

**NASD REGULATION, INC.  
OFFICE OF HEARING OFFICERS**

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DEPARTMENT OF ENFORCEMENT,	:	
	:	
Complainant,	:	Disciplinary Proceeding
	:	No. CAF000015
v.	:	
	:	<b>Hearing Panel Decision</b>
JOSEPHTHAL & CO., INC.	:	
(BD #3227),	:	
	:	Hearing Officer - GAC
New York, NY	:	
	:	
	:	
	:	
	:	
Respondent.	:	April 18, 2001

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**Member firm failed to produce a document ordered by an arbitration panel. Respondent was found liable for violation of NASD Conduct Rule 2110, censured and fined \$10,000.**

*Appearances*

Jeffrey P. Bloom, Esq., Washington, DC (Rory C. Flynn, Washington, DC, Of Counsel), on behalf of the Department of Enforcement.

Joseph K. Brenner, Esq., and Thomas E. Sharp, Esq., Washington, DC, Donald G. McCabe, Esq., New York, NY, on behalf of Respondent.

**DECISION**

**I. PROCEDURAL BACKGROUND**

A. Complaint

Enforcement filed a single cause Complaint on May 10, 2000, charging that Respondent Josephthal & Co., Inc. (“Respondent” or “Josephthal”) violated NASD Conduct Rule 2110 by

failing to comply with an order issued by an NASD arbitration proceeding hearing panel (“Arbitration Panel”). The Complaint alleges that during the arbitration discovery process, the claimants requested that Josephthal produce a consultant’s report.<sup>1</sup> Respondent asserted that the document was protected from disclosure by the attorney-client privilege. After consideration of the parties’ submissions, including oral argument, the Arbitration Panel ordered, pursuant to NASD Code of Arbitration Procedure Rule 10322(b), that Respondent produce the document to the Arbitration Panel for *in camera* inspection, to determine whether the document was privileged.<sup>2</sup> The Complaint alleges that “in direct violation of the [Arbitration Panel’s] order, Josephthal failed and refused, unjustifiably, to produce the document for *in camera* review,”<sup>3</sup> in violation of NASD Conduct Rule 2110.

B. Answer

Respondent filed an Answer on July 7, 2000, in which it admitted many of the factual allegations in the Complaint, but denied that such acts violated NASD Conduct Rule 2110. Specifically, Respondent admitted that it was subject to the NASD arbitration proceeding, that after hearing argument on the issue, the Arbitration Panel Chairman ordered the firm to produce the consultant’s report for *in camera* inspection, and that the firm failed to produce the report based on a claim of attorney-client privilege.

Respondent argued that it acted in good faith and with reasonable justification in responding to the Arbitration Panel’s order. In attempting to choose between what it saw as two

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<sup>1</sup> Complaint, ¶ 4.

<sup>2</sup> Complaint, ¶¶ 4-7.

<sup>3</sup> Complaint, ¶ 8.

legitimate, but conflicting obligations, Respondent stated that it acted reasonably to protect its attorney-client privilege.<sup>4</sup> Respondent noted an absence of specific procedures in the NASD Code of Arbitration Procedure (“Code”) for the protection of lawful privileges and argued that neither the Arbitration Panel nor its Chairman had the authority to order production of the document.<sup>5</sup>

C. Filing of Stipulations and Motions for Summary Disposition

At a pre-hearing conference, the Parties agreed that there were few, if any, facts in dispute. The Parties thereafter filed Stipulations (“Stip.”), followed by motions for summary disposition. Complainant’s Motion for Summary Disposition was accompanied by a Memorandum of Points and Authorities (“Complainant’s Memorandum”), a Statement of Undisputed Facts, a Declaration of Jeffrey P. Bloom, a Summary of Disciplinary History of Josephthal from 1990 to the Present, and correspondence from Josephthal relating to the underlying arbitration.

Respondent’s Motion for Summary Disposition was accompanied by a Memorandum of Points and Authorities (“Respondent’s Memorandum”), a Declaration of John E. Bersin with attachments, and Respondent’s Statement of Undisputed Facts. Each Party then filed a memorandum in opposition to the opposing Party’s motion for summary disposition.

