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PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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Public Investors Arbitration Bar Association

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President's Message

by J. Pat Sadler

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In the press release which announced the finalization of the global settlement of the analyst fraud cases, NASD Chairman and CEO Robert Glauber was quoted as saying that in finalizing the settlement "we take a giant step on the road to restoring and renewing investor confidence."

Chairman Glauber's comments were similar to those of officials from the NYSE and SEC, all of whom trumpeted the settlement as an important step in restoring investor confidence in the fairness and integrity of the American capital markets.

While I agree that the settlement is a step in restoring that confidence which was stolen from the investing public, I hope that the industry's regulators understand that it is not the ultimate solution. There are many investors who can no longer afford to send their kids to college because of this fraud. Others will have to postpone retirement and scale back retirement lifestyles. The suggestion that individuals who have lost all or most of their life savings will find the global settlement to be a confidence booster is far from accurate.

Already, SEC Chairman Donaldson has taken the CEO of Morgan Stanley to task for his post settlement comments attempting to spin MSDW's role in this shameful scandal. Claimants' lawyers are already bracing for the avalanche of denials of liability that will undoubtedly follow as the settling firms face the arbitration cases which their victims are already filing.

In the press conference announcing the global settlement, it was revealed that there was a conscious decision on the part of the regulators to not put the offending firms out of business, which they believed specific fraud findings might have done.

That decision having been made, there remains the question of whether these firms deserve to be in a business which involves the public trust. The coming arbitration cases will provide the answer to this question.

If the firms that are responsible for the erosion of public confidence in the integrity of the brokerage industry want to be a part of restoring investor confidence, the course to be taken is simple and obvious. First, admit your wrongdoing and apologize. Call off the spin doctors. Second, accept financial responsibility for what you have done. The Toronto Star reports that the ten settling firms made roughly $100 billion in profits between 1998 and 2000 as this scandal was unfolding.

If brokerage firms want the public's trust, they need to be prepared to return those profits and more as the losses of their victims are tallied. Regulators cannot buy trust for the industry.

Just as the major brokerage firms squandered the public's' trust by their fraudulent actions, they must earn it back by their future actions.

But what if they don't? What if they adopt the tactic of denying liability, fighting discovery requests and in general, choose to litigate in the same dishonest way they chose to operate? How then does the public get justice?

The answer is in the hands of the women and men, both public and industry, who serve as arbitrators. It is you who will be charged with the responsibility of rendering awards which will fairly and fully compensate the victims of this fraud.

While arbitrators do not have the power to restore the confidence of the investing public, they do have the power to assure victims of fraudulent conduct that they will be treated fairly, and will be compensated for their losses.

If an investor has been induced to

purchase a security on the basis of a fraudulent research report, arbitrators must recognize and reject the red herring defenses which the firms will advance. For example, it is intellectually dishonest for the firms to be arguing that investors would have lost money in the security regardless of the research reports due to the down market. Arbitrators should be mindful that these same firms were not arguing that damages should be increased during the bull market of the late 1990s.

NASAA President Christine Bruenn correctly pointed out that every purchaser of a stock which was the subject of fraudulent research is a victim of this scandal. New York Attorney General Eliot Spitzer explained it this way: "Small investors were being led astray by fraudulent research. We have seen how crass the system was."

The regulators have done all that they can to restore fairness to investors. Now it is up to the arbitrators to stand up for the victims as their cases come to hearing.

ProfLipner's "I Love New York Law" Column: Jurisdiction and Arbitration

by Seth E. Lipner

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Although arbitration is the product of "agreement", disputes sometimes arise about the duty to arbitrate. And although arbitration is supposed to be "final", the dispute sometimes does not end even after the award is rendered. In what court can these and subsequent matters be litigated? What court has "jurisdiction"? New York law has some good answers.

State vs. Federal Court: While the enforceability of arbitration agreements is federalized in section 2 of the Federal Arbitration Act ("FAA"), and confirmation and vacatur are governed by sections 9 and 10, all courts hold that the FAA provides no independent basis for bringing such a proceeding in federal court. A federal court proceeding will lie only where there is complete diversity of citizenship and at least $75,000 in controversy.

What State? Over the years, the brokerage firms seeking to stay arbitration or vacate an award have preferred New York as the forum for such proceedings, regardless of where the investor lived or where the arbitration will be held. That tactic was especially popular in the early 90s, before New York accepted the notions that arbitrators shall decide the eligibility rule and that punitive damages are permissible. And while such pre-arbitration proceedings have all but disappeared from the landscape, New York has again become a popular situs for arbitration-related litigation - only this time, it is in the area of motions to vacate.

When Merrill Lynch and other national firms began, in the early 90s, to sue everyone in New York to stay claims, the decisions were spotty at first because of a bad decision from the Second Circuit Court of Appeals in Merrill Lynch, Pierce, Fenner & Smith Inc. v. Lecopulos, 553 F.2d 842 (2d Cir. 1977). That case, involving a foreign investor who had no choice but to arbitrate in New York, seemed to hold that the standard form agreement to arbitrate before the New York Stock Exchange conferred jurisdiction on the New York courts simply because the NYSE is in New York. The case was decided correctly - having agreed to arbitrate in New York, the court held that the investor had consented to personal jurisdiction in New York's courts.

Despite the Second Circuit's limited holding, some state court judges were nevertheless confused about what to do in cases where the hearing would be held outside New York. The brokerage firms took advantage, and then confused the situation by arguing that the New York choice of law clause and the fact that the initial filing had to be sent to New York conferred jurisdiction on New York.

Most courts, however, got it right, and in 1995 the Appellate Division laid the issue to rest:

> Some minimal New York nexus is required in order to commence a special proceeding in our courts to stay arbitration (Siegel, New York Practice ' 588, at 940 [2d ed.]). In determining such a nexus, the focus must be on respondent's purposeful activity within this State, not petitioners' (see, Haar v. Armendaris Corp., 31 N.Y.2d 1040, 342 N.Y.S.2d 70, 294 N.E.2d 855, revg on dissenting opn. in 40 A.D.2d 769, 337 N.Y.S.2d 285). Respondent never engaged in any business transactions in this State which would subject her to the long arm of our jurisdiction (CPLR 302[a][1]), nor did her use of the NYSE correspondence "facility" in New York (see, Kidder, Peabody & Co. v. Marvin, 161 Misc.2d 12, 22, 613 N.Y.S.2d 1011) constitute a jurisdictional choice of forum. Rather, she exercised her option to arbitrate in Florida simply by filtering her request through an agency whose designated office for correspondence happened to be

> located in New York. That act was insufficient to establish a nexus for jurisdiction here, even combined with the choice of New York law. In the last analysis, if Merrill Lynch, through its Florida brokerage office, had been so determined to force this Florida client to arbitrate claims in New York, it could easily have provided as much, explicitly, in the customer agreement. Thus, not only contractual principles but also fairness and due process require this proceeding to be dismissed on jurisdictional grounds.

Merrill Lynch v. McLeod, 622 N.Y.S.2d 954 (1st Dept. 1995)

One lower court judge to who many of these cases were referred was even more blunt about the New York litigation tactic:

> In the six months that [applications to stay arbitration of] disputes between broker dealers and their customers have been referred regularly to me, I have learned of the practical difficulties of requiring individuals from across the country to defend fundamentally modest claims in a New York court. Their options are: incur the expense of hiring New York counsel, usually by expecting their home attorney to locate and retain one on short notice; take their chances and appear pro se, as the attorney-in-fact for the [investors] did here; or have their original attorney respond for them. . . . These realities highlight the fundamental unfairness of subjecting respondents and those similarly situated to jurisdiction in New York courts in the absence of their true consent.

Merrill Lynch v. Barnum, 616 N.Y.S.2d 857 (Sup.Ct.N.Y.Cty. 1994)(Solomon, J.)

In these pre-arbitration litigations, New York's courts (appropriately) do take jurisdiction where the parties agreed to arbitrate in New York (see, e.g. *Dain Bosworth, Inc. v. Fedora*, [SDNY 1993], 92 Civ 7813 [JSM], 1993 WL 33642 at *1-2 1993 US Dist LEXIS 1139, at 3-4) or where the out-of-state investor did business with a New York branch of a broker-dealer. On vacatur applications, New York courts will clearly assume jurisdiction if the arbitration hearing was in New York, or if the investor is a New York domiciliary.

But what of a case involving vacatur where neither the hearing nor the investor is in New York? A New York broker-dealer may be tempted to bring on that proceeding in New York because of cases like *Halligan v. Piper Jaffray*, 148 F.2d 197 (2d Cir. 1997) and *Wallace v. Buttar*, 2003 U.S. Dist. LEXIS 316 (SDNY 2003), but to do so there must be jurisdiction.

The broker-dealer's own presence in New York is of course irrelevant to the jurisdictional equation, because jurisdiction is based on the forum-directed conduct of the defendant (here, the investor), not that of the plaintiff. See generally *World-Wide Volkswagen v. Woodson*, 444 U.S. 286, 291-292, 100 S.Ct. 559, 62 L.Ed.2d 490 (1976). And if (a) the arbitration did not take place in New York, (b) the investor lives outside New York; and (c) the client did business with a non-New York branch of the broker-dealer, case is clearly covered by *McLeod* and *Barnum*.

But what if the account was, in fact, handled from New York? Does the fact that the investor "transacted business" with the broker in New York confer jurisdiction? The answer is "no", because the claim being made in the court proceeding (arbitrator error) is unrelated to the investor's forum-directed conduct (i.e. making investments). In a sense, the earlier (jurisdiction-conferring) activity is merged into the award. Even if the investor had lots of New York contact with the broker, that conduct provides an insufficient constitutional nexus to support an exercise of long-arm jurisdiction (See generally *Helicopteros Nacionales De Columbia, S.A. v. Hall*, 466 U.S. 408, 104 S.Ct. 1868, 80 L.Ed.2d 404)

Unfortunately, we know of no cases to cite for this direct proposition. The few times we have confronted the issue, the party seeking vacatur has voluntarily discontinued (usually because we also filed first to confirm elsewhere - a very important tactic -apparently ignored too often B which goes hand-in-hand with the strategies suggested here). We predict, however, that such cases will arise soon, and that New York courts will follow the wisdom of Solomon and dismiss such cases.

Court vs. Arbitration: Aside from the question of personal jurisdiction, there is sometimes the issue of court or arbitration in broker disputes. The typical broker-customer agreement provides for arbitration of disputes which relate to the account or account activity. That means that most disputes between a brokerage and its customer will go to arbitration, but not all. For example, in *Rizzo v. Prudential Securities, Inc.*, 287 N.J.Sup. 523, 671 A.Jud. 608 (A.D. 1996), an intermediate level appellate court in New Jersey ruled that a "wrongful disclosure" claim (brought against Prudential for complying with an allegedly improper subpoena and disclosing confidential information) was not within the scope of the arbitration agreement that Mr. Rizzo had with Prudential Securities. That argument covered all disputes about "transactions" in Mr. Rizzo's Prudential account, but, the court ruled, the "wrongful disclosure" claim Rizzo was bringing against Prudential did not relate to "transactions" in his Prudential account. The court thus declined to compel arbitration of the "wrongful disclosure" claim.

Similarly, in *Eychner v. Van Vleet*, 870 P.2d 486 (Colorado Court of Appeals 1993), a Colorado court similarly ruled that "the term 'transactions' used in the arbitration clause refers specifically and only to transactions performed in the Eychners' [Shearson] accounts as described throughout that agreement." The court thus ruled that the broker, a former employee of Shearson, was not entitled to use the arbitration agreement to compel arbitration of claims which arose after the broker after had left Shearson.

One should thus not assume that "all disputes" with a broker are automatically relegated to arbitration. A close reading of the agreement is required.

CONCLUSION

Battles over forum can be important battles to win. Those who sue are entitled to pick the forum for resolution of controversies, but the law requires that the chosen forum (judicial or arbitral) must have jurisdiction. Knowledge of these jurisdictional rules is crucial for the practitioner.

Practitioner's Column: Examining Brokers in Arbitration- The Most Fun You Can Have With Your Clothes On [1]

by David E. Robbins

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Introduction

Opening Statements have just finished. Claimant's counsel provided the arbitrators with a concise outline of what will be proven; how the misconduct will be shown to have directly caused the losses; and, what the witnesses on the direct case will say. Basically, she repeated and expanded upon the main points raised in the Statement of Claim. It took ten minutes. Respondent's Opening Statement was a long, pedantic recitation of the law; a dry, detailed presentation of all the evidence; and, a string of patronizing remarks about the Claimant's lack of common sense and lack of veracity. It took a half hour. The Chair did not interrupt Respondent's counsel, as he should have, and the two wings had mentally flown away some time ago.

To refocus the arbitrators on the central issues, Claimant's counsel calls her first witness*: the broker*. Electricity enters the room. It's as if the door mouse at Alice's tea party suddenly woke with a start. Claimant's counsel, desirous of asking the broker leading questions, asks the Chair to have the broker declared a *hostile witness* and then, seeing blank stares from the three mice, explains that since the broker is a party adverse to the interests of her client, she would like to be able to ask questions of the broker in the format usually reserved for cross-examination. That is, leading questions where you hope to elicit the same short responses most teenagers give to any question asked of them.

Claimant's counsel begins her questioning and then hears, like a mantra: "To tell you the truth … To be honest with you." No sweeter words can pass an opposing witness' lips, especially when that witness is a stock broker testifying as a hostile witness on the customer's direct case or during cross-examination. This article will discuss various issues concerning the questioning of brokers at arbitration hearings. The wonderful world of cross-examination, if done right, gets your juices flowing and keeps the arbitrators attuned to your client's case. It can even win your case long before summations have been given.

Batter Up: Lead-Off Questions

How to start? There are a number of techniques available to the cross-examiner. Each can be effective depending on the witness being examined, the facts of the case and your ability to perceive weaknesses in the witness' direct examination. *In My Life in Court*, pp.52 – 53, 101 (Doubleday 1961), the great trial lawyer Louis Nizer summarized the ways to break down a witness.

A favorite strategy in cross-examination is to begin with a strong contradiction, shaking the witness at the outset and bleeding him of his confidence. There is such a thing as the momentum of contradiction. As the witness is forced repeatedly to retract his answers, the effect upon the jury is increased disproportionately. Each succeeding defeat registers more deeply because of the accumulated impact.

The best way to do this with brokers is through documents, since they speak louder than sworn testimony. (I often tell my clients that if the contest were between the Pope, testifying from memory, and a stock broker with contemporaneous notes, the broker would usually win out, unless you could prove those "contemporaneous" notes were prepared after the fact.)

[1] I can't take credit for this article's catchy subtitle, although I would love to. I first heard the phrase a few years ago from H Thomas Fehn, with whom I've had the pleasure of co-chairing the annual PLI program on securities arbitration.

With respect to documents, when counsel to a customer knows that a written office procedure -- important to the case -- was not followed by the firm, he or she should home in on this failure to follow their own standards. Or, if there is an incident in a broker's past -- reported on a U-4, U-5, or RE-3 form -- and such conduct is similar to the wrong alleged in your case, start the cross-examination of the broker with that incident's similarity to your case.

The greatest challenge for a customer's attorney is to chip away at the broker's appearance of professionalism and honesty (assuming the broker is in the minority of brokers who are less than professional). After all, that broker is usually a successful salesperson of used goods (i.e., stocks) and will be very effective in trying to sell the panel on his or her case at the hearing.

The attorney should keep posturing to a minimum during cross-examination, so that the arbitrators are not moved to come to the defense of the witness being cross-examined. If the witness's testimony is implausible, arbitrators will be quick to discern that fact.

The Effective Use of Enthymemes

An enthymeme is a syllogism or other argument in which a premise or conclusion is unexpressed or implicit. It is the listener who completes the thought as if it were his own.

Whatever strikes the mind of an arbitrator as the result of his own observation and discovery always makes the strongest impression upon him. The arbitrator holds on to his own discovery with the greatest tenacity and, possibly, to the exclusion of contrary facts in the case. He sees the point for himself, as if it were his own. How do you know when you've given the arbitrator enough dots to connect? You will see it in the arbitrator's face – that Ah Hah, followed by a nod of the head. It ranks up there with arbitrator questions as an indicator that you've broken through, into the arbitrator's mind.

The Characteristics of A Successful Cross-Examiner

In 1903, when Oyster Bay's Theodore Roosevelt was president of the United States, Francis L. Wellman wrote the landmark book, *The Art of Cross Examination* (Collier Books, 4th ed. 1936). In it, he noted that successful cross-examination requires the greatest ingenuity; a habit of logical thought; clearness of perception in general; infinite patience and self-control; power to read men's minds intuitively, to judge their characters by their faces, to appreciate their motives; the ability to act with force and precision; a masterful knowledge of the subject-matter itself; an extreme caution; and, above all, the instinct to discover the weak point in the witness under examination.

Many of these characteristics are innate; most are acquired. Those that are acquired can only be accomplished if you know your case cold and you learn to listen actively – listen not only to *what* is being said by the witness, but *how* it is said. You must be sensitive to a pause, a look away, or a furtive glance to that witness' attorney.

Cross-Examination – Some General Comments

Before you start the cross-examination, while the witness is on direct, what should you be doing? A skillful cross-examiner seldom takes his eye from an important witness while that person is being examined by his adversary. Every expression of his face, especially his mouth, every movement of his hands, his manner of expressing himself all help you to arrive at an accurate estimate of the witness' veracity.

How can a cross-examiner get the most out of a witness? If your manner is courteous and conciliatory, the witness may soon lose the fear all witnesses have of the cross-examiner, and can almost imperceptibly be induced to enter into a discussion of his testimony, which, if you are able, will soon disclose any weak points in the testimony.

When the testimony of an opposing witness seems too contrived and is contrary to the truth, there is an opening for the effective cross-examination of that witness. If the manner of the witness and the wording of his testimony bear all the marks of fabrication, it is often useful, as your first question, to ask him to repeat his story. Usually he will repeat it in almost identically the same words as before, showing he has learned it by heart. Take him to the middle of the story, and from there jump quickly to the beginning and then to the end of it. If he is speaking by memorization rather than from memory, he will falter. He cannot invent answers as fast as you can invent questions and at the same time remember his previous inventions correctly.

An effective way to cross-examine a stockbroker is to contrast the broker's direct examination with statements written in the Answer, since the Answer is often not reviewed by the broker prior to its filing. Another technique is to give the loquacious broker free reign to talk on and on and then catch him or her in inconsistencies, implausibilities and overly rehearsed testimony.

Rationalizing the Irrational

One of the difficulties in trying to convince arbitrators that a broker is not telling the truth and that his misconduct in the customer's account was irrational is that we all, as rational people, want to figure out why the misconduct took place -- to rationalize the irrational. I try to counter the arbitrators' inclination to

go through this mental exercise by suggesting that sometimes irrational conduct simply cannot be explained--but it happens nevertheless. The great Francis Wellman framed the issue this way: "All men stamp as probable or improbable that which they themselves would, or would not, have said or done under similar circumstances. Things inconsistent with human knowledge and experience are properly rated as improbable.'' (Id. at 183.)

The Best Time to Stop Cross-Examination

Be on the alert for a good place to stop. Nothing can be more important than to close your examination with a triumph. So many lawyers succeed in catching a witness in a serious contradiction; but, not satisfied with this, continue to ask questions and taper off their examination until the effect upon the jury - of their former advantage - is lost altogether. Stop with a victory.

In an arbitration hearing, where anything goes, it's very difficult for some attorneys just to stop and sit down. The more experienced securities arbitration attorneys develop a sixth sense that tells them when the arbitrators have heard enough or are appropriately moved by the testimony. In some cases, arbitrators will be so affected by the testimony that they will undertake their own form of cross-examination of the witness. Those are the questions (and answers) that an experienced securities arbitration attorney will pay close attention to, and possibly repeat in his or her summation.

