This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision CAF030014.

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondent.	Disciplinary Proceeding No. CAF030014 Hearing Officer—Andrew H. Perkins **EXTENDED HEARING PANEL DECISION** March 3, 2006

Member firm found not liable for: (1) engaging in profit sharing, in violation of NASD Conduct Rules 2330(f) and 2110; (2) failing to file information and documents with NASD's Corporate Finance Department, in violation of NASD Conduct Rules 2710 and 2110; (3) failing to maintain accurate books and records, in violation of Section 17(a) of the Securities Exchange Act of 1934, Exchange Act Rule 17a-3, and NASD Conduct Rules 3110 and 2110; and (4) failing to maintain and enforce adequate supervisory procedures and failing to supervise its brokers, in violation of NASD Conduct Rules 3010 and 2110. Complaint dismissed.

Appearances

For the Complainant: David R. Sonnenberg, Lane A. Thurgood, and Jeffrey P. Bloom, NASD, Department of Enforcement, Washington, DC.

For the Respondent: Theodore N. Mirvis, Allan A. Martin, David Gruenstein, and George T. Conway, III, WACHTELL, LIPTON, ROSEN & KATZ, New York, NY.

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision CAF030014.

Table of Contents

This Decision has been published by the NASD Office of Hearing Officers and should be cited as OHO Redacted Decision CAF030014.

DECISION

I. INTRODUCTION

The Department of Enforcement ("Enforcement") brought this proceeding against ________________________ ("Respondent" or the "Firm"), an NASD member firm, alleging that between October 1, 1999, and March 31, 2000, the Firm engaged in profit sharing by accepting higher-than-normal commission rates from customers seeking allocations of initial public offerings ("IPOs").

The Complaint contains six causes of action. The first cause of action, as supplemented by the Bill of Particulars,[1] alleges that the Firm violated NASD's profit-sharing rule (Conduct Rule 2330(f))[2] when, on agency trades of listed securities, and in the absence of any profit-sharing agreement or quid pro quo, the Firm accepted customer-set commission rates that were higher than the normal industry rates paid by institutional customers. Enforcement refers to these commissions as "inflated rate commission payments" and alleges that the limited services the Firm provided to its customers did not justify the payments. In addition, although not an element of the profit-sharing charge, Enforcement alleges that customers made the inflated rate commission payments in order to gain access to "hot" IPOs.[3]

In large measure, the remaining five causes of the Complaint spring from the first. The second cause of action alleges that the Firm improperly received inflated rate commission

---

[1] Bill of Particulars (Oct. 15, 2003).

[2] The Complaint further alleges that the Firm thereby violated Conduct Rule 2110, which provides that "[a] member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade."

[3] An IPO is a corporation's first offering of stock to the public. A *hot IPO* or *hot issue* is one in which the stock immediately trades at a premium in the aftermarket because there is greater public demand for the stock than there are available shares.

payments and permitted its customers to try and influence the Firm to allocate them IPO shares, in violation of NASD Conduct Rule 2110. The third cause of action alleges that the Firm violated NASD's corporate finance rules, NASD Conduct Rules 2710(b)(1) and 2710(5)(a)(ii), and NASD Conduct Rule 2110, by failing to file information with NASD that disclosed the Firm's profit sharing in its customers' accounts. The fourth cause of action alleges that the Firm failed to maintain accurate books and records that reflected the shared customers' profits, in violation of NASD Conduct Rules 3110 and 2110, Section 17(a) of the Securities Exchange Act of 1934 ("Exchange Act"), and Exchange Act Rule 17a-3. The fifth cause of action alleges that the Firm failed to supervise its registered representatives, in violation of NASD Conduct Rules 3010(a) and 2110. The Complaint charges that the Firm's supervisors failed to follow up on numerous "red flags" of improper profit sharing. The final cause of action alleges that the Firm failed to establish, maintain, and enforce an adequate supervisory system and written supervisory procedures that were reasonably designed to achieve compliance with applicable federal securities laws and NASD rules. Specifically, the Complaint charges that the Firm's supervisory procedures provided insufficient standards regarding allocation of IPO shares, the receipt of commissions, and the supervision of Firm employees who allocated IPO shares, and the Firm thereby violated NASD Conduct Rules 3010(a), 3010(b), and 2110.

II. PROCEDURAL HISTORY

The Department filed the Complaint on April 15, 2003. The Firm filed its Answer on May 23, 2003, and denied any wrongdoing. In addition, the Firm raised 12 affirmative defenses.

On September 16, 2003, the Firm filed a Motion for Summary Disposition, which Enforcement opposed on October 24, 2003. The Firm's motion sought dismissal of the Complaint on two of its affirmative defenses. First, the Firm argued that Enforcement's profit-sharing theory is invalid because it amounts to a rule change that NASD did not submit to the Securities and Exchange Commission ("SEC"), as required by Section 19(b) of the Exchange Act. Second, the Firm argued that the Complaint must be dismissed because Enforcement had conducted its investigation in a manner that violated basic tenets of investigative fairness and NASD's obligation under Section 15A of the Exchange Act to provide a fair procedure for disciplining members. The full Extended Hearing Panel ("Panel") heard oral argument on the Firm's motion on January 14, 2004, in Washington, DC. The Panel denied the motion by Order dated March 18, 2004.[4]

Between January 19, 2005, and February 24, 2005, a 17-day hearing was held in New York City.[5] The Panel included the Hearing Officer, a former member of NASD's Board of Governors, and a former member of NASD's District 10 Committee. Enforcement presented 12 witnesses and introduced 37 exhibits. The Firm presented 14 witnesses and introduced 172 exhibits. In addition, the Parties introduced 15 joint exhibits.[6] The transcript of the hearing contains more than 4,600 pages.

Both Parties relied heavily on expert opinion testimony. In total, the Panel heard from 17 experts. The Panel considered all of the opinion evidence, which diverged significantly on crucial points. However, the Panel did not accept the experts' opinions where they strayed into

---

[4] In light of the Panel's findings in this Decision, the Panel did not address the Firm's remaining affirmative defenses.

[5] The hearing was postponed twice. The original hearing was scheduled for February 2004; however, the Parties requested that it be postponed to give the Panel ample time to consider the Firm's Motion for Summary Disposition. The Hearing Officer rescheduled the hearing to November 2004. Enforcement later moved to adjourn the hearing again because two members of its defense team were scheduled to participate in another hearing that conflicted with the schedule in this case. Accordingly, the Hearing Officer rescheduled the hearing with the Parties' agreement to January 19, 2005.

[6] The hearing transcript is cited as "Tr.," followed by the page number, the line number, and the witness's name. Enforcement's exhibits are referred to as "CX," Respondent's are referred to as "RX," and the joint exhibits are referred to as "JX."

those areas reserved exclusively for the Panel's determination. For example, several experts testified directly or tangentially on conclusions of law. The Panel did not give weight to such testimony in reaching its decision.[7]

Following the hearing, the Parties submitted post-hearing briefs. Enforcement filed its brief on May 16, 2005, and the Firm filed its brief on June 27, 2005. The Panel then heard closing arguments in Washington, DC, on July 27, 2005.

In summary, the Panel concluded that Enforcement failed to prove that the Firm shared in the profits of its customers' accounts or engaged in other conduct that contravened high standards of commercial honor or just and equitable principles of trade. Accordingly, the Panel dismissed the primary charges in the Complaint. In addition, the Panel dismissed the remaining charges. To the extent that the remaining charges were not dependent on a finding that the Firm had engaged in profit sharing in violation of Conduct Rule 2330(f), the Panel concluded that Enforcement had not proven them by a preponderance of the evidence.

III. FACTS

A. Background

A considerable amount of testimony centered on two issues: (1) the customary level of commission rates institutional customers paid on agency trades of listed securities; and (2) the

[7] *See, e.g.*, *Snap-Drape, Inc. v. Commissioner*, 98 F.3d 194, 198 (5th Cir. 1996) (Tax Court properly declined to admit expert witness reports offered by taxpayer that "improperly contain[ed] legal conclusions and statements of mere advocacy"); *United States v. Scop*, 846 F.2d 135, 138–40 (2d Cir. 1988), modified, 856 F.2d 5 (2d Cir. 1988) ("repeated statements [by expert] embodying legal conclusions exceeded the permissible scope of opinion testimony"); *In the Matter of Potts*, 53 S.E.C. 187, 1997 SEC LEXIS 2005, at *45 (1997) (ALJ properly excluded testimony of law professor and former SEC commissioner that would have consisted of "mere opinion of law" and "would not [have] provide[d] evidence"); *Department of Enforcement v. Fiero*, No. CAF980002, 2002 NASD Discip. LEXIS 16, at *91 (N.A.C. Oct. 28, 2002) ("the lawyers for the parties, not expert witnesses, ha[ve] the task of arguing to the Hearing Panel what the applicable legal standards [are]").

methods used by brokers to allocate IPO shares to their customers. In each case, Enforcement argued that the Firm's practices materially deviated from accepted industry norms and violated applicable NASD conduct rules. Accordingly, the Panel first considered these underlying issues.

1. Industry Commission Rates

Fixed commissions were eliminated in 1975.[8] Since then, institutional customers generally have set the rates they pay, which was true during the relevant period.[9]

The Parties agreed that commission rates paid by the largest institutional customers for agency trades of listed securities generally fell within the four to seven cents per share level during the relevant period, depending on the nature of the transaction and services rendered. Three of Enforcement's experts addressed this issue. Enforcement's key expert on commission rates, J. Patrick Campbell ("Campbell"),[10] stated in his report that the typical rate was approximately six cents per share for both large and small institutional accounts.[11] Dennis A. Green ("Green")[12] stated that the generally accepted institutional rate at the time was between

---

[8] JX 14 ¶ 49 (Joint Stipulations).

[9] *Id.* ¶ 38.

[10] Campbell has a wealth of expertise regarding the securities industry and financial market structure, which he obtained from his more than 30 years experience in the industry. Campbell spent the first 26 years of his career with The Ohio Company, a privately held investment-banking firm. Campbell sat on The Ohio Company's Board of Directors from 1991 until 1996, during which time he oversaw most of the company's institutional and retail trading. At the time of the hearing, Campbell was acting Chief Operating Officer of the American Stock Exchange. He served in numerous industry roles with, among others, the Securities Industry Association and NASDAQ. In addition, Campbell held a number of leadership positions at NASDAQ, including Chief Operating Officer and a as member of its Board of Directors. He retired from NASDAQ at the end of 2001 as the President of NASDAQ US Markets. CX 32 (Campbell report).

[11] CX 32 at 6 (Campbell report).

[12] Dennis A. Green is a securities industry consultant. He worked as a trader and supervisor at NASD member firms for more than 38 years. In May 2002, he retired from Legg Mason where he held the position of Senior Vice-President, Manager of NASDAQ Equity Trading. CX 34 at 1-2 (Green report).

five and seven cents per share, regardless of the size of the trade.[13] And Edward A. Raha ("Raha")[14] stated that five to six cents per share was a "fair rate" at the time.[15]

Based on the foregoing, Enforcement argued that the prevailing fair rate during the relevant period was six cents per share for all institutional agency trades, irrespective of either the customer's or the trade's size. Thus, Enforcement questioned any rate that exceeded six cents per share.

The Panel found, however, that industry rates were far from uniform. In fact, Enforcement's experts recognized that some customers paid less than three cents per share and others paid substantially more than six cents per share. For example, Raha testified that rates as low as two cents per share were common for simple executions.[16] And, at the high end, Enforcement acknowledged that other member firms received commission rates equivalent to the rates at issue here: over 20 cents per share.[17]

The Firm's experts testified that commission rates, particularly for smaller customers, were far from uniform and that many major broker-dealers accepted commissions far in excess of six cents per share. For example, the Firm presented evidence that Morgan Stanley Dean Witter ("Morgan Stanley") maintained a commission formula that yielded rates as high as 71

---

[13] CX 34 at 4 (Green report).

[14] Edward A. Raha holds a Masters of Business Administration in finance from the University of Chicago Graduate School of Business. Raha has been employed as a broker and trader in the securities industry since 1983. Between 1990 and 1994, he worked at Bankers Trust, managing the bank's private equity portfolio, and at Donaldson, Lufkin and Jenrette, as a broker for high net worth individuals and large institutions. Currently, Raha is employed by Managed Quantitative Advisors, a registered investment advisor/hedge fund. CX 36 at 2-4 (Raha report).

[15] CX 36 at 3 (Raha report).

[16] Tr. 2109:15-18 (Raha).

[17] JX 14 ¶ 39 (Joint Stipulations).

cents per share on trades of 10,000 shares at $100 per share.[18] Enforcement did not present any evidence disputing these facts. To the contrary, Raha, one of Enforcement's commission experts, testified that his former firm, Donaldson, Lufkin and Jenrette, maintained a rate card[19] that reflected rates as high as 27, 35, 42, and 49 cents per share for 10,000-share trades at share prices of $25, $50, $75, and $100 respectively per share.[20] Green, another Enforcement expert, similarly admitted that many firms maintained rate schedules that permitted brokers to accept commissions at rates exceeding 20 cents per share.[21] Indeed, Green testified that his former firm, Legg Mason, maintained rate schedules with rates "way more than six cents per share."[22]

Nevertheless, Enforcement argued that Green and Raha supported its position that rates in excess of six or seven cents per share were excessive for institutional customers. The Panel, however, rejected their opinions because they based their conclusions on non-comparable data. Green and Raha referenced data concerning institutions many times the size of the customers who paid the "inflated rate commissions" to the Firm.[23] Green based his opinion on his personal experience with customers at Legg Mason that had assets in excess of $10 million, while many of the Firm's customers were much smaller.[24] Moreover, Green did not conduct a survey of commission rates to verify his conclusions.[25] Raha on the other hand testified about the rates paid

---

[18] RX 234; RX 238.

[19] RX 230.

[20] *See* RX 239 at 10534 (calculations based on RX 230).

[21] Tr. 1182:24-1183:13 (Green).

[22] Tr. 1185:12-14 (Green).

[23] Green formulated his opinion without any information about the size of the Firm's customers. Tr. 1131:4-9, 1193:18–24 (Green).

[24] Tr. 1162:8-12, 1163:2-8 (Green).

[25] Tr. 1185:17-1186:14 (Green).

by investment advisors, although none of the Firm's customers were investment advisors,[26] and his knowledge of commission rates was based on his experience as someone who managed approximately $100 million in client assets, and traded approximately 200 million shares annually.[27] Significantly, 200 million shares annually is approximately five times the total number of shares traded by all 35 customers at issue in this case during the relevant period.[28] Finally, both Green and Raha relied on industry data derived from surveys of institutional customers far larger than any of the Firm's. For example, Green relied on a New York Times article[29] that cited to a report prepared by the Plexus Group, a company that studies commissions for buy-side firms.[30] However, Green was not aware that the Plexus report was based on trade data from 125 clients that managed $4.5 trillion in equities, which meant that the average client managed $36 billion in assets and traded hundreds of millions of shares per quarter.[31] Raha relied on Plexus data as well as data from another firm called Abel/Noser, which similarly was based on firms that traded billions of dollars annually.[32] The Firm's customers were dwarfed in comparison. For example, 20 of the customers who paid inflated rate commissions had a net equity of less than $5 million each.[33] Enforcement's experts did not study separately the practices of such smaller firms to confirm their general conclusions regarding "institutional rates."

---

[26] Tr. 2163:15-21 (Raha was asked to render opinion "on the commissions and commission rates small to medium-sized investment advisor[s] would be expected to pay").

[27] Tr. 2122:5-7, 2125:17-25, 2126:12-14 (Raha).

[28] *See* RX 312; Tr. 2127:14-20 (Raha).

[29] S*ee* Tr. 1187:7–1188:7, 1188:24–1189:5; CX 34 at 5 (Green report).

[30] Tr. 1187:15-20, 1190:21–1191:8 (Green).

[31] Tr. 1192:3-1193:17, 1194:13-1195:18 (Green).

[32] Tr. 2169:14-16, 2169:25–2170:9, 2170:15-2171:2, 2171:12–2173:2 (Raha); CX 36 at 18, 22 (Raha report).

[33] RX 247 at 10636-37.

The Panel concluded that while six cents per share was a very common rate paid by large institutions, it was not the universal standard for smaller "institutional" customers. Indeed, the evidence shows that larger institutions with greater volume to give brokers often paid less than six cents per share, while smaller institutional customers paid substantially higher rates in order to obtain services and maintain a favorable relationship with their brokers. Moreover, member firms did not prohibit the acceptance of commission rates above 20 cents per share where the customer set the rate without being pressured to do so by its broker. Accordingly, the Panel did not consider the magnitude of the commission rates by itself to evidence profit sharing or other wrongful conduct.

2. Industry IPO Allocation Practices

The industry-wide practice is to allocate IPO shares to broker-dealers' best customers measured by their aggregate commissions. This method has been accepted industry practice for at least the last 30 years.[34] All of the experts who testified on this point agreed. For example, Edwin R. Olsen,[35] who was involved in more than 1,000 underwritings during his career, testified on behalf of the Firm that he knew of no other way to allocate IPO shares.[36] Indeed, Olsen explained that the firms for which he worked gave very specific instructions on how to allocate IPOs based on commission business. They directed him to ensure that he allocated the firms' resources "to the firm's largest accounts as measured by gross aggregate commissions or the revenue and the value … those institutions brought to the firms .…"[37] The Firm's experts

[34] Tr. 3159:11–3160:13 (Olsen).

[35] Edwin R. Olsen has more than 30 years experience in the securities industry, 25 of which involved responsibility for managing the allocation of shares in IPO and secondary offerings. Most recently, Olsen was employed by J.P. Morgan Chase as Managing Director of Equity Capital Markets. Olsen retired from J.P. Morgan Chase in February 2002. RX 8 at 1003-1005 (Olsen report).

[36] Tr. 3163:9-13 (Olsen).

[37] Tr. 3152:3-13 (Olsen).

Dan W. Lufkin ("Lufkin")[38] and Professor John C. Coffee, Jr. ("Coffee")[39] agreed. Lufkin testified that it was "the common practice of firms to allocate shares to best or good customers based on their commission business."[40] According to Coffee, "the basic rule was—within this industry—that aggregate commissions were going to be the principal criterion upon which IPO shares were allocated when there was an oversubscribed or hot IPO."[41] In addition, Stanley Shopkorn ("Shopkorn"),[42] another Firm expert, testified to this practice.[43] Indeed, Enforcement stipulated that it was a common practice during the review period for firms to take commission business into account in making IPO allocations.[44]

Enforcement further stipulated that an underwriter lawfully may exercise discretion in IPO allocations, and may allocate IPO shares to customers as it chooses, unless such an

[38] Dan W. Lufkin is the founder and former Chairman of Donaldson, Lufkin & Jenrette, Inc. He is a graduate of Harvard Business School, and he served as a Governor of the NYSE. RX 6 at 848, 851 (Lufkin report).

[39] Professor John C. Coffee, Jr., holds a law degree from Yale University and is the Adolf A. Berle Professor of Law at Columbia University Law School, specializing in corporate and securities law. Coffee has served on the Legal Advisory Board of NASD and on the Legal Advisory Committee to the Board of the NYSE. RX 2 at 78-79 (Coffee report).

[40] Tr. 3657:9-13; *accord* RX 6 at 851-52 (Lufkin report).

[41] Tr. 4287:2-6; RX 2 at 92, 106 (Coffee report) (citing, in part, remarks of former SEC Chairman Arthur Levitt supporting the practice of allocating hot IPOs to brokers' best customers as measured by their aggregate level of commission business and acknowledging that shares are often allocated according to business relationships and other subjective criteria) (citations omitted).

[42] Stanley Shopkorn runs Shopkorn Management LLC, an investment firm with seven securities professionals. Shopkorn has over 35 years of experience as a securities industry professional. From 1973 to 1991, he was with Salomon Brothers. In 1978, he became a general partner of Salomon Brothers and eventually served as its Vice Chairman and as a member of its Executive Committee. Following his tenure at Salomon Brothers, Shopkorn was the Chairman of Ethos Capital, a hedge fund that merged into Moore Capital in 1996. He then managed all of Moore Capital's equity activities, including the purchase of underwritings. RX 10 at 1958-59 (Shopkorn report).

[43] Tr. 3357:25–3358:8 (Shopkorn); *accord* RX 10 at 1954 (Shopkorn report).

[44] JX 14 ¶ 37 (Joint Stipulations).

allocation constitutes spinning,[45] an unlawful quid pro quo, or other prohibited conduct.[46] Such lawful discretion includes allocating IPO shares to an underwriter's best customers measured by aggregate commission business the customers did with the underwriter.

