

This Order has been published by NASD's Office of Hearing Officers and should be cited as OHO Order 06-16 (C02040032).

NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
	:	
	:	
Complainant,	:	Disciplinary Proceeding
	:	No. C02040032
v.	:	
	:	Hearing Officer - SW
	:	
Respondent.	:	

ORDER DENYING MOTION TO DISMISS

On September 9, 2005, along with his post-hearing brief, Respondent filed a Motion to Dismiss the Complaint (“Motion”), alleging prosecutorial misconduct by the Department of Enforcement (“Enforcement”) because of a failure to follow the disclosure of evidence rules governing the proceeding. On September 30, 2005, Enforcement filed an opposition to Respondent’s Motion.

Finding (i) that Enforcement acted in compliance with a reasonable interpretation of Rule 9251, and (ii) that the delay in obtaining the particular documents constituted harmless error, the Hearing Panel denies Respondent’s Motion. The Hearing Panel Decision in this proceeding is being issued simultaneously with this Order.

I. Procedural Background

On August 16, 2004, Enforcement filed a three-count Complaint against Respondent. On April 13, 2005, the Hearing Officer granted Enforcement’s request to Amend the Complaint.

The three-count Amended Complaint set forth allegations of misconduct surrounding Respondent’s offer and sale of limited partnership interests in a private option fund titled

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Summit Asset Fund, L.P. ("Summit Fund" or the "Fund"). Count one of the Complaint alleges that Respondent solicited two customers, [Customer 1] and [Customer 2], through her son [], to purchase interests in the Summit Fund without disclosing certain material information about Fund, in violation of Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5 thereunder, and NASD Conduct Rules 2110 and 2120. Specifically, the Complaint alleges that, when soliciting Customer 1 and Customer 2, Respondent failed to disclose: (i) the Fund's operating losses since its inception; and (ii) the Fund's intent to permit the withdrawal of \$450,000, in violation of the Fund's terms of withdrawal, by [Trustee] as trustee for _____.

Count two of the Complaint alleges that Respondent recommended that Customer 1 and Customer 2 purchase the interests in the Fund without having reasonable grounds for believing that the investment was suitable for the customers, in violation of NASD Conduct Rules 2110 and 2310.

Count three of the Complaint alleges that Respondent participated in the sale of interests in the Fund to Customer 1 and Customer 2, without obtaining the prior approval of his employer, [Firm], in violation of NASD Conduct Rules 2110 and 3040.

The Hearing regarding these allegations was held in Los Angeles, CA, from May 24-27, 2005. At the conclusion of the Hearing on May 27, 2005, Enforcement requested that the Parties be permitted to file post-hearing briefs. In an Order dated May 31, 2005, the Hearing Officer set a deadline of no later than July 29, 2005 for Enforcement to file its brief, and a deadline of no later than August 29, 2005 for Respondent to file his brief.

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On August 22, 2005, Respondent filed a request for an extension to file his brief until September 6, 2005, which motion the Hearing Officer granted. On August 29, 2005, Respondent filed a second request for extension until September 9, 2005 to file his brief, which the Hearing Officer also granted.

On September 9, 2005, in addition to the post-hearing brief, Respondent filed separately the Motion. On September 23, 2005, Enforcement filed a request for leave to respond to the Motion, which was granted by the Hearing Officer. Enforcement filed its opposition to Respondent's Motion on September 30, 2005.

II. Allegations of Prosecutorial Misconduct

Respondent's Motion alleges that Enforcement failed to disclose certain documents, as required by Rule 9251, and presented tainted, inadmissible, hearsay evidence directly contradicted by the undisclosed documents.

Specifically, Respondent alleges that Enforcement failed to timely disclose:

- (1) The auditors' compilation report for the Fund's June 30, 2000 financial statements, which Enforcement had requested but not obtained;
- (2) A press release announcing Respondent's association with the Firm, as of May 2, 2000, which press release Enforcement obtained after its investigation was completed, in anticipation of the Hearing for use as rebuttal evidence;
- (3) A memorandum prepared by NASD investigator Horwitz regarding his conversation with the Trustee;

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(4) The Trustee's account documents, which documents Enforcement received from Mr.

_____ on the day that he testified; and

(5) Mr. _____'s emails, which he provided to Enforcement on May 19, 2005.

III. Enforcement's Response

Enforcement filed a response to Respondent's Motion accompanied by three affidavits, and a declaration of undisputed facts, which discussed in great detail the circumstances surrounding Enforcement's acquisition of the above-mentioned documents. Enforcement argued that it complied with the requirements of Rule 9251, and that, in any event, the failure to make the documents available timely was harmless error within the meaning of Rule 9251(g).

IV. Enforcement Complied with Rule 9251

Rule 9251(a) requires that unless otherwise provided by order of the Hearing Officer, Enforcement shall make available for inspection and copying by Respondent documents prepared or obtained by the staff in connection with the investigation that led to the institution of proceedings, i.e., the "Investigative File."