Advice from O.J. Simpson's Attorney

In the opinion of many practitioners, the modern-day Francis Wellman is F. Lee Bailey, the often controversial but always effective trial attorney. In his book to law students, T*o Be a Trial Lawyer* (John Wiley & Sons, 2d ed. 1984), he states that good cross-examination has a long list of ingredients: control, speed, memory, precise articulation, logic, timing, manner, and termination. How do his insights apply to securities arbitration hearings?

1. **Control** --Mr. Bailey believes that a cross-examiner must control his witness tightly and not let him or her run away with long, self-serving narrative answers. The cross-examiner must control the direction and pace of the questioning. This is done by having a game plan defining what you hope to get out of each witness.

   For example, if you know that the branch manager will be testifying, it's always a good idea to obtain the internal compliance manual of the firm and go through the daily, monthly, and quarterly reviews the manager was required to undertake. If you know or suspect the manager did not comply with those rules, you know the direction your questions should be going.
   Similarly, if one of your issues is excessive compensation on trades that were not fully disclosed on the confirmations, you will want to obtain the broker's commission runs or the firm's copy of the monthly account statements, which includes an extra column for "commissions'' for each trade (something that is not on the customer's copy of the monthly account statements). If the broker believes you will just be questioning him or her on the customer's copy of the monthly account statements, you can instantly take control in your cross-examination by pulling out his commission runs or the monthly statement version the broker received, and not the one the customer received.

2. **Speed** -- Mr. Bailey believes that ``[a] witness telling less than the perfect truth needs time to think up and fashion his answers, time that he must not be allowed to have. Effective cross-examination must be conducted at a pace nothing short of relentless, which will give one who is fabricating his answers insufficient time to do so.''

Since many brokers are not properly prepared by the brokerage firm's attorney to testify and since many have not even read the Answer, you may be able to quickly go through a checklist of inconsistencies and apparent misstatements in the Answer during the broker's cross-examination. It will make the broker look confused about the actual trading and other events (e.g., conversations) that took place.

3. **Memory** – "The cross-examiner must have his head stuffed with a plethora of facts and information, including every prior statement the witnesses made, the testimony other related witnesses have given or are expected to give, all relevant documents and other kinds of evidence, and a clear image of the details of the scene of the event if there is one. His hands must be empty most of the time and his eyes must be riveted on the witness. If he needs constantly to refer to notes and other written materials, he will sacrifice something essential: speed.''

This can only be accomplished if you know the facts cold. You can never learn too many facts in preparation for an arbitration hearing; you just never know when casual testimony on direct will trigger a connection with some apparently tangential fact that you learned prior to the hearing. When you are listening

to a witness whom you will have to cross-examine, your focus should be on what he says as well as how he says it. Again, a pause, a glance, a blush, or a need to "clarify" what he just said could prompt you to see the missing link to evidence that you did not think was particularly relevant.

4. **Precise articulation** – You should try very hard to refrain from asking questions that will allow a witness any opportunity to explain away a situation. Unfortunately, many panel Chairpersons are unwilling or unable to control the testimony of witnesses, no matter how hard the cross-examiner tries to limit the answers. Simply put, don't ask the witness "Why?" unless any answer, however long, will hurt him. You'll know you're doing a good job if the witness gets frustrated, turns to the arbitrators and asks if he can give the answer "in his own words." Remind the witness that he'll have an opportunity to "enlarge upon" his testimony on re-direct.

5. **Logic** – If the witness' answer on cross-examination doesn't make sense to you, it probably won't make sense to the arbitrators. If it's not logical to the arbitrators, they will probably infer that the events in question did not take place as the witness has testified. When the broker, for example, tries to explain how the investment objective of "conservative – income" is similar to "moderate – growth" (since he checked-off both boxes on the customer's new account form), give him plenty of rope on cross so that he can hang himself before the arbitrators' eyes.

6. **Timing** – Mr. Bailey says that, "Once he has backed a witness into a corner, [the cross – examiner] must go for the jugular moments before the witness has girded himself to repel attack. If he can, before every break in the trial, [the cross-examiner] must leave the air heavy with doubt and suspicion about the witness' testimony, allowing this last impression to sink into the jurors' minds during the recess." Experienced securities arbitration practitioners will frequently "play the clock" and wait for a few moments right before the lunch break or before the end of the afternoon session to ask a *Columbo Question*. You know that kind of question: "Oh, by the way, there's just one more question I have. Why did you give my client this check for $10,000 the same day you intercepted her complaint letter to your branch manager, this un-cashed check?"

7. **Manner** – Despite the desire of some of my clients to have me put a stake through the broker's heart, I have found it just as effective to be as respectful as possible to all witnesses on cross-examination and when I have caught a witness in an obvious lie, inconsistency, or illogical statement, to "play the silence." That is when I ask the "Why" question or simply ask: "And then?" We – the witness, the attorneys, the parties and the arbitrators - listen to the silence as it answers the question.

Location, Location, Location Is Not Important – It's Control

The experienced arbitration attorney and the experienced litigator know that the key to success in cross-examination is to control the witness. You need to question the witness on the subjects of his direct testimony, not in a manner that allows a chronological repetition of that testimony. In preparing to cross-examine witnesses, you should make a chart in your trial book of subjects to focus on with each witness. You should list a few introductory questions or phrases with which to hit the witness. It's also a good idea to prepare summary questions on the chart.

For example, in a churning case, a customer's attorney, on the cross of a broker, should control the broker's testimony by focusing on the issue of the broker's control and the broker's compensation. If the attorney has gone over every trade and shown that each order ticket was marked solicited (or, as is usually the case, not marked "unsolicited") and, through the broker's admission, shown that no recommendation was ever questioned by the customer, it's a good idea for the customer's attorney to ask the following kinds of questions: "So, in other words, you *effectively* controlled the investment decisions in this account?" "Objection," says the defense attorney.

"Try to rephrase your question," suggests the Chair. "OK," says the customer's attorney, turning to the broker, "Every time you made a recommendation, it was followed by an order, correct? My client never questioned or rejected any of your recommendations, yes? And the subject of your commissions never came up, right? Did he ever ask you what one-half or one-quarter or one-eighth mark-up or mark down translated to in dollars and cents? Did you tell him that you received a portion of the spread, of the concession? Did you tell him that you and your firm received a portion of the margin interest?"

Preparing Cross-Examination During the Direct

When the witness is testifying, draw a line down the center of your legal pad. On the left record the witness' testimony and on the right put down your impressions of that testimony, possible areas of cross-examination, questions from the arbitrators,

questions to ask your client at the break and notations to adjust your intended cross-examination based on the testimony elicited on direct.

My friend, defense attorney Michael Shannon, had the following advice on cross-examining customers, in a PLI chapter. His suggestion could equally apply to brokers. "If the witness makes a statement on direct which is extremely helpful to your case and which you wish to quote back to him on cross, try to note it exactly. There is no rule that prohibits you from saying in the middle of his direct exam, 'Excuse me, I was trying to get that down word for word. Can you just repeat it or could the Chairman play that back?' Later on during cross-examination, you now have the ability when confronting the witness about that statement to underscore it again by a simple preface to your questions, 'Mr. Jones, do you recall saying earlier ...?' The arbitrators will remember -- by repetition and the suggestion of reinforcement contained in your question -- that the witness definitely said 'X'. "

Cross-Examining a Firm's Compliance Officer

In "Making the Compliance Officer a `Power Witness' for Claimants" (*Securities Arbitration 1996* (PLI)), past PIABA president Diane A. Nygaard suggested that before deciding whether to cross-examine the compliance officer, certain key documents must be obtained:

1. The compliance officer's CRD, which will reflect his or her education, work history, tenure at the firm, and any other previous disciplinary problems.

2. The firm's compliance manual, since it includes listings of documents that must be generated, such as sign-in sheets and hand-outs at annual compliance meetings, concentration reports and their review, daily, weekly and monthly reviews of all accounts and all order tickets, documents reflecting the monitoring of registered representatives' own accounts, activity reports generated for active accounts, and how to conduct annual audits.

3. An organizational chart for the firm, showing whether the compliance officer's position had sufficient scope for independent action.

4. All compliance memos for the time in question, since they can show that the compliance officer addressed issues that appear in your case, such as excessive trading, concentration, options trading, or market making issues.

5. Notes or memos regarding any meeting or discussions regarding the accounts in question.

6. The complete file on both the hiring and termination of a broker, with all U-4s and U-5s, including amendments. She noted that often a red flag is raised when the problem broker was hired and the compliance officer either did, or should have, established extra supervisory procedures.

With these documents in hand, as well as new account forms, trade confirmations, monthly statements, trade blotters and order tickets (where relevant), a customer's attorney may, on cross-examination, find that the compliance officer either:

1. Failed to identify the problem and failed to review documents and maintain records that would have revealed the problem; or

2. Recognized there was a problem but failed to address it or failed to address it forcefully, perhaps due to a lack of resources or lack of authority; or

3. Recognized the problem, wrote notes of his discussions of the problem, kept records of memos and instructions to the broker or office managers, all of whom failed to address the problem.

One of the things I learned in the early 1980s when I was a Compliance Attorney at the American Stock Exchange, was that the more negligent the firm's compliance of the broker was, the better the customer's case will be. When compliance fails, customers have a better chance of winning.

Cross-Examination and Your Summation

Often the most important testimony in a case comes from the cross-examination of a witness. Little is gained, however, if the victorious cross-examiner leaves that evidence on the battlefield and fails to highlight it in his summation. Frequently, months can go by between a *coup de grâce* in cross-examination and the summation of a case. That intervening period can dull an arbitrator's appreciation for the earlier cross-examination.

What can be done? During your summation, review the cross-examination to remind the arbitrators how relevant certain admissions now become, when all the pieces of the puzzle are being fit together. Tie the specific cross-examination concessions together with a few documents which reinforce them. If you can make the adverse witnesses eat their own words, do so. Be demonstrative and be dramatic with *their own words*.

Do not say, in some conclusory form, that the adverse witnesses were unbelievable or that they admitted some point. If you have a transcript, read one or two of the best excerpts from cross. Have some flair with your

recitation of that testimony. If you do not have a transcript, hold up your notes as you dramatically remind the panel of the admission on cross-examination, an admission so stunning that you captured it, word for word, in your contemporaneous handwritten record.

However, as most experienced securities arbitration attorneys know, by the time you get to the summation, the arbitrators have pretty much made up their mind on whether liability was proven. Help them to make up their mind early in the process by effective cross-examination of the broker. If strong and certain points are scored early on in the case, your adversary will truly be on the defensive for the balance of the case and may never be able to recover.[2]

[2] For a more comprehensive examination of cross-examination of brokers *and* customers in arbitration, *see ¶12.22 of Securities Arbitration Procedure Manual.*

The Regulator's Corner: NASD's Recent Regulatory and Enforcement Initiatives in Support of a Fair Arbitration System

by Barry R. Goldsmith, David E. Shellenberger, Jon S. Batterman

Copyright © 2003. All Rights Reserved. *David Goldsmith has more than 20 years experience in the investment business. For more information, visit www.InvestmentReview.info or call 404-467-9595. Mr. Shellenberger is Regional Chief Counsel of District 10, New York, of the Department of Enforcement of NASD. Mr. Batterman is a Regional Counsel in District 10, and also is with the Department of Enforcement. NASD, as a matter of policy, disclaims responsibility for any private publication or statement of any of its employees. Any views expressed herein are those of the authors and do not necessarily reflect the views of NASD.*

Introduction

The year 2002 was a busy one for NASD's arbitration program, administered through NASD's Dispute Resolution Division. Arbitration filings increased more than eleven percent from the prior year, and industry experts predict that the increase will continue throughout the current year.[1]

At the same time, NASD implemented several regulatory and enforcement initiatives that will promote the fairness and efficacy of NASD's arbitration system. They deal with a number of areas of importance to arbitration practitioners, including impermissible confidentiality agreements; failure to pay arbitration awards and arbitration and mediation-related settlements; compliance with arbitration-related court orders; discovery in arbitration; arbitration default procedures; retention and accessibility of public registration and disciplinary information; choice of law and choice of situs contractual clauses; the collateral effects of NASD closing an examination against a firm or associated person; and Rule 3070 civil and criminal complaint and arbitration claim reporting requirements.

In 2002, NASD's Departments of Enforcement and Member Regulation, both part of the Regulatory Policy and Oversight Division, also continued to receive referrals from claimants' attorneys related to potential enforcement actions. These referrals involved a variety of sales practice abuses, including unauthorized trading, excessive trading and suitability, misrepresentations and omissions of material facts, mutual fund sales practice claims, initial public offering abuses, as well as other forms of misconduct. NASD's headquarters in Washington, D.C. has investigators and enforcement attorneys in the Department of Enforcement who work closely together to investigate many of these referrals. Similarly, NASD's district offices throughout the country have examiners in the Department of Member Regulation who work with regional attorneys in the Department of Enforcement to investigate referrals.

The strongest candidates for referral to NASD are those cases involving significant misconduct and investor harm, with anticipated customer cooperation. We encourage counsel to continue to carefully assess whether the facts in particular matters appear to support a referral to NASD for possible enforcement action and, if so, to make referrals to NASD promptly through the appropriate district office or the Department of Enforcement contacts listed at the end of this article.

NASD, of course, also continued to rely strongly on the cooperation of customers and their counsel while investigating and, in appropriate circumstances, litigating disciplinary actions in 2002. We encourage claimants' counsel to instill in their clients the value and importance of such cooperation, not only to address the particular alleged misconduct at issue, but also to deter future misconduct and to preserve the integrity of our industry and the securities markets.

Background of NASD and its Enforcement, Regulatory and Dispute Resolution Functions

NASD is a private, not-for-profit, self-regulatory organization, which is the leading private-sector provider of financial regulatory services. Since its inception more than sixty years ago, NASD's mission has been dedicated to protecting investors and maintaining market integrity. NASD endeavors to accomplish its mission through effective and efficient regulation and complementary

[1] NASD Website, Dispute Resolution Homepage, www.nasdadr.com. In fact, this year's statistics as of the end of February 2003 reflect that arbitration filings have already increased twenty percent over last year. *Id.*

compliance and technology-based services. NASD touches virtually every aspect of the securities business. Its functions include registering member firms, writing rules to govern their behavior, educating all industry participants, examining firms and employees for compliance, disciplining those who fail to comply with both NASD rules and the federal securities laws, and monitoring all trading on The Nasdaq Stock Market (Nasdaq) and other domestic and international securities markets with which NASD has entered into contracts to provide regulatory services, including Nasdaq Liffe Markets (the single stock futures joint venture between Nasdaq and the London International Financial Futures and Options Exchange) and the International Securities Exchange (the nation's first entirely electronic options market). Under federal law, every securities broker-dealer doing business with the United States public must be a member of NASD, which in turn is subject to close oversight by the United States Securities and Exchange Commission (SEC). Roughly 5,500 brokerage firms, 90,000 branch offices and more than 650,000 registered securities representatives come under NASD's jurisdiction.[2]

Additionally, NASD's Dispute Resolution Division administers the largest dispute resolution forum for investors and member firms worldwide.[3] Since its inception more than thirty years ago, NASD's dispute resolution program has strived to serve as a fair and efficient forum for the resolution of monetary, business and employment disputes among investors, securities firms and employees of securities firms. Dispute Resolution offers both arbitration and mediation services through a network of offices throughout the United States. Dispute Resolution's docket of cases includes employment and business disputes within the industry, as well as a wide variety of investment disputes involving stocks, bonds, options, mutual funds, and other types of securities. Today, Dispute Resolution handles approximately ninety percent of all arbitrations and mediations in the United States, with over 7,000 cases filed annually.[4]

A quick sampling of the functions performed by some of the departments within NASD's Regulatory Policy and Oversight Division conveys the magnitude of NASD's self-regulatory responsibilities:

Enforcement: NASD's Department of Enforcement is a fundamental part of NASD's mission. The Department of Enforcement not only encourages compliance and punishes wrongdoing, but it maintains the integrity of the markets for the vast majority of our members that obey the rules and have a strong interest in maintaining the industry's reputation. Investors have greater confidence in the securities industry when they know that a tough police officer is patrolling the "securities beat." NASD has statutory authority to impose a full range of disciplinary sanctions, ranging from censures and fines to suspensions, bars and expulsions from the industry. Each year, on average, NASD files more than 1,000 disciplinary actions, imposes well in excess of $10 million in fines, and expels or bars more than 700 unfit participants from the broker-dealer industry.[5] NASD's Enforcement Department is composed of approximately 190 employees in offices located in NASD's headquarters in Washington, D.C., as well as fourteen District Offices located throughout the United States.

Industry Oversight and Regulation: NASD's Department of Member Regulation also plays an integral role in furthering NASD's mission, including developing rules that govern industry conduct, examining members for compliance and recommending disciplinary action against those that fail to comply, and providing education to industry members. In recent years, the Department of Member Regulation has educated members on the new federal anti-money laundering provisions, and has worked with member firms to assess their disaster recovery plans in the wake of the September 11, 2001 terrorist attacks. In a typical year, the Department of Member Regulation conducts some 15,000 examinations for cause – including over 5,000 customer complaints – and performs more than 2,500 routine audits of NASD member firms.[6]

Market Monitoring and Surveillance:

NASD's Department of Market Regulation monitors all trading on Nasdaq and those other domestic

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[2] NASD: Building Investor Confidence Every Day (2002).

[3] *Id*. at 11.

[4] *Id.*

[5] *Id.*

[6] *Id.* at 10.

and international securities markets with which NASD has entered into contracts to provide regulatory services, including Nasdaq Liffe Markets and the International Securities Exchange. The Department of Market Regulation ensures compliance with the rules governing best execution, insider trading, money laundering, and other trading obligations. NASD's market surveillance program relies on sophisticated technology and automated monitoring systems to identify sequences of quotes and trades that may signal a potential violation.[7]

Disclosure Policy and Review: NASD's Advertising Department works to ensure that securities advertising by members is accurate and free of misleading claims. The Department reviews over 80,000 advertisements per year, including print advertisements and direct marketing materials, as well as advertisements on television, radio, and the Internet. The Advertising Department worked closely with NASD's Office of General Counsel and Regulatory Policy and Oversight Division in drafting and implementing new rules to govern research analyst conflicts of interest.

NASD's Recent Regulatory and Enforcement Initiatives Related to the Arbitration Program

Improper Confidentiality Provisions

NASD examinations conducted in 2002 revealed that, despite repeated cautioning on this subject, a number of member firms, as well as securities counsel, continued to use overly broad confidentiality clauses in settlement agreements with customers and other parties.[8] These settlement agreements often impede, or have the potential to impede, NASD investigations and the prosecution of NASD enforcement actions.

The exact wording of such overly broad confidentiality clauses differs from case to case. However, in general, the problematic settlement agreements contain confidentiality or nondisclosure provisions that prohibit or discourage the customers or other persons from disclosing the settlement terms and/or the underlying facts of the dispute in question to NASD or other securities regulators. In many instances, the settlement agreements contain confidentiality clauses that require a court order, subpoena, or other legal mechanism before permitting this disclosure to a securities regulator. Such restrictive language is especially problematic for self-regulatory organizations (SROs), such as NASD, which do not have the legal authority to compel cooperation by customers or other persons not subject to the SROs' jurisdiction.

Other problematic settlement agreements contain language prohibiting a customer or other parties from testifying about the settlement terms, or the facts underlying the settlement. Since NASD and other securities regulators, rely upon testimony to conduct investigations and to prosecute enforcement actions, the use of such language has the potential to inhibit the regulation of the securities industry.

As noted in earlier NASD notices to its members, settlement agreements certainly may require confidentiality as to persons other than securities regulators.[9] Indeed, aside from the use of such overly broad confidentiality clauses that may interfere with regulatory investigations, it is certainly not NASD's intent or desire to preclude members from obtaining general releases from customers in connection with settling disputes or grievances.