The Panel further found that customers that desire IPO allocations have to compete for them by the amount of non-IPO commission revenue they generate.[47] This is standard practice throughout the securities industry.[48] For customers who are unable to do a substantial volume of trades, this means they must find an alternate way to generate sufficient non-IPO commission business, or they are ineligible to receive IPO allocations.[49]

Several Firm customers confirmed this industry-wide practice. For example, TR, an individual who managed about $1 million of "family money,"[50] testified at his on-the-record interview that he learned when he first entered the business that he had to establish himself as a "good client" to get IPO allocations and that broker-dealers determined their good clients by the amount of commission business they did.[51] He understood "good clients" to be regular traders

---

[45] Spinning is the practice whereby underwriters allocate hot IPO shares to executives of prospective investment banking clients in return for future investment banking business.

[46] JX 14 ¶ 36 (Joint Stipulations).

[47] *See, e.g.,* Tr. 376:15-24 (Ozag).

[48] *See, e.g.,* Tr. 1754:18-20, 1694:22-25 (Campbell); Tr. 2161:22-2162:2 (Raha) (it was "standard practice to look at aggregate commissions and potential for aggregate commissions in allocating IPOs"); Tr. 2493:11-13; *accord* Tr. 2448:8-11 (Bogle) (acknowledging "common practice in the industry to take commission business into account in giving out IPOs").

[49] *See, e.g.,* RX 1 at 23 (Antolini report) (professional investors pay commissions "to maximize their aggregate amount of commission business in order to be considered one of an underwriter's 'best' customers" so that they can receive IPO allocations). Robert Antolini, one of the Firm's experts, is one of the principals of Great South Bay Trading LLC, a small-cap hedge fund. Before establishing Great South Bay in 1998, Antolini spent his nearly 40 year career at several NASD member firms where he held various senior positions relating to the firms' over-the-counter operations. His experience involved his firms' IPO allocation practices. RX 1 (Antolini report).

[50] Despite the relative small size of this account, the Firm treated it as an "institutional account."

[51] RX 121 at 6440-41, 6495-97. Some large firms even had express policies that required at least 50% of their customers' business come from non-syndicate trades. The Firm did not have such a policy.

who generated commissions.[52] Thus, to be seen as a "good client," TR concluded he had to trade frequently and pay higher commission rates than would be necessary if he only wanted trade executions.[53]

TR described his process of selecting a registered representative and becoming a good client as follows. First, TR identified firms and registered representatives at those firms which had access to IPOs. He would do this by observing the firms listed on the prospectuses he received and by reviewing IPO tombstone announcements carried in the Wall Street Journal and other financial publications.[54] Once he identified a broker-dealer that had access to IPOs, he called the firm to open an account.[55] TR testified that to his best recollection he made such a call to establish his account at the Firm.[56]

After TR identified a firm and broker, he would open an account and commence doing a limited amount of business with the broker to evaluate whether the broker was one of the better producers of IPO shares at the firm.[57] TR referred to this as a "feeling out period," during which he would do a minimal amount of business with the new broker. If TR was pleased with the allocations he received, he increased the amount of business he did with the broker.[58]

If a broker proved he had good access to IPOs, TR's next step was to attempt to increase the size of his allocations. TR did so by doing more volume and by increasing the cents-per-

---

[52] RX 121 at 6446.

[53] *Id.*

[54] RX 121 at 6442.

[55] *Id.*

[56] *Id.*

[57] RX 121 at 6495-96.

[58] RX 121 at 6496.

share rates he paid. The object was to become a better client. TR viewed this process as a competition with the brokers' other customers who also were interested in purchasing IPO shares.[59] The process proved difficult because it operated as a "blind draw." TR did not learn where he stood until the morning an IPO came out.[60] Only then would he know how he stood with the broker. If TR got a good allocation, he knew that the level of business he was doing with that broker was sufficient. If not, he knew he had to increase the level of commission revenue he did with the broker.[61]

TR's sole reason to increase business with the Firm and other similar firms was to receive greater IPO allocations. TR did not base the rate he paid on his profits.[62] Nor did he set commissions as a percentage of his IPO profits.[63] TR pegged both his trading volume and his commission rates to the levels he considered necessary to obtain IPO allocations. He judged those levels through a trial and error process; he never discussed with any broker the amount he needed to pay in order to become a "good client."[64]

TR further explained that his limited capital meant that he had to engage in short-term trading because he did not have enough capital to become a "good client" and hold investments for the long term. Instead, TR relied on frequent trading to generate a valued level of business.

---

[59] RX 121 at 6449.

[60] *Id.*

[61] RX 121 at 6448.

[62] RX 121 at 6492-93.

[63] RX 121 at 6493.

[64] RX 121 at 6462.

Nonetheless, TR testified that he did not engage in trades only to benefit his broker.[65] To the contrary, TR testified that he expected to make a profit on all of his trades.[66]

TR's experience typifies that of other small "institutional" customers. In contrast, large institutions use their superior economic advantage to obtain IPO allocations. For example, Fidelity Investments insists upon receiving at least twice the next-highest allocation in return for large order flow.[67] This policy is referred to in the industry as the "Fidelity Formula." If a broker-dealer refuses to comply, Fidelity puts it in the "penalty box" by pulling business from the recalcitrant firm.[68]

Enforcement's experts testified that industry participants and regulators accepted the practice of favoring such large institutions. For example, Campbell testified that he saw nothing wrong with a customer directing commission business to a broker-dealer to improve its standing as a good customer.[69] Even John C. Bogle,[70] Enforcement's ethics expert, could only quibble with the ethics of the Fidelity Formula before ultimately conceding that it was an accepted practice to favor those customers who directed commission business to a broker-dealer for the purpose of influencing the IPO allocation process.

---

[65] RX 121 at 6458-59.

[66] *Id.*

[67] *See, e.g.*, Tr. 2494:10-15.

[68] Tr. 3185:18–3188:15 (Olsen); 2494:20–2495:7 (Bogle).

[69] Tr. 1703:13–1704:7 (Campbell).

[70] John C. Bogle, founder of The Vanguard Group, has a long and distinguished career in the financial services industry. He started his career in the field of financial markets in 1951 following his graduation from Princeton University, magna cum laude, with a degree in economics. He served for 30 years as Chief Executive Officer of two mutual fund firms—Wellington Management Company from 1967 until 1974, and The Vanguard Group from 1974 until 1996. Among his numerous accomplishments, he has written four books and many articles about investing, financial markets, and mutual funds. CX 31 (Bogle report).

Enforcement's witnesses expressed no concern over the fact that the largest institutions, such as Vanguard and Fidelity, often pay higher cents-per-share commission rates to broker-dealers from which they sought new issues. Every witness who addressed the topic readily admitted that large institutions could pay far less than six cents per share on trades of listed securities. Indeed, the largest customers have the economic power to push the rate below a penny a share. Nevertheless, they pay more where they seek other services, including IPO allocations. In so doing, the large institutions routinely reward broker-dealers with increased order flow and commissions for generous IPO allocations.

In conclusion, the Panel finds that there was keen competition for IPOs during the review period, which drove institutional customers to direct order flow—and pay increased commission rates—to those broker-dealers that had a supply of IPOs. In both cases, customers voluntarily set higher commission rates to increase their relative position as "good customers." But in neither scenario did this conduct alone amount to profit sharing.

B. The Firm

The Firm is a small registered broker-dealer in New York City.[71] At no time has it had more than about 12 registered employees.[72] During the relevant period, the Firm had no more than 100 active accounts at any one time (i.e., accounts that executed at least three trades per month) and processed only about 40 to 50 agency trades per day.[73] Most of the Firm's customers were hedge funds and other institutional investors.[74]

---

[71] JX 14 ¶¶ 1, 3 (Joint Stipulations).

[72] JX 14 ¶ 4 (Joint Stipulations).

[73] Tr. 1265–68, 1271 (LS).

[74] JX 14 ¶ 5 (Joint Stipulations).

KL founded the Firm in 1974, and he has headed the Firm since then.[75] During the six-month period in issue, October 1, 1999, to March 31, 2000, KL was the Firm's Chief Executive Officer; CK was the Chief Operating Officer; JB was the Chief Compliance Officer and Chief Financial Officer; and LS was the head trader and sales supervisor.[76]

Commission business was a minor portion of the Firm's revenue. The Firm earned most of its revenue from its investments.[77] During the relevant period, the Firm derived 11.8% of its gross revenue from commissions.[78] The Firm did not stress commission business, and most of its order flow was unsolicited.[79] JB testified that commission business was relatively unimportant to KL, who, JB believed, looked to commission revenue merely to cover the Firm's overhead.[80]

The Firm actively participated in new offerings. Thanks to a close relationship with Credit Suisse First Boston ("CSFB") forged in the 1980s, the Firm often was brought into the syndicate or selling group in offerings lead-managed or co-lead-managed by CSFB.[81] Most of the 57 IPOs in which the Firm participated during the relevant period were such offerings.[82] The Firm's allocations ranged from a low of 400 shares to a high of 300,000 shares.[83] In one-third of these IPOs, the Firm received 10,000 shares or fewer.[84] In a given IPO, the Firm's four sales

---

[75] JX 14 ¶ 4 (Joint Stipulations)*;* Ans. ¶ 1.

[76] JX 14 ¶ 4 (Joint Stipulations); Tr. 1241, 1244, 1452, 1569.

[77] Tr. 1566–67.

[78] RX 350.

[79] Tr. 1570:2-3 (JB).

[80] Tr. 1568:11-14 (JB).

[81] *See* Compl. ¶ 12.

[82] JX 14 ¶¶ 7–8, 54–55 (Joint Stipulations).

[83] *See* CX 7 (All Review Period IPOs).

[84] Id.; see also Tr. 620 (Ozag).

representatives got 30 to 35% of the Firm's retention for allocation to customers. The rest of the retention was distributed among the Firm's house accounts—accounts to which no broker was assigned and to which IPO allocations were made by a supervisory principal.[85] The Firm's IPO allocations were based upon, among other things, the aggregate amount of business the customer had generated in the past, the customer's potential to develop regular commission business, and the customer's expressed interest in becoming a holder of the shares.[86]

C. The Investigation

Enforcement opened the investigation that led to the filing of the Complaint in this proceeding because it had been investigating CSFB's IPO allocation practices.[87] The CSFB investigation originated out of a broader inquiry by NASD and the SEC into whether broker-dealers had taken advantage of customers during the "hot" IPO boom of the 1999–2000 period. Ultimately, the CSFB investigation focused on evidence that, in exchange for shares in hot IPOs, CSFB had wrongfully extracted from certain customers a percentage of the profits those customers made by flipping[88] their IPO stock. The SEC alleged that CSFB forced customers to comply by withholding IPO allocations from those customers who refused to make the demanded payments. The SEC and NASD contended that CSFB's extraction of payments from its customers amounted to impermissible profit sharing, in violation of NASD Conduct Rule

---

[85] JX 14 ¶¶ 59, 77 (Joint Stipulations); Ans. ¶ 18.

[86] JX 14 ¶ 56 (Joint Stipulations).

[87] Tr. 174. These investigations were launched because of an anonymous tip letter received by NASD's Corporate Financing Department. Tr. at 2839:19-22 (Price).

[88] *Flipping* is the process of buying shares in an IPO and selling them immediately for a profit. A customer who engages in this practice is called a *flipper*.

2330.[89] Here, however, there is no allegation that the Firm or any of its brokers coerced any customer to pay commissions to the Firm in connection with IPO allocations.

In order to analyze CSFB's allocation practices, Joseph Ozag ("Ozag"), NASD's lead investigator on both the CSFB and the Firm investigations, formulated a criterion to define the scope of the CSFB investigation.[90] Ozag determined that he would limit his inquiry to transactions of 20 cents per share or more on trades of 10,000 shares or more.

Ozag developed the 20-cent, 10,000-share metric in two steps. First, at the start of the CSFB investigation, Ozag and other NASD staff determined that they wanted to examine "institutional" size trades. Ozag understood that trades of 10,000 shares had to be reported as a block trade, so he defined "institutional trades" as trades of 10,000 shares or more.[91] Enforcement adopted Ozag's definition as the CSFB investigation progressed, and Enforcement used the same definition in this case.[92]

Ozag developed the second criterion based on his discussions with the head of Equity Sales Trading at CSFB.[93] During the on-site investigation at CSFB, Ozag interviewed a number of employees selected by CSFB to better understand the nature of CSFB's business and operations. One of those employees was Tony Ehinger ("Ehinger"), the head of CSFB's Equity Sales Trading. Ozag asked Ehinger if there was a standard or normal commission in the industry for 10,000-share trades done on an agency basis in listed securities. Ehinger replied that he could

---

[89] CX 50. The SEC alleged that the cooperating customers channeled payments to CSFB in the form of excessive brokerage commissions generated in unrelated securities trades that the customers effected solely to share their IPO profits with CSFB. In January 2002, CSFB settled all charges related to its IPO allocation practices.

[90] Tr. at 320:10-17 (Ozag).

[91] Tr. 313:10-15 (Ozag).

[92] Tr. 313:10-15 (Ozag).

[93] Tr. 326:5-25 (Ozag).

not say that there was a standard commission, but commissions on such trades ranged from 6 to 10 cents per share, with 6 cents being more the norm in the relevant period.[94] Ozag then doubled the top end of the range and arrived at 20 cents per share—a value he considered well outside the norm. In his opinion, such a commission would be "unusual or semi-unique."[95]

When Ozag opened the [] investigation [of the Firm], he applied the same metric he had developed for the CSFB investigation to define unusual, institutional-size trades. However, whereas Enforcement used the metric as a data management tool in the CSFB case, here, Enforcement used the metric to define profit sharing under Conduct Rule 2330(f).

Ozag opened the [] investigation [of the Firm] because he noticed during the CSFB investigation that the Firm's name often appeared as a member of either the syndicate or selling group.[96] Ozag suspected that the Firm might have engaged in conduct similar to that charged in the CSFB case.[97] Ozag limited his investigation to the Firm's agency trades executed between October 1, 1999, and March 31, 2000, because this was a period of many hot IPOs.[98]

To test his suspicion that the Firm had accepted profit-sharing payments in the form of higher-than-normal commissions on agency trades, Ozag asked the Firm to provide trade data for all agency transactions of 10,000 shares or more where the commission equaled or exceeded 20 cents per share.[99] In addition, on May 21, 2001, Ozag delivered a Rule 8210 request that the Firm provide a broad range of documents relating to all equity IPOs the Firm participated in during

---

[94] Tr. 326:13-16 (Ozag).

[95] Tr. 326:21-25 (Ozag).

[96] Tr. 174:22-24, 187:7-10 (Ozag). CSFB led or co-led 85% of the IPOs Ozag reviewed. Tr. 188:2-3 (Ozag).

[97] *See* Tr. 183:2-5 (Ozag).

[98] Tr. 182:16–183:18. The Firm participated in more than 50 IPOs during the review period. JX 14 ¶ 54 (Joint Stipulations).

[99] Tr. 183:6-10. Exhibit CX 9 lists the agency trades by customer.

the review period and its IPO allocation policies and procedures.[100] The Firm produced documents responsive to Ozag's Rule 8210 request during the on-site visit.[101] The Firm also produced documents in response to supplemental Rule 8210 requests Enforcement made after its on-site visit.[102]

Ozag then "eyeballed" the data the Firm produced and concluded that it looked like many trades with inflated rate commission payments had been executed on or about the days on which the Firm had participated in a hot IPO.[103] With his suspicion tentatively confirmed, Ozag proceeded to load the data he had collected into a computer program he developed for the CSFB investigation, which he called a Matched Transaction Analysis.[104]

The Matched Transaction Analysis was a computer query with two tables. The first held the agency trade data, and the second held the data related to the Firm's IPO allocations. The program compared the agency transactions completed on or within one business day of an IPO with the Firm's IPO allocations.[105] The purpose was to identify customers who paid inflated rate commission payments of 20 cents or more on trades of 10,000 shares or more who also received IPO shares from the Firm.[106] From this analysis, Ozag found that all customers who paid an inflated rate commission received at least one hot IPO during the review period.[107] Although Ozag found no apparent difference in the allocations to customers who had not made inflated

[100] RX 102; JX 14 ¶ 86 (Joint Stipulations).

[101] JX 14 ¶ 87 (Joint Stipulations).

[102] *Id.* ¶ 88.

[103] Tr. 188:8-12 (Ozag). Exhibit CX 7 lists the IPOs the Firm sold during the review period.

[104] Tr. 188:12-16 (Ozag).

[105] Tr. 188:12–189:4, 199:16-20 (Ozag).

[106] Tr. 188:15–189:4 (Ozag).

[107] Tr. 191:20-22 (Ozag).

rate commission payments within one day of an IPO, Enforcement concluded that the Matched Transaction Analysis confirmed its tentative thesis that the Firm's customers had made profit sharing payments to the Firm.[108]

Next, Enforcement took on-the-record testimony from 11 Firm employees—four managers, four sales representatives, and three individuals on the Firm's trading desk.[109] In addition, Enforcement informally interviewed three of the Firm's customers regarding their commission payments.[110] Enforcement had wanted to interview others, but many refused to cooperate.[111]

On April 9, 2002, Enforcement delivered a Wells notice to the Firm telephonically.[112] The Firm submitted its initial Wells Submission on May 31, 2002,[113] and, on September 23, 2002, met with Enforcement to discuss the investigation.[114] Thereafter, between October 2002 and February 2003, Enforcement interviewed an additional customer on an unsworn basis and took the on-the-record testimony of four other customers.[115] Each customer denied that he had entered into an agreement to share profits with the Firm or any of its registered representatives.[116]

---

[108] *See* Tr. 455:3-7 (Ozag). Enforcement never analyzed whether there was a difference in the quantity of shares the Firm allocated customers depending on whether they made inflated rate commission payments.

[109] JX 14 ¶ 90 (Joint Stipulations).

[110] See RX 106 (Enforcement's interview notes).

[111] RX 111.

[112] JX 14 ¶ 91 (Joint Stipulations).

[113] RX 107.

[114] JX 14 ¶ 92 (Joint Stipulations).

[115] JX 14 ¶¶ 94, 96 (Joint Stipulations). The Firm provided Enforcement with contact information for each of the 30 customers Enforcement wanted to interview. RX 112; RX 113. In addition, the Firm encouraged its customers to cooperate with NASD's investigation although Enforcement never requested the Firm's assistance. Tr. 565:17-24 (Ozag).

[116] Tr. 344:23–346:14; 350:5-18; 355:13–357:11; 368:25–369:3; 371:18-25; 547:7-17 (Ozag); RX 106 at 6199, 6201, 6203, 6215, 6231–6233, and 6235; CX 38 at 68-69; RX 130 at 6754-55.

Ultimately, Enforcement reached the following conclusions regarding commission payments at the Firm, which are incorporated into the Joint Stipulations (JX 14) filed in this case:

- "[The Firm]'s customers decided themselves what commission rate they would pay." (Joint Stipulation No. 41.)
- The Firm never "urged or demanded that its customers pay a set amount or range of commissions or pay commissions at 'inflated' rates." (Joint Stipulation No. 42.)
- The Firm never "told the customers at issue that they had to pay a set amount or range of commissions or pay commission at or above any cents-per-share rate in order to receive IPO allocations." (Joint Stipulation No. 43.)
- "None of the customers inquired of [the Firm] what level of commissions (gross or cents-per-share) they would have to pay in order to receive IPO allocations." (Joint Stipulation No. 44.)
- "[The Firm]'s historical practices and procedures with regard to customer commissions and IPO (and secondary) allocations during the time period covered by the Complaint were the same as those in existence at the Firm since the elimination of fixed commissions in 1975." (Joint Stipulation No. 49.)

These findings distinguish this case from the CSFB matter.

In addition, Enforcement concluded that order flow from the customers Enforcement alleged made inflated rate commission payments was unsolicited, and was given directly to the trading desk.[117] There is no evidence that any Firm broker ever requested or coerced any customer to pay higher commission rates to receive IPO allocations, or for any other reason. Nonetheless, Enforcement concluded that between October 1, 1999, and March 31, 2000, the Firm had engaged in widespread misconduct by accepting commissions paid by customers who were sharing with the Firm a portion of their real or hypothetical profits derived from the hot IPOs they received from the Firm.[118] Enforcement further alleged that the same customers made similar payments to other broker-dealers and received hot IPOs from those firms.[119] The Complaint provided examples of the trades Enforcement questioned but did not identify the entire list of trades involving inflated rate commissions.

Ultimately, Enforcement charged that the Firm shared in the profits in its customers' accounts in three ways: (1) by accepting commissions of 20 cents per share or more on trades of 10,000 shares or more;[120] (2) by accepting commissions from two customers who engaged in cross or wash trading;[121] and (3) by accepting high commissions from at least two customers who flipped their IPO shares through the Firm at a substantial profit.[122]

---

[117] JX 14 ¶¶ 64-65 (Joint Stipulations).

[118] Compl. ¶¶ 1, 21, 23.

[119] *Id.* ¶ 22.

[120] *Id.* ¶ 21.

[121] *Id.* ¶ 34. Although Enforcement refers to "wash trading," none of the trades met the definition of a wash sale. "'Wash' sales are transactions involving no change in beneficial ownership." *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 206 n.25 (1976). NASD Marketplace Rule 6440(b)(1) prohibits wash trades where they are made to create or induce a false or misleading appearance of activity in a security or to create or induce a false or misleading appearance with respect to the market in such security. Here, all of the sales involved a bona fide change of ownership.

