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NASD REGULATION, INC.
OFFICE OF HEARING OFFICERS

DEPARTMENT OF ENFORCEMENT, Complainant, v. Respondents.	Disciplinary Proceeding No. CAF980022 Hearing Officer─AHP

ORDER DENYING IN PART AND GRANTING IN PART ENFORCEMENT'S MOTION TO STRIKE AFFIRMATIVE DEFENSES AND DENYING _____ MOTION TO DISMISS

The Respondent, _____, has moved to dismiss the Complaint, and the Department of Enforcement (Enforcement) has moved to strike _____ affirmative defenses. For the reasons set forth below, Enforcement's motion to strike _____ affirmative defenses is granted in part and denied in part. _____ motion to dismiss is denied.

I. *Introduction*

_____ is charged with violating Rule 2110 by unjustifiably terminating a firm commitment underwriting of _____ common stock in November 1995. In its Answer to the Complaint, _____ admits the underlying facts but contends that the ___ offering was terminated because its clearing firm, _____, failed to deliver the

funds needed to close.[1] _____ further contends that it used it best efforts to close the offering, but _____ frustrated those efforts by breaching the clearing agreement between them.[2]

_____ also challenges the Complaint on the ground that it is insufficient as a matter of law. _____ asserts that Rule 2110 is unconstitutionally vague as applied in this case. In essence, _____ argues that Rule 2110 does not provide fair warning of the conduct it prohibits and the standard used by the NASD in its application.

On the other hand, Enforcement urges the Hearing Panel to strike _____ four affirmative defenses, including its Third Affirmative Defense that seeks dismissal of the Complaint on the ground that Rule 2110 is unconstitutionally vague. In summary, Enforcement contends that _____ affirmative defenses are insufficient as a matter of law and should be stricken to avoid unnecessary argument and delay at the hearing.

II. *Facts*

Enforcement's Complaint contains the following allegations, which are not findings of fact by the Hearing Panel. _____ is a member of the NASD that undertook the organization and management of an underwriting group to effect an initial public offering for ___.[3] According to the letter of intent dated June 9, 1995, between _____ and ___, the underwriting was to be on the basis of a firm underwriting.[4]

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[1] Ans. ¶ 1.

[2] Id. ¶ 17.

[3] Compl. ¶¶ 2, 5.

[4] Id. ¶ 5.

On September 8, 1995, ___ filed a registration statement with the Securities and Exchange Commission (SEC) for an offering of one million shares of common stock at an initial price of $7.00 per share.[5] On November 20, 1995, _____ and ___ entered into an underwriting agreement under which the underwriting group agreed to purchase the entire offering at the initial offering price of $7.00 per share.[6] After discounts and commissions, ___ was to receive $6.3 million.[7] Payment to ___ was due on November 24, 1995.

_____ stock commenced trading on Monday, November 20, at $7¼ bid and $7¾ asked.[8] Trading continued through Friday, November 24, with a total volume of more than 610,000 shares.[9] On November 24, the date originally set for the closing, ___ and _____ agreed to extend the closing date to the following Monday, November 27.[10] However, on November 27, numerous customers either did not affirm or pay for the shares they purchased. Therefore, faced with a shortfall of approximately $1.1 million, _____ terminated the offering. Enforcement alleges that the termination of the offering was unjustified.[11]

III. *Enforcement's Motion to Strike Affirmative Defenses*

A. *Legal Standards for Motions to Strike Affirmative Defenses*

Because a motions practice did not exist prior to the adoption of the current Code of Procedure in August 1997, and there are no reported NASD decisions setting forth the standard

[5] Id. ¶ 6.

[6] Id. ¶ 7.

[7] Id.

[8] Id. ¶ 8.

[9] Id.

[10] Id. ¶ 9.

[11] Id. ¶¶ 13, 15.

to be applied under the new code to motions to strike affirmative defenses, it is appropriate to look to the standards that have been developed by the federal courts under the Federal Rules of Civil Procedure (Fed. R. Civ. P.) for guidance.

