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NASD OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT,	:	
Complainant,	:	Disciplinary Proceeding No. CAF020007
v.	:	
	:	Hearing Officer – DMF
Respondents.	:	

ORDER GRANTING MOTION FOR RECONSIDERATION

During the first stage of the hearing in this proceeding, in November 2002, the Hearing Officer, after consulting with the other members of the Extended Hearing Panel, excluded proposed Complainant's Exhibit 56 (C056) because it had not been produced to the respondents for inspection and copying, pursuant to Rule 9251(a)(1). Enforcement has moved for reconsideration of that ruling.

The Exhibit in question is a Chronological Transaction Analysis (CTA) that purports to show a full chronology of all trades in Pallet Management Systems common stock (PALT) involving respondent _____, Inc. during the period December 7, 1997 through January 30, 1998. The CTA is a staff-prepared spread sheet that lists for each trade a trade date, a settlement date, an execution time, the buying broker-dealer or buying customer, the quantity, the price, the selling broker-dealer or customer, the "rep," the customer name, an inventory amount, the "amount of each principal trade," and a "running profit balance." The CTA indicates it was prepared at least by November 2000.

Staff-prepared CTAs are frequently offered by the Complainant in NASD disciplinary proceedings that involve complex and voluminous trading records. A CTA summarizes and organizes the data in those records, to make the data more accessible to and useful for the Hearing Panel. A CTA is helpful to the Hearing Panel, however, only if it accurately reflects the underlying trading records; if it does not, it can be seriously misleading. The best way to ensure that a CTA is reliable is to give respondents a fair opportunity to review the CTA and compare it to the underlying trading records. In this case, Enforcement made the trading records available to respondents during the discovery process, but not the CTA itself.

Enforcement was required to produce documents to respondents pursuant to Rule 9251(a)(1), which provides, "Unless otherwise provided by this Rule, or by order of the Hearing Officer, the Department of Enforcement … shall make available for inspection and copying by any Respondent, Documents prepared or obtained by Interested Association Staff in connection with the investigation that led to the institution of proceedings." Enforcement contends that, in spite of this broad language, it was not required to produce the CTA because Rule 9251(b)(1) provides, "The Department of Enforcement … may withhold a Document if: … (B) the Document is an examination or inspection report, an internal memorandum, or other note or writing prepared by an Association employee <u>that shall not be offered in evidence</u> …" (emphasis added).

The difficulty with this argument is that, although the CTA was prepared by an NASD employee, Enforcement <u>is</u> offering it in evidence. Therefore, on its face, Rule 9251(b)(1)(B) did not authorize Enforcement to withhold it from production to respondents. Enforcement contends, however, that the Rule should be interpreted to permit Enforcement to withhold any staff-prepared document until Enforcement affirmatively determines that it will offer the document in evidence. In this case, Enforcement says it did not finally decide that it would offer the CTA

until it was preparing its proposed exhibit list in August 2002. Enforcement then included the CTA in the proposed exhibits it served on respondents in September 2002, in accordance with the pre-hearing schedule. Enforcement argues that any other reading of the Rule would require it to determine at an unreasonably early date which staff-prepared documents it will offer at the hearing.

Respondents, on the other hand, point out that under the scheduling order in this case, Enforcement had until May 31, 2002 to make its production to respondents pursuant to Rule 9251(a)(1). They contend that Enforcement should have determined by that date that it would offer the CTA, and, having done so, should have produced it.

The Hearing Officer agrees that Enforcement should have produced the CTA prior to its pre-hearing submission, but for somewhat different reasons. In proposing Rule 9251, NASD explained that the Rule was "[i]n response to and consistent with" the recommendation in The Report of the NASD Select Committee on Structure and Governance to the NASD Board of Governors, (Sept. 15, 1995), that:

> The documentary discovery rights in NASD disciplinary proceedings should be expanded to furnish respondents, at a reasonable time in advance of the initial hearing, with all non-privileged materials in the NASD's possession (including exculpatory evidence) directly relevant to the dispute.