**II. UNDISPUTED FACTS**

Respondent Josephthal is a member firm, with its principal offices located in New York, New York. (Stip., ¶ 1.) From May 1998 through September 1999, Josephthal was a

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<sup>4</sup> Answer, ¶¶ 10-11.

<sup>5</sup> Answer, ¶¶ 11-12.

respondent in an NASD arbitration proceeding. (Stip., ¶ 2.) During pre-hearing discovery, Josephthal was required by the Arbitration Panel to respond to document requests and interrogatory requests served by the claimants. (Stip., ¶ 3.)

The first hearing session was held from June 8, through June 10, 1999. (Stip., ¶ 5.) The Arbitration Panel permitted claimants to make additional discovery requests of Josephthal after that session. On June 17, 1999, consistent with the Arbitration Panel's ruling, the claimants filed a written request that Josephthal produce several specific additional documents or categories of documents, including a request to produce "the report of the independent consultant, retained pursuant to the NASD order of June, 1996 [sic], pertaining to Josephthal's supervisory procedures." (Stip., ¶¶ 5-6.)

On June 30, 1999, Josephthal filed a response to the claimants' request in which it accurately stated that no such document existed. The firm then voluntarily disclosed the existence of another document, not previously requested by claimants, that had been prepared in connection with a 1996 New York Stock Exchange ("NYSE") proceeding. Though it identified the document, Josephthal stated that the document was protected by the attorney-client privilege. (Stip., ¶ 7.) On July 12, 1999, the Arbitration Panel granted claimants' discovery request for production of the document related to the NYSE matter. (Stip., ¶ 9.)

Following the issuance of the Arbitration Panel's order, Josephthal retained outside legal counsel specifically for the purpose of seeking reconsideration of the Panel's order requiring production of the document. (Stip., ¶ 10.) On July 29, 1999, Josephthal filed a motion for reconsideration of the Arbitration Panel's order arguing that the document was protected by the attorney-client privilege and, accordingly, was not subject to production in the arbitration. (Stip.,

¶ 11.) In support of the motion, Josephthal submitted an affidavit from its General Counsel attesting to the nature of the document, and describing underlying facts that led the firm to consider it protected by the attorney-client privilege. (Stip., ¶ 12.) Claimants did not dispute the facts set forth in the General Counsel's affidavit submitted in connection with the motion for reconsideration. (Stip., ¶ 15.)

In oral argument before the Arbitration Panel on August 2, 1999, Josephthal addressed a proposal to have the document submitted to the panel for an *in camera* inspection. Arguing against that proposal, Josephthal noted its concern that such an act may be argued or held to be a waiver of the attorney-client privilege. (Stip., ¶ 16.) Despite Josephthal's arguments, on August 2, 1999, the Arbitration Panel directed the firm to produce the document to the Panel for *in camera* inspection. (Stip., ¶ 17.)

As an alternative to *in camera* inspection, Josephthal proposed having an NASD attorney review the document under a "non-waiver agreement" to confirm that it was privileged. (Stip., ¶ 18.) The Arbitration Panel did not accept Josephthal's alternative proposal and continued to call on the firm to produce the document for *in camera* inspection. (Id.) Josephthal subsequently declined to produce the document, citing what it believed to be a risk of a waiver of the attorney-client privilege. (Stip., ¶ 19.) Josephthal informed the Arbitration Panel that it did not intend any disrespect toward the panel for its refusal to comply, and the Arbitration Panel noted that it did not interpret the firm's refusal to produce the document for *in camera* inspection as disrespectful. (Stip., ¶¶ 20-21.)

The Arbitration Panel advised Josephthal that it would refer Josephthal's failure to produce the document for *in camera* inspection to the NASD for whatever action the NASD

deemed appropriate. (Stip., ¶ 22.) Josephthal did not seek a ruling from any court on the privilege issue. (Stip., ¶ 23.) On September 1, 1999, the Arbitration Panel granted an award to claimants that was paid by Josephthal on a timely basis. (Stip., ¶¶ 24-25.) The award was for less than the amount requested by claimants. (Stip., ¶ 24.)