A violative confidentiality clause is one that undermines, or has the potential to undermine, the regulatory functions of NASD and other securities regulators. Therefore, a member firm may violate NASD Conduct Rule 2110 when it uses confidentiality clauses that: (i) prohibit or inhibit a customer or other person from disclosing the settlement terms and/or the underlying facts of the dispute to a securities regulator (including the SEC, NASD, any other SROs, and/or any other federal or state regulatory authorities); (ii) prohibit or inhibit a customer or other person from testifying about the settlement terms or underlying facts before any such regulatory authority; or (iii) impose conditions on such disclosure.

NASD Conduct Rule 2110 (Standards of Commercial Honor and Principles of Trade) provides that "[a] member, in the conduct of his

[7] *Id.* at 11.

[8] Specifically, Notice to Members (NTM) 86-36 (1986), NASD Regulatory & Compliance Alert (June 1994 and July 1995) and NTM 95-87 (1995) warned members against executing settlement agreements containing confidentiality language which may prevent or discourage any customer or other person from providing information, documents or testimony, or otherwise cooperating with NASD or any other regulatory organization in their investigations of alleged violations.

[9] *See, e.g.*, NTM 95-87.

business, shall observe high standards of commercial honor and just and equitable principles of trade." Both NASD and the SEC have held that the use of such overly broad confidentiality clauses undermines NASD's regulatory functions and therefore violates NASD Conduct Rule 2110.[10]

As noted in earlier NASD notices on this subject, whenever the settlement agreement references confidentiality, the confidentiality agreement should be written to expressly authorize the customer or other person to communicate, without restriction or condition, regarding the settlement or its underlying facts with any securities regulator, including NASD.[11]

NASD's Department of Enforcement has brought several disciplinary actions in recent years related to impermissible confidentiality clauses. We encourage counsel for the industry to promptly review and correct settlement agreements that contain impermissible confidentiality clauses. We also strongly encourage arbitration counsel for investors to bring any problematic settlement agreements to the attention of the appropriate NASD office.

Failure to Pay Arbitration Awards

During 2002, NASD continued to take steps to compel members and their associated persons to comply with arbitration awards and arbitration and mediation-related settlement agreements. Specifically, NASD made frequent use of its ability to bring non-summary proceedings under NASD Rule 9511(a)(2)(A). Under this provision, the Enforcement staff may issue a notice imposing either a suspension (against an individual) or cancellation (against a member) if an associated person or member fails to pay an arbitration award or settlement agreement related to an arbitration or mediation pursuant to Article VI, Section 3 of the NASD By-Laws.

Pursuant to Rule 10330(h) of the NASD Code of Arbitration Procedure, once an arbitration award is issued and received by a respondent, the respondent has thirty days to pay the award, unless a motion to vacate has been filed with a court of competent jurisdiction. If a respondent has not paid the award in a timely fashion, Dispute Resolution may commence a Rule 9513 non-summary suspension proceeding against the respondent member firm or associated person. While Dispute Resolution has responsibility for commencing the non-summary suspension proceeding, NASD's Department of Enforcement is responsible for litigating the matter. Pursuant to a 1998 rule change, members of NASD's District Committees are no longer involved in these proceedings and, instead, an NASD professional hearing officer serves as the sole trier of fact.[12]

Dispute Resolution commences the proceeding by serving a notice on the respondent pursuant to Rule 9513 of NASD's Code of Procedure. The respondent is then given fifteen days to provide documentary proof to Dispute Resolution that one of the following events has taken place: (1) the award has been fully paid or complied with; (2) the claimants have agreed to installment payments of the amount of award or have otherwise agreed to settle the action; (3) the award has been modified or vacated by a court; (4) a motion to vacate or modify the award is pending in a court; or (5) the respondent has a pending bankruptcy petition or the award has been discharged by a United States Bankruptcy Court. These are the five recognized defenses to these non-summary suspension proceedings, although respondents are also permitted to argue at a hearing that they have a bona fide inability to pay an arbitration award.[13] Pursuant to Rule 9514(a), the respondent has seven days after service of the notice by Dispute Resolution to request a hearing. The written request must be filed with NASD's Office of Hearing Officers. A request for hearing stays the notice issued under Rule 9513. If the respondent does not request a

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[10] *See, e.g., In the Matter of Stratton Oakmont, Inc.*, 1997 SEC LEXIS 562, 52 S.E.C 1170 (Mar. 12, 1997) (sustaining NASD's findings of violations of Article III, Section 1 of the NASD Rules of Fair Practice, the predecessor to NASD Conduct Rule 2110, based on unacceptable confidentiality provisions requiring that, prior to cooperating with NASD, a customer provide: (i) ten (10) days advance notification to counsel for Stratton and its account executives; and/or (ii) a statement or testimony to Stratton and/or its attorneys and attorneys for the account executives); *In the Matter of William Edward Daniel*, Exch. Act Rel. No. 28408, 50 S.E.C. 332, 335-36 (1990) (in upholding finding that registered representative violated just and equitable principles of trade where he conditioned payment of restitution on customer's withdrawal of complaint filed with NASD, the SEC noted that "an integral aspect of the statutory scheme for regulating broker-dealers and protecting investors is the responsibility of SROs such as NASD to investigate allegations that members and their associated persons have engaged in misconduct and to impose sanctions when appropriate.").

[11] *See* NTM 95-87.

[12] Securities Exchange Act Rel. No. 40026, 1998 SEC LEXIS 1154 (May 26, 1998).

hearing or provide satisfactory proof of one of the recognized defenses, the suspension becomes effective fifteen days after service of the notice, which is commonly referred to as the "fifteen-day letter."

In 2002, NASD sent out 248 fifteen-day letters for failure to comply with arbitration awards and arbitration and mediation-related settlement agreements. Of those, the vast majority -- 167 individuals or firms -- either settled or paid the awards in full after receiving the fifteen-day letter. NASD suspended another thirty-three individuals who failed to request a hearing or raise a valid defense after receiving a fifteen-day letter. The remaining forty-eight individuals or firms requested hearings, with approximately one-third of those matters resulting in payments of the awards.[14]

Failure to Comply with Arbitration-Related Court Orders

In a very significant decision by NASD's National Adjudicatory Council (NAC) in June 2000, the NAC reversed an NASD hearing panel's decision dealing with a member's duty to comply with a state court order to pay attorneys fees and costs resulting from an arbitration proceeding. In the *Shvarts* case,[15] an NASD hearing panel had dismissed a complaint filed by the Department of Enforcement against respondent Shvarts, alleging that he violated NASD Conduct Rule 2110 by failing to pay attorney fees and costs awarded in state court proceedings related to a customer-initiated arbitration. Specifically, Shvarts had filed litigation in state court against his former customers challenging an arbitration award in their favor.

The NAC held that Shvarts violated NASD Conduct Rule 2110 by failing to comply with the state court's judgment awarding to his former customers the attorneys fees and costs they incurred in the state litigation. The NAC fined Shvarts $5,000, suspended him from association with any member firm for six months, and required him to pay the customers the costs and fees awarded to them. The NAC finally noted that if Shvarts did not submit satisfactory proof of compliance within sixty days of the date of the decision, he would be barred from the industry.[16]

The NAC held that Shvarts' failure to comply with the court order awarding attorneys fees and costs was the sort of behavior that in itself violates NASD Conduct Rule 2110, barring extraordinary circumstances.[17] The NAC found that, just as associated persons are required under high standards of commercial honor and just and equitable principles of trade to comply with the securities statutes and rules, they also are required to comply with court orders issued in business-related cases.[18] The NAC held that "[t]he fact that Shvarts transferred his dispute with [his customers] from NASD arbitration to a new forum – a state court – did not isolate the dispute from the conduct of his business or relieve him of his ethical obligations."[19]

Failure to Comply with Discovery Orders

In 2002, NASD took steps to ensure that industry parties comply with discovery orders in arbitration proceedings. In July 2002, NASD's NAC announced that it had affirmed an NASD Hearing Panel's decision that Josephthal & Co., a member firm, violated NASD Conduct Rule 2110 when it improperly refused to comply with a discovery order of an NASD arbitration panel.[20] The NAC censured Josephthal and ordered the firm to pay a $10,000 fine.[21]

During a mid-1999 NASD arbitration proceeding brought by two customers against Josephthal, the claimants requested a document

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[13] *Id*. at *7, n.14.

[14] Of the forty-eight individuals or firms that requested hearings, fifteen proceedings were dismissed because the award was paid. Seven individuals were suspended. Three proceedings were dismissed by decision after a hearing took place based on findings of a bona fide inability to pay. Six proceedings were dismissed by the Department of Enforcement, prior to a hearing, based on a review of financials and a determination of a valid inability to pay. Three proceedings were dismissed due to bankruptcy filings. Six proceedings were dismissed because motions to vacate were timely filed after the respondents requested a hearing. Eight hearings are currently scheduled for 2003.

[15] *Department of Enforcement v. Shvarts*, No. CAF980029, 2000 NASD Discip. LEXIS 6 (June 2, 2000).

[16] *Id.*

[17] *Id*. at *11-25.

[18] *Id.*

[19] *Id.*

pertaining to "supervisory procedures" from the firm. Josephthal objected to the request, claiming that the document was protected by attorney-client privilege. The arbitration panel then ordered Josephthal to produce the document for its confidential review. Josephthal again refused, claiming that the arbitration panel's review of the document would potentially waive the attorney-client privilege.[22]

After the arbitration proceeding was concluded in favor of the claimant against Josephthal, NASD's Department of Enforcement filed a disciplinary complaint against Josephthal for failing to comply with the arbitration panel's order and produce the document. An NASD Hearing Panel conducted a hearing in the case and ruled that Josephthal had violated Rule 2110. Josephthal then appealed this ruling to the NAC. Following an independent review, the NAC affirmed the Hearing Panel's findings of a violation.[23]

The NAC found that the arbitration panel was well within its authority in ordering Josephthal to produce the document to the arbitration panel for a confidential review.[24] The NAC further found NASD's Code of Arbitration Procedure provides that a member firm that fails to abide by an arbitration panel's order to produce a document may be subject to disciplinary action for violation of just and equitable principles of trade.[25] The NAC rejected Josephthal's argument that complying with the arbitration panel's order would have waived the attorney-client privilege.[26]

Given the importance that discovery plays in the arbitration process, we strongly encourage the investor bar to bring to our attention cases involving clear violations of an arbitration panel's discovery orders. We are particularly interested in situations where there has been a pattern of discovery failures throughout the proceeding.

Default Procedures

In April 2001, the SEC approved a rule change proposed by NASD, which allowed investors with claims against defunct brokerage firms to take their claims to court if they preferred, regardless of any arbitration agreement they might have signed.[27] Shortly after that rule change went into effect, NASD began notifying investor claimants if the member firm was defunct, so that investors could make an informed decision regarding whether to proceed in arbitration, to file their claim in court, or to take no action.

In September 2002, the SEC approved another rule change proposed by NASD to use streamlined default procedures when a terminated or defunct member, or associated person who is no longer in the industry, does not answer an arbitration claim.[28] The procedures are designed to make it easier, faster, and less expensive for investors to obtain an arbitration award against such a defunct firm or broker that can then be enforced in court. The new procedures became effective October 14, 2002.[29]

Under the new rule, if an investor or other claimant determines to use the default procedures, the case will proceed with a single public arbitrator. The arbitrator in the default case will make a decision based upon the Statement of Claim and any other materials submitted by the claimant. In keeping with the streamlined nature of the proceeding, no evidentiary hearing will be conducted.[30]

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[20] *Department of Enforcement v. Josephthal & Co., Inc.*, No. CAF000015, 2002 NASD Discip. LEXIS 8 (May 6, 2002).

[21] *Id.*

[22] *Id.*

[23] *Id.*

[24] *Id.*

[25] *Id.*

[26] *Id.*

[27] Securities Exchange Act Rel. No. 44158, 2001 SEC LEXIS 661 (Apr. 6, 2001).

[28] 67 FR 21789, Securities Exchange Act Rel. No. 45818 (May 1, 2002); *see also* NASD News Release, Sept. 19, 2002.

The collective purpose and effect of the two new rule changes is to provide investors with more options to quickly seek collection against a terminated or defunct member, or former associated person.

Expungement of CRD Records

In 2002, NASD also worked to preserve the integrity and accessibility of its public records system. Specifically, in October 2002, NASD's Board of Governors approved a rule proposal limiting the removal of customer dispute information from the Central Registration Depository (CRD).[31] The CRD system, which is part of NASD's Regulatory Services and Operations Division, is the registration and licensing system for the United States securities industry and its federal and state securities regulators and SROs. The CRD system is jointly administered by NASD and the North American Securities Administrators Association (NASAA). The new CRD policy will be implemented after NASD's rule proposal is reviewed and approved by the SEC.[32] It will make permanent the previously imposed moratorium, which requires that a court must confirm any arbitration order for the removal of customer dispute information. In addition, NASD members and associated persons would be required to make NASD a party to an arbitration expungement order. NASD will oppose expunging arbitrations in court proceedings unless the elimination of the information is based on findings by the arbitrators or judge that the subject matter of the claim or the information in the CRD system: (1) is without factual basis (i.e., is factually impossible or unclear); (2) fails to state a claim (i.e., fails to state a claim upon which relief can be granted or is frivolous); or (3) is defamatory in nature.[33]

There may be rare instances when NASD determines that an exceptional case exists where the basis for the removal is appropriate, but does not fall within one of the three preceding standards (like identity theft and confidential customer information). NASD would make this type of determination only if it determines that the expungement is warranted based on a reason outside of the three categories and the removal would not have an adverse impact on investor protection, the integrity of the CRD system or regulatory requirements. NASD also proposes to include a process by which it will waive the requirements to be made a party if it determines that the expungement meets one of the above standards. NASD will notify state regulators when it is named a party or receives a waiver request. State regulators may decide to join the proceedings and oppose the expungement.[34] The goal of the proposed rule is to balance investor protection and the investor's ability to make an informed decision with the legitimate privacy issues of individuals and proprietary interests of member firms.

Choice of Law Provisions

Choice of law contractual provisions have long been the subject of dispute. Such provisions are sometimes used by brokerage firms in arbitrations to deprive investors of the protections afforded to them by the laws of their state of residence. For instance, some brokerage firms have included New York choice-of-law clauses in their customer agreements in an effort to preclude claimants from obtaining punitive damages in arbitrations.[35]

Rule 3110(f)(4) was proposed by NASD in 1989 and approved by the SEC in May of that year. Rule 3110(f)(4) provides that: "No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability to file any claim in arbitration or limits the ability of the arbitrators to make any award." In its release approving adoption of the rule, the SEC stated that the rule:

> makes clear that the use of arbitration for the resolution of investor/broker-dealer disputes

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[29] *Id.*

[30] *Id.*

[31] NTM 01-65; NASD News Release, Oct. 1, 2002.

[32] NASD filed the proposed new rule (Rule 2130) with the SEC on November 19, 2002 and filed an amendment to the proposed rule with the SEC on January 28, 2003. On March 4, 2003, the SEC published notice of the proposed new rule for comments from interested persons. Securities Exchange Act Rel. No. 47435, 2003 SEC LEXIS 507 (Mar. 4, 2003).

[33] *Id.*

[34] *Id.*

[35] *See* Norman S. Posner, Broker-Dealer Law and Regulation, Sec. 10.02 (2d ed. 2001) (for a general discussion of the ongoing debate over the appropriateness and availability of punitive damages in securities arbitrations).

represents solely a choice of arbitration as a means of dispute resolution. Agreements cannot be used to curtail any rights that a party may otherwise have had in a judicial forum. If punitive damages or attorneys fees would be available under applicable law, then the agreement cannot limit parties' rights to request them, nor arbitrators' rights to award them.[36]

Therefore, an important purpose of this rule is to prohibit any brokerage firm from including any language or condition in a customer agreement that could limit the ability of a customer to obtain an award in arbitration, or the ability of arbitrators to make an award, if the customer would have been able to seek the relief in a judicial forum.[37] Despite several NASD notices cautioning members against including choice of law clauses to limit a customer's ability to obtain an award in arbitration or the ability of an arbitrator to make an award,[38] some firms continue to include such provisions.

In November 2002, NASD's Department of Enforcement settled a disciplinary action against Prudential Securities, Inc. for improper use of choice-of-law provisions in customer agreements.[39] Prudential submitted a Letter of Acceptance, Waiver and Consent [40] in which the firm was censured and fined $20,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that in arbitration proceedings filed with NASD, it had public customers sign a customer agreement stating that the terms of the agreement would be governed by the laws of the State of New York. The findings also stated that the firm had asserted that New York law applied to the proceedings by virtue of the governing law clause in the customer agreement, and that New York law precluded an award of punitive damages or attorneys fees.[41] In addition to accepting the censure and paying the monetary fine, Prudential was also required to undertake to withdraw any New York choice-of-law defense asserted in any pending arbitration, not to assert a New York choice-of-law defense in any future arbitration proceeding, and to instruct all in-house and outside attorneys representing the firm in arbitration proceedings not to assert a New York choice-of-law defense.

NASD's enforcement action against Prudential should further discourage firms from relying on such choice-of-law provisions as a means to deprive claimants of their ability to obtain available relief or the ability of arbitrators to award such relief.

Choice of Situs Provisions

Choice of situs contractual provisions, as well as choice of law provisions, remain an area of concern to NASD. A choice of situs provision is a clause in a customer agreement that limits the location of any arbitration hearings related to the member firm and/or its employees. For instance, a New York based brokerage-firm might include a provision in its customer account agreements indicating that any arbitration hearing must take place in New York, irrespective of where the customer resides. NASD has issued several notices to members indicating that the time and place for any hearing shall be determined by Dispute Resolution and the arbitrators and that it is violative of NASD Conduct Rule 2110 for a firm to attempt to dictate the location for an arbitration hearing through such choice of situs clauses.[42] NASD's

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[36] Securities Exchange Act Rel. No. 26805 (May 10, 1989).

[37] Arbitration Policy Task Force Report, at 11.

[38] NTM 95-16, NTM 95-85 (the assertion of a choice-of-law clause might violate Rule 3110(f)(4) where sufficient contact does not exist between the customer and the transaction at issue and the jurisdiction whose law is designated, and a firm nonetheless uses the choice-of-law clause to argue that the designated law apply and that a specific remedy, such as punitive damages, is unavailable to the customer).

[39] Prudential Securities, Inc. (CAF020052).

[40] A Letter of Acceptance, Waiver and Consent is a settlement agreement, which is reached prior to the filing of a formal complaint by NASD's Department of Enforcement.

[41] Prudential Securities, Inc. (CAF020052).

Enforcement and Member Regulation Departments continue to monitor customer account documentation to ensure that member firms refrain from including such provisions in their account agreements.

We encourage arbitration counsel for investors to bring any problematic choice of law and/or choice of situs provisions in customer account agreements to the attention of the appropriate NASD office.

Close-out Notices

In 2002, NASD issued a notice to its members indicating that it has revised the letters the Department of Member Regulation sends to customers and members when a determination is made to close an investigation without disciplinary action.[43] The revised letters now state that a determination by NASD not to take action against a member or a member's associated person has no evidentiary weight in any mediation, arbitration, or judicial proceeding. Further, the notice notes that NASD considers it inconsistent with just and equitable principles of trade (Conduct Rule 2110) for a member or a member's associated person to attempt to introduce such a determination into evidence in any mediation, arbitration, or judicial proceeding.[44] NASD's decision to close out an investigation without further action can be the result of many factors unrelated to the merits of a complaint, such as jurisdictional limitations, the existence of an ongoing investigation, resource limitations, or a completed enforcement action by another regulator. Accordingly, NASD wants to make it clear that it is unethical and misleading to suggest to an arbitrator, mediator or adjudicator that NASD's decision not to further pursue an investigation is probative evidence in a dispute on a related claim. We encourage arbitration practitioners to bring any examples of such misconduct to the attention of the appropriate NASD office.