Motions to strike affirmative defenses are governed by Fed. R. Civ. P. 12(f), which provides that the court may strike any insufficient defense from any pleading. Courts generally disfavor Fed. R. Civ. P. 12(f) motions and do not grant them routinely.[12] This is true in part because often they are filed as a dilatory tactic.[13] The generally favored policy is that pleadings should be treated liberally and that parties should be given the opportunity to be heard on their contentions.[14]

Before a federal court will grant a motion to strike affirmative defenses, it must be convinced of the following: (1) there is no question of fact which might allow the defense to succeed; (2) there is no substantial question of law; and (3) there is prejudice to the opposing party from inclusion of the defense.[15] To be stricken, the defense asserted must be clearly insufficient as a matter of law.[16] Furthermore, the grounds for the motion must appear on the face of the pleading or from a matter the federal court may judicially notice.[17] Increased time and expense of trial may constitute sufficient prejudice to warrant granting a motion to strike under Fed. R. Civ. P. 12(f).[18]

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[12] See, e.g., New York v. Almy Brothers, Inc., 971 F.Supp. 69, 72 (N.D.N.Y. 1997).

[13] See, e.g., Oliner v. McBride's Industries, Inc., 106 F.R.D. 14, 17 (S.D.N.Y. 1985).

[14] Id.

[15] See, e.g., Almy, 971 F.Supp. 72.

[16] See, e.g., Oliner, 106 F.R.D. 17. Cf. Thorn, Welch & Co., Inc., Admin. Proc. File No. 3-8400, 57 S.E.C. Docket 2147, 1994 SEC LEXIS 3252, at *2 (Oct. 13, 1994) (motion to strike may be granted if an affirmative defense would not constitute a valid defense under any facts proved).

[17] See, e.g., S.E.C. v. Sands, 902 F.Supp. 1149, 1165 (C.D. Cal. 1995).

[18] See, e.g., S.E.C. v. Toomey, 866 F.Supp. 719, 722 (S.D.N.Y. 1992).

With these general principles, the Hearing Panel will consider each of _____ affirmative defenses.

B. *Analysis*

1. *First Affirmative Defense*

In its first affirmative defense, _____ asserts that it used its best efforts to close the initial public offering, but _____ frustrated those efforts by failing to deliver the closing funds in breach of their clearing agreement.[19] Enforcement argues that this defense is not technically an affirmative defense. This argument is based on the definition of affirmative defense adopted in an SEC administrative ruling.[20] In that ruling, the administrative law judge concluded that by definition an affirmative defense raises a new matter that constitutes a defense to the complaint assuming the facts alleged in the complaint are true. In this case, Enforcement argues that _____ first affirmative defense neither raises a new matter nor assumes the facts alleged in the Complaint are true.

Construing the pleading liberally, _____ first affirmative defense meets the generally accepted definition of an affirmative defense; therefore it will not be stricken on the ground advocated by Enforcement. Moreover, Enforcement's motion should be denied for two further reasons. First, Enforcement has not demonstrated that it will be prejudiced by the retention of this defense. Second, the defense raises substantial issues of fact and law that are inappropriate for disposal on a motion to strike. The defense raises important issues that apply not only to the defense of the charges but also to the assessment of sanctions in the event that _____ is found to have violated Rule 2110. An affirmative defense should not be stricken, though it may appear

[19] Ans. ¶ 17.

[20] Thorn, Welch & Co., supra.

that the defense is certain to fail, where the Hearing Panel should hear the evidence.[21] This is such a case. Accordingly, Enforcement's motion to strike the first affirmative defense is denied.

2. *Second Affirmative Defense*

In its second affirmative defense, _____ asserts that the Complaint fails to allege a violation of Rule 2110. This is the equivalent of the defense of failure to state a claim upon which relief can be granted under Fed. R. Civ. P. 12(b)(6).[22] In essence, _____ is challenging the legal sufficiency of the Complaint as a matter of law.

Adopting the rule that a motion to dismiss under Fed. R. Civ. P. 12(b)(6) must be denied unless the moving party can show that the complainant can prove no set of facts which would entitle him to relief,[23] Enforcement asserts that the second affirmative defense must be stricken. Enforcement argues that the law is well settled that a firm violates Rule 2110 when it improperly terminates a firm commitment underwriting.[24] Thus, Enforcement concludes that _____ cannot establish any set of facts that would allow it to succeed on this defense.

However, when the language of Fed. R. Civ. P. 12(b)(6) is used as an affirmative defense, the burden on the pleader is not the same as with a motion to dismiss.[25] Instead, the plaintiff has the burden to demonstrate that there can be no question of fact or significant question of law, and it will be prejudiced by the pleading's inclusion.