### III. LEGAL DISCUSSION

#### A. Standard for Granting a Motion for Summary Disposition Has Been Satisfied

Code of Procedure Rule 9264(e) provides that the Hearing Panel “may grant the motion for summary disposition if there is no genuine issue with regard to any material fact and the party that files the motion is entitled to summary disposition as a matter of law.” It is well-established that the moving party bears the initial burden of showing “the absence of a genuine issue of material fact.”<sup>6</sup> The substantive law governing the case will identify those facts which are material and “only disputes over facts that might affect the outcome of the suit under the governing law will properly preclude the entry of summary judgment.”<sup>7</sup>

If the moving party meets that initial burden, the opposing party must come forward with specific evidence demonstrating the existence of a genuine dispute of material fact.<sup>8</sup> In so doing, the non-moving party “must do something more than simply show that there is some metaphysical doubt as to the material facts.”<sup>9</sup> “The pivotal question will always be whether the

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<sup>6</sup> Celotex Corp. v. Catrett, 477 U.S. 317, 323 (1986).

<sup>7</sup> Anderson v. Liberty Lobby, Inc., 477 U.S. 242, 248 (1986).

<sup>8</sup> Id. at 249.

<sup>9</sup> Matsushita Elec. Indus. Co. v. Zenith Radio Corp., 475 U.S. 574, 586 (1986) (citations omitted).

non-moving party has produced sufficient evidence that a reasonable jury could find for him at a trial on the matter.”<sup>10</sup>

In this case, there are no material facts in dispute. The Parties filed extensive stipulations that established the relevant facts needed for the Hearing Panel to rule, based on its application of the facts to NASD Rules.

#### B. Finding of Violation

Under Code Rules 10322 and 10323, arbitrators are vested with judge-like powers such as the ability to issue subpoenas, direct the appearance of members and associated people, direct the production of any records in the possession or control of members and associated people, and to determine the materiality, relevance and admissibility of any proffered evidence. Rule IM 10100(c) under the Code states that a failure to produce any document as directed pursuant to provisions of the Code may constitute conduct inconsistent with just and equitable principles of trade and a violation of NASD Conduct Rule 2110.

The Hearing Panel finds that Respondent willfully disobeyed a duly issued order of the Arbitration Panel to submit the independent consultant’s report for an *in camera* inspection to determine whether the document was discoverable or protected by the attorney-client privilege. There was no legal basis for withholding the document. In so doing, the firm inappropriately and unilaterally substituted its own judgment for the judgment of the Arbitration Panel.

In opening an account for the customer at the firm, Josephthal imposed the arbitration forum on itself as well as the customer, and like all parties, was required to abide by the arbitration forum’s rules and procedures. The NASD has a strong interest in ensuring that all

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<sup>10</sup> Pickett v. RTS Helicopter, 128 F.3d 925, 928 (5<sup>th</sup> Cir. 1997).

participants to arbitration proceedings in its forum receive a fair hearing. As the SEC noted in upholding sanctions against a registered representative for failing to file a timely answer in an arbitration, there is no unfairness in requiring firms to meet their obligations under the Code. “The NASD’s Code of Arbitration Procedure provides its members, their employees, and their public customers with a very useful mechanism for resolving disputes. The NASD is therefore entitled ... to make this procedure effective and workable ....” In re Jerry L. Marcus, 47 S.E.C. 72, Exchange Act Release No. 34-15755 (April 23, 1979), *quoting Stix & Co., Inc.*, 10 SEC Docket 355, 356, Exchange Act Release No. 12760 (September 2, 1976).

Federal courts have recognized the ability of arbitration panels to conduct *in camera* reviews of documents that have been under a claim of privilege. Painewebber Group v. Zinsmeyer Trusts Partnership, 187 F.3d 988 (8<sup>th</sup> Cir. 1999), *cert. denied*, 2000 WL 48885 (2000), *See also*, Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lambros, 1 F. Supp 2d 1337, 1345-46 (M.D. Fla. 1998).

