UNITED STATES OF AMERICA
Before the
SECURITIES AND EXCHANGE COMMISSION
Washington, D.C. 20549

ADMINISTRATIVE PROCEEDINGS RULINGS
Release No. 4324/November 4, 2016

ADMINISTRATIVE PROCEEDING
File No. 3-16349

In the Matter of BARBARA DUKA	ORDER ON MOTIONS TO EXCLUDE

The Division of Enforcement filed the report of its expert, Peter D. Rubinstein, Ph.D. Respondent Barbara Duka argues that I should strike large parts of Dr. Rubinstein's report. Following Commission guidance, and in light of federal practice in bench trials, I decline to strike the report but will give portions of it minimal weight, as described below.

Separately, the Division argues that I should exclude evidence concerning an internal inquiry performed by Standard & Poor's Ratings Services (S&P). For the reasons discussed below, I deny the Division's motion.[1]

Legal Principles

In a bench trial, "it is virtually impossible for a trial judge to commit reversible error by receiving incompetent evidence, whether objected to or not."[2] Applying this principal to administrative agencies, courts have "strongly advise[d] administrative law judges: if in doubt, let it in."[3] Following this guidance, the Commission has held that "all evidence which 'can

[1] The Division also registers omnibus relevance, materiality, repetitiousness, and hearsay objections to Duka's exhibits. I defer ruling on these objections until the exhibits in question are offered during the hearing.

[2] *Builders Steel Co. v. Comm'r*, 179 F.2d 377, 379 (8th Cir. 1950); *see Herlihy Mid-Continent Co. v. N. Ind. Pub. Serv. Co.*, 245 F.2d 440, 444-45 (7th Cir. 1957); *see also In re Unisys Sav. Plan Litig.*, 173 F.3d 145, 164 (3d Cir. 1999) (Becker, C.J., dissenting) ("[t]he better course" in a bench trial "is to admit the evidence and then take factors that otherwise might affect its admissibility into consideration in determining its weight").

[3] *Multi-Med. Convalescent & Nursing Ctr. of Towson v. NLRB*, 550 F.2d 974, 978 (4th Cir. 1977); *see Samuel H. Moss, Inc. v. FTC*, 148 F.2d 378, 380 (2d Cir. 1945).

conceivably throw any light upon the controversy' should normally be admitted."[4] Administrative "law judges should [thus] be inclusive in making evidentiary determinations."[5]

Similar considerations apply when determining whether to admit expert testimony. In a jury trial, a district court must perform a "gatekeeping" function under Federal Rule of Evidence 702 and "ensure that any and all scientific testimony . . . is not only relevant, but reliable."[6] Courts have recognized, however, that in a bench trial, the gatekeeping function—which "was designed to protect juries"—is less important.[7] A "court can hear the evidence and make its reliability determination during, rather than in advance of, trial."[8]

The Commission has no rule specifically addressing the admission of expert testimony as opposed to other types of evidence. Instead, the Rules of Practice simply provide that relevant evidence is admissible and "irrelevant, immaterial, unduly repetitious, or unreliable" evidence should be excluded.[9] Although recent amendments to the Rules of Practice added the word

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[4] *Charles P. Lawrence*, Securities Exchange Act of 1934 Release No. 8213, 1967 WL 86382, at *4 (Dec. 19, 1967).

[5] *City of Anaheim*, Exchange Act Release No. 42140, 1999 WL 1034489, at *2 (Nov. 16, 1999).

[6] *Kumho Tire Co. v. Carmichael*, 526 U.S. 137, 147 (1999) (quoting *Daubert v. Merrell Dow Pharm., Inc*., 509 U.S. 579, 589 (1993)).

[7] *Deal v. Hamilton Cty. Bd. of Educ*., 392 F.3d 840, 852 (6th Cir. 2004); *see Whitehouse Hotel Ltd. P'ship v. Comm'r*, 615 F.3d 321, 330 (5th Cir. 2010); *United States v. Brown*, 415 F.3d 1257, 1268-69 (11th Cir. 2005).

