BEFORE THE NATIONAL ADJUDICATORY COUNCIL

In the Matter of Department of Enforcement, Complainant, vs. Morgan Stanley DW Inc. *et al.*, Respondents.	**DECISION** Disciplinary Proceeding No. CAF000045 Dated: July 29, 2002

Hearing Panel dismissed the case on the grounds that the action was filed beyond the time limits set forth in the Securities and Exchange Commission's decision in *Jeffrey Ainley Hayden*. Held, Hearing Panel's dismissal of the case affirmed.

Appearances

For the Complainant Department of Enforcement: Barry R. Goldsmith, Esq., Rory C. Flynn, Esq., Thomas B. Lawson, Esq., David R. Sonnenberg, Esq., Robert L. Furst, Esq., Robert W. Turk, Esq., of the Department of Enforcement of NASD.

For the Respondent Morgan Stanley DW Inc.: Martin London, Esq., Richard A. Rosen, Esq., Jeannie S. Kang, Esq., Alisa A. Pincus, Esq., Tadd A. Kipnes, Esq., of Paul, Weiss, Rifkind, Wharton & Garrison.

For the Respondent John B. Kemp III: Bradford D. Kaufman, Esq., William D. Briendel, Esq., Timothy E. Di Domenico, Esq., of Greenberg Traurig, LLP.

For the Respondent Lawrence J. Solari, Jr.: Paul W. Stivers, Esq., Dan F. Laney, III, Esq., Jonathan B. Butler, Esq., of Rogers & Hardin LLP.

I. Introduction

The Department of Enforcement ("Enforcement") for NASD appealed the December 14, 2001 decision of a Hearing Panel as to respondent Morgan Stanley DW Inc. ("Morgan Stanley").[1] We then called the case for review as to all respondents—Morgan Stanley, John B. Kemp ("Kemp") and Lawrence J. Solari, Jr. ("Solari"). The sole issue raised by this appeal and call for review is whether the Hearing Panel erred by dismissing this case as untimely based on its interpretation of the Securities and Exchange Commission's decision in *Jeffrey Ainley Hayden*, Exchange Act Rel. No. 42772, 2000 SEC LEXIS 946 (May 11, 2000). As discussed in greater detail *infra*, the Hearing Panel held that the case should be dismissed because all of the applicable periods of delay in the instant case were longer than the corresponding periods that the SEC found excessive in *Hayden*. We affirm the Hearing Panel's dismissal of the action, but we base our decision on a somewhat different rationale.

II. Factual and Procedural History

In 1992 and 1993, Morgan Stanley sold three closed-end funds called TCW/DW Term Trust 2002, TCW/DW Term Trust 2003 and TCW/DW Term Trust 2000 (collectively referred to as "Term Trusts"). The offerings occurred in November 1992, April 1993 and November 1993, respectively. Morgan Stanley prepared a "sales kit" which included the Term Trusts prospectus, public-use sales materials (including a client sales brochure, a prospecting letter and an advertisement) and internal-use sales materials. The public-use sales materials were provided to and reviewed by NASD's Advertising Department while the internal-use sales materials were not. (The NASD rules do not require that broker-dealers submit *internal* sales materials to NASD for its review.) Morgan Stanley then distributed copies of the sales kits to branch offices nationwide before it offered the Term Trusts to the public.

Morgan Stanley also conducted internal sales presentations (often referred to as "road shows") for various branch offices around the country prior to and during each Term Trust offering. Regional wholesalers of Morgan Stanley, along with representatives of the Term Trusts' manager, conducted the road shows. The audience at the road shows

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[1] The complaint in this matter named Dean Witter Reynolds Inc. ("Dean Witter") and not Morgan Stanley as a respondent. The products at issue were those of Dean Witter and the registered representatives named in the complaint were Dean Witter employees. While this action was pending, however, Dean Witter merged with Morgan Stanley. By order dated October 15, 2001, the Hearing Officer, with the consent of the parties, substituted Morgan Stanley as a respondent in the place of Dean Witter. At that time, the Hearing Officer also amended the caption of this action to reflect that fact. For purposes of this decision only, we refer to Dean Witter as Morgan Stanley.

was internal, composed of Morgan Stanley's sales force of account executives and branch managers. Copies of the sales kits were made available in advance of and during the road show presentations. Sales kits were not made available to the investing public.

In 1992 and 1993, Morgan Stanley sold more than $2 billion worth of shares of the Term Trusts to more than 100,000 customers. Investors received a prospectus and sales materials. When interest rates rose significantly in 1994, the Term Trusts began to decline sharply in value.[2] In 1994 and 1995, nearly 30,000 customers allegedly sold their Term Trusts shares before maturity for losses totaling approximately $65 million. The Term Trusts' values subsequently recovered, however. Morgan Stanley emphasizes that, in addition to providing regular income payments, Term Trust 2000 exceeded its target price of $10 per share and returned $10.10 per share to investors on December 31, 2000. Term Trusts 2002 and 2003, also with target prices of $10 per share, had net asset values of $10.77 and $11.06, respectively, as of the time of this appeal.

As early as 1993, NASD District Offices began receiving customer complaints from Term Trusts investors. Between 1994 and 1995, Morgan Stanley filed numerous Uniform Applications for Securities Industry Registration or Transfer ("Form U-4") and Uniform Termination Notices for Securities Industry Registration ("Form U-5") with NASD that reported customer complaints alleging problems with sales of the Term Trusts. During that same period, the New York Attorney General's Office ("NYAG") investigated the Term Trusts.