Rule 3070 Criminal and Civil Complaint and Arbitration Claim Reporting

In August 2002, NASD filed with the SEC a proposed rule change to amend NASD Conduct Rule 3070 to broaden the reporting requirements. The SEC approved the proposed rule change on March 3, 2003.[45] The rule change requires members promptly to file copies with NASD of certain criminal and civil complaints and arbitration claims against a member or a person associated with a member. The purpose of the rule change is to improve the quality and flow of information to NASD with respect to allegations of broker misconduct, so that NASD can enhance investor protection efforts by promptly taking appropriate regulatory action to address the specific alleged misconduct and to prevent similar or related misconduct in the future.

Specifically, the rule change requires members to file with NASD copies of: (1) any criminal complaints filed against the member or plea agreements entered into by the member that are covered by the rule; (2) any securities or commodities-related private civil complaints filed against the member; (3) any arbitration claims against the member (except those claims that have already been filed with NASD Dispute Resolution); and (4) any criminal complaints or plea agreements, private civil complaints or arbitration claims against an associated person that are reportable under question 14 on the Uniform Application for Securities Industry Registration or Transfer (Form U-4) (except those arbitration claims that have already been filed with NASD Dispute Resolution).[46] To avoid duplicative filing, the rule provides that members need not separately produce any of the above-referenced documents if they have already been the subject of a request by NASD's Registration and Disclosure staff.[47]

The rule change promises to enhance NASD's regulatory efforts and investor protection mission. The rule change should also improve

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[42] NTM 95-85; NTM 95-16.

[43] NTM 02-53.

[44] *Id.*

[45] Securities Exchange Act Rel. No. 47434, 2003 SEC LEXIS 510 (Mar. 3, 2003).

[46] Question 14 of the Form U-4 contains numerous disclosure questions with areas related to criminal disclosure, regulatory disciplinary actions, civil judicial actions, customer complaints, terminations, and financials. Under the rule change, members must file with NASD copies of any criminal complaints or plea agreements, private civil complaints or arbitration claims against an associated person that are reportable under Question 14, irrespective of any dollar threshold requirements that Question 14 otherwise imposes for notification.

NASD's ability to detect and prevent fraudulent and manipulative conduct and enable it to develop regulatory responses to problem areas at the earliest possible time.

Conclusion

The year 2002 saw a significant increase in arbitration filings for NASD. At the same time, the year was marked by significant NASD enforcement and regulatory initiatives aimed at improving the efficacy and fairness of NASD's dispute resolution program. Our hope is that these NASD regulatory and enforcement initiatives, and others that will follow, will help ensure fairness for all who look toNASD Dispute Resolution as a forum to resolve their disputes in 2003 and the years to come.

We encourage arbitration practitioners to continue to assess whether the facts of particular cases support a referral to NASD for possible enforcement action and to continue to remind clients of the importance of their assistance and cooperation in our examinations and enforcement proceedings. Such referrals and cooperation are some of the most vital tools at NASD's disposal to carry on its mission of protecting investors and maintaining the integrity of our markets.

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[47] *Id.*

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Expert's Corner: Analyst Conflicts and Industry Misconduct: How Did It Happen?

by Peter L. Aseritis

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Conflict and Scandal

For the many individuals associated with the U.S. brokerage and financial industries either as investors and/or employees, 2002 was a year that most would like to forget. Investors saw the value of their investments decline for a third straight year, something that had not happened to U.S. equity investors since 1939–1941. Nationwide, tens of thousands of industry employees received "pink slips" during 2002. Looking at market performance during 2002, the Dow Jones Industrials fell 17%, the S&P 500 Stock Index showed a decline of 23%, and the NASDAQ Composite Index fell 32%. Even worse, 2002 marked the year that trust in the U.S. financial industry fell to new lows with each revelation of U.S. corporate and brokerage industry wrongdoing.

As these negative revelations came to light, a commonly asked question in the industry and among investors was, *"How could this happen"?*

In this article, we initially focus on the investment banking and equity research departments of the major U.S. brokerage firms, and how industry structure and dynamics ultimately contributed to the recently revealed troubles. Next, we will explore the interplay between investment bankers and equity research analysts, and how the overwhelming "profit" power of one side led to the "corruption" of both sides.

Historical Perspective

To understand how the present day relationship between investment banking and equity research evolved, one must take a trip back in time. We will examine the industry over two very specific periods. The first period begins at the end of World War II (1945) and continues through the end of fixed commission rates (1975). The second period stretches from 1975 to the end of the 1990s "Bull" market in early 2000. Unfortunately, as investors now know with the benefit of perfect 20/20 hindsight, the tremendous stock market price gains of the 1990s were an unsustainable bubble that has since burst. Measured against the market's all-time highs, the Dow Jones Industrials are down 32%, the S&P 500 has fallen 49%, while the NASDAQ Composite Index is down a staggering 74%.

Fixed Commission Era

Over the 1945-1975 period, a symbiotic relationship developed among research, sales, and trading at the large U.S. brokerage firms. The system essentially worked as follows:

1. Working in the brokerage firm's equity research department, "Sell" side analysts sought out the stocks of the very best companies in their respective industry area to recommend. At most firms, each industry group (such as aerospace, automotive, construction, electrical equipment, retail, semiconductors, telecommunications, etc.) had its own analyst. After conducting a thorough review and analysis of all the firms in their particular area of expertise, the analyst wrote a detailed research report that recommended certain stocks for purchase. The finished research report, which was distributed to clients (via mailing list during this era), also explained the rationale behind the analysts' recommendation, usually in considerable detail.

Once the research report on any given stock was published, the analyst basically had to market his/her research to three audiences.

- The first audience was the analyst's own internal institutional sales force.
- The second audience was the firm's highest producing retail brokers (if the firm had a retail business). At most firms with a retail client

business, only a certain select number of the biggest commission-producing brokers were allowed to directly call and/or otherwise directly interact with the equity research analyst.

- Third, the analyst marketed his or her research to counterpart "Buy" side institutional analysts and/or money managers at large financial institutions such as Fidelity, Allstate, Alliance Capital, and Vanguard, among many others.

3. It was only by building a positive track record of "correct" research calls over a period of time, that the analyst was able to build his or her professional reputation, and win the confidence of the audiences discussed above. Normally, all three audiences were skeptical of any new analyst, and simply would not use an analyst that they did not know or were not comfortable with.

4. From the ongoing interplay among/between this three-sided relationship of equity research, sales, and trading, the brokerage firm would receive financial remuneration as the following sequence of events occurred. The analyst would put out a "buy" recommendation on a certain stock, the institutional sales force and the firm's retail brokers would believe the veracity of the analyst's story, and would then attempt to sell this investment recommendation to their clients (either institutional or retail). If institutional and/or retail sales was/were successful in selling this particular research recommendation, the brokerage firms' trading department would execute the trade(s). The commissions generated from the trade(s) would pay the salaries of the analyst and the salesperson/broker, with any residual monies going to the brokerage firm as profit. During this era, before the end of fixed commission rates, and under this business model, equity research was a "profit" center even after "substantial" five- and six-digit analyst salaries were factored in.

Post Fixed-Commission Bull-Market Era

With the end of fixed commissions in 1975, the U.S. brokerage industry entered an entirely new era with increased levels of competition occurring between and among the various firms as they pursued new clients and new business opportunities. It was over this 1975-2000 time frame that the following events took place.

1. In this much more competitive post 1975 world, commission rates charged to the brokerage client fell dramatically, in many cases falling to only pennies per share traded. In this environment and under changed operating conditions, it was no longer possible for research and/or trading to directly earn a profit.

2. Thus, the equity research department went from being a "profit" center to being a "cost" center. Moreover, it was because of these changed economic dynamics in the brokerage industry that the new equity research/investment banking relationship was born.

3. Despite dramatic market fluctuations in recent years, basic Initial Public Offering (IPO) investment banking fees have changed little, and remain at the 7% level where they have been for a number of years. In other words, a $100-million IPO (which was generally viewed as a "small" deal) would generate about $7 million in gross fees for the lead underwriting firm, with the net gain usually being in the $4- to $5-million range after expenses. Working with investment banking, equity research could once again "pay the bills" while continuing to pay analysts large salaries.

4. In the new highly competitive economic environment that arose in the U.S. brokerage industry after the demise of fixed commissions, equity research analysts became much more involved in looking for, soliciting, and supporting investment banking clients. As a result of this relationship with investment banking, the average New York-based equity research analyst could earn a six-digit salary, while analysts who were highly ranked in the *Institutional Investor* research poll could take home annual paychecks that stretched out to seven, and in some cases, even eight digits.

5. To manage the inherent conflict between the underwriting of new securities (investment banking) and the publication of research about an existing company's future business prospects (equity research), the SEC promulgated rules and regulations that required a "Chinese Wall" to be established between the two functions.

6. Conceptually, the "Chinese Wall" was erected by the regulatory authorities to prevent the direct flow of information between investment bankers (whose access to information in discussions with company management often made them "insiders") and equity research, where information about any particular company was supposed to be independently gathered, compiled, and analyzed. In the early years after the end of the fixed commission era, the required "Chinese Wall" separation between investment banking and equity research was rigorously enforced. However, as practiced by the U.S. brokerage industry in the 1990s (with the de facto consent of the SEC, which did nothing to enforce the "Chinese Wall" separation as originally envisioned), the

separation between investment banking and equity research became less and less formal.

Old Industry Structure Favored Equity Research

The old adage of "follow the money" will highlight what has happened to brokerage firm equity research departments and equity research analysts since 1975. During the fixed commission era, equity research analysts could absolutely focus on making the best "stock market" investment recommendations because that is how they built their professional reputations and got paid. In those days, if an analyst recommended a certain stock, successfully sold it to all the necessary target audiences, and the price of that stock went up, the analyst was rewarded in two ways.

- First, the research analyst's professional reputation was enhanced, as he or she became perceived as an industry expert and a good stock picker.

- Second, the analyst and the analyst's firm both got paid because the business of recommending stocks and trading stocks, particularly if the analyst's investment calls were timely and accurate, was quite profitable.

New Industry Structure Favors Investment Banking

In the brokerage industry environment of the late 1990s, equity research and trading were no longer profitable in and of themselves, while investment banking remained highly profitable. In this environment, the research analyst could potentially be faced with diverse situations that often resulted in very different outcomes.

1. In the first case, and in what would be an ideal situation for the equity research analyst, he or she would be able to recommend the stock of an investment-banking client based on that company's strong business fundamentals. Next, when that firm's sales, earnings and stock price all increased in line with stated forecasts, the analyst's professional reputation was enhanced. In this situation, the investment-banking client was happy, and the analyst and his/her firm both get paid through the investment banking side of the business.

2. However, the second situation we will examine is not nearly as positive. What would happen if an investment banking client's fundamental business story was not good, and would not normally merit a positive investment recommendation? Yet assume that the investment banking relationship with this particular firm remained highly profitable for the brokerage firm. Would the research analyst write a negative, but honest, assessment based on the company's underlying business fundamentals, or would the analyst write a positive business review knowing that it simply was not true?

3. If there were no threats against the analyst's job security and/or income, most professional research analysts would write an accurate assessment of a high-profile investment banking client's business outlook, even if it upset the management of the client firm. However, if the analyst perceived that his or her job and/or income were at risk if the high-profile investment banking client were offended, then many analysts would likely choose to be less than honest in their public commentary (either written or spoken).

4. Simply put, the "conflict of interest" situation discussed above was quite prevalent in the U.S. brokerage industry of the late 1990s. Unfortunately, it now appears that many analysts were looking more to their own perceived self-interest (keeping their high-paying job), rather than clearly and honestly stating what they truly believed to be the fundamental business outlook for any given investment-banking client.

5. In addition, given the increased focus on investment banking that was keyed by the high levels of profit generated by this activity in the 1990s, many industry research analysts began actively searching for private companies that could be taken public via an Initial Public Offering (IPO). Often, these firms were small and not well known, and would give the research analyst an ownership stake as compensation for setting up the investment banking relationship.

6. If and when the IPO did occur, these analyst ownership positions usually became quite valuable. However, if the analyst then uncovered "bad news" about a company in which he or she had an ownership stake, how likely were they to write a negative (but honest) report that would negatively impact their personal wealth? Analysts having a vested interest in the companies that they cover and write about is the second major "conflict of interest" that occurred during the bubble market of the late 1990s.

How / Why Did a Dishonest Situation Become Institutionalized?

Our examination of the U.S. brokerage industry has highlighted how the equity research department moved from being a "profit" center during the fixed-commission era, to a "cost" center by the time the "Bull" market of the 1990s rolled around. While this change in internal industry dynamics certainly can explain some of the increased pressure that was faced by the "Sell" side equity

research analyst over the 1975 through 2000 period, it does not explain why brokerage firm legal departments allowed the "Chinese Wall" separation between equity research and investment banking to become meaningless. In fact, as highlighted in a number of recent *Wall Street Journal* articles, at least one large brokerage firm had a number of equity research analysts report directly to senior investment bankers. Structural dynamics also do not explain why the SEC and other regulatory agencies essentially left the U.S. brokerage industry to its own devices during the later part of the 1990s. Nor does the change in industry dynamics explain why senior management and/or senior investment bankers allowed highly inflated business forecasts to go unchallenged to the investing public as if these projections were derived through truly independent research.

Did a number of large U.S. brokerage firms simply have their senior management and investment banking leadership positions filled by dishonest people, or was there some other dynamic at work here? Not having been an industry regulator and/or in a position of senior management during this period, we have no personal experience from which to base a response to these questions. On the other hand, having been employed in New York from 1982 through 1999 as an equity research analyst by a number of large brokerage firms, we can offer some anecdotal insights based on personal experience.

Separation of Powers Existed Early On

During the first ten years (1982 –1992) of our Wall Street experience, the three large brokerage firms at which we were employed did not combine the efforts of different departments into a single-minded pursuit of new business opportunities. In other words, a research analyst would initiate coverage on stocks he or she believed had the most upside price potential, without looking at the underlying company for commercial banking, investment banking, mergers/acquisitions, and/or other related business opportunities.

After 1992, this began to change rapidly as a number of large brokerage firms merged with commercial banks, investment management companies, and insurance companies. Research analysts now began to get calls from senior persons in other departments of the firm who were looking to leverage the research relationship in an effort to win new business in both traditional and non-traditional areas. If you were senior to the person calling with a request, you could readily say "no" if you did not like what was being proposed. However, if the person calling was senior to you, then it became much more difficult to say "no." In other words, the "separation of powers" that allowed research analysts a great deal of autonomy to pick and choose which stocks to cover and which not to cover began to be usurped, primarily by investment bankers, from the mid-1990s on. Also frowned upon by investment bankers was the publication of any research report that expressed anything but the most glowing opinion about an investment-banking client.

Being a "Team Player" Became Paramount

During the 1990s, the traditional brokerage firm changed from a company primarily focused on client services (institutional and/or retail) into a "financial supermarket." Once in the "financial supermarket" mode, brokerage firms were looking to offer clients a wide array of services ranging from traditional brokerage services like research and trading to commercial banking, investment banking, merger/acquisition advisory, and asset management, among others. The concept of being a "team player" was widely heralded, with the expectation being that each person involved would bring all of their particular experience and expertise to bear, with the primary focus being to get a particular piece of business done. What you, as an individual and/or as a research analyst, thought about any particular business transaction was not important. All that was important was that you totally supported the "team effort" and got the deal done.

How Badly Did You Want to Keep Your Job?

In retrospect, it is not surprising that the U.S. brokerage industry now labors under a cloud of scandal and controversy. Particularly egregious examples of questionable industry behavior were the low-quality IPO deals that were brought public during the bubble market of the 1990s. Under the new "team concept," once a decision had been made at the upper levels of management to pursue a particular business opportunity, everyone at the firm was expected to march in unquestioning lockstep until the transaction was completed. Anyone who questioned a less than "top flight" transaction was accused of not being a "team player." And in a number of cases, analysts who persisted in attempting to write factual research reports or resisted supporting the "low grade" transactions that became common during the later part of the 1990s were fired.

While all brokerage firm employees who supported these questionable business transactions must share in the blame for what happened, analysts are being particularly singled out because what they said about any particular stock or transactions was "on the record." Obviously, a published research report can be dissected and analyzed word-by-word and sentence-by-sentence long after all other traces of a "deal gone bad" have long since vanished.

On the other hand, in many instances, analysts deserve to be blamed for much of the shoddy research that occurred during the late 1990s. It was analysts who thought up new and novel valuation

measures like *backlog to sales/book to bill ratios, times sales ratios, times operating cash flow ratios, times free cash flow ratios, and economic value added measures using unrealistic growth and discount rates* when a company's stock price no longer appeared attractive using established measures like *times earnings per share (the old P/E ratio)*. It was also analysts who came up with even more bizarre valuation parameters like *market share of an undefined or unprofitable market, mouse clicks (hits) per web site,* and the *number of incremental new subscribers per month* regardless of customer cancellation rates and/or other true cash and profitability measures.

HOW COULD IT HAPPEN? / WHO IS TO BLAME?

"Team Player" Concept Was Part of Industry Structure

Although there appears to be enough blame to go around, we believe that the "team player" or "team concept" mode of doing business that was espoused by U.S. brokerage firms during the 1990s made it easy to silence critics and suppress dissent. It is hard to individually oppose a large number of "team" members when one does not have perfect information and foresight, particularly if billions of dollars are at stake, and if the market is taking the price of a security well above what the analyst believes is reasonable. Keep in mind that no analyst can predict with 100% certainty what will happen to the price of any stock over any given period of time. Finally, when the market price of a security goes against an analyst's deeply held convictions and expectations in a major way for a prolonged period of time, that analyst will almost always be plagued by doubts. He or she will keep asking, "What does the market know that I don't know?" If this goes on long enough, even the most convinced analyst may waver and change his or her investment opinion, because the belief is that the millions and millions of people whose combined input goes into the making of any given stock's market price are collectively in possession of more information than you are as an individual analyst.

Senior Management/Market Regulators/Analysts Are to Blame

Placing blame after any negative occurrence has taken place, particularly if backed by major fines and/or prison time, will normally prevent the same thing from happening for some period of time going forward. However, people forget over time, and the human emotions of "fear" and "greed" will once again lead to market excesses. However, we believe that blame for the extreme market excesses of the late 1990s should be placed primarily with senior U.S. brokerage firm management persons and with SEC regulators and law enforcement officials. Finally, we would hold responsible those individual analysts who acted in a less than a professional manner, and who essentially "sold their soul" to the highest bidder.

Keep in mind that senior management (by dint of the position held) is responsible for all that happens or fails to happen at their firms. During the decade of the 1990s, they established the culture that put profit and the "team player" concept of doing business above ethics, client service, and individual employee dissent. It was senior management who rewarded "rogue" analysts and investment bankers with enormous seven- and eight-digit salaries. It was senior management who reined in their firm's legal and compliance departments, and who turned a blind eye to the excesses that occurred at their firms during the later part of the 1990s.

SEC regulators and U.S. law enforcement officials are supposed to enforce the business and securities laws of the United States. For a number of years, especially at the end of the 1990s, they failed to do so for reasons known only to themselves. We can only speculate what their motives for turning a blind eye to the industry they were supposed to regulate might have been, but it is probably related to the fact that they did not want to interfere with the raging "bull market," which at the time, seemed to be making everyone rich.

Finally, individual investment bankers, analysts, traders, and brokers all have to look in the mirror and judge whether they honestly performed their jobs to the best of their ability. Can they honestly say that they put their clients' interests ahead of their own. Until the investing public perceives that client interests are once again paramount, we do not expect a major sustainable stock market recovery to occur.

In Many Instances Individual Investors Were Truly Hurt

During the late 1990s, many brokers and their firms engaged in a "one size fits all" approach to dispensing investment advice. We are generalizing when we say this, but most investment portfolios of that period tended to be 100% equity based, with the majority of individual holdings being technology stocks. Although this type of portfolio might be appropriate for a young couple in their 20's with no immediate financial obligations, it certainly would not be appropriate for a retired couple in their 70's, where a portfolio comprised primarily of bonds might be much more appropriate.