Exchange Act Release No. 38545, 62 Fed. Reg. 25,251 (May 8, 1997). The Hearing Officer concludes that the various provisions of Rule 9251 governing discovery should be interpreted in accordance with this general principal of openness.

Rule 9251(b)(1)(B) allows Enforcement to withhold staff-prepared materials only if they "shall not be offered in evidence." It therefore seeks to strike an appropriate balance between the staff's interest in maintaining internal communications in confidence and the respondents' interest

in having early and open access to the evidence that may be offered against them. Allowing Enforcement unfettered discretion to withhold staff-prepared documents until it makes a final decision as to whether it will offer them in evidence at the hearing would upset this balance and invite gamesmanship. The Hearing Officer therefore will apply the Rule as it is written; in order to withhold a staff-prepared document, Enforcement must affirmatively determine that it "shall not be offered in evidence."

Applying the Rule in this manner does not require Enforcement to make a premature decision about what evidence it will offer. If Enforcement is genuinely unsure whether it will ultimately offer a staff-prepared document, it can either disclose the document or, if it believes disclosure would somehow be prejudicial, seek leave from the Hearing Officer, pursuant to Rule 9251(b)(1)(D), to withhold the document until it decides whether it will offer it in evidence.

Nor does it mean that if Enforcement decides that a staff-prepared document "shall not be offered in evidence," the decision is irrevocable. As a case evolves during the pre-hearing process, Enforcement may find that it wants to offer a staff-prepared document that, initially, it did not intend to offer. In such a case, Enforcement can promptly disclose the document, in the spirit of openness and fairness that underlies Rule 9251. In this case, however, Enforcement does not claim that it initially determined that it would not offer the CTA, but later, for good cause, changed its mind. Instead, Enforcement merely says that it deferred deciding whether to offer the CTA until it was putting its proposed exhibits together in August. But, given the nature of the document, Enforcement must have known well before August that, at a minimum, it <u>might</u> offer the CTA. Therefore, it did not withhold the CTA based on a determination that it "shall not be offered in evidence."

Having determined that Enforcement should have disclosed the CTA, the remaining issue for the Hearing Officer is whether the CTA should be excluded for that reason. In arguing for exclusion, respondents rely on Rule 9280(b)(2), which, under the general heading "Contemptuous Conduct," provides, "A Party that without substantial justification fails to disclose information required by the … Rule 9250 Series … shall not, unless such failure is harmless, be permitted to use as evidence at a hearing … any witness or information not so disclosed."

The Hearing Officer does not believe this provision requires that the CTA be excluded. In withholding the CTA, Enforcement did not flout its obligations under Rule 9251(a)(1), and its actions cannot properly be characterized as contemptuous. Instead, Enforcement read the requirements of the Rule in a manner that was arguably permissible, even though the Hearing Officer has now ruled it was incorrect. Furthermore, the practical effect was to delay production of the CTA from the end of May until September. While that delay might conceivably have been prejudicial if the hearing had concluded in November, in fact the hearing is scheduled to reconvene for the week of February 3 and if necessary, March 3, 2003. Thus, Respondents have had a reasonable period to review the CTA for errors.

The Hearing Officer rejects respondents' contention that they were prejudiced by the delay because "[t]here is no further discovery, the respondents have submitted their theories of defense and made opening statements, strategic decisions have been made and executed, and all deadlines for motions have passed – including motions relating to expert testimony and discovery." Enforcement provided the CTA in September; it is too late to offer general, unsupported claims of prejudice that could have been raised at that time. The Hearing Officer also notes that respondents submitted their theories of defense and made their opening statements in November, long after they received the CTA.

The Hearing Officer therefore withdraws his ruling excluding the CTA on the ground that it was not timely produced to respondents. Enforcement may offer the CTA when the hearing resumes on February 3.

SO ORDERED.

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David M. FitzGerald
Hearing Officer

Dated: January 17, 2003