

**NASD OFFICE OF HEARING OFFICERS**

DEPARTMENT OF ENFORCEMENT,

Complainant,

v.

Respondent.

Disciplinary Proceeding  
No. CAF040079

Hearing Officer – DRP

**ORDER DENYING RESPONDENT'S MOTION FOR SUMMARY DISPOSITION**

**I. Background**

On November 8, 2004, the Department of Enforcement filed a four-count Complaint against ["Respondent" or "the Firm"]. The first cause of the Complaint alleges that the Firm, through its registered representatives, violated Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 promulgated thereunder, as well as NASD Conduct Rules 2120 and 2110, by fraudulently soliciting and selling \_\_\_\_\_ bonds to hundreds of customers during the final weeks predating \_\_\_\_\_'s filing of its petition for bankruptcy in December 2001. On May 9, 2005, Respondent filed a motion for summary disposition of this cause of action, as well as summary disposition of Enforcement's request for restitution. After Enforcement filed its opposition to the motion on June 6, 2005, Respondent filed a reply and Enforcement filed a sur-reply.<sup>1</sup> On December 22, 2005, Respondent filed an additional brief in support of this motion, which Enforcement opposed on January 6, 2006.<sup>2</sup>

<sup>1</sup> At a pre-hearing conference held on July 26, 2005, the Hearing Officer granted the parties' request to postpone the hearing from October 2005 to May 2006.

<sup>2</sup> The Hearing Officer also considered related arguments raised by Enforcement in its motion to strike affirmative defenses and Respondent's opposition thereto.

Respondent argues that the first cause of action must be dismissed, because Enforcement failed to allege sufficient facts to sustain a fraud charge, including materiality and scienter.<sup>3</sup> Respondent further contends that any omissions or misrepresentations made by its representatives were not material as a matter of law and that the Firm did not act with the requisite scienter to constitute a violation of antifraud laws. Respondent asserts that Enforcement's prayer for restitution constitutes a request for money damages, thereby converting the case to a private lawsuit under Section 10(b), requiring Enforcement to allege and prove the elements of causation and reliance.

Respondent also moves for summary disposition of Enforcement's prayer for restitution. Respondent argues that Enforcement is "functionally seeking individual damages awards," thereby interfering with Respondent's right to arbitrate such claims. Respondent asserts that Enforcement lacks authority to seek money damages for individual customer losses and is barred from seeking damages, because NASD is a state actor with a hearing process that violates due process.

Enforcement opposes summary disposition of the fraud charge, arguing that materiality and scienter are fact-based issues and asserting that there are genuine issues of material fact that must be decided by the Hearing Panel. Enforcement further contends that causation and reliance are not elements of a fraud charge in an enforcement action, and the request for restitution notwithstanding, this disciplinary action is not a civil lawsuit. Enforcement also opposes summary disposition of its request for restitution, contending that the sanction is a well-recognized and proper form of relief in NASD disciplinary proceedings. Enforcement denies that NASD is a state actor subject to constitutional restrictions or that this proceeding violates Respondent's contractual rights to arbitration of customer claims.

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<sup>3</sup> Although styled as a motion for summary disposition, some of Respondent's arguments are more in the form of a motion to dismiss. The Hearing Officer notes that while the Federal Rules of Civil Procedure provide for motions to dismiss for failure to state a claim, there is no parallel provision in the NASD Code of Procedure.