Pick Your Cases Carefully

While virtually all investors in the U.S. stock market suffered losses during the "bear" market of the last three years, a key component of judging whether or not investors might have a legitimate case is the relative performance of their portfolio versus market benchmarks. At Portfolio Performance Analysis, Inc. (PPA), we have used market benchmarks such as the investor's home state statutory rate of return, the S&P 500 Stock Index, the NASDAQ Composite Index, and the Lehman Brothers Long Term Bond Index in our work to

measure the relative performance of any given portfolio against the market. However, based on any given set of investment objectives, other reputable market indexes like the Dow Jones 30 Industrials, the Russell 2000, the Lehman Brothers Intermediate Term Bond Index, and/or the Lehman Brothers Composite Bond Index might also be used to measure relative performance.

In our opinion, in cases where a portfolio's performance was "in-line-with" or "better-than" its appropriate benchmark, broker misconduct probably will be hard to find, or alternatively, hard to "prove" before an arbitration panel or in a court of law. On the other hand, portfolios that dramatically under performed related benchmarks over a significant period of time were likely based on "unsuitable" investments and/or "unsuitable" investment strategies. While, from a theoretical perspective, it might be argued that a "good" performing portfolio was not "suitable", or conversely, that a "bad" performing portfolio was "suitable," in the real world of arbitration panel findings and awards, taking this approach is not recommended. In other words, if your client made money, it probably will be difficult to convince a panel or jury that the broker acted improperly.

Investors Invest to Make Money, But...

Note, most investors enter the market with the expectation of receiving a positive return, or "making money." In the context of "real world" returns during the post World War II era, the U.S. equity market as measured by the S&P 500, generated a positive average annual return of some 10%-12%. However, in the context of bringing a case to arbitration or trial in the present environment, where the S&P 500 Index has been down substantially over the last three years, one might have to explain to an investor that they were not wronged by their broker in every instance where their account experienced a negative rate of return.

Analysts and Their Firms Could Be Targets

Finally, written from my perspective as a former analyst, in an environment of publicly identified analyst conflicts and brokerage firm misconduct, our recommended "plan of action" would be as follows.

1. Where PIABA members do not have sufficient evidence to file a claim, but believe that a client was wronged by one of the firms currently being investigated by the New York State Attorney General and/or SEC, we would recommend that a comprehensive review of all available investigative reports and relevant documents (some concerning the purported $1.4-billion "industry settlement" should be coming out soon) be made.

2. Should any of the wrongdoing outlined in these documents overlap with any given client's particular case, the basis for bringing legal action has already been made by regulatory authorities, and has been outlined in great detail for all to see in related regulatory agency filings.

3. Particularly look for instances where a written research report, recommending purchase of a "speculative" type security (which in your opinion was not suitable for your client), was directly passed by the broker to the client. Historically, a written brokerage firm research report mailed to a client was not recognized as a solicitation to buy or sell without some other "call to action." For example, a direct recommendation by a broker to a client such as "take a look at this research report written by our all-star analyst on ABC stock, we recommend that you purchase this stock because it is a compelling story with great upside potential" would be such a "call to action."

4. Cases where a client spoke directly with a research analyst (a privilege normally restricted to high net worth clients) about a stock might be quite compelling if there is a provable trail of evidence like telephone logs showing direct contact and/or copies of research reports on file with the client.

5. Finally, all "analyst" cases in which we have been involved to date have settled before going to arbitration or trial. Given that no "analyst" case has moved through the entire process, it is hard to judge what the final outcome might be. On the other hand, if a client has been improperly led into "unsuitable" investments because of "flawed" equity research reports and/or analyst recommendations, then certainly, legal action should be pursued.

Expert's Corner: Suitability, Liability and Risk Creep

by John Lyman

If a used car salesman browbeats an elderly person into buying a car that they do not need, as ethically repulsive as it is, it usually does not result in financial Armageddon for that elderly person. Misconduct with the bulk of their financial assets often does. That is why the retail securities industry is more regulated than the retail auto industry.

It is a convoluted and incorrect argument to say that investors who buy stocks assume the risks of whatever happens. This caveat emptor theory flies in the face of the rules of the NASD and the Rules of the NYSE.

If an investor was truly shocked by the performance of their equity positions from March of 2000 to present and the loss of principal was devastating to their only means of support, then I would argue that this is evidence that the investment(s) was unsuitable for that investor. To me, this means they were not properly informed of the risks and it is likely that the investment strategy and/or asset allocation model was inappropriate for that investor from a suitability determination.

The suitability of the investor must be, by industry rule and written procedure of at least every major wire house firm, established before the account makes its first investment.

A trade cannot physically take place until there is an account in which the client performs his half of the bargain. At this point, before the trade, Rule 405 (3) of the NYSE says that a principle executive officer of the member firm must "approve of the opening of the account" and "prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account". In other words, the determination as to what investments are appropriate for that particular investor is made, in theory, before the first investment is recommended.

Rule 405 of the NYSE says that members, are "required" to "Use due diligence to learn the essential facts relative to every customer, every order every cash or margin account accepted". The rule goes on to say that "every member organization" "is required to supervise diligently all accounts handled by representatives".

Rule 3010 (a) of the NASD Conduct Rules says that "Final responsibility for supervision shall rest with the member" (Respondents). This means that the responsibility for suitability cannot be assigned to the investor, it is clearly assigned to the supervision and compliance personnel. Nowhere in the industry rules does it say that there are exceptions to Rule 3010 (a). Nowhere does it say that if the broker perceives the investor to be "sophisticated", the industry is relieved from it's fiduciary duty on suitability.

An historic example of this argument occurred during the 1980s when so called "discount" brokerage firms emerged after the "big bang" (deregulation of commissions). The discount firms claimed that since they do not offer investment recommendations, they are relieved of the suitability determination responsibilities. The industry rules governing this issue did not change at that time and have not changed essentially since 1934. They did, and still do, place the duty squarely on the shoulders of the industry. This shift of suitability onto the investor and away from the industry never occurred in the rules, only in the arguments of respondent's counsel. The industry has had almost 70 years now to change the rules, assuming for a moment that they are unfair to the industry, and no significant changes to the rules have happened yet.

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Many of you have already heard respondent's argument that this particular investor was "sophisticated" and therefore the responsibility for suitability is somehow shifted to the investor. This is also 180 degrees contrary to the advertising of all major wire house firms which suggests that they will be there to guide you through the dangers of investing in the financial markets to assure successful investing.

The information necessary for supervision and compliance to 'learn the essential facts' is located only in one place, the New Account Form (NAF), which is always to be completed before the account is opened.

The SEC requires brokerage firms to have, and keep, this information for at least six years after the account closes. The reason is that this is the criteria for making any investment suitability decision, and it is stored and updated only on this NAF and nowhere else in the firm.

The NAF is the only place in the vast information systems of the brokerage firms where this critical data is stored and maintained. When the NAF is filled out, copies are forwarded to the supervisor and the compliance department for approval, reference for those making suitability decisions and recordkeeping. When Rule 405 of the NYSE requires the registered representative, his supervisor or compliance personnel to make a suitability determination (which is on every trade), they must rely on this form to "learn the essential facts" to make that determination.

If the form is not complete, which, in my experience, is common, the account should not be approved even for the first trade. This is the crack through which many unsophisticated investors fall. Contrary to the rules of the NASD, the NYSE and the firms' own written procedures, the account is often opened with either contradictory or missing data on this critical form. For example, it is common to see a NAF on which two or more levels of risk are indicated. There can be only one level of risk for that account. If the client has funds with which he is willing to take more risk, those funds should be separated into a different account with the appropriate risk level assigned. If the funds are mingled in one account, there is no way to make a proper suitability determination on any trade.

If registered representatives, their supervisors and the compliance departments are following industry rules and their own written procedures when the client's account is opened, they know exactly what kind of investor he is, in terms of appropriate risk and his ability to understand the risk, accept the risk and absorb the potential losses. Further, they are aware of the essential facts, which include the diversification and level of risk of all of the assets in any other investment accounts and the investment objectives of the investor.

Most brokerage firms publish their asset allocation model based on their research and it is usually a guide as to how they currently recommend investors allocate the assets in terms of bonds versus equities. During the late 1990s they all were around 45% bonds and 55% equities, notwithstanding the various levels of risk to which each allocation should be exposed. The question is, what made this particular investor an exception to this general rule?

My experience has been that if registered representatives had only followed the asset allocation model that that their own firm publicly recommend, there probably would not be arbitration in the matter.

Often the slide into too much risk is gradual. I like to call it "risk creep". As the stock markets rose to extreme levels, the confidence of the registered representatives increased accordingly. Many of them really believed that it was their own genius and not the rising tide that increased the value of their clients' accounts. Then, as the markets ate away the capital gains, their recipe for recovery was more risk, which they probably truly believed they could manage. But by this point, they were already far beyond the level of risk that was suitable for that client. In the meantime, supervision and compliance looked the other way.

Millions of American investors could see their own investment experience in this description. For their part, because of the failure to properly inform them of the risks associated with their particular investments, these investors associated gains with safety of principal because that is the extent of the information they had to make any self determination of suitability on their own. The regulators say the real responsibility falls squarely on the shoulders of the supervision and compliance as well as the registered representative. Much of the losses American investors experienced in the last three years can be directly attributed to the failure of the industry to know their customer and to follow their own rules on suitability.

Chomping At The Bit: Representing Investors In Arbitrations Against Foreign Governments With Bilateral Investment Treaties

by Kurt Arbuckle

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I. Introduction

We know why we have securities laws, right? It is because too many times people who start companies or raise money for companies say they are asking for an investment, when in fact they are asking for a donation. Sometimes, whole countries are like that. Countries that are small, or underdeveloped, or have capital needs for some other reason (call them capital importing countries) have programs to "attract foreign investment." Investments in such a country, with its sovereign immunity, powers of expropriation, and military/police force, could easily turn into an act of involuntary charity.

Having been drafted into philanthropy for the benefit of the foreign country, what is our investor to do? Complaining to the local tribunals of the foreign country can be like complaining to a self-regulating organization that can pass and amend its own enabling legislation and is run by the very entity that the complaint is about.

Investors who have enough money to get the attention of a foreign country also have enough sense, generally, to anticipate these problems. Smart investors are reluctant to invest in capital importing countries, and, when they do, they expect a return commensurate with the risk. The result for the country involved is that capital is less available and more expensive. The problem is easily stated: The investor wants protection and the foreign government wants capital. The solution that has developed has two components, the Convention on the Settlement of Investment Disputes between States and Nationals of Other States (the "Convention") and a Bilateral Investment Treaty. Bilateral Investment Treaties (which I will call BITs and which are the main subject of this article) are intended to protect investments and to provide for arbitration in the event of an investment dispute. The Convention provides the mechanism for arbitration of investment disputes and the means of enforcing arbitral awards. I will begin this article with some background on the Convention, and then I will go into some detail about the contents of a BIT. After I have dissected a BIT, I will get to the fun part about what is involved in actually doing an arbitration under a BIT.

II. The Convention and ICSID

The Convention has a preamble that is remarkable only in that it has a bunch of "whereas" paragraphs, but never uses the word "whereas." Instead it uses "Considering," "Bearing in mind," "Recognizing," "Attaching particular importance to," "Desiring to," and "Declaring." You do not really need to know that, but if you ever have to do a contract, you might keep these phrases in mind.

The Convention is essentially a huge multilateral treaty that, as time goes by, more nations can join. Currently, over 150 countries have signed on to the Convention. The Convention established the International Centre for the Settlement of Investment Disputes (ICSID), which is part of the World Bank. ICSID is in charge of administering arbitrations in accord with the Convention. The Convention does two other main things: It provides a mechanism for a national of one Convention member to bring an arbitration against another Convention member (a foreign country), and it establishes that all of the countries which have signed on to the Convention agree to recognize and enforce the pecuniary portions of any arbitral awards issued through ICSID. Before the Convention, nationals had to get their government to advocate on the national s behalf in any dispute with a foreign country. The enforceability provision is important, because it gives the investor the potential to collect an award from a reluctant foreign government in some other country where the foreign government may keep its funds (not necessarily easy, but it is the best one can do). The Convention also provides diplomatic pressure to

honor the arbitral award. If you want to bring an arbitration through ICSID, you have to familiarize yourself with four different documents:

1. **The Convention Itself:** The Convention has provisions relating to the jurisdiction of ICSID[1]; the request for arbitration[2]; the constitution of the Arbitral Tribunal[3]; the powers and functions of the Tribunal[4]; the arbitral award[5]; the interpretation, revision and annulment of the award[6]; the recognition and enforcement of the award[7]; the replacement and disqualification of arbitrators[8]; the cost of the proceedings[9]; and the place of the proceedings[10].

2. **Administrative and Financial Regulations:** A great deal of what is in this document is not applicable, but there are a few relevant things buried in its provisions. For example, this document contains provisions having to do with the cost of the proceedings, although the actual amounts are set out in a separate schedule.[11] Regulation 29 discusses how to calculate time limits[12], and Regulation 30 discusses the number of copies of supporting documentation that must be provided.[13] These are examples, and the point is that you do have to read the document even though most of it doesn't apply.

3. **The Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings:** There is a whole separate set of rules on how to start an arbitration. These rules talk about the request[14], the contents of the request[15], optional information you can include in the request[16], the number of copies of the request[17], and what the Centre does to register the request[18]. If you look back at what I said about the Convention, you will notice that

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[1] Convention on the Settlement of Investment Disputes Between States and Nationals of Other States, Art. 25-27.

[2] *Ibid.*, Art. 36.

[3] *Ibid.*, Art. 37-40.

[4] *Ibid.*, Art. 41-47.

[5] *Ibid.*, Art. 48-49.

[6] *Ibid.*, Art. 50-52.

[7] *Ibid.*, Art. 53-55.

[8] *Ibid.*, Art. 56-58.

[9] *Ibid.*, Art. 59-61.

[10] *Ibid.*, Art. 62-63.

[11] ICSID Administrative and Financial Regulations, Reg. 14.

[12] *Ibid.*, Reg. 29.

[13] *Ibid.*, Reg. 30.

[14] ICSID Rules of Procedure for the Institution of Conciliation and Arbitration Proceedings, Rule 1.

[15] *Ibid.*, Rule 2.

[16] *Ibid.*, Rule 3.

[17] *Ibid.*, Rule 4.

[18] *Ibid.*, Rule 6.

the Convention sets out the jurisdiction for ICSID. The Secretary-General of ICSID will make a determination when you file your request for arbitration as to whether or not to register it. If the Secretary-General (it is actually his staff) decides that the request does not fall within the Convention or the request does not meet the jurisdictional requirements of ICSID, the Secretary-General will refuse to register your request. Guess what? If the Secretary-General does not register your request, you are flat out of luck. There is no recourse. Moral: Be nice to the staff. Be understanding, they have to answer to complaints from the Convention members who never seem to think a request should be registered. It is likely the staff will ask you to revise portions of your request. I have actually had the staff request me to put more information into a request, and then say that they have changed their mind and wish that I would take it out. I declined the latter suggestion, but I was very polite about it.

4. **The Rules of Procedure for Arbitration Proceedings:** This document consists of 56 Rules split into 8 Sections: the establishment of the Tribunal[19]; workings of the Tribunal[20]; general procedural provisions[21]; written and oral procedures[22]; particular procedures[23]; the award[24]; interpretation, revision and annulment of the award[25]; and general provisions.[26]

None of these four documents is particularly long. The tricky part is that each document is intertwined with the other documents, so that you really have to know them all.

As of the time that I am writing this article, ICSID has disposed of 69 arbitrations (about half through settlement) and has about 45 arbitrations pending. This does not seem like a great number of arbitrations for an organization that has been in existence for 40 years. In fact, the vast majority of these cases have been filed since 1995, and the caseload is mounting. The reason for the slow start was that while the Convention provided a forum for arbitration, and a potential means to enforce arbitral awards, arbitrations could only be initiated if the investor and the foreign government (which had to be a member of the Convention) consented to such arbitration in writing. The Convention itself does not constitute consent by the foreign country.

III. The Bilateral Investment Treaty

It is the proliferation of BITs that has solved that problem. The first BIT that I am aware of was negotiated in 1959 between Germany and some developing country I don't even remember. The United States did not start entering into BITs until the 1980s. However, the United States has developed a form BIT that is then modified to meet specific requirements. An example of a special requirement is the BIT with Estonia. Since Estonia is emerging into a market economy from a former soviet block country, much of its governing is done through state enterprises. To account for this, the BIT between the United States and Estonia has provisions in it dealing specifically with the requirement that the government make sure its state enterprises abide by the Treaty. Using the Treaty between the United States and Estonia (which is, for the most part, a typical form of a United States BIT) as an example, here is a

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[19] ICSID Rules of Procedure for Arbitration Proceedings, Chapter 1, Rules 1-12.

[20] *Ibid.*, Chapter 2, Rules 13-18.

[21] *Ibid.*, Chapter 3, Rules 19-28.

[22] *Ibid.*, Chapter 4, Rule 29-38.

[23] *Ibid.*, Chapter 5, Rule 39-45.

[24] *Ibid.*, Chapter 6, Rule 46-49.

[25] *Ibid.*, Chapter 7, Rule 50-55.

[26] *Ibid.*, Chapter 8, Rule 56.

[27] Treaty Between the Government of the Republic of Estonia and the Government of the United States of America for the Encouragement of Reciprocal Protection of Investment, Art. I, 1.(a).

rundown of the Treaty sections with some comments about each one.

After the Preamble, Article I of the Treaty sets out definitions. By far the most important definition is the definition of "investment."[27] I will not reproduce it here, just be aware that it is extremely broad. It includes equity, debt, service contracts, and investment contracts. Certainly, tangible property and shares of stock in a company would be included, but so are intangible assets including such things as mortgages and liens. Intellectual property is included, and even a claim for money or performance is included if it is in connection with an investment. An investment also includes licenses and permits.

Article I also has definitions of "company," "national," "return," "associated activities," "state enterprise," and "delegation."[28] This article of the Treaty also has a provision that changing the form in which assets are invested or reinvested does not affect their character as an investment.[29] The Treaty also has a fairly complex paragraph in Article I that excludes applicability of the Treaty to certain investors that are actually controlled by nationals of third countries.[30] So if you have a case in which your client is a United States company, but it is actually controlled by nationals of some third country, then you will want to take a look at this paragraph. As long as the third party country has diplomatic relationships with Estonia and the United States, and the United States company actually conducts business activities within the United States, you should be safe.

Articles II, III, and IV of the Treaty have to do with protecting the investment. Article II, the most extensive of these three articles, states that the investment must be treated the same as an investment made by a citizen of that country, or the same as investments made by investors from other countries, whichever is most favorable.[31] This includes not only the investment, but also all activities associated with the investment. Each party is allowed to make exceptions to the Treaty, but it must state in an addendum to the Treaty what those exceptions are.[32] This article of the Treaty also is the article that mandates that the government ensures that all state enterprises act in a manner that is not inconsistent with the government's obligations under the Treaty.[33] Paragraph 3 of this article goes further to state that the investment "shall at all times be accorded fair and equitable treatment, shall enjoy full protection and security and shall in no case be accorded treatment less than that required by international law." This is one of the most important provisions in the Treaty. This is the case for several reasons. First of all, it is in essence a requirement of due process. Second, it places an affirmative duty on the government to protect the investment. Third, it introduces international law into the Treaty.

I want to comment on the third reason to give you an idea of just how important it is. As you can see, the other portions of this article of the Treaty require treating the investment the same as any investment of a citizen of the country. The implication is that the law of the country involved in the arbitration is going to control the arbitration as long as that law does not discriminate against the foreign investor. Invoking international law as the standard below which a country cannot fall is immeasurably important in making sure that the investment has a definable minimum of protection. For example, it is a well established concept in international law that all parties act in good faith. Such a requirement is not universal, even in the United States. Further along in this article I am going to go over some principles of international law that I think will interest you. This provision of the Treaty provides a means for an investor to argue international law principles as a minimum standard of conduct. The fact that a foreign country may steal from its own citizens, does not provide justification under the BIT to steal from a United States investor.

