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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 DENYING RESPONDENT'S MOTION FOR SUMMARY DISPOSITION AND REQUEST FOR PRECLUSION ORDER BASED UPON UNFAIR INVESTIGATORY PROCESS

Respondent's ("Respondent" or the "Firm") Motion for Summary Disposition (the "Motion") seeks dismissal of the Complaint as a matter of law. Principally, the Respondent argues that the Department of Enforcement (the "Department") conducted its investigation of the Firm's initial public offering ("IPO") allocation practices in an unfair manner and in violation of its obligation under Section 15A of the Securities Exchange Act of 1934 to "provide a fair procedure for the disciplining of members and persons associated with members."[1] In the Respondent's view, rather than "engaging in a fair and balanced process of ascertaining the facts concerning the Firm's IPO allocation practices …, [the Department] conducted a truncated, result-driven inquiry …,"[2] thereby depriving the investigatory record of "significant additional evidence materially exculpatory of Respondent that [the Department] would have been obliged

[1] Respondent's Mem. Summ. Disp. at 1 (citing 15 U.S.C. § 78o-3(b)(8)).

[2] *Id.*

to provide to Respondent under NASD Rule 9251(a)(1) and … the *Brady* doctrine."[3] In short, Respondent contends that "fairness requires the inquiry into, and development of, exculpatory evidence when investigators become aware of its existence."[4] Respondent complains that the Department breached that duty when it refused to pursue or accept additional customer information after three Firm customers denied that they had any profit sharing arrangement with Respondent.[5] Respondent ascribes bad faith to the Department's actions; i.e., the Department deliberately avoided exculpatory evidence it would have been obliged to give to Respondent under Procedural Rule 9251(a)(1).

The Department opposes Respondent's motion. The Department argues that Respondent is seeking to hijack the Department's investigation by urging the Hearing Panel to second-guess the Department's investigatory methods and decisions.[6] The Department largely sees Respondent's challenge as centering on the Department's insistence that the customer witnesses submit to on-the-record-interviews, which position the Department justifies with the contention that the subject customers were "in league" with Respondent.[7] The Department contends that the subject witnesses were under Respondent's control, which caused the Department to question the reliability of their prepared and coached statements.[8] The Department specifically points to the fact that Respondent was paying the legal fees for some of the customer witnesses. Accordingly, the Department argues that it was reasonable to require the customer witnesses to appear for

[3] *Id.* at 2. In *Brady v. Maryland*, 373 U.S. 83, 87 (1963), the Supreme Court held that "the suppression by the prosecution of evidence favorable to the an accused upon request violates due process where the evidence is material either to guilt or punishment, irrespective of the good faith or bad faith of the prosecution."

[4] Respondent's Mem. Summ. Disp. at 4.

[5] *Id.* at 2.

[6] Opp'n at 46.

[7] *Id.* at 47.

[8] *Id.* at 48.

questioning so that their credibility could be determined. Moreover, the Department argues that Respondent has failed to show that the Department acted unfairly or that Respondent suffered any harm from the Department's refusal to pursue more customer evidence. Finally, the Department argues that the *Brady* doctrine is inapplicable to NASD investigations; hence, "*Brady* has no role in determining whether [the Department] conducted a fair investigation."[9] But even if *Brady* is applied, no violation can be found because Respondent had access to all of the alleged exculpatory evidence.[10]

On January 14, 2004, the Hearing Panel heard oral argument on the Motion in Washington, DC. Now, after careful consideration of the Parties' papers and arguments, the Hearing Panel denies the Motion for the following reasons.

Discussion

I. Background

In or about May 2001, the Department commenced the investigation that ultimately led to the Complaint in this matter. By letter dated May 21, 2001,[11] the Department asked Respondent to provide information relating to "certain offerings" between October 1, 1999, and March 31, 2000, in which Respondent had participated, and information concerning 36 of its customers.[12] Apart from what Respondent may have been able to glean from the description of the 19 categories of documents and information the Department requested pursuant to NASD Procedural Rule 8210, the Department's May 21 letter did not contain information regarding the

[9] *Id.* at 52.

[10] *Id.* at 54.

[11] Aff. Supp. Summ. Disp. Ex. A.

