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FINANCIAL INDUSTRY REGULATORY AUTHORITY
OFFICE OF HEARING OFFICERS

DEPARTMENT OF MARKET REGULATION, Complainant, v. RESPONDENT 1, RESPONDENT 2, RESPONDENT 3 and RESPONDENT 4 Respondents.	Disciplinary Proceeding No. 20080148227-02 Hearing Officer—DRS

ORDER GRANTING RESPONDENTS' PRECLUSION MOTION

A. Introduction

On August 24, 2015, the Respondents jointly moved for an order precluding the Department of Market Regulation from seeking a finding of a violation by Respondent 2 or Respondent 3 (the "two traders") based on "in concert" activity or any related "combined trading" by the two traders ("Preclusion Motion").[1] Respondents represent that they only recently learned from conversations they initiated with Market Regulation that it intends to base the violative activity of the two traders on evidence that they schemed together to manipulate stocks in violation of Rule 10b-5. Stated another way, Respondents understand that Market regulation intends to base Respondent 2's liability, at least in part, on Respondent 3's transactions, and vice versa. Respondents contend that it would be unfair for Market Regulation to pursue such findings because, based on their pre-Complaint dealings with Market Regulation and the Complaint's allegations, Respondent 2 and Respondent 3 reasonably understood that

[1] The Preclusion Motion also requested that I extend certain deadlines in the pre-hearing schedule by 28 days to provide me with time to resolve the Preclusion Motion. I declined to do so, but by Order dated September 8, 2015, I extended certain deadlines by fewer than 28 days.

their respective alleged misconduct was based only on their respective transactions and not a combination of those transactions.

In support of their Preclusion Motion, Respondents make a number of arguments. According to Respondents, Market Regulation gave them no indication, pre-Complaint, that it was investigating joint trading activities. Respondents point to the absence of any questions on this subject during Respondent 2's on-the-record interviews, and note that Respondent 3 was only asked a general question about whether he had acted "in conjunction" with other traders regarding one security (STRN). Further, Respondents observe that the Wells notices contain no reference to combined trading conduct and, thus, they did not address the subject in their Wells responses,

Similarly, Respondents maintain that the Complaint does not allege that Respondent 2 and Respondent 3 acted "in concert" or in a similar manner. As a result, the Complaint did not contain the "reasonable detail" necessary to put them on notice that Market Regulation intended to base the two traders' liability, in part, on alleged joint activities. Respondents submit that if Market Regulation intended to base liability findings on common conduct, it should have charged that alleged wrongdoing in a separate cause of action or should have moved to amend the Complaint to add an additional charge.

Respondents also assert that even after they filed a motion for more definite statement in response to the Complaint, they were still not placed on notice that Market Regulation was pursuing a joint activities-based charge. They claim that Market Regulation's opposition to that motion did not explain that Respondent 2 and Respondent 3 may be subject to liability for the other's trading. To the contrary, Respondents assert that by addressing the activity of each trader as the basis for that trader's liability, the opposition to the motion continued to lead them to believe that Market Regulation had alleged discrete manipulative conduct by Respondent 2 and separate conduct by Respondent 3.

Finally, Respondents claim that by failing to provide them with adequate notice that Market Regulation intends to prove that the two traders schemed together to manipulate securities, they are prejudiced for several reasons: (1) They have reasonably proceeded in defending this case on the basis that Respondent 2 and Respondent 3 needed to defend against claims of manipulation violations based only on their respective transactions and not those of any other Respondent or trader; (2) in their Answers, each trader failed to respond to allegations in the Complaint that they thought related only to the other trader's activities, not realizing that those activities may now be a source of alleged liability; (3) even now, they still have "no reasonable detail" of the conduct Market Regulation will assert comprises the joint violative conduct; and (4) they had no opportunity to make Rule 8210 requests relating to such conduct or to perform their own investigation into the alleged misconduct.

Market Regulation opposed the Preclusion Motion, but did not deny that it intends to demonstrate at the hearing the Respondent 2 and Respondent 3 engaged in joint misconduct. The core of the opposition is that the Complaint clearly alleged that Respondent 2 and Respondent 3

engaged in a common fraudulent scheme and, therefore, each Respondent can be found liable for misconduct committed in connection with the scheme, including conduct committed by co-schemers. Market Regulation thus asserts that the Hearing Panel should consider the totality of the scheme in evaluating each Respondent's culpability. Market Regulation disputes that it was required to plead common scheme liability in a separate cause of action or that any assertion of common scheme liability constitutes an improper attempt to amend the Complaint.