Article II also has an interesting provision that anticipates the article of the Treaty having to do with arbitration. The article on arbitration,

[28] *Ibid.*, (b)-(g).

[29] *Ibid.*, 3.

[30] *Ibid.*, 2.

[31] *Ibid.*, Art. II, 1.

[32] *Ibid.*

[33] *Ibid.*, 2.(a)-(b).

which is discussed below, essentially provides arbitration as an election of remedies. Going to the courts of the country in which the investment is situated is an election not to go to arbitration and precludes any subsequent arbitration proceeding. However, Paragraph 3.(b) of Article II states that neither party to the BIT shall in any way impair by arbitrary or discriminatory measures the management, operation, maintenance, use, enjoyment, acquisition, expansion, or disposal of investments. Then it goes on to state that "a measure may be arbitrary or discriminatory notwithstanding the fact that a party has had or has exercised the opportunity to review such measure in the courts or administrative tribunals" of the government involved in the arbitration. In other words, an arbitrary or discriminatory administrative or court proceeding within the country does not launder a violation of the Treaty. This, along with a prohibition discussed below about having effective means of asserting claims, and the definition of "investment dispute" also discussed below, in essence creates a new violation -- a new dispute that can be arbitrated. The issue that is being arbitrated is whether or not the actions by the administrative or judicial agency were a violation of the Treaty. As that was not the issue that was actually before the administrative or judicial agency, there has been no election of remedies as to that issue. However, in order for this new dispute to have any real impact, it must be demonstrated that a different result would have occurred in the outcome of the underlying dispute, had the administrative or court proceeding been conducted in accord with the Treaty.

Article II of the Treaty also has several other requirements including the following:

1. Not interfering with the investor entering and remaining in the country for purposes dealing with the investment;[34]

2. Not interfering with the employment of managerial personnel of the investor's choice;[35]

3. Not imposing performance requirements as a condition of the investment;[36]

4. Having effective means of asserting claims and enforcing rights[37]; and

5. Not having secret laws or regulations that apply to the investment that are not published.[38]

No. 4 is the prohibition that dovetails with Article II, Paragraph 3.(b), discussed above, which creates a dispute that can be arbitrated even if local judicial or administrative proceedings were invoked. (Note also that No. 4 and Article II, Paragraph 3(b) also apply to an action in a local court or administrative agency against the investment. Such an action -- as well as the action of the court or agency -- could violate the BIT and would never be an election of remedies by the investor.)

Article II concludes with some exceptions having to do with most favored nation status and goes on to list approximately eleven sets of activities that would be considered "associated activities" (i.e., associated with the investment) that are also protected under the Treaty.[39] These include such things as granting franchises or rights under licenses; access to registrations, licenses, and permits; access to financial institutions and credit markets; access to the investments' funds held in financial institutions; the importation and installation of equipment; the dissemination of commercial information; the conduct of market studies; the appointment of agents; the marketing of goods and services; access to public utilities and public services; and access to raw materials, imports, and services of all types at non-discriminatory prices.

I have gone over the provisions of this particular article in such detail to give you an idea of just exactly how broad it is. What it boils down to is that every aspect of the investment is entitled to treatment at least as good as what is required by international law, is entitled to treatment that is at least as good as

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[34] *Ibid.*, 4.

[35] *Ibid.*, 5.

[36] *Ibid.*, 6.

[37] *Ibid.*, 7.

[38] *Ibid.*, 8.

[39] *Ibid.*, 11(a)-(k).

what is given to domestic investments and investments from third countries, and is entitled to be regulated fairly and with due process.

Article III of the Treaty specifically addresses expropriation. An important and potentially useful provision of this article is that it includes direct and "indirect" expropriations.[40] Essentially what the Treaty requires is that any expropriation of the investment has to meet the same kind of requirements that are required for what we in the United States would call eminent domain proceedings or condemnation proceedings.[41] This includes that the expropriation is for a public purpose; accomplished with due process; that effective means to challenge it are available; and that there be fair compensation in good currency. This article also has a provision on how investments must be treated if they suffer losses due to war or civil strife.[42] The requirement for such treatment is basically that the treatment be non-discriminatory.

Article IV of the Treaty mandates that the country allow transfers into and out of the country of funds invested in or generated from the investment.[43] This article also provides that the transfer shall be made in freely useable currency at prevailing market rates of exchange.[44] In other words, after receiving dollars invested, the country cannot insist that any money be transferred out in what is essentially worthless currency.

Article V of the Treaty is a short provision that says that the parties will get together and discuss any disputes over interpretation questions having to do with the Treaty. This may seem like a fairly innocuous provision, but it can be a pitfall in rare instances. For example, the North American Free Trade Agreement (NAFTA), although it is a multilateral Treaty, has many provisions similar to a BIT. It has a similar provision to this Article V. There have been some arbitrations under NAFTA having to do with the treatment of investments in connection with environmental protection activities of the countries involved. Some of those arbitrations have not gone well for the countries, and it is likely that Mexico, Canada, and the United States will all get together and say those activities are not intended by them to be part of the Treaty. This would not only affect future claims, but even existing claims could be nullified by such actions. In the context of a BIT, it is likely to be rare that the parties get together and interpret the Treaty. If they do, however, it is likely because of a claim that neither party to the Treaty likes, and so it will have an obvious effect not only on future claims but also on existing claims that involve the relevant issue. As United States BITs are form treaties for the most part, a claim under a similar provision in a BIT between the United States and a different country could also be affected, although the third country's position regarding the provision's interpretation would have to be assessed.

Article VI is the dispute resolution article of the Treaty. The first thing this article does is define "investment dispute."[45] An investment dispute is a dispute between a country and a national or company of the other country arising out of or relating to (a) an investment agreement, (b) an investment authorization granted by that country's foreign investment authority, or (c) "an alleged breach of any right conferred or created by this Treaty with respect to an investment." The first two parts of the definition are essentially breach of agreement or breach of authorization claims, but the third which I quoted makes a breach of the Treaty an investment dispute. This can become a little bit confusing when you note that the third part of the definition of "investment dispute" is frequently going to be a dispute about an investment dispute. In other words, the third kind of dispute is going to be a complaint about how one of the first two kinds of investment disputes were dealt with by the government. You can raise three different combinations of these kinds of disputes. You can raise an investment dispute that is a breach of an agreement or authorization; an investment dispute that is a breach of an agreement or authorization which is also breached in a way that is a violation of the Treaty; or an investment dispute that is a violation of the Treaty which has nothing to do with the actual breach of an agreement or authorization. In the latter case, an investor might be bringing an investment dispute against a country even though the investor has no agreement directly with the country, but this dispute is based on the way an investment is

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[40] *Ibid.*, Art. III, 1.

[41] *Ibid.*, 1-2.

[42] *Ibid.*, 3.

[43] *Ibid.*, Art. IV, 1.

[44] *Ibid.*, 2.

[45] *Ibid.*, Art. VI, 1.

being treated by the country. Suppose, for example, your client has invested in a telecommunications company that has a particular license within the foreign country. The foreign government has cancelled that license in a manner that is in violation of the Treaty. Your client has an investment dispute with that government, even though your client has no contract directly with the government.

It is the "investment dispute" for which Article VI of the Treaty provides remedies. After the parties have tried to amicably settle the matter, the investor has a choice of bringing an action in the courts or administrative tribunals of the government with whom the investor is having the dispute, use any applicable previously agreed upon dispute resolution procedure, or arbitrate the dispute in accordance with Article VI of the Treaty.[46]

This article of the Treaty provides for arbitration through ICSID, through the "additional facility" of ICSID (which must be used if the government is not a member of the Convention), through the arbitration rules of UNCITRAL, or through any other arbitration proceeding or organization to which the parties agree.[47]

Article VI goes on to state that this article of the Treaty constitutes the consent required or the "agreement in writing" required for purposes of ICSID and the New York Convention.[48] The New York Convention is a convention having to do with the enforcement of international arbitration awards. Article VI of the BIT requires that any arbitration that is not done through the ICSID Convention must be done in a country that is a party to the New York Convention. This ensures that any arbitration award received in that country will be enforceable in the courts of that country. If the case is to be arbitrated before ICSID, then it is being arbitrated under the Convention, which also provides for the enforcement of arbitral awards.

Article VI prohibits the government from seeking any setoff or credit for any insurance payments in connection with an investor's loss.[49]

Paragraph 8 of this article is a neat device.[50] Under the ICSID Convention, for ICSID to have jurisdiction, the dispute must be between the government of one party to the Convention on the one hand, and on the other hand an investor who is a national of another party to the Convention. What this paragraph does is define the company in which the investor invested as a national of the country of which the investor is also a national, even if the company is constituted under the laws of the government against whom the case is being brought. For example, if your client invests in a foreign country as the 100% owner of a telecommunications company, and the telecommunications company was formed under the laws of that foreign government, the telecommunications company is itself considered a national of your client's home country. So not only can your investor bring a claim, but the telecommunications company could also bring a claim under this Treaty. Obviously, some of the people in our State Department are really smart.

Article VII of the Treaty provides for a dispute resolution mechanism between the two parties to the Treaty (i.e., the two governments) in the event that they cannot resolve their disputes under Article V by discussion.

Article VIII of the Treaty provides that if there are any laws, or regulations, or administrative practices of the foreign government, or any international legal obligations of the foreign government, or any other obligations assumed by that foreign government which are more favorable than what is provided in the Treaty, those provisions must be followed. In other words, the Treaty is a minimum standard. Taking this article of the BIT, with other provisions I have mentioned, you can choose from several standards of conduct and argue the highest in the arbitration. These standards include the local law of the government, the BIT itself, international law, treatment afforded nationals of third party governments, or any obligation undertaken by the country that is a party to the investment dispute (whether it be an international obligation, an obligation brought about by a direct agreement with the investor, or an authorization).Article IX of the Treaty allows the country to provide for the maintenance of public order and fulfillment of its obligations with respect to the maintenance or restoration of international peace and security, and points out that the Treaty does not prevent that.[51]

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[46] *Ibid.*, 2.(a)-(c).

[47] *Ibid.*, 3.(a) (i)-(iv).

[48] *Ibid.*, 4.(a)-(b).

[49] *Ibid.*, 7.

[50] *Ibid.*, 8.

[51] *Ibid.*, Art. IX., 1.

Article IX also states that countries can have special formalities having to do with investments, as long as those do not impede the substance of any of the rights set forth in the Treaty.[52] A country could, for example, require registration of foreign investments.

Article X of the Treaty states that, in general, the Treaty does not apply to taxation issues, except taxation issues having to do with expropriation, transfers, or the observance and enforcement of terms of an investment agreement. The Treaty does not even apply to those exceptions if those exceptions are covered by a different treaty having to do with double taxation.

Article XI of the Treaty states that it will apply to political subdivisions of the parties.

Article XII of the Treaty has to do with when the Treaty will go into effect, how it can be cancelled, and to what it applies. The two important parts of this article are, first, that it applies to all investments existing at the time of the entry into force of the Treaty, and, second, if the Treaty is terminated, any investments in existence at the time of the termination are still covered by the Treaty for an additional 10 years.

IV. The Arbitration

While I have used the Treaty with Estonia as an example, all of the other BITs entered into by the United States are very similar in their provisions. Now that you know more than you probably ever wanted to know about what a BIT contains, I can now tell you about the fun part, which is actually handling an arbitration under the Treaty. I will primarily discuss handling an arbitration through ICSID. You may have noticed that under the Treaty you can arbitrate under the UNCITRAL rules. The UNCITRAL rules are not attached to any particular organization, but are a set of recommended rules and procedures to follow in an arbitration taking place in the context of a commercial international transaction. While using the UNCITRAL rules can seem as if it is more economical, as you do not for example have to pay the filing fees for ICSID, many times you end up going to a governing organization to resolve impasses in the selection of arbitrators and similar matters. So it is often simpler just to use ICSID and be done with it. ICSID is frequently chosen to be the organization that is relied on by parties using the UNCITRAL rules.

A. Expense

Be warned, your client must have a substantial claim in order to justify the expense that is going to be incurred in arbitrating before ICSID. To begin with, ICSID charges a $7,000 fee for the filing of your request for arbitration.[53] Once the arbitration is registered, an additional $3,000 is charged.[54] According to ICSID's latest schedule of fees, supposedly your client is going to pay the arbitrators $2,000 a day, split between the parties. That is not what actually happens. What actually happens is you are approached early on by the arbitrators, who point out that it is customary to pay the arbitrators more than is contemplated by ICSID's fee schedule. It is not unusual to pay $450 per hour per arbitrator. In the typical case, you will have three arbitrators, so at hearings the fees are more in the neighborhood of $1,200 to $1,300 per hour. Arbitrators also get paid for their time working on the case outside hearings. ICSID rules require each side to put up advance deposits every six months or so, and these will typically be in the $40,000 to $60,000 range per party.

B. Selection of Arbitrators

Getting ICSID to register your request for arbitration can take several attempts, and I counsel patience as I have already mentioned. You can review the rules for what information is required in the request. Once it is registered, the next step is to choose the arbitrators. The ICSID rules encourage the parties to agree on the selection of arbitrators, and provide a method for the selection of arbitrators if the parties cannot agree. In the latter case, one party chooses an arbitrator and proposes a second arbitrator to be the President of the Tribunal. Then, the other party has a given amount of time to state which arbitrator it chooses and to either agree to the President proposed by the other side or make its own proposal as to a third arbitrator to act as President. If the parties cannot agree on a President, ICSID will choose one from a list of arbitrators. This list is a list of arbitrators that is composed of persons appointed by the various countries who are members of the Convention. If the parties to the arbitration do not want the President of the Arbitration Tribunal to be from this list, they must come up with a way to agree on the President. Typically the parties agree that each side chooses their arbitrator, and those two arbitrators then choose a President. This is where we get to

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[52] *Ibid*., 2.

[53] As of this writing: http://worldbank.org/icsid/schedule/main-eng.htm.

[54] *Ibid*.

one of the fun parts. It is accepted in international arbitration for you to talk to your arbitrator before you choose him or her. It is like *voir dire*, only the other party does not even know you are doing it. You could talk to 20 arbitrators before you choose one. You can talk to the arbitrator about his or her willingness to serve, who the arbitrator might propose as a President for the Tribunal, what other cases the arbitrator has been involved in, what other experience the arbitrator might have in life, etc.

Here is another fun part. In international arbitrations, traditionally your arbitrator (sort of) acts as your advocate on the arbitration panel. This does not mean that your arbitrator is even going to find in your favor, but what it does mean is that your arbitrator will feel some obligation (if he or she is a professional international arbitrator) to take your side in discussing the case and asking questions.

C. Procedure

Once the arbitrators are selected, the ICSID rules provide for a first session within 60 days.[55] The dates of subsequent sessions will be determined by the arbitrators. At the first session, you can expect two areas to be covered. The first is the consideration of procedures. Rule 20 of the ICSID Arbitration Rules provides for a preliminary procedure consultation in which the Tribunal seeks the views of the parties regarding procedure. The rule specifically includes getting the parties' views on these items:

(a) the number of members of the Tribunal required to constitute a quorum at its sittings,

(b) the language or languages to be used in the proceeding,

(c) the number and sequence of the pleadings and the time limits within which they are filed,

(d) the number of copies desired by each party of instruments filed by the other,

(e) dispensing with the written or oral procedure,

(f) the manner in which the cost of the proceeding is to be apportioned, and

(g) the manner in which the record of the hearings shall be kept.

Other matters of a procedural nature can be discussed, and the rules provide that the agreements of the parties will be followed to the extent possible within the Convention and rules. Of course, the parties will want to keep the arbitrators happy, so there will be some deference to the preferences of the arbitrators in setting the procedures.

The other matter that is likely to be brought up at the first session is the respondent's contention that there is a lack of jurisdiction in the arbitration. Once the request for arbitration is registered by ICSID, it becomes the responsibility of the arbitrators to determine whether or not ICSID has jurisdiction. You can bet that in all but the simplest cases, there will be a challenge to jurisdiction by the foreign government. Given that the arbitration must fit within the framework of both the Convention and the BIT, and given that the interplay between these two documents is relatively complex, there is almost always going to be a jurisdictional argument. The argument may be that there is no consent as required or in the form required by the Convention (although the BIT specifically addresses consent), that the definition of investment is not met, that the definition of investment dispute is not met, that the parties have elected a different remedy, or some similar argument. The arbitrators have a choice of hearing the arguments on jurisdiction first and determining them before going on to the merits of the case, or carrying the jurisdictional issue with the merits of the case.[56] There has been at least one case in which the arbitrators began by hearing the jurisdictional arguments first, and then determined to carry the jurisdictional issues with the merits of the case. So far, the trend definitely seems to be in favor of the arbitrators finding that they have jurisdiction. This mostly reflects the breadth of the consent to arbitration provided in the BIT, but no doubt also reflects a tendency on the part of professional neutrals to ensure that there is a forum for the dispute.

Absent an agreement by the parties otherwise, and under time limits set by the arbitrators in consultation with the parties, the ICSID Rules of Arbitration provide a normal procedure for the conduct of the arbitration.[57] This consists of an oral procedure and a written procedure. The written procedure consists of a memorial by the requesting party, a counter-memorial by the other party,

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[55] ICSID Arbitration Rules, Rules 13(1) and 20.

[56] *Ibid.*, Rule 41(4).

[57] *Ibid.*, Rule 29.

and if the parties agree or the Tribunal deems necessary, a reply by the requesting party and a rejoinder by the other party.[58] The oral procedure consists of a hearing by the Tribunal to hear the parties and their agents, counsel, advocates, witnesses, and experts.[59] The arbitration rules of ICSID provide that the arbitrators may ask questions during the hearings.[60]

The Tribunal is the judge of the admissibility of the evidence, and it may call upon the parties to produce documents, witnesses, or experts and may visit any place connected with the dispute and conduct inquiries there.[61] At the hearing, the parties are allowed to question witnesses and experts under the control of the Arbitration Tribunal.[62] With regard to the presentation of witnesses, it is becoming a very common practice in international arbitrations to present the direct testimony of the witness or expert in writing in advance of the hearing. The common wisdom is that this shortens the hearing and allows the arbitrators to better prepare for the hearing. What happens at the hearing is that the witness is introduced and his or her testimony summarized, and then the witness is turned over to the other party and the arbitrators for cross-examination. From a strategic point of view this is a mixed bag. The written direct is a great tool to be able to thoroughly prepare the witness in advance and make sure that the witness understands all of the implications of his or her own testimony. It forces the advocate to sit down with the witness and go over the testimony in some detail in advance, and gives tangible form to the process of determining what is likely to be raised in opposition to the testimony. The down side of the procedure is that even though the complainant is probably going to go first at the hearing, what the arbitrators actually hear first is the cross-examination of the witnesses. Thus, the first personal and non-verbal aspects of the witness's communication are presented to the Tribunal through the lens provided by the opposition. This to some extent takes away from the advantage of going first.

Incidentally, there is a custom in some countries that you should be aware of, as some of the arbitrators on your Tribunal may be from one of those countries. There is a rule in many countries that you cannot talk to witnesses beforehand. This obviously tends to fly in the face of the idea of providing written direct testimony, but it is a touchy issue for some arbitrators, and for some foreign counsel. If you have the opportunity to participate in one of these arbitrations, I highly recommend bringing that issue up at the first session and discussing how it is going to be handled explicitly so there will not be any complaints later on.