In July 1994, moreover, investors filed a federal class action lawsuit against Morgan Stanley, alleging that Morgan Stanley had misrepresented the risks of the Term Trusts and used deceptive marketing practices in selling the products. That case, *Sheppard v. TCW/DW Term Trust 2000*, 938 F. Supp. 171 (S.D.N.Y. 1996), ultimately was dismissed in part on the grounds that the prospectus for the Term Trusts "sufficiently disclosed the risks related to the types of securities in which the Trusts would invest,

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[2] According to the complaint, the Term Trusts were designed to generate current income and to return the investors' initial investments at the end of a specified term of either seven or ten years. The complaint alleges that the Term Trusts relied heavily on mortgage-backed derivatives, including inverse floaters, and the aggressive use of leverage to achieve these results. The complaint further alleges that the Term Trusts relied on steady or declining interest rates to achieve their maximum return and were not hedged against a sharp rise in interest rates. The Term Trusts were thus allegedly exposed to potential losses in relation to both net asset value and dividends if interest rates rose significantly.

including the interest rate risk." *Sheppard*, 938 F. Supp. at 176. State courts in New York and New Jersey dismissed other Term Trusts lawsuits on similar grounds.[3]

Enforcement maintains that NASD did not become aware of possible significant misconduct by Morgan Stanley until January 1995, when the NYAG provided Enforcement with information of its investigation into the Term Trusts. (At the conclusion of its investigation, the NYAG did not take any action against Morgan Stanley relating to the Term Trusts.) Enforcement cannot rule out, however, that the alleged problems with the marketing of the Term Trusts came to the NASD's attention earlier.[4]

Enforcement elected to undertake a sweeping review of all transactions in the Term Trusts. Between January 1996 and September 1998, Enforcement issued 163 formal requests for documents, information and testimony to Morgan Stanley and more than 100 of its current and former employees. Enforcement deposed sixty individuals, and these depositions resulted in sixty-four transcripts totaling approximately 6,537 pages of recorded oral testimony. Enforcement also requested and received more than 1,600 documents and at least ten deposition transcripts from the NYAG that had been gathered during the course of its investigation of the Term Trusts. The documents included internal sales literature, sales kits, prospectuses, road-show materials, internal sales news letters, newspaper articles, customer complaints, internal memos and 101 five-page customer questionnaires sent by the NYAG and completed by Term Trusts customers.

Enforcement substantially completed its fact gathering by July 1998. Other than one brief on-the-record interview in October 1998, all of the on-the-record interviews

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3 The New York Supreme Court held that the "claim that defendants failed to disclose risks is flatly contradicted by the prospectuses for each of the Term Trusts." *Keeley v. Morgan Stanley Dean Witter Servs. Co.*, No. 604887/98, slip op., at 8 (N.Y. Sup. Ct. Apr. 25, 2000). Likewise, the Superior Court of New Jersey held that plaintiffs' claims for fraud based on oral misrepresentations failed as a matter of law because the Term Trusts prospectus outlining the possible risks was delivered to the investors at the time the written confirmation was mailed. *See Gall v. Morgan Stanley Dean Witter Servs. Co.*, No.L-9269-98, slip op., at 3-4 (N.J. Super. Ct. Law Div. Jan. 31, 2000).

4 This critical information, along with other information about the commencement of the investigation, is lost. According to Enforcement, there is no one remaining at NASD who can recall the exact course of events that led to the commencement of the investigation. There is also some confusion regarding exactly when Enforcement began the investigation in this matter. For instance, Enforcement sent Morgan Stanley a request for information regarding the Term Trusts in January 1996, but Enforcement asserts that it did not open the "formal" investigation until March 1996.

were completed by July 2, 1998. Enforcement received most of the documents requested of Morgan Stanley by January 1997.

On June 21, 1999, Enforcement sent "Wells" letters[5] to Morgan Stanley and a number of current and former employees, including Kemp and Solari. In September 1999, Enforcement received responses to its "Wells" letters. On November 20, 2000, Enforcement filed the current complaint against Morgan Stanley, Kemp and Solari.

In general, the complaint alleged that Morgan Stanley used a firm-wide, internal marketing campaign that misrepresented the nature of the Term Trusts, resulting in fraudulent and unsuitable sales to an unidentified number of customers. The complaint did not allege that the prospectus or other public sales materials were false or misleading. The complaint claimed that Morgan Stanley instructed and encouraged its sales force to sell the Term Trusts as safe, low-risk investments equivalent to certificates of deposit without disclosing the Term Trusts' substantial investment risk. The complaint further alleged that, as a result of Morgan Stanley's internal marketing campaign, its sales force made material misrepresentations and omitted material information in connection with the sale of the Term Trusts and that the sales force recommended and sold the Term Trusts to customers for whom such securities were unsuitable.

The complaint also charged Kemp and Solari with failing to adhere to just and equitable principles of trade in relation to the Term Trusts. Kemp, who is sixty years old, entered the securities industry in 1967.[6] During the relevant period, he was Director of National Sales for Morgan Stanley. The complaint alleged that he "failed to observe high standards of commercial honor and just and equitable principles of trade when he oversaw and approved road show sales presentations that provided an unbalanced picture of the Term Trusts, omitted disclosure of any risks, and misinformed [Morgan Stanley's] brokers about the nature of the investment." Solari, who is a seventy-one year-old retiree, entered the securities industry in 1958. He does not have any disciplinary history. He was Regional Director of Morgan Stanley's Northeast region in 1992-1993. The complaint alleged that he failed to observe high standards of commercial honor and just and equitable

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[5] A "Wells" letter refers to a letter sent by NASD staff notifying a respondent "that a recommendation of formal disciplinary charges is being considered" and usually provides the respondent with an opportunity to "submit a written statement explaining why such charges should not be brought." NASD Notice to Members 97-55, 1997 NASD LEXIS 77, at *13 (Aug. 1997).

[6] Kemp's only disciplinary history took place twenty-eight years ago when in 1974 he was censured and fined $2,000 by the New York Stock Exchange.

principles of trade when he sent memoranda to the branch managers under his supervision that directed the use of misleading sales presentations to customers.

The respondents filed answers to the complaint denying the substantive allegations. The respondents also filed a motion for summary disposition seeking dismissal of the complaint on the grounds that the proceeding was time-barred based on the SEC's holding in *Jeffrey Ainley Hayden*, Exchange Act Rel. No. 42772, 2000 SEC LEXIS 946 (May 11, 2000). The Hearing Panel agreed and dismissed the action. In doing so, the Hearing Panel did not make any findings relating to the merits. Enforcement appealed the case as to Morgan Stanley but not as to Kemp and Solari. Kemp and Solari currently are involved in this action only because of our call for review as to all of the respondents.

