

BY JOHN F.X. PELOSO AND BEN A. INDEK

NASD Sets Standards to Evaluate Delays in Disciplinary Actions

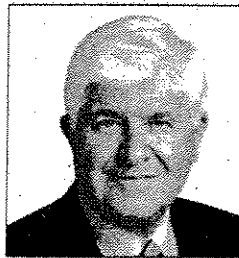
SEVERAL MONTHS ago, we reported on an important National Association of Securities Dealers Hearing Panel decision dismissing a disciplinary complaint against a broker dealer and two of its executives for unfair delay.¹ In *In the Matter of Department of Enforcement v. Morgan Stanley DW Inc. et al.*, the NASD's National Adjudicatory Council (NAC) recently affirmed the dismissal but based its decision "on a somewhat different rationale."² The NAC's decision will have a significant impact on the litigation of future NASD disciplinary cases and may affect how such matters are investigated. To understand the *Dean Witter* decision, it is helpful to review the prior state of the law.

Addressing the Issue of Delay

In *In re Hayden*, Exchange Act Release No. 42,772, 2000 WL 571683 (May 11, 2000), a broker appealed to the Securities and Exchange Commission (SEC) a New York Stock Exchange finding that he violated various exchange rules in connection with the sale of limited partnerships to investors. He asserted that the proceeding against him was barred by the five-year statute of limitations applicable to certain federal government actions contained in 28 USC §2642 and the Due Process Clause of the United States Constitution.

The commission, which previously had been told by the D.C. Circuit in *Johnson v. SEC*, 1996 USApp. LEXIS 14917 (June 21, 1996) that §2642 applied to SEC administrative proceedings, inexplicably did not address whether that section also should be applied to disciplinary proceedings initiated by self-regulatory organizations (SRO) such as the NYSE or the NASD. Instead, it recognized a more fundamental obligation to ensure fairness in SRO disciplinary proceedings. Applying this principle, the SEC measured the time that had elapsed between (i) the date of the first alleged violation and the date the NYSE filed its complaint; (ii) the last alleged misconduct and the filing of the NYSE's complaint; (iii) the date the exchange was on notice of the alleged misconduct and the date the complaint was filed; and (iv) the date the NYSE began its investigation and the date the complaint was filed.

While the SEC wrote that it was unable to state "that Hayden's ability to mount an adequate defense was impaired by the Exchange's delay," the commission nevertheless set aside the NYSE's disciplinary action, holding that "the Exchange does have a statutory obligation to ensure the fairness and integrity of its disciplinary proceedings." *Hayden*, 2000 WL 571683 at *2. In sum, the SEC found that "the delay in the underlying proceedings was inherently unfair." *Id.* In arriving at its decision, the SEC did not make any attempt to articulate what was unfair about the delay or provide any guidance as to whether such a delay would always be unfair or whether its holding was limited to the specific facts of the case.



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The commission again addressed the issue of delay in *In re William D. Hirsch*, Exchange Act Release No. 43,691, 2000 SEC Lexis 2703 (Dec. 8, 2000), where Mr. Hirsch appealed an exchange disciplinary action concerning two customer accounts. Much like Mr. Hayden, Mr. Hirsch contended that a statute of limitations should bar certain of the charges brought against him.

Here the SEC did observe that it had consistently held that the five-year federal statute of limitations in §2462 does not apply to SRO disciplinary actions.³ However, the commission reiterated that under certain circumstances, SRO delays can render a disciplinary action unfair, citing to its prior decision in *Hayden*. Nevertheless, the SEC rejected the application of *Hayden* to Mr. Hirsch's case, noting that in the case under review, the NYSE's delays exceeded only one of the four measurements set forth in *Hayden*.

NASD Hearing Panel Decision

In *Dean Witter*, NASD's enforcement department alleged that in 1992 and 1993 the firm violated the antifraud, suitability and supervisory rules in connection with the sale of certain closed-end trusts. As early as 1993, enforcement began receiving customer complaints regarding the trusts. By July 1994, investors had filed a class action suit alleging fraud and deceptive marketing practices in connection with the sale of the trusts. Enforcement commenced its investigation in January 1996. However, enforcement did not file its complaint until Nov. 20, 2000.

The firm (and two executives also charged) moved for summary disposition under two theories: first, that the delay in bringing the complaint was inherently unfair and required dismissal under the commission's decision in *Hayden*; and second, that the five-year statute of limitations contained in §2462 had run.⁴

Enforcement argued that *Hayden* did not require dismissal of the charges and that §2462 did not apply to SRO disciplinary actions. According to enforcement, fairness was an equitable concept requiring adjudicators to consider the causes for delays on a case-by-case basis. In particular, enforcement asserted that the hearing panel should take into consideration the complexity of the matter and respondents' conduct during the investigation, which was allegedly a significant factor in the delay in filing a complaint. Summing up enforcement's argument, the hearing panel stated that "in essence, [enforcement] urges the [hearing] Panel to permit all the time it needs under the particular facts and circumstances of each case." OHO Redacted Decision CAF 000045 at 15.

The hearing panel rejected these arguments. It noted that in *Hayden* the commission emphasized that SROs had an obligation to ensure that its disciplinary proceedings were fair and that delay alone can render that process unfair. In the absence of any articulation by the SEC concerning how much delay is unfair, the hearing panel applied a rigid comparison of the delay in the case before it with the delay in *Hayden*, and found that the delay exceeded the corresponding delays in *Hayden* in three of the four time periods it measured.⁵ The hear-

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ing panel concluded that the fairness principle articulated in *Hayden* compelled dismissal of the charges against the respondents.