[122] *Id.* ¶¶ 31-33.

D. Enforcement's Post-Complaint Development of its Profit-Sharing Theory

Several months after Enforcement filed the Complaint, Enforcement retained Campbell as an expert to review the commission rates paid by the Firm's customers.[123] Campbell testified that he looked at the transactions Enforcement identified and then suggested that Enforcement should develop additional metrics "to identify if there was something that was out of the norm."[124] Campbell thought that Enforcement needed to employ finer increments to analyze the trades in question.[125] He therefore proposed additional metrics, which Enforcement adopted without reference to the Firm's specific policies and practices.[126] Campbell arrived at his suggested metrics by what made good economic sense to him.[127] They are:

> 1. **$.20** per share or more on agency trades of **10,000** shares or more;
> 2. **$.20** per share or more on **non-economic cross trades**[128] **of 5,000** shares or more;
> 3. If the customer's trading activity included trades meeting one of the above criteria, DOE also viewed as profit-sharing trades, any trades at a commission of **$.75** per share or more on trades of **1,000** shares or more; [and]
> 4. **$1** per share or more on "flips" of 200 shares or more that the Firm allocated to the customer.[129]

---

[123] Tr. 1661:12-24; 1688:20-24 (Campbell).

[124] Tr. 1662:5-12 (Campbell).

[125] Tr. 1670:10-13 (Campbell).

[126] Tr. 1671:8-12; 1705:23–1707:25 (Campbell).

[127] Tr. 1671:13–1672:11 (Campbell).

[128] Enforcement defined "non-economic cross trades" as those where a customer bought and sold the same number of shares of a security at or about the same price on the same day. Tr. 200:3-6 (Ozag). At other points, Enforcement refers to the same category of trades as "non-economic wash trades."

[129] Bill of Particulars at 2 (emphasis in the original).

Campbell saw the central issue as the problematic behavior of paying above-normal commissions to get access to IPOs rather than profit sharing. Accordingly, he devised the metrics to identify the commission levels that made no economic sense unless the customer is assured that there will be an IPO allocation to justify the costs.[130] Thus, although the metrics defined "inflated rate commission payments," the metrics rested on Campbell's objection to customers competing for IPO allocations through increased commissions as opposed to increased order flow. Campbell stopped short, however, of declaring all commissions within his metrics to be inherently excessive. Campbell recognized that sometimes a commission falling within the metrics could make economic sense. In his opinion, ultimately, whether or not a payment was excessive, and therefore constituted impermissible profit sharing, depended on what service the customer received in return for the higher-than-normal commission payment.[131] In that regard, Campbell testified that a customer could judge for itself the value of the services it received without conflicting with any conduct rules or regulations.[132]

Enforcement adopted Campbell's suggestions. However, Enforcement determined that the Firm's acceptance of any commission that fell within any of the enumerated criterion constituted a per se violation of Conduct Rule 2330(f). That is, unlike Campbell, Enforcement determined that the commission levels evidenced profit sharing without regard to the Firm's IPO allocation practices.

[130] Tr. 1681:25–1682:15 (Campbell).

[131] Tr. 1684:11-23 (Campbell).

[132] Tr. 1684:24–1685:5 (Campbell).

E. The Alleged Profit-Sharing Payments

Enforcement reviewed 9,621 agency trades placed by 1,364 customers at the Firm between October 1, 1999, and March 31, 2000. From this review, Enforcement determined that 695 of the trades fell within the metrics it had formulated for this case and were, therefore, profit-sharing payments. Their classification as profit-sharing payments was not dependent upon a finding that the Firm allocated IPO shares to the paying customers. Enforcement listed the 695 trades on Amended Schedule A ("Schedule A-35"),[133] which Enforcement filed with its response to [Respondent's] Motion for a More Definite Statement.[134] The transactions sometimes are referred to as the "Schedule A-35 trades."[135]

The Firm earned total gross commissions of $4,133,013 on the Schedule A-35 trades, which equaled more than one-third of the Firm's total agency commissions during the review period.[136] The weighted average of the commissions on the transactions is approximately 1% of the principal amount of the trades.[137]

Most of the Schedule A-35 trades fell into the first category of inflated rate commission payments—20 cents or more on transactions of 10,000 shares or more ("Type 1 Trades"), Ozag's original criterion. Enforcement presented additional evidence, however, regarding two of the remaining categories Campbell formulated: non-economic cross or wash trades ("Type 2 Trades") and IPO flips ("Type 4 Trades"). Because these categories present distinct issues, the Panel discusses them in further detail below.

---

[133] CX 8.

[134] JX 14 ¶ 14 (Joint Stipulations).

[135] JX 14 ¶ 14 (Joint Stipulations). Exhibit CX 9 breaks out all of the agency trades by customer. Tr. 197:8-10 (Ozag).

[136] Tr. 247:6-11 (Ozag).

[137] JX 14 ¶ 22 (Joint Stipulations).

1. Non-Economic Cross or Wash Trades

Just six sets of trades placed by customers GAM and BRM fell into the category of Type 2 Trades—20 cents or more on "non-economic cross trades" of 5,000 shares or more.[138] Although Enforcement denoted the Type 2 Trades as cross or wash trades, they were neither.[139] Indeed, Campbell did not consider Type 2 Trades to constitute "wash sales" or "cross trades." Campbell testified that he formulated the criterion for Type 2 Trades to catch pairs of trades that he considered the functional equivalent of Type 1 Trades. That is, he viewed the sale and purchase of 5,000 shares of the same stock on the same day at commissions of 20 cents per share or more as the equivalent of a single trade of 10,000 shares at a commission of 20 cents or more.[140]

The Panel concluded that the Type 2 Trades were neither wash sales nor cross trades. By definition, a "wash sale" involves no change of beneficial ownership,[141] whereas each sale here did involve a bona fide change in ownership. And a cross trade entails a simultaneous match by a single broker-dealer of a buy and sell order from two different customers.[142] Here, each sell order was executed in the marketplace through a different broker, and none of the "matched" trades was simultaneous.

Calling the trades "wash" or "cross" trades inaccurately implied that the trades were inherently improper. Indeed, Enforcement argued that, from the customers' perspective, the trades were economically irrational; thus, the Panel must conclude that GAM and BRM placed

[138] *Id.* ¶¶ 25, 31.

[139] Enforcement did not explain why it referred to the Type 2 Trades as cross or wash trades.

[140] Tr. 1799:7-17 (Campbell).

[141] *See* NASD Marketplace Rule 6440(b)(1).

[142] Tr. 252:18–253:2 (Ozag).

the trades for an improper purpose—to generate commissions for the Firm's benefit.[143] However, Green and Raha, Enforcement's experts who addressed this subject, each testified on cross-examination that the Firm did nothing wrong in accepting the commissions on these trades.[144] The Panel agrees.

Enforcement did not present sufficient evidence to prove that the "inflated rate commissions" on the Type 2 Trades were improper profit-sharing payments. Enforcement and its experts did not interview GAM and BRM or review their prime brokerage accounts. Consequently, Green and Raha could only speculate about the motives behind their trades.[145]

In addition, Enforcement's assumption that the trades could only be explained as profit sharing is incorrect. As Enforcement concedes at other points, a customer may do extra business with, or pay higher commissions and fees to, a broker in order to be deemed a valued customer. From an economic perspective, this is a legitimate business strategy. And, where a customer invests its own funds, as did GAM and BRM, such activity is not inherently improper. Unlike a broker or mutual fund, GAM and BRM were under no duty to trade at or near the lowest cost. In short, they were entitled to make their own business decisions about the value of the services the Firm provided. The fact that they placed a higher value on those services than Green and Raha would have is not evidence of profit sharing.

---

[143] *See, e.g.,* Enforcement's Post-Hr'g Br. at 21.

[144] Tr. 1207:16-19 (Green); Tr. 2203:13-24 (Raha).

[145] For example, Raha states in his report that GAM appeared to be "engaged in day trading and did not like to take a lot of risk." CX 36 at 11 (Raha report). Raha defined "risk" as a function of the volatility of the underlying asset, the holding period, and the security's liquidity. Then, Raha concluded that GAM's trades were of no "economic benefit" because they deviated from the typical day-trading strategy. Raha drew this conclusion with no knowledge of GAM's operations as a whole. *See* CX 36 at 11-12 (Raha report).

2. IPO Flips

Enforcement presented evidence regarding a single Type 4 Trade—a trade involving receipt of a commission of $1 or more per share on a flip of not fewer than 200 IPO shares.[146] Customer JD flipped 200 shares of VA Linux stock on December 9, 1999.[147] Enforcement noted that the VA Linux IPO was the hottest offering of the 1999–2000 IPO boom. JD purchased the VA Linux IPO at $30 per share and sold the same day at $270 per share, for a gross profit of $48,000. JD paid the Firm a commission of $1,600, or $8 per share.[148]

Enforcement claimed that the commission was a payment of a share of the profits in JD's account because the commission fell within the definition of a Type 4 Trade. The Panel concluded however that the evidence did not support Enforcement's conclusion.

JD denied that he paid the commission to share profits with his friend and broker, CJ.[149] JD testified that he considered CJ a unique resource with 50 years of experience in the securities industry.[150] Over the years, JD relied on CJ's advice, but JD set the commissions he paid CJ independently.[151]

As did some of the other customers who testified, JD generally set the amount of gross commissions he paid brokers annually based on the relative value of the services they provided.

---

[146] Other Type 4 Trades appeared in Enforcement's exhibits, but Enforcement did not present an analysis of any of those transactions.

[147] CX 10 at 4.

[148] Although the total commission was insignificant, the Panel concluded that Enforcement stressed this trade because of VA Linux's extraordinary first trade premium and the magnitude of the commission rate JD placed on the trade.

[149] Tr. 3057:13-17 (JD); *accord* RX 135 at 06933. In addition, JD testified that he did not consider the $8 per share payment to constitute underwriting compensation. Tr. 3062:18–3063:2; 3064:17–3066:4 (JD).

[150] Tr. 3047:3-9 (JD).

[151] Tr. 3057:19-21 (JD).

On individual trades generally, JD was guided by NASD's 5% Policy.[152] When questioned about the VA Linux commission, JD explained that he considered three factors in setting that commission. First, he considered the flip of VA Linux an extraordinary event. He stressed that he had never before made $48,000 in two hours. JD had given the trading desk the authority to sell at the open, using the trader's best judgment.[153] Given the wild nature of the security, JD concluded that he had received a "wonderful execution."[154] Second, JD calculated that the commission "was well under [NASD's] 5-percent guideline."[155] Third, JD considered that he had paid CJ less than the total amount budgeted for the year.[156] Thus, he used this extraordinary event as an opportunity to increase the total.

The Panel accepts JD's testimony that he never considered sharing profits with the Firm. Although Enforcement attempted to discredit JD because he is a friend of CJ and KL, the Panel found his testimony credible and reliable. In addition, the Panel notes JD's long and distinguished background in self-regulation of the securities industry. JD served as a member of the Corporate Bond Committee of the Securities Industry Association, as a hearing panel member for the New York Stock Exchange ("NYSE"), as Chairman of NASD's District 10 Business Conduct Committee, as a member of NASD's Board of Governors, as a member of

---

[152] Under the NASD's Mark-Up Policy, IM-2440, mark-ups or spreads more than 5% above the prevailing market price in equity securities may be considered excessive, and thus violative of NASD Conduct Rules 2110 and 2440, unless justified in light of other relevant circumstances set forth in Conduct Rule 2440 and in IM-2440. *See, e.g., First Independence Group, Inc. v. SEC*, 37 F.3d 30, 32 (2d Cir. 1994); *District Bus. Conduct Comm. v. First Am. Biltmore Sec., Inc.*, No. C3A920018, 1993 NASD Discip. LEXIS 235, *19-20 (N.B.C.C. May 6, 1993). Although the 5% Policy does not apply to agency trades of listed securities, brokers often refer to the policy when reviewing the fairness of commissions charged on such transactions.

[153] Tr. 3053:8-15 (JD).

[154] Tr. 3055:6-25(JD).

[155] Tr. 3057:22-24 (JD).

[156] JD testified that he, like other institutional customers, set dollar volume targets for the commissions he would pay each broker per year.

NASD's National Business Conduct Committee, and ultimately as Chairman of NASD's Board of Governors.[157] The Panel finds no reason to question JD's integrity.

Accordingly, the Panel finds that the Firm did not share in the profits of JD's account by accepting the commission on the VA Linux transaction. In addition, the Panel finds that Enforcement failed to prove that the commissions the Firm accepted on any of the other Type 4 Trades were profit-sharing payments.

F. No Customer Evidence of Profit Sharing

Each of the Firm's customers that cooperated with Enforcement or otherwise provided evidence denied sharing profits with the Firm. They consistently denied profit sharing in investigative interviews, in written statements they and their counsel made, in hearing testimony, and in sworn on-the-record interviews taken by Enforcement during its investigation.

1. April 2002 Telephone Interviews

In April 2002, Enforcement's investigator, Ozag, began calling some of the the Firm's customers in order to interview them.[158] Ozag testified, and his interview notes confirm,[159] that the customers he spoke to denied sharing profits with the Firm.[160] Indeed, they denied engaging in any of the questionable conduct about which they were asked, and they denied that the Firm had engaged in improper conduct. For example, they denied that the Firm had ever asked them "to pay back a portion of [their] IPO profits."[161] They also told Ozag that the Firm did not

---

[157] Tr. 3043:8–3045:17 (JD).

[158] Tr. 224:16–225:2, 343:4-6 (Ozag).

[159] Tr. 343:7-22, 351:10-14 (Ozag); RX 106 at 6199-6228, 6230-6239.

[160] Tr. 226:20-25 (Ozag).

[161] Tr. 344:23–345:6 (Ozag).

"impose[] requirements on the customer in order to receive an allocation of hot issues";[162] they paid high commissions to be valued customers and obtain IPO allocations.[163] The customers further denied that the Firm "would accept higher than normal commissions on secondary trades as payment in exchange for allocations,"[164] and denied that the Firm "would accept cash as payment in exchange for allocations of hot issue IPOs."[165] And the customers told Ozag that the Firm had not engaged in a quid pro quo.[166]

2. Customer Statements and Memoranda

The Firm submitted customer statements, affidavits, and counsel letters that were consistent with Ozag's interviews. In September 2002, the Firm produced to Enforcement two binders of materials reflecting its customers' understandings of their dealings with the Firm; the first was a binder of statements signed by 23 customers,[167] and the second was a binder of memoranda reflecting interviews the Firm had conducted with 30 of its customers.[168] The

[162] Tr. 344:9-20 (Ozag).

[163] Ozag's notes reflect how the customers explained that they were simply trying to be valued customers of the Firm. *E.g.*, RX 106 at 6199, 6201, 6203, 6231-33 ("Broker for 18 yrs./ When I allocated IPOs, I did it to biggest account/ w/ that in mind, I wanted to be one of the accounts that would/ I wanted to be a big account because big accounts get IPOs," "Tries to be a 'competitive[']/'valued' client," "Factors influencing comm. rate/ Wants to be a 'valued competitive' client," "Wants to develop a relationship where the brokers are making [them] money—may include getting IPO shares").

[164] Tr. 345:11-18 (Ozag).

[165] Tr. 345:21–346:4 (Ozag).

[166] Tr. 350:9-14 (Ozag).

[167] RX 12.

[168] RX 13.

statements were provided at the Firm's request.[169] Each signed statement denies that any profit sharing, tie-ins, quid pro quos, or any conversations about these subjects had occurred.[170]

The 30 interview memoranda similarly deny the existence of any profit sharing, tie-ins, quid pro quos, or any conversations about these subjects.[171] Although the Firm solicited these statements, Ozag conceded that the customers would reaffirm the substance of their statements under oath if they were called to testify at the hearing.[172] Indeed, Ozag testified that three of the four statements—that customers set commissions, that there were no tie-ins or quid pro quos, and that there were no discussions about tie-ins—were all categorically true.[173] And as for the fourth statement—the denial of profit sharing—Ozag conceded that the customers were being truthful: they did not believe they were sharing profits with the Firm, as they understood the meaning of the term.[174]

---

[169] Tr. 227:8-13 (Ozag); *see also* JX 14 ¶ 74 (Joint Stipulations).

[170] *E.g.*, RX 12 at 2405. The form statements prepared for the customers by the Firm's counsel "confirmed" the following facts:

> 1. At all times, I (or my representatives) unilaterally set the commissions on orders placed at the Firm.
>
> 2. At no time was there ever any tie-in arrangement or quid-pro-quo linking commissions and IPO allocations.
>
> 3. There were no discussions with the Firm suggesting or implying a tie-in arrangement between commissions and IPO allocations.
>
> 4. I (or my representatives) did not engage in any profit-sharing with the Firm.

[171] *E.g.*, RX 13 at 2456.

[172] Tr. 421:5-14 (Ozag).

[173] Tr. 422:3-12 (Ozag).

[174] Tr. 422:13–423:10 (Ozag).

3. Customer Affidavits

In addition, the Firm submitted seven customer affidavits that deny the existence of any tie-in arrangements, quid pro quos, kickbacks, or discussions about linkages between commissions and IPO allocations.[175] Enforcement introduced no evidence to contradict these affidavits.

4. Customer Counsel Letters

The record also includes several exhibits containing various letters to Enforcement from lawyers representing 14 customers. These exhibits show that these customers offered to confirm in interviews or affidavits that they had not engaged in profit sharing.[176]

5. Hearing Testimony

Three Firm customers—EB, JD, and SD—testified in person. Enforcement claims that two of them, EB and JD, shared profits with the Firm.[177] Both denied the charge.

EB, who paid the most total commission dollars of all the other customers on Schedule A-35,[178] consistently paid 60 cents per share on all his trades[179] although he paid other firms far less. He testified that he paid the Firm 60 cents per share because he valued KL's advice.[180] In his words, KL "either saved me money or made me money."[181] EB did not vary the rate depending on the availability of IPOs, and he continues to pay 60 cents per share on all of his trades.

---

[175] RX 133-139.

[176] RX 116-123.

[177] The third customer, SD, did not purchase IPO shares from the Firm.

[178] *See* RX 312.

[179] JX 14 ¶ 51 (Joint Stipulations).

[180] Tr. 4213:22–4214:3; 4236:7-15 (EB).

[181] Tr. 4218:5-8 (EB).

When questioned about his motive in paying such a high rate, EB denied the existence of any profit sharing, payback, tie-in, or quid pro quo. In addition, he stated that he had no conversations with the Firm about any of those subjects.[182]

As discussed above,[183] JD likewise denied sharing profits with the Firm.[184] As was the case with other Firm customers, JD paid higher commissions to ensure access to the services the Firm provided him. Aside from access to IPOs, these included the investment advice he received from CJ, his broker, whom JD considered to be a uniquely valuable resource. The Panel credits EB's testimony and finds that the Firm did not share in the profits of his account.

6. On-The-Record Interview Testimony

Enforcement took on-the-record testimony from several customers during the investigation; each denied sharing profits with the firm.[185] Of those, LM's testimony is particularly significant because Enforcement pointed to him as the customer who most supported Enforcement's profit-sharing theory. The Panel finds otherwise. LM's on-the-record interview testimony actually undercuts Enforcement's theory.[186]

LM is an unregistered professional investor who speculates in new issues for his own account.[187] He disclaimed being an "investor," by which he meant that he did not purchase stock to hold for the long term.[188] His business plan was to concentrate on IPOs. Thus, to maximize his

---

[182] Tr. 4215:9–4216:17 (EB).

[183] *See* Part III.E.2 at p. 30.

[184] *See* discussion *infra* Part III.E.2.

[185] Tr. 355:16–356:2 (Ozag).

[186] LM refused to testify at the hearing because he thought that Enforcement had mischaracterized his on-the-record interview testimony. *See* RX 240 at 10536-37 (LM Aff.).

[187] CX 38 at 22-23.

[188] *Id.* at 72.

ability to acquire IPO shares, he opened accounts at all the firms he could identify as having access to IPOs, including all of the major Wall Street firms.[189] In contrast to a hedge fund, he did not invest or manage money for others.[190] Nor did he engage in other investment strategies during the relevant review period. LM placed agency trades of listed securities through his various brokerage accounts only to get new issues.[191] In other words, he ran business through brokerage firms, including the Respondent Firm, to qualify for IPO allocations.[192]

LM testified that in 1999 and 2000 he used a formula to determine the amount of commissions he paid. LM generally tried to limit his commission payments to between 30 and 40% of his profits, which he considered a fair and reasonable level.[193] In effect, LM viewed these payments as the cost of doing IPO business. LM arrived at this formula without any input from the Firm. Indeed, he did not discuss the formula with HB, his Firm broker, or any other broker at any firm. It was just an internal guideline.[194]

LM's testimony does not support Enforcement's claim of profit sharing. LM set his commissions without his broker's involvement. He testified that HB could not have known how much profit LM was making on IPOs because LM sold the shares at other firms. LM further testified that he did not tell HB what he was making because it was none of HB's business.[195] Indeed, LM testified at his on-the-record interview that he did not share that type of information

---

[189] *Id.* at 17.