III. Discussion

The 1938 Maloney Act Amendments to the Securities Exchange Act of 1934 ("Exchange Act") created a system of self-regulation of broker-dealers in the securities industry. NASD is responsible for creating and enforcing rules that serve the statutory objectives of protecting the public from unethical and fraudulent practices, providing supervision of NASD members' activities and promoting public confidence in the integrity of the securities markets. *See* Section 15A(b)(6)-(8) of the Exchange Act, 15 U.S.C. §78o-3(b)(6)–(8).

NASD and other securities self-regulatory organizations ("SROs"), however, do not have unfettered discretion in creating and enforcing their rules. The SEC reviews and, under certain circumstances, can disapprove SRO rules. *See* Section 19(b)(1) of the Exchange Act, 15 U.S.C. §78s (b)(1). The SEC also reviews SRO final disciplinary actions that are appealed to it. *See* Section 19(e)(1)(A) of the Exchange Act, 15 U.S.C. §78s(e)(1)(A). The Exchange Act, moreover, requires that SRO rules "provide a *fair* procedure for the disciplining of members and persons associated with members[.]" Section 15A(b)(8) of the Exchange Act, 15 U.S.C. §78o-3(b)(8) (emphasis added). It is these latter two principles—SEC review of SRO disciplinary actions and the Exchange Act's requirement that SROs adhere to fairness principles—that are at the heart of the current matter.

For many years, the SEC's interpretation of the Exchange Act's fairness language focused primarily on whether an SRO had followed its internal procedures and whether those procedures were fair.[7] The SEC's *Hayden* decision for the first time dismissed an SRO disciplinary action on fairness grounds because of the age of the case.

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7 *See Scattered Corp.*, 53 S.E.C. 948, 958 (1998) (noting that the usual cases involving "fairness" analyses "have focused on the fairness of the SRO's internal procedures, including organization structure as it affects the fairness and impartiality of the

[Footnote continued on next page]

In *Hayden*, a New York Stock Exchange ("NYSE") Hearing Panel found that the respondent had made unsuitable recommendations and material misrepresentations about certain investments. *Hayden*, Exchange Act Rel. No. 42772, 2000 SEC LEXIS 946, at *1-3. On appeal to the SEC, the respondent argued that the action was time-barred on two theories. The first theory was that the five-year statute of limitations in 28 U.S.C. §2462, which the United States Court of Appeals for the District of Columbia Circuit found applicable to SEC enforcement proceedings in *Johnson v. SEC*, 87 F.3d 484 (D.C. Cir. 1996), applied with equal force to actions brought by the NYSE. *Hayden*, Exchange Act Rel. No. 42772, 2000 SEC LEXIS 946, at *3 & n.2. The second theory was that the inordinate time delay between the alleged misconduct and the NYSE's filing of the action did not comport with the requirements of the due process clause of the United States Constitution. *Id.* at *3.

The SEC did not directly address either of the respondent's contentions. Instead, the SEC focused on the fairness language of the Exchange Act. The SEC stated that "a fundamental principle governing all SRO disciplinary proceedings is fairness" and that an SRO has "a statutory obligation to ensure the fairness and integrity of its disciplinary proceedings." *Id*. at *4-6.[8] The SEC mentioned four different time periods in reviewing whether those proceedings were fair: (1) the time between the first alleged occurrence of misconduct and the date that the NYSE filed the complaint (thirteen years and ten months); (2) the time between the last alleged occurrence of misconduct and the date that the NYSE filed the complaint (six years and seven months); (3) the time between the date that the NYSE received notice of the alleged misconduct and the date that the NYSE filed the complaint (five years); and (4) the time between the date that the NYSE commenced its investigation and the date that the NYSE filed the complaint (three years and six months). *Id*. at *5. The SEC dismissed the action because "the delay in the underlying proceedings was inherently unfair," even though it did not find "as a factual matter" that "Hayden's ability to mount an adequate defense was impaired by the Exchange's delay." *Id*. at *6.

Subsequently, in *William D. Hirsh*, Exchange Act Rel. No. 43691, 2000 SEC LEXIS 2703 (Dec. 8, 2000), the SEC stated that no statute of limitations applies to SRO

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course of the proceeding"); *U.S. Associates, Inc*., 51 S.E.C. 805 (1993) (performing a "fairness" analysis and finding that NASD had failed to follow its own procedural rules).

8 The SEC based its ruling on Section 6(b)(7) of the Exchange Act, 15 U.S.C. §78f(b)(7), which requires exchanges to "provide a fair procedure for the disciplining of members and persons associated with members. . . ." While Section 6(b)(7) applies only to exchanges, Section 15A(b)(8) of the Exchange Act, 15 U.S.C. §78o-3(b)(8), discussed above, applies to NASD proceedings and contains an identical requirement.

proceedings. *Id*. at *18. Nonetheless, the SEC confirmed the holding in *Hayden* that an extreme delay in bringing an action can result in dismissal based on fairness grounds. *Id*.

In *Hirsh*, the NYSE found that the respondent had effected unauthorized, unsuitable and excessive trades in the accounts of two customers. *Id*. at *1-3. On appeal to the SEC, the respondent argued that the complaint as to one of the customers was time-barred. *Id*. at *3. The SEC concluded, however, that *Hayden* did not necessarily require the dismissal of the charges in *Hirsh* because in *Hirsh* the NYSE exceeded only one of the four time-periods identified in *Hayden. Id*. at *17-19. The time between the first alleged occurrence of misconduct and the date that the NYSE filed the complaint in *Hirsh* was eight years and eleven months, compared with a delay of thirteen years and ten months in *Hayden*. *Id*. at *6-9, *17-18. The NYSE filed its charges only twenty months after receiving notice of the misconduct in question, in contrast to the five years that had lapsed in *Hayden*. *Id*. at *18-20.[9] In *Hirsh* there also was only a one-year delay between the date that the NYSE commenced its investigation and the date it filed charges, compared with a delay of three and one-half years in *Hayden*. *Id*. at *17-18. Only the delay between the date of the last act of misconduct and the date when the charges were brought was longer in *Hirsh* (eight years versus six years and seven months from the last act in *Hayden*). *Id*. at *8, *18. The SEC also emphasized that even if it had dismissed the complaint regarding the one customer it would not have altered the sanctions because the respondent's misconduct as to the other customer was serious enough to uphold the NYSE’s sanctions. *Id*. at *20-21.