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[21] Cf., e.g., Toomey, 866 F.Supp. 719, 726.

[22] Mem. of P. & A. in Supp. of Complainant's Mot. to Strike _____ Affirmative Defenses at 4.

[23] Enforcement relies upon Conley v. Gibson, 355 U.S. 41, 45-46 (1957) in which the Supreme Court affirmed "the accepted rule that a complaint should not be dismissed for failure to state a claim unless it appears beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."

[24] Id. at 6.

[25] See Toomey, 866 F.Supp. 719, 723 (denying motion to strike failure-to-state-a-claim defense).

The Hearing Panel agrees with the general rule under Fed. R. Civ. P. 12(f) that the complainant suffers no harm when the failure-to-state-a-claim defense is used in the defensive pleadings. As some courts have stated, it is the equivalent of a general denial and does not demand immediate resolution.[26] Allowing the defense to remain will not delay the hearing or introduce unnecessary argument. Accordingly, Enforcement's motion to strike the second affirmative defense is denied.

3. *Third Affirmative Defense*

In its third affirmative defense, _____ asserts that Rule 2110 is unconstitutionally vague as applied to it on the facts of this proceeding. Enforcement moves to strike this defense on the grounds that the Court of Appeals and the SEC have repeatedly held that Rule 2110 (and its predecessor Article III, Section I) is not unconstitutionally vague.[27] Thus, Enforcement argues that _____ affirmative defense is meritless.

As discussed above, however, an affirmative defense usually will be construed to permit the respondent to be heard on its contentions, and an affirmative defense will not be stricken if it involves a substantial question of law. Here, viewing the entirety of the argument advanced by _____ in its memorandum filed in opposition to Enforcement's motion to strike, the Hearing Panel construes the Third Affirmative Defense—although stated as a constitutional challenge—to attack the application of Rule 2110 on the ground that it did not provide fair notice of the nature of the offense with which _____ is charged.[28] Arguably, when so construed, the

[26] Id.

[27] Mem. of P. & A. in Supp. of Complainant's Mot. to Strike _____ Affirmative Defenses at 9.

Third Affirmative Defense sufficiently raises the issue that Rule 2110—as applied to the specific facts of this case—does not meet the fairness requirements of Section 15A of the Securities and Exchange Act of 1934. Further, Enforcement has cited no authority applying Rule 2110 to the termination of a firm commitment underwriting by the underwriter. Consequently, Enforcement has not demonstrated the absence of a substantial issue of law and fact regarding the application of Rule 2110 to the facts of this case. Therefore, Enforcement's motion to strike the third affirmative defense is denied.

4. *Fourth Affirmative Defense*

If a violation is found, _____ fourth affirmative defense asks the Hearing Panel in assessing sanctions to consider that the violations were the sole responsibility of _____ Chief Financial Officer and Financial Principal. _____ argues that this is a mitigating factor that the Hearing Panel should consider in setting sanctions. Enforcement, on the other hand, moves to strike this affirmative defense on the ground that it is not a true defense to the Complaint.

The Hearing Panel agrees with Enforcement's assessment of this defense. Facts to be presented solely in mitigation of sanctions do not constitute a defense to the charge; therefore, they are not properly raised in the pleadings as an affirmative defense. Accordingly, Enforcement's motion to strike the fourth affirmative defense is granted. However, _____ is not be precluded by this ruling from presenting any relevant and material mitigating facts at the hearing.

[28] A number of courts have held that the NASD is a private organization not subject to the strictures of the Constitution. See Datek Secs Corp. v. National Ass'n of Secs Dealers, Inc., 875 F.Supp. 230, 233-34 (S.D.N.Y. 1995) and cases cited therein.

IV. _____ *Motion to Dismiss*

A. *Legal Standards for Motions to Dismiss*

A motion to dismiss under Fed. R. Civ. P. 12(b) may address the court's jurisdiction or the complaint's legal sufficiency. In each case the federal courts have imposed a substantial burden on the moving party. A federal court may not dismiss a complaint for failure to state a claim under Fed. R. Civ. P. 12(b)(6) unless the moving party demonstrates "beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."[29] The court's function "is merely to assess the legal feasibility of the complaint, not to assay the weight of the evidence which might be offered in support thereof."[30] "[T]he issue is not whether a plaintiff will ultimately prevail but whether the claimant is entitled to offer evidence to support the claims."[31]

In reviewing a motion to dismiss under Fed. R. Civ. P. 12(b)(6), a court must "accept as true the factual allegations of the complaint, and draw all inferences in favor of the pleader."[32] However, the inferences drawn from the allegations in the complaint must be reasonable.[33]

B. *Analysis*

Rule 2110 provides that a member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable principles of trade. "The crux of a Conduct

[29] See, e.g., Primavera Familienstiftung v. Askin, 173 F.R.D. 115, 122-23 (S.D.N.Y. 1997) (quoting H.J. Inc. v. Northwestern Bell Tel., Co., 492 U.S. 229, 249-50 (1989)).

