BEFORE THE NATIONAL ADJUDICATORY COUNCIL

NASD

In the Matter of	
Department of Enforcement,	DECISION
Complainant,	Complaint No. CAF000013
vs.	
Respondent Firm	Dated: November 14, 2003
Frank J. Skelly, III Rockville Centre, NY,	
Craig H. Gross Kings Park, NY,	
and	
Respondent 3	
Respondents.	

Firm and two principals and part owners appeal findings that they charged fraudulently excessive markdowns in purchases of equity securities and that the firm's two owners failed to appear for on-the-record interviews. Decision is called for review as to finding that head trader is, in part, responsible for excessive markdowns, but that he did not act fraudulently. Held, findings and sanctions modified.

Appearances:

For the Complainant Department of Enforcement: Paul D. Taberner and Leo F. Orenstein.

For the Respondents Respondent Firm, Frank J. Skelly, and Craig H. Gross: Marvin G. Pickholz, Pickholz Law Firm (formerly with Hoffman, Pollok & Pickholz, LLP).

For Respondent 3: Simon S. Kogan, Kogan, Taubman & Neville, LLC.

Opinion

Respondent Firm, Frank J. Skelly, III ("Skelly"), and Craig H. Gross ("Gross") appeal a March 11, 2002 decision of an NASD Hearing Panel. NASD's Department of Enforcement ("Enforcement") cross-appealed, and we called the matter for review to examine the findings and sanction as to Respondent 3. The Hearing Panel held that Respondent Firm and Skelly, a principal and part owner of the Firm, charged customers fraudulently excessive markdowns in violation of NASD Rules 2110, 2120, and 2440 and Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Rule 10b-5 thereunder. The Hearing Panel held Respondent 3 responsible for excessive markdowns in the same transactions, in violation of NASD Rules 2110 and 2440, but it did not find that he acted fraudulently. Finally, the Hearing Panel found that Gross and Skelly failed to appear for on-the-record testimony, in violation of NASD Rules 2110 and 8210.

For the reasons discussed herein, we reverse the Hearing Panel's findings that the Firm and Skelly charged fraudulently excessive markdowns and reverse the Hearing Panel's finding of liability with respect to Respondent 3. We affirm the Hearing Panel's findings that Gross and Skelly failed to appear for on-the-record testimony and affirm the imposition of a bar for this misconduct. We eliminate all other sanctions imposed by the Hearing Panel.

I. Background

Respondent Firm became a registered broker-dealer and NASD member firm in the early 1990s. Gross and Skelly joined Respondent Firm in September 1995 and, in 1996, acquired a controlling interest in the Firm.

During the last quarter of 1996 and the first quarter of 1997, the period relevant to this matter, Gross served as Respondent Firm's president and financial and operations principal.[1] Gross was responsible for the Firm's administrative and financial management. The complaint did not allege that Gross shared responsibility for the Firm's markdown violations.

During the relevant period, Skelly was registered as a principal at Respondent Firm.[2] He supervised trading, determined in which securities Respondent Firm made a market, and set the Firm's markups and markdowns. The Firm's trading department could not execute principal trades without Skelly's express approval.

---

1 Gross entered the securities industry in January 1991. He is not currently in the securities industry.

2 Skelly entered the securities industry in January 1991. He is not currently in the securities industry.

During the relevant period, Respondent 3 held the title at Respondent Firm of head trader.[3] Respondent 3 reported directly to Skelly and, although he did not have authority to set the Firm's markups and markdowns, he reviewed the Firm's markups and markdowns on all trades.[4]

During late 1996 and early 1997, Respondent Firm generally made markets in approximately 15 to 18 securities at any one time. Respondent Firm filed a Uniform Request for Broker-Dealer Withdrawal in 1998.

II. Fraudulently Excessive Markdowns

A. Facts - Markdowns

1. Company 1

The Hearing Panel found that respondents charged excessive markdowns in the Firm's 1997 purchases of the common stock of Company 1. Company 1 was incorporated in 1991 and provided interactive games. In 1996, Company 1 completed two private placements of securities.[5] Company 2 acted as placement agent for the first private placement. Respondent Firm acted as placement agent for the second private placement, which was completed in 1996. The parties who purchased Company 1 stock in both private placements entered into lock-up agreements whereby they agreed not to sell their Company 1 shares for set periods (one year for the first private placement and 18 months for the second private placement) without Respondent Firm's prior consent.[6]

---

3 Respondent 3 is currently in the industry.

4 The complaint also contained allegations of supervisory deficiencies against Respondent Firm's chief operating officer and compliance officer. Prior to the Hearing Panel hearing, the Chief Operating Officer settled this matter with respect to the allegations against him. Accordingly, the Hearing Panel decision that we reviewed applied only to Respondent Firm, Skelly, Gross, and Respondent 3.

5 Section 4(2) of the Securities Act of 1933 exempts certain transactions not involving the public offering of securities, known as "private placements," from the registration requirements of the Securities Act of 1933. The securities sold in private placements are not freely tradable. Capital Markets Handbook, Securities Industry Association, Glossary (John C. Burch, Jr. and Bruce S. Foerster ed., 2003).

6 Respondent Firm held the rights to a "lock up" of the shares purchased in the first private placement until 1998 and the shares purchased in the second private placement until 1998.

On November 25, 1996, Company 1 filed a Form S-3 registration statement to register, under SEC Rule 415,[7] 2,293,208 shares of its common stock to be offered for sale by a list of selling shareholders that included the shareholders who purchased in the two private placements. The registration statement indicated that Company 1 would not receive any of the proceeds of the sales and that the stock would be sold "at market prices prevailing at the time of sale, at prices related to such prevailing market prices or at negotiated prices." It further indicated that "[u]sual and customary or specifically negotiated brokerage fees or commissions may be paid by the selling stockholders in connection with such sales." In 1997, Company 1 filed a Form S-3/A to increase the number of registered shares.[8]

During the period at issue (Company 1 stock traded on the NASDAQ SmallCap Market. The market for Company 1 stock was active and competitive, and approximately 14 broker-dealers made a market in the stock. At that time, Respondent Firm was not a market maker in Company 1 stock.