## II. Standard of Review for Summary Disposition

NASD Procedural Rule 9264 provides that in a disciplinary action, either the complainant or a respondent may move for summary disposition of any or all of the causes of action against the respondent. A hearing officer may deny or defer decision on any motion for summary disposition. A hearing panel may grant a summary disposition motion if there is no genuine issue with regard to any material fact that the moving party relies on in filing its motion, and the opposing party does not come forward with specific facts showing a genuine issue in dispute.<sup>4</sup>

As the moving party, Respondent thus bears the initial burden of showing no genuine issue of material fact exists.<sup>5</sup> The facts alleged in the pleadings filed by Enforcement are taken as true except as modified by any stipulations or admissions by Enforcement, by uncontested affidavits or declarations, or by facts officially noticed pursuant to Rule 9145.<sup>6</sup> If Respondent meets this burden, Enforcement must come forward with specific facts showing that there is a genuine issue in dispute.<sup>7</sup> Absent such a showing, summary disposition should be granted.<sup>8</sup>

## III. Discussion

### A. Elements of Fraud

To establish that Respondent violated the antifraud provisions of the federal securities laws and NASD rules, as charged in the first cause of the Complaint, Enforcement must show that Respondent, through its registered representatives, made material misrepresentations, or failed to

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<sup>4</sup> See *Celotex Corp. v. Catrett*, 477 U.S. 317, 322-23 (1986); *Matsushita Elec. Indus. Co. v. Zenith Radio Corp.*, 475 U.S. 574, 585-86 (1986).

<sup>5</sup> *Celotex*, 477 U.S. 317, 325.

<sup>6</sup> NASD Procedural Rule 9264(e).

<sup>7</sup> *Matsushita*, 475 U.S. 574.

<sup>8</sup> See *Dep't of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6, at \*10, n. 11 (NAC June 2, 2000) (citations omitted).

disclose material information to insure that statements were not misleading, in connection with the purchase or sale of securities, and acted with scienter.<sup>9</sup>

Respondent's insistence that Enforcement must also prove reliance and causation to sustain the fraud charge is mistaken. In a fraud case, NASD is not subject to the same elements of proof as are required in a private cause of action.<sup>10</sup> Enforcement's request for restitution as a remedial sanction does not convert this enforcement action to a private lawsuit.

### 1. Materiality

The Complaint alleges that the Firm's registered representatives failed to disclose material negative information<sup>11</sup> and/or made material misrepresentations of fact<sup>12</sup> about \_\_\_\_\_ when soliciting customer purchases of \_\_\_\_\_ bonds. Respondent contends that any omissions alleged by Enforcement were not material as a matter of law, because there was no duty to disclose the

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<sup>9</sup> See *SEC v. First Jersey Sec. Inc.*, 101 F.3d 1450, 1467 (2d Cir. 1996). See also Section 10(b) of the Exchange Act, which makes it unlawful in connection with the purchase or sale of any security, for any person, directly or indirectly to use or employ "any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe...." SEC Rule 10b-5, promulgated thereunder, renders it unlawful for any person: (a) to employ any device scheme or artifice to defraud, (b) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or (c) to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person. NASD Conduct Rule 2120 prohibits the use of any manipulative, deceptive or other fraudulent device or contrivance to effect a transaction in, or induce the purchase or sale of, any security. Rule 2120 is the equivalent of SEC Rule 10b-5. *Market Regulation Comm. v. Shaughnessy*, No. CMS950087, 1997 NASD Discip. LEXIS 46, at \*24 (NBCC June 5, 1997).

<sup>10</sup> See, e.g., *Dep't of Enforcement v. Faber*, No. CAF010009, 2003 NASD Discip. LEXIS 3 (NAC May 7, 2003) (customer reliance is not an element of a fraud claim brought by NASD), *aff'd*, Exchange Act Release No. 49,216, 2004 SEC LEXIS 277 (Feb. 10, 2004); *Newton v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 259 F.3d 154, 179 (3d Cir. 2001) (loss causation, which derives its function from tort law, is a statutory element of private securities fraud claims under 10b-5).

<sup>11</sup> Enforcement asserts that Respondent's sales force failed to disclose the following facts about \_\_\_\_\_: recent credit rating downgrades; negative credit watch for potential downgrades; restated financials for the previous four years by more than \$552 million for accounting errors; disclosure of information likely to have a material adverse impact on the company's ability to continue as a going concern; an SEC investigation of partnerships related to \_\_\_\_\_; Respondent's removal of an \_\_\_\_\_ preferred security from its approved list due to concerns about the company's debt rating; and the SEC investigation.