The hearing panel found that nothing in *Hayden* implies that the question of fairness turns on how difficult it is to detect and investigate misconduct or whether that task is made more problematic by the conduct of member firms or associated persons. Rather, the hearing panel imposed upon the NASD the obligation to develop and implement a disciplinary process that under all the circumstances would not be unfair including the concept that, as an objective matter, the lapse of too much time could in itself render a proceeding unfair. In the absence of any commission (or NAC) standards governing delay in SRO disciplinary proceedings, the hearing panel concluded that "the ultimate question ... is how much delay is unfair." Id at 17. Acknowledging that guidance was needed, the hearing panel took the unusual step of recommending that the NAC call the case for expedited review.

NAC's Decision on Appeal

In a lengthy opinion, the NAC affirmed the hearing panel's decision, holding that "Enforcement's delay in filing the complaint exceeded the bounds of fairness that the Exchange Act requires." NAC Decision CAF000045 at 10. The NAC, however, established a different analysis to be applied in cases where a respondent alleged that enforcement had unfairly delayed commencement of an action.

The NAC began its review by pointing out that the Securities and Exchange Act of 1934 does not define "fairness" and noting that it found no cases providing direction as to the meaning of that term. Borrowing from court decisions from a variety of areas of the law, the NAC found that concepts of fairness "are rooted in equity and require consideration of the facts and circumstances of each case." Id at 11. Specifically, the NAC stated that the equitable concepts of "unclean hands" and the harm occasioned by the delay must be analyzed. In focusing on these two concepts, the NAC declined to adopt enforcement's suggestion that the complexity of a case should also be reviewed, finding that this notion is not a traditional equitable consideration. However, in a footnote, the NAC indicated that there may be additional relevant equitable considera-

tions in conducting a fairness analysis. Finally, the NAC concluded that NASD adjudicators must also measure the four time-periods contained in *Hayden* to determine whether an action was unfairly delayed.

In analyzing these issues, the NAC first evaluated whether the "unclean hands" doctrine was applicable because respondents had allegedly caused part of the delay. In particular, enforcement asserted that respondents hampered the investigation by failing to produce customer complaint information to the staff in a timely manner. The NAC observed that part of the delay in providing certain documents to the staff was "sanctioned" by enforcement when it agreed to permit respondents to provide the materials on a rolling basis. In reaching that conclusion, the NAC suggested that enforcement could have entered into a tolling

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agreement to ensure that extensions of time that it had granted were not later held against it in evaluating the length of the investigation's delay.

The NAC also noted that to the extent respondents' alleged failure to produce documents did impede the investigation, enforcement could have filed a disciplinary action under NASD Rule 8210, which permits the staff to require firms and individuals to provide information in connection with any investigation. The NAC found that "under these circumstances, we are unable to conclude that the respondents acted with "unclean hands" and therefore are precluded from advancing a fairness argument." Id at 19.

Second, the NAC evaluated whether respondents were harmed by delay in commencing enforcement's case. The NAC decided that the respondents were hampered in their ability to mount a defense because of the faded memories of witnesses and lost documents. Lastly, the NAC concluded that enforcement exceeded three of the four time periods measured by *Hayden*.

Based upon its analysis of the *Hayden* measures and its finding that respondents had demonstrated harm as a result of enforcement's delay, the NAC affirmed the dismissal of the complaint.

Dean Witter will obviously impact litigated NASD disciplinary actions. Where an issue is raised about delay in the initiation of an NASD complaint, hearing panels will be required to analyze traditional equitable concepts, including the doctrine of "unclean hands" and the harm to respondents. In addition, the time periods identified by the SEC's *Hayden* case must also be measured.

Perhaps more interestingly, however, *Dean Witter* may also affect the investigatory phase of NASD matters. For example, as noted above, the NAC ruled that enforcement "sanctioned" part of the delay in the production of documents by permitting the submission of documents on a rolling basis. In light of this, NASD investigators may be less willing in the future to permit firms to produce materials and information in this standard manner where the length of the investigation may be approaching the *Hayden* time periods.

Moreover, in noting that enforcement could have commenced a disciplinary action under NASD Rule 8210 for respondents' alleged failure to produce documents timely, enforcement staff may now be more willing to use this mechanism. Finally, the NAC's suggestion that enforcement could have used a tolling agreement to assure that any delays in its investigation would not be counted against it may prompt the staff's use of such agreements in future investigations. Each of these issues bears watching over the next several years.

(1) See "SRO Disciplinary Proceedings: How Much Delay is Unfair?" New York Law Journal, Feb. 21, 2002 discussing NASD Regulation, Inc., Office of Hearing Officers Redacted Decision CAF 000045 (Dec. 14, 2001) (available on the web at www.nasdr.com/pdf-text/oh01201_01red.txt).

(2) See NASD National Adjudicatory Council decision CAF000045 (Jul. 29, 2002) (available on the web at www.nasdr.com/pdf-text/nac0702_01.pdf). While the earlier hearing panel decision redacted the identities of the respondents in accordance with NASD rules, the NAC action indicates that Dean Witter Reynolds Inc. was the broker dealer named in the case. Consistent with the NAC decision, we refer to the matter here as the *Dean Witter* case.

(3) See id at footnote 11 and cases cited therein.

(4) The hearing panel did not decide the statute of limitations issue in its decision but, citing to the SEC's *Hirsch* decision, noted that the commission had previously rejected the idea that §2462 applies to an SRO. OHO Redacted Decision CAF000045 at 12.

(5) The hearing panel did not discuss the period of time that had elapsed from the first act of misconduct to the filing of the complaint.