2. <u>Respondent Firm's Purchase of Company 1 Stock</u>

Investors who had purchased Company 1 stock in the two private placements approached Respondent Firm and requested that the Firm consider purchasing 1,400,500 shares of Company 1 stock. Skelly discussed the possible purchase with outside counsel, other members of the Firm's management, including Gross and the Chief Operating Officer, and representatives of Company 1. During these meetings, they discussed the costs to the Firm of purchasing the stock, the number of shares that the Firm should purchase, and how to handle the purchases.

---

[7] The registration of securities pursuant to Rule 415 of the Securities Act of 1933 is also known as "shelf registration." 17 C.F.R. § 234,415 (2003). Rule 415, which was adopted in the 1980s, allows securities to be sold in continuous or delayed offerings. With "shelf registration," the issuer, by filing certain publicly available financial reports (which, in effect, updates the prospectus), enables the issuer or selling stockholders (such as purchasers in a private placement), to sell the shelf-registered securities in the market as conditions become favorable. <u>Shelf Registration</u>, Exchange Act Rel. No. 20384 (Nov. 17, 1983); <u>Capital Markets Handbook</u>, Securities Industry Association, Section 2.08 (John C. Burch, Jr. and Bruce S. Foerster ed., 2003); John Downes and Jordan Elliot Goodman, <u>Dictionary of Finance and Investment Terms</u> (4th ed. 1995). A Rule 415 distribution of securities generally takes the form of a series of brokerage transactions, with compensation limited to normal brokerage commissions. <u>NASD Notice to Members 83-12</u> (Clarification of NASD Filing Requirements for Offerings Made Pursuant to SEC Rule 415) (March 8, 1983).

[8] Company 1's Form 10-K, dated 1997, reported the amount of shares of Company 1 stock outstanding.

Ultimately, they decided that Respondent Firm would purchase the stock in two transactions of approximately 700,000 shares each.

Skelly, Gross, and the Chief Operating Officer had determined that, in undertaking these purchases, the Firm would incur significant costs and bear substantial risk.[9] Skelly testified that he and Gross determined that it was appropriate for the Firm to charge an eight percent markdown from the best bid price.

During the weeks prior to the stock purchase, Skelly and the Chief Operating Officer also met with some of the selling stockholders to discuss the pricing of Company 1 stock. Skelly contended that Company 2 represented many of the selling stockholders and that he sought to agree on a price that was fair to all of the parties. Skelly argued that the stockholders were under no obligation to sell and that many of them were professional investors, hedge funds, and venture capital funds, all of whom were knowledgeable about the market and satisfied with the price that Respondent Firm proposed to pay. Gross testified that the Firm had hoped to establish a business relationship with many of the selling stockholders, so the sellers were in a position to dictate favorable terms for the sale.

The NASDAQ Integrated Equity Journal indicates that, at 11:42 a.m., Respondent Firm reported as an aggregated or bunched trade that it had purchased 718,595 shares of Company 1 common stock at $5 1/4 "as of" 9:40 a.m. At 12:02 p.m., Respondent Firm reported an additional purchase of 6,000 shares of Company 1 stock "as of" 9:40 a.m.

---

9 Respondents contended that Respondent Firm incurred significant costs in executing its purchases of Company 1 stock. They contended that the purchase of restricted stock is costlier and more time-consuming than the purchase of non-restricted stock. For example, the Chief Operating Officer testified that several individuals at Respondent Firm had to devote significant amounts of time to obtaining unrestricted stock certificates. He stated that the Firm also incurred interest charges when it forced its clearing firm to pay the sellers before the stock cleared transfer, and he stated that the fact that the purchase involved approximately 50 sellers, some of whom had fluctuated as to the amount of stock that they wanted to sell, also complicated the transaction. Similarly, Gross testified that the Firm incurred significant expenses when it attempted subsequently to sell the Company 1 stock, because the Firm was not able to deliver the shares timely due to complications in removing restrictions. Gross contended that, as a result, Respondent Firm lost the use of its capital and suffered net capital consequences on its failures to deliver stock. Gross noted that some of the shares of Company 1 that Respondent Firm purchased were not freely transferable until two months later. Skelly also testified that Respondent Firm lost the use of a significant portion of its capital during the period when it had paid for Company 1 stock, but had not been able to remove restrictions from the shares that it had purchased.

At 4:01 p.m., Respondent Firm canceled the original bunched trade to add an additional 8,333 shares to its purchase of Company 1 stock. At 4:09 p.m., Respondent Firm reported the corrected volume as a total of 726,928 shares of Company 1 stock that it had purchased "as of " 9:40 a.m. at $5 1/4. Respondent Firm reported the trade with an "SLD" modifier, which indicated that it was reported as a "late trade," and with a "T" status symbol, which indicated that the report was for trade reporting only and not for clearing submission.

3. Respondent Firm's Sales of Company 1 Stock

The record does not indicate precisely how and when Respondent Firm sold the entire 726,928-share block of Company 1 stock that it had purchased from the selling stockholders. The trading records indicate, however, that at 11:48 a.m., Respondent Firm reported selling 175,000 shares of Company 1 stock to another broker-dealer at $6 per share. Respondent Firm reported selling an additional 250,000 shares of Company 1 stock to a second broker-dealer at $6 per share at 11:50 a.m. Respondent Firm sold most of the balance of its purchase of Company 1 stock over the following two weeks. Respondent Firm's total profit on its first purchase and subsequent sales of Company 1 stock was approximately $1.1 million.

B. Discussion – Markdowns

We find that NASD's Policy on Markups and Markdowns applied to the transactions at issue, but that Respondent Firm's markdowns were not excessive. We therefore reverse the Hearing Panel's findings of fraudulently excessive markdowns, but affirm the finding that the NASD Markup Policy applied to these trades.

1. NASD's Policy on Markups and Markdowns Applied to the Transactions At Issue

Respondent Firm, Skelly, and Respondent 3 argued that NASD's policy with respect to pricing (IM-2440) did not apply to the transactions at issue because the transactions fell within an exemption to the policy. We reject this argument.

NASD Rule 2440 generally requires member firms that buy for their own accounts from customers or sell from their own accounts to customers to buy or sell at a price that is fair, taking into consideration all relevant circumstances. IM-2440, NASD's "Mark-Up Policy," provides further guidance on the issue of pricing securities and applies to both markups and markdowns. IM-2440 states that it is a violation of Rules 2110 and 2440 for a member to enter into any transaction with a customer in any security at any price not reasonably related to the current market price of the security. IM-2440(d) exempts certain types of transactions from the applicability of the policy. It states that the policy does not apply to the sale of securities: (1) where a prospectus or offering circular is required to be delivered and (2) the securities are sold at "the specific public offering price." Respondents contended that the transactions at issue fell within this exemption.

