

SECURITIES LITIGATION AND ENFORCEMENT

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SRO Disciplinary Proceedings: How Much Delay is Unfair?

AN NASD REGULATION Hearing Panel recently concluded that disciplinary charges against an unidentified broker dealer and two of its executives must be dismissed for unfair delay.¹ Like two earlier U. S. Securities and Exchange Commission decisions, however, this case provides little guidance to SRO (self-regulatory organizations) Hearing Panels to evaluate how much delay is unfair. The case is now under review by NASDR's National Adjudicatory Council. Some background is in order.

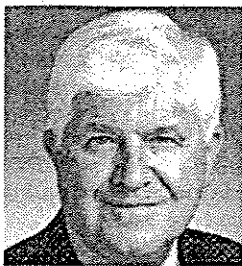
Prior SEC Opinions

In *In re Hayden*, Exchange Act Release No. 42,772, 2000 WL 571683 (May 11, 2000), a broker appealed a New York Stock Exchange finding that he violated various Exchange rules in connection with the sale of limited partnerships to investors. In Mr. Hayden's appeal to the commission, he asserted that the proceeding against him, which was filed more than five years after the last alleged act of misconduct, was barred by the five-year statute of limitations applicable to certain federal government actions contained in 28 U.S.C. §2642 and the Due Process Clause of the United States Constitution.²

The commission did not address these arguments, finding instead that it had an obligation to ensure fundamental fairness in SRO disciplinary proceedings. In applying the fairness principle to *Hayden*, the SEC measured the time that had elapsed between (i) the last alleged misconduct and the filing of the NYSE's complaint; (ii) the date the Exchange was on notice of the alleged misconduct and the date the complaint was filed; and (iii) the date the NYSE began its investigation and the date the complaint was filed. The commission found that Mr. Hayden's last alleged act of misconduct occurred in April 1990 and that the Exchange first became aware of the allegations in 1991. Nevertheless, the NYSE did not begin its investigation until May 1993 and filed its complaint against Mr. Hayden in November 1996.

In considering this time line, the commission wrote that it was not, on the record before it, able to state "that Hayden's ability to mount an adequate defense was impaired by the Exchange's delay." *Hayden*, 2000 WL 571683 at *2. Nevertheless, the commission 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. We believe that the delay in the underlying proceeding was inherently unfair." Id.

While indicating that the delay did not prejudice Mr. Hayden, the SEC did not make any attempt to articulate what was unfair about the delay. The commission also did not 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. Finally, the SEC did not



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discuss the merits of the NYSE's charges in reaching its conclusion.

Six months after *Hayden*, the commission again addressed delays in the commencement of an NYSE disciplinary action. In *In re William D. Hirsch*, Exchange Act Release No. 43,691, 2000 SEC Lexis 2703 (Dec. 8, 2000), Mr. Hirsch appealed an Exchange disciplinary action finding that he had engaged in various NYSE rule violations concerning two customer accounts. Much like *Hayden*, *Hirsch* contended that a statute of limitations should bar certain of the charges brought against him.

The SEC first noted that it had consistently held that the five-year federal statute of limitations in §2462 does not apply to SRO disciplinary actions.³ Next, the commission indicated that under certain circumstances, SRO delays can render a disciplinary action unfair, citing its prior decision in *Hayden*. However, with little comment, the SEC rejected the application of *Hayden* to Mr. Hirsch's case, simply noting that the charges were filed within just 20 months after the NYSE was informed of the alleged misconduct, even though nearly eight years had passed since the last alleged violation. *Hirsch* at *18. *Hirsch*, however, provided no guidance as to how the *Hayden* rationale was to be applied in cases generally.

Recent NASDR Panel Decision

In the recent case, NASDR alleged that in 1992 and 1993 the firm violated the NASD's antifraud, suitability and supervisory rules in connection with the sale of certain closed-end trusts. The complaint charged that the firm urged its sales force to market the trusts as safe, low-risk investments designed to replace expiring certificates of deposits without disclosing the trusts' substantial investment risks, including their use of mortgage-backed derivatives.

As early as 1993, NASDR began receiving customer complaints regarding the trusts. In that same year, articles appeared in the press describing the dangers posed by certain funds (such as the trusts) that invested in derivative products. By July 1994, investors had filed a class action suit alleging fraud and deceptive marketing practices in connection with the sale of the trusts. Around this same time, the media reported that the New York Attorney General had begun an investigation into funds investing in derivatives and that the trusts were a possible target of the probe. The use of derivatives even spawned congressional hearings at which SEC Chairman Arthur Levitt and the New York Attorney General testified.