D. Burden of Proof

In the United States we tend to look at the burden of proof first. If you have the burden of proof, you must meet it, or the other side does not have to say a word. An example of this attitude is enshrined in the federal summary judgment practice. In international arbitration, the general rule is that the burden of proof on an issue is on the party who wishes to prove the fact. If you want to prove a violation of the Treaty, the burden is on you, but if the foreign government has a fact that it believes counters your argument, it must prove it. If the foreign government wants to prove there is no jurisdiction, the burden of proof is on it, but if you have some fact that you believe defeats the jurisdictional argument, you must prove it. What this boils down to in practice is that in an international arbitration, the Arbitration Tribunal is presented all of the evidence that either party has available to it, and the burden of proof only becomes a question if, after receiving all of that evidence, the arbitrators still cannot determine the issue. Only then will the party with the 'burden of proof' lose the issue. (Note: This is an informal description of the outcome, not a formal statement of the rules, so do not quote me on this.) Essentially, this has the effect of encouraging all parties to bring forth all of the evidence that they have that is favorable to their claim.

What you can quote me on (if you actually believe I have any authority in the matter) are the statements setting out the principles of the burden of proof in international law that are contained in the case of *Asian Agricultural Product, Ltd. v. Republic of Sri Lanka*.[63] The Tribunal in that case refers to these principles as "established international law rules." Bear in mind that these are

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[58] *Ibid.*, Rule 31.

[59] *Ibid.*, Rule 32.

[60] *Ibid.*

[61] *Ibid.*, Rule 34.

[62] *Ibid.*, Rule 35.

[63] 30 I.L.M. 577, 603 (1991).

akin to common law rules, in that there is no codification of international law. However, these rules seem to be the generally accepted rules, and quoting them is persuasive when it serves your case to do so. Here are the principles:

1. The general principle is that the burden of proof is placed on the claimant.

2. The idea of "claimant" does not mean the plaintiff from the procedural standpoint, but the real claimant in view of the issue involved.

3. The party who has the burden of proof not only has the burden to bring forth evidence, but also has the burden to convince the Tribunal of its truth.

4. The international responsibility of a foreign government is not to be presumed, and the party alleging a violation of international law giving rise to international responsibility has the burden of proving the assertion.

5. International Tribunals are not bound to adhere to strict judicial rules of evidence, and probative force of the evidence presented is for the Tribunal to determine.

6. In exercising the evaluation of evidence, International Tribunals will decide the case on the strength of the evidence produced by both parties, and in case a party adduces some evidence which *prima facie* supports its allegation, the burden of proof shifts to that party's opponent.

7. Finally, in cases where proof of a fact presents extreme difficulty, a Tribunal may thus be satisfied with less conclusive proof, i.e., some sort of *prima facie* evidence.

Now that is a sensible set of rules. I especially like the last one and the one before it that in tandem tend to put the burden of proof on the party most capable of producing the evidence.

E. Substantive Law

As I mentioned earlier in this paper, under the United States form of the BIT, you are going to have several choices of what standard of substantive law to apply. Generally, in an ICSID arbitration, the law of the country which is a party to the dispute will be applied. However, the Treaty sets minimum standards to which that law must adhere. The Treaty itself provides substantive legal rules that must be applied to the claim. While the law of the foreign country and the law of the Treaty may vary from case to case, principles of international law provide a minimum standard with which the foreign country must comply.

Let us suppose you are sitting in your office one day and a potential new client walks in the door. He is a multi-trillionaire who has entered into a contract with a private company in Estonia to invest in a private company in Estonia. He is not stupid and he has entered into a reasonable contract. After entering into the contract, he indeed put his $10,000,000 into the company, and it was immediately stolen from him by various nefarious means. He took the perpetrators to court in Estonia, but due to his foreign status, he was essentially railroaded out of town and his $10,000,000 is still in the Swiss bank account of some crook in Estonia. You listen to the facts and believe that you can prove that your client was treated in violation of the BIT, and he is willing to pay your huge fees with plenty of money left over to pay for his share of the cost of arbitration, which, of course, he hopes to recover at the end along with his $10,000,000. You take the case and you convince ICSID to register your request for arbitration. The three arbitrators are chosen, you have your first session, at which time Estonia claims that your case lacks jurisdiction to arbitrate because your client availed himself of the courts in Estonia before going to arbitration. Once you convince the arbitrators that your complaint is how the courts in Estonia treated your client, and that the treatment is your issue under the BIT, the panel finds jurisdiction and you proceed to the merits of the case. As it turns out, the issue of the railroading that took place in Estonia hinges on an interpretation of the BIT. Noting that the BIT requires that your contract be interpreted by standards no less than international law, what do you do now? One thing you can do is start again with that same *Asian Agricultural Products, Ltd. v. Republic of Sri Lanka* case[64] which sets out the international law principles having to do with the interpretation of the words of a Treaty. The case also cites authority for these rules. Here they are:

1. The first general maxim of interpretation is that it is not allowed to interpret what has no need of interpretation. (I love this stuff.)

2. If interpretation is necessary, we first look to common usage of terms in the context of Treaties.

3. When interpreting the meaning of the words in the Treaty still leaves an ambiguity, we look at the Treaty as a whole to derive the object and intent of the Treaty, or the spirit of the Treaty, or the objectives of the Treaty, to arrive at a comprehensive construction of the Treaty as a whole.

4. In interpreting a Treaty in

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[64] *Ibid.*, 594.

addition to interpreting it as a whole, we look to Rules of International Law that establish the relationship between the parties.

5. It is a nearly universal principle that a clause must be so interpreted as to give it meaning rather than so as to deprive it of meaning.

6. When there is a need of interpretation of a Treaty, it is proper to consider stipulations of earlier or later Treaties in relation to subjects similar to those treated in the Treaty under consideration.

I have already mentioned that there is no codified international law. That, however, does not mean that there has never been an attempt to codify international law. In fact, through the years there have been such attempts. They have all failed. These attempts had to do with commercial arbitrations, and were attempts to codify what has come to be known as the *lex mercatoria* (law of merchants). While there has been no successful codification of the *lex mercatoria*, there has been a tendency over the decades for certain principles to become so commonly used that they amount to what we would call in the United States a common law set of principles, and because they arise in the arena of commercial arbitration, most of them have to do with contracts. Because the tradition of international commercial arbitration has arisen in a context in which the parties to the arbitration are generally on equal footing, the principles of law that have emerged have a sense of fairness that is often missing in litigation in which special interests creep into the process either through the election of judges or through the political process by which judges are appointed. The international law of contracts will frequently be relevant in an arbitration under a BIT.

I thought you might like to know some of the principles that have come to be generally accepted in international law as what would be the *lex mercatoria* if there was one. Here are some of my favorites:

1. The parties are free to enter into contracts and to determine their contents.

2. The parties must act in accordance with the standard of good faith and fair dealing in international trade. (Yes, my friends, this is a generally accepted principle of international law.)

3. A valid contract can only be modified or terminated by the consent of the parties.

4. The parties always have to act according to what is reasonable in view of the particular nature of their contract and the circumstances involved, in particular the economic interests and expectations of the parties.

5. The parties, unless they have agreed otherwise, are bound by the usages of the particular trade in which they are engaged.

6. To be valid, a contract must state its provisions with sufficient specificity to identify the terms of the contract with respect to the parties and the subject matter.

7. Silence by an offeree does not constitute acceptance, unless the parties have previously agreed that it would, or the parties have established a practice that it would, or it is a general usage well known in the trade.

8. Contractual declarations are valid even when they are not evidenced in writing.

9. Contracts may not be concluded to the detriment of a third party.

10. The interpretation of a contract goes as follows:

    a. Determine the common interest of the parties;

    b. Failing that, establish the meaning that reasonable persons of the same kind as the parties (such as average diligent businessmen) would give to it in the same circumstances taking into account such things as the particular nature of the contract, the conduct of the parties, and the meaning commonly given to contract terms in the trade. (In other words, come up with a reasonable interpretation.)

11. Where there is some doubt, give preference to contract term interpretations that make the contract lawful and effective.

12. Ambiguity is interpreted against the scrivener as to terms that were not specifically negotiated.

13. Specific contractual provisions are interpreted in the context of the whole contract.

14. In the case the parties have used the wrong term, but mean the same thing, their common intention prevails.

15. Time is of the essence unless otherwise specified.

16. A party who breaks off negotiations in bad faith (i.e., when the other party was justified in assuming that a contract would be concluded) is liable for the losses caused to the other party.

There are actually many more

principles than I could ever hope to list in this paper. The ones I have listed here are among the first several in the appendix to a book by Klaus Berger called *The Creeping Codification of the Lex Mercatoria*.[65] The appendix contains 78 principles of law, and I suggest you read through them if you have a case involving a contract and international law principles. The rules Mr. Berger sets out are provided with citations to authority, and can not only be used persuasively before a Tribunal of arbitrators, but can also give you great ideas as to theories of recovery or defense that may be raised by you or against you in the arbitration proceedings. You will find, especially if you are accustomed only to United States law, some provisions that you might not expect. For example, penalty clauses in contracts are enforceable, regardless of the actual loss of the parties. The only caveat to this is that if the penalty is grossly excessive, it can be reduced. One other principle of international law that is important in the context of BITs is the principle that a state or state controlled entity may not invoke its sovereignty or internal law to repudiate contractual consent. While this issue is addressed specifically in the BIT, this provides additional authority for the idea that the government party to the arbitration cannot go outside the BIT and argue its sovereignty on the basis of its own internal laws.

F. Remedies and Relief

In addition to ruling on the jurisdictional issues and the merits of the case, an ICSID Arbitration Tribunal has the power to enter into provisional measures to preserve the rights of the parties.[66] (Incidentally, going to court in the country that is a party to the dispute in order to protect or preserve property or other rights has been held not to be an election preventing arbitration under a BIT.) The Tribunal also has the power to consider ancillary matters including incidental or additional claims or counterclaims arising directly out of the subject matter of the dispute, provided that such an ancillary claim is within the scope of the consent of the parties and is otherwise within the jurisdiction of ICSID.[67]

Once the Tribunal "closes" the proceedings, it has 120 days within which to determine its award, which it can extend for 60 days if it wishes.[68] Prior to January 2003, this 180 day period was 90 days. That was not enough time, and a wise Tribunal got around the requirement by simply not closing the proceedings officially until it had basically determined what the award was going to be. It then had 90 days to write the award. The amendment of the rule remedies the time crunch and this will probably lead to an earlier "closing" for most ICSID arbitrations.

Here is another part you are going to like. Once the award is entered, you can request further interpretation and revision of the award from the Tribunal.[69] If that fails, and you are still not satisfied, you can file an application for the annulment of an award and ICSID will appoint an *Ad Hoc* Committee in accordance with the Convention.[70] In other words, YOU CAN APPEAL. Of course, you do not get to determine who is going to hear the appeal, and in that sense, it is not as favorable a procedure as the original arbitration. However, there have been annulments. You can also request a stay of the enforcement of the award during your request for interpretation or revision or during your request for annulment.[71] The Arbitration Tribunal or *Ad Hoc* Commission will consider the request for stay as a priority.[72] If you are successful in getting your annulment, the case is resubmitted to arbitration with a whole new arbitration panel and the process begins again.[73] If the annulment was only partially granted, only that part which was annulled is resubmitted.[74]

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[65] *Berger, Klaus, The Creeping Codification of the Lex Mercatoria, Kluwer Law International*, 1997.

[66] ICSID Arbitration Rules, Rule 39.

[67] *Ibid.*, Rule 40.

[68] *Ibid.*, Rule 46.

[69] *Ibid.*, Rules 49 and 50.

[70] *Ibid.*, Rule 52.

[71] *Ibid.*, Rule 54.

[72] *Ibid.*

Both the request for further consideration and the annulment procedures are subject to filing fees, and, if your client does not win, the cost of the additional proceeding will almost certainly be placed on your client.

In addition to awarding any kind of money damages that are allowed, the Tribunal can award the costs of the arbitration, including attorneys' fees.[75]

I hope you found this article interesting. One of my goals in writing it was to alert you to the existence of what I consider an interesting and fun niche in representing public investors. Obviously, these cases do not come along every day, but if one does walk in your door, do not shy away from it. If you do get such a case and have any issues you would like to discuss, or if you are just curious about anything I did not mention in this article, please feel free to send me an email with your questions.

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[73] *Ibid.*, Rule 55.

[74] *Ibid.*, Rule 55(3).

[75] *Ibid.*, Rule 47(1)(j).

Private Securities Litigation Reform Act - What Consequences?

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On December 22, 1995, in response to what Congress perceived to be significant evidence of abuse in private securities litigation and aggressive lobbying by the accounting industry, the securities industry, and high-technology companies who have been susceptible to lawsuits because of the volatility of their stocks, Congress passed the Private Securities Litigation Reform Act (PSLRA).[1] During the House and Senate Committee hearings, testimony was given about such practices as routine filing of lawsuits against issuers whenever the stock price dropped significantly; targeting "deep pocket" defendants without regard to culpability; abusive discovery imposing burdensome costs to force settlement; and manipulation by class action lawyers of the clients they represent.[2] Very little debate was had on the utility of the securities class action suit as a policing mechanism in a stock market that embraces fair and full disclosure.

Ostensibly, Congress' goals in passing the legislation were:

- to protect outside directors and others who may be sued for non-knowing securities law violations from liability for damage actually caused by others;
- to reform discovery rules in order to minimize costs incurred during the pendency of a motion to dismiss or a motion for summary judgment;
- to protect investors who join class actions against lawyer-driven lawsuits;
- to give victims of abusive securities lawsuits an opportunity to recover their fees; and
- to establish a safe harbor for forward looking statements so issuers could disseminate relevant information to the market without fear of open-ended liability.[3]

The act contains three titles:

Provisions of Title I are aimed at the reduction of abusive litigation by mandating a series of procedural requirements:

Lead plaintiffs must make sworn representations with the complaint that certify they have reviewed and authorized the filing of the complaint; did not purchase the securities at the direction of counsel or in order to participate in a lawsuit; are willing to serve as the lead plaintiff; and identify any transaction in the securities covered by the class period and any other lawsuits in which the plaintiff has sought to serve as lead plaintiff in the last three years.[4]

Plaintiffs filing a securities class action must, within 20 days of filing the Complaint, provide notice to members of the purported class in a widely circulated business publication, informing the public of the claims alleged in the suit, the class period, and that members have 60 days to move to be designated as lead plaintiff.[5]

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[1] Vincent Louwagie, *Private Securities Litigation Reform Act of 1995 and Investors' Rights,* The Hennepin Lawyer March-April 1996, Vol. 65 No.4.

[2] H.R. CONF. REP. No. 104-369, 104th Cong. 1st sess. (1995).

[3] *Id.*

[4] §27(a)(2) of the 1933 Act and §21D(a)(2) of the 1934 Act.

The court must consider these motions within 90 days, and appoint the lead plaintiff. In appointing the lead plaintiff, the legislation provides for a presumption that the member with the largest financial stake is the "most adequate plaintiff." This presumption may be rebutted by evidence that the plaintiff would not fairly and adequately represent the interests of the class, and class members may seek discovery on this issue. Once the lead plaintiffs are appointed, they will retain class counsel subject to court approval. The lead plaintiff's recovery is limited to his or her pro rata share of the settlement or final judgment.

There are limitations on attorney's fees. The fees must be a reasonable percentage of the amount of recovery awarded to the class.[6]

Settlement notices to class members must contain a statement of the average amount of damages/share; an explanation of the attorney's fees and costs sought; and a brief statement explaining the reason for the proposed settlement. Sealed settlement agreements are prohibited unless a party can show "good cause."[7]

The act calls for uniform and more stringent pleading requirements. The standards are based in part on the pleading standards of the Second Circuit, and are written to conform to Rule 9(b)'s notion of pleading with "particularity." The Second Circuit requirement is that the plaintiff state facts with particularity, and that these facts, in turn, must give rise to a "strong inference" of the defendant's fraudulent intent. However, the act states that because it intends to strengthen existing pleading requirements, it does not codify the Second Circuit standards. The plaintiff must also specifically plead with particularity each statement alleged to have been misleading. The reason or reasons why the statement is misleading must also be set forth in the complaint in detail. If an allegation is made on information and belief, the plaintiff must state with particularity all facts in the plaintiffs possession on which the belief is formed.[8] If these requirements are not met, the court shall, on the motion of any defendant, dismiss the complaint. In addition, the plaintiffs must show loss causation by pleading and proving that the misstatement or omission alleged in the complaint actually caused the loss incurred by the plaintiff.[9]

At the same time, the act provides that courts must stay all discovery pending a ruling on a motion to dismiss, unless exceptional circumstances exist where particularized discovery is necessary to preserve evidence or to prevent undue prejudice to a party. To ensure that relevant evidence will not be lost, §27(b) of the 1933 Act and §21 D(b)(3) of the 1934 Act make it unlawful for any person to willfully destroy or otherwise alter relevant evidence. The Reform Act provides for an award of attorney's fees to prevailing parties in abusive litigation by strengthening the application of Rule 11 of the Federal Rules of Civil procedure. The legislation requires the court to include in the record specific findings at the conclusion of the action as to whether all parties and all attorneys have complied with each requirement of Rule 11(b) of the Federal Rules of Civil Procedure.[10] These provisions also establish the presumption that the appropriate sanction for filing a complaint that violates Rule 11(b) is an award to the prevailing party of all attorney's fees and costs incurred in the entire action.

There are limitations on damages by providing that in most cases the damages must be calculated based on the difference between the

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[5] §27(a)(3) of the 1933 Act and §21D(a)(2) of the 1934 Act.

[6] §27(a)(6) of the 33 Act and §21(a)(6) of the 34 Act.

[7] §27(a)(5) of the 33 Act and §21D(a)(5) of the 34 Act.

[8] H.R CONF. REP. No. 104-369, 104th Cong., 1st sess. (1995).

[9] §21D(b)(4) of the 1934 Act.

[10] Fed. R. Civ. P. 11 Rule 11(b) reads:

> **(b) Representations to Court.** By presenting to the court (whether by signing , filing, submitting, or later advocating) a pleading, written motion, or other paper, an attorney or unrepresented party is certifying that to the best of the person's knowledge, information, and belief formed after an inquiry reasonable under the circumstances –

investor's purchase or sale price and the average trading price of the security during the 90-day period beginning on the day the true information is disseminated to the public. In addition, the act provides that in any private action in which the plaintiffs may recover money damages, the court shall, when requested by a defendant, submit to the jury a written interrogatory on the issue of each such defendant's state of mind at the time the alleged violation occurred [11]

One of the more contentious provisions of the act and possibly the most counterproductive was the adoption of the "safe harbor" for forward-looking statements. This provision was adopted to enhance market efficiency by encouraging companies to disclose forward-looking information. The Act adopts a statutory "safe harbor." The safe harbor is based on aspects of SEC Rule 175 and the judicially created "bespeaks caution" doctrine.[12]

The Reform Act takes a bifurcated approach. The first prong of the safe harbor protects a written or oral forward-looking statement that is: (1) identified as forward-looking, and (2) is accompanied by meaningful cautionary statement identifying important factors that could cause actual results to differ materially from those projected in the statement. The second prong of the safe harbor provides an alternative analysis focusing on the state of mind of the person making the forward-looking statement. The second prong applies to both written and oral forward-looking statements. There will be no liability under the second prong unless a plaintiff proves that the defendant made a false or misleading forward-looking statement with actual knowledge that it was false or misleading.[13]

The act confirms the authority of the Securities and Exchange Commission to prosecute aiders and abettors, a right not available to private investors after the Supreme Court decision in Central Bank of Denver.[14]

The act also amends the Racketeer Influenced and Corrupt Organizations Act (RICO) to exclude acts that constitute securities fraud from the definition of racketeering. Securities fraud defendants are thereby freed from the threat of treble damages or other severe remedies available under RICO.

Provisions of Title II are aimed at reduction of coercive settlements by providing for proportionate liability. Under the act, joint and several liability is eliminated in all cases except where the defendant's violation was "knowing" or when a plaintiff's loss was more than 10 percent of his or her net worth as long as the plaintiff's net worth is not more than $200,000.00. The jury assigns percentage responsibility for the plaintiff's loss. If the party is judgment-proof, their liability is allocated back to the other responsible parties. However, no party will be liable for more than 150 percent of their proportionate share of the loss.[15]

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reasonably based on a lack of information and belief.