The SEC's *Hayden* and *Hirsh* decisions recognize that after a certain period of time it is unfair to require respondents to attempt to piece together defenses to old claims. With the passage of time, memories fade, witnesses become unavailable and documents are lost or destroyed. Indeed, even without a showing of actual harm, it can be inherently unfair to require respondents to face the prospect of potential claims for prolonged and indeterminate periods of time.[10]

In the current proceedings, the Hearing Panel interpreted the SEC's *Hayden* decision as setting the outer limits for periods of delay beyond which the proceedings must be dismissed. The Hearing Panel, however, viewed only three of the four time periods as

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[9] In *Hirsh*, the SEC focused on this time period when it distinguished *Hayden*. The other periods can be gleaned only from a close reading of the entire decision in *Hirsh.*

[10] In addition to the fairness to respondents, requiring actions to be brought in a reasonable amount of time serves the purposes of encouraging SROs to investigate promptly wrongdoing and prevents adjudicators from being overburdened with stale claims.

crucial to the analysis, omitting any discussion of the period from the first act of alleged misconduct to the filing of the complaint. Comparing three of the four time periods in *Hayden* with those in the current case, the Hearing Panel determined that each of the periods in this case was longer than the corresponding periods in *Hayden*. The comparisons are as follows: (1) six years and seven months passed between the date of the misconduct and the date when the NYSE brought charges in *Hayden* versus seven years in the current case; (2) five years passed between the time when the NYSE was first informed of the misconduct and the date when it brought charges in *Hayden* compared with five years and nine months in the present matter;[11] and (3) three years and six months passed between the time when the NYSE initiated its investigation and the date when it brought formal charges in *Hayden* whereas in this case four years and nine months had passed. The Hearing Panel held that the case had to be dismissed because Enforcement had exceeded the three *Hayden* prongs that the Hearing Panel had identified as significant. That, the Hearing Panel found, ended the inquiry.

In so holding, the Hearing Panel rejected Enforcement's argument that adjudicators must look beyond the time periods referenced in *Hayden* and instead consider the facts and circumstances of each case, including the complexity of the case and the respondents' possible contribution to the delay. The Hearing Panel emphasized that the SEC did not base its decision in *Hayden* on any of the factors Enforcement sought to have applied in this case. The Hearing Panel stated that Enforcement's position, if adopted, would not only be contrary to *Hayden*, it would be unworkable as well. The Hearing Panel noted that adopting Enforcement's test would raise myriad issues, such as how adjudicators should determine whether a case is "complex" and how much additional time "complex" cases should be given.

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11 We note that there is support in the record for respondents' argument that NASD was aware of the misconduct prior to January 1995, the date Enforcement claims it first learned of the misconduct from the NYAG. For instance, NASD District Offices received customer complaints about the Term Trusts starting in 1993, news articles appeared on the Dow Jones News Service, in Worth magazine, in the New York Times, on Bloomberg News Service and in Barron's concerning the Term Trusts in 1993 and 1994, Morgan Stanley sent the NASD Forms U-4 and U-5 discussing complaints in relation to the Term Trusts beginning in 1994, a class action lawsuit was filed against Morgan Stanley concerning the Term Trusts in 1994, and a United States House of Representatives subcommittee held public hearings at which the SEC Chairman and the New York Attorney General testified about the use by funds of derivative products, including inverse floaters in 1994. However, for this decision, we need not decide when Enforcement knew or should have known about the misconduct because even using the later date at which Enforcement claims it learned of the misconduct, Enforcement still exceeded the third time period referenced in *Hayden* (the second time period identified in the Hearing Panel's decision) by approximately nine months.

On appeal, Enforcement argues that *Hayden* does not require a statute of limitations analysis that results in a "one size fits all" review. Enforcement emphasizes that the "fairness" language of the Exchange Act is an equitable notion allowing for a case-by-case analysis. Enforcement contends that the SEC did not intend to limit "fundamental fairness" analyses in post-*Hayden* cases to a mechanical calculation of three dates. According to Enforcement, the Hearing Panel thus erred by refusing to consider the complexity of the case and the respondents' conduct in relation to the delay.

The respondents, on the other hand, argue that Enforcement is improperly attempting to interject factors into the analysis that the SEC rejected in *Hayden*. According to the respondents, *Hayden* is controlling and does not allow for any balancing of equities. The respondents argue that once the time delays exceed those in *Hayden*, the case must be dismissed. The respondents opine, moreover, that the actual fairness limits may involve shorter periods of time than those identified in *Hayden*.

We find that, under the facts of this case, the Hearing Panel correctly dismissed the action. We hold, as did the Hearing Panel, that Enforcement's delay in filing the complaint exceeded the bounds of fairness that the Exchange Act requires. We differ from the Hearing Panel, however, regarding the proper analysis that should be applied. As discussed in greater detail below, the Hearing Panel improperly relied exclusively on a calculation of three of the four periods mentioned in *Hayden* and *Hirsh*, foreclosing even the possibility that other factors may be relevant in this or future cases and omitting any discussion of the fourth time period that the SEC had referenced. In essence, the Hearing Panel interpreted *Hayden* and *Hirsh* as creating a three-pronged, quasi statute of limitations. Although we agree that the time periods referenced in *Hayden* and *Hirsh* are important components of the SEC's "fairness" analysis,[12] we do not believe that the SEC intended to create a mechanical test based solely on those time periods, irrespective of other factors.

Neither *Hayden* nor *Hirsh* set forth a specific test that adjudicators must use when "fairness" issues are raised. Indeed, beyond referencing four time periods and noting that the respondent in *Hayden* had not proved that he had been prejudiced by the delay, the SEC offered very little guidance. Our analysis, therefore, necessarily begins with the statutory authority for the SEC's holding in those cases. In both instances, the SEC relied on the Exchange Act's "fairness" language. The Exchange Act does not define the term, however, and we have found no cases that provide clear guidance on the meaning or scope of the term in relation to timing issues. The exact meaning of the term in this

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[12] We emphasize, however, that adjudicators should consider all four of the periods referenced in *Hayden* and *Hirsh.*

context is thus not easily ascertainable. Nonetheless, a review of how the judiciary has treated "fairness" concepts outside the Exchange Act's framework is instructive.

