



SECURITIES REGULATION & LAW



REPORT

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ENFORCEMENT

The House That the Regulators Built (Revisited): An Analysis of Whether Respondents Should Litigate Against NASD

By BRIAN L. RUBIN AND CHRISTIAN J. CANNON

“Statistics are about as interesting as first base coaches.” Jim Bouton¹

“What are the odds?” “Should I settle, or step up to the plate and litigate?”

These questions (or similar ones) are frequently asked of us when member firms or associated persons find themselves the unlucky targets of NASD disciplinary inquiries. In an article published last year,² we ana-

lyzed five years’ worth of NASD cases to determine whether it was worthwhile to litigate against NASD, or whether the venue (a private, NASD-sponsored setting with no jury right), the rules (written by NASD), the Hearing Officers (employed by NASD), the staff (more than 2,000 strong) and the resources (an annual budget in excess of \$500 million),³ and other factors provided too much of a “home field” advantage for NASD staff. Our analysis showed that respondents who litigated won outright only 11% of the time (25% of the time when the charges alleged fraud), but had a very good chance (60% when represented by counsel) at getting sanctions less than those requested by the staff.⁴

Despite these statistics, recent analysis shows that most respondents (96.5% in 2005) continue to settle cases rather than to litigate, paying higher and higher fines every year, even when they may believe they have not violated any rules. It’s enough to make one wonder:

¹ <http://www.baseball-almanac.com/bstatmen.shtml>.
² Brian L. Rubin and Christian J. Cannon, *The House That the Regulators Built: An Analysis of Whether Respondents Should Litigate Against NASD*, 37 Sec. Reg. & L. Rep. (BNA)

Mr. Rubin is a partner with Sutherland Asbill & Brennan LLP. Prior to joining Sutherland, he was NASD’s Deputy Chief Counsel in the Department of Enforcement. Mr. Cannon is an associate with Sutherland and was previously a registered representative. This article is published for informational purposes only. The views and conclusions expressed in the article are those of the individual authors and not of the firm, and are not intended to constitute legal advice or a recommended course of action for any individual or organization.

781, May 2, 2005 (hereinafter “*The House*”). The original article compared litigating against NASD staff with playing against the Yankees in Yankee Stadium—or “The House That Ruth Built”—which hosted 33 World Series, 26 of which were won by the Yankees. Rubin and Cannon recently won a 2006 Burton Award for Legal Achievement for that article. For the 2006 Burton Awards, see www.burtonawards.com.

³ About NASD, at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&nodeId=608.

⁴ *The House* at 784. For purposes of easing calculations and analysis, many figures have been rounded.

Is the staff getting strikeouts without even throwing a pitch?

Background and Methodology

“You can observe a lot by watching.” Yogi Berra⁵

This article analyzes NASD’s disciplinary proceedings since 2004; for respondents, the outlook continues to appear ominous. In 2005, NASD set new highs for disciplinary actions filed (1,412) and fines collected (\$125.4 million).⁶ The fines represented a 21% increase over 2004 (\$103.9 million), which were triple the 2003 figures. Of the 1,296 formal actions resolved in 2005, 96.5% were settled.

During 2005, at the trial level, the Office of Hearing Officers (“OHO”) issued 33 decisions, rendering a verdict with respect to 46 respondents (some cases involved more than one member firm and/or registered or associated person). All of these decisions have been analyzed to determine whether NASD staff proved liability and whether it received the sanctions requested, and if not, how much more or less the sanctions were.⁷ Sanctions were divided into two categories: fines and suspensions. Of the 33 decisions, 11 did not contain sufficient information to determine whether the Hearing Panel awarded the sanctions sought by NASD staff. This article analyzes the remaining 22 decisions (involving 27 respondents), which contained information about the staff’s sanction requests. This article also analyzes appeals of NASD disciplinary decisions to the National Adjudicatory Council (NAC),⁸ to the Securities and Exchange Commission (SEC), and to the federal courts of appeals. During 2005, the NAC published 22 appellate decisions, the SEC published 16, and the federal courts of appeals published only three.

⁵ *Things People Said*, at <http://rinkworks.com/said/yogiberra.shtml>.

⁶ *NASD News Release: 2005 in Review* (Dec. 27, 2005), at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015794.

⁷ As noted in our previous article, although regulators sometimes talk about “settlement discounts,” there is no available data to compare the staff’s last settlement offer with its demand for sanctions at a hearing. *The House* at 783; see also *DOE v. Philippe N. Keyes*, 2005 NASD Discip. LEXIS 9, *30 (NAC Dec. 28, 2005) (“Generally, in settled cases, the parties forgo the cost of litigation and agree to lesser sanctions; this is well recognized as a ‘settlement discount.’”) (citation omitted). The Sanction Guidelines also recognize that “settled cases generally result in lower sanctions than fully litigated cases to provide incentives to settle.” Guidelines at 1, available at http://www.nasd.com/web/groups/enforcement/documents/enforcement/nasdw_011038.pdf. Moreover, it is possible that the staff requests more in sanctions than they believe the case is worth because the Hearing Panel may reach compromise verdicts.

⁸ The NAC is composed of between 12 and 14 individuals who can be compensated by NASD. See NASD Regulation, Inc. By-Laws, Art. IX § 9.1. They are appointed by the Board of Directors of NASD Regulation, Inc. NASD Regulation, Inc. By-Laws, Art. V, § 5.1. The majority of the NAC must comprise “non-industry members.” NASD Regulation, Inc. By-Laws, Art. I (y); NASD By-Laws, Art. I (aa). When an appeal is filed, the NAC appoints a subcommittee of at least two current or former NAC members (or its predecessor body) to consider the appeal and make a written recommendation to the full NAC. NASD Code of Proc. Rules 9331(a), 9331(b).