<sup>12</sup> Enforcement alleges several examples of misrepresentations or false statements of fact: \_\_\_\_\_ bonds are safe, stable, secure, low risk and have a 'AAA' rating; \_\_\_\_\_ "would not fail" (within time period of bond maturity); customers would be protected from any potential loss; and the government would not allow \_\_\_\_\_ to go into bankruptcy.

information, or the information was “already available to the reasonable investor or ... [was] obvious because, among other things, the fact [was] widely known.”

Respondent argues that any misrepresentations, if made, were not material, because there was a reasonable basis for such statements, the correct information was provided on the customer confirmation, or the broker's comments were a reasonable opinion. Respondent's motion attacks the materiality of each alleged omission and misrepresentation alleged in the Complaint but fails to address whether any combination of omitted facts or misrepresentations would satisfy the materiality element.

Enforcement asserts that a broker's pitch to a customer “must be viewed as part of a ‘mosaic’ to see if those statements, in the aggregate, created a misleading impression”<sup>13</sup> and argues that a reasonable investor would have found the omissions and misrepresentations alleged in the Complaint significant, i.e., material. Enforcement supports this contention with statements from customers who affirm that they would not have made the investments had Respondent's registered representatives disclosed the omitted information.<sup>14</sup> Enforcement further contends that the Firm's sales force was required to disclose material adverse information, even if publicly known or readily ascertainable.

Information is material if there is a “substantial likelihood that a reasonable [investor] would consider it important in deciding how to [invest].”<sup>15</sup> To be material, the “information need not be such that a reasonable investor would necessarily change his investment decision based on the information, as long as a reasonable investor would have viewed it as significantly altering the

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<sup>13</sup> *SEC v. Fitzgerald*, 135 F.Supp. 2d 992, 1028 (N.D. Cal. 2001) (citations omitted).

<sup>14</sup> Hanlon Decl. ¶ 66.

<sup>15</sup> *SEC v. Mayhew*, 121 F.3d 44, 51 (2d Cir. 1997) (citations omitted).

'total mix' of information available."<sup>16</sup> Material facts include those investors would want to consider when making a decision whether to buy, sell or hold a stock.

A misrepresented or omitted fact may be immaterial if it is "trivial, or is 'so basic that any investor could be expected to know it,'"<sup>17</sup> but the fact that some of the adverse information about \_\_\_\_\_ was publicly available or widely known does not necessarily render it immaterial or relieve a registered representative of his duty to fully disclose risks to a customer.<sup>18</sup>

Enforcement alleges that the Firm's sales force minimized the possibility of \_\_\_\_\_'s default and omitted any adverse information that would suggest caution to a reasonable investor. A determination of the materiality of the alleged omissions and/or misrepresentations "requires delicate assessments of the inferences a reasonable shareholder would draw ... and the significance of those inferences,"<sup>19</sup> which must be made by the trier of fact. Accordingly, summary disposition must be denied.

## **2. Scienter**

To be liable under Section 10(b) and Rule 10b-5, and therefore under NASD Rule 2120, a respondent must act with scienter. Scienter is "a mental state embracing intent to deceive, manipulate, or defraud."<sup>20</sup> Reckless conduct can satisfy the scienter requirement under Rule 10b-5.<sup>21</sup> Scienter may be shown by circumstantial evidence.<sup>22</sup>

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<sup>16</sup> *Id.*, citing *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

<sup>17</sup> *RMED Int'l, Inc. v. Sloan's Supermarkets, Inc.*, 185 F.Supp. 2d 389, 400 (S.D.N.Y. 2002) (citations omitted). *See also Zerman v. Ball*, 735 F.2d 15, 21 (2d Cir. 1984) (broker has no duty to disclose the obvious) (citations omitted).

<sup>18</sup> *Cf. Dep't of Enforcement v. Reynolds*, No. CAF990018, 2001 NASD Discip. LEXIS 17, at \*37, n. 22 (NAC June 25, 2001).

