Officer asked the parties how much time they would need for their opening statements. The Department stated that 30 minutes would be sufficient, and Respondent 2's counsel opposed any limitation. In light of Respondent 2's vehement objection, the Hearing Officer declined to impose a limit. However, upon further review of the record, the Hearing Officer has concluded that a limit is appropriate. Accordingly, each party shall have one hour for its opening statement.

IT IS SO ORDERED

Andrew H. Perkins
Hearing Officer

April 25, 2006