[190] Some of the Firm's customers labeled as "hedge funds" likewise did not invest customer funds.

[191] CX 38 at 22-23, 29, 71-72.

[192] *Id.* at 13, 27. According to LM, no firm on Wall Street was willing to give hot new issues to customers who did no other business with the firm.

[193] CX 38 at 63-64.

[194] *Id.*

[195] *Id.* at 48-49.

with anyone. In effect, Enforcement ignores LM's repeated and consistent denials of having reached any agreement with HB regarding the payment of profits. LM testified that there was no arrangement or agreement between himself and HB.[196] Enforcement ignores LM's testimony that HB never dictated or suggested the specific commission LM should place on a trade.[197]

In conclusion, LM's testimony does not show a profit-sharing arrangement between him and HB. Rather, the Panel concludes that the evidence shows that LM was describing the general business model he used during the exuberant IPO market of 1999 and early 2000 when he testified that he tried to limit his commission expenses to between 30 and 40% of his profits. Fundamentally, his goal was to flip hot IPOs, and he was willing to pay upwards of 40% of the profits he earned on those flips to stay in the game. He could not obtain IPO shares unless he did sufficient non-IPO business to be considered a valued customer. There was no other method available to generate revenue at the firms that had IPO shares. Thus, LM first estimated the level of revenue he needed and then met that level by trading listed securities. In addition, he sometimes placed higher commission rates on those trades to reduce the burden associated with doing higher volume.[198] Importantly, Enforcement offered no evidence that LM intended to share profits with HB or that HB expected to receive a share of the profits generated in LM's account. The Panel finds unpersuasive Enforcement's argument that HB engaged in profit sharing because he had a general idea of the amount LM made on the IPOs he received from the Firm and asked LM to throw more commissions his way. Indeed, most brokers, particularly at firms of Respondent's size, would have a general idea of the amount their customers made on IPOs the brokers allocated, but knowledge of that information alone does not equate to profit sharing.

[196] *Id.* at 51.

[197] *Id.* at 60.

[198] *Id.* at 61.

G. Statistical Evidence of Profit Sharing

1. Overview

Because a central element of Enforcement's theory is that there were obvious patterns of profit sharing, each side retained experts to examine the data. Enforcement retained Dr. Michael G. Ferri ("Ferri"),[199] and the Firm retained Professor Joseph L. Gastwirth ("Gastwirth").[200] Both experts filed reports of their findings and testified at the hearing.

As a preliminary matter, the Panel dismisses the Parties' respective objections to these two experts. The general framework regarding the admissibility of expert testimony, like the statistical evidence here, is set forth in the Supreme Court's decisions in *Daubert v. Merrell Dow Pharm., Inc.*, 509 U.S. 579 (1993) and *Kumho Tire Co. v. Carmichael*, 526 U.S. 137 (1999). In *Daubert*, the Court made clear that expert testimony should not be considered in a case unless the expert has genuine expertise and that expertise will assist the trier of fact to understand or determine a fact issue in the case.[201] The Court elaborated on *Daubert's* framework in *Kumho*

[199] Ferri holds the Foundation Chair in Finance at George Mason University. He holds a Ph.D. in economics from the University of North Carolina at Chapel Hill. He is the co-author with Frank Fabozzi and Franco Modigliani of the widely used textbook *Foundations of Financial Markets and Institutions*. His other publications and research relate to financial instruments, rates of return, financial structures, and asset pricing. Dr. Ferri has over thirty years of teaching experience. In addition, Ferri is associated with Nathan Associates, Inc., a consulting firm that provides expert economic, financial, fraud, and forensic accounting analysis and testimony in legal and regulatory proceedings. CX 33 (Ferri report). Ferri is not a statistician. Tr. 2013:21-25 (Ferri).

[200] Gastwirth is Professor of Statistics and Economics at George Washington University, where he has taught since 1972, and has also taught at Johns Hopkins, Harvard, and the Massachusetts Institute of Technology. He also served at the National Cancer Institute and the Office of Management and Budget. His many awards and honors include the American Statistical Association Award for Outstanding Applications Article (2002), the Shiskin Award for Economic Statistics (1998), and a John Simon Guggenheim Foundation Fellowship (1985). Gastwirth has expertise in application of statistics to the law. He authored a two-volume treatise in the field, *Statistical Reasoning in Law and Public Policy* (1988), which has been cited repeatedly in the Federal Judicial Center's *Reference Manual on Scientific Evidence*. *See, e.g.*, David H. Kaye & David A. Freedman, *Reference Guide on Statistics*, in ANNOTATED REFERENCE MANUAL ON SCIENTIFIC EVIDENCE 83, 85 n.1, 86, 106 n.77 (West 2004); Shari Seidman Diamond, *Reference Guide on Survey Research*, in ANNOTATED REFERENCE MANUAL ON SCIENTIFIC EVIDENCE 229, 237 n.33, 245 nn.62-63 (West 2004). He also has written many peer-reviewed papers. RX 4 at 245-47, 293 (Gastwirth report); Tr. 3901:16–3904:6 (Gastwirth).

[201] 509 U.S. at 592.

and explained that the twin requirements for expert testimony are relevance and reliability. The expert must employ at trial "the same level of intellectual rigor that characterizes the practice of an expert in the relevant field."[202] Moreover, the trial court, exercising its gate keeping function, must examine (among other things) the expert's qualifications, the methodologies used by the expert, and the relevance of the results to the questions before the jury. The same framework provides appropriate guidance in NASD disciplinary proceedings.[203]

The Panel further notes that the admissibility of expert opinion evidence is not governed by whether the expert's opinion is dispositive of the case. No one piece of evidence has to prove every element of a party's case; it need only make the existence of "any fact that is of consequence" more or less probable.[204] Thus, an expert's report may fall short of proving a claim yet still remain relevant to the issues in dispute.[205] Applying the foregoing standards, the Panel finds that both reports are admissible.

Once the admissibility of an expert's report is determined favorably, the Panel next must determine the probativeness of the report.[206] Here, the Panel finds Ferri's report less probative than Gastwirth's. As discussed below in more detail, Ferri's methodology was less rigorous. Ferri failed to analyze alternative explanations for the patterns he observed and to employ a comparative study to verify the correlations he reported. Accordingly, the Panel rejects Enforcement's statistical conclusions of profit sharing.

---

[202] *Kumho*, 526 U.S. at 152.

[203] However, unlike federal court proceedings, NASD disciplinary proceedings are not subject to formal rules of evidence. Accordingly, the principles in *Daubert* and *Kumho* are not binding.

[204] *See* Fed. R. Evid. 401.

[205] *See, e.g., Obrey v. Johnson*, 400 F.3d 691, 695 (9th Cir. 2005) (holding that court erred in excluding expert report in employment discrimination case).

[206] *Cf., e.g., Bazemore v. Friday*, 478 U.S. 385, 400 (1986) (Normally, failure to include variables [in regression analysis] will affect the analysis' probativeness, not its admissibility.).

2. Enforcement's Statistical Evidence—the Ferri-27

Enforcement asked Ferri to determine if there were any discernible patterns involving the Firm's IPO allocations and the commissions that the recipients of the IPO shares paid on non-IPO shares.[207] To analyze this issue, Ferri focused on 27 of the 31 customers who engaged in at least one "inflated rate transaction" during the review period (the "Ferri-27").[208] Ferri defined an "inflated rate transaction" as "an agency trade in a non-IPO stock that involved either (1) at least 10,000 shares with a commission per share of 20 cents or more or (2) at least 1,000 shares with a commission of at least 75 cents per share."[209]

Ferri found three principal correlations that he considered significant: (1) inflated rate transactions were more frequent on IPO days;[210] (2) total commissions were higher on IPO days;[211] and (3) total agency commissions paid by the Ferri-27 tended to rise and fall with the size of their first-trade hypothetical profits.[212]

(a) Frequency of Inflated Rate Commissions

Ferri reached his first conclusion—inflated rate transactions were more frequent on IPO days—by comparing the frequency of inflated rate transactions on days of hot IPOs with their frequency on days when the Firm did not have shares of hot IPOs to sell. In other words, he tested for the degree of association between the timing of the inflated rate commission payments

---

[207] CX 33 at 6-7 (Ferri report).

[208] Enforcement directed Ferri to exclude four customers as well as those customers who only flipped IPO shares. CX 33 at 8 n.6 (Ferri report). Ferri testified that he did not know why Enforcement excluded these customers. Tr. 1810:11-24 (Ferri).

[209] Enforcement gave Ferri this definition based on information its other experts provided. CX 33 at 8 n.5 (Ferri report).

[210] CX 33 at 17-18 (Ferri report); Tr. 1927:15-18 (Ferri).

[211] CX 33 at 12-13 (Ferri report); Tr. 1928:22–1929:14 (Ferri).

[212] CX 33 at 13–14 (Ferri report).

and the timing of the hot IPOs.[213] From this comparison, Ferri concluded that inflated rate transactions generally were more likely to occur on IPO days than on non-IPO days.[214] In addition, Ferri found that 37% of the Ferri-27 were more likely to engage in an inflated rate transaction on the day of a hot IPO.[215]

(b) Higher Total Gross Commissions

Ferri reached his second conclusion—that total gross commissions from agency trades in non-IPO shares were higher, in general, on days when the Firm was allocating shares of hot IPOs than on other days—by comparing the group of total commissions on the days the Firm allocated hot IPOs with the group of total commissions on other days.

Ferri concluded that total gross commissions from agency trades in non-IPO shares were higher on days when the Firm was allocating shares of hot IPOs than on other days.[216] Ferri also found that for the house accounts and three of the sales representatives, total commissions from agency trades in non-IPO shares were much higher on days when they had shares of hot IPOs to offer than on other days. And for the fourth sales representative, total commissions from agency trades in non-IPO shares were larger on days of and following a hot IPO allocation than on other days.[217]

---

[213] Ferri conducted this analysis at three levels. First, he looked at the trading data of the Firm, taken as a whole. Second, he looked at the trading data of the customer-pools of the four sales representatives and the Firm's house accounts. Third, he looked at the trading data of each of the Ferri-27. *See* CX 33 at 9 (Ferri report).

[214] CX 33 at 17-18 (Ferri report); Tr. 1927:15-18 (Ferri). As to one registered representative, Ferri found no correlation on hot IPO days; however, he did find that there was a similar correlation when he looked at inflated rate transactions on the day of and following each hot IPO. Tr. 1927:19–1928:9 (Ferri); CX 33 at 13–14 (Ferri report).

[215] CX 33 at 14 (Ferri report).

[216] CX 33 at 12-13 (Ferri report); Tr. 1928:22–1929:14 (Ferri).

[217] CX 33 at 13–14 (Ferri report).

(c) Correlation of Total Agency Commissions and Hypothetical Profits

Ferri reached his third conclusion—total commissions from agency trades of non-IPO shares moved in tandem with the total first-trade premium on hot IPOs—by comparing the IPOs' total first trade premium (or hypothetical IPO trading profit) and that day's total commissions from agency trades in non-IPO shares.[218] Ferri asserted that this comparison enabled him to examine whether total commissions followed a regular pattern of being relatively large when the total first-trade premium was comparatively high, and relatively small when the total first-trade premium was comparatively low.[219]

Ferri concluded that, on an aggregate basis, the Firm's total commissions from agency trades of non-IPO shares moved in tandem with the total first-trade premium on hot IPOs.[220] In other words, Ferri reported that he found an association between the commissions and hypothetical profits in the sense that as one went up, the other more often than not tended to go up as well.[221] Ferri also reported very similar results from his study of the house accounts and the four registered representatives' accounts. On the other hand, Ferri did not find a consistent ratio between commissions and hypothetical profits, which the Firm argued would be necessary to infer the existence of an agreement to share a set percentage of profits.

[218] CX 33 at 33 (Ferri report).

[219] CX 33 at 10 (Ferri report).

[220] CX 33 at 13–14 (Ferri report).

[221] Tr. 2239:21–2240:6 (Ferri).

3. The Firm's Statistical Evidence

Gastwirth conducted a far more exhaustive study of the relevant trading data. Gastwirth assembled a team of seven other experts to assist him. Collectively, they spent more than 3,000 hours analyzing the data and preparing Gastwirth's report.[222]

Gastwirth approached the profit-sharing issue by examining three key questions not addressed by Ferri: (1) whether the alleged profit sharers were favored by the Firm when IPO allocations were made; (2) whether individual alleged profit sharers paid commissions that revolved around a percentage (or a "share") of their profits; and (3) whether commissions substantially higher than six cents per share were unusual at the Firm.[223] From his analysis of these issues, Gastwirth concluded that there was no reliable statistical evidence of profit sharing.

(a) Profit Sharers were not Favored

Gastwirth formulated his starting question of whether the Firm favored the alleged profit sharers in response to Enforcement's allegation that the Firm was accepting "bribe-like" payments from its customers. Gastwirth reasoned that "one would expect that the givers of 'bribe-like' 'kick-backs' would get preference in IPO allocations."[224] The Firm argued that in such a scenario, an incentive would exist for the broker to give the customer more shares, which

---

[222] Enforcement argued that the Panel should exclude Gastwirth's report because it was too complicated to be helpful to the Panel. *See* Enforcement's Post-Hr'g Br. at 1, 41. The Panel rejects Enforcement's argument. Under Rule 702 of the Federal Rules of Evidence, expert testimony is admissible if it "will assist the trier of fact to understand the evidence or to determine a fact in issue." The admissibility of evidence in NASD disciplinary proceedings is governed by Rule 9263, which provides that "[t]he Hearing Officer shall receive relevant evidence, and may exclude all evidence that is irrelevant, immaterial, unduly repetitious, or unduly prejudicial." There is no specific NASD rule concerning expert testimony; accordingly, NASD looks to Federal Rule of Evidence 702 for guidance. *See, e.g.,* OHO Order 99-11, No. C8A990015 (June 17, 1999); OHO Order 99-03, No. C02980073 (Mar. 23, 1999). Expert testimony is particularly helpful here because the Panelists do not have expertise in statistical analysis.

[223] RX 4 at 255-56, 269-79, 287-90 (Gastwirth report).

[224] RX 4 at 255-56 (Gastwirth report).

would result in greater IPO profits, and, in turn, greater profit-sharing payments. Gastwirth performed four studies, each of which reflected no statistically significant evidence of favoritism or profit sharing.[225]

(1) Access to IPOs

In Paragraph 21 of the Complaint, Enforcement alleges "[Respondent] allocated shares in at least one hot IPO to every customer who paid inflated commissions of 20 cents or more on a trade of 10,000 shares or more on at least one occasion in the review period." In other words, 100% of such customers received at least one hot IPO. Because the evidence likewise showed that customers who did not pay inflated rate commissions also received hot IPO allocations, Gastwirth sought to determine whether the factual allegations in Paragraph 21 of the Complaint were statistically significant.[226]

As a starting point, Gastwirth noted that to draw a statistical inference concerning causal relationships, he had to compare the group of alleged profit sharers to a comparison group of similar customers, which Ferri did not do.[227] Gastwirth constructed two comparison groups: (1) the "non-Ferri-27," a group of similar customers who are not alleged to have shared profits; and (2) the "MR-30," a group of 30 customers who, like the Ferri-27, made multiple IPO requests.[228]

---

[225] Tr. 3937:4-14 (Gastwirth).

[226] In statistics, "significant" is a technical term, meaning "not attributable to chance-like variation."

[227] RX 4 at 250-51 and n.3 (Gastwirth) (citing D.H. Kaye & D.A. Freedman, *Reference Guide on Statistics*, REFERENCE MANUAL ON SCIENTIFIC EVIDENCE 93-96 (Federal Judicial Center 2000); Tr. 3937:19-3940:25 (Gastwirth); *see also* RX 4 at 313 (Ex. 3).

[228] The MR-30 group is comprised of customers never accused of profit sharing who, like the alleged profit sharers, requested IPOs eight or more times. There are 30 such multiple requestors—hence, the name "MR-30." Ferri testified he did not identify any better control group or indeed "reach[] any conclusion about possible control groups." Tr. 2365:7-11, 2364:10-11 (Ferri).

Gastwirth found that there was no statistical difference between the Ferri-27 and the two comparison groups. The non-Ferri-27 experienced a success rate of 94.5% percent,[229] and the MR-30 did exactly as well as the Ferri-27—they also experienced a 100% success rate.[230] Thus, Gastwirth concluded that the Ferri-27 were not favored with IPO allocations.

(2) Success Rates

Gastwirth also looked at customer average "success rates," or the proportion of IPO allocations a customer requested that were granted. For example, if a customer requested 10 allocations and received 7, the success rate is 70%. Gastwirth hypothesized that this inquiry is appropriate because, logically, profit-sharing customers should do better than those who did not share profits.[231] Put another way, he questioned why sophisticated investors would pay out a substantial share of their profits and receive nothing in return.

Gastwirth found that the average success rates for all customers were similar. The rate for the Ferri-27 was 89%, the rate for the non-Ferri-27 was 88%, and the rate for the MR-30 control group was 85.7%.[232] Again, Gastwirth concluded that the differences were not statistically significant.

In addition, Gastwirth tested the distribution of success rates because the average success rate did not provide a full summary of the data, and a few very large or small observations could skew the average rate.[233] Gastwirth found that the Ferri-27 actually experienced lower success

---

[229] *See* RX 4 at 257 (Illustration No. 2), 313 (Ex. 3) (Gastwirth report).

[230] Tr. 3940:10-14 (Gastwirth). In addition, Gastwirth ran parallel studies for other groups of customers Enforcement had identified as profit sharers. These studies likewise showed no favoritism. S*ee* RX 4 at 311 (Ex. 2), 462-73 (Exs. 24-29) (Gastwirth report).

[231] *See* Tr. 3941:23–3942:9 (Gastwirth).

[232] RX 4 at 257-260 (Gastwirth report); *see also* RX 4 at 258 (Illustration 3), 315-322 (Exs. 4, 5) (Gastwirth report). *See also* Tr. 3942:16-23 (Gastwirth).

[233] RX 4 at 259 (Gastwirth report).

rates than the non-Ferri-27 and that there was no statistically significant difference between the success rates for the Ferri-27 and the MR-30 control group.[234] Thus, Gastwirth concluded that the relative success rates provide no evidence that the Firm favored the Ferri-27.[235]

(3) Expectancy Analysis

Gastwirth also performed what he termed an expectancy analysis. Whereas the success-rate analysis examined the number of offerings in which a customer received an allocation in relation to the number of offerings the customer requested, the expectancy analysis looked at the number of shares allocated to customers. Gastwirth compared the number of shares the customers actually received with the number of shares that they would have been expected to receive relative to a particular benchmark for an allocation criterion.[236]

The benchmark utilized to compute the expected number of shares was the customers' previous 12 months' aggregate commission business.[237] Thus, if 10 customers asked to participate in an offering, Gastwirth tallied the historical commissions for each of those 10 customers over the 12 months ending November 1999; then, to compute the expected number of shares for each customer, he multiplied the Firm's retention (e.g., 10,000 shares) by the percentage of historical business represented by each of the 10 customers. (If the 10 customers asking for an offering paid a total of $1 million in aggregate commission business and Customer

---

[234] *See* RX 4 at 260 (Illustration 4), 315-22 (Exs. 4, 5) (Gastwirth report); Tr. 3943:17–3945:7 (Gastwirth). To double check his conclusion, Gastwirth conducted a regression analysis of the success rates of the two groups to determine whether controlling for other possible factors might show that the Ferri-27 customers received more favorable treatment than the MR-30 group. The result of this analysis showed that being a member of the Ferri-27 group did not have a statistically significant relationship with the number of successful requests for IPO shares. RX 4 at 490 (Ex. 33) (Gastwirth report).

[235] Tr. 3945:11-17 (Gastwirth).

[236] Tr. 3946:13-18; 4060:3-24 (Gastwirth); RX 4 at 261 (Gastwirth report).

[237] Tr. 3951:20–3952:17 (Gastwirth).

A paid $100,000 or 10% of the total, Customer A could be expected to get 10% of the retention, or 1,000 shares.) Gastwirth performed the same computations for all of the IPOs, and thus was able to compute the total number of shares expected by customers based on historical business from all 57 IPOs.

Gastwirth found that the alleged profit sharers did not get more than their expected, or proportionate, share—they received less. The Ferri-27 received approximately 1.3 million shares, while they would have expected approximately 1.8 million shares; their shortfall was 0.5 million shares.[238] In percentage terms, they received 41.04% of shares allocated versus their expected rate of 57.9%. The shortfall was 16.9% in absolute terms, and 29.2% in relative terms (16.9% divided by 57.9%). The alleged profit sharers thus received, on average, only 71 shares for every 100 shares they could be expected to receive based on their proportion of historical commission business.[239]

Gastwirth also analyzed whether the alleged profit sharers who were house accounts were favored over other house accounts, and separately analyzed whether non-house accounts (serviced by the brokers) alleged to have been profit sharers were favored over the other non-house accounts. In each case, Gastwirth found that the Ferri-27 received fewer shares than their expected allocations.[240]

---

[238] RX 4 at 262 (Illustration 5) (Gastwirth report).