[12] Aff. Supp. Summ. Disp. ¶ 9.

scope of the investigation.[13] Respondent became aware of NASD's investigation by receipt of that letter, which the Department delivered to Respondent's compliance department during an unscheduled on-site visit by Joseph Ozag, Jr. ("Ozag"), an NASD Senior Compliance Examiner.[14]

Respondent and the Department dispute the original scope of the investigation. Respondent deduces from the timing of the initial request and the nature of the information requested that the Department

> initially sought to investigate whether the Firm had engaged in recognizable forms of profit-sharing with its customers to whom it allocated "hot" IPO shares, in violation of NASD Rule 2330(f), by entering into agreements with those customers to share their IPO profits via the payment of "excessive" or "inflated" commissions to Respondent in return for, and as a condition of, receiving IPO allocations — the type of quid-pro-quo profit-sharing arrangements that resulted in the AWC entered into by ____ in January 2002.[15]

Respondent bases its conclusion, at least in part, on the fact that a high percentage of the IPOs in which the Firm participated during the period in question had been led or co-led by ____, which firm was the subject of an NASD investigation that culminated in a settlement that contained detailed findings of explicit profit-sharing arrangements by ____ and its brokerage customers who received IPO allocations from that firm.[16]

The Department contends that its investigation of Respondent was not so limited. In his declaration attached to the Department's Opposition to Respondent's Motion for Summary

[13] A second letter dated June 25, 2001, seeking the on-the-record testimony of a Firm employee, likewise did not disclose fully the nature and scope of the investigation. This letter stated simply that the individual's testimony was sought in "an inquiry into certain public offering allocation practices." (Aff. Supp. Summ. Disp. Ex. B.)

[14] *Id.* ¶¶ 9, 14. Apparently, Ozag supplemented the initial request the following day in a hand-written "On-Site Request." (Aff. Supp. Summ. Disp. Ex. A, at 5.)

[15] Aff. Supp. Summ. Disp. ¶ 7. *See also* Respondent's Mem. Summ. Disp. at 15.

[16] Aff. Supp. Summ. Disp. ¶¶ 12–13 and Ex. D (____ Letter of Acceptance, Waiver and Consent).

Disposition,[17] Ozag states that he "dispute[s] that [the Department] sought to determine, exclusively, whether the Firm and its customers entered into profit sharing agreements, if the Firm conditioned IPO allocations in return for some benefit or if quid-pro-quo profit-sharing arrangements existed."[18] But the Department does not provide an explanation of the further scope of its investigation. In this equivocal manner, the Department dismisses any further discussion of the genesis or scope of the investigation.

In Respondent's view, however, the scope of the original investigation is crucial to evaluating whether the Department conducted the investigation in a fair manner. In short, Respondent contends that the Department initiated the investigation expecting to uncover evidence of profit-sharing agreements, but, when that line of inquiry appeared unfruitful, the Department turned a blind eye to a substantial body of exculpatory evidence and then filed the Complaint using a novel theory that is not dependent upon the existence of express profit-sharing agreements. In other words, Respondent contends that the Department filed the Complaint knowing that it could not prove critical elements of traditional profit-sharing.

Respondent details, and the Department does not dispute, that in the early stages of the investigation of the Firm, the Department took the testimony of 11 of the 14 professional-level employees at the Firm: every employee with any involvement in the IPO allocation process.[19] Respondent further contends that each of the deposed employees confirmed the absence of any type of profit-sharing conduct or arrangements by Respondent.[20]

In April 2002, almost one year after the investigation commenced, the Department conducted telephone interviews of three Firm customers. While there is some disagreement over the results

[17] Department's Opp'n Ex. 4.

[18] Ozag Decl. Dep't Opp'n ¶ 5.

[19] Aff. Supp. Summ. Disp. ¶ 14.

of those interviews, the Department generally concedes that each of the three customers denied he had a profit-sharing agreement with Respondent.[21] Indeed, the Department has stipulated since it filed the Complaint that "[it] has no evidence, and does not contend, that Respondent ever demanded that its customers pay a set amount or range of commissions, or commissions at 'inflated' rates, as that term is used in the Complaint."