[8] *In re Salem*, 465 F.3d 767, 777 (7th Cir. 2006). In *Salem*, the Seventh Circuit explained that:

> Where the gatekeeper and the factfinder are one and the same—that is, the judge—the need to make such decisions prior to hearing the testimony is lessened. That is not to say that the scientific reliability requirement is lessened in such situations; the point is only that the court can hear the evidence and make its reliability determination during, rather than in advance of, trial. Thus, where the factfinder and the gatekeeper are the same, the court does not err in admitting the evidence subject to the ability later to exclude it or disregard it if it turns out not to meet the standard of reliability established by Rule 702.

465 F.3d at 777.

[9] 17 C.F.R. § 201.320.

"unreliable" to the list, that addition was motivated by concerns over hearsay rather than expert testimony.[10] In fact, when pressed to apply *Daubert* in administrative proceedings, the Commission declined.[11] Following the above reasoning related to bench trials, the Commission instead observed that there was no reason an administrative law judge could not exercise his or her discretion and "hear expert testimony (and cross-examination) and then determine what weight to give that testimony."[12]

The fact that an expert's testimony is based on an assumption at odds with certain evidence does not, in and of itself, make the opinion excludable.[13] Only if there is no factual support for the opinion should the report be excluded for lack of usefulness.[14] Doubts about the usefulness of a report "should generally be resolved in favor of admissibility."[15]

The Division's expert report

The Division alleges that while employed at S&P, Duka used a "relaxed methodology" for rating certain commercial mortgage-backed securities, in a fraudulent attempt to attract business from bond issuers.[16] In support, the Division submitted Dr. Rubinstein's expert report. Dr. Rubinstein has experience researching, analyzing, and rating commercial and residential mortgage-backed securities.[17]

In light of the principles discussed above, I decline to strike Dr. Rubinstein's report. I bear in mind, however, that the point of the gatekeeping requirement "is to ensure the reliability

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10 Amendments to the Commission's Rules of Practice, 81 Fed. Reg. 50212, 50226-27 (July 29, 2016) (to be codified at 17 C.F.R. pt. 201), https://www.gpo.gov/fdsys/pkg/FR-2016-07-29/pdf/2016-16987.pdf. Amended Rule 320 applies to this proceeding. *Id.* at 50230.

11 *Ralph Calabro*, Securities Act of 1933 Release No. 9798, 2015 WL 3439152, at *11 n.66 (May 29, 2015).

12 *Id.*

13 1-13 Weinstein's Evidence Manual § 13.02[2] (Lexis 2015); *see Stuhlmacher v. Home Depot U.S.A., Inc.*, 774 F.3d 405, 410 (7th Cir. 2014) (holding that in performing the threshold gatekeepter function, "[i]t is not the trial judge's job to determine whether the expert's opinion is correct").

14 1-13 Weinstein's Evidence Manual § 13.02[2].

15 *Id.*

16 Order Instituting Proceedings at 2, 5-7.

17 Report at 3-7.

and relevancy of expert testimony."[18] Purported expert testimony concerning a matter about which the witness lacks expertise is not relevant because it is not helpful to the trier of fact; the witness is in no better position than the trier-of-fact to evaluate the issue.[19] And irrelevant evidence is not admissible.[20] I will therefore give no or diminished weight to certain portions of his report, as follows.

To the extent Dr. Rubinstein purports to rely on factual evidence specific to this case, such as portions of certain witnesses' investigative testimony, I will only consider Dr. Rubinstein's assertions insofar as they fall within the scope of his expertise and will otherwise only rely on credible and reliable evidence actually presented during the hearing to make factual determinations.[21] If, as Duka argues, Dr. Rubinstein's opinions are based on a selective reading of the investigative record, Duka is free to test the basis of Dr. Rubinstein's opinions by demonstrating that he "cherry-pick[ed] portions of untested investigative testimony."[22]

Duka argues that Dr. Rubinstein lacks sufficient experience to offer an opinion from the perspective of an investor in mortgage-backed securities.[23] She notes that Dr. Rubinstein offers nothing about "the due diligence process" undertaken by such investors.[24]

In his report, Dr. Rubinstein states that from 1988 to 1992, he was a university lecturer and then assistant professor of finance.[25] In these capacities, he "taught courses covering both the residential and commercial real estate markets, on topics including real estate, mortgages,

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18 *Kumho Tire Co*., 526 U.S. at 152.