Additionally, Market Regulation denies that it was placed on notice that the Respondents misunderstood the nature of the charges simply because each trader did not address in their Answers certain allegations that they believed applied only to the other trader. Moreover, Market Regulation asserts that "Respondents' choice to refrain from fully addressing all of the allegations in their Answers creates no duty on [its] part to inquire further or to amend the Complaint." Indeed, Market Regulation submits that the traders' Answers demonstrate that they understood that the Complaint alleged joint activity between because, in their Answers, they denied acting in concert or colluding with each other.

Finally, Market Regulation argues that even if the Complaint did not provide Respondents with proper notice regarding scheme liability, preclusion is not the proper remedy. Instead, Market Regulation recommends that I give Respondents more time to prepare their defense by extending the deadline for filing pre-hearing briefs by two to three weeks.

After Market Regulation filed its opposition to the Preclusion Motion, Respondents sought leave to reply.[2] I denied that request,[3] and scheduled a pre-hearing conference to permit oral argument on the motion.[4] I held that pre-hearing conference September 16, 2015.

For the reasons set forth below, I grant the Preclusion Motion, but will permit Market Regulation to file a motion seeking leave to amend the Complaint to include liability charges based on joint activity by Respondent 2 and Respondent 3.

B. Discussion

FINRA Rule 9212(a) requires that a Complaint "specify in reasonable detail the conduct alleged to constitute the violative activity and the rule, regulation, or statutory provision the Respondent is alleged … to have violated." To meet this standard, Market Regulation need not include evidentiary details in the Complaint,[5] and the "complaint need not specify all details

[2] *See* Joint Request filed September 3, 2015.

[3] *See* Order dated September 8, 2015.

[4] *See* Order dated September 11, 2015.

[5] OHO Order 09-05 (2008012955301) (Dec. 16, 2009) at 3, http://www.finra.org/sites/default/files/OHODecision/p121082_0.pdf.

regarding a case against a respondent."[6] But the Complaint's allegations must "provide a respondent sufficient notice to understand the charges and adequate opportunity to plan a defense."[7]

Here, the Complaint alleges that Respondents engaged in a fraudulent manipulation through (among other things) a scheme, [8] and it sets forth their alleged wrongful conduct. But merely accusing Respondents of participating in a scheme, and setting forth each traders' activities, did not inform the two traders that they were charged with acting jointly in furtherance of the scheme, or that that each trader was prosecuted, in part, based on the other's activities. Specifically, the Complaint does not allege that Respondents engaged in violative conduct by acting in concert, jointly, collusively, or in a common scheme. Consequently, Respondents were not placed on sufficient notice to understand that this theory of liability was encompassed within the manipulation charge alleged in the First Cause of Action.

In its opposition, Market Regulation argues that a respondent can be found liable for the activities of a common scheme, even if the respondent did not participate in all the wrongful activities. That, however, is not the issue. The issue is whether the Complaint placed the Respondents on notice that they were charged with that conduct. And I find that, here, the Complaint failed to provide them with that notice.[9]

Additionally, neither of the two traders construed the Complaint as clearly charging each of them with conduct allegedly committed by the other trader. Their Answers did deny that they had acted in concert or colluded with each other.[10] But more telling is that each trader limited his answer to the allegations made specifically against him, explaining in certain responses that allegations against one trader did not appear to be directed against the other.[11] The two traders'

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[6] *Dep't of Enforcement v. Zenke*, No. 2006004377701, 2009 FINRA Discip. LEXIS 37, at *11 n.7 (NAC Dec. 14, 2009) (citing *Wanda P. Sears*, Exchange Act Release No. 58075, 2008 SEC LEXIS 1521, at *11 (July 1, 2008)).

[7] OHO Order 09-05 at 2 (quoting *Dist. Bus. Conduct Comm. v. Euripides*, No. C9B950014, 1997 NASD Discip. LEXIS 45, at *10 (NBCC July 28, 1997)); OHO Order 10-04 (2008014621701) (July 12, 2010) at 3, http://www.finra.org/sites/default/files/OHODecision/p122653_0_0.pdf ("The standard is whether the Complaint discloses enough information to enable a respondent to plan his or her defense.").