The Department did not interview any other Firm customers. The reasons for this are disputed. The Department contends that it made reasonable efforts to secure the testimony of other customers, but they would not agree to on-the-record interviews. In defending its decision to insist that the customers appear for on-the-record interviews, the Department points to a number of factors that called the customers' unsworn statements into question.[22] On the other hand, Respondent contends that the Department unreasonably demanded that the customers appear and testify under oath when they were willing to provide information by alternate means. In conclusion, Respondent argues that the Department required on-the-record interviews to set up an obstacle to obtaining exculpatory evidence.[23]

II. Respondent's *Brady* Claim

The threshold question is whether the Brady doctrine, coupled with the Department's obligations under Procedural Rule 9251(a)(1), requires the Department to pursue potentially exculpatory evidence in the course of a pre-complaint investigation. Respondent points to no direct authority imposing such an obligation. Accordingly, our analysis begins with a review of the purpose underlying the *Brady* doctrine.

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[20] *Id.*

[21] *See* Aff. Supp. Summ. Disp. ¶ 17 (quoting from the Department's interview notes).

[22] Ozag Decl. Dep't Opp'n ¶ 16.

[23] Aff. Supp. Summ. Disp. ¶ 35.

A. The *Brady* Doctrine

The Supreme Court formulated the *Brady* doctrine to protect the integrity of the adjudicative process from potential prosecutorial abuse, not the defense's ability to prepare for trial. As noted above, in *Brady*, the Court held "that the suppression by the prosecution of evidence favorable to an accused upon request violates due process where the evidence is material either to guilt or to punishment, irrespective of the good faith or bad faith of the prosecution."[24] The Court later held that the duty encompasses impeachment evidence as well as exculpatory evidence.[25]

In setting forth the principle that the government may not suppress material exculpatory evidence, the Court drew upon the Due Process Clause of the Fourteenth Amendment and "early 20th-century strictures against misrepresentation."[26] Following this doctrinal underpinning, the Court in *Brady* was concerned about the prosecutor's ability to corrupt the trial by allowing the introduction of false testimony and the danger that the jury would accept the false testimony as true when the government had in its possession evidence relevant to the credibility of the witness. The Court articulated its rationale:

> A prosecution that withholds evidence on demand of an accused which, if made available, would tend to exculpate him or reduce the penalty helps shape a trial that bears heavily on the defendant. That casts the prosecutor in the role of an architect of a proceeding that does not comport with standards of justice ….[27]

The Supreme Court has explained further that *Brady* and its progeny underscore the "special role played by the American prosecutor in the search for truth in *criminal trials*."[28] In

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[24] 373 U.S. 83, 87 (1963).

[25] *United States v. Bagley*, 473 U.S. 667, 676 (1985).

[26] *Kyles v. Whitley*, 514 U.S. 419, 423 (1995). *See Brady*, 373 U.S. at 86.

[27] Brady, 373 U.S. at 87-88.

[28] Strickler v. Greene, 527 U.S. 263, 281 (1999) (emphasis added).

the criminal justice system, prosecutors represent not just ordinary parties to controversy; they act as impartial truthseekers whose interest in criminal prosecution is that "justice shall be done."[29] "This special status explains both the basis for the prosecution's broad duty of disclosure and [its] conclusion that not every violation of that duty necessarily establishes that the outcome was unjust."[30]

B. Elements of a *Brady* Prosecutorial Misconduct Claim

To establish a *Brady* prosecutorial misconduct claim, the defense must satisfy three essential requirements: (1) the evidence at issue must be favorable to the accused as exculpatory or impeaching; (2) the State must have suppressed the evidence; and (3) prejudice must have ensued.[31] Prejudice exists when the suppressed evidence is "material" for *Brady* purposes.[32] And the materiality standard for *Brady* is met when "the favorable evidence could reasonably be taken to put the whole case in such a different light as to undermine confidence in the verdict."[33] In the context of destroyed evidence that was in the State's possession, the Supreme Court has further explained that evidence is material if its exculpatory value was apparent on the face of the evidence before it was destroyed and the defendant would be unable to obtain comparable evidence by other reasonably available means.[34]

Although *Brady* generally should be applied to carry out its purpose of assuring a fair hearing and producing a decision which is "worthy of confidence,"[35] the body of case law

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[29] *Id.* (quoting *Berger v. United States*, 295 U.S. 78-88 (1935)).