19 *See Ancho v. Pentek Corp*., 157 F.3d 512, 518 (7th Cir. 1998). As one court put it, "The fact that a proposed witness is an expert in one area, does not *ipso facto* qualify him to testify as an expert in all related areas." *Shreve v. Sears, Roebuck & Co*., 166 F. Supp. 2d 378, 391 (D. Md. 2001).

20 17 C.F.R. § 201.320.

21 *See CIT Grp./Bus. Credit, Inc. v. Graco Fishing & Rental Tools, Inc*., 815 F. Supp. 2d 673, 678 (S.D.N.Y. 2011) ("While an expert may rely on hearsay in forming his opinion, he may not 'simply transmit that hearsay to the jury' to prove the truth of the matter asserted."); Mot. at 13-14, 17-20.

22 Mot. at 17; *see Mims v. United States*, 375 F.2d 135, 143 (5th Cir. 1967) ("expert opinion evidence may be rebutted by showing the incorrectness or inadequacy of the factual assumptions on which the opinion is based").

23 Mot. at 4-7, 11-12.

24 Mot. at 6.

25 Report at 4.

real estate and mortgage valuation, real estate development, and securitization."[26] Part, though not all, of his responsibilities while employed by Donaldson, Lufkin & Jenrette from 1994 to 1997 and PaineWebber Inc. from 1997 to 1998, involved "meeting with investors to present research and learn about investor concerns."[27] From 2001 to 2005, Dr. Rubinstein worked for Bear Stearns and was responsible for "all research relating to" commercial mortgage-backed securities.[28] His responsibilities in this position included attending "investor road shows[] and one-on-one meetings with investors."[29] From 2005 to 2006, he was employed by Realpoint-GMAC Institutional Advisors as a vice president in charge of real estate and commercial mortgage-backed securities research.[30] According to Dr. Rubinstein, Realpoint provides "information to investment professionals."[31] At Realpoint, he was responsible for "overseeing risk modeling, meeting with investors, publishing research articles, developing new products and constructing a second-generation risk model for estimating defaults and losses in commercial real estate loans."[32]

Duka argues that Dr. Rubinstein's experience is insufficient to allow him to offer an expert opinion about the "processes and financial modeling . . . [investors] undertake to formulate investment decisions" about the securities at issue in this proceeding.[33] As Duka notes, Dr. Rubinstein does not explain the steps a duly diligent investor would take before investing in a mortgage-backed security.[34] Reviewing Dr. Rubinstein's experience, noted above, it is unclear whether his experience is sufficient to allow him to opine about the perspective of an investor in commercial mortgage-backed securities. Because doubts about the usefulness of an expert's testimony should be resolved in favor of allowing the expert to testify—and thus to have the strength of his experience and opinion tested through cross-examination—I will not strike Dr. Rubinstein's opinion.[35] I will determine the weight, if any, to accord his opinion on this subject based on the evidence developed during his cross and direct examination.

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26 *Id.*

27 *Id.* at 5.

28 *Id.* at 6.

29 *Id.*

30 *Id.*

31 *Id.*

32 *Id.*

33 Mot. at 6-7.

34 *Id.* at 6.