<sup>19</sup> *TSC Indus., Inc.*, 426 U.S. at 450.

<sup>20</sup> *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12 (1976).

<sup>21</sup> *SEC v. Burns*, 816 F.2d 471 (9th Cir. 1987); *Dep't of Enforcement v. Levitov*, No. CAF970011, 2000 NASD Discip. LEXIS 12, at \*11 (NAC June 28, 2000).

<sup>22</sup> *U.S. v. Mylett*, 97 F.3d 663 (2d Cir. 1996).

In addition to allegations that Respondent's sales force made material misrepresentations and/or omitted material facts, the Complaint alleges that in late October 2001, the Firm's corporate bond trader bought and held \_\_\_\_\_ bonds in the firm's proprietary account and continued acquiring \_\_\_\_\_ bonds during the weeks immediately preceding \_\_\_\_\_'s filing for bankruptcy. The Complaint further alleges that registered representatives were offered inflated sales credits as incentive to solicit customers to purchase \_\_\_\_\_ bonds during this period.

Respondent insists there was no intent to defraud and disputes Enforcement's claim that improper sales incentives were offered to financial advisors who pushed \_\_\_\_\_ bonds; the Firm asserts that compensation for selling \_\_\_\_\_ bonds to retail customers was commensurate with compensation for selling similar bonds. Respondent contends it acted in good faith by providing timely, relevant information to, and adequate supervision of, its financial advisors, who reasonably relied upon NRSRO ratings<sup>23</sup> for \_\_\_\_\_ bonds.

Though the allegations regarding scienter are meager, Enforcement has asserted motive and opportunity to commit fraud, which may circumstantially show scienter.<sup>24</sup> Moreover, there is a factual dispute regarding the amount of the sales credits offered by the Firm to its registered representatives for selling \_\_\_\_\_ bonds, as well as the reasons therefor.<sup>25</sup> Accordingly, Respondent is not entitled to summary disposition as a matter of law.

## **B. Restitution**

Respondent also seeks dismissal of the prayer for restitution. The Firm asserts that restitution involves disgorgement of a defendant's gain rather than reimbursement of a victim's

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<sup>23</sup> A Nationally Recognized Statistical Rating Organization (NRSRO) is a rating organization the SEC has designated as nationally recognized, such as Moody's, Standard & Poor's and Fitch.

<sup>24</sup> See *Press v. Chem. Inv. Servs. Corp.*, 166 F.3d 529, 538 (2d Cir. 1999) (whether fraudulent intent existed is a question of fact, allowing scienter issues to withstand summary judgment on "fairly tenuous" inferences).

<sup>25</sup> Compare Respondent's Statement of Undisputed Facts ¶¶ 61-76 (and \_\_\_\_\_ Decl.) with Enforcement's Response to Respondent's Statement of Undisputed Facts ¶¶ 9, 65, 68-73 (and Hanlon Decl.).

loss. Furthermore, by seeking compensation for customers, the Firm argues that Enforcement is seeking money damages – a remedy for which there is no statutory authority.

The Firm further contends that NASD is a state actor and that Enforcement's use of hearsay declarations to prove customer losses violates due process. Finally, the Firm asserts that the claim for restitution must be dismissed, because it interferes with its contractual and federal right to arbitrate.

Enforcement asserts that restitution is a long-standing form of relief specifically recommended by NASD's Sanction Guidelines, which instruct that restitution orders should be calculated based on the amount of loss sustained and may exceed the amount of respondent's ill-gotten gain. Enforcement further notes that restitution awards have been imposed by NASD Hearing Panels and the National Adjudicatory Council and been affirmed by the SEC and several United States Courts of Appeal.

Finally, Enforcement asserts that constitutional provisions do not apply to NASD proceedings and that this disciplinary proceeding does not impermissibly interfere with Respondent's right to arbitrate claims.