Neither party disputes that prospectus delivery was required for these trades and that a prospectus was in fact delivered. Furthermore, neither party proffered evidence as to whether a prospectus was required. Based on the parties' failure to argue otherwise, we find that Respondent Firm's block purchase of Company 1 stock meets the first prong of the exemption.

In this case, the applicability of the second prong of the exemption and the meaning of the term "the specific public offering price" are at issue.[10] According to the terms of the Company 1 prospectus, Company 1 stock could be sold at "market prices prevailing at the time of the sale, at prices related to such prevailing market prices, or at negotiated prices." Respondents argued that this reference to sales prices in the prospectus, although general in nature, was "the specific public offering price," as that term is used in the IM-2440(d) exemption. Enforcement countered that, in order to meet the exemption, the offering price must be clearly specified. Enforcement argued that shelf offerings involve sales that are similar to routine brokered transactions and are not distinguishable from ordinary trades in the secondary market. As such, Enforcement argued, customers involved in purchases and sales of shelf-registered stock are entitled to the benefits and protections provided by IM-2440. We agree.

The issue of whether, under this unique set of circumstances, securities bought and sold in a shelf offering are exempt from IM-2440 is an issue of first impression. We begin our analysis by looking to the plain language of the exemption provision.[11] We read the term "**the**

---

[10] Respondents sought to offer expert testimony on the issue of the applicability of IM-2440 to the transactions at issue. The Hearing Panel refused to accept expert testimony on this issue. We affirm the Hearing Panel's ruling. The issue of whether Respondent Firm's purchase transactions fell within an exemption to IM-2440 is a legal issue. "Although testimony concerning the ordinary practices in the securities industry may be received to enable a fact finder to evaluate [a party's] conduct against the standards of accepted practice . . . testimony encompassing an ultimate legal conclusion based upon the facts of the case is not admissible." Marion Bass Sec. Corp., 1998 SEC LEXIS 2690 at *7, Admin. Proceeding Rel. No. 574 (Nov. 13, 1998) (Order Ruling on Motion to Exclude Expert Testimony).

[11] Cf. Kmart Corp. v. Cartier, Inc., 486 U.S. 281 (1988) ("If the statute is clear and unambiguous 'that is the end of the matter, for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.'") (citations omitted). Furthermore, in considering the plain language of the provision, we have not isolated any single word or phrase. Rather, we considered the provision in its entirety and the object of and policy behind the interpretation. Cf. Mastro Plastics Corp. v. NLRB, 350 U.S. 270, 285 (1956) ("In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law, and to its object and policy."); District Bus. Conduct Comm. v. Gurfel, 1998 NASD Discip. LEXIS 52 (June 12, 1998) (same). We also have considered the overarching purpose of IM-2440 and NASD Rules in general. See Department of Enforcement v. Morgan Stanley DW, Inc., Complaint No. CAF000045, 2002 NASD Discip. LEXIS 11 (July 29, 2002) ("We are also mindful of the maxim that adjudicators should 'construe the details of an

[Footnote continued on the next page]

specific public offering price" to mean a specified price that is delineated in the prospectus and applies to all purchasers. In our view, the burden falls to the respondents to demonstrate that the general reference contained in the Company 1 prospectus was "the specific public offering price," as that term is used in IM-2440. In order to fall within the meaning of the term, a **specific** offering price must be stated for all interested purchasers to see. In the context of IM-2440, which relates to the reasonableness of brokers' compensation, a prospectus that contains "the specific public offering price" must contain information sufficient to enable interested parties to ascertain the reasonableness of the compensation that the selling broker-dealer will receive and to determine the ultimate cost of purchasing the securities at issue. The price need not be a specified dollar amount, but may be formulaic or determined by a reference amount such as a market price or discount therefrom. The Company 1 prospectus, which indicated that Company 1 stock would be sold at prevailing market prices, prices related to the market price, or negotiated prices, did not contain the level of specificity necessary to be considered "the specific public offering price" and therefore did not meet the terms of the exemption.

Our reading of IM-2440(d) is consistent with the developmental history of IM-2440. In 1943, NASD's Board endeavored to provide NASD's membership with an interpretation of NASD's rules with respect to the fair pricing of securities. In an October 1943 letter to NASD membership, NASD published an interpretation in which it set forth a workable guide for NASD to use in determining whether prices charged by member firms were reasonably related to the prevailing market. In the October 1943 letter, the Board stated that, in adopting its policy, "transactions with the public during the period of initial distributions . . , since they are made at the public offering price . . .were naturally excluded from [the Board's] consideration of this question and the interpretation . . ." Rules of the National Association of Securities Dealers, Inc., 17 S.E.C. 459, 473 (1944). Thereafter, the interpretation was incorporated into NASD's Manual. The version of NASD's policy included in IM-2440 has been in effect since approximately December 1960. A slightly longer version of NASD's Mark-Up Policy was included in earlier manuals, dating back to July 1950. The 1950 version stated that the policy did not apply to the sales of securities sold in public offerings under a prospectus in which underwriting concessions and dealer discounts are set forth. In our view, based on the course of IM-2440's development, NASD intended to exclude from IM-2440's applicability only those public offerings in which the offering prospectus or circular clearly discloses the offering price and dealer discounts or allows the price and dealer discounts to be determined from the information in the prospectus.

[cont'd]
act in conformity with its dominating general purpose.'") (citing Herman & MacLean v. Huddleston, 459 U.S. 375, 387 n. 23 (1983)). Indeed, "the Supreme Court has held that provisions governing the securities industry should be construed, not strictly and technically, but flexibly to achieve their remedial purpose." Donald M. Bickerstaff, 52 S.E.C. 232, 234 (1995). Also see Affiliated Ute Citizens v. United States, 406 U.S. 128, 151 (1972).