OHO Decisions

At the trial level, respondents had a more difficult time disputing liability during 2005 than they have had historically. Of the 46 respondents adjudicated through OHO decisions during 2005, only two were found to have no liability, a success rate of 4.3%, compared with 11% for respondents over the previous five years. Three other respondents (6.5%) succeeded in having at least one charge dismissed but were found liable on other grounds. Once again, fraud charges—which require that the staff prove intent—were more difficult for the staff to prove. In seven cases where fraud was alleged, two cases (28.6%) were dismissed entirely.⁹ This statistic is relatively consistent with the previous five years, during which 25% of fraud cases were dismissed.

■ Fines

“The penalty is a bit more than I expected.” Stanley George “Frenchy” Bordagaray (following a \$500 fine and 60-day suspension for spitting at an umpire)¹⁰

As in baseball, fines are one of the primary sanctions imposed against NASD evildoers,¹¹ and they are often more than firms and/or individuals expect (or even expectorate). However, the fines actually assessed often are less than the amount sought by the staff. Of the 2005 cases in which liability was found and the fines sought by the staff were reported, the average fine sought was approximately \$26,750. The average fine granted, however, was approximately \$20,750, or 22.4% lower than the amount sought.¹² Respondents were successful in getting lower fines 30% of the time, although fines were increased 20% of the time. When the Hearing Panel awarded reduced fines, they were decreased by an average of 72%, from approximately \$30,000 to \$8,333. In the two cases where they were increased, they were increased by 33% and 333%, respectively, from \$15,000 to \$20,000 in one case and from \$150,000 to \$500,000 in the other. In the remaining 50% of the cases, the staff received the fine sought, which averaged approximately \$33,500.

In contrast to 2005, during the previous five years, respondents had much more success defending against fines. While the average fine granted during that period was higher (\$25,500), respondents were successful in getting lower fines 54% of the time.¹³ Sanctions were increased only 8% of the time.¹⁴ When reduced, fines were reduced by 64%, from approximately \$52,000 to

⁹ These seven cases resolved fraud charges against 14 respondents, resulting in a dismissal for two respondents.

¹⁰ <http://quote.webcircle.com/cgi-bin/search.cgi?position=OF%2F3B>.

¹¹ See George W. Bush (former co-owner, general manager, Texas Rangers): “We’re too great a nation to allow the evildoers to affect our soul.” (http://en.wikipedia.org/wiki/Texas_Rangers); http://quotes.liberty-tree.ca/quote/george_bush_quote_65f6.

¹² This excludes one case which involved figures substantially disproportionate to those found in other cases. In *DOE v. LH Ross*, Case No. CAF040056 (OHO Jan. 14, 2005), the staff sought a fine of \$150,000 and the Hearing Panel assessed \$500,000. The decision is available at http://www.nasd.com/web/groups/enforcement/documents/oho_disciplinary_decisions/nasdw_014120.pdf.

¹³ *The House* at 784.

¹⁴ *Id.*

\$18,500.¹⁵ When increased, they were increased by 33%, from an average of \$35,000 to \$46,500.¹⁶

■ **Suspensions**

“Getting thrown out of baseball was like having part of me amputated. I’ve heard that old men wake up and scratch itchy legs that have been dust for over fifty years. That was me. I’d wake up at night with the smell of the ball park in my nose, the cool of the grass on my feet.” Shoeless Joe Jackson in “Field of Dreams”¹⁷

Suspensions are the other primary sanction imposed by NASD. In 2005, respondents were more successful in combating suspensions than fines. In the 26 instances where it was possible to determine whether the suspension was more, less, or equal to the sanction sought by NASD staff, respondents were able to reduce the suspension sought 50% of the time. Thus, respondents were more successful than during the prior five years, when suspensions were reduced approximately 40% of the time.¹⁸ For more than two-thirds of these respondents (18 of 26), the staff sought a bar; where a bar was sought, it was imposed 50% of the time (9 out of 18). (This compares with 65% of the time in the previous five years.¹⁹) When the Hearing Panel did not order a bar, the respondent was suspended for approximately 13.5 months. (This compares with nine months for the previous five years.²⁰)

Of the eight instances where the staff requested a suspension, the Hearing Panel imposed the specific time out requested on two occasions. In another two cases, the Hearing Panels increased the suspensions. On average, the staff requested a suspension of 5.9 months (down from 7.6 over the previous five years²¹). When suspensions were reduced, they were reduced by 76%, from an average of seven months requested to 1.8 months imposed. (This is comparable to previous years, when suspensions were reduced by 70%, from 8.8 months to 2.6.)²² In the two cases where suspensions were increased, they were increased to a bar; the staff sought four months in one case and 12 months in the other. (In previous years, they were increased from 7.2 months requested to 10.3 months imposed or to a bar.)²³

¹⁵ *Id.*

¹⁶ *Id.*

¹⁷ http://en.wikiquote.org/wiki/Field_of_Dreams.

¹⁸ *The House* at 784.

¹⁹ *Id.*

²⁰ *Id.*

²¹ *Id.*

²² *Id.*

²³ *Id.*

Note to Readers

The editors of BNA’s *Securities Regulation & Law Report* invite the submission for publication of articles of interest to practitioners.

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■ **Attorney litigated vs. pro se cases.**

“Baseball is almost the only orderly thing in a very unordered world. If you get three strikes, even the best lawyer in the world can’t get you off.” Bill Veeck.²⁴

Unlike in baseball, lawyers sometimes do make a difference for respondents—and have, on average, over the past six years. For example, of the 32 respondents between January 2000 and December 2005 who were successful in obtaining a complete dismissal of the charges against them, only three appeared *pro se*. Thus, attorneys were completely successful 12.1% of the time (29 of 240), while *pro se* respondents were completely successful 3.3% of the time (3 of 90).