[30] See, e.g., Geisler v. Petrocelli, 616 F.2d 636, 639 (2d Cir.1980).

[31] See, e.g., Scheuer v. Rhodes, 416 U.S. 232, 236 (1974).

[32] Mills v. Polar Molecular Corp., 12 F.3d 1170, 1173 (2d Cir. 1993).

[33] Hernandez v. Coughlin, 18 F.3d 133, 136 (2d Cir.), cert. denied, 513 U.S. 836 (1994).

Rule 2110 violation is the breach of a duty imposed by just and equitable principles of trade."[34] The Rule goes beyond simple legal requirements in imposing a duty of fair dealing.[35] Thus, a violation of Rule 2110 can be found where no legally cognizable wrong occurred.[36]

_____ moves to dismiss the Complaint on the grounds that Rule 2110 fails to provide fair notice of the charge and reasonable guidance as to the standard under which to judge the charge. In support, _____ relies on the recent decision of the United States Court of Appeals for the District of Columbia in Checkosky and Aldrich v. S.E.C., 139 F.3d 221 (D.C. Cir. 1998).

In Checkosky the SEC claimed that two accountants at Coopers & Lybrand had engaged in "improper professional conduct" in violation of SEC Rule 2(e)(1)(ii) by filing financial statements for a client that categorized certain research and development costs in a manner contrary to generally accepted accounting standards. After a disciplinary hearing, the SEC found that the accountants had improperly represented that the financial statements conformed to generally accepted accounting standards and suspended them from practicing before the SEC for a period of years.

The accountants appealed, and the court remanded the case to the SEC with instructions to explain its interpretation and application of SEC Rule 2(e)(1)(ii). On remand, the SEC affirmed the sanction against the defendants without further articulating the standard it used in deciding the case, and the defendants again appealed.

On the second review, the Court of Appeals severely criticized the SEC for failing to delineate a clear and coherent standard for violations of Rule 2(e)(1)(ii). Lacking such a standard,

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[34] See, e.g., District Business Conduct Committee for District No. 5 v. Jeffrey O. Putterman, Complaint No. C05960041, 1997 NASD Discip. LEXIS 52, at *22 (NASD Oct. 10, 1997).

[35] Id.

[36] Timothy L. Burkes, 51 S.E.C. 356 (1993), aff'd mem., Burkes v. SEC, 29 F.3d 630 (9th Cir. 1994).

the court feared the SEC's opinion came close to a "self-proclaimed license to charge and prove improper professional conduct, constrained only by its own discretion [and perhaps generally accepted accounting practices and standards]."[37] Accordingly, the Court of Appeals remanded the case a second time with instructions to dismiss the case.

Checkosky, however, is distinguishable from this proceeding. The court in Checkosky did not hold that SEC Rule 2(e)(1)(ii) was unconstitutionally vague. Rather, it held that the SEC violated the Administrative Procedure Act by failing to provide a standard for its decision.[38] The defect was the SEC's failure to articulate the standard it used in judging the defendants' conduct under the rule, which precluded effective judicial review. Presumably, if the SEC had announced the standard it applied in reaching its decision, the court may have upheld the decision.

Accordingly, the Hearing Panel finds that Enforcement's allegations of a violation of Rule 2110 are sufficient to withstand a motion to dismiss at this stage of the proceeding. Enforcement has alleged that _____ terminated the underwriting without justification. This allegation is sufficient to state a violation of the ethical requirement that members observe high standards of commercial honor and just and equitable principles of trade. Thus, _____ motion to dismiss the Complaint is denied.

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By: Andrew H. Perkins, Hearing Officer
For the Hearing Panel

Dated: Washington, DC
October 2, 1998

[37] Checkosky, 139 F.3d at 225.

[38] Id., 139 F.3d at 226.