Our reading of IM-2440 also is consistent with one of the overriding regulatory purposes of NASD rules in general and this rule in particular. IM-2440 is founded on the basic principle that a securities dealer impliedly represents that it will deal honestly and fairly with its customers in accordance with standards established in the industry. Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943). IM-2440 provides guidance to the membership on how to price securities transactions fairly, because prices that are not reasonably related to the prevailing market price are inherently unfair. Alstead, Dempsey & Co., 47 S.E.C. 1034 (1984). IM-2440(d) expressly exempts offerings in which the sales price of the security to the public is set in the offering documents, such as initial public offerings, secondary offerings, and other public offerings of securities that are subject to regulatory review of compensation and remuneration.[12] This process for public offerings provides for regulatory review of dealer compensation and ensures that the compensation is fully disclosed. The IM-2440 exemption acknowledges that the protections that IM-2440 offers to the public are not necessary in certain offerings when the price of a security is clearly identified in an offering document, the dealer compensation is fully disclosed to all potential buyers, and, in most cases, the amount of dealer compensation has been subjected to a regulatory review designed to assess fairness and reasonableness. NASD's regulatory objective in developing IM-2440(d) was to exempt those offering transactions that incorporate these three features.

Finally, NASD does not require the broker-dealer's compensation to be reviewed in this type of offering under Rule 2710. In part because an underwriting agreement or contract often is not formalized in a shelf offering, transactions in a Rule 415 shelf offering may "take the form of a series of brokerage transactions" or "are offered in broker's transactions which are virtually indistinguishable from ordinary secondary trades." NTM 83-12 (Clarification of NASD Filing Requirements for Offerings Made Pursuant to SEC Rule 415) (March 8, 1983). Although not subject to review under Rule 2710 for a variety of reasons, the lack of review under Rule 2710 for shelf offerings registered on Form S-3 does not mean that these transactions are exempt from the requirement to charge fair prices contained in IM-2440.

We find that, in dealing with the selling stockholders in this case, Respondent Firm was subject to the same obligations and responsibilities to which it would have been subject in any other purchase of securities from customers. IM-2440 therefore applied to the transactions at issue.

2. Respondent Firm's Markdowns Were Not Excessive

We reverse the Hearing Panel's findings that Respondent Firm, Skelly, and Respondent 3 charged customers excessive markdowns in the purchases of 726,928 shares of Company 1

---

[12] NASD Rule 2710 (Corporate Financing Rule – Underwriting Terms and Arrangements) regulates the underwriting terms and arrangements of most public offerings of securities sold through NASD members.

stock. Our conclusion in this case is based largely on our finding that Respondent Firm's "markdowns" are, in part, remuneration to Respondent Firm from the selling stockholders for Respondent Firm's early release of the stockholders from the sales restrictions in the lock-up agreements. Once we factored into our analysis of the Firm's markdowns the fact that the Firm was entitled to receive fair compensation for releasing the lock-up agreements, we concluded that the remaining markdowns were not excessive or unfair. We reject Enforcement's position that Respondent Firm is not entitled to credit for releasing its rights under the lock-up agreements and conclude that these purchases were highly negotiated, complicated transactions that differed in many respects from normal brokered transactions.

In our view, certain key facts set this case apart from other markdown cases. First, Respondent Firm released the selling stockholders from the lock-up agreements. A contract is a legally binding agreement pursuant to which the law recognizes a duty of performance. Samuel Williston, A Treatise on the Law of Contracts § 1:1 (Richard A. Lord ed., 4th ed. 1990). The lock-up agreements were contracts and Respondent Firm was the beneficiary of the contracts. The selling stockholders were obligated legally not to sell their Company 1 stock until early to mid-1998. Under the terms of the lock-up agreements, Respondent Firm held the rights to enforce the selling stockholders' obligations not to sell. Rather than enforce those rights, which under the law Respondent Firm was entitled to do, Respondent Firm instead chose to release the selling stockholders from their contractual obligations by allowing them to sell their Company 1 stock 10 to 16 months earlier than would have been allowed under the terms of the lock-up agreements. Respondent Firm therefore was entitled to consideration for releasing its rights. In our view, we cannot consider the reasonableness of Respondent Firm's markdowns without crediting the Firm for releasing the selling stockholders from their contractual obligations to Respondent Firm.

Second, Respondent Firm purchased Company 1 shares that were restricted. Respondent Firm incurred significant additional expenses, such as legal fees, processing fees, interest expenses and other costs associated with removing restrictive legends from the Company 1 stock certificates. These costs would not have existed at the same level or to the same degree if Respondent Firm's purchases did not involve restricted shares of stock. Respondent Firm may factor these costs into its markdown assessment.

Third, Respondent Firm took risks in acquiring restricted stock and may be compensated for the risks. Respondent Firm paid the selling shareholders, in many instances, before the stock cleared transfer. Respondent Firm prevailed upon its clearing firm to pay the sellers before the Company 1 stock was freely transferable. In doing so, Respondent Firm took risks and incurred interest charges and other costs and lost the use of its capital until it successfully removed the restrictions from the Company 1 shares that it had purchased. Respondent Firm also suffered net capital consequences from paying for and attempting to sell stock that was not freely transferable. We considered all of these facts in connection with reviewing the Firm's markdowns.

Fourth, Respondent Firm purchased a considerably large block of Company 1 stock and took inventory risk in carrying the securities. At the time of Respondent Firm's purchases, the average daily trading volume in Company 1 stock was 50,000 to 60,000 shares. Respondent Firm purchased an amount approximately 10 times the average daily trading volume. Respondent Firm was at risk until the stock was sold. If that amount of Company 1 stock had been allowed to flood the market, it may have affected the stock's price and liquidity. Furthermore, the fact that Respondent Firm enabled the selling stockholders to sell their entire positions was a benefit to the stockholders for which Respondent Firm may be credited.

Finally, Respondent Firm negotiated its purchases of Company 1 stock for weeks prior to the date of the actual purchases and negotiated with numerous selling stockholders, an effort and expense different from a normal brokerage transaction. These factors also complicated Respondent Firm's purchases of Company 1 stock.

In our view, Respondent Firm's purchases differed from ordinary brokered transactions in several ways. Under these facts, and in light of the specific circumstances discussed above, we cannot find that Respondent Firm charged the selling stockholders fraudulently excessive markdowns in its purchases of Company 1 stock. We therefore dismiss the allegations of causes one and two of the complaint.