Courts have consistently noted that "fairness" concepts—whether in the context of constitutional, statutory or common law claims or defenses—are rooted in equity and require consideration of the facts and circumstances of each case. For instance, the United States Supreme Court considered the meaning of "fundamental fairness" in reviewing a claim based on the due process clause of the United States Constitution in *Lassiter v. Department of Social Services*, 452 U.S. 18 (1981), where it explained:

> [T]he phrase [due process] expresses the requirement of "fundamental fairness," a requirement whose meaning can be as opaque as its importance is lofty. Applying the Due Process Clause is therefore an uncertain enterprise which must discover what "fundamental fairness" consists of in a particular situation by first considering any relevant precedents and then by assessing the several interests that are at stake.

Id. at 24-25.[13] The Court in *United States v. Fuller*, 409 U.S. 488 (1973), evoked a similar notion in resolving a claim under the just compensation clause to the United States Constitution. The Court stated, "The owner is entitled to fair market value, but that term is 'not an absolute standard nor an exclusive method of valuation.' The constitutional requirement of just compensation derives as much content from the basic *equitable principles of fairness* as it does from technical concepts of property law." *Id.* at 490 (citations omitted) (emphasis added).

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[13] We note as well that courts have looked to due process principles in reviewing "fairness" claims made pursuant to the securities laws. For instance, in *Gold v. SEC*, 48 F.3d 987 (7th Cir. 1995), the court stated:

> [W]e confine our analysis to a determination of whether the SEC provided "a fair procedure" for disciplining Gold pursuant to 15 U.S.C. §78f(b)(7). This statutory fairness requirement is closely related to the fairness requirements derived from the Fifth Amendment's Due Process Clause. We have therefore assessed the fairness of the NYSE's jurisdictional rules and enforcement action against Gold by relying on traditional due process principles.

Id. at 991.

In addition, courts deciding whether to issue injunctive relief under the federal securities laws have emphasized that they "are called upon to weigh all those considerations of fairness and justice that have been the historic concern of the equity courts." *SEC v. Harwyn Industries Corp*., 326 F. Supp. 943, 955 (S.D.N.Y. 1971); *see also SEC v. Penn Central Co*., 425 F. Supp. 593, 596 (E.D. Pa. 1976) (same). Likewise, the court in *Partlow v. Frank*, No. 90-022-S, 1991 U.S. Dist. LEXIS 21690, *9-10 (D.N.H. Nov.19, 1991), stated that "the tolling doctrine [is] based on 'equitable concerns of fairness' . . . ."

Again, the thread that ties these and many other cases together is that "fairness" has its roots in equity,[14] a notion that by its very nature requires consideration of the necessities of each particular case.[15] Nothing in these cases suggests that a mechanical analysis should be applied to determinations of whether a particular proceeding or decree is fair. In addition, the legislative history of Section 15A(b)(8) of the Exchange Act, 15 U.S.C. §78o-3(b)(8), does not indicate that Congress intended to attach some different or unusual meaning to the term "fairness."

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14 *See Bowden v. Cole*, 186 B.R. 523, 525 (Bankr. M.D. Fla. 1995) ("'[S]et off is a permissive doctrine that is within the equitable power of the Court to grant or deny,' and 'is based on fairness.'"); *In re Royster Co.*, 132 B.R. 684, 689 n.12 (Bankr. S.D.N.Y. 1991) (noting that "there are some instances where the Court may modify a Stipulation and Order based on general equitable principles of fairness"); *Hecla Mining Co. v. Star-Morning Mining Co*., 839 P.2d 1192, 1196 (Ida. 1992) ("Waiver is an equitable doctrine based upon fairness and justice."); *Wyeth Laboratories, Inc. v. Jefferson*, 725 A.2d 487, 494 (D.C. App. 1999) ("[F]orum non conveniens is an equitable doctrine based on considerations of fundamental fairness and justice. . . . "); *White Motor Corp. v. Teresinski*, 214 Cal. App. 3d 754, 763 (Cal. App. 1989) ("[C]ollateral estoppel is an equitable concept based on fundamental principles of fairness."). *See also* JAMES M. FISCHER, UNDERSTANDING REMEDIES §294, at 684 (Mathew Bender & Co. 2001) ("One of the enduring hallmarks of equity is the notion of fairness."); DAN B. DOBBS, LAW OF REMEDIES: DAMAGES, EQUITY, RESTITUTION §2.1(3), at 55 (1993 2d ed.) ("When a decision is explained on the ground that it is equitable in the sense that it is fair, compassionate, or flexible, . . . several things stand out. First, equity courts originated such approaches to judicial decision making.").

15 As the United States Supreme Court explained, "The essence of equity jurisdiction has been the power of the Chancellor to do equity and to mould each decree to the necessities of the particular case. Flexibility rather than rigidity has distinguished it." *The Hecht Co. v. Bowles*, 321 U.S. 321, 329-30 (1944).

We are also mindful of the maxim that adjudicators should "construe the details of an act in conformity with its dominating general purpose." *Herman & MacLean v. Huddleston*, 459 U.S. 375, 387 n.23 (1983). Congress's dominating general purpose in enacting the Exchange Act amendments related to SROs was to provide the broadest possible protection to the investing public and the securities markets by authorizing national self-regulation of broker-dealers under both legal and *ethical* standards.[16] Congress thus purposefully provided SROs a wider array of tools with broader applications than those available to federal regulators like the SEC.[17] In that same vein, Congress did not impose a statute of limitations on SRO disciplinary actions. *See Steven B. Theys*, 51 S.E.C. 473, 480, 1993 SEC LEXIS 1348, *16 (1993) ("[N]either the Federal securities laws nor the NASD's rules require such a limitation"). The SEC and the courts also have repeatedly and consistently refused to apply a statute of limitations to SRO proceedings.[18] Indeed, as the SEC explained in *Henry James Faragalli, Jr.*, 52 S.E.C.

