# Public Investors Arbitration Bar Association



April 25, 2008

**VIA E-MAIL TO RULE-COMMENTS@SEC.GOV**

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

**Re: SR-FINRA-2007-021**
**Proposed Revisions to 12206 and 12504 of the FINRA Customer Code Motions to Dismiss**

Dear Ms. Morris:

I write on behalf of the Public Investors Arbitration Bar Association (PIABA) in further support of the above-referenced FINRA rule change. We have already written to express our support of the rule change, and to request its approval on an accelerated basis.[1] The purpose of this letter is to respond to the comments of the Arbitration, Litigation Advisory and Clearing Firms Committees of the Securities Industry and Financial Markets Association (SIFMA) in its letter of April 7, 2008 (the "SIFMA letter").

As the mouthpiece of the securities industry, it is not surprising that SIFMA is critical of the rule revisions. While giving lip service to the concept of bringing an end to abusive or frivolous motions, SIFMA has proposed revisions which would gut the rule and only encourage wasteful and unmeritorious motions to dismiss.

<u>*Discouraging Motions to Dismiss*</u>

The SIFMA letter seeks deletion of the policy statement in proposed Rule 12504(a)(1), which reads: "Motions to dismiss a claim prior to the conclusion of a party's case in chief are discouraged in arbitration." This language is far from "superfluous," as claimed by the SIFMA letter. Rather, it goes to the very heart of the distinction between arbitration and litigation.

Arbitration is intended to provide a speedy and economic alternative to litigation. As such, the NASD Code of Arbitration Procedure eschews strict pleading requirements (Customer Code Rule 12302(a)(1)), and discourages depositions and interrogatory-style requests for information (Customer Code Rules 12507(a)(1) and 12510). Inserting pre-hearing motions to dismiss into this scheme, most of which are

[1] Letter of Laurence S. Schultz, President, Public Investors Arbitration Bar Association, March 18, 2008.

denied, is inconsistent with the concept of economy. As the proposed rule recognizes, such motions should be permitted only in the most unusual of circumstances.

Moreover, it must be remembered that there is almost no judicial review of FINRA arbitration awards. The grounds for vacatur are very narrow. Unlike court, where an appellate court may review the grant of dispositive motions for errors of law, an arbitration award will generally be left undisturbed except for arbitral misbehavior as provided under the Federal Arbitration Act, or "manifest disregard of the law," a standard which requires that the court uphold arbitration awards even when the court is convinced that the panel misapplied the law or the facts. Given this profound potential for irreversible error and in order to preserve at least the perception that each party will have his "day in court," nearly every case must have an evidentiary hearing. Accordingly, the policy statement discouraging pre-hearing dispositive motions is an important component to the overall Code, and ought to be approved.

<u>Clearing Firm Disputes</u>

The SIFMA letter takes aim at FINRA's failure to include language in the rule which would enable clearing firms to file pre-hearing motions to dismiss. SIFMA argues that, since clearing firms owe no duties to the customer, and are not liable for the conduct of the introducing broker, they should be permitted to get out of the case at the outset.

SIFMA's argument rests upon an outright misstatement of the law. The SEC has ruled that a clearing firm can indeed be responsible to investors when it "enables" an introducing firm to defraud its customers.[2] There is abundant case law holding that clearing firms are not immune from liability, and can be liable for the fraudulent acts of the introducing broker.[3] These cases hold that clearing firms can be liable as would be any participant in a fraudulent scheme under the Blue Sky statutes and at common law. In short, clearing firms may not turn a blind eye to the fraudulent conduct of their correspondent firms and blithely collect their fees without fear of liability.

Clearing firms are rarely named in cases where the introducing broker is a large, reputable firm. In many cases, the clearing firm is named as a respondent based on assertions that the clearing firm helped to perpetrate a fraud on the investing

---

[2] *In The Matter* of *Bear Stearns Securities Corporation,* 99 LEXIS 1551.

[3] See, e.g., *Koruga v. Fiserv Correspondent Services, Inc.,* 183 F.Supp.2d 1245 (D. Or. 2001), *aff'd,* 2002 U.S.App. LEXIS 6439 (9th Cir. 2002); *McDaniel v. Bear Stearns & Co., Inc.,* 196 F.Supp.2d 343 (S.D.N.Y. 2002); *Hirata v. J.B.Oxford & Co.,* 193 F.R.D. 589, 600 (S.D. Ind. 2000).

public by clearing for a "bucket shop" introducing broker, or similar allegations. In such cases, the liability of the clearing broker will depend on what the clearing firm knew, and when, and what it did as a result. These are inherently factual issues, which cannot be resolved without full documentary discovery and an evidentiary hearing. Yet, under the current system, the filing of a pre-hearing motion to dismiss by any named clearing firm is inevitable. It is precisely this kind of conduct which adds complexity and expense to a procedure which is supposed to be an economical alternative to litigation.

We oppose SIFMA's proposed language to permit motions to dismiss by clearing firms.