III. Gross' and Skelly's Failure to Appear for On-the-Record Interviews

A. Facts – Failure to Appear

The facts relevant to Gross' and Skelly's failure to appear are largely undisputed. By letters dated December 14, 1998, NASD requested that Skelly appear on January 7, 1999, and that Gross appear on January 8, 1999, for on-the-record interviews pursuant to Rule 8210[13] regarding Respondent Firm's trading activity.[14] At respondents' request, NASD rescheduled the dates for their on-the-record testimony to January 21, 1999 (for Skelly) and February 1, 1999 (for Gross). Neither appeared for his scheduled testimony. On January 20, Skelly's counsel advised NASD staff that, due to a pending, related criminal investigation, NASD's interview must be postponed indefinitely or limited in scope. Similarly, on January 22, Gross' counsel advised NASD staff that, in light of a related criminal investigation of Gross, he too requested an indefinite adjournment of the scheduled interview. NASD did not agree to reschedule Skelly's or

---

[13] Rule 8210 requires members and associated persons to provide information orally and/or to testify under oath at the direction of NASD staff in connection with an NASD investigation.

[14] Skelly and Gross terminated their NASD registrations on August 5, 1998, and have not since been registered with NASD. Thus, respondents were not registered with NASD when NASD requested their appearances for on-the-record interviews.

Gross' on-the-record interviews, and neither appeared at the interviews. On May 4, 2000, Enforcement filed the complaint in this matter.

B. Discussion – Failure to Appear

Prior to the Hearing Panel hearing, Skelly and Gross filed a motion for summary disposition with respect to the Rule 8210 allegations against them. Enforcement filed a counter-motion for summary disposition on the same issue. Respondents' motion argued two bases for dismissal of the Rule 8210 allegations. First, they argued that NASD lacked jurisdiction to request their appearance for on-the-record interviews, since they no longer were registered with NASD. Second, they argued that they could not be compelled to testify about matters connected to an ongoing criminal investigation. They contended that NASD was a state actor at the time of the requests, and that they were entitled to assert, under the Fifth Amendment to the United States Constitution, their right to avoid self-incrimination. The Hearing Panel rejected both arguments, denied respondents' motion for summary disposition, and granted Enforcement's counter-motion. The Hearing Panel further found that Gross and Skelly had violated NASD Conduct Rules 2110 and 8210 when they failed to appear for on-the-record testimony. The Hearing Panel deferred imposing sanctions until after the Hearing Panel hearing, at which Gross and Skelly were given the opportunity to present evidence in mitigation of their Rule 8210 violations.

When reviewing a Hearing Panel ruling on a motion for summary disposition, we follow Rule 9264, which states that summary disposition may be granted if there is no genuine issue with regard to any material fact and the moving party is entitled to summary disposition as a matter of law. In cases involving motions for summary disposition, federal law also provides significant guidance.[15] In this case, the Hearing Panel concluded that there were no issues with respect to the facts related to Skelly's and Gross' failure to appear and that Enforcement was entitled to summary disposition on the Rule 8210 issue as a matter of law. For the reasons set forth below, we agree.

1. NASD Jurisdiction to Issue Requests for Information

Skelly and Gross contended that, since they no longer were associated with NASD members when NASD requested their appearance, they no longer were subject to NASD

---

15 See Celotex Corp. v. Catrett, 477 U.S. 317 (1986) (the moving party bears the initial burden of showing that no genuine issue of material fact exists); Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574 (1986) (if the moving party meets its burden of establishing the absence of a genuine issue of material fact, the opposing party must come forward with specific facts to establish a genuine factual issue); Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248 (1986) (the substantive law governing a case will identify those facts that are material and "only disputes over facts that might affect the outcome of a suit under the governing law will properly preclude the entry of summary judgment.").

jurisdiction. They contended therefore: (1) that NASD did not have jurisdiction initially to request their appearance, and (2) that even if NASD had jurisdiction to request their appearance, NASD did not have jurisdiction to file a complaint for their failure to appear, since their failure to appear occurred after their registration was terminated. Respondents misread NASD's jurisdictional provisions.

Article V, Section 4 of NASD's By-Laws (Retention of Jurisdiction) states, in pertinent part:

> A person whose association with a member has been terminated and is no longer associated with any member of the NASD . . . shall continue to be subject to the filing of a complaint . . . based upon [1] conduct which commenced prior to the termination, revocation, or cancellation or [2] upon such person's failure, while subject to [NASD's] jurisdiction as provided herein, to provide information requested by the NASD pursuant to the [NASD] Rules . . . but any such complaint shall be filed within [two years.]

Rule 8210 states that NASD staff may require a person who is still subject to NASD jurisdiction to provide information orally and to testify under oath at a specific location. Gross and Skelly terminated their registrations in August 1998. Under the plain language of Rule 8210, NASD possessed authority to request that they testify under oath during the entire period that NASD had jurisdiction over them which, under Article V, Section 4 of the By-Laws, was during the two years following the termination of their registration. Furthermore, under the plain language of Article V, Section 4 of the By-Laws, NASD's jurisdiction to file a complaint against Gross and Skelly continued for two years after the termination of their registrations based on either (1) misconduct that occurred prior to the termination of their registrations or (2) their failure during the two-year period to respond to Rule 8210 requests issued during the two-year extension of jurisdiction.

Our reading of Article V, Section 4 of the By-Laws and Rule 8210 is supported by our own earlier interpretations, the SEC's interpretation in an adopting release for the amendment of Article V, Section 4 of the By-Laws and Rule 8210, and SEC decisions in NASD disciplinary matters involving similar jurisdictional issues. In April 1992, NASD announced to its membership in NASD Notice to Members 92-19 (April 1992) that the SEC had approved amendments to Article V, Section 4 of the NASD By-Laws (previously Article III, Section 5) and Rule 8210 (previously Article IV, Section 5 of the Rules of Fair Practice) to extend NASD jurisdiction to file complaints and to request information (under Rule 8210) to two years subsequent to an individual's termination of registration. In Notice to Members 92-19, NASD reminded the membership that individuals must respond to NASD requests for information, even if their registrations had been terminated, for the entire period that they remained subject to NASD jurisdiction and that NASD may thereafter bring an action against them for their failure to do so. The SEC's adopting release contained similar language. See Order Approving Amended Proposed Rule Change Relating to Retention of Jurisdiction and Conforming Changes to the

Rules of Fair Practice, Exchange Act Rel. No. 30506, 57 Fed. Reg. 10780 (Mar. 23, 1992); 57 Fed. Reg. 10780 (Mar. 30, 1992). Furthermore, immediately after the SEC's approval of amendments to Article V, Section 4 of the By-Laws and Rule 8210, the SEC issued a decision in Reed A. Hatkoff, 51 S.E.C. 769 (1993), in which it confirmed NASD's long-standing position that a person who remains subject to the filing of a complaint also remains subject to Rule 8210 requests for information and to the filing of a subsequent complaint for failing to respond to the information requests.