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[16] *See generally* 1938 Maloney Act Amendments to the Exchange Act ("Maloney Act"), 15 U.S.C. §§78a *et seq.* *See also Jones v. SEC*, 115 F.3d 1173, 1182 (4th Cir. 1997) ("Under the Maloney Act, the NASD is authorized to regulate itself by prohibiting and preventing fraud and unethical conduct by its members . . ."), *cert. denied*, 523 U.S. 1072 (1998); *First Jersey Sec., Inc. v. Bergen*, 605 F.2d 690, 698 (3d Cir. 1979) (noting that the Maloney Act amendments to the Exchange Act sought to promote self-regulation of the securities industry to guard against both unethical and illegal practices), *cert. denied sub nom, First Jersey Sec., Inc. v. Biunno*, 444 U.S. 1074 (1980); *Cariveau v. Halferty*, 83 Cal. App. 4th 126, 134, 99 Cal. Rptr. 2d 417, 422 (2000) ("The NASD rules serve the statutory objectives of protecting the public from unethical practices. . . ."); *State Mut. Life Assuance Co. of Am. v. Texas*, 345 S.W.2d 325, 327 (Tex. App. 1961) ("[The NASD] is the regulating instrument established under the Maloney Act [and its] obligations, responsibilities, authorities and powers . . . primarily are concerned with the enforcement of ethical standards and practices of investment banking and securities businesses.").

[17] *See Timothy L. Burkes*, 51 S.E.C. 356, 359 n.16 & 360 n.21, 1993 SEC LEXIS 949, *8 n16 & *10 n21 (1993) (noting that NASD's conduct rules are based on broad ethical notions and cover more than simply legal conduct), *aff'd*, 29 F.3d 630 (9th Cir. 1994) (table format). *See also DWS Secs. Corp.,* 51 S.E.C. 814, 822, 1993 SEC LEXIS 3137, *19 (1993) ("We have repeatedly held that a self-regulatory organization's disciplinary authority is broad enough to encompass business-related conduct that is inconsistent with just and equitable principles of trade, even if that activity does not involve a security.").

[18] *See Hirsh*, Exchange Act Rel. No. 43691, 2000 SEC LEXIS 2703, at *18 ("[N]o statute of limitations applies to disciplinary actions of the . . . SROs."); *Lang v. French*, 974 F. Supp. 567, 569 (E.D. La. 1997) ("[SROs] generally are not subject to the

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1132, 1144 n.36, 1996 SEC LEXIS 3559, *31-32 n.36 (1996), "a limitations period . . . would impair [an SRO's] statutory obligation and duty to protect the public and discipline its members."[19] The Hearing Panel's holding in this case—which effectively creates a three-pronged, quasi statute of limitations—is in direct conflict with these notions.

In sum, the cases discussed above clearly indicate that "fairness" is an equitable principle that requires that the result be dependent upon the facts and circumstances of the particular case. Furthermore, Congress, in enacting the Exchange Act amendments related to self-regulation, intended SROs to have broad powers, unencumbered by any statute of limitations, to ensure the protection of the investing public and the integrity of the securities markets. Our view of the proper approach to resolving "fairness" issues, moreover, leads us to conclude that, in addition to the four time-periods referenced in *Hayden* and *Hirsh*, adjudicators must look to traditional equitable principles to determine whether a particular proceeding is fair under the circumstances.

One longstanding equitable concept is that a party with "unclean hands" may not benefit from equitable relief, whether in the form of a defense to a claim or an affirmative cause of action.[20] The "unclean hands" doctrine permits an adjudicator to withhold

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requirements applicable to a government agency. . . . [T]here is no statute of limitations applicable to disciplinary actions brought by [SROs] like NASD."), *aff'd*, 154 F.3d 217 (5th Cir. 1998).

[19] In *Hirsh*, the SEC reiterated this point by citing to its decision in *Stephen J. Gluckman*, Exchange Act Rel. No. 41628, 1999 SEC LEXIS 1395, *27-28 (July 20, 1999), which held that "to impose [a statute of limitations] would 'impair the NASD's . . . duty to protect the public and discipline its members[,]'" as well as citing to *Faragalli*, discussed above. *Hirsh*, Exchange Act Rel. No. 43691, 2000 SEC LEXIS 2703, at *18 n.11 (citing *Gluckman*, Exchange Act Rel. No. 41628, 1999 SEC LEXIS 1395, at *27-28; *Faragalli*, 52 S.E.C. at 1144).

[20] The United States Supreme Court explained:

> [H]e who comes into equity must come with clean hands. This maxim is far more than a mere banality. It is a self-imposed ordinance that closes the doors of a court of equity to one tainted with inequitableness or bad faith relative to the matter in which he seeks relief, however improper may have been the behavior of the [other party]. . . . This maxim necessarily gives wide range to the equity court's use of discretion in refusing to aid the unclean litigant. It is not

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equitable relief from a party who is guilty of wrongdoing in relation to the controversy. The doctrine thus prevents a party from reaping the benefits of his or her wrongdoing.[21]

In *Hayden* and *Hirsh*, the SEC did not expressly address whether the "unclean hands" doctrine prevents a proponent of an equitable defense from prevailing. We hold that the doctrine is relevant to resolution of a "fairness" argument. If the SEC had intended in *Hayden* and *Hirsh* to depart drastically from the traditions of equity practice by eliminating an adjudicator's ability to consider whether the respondent unreasonably caused any of the delay, we are confident that it would have made an unequivocal

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> bound by formula or restrained by any limitation that tends to trammel the free and just exercise of discretion.

Precision Instrument Mfg. Co. v. Automotive Maintenance Mach. Co., 324 U.S. 806, 814-15 (1945). *See also Muscianese v. United States Steel Corp.*, 354 F. Supp. 1394, 1402 (E.D. Pa. 1973). (noting that, although the "unclean hands" doctrine is not "as strictly applied as it once was, . . . the doctrine is still valid as a measure of the reasonableness of a party's actions in considering the overall equities in a given case").