[239] Tr. 3952:18-3953:17 (Gastwirth). In addition, Gastwirth looked at the expectancy rates for all 110 offerings during the review period. The results were similar. In percentage terms, the Ferri-27 experienced a shortfall of 16.78% in absolute terms, and 25.72% in relative terms, on all 110 offerings. Similarly, the percentage shortfalls were 16.63% in absolute terms, and 22.26% in relative terms, for the secondary offerings. RX 4 at 262 (Illustration 5) (Gastwirth report).

[240] Tr. 3955:20–3957:6 (Gastwirth).

To test for any bias in the results that might result from the fact that the brokers received only 35% of the available IPO shares and the house accounts received the remainder, Gastwirth performed an "adjusted expectancy analysis." For this analysis, Gastwirth assumed that Ferri's criteria for "inflated rate transactions"[241] were in place at the time of the trading. Thus, Gastwirth adjusted the commission rates paid by the alleged profit sharers to those levels. Every commission of 20 cents per share or more on a trade of 10,000 shares or more was reduced to 19 cents per share, and every commission of 75 cents per share or more on a trade of 1,000 shares or more was reduced to 74 cents per share.[242] The adjusted expectancy analysis likewise showed that the Ferri-27 customers were disadvantaged, albeit by smaller margins.[243]

In addition, Gastwirth individually examined each IPO highlighted in the Complaint,[244] and found a similar absence of evidence of favoritism for alleged profit sharers in each such offering. For example, for the VA Linux offering, the calculated expectancy rate for the Ferri-27 was 53.2%, yet Gastwirth found that they received 30.8% of the shares, an absolute shortfall of 22.4% and a relative shortfall of 42.16%. The same held true for each of the other IPOs highlighted in the Complaint.[245]

---

[241] Twenty cents per share on trades of 10,000 shares or more, and 75 cents per share on trades of 1,000 to 9,999 shares or more.

[242] *See* Tr. 3957:7–3962:15 (Gastwirth); RX 4 at 263-64, 329-32 (Ex. 7) (Gastwirth report).

[243] RX 4 at 331 (Gastwirth report); Tr. 4002:7-11 (Gastwirth). In addition, Gastwirth performed the same "adjusted expectancy analysis" separately to determine if the Ferri-27 who were house accounts were favored over other house accounts, and similarly to see whether the Ferri-27 non-house accounts were favored. Gastwirth concluded that they were not. The Ferri-27 house accounts received slightly less shares than would have been expected. The Ferri-27 broker accounts received 13% less shares than would have been expected. Tr. 3962:16–3963:4 (Gastwirth).

[244] Tr. 3963:5-22 (Gastwirth); RX 4 at 266-67, 341-43 (Gastwirth report).

[245] Tr. 3963:12-16 (Gastwirth); RX 4 at 267 (Illustration 11) (Gastwirth report).

(4) Favoritism Relative to Retail Customers

Finally, Gastwirth examined whether retail customers were disadvantaged relative to the Ferri-27. He first compared the success rates of the two groups, which showed that retail customers as a group were successful 97.95% of the time, and the Ferri-27 were successful 89.58% of the time. Gastwirth also performed a more detailed comparison that showed on an IPO-by-IPO basis that both groups had virtually equal success rates.[246] Thus, Gastwirth concluded that here also the Ferri-27 were not favored. Gastwirth's conclusion directly contradicted Enforcement's hypothesis that the Schedule A-35 customers were sharing their profits in order to be favored with a greater number of hot IPO shares.

(b) No Consistent Ratio of Commissions to Hypothetical Profits

Gastwirth next examined the degree of consistency of the relationship between the commissions paid by the Ferri-27 and their hypothetical profits on allocated IPO shares. Gastwirth theorized that if he found substantial variation in the ratio of commissions to hypothetical profits, it would be difficult to conclude that the customers, either unilaterally or in agreement with their brokers, were paying a targeted "share" of their profits back to the Firm. Gastwirth considered this a relevant inquiry because the Complaint singled out one customer who had the alleged practice of paying back 30-40% of his profits.[247] Moreover, the Complaint alleged that the Firm typically received inflated rate commission payments on the day, or within

---

[246] Tr. 3963:23–3964:14 (Gastwirth); RX 4 at 268-69, 345-46, 527 (Gastwirth report).

[247] Compl. ¶ 28.

one day, of an IPO.[248] If these allegations were true generally, Gastwirth theorized that the data would reflect a fairly consistent ratio of commissions to hypothetical profits.[249]

To analyze this question, Gastwirth performed two studies.

(1) Variability Study

In the first study, Gastwirth examined the level of variability of commissions to hypothetical profits. To do so, he first computed a ratio for each customer on or around an IPO by dividing commissions by hypothetical IPO profits (a "C/HP Ratio").[250] Gastwirth then used two measures of variability to assess whether these daily fractions were concentrated around a "target fraction" or "target share."[251]

The first measure of variability Gastwirth used is the Gini Index of Income Inequality. In non-technical terms, the Gini index provides a standard benchmark of inequality for comparative purposes. For example, household income in the U.S., which generally is considered to be quite unequal, has a Gini index of about .45. Statisticians consider higher values to indicate greater inequality. Here, Gastwirth found that the Gini index of the C/HP Ratios for the Ferri-27 and other groups of customers indicated a very high degree of inequality. Even when the data were restricted to days with a positive hypothetical profit, the Gini indices for all groups exceeded .88. Only two customers had a Gini index below .45.[252]

---

[248] *Id.* ¶ 2.

[249] The converse would not be as conclusive because a high level of consistency could be the result of the customers' unilateral decision to pay inflated rates as opposed to an agreement to do so. *See* Tr. 3965:14-3966:15 (Gastwirth).

[250] Gastwirth ultimately tested the data using one, two, and three day windows around the IPO days. The results for each were consistent.

[251] Tr. 3967:25–3973:22 (Gastwirth); RX 4 at 269-76 (Gastwirth report).

[252] Tr. 3971:3-7 (Gastwirth).

The second measure of variability Gastwirth used is the "coefficient of dispersion," which is a standard measure of the variability of assessment-sales ratios that is used to evaluate whether real estate tax assessments are uniform. Statisticians generally regard values of the coefficient of dispersion greater than .40 as indicating that the assessment-sales ratios are not uniform. Thus, values for the C/HP in excess of .40 would indicate that the C/HP Ratios are not concentrated about a central value (their median) and, thus, are highly variable.

Gastwirth found that the values of the coefficient of dispersion of the C/HP Ratio for the alleged profit sharers indicate a substantial degree of variability. Indeed, every group of customers Gastwirth studied had a coefficient of dispersion exceeding 5.0, which Gastwirth considered an extreme degree of non-uniformity. In addition, viewed individually, all of the Ferri-27 customers had values greater than 1.0.[253]

(2) Correlation Study

Gastwirth also examined whether the C/HP Ratio varied with the magnitude of the hypothetical profit.[254] Gastwirth considered this an appropriate subject of study because, he reasoned, if there was an agreement or arrangement to share profits one would not expect the "share" to increase or decrease with the amount of the hypothetical profit. In other words, if a customer was paying a target amount (e.g., 30%) of his profits to the Firm, the percentage would not be expected to vary when the hypothetical profits increased or decreased. Rather, the ratio would remain relatively constant.[255]

[253] Gastwirth further notes that for seven customers a coefficient of dispersion could not be calculated because they paid no commissions on more than half of the days they received hot IPO shares.

[254] *See* Tr. 3973:23–3978:6 (Gastwirth); RX 4 at 276-79 (Gastwirth report).

[255] Tr. 3975:18-3976:6 (Gastwirth).

Gastwirth discovered that there was a negative correlation between the C/HP Ratio and the hypothetical profit. When profit rose, the customers as a group paid less as a fraction of profit.[256] Gastwirth concluded that this negative correlation tended to indicate the absence of an agreement or arrangement for the sharing of profits.

(c) Rates above Six Cents per Share were not Uncommon

Gastwirth next examined Enforcement's conclusions about the relative rarity of commissions in excess of six cents per share.[257] Gastwirth noted that Campbell, Enforcement's primary expert on commission rates, had reported that industry-wide commission rates for institutional customers during the relevant period typically ranged between four and ten cents per share, depending upon the nature of the transaction and services rendered.[258] Accordingly, Gastwirth thought it appropriate to examine how common rates above those levels were at the Firm during the relevant period, particularly for customers of a similar size to those that comprise the Ferri-27.

Gastwirth first studied commissions paid over two periods, the relevant period under the Complaint and the 12 months preceding the Complaint. For both periods, Gastwirth concluded that it was not unusual in a statistical sense to have commissions at the Firm outside the range of four cents to ten cents. Slightly more than 40% of the commissions in these periods were either below four cents or above ten cents per share.[259]

---

[256] *See* Tr. 3976:8-25 (Gastwirth); RX 4 at 278 (Gastwirth report); *see also* RX 4 at 359-63 (Gastwirth report). The probability of this occurring randomly "was less than 1 in 10,000." Tr. 3977:9 (Gastwirth); *see also* RX 4 at 277 (Illustration 17) (Gastwirth report).

[257] Gastwirth performed this study in the context of a broader review of the integrity of Enforcement's evidence regarding the Ferri-27 customers' "pattern" of paying increased commissions on IPO days. RX 4 at 279-90 (Gastwirth report).

[258] CX 32 at 6 (Campbell report).

[259] RX 4 at 288 (Gastwirth report).

Gastwirth also examined the frequency of commissions at or above 10 and 20 cents per share. Again, he found that commissions at those rates were not uncommon during both periods. For example, commissions of 10 cents or more per share happened 39.55% of the time during the review period, and commissions of 20 cents or more per share happened 28.53% of the time during the same period.

In addition, in terms of cents per share, Gastwirth found that the commissions had a relatively high degree of "variability," which he demonstrated using both Gini indices (.574) and coefficients of dispersion (1.274).[260] He reported similar values for the pre-Complaint period.[261]

At the hearing, Gastwirth supplemented his findings to address Enforcement's criticism that Gastwirth had not excluded trades outside of Enforcement's inflated rate commission matrix. Gastwirth therefore limited his supplemental review to trades of 1,000 shares or more and added a third commission threshold of seven cents per share. Gastwirth found that trades in all reported categories were significantly more common than Enforcement had argued. At a minimum, nearly 1 out of 5 trades involved a commission rate equal to or greater than 20 cents per share.[262] In addition, Gastwirth noted that the average commission during the 12 months immediately before the review period was 21.6 cents per share and that there were thousands of trades above 20 cents per share.[263]

Gastwirth's findings regarding the relative common occurrence of commission rates in excess of six cents per share are significant because they undercut Enforcement's argument that

[260] *See* RX 4 at 389 (Ex. 21) (Gastwirth report).

[261] See RX 4 at 288 (Gastwirth report).

[262] RX 313 and RX 314.

[263] RX 4 at 288, 384-86 (Gastwirth report).

the pattern of inflated rate commission payments on or around IPO days was so dramatic as to constitute notice that the Firm's customers were making profit-sharing payments to their brokers.

4. Enforcement's Statistical Evidence Lacks Probative Value

Enforcement argued that the Panel can infer from Ferri's correlations that the Firm (1) participated in profit sharing and (2) knew or should have known that its customers were paying back a share of their profits to the Firm. The Panel disagrees.

As a starting point, the Panel notes that correlation is not causation.[264] "Statistical associations or correlations only represent the first step in determining whether there is a causal relationship."[265] To verify if an observed correlation is causally related, a similar comparison group must be employed.[266] Absent such a comparison, the correlation is not reliable. Here, Ferri did not make such comparisons to verify his conclusions. Therefore, the Panel finds that his findings lack probative value. Hence, the Panel cannot infer from Ferri's correlations that the Firm participated in profit sharing.

The significance of Ferri's conclusion that "inflated rate transactions were more likely to occur on days of hot IPOs"[267] is lessened by the fact that the Ferri-27 were selected because they had paid rates Enforcement defined to be "inflated." Most of these customers—as the other customers interested in IPOs (the MR-30[268])—clustered their trading on IPO days. Thus, as Gastwirth observed, it would be logical to find that the Ferri-27 paid inflated rate commissions

[264] *E.g., Wessmann v. Gittens*, 160 F.3d 790, 804 (1st Cir. 1998) (citing *Tagatz v. Marquette Univ.*, 861 F.2d 1040, 1044 (7th Cir. 1988)); *Ste. Marie v. Eastern R.R. Ass'n*, 650 F.2d 395, 400 (2d Cir. 1981) (Friendly, J.).

[265] RX 4 at 283 (Gastwirth report).

[266] *See* REFERENCE MANUAL ON SCIENTIFIC EVIDENCE 336 (Federal Judicial Center 2000).

[267] CX 33 at 17-18 (Ferri report).

[268] RX 4 at 578-79 (Ex. 58) (Gastwirth report); Tr. 3983:24–3984:3 (Gastwirth).

on IPO days because they placed most of their trades on those days.[269] For the same reasons, their total commissions would be higher on those same days. The observed correlations, therefore, shed little or no light on the issue of profit sharing.

With respect to Ferri's observation that the Ferri-27 paid higher commissions on IPO days, Gastwirth studied a control group, the MR-30, that was comprised of customers who had never been accused of profit sharing to determine if Ferri's finding was significant. Gastwirth found that the control group also showed a statistically significant increase of commissions on IPO days. Approximately 71% of the comparisons showed total commissions higher on IPO days than on non-IPO days;[270] the comparable statistic for the Ferri-27 was 74%. Gastwirth concluded that the difference was not statistically significant. Indeed, for all groups Gastwirth studied, this was the general phenomenon.[271] Moreover, Gastwirth demonstrated that when the customers for whom there are statistically significant results are viewed individually, more had higher aggregate commissions on non-IPO days.[272]

Another factor undercutting the probative value of Ferri's analysis is that he pooled two types of "inflated rate" transactions—20 cents or more on trades of 10,000 shares or more, and 75 cents or more on trades of between 1,000 and 9,999 shares—which categories he admitted were "statistically significantly different."[273] Ferri could not say whether the pooling of the two groups skewed his findings.[274] In contrast, Gastwirth independently studied the 20-cent group

[269] Tr. 3983:3-7 (Gastwirth).

[270] RX 4 at 282-83 (Gastwirth report).

[271] Tr. 3992:18 (Gastwirth).

[272] Tr. 3989:23–3990:21 (Gastwirth). Ferri conceded the same thing. Tr. 2350:17-22 (Ferri).

[273] Ferri did not study the remaining two categories of inflated rate transactions specified in the Bill of Particulars.

[274] Tr. 2323:11-12 (Ferri).

and the 75-cent group and found that rates of 75 cents or more per share on trades of 1,000 to 9,999 shares actually were less frequent on IPO days for the Ferri-27.[275] In addition, Ferri incorrectly concluded that 75-cent trades "almost never happen[ed] on non-IPO days."[276] Gastwirth's report demonstrated this error.

The Panel also finds that Ferri's analysis of total commissions paid by the Ferri-27 is less helpful than Gastwirth's analysis of the commission rates they paid. As the Firm argues, Enforcement's Complaint is grounded on the theory that the Firm engaged in profit sharing by accepting inflated rates, measured in cents per share. Enforcement has never asserted that increased order flow on IPO days constituted profit sharing. Nevertheless, Enforcement did not ask Ferri to analyze commission rates. On the other hand, Gastwirth did look at commissions in terms of their percentage to the value of the trades placed by the Ferri-27 and found that the percentages were lower on IPO days.[277] "[I]n percentage terms, for the Ferri-27, the percentage was statistically significantly lower on the IPO days."[278] In addition, Gastwirth found that commissions in cents per share terms were not higher on IPO days.[279] To the contrary, for the Ferri-27, the average commission was higher on non-IPO days—23.4 cents (non-IPO days) versus 19.5 cents (IPO days).[280] Although Gastwirth concluded that this was not a statistically significant difference, it nevertheless calls into question the reasonableness of the inferences Enforcement draws from Ferri's study.

---

[275] Tr. 3984:5-3985:4 (Gastwirth); *see* RXs 704, 705.

[276] Tr. 1976:5-10 (Ferri).

[277] RX 4 at 286 (Gastwirth report).

[278] Tr. 3988:19-22 (Gastwirth).

[279] RX 4 at 285, 374-77 (Exhibit 18) (Gastwirth report).

[280] Tr. 3988:4-5 (Gastwirth).

Similarly, the Panel concludes that it cannot infer profit sharing from the fact that Ferri found a correlation between the total commissions paid by the Ferri-27 and the size of the total first-trade premium of the hot IPOs.[281] As Gastwirth concluded, this was equally true for the non-profit sharers. In other words, here again the phenomenon was general in nature and not limited to the Ferri-27.[282] The correlation also was positive for both the MR-30 and the non-Ferri-27 control groups.[283] Gastwirth demonstrated that there was virtually no correlation between total commissions and cents per share for the Ferri-27.

Enforcement did not produce a statistical analysis challenging any of Gastwirth's findings. On the other hand, the Firm did present corroborating expert opinion. Dr. Vincent Warther ("Warther"),[284] a financial economist, testified that the economic evidence does not support Enforcement's charge that the Firm shared in its customers' profits. Warther based his opinion on, among other things, two findings he developed from his analyses of the trading data in this case, which are consistent with Gastwirth's statistical work. First, Warther found that "there are many examples that contradict [Enforcement's] claims of [a] relationship between IPO allocations and inflated commissions."[285] Second, he found that "there is no consistent ratio of commissions to IPO profits."[286]

---

[281] CX 33 at 10 (Ferri report).

[282] Tr. 2357:24–2358:6 (Ferri).

[283] Tr. 3995:7-11 (Gastwirth).

[284] Warther is a Senior Vice President with Lexicon, Inc., a consulting firm that specializes in the application of economics to issues that arise in legal and regulatory proceedings. Warther holds a Ph.D. in finance and a M.B.A. from the University of Chicago. He has served on the faculties of the University of Michigan Business School, the University of Chicago Graduate School of Business, and the University of Southern California School of Business where he taught finance courses at both the undergraduate and graduate levels. RX 11 (Warther report).

[285] Tr. 3237:2-5 (Warther).

[286] Tr. 3237:6-7 (Warther).

First, Warther examined trading data before, during, and after the relevant period to determine how well it fit the patterns Enforcement claims are revealed by Ferri's study. Warther found a significant number of exceptions.

Warther started by examining the 695 allegedly violative trades on Schedule A-35. For each transaction, he looked to see if the customer who made the trade received an IPO allocation within the three-day window used by Enforcement. Warther found many transactions were not associated with IPO allocations.[287]

Specifically, Warther found 113 instances where the alleged profit sharers paid "inflated" commissions within the three-day window around an IPO without receiving an allocation from the Firm.[288] He also found 473 instances where the Firm allocated IPO shares to a member of the Ferri-27 group, but the customer did not make a Schedule A-35 trade in the three-day window around the IPO.[289] And when he broadened the definition of "inflated" commissions to include commissions greater than 7 cents per share on trades of 1,000 or more shares, he found 223 instances where alleged profit sharers received an allocation without paying an "inflated" commission in the corresponding three-day window.[290]

In addition, Warther ran these same analyses for all the Firm's customers over the review period, as well as for the six-month period before the review period, and reached the same conclusion. He found many transactions that did not fit Enforcement's inferences.[291]

---

[287] Tr. 3237:2-17 (Warther).

[288] Tr. 3238:6-21 (Warther); RX 11 at 2034, 2051 (Ex. B) (Warther report).

[289] Tr. 3241:17–3242:13 (Warther); RX 11 at 2034, 2057 (Ex. C) (Warther report).

[290] Tr. 3242:14-3243:8 (Warther); RX 11 at 2034-35, 2078 (Ex. D) (Warther report).

[291] Tr. 3243:16-21 (Warther); RX 11 at 2035-36, 2088, 2175, 2226, 2266, 2283, 2315 (Exs. E, F, G, I, J, K) (Warther report).

Second, Warther studied Ferri's correlation between commissions and hypothetical profits and found, as did Gastwirth, that there was no consistent pattern of so-called kickback or profit-sharing ratios.[292]

Finally, Warther seconded Gastwirth's criticisms of Ferri's methodology. Like Gastwirth, Warther pointed out that Ferri had failed to take into account alternative explanations.[293] Of significance, Warther determined that total volume was higher around IPO days than non-IPO days;[294] total commissions on non-"inflated" trades were higher around IPO days than non-IPO days;[295] and total "low" commissions (commissions less than or equal to six cents per share) were higher on IPO days than non-IPO days.[296] Warther testified that these findings were statistically significant[297] and consistent with the idea that "business was generally greater around IPO allocations."[298] Accordingly, he concluded that an inference of profit sharing could not be based on the association of inflated rate transactions on or around IPO days.

