

**NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,	:	
	:	
Complainant,	:	
	:	Disciplinary Proceeding
v.	:	No. CAF990007
	:	
	:	Hearing Officer - EBC
	:	
Respondents.	:	

**ORDER DENYING RESPONDENTS' MOTION SEEKING
LEAVE TO INTRODUCE EXPERT WITNESS TESTIMONY**

On April 7, 2000 Respondents, through their counsel, filed a motion seeking leave to introduce expert witness testimony at the hearing in this proceeding and, on April 14, 2000, the Department of Enforcement (Enforcement) filed papers in opposition to the motion. For the reasons set forth below, Respondents' motion is denied.¹

**I. Factual Background and the
Proposed Expert Witness Testimony**

Respondent _____ was the managing underwriter for the initial public offerings of _____ and _____ and became a market maker for _____ and _____

¹ On April 19, 2000, Respondents submitted a letter requesting leave to file a reply to Enforcement's opposition papers and, in which, they set forth their reply. On April 24, 2000, Enforcement submitted a responsive letter in which it argued, among other things, that the Hearing Officer should deny Respondents' request for leave to reply. Rule 9146(h) of the Code of Procedure prohibits a moving party from filing a reply absent permission of the adjudicator and, accordingly, provides for the filing of a reply only after the adjudicator has granted the moving party leave to do so. The Rule also contemplates that a request for leave to file a reply be made through a formal motion. Respondents not only failed to comply with these procedures but failed to offer any reasons why reply papers should be permitted and, in fact, their letter submission consists largely of no more than a repetition of the arguments they previously made in their moving papers. However, to the extent Respondents' raise any new arguments in their letter, the Hearing Officer has considered them as well as Enforcement's response in ruling on the pending motion. In the

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securities on March 20 and July 17, respectively, when the securities began trading in the aftermarket.²

The Complaint alleges that Respondents charged their customers undisclosed, excessive and fraudulent mark-downs on purchases of _____ and _____ and on purchases of _____ and _____ made on the first day of aftermarket trading in each issue. According to the Complaint, _____, acting through Respondents _____ and _____, dominated and controlled the markets for these securities and, as a result, was required to determine mark-downs based on the Firm's contemporaneous sales to other broker-dealers, which they failed to do. Based on the foregoing, Respondents are charged with violating Section 10(b) of the Securities Exchange Act of 1934, SEC Rule 10b-5, and NASD Conduct Rules 2110, 2120, and 2440.

The Complaint also alleges that Respondents, while engaged in a public distribution of _____ and _____ (which they purchased from 26 Selling Securityholders³), bid for, purchased, and induced others to purchase these securities, and thereby violated Section 10(b) and SEC Rule 10b-5, SEC Regulation M and SEC Rule 101, and NASD Conduct Rules 2110 and 2120. As to Respondents' conduct regarding _____ and _____, the Complaint further alleges that the purchase and resale of these securities from the Selling Securityholders constituted a public offering and that the Firm, acting through _____, violated Conduct Rule 2110 and various provisions of Conduct Rule 2710 by failing to file required documents and information with the Association in connection with the offering; commencing an offering without receiving an opinion letter as to the proposed underwriting; and failing

future, the Hearing Officer expects the Parties to comply with the Code of Procedure unless specifically excused from doing so, and will not grant the latitude accorded here.

² Complaint, ¶¶ 1, 13-14, 33-34; Answer, ¶¶ 1, 13-14, 33-34.

³ According to the Complaint, _____ issued shares of Series A Convertible Preferred Stock and Class A Warrants to 26 Selling Securityholders as part of a private offering conducted between December 1995 and March 1996. (Complaint. ¶ 52.)

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to disclose all items of underwriting compensation in the prospectus or similar document. In addition, the Complaint alleges that, in connection with the public offering of the Selling Securityholders' _____ and _____, acting through _____ and _____, received excessive underwriter's compensation in violation of Conduct Rules 2110 and 2710. Finally, the Complaint alleges that the Firm, acting through _____ and _____, failed to establish, maintain, and enforce adequate written supervisory procedures regarding the Firm's business activities and, in particular, failed to include procedures designed to achieve compliance with the federal securities laws and rules or NASD rules pertaining to mark-downs and underwriter's compensation, and SEC Regulation M.