*Executives Named as Respondents*

Proposed Rule 12504(a)(6)(B) would permit a motion to dismiss where "the moving party was not associated with the account(s), security(ies), or conduct at issue." The SIFMA letter raises a hypothetical where the chief executive of a large wirehouse is named as a party, and asserts that such a party should have the ability to obtain dismissal by a pre-hearing motion. They conclude that the rule should be amended to permit a motion to dismiss where "the moving party was not involved in, or had no personal knowledge of, or had no direct supervisory control over, or owed no legal or regulatory duty with respect to, the account(s), security(ies), or conduct at issue."

Aside from the fact that executives of large, solvent firms are rarely named as respondents in customer arbitrations,[4] SIFMA's proposed language is emblematic of why pre-hearing motions to dismiss should not be allowed. Almost by definition, the named respondent's involvement, or personal knowledge, or supervisory control, present factual issues. These types of issues are not appropriate for pre-hearing dispositive motions. As we pointed out in our previous comment, the procedural checks and balances in our court system are absent in arbitration – there are no depositions or sworn interrogatory answers, for example – so it makes no sense to have arbitrators deciding factual issues on pre-hearing motions to dismiss.

[4] Generally speaking, such executives will receive full indemnification from their firms, so this is really not an issue. Where the naming of the executive becomes an issue is when the firm is insolvent, or on the brink of becoming insolvent. In such a case, many state securities statutes, patterned upon Section 509(g) of the Uniform Securities Act of 2002 or Section 401(a) of the predecessor Uniform Act, provide that the officers, directors or other "control persons" are equally liable with the firm for violations of the Blue Sky statutes unless they can prove that they had no knowledge or grounds to know about the conduct giving rise to the liability. The federal securities laws have a similar provision. 15 U.S.C. 77o. Once again, the control person's state of knowledge is a factual issue, which should not be determined upon a motion to dismiss.

What SIFMA urges here is an expansion of the grounds upon which a motion can be made. We are already concerned that the language of FINRA's proposed rule may be somewhat ambiguous as to the meaning of the term "associated with," and that some respondents may see it as an opening to permit motions to dismiss by control persons, clearing firms and the like.[5] We adamantly oppose the expansion of this rule to include such fact-based motions.

<u>*Legal Impossibility*</u>

The SIFMA letter cites to three potential situations which would give rise to a complete defense of legal impossibility on a pre-hearing motion to dismiss: (1) U-5 defamation under New York law;[6] (2) *res judicata*; and (3) lack of standing. From this, they urge that the rule be expanded to permit motions to dismiss based on "legal impossibility."

It is not hard to envision large numbers of motions to dismiss being brought on the ground of "legal impossibility," should this language be adopted. When FINRA sought to limit motions to dismiss to "extraordinary circumstances," virtually every subsequent motion to dismiss asserted that the circumstances of its case were "extraordinary." Likewise, with SIFMA's change, respondents would no doubt routinely argue that it will be "legally impossible" for a claimant to prevail. It is not likely that many such motions would be granted, but that is not the point. The new rule also is intended to do away with unmeritorious motions to dismiss and eliminate the burden of responding to them. By broadening the scope of permissive motions to include something this vague, one can fully expect that respondents will latch on to the language, routinely file such motions, and claim that their flawed motions are made in good faith.

Adoption of SIFMA's "legal impossibility" language would also take a step down the dangerous path of requiring legalistic pleadings. Under Rule 12302(a)(1) of the Customer Code, all that is required in a statement of claim is to "specif(y) the relevant facts and remedies requested." Given how often public investors file claims *in propria persona,* it would be unfair to require statements of claim to satisfy some particular legal form. One can easily imagine an industry respondent filing motions to dismiss claims against an unrepresented public investor who lacks the training necessary to enable him to frame his claim in such a way as to pass legal muster.

---

[5] We do not believe, however, that this is FINRA's intention. We trust that FINRA will clarify the proper scope of this rule if industry respondents begin to find ways to abuse the "associated with" language.

[6] As this does not implicate the Customer Code in any way, PIABA expresses no opinion as to whether there should be an exception in the corresponding Industry Code rule.

Adoption of SIFMA's proposed language would lead to further abuse of pre-hearing motions by industry respondents, and will do nothing to further investor protection. PIABA opposes the expansion of the proposed rule to include "legal impossibility" as a ground for dispositive motions.

<u>Time-Barred Claims</u>

The SIFMA letter bemoans the loss of the industry's ability to file dismissal motions based on statutes of limitations. These types of motions are entirely inappropriate in FINRA arbitrations, and represent a large portion of the abusive motions filed by industry respondents.

To begin with, it must be remembered that proposed Rule 12206(b) has in fact codified the right to make motions to dismiss based upon the six-year eligibility rule. Thus, there are safeguards in place to prevent truly "stale" claims from proceeding all the way through to hearing. As SEC Rules require many client documents to be retained for a minimum of six (6) years, SIFMA's expressed concerns about loss of documents and dimming memory ring hollow. See SEC Rule 17a-4(a) and (c).