As for Ferri's conclusion that inflated rate transactions were positively correlated with hypothetical profits, Warther agreed with Gastwirth's finding that this was a general phenomenon. Total dollar volume of trading at the Firm moved in tandem with IPO profits. Total commissions on non-inflated commissions moved in tandem with IPO profits. And total

[292] Tr. 3244:5-23 (Warther).

[293] Tr. 3255:2-3 (Warther).

[294] Tr. 3257:5-7 (Warther); RX 11 at 2042, 2391 (Ex. V) (Warther report).

[295] Tr. 3257:17-19 (Warther); RX 11 at 2042, 2393 (Ex. W) (Warther report).

[296] Tr. 3257:20-3258:7, 3260:2–3261:3 (Warther); RX 11 at 2042, 2395 (Ex. X) (Warther report).

[297] Warther used a level of significance of 5% because he considered it consistent with proper science method. Tr. 3258:10-15 (Warther).

[298] Tr. 3256:14-18 (Warther).

commissions on low commission trades moved in tandem with IPO profits.[299] Warther testified that these findings, too, were statistically significant.[300]

And like Gastwirth, Warther noted that one of Ferri's analyses purporting to show that the Ferri-27 paid higher total commissions on IPO days (Table XVI of Ferri's report) actually contained more statistically significant results against that hypothesis than it did in favor of it.[301]

5. Conclusion Regarding Statistical Evidence

At the hearing, Enforcement argued that its "pattern evidence" proved both the fact of profit sharing and the fact that the Firm must have known that its customers were paying the Firm a share of the profits in their accounts. The Panel rejects both arguments.

While Ferri identified several correlations between the commissions the Firm received and the timing of hot IPOs during the review period, his report did not prove profit sharing. And, due to the methodology Ferri used, the Panel cannot draw a reasonable inference of profit sharing from his findings. Enforcement has not produced sufficient evidence to meet the shortcomings in Ferri's analysis, as demonstrated by the Firm's experts. Accordingly, the Panel rejects Enforcement's statistical evidence of profit sharing. And, since the Panel has found no other evidence of profit sharing, Ferri's correlations do not constitute red flags of potential wrongdoing.

---

[299] Tr. 3259:5-12 (Warther); RX 11 at 2391, 2393, 2395 (Exs. V, W, X) (Warther report).

[300] Tr. 3259:17-22 (Warther).

[301] Tr. 3263:16–3266:22 (Warther); *see* RX 11 at 2399 (Ex. Z) (Warther report); CX 33 at 31 (Table XVI) (Ferri report).

H. The Firm's IPO Allocation Practices

The Firm's IPO allocation practices were consistent with those of the industry in general. At the beginning of each week, the Firm generated a list of syndicate offerings, which it circulated to the Firm's registered representatives.[302] Each registered representative would then take indications of interest from his customers. Most of the time, customers were aware of upcoming offerings, in which case they would initiate a call to their broker if they wished to participate in the offering. In other cases, the registered representatives would call their customers and inquire if they had an interest in an upcoming offering.[303] Then, the registered representatives would allocate the IPO shares they received among those customers who submitted an indication of interest.[304]

Generally, the registered representatives at the Firm used three criteria to allocate IPO shares.[305] The most important criterion was the aggregate level of business each customer did with the Firm. Customers' historical aggregate commissions were reported on the Schedule of Institutional Income prepared by JB's assistant.[306] Typically, the registered representatives looked at revenue levels for the last 12 months. The Schedule of Institutional Income did not reflect separately the commission levels customers paid on or around IPO days, nor did it reflect the commissions on a cents-per-share basis. Indeed, the Schedule of Institutional Income did not include data that would have permitted the calculation of a cents-per-share commission rate. The

---

[302] Tr. 917:7-10 (Link).

[303] Tr. 917:16-18 (Link).

[304] The Firm allocated between 65% and 70% of the shares it received to the house accounts. The Firm divided the balance among its registered representatives to be allocated to their customers. Tr. 1319:2-13 (LS). The Firm typically received no more than 1% to 1.5% of any offering. Tr. 1323:8-10 (LS).

[305] JX 14 ¶ 56 (Joint Stipulations); Tr. 1319:21–1320:20 (LS).

[306] JX 15; Tr. 1327:9–1328:13 (LS).

second criterion was the customer's expressed interest in becoming a holder of the stock.[307] And the third criterion was the potential for future business. Each registered representative, however, was free to make the allocations among his customers as he saw fit. The Firm provided no direction on how to allocate the shares among the customers who indicated an interest in an offering.[308]

I. The Firm's Supervisory System

The only witness to directly address the Firm's supervisory system and written procedures in any detail was Lorena J. Kern ("Kern"), one of the Firm's experts, who the Panel credits.[309] The Panel found Kern to be forthright, and her report to be based upon a thorough, unbiased review and analysis of the facts and circumstances of this case. The Panel finds no merit in Enforcement's argument that her opinion is biased because she was the Director of Compliance for the retail division of Morgan Stanley, which itself was under investigation regarding its IPO allocation practices to its institutional customers at the time of the events in question in this case.[310] Kern was not involved with Morgan Stanley's institutional business or

[307] JX 14 ¶ 56 (Joint Stipulations).

[308] Tr. 1004:10-24 (Smith).

[309] Kern is a partner at Ferguson Pollack Kern Consulting LLC ("FPK"), a consulting firm that specializes in providing support to in-house counsel and compliance professionals within the securities industry. FPK claims nearly every major brokerage firm as a past or present client. Kern, a graduate of Fordham Law School, has extensive experience as a securities lawyer. Before joining Morgan Stanley, She served as a staff attorney with Merrill, Lynch, Pierce, Fenner & Smith, as Vice President-Litigation with Dean Witter Discover & Co., and Associate General Counsel-Litigation with Interstate Johnson Lane. Between 1989 and 2002, Kern held a number of litigation and compliance positions with Morgan Stanley, including the position of Senior Vice President–Director of Compliance for its retail operations. RX 5 at 619-622, 697-699 (Ex. A) (Kern Report).

[310] *See* Tr. 105:4–108:15 (Enforcement's Closing Argument); Enforcement's Post-Hr'g Br. at 88-89.

with the investigation. She learned of the Morgan Stanley investigation after she had formulated her opinions for this case.[311]

1. The Firm's Supervisory Structure

The Firm had 17 staff members located in its single office in New York City. In addition to KL, the staff consisted of three supervisors, three trading desk staff, four brokers, one corporate finance staff member, and five clerical staff. The Firm's supervisors had the following responsibilities:

CK held the position of Executive Vice President and Chief Operating Officer. She worked for the Firm for approximately 22 years before she retired in January 2001. One of her primary responsibilities was the Firm's corporate finance activity, including its IPO activity. The Firm's two other supervisors, JB and LS, reported to her, and she, in turn, reported to KL.

JB is the Firm's Chief Financial Officer and Compliance Director. LS, the Firm's head trader, reported to JB.

LS became the Firm's head trader in 1994. The Firm's three other trading room personnel reported to LS. In addition, LS holds the position of sales supervisor. The Firm's four other brokers reported to LS.

Physically, LS, the traders, and the four sales representatives were closely located. LS and the Firm's three other traders sat facing each other at a four-station desk in a trading room

[311] Tr. 3728:21-24, 3729:7-10 (Kern). She testified that she has never spoken to anyone at Morgan Stanley about the investigation. Tr. 3729:11-13 (Kern).

just 15 feet square.[312] The Firm's registered representatives had offices just outside the trading room, in close proximity to JB's, CK's, and KL's offices.[313]

Given the Firm's size and business, its supervisory structure was reasonable. The Firm's three supervisors were seasoned securities professionals with just eight staff members under their supervision. Each supervisor was active in the day-to-day operations of the Firm. Of particular significance, the Panel notes that LS directly participated in, or overheard, conversations the brokers had with their customers. LS confirmed that none of these conversations ever involved the brokers setting commission rates. As Enforcement stipulated, the Firm's customers always set the commission rates they paid.[314] In addition, LS had frequent contact with all of the Firm's customers because they typically called their trades into the trading desk.[315] LS routinely took customer calls himself, which gave him direct knowledge of the Firm's business.

2. The Firm's Supervision of Commissions

The Firm's customers have always set their own commissions, subject to the Firm's commission policies. Until December 1999, the Firm limited commissions to 5% of the dollar value of the trade.[316] Then, in December 1999, the Firm adopted a limit of 3%.[317] JB testified that the Firm lowered the limit to 3% at his suggestion because the Firm wanted to maintain a conservative environment.[318] Thereafter, in June 2001, the Firm again modified its commission

[312] Tr. 1263:11-12 (LS).

[313] Tr. 1263:19–1265:19 (LS).

[314] JX 14 at ¶ 41 (Joint Stipulations).

[315] Tr. 1316:19-24 (LS).

[316] RX 5 at 675 (Kern report).

[317] JX 14 at ¶ 50 (Joint Stipulations).

[318] Tr. 1554:19-24 (JB). JB observed that the Firm's clearing firm utilized a 3% guideline.

policy to limit commissions to the lesser of 3% or 20 cents per share. The impetus for this last modification was NASD's investigation that led to the filing of this action.[319] The weighted average of the commissions at issue here equaled approximately 1% of the total value of the trades.[320]

Pursuant to the Firm's written supervisory procedures, the Firm's supervisors reviewed customer's orders, including commissions, appropriately. As Enforcement stipulated, "Customer order flow, including commissions, was the subject of at least two separate reviews: one by the trading desk supervisor [LS] and the other by [the Firm]'s Compliance Officer [JB]."[321] LS and JB reviewed all order tickets[322] and the Daily Commission Detail Report ("Trade Blotter")[323] provided by Bear, Stearns Securities Corp. ("Bear Stearns"), the Firm's clearing firm. The Trade Blotter showed the agency trades executed on the previous day for each registered representative.[324] The Trade Blotter reported gross commissions only; it did not contain a calculation of the commission rate in cents per share. LS compared the order tickets to the Trade Blotter to ensure there were no discrepancies between the two.[325] He also reviewed the trades to ensure that the commissions did not exceed the Firm's internal guidelines.[326] In addition, CK periodically reviewed the order tickets as part of her supervisory function.[327]

---

[319] Tr. 1276:4-19, 1372:14–1373:11 (LS).

[320] JX 14 at ¶¶ 15, 22 (Joint Stipulations).

[321] *Id.* at ¶ 78.

[322] CX 39.

[323] CX 27. Bear Stearns also provided a similar blotter showing the Firm's principal trades and over-the-counter activity, which LS reviewed daily. CX 41.

[324] JX 14 at ¶¶ 79, 80, 81 (Joint Stipulations).

[325] Tr. 1278:22–1279:3 (LS).

[326] Tr. 1279:4-7 (LS).

[327] Tr. 1291:11-16 (LS).

Enforcement does not allege, and there is no evidence, that LS or JB failed to review the order tickets or the Trade Blotter in accordance with the Firm's supervisory procedures.

Finally, the Firm's written supervisory procedures required each employee to submit a signed annual certification that they had not shared in the profits or losses of any account of a customer, or in a transaction with or for a customer during the past year.[328] Without exception, every Firm staff member signed such a certification annually and denied having engaged in profit sharing.

3. The Firm's Supervision of IPO Allocations

During the relevant period, the Firm participated in 110 offerings—57 IPOs and 53 secondary offerings. The Firm received relatively small amounts of stock for distribution in these IPOs. The Firm typically received no more than 1% to 1.5% of any offering.[329] Of the shares the Firm received in any IPO, [it] set aside between 65% and 70% for the house accounts and divided the balance among its registered representatives, which they in turn allocated among their respective customers.[330]

JB, LS, and CK reviewed the allocations for compliance with the Firm's allocation policy.[331] For example, JB testified that he reviewed the allocations to be sure they were broad based. His goal was to ensure that all customers that had indicated an interest in an IPO received an allocation.[332]

---

[328] JX 14 at ¶ 75 (Joint Stipulations).

[329] Tr. 1323:8-10 (LS). Kern calculated the Firm's weighted average participation in the IPOs at 0.432%. RX 5 at 774 (Kern report).

[330] Tr. 1319:2-13 (LS).

[331] JX 14 at ¶ 84; RX 5 at 682 (Kern report).

[332] Tr. 1492:5-18 (JB).

In conclusion, the Panel finds that JB, LS, and CK supervised the IPO allocations at issue here in a manner consistent with the policies and procedures set forth in the Firm's compliance manual.

IV. CONCLUSIONS OF LAW

A. Profit-Sharing Charge

Enforcement argued that the Firm's receipt of higher-than-normal commissions on or within one day of an IPO constituted profit sharing, in violation of Conduct Rule 2330(f). As discussed below, Conduct Rule 2330(f) does not prohibit the receipt of higher commissions under the facts and circumstances of this case, and cents per share has never been applied to measure the reasonableness of commissions or to determine if a firm is engaged in profit sharing. Accordingly, the Panel finds that Enforcement did not prove by a preponderance of the evidence that the Firm violated Conduct Rule 2330(f).

1. Conduct Rule 2330(f)

The Panel's analysis of the applicability of Conduct Rule 2330(f) to the facts of this case starts with the rule's plain language. NASD Conduct Rule 2330(f) provides in pertinent part:

> Except as provided in paragraph (f)(2) no member or person associated with a member shall share directly or indirectly in the profits or losses in any account of a customer carried by the member or any other member . . . .

The Rule has two core elements. The Rule expresses a prohibition on members or persons associated with members, who are enjoined not to "share." And what they are not to share are profits or losses in any account of a customer carried by a member. Neither element is present in this case.

(a) Sharing Element

The plain meaning of "share in" connotes active, intentional conduct quite distinct from the passive receipt of commissions shown in this case. Enforcement argued that the term "share in" also means, "to have a share or part," as in "shared in the profits."[333] However, in this sense, the term also connotes active, intentional conduct. "To have a share" connotes that a person has acquired the right to use or enjoy another's property, elements that are not alleged in this case.[334] To "have" in this sense means "to acquire or get possession of something: OBTAIN."[335] Here, there is no evidence that the Firm obtained a right to a portion of the profits in any of its customers accounts by agreement or otherwise.

The Panel concludes that the plain meaning of Rule 2330(f) does not support Enforcement's theory. To hold otherwise would result in an illogical construction of the Rule. If the act of sharing does not require an intentional act by the broker, the Rule in essence would amount to a prohibition against the receipt of higher-than-typical commissions. However, if NASD intended the Rule to regulate commission rates, there would have been no need to include the concepts of "sharing" or "profits" in the Rule.

The Panel further concludes that the context of subparagraph (f) of Rule 2330 substantiates that the Rule prohibits intentional conduct. As Enforcement's expert Campbell testified, the Rule is a "customer protection rule";[336] it does not exist to discipline brokers for the unilateral acts of customers, but to discipline brokers for doing things that could harm customers.

---

[333] AMERICAN HERITAGE DICTIONARY (4th ed. 2000).

[334] *Id.* Other meanings of "share" similarly connote an intentional act. *See* WEBSTER'S THIRD NEW INT'L DICTIONARY 2087 (1993).

[335] WEBSTER'S at 1039.

[336] Tr. 1754:21-1755:2 (Campbell).

The Rule is intended to prevent overreaching by brokers. The other subparagraphs of the Rule bear out this conclusion; each governs the intentional, affirmative conduct of brokers in some way.[337]

Furthermore, all of the reported cases dealing with profit sharing have looked to the broker's intentional conduct in finding a violation. In *District Bus. Conduct Comm. v. Amsel*, No. C10930016, 1995 NASD Discip. LEXIS 215, at *54 (N.B.C.C. June 26, 1995) (emphasis added), NASD concluded that a Rule 2330(f) profit-sharing charge must be based upon conduct by which "registered individuals seek to share in the profits generated in customer accounts." In *District Bus. Conduct Comm. v. Doshi*, No. C10960047, 1999 NASD Discip. LEXIS 6, at *5 (N.A.C. Jan. 20, 1999) upon which Enforcement relies heavily, the broker, "admitted that he 'agreed to guarantee his customer … against losses in return for a share in profits.'" An audiotape recorded the broker saying to his customer, "okay I am gonna charge you 25% of the profit [in the account] and the loss is mine. Loss is entirely mine."[338] The evidence established that the broker knew he was violating the rule: he told the customer that, "because of law violation" he could not put the offer in writing, and that the profit-sharing arrangement would be oral "because if letter goes in hands of NSD [sic] I lose license one minute."[339] In other words, NASD found a quid pro quo.

---

[337] Subparagraph (a) prohibits members from making "improper use of a customer's securities or funds"; subparagraph (b) requires members to adhere to an SEC rule on "possession and control of securities," and to maintain "appropriate cash reserves"; subparagraph (c) prevents members from lending customers' securities without the customer's "written authorization"; subparagraph (d) bars members from holding customer's securities unless the securities are "segregated" or separately "identified" as the customer's; subparagraph (e) prohibits members from guaranteeing customers against losses. Subparagraph (f) prohibits members from sharing in customers' profits, except under specified circumstances.

[338] *Doshi*, No. C10960047, 1999 NASD Discip. LEXIS 6, at *2.

[339] *Id.* at *3.

In another case Enforcement relies on, *Richard J. Daniello*, 50 S.E.C. 42 (1989), the evidence likewise showed that the broker intentionally took a share of the profits in his customer's account.[340] "Daniello contributed one-half of the initial capital in [the customer's] account, and received one-half of the profits."[341] Further, the SEC found that the profits were paid, not in commissions, but through a series of accounts and cashiers' checks that the broker intentionally used to conceal the payments.[342]

To the same effect is *Department of Enforcement v. Reynolds*, No. CAF990018, 2001 NASD Discip. LEXIS 17 (N.A.C. June 25, 2001), the case Enforcement contends most supports its theory. There, the National Adjudicatory Council ("NAC") found that the broker intentionally shared in a customer's losses, a fact the broker did not dispute. The account belonged to the broker's grandfather, and the broker transferred $200,000 in stock into the account because, in his words, "I had lost some money in my granddad's account, and I felt bad and I wanted to put something back in it."[343] The NAC concluded, "A broker who contributes his own assets (whether received as compensation or a loan) because he wants 'to put something back in' to offset trading losses is 'sharing' those losses in any sense of the word."[344] Contrary to Enforcement's interpretation of *Reynolds*, the NAC did not premise liability on unintentional and unknowing conduct.[345]

---

[340] *Daniello*, 50 S.E.C. at 45 ("It is undisputed that Daniello received a share of profits realized in [the customer's] account.").

[341] *Id.*

[342] *Id.* at 43, 45.

[343] *Reynolds*, 2001 NASD Discip. LEXIS 17, at *56.

[344] *Id.* at *57.

[345] *Accord, Stephen Michael Sohmer*, NYSE Disc. Action 2002-156, 2003 NYSE Disc. Action LEXIS 35, at *16 (Apr. 3, 2003) (holding that to be guilty of profit sharing the broker must "knowingly engage[] in a corrupt profit-sharing scheme").

Enforcement further cites *Reynolds* for the proposition that Rule 2330(f) "contains no requirement for an antecedent agreement or for any particular motive."[346] But the fact that no particular "antecedent agreement" or "motive" is required does not mean that the Panel can disregard the element of intent. In *Reynolds*, the broker intentionally established an arrangement to share in the customer losses; to carry out that arrangement, he put assets into an account with the obvious, undisputed intent of covering losses in that account. There is no evidence of such an arrangement or intent in this case.

(b) Profit Element

Enforcement's argument that it need not prove that customers paid the inflated rate commission out of actual or realized profits also is not persuasive. Enforcement argues that limiting the Rule to mean only "realized" profit "would make its application haphazard and dependent upon the fortuitous timing of the realization event."[347] In support, Enforcement points out that the NASD sanction guideline for violation of the Free-Riding and Withholding Interpretation provides for the disgorgement of "transaction profits" defined as either "the greater of the immediate after market unrealized profit (the price determined to be the immediate after market price times the number of shares minus the public offering price) or the actual profit realized."[348] Enforcement also relies on Exchange Act § 21A(f), 15 U.S.C. § 78u-1(f), which defines "profit gained" and "loss avoided" for purposes of computing insider trading penalties as "the difference between the purchase or sale price of the security and the value of that security as measured by the trading price of the security a reasonable period after public dissemination of the nonpublic information."

---

[346] *Reynolds*, 2001 NASD Discip. 17, at *57.

[347] Enforcement's Post-Hr'g Br. at 13, n.50.

[348] NASD SANCTION GUIDELINES at 25, n.1 (2005).