Respondent _____ denied all of the substantive allegations against it⁴ and asserted, among its affirmative defenses, that: (1) Enforcement improperly calculated the prevailing market price for the subject securities in alleging that they charged their customers excessive and fraudulent mark-downs; and (2) the purchase and resale of the Selling Securityholders' _____ and _____ did not constitute a public offering within the meaning of Regulation M.

Respondents seek to offer the testimony of an "expert witness," _____, regarding the reasonableness of the prices they charged their customers on the transactions at issue, the underwriter's compensation the Firm received, and matters pertaining to the alleged Regulation M violation.⁵ More particularly, they propose offering an expert witness to explain the concepts of domination and control

⁴ Respondents _____ and _____ invoked the Fifth Amendment privilege in response to each of the allegations against them.

⁵ Respondents also suggest, without providing any specificity, that there are other matters its proposed expert intends to address. Obviously, the Hearing Officer cannot consider the propriety of expert testimony if no indication of the substance of that testimony has been provided.

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as applied to the facts of this case;⁶ discuss the fairness and reasonableness of markdowns for block trades; explain the dynamics of an IPO for a small broker; and discuss the “untested landscape of Regulation M,”⁷ and the “mechanics of when an ‘offering’ is occurring and when the aftermarket begins.”⁸

II. Discussion

In support of their motion, Respondents contend that the issues in this proceeding are “sufficiently complex” to warrant the use of expert witness testimony. Respondents further assert that the matters at issue do not implicate “general industry-wide practices with which a Hearing Panel may be familiar based on their [sic] experience in the industry.”⁹ In their letter submission, Respondents also assert that they should be permitted to offer expert witness testimony pertaining to mark-downs and any other issue because Enforcement intends to offer testimony from two NASD Regulation, Inc. employees concerning their analysis of mark-downs and supervisory issues. Enforcement argues that: (1) in NASD disciplinary proceedings, expert witness testimony is not ordinarily required on the issues Respondents have identified; (2) the two “industry members” who will serve as Hearing Panelists possess sufficient expertise to decide the issues on which Respondents propose offering expert testimony; and (3) _____’s expertise is no greater than that possessed by the two “industry member” panelists.

⁶ In this regard, Respondents state: “the expert will testify that simply because there is trading by a single market maker that accounts for a substantial percentage of the volume and transactions during a period, it does not necessarily mean that the marketmaker [sic] had ‘control’ of the marketplace. The expert will explain why in practice, that it is not surprising that _____, as the underwriter of the IPO was the ‘dominating’ presence on the first day of trading.” Motion for Leave to Offer Expert Witness and Telephone Testimony (“Respondents’ Motion”) p. 4.

⁷ Id., p. 4

⁸ Id.

⁹ Id., p. 3.

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Enforcement also contends that whatever benefit the Hearing Panel may derive from _____'s testimony is outweighed by the fact that it would prolong an already lengthy hearing.

Indeed, in NASD disciplinary proceedings, because two of the three Hearing Panelists will have considerable expertise about the securities industry and industry practice, the use of expert witness testimony is far less necessary or routine than it may be in federal court proceedings. Typically, expert witness testimony is not offered in NASD disciplinary matters, unless novel issues or new, complex, or unusual securities products are involved. The fundamental question is whether the proposed testimony would assist the Hearing Panel in understanding the evidence or a fact at issue in the proceeding.

In this case, the proposed expert testimony is unnecessary. The NASD Board of Governors Mark-Up Policy (IM-2440) provides specific guidance on pricing equity securities,¹⁰ and matters pertaining to the fairness and reasonableness of the mark-downs charged on such securities, including the determination of prevailing market price, are well within the expertise of the industry members of the Hearing Panel.¹¹ Likewise, the Hearing Panel members do not require expert assistance to understand the relatively common concepts of marketplace domination and control, and they are independently capable of applying these concepts to the facts and evidence that will be introduced at the hearing in

¹⁰ Under the NASD's policy, mark-ups and mark-downs on equity securities exceeding 5% of the prevailing market price generally are considered excessive, and mark-ups and mark-downs exceeding 10% of the prevailing market price generally are considered fraudulent.