[21] *See id*. The "unclean hands" doctrine often has been applied to defenses based on delays in bringing an action. In *Muscianese*, for instance, the defendant had argued that the plaintiff's action was barred under a laches theory. *Muscianese*, 354 F. Supp. at 1401-02. The plaintiffs countered that the laches defense was unavailable because the defendant did not have "clean hands." *Id*. The court found that the defendant did "not have 'clean hands' because [it] contributed to the time delay asserted as a defense. . . . ." *Id*. at 1402. The court concluded that the "plaintiff acted in a way in which a reasonable man in his position would have acted and is not guilty of laches." *Id*. *See also City of Reading v. Austin*, 816 F. Supp. 351, 367 (E.D. Pa. 1993) ("A delay may be excused upon a showing that the party asserting the defense substantially contributed to the delay through concealment, misrepresentation, unfilled promises, or any other inequitable conduct."); *Pierce v. International Telephone & Telegraph Corp.*, 147 F. Supp. 934, 938 (D.N.J. 1957); ("Where the party interposing the defense of laches has contributed to or caused the delay, he cannot take advantage of it."*); In re After Six, Inc.*, 167 B.R. 35, 44 (E.D. Pa. 1994) (emphasizing that, in resolving an equitable claim, the court must scrutinize the particular facts and balance "the respective interest and equities of the parties, as well as of the general public," and noting that "a delay may be excused upon a showing that the party asserting the defense substantially contributed to the delay").

statement to that effect. We therefore conclude that the doctrine may properly be considered.[22]

Another factor that adjudicators have traditionally considered when resolving equitable claims is whether the proponent was harmed by the alleged misconduct. We recognize that the SEC stated in *Hayden* that it was not basing its decision on any finding that the respondent had been prejudiced by the NYSE's delay in bringing the action, but we do not read this to mean that a showing of prejudice is always irrelevant. Rather, we find that the SEC intended only to relieve respondents of the heavy burden of making a threshold showing of prejudice. In other words, such a showing can benefit the respondent but a lack of such proof is not fatal to a respondent's "fairness" claim.

Enforcement also asks us to consider the complexity of the case in determining whether the period of delay was unfair. The complexity of a case, however, is not a

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22 The respondents in the instant case argue that, in *Hayden*, the NYSE raised and the SEC did not find persuasive an argument relating to the dilatory tactics by the proponent of the "fairness" defense. While it is true that, in its brief to the SEC in *Hayden*, the NYSE argued that the delay had been caused in part by the respondent's firm's dilatory tactics and by lengthy settlement negotiations, the SEC did not mention, let alone expressly resolve, the issue in the decision. As courts have long recognized, "[A]n issue of law must have been heard and decided," and "if an issue is not argued, or though argued is ignored by the court, or is reserved, the decision does not constitute a precedent to be followed." *Gately v. Massachusetts*, 2 F.3d 1221, 1226 (1st Cir. 1993), *cert. denied*, 511 U.S. 1082 (1994). *See also Webster v. Fall*, 266 U.S. 507, 511 (1925) ("Questions which merely lurk in the record, neither brought to the attention of the court nor ruled upon, are not to be considered as having been decided as to constitute precedents.").

Nonetheless, the respondents argue that the SEC did resolve the issue and they point to the SEC's statement in a footnote in *Hayden* that it had "considered all of the arguments advanced by the parties [and it had] reject[ed] or sustain[ed] them to the extent that they [were] inconsistent or in accord with the views expressed in this opinion." *Hayden*, Exchange Act Rel. No. 42772, 2000 SEC LEXIS 946, at *6 n.7. The respondents' argument is unpersuasive. As an initial matter, it is unclear whether the SEC is rejecting the factual basis or the relevance of the dilatory tactics argument. The statement could be read as suggesting that the SEC considered the NYSE's argument to be relevant but did not find that the respondent had, in fact, caused any unreasonable delay. Moreover, in *Hayden*, the NYSE claimed that the respondent's firm, rather than the actual respondent, was responsible for a portion of the delay. The SEC thus did not consider whether the actual proponent of the equitable defense had "unclean hands."

traditional equitable consideration, even where timing issues are concerned, and we decline Enforcement's invitation to adopt it as a factor here.[23]

Having determined that the Hearing Panel applied too rigid an analysis, we turn now to application of the appropriate "fairness" principles to the facts of this case.[24] We look first to whether the "unclean hands" doctrine applies here because the respondents unreasonably caused a portion of the delay. Enforcement's argument in this regard relates primarily to the fourth time period referenced in *Hayden*; i.e., the time that elapsed between the commencement of the investigation and the filing of the complaint (here, January 1996 through November 2000). Enforcement's only claim of significant delay caused by the respondents is that they hampered the investigation by failing to timely provide customer complaints relating to the Term Trusts. Enforcement asserts that it requested the customer complaints in April 1996, but the respondents did not provide them until February 1998.

We find that the delays allegedly caused by the respondents (even if true) did not unreasonably prolong Enforcement's investigation. First, part of the delay in the production of the documents was sanctioned by Enforcement when, in August 1997, Enforcement allowed the respondents to submit the documents on a rolling basis.[25]

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[23] There are sound reasons for refusing to consider the complexity of the case. First, it is difficult to discern exactly how Hearing Panels would determine whether a particular disciplinary case was "complex" and, if so, how much additional time if any Enforcement should be provided in such complex cases. Enforcement argues that the current matter qualifies as "complex," although Enforcement admits that it cannot provide any specific guidelines for making such a determination. Enforcement's argument, moreover, appears to be based not on complexity, but rather on the size of the case. Enforcement's position begs the question of how much additional time it should get for each extra respondent, customer, deposition or document that is involved in a given case.

[24] We note that there may be other equitable considerations in addition to those discussed above that may be relevant to a "fairness" analysis.

[25] Enforcement has available to it adequate measures to ensure that the time elapsed as a result of its granting an extension of time, engaging in lengthy settlement negotiations or sending out Wells letters and then analyzing the responses would not be counted against it. For instance, it is not uncommon for parties to enter into tolling or waiver agreements to ensure that the time needed for settlement negotiations or extensions of time are not later held against them. *See, e.g.*, *McCool v. Strata Oil Co.*, 972 F.2d 1452, 1460-61 (7th Cir. 1992) (upholding the effectiveness of a tolling agreement against statute of limitations argument); *Badger v. Boulevard Bancorp, Inc.*, 970 F.2d 410, 410 (7th Cir. 1992) (noting that the parties had entered into a tolling agreement after breakdown in

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Second, Enforcement has not shown how its overall investigation was halted or significantly hindered because of the alleged difficulties it encountered in getting this information from the respondents.[26] On the contrary, Enforcement appears to have been proceeding with other aspects of its investigation—aspects that were not necessarily dependent on the customer complaints—during this period. We also note that Enforcement could have investigated issues relating to specific customers as the

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negotiations concerning rescission of sale of interest in bank); *ESI Montgomery County, Inc. v. Montenay International Corp*., 899 F. Supp. 1061, 1066 (S.D.N.Y. 1995) (noting that an express waiver is effective in waiving a statute of repose defense under federal securities law); *First Interstate Bank of Denver v. Central Bank & Trust Co. of Denver*, 937 P.2d 855, 859-63 (Col. Ct. App. 1996) (upholding effectiveness of an express tolling agreement as to argument regarding state securities act statute of repose); *One North McDowell Ass'n of Unit Owners, Inc. v. McDowell Development Co.*, 389 S.E.2d 834, 836 (N.C. App. Ct. 1990) (holding that statute of repose was tolled by express agreement). The parties did not enter into a tolling or waiver agreement in this case, however.