Many jurisdictions have express authority to the effect that statutes of limitations do not apply in private arbitration proceedings.[7] Inserting a rule permitting motions to dismiss based on time bars may lead arbitrators to believe that such authority is superseded by FINRA's belief that such statutes do in fact apply.

More to the point, most statutes of limitations in securities arbitration matters raise issues of fact, which require an evidentiary hearing. Many of the statutes of limitations relating to securities fraud are discovery-based – thus, there is nearly always an issue of fact as to when actual discovery occurred, and whether sufficient diligence was exercised by the claimant. The state statutes of limitations usually also have tolling provisions, which again raise issues of fact. In short, even in those few states where statutes of limitations may have application, hearings are necessary to determine whether the statute has run. It is for this very reason that most motions to dismiss on the basis of the statute of limitations are denied. Yet, claimants are

[7] See, e.g., *NCR Corp. v. CBS Liquor Control,* 874 F. Supp. 168 (S.D. Ohio 1993), *partially modified on unrelated grounds,* 1993 WL 767119 (S.D. Ohio Dec 24, 1993) (NO. C-3-91-027, C-3-01-031) *aff'd sub nom.* NCR Corp. v. Sac-Co., 43 F.3d 1076 (6th Cir. Ohio 1995), cert. denied sum nom. *Sac-Co Inc. v. AT&T Global Info. Solutions Co.,* 516 U.S. 906, 116 S. Ct. 272, 133 L. Ed. 2d 193 (1995); *Son Shipping Co. v. De Fosse & Tanghe,* 199 F. 2d 687 (2d Cir. 1952); *Har-Mar, Incorporated v. Thorsen & Thorshov, Inc.,* 218 N.W.2d 751 (Minn. 1974); *Carpenter v. Pomerantz,* 36 Mass. App. Ct. 627, 634 N.E.2d 587 (1994); *Lewiston Firefighters Association v. City of Lewiston,* 354 A.2d 154, 167 (Maine 1976); *Skidmore, Owings and Merrill v. Connecticut General Life Insurance Company,* 25 Conn. Sup. 76, 197 A.2d 83.

repeatedly required to incur the expense of defending such motions, and are normally assessed half the forum fee for the telephonic hearing.

We believe the time-bar exception to the prohibition on motions to dismiss should be limited to motions based on the six-year eligibility rule, as the proposed rule is currently drafted.

*Procedural Issues*

The SIFMA letter predictably decries those portions of the proposed rule which provide protection to investors. Absent these provisions, however, the rule will be a paper tiger, lacking any real teeth.

The requirement of unanimity is a necessary protection because FINRA rules do not require all or even any of the arbitrators to be lawyers, while mandating that one arbitrator must be associated with the securities industry. Even more important, as noted above, there is no appeal for erroneous arbitration awards based on factual or legal errors. This provision of the rule should be retained.

The SIFMA letter opposes the provision which mandates the assessment of forum fees against unsuccessful movants. This is one of the key provisions of this rule revision, and it must be retained. SIFMA asserts that it is patently unfair to penalize a party who files a motion in good faith, "in reliance on the accuracy and completeness of the papers filed by the opposing party." Once again, SIFMA attempts in a backhanded way to impose strict pleading requirements upon public investor claimants, where the rules clearly do not require such strictness. It is not unfair to require a brokerage firm which files a motion which is discouraged under the rule to be assured of the correctness of its position. Rather, the *status quo* is patently unfair. Despite the fact that a minuscule percentage of dispositive motions are ever granted, it is currently the norm to require the claimant to pay half of the forum fees for the hearing on the motion. This simply adds insult to injury, in view of the fact that the claimant has already been required to respond to the unmeritorious motion in the first place. Only by requiring the moving party to be sure of its grounds will the glut of weak motions ever come to an end.

Finally, the SIFMA letter seeks to turn the attorney fee provision on its head. Under the rule proposal, the panel is entitled to award attorney fees against a losing moving party where the motion was deemed to be frivolous. SIFMA argues that this is fine, so long as the panel makes the decision to award such fees *sua sponte*. SIFMA goes on to argue that, if the party opposing the motion has the temerity to point out to the panel its authority to award such fees and request such an award, the panel may assess sanctions *against the party which successfully defeated the motion*! Obviously, this would have an *in terrorem* effect on claimants who might well be entitled to reimbursement for their fees incurred in opposing a frivolous motion. The industry is looking for a free ride – they can make whatever motions they want without any fear of serious reprisals.

*Conclusion*

The securities industry's opposition to this rule change is not surprising. FINRA is clearly making an effort to fill a procedural vacuum which has been exploited by the industry to the detriment of those investors who seek justice in the only forum open to them. FINRA is to be commended for this effort. We again wish to express our support for this rule, and request its speedy approval and implementation.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

Laurence S. Schultz
President, 2007-2008

*Contact Information:*
Laurence S. Schultz, Esq.
Driggers, Schultz & Herbst, P.C.
2600 West Big Beaver Road, Suite 550
Troy, Michigan 48084
Phone: (248) 649-6000
Fax: (248) 649-6442
E-mail: LSSARB@AOL.COM