[30] *Id.*

[31] *Banks v. Dretke*, No. 02–8286, 2004 U.S. Lexis 1621, at *45–46 (Feb. 24, 2004) (citing *Strickland*, 527 U.S. at 281–82.

[32] *Id.* at *46.

[33] *Id.* at *60 (quoting *Kyles v. Whitley*, 514 U.S. 419 (1995)).

[34] *California v. Trombetta*, 467 U.S. 479, 489 (1984).

[35] *Smith v. Holtz*, 210 F.3d 186, 196 (3d Cir. 2000).

applying *Brady* in criminal trials limits its application in several significant ways. First, it is important to note that while the term "*Brady* violation" is used to refer to any breach of the broad obligation to disclose exculpatory evidence, *Brady* is not violated "unless the nondisclosure was so serious that there is a reasonable probability that the suppressed evidence would have produced a different verdict."[36] Second, *Brady* is not a discovery rule;[37] it is a rule of fairness and minimum prosecutorial obligation.[38] As such, it does not entitle the defense to conduct a "fishing expedition" through the prosecutor's file in the hope of finding helpful evidence.[39] Nor does it entitle the defense to receive every scintilla of evidence that might be beneficial.[40] Third, as discussed more fully below, *Brady* does not require the prosecutor to gather potentially exculpatory evidence.[41]

C. Respondent's *Brady* Claim Fails

Respondent has failed to show two of the requisite elements for a *Brady* prosecutorial misconduct claim. First, the Department has not suppressed any exculpatory evidence.[42] Indeed, Respondent's motion shows unequivocally that Respondent not only knows of the existence of the evidence it claims to be exculpatory, but Respondent actually has superior access to that evidence than does the Department.[43] Most, if not all, of the subject witnesses are cooperating in Respondent's defense. Under these circumstances, Respondent cannot establish that the Department suppressed evidence in violation of *Brady*. Because *Brady* concerns the suppression

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[36] *Strickler*, 527 U.S. at 281.

[37] *Pennsylvania v. Ritchie*, 480 U.S. 39, 59 (1987).

[38] *See United States v. Beasley*, 576 F.2d 626 (5th Cir. 1978), *cert. denied*, 440 U.S. 947 (1979).

[39] *See, e.g., In re Jett*, 50 S.E.C. 830, 1996 SEC LEXIS 1683, at *1–2 (1996).

[40] *See, e.g., Lieberman v. Washington*, 128 F.3d 1085, 1092 (7th Cir. 1997).

[41] *Miller v. Vasquez*, 868 F.2d 1116, 1119 (9th Cir. 1989).

[42] For the purposes of this Order, the Hearing Panel assumes that the evidence is potentially exculpatory.

of evidence unknown to the defense, failing to disclose information already known to the defense does not violate *Brady*.[44] There is no suppression when the information is already known to the defense and when such knowledge would have allowed the defense to take advantage of such exculpatory evidence.

In addition, Respondent has failed to establish prejudice. As discussed above, Respondent has both the ability and the opportunity to develop any exculpatory evidence before the hearing, which is not scheduled for another eight months. Under these circumstances, the failure of the Department to gather and produce witness statements from the Firm's customers would not be "so serious that there [would be] a reasonable probability that the … evidence would have produced a different verdict."[45] Accordingly, the Hearing Panel finds *Brady* inapplicable.

III. Respondent's Fairness Claim under Section 15A of the Exchange Act

Although closely related to its *Brady* claim, Respondent also argues that the Hearing Panel should dismiss the Complaint, or otherwise sanction the Department, because it violated its duty to conduct a fair investigation. Respondent contends that the Department's investigatory process was unfair because of the manner the Department went about its attempt to secure additional information from the customer witnesses and because the Department based the Complaint on "novel theories developed as an end-run around exculpatory evidence."[46]

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[43] "[The Department] was offered Firm customer information on a silver platter." (Respondent's Mem. Summ. Disp. at 18.)