Thus, NASD appropriately exercised jurisdiction over Skelly and Gross both when it issued, pursuant to Rule 8210, requests that Skelly and Gross appear and testify under oath and when it subsequently issued a decision against them for failing to appear. See Market Regulation Comm. v. Zubkis, Complaint No. CMS950129, 1997 NASD Discip. LEXIS 47 (NBCC Aug. 12, 1997) (in the two-year period during which NASD retains jurisdiction, persons subject to jurisdiction are required to comply with information requests made pursuant to Rule 8210); District Bus. Conduct Comm. v. Veisman, Complaint No. C10960060, 1997 NASD Discip. LEXIS 36 (NBCC May 20, 1997) (same).

2. NASD Was Not a State Actor

Skelly and Gross argued that NASD should have granted them a continuance of their on-the-record interviews because of the pending criminal investigations of their misconduct. They argued that, because of the work of NASD's Criminal Assistance Prosecution Unit, NASD was a state actor and respondents therefore were entitled to claim the protections of the Fifth Amendment to the United States Constitution. We do not agree that NASD was a state actor and therefore reject respondents' argument.

As an initial matter, we note that "questions put to [an associated person] by the NASD in carrying out its own legitimate investigative purposes do not activate the privilege against self-incrimination." U.S. v. Shvarts, 90 F. Supp. 2d 219, 222 (E.D.N.Y. 2000). In D.L. Cromwell Inv., Inc. v. NASD Regulation, Inc., 279 F.3d 155 (2d Cir. 2002), the United States Court of Appeals for the Second Circuit considered a similar issue. In Cromwell, the Second Circuit held that the Fifth Amendment restricts the actions of non-governmental entities (like NASD) only if the entity's actions are fairly attributable to the government. "Actions are 'fairly attributable' to the government where 'there is a sufficiently close nexus between the State and the challenged action of the regulated entity.'" Cromwell, 279 F.3d at 161 (citing, Jackson v. Metropolitan Edison Co., 419 U.S. 345, 351 (1974)). That nexus exists, the court held, (1) where the state has exercised coercive power over or provided such significant encouragement of a private decision that the action must be deemed to be that of the state; and (2) where the private entity has exercised powers in an area traditionally thought to be the exclusive prerogative of the state. 279 F.3d at 161 (citations omitted).

The Second Circuit noted in Cromwell that courts repeatedly have held that NASD is not a governmental functionary, notwithstanding that it is subject to extensive and detailed government regulation from the SEC.[16] The Cromwell court also held that, although testimony in an NASD proceeding may entail exposure to criminal liability, additional facts are necessary to establish a nexus between NASD and the government. The respondents in this matter have not provided sufficient additional facts to prove such a nexus.

Respondents contended that an attorney with NASD Enforcement who requested Skelly's and Gross' appearance for on-the-record interviews also worked with NASD's Criminal Prosecution Assistance Unit and therefore assisted governmental criminal prosecutors, such as the New York County District Attorney. Respondents sought the Hearing Panel to order the attorney to appear to answer questions as to whether, in requesting Skelly and Gross to appear for on-the-record interviews, he was acting at the behest of the New York County District Attorney. Respondents' proffer as to why the attorney's actions should be questioned was that, in an unrelated criminal matter, the New York District Attorney had asserted that he had received information in that matter directly from the attorney at NASD. The Hearing Panel denied respondents' request to question the attorney.

We do not find respondents' two assertions -- that the attorney worked with NASD's Criminal Prosecution Assistance Unit or that he provided information to the New York District Attorney in an unrelated matter -- sufficient to constitute evidence of a nexus between NASD and the state in this matter. Nor do we find that Skelly and Gross should have been allowed, based on the minimal information that they provided regarding the attorney, to have gone on a "fishing expedition" in an effort to produce evidence that the attorney, in requesting their appearances, was acting on behalf of any entity other than NASD.[17] Even if, as respondents contended, the attorney worked with NASD's Criminal Prosecution Assistance Unit and assisted the New York District Attorney in another matter, that does not persuade us that NASD was a state actor as a result of the attorney's information requests in this matter. See Cromwell, 279 F.3d at 162-163. Furthermore, NASD's requests for Skelly and Gross to appear for testimony (not all of which came from the attorney) indicated that NASD sought Skelly's and Gross'

---

16 See Marchiano v. NASD, 134 F. Supp. 2d 90 (D.D.C. 2001) (NASD is not a state actor); Desiderio v. NASD, 191 F.3d 198 (2d Cir. 1999), cert. denied, 531 U.S. 1069 (2001) (same); United States v. Schvarts, 90 F. Supp. 2d 219 (E.D.N.Y. 2000) (same); Datek v. NASD, 875 F. Supp. 230 (S.D.N.Y. 1995) (same).

17 Cf. John Montelbano, Exchange Act Rel. No. 47227, 2003 SEC LEXIS 153 (Jan. 22, 2003) (respondent was not entitled to go on a fishing expedition through NASD staff's files in the hope that something might turn up to aid his defense); A. S. Goldmen & Co., Exchange Act Rel. No. 44328, 2001 SEC LEXIS 966 (May 21, 2001) (respondents were not entitled to go on a fishing expedition -- questioning NASD staff -- to prove selective prosecution); Keith L DeSanto, 52 S.E.C. 316 (1995) (respondent was not entitled to go on a fishing expedition through NASD files in the hope of finding something that might be helpful to his case).

testimony in connection with NASD's own inquiry into whether a violation of NASD Rules had occurred. As a self-regulatory organization, NASD has an independent obligation to investigate possible rule violations, and respondents have offered no evidence that NASD was acting on anything other than its own investigation.