Fines in 2005. In 2005 there were only seven cases for which sufficient information was available to analyze fines for attorney-litigated cases. Only two of those cases (28.6%) resulted in lower fines, and one case (*L.H. Ross & Company, Inc.*)²⁵ resulted in an increase from \$150,000 sought by the staff to \$500,000 imposed (in addition to an expulsion and more than \$11.4 million in restitution and interest). *Pro se* litigants had only three cases with sufficient information concerning fines. One resulted in a reduction from \$50,000 sought to \$15,000 imposed; one resulted in an increase from \$15,000 sought to \$20,000 imposed; and one resulted in the same amount imposed as sought (\$12,500).

Suspensions in 2005. Lawyer-represented respondents were more successful in fending off suspensions sought by the staff, and succeeded in reducing them 61% of the time (11 of 18), compared with 45% over the previous five years. When the staff sought a bar, which occurred 13 times for respondents with counsel, the Hearing Panel did not order a bar on nine occasions. In those nine instances, the respondents were suspended for an average of 10.4 months. The staff sought a suspension five times, but it was reduced three times (or 60%). On those five occasions, the staff sought an average suspension of nine months but the suspensions ordered averaged approximately 2.4 months.

By contrast only 25% of *pro se* respondents (two of eight) were successful in getting suspensions lowered; this was down from 30% over the previous five years. In the two instances where they were successful in reducing suspensions, one resulted in a suspension of 24 months (the staff had sought a bar) and the other resulted in no suspension (the staff had sought a one-month suspension). In addition, in one case, the suspension was increased from 12 months sought to a bar imposed.

■ **Cases against member firms**

“I just want the organization to do something: go get pitching. If they don’t . . . they’re telling me they don’t want to win.” Miguel Tejada²⁶

Much like certain baseball teams, member firms—especially reputable ones—have a long-standing aversion to aggressively fighting regulatory actions. There were only five OHO decisions issued during 2005 that involved firms fighting NASD charges. Two of them in-

²⁴ http://www.brainyquote.com/quotes/authors/b/bill_veeck.html.

²⁵ Case No. CAF040056 (OHO Jan. 14, 2005), at http://www.nasd.com/web/groups/enforcement/documents/oho_disciplinary_decisions/nasdw_014120.pdf.

²⁶ <http://www.baseballprospectus.com/article.php?articleid=4661>.

volved the same firm, L.H. Ross & Company, Inc.²⁷ Of the remaining three decisions, one resulted in a \$20,000 fine when only \$15,000 had been sought; one resulted in a \$15,000 fine and no suspension, when \$50,000 and a one-month suspension had been sought; and in the third, it was unclear what sanctions had been sought. During the previous five years, there were 14 cases against member firms whose OHO opinions contained sufficient information for comparative analysis regarding fines.²⁸ In those cases, the average fine imposed was \$31,000.²⁹ Firms were able to get the fine reduced 62% of the time, from an average of \$113,000 requested to \$27,000 imposed (a reduction of 76%).³⁰ Fines stayed the same in the other 38% of these cases; fines were not increased in any of them.

Appeals

"I've never questioned the integrity of an umpire. Their eyesight, yes." Leo Durocher³¹

■ National Adjudicatory Council (NAC)

As explained above, after the OHO trials, appeals are heard by the NAC. During 2005, the NAC issued 22 decisions addressing the cases of 29 respondents. The vast majority of these cases (24 of 29) were appealed by the respondents themselves. Of the remainder, two were appealed by the respondents but were cross-appealed by the staff, two were appealed by the staff alone, and one was called for review by the NAC.³² When appealed by the respondents alone, fines imposed by the OHO were affirmed approximately 78% of the time (seven of nine),³³ were increased once, and were decreased only once. When appealed by respondents alone, suspensions imposed by the OHO were affirmed approximately 74% of the time (14 of 19),³⁴ were increased 21% of the time (4 of 19), and were decreased only once (to a one-year suspension from a bar).

When the staff appealed on its own, it was two-for-two, obtaining reversals of cases that had been dismissed entirely by the OHO. In the two cases appealed by both parties, one resulted in increased fines and suspensions (\$95,000 fine was replaced with a \$276,265 restitution order, and a bar was imposed instead of a one-year suspension) while the other affirmed a bar. In the one case that was called for review by the NAC, fines stayed the same, while the 10-day suspension that

had been imposed was reversed and no suspension was ordered.

While Quattrone and Sihpol individually won victories for themselves . . . , the *Invened* decision may have exposed a weakness in the staff's enforcement arsenal.

One factor aggravating these results was the dogged perseverance with which *pro se* litigants pursued failure. Respondents who represented themselves were 0-for-7 in appeals (and were 0-for-12 in the previous 5 years). Six had their OHO sanctions affirmed, and one suspension was slightly increased (15 days to 30). Nevertheless, even respondents represented by counsel only succeeded once on appeal to the NAC last year (and only seven times in the previous five years). In contrast, during the previous five years, no *pro se* respondents succeeded in getting sanctions reduced on appeal.

■ Securities and Exchange Commission and Federal Courts of Appeals

Respondents who are unsuccessful before the OHO and the NAC have the right to appeal to the SEC,³⁵ and from there, they may appeal to the appropriate Federal Court of Appeals. During 2005 the SEC published 16 decisions addressing appeals from NASD disciplinary decisions. Three were dismissed at the application stage and were therefore never fully briefed.³⁶ Twelve of the remaining 13 appeals resulted in affirmances of the NAC, and the one respondent who succeeded in obtaining a reversal (of a NAC-imposed bar) had the bar reinstated on remand to the NAC.³⁷

During 2005, Federal Courts of Appeals issued only three decisions addressing NASD disciplinary cases. Two of the cases denied the respondents' petitions for

²⁷ In one action against L.H. Ross, discussed above, the Hearing Panel sanctioned the firm far more severely than the staff requested. *DOE v. LH Ross*, CAF040056 (OHO Jan. 14, 2005), at http://www.nasd.com/web/groups/enforcement/documents/oho_disciplinary_decisions/nasdw_014120.pdf. In the other case, the firm was expelled for failure to provide information in violation of Rules 8210 and 2110. Case No. C07040074, 2005 NASD Discip. LEXIS 15 (OHO Jan. 25, 2005).