35 *See McCullock v. H.B. Fuller Co.*, 61 F.3d 1038, 1043 (2d Cir. 1995) (disagreement about expert's qualifications "were properly explored on cross-examination and went to his

Dr. Rubinstein opines that "the switch to blended loan constants resulted in materially decreased credit support and materially inflated ratings."[36] To support this opinion and provide an example, he examines S&P's default estimate for a loan in a transaction referred to as GSMS 2011-GC4.[37]

Duka asserts that this opinion should be struck because Dr. Rubinstein explains neither why he thinks the ratings were materially inflated nor the methodology he employed to reach that conclusion.[38] In particular, Duka takes issue with the opinion that the switch resulted in "inflated" ratings.[39] She notes that not only is there no evidence that the switch led to a downgrade or investor losses but S&P's commercial mortgage-backed securities analytical team also affirmed the rating Dr. Rubinstein highlights.[40] She notes that when Dr. Rubinstein worked at Morningstar, it gave GSMS 2011-GC4 the same preliminary ratings and credit enhancement levels as S&P.[41] Duka thus appears to read Dr. Rubinstein's report as asserting that the switch "inflated" ratings above a hypothetically correct rating, rather simply than above what they would have been using another model.

I disagree with Duka's argument. Dr. Rubinstein's report describes the calculations he employed and the manner in which he reached his conclusion.[42] I do not read the report's use of "inflated" in the manner Duka reads it. The report does not define the term, but the manner in which the calculations are presented suggests that Dr. Rubinstein simply means that using blended constants inflated—*i.e.*, increased—the ratings above what they would have been using criteria constants.[43]

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testimony's weight and credibility—not its admissibility"); *Larabee v. M M & L Int'l Corp*., 896 F.2d 1112, 1116 n.6 (8th Cir. 1990) ("doubts about whether an expert's testimony will be useful should generally be resolved in favor of admissibility" (quoting 3 Jack B. Weinstein & Margaret A. Berger, Weinstein's Evidence ¶ 702[02] (1988))); *see also* 1-13 Weinstein's Evidence Manual § 13.02[2].

36 Report at 48-52.

37 *Id.* at 48-50.

38 Mot. at 9-11.

39 *Id.* at 9-10.

40 *Id.* at 9-10.

41 *Id.* at 10.

42 *See* Report at 48-50; *id.* at App. 1.

43 *See id.* at 48-50.

In opining that the switch to blended constants was inadequately disclosed, Dr. Rubinstein asserts that the switch was misleading to investors and others at S&P.[44] Duka takes issue with the report's use of the word "misleading."[45] She argues that the use of this language is improper because it goes to the ultimate issue.[46] Because there is no jury in this matter, Duka's concern is overstated. Dr. Rubinstein may opine, based on his experience, whether the disclosures in question were misleading as a factual matter.[47]

Finally, Dr. Rubinstein opines that "the switch to blended constants was an analytical issue that was required to be escalated and evaluated under S&P's internal policies and procedures."[48] In explaining this opinion, Dr. Rubinstein reviews S&P's internal guidelines and relies on evidence specific to this matter.[49] He does not purport to rely on his specialized experience or knowledge.

Duka argues that Dr. Rubinstein is not qualified to opine about S&P's internal procedures, which are, in any event, not a proper subject for an expert report.[50] I agree. Had Dr. Rubinstein purported to rely on his years of experience, it is possible to envision a circumstance in which this testimony might be relevant. But as provided, the testimony is not helpful because I am in as good a position as Dr. Rubinstein to read the policies in question and to interpret their language.

To the extent Dr. Rubinstein's report touches on issues of intent, state of mind, or the "pressure" Duka or any witness may have felt, I will disregard that aspect of the report.[51] He

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44 Report at 52-55.

45 Mot. at 12.

46 *Id.*

47 *See Wechsler v. Hunt Health Sys., Ltd.*, 381 F. Supp. 2d 135, 146 (S.D.N.Y. 2003) ("Although an expert may opine on the ultimate issue of fact, he 'may not give testimony stating ultimate legal conclusions based on those facts.'") (quoting *United States v. Bilzerian*, 926 F.2d 1285, 1294 (2d Cir. 1991))); Fed. R. Evid. 704(a).