Thus, we conclude that NASD was not a state actor and that Skelly and Gross were not entitled to assert a Fifth Amendment right in response to NASD's requests that they appear to testify.

* * * * *

In sum, we find that NASD appropriately exercised jurisdiction over Skelly and Gross both in requesting that they appear for on-the-record testimony and in filing a complaint for their failure to do so. We further find that Skelly and Gross failed to appear for testimony, in violation of NASD Rules 2110 and 8210, and that the Hearing Panel properly granted Enforcement summary disposition on this issue.

IV. Procedural Arguments

As more fully discussed below, we also have considered and rejected the respondents' procedural arguments. We find that the Hearing Panel afforded these respondents procedural fairness in its consideration of this matter. Furthermore, our de novo review of the record has corrected any procedural unfairness by affording them a full and fair opportunity on appeal to defend themselves. See Randolph K. Pace, 51 S.E.C. 361 (1993).

Respondents argued that the composition of the Hearing Panel contravened NASD Procedural Rules and that the NAC therefore should vacate the Hearing Panel decision and remand the matter for a new hearing before a properly constituted panel. Respondents' argument was based on two points. First, respondents contended that, since the Hearing Officer identified District No. 10 as the primary district committee for this case, NASD erred in allowing a District No. 9 Committee member to sit on the Hearing Panel in lieu of a District No. 10 Committee member. Second, respondents argued that, given the subject matter of the complaint, NASD erred in failing to ensure that a current or recent member of the Market Regulation Committee ("MRC") served on the Hearing Panel. We reject both arguments and find that the composition of the Hearing Panel comported with NASD's Procedural Rules.

At the outset, we note that respondents failed to raise both arguments before the Hearing Panel. During the pre-hearing conference, the Hearing Officer designated District No. 10 as the primary district committee for this case. Thereafter, on October 23, 2000, the Hearing Officer notified the parties of the identity of the panel members, their prior NASD service, and their industry affiliations. The hearing occurred on June 5, 2001. Respondents did not object to the composition of the Hearing Panel before or during the Hearing Panel hearing. Respondents thus "failed to raise this issue when remedial action could have been taken." Ko Sec., Inc., 53 S.E.C. 368, 377 (1997), remanded in part and reversed in part on other grounds Yoshikawa v. SEC, 192

F.3d 1209 (1999). Under these circumstances, respondents have waived this argument. See Ko Securities, 53 S.E.C. 368 (1997) (respondent's failure to object to make-up of Market Surveillance Committee ("MSC") Hearing Panel until after issuance of MSC decision resulted in waiver of argument); Brooklyn Capital & Sec. Trading, Inc., 52 S.E.C. 1286 (1997) (respondent waived objections to conduct of Hearing Panel Chair because respondent failed to raise objections at a time when the matter complained of could have been remedied); Mayer A. Amsel, 52 S.E.C. 761 (1996) (respondent waived argument regarding composition of District Business Conduct Committee Hearing Panel because he failed to raise issue before District Committee issued its decision). A respondent "cannot be permitted to gamble on one course of action and, upon an unfavorable decision, to try another course of action." 52 S.E.C. at 767, citing David T. Fleischman, 43 S.E.C. 518, 522 (1967). Thus, respondents' failure to raise this issue before the Hearing Panel resulted in a waiver of the issue.

Furthermore, notwithstanding respondents' waiver of these arguments, respondents also do not prevail based on the substance of their arguments. As discussed below, the composition of the Hearing Panel complied with the requirements of NASD's Code of Procedure.

A. Hearing Panel Member from Primary District Committee

Respondents contended that, since the Hearing Officer identified District No. 10 as the primary district committee[18] for this case, NASD erred in not ensuring that the Hearing Panel included a member of the District Committee for District No. 10. Respondents argued that NASD erred in including Panel Member 1 on the Hearing Panel, because Panel Member 1 was a member of the District No. 9 Committee. We do not agree.

Although NASD's Procedural Rules suggest that Hearing Panel members generally are drawn from the primary district committee designated in a case, the Code of Procedure does not require that Hearing Panels include a panel member from the primary district committee. Procedural Rule 9232, which provides criteria for the selection of panelists, states in subsection (a) that, in a disciplinary proceeding, the Chief Hearing Officer shall designate a district committee as the primary district committee for the proceeding. Rule 9232(d) states that, after the Chief Hearing Officer designates the primary district committee, the Chief Hearing Officer shall select panelists from: (1) the current members of the primary district committee; (2) the other categories of persons eligible to serve as panelists as set forth in Rule 9231(c)[19] who are

---

18 NASD Procedural Rule 9120(y) defines "primary district committee" as the district committee, in a disciplinary proceeding under the Rule 9200 Series, that is designated by the Chief Hearing Officer pursuant to Rule 9232 to provide one or more of the panelists for a Hearing Panel for such disciplinary proceeding.

19 Rule 9231(c) pertains to extended hearing panels. Given the size of the record, the complexity of the issues, and the length of the hearing in this matter, the Chief Hearing Officer designated the Hearing Panel as an Extended Hearing Panel. Rule 9231(c) provides that an

[Footnote continued on the next page]

located in the same geographic area as the primary district committee; and (3) if applicable, from the current or former members of the Market Regulation Committee. Rule 9232 states that the Chief Hearing Officer's panelist selection process shall be based on expertise, absence of a conflict of interest, availability, and the frequency of the panel member's service on hearing panels over the prior two years. Furthermore, Rule 9232(e), which is entitled "Appointment of Panelists from Other than Primary District Committee," states that the designation of the primary district committee <u>does not preclude the Chief Hearing Officer from selecting one or more panelists from other categories of eligible panelists</u> if the Chief Hearing Officer determines that one or more persons from other categories of eligible panelists more clearly meet the criteria for appointment of panelists and the public interest or the administration of NASD's regulatory and enforcement program would be enhanced by the selection of such panelists. Thus, Rule 9232 allows for the appointment of panelists from District Committees other than the primary district committee if the panelist is otherwise eligible and does not <u>require</u> that all hearing panels include a member of the primary district committee.