²⁸ *The House at 787*. The OHO opinions for these contained insufficient information to analyze suspension sanctions.

²⁹ *Id.*

³⁰ *Id.*

³¹ <http://www.peterga.com/baseball/quotes/umpires.htm>.

³² Under Code of Proc. Rule 9312(a), any member of the NAC or, pursuant to delegated authority, any member of the Review Subcommittee may "call for review" an OHO decision. Once called for review, the case proceeds as if appealed by either party.

³³ Only nine of the 24 cases appealed by respondents alone involved monetary sanctions.

³⁴ Nineteen of the 24 cases appealed by respondents alone involved suspension sanctions.

³⁵ The SEC appeal is actually a two-step process. An SEC appeal begins when a Respondent files an "application for review." NASD Code of Proc. Rule 9370(a). If the application is granted, the parties fully brief the appeal.

³⁶ *L.H. Ross & Company, Inc.*, Admin. Proc. File No. 3-11686, 2005 SEC LEXIS 452 (Feb. 28, 2005) (dismissing application for review); *Larry A. Saylor*, Admin. Proc. File No. 3-11733, 2005 SEC LEXIS 1536 (June 30, 2005) (same); *Jeffrey A. King*, Admin. Proc. File No. 3-11851, 2005 SEC LEXIS 2516 (Oct. 7, 2005) (same).

³⁷ *Rooney A. Sahai*, Admin. Proc. File No. 3-11652, 2005 SEC LEXIS 864 (April 15, 2005) (remanding case to the NAC); *DOE v. Rooney A. Sahai*, Compl. No. C9B020032, 2006 NASD Discip. LEXIS 2 (NAC March 2, 2006) (re-affirming bar). Two other cases involved partial, but meaningless, victories that are counted here as defeats for respondents because the overall sanctions did not change: *Michael A. Rooms*, Admin. Proc. File No. 3-11621, 2005 SEC LEXIS 728 (April 1, 2005) (dismissing 8210 charge but affirming penny stock rule violations for which respondent was barred); and *Castle Securities Corp.*, Admin. Proc. File No. 3-11847, 2005 SEC LEXIS 2628 (Oct. 11, 2005) (setting aside suspension, but only because firm had voluntarily withdrawn from industry, and affirming fine of \$80,000 for Order Audit Trail System violations).

review of sanctions that were imposed.³⁸ The other case was *NASD v. SEC*,³⁹ which began as an enforcement case against Key West Securities and its head trader, owner, and sole executive, Amr “Tony” Elgindy, for alleged market manipulation. The OHO dismissed the market manipulation charges but imposed a fine of \$3,000 and a one-year suspension on both Elgindy and Key West for other, less serious charges.⁴⁰ The staff appealed to the NAC and the respondents cross-appealed. The NAC reversed, finding that there was market manipulation, and expelled Key West and barred Elgindy, among other sanctions.⁴¹ On appeal to the SEC, the case was reversed yet again. The SEC held that “we cannot conclude that the evidence demonstrates that Applicants engaged in a manipulative scheme.”⁴² Although NASD had never before appealed an SEC decision reversing disciplinary action taken by NASD,⁴³ it appealed this decision, filing a petition for review in the D.C. Circuit. The D.C. Circuit dismissed the petition for lack of jurisdiction, holding that NASD is not a “person aggrieved” under Section 25(a) of the Securities Exchange Act of 1934⁴⁴ and therefore had no right to appeal.⁴⁵ Elaborating, the court stated that “NASD appears before this court as a disgruntled first-level tribunal, complaining because it has been reversed by a higher tribunal.”⁴⁶ Therefore, “NASD is the private equivalent of an [Administrative Law Judge], and it has no more authority than would an ALJ to seek review of a Commission decision under § 25(a).”⁴⁷ This case is but one example of a noteworthy success by a respondent; other examples are highlighted below.

³⁸ *Barkate v. SEC*, 125 Fed. Appx. 892, 2005 U.S. App. LEXIS 6353 (9th Cir. March 23, 2005) (denying petition for review of SEC’s affirmance of NASD sanctions); *Yoshikawa v. SEC*, 122 Fed. Appx. 364, 2005 U.S. App. LEXIS 2576 (9th Cir. Feb. 7, 2005) (denying petition for review of SEC’s affirmance of NASD disciplinary decision against petitioner for violating NASD Manual Rules 2110 and 3370(b)(2)(B)).

³⁹ 431 F.3d 803 (D.C. Cir. Dec. 13, 2005), *rehearing denied*, 2006 U.S. App. LEXIS 7343 (D.C. Cir. March 13 2006).

⁴⁰ The other charges were for violating Rule 2110 by making a series of high bids without intending to honor them, and for violating Rule 2210 by disseminating recommendations without disclosing the firm’s market maker status. *Market Regulation v. Amr “Tony” Elgindy and Key West Securities, Inc.*, Compl. No. CMS000015 (OHO Dec. 28, 2001), available at http://www.nasd.com/web/groups/enforcement/documents/oho_disciplinary_decisions/nasdw_006578.pdf.

⁴¹ *Market Regulation v. Amr “Tony” Elgindy and Key West Securities, Inc.*, Compl. No. CMS000015, 2003 NASD Discip. LEXIS 14 (NAC May 7, 2003).

⁴² *Amr Elgindy and Key West Securities, Inc.*, Admin. Proc. File No. 3-11145, 2004 SEC LEXIS 555, at *18 (March 10, 2004).