[26] To the extent that the respondents' failure to timely provide the information actually did hinder Enforcement's investigation, NASD Rule 8210 provides ample means of deterring and punishing such conduct. Rule 8210 states in unambiguous language that Enforcement may require members and associated persons "to provide information orally, in writing, or electronically . . . and to testify . . . under oath . . . with respect to any matter involved in [an] investigation, complaint, examination, or proceeding." The SEC, moreover, has repeatedly held that Rule 8210 requires members and associated persons to provide "full and prompt cooperation." *Robert Fitzpatrick*, Exchange Act Rel. No. 44956, 2001 SEC LEXIS 2185, at *8 (Oct. 19, 2001); *see also Brian L. Gibbons*, 52 S.E.C. 791, 794, *1996 SEC LEXIS 1291*, at * 7 (1996) (emphasizing that a failure to provide information fully and promptly undermines the NASD's ability to carry out its regulatory mandate), *aff'd*, 112 F.3d 516 (9th Cir. 1997) (table format). Finally, the NASD Sanction Guidelines recommend the imposition of severe sanctions for violations of Rule 8210. The Sanction Guidelines states that where "the individual did not respond in any manner, a bar should be standard." NASD Sanction Guidelines (2001 ed.) at 39. "Where mitigation exists, or the person did not respond in a timely manner, consider suspending the individual in any or all capacities for up to two years." *Id*. With regard to member firms, the Sanction Guidelines state that, "[I]n an egregious case, expel the firm. . . . In cases involving failure to respond in a timely manner, consider . . . suspending the firm with respect to any or all activities or functions for a period of up to 30 business days." *Id*. If, as Enforcement intimates, Morgan Stanley was not cooperating with the investigation, Enforcement could have filed an action under Rule 8210.

information was produced. By and large, however, Enforcement waited for months after the respondents finally provided all of the customer-complaint information to send letters to Morgan Stanley customers requesting information. Under these circumstances, we are unable to conclude that the respondents acted with "unclean hands" and therefore are precluded from advancing a fairness argument.[27]

Next we review whether the respondents have been harmed by Enforcement's delay in bringing this action. We find in the affirmative. The elapsed time has severely limited the respondents' ability to defend themselves against this action because of faded memories and lost documents. Enforcement still has not deposed many potential witnesses who conducted the road-show presentations, and it has not yet identified a single customer or particular transaction that is central to the allegations made in the complaint. We find it hard to imagine that these witnesses' memories have not faded after ten years. It also is undisputed that documents have been lost or destroyed in the intervening years due to no fault on the part of respondents.[28]

Finally, we compare the time periods in this case with the corresponding periods in *Hayden*. Enforcement exceeded three of the four periods. Only the period covering the first alleged occurrence of misconduct to the date that Enforcement filed the complaint is shorter in this case (8 years in the instant case versus 13 years and 10 months in *Hayden*).

Delay in bringing an action at some point becomes unfair. When it does, the case must be dismissed. Of course, what constitutes unfair delay will vary from case to case. In the instant matter, we find that it is unfair for the respondents to be faced with the specter of litigating nearly decade-old claims. This is especially true because Enforcement was aware early on of the nature of the allegedly wrongful conduct. Furthermore, the justification for dismissal on fairness grounds is even more compelling when, as here, there is a showing of prejudice to the respondents as a result of that delay. Based on the totality of circumstances, including the length of delay and harm to the respondents, we dismiss this action as being inherently unfair.

IV. Conclusion

In *Hayden* and *Hirsh*, the SEC relied on the Exchange Act's "fairness" language in resolving whether an SRO's undue delay in bringing a case requires dismissal. Fairness is

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[27] Nor do we find that the delay Enforcement attributes to the respondents' actions should be subtracted from the time equation for the fourth period mentioned in *Hayden* and *Hirsh*.

[28] Numerous documents stored in the World Trade Center that the respondents argue might have been crucial to their defense were destroyed on September 11, 2001.

an equitable principle requiring consideration of the facts and circumstances of each particular case. The SEC indicated that four periods should be reviewed as part of a fairness analysis dealing with timing issues: the elapsed time between (1) the first alleged occurrence of misconduct and the date that the SRO filed the complaint; (2) the last alleged occurrence of misconduct and the date that the SRO filed the complaint; (3) the date that the SRO received notice of the alleged misconduct and the date that it filed the complaint; and (4) the date that the SRO commenced its investigation and the date that it filed the complaint. The test is not a mechanical one, however, as adjudicators also must look to traditional equitable concepts for guidance on whether the proceeding is fair under the circumstances.

In this case, Enforcement exceeded three of the four time periods that the SEC found excessive and inherently unfair in *Hayden*. The respondents, moreover, made a showing of harm resulting from Enforcement's delay.[29] Under these circumstances, and consistent with the discussion above, we affirm the Hearing Panel's dismissal of this action. Accordingly, this action is dismissed.[30]

On Behalf of the National Adjudicatory Council,

Barbara Z. Sweeney
Senior Vice President and Corporate Secretary

29 In so finding, we do not imply that Enforcement was intentionally dilatory or acted in bad faith. We also are cognizant of the fact that *Hayden* was decided a mere six months before Enforcement filed the current action. Enforcement thus did not have the benefit of *Hayden*'s guidance when it initiated and prosecuted this matter.

30 We have also considered and reject without discussion all other arguments advanced by respondents and Enforcement.