The auditors' report was not in the Investigative File. Enforcement is not required to disclose a document that it does not have. Respondent's primary argument seems to be that since Enforcement could have easily obtained a copy of the report by contacting the auditor, Enforcement should have tried harder to obtain the report in a timely manner, but nothing in NASD's rules imposes a duty on Enforcement to obtain materials it believes it does not need.

The press release was not part of the Investigative File that was the basis for issuing the Complaint. Enforcement obtained the press release after the investigation was completed and in

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anticipation of the Hearing, to be used as rebuttal evidence, if necessary. Rule 9251(a)(2) requires Enforcement to make available to a respondent any post-Complaint documents that it obtains pursuant to Rule 8210. In this instance, Enforcement did not utilize Rule 8210 to obtain the press release. The press release was publicly available and equally obtainable by Respondent via an internet search.

Rule 9251(a)(2) also provides that if the staff receives additional documents after the Complaint is filed in response to a Rule 8210 request, it must make those documents available to Respondent. If Enforcement receives the documents less than 10 days before the Hearing scheduled in the matter, and the additional documents are material and relevant to the disciplinary proceeding, Enforcement must make the documents available to Respondent immediately.

The Trustee account documents provided to Enforcement by Mr. _____ were relevant to this proceeding and provided in response to a Rule 8210 request. Although the Hearing Officer believes that the better procedure would have been for the staff to immediately announce that they had received additional documents, Enforcement elected to copy the documents and determine whether to make them available before advising Respondent of the existence of the documents. It was not unreasonable for the staff to do this, particularly since at the time the documents were received, counsel for Enforcement was participating in the Hearing.

Mr. _____'s emails were not the subject of a Rule 8210 request letter, and so Enforcement was not required to produce them under Rule 9251(a)(2). In any event, the emails

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were not material to the allegations of the Complaint, and Respondent had them in sufficient time to cross-examine Mr. _____ about the emails.

With regard to Mr. Horowitz's memorandum, Rule 9252(b) explicitly provides that Enforcement may withhold an internal memorandum or other note or writing prepared by an NASD employee that shall not be offered in evidence.

Absent an order from the Hearing Officer, Enforcement is not required to disclose NASD investigator notes unless (1) they are to be offered in evidence, or (2) they contain material exculpatory evidence. In this instance, the Hearing Officer ordered that the notes be disclosed because Mr. Horowitz referred to the notes during his testimony. Contrary to Respondent's characterization of the notes as contradicting Mr. Horowitz's testimony, the notes were consistent with the testimony and the other evidence presented at the Hearing that (i) the Trustee's monies were deposited in the Fund's trading account, and (ii) the Trustee wanted the monies returned if he decided "not to finish the investment."

The Hearing Panel finds that Enforcement's actions were consistent with Rule 9251. There was no prosecutorial misconduct, or presentation of tainted or inadmissible hearsay evidence.

V. Harmless Error

Rule 9251(g) provides that in the event that the NASD staff fails to make available to a respondent a document that it is required to make available under Rule 9251, the Respondent must establish that the failure was "not harmless error" in order to obtain relief. In this case,

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even assuming that Enforcement failed to comply with Rule 9251 with regard to the documents identified by Respondent, that failure was clearly "harmless error."

1. The auditors' report showed that the financial statements for the Fund were completed in November 2000, which was after Customer 2 and Customer 1 made their investments. Nevertheless, the evidence established that: (i) the Fund lost a significant amount of money prior to Customer 2 or Customer 1 investing in the Fund; (ii) Respondent was made aware of those losses; and (iii) in connection with Respondent's recommendation of the Fund and the facilitation of the investment in the Fund, Respondent did not advise Customer 2 or Customer 1 of the Firm's negative financial performance. The audited financial statements did not exist when Respondent solicited Customer 2 and Customer 1, but they are consistent with the evidence regarding the Fund's financial condition at that time. Accordingly, the auditors' report was not material, and Enforcement's failure to obtain the report and provide it to Respondent was harmless.

2. The obligation to comply with Rule 3040 becomes effective upon the execution of the Form U-4. In this case, the Form U-4 was executed on April 10, 2004. The May 2, 2000 date in the press release, therefore, is not relevant to a finding of liability for Rule 3040.

3. The memorandum of Mr. Horwitz's conversation with the Trustee indicated that the Trustee wanted his money held separate from the Fund. This memorandum was consistent with other evidence in the record, and was not inconsistent with any evidence relied upon by the Hearing Panel. In addition, the Hearing Officer instructed Respondent that he would be

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permitted to recall Mr. Horwitz to the witness stand if he had any additional questions after reviewing the notes, but Respondent elected not to recall him.

4. The Hearing Panel found it unnecessary to give any weight to the Trustee documents that Mr. _____ provided late in the Hearing.

5. Mr. _____'s emails were consistent with other evidence and Respondent's testimony that Respondent was intimately involved in the setting up of the Fund.

VI. Ruling

Accordingly, for the reasons set forth above, the Hearing Panel denies Respondent's Motion.

HEARING PANEL

by: Sharon Witherspoon
Hearing Officer

Dated: Washington, DC
February 1, 2006