By reason of the foregoing, the Hearing Panel finds that Josephthal violated NASD Conduct Rule 2110 by failing to comply with the order of the Arbitration Panel to produce the consultant’s report for *in camera* inspection.

#### **IV. SANCTIONS**

Enforcement requested that Respondent be censured, fined \$30,000, and ordered to pay costs of the proceeding.<sup>11</sup> In discussing its recommendation, Enforcement noted that it was unaware of any similar cases where an entity engaged in an arbitration failed to abide by an

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<sup>11</sup> Complainant’s Motion, p. 1.



arbitrator's order, other than in failure to pay cases.<sup>12</sup> Although there are no NASD Sanction Guidelines ("Guidelines") that specifically address this type of violative conduct, Enforcement cited the Guidelines for failing to honor an arbitration award, and also argued that the Guidelines for failure to comply with a request pursuant to NASD Rule 8210 were "somewhat analogous."<sup>13</sup>

Respondent argued that the Guidelines for a violation of Rule 8210 were not analogous to the facts of this case.<sup>14</sup> Although arguing that Respondent was not liable for its refusal to produce the document, it urged that if the Hearing Panel were to determine that some sanction was necessary, it would be most appropriate to issue a letter of caution.<sup>15</sup> In furtherance of its position, Respondent contended that there is "extensive mitigating evidence in this case."<sup>16</sup>

The Hearing Panel found that there were important differences between failing to respond to a request issued by NASDR pursuant to Rule 8210, and failing to comply with the order of the Arbitration Panel to produce the document for an *in camera* inspection. NASDR is seriously hampered in carrying out its regulatory investigations or proceedings when a member firm fails to cooperate, and severe sanctions imposed under the Guidelines may be its only recourse. When a firm fails to comply with the order of an Arbitration Panel, however, the Panel has the authority to impose sanctions in that arbitration proceeding, including granting the

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<sup>12</sup> Complainant's Memorandum, p. 21.

<sup>13</sup> Complainant's Memorandum, p. 23.

<sup>14</sup> Respondent's Memorandum in Opposition to Complainant's Motion for Summary Disposition, p. 25.

<sup>15</sup> Respondent's Memorandum in Opposition to Complainant's Motion for Summary Disposition, p. 26.

<sup>16</sup> Id.

relief sought by the opposing party. Thus, the Hearing Panel determined in this case not to apply the Guidelines for failing to cooperate pursuant to Rule 8210.

The Hearing Panel found the Guidelines for failing to pay an arbitration award to be analogous to the facts in this case, since it also involves a failure to comply with a directive of an Arbitration Panel. The Guidelines recommend a fine of at least \$5,000, and a suspension in all capacities until the respondent has satisfied the arbitration award.<sup>17</sup> In this case, since the Arbitration Panel issued an Award that the firm paid promptly, the Hearing Panel found it unnecessary to impose any type of suspension.

In reviewing the Guidelines, the Hearing Panel considered the serious nature of the violation and its potential to undermine an important precept of maintaining a fair and effective tribunal for the speedy and just resolution of disputes in the securities industry. Based on the foregoing, the Hearing Panel orders that Respondent be censured and fined \$10,000.

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<sup>17</sup> NASD Sanction Guidelines 18 (1998 ed.).

## V. CONCLUSION

The Hearing Panel found that Respondent Josephthal violated NASD Conduct Rule 2110 as alleged in the Complaint.<sup>18</sup> Respondent was censured and fined \$10,000. The sanctions shall become effective on a date set by the Association, but not earlier than 30 days after this decision becomes the final disciplinary action of the Association.

Hearing Panel

by: \_\_\_\_\_  
Gary A. Carleton  
Hearing Officer

Copies to:

Via Overnight Courier and First Class Mail

Joseph K. Brenner, Esq.  
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Via First Class Mail and Electronic Transmission

Jeffrey P. Bloom, Esq.  
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<sup>18</sup> The Hearing Panel considered all of the arguments of the Parties. They are rejected or sustained to the extent they are inconsistent or in accord with the views expressed herein.