[8] Complaint ¶ 119.

[9] In *Market Regulation v. Proudian*, No. CMS040165, 2008 FINRA Discip. LEXIS 21, at *21 n.22 (NAC Aug.7, 2008), cited by Market Regulation in its opposition, the NAC rejected the argument that the hearing panel's finding of aiding and abetting liability effectively amended the complaint. Rather, the NAC found that by alternatively charging that the respondent "knowingly or recklessly provided substantial assistance" in furtherance of the manipulative scheme, the complaint gave him "the required notice to sustain a claim that he aided and abetted a market manipulation," even though the complaint did not specifically include that charge. *Id.* By contrast, here, the Complaint does not allege joint activity; therefore, joint activity cannot serve as a basis for liability.

[10] Respondent 2's Answer ¶ 13 (denying "any allegation … that he acted in concert with Respondent 3"), ¶ 14 (denying any "suggestion" that he colluded with Respondent 3); Respondent 3's Answer ¶ 113 (denying any allegation or implication that he colluded with anyone).

[11] Respondent 2's Answer ¶¶ 16, 55–77, 116–117; Respondent 3's Answer ¶¶ 11–15, 28–53.

interpretation of the Complaint was reasonable, given the absence of specific allegations of joint action. (Further, upon receiving the Answers, Market Regulation took no action to correct what it now claims was Respondents' misconstruction of the Complaint). By not placing Respondents on notice through the Complaint of the allegedly violative conduct it intends to pursue against them, Market Regulation failed to comply with FINRA Rule 9212(a).

Market Regulation's failure also puts Respondents at substantial risk of unfair prejudice. First, because of the lack of notice, Respondents have not had an adequate opportunity to plan a defense to a liability charge based on an alleged common scheme. And insufficient time remains before the hearing to afford them that opportunity. The hearing is scheduled to begin on November 2, 2015, and many key pre-hearing deadlines have already expired,[12] while several others are fast approaching.[13]

Second, Respondents are at risk of unfair prejudice because of their reasonable interpretation that certain allegations in the Complaint did not apply to both of them. As a result of this interpretation, each trader chose not to respond to these allegations. Rule 9215(b) provides that"[a]ny allegation not denied in whole or in part shall be deemed admitted." It appears from its opposition that Market Regulation intends to use against each trader the allegations they chose not to deny.[14] Consequently, if Market Regulation pursues a common scheme theory of liability, each trader would be unfairly disadvantaged by the use against them of the undenied allegations relating to the activities of the other trader.

Based on the foregoing, I find that it would be unfair to require Respondents to defend against common scheme liability charges that were not alleged in the Complaint.[15] Accordingly, I **GRANT** the Preclusion Motion. Market Regulation is therefore precluded from asserting that either Respondent 2 or Respondent 3 violated the provisions alleged in the First Cause of Action on the basis that they acted together in a combination of trading activity to manipulate the stocks alleged in the Complaint.

This ruling, however, does not preclude Market Regulation from seeking leave to amend the Complaint for the limited purpose of asserting, as a basis of liability, that Respondent 2 and Respondent 3 acted together in such a combination. But any motion seeking leave to amend must

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[12] Deadline for Respondents to move under Rule 9252 for Market Regulation to invoke Rule 8210 to compel the production of documents (July 1, 2015); deadline for filing motions for expert testimony (July 24, 2015); and deadline for filing motions for summary disposition (August 7, 2015).

[13] Deadline for the parties to exchange proposed witness and exhibit lists, proposed stipulations, and expert witness reports (September 25, 2015); deadline for filing pre-hearing submissions and stipulations (October 2, 2015); deadline for filing motions (October 9, 2015); and deadline for filing oppositions to motions (October 20, 2015).

[14] Opposition at 7.

[15] *See Zenke*, 2009 FINRA Discip. LEXIS 37, at *10 (reversing hearing panel's findings of liability because the findings exceeded the scope of the complaint's allegations) (citing *James L. Owsley*, 51 S.E.C. 524, 527–28 (1993) (refusing to affirm findings of liability for purported fraudulent misconduct that had not been charged in the complaint and where applicant did not have a fair chance to rebut the charges)).

be filed by **October 5, 2015**, and any response to the motion will be due no later than **seven days** after the motion is filed.

SO ORDERED.

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David R. Sonnenberg
Hearing Officer

Dated: September 21, 2015