⁴³ *NASD v. SEC*, 431 F.3d at 805 (noting that “we can find no case in which NASD, in its capacity as a first-level adjudicator in disciplinary actions, has ever petitioned for judicial review to challenge a SEC judgment overturning the initial decision rendered by NASD in its adjudicative capacity”).

⁴⁴ 15 U.S.C.S. § 78y(a).

⁴⁵ *NASD v. SEC*, 431 F.3d at 805.

⁴⁶ *Id.* at 809-810.

⁴⁷ *Id.* at 811.

Delay of Game (or Delay of Sanctions)

“Now there’s three things that can happen in a ball-game: you can win, you can lose, or it can rain.” Casey Stengel⁴⁸

While rain generally will not delay the imposition of a sanction, when deciding whether to litigate, respondents should not ignore the issue of time. It frequently takes many months, or even years, for the staff to complete an investigation. Some respondents might prefer settling, to avoid these delays and to put the matter behind them. Others might value the time it takes to litigate.⁴⁹ In 2005, for the 35 respondents whose cases did not involve alleged violations of Procedural Rule 8210 (which requires any person or firm subject to NASD’s jurisdiction to timely provide records, information or testimony when requested by the staff), approximately 33.2 months elapsed between the most recent relevant conduct cited in the OHO decision and the filing of the complaint.⁵⁰ The time between the filing of the complaint and the rendering of a decision averaged 12.5 months for respondents who were not charged with violating Rule 8210, and 8.7 months for respondents who were so charged. This complaint-to-decision period ranged between 6 and 22 months for non-8210 respondents, and between 5 and 12 months for 8210 respondents.

Appeals similarly take a substantial amount of time. During 2005, appeals to the NAC took an average of 14.7 months between the date of the OHO decision and the date of the NAC decision (the least was nine months; the most was 21). While the appeal is pending, the OHO decision is stayed and a respondent can therefore continue to work.⁵¹ This fact is something that respondents may want to consider even though their appeals will usually fail. Similarly, while appeals to the SEC are generally not successful, they often buy additional time. An SEC appeal involving a sanction other than a bar or suspension stays the effectiveness of any sanction imposed by NASD.⁵² During 2005, fully

⁴⁸ http://www.brainyquote.com/quotes/authors/c/casey_stengel.html.

⁴⁹ Respondents (and particularly attorneys for respondents) should be cognizant of prohibitions regarding making legal submissions for the purpose of delaying or increasing litigation costs. See, e.g., Fed. R. Civ. P. 11(b) (“By presenting to the court (whether by signing, filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person’s knowledge, information, and belief, formed after an inquiry reasonable under the circumstances, it is not being presented for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation.”)

⁵⁰ Complaints against respondents charged with violations of Rule 8210 (there were 11 in 2005) were issued much faster, averaging only 9.3 months after the relevant conduct. Presumably, the reason Rule 8210 cases move faster is that they are easier to prove and the staff knows immediately when they occur because the staff makes the request for information.

⁵¹ NASD Code of Proc. Rules 9311(b) and 9312(b) (appeal by any party, cross-appeal, or call for review by the NAC “shall operate as a stay [of the decision under appeal] until the [NAC] issues a decision. . .”).

⁵² This filing of the application for review generally “shall stay the effectiveness of any sanction, other than a bar or an expulsion, imposed in a decision constituting final disciplinary action . . .” NASD Code of Proc. Rule 9370(a). Even where a

briefed appeals (which followed the SEC's acceptance of the application for review) took between 7 and 12 months, and averaged 9.4 months, between the date of the NAC decision and the date of the SEC decision.⁵³ When added to the 47.9 months that non-8210 cases take from the date of the conduct at issue to the date of the NAC decision, this means that respondents can avoid sanctions for more than four and one-half years from the time of the violation. Unfortunately for respondents, an appeal to the appropriate federal court does not operate as a stay of the penalty or remedy imposed by the SEC.⁵⁴

Recent Staff Losses

"Mighty Casey has struck out." Ernest L. Thayer⁵⁵

■ *Invemed Associates LLC*

Like the mighty Casey, NASD is not invincible. Recently, one firm decided to step up to the plate and force the staff to prove charges similar to those alleged against other firms that ended up settling. In April 2003, NASD's Department of Enforcement filed a disciplinary complaint against Invemed, alleging violations of several NASD rules in connection with how Invemed allocated "hot" IPO shares to its customers and shared their profits.⁵⁶ Invemed was unique because, while it litigated, at least seven of its peers settled cases involving similar allegations, paying fines to NASD and disgorgement ranging from \$4.95 million to \$50 million that, in total, exceeded \$87 million.⁵⁷

On March 3, 2006, in a "withering 94-page critique of the original complaint,"⁵⁸ an NASD hearing panel dismissed the complaint against Invemed because, among other things, it concluded that the staff had failed to prove that Invemed shared in the profits of its custom-

bar or expulsion has been ordered, respondents may apply for a stay of disciplinary action under SEC Rule 19d-2.

⁵³ In contrast, the denial of applications for review generally took less time than "fully briefed" appeals, averaging eight months, and ranging from 5 to 10 months.

⁵⁴ 15 U.S.C.S. § 78y(c)(2). The SEC, however, "may stay its order or rule pending judicial review if it finds that justice so requires." This provision does not appear to have been invoked by the SEC during the past 10 years for the purpose of staying an enforcement decision during an appeal.

⁵⁵ Casey at the Bat (<http://www.onenet.net/~njtdb/casey.html>).

⁵⁶ NASD News Release: *NASD Hearing Panel Dismisses Profit Sharing Complaint Against Invemed* (March 3, 2006), at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002829; http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013698; http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002951; http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002957; http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002965.

⁵⁷ For NASD News Releases concerning the relevant settlements, see http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002829; http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_013698; http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002951; http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002957; http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002965.