In this case, Panel Member 1 was eligible to serve as a panelist under Rules 9231 and 9232, although he was not a current member of the District No. 10 Committee. At the time of the proceeding, Panel Member 1 was associated with a member firm, a current member of the District No. 9 Committee, available to serve, and free of potential conflicts of interest. District No. 9 is located in the same geographic area as District No. 10. Furthermore, Panel Member 1 was appointed after one of the original Hearing Panel members, WB, a current member of the District No. 10 Committee, withdrew after respondents objected to his appointment to the Hearing Panel. Panel Member 1's appointment to the Hearing Panel therefore complied with the requirements of NASD's Code of Procedure.

The second Hearing Panel member also was eligible under Rules 9231 and 9232 to serve on the Hearing Panel. At the time of the proceeding, he was associated with a member firm and was a former member of the MRC, the District No. 11 Committee, the NASD Board, and the National Business Conduct Committee (predecessor to the NAC). He too was available to serve and free of potential conflicts. District No. 11 also is located in the same geographic area as

---

[cont'd]
Extended Hearing Panel shall consist of a Hearing Officer and two panel members, each of whom (1) shall be associated with a member or retired therefrom, and (2) shall currently or previously have served on a District Committee, previously served on the NAC, previously served on a disciplinary subcommittee of the NAC or National Business Conduct Committee (predecessor to the NAC), <u>or</u> previously served as a Director on the NASD Regulation Board of Directors, Governor on the NASD Board of Governors, or Director on the NASDAQ Board, but does not currently serve in any of these positions.

District No. 10. Thus, Panel Member 2's appointment to the Hearing Panel also complied with the Code of Procedure.[20]

B. Hearing Panel Member from Market Regulation Committee

Respondents also failed to prove that the composition of the Hearing Panel contravened NASD's Code of Procedure by virtue of NASD's failure to include a current member of the MRC. Specifically, respondents contended that, pursuant to Rule 9231(c)(2), the Hearing Panel should have included one current member of the MRC. We do not agree.

The Code of Procedure does not require that a Hearing Panel include one member of the MRC. Procedural Rule 9231(c)(2) states that, if a complaint alleges at least one cause of action involving a violation of a statute or rule described in the Rule 9120 Series,[21] the Chief Hearing Officer may select as a panelist a person who currently serves on the MRC or who previously served on the MRC not earlier than four years before the date of service of the complaint.[22] The Code does not require that the MRC be represented on any Hearing Panel, regardless of the allegations of the complaint. The appointment of members of the MRC to a Hearing Panel rests solely within the discretion of the Chief Hearing Officer. NASD therefore did not err in failing to include a member of the MRC on the Hearing Panel in this matter.

* * * * *

In sum, the composition of the Hearing Panel in this matter complied with the requirements of the NASD Code of Procedure, and respondents have demonstrated no procedural irregularities in this proceeding. We therefore reject respondents' procedural arguments.

---

20 We also note that, even if respondents had demonstrated an irregularity in the composition of the Hearing Panel based on the Hearing Officer's failure to include on the Hearing Panel a member of the District No. 10 Committee, we may have considered the irregularity to be technical in nature and, without demonstrating prejudice, respondents' argument would have failed. See Thomas P. Reynolds, 50 S.E.C. 721 (1991) (a technical irregularity in the composition of a hearing panel, without more, does not automatically establish prejudice); Curtis I. Wilson, 49 S.E.C. 1020 (1989) (same).

21 Rule 9120(s) identifies the following areas as relating to the work of the MRC: the quotation of securities; the execution of transactions; the reporting of transactions; and trading practices. It is not altogether clear whether the allegations of the complaint in this matter fall within these areas.

22 Hearing Panel Member 2 served on the MRC more than four years prior to the issuance of the complaint in this matter.

V. Sanctions

The Hearing Panel imposed the following sanctions: for fraudulently excessive markdowns, the Hearing Panel fined Respondent Firm and Skelly $75,000 each, suspended them for two years, and ordered restitution of $226,882 (joint and several); for excessive markdowns, the Hearing Panel ordered that the decision serve as a letter of caution as to Respondent 3; and for failing to respond to NASD requests for on-the-record testimony, the Hearing Panel barred Skelly and Gross. The Hearing Panel also assessed joint and several hearing costs of $6,385 as to Skelly, Gross, and Respondent Firm. We affirm the bar of Skelly and Gross for failing to respond to NASD requests for on-the-record testimony. In light of our reversal of the Hearing Panel's remaining findings, we eliminate all other sanctions as to Skelly and Gross and all sanctions imposed on Respondent 3 and Respondent Firm.

The applicable NASD Sanction Guideline[23] indicates that a bar in all capacities should be standard in cases like this in which an individual does not respond in any manner. Furthermore, we find no mitigating factors present in this matter.

NASD Rule 8210 is widely accepted as one of NASD's most important tools for investigating potential wrongdoing, particularly in the absence of subpoena power. The assertion of the privilege against self-incrimination is not a mitigating factor in a disciplinary action involving a respondent's failure to respond to investigative requests. District Business Conduct Committee No. 7 v. Joiner, 1994 NASD Discip. LEXIS 200 (NBCC Dec. 8, 1994). Thus, under Rule 8210, respondents had an absolute obligation to appear for testimony, and they knowingly chose not to do so. We find that the sanctions imposed are within the range recommended in the applicable Sanction Guideline and are commensurate with the gravity of respondents' misconduct.

* * * * *

---

[23] See NASD Sanction Guidelines (2001 ed.) at 39 (Failure to Respond or Failure to Respond Truthfully, Completely, or Timely to Requests Made Pursuant to NASD Procedural Rule 8210).

Accordingly, for failing to appear for on-the-record testimony, we bar Skelly and Gross from associating with any NASD member in any capacity. We also affirm the Hearing Panel's imposition of joint and several costs of $6,385 as to Skelly and Gross. In light of our dismissal of Respondent Firm, we do not affirm the Hearing Panel's inclusion of Respondent Firm in its imposition of costs. The bars imposed herein are effective upon service of this decision.[24]

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

[24] We also have considered and reject without discussion all other arguments advanced by the respondents.

Pursuant to NASD Procedural Rule 8320, any member that fails to pay any fine, costs, or other monetary sanction imposed in this decision, after seven days' notice in writing, will summarily be suspended or expelled from membership for non-payment. Similarly, the registration of any person associated with a member who fails to pay any fine, costs, or other monetary sanction, after seven days' notice in writing, will summarily be revoked for non-payment.