In an NASD disciplinary action, restitution is a remedial sanction that requires the wrongdoer to restore customers to the status quo ante, in other words, "to return customers to their prior positions by restoring the funds of which they were wrongfully deprived."<sup>26</sup> The Hearing Officer rejects Respondent's claim that Enforcement's request for restitution is an attempt to obtain money damages under the guise of a disciplinary proceeding. Enforcement's prayer for relief includes a request for an order imposing sanctions in accordance with Rule 8310,<sup>27</sup> as well as a

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<sup>26</sup> *Wendell D. Belden*, Exchange Act Release No. 47, 859, 2003 SEC LEXIS 1154, at \*18 (May 14, 2003) (citations omitted). *See also NASD Sanction Guidelines* (2005 ed.) at 4.

<sup>27</sup> Sanctions that may be imposed on a member firm include: censure, fine, suspension, cancellation, expulsion, temporary or permanent cease and desist order, and "any other fitting sanction."



request for an order requiring the Firm to “disgorge ... ill-gotten gains and/or make full and complete restitution.”

Restitution is not only authorized, but is an appropriate form of relief in NASD proceedings.<sup>28</sup> It is well within the sound discretion of a hearing panel to order restitution “where necessary to remediate misconduct,”<sup>29</sup> and a request for an order of restitution, does not convert a disciplinary proceeding into a private lawsuit.

It is premature to decide whether Respondent engaged in violative conduct, and if so, whether restitution would be necessary to remediate the misconduct. It is also inappropriate to decide at the pre-hearing stage whether Enforcement will offer sufficient proof in support of its request, though the SEC has repeatedly held that hearsay declarations are admissible in NASD proceedings, if reliable and probative.<sup>30</sup>

Finally, the Hearing Officer rejects Respondent's contention that by seeking restitution, Enforcement has abrogated the Firm's right to arbitrate customer claims arising from the sale of \_\_\_\_\_ bonds.<sup>31</sup>

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<sup>28</sup> See *Guidelines* at 2-4 (General Principles No. 1, 3 and 5). Accord Section 15A of the Exchange Act (15 U.S.C. § 78o-3). See also *NASD Notice to Members* 99-86 (Oct. 1999).

<sup>29</sup> OHO Order 05-30 (C3A040045) at 3.

<sup>30</sup> See, e.g., *Michael A. Rooms*, Exchange Act Release No. 51,467, 2005 SEC LEXIS 728, at \*4, n.8 (Apr. 1, 2005), citing *John Montelbano*, Exchange Act Release No. 47,227, 2003 SEC LEXIS 153, at \*22-23 (Jan. 22, 2003) and cases cited therein. Hearsay may even form the basis for findings of fact. *Id.*

<sup>31</sup> *Olde Discount Corp. v. Tupman*, 1 F.3d 202 (3d Cir. 1993), which Respondent cites, does not dictate a different conclusion. Olde argued that the Delaware Securities Commission's pursuit of rescission on behalf of two investors interfered with Olde's right to arbitration. The court agreed, holding that the Delaware statute was preempted by the Federal Arbitration Act, because state law interfered with the congressional purpose of enforcing arbitration agreements. The same rationale would not apply here. This disciplinary case involves allegations that Respondent defrauded hundreds of customers, in violation of federal securities laws. Given these facts, a finding that NASD's enforcement action violates the Firm's contractual right to arbitration would substantially undermine NASD's regulatory mission to protect investors and strengthen market integrity through enforcement of federal securities laws and NASD rules. Furthermore, NASD rules are not the equivalent of a state statute, and when approved by the SEC pursuant to congressional mandate, they have the force of federal law. *Credit Suisse First Boston Corp v. Grunwald*, 400 F.3d 1119 (9th Cir. 2005).

**IV. Conclusion**

Respondent's motion for summary disposition of the first cause of action and the restitution claim is denied.

**SO ORDERED.**

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Dana R. Pisanelli  
Hearing Officer

Dated: March 13, 2006  
Washington, DC