⁵⁸ *After Losing 2 High-Profile Cases, NASD Faces Questions About Its Tactics*, NY Times, April 21, 2006, at C3.

ers' accounts.⁵⁹ While the NAC has called the case for review,⁶⁰ the firm (for the time being, at least) appears to have been vindicated.⁶¹

■ *Frank P. Quattrone*

Similarly, Frank P. Quattrone, former Managing Director of the Global Technology Group at Credit Suisse First Boston LLC (CSFB), has successfully litigated against the staff. Quattrone was charged by NASD with failing to respond to a request for on-the-record testimony in connection with the staff's investigations into IPO spinning⁶² and investment banker-research analyst conflicts of interest at CSFB.⁶³ Citing the Fifth Amendment, Quattrone refused to testify unless the staff agreed to postpone the testimony until after certain related criminal proceedings had been resolved.⁶⁴ He argued that the Fifth Amendment (which technically does not apply to NASD because it is a private party, rather than a state actor) could be applied because the investigation was being conducted jointly with the SEC and NYSE, and therefore constituted "state action."⁶⁵ As evidence for this claim, Quattrone submitted a letter he had received from the SEC stating that the investigation was, in fact, being conducted jointly.⁶⁶

⁵⁹ Invemed News Release, at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_016110.

⁶⁰ *Panel to Review Case of Invemed Dismissal*, Wall St. J., April 12, 2006, at C4.

⁶¹ Another significant victory—although not an NASD enforcement action—is Theodore Sihpol's successful defense against the New York State Attorney General. Sihpol, a former broker with Bank of America, and others had been charged with illegal market timing and late trading on behalf of hedge fund Canary Capital Partners. While the other defendants settled, Sihpol litigated and, after a 6-week trial, a jury found him not guilty on 29 of 33 counts, and was unable to reach a verdict with respect to the other four counts. *New York v. Sihpol*, N.Y. Sup. Ct., Indictment No. 1710/2004 (June 9, 2005); see also *Ex-Broker Acquitted in Fund Case*, N.Y. Times, June 10, 2005, at C1. The judge declared a mistrial on the remaining four counts, which were ultimately dropped. *Spitzer Drops Charges Against an Ex-Broker*, N.Y. Times, Oct. 13, 2005, at C3.

⁶² "Spinning" has been defined by the SEC as "the practice of attracting future underwriting business by allocating hot IPO shares to the personal brokerage accounts of corporate or venture-capital executives who then resell or 'flip' the shares in the immediate aftermarket in order to obtain quick profits." *Frank P. Quattrone*, Admin. Proc. File No. 3-11786, 2006 SEC LEXIS 703, at *3, n.4 (March 24, 2006).

⁶³ Research analysts and investment bankers were alleged to have conflicts of interest that resulted in pressures on analysts to compromise the analysts' independence and objectivity. See *DOE v. Quattrone*, Compl. No. CAF030008, 2004 NASD Discip. LEXIS 2, at *7 (OHO Jan. 16, 2004). CSFB ended up settling for \$200 million in connection with the \$1.4 billion global settlement with the SEC, NASD, New York Stock Exchange and New York Attorney General's Office for violations arising from these conflicts of interest (\$100 million of CSFB's fine was for IPO spinning). See *NASD News Release: Ten of Nation's Top Investment Firms Settle Enforcement Actions Involving Conflicts of Interest Between Research and Investment Banking* (April 28, 2003), at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_002909.

⁶⁴ *DOE v. Quattrone*, 2004 NASD Discip. LEXIS 2, at *24-25 (OHO Jan. 16, 2004).

⁶⁵ *Id.*

⁶⁶ Although Quattrone's evidentiary proffer is not discussed specifically in the OHO or NAC decisions, it is discussed by the SEC. See *Frank P. Quattrone*, Admin. Proc. File No. 3-11786,

The Hearing Panel rejected Quattrone's argument without holding an evidentiary hearing on the "state action" issue and, by summary judgment, fined him \$30,000 and suspended him for one year.⁶⁷ When both he and the staff appealed, the NAC affirmed the findings but increased the sanctions, barring Quattrone and denying him an evidentiary hearing.⁶⁸ But Quattrone appealed once more, and on March 24, 2006, the SEC set aside the NAC's decision because the investigations were being conducted jointly with the SEC and NYSE and because Quattrone (due to the letter) "did not rely on mere conclusory allegations or speculation but instead offered specific facts to support his contention that NASD engaged in state action as a joint actor with the [SEC]."⁶⁹ Therefore, the SEC found that Quattrone deserved a hearing to determine whether there was sufficient interaction between the agencies to constitute state action by NASD.⁷⁰

Since the SEC set aside the NAC decision, the staff appears to have the ability to proceed with its original case against Quattrone. One of the issues that needs to be resolved is whether the SEC's and NYSE's involvement in the underlying investigations amounted to state action. Of course, the staff may decide not to go forward due to the precedent that would be set were Quattrone to prevail.⁷¹ Regardless of how Quattrone's case is ultimately resolved, it has already established an important precedent: too much cooperation between NASD and state or federal regulators does, in fact, raise the possibility of state action and may, in fact, permit respondents to be able to assert the Fifth Amendment without automatically violating Rule 8210. Thus, Quattrone's litigation appears to have resulted in something of value to future litigants.

Conclusion

"Good pitching will beat good hitting any time, and vice versa."⁷² Bob Veale

What does this analysis tell us? Should firms and individuals litigate or settle? The answer, like much in life (and sometimes in baseball), is—it depends. As Yogi Berra said, "If you come to a fork in the road, take it."⁷³ While NASD has historically won litigated cases the vast majority of the time, that statistic alone may no longer be dispositive. (In any event, as regulators are always reminding us, past performance is no indication of future returns.) Other factors must be considered when deciding whether to litigate.