Despite this widespread notice, NASDR claimed that it had not become aware of any possible misconduct by the firm involved until January 1995 at the earliest. Specifically, NASDR asserted that no one within the SRO was aware of the class-action lawsuit, congressional hearings or, with one exception, press attention relating to the trusts. Even after the issue surrounding the trusts became known within the organization, NASDR did not commence an investigation until January 1996. Between January 1996 and September 1998, NASDR undertook a sweeping review of

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the matter, issuing 163 formal requests for documents and deposing over 60 individuals. Despite the breadth of this review, NASDR received most of the requested documents by January 1997 and had completed its interviews by July 1998.

In June 1999, NASDR notified the firm that it was considering formal disciplinary charges. The firm responded to this notification by providing a *Wells* submission in September 1999 and met with NASDR two months later to discuss the investigation. NASDR did not file its complaint until Nov. 20, 2000.

The firm (and two executives also charged by NASDR) moved for summary disposition under two theories. First, the respondents asserted that the delay in bringing the complaint was inherently unfair and required dismissal under the commission's decision in *Hayden*. The respondents also argued that the five-year statute of limitations contained in §2462 had run.¹

NASDR asserted that *Hayden* did not require dismissal of the charges and that §2462 did not apply to SRO disciplinary actions. According to NASDR, fairness was an equitable concept requiring adjudicators to consider the causes for delays on a case-by-case basis. In particular, NASDR 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. The Hearing Panel recounted that "in effect, the [NASDR] urges the [Hearing] Panel to read into *Hayden* a number of factors not addressed in that decision" OHO Redacted Decision CAF 000045 at 14. To distinguish *Hayden*, NASDR claimed that "it was fair to take longer with this case because it is more complex." *Id.* at 15. Summing up NASDR's argument, the Hearing Panel stated that "in essence, [NASDR] urges the [Hearing] Panel to permit all the time it needs under the particular facts and circumstances of each case." *Id.*

Arguments Rejected

At the end of the day, the Hearing Panel rejected these arguments. To begin with, 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 each of the three periods to be measured. The Hearing Panel concluded that the fairness principle articulated in *Hayden* com-

pelled dismissal of the charges, against the respondents.

In arriving at its decision, the Hearing Panel found that nothing in *Hayden* implies that the question of fairness turns on how difficult it is for NASDR 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 recognized that NASDR must develop and implement a fair disciplinary process and that delay alone can 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.

Conclusion

As a basic principle, one could argue that the SRO enforcement process might be improved if there were a defined period within which the SROs were required to commence proceedings. That is so not only to ensure fairness to the respondents but also to motivate the SROs to deal with their cases in an expeditious manner. Applying the provisions of 28 U.S.C. §2462 to SROs could be one way to do this; but we will have to wait for a court to agree.

In the meantime, what lessons can we draw from *Hayden* (case dismissed), *Hirsch* (case not dismissed) and this most recent NASDR decision? The first obvious point is that stale cases will be thrown out not withstanding the SROs' objections to extending the provisions (or rationale) of 28 U.S.C. §2462 to their proceedings. But another important lesson is that we should look hard at whether or not some objective standard for measuring unfair delay would

be an improvement over the current state of affairs.

To be sure, both SROs and respondents might well argue that the absence of a defined period of limitation or even concrete criteria, allows each side continued flexibility in dealing with delay on a case-by-case basis. Thus, SROs might have good reasons to bring old cases, and respondents might be able to show prejudice and unfairness in bringing charges in aged cases. But that is true in any litigation and the law has recognized that, on balance, the system is better, if it has predictability.

How this ultimately will be resolved is still unclear. It will be interesting to see how the National Adjudicatory Council handles this case and whether it will lead to more definitive guidelines.

(1) See 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). In accordance with NASD rules, the identities of the respondents in this case were redacted from the published decision.

(2) Section 2462 provides that "an action, suit or proceeding for the enforcement of any civil fine, penalty, or forfeiture, pecuniary or otherwise, shall not be entertained unless commenced within five years from the date when the claim first accrued" For years, the SEC took the position that §2462 did not apply to its enforcement activities. In 1996, the U.S. Court of Appeals for the District of Columbia Circuit squarely held that a six-month supervisory suspension imposed by the commission was a "penalty" subject to the five-year statute of limitations provision of §2462. Accordingly, the Court vacated the sanction. See *Johnson v. SEC* 87 F.3d 484 (D.C. Cir. June 21, 1996).

(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) Sooner or later, a court is going to be receptive to the argument that when SROs are carrying out their statutory responsibility to enforce the federal securities laws, they should be bound by the same ground rules as the SEC, which could mean the recognition that suspension from the securities business by an SRO is as much a "penalty" as when the suspension is imposed by the SEC, thus providing a springboard for the application of Section 2462 to SRO proceedings.