¹¹ In support of their request to offer expert witness testimony pertaining to the excessive and fraudulent mark-down charges, Respondents rely on cases endorsing the use of expert testimony regarding the customary and usual mark-ups or mark-downs charged on corporate or municipal debt securities, where the challenged mark-ups or mark-downs were less than 5%. See In re First Honolulu Securities, Inc., Exchange Act Release No. 32933, 1993 SEC LEXIS 2422, at *15 n.26 (Sept. 21, 1993); OHO Order 99-03 (C02980073). These cases are plainly inapposite. Respondents' reliance on District Business Conduct Committee No. 5 v. MMAR Group, Inc., Complaint No. C05940001, 1996 NASD Discip. LEXIS 66 (NBCC Oct. 22, 1996) also is misplaced. That case involved the pricing of CMOs and CMO-derivative products, such as principal-only strips, interest-only strips, and inverse floaters.

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order to determine whether Respondents dominated and controlled the markets for _____ and _____ securities as alleged in the Complaint.

Insofar as Respondents seek to offer expert testimony on matters pertaining to Enforcement's allegations that they violated Regulation M and received excessive underwriting compensation, the Hearing Officer notes, as a threshold matter, that Respondents have not clearly articulated the substance of _____'s anticipated testimony or expert witness opinion.¹² Putting that aside, Respondents offer no persuasive reasons (if any at all) why the Hearing Panel would require expert assistance on these subject areas. Contrary to their assertion, Regulation M is not a "new rule of law"¹³ and, in any event, expert testimony interpreting a law, regulation, or statute generally is impermissible.¹⁴

Further, as Enforcement has recognized, the two "industry members" who will serve on this particular Hearing Panel possess extensive industry experience and are well qualified to decide this matter without expert assistance. These two individuals have 77 years of combined experience in the securities industry; both have served as members of NASD District Business Conduct Committees; and one has served on the Market Regulation Committee (formerly known as the Market Surveillance Committee) and was a member of the NASD's Board of Governors. In addition, one of the panelists was the President of a broker-dealer that in 1994 was approved by the NASD Corporate Financing

¹² The Hearing Officer assumes that Respondents expect _____ to opine that they were not engaged in a "public distribution" when they purchased and resold the Selling Securityholders' _____ securities.

¹³ Respondents' Motion, p. 2. Regulation M became effective on March 4, 1997 and revised and re-codified various previously existing Exchange Act Rules, including SEC Rule 10b-6. However, with respect to the violative conduct at issue in this proceeding, the relevant provision, i.e., SEC Rule 101 of Regulation M, is virtually identical to prior SEC Rule 10b-6, which was adopted on July 5, 1955.

¹⁴ Respondents also suggest that _____ will explain to the Hearing Panel how it should assess "damages" in this case. Respondents' Motion, p. 5. It is unclear what Respondents mean by their use of the term "damages." To the extent they seek to offer expert testimony pertaining to the possible imposition of a restitution or disgorgement order, they have not explained the rationale for offering, and the Hearing Officer independently can find no reason for permitting, expert testimony on this subject.

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Department to act as a “Qualified Independent Underwriter,” as defined in NASD Conduct Rule 2720(b)(15), and while he was President of the firm participated as a manager or co-manager in 10 underwritings, including three secondary offerings.¹⁵ By contrast, _____, while undoubtedly knowledgeable about various aspects of the securities industry, apparently has not been registered with a member firm that has participated as a manager or co-manager of any public offerings,¹⁶ and his resume (a copy of which is attached to Respondents’ motion) does not indicate that he has any particular expertise in the area of underwriters’ compensation.

Finally, that Enforcement intends to elicit testimony concerning the mark-down and supervisory issues in this case from two NASD Regulation, Inc. employees – neither of whom are designated as expert witnesses – does not alter the equation or the conclusion as to the propriety of expert testimony.

The Hearing Officer concludes that Respondents have failed to demonstrate that the proposed expert witness testimony would assist the Hearing Panel in deciding the issues in this case and, accordingly, their motion is denied.

SO ORDERED.

Ellen B. Cohn
Hearing Officer

Dated: New York, New York
May 5, 2000

¹⁵ Complainant’s Opposition to Respondents’ Motion for Leave to Offer Expert Witness, Exhibit A (Declaration of _____ in Support of Complainant’s Opposition to Respondents’ Motion for Leave to Offer Expert Witness “_____ Decl.”) ¶¶ 2-3.

¹⁶ _____ Decl. ¶ 4.