First, it is possible that under the present regulatory paradigm, the "settlement discount" is a myth (perhaps

like Babe Ruth's called shot in game three of the 1932 World Series).⁷⁴ The past several years have seen a major-league shift in the regulatory mind-set.⁷⁵ During 2004 and 2005, for example, NASD collected fines of \$125.4 million and \$103.9 million, respectively, representing an enormous increase over the previous three years, which averaged \$38 million.⁷⁶ Presumably, the behavior of firms and registered representatives is not two or three times worse than it was previously. The staff's success at eliciting fines appears to be due to a paradigm shift, not different performance by firms or individuals. With only 3.5% of respondents challenging the staff through litigation, it is not surprising that fines are going through the roof. Firms and individuals may not be defending themselves adequately against the new enforcement mindset.⁷⁷

Second, as the statistics above demonstrate, litigation buys time. While this factor may not be that helpful for firms, litigating over legitimate issues may be of value to certain individuals who prefer continuing to work

⁷⁴ See *Calling His Shot*, The Cavalier Daily, Tuesday, Sept. 16, 2003, at <http://www.cavalierdaily.com/CVArticle.asp?ID=16726&pid=1042> ("Having already hit a three-run homer in the first inning, Ruth walked to the plate amidst a cascade of [Cubs fan] jeers and boos. Before settling in the batter's box, Ruth waved his arm towards centerfield. Although Ruth never confessed what the gesture actually meant, it has gone down in baseball lore as Ruth 'calling his shot.' On the very next pitch, Ruth crushed the ball over the centerfield fence in Wrigley Field."); cf. http://en.wikipedia.org/wiki/Babe_Ruth's_Called_Shot ("The myth is dead," said ESPN producer, Mark Shapiro, "He was clearly pointing at the Cub dugout. He wasn't pointing at center field.")

⁷⁵ Some commentators have highlighted recent "rulemaking by enforcement." See, e.g., Jonathan R. Macey, *The Tenth Abraham L. Pomerantz Program: Wall Street in Turmoil: Who is Protecting the Investor?: State-Federal Relations Post-Eliot Spitzer*, 70 Brooklyn L. Rev. 117, 128 n.36 (Fall 2004) (defining the "rulemaking by enforcement" as "the presumptively illegitimate process by which regulators proceed with rulemaking 'ex post,' i.e. after certain conduct occurs, rather than through more legitimate formal notice-and-rulemaking procedures").

⁷⁶ See NASD News Release: 2004 in Review (Dec. 29, 2004), at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_012858. The 2002 figures are skewed because \$50 million of the \$68.2 million collected was due to the fine against one firm. See *InvestmentNews*, April 10, 2006 at 7. Without that fine, fines for 2001, 2002, and 2003 averaged only \$21.6 million.

⁷⁷ NASD is not the only regulator that appears to be on performance-enhancing steroids. The SEC's penalties and disgorgement figures are "off the page," in the words of former Commissioner Harvey Goldschmid, who noted that in fiscal year 2003, "the amount of civil penalties collected by the SEC was higher than during the prior fifteen years combined." Harvey J. Goldschmid, *The SEC at 70: Let's Celebrate Its Reinvoigorated Golden Years*, 80 Notre Dame L. Rev. 825, 829 (2005). Total penalties ordered in SEC judicial and administrative enforcement actions for the past five years were as follows: \$44 million in 2001, \$101 million in 2002, \$1.1 billion in 2003, \$1.2 billion in 2004, and \$1.5 billion in 2005. See <http://www.sec.gov/pdf/annrep01/ar01enforce.pdf> (for 2001); <http://www.sec.gov/pdf/annrep02/ar02enforce.pdf> (for 2002); <http://www.sec.gov/pdf/annrep03/ar03enforce.pdf> (for 2003); <http://www.sec.gov/about/secpar/secpar04stats.pdf> (for 2004); and <http://www.sec.gov/about/secstats2005.pdf> (for 2005). These increased levels of sanctions represent a whole new ballgame, much like Babe Ruth's first year with the Yankees. In 1920, he hit 54 home runs, which was more than any team hit, except for one. See [http://www.baseballibrary.com/baseballibrary/submit/Frommer_Harvey79.stm](http://www.baseballlibrary.com/baseballibrary/submit/Frommer_Harvey79.stm).

2006 SEC LEXIS 703, at *19-22 (March 24, 2006) (noting evidence proffered by Quattrone in opposing NASD's motion for summary judgment before the OHO).

⁶⁷ *DOE v. Quattrone*, 2004 NASD Discip. LEXIS 2, at *56.

⁶⁸ *DOE v. Quattrone*, Amended Decision, Compl. No. CAF030008, 2004 NASD Discip. LEXIS 17 (NAC Nov. 22, 2004).

⁶⁹ *Frank P. Quattrone*, 2006 SEC LEXIS 703, at *19.

⁷⁰ *Id.*

⁷¹ NASD has never been found to have engaged in "state action." *Frank P. Quattrone*, 2006 SEC LEXIS 703, at *16 n.20 (noting that SEC cases "as well as federal court opinions hold consistently that NASD disciplinary proceedings are not state action").

⁷² <http://www.quoteagarden.com/baseball.html>.

⁷³ http://www.brainyquote.com/quotes/authors/y/yogi_berra.html.

and earning a living over putting the issues behind them through settlement.

Third, the recent significant victories (such as *Invedmed*, *Quattrone* and *Sihpol*) contain an important message: it sometimes pays to fight (or, you've got to play to win). While *Quattrone* and *Sihpol* individually won victories for themselves (and thus helped show that the staff can be beat on a case-by-case basis), the *Invedmed* decision may have exposed a weakness in the staff's enforcement arsenal. Recently, NASD has brought a variety of cases against numerous firms involving similar allegations. However, this one-size-fits-all approach to enforcing rules may not be appropriate because the size doesn't always fit. NASD's theories arguably have stretched the rules in ways not anticipated by firms and those theories have not been tested through litigation. A few examples include market timing, late trading, Form U4 and U5 filings, directed brokerage, and B-share and C-share sales practices.⁷⁸ Like batters getting mowed down by Nolan Ryan, firms fell in line and settled these charges. The fact that some respondents are stepping up to the plate, swinging for the fences and hitting home runs will likely make other firms and individuals think twice about whether they should have settled and what they should do in the future.