48 Report at 55-59.

49 *Id.*

50 Mot. at 15-16.

51 *See United States v. Seschillie*, 310 F.3d 1208, 1212 (9th Cir. 2002); *Salas v. Carpenter*, 980 F.2d 299, 305 (5th Cir. 1992); *CIT Grp./Bus. Credit, Inc.*, 815 F. Supp. 2d at 678 ("expert testimony is not admissible to establish a fact fundamentally grounded on a party's state of mind").

may, however, opine based on his experience about how a hypothetical person in the industry might respond to various relevant factors.

Evidence concerning S&P's internal investigation

The Division argues that I should exclude evidence concerning S&P's internal inquiries into the switch in the ratings process.

The Division's first concern appears to relate to an e-mail and a report, aspects of which allegedly contain lay opinions.[52] Preliminarily, the Division states that the parties are attempting to narrow the scope of their dispute about evidence related to the internal inquiries. This suggests that ruling on this aspect of the motion at this point would be premature, and I will defer doing so until when and if the evidence in question is offered at the hearing. I note, however, that in order for a party to present lay opinion testimony, the party would have to show that the witness has personal knowledge of the matter forming the basis of the witness's opinion, the opinion is rationally based on his own perception, and the opinion would be helpful to the trier of fact.[53] And, assuming the proponent can demonstrate the relevance of such an opinion, it is at least theoretically possible for a lay witness to opine about a person's state of mind.[54]

Next, the Division objects to my consideration of double hearsay in a number of documents.[55] As the Division recognizes, hearsay is admissible in Commission proceedings.[56] I will evaluate the weight to be given any hearsay evidence based on the factors announced by the Commission.[57] If a party demonstrates that a particular statement is not hearsay or is admissible for a non-hearsay purpose, however, there will be no need to consider the Commission's hearsay factors.

Finally, the Division argues that the findings and conclusions of S&P's internal inquiries "should be excluded under the principles animating Rule 403" of the Federal Rules of

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52 Div. Mot. at 5-6.

53 *See United States v. Tsekhanovich*, 507 F.3d 127, 129 (2d Cir. 2007); Fed. R. Evid. 701.

54 *See Tsekhanovich*, 507 F.3d at 129; *United States v. Rea*, 958 F.2d 1206, 1215-16 (2d Cir. 1992). Given that Duka "agrees that lay or expert opinion as to Duka's state of mind (by anyone other than Duka) is not relevant," Opp'n at 2, this is likely not an issue.

55 Div. Mot. at 6-8.

56 *Id.* at 6; *see Edgar B. Alacan*, Securities Act Release No. 8436, 2004 WL 1496843, at *6 (July 6, 2004); *see also* 5 U.S.C. § 556(d).

57 *See Edgar B. Alacan*, 2004 WL 1496843 at *6; *Mark James Hankoff*, Exchange Act Release No. 30778, 1992 WL 129520, at *3 (June 4, 1992).

Evidence.[58] Even if the Rules of Evidence applied in Commission proceedings, the unfair prejudice concerns addressed by Rule 403 do not apply.[59] For the foregoing reasons, the Division's motion is denied.

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James E. Grimes
Administrative Law Judge

[58] Div. Mot. at 8.

[59] *Cf. LiButti v. United States*, 107 F.3d 110, 124 (2d Cir. 1997) ("many of the . . . problems which a trial court invariably has to wrestle with in order to guard against unfair prejudice [by the jury] . . . simply do not exist in the context of a bench trial."); *Schultz v. Butcher*, 24 F.3d 626, 632 (4th Cir. 1994) ("in the context of a bench trial, evidence should not be excluded under [Rule] 403 on the ground that it is unfairly prejudicial"); *Gulf States Utils. Co. v. Ecodyne Corp*., 635 F.2d 517, 519 (5th Cir. Unit A Jan. 1981) ("in a bench trial . . . excluding relevant evidence on the basis of 'unfair prejudice' is a useless procedure").