However, both of the provisions Enforcement cites center on specific transactions, not activity with respect to a customer's account. In contrast, although a single transaction may evidence profit sharing, Conduct Rule 2330(f) specifically prohibits brokers sharing in the "account" of a customer. Campbell testified that the definition of account as used in the Rule did not refer to "just a select group of transactions." Rather, it means "the entirety of the account's activity."[349]

The distinction Campbell noted is significant because Enforcement did not have the necessary evidence to determine whether the Firm's customers made or lost money in their accounts as a whole.[350] Indeed, without the customers' prime brokerage accounts, and except for those transactions involving an immediate flip of IPO shares, Enforcement was not able to determine if the customers made a profit even at the transaction level.[351]

The controlling case law confirms the Panel's interpretation that Conduct Rule 2330(f) addresses realized rather than hypothetical profits. For example, in *District Bus. Conduct Comm. v. Amsel*,[352] NASD held that the Rule "is intended to address instances where registered individuals seek to share in the profits generated in customer accounts." Without question, the decision refers to actual as opposed to hypothetical profits. Similarly, in *District Bus. Conduct Comm. v. Doshi*, the decision referred to realized profits. The broker had "agreed to guarantee [the customer] against losses in return for a 25 percent share of [the] profits in the [customer's]

---

[349] Tr. 1873:22-1874:13 (Campbell).

[350] Tr. 1877:15-1878:13 (Campbell).

[351] Enforcement "does not contend that it is an element … that commissions paid by a customer be traceable to the amount of profit (actual or unrealized) of the customer .…" JX 14 ¶ 13 (Joint Stipulations).

[352] 1995 NASD Discip. LEXIS 215, at *54.

account," and "the 25 percent would be paid in cash."[353] The use of the word "cash" obviously refers to realized profit.

Another illustrative case is *District Bus. Conduct Comm. v. Davidson*, No. LA-4131, 1988 WL 858062 (Bd. Govs. Aug. 30, 1988), which held that commissions do not constitute "profits generated in customer accounts" for the purposes of NASD's profit sharing rule. In *Davidson*, the respondent had set up a partnership account in which he and his clients had agreed to share profits. The District Business Conduct Committee sanctioned Davidson for violating Article III, Section 19(f) of the Rules of Fair Practice, the predecessor to Conduct Rule 2330(f), because it concluded that his receipt of commissions had resulted in his sharing profits in excess of the proportionate share of his contribution to the account. The Board of Governors reversed the District Committee, stating:

> [W]e disagree with the District Committee's interpretation of Article III, Section 19(f). Specifically, we do not believe that the commissions that Davidson received in connection with the Alpha account constituted "profits" for purposes of Section 19(f). . . . It is our view that Section 19(f) was not intended to prohibit a representative who contributed to an account from receiving agreed-upon commissions in excess of his proportional share of the account's trading profits or losses.[354]

In short, the foregoing cases make clear that, for a violation to be found, Enforcement must show that the Firm shared actual profits in its customer accounts, which the evidence fails to establish.

---

[353] *Doshi*, 1999 NASD Discip. LEXIS 6, at *3, *5.

[354] *Davidson*, 1988 WL 858062, at *3.

2. Post-Conduct Settlements

Enforcement also relies on two SEC settlements: *SEC v. Robertson Stephens*, *Inc*., No. 03cv27(RCL) (D.D.C. Jan. 9, 2003) (final judgment accepting settlement)[355] and *SEC v. Credit Suisse First Boston Corp*., No. 02cv90(RWR) (D.D.C. Jan. 22, 2002) (final judgment of permanent injunction and other relief).[356] Enforcement argues that these settlements show that the SEC would view the conduct in this case to violate Conduct Rules 2110 and 2330(f). That is, Enforcement contends that the Panel can rely on the two settlements as evidence of the SEC's view that "a member firm's sharing customers' IPO profits through its receipt of inflated commissions violates NASD 2330(f) and 2110."[357] Enforcement asserts that the Panel should give the settlements great consideration because the SEC authorized the underlying federal court actions and hence they carry the SEC's "imprimatur."[358]

The Panel finds, however, that the *Robertson Stephens* and *CSFB* settlements are distinguishable on their facts. Therefore, regardless of the appropriate weight to be given to such settlements in general,[359] they do not support Enforcement's contentions in this case.

As the Complaints and press releases reveal, Robertson Stephens and CSFB demanded and extracted profit-sharing arrangements and quid pro quos from their customers.[360] The evidence regarding the *Robertson Stephens* case shows: (1) Robertson Stephens pressured customers to increase commissions in order to obtain IPO allocations; (2) a Robertson Stephens

---

355 CX 23

356 CX 50.

357 Enforcement's Post-Hr'g Br. at 16.

358 *Id.*

359 Because the Panel found the *Robertson Stephens* and *CSFB* settlements inapposite, the Panel did not reach the legal issue of whether such settlements have precedential value.

360 *E.g.*, CX 23 at 2, 4, 7, 11; CX 50 at 1-2, 4, 8-9; *see also* Tr. 4315:15–4325:3 (Coffee).

broker told a customer what liquid security to use for a commission-generating offsetting trade; and (3) Robertson Stephens' management was informed that the firm's brokers were sharing in their customers' profits. Indeed, the Complaint against Robertson Stephens alleges that its internal documents showed that Robertson Stephens had imposed actual quid pro quo arrangements on its customers.[361]

Likewise, the *CSFB* case involved wrongful demands that customers pay a large portion of their profits to CSFB in order to receive IPO allocations. If customers refused, CSFB denied them allocations. Moreover, CSFB's internal documents showed that CSFB had set ratios for its customers. If a customer's IPO-profit-to-commission ratio was too high, CSFB demanded that it be reduced.[362] In short, *CSFB* involved express and coerced profit-sharing deals not present here.

The present case involves none of the wrongful conduct present in the *Robertson Stephens* and *CSFB* cases.

In conclusion, Enforcement did not show by a preponderance of the evidence that the Firm shared in the profits of its customer accounts. Accordingly, the Panel dismisses the first cause of action.

B. Ethics Charge

In its second cause of action, Enforcement alleged that the Firm violated Conduct Rule 2110 by accepting inflated commission payments made by customers to try to influence the Firm to allocate IPO shares to them, independent of whether the payments constituted profit sharing or contravened generally accepted industry norms.[363] Enforcement argued that the receipt of inflated

---

[361] CX 23 at 2, 4, 7, 11.

[362] CX 50 at 1-2, 4, 8-9.

[363] Compl. ¶ 50.

rate commissions violated Conduct Rule 2110 because they were paid for the customers' improper purpose—to influence the Firm's allocation of IPO shares.[364]

1. NASD Conduct Rule 2110

NASD Conduct Rule 2110 provides: "A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade." The origin, purpose, and scope of Rule 2110 rest at the core of self-regulation. Rule 2110's language of "just and equitable principles of trade" comes directly from the preamble of the Maloney Act, the 1938 amendment to the Exchange Act that sought to regulate the over-the-counter securities market.[365] Congress incorporated the Maloney Act into the Exchange Act as Section 15A, which provides the authority to create self-regulatory organizations such as NASD.[366]

The legislative history of the Maloney Act makes clear that its purpose was to respond to the perceived abuses in the over-the-counter market by establishing a system of self-regulation that would uphold "just and equitable principles of trade." In presenting the statute, the Senate Committee on Banking and Currency identified two alternative avenues to regulation of the over-the-counter market—either an increased role for the SEC or a system of "cooperative regulation" in which the exercise of supervision would be handled by industry members themselves. In a move that heralded the philosophy of self-regulation, the Committee recommended the latter option—to "enable the people of this business to guide and direct the affairs of their own industry under governmental supervision. It is intended to provide a way to

[364] Bill of Particulars at 1–2.

[365] Pub. L. No. 719, Ch. 677, 52 Stat. 1070, 1070 (1938).

[366] *See generally* Tr. 4283:8-17 (Coffee).

prevent acts and practices inconsistent with just and equitable principles of trade … [to afford the industry] the chance to make their own rules and to impose their own penalties."[367]

Thus, from the outset, the concept of "just and equitable principles of trade" was grounded in the enforcement of industry norms.[368] The core concept of unethical conduct under "just and equitable principles of trade" has always been the requirement that customers be dealt with "in accordance with the standards of the profession."[369] As NASD has underscored, the ethical standards imposed by NASD's Conduct Rules, and particularly Rule 2110, in a broad sense, depend on general rules of fair dealing and marketplace practices.[370] Thus, "[i]f no other rule has been violated, a violation of Rule 2110 requires evidence that the respondent acted in bad faith or unethically."[371] Such evidence must establish "misconduct [that] reflects on the [respondent's] ability to comply with the regulatory requirements of the securities business and to fulfill his fiduciary duties in handling other people's money."[372] "The principal consideration is whether the misconduct reflects on an associated person's ability to comply with regulatory

---

[367] *See* S. REP. NO. 1455, 75th Cong., 3d Sess. 3-4, 7 (1938); *see also* Tr. 4283:5–4284:16 (Coffee).

[368] *See* Statement of Policy of the Director of the Division of Trading and Markets Regarding the Comparability of NASD and SECO Regulation and the Relevance of Published NASD Standards and Rules of Conduct to Nonmember Broker-Dealers and Their Associated Persons, Exchange Act Release No. 9420, 1971 SEC LEXIS 245, at *12 (Dec. 20, 1971) (noting that "the evolutionary development of business ethics has occurred through the disciplinary route where conduct recognized as patently contrary to professional standards has been found, but where, for example, the *applicable norms* previously were not or could not readily be reduced to written rule or guidelines") (emphasis added).

[369] *Duker & Duker*, 6 S.E.C. 386, 388-89 (1939), *quoted in Department of Enforcement* v. *Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at *24 (N.A.C. June 2, 2000). The SEC has described the "broad ethical principle" in "just and equitable principles of trade" to present "the question … whether the member's conduct in question violates standards of fair dealing." *Samuel B. Franklin & Co.*, 38 S.E.C. 113, 116 (1957) (reversing NASD discipline for member's failure to make good delivery of stock).

[370] *See, e.g., Shvarts*, 2000 NASD Discip. LEXIS 6, at *12.

[371] *Chris Dinh Hartley*, Exchange Act Release No. 50031, 2004 SEC LEXIS 1507, at *10 n.13 (July 16, 2004) (citation omitted).

[372] *Daniel D. Manoff*, Exchange Act Release No. 46708, 2002 SEC LEXIS 2684, at *11-12 (Oct. 23, 2002).

requirements necessary to the proper functioning of the securities industry and protection of the public."[373]

2. Expert Testimony

Enforcement relied on Bogle's opinion that the Firm's receipt of inflated rate commissions was unethical.[374] Bogle testified that the payment of inflated rate commissions was "bribe-like," and, therefore, manifestly contrary to universally accepted standards of conduct.[375] In addition, Bogle considered the practice of allocating new issues to customers who pay many times normal commission rates unethical and a violation of NASD Conduct Rule 2110.[376]

Bogle is a man of exceptional accomplishment and stature. His extraordinary accomplishments have been recognized repeatedly. He has received 20 awards and 9 honorary degrees in recognition of his contributions to the financial services industry and investors. In 2004, Time Magazine named him one of the most important and influential people in the world. Throughout his career, Bogle has had an abiding interest in business ethics. He has written and lectured on ethics, and he has assumed a position as one of the mutual fund industry's greatest critics.[377] Without question, Bogle's opinions are worthy of very thoughtful consideration.

---

[373] *Department of Enforcement v. Davenport*, No. C05010017, 2003 NASD Discip. LEXIS 4, at *9 (May 7, 2003).

[374] Enforcement stipulated that, as of the time of the Complaint, NASD had not specifically stated in any publication or rule that it was unethical for a member firm to accept inflated commissions from customers who were attempting to influence the firm to allocate IPO shares to them. JX 14 ¶ 18.

[375] Tr. 2437:6-8 (Bogle); CX 31 at 1 (Bogle report).

[376] CX 31 at 1 (Bogle report).

[377] Tr. 2435:11-24 (Bogle). On the other hand, Bogle admitted that he is not an expert on NASD's Conduct Rules or on IPOs. Tr. 2433:3-5, 2465:19-21, 2507:12-17, 2543:14-15 (Bogle).

(a) Commercial Bribery Analogy

The Panel does not believe that the analogy of the present case to commercial bribery withstands scrutiny. By definition, commercial bribery requires two elements not alleged in this case—a quid pro quo agreement (by which the payment is exchanged for a requested act), and a breach of a duty of loyalty owed by the recipient.[378] The second element—breach of fiduciary duty—is of particular significance because it has been considered the foundation of the offense of commercial bribery.[379] "[C]ommercial bribery was criminalized on the theoretical premise that such acts represent a violation of the duty of loyalty that an [agent] owes to [a principal]."[380] Accordingly, to take the applicable New York statute as an example, the receipt of a bribe occurs

> when, without the consent of his employer or principal, [an employee or agent] solicits, accepts or agrees to accept any benefit from another person upon an agreement or understanding that such benefit will influence his conduct in relation to his employer's or principal's affairs ….[381]

Here, there is no evidence that the Firm breached any fiduciary duty in allocating IPOs during the relevant period, which Enforcement's other experts recognized.[382]

Moreover, Bogle admitted on cross-examination that firms have to allocate shares when IPOs are hot, and if they do so in their business judgment to their best customers, such practice is ethical.[383] Brokers are free to allocate IPO shares in their discretion. As an advisory committee of NASD and the NYSE stated in 2003, "Unless such an allocation constitutes spinning, an

---

[378] *See* RX 2 at 102-03 (Coffee report).

[379] Note, *Bribery in Commercial Relationships*, 45 HARV. L. REV. 1248, 1249 n.10 (1932).

[380] *United States v. Parise*, 159 F.3d 790, 799-800 (3d Cir. 1998).

[381] N.Y. PENAL LAW § 180.08.

[382] Tr. 1782:14-17 (Campbell); 2186:12-13 (Raha). *See also* RX 2 at 102-03 (Coffee report); Tr. 3269:19–3270:3 (Warther) (not like bribery since "[f]rom an economic perspective there's been no showing that [the Firm] was acting as an agent and had a duty to some sort of principal that it violated").

[383] Tr. 2492:23–2493:13 (Bogle).

unlawful quid pro quo or other prohibited conduct, the underwriter may allocate IPO shares to customers as it chooses"; it may freely allocate "shares to [its] best customers in order to maintain client relationships."[384]

The Panel concludes that the conduct in question here cannot be condemned as unethical by analogizing it to commercial bribery. As shown above, the commercial bribery label is inapposite. However, this determination does not end the Panel's inquiry. While Bogle's opinion rests foremost on his judgment that the payments were tantamount to commercial bribery, he also urges an independent rationale that hinges on a distinction between the nature of the business conducted by "customers" versus "clients."

(b) Customer–Client Dichotomy

Bogle's testimony was at heart a broad-based criticism of the IPO allocation system. Bogle believes that the securities industry has "lost its way," and he hoped to speak out in this case against the industry's acceptance of the status quo.[385]

Bogle starts with the premise that the securities industry should favor "client" relationships over "customer" relationships. Bogle defines the difference as follows:

> A client … is someone with whom you have a long-term, established relationship based on mutual trust. And a customer is someone who goes from place to place, looking for the latest deal. There's no issue of loyalty. There's no issue of trust. There's no issue of trusting or being trusted, in a customer's sense. And in a client, those things are everything.[386]

---

[384] RX 185 at 9865, 9868 (NYSE/NASD IPO ADVISORY COMMITTEE REPORT AND RECOMMENDATIONS 10, 13 (May 29, 2003)).

[385] Tr. 2438:2-19 (Bogle).

[386] Tr. 2596:22–2597:7 (Bogle). Bogle testified that this was an ethically required distinction. Tr. 2495:2-21 (Bogle).

In Bogle's opinion, because client relationships rest on mutual trust, those relationships are inherently more ethical and consistent with the sound functioning of the system of financial markets. Thus, Bogle concludes, favoring clients over customers enhances the integrity of the financial markets, and the greed associated with "customers" jumping from firm to firm to maximize their returns from hot new issues undermines investors' trust. In addition, Bogle postulates that if you generalize the practice of allocating hot new issues to those who lack a long-term relationship with their broker-dealer, the result is a chaotic and unethical market system.[387]

Bogle explained his opinion as follows:

> [A]ny sound market system depends, finally, upon integrity. Strike a blow at the confidence of investors and the marketplace is impaired. Allocate new issues, not by fair but by foul means, and the value of trusting and being trusted is debased. When the rules of the game are massaged to enable privileged investors to buy their way into "free rides"[388] on new issues by paying grossly excessive commission rates on their regular trades, the market system is abased.[389]

Bogle's opinion is more far reaching than Enforcement's theory in this case. Bogle considers troubling all efforts by customers to enhance their relative access to hot new issues through increased commissions, and he considers it antithetical to the sound functioning of financial markets for broker-dealers to accept this business. For example, Bogle testified that it is improper for a firm to accept commission rates as low as three cents per share from a mutual

---

[387] Tr. 2461:3-11 (Bogle). Bogle bases his opinion in part on Immanual Kant's "categorical imperative," which states that for ethical conduct "act so that the consequences of your actions can be generalized without self-contradiction." *See* CX 31 at 2 (Bogle report).

[388] By free ride, Bogle meant that, in the IPO environment of the late 1990's, profits were just "lying on the table" for purchasers of new issues because there was little or no market risk associated with their purchase. Tr. 2447:9-15 (Bogle).

[389] CX 31 at 2 (Bogle report).

fund that wants IPOs when it could have paid a half a cent.[390] Under Bogle's paradigm, the key is the payment of money to influence allocations. He testified that it is unfair for the allocation process to be shaped by "extra payments."[391] The better system, according to Bogle, is to permit firms to reward their best, long-term clients with hot new issues even if the client, such as a mutual fund, intentionally aggregates business to garner increased allocations.[392]

Bogle's bottom line is that the IPO allocation system breaks when greedy individuals are willing to pay higher-than-normal commissions in order to receive certain profits during a crazed IPO market. In his opinion, such unseemly behavior by customers and firms alike tends to erode investor trust in the financial markets and therefore is unethical. Thus, Bogle calls for a total reform of the IPO allocation system.

While Bogle urges improvement in the IPO allocation system to eliminate the greed that undermines investor confidence, he recognizes that the determination of what an improved system would look like is complicated—much like writing an industry rule, a process that must take into consideration all competing viewpoints.[393] He personally favors a system where customers pay commission rates of no more than four and one-half cents per share although he sees that such a system would necessarily exclude some from the IPO market while favoring others (such as the large mutual funds) that can use their buying power to ensure a supply of hot

[390] Tr. 2479:21-25 (Bogle).

[391] Tr. 2450:6-12 (Bogle).

[392] Tr. 2448:21–2449:5, 2459:22–2460:13 (Bogle). Here again, Bogle places a significant degree of importance on the nature of the relationship between the broker-dealer and its client. For example, Bogle declares it unethical for a firm to allocate shares to a new institutional customer even where the customer had not paid commissions that were out of the norm although he admits that it is not an easy distinction to articulate. Tr. 2460:14–2461:11 (Bogle). At another point, however, he hints that it might be acceptable if the new customer wanted to develop a long-term relationship. Tr. 2553:5-12 (bogle). In addition, Bogle could not quantify the meaning of "long-term." Tr. 2463:20–2465:3 (Bogle).

[393] Tr. 2521:13–2522:7, 2553:19–2554:20, 2560:6–2561:2 (Bogle).

new issues. This resulting inherent bias does not concern Bogle because the surefire IPO profits are going to those clients that conduct what he defines as "normal" business.[394] On the other hand, he testified that he is not in a position to proscribe a better system than letting the large mutual funds get all the IPO allocations.[395]

When Bogle was asked to apply his opinion to industry-accepted practices, he testified that he could not make an ethical determination without knowing the customers' motives. For example, when Bogle was asked about the ethics of a broker accepting a commission of 20 cents per share where the customer told the broker that he knew he could pay four and one-half cents per share, Bogle answered, "if it's a real bona fide client, I don't see a particular problem with that."[396] In other words, the result depends upon each customer's intent. Thus, before a firm accepted a commission, it would have to determine the customer's intent to avoid violating Conduct Rule 2110. Moreover, in some cases, Bogle admitted that the determination could only be made after a review of the customers' entire transactional history.[397]

The Firm challenges Bogle's customer-client dichotomy on several grounds. Apart from the fact that Bogle's definitions are not found in any published guidance, the Firm points out that Enforcement's application of the dichotomy is unworkable. The Firm questions Enforcement's premise that acceptance of otherwise lawful commission payments can be found to violate just and equitable principles of trade where Enforcement concludes that the customer had an underlying "improper purpose" to "try and influence" IPO allocations. The Firm demonstrates that application of this new standard would result in a system that permits member firms to

[394] Tr. 2448:21–2449:5 (Bogle).

[395] Tr. 2554:8-20 (Bogle).

[396] Tr. 2584:19-25 (Bogle).

[397] Tr. 2577:3–2578:4 (Bogle).

allocate IPO shares to their best customers, measured by commission business, but condemns as an improper purpose those payments made by customers to achieve best customer status. Moreover, under this approach, the firm accepting the inflated rate commissions violates Rule 2110 despite the fact that it did nothing to induce the payment. Under Bogle's analysis, the lack of any actual influence is irrelevant. Moreover, because Bogle focuses on the customer's motive, a violation can occur even if the customer fails in acquiring a larger allotment of IPO shares.