Of course, there are clear advantages to settling, including finality, predictability, and a certain level of control over the outcome. Settling respondents can generally negotiate the language of the settlement order (the Letter of Acceptance, Waiver and Consent) as well as the amount of the fine and/or suspension. Moreover, litigation carries risks and costs that firms may not be prepared to tolerate, including the possibility of losing, the length and cost of the process,⁷⁹ sanctions greater than anticipated, adverse publicity, and litigated ad-

verse findings. The latter issue is significant because if a respondent settles, the allegations or findings are neither admitted nor denied, and therefore the respondent may litigate such issues in subsequent private litigation. In contrast, if the party litigates against NASD and loses, adverse findings are likely to be given collateral estoppel effect in subsequent private actions.⁸⁰

But one thing is for certain: despite the notion that settling respondents are awarded a "settlement discount," there appears to be a great disparity, in the opposite direction, between sanctions in settlements and sanctions in litigated actions. While NASD has settled dozens of cases for fines that range well into the hundreds of thousands (or even millions) of dollars, there have only been six litigated proceedings since January 2000 that resulted in a fine of \$100,000 or more against a member firm.⁸¹ Presumably, NASD prefers when firms and individuals settle for significant sanctions without putting up much of a fight. With almost no one challenging the staff's actions, the staff ends up playing offense, while calling the balls and strikes. But unlike in baseball where the defense controls the ball,⁸² respondents in disciplinary proceedings have the ability to choose whether to settle and go home,⁸³ or step up to the plate and litigate.

⁸⁰ See, e.g., *Parklane Hosiery Co., Inc. v. Shore*, 439 U.S. 322, 325 (1979) (holding that party to earlier SEC injunctive action was collaterally estopped from relitigating the same issues of fact in subsequent private litigation).

⁸¹ *Fiero Brothers, Inc.*, CAF980002 (OHO Dec. 6, 2000) (fine of \$1 million plus expulsion); *Josephthal & Co., Inc.*, C3A990071 (OHO May 15, 2001) (fine of \$500,000, restitution of \$1.5 million); *U.S. Rica Financial, Inc.*, C01000003 (OHO July 9, 2002) (fine of \$133,579.83); *J. Alexander Securities, Inc.*, CAF010011 (Sept. 3, 2003) (fine of \$112,000 plus independent consultant requirement); *D.L. Cromwell Investments, Inc.*, CAF020007 (OHO Nov. 19, 2003) (fine of \$1.5 million, disgorgement of \$1.5 million, and interest of \$800,000); *LH Ross & Company, Inc.*, CAF040056 (Jan. 14, 2005) (fine of \$500,000 plus expulsion). For four of these six litigated cases (*Fiero Brothers, Inc.*, *U.S. Rica Financial, Inc.*, *D.L. Cromwell Investments, Inc.* and *LH Ross & Company, Inc.*), it is unclear whether NASD actually received payment of the fines because the firms were expelled from the industry or were subsequently no longer in business.

⁸² See George Carlin: "In most sports the ball or object, is put in play by the offensive team; in baseball the defensive team puts the ball in play, and only the defense is allowed to touch the ball. In fact, in baseball if an offensive player touches the ball intentionally, he's out; sometimes unintentionally, he's out. Also: In football, basketball, soccer, volleyball, and all sports played with a ball, you score with the ball, and without the ball you can't score. In baseball, the ball prevents you from scoring." (http://home.earthlink.net/~sscutchen/baseball/Quotes/baseball_vs_football.htm).

⁸³ Carlin, *id.*: "In football, the object is for the quarterback, otherwise known as the field general, to be on target with his aerial assault, riddling the defense by hitting his receivers with deadly accuracy in spite of the blitz, even if he has to use the shotgun. With short bullet passes and long bombs, he marches his troops into enemy territory, balancing this aerial assault with a sustained ground attack that punches holes in the forward wall of the enemy's defensive line.

"In baseball the object is to go home! And to be safe! 'I hope I'll be safe at home!'"

⁷⁸ *NASD News Release: 2005 in Review* (Dec. 27, 2005), at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_015794 (noting Enforcement's achievements in 2005, which included "bringing more than 120 disciplinary actions involving deceptive market timing, late trading, unsuitable sales of Class B and Class C mutual fund shares and impermissible revenue sharing"). During 2005 alone, NASD collected \$55 million from 26 member firms for directed brokerage and impermissible revenue sharing, \$40 million from six firms for allegedly unsuitable B-share and C-share sales, and several million more from the 11 firms hit with market-timing and/or late trading-related charges. See *id.* Most of the U4/U5 late reporting cases occurred in 2004, when NASD collected over \$9.2 million from 29 firms at one time. See *NASD News Release: NASD Fines 29 Firms Over \$9.2 Million for Late Reporting* (Nov. 30, 2004), at http://www.nasd.com/web/idcplg?IdcService=SS_GET_PAGE&ssDocName=NASDW_012595.

⁷⁹ Indeed, the expense incurred in defending *Invedmed* has been noted in at least one publication. As *The New York Times* noted: "In his well-financed fight against an outgunned corps of NASD lawyers, Mr. Langone [Invedmed's founder] spared little expense to make his case. . . ." *N.Y. Times*, *supra*, April 21, 2006, at C3. John C. Bogle, the founder of Vanguard, who testified for NASD, "acknowledges the difficulty in winning a case against a free-spending and aggressive defendant such as Mr. Langone. 'If you have a billion bucks and a sense of power, you will fight everything. I guess that is what is best about America and what is worst about America.'" *Id.*