[44] *See United States v. Morris*, 80 F.3d 1151, 1170 (7th Cir.), *cert. denied*, 519 U.S. 868 (1996); *see also United States v. LeRoy*, 687 F.2d 610, 618 (2d Cir.), *cert. denied*, 459 U.S. 1174 (1983); *United States v. Kolesova*, 2000 U.S. App. LEXIS 5194 (2d. Cir) at *6 (denying the applicability of *Brady* because the evidence was not suppressed and defense knew or should have known of certain essential facts that would have allowed her to take advantage of any exculpatory evidence) (citing *LeRoy*, 687 F.2d at 618).

[45] *Strickler*, 527 U.S. at 281.

[46] Respondent's Mem. Summ. Disp. at 18.

Respondent cites no case, nor has the Hearing Panel found any, which hold that the fair process requirement of Section 15A of the Exchange Act[47] is violated when a self-regulatory organization fails to gather potentially exculpatory evidence. Absent such authority, Respondent relies on a few cases that address the unique role and obligation of criminal prosecutors to assure that convictions are secured on evidence free of fraud. For example, in *Northern Mariana Islands v. Bowie*, 243 F.3d 1109 (9th Cir. 2001) the court reversed a conviction where prosecutors failed to investigate clear evidence that their own witnesses were conspiring to commit perjury. The Court found that by failing to take action and allowing the witnesses to testify, the prosecutors failed in their duty to "protect the system against false testimony."[48] The present case does not present the same concerns. Respondent makes no claim that any of the evidence the Department intends to rely upon at trial is false; rather, Respondent only contends that the investigative record is incomplete. Even under the strict requirements imposed on criminal prosecutors as representatives of the State, this is an insufficient showing to establish that the Department breached its obligation to provide a fair disciplinary process.

Moreover, the Supreme Court has made clear that a claim of a due process violation for failing to preserve and gather exculpatory evidence fails unless the defendant can show that the prosecutor acted in bad faith.[49] "Due process guarantees that a criminal defendant will be treated with 'that fundamental fairness essential to the very concept of justice in order to declare a denial of [due process the court] must find that the absence of that fairness fatally infected the trial; the

[47] Section 15A(b)(8) of the Exchange Act requires self-regulatory organizations to "provide a fair procedure for the disciplining of members and persons associated with members[.]"

[48] *Northern Mariana Islands v. Bowie*, 243 F.3d at 1118.

[49] *Arizona v. Youngblood*, 488 U.S. 51, 58 (1988).

acts complained of must be of such quality as necessarily prevents a fair trial.'"[50] The same standard should apply to claims of unfairness under Section 15A of the Exchange Act.

Respondent attempts to show the Department's misconduct by noting that the Department failed to accept evidence other than sworn testimony at on-the-record interviews, failed to advise Respondent of the three telephonic customer interviews in April 2002, and failed to apprise the customers of the scope of the Department's investigation in the letters requesting that they appear for on-the-record interviews. This evidence if true does not prove bad faith. To establish bad faith, Respondent must "put forward specific nonconclusory factual allegations that establish improper motive."[51] Respondent cannot establish bad faith by pointing to the Department's efforts to bring this case on a novel theory of law or the fact that the Department determined that the customer witnesses might be untrustworthy, requiring that their testimony be taken in person and under oath. And Respondent has produced no evidence to support its conclusion that the Department's investigatory tactics were designed to avoid collecting and producing exculpatory evidence. This claim is particularly weak in light of the fact that Respondent knew what the witnesses would say. Accordingly, Respondent's claim that the Department violated Section 15A of the Exchange Act fails.

For the foregoing reasons, the Hearing Panel denies Respondent's Motion for Summary Disposition and Request for Preclusion Order Based upon Unfair Investigatory Process.

HEARING PANEL.

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[50] *United States v. Valenzuela-Bernal*, 458 U.S. 858, 872 (1982) (quoting *Lisenba v. California*, 314 U.S. 219, 236 (1941). Thus, in a similar setting involving Jencks Act violations, wherein the State withholds evidence required by statute to be disclosed, the Supreme Court has held that such violations rise to the level of due process violations only when they so infect the fairness of the trial as to make it "more a spectacle or trial by ordeal than a disciplined contest." (*Id.* (quoting *United States v. Augenblick*, 393 U.S. 348, 356 (1969)).

[51] *Jeffers v. Gomez*, 267 F.3d 895, 907 (9th Cir. 2001).

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By Andrew H. Perkins
Hearing Officer

March 18, 2004