In conclusion, for the reasons stated, the Panel dismisses the second cause of action. In so doing, however, the Panel does not express an opinion on the fairness of the current IPO allocation system. Indeed, Bogle raises a number of probing questions about the manner in which the IPO allocation system functions throughout the industry. But that issue is outside the scope of this hearing. Industry reform and standard setting are not functions within the province of an NASD hearing panel.[398]

C. Corporate Finance Charge

The third cause of action alleges that the Firm failed to file information and documents required by Conduct Rules 2710(b)(1) and (5) for each of the more than 50 IPOs between October 1999 and March 2000. Specifically, the Complaint alleges that the Firm failed to file information and documents reflecting that it received excessive commissions and engaged in profit sharing with its customers in connection with IPOs.

[398] *Cf. General Bond & Share Co.* v. *SEC*, 39 F.3d 1451, 1459-60 (10th Cir. 1994) (holding that establishment of new standards are "rule changes" that must first be submitted to the SEC for approval under the Exchange Act).

1. NASD Conduct Rule 2710

NASD's Corporate Financing Rule, Conduct Rule 2710,[399] regulates underwriting terms and arrangements. The Rule requires NASD members to file specified documents and other information with NASD before they participate in an IPO or certain other public offerings.[400] The NASD Corporate Financing Department then reviews the submitted information with an emphasis on the underwriting terms and arrangements, including the underwriters' compensation.[401] The Rule prohibits members from receiving an amount of underwriting compensation that is unfair or unreasonable, and from underwriting or participating in a public offering of securities if the underwriting compensation is unfair or unreasonable.[402]

The purpose of the Corporate Financing Rule is to ensure that underwriters do not take advantage of issuers by charging too much for taking them public.[403] Thus, underwriting compensation is the focus of the Corporate Financing Department review.[404] The Rule also protects investors because it assures that investor funds are going to be used by the issuers for their business plans and are not siphoned off in the underwriting process.[405]

Conduct Rule 2710(c) defines underwriter compensation by both amount and item. Under Rule 2710(c)(2), members are prohibited—in connection with a public offering—from

---

[399] RX 251 (Conduct Rule 2710 (2000)). All references to the Corporate Financing Rule are to the 2000 version, which was in effect during the relevant period. Subsequently, NASD renumbered the Rule without substantive change to the provisions relevant to this proceeding.

[400] Conduct Rule 2710(b) governs the filing requirements, and Rule 2710(b)(5) specifies the documents members participating in an offering covered by the Rule must file.

[401] Tr. 2706:17-23, 2709:17-22 (Price). In contrast, the SEC concentrates its review on the issuer's management and financial statements.

[402] Conduct Rule 2710(c)(2)(A).

[403] Tr. 2716:3-16 (Price).

[404] Tr. 2781:9-13 (Price).

[405] Tr. 2716:3-16 (Price).

receiving an amount of compensation that is unfair or unreasonable. The Rule further states that the amount of compensation is determined by including all items of value[406] received (or to be received) by the underwriter or related persons from any source where the items are deemed to be received "in connection with or related to the distribution pursuant to subparagraphs (3) and (4)."[407] Subparagraph 3 defines "Items of Compensation," and subparagraph 4 sets out the standards for determining whether compensation is "received in connection with the offering."

Under the definitional scheme of Conduct Rule 2710(c), the critical inquiry is whether the particular item under review can be deemed to be connected or related to the distribution. The Rule addresses this factor both temporally and contextually. As to the former, the Rule establishes a presumption that items of value received by the underwriter during the 12-month period immediately preceding the filing of the offering registration statement are related sufficiently to the offering so that they are included in the computation of underwriter compensation.[408]

With respect to the second criterion, context, the Rule directs consideration of a number of specific factors, as well as other unspecified relevant facts and circumstances. The enumerated factors give strong indication of the Rule's intended reach. First, the Rule directs that the Corporate Financing Department consider the length of elapsed time between the registration statement and the receipt of the item under review. Second, the Rule directs the Corporate Financing Department to consider the nature of the services provided in return for the item of value under review. Third, the Rule directs the Corporate Financing Department to consider the

[406] "Items of value" is not a defined term under the Rule, but Price testified that it is understood generally to mean "any item that is going to benefit the underwriters." Tr. 2718:3-9 (Price).

[407] Conduct Rule 2710(c)(2)(B).

[408] *See* Conduct Rule 2710(c)(4)(A).

relationship between the services provided and: (1) the nature of the item of value; (2) the compensation value of the item; and (3) the proposed public offering. Finally, the Rule directs the Corporate Financing Department to consider the presence or absence of arm's length bargaining, or the existence of any affiliate relationship between the issuer and the recipient of the item of value.

2. Expert Testimony

Joseph E. Price ("Price"),[409] the head of NASD's Corporate Financing Department, testified that—assuming that the Firm was sharing in the profits of its customers—the excessive commission payments (or inflated rate commission payments) paid by customers on agency trades of listed securities were underwriting compensation under Rule 2710 because they were paid to the Firm to influence [its] IPO allocations.[410] On the other hand, Price testified that he would change his opinion if the Firm had not engaged in profit sharing.[411]

Price's expert opinion testimony is critical to the third cause of action because there is no other authority for Enforcement's theory. Not only has NASD never published any interpretation of the Corporate Financing Rule concluding that all agency commissions paid by customers within three business days of an IPO must be reported as possible underwriting compensation,[412] but no one has ever done so.[413] In fact, Price had no knowledge of a single underwriter or law

[409] Price is the Vice President in charge of the NASD Corporate Financing Department. He has headed the department since 1998. Before joining NASD, Price worked for the SEC where he held various positions within the Office of General Counsel, including Assistant General Counsel with responsibility for issues arising from the Division of Corporation Finance. He has also been an Adjunct Professor at the Georgetown University Law School where he taught securities regulation. *See* CX 35 (Price report).

[410] Tr. 2758:6-13 (Price).

[411] Tr. 2795:5–2796:11 (Price).

[412] Tr. 4499:3-9 (Price).

[413] Tr. 4525:10-15 (Price).

firm to an underwriter ever recognizing this disclosure obligation.[414] Frank J. Formica[415] ("Formica"), the Firm's expert on the Corporate Financing Rule, confirmed Price's statement. Formica testified that commissions of any amount have never been considered to constitute underwriting compensation.[416] Rather, aftermarket pricing and transactions have been covered by the NASD Free-Riding and Withholding Interpretation, IM–2110–1 (now Conduct Rule 2790).[417]

Without proof of profit sharing, the Panel finds no violation of the Corporate Financing Rule. Absent the requisite nexus to an underwriting, the subject commission payments do not constitute underwriting compensation. The Panel therefore dismisses the third cause of action.

D. Books and Records Charge

The fourth cause of action alleges that the Firm failed to reflect accurately in its books and records that the Firm shared in its customers' profits in violation of Section 17(a) of the Exchange Act, Rules 17a-3(a)(1), (2), and (6), and NASD Conduct Rules 2110 and 3110.[418] Exchange Act Rule 17a-3 requires broker-dealers to make and keep records of all purchases and sales of securities, and of all income and expense and capital accounts; and to make and keep current a memorandum of each brokerage order that shows, among other things, the terms and conditions of the order.[419] In turn, NASD Conduct Rule 3110(a) requires members to comply

---

[414] Tr. 2943:15-23 (Price).

[415] Formica worked at NASD for 30 years. He began his career as an attorney in the Office of General Counsel. In 1984 he was appointed Director of the Corporate Financing Department. He held that position until 1990 when he was appointed Director of NASD's Congressional and State Liaison Department. Currently Formica serves as a retained consultant in connection with various litigation and arbitration matters, primarily involving NASD rules and regulatory issues. RX 3 at 125-29 (Formica report).

[416] RX 3 at 139 (Formica report).

[417] *Id.* at 162. Enforcement stipulated that the Firm never violated the Free-Riding and Withholding regulations. JX 14 ¶ 16.

[418] Compl. ¶ 58.

[419] 17 C.F.R. § 240.17a–3(a)(1), (2), and (6).

with Exchange Act Rule 17a-3. Enforcement's claim is that the Firm should have recorded as profit-sharing payments the 695 Schedule A-35 transactions that the Firm recorded as commissions.

The Firm contends that it properly booked all of its income. In support, the Firm presented the expert opinion testimony of Charles R. Lundelius, Jr. ("Lundelius"),[420] an accountant with FTI Consulting Inc., who reviewed the Firm's financial statements prepared by its independent auditors, Goldstein Golub Kessler LLP ("GGK"). GGK issued unqualified opinions on the Firm's financial statements,[421] which GGK filed with the SEC pursuant to Section 17(a) of the Exchange Act and Exchange Act Rule 17a-5.[422] The Firm's financial statements reflected the commissions at issue under a separate line item specifically denominated "commissions."[423]

Lundelius testified that the Firm and GGK properly classified the challenged payments as commissions and that the commissions could not be accounted for under another income category, such as "profit sharing."[424] In his opinion, the Firm's books and records accurately recorded the challenged payments as "commissions" in accordance with generally accepted accounting principles ("GAAP") and generally accepted auditing standards ("GAAS").[425]

---

[420] Lundelius is a Senior Managing Director of FTI, a thousand-member financial consulting firm that specializes in restructuring, forensic accounting, and economic analyses. Tr. 4116:8-11 (Lundelius); RX 7 at 914-16 (Lundelius report). He is a Certified Public Accountant with 20 years of experience. He has specialized expertise in financial institutions and broker-dealers, and he has experience with running an NASD member firm. In addition, Lundelius is a member of the NASDAQ Listing Panel. Tr. 4117:23-4119:15 (Lundelius).

[421] RX 79 at 6026-35; Tr. 1607:2–1608:7 (JB).

[422] Tr. 1608:3-20 (JB); RX 79 at 6024-6026.

[423] RX 79 at 6028.

[424] Tr. 4119:19–4120:9; RX 7 at 911 (Lundelius report).

[425] Tr. 4128:2-8; 4128:24–4129:8 (Lundelius); RX 7 at 913-14 (Lundelius report).

Enforcement, on the other hand, presented no evidence of any irregularities in the Firm's books and records apart from its judgment that the inflated rate commission payments were not bona fide commissions and were instead profit-sharing payments.

The Panel concludes that Enforcement failed to prove a violation of Section 17(a) of the Exchange Act, Exchange Act Rules 17a-3(a)(1), (2), and (6), or NASD Conduct Rules 2110 and 3110. The inflated rate commission payments did not constitute profit-sharing payments; therefore, there is no factual basis for Enforcement's contention that the Firm's books and records were inaccurate. And Enforcement points to no standard requiring a broker-dealer to classify items of income based on its customers' intent in doing business with the firm. Accordingly, the Panel dismisses the fourth cause of action.

E. Supervision Charges

In the fifth and sixth causes of action, Enforcement charges that the Firm: (1) failed to follow up on numerous indications of problems, or "red flags," regarding profit sharing and the allocations of IPO shares, in violation of Conduct Rules 3010(a) and 2110; and (2) failed to establish, maintain, and enforce an adequate supervisory system and written supervisory procedures regarding the receipt of commissions and the allocation of IPO shares, in violation of Conduct Rules 3010(b) and 2110.[426]

1. Conduct Rule 3010

Conduct Rule 3010(a) requires each member to establish and maintain a supervisory system that is reasonably designed to achieve compliance with applicable securities laws and

[426] The Complaint further charges that these violations constitute violations of Conduct Rule 2110. *See, e.g., Department of Mkt. Regulation. v. Castle Sec. Corp.*, No. CMS030006, 2005 NASD Discip. LEXIS 2, at *16 n.14 (N.A.C. Feb. 14, 2005) ("Any violation of an NASD rule such as … Rule 3010, is also a violation of Conduct Rule 2110.").

rules. Under this Rule, members are required to "set forth the applicable rules and policies that must be adhered to and describe specific practices that are prohibited."[427] The supervisory system must be tailored specifically to the member's business and must address the activities of all of its registered representatives and associated persons.[428]

Conduct Rule 3010(b) requires each member to establish, maintain, and enforce written supervisory procedures that are reasonably designed to ensure such compliance.[429] A firm's written supervisory procedures memorialize a firm's supervisory system; they "describe the actual supervisory system established by the firm to achieve compliance with applicable rules and regulations."[430] Hence, the written supervisory procedures should include a description of the controls and procedures the firm uses to deter and detect improper activity.[431]

However, the standard set in Conduct Rule 3010 does not require a supervisory system that guarantees firm-wide compliance with all laws and regulations.[432] The governing principle is that the written supervisory procedures must be reasonable under the particular facts and circumstances of the case at issue.[433] "The duty to exercise reasonable, effective supervision has never been construed to be an absolute guarantee against every malfeasance by errant subordinates."[434] Nevertheless, when presented with "red flags," supervisors are obligated to act

---

[427] NASD Notice to Members 99-45, 1999 NASD LEXIS 20, at *3 (June 1999).

[428] *Id.* at *4.

[429] Reference to Conduct Rule 3010 is to the version of the Rule in effect in 1999 and 2000.

[430] NASD Notice to Members 98-96, 1998 NASD LEXIS 121, at *6 (December 1998).

[431] *Id.*

[432] NASD Notice to Members 99-45, 1999 NASD LEXIS 20, at *10.

[433] *See La Jolla Capital Corp.*, Exchange Act Release No. 41755, 1999 SEC LEXIS 1642, at *13 (Aug. 18, 1999); *see also Department of Enforcement v. Lobb*, No. C07960105, 2000 NASD Discip. LEXIS 11, at *16 (Apr. 6, 2000) (citation omitted).

[434] *Dean Witter Reynolds Inc.*, Initial Decisions Release No. 179, 2001 SEC LEXIS 99, at *168 (Jan. 22, 2001) (quoting *James Harvey Thornton*, 53 S.E.C. 1210, 1219 (1999)).

decisively, with appropriate follow-up, to detect and prevent violations of securities laws and rules.[435]

2. Failure to Supervise Charge

The fifth cause of action charges that "[Firm] supervisors failed to follow up on numerous red flags … that [Firm] customers were sharing a portion of their IPO profits with the firm or that customers were paying inflated commissions to try and influence the firm to allocate IPO shares to them," and that "[t]hese red flags reasonably should have caused [the Firm's] supervisors to follow-up and investigate."[436] The fifth cause of action further charges that the Firm thereby violated Conduct Rules 3010(a) and 2110.[437]

Here, Enforcement rests liability under the fifth cause of action on Enforcement's determination that the inflated rate commission payments constituted "red flags" of profit sharing, which the Firm's supervisors ignored. The Panel disagrees with Enforcement's determination and therefore dismisses the fifth cause of action.

Enforcement repeatedly stressed that rates far below those specified in the Bill of Particulars could constitute profit sharing. Enforcement adopted the keystone rate of 20 cents per share for trades of 10,000 shares or more to filter information in the CSFB investigation. As Ozag testified, he devised the cutoff as a starting point in his analysis of a substantial amount of

---

[435] *Cf., e.g., Robert Grady*, Exchange Act Release No. 41309, 1999 SEC LEXIS 768, at *9 (Apr. 19, 1999) (finding violation of Section 15(b) of the Exchange Act when respondent failed to follow up on red flag); *see also, e.g., Department of Enforcement v. Levitov*, No. CAF970011, 2000 NASD Discip. LEXIS 12, at *26-27 (N.A.C. June 28, 2000) (finding supervisory violation under Conduct Rule 3010 when respondent failed to investigate red flags).

[436] Compl. ¶ 60.

[437] NASD Notice to Members 98-96, 1998 NASD LEXIS 121, at *5. *Cf. Dean Witter Reynolds Inc.*, 2001 SEC LEXIS 99, at *178-79 (finding no violation of Section 15(b) of the Exchange Act absent an underlying substantive violation).

data in that unrelated investigation. The rate he chose bears no relation to accepted industry practice or available regulatory guidance.

Moreover, the Panel notes that commission rates are far from uniform. Large institutions with substantial market power, such as Fidelity and Vanguard, can negotiate rates of less than one penny per share, yet they pay far more. And smaller institutional customers, such as the Firm's, pay varying rates, including rates that are higher than published retail rates. These smaller intuitional customers pay higher rates so that brokers will view them as valued customers. It is in this manner that smaller institutional customers compete for limited resources in a fierce competitive environment. Accordingly, the Panel concludes that commission rates higher than those paid by institutional customers as a whole are not intrinsically red flags of improper conduct.

The Panel further notes that there has never been any guidance from NASD indicating that member firms must treat commissions as red flags of profit sharing.[438] There are no publications that set forth the approach Enforcement urges the Panel to apply against the Firm. Nor are there any reported cases holding that a supervisor can be faulted for failing to investigate the circumstances surrounding the payment of customer-set commissions that do not otherwise violate the securities laws or regulations.[439]

Equally basic is the fact that there has never been a requirement for supervisors to question institutional customers about their motivation in setting commission rates on unsolicited agency trades. Such surveillance is not a part of accepted compliance practices and systems.[440]

[438] JX 14 ¶ 17 (Joint Stipulations).

[439] *Cf., e.g., George M. Lintz*, Exchange Act Release No. 43961, 2001 SEC LEXIS 264, at *5 (Feb. 14, 2001) (past SEC decisions had clearly indicated that payment to an unregistered entity was an irregular arrangement and thus should have served as a red flag).

[440] RX 5 at 659 (Kern report).

Indeed, the Panel concludes that a supervisory system that would require supervisors to discern their customers' motivations in setting commissions would be impractical and unreasonable. Further, the Panel notes that the evidence shows that had the Firm made such an inquiry, each customer would have denied a profit-sharing motive. Thus, such an inquiry would have yielded no evidence of possible misconduct.

In addition, there is no evidence of non-compliance with the Firm's written supervisory procedures.[441] Indeed, the evidence shows that the Firm followed its prescribed policies without exception. It conducted annual compliance reviews, and each broker signed an annual certification that he had not engaged in profit sharing. Furthermore, the supervisors reviewed daily the reports they received from Bear Stearns, which reports did not breakout the commissions on a cents-per-share basis. The Firm reasonably supervised its operations using the reports supplied by Bear Stearns, and at no point did NASD bring a supervisory deficiency to the Firm's attention.[442]

In short, commission rates of 20 cents per share or more were not unusual at the Firm or at other firms. Accordingly, the mere receipt of commissions at those rates did not constitute red flags of improper conduct. Therefore, the Panel finds that Enforcement did not prove by a preponderance of the evidence that the Firm failed to supervise its registered representatives.

---

[441] *Quest Capital Strategies, Inc.*, Exchange Act Release No. 44935, 2001 SEC LEXIS 2147, at *15 (Oct. 15, 2001) (red flag indicated by violation of existing firm policies through "deliberately flout[ing] the firm's compliance policies").

[442] *Cf. IFG Network Sec., Inc.*, Initial Decisions Release No. 273, 2005 SEC LEXIS 335, at *6 (Feb. 10, 2005) ("red flags, such as exception reports, a deficiency letter from Commission staff, and a customer complaint").

F. Inadequate Supervisory System and Written Procedures Charge

The Panel finds that the Firm's written supervisory procedures relative to the issues in this proceeding were reasonably designed to ensure compliance with applicable securities laws and regulations, taking into consideration the nature of the Firm's business. The Firm prohibited negotiated commissions, quid pro quos involving allocations;[443] tie-ins between commissions and allocations;[444] linkages between allocations and aftermarket purchases of the securities being distributed;[445] linkages between allocations and cold offerings;[446] and spinning.[447] These policies are consistent with generally accepted industry standards.

The Firm implemented these policies, among other ways, by requiring all its employees to certify annually that they had not engaged in profit sharing. In addition, the Firm's supervisors reviewed each commission at least twice. Before December 1999, the Firm evaluated commissions under NASD's 5% Policy (IM-2440) and thereafter under its self-imposed, lower limits. As to IPOs, the Firm had a minimum of two levels of review for allocations and syndicate files.[448]

Enforcement presented no evidence of any shortcoming in any of the Firm's written policies and procedures relative to the charges in the Complaint. Accordingly, the Panel finds that Enforcement failed to prove by a preponderance of the evidence that the Firm failed to maintain and enforce an adequate supervisory system and written supervisory procedures.

---

443 Tr. 1620:224–1621:5 (JB).

444 Tr. 1621:6-9 (JB).

445 Tr. 1621:10-14 (JB).

446 Tr. 1621:15-18 (JB).

447 Tr. 1545:8-14 (JB); JX 3 at 158; JX 14 ¶ 16.

448 Tr. 1491:5–1492:4 (JB); JX 14 ¶¶ 77, 84.

V. ORDER

For the foregoing reasons, the Panel dismisses the Complaint.[449]

Andrew H. Perkins
Hearing Officer
For the Extended Hearing Panel

[449] The Hearing Panel has considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.