1. it not being presented or maintained for any improper purpose, such as to harass or to cause unnecessary delay or needless increase in the cost of litigation;
2. the claims, defenses, and other legal contentions therein are warranted by existing law or by a nonfrivolous argument for the extension, modification, or reversal of existing law or the establishment of new law;
3. the allegations and other factual contentions have evidentiary support or, if specifically so identified, are likely to have evidentiary support after a reasonable opportunity for further investigation or discovery; and
4. the denials of factual contentions are warranted on the evidence or, if specifically so identified, are reasonably based on a lack of information and belief.

[11] The House Conference Report states that the interrogatories may be appropriate in contribution proceeding among defendants or in computing liability when some of the defendants have entered into settlement with the plaintiff prior to verdict or judgment.

[12] "The doctrine holds that economic projections, estimates of future performance, and similar optimistic statements in a prospectus are not actionable when precise cautionary language elsewhere in the document adequately discloses the risks involved." In re Worlds of Wonder Securities Litigation, 35 f.3d 1407 (9th Cir. 1994).

[13] §27A of the 1933 Act and §21E of the 1934 Act.

[14] Central Bank of Denver v. First Interstate Bank of Denver, 114 s. Ct. 1439 (1994).

[15] Vincent Louwagie, *Private Securities Litigation Reform Act of 1995 and Investors' Rights,* The Hennepin Lawyer March-April 1996, Vol. 65 No.4.

Title III of the act requires auditors to disclose corporate fraud. Auditors must include procedures designed to detect illegal acts. If they detect illegal acts, they must disclose them to the company's management or board of directors. The company is then required to disclose them to the SEC. If the company fails to make disclosure to the SEC, the auditor must resign and report the illegal acts directly to the SEC.[16]

The immediate reaction of the plaintiffs bar after the passage of the act was to file such actions in state court where the state law remedies were more investor-friendly. To close this loophole, the State Litigation Uniform Standard Act (SLUSA) was enacted in 1998. SLUSA effectively preempts all state court-based securities class actions, thereby forcing investors to litigate under the heightened pleading standards and liability requirements of the Reform Act. Thus, shareholders in class actions are effectively denied the right to pursue any claims or remedies under state laws.[17]

Seven years after passage of the PSLRA, there has been a massive upsurge in securities fraud, and many critics of the act feel that it is in large part responsible for creating a permissive environment, where corporate executives and their partners had little to fear in the way of regulation. While its not clear how effective certain provisions of the act have been in achieving the goals intended, it does appear that overall the Reform Act has had a chilling effect on securities class action litigation.

The *Lead Plaintiff Provisions* have not led to the desired results of institutional investors taking on the role of lead plaintiff. Instead, the plaintiffs' firms now work to piece together large numbers of small investors who have, in the aggregate, the largest financial interest of any other group of investors. The prevailing lead plaintiff group then selects the lead plaintiffs' counsel, inevitably the aggregating law firm. Interestingly, most institutional investors have shied away from the lead plaintiffs' role, whether because a $10 million loss in a multibillion-dollar portfolio is not material or because the institution simply does not wish to devote resources to a protracted litigation when such resources could be used for making investment decisions. Additionally, an institutional investor may not be enthusiastic about taking on any extra fiduciary duties as representative of all shareholders or opening itself up to the discovery that a class representative role requires. The exception to this pattern has been some pension funds, which have been the lead plaintiffs in a variety of actions.[18]

Ironically, while one of the stated objectives of the legislation was to move securities litigation away from professional plaintiffs and plaintiff litigation firms, it has only served to further entrench them. In fact, the same plaintiffs firms that dominated the pre-PSLRA lawsuits continue to drive the post PSLRA lawsuits. The firm of Milberg Weiss has continually increased their presence in the securities litigation field. Prior to the Reform, Milberg Weiss was involved in approximately 31% of the cases; now they are involved in close to 70% of the cases.[19]

The *Heightened Pleading Standards*, which were intended to result in a uniform pleading standard, have been interpreted in significantly different ways by the federal appellate courts. Three separate standards have emerged. The Second and Third Circuits allow plaintiffs to adequately plead scienter by alleging facts leading to an inference that defendants had a "motive and opportunity" to commit fraud or facts showing circumstantial evidence of recklessness or knowing misbehavior. The First, Sixth, and Eleventh Circuits have adopted a tougher standard under which scienter is adequately pleaded by "alleging facts giving rise to a strong inference of recklessness, but not by alleging facts merely establishing that a defendant had the motive and opportunity to commit securities fraud."[20] The Ninth Circuit has adopted the toughest standard of them all, requiring plaintiffs to "plead, in great detail, facts that constitute strong circumstantial evidence of

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[16] *Id.*

[17] Blair Nichols, *Reforming the Reform Act and Saving Our Securities Markets in the Post-Enron Era, Institutional Investor Advocate, Vol. 4 Second Quarter 2002.*

[18] David De Berry and Steven White, *Significant Developments Since Passage of Securities Reform Legislation.*

[19] Private Securities Litigation Reform Act: A Post-Enron Analysis.

[20] Lori Iwan and Charles Watts, *Enron and the D&O Aftermath: Tips and Traps for the Unwary*.

deliberately reckless or conscious misconduct."[21] This split between the circuits has led to a shift in the frequency of filings from West to East. More suits have been filed in the Southern District of New York over the last two years than in the less plaintiff-friendly Northern District of California, which is in the Ninth Circuit.[22]

The heightened pleading standards have resulted in more dismissals and fewer settlements.[23] Hillary Sale, a professor at the University of Iowa College of Law, attributes this rise in the percentage of dismissals directly to the reform act. She argues that the overworked federal courts have, in fact, too readily accepted the opportunity that Congress has offered them to exercise docket control by eliminating typically complex and time-consuming securities fraud cases early on.[24]

The "heightened" pleading standards, coupled with an automatic stay of discovery pending a motion to dismiss, have created an anomaly for plaintiffs who are required to plead "with particularity all facts giving rise to a strong inference that the defendant acted with the required state of mind," while at the same time denying them the right to any discovery until all defendants' motions to dismiss the complaint have been denied. As Columbia Law School professor Jack Coffee has observed, the two rules comprise a Catch-22: "You can't get discovery unless you have strong evidence of fraud, and you can't get strong evidence of fraud without discovery".[25] At least one plaintiffs firm is learning to work around the discovery stay by establishing an in-house unit and outside consultants, including private investigators, forensic accountants, former company employees and industry experts to conduct pre-filing investigations of possible fraud claims.[26]

Possibly the most damaging provisions of the act were the safe harbor provisions and the elimination of joint and several liability provisions. Prior to the passage of the Reform Act, the SEC prohibited companies from issuing predictions or 'forward-looking statements' that had no reasonable basis in fact. Under the Reform Act, however, corporate executives can issue predictions, such as earnings projections, without the fear of shareholder liability, provided that such predictions are accompanied by "meaningful cautionary statements" -- often just a menu of boilerplate risk disclosures.[27]

Joint and several liability for reckless participants was abolished, and a level of "proportionate" liability was instituted for each of the participants' wrongdoings. This was considered a tremendous victory for the large accounting firms, among others, as they no longer faced the viable threat of being held fully accountable for their audit failures, allowing them to pass blame for their failures onto others in order to decrease or eliminate their own liability.[28] There have been over 1000 corporate restatements since passage of the act. With the current batch of corporate scandals, it has become painfully obvious that this provision is clearly detrimental to shareholders who are primarily chasing companies that have no assets.

The Safe Harbor Provision does

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[21] Recklessness is "a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." To properly allege a "strong inference of deliberate recklessness," a plaintiff must state facts that come closer to demonstrating intent, as opposed to mere motive and opportunity.

[22] David De Berry and Steven White, *Significant Developments Since Passage of Securities Reform Legislation*.

[23] Private Securities Litigation Reform Act: A Post-Enron Analysis.

[24] Tamara Loomis, *Securities Reform: What Went Wrong?* The New York Law Journal 10/26/2000.

[25] Blair Nicholas, *Reforming the Reform Act and Saving Our Securities Markets in the Post-Enron Era,* Institutional Investor Advocate, Vol. 4 Second Quarter 2002.

[26] Tamara Loomis, *Securities Reform: What Went Wrong?* The New York Law Journal 10/26/2000.

[27] Blair Nicholas, *Reforming the Reform Act and Saving Our Securities Markets in the Post-Enron Era,* Institutional Investor Advocate, Vol. 4 Second Quarter 2002.

[28] *Id.*

appear to have cut down on the number of securities class actions alleging misrepresentations in connection with forward-looking statements. However, there are a larger number of lawsuits alleging accounting fraud. Whereas the percentage of accounting fraud cases filed hovered between 35 percent and 40 percent of pre-PSLRA securities class actions, that number has risen to between 50 percent and 55 percent of post-PSLRA securities class actions.[29]

Statistical data shows that there are as many securities class action filings now as before the Reform Act (far more if 2001 suits alleging fraud in connection with IPO's are taken into account).[30] However, given the marked increase in corporate fraud these figures do not necessarily lead to the conclusion that the Reform Act has not succeeded in reducing class action litigation. In fact, there has been a trend, following the act, toward more dismissals and fewer settlements with an increase in the inventory of pending securities class actions. It appears that companies are less willing to settle matters quickly until they have had their “day in court” on the motion to dismiss.[31]

Not surprisingly, defendants are scoring successes under the provisions of the PSLRA and SLUSA. On March 6, 2003, the U.S. District Court for the Southern District of New York threw out a class action alleging Merrill Lynch & Co. breached fiduciary duties owed to retail customers under New York law in a quest to boost its investment banking business. Judge Deborah Batts, writing for the court, found that the suit was barred by SLUSA because it was “undisputed” that the plaintiffs' action was a “covered class action” within the meaning of SLUSA. “The parties' dispute hinges on whether or not the alleged breach of fiduciary duties occurred in connection with the purchase or sale of a security,” the court said. (*McCullagh v. Merrill Lynch & Co.*, S.D.N.Y., 01 Civ. 7322 (DAB), 3/6/03)

In *Korinsky v. Salomon Smith Barney Inc.,* 34 SRLR 270, 2/18/02, the plaintiffs alleged that analysts at Salomon Smith Barney had maintained positive recommendations on shares of AT&T stock, despite their knowledge that AT&T was facing financial problems, in order to boost their investment banking business. The *Korinsky* court found that the alleged misrepresentations were “in connection with” the purchase or sale of a security, and dismissed the suit under SLUSA.

In Enron litigation, defendant Jeffrey Skilling (former CEO of Enron) filed a motion to dismiss, asserting, “Every statement allegedly made by Mr. Skilling and claimed by plaintiffs to provisions.” Andrew Fastow (former CFO of Enron) also filed a motion to be false or misleading, is protected under PSLRA's safe harbor dismiss, stating that “[t]he PSLRA imposes a heightened pleading burden particularly upon a securities fraud action,” and that “plaintiffs failed to meet this heightened pleading requirement” in alleging that the defendant acted with a particular state of mind; therefore, the court “should dismiss the complaint.”[32]

Bernie Ebbers and WorldCom were successful in having a case dismissed in 2001, as was Larry Ellison of Oracle, who benefitted from the sale of over 900 million dollars in stock options prior to the release of negative news on the company.[33]

In 2002, Congress had no choice but to react to public criticism regarding the onslaught of corporate scandals and passed the Sarbanes-Oxley Act, signed by the President on July 30, 2002. The act contains measures dealing with financial reporting, conflicts of interest, corporate ethics, and the oversight of the account profession, establishing new civil and

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[29] Private Securities Litigation Reform Act: A Post-Enron Analysis.

[30] Private Securities Litigation Reform Act: A Post-Enron Analysis.

Annual filings since 1995:

1996	108	2000	214
1997	173	2001	488 *IPO allocation lawsuits accounted for 308 of the cases filed.
1998	238	2002	263
1999	206	2003	44

[31] *Id.* In 1995, 85.7% of the cases filed were settled and 12.0% were dismissed. In 2001, 73.6% of the cases filed were settled and 24.3% were dismissed.

[32] Enron Suspects Enjoy Litigation ‘Reforms'.

[33] William Lerach, “The Chickens Have Come Home to Roost”, 2002.

criminal penalties. However, for the most part PSLRA was left intact.

Uniform Practice Act have significantly reduced investors' rights with respect to class actions, while The Private Securities Litigation Reform Act and the State Litigation corporate fraud has inflicted massive losses on the investing public. The provisions of the Securities Reform Act do not directly impact securities arbitration, but the act has indirectly led to an increase in the volume of arbitrations, as many investors have seen their portfolios shrink due to the corporate fraud and analyst conflicts that have seemed omnipresent for the last five years.[34]
We have yet to learn what new legal obstacles will emerge to further obstruct investors, or how effective securities arbitrations will be in recovering their losses. In the meantime, investors seem somewhat shell-shocked, and have yet to articulate a united voice in opposition to the wholesale legislative and judicial assault on the rights and remedies available to them.

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[34] www.nasdadr.com

Arbitration Cases Filed

1995	5,586	1999	5,608	2003 filed through January 745 a 23% increase over 2002
1996	6,058	2000	5,558	
1997	5,997	2001	6,915	
1998	4,938	2002	7,704	

Risks, Costs and Benefits of Hedging A Portfolio with Naked Puts

by A. Daniel Woska and Rob Shaff

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Hedging. Most investors have heard of this investment maxim but only know it as a buzzword. How does one hedge? Theoretically, an investor hedges his portfolio by taking a position designed to bridge the risk gap with the goal of achieving risk parity. An insurance policy, if you will. Just as one insures a home or car, hedging can be likened to an insurance policy for an investment portfolio. So, why do investors seek a good hedge? Quite simply, to protect their wealth by minimizing losses.

The centerpiece of successful investing is composed of managing market and portfolio risks. Because market volatility is a fact of life and equity markets are uncertain at best, ensuring one's risk parameters are circumspect is tantamount to profitability. The most exclusive investors and traders have been using sophisticated hedging vehicles and other structured financial transactions for years to implement risk management strategies. And, increasingly, individual investors have been using options to protect specific positions from precipitous declines. To wit, this discussion is centered on an often-misunderstood hedge yet one that is relatively simple to employ and can be quite lucrative: naked puts.

Shorting the Puts

Put writing is considered to be a relatively complicated option strategy and, in all fairness, it is not for the faint of heart. However, used properly within a portfolio, it can be extremely effective and profitable. A "naked put" or "selling a put" is a strategy in which an investor writes a put contract and seeks a buyer for the put. By selling the contract to the put buyer, the investor has sold the right to sell shares at a specific price. Thus, the put buyer now has the right to sell shares to the put seller. The put seller is considered "naked" if he does not own a corresponding short position in the stock.

Selling a put is advantageous to an investor because he or she will receive the contract premium in exchange for agreeing to buy shares at the strike price. If the price of the stock falls below the strike price, the put seller will have to purchase the shares from the put buyer when the option is exercised. Therefore, a put seller usually has a neutral or positive outlook on the stock or expects a relative decrease in market volatility thereby creating a profitable position.

Strategy Considerations

Writing naked puts can create generous profits, cash flow, and entering an equity position at a predetermined price. Put writing generates income. While the buyer obtains the option rights to the underlying shares, the put writer receives the premium attached to the option contract. If timed correctly, a put writing strategy can generate profits for the seller as long as he or she is not forced to buy shares of the underlying stock. Thus, one of the major risks the put seller faces is the possibility of the stock price falling below the strike price, forcing the put seller to buy the underlying shares. Of equal magnitude are the funds or margin required to secure the put writer's naked position.

In certain cases, a put writer may have the forethought to purchase shares of a particular equity at a predetermined price lower than the market price. In these situations, the put writer would sell a put at a strike price below the market price and collect the premium. Such an investor would be eager to purchase shares at the strike price, and, as an added advantage, the investor makes a profit on the option premium if the price remains high. The downside to this strategy is the stock being purchased has fallen or is falling. And, since the investor agreed to pay a certain price for the shares, he will suffer a significant loss if the shares fall significantly below the strike price. As always, this strategy, like all investment

strategies, is predicated on divining the direction of a particular equity issue, not an easy task.

Margin Issues

As the strategy infers, selling a naked put is the sale of a put option without being short the underlying stock. Selling a stock short refers to an investor borrowing a stock and selling it in hopes its market value will decrease at which point the investor would buy the stock back, at the lower market value, to close the position with a profit. In contrast, selling a naked put refers to the position taken by an investor who sells someone the right (option) to make the investor buy the shares represented by the put option sold, without a corresponding short position.

Because the put seller could be required to buy the stock represented by the put option, brokerage houses require varying levels of margin. The typical margin requirement is 25% of the strike price of the option sold plus 100% of the option premium. Thus, the basic margin formula for selling naked puts can be presented as follows:

*({strike price **x** 25%} **+** option premium) **x** 100 **x** number of contracts*

Where:

strike price = the target price of the put option

option premium = the premium received from the sale of the put option

100 = the number of shares represented by each option contract,

number of contracts = the number of put contracts sold

Assume an investor sold 10 MSFT October $50 put contracts for $1.00 each, the margin requirement would be:

({$50 **x** 25%} **+** $1.00) **x** 100 **x** 10 **=** $13,500.00

One mitigating factor to the margin requirement cost is the premium received upon execution of the puts sold. However, most brokerage houses require an investor to have met the margin requirements *before* initiating a naked put position. Please note this represents a typical margin requirement. The requirements will vary from house-to-house. Regardless the size of the requirement, this represents the cost just to initiate the trade.

The Risks of Being Naked

When an investor sells naked puts, the maximum potential loss is limited to the number of contracts sold multiplied by the strike price of the options. Consequently, if an investor sells ten $50 puts, the maximum loss can be expressed as: 10 {number of contracts} **x** $50 {strike price} **x** 100 {number of shares represented by each contract} **=** $50,000. This risk of loss is hypothetical and represents the ultimate downside (i.e. what would happen if the stock was "put" to the investor at $50 and then the stock dropped to $0). While this type of precipitous drop would likely never occur without the investor circumventing the situation, it is possible as witnessed by the current Bear tearing through our capital markets. However, most investors will peg their exit if the stock price were to hit the strike price of the naked puts.

Another market risk associated with writing naked puts is gapping. Assume the stock in the above example is at $52 and the investor is short ten $50 puts. The next day, the stock gaps down to $48 (i.e. opens at $48), which means the investor would have to repurchase the naked puts at $48 instead of $50. While gapping is not a common occurrence, breaking news can send a stock in the wrong direction in a hurry. Of course, stocks have a tendency to "fill their gaps" but this may take time or never happen at all.

As discussed in the Strategy Considerations section above, investors partake in naked puts for both "investing" and "trading" motives. The risks associated with each motive have different perceptions and realities.

The naked put investor is described as having sold a "cash-secured put" if the cash sufficient to purchase the stock has been placed on deposit with the brokerage house. In this situation, if the put were assigned to the investor, the funds on deposit would be utilized to pay for the shares. Consequently, in an investing situation, the maximum theoretical risk is the same as if the investor purchased the stock outright. Thus, the maximum percentage risk is 100% of the cash invested in the stock.

The naked put *trader's* situation is entirely different. Selling a put contract and depositing the minimum margin required (discussed above) encompasses the definition of selling a naked put. Simply put, this means that the margin deposit is not sufficient to purchase the underlying stock. As such, it is likely the trader will receive a margin call if the put option is assigned. While the maximum theoretical risk of a stock price decline is the same in dollar terms for both the investor and trader, the maximum percentage risk for a trader is greater than 100% of the margin deposit. Consequently, it is possible the seller of a naked put could lose more than the initial margin deposit. This is one of the primary reasons selling naked puts is seen by many as a high-risk strategy.

Getting Naked

Mike is interested in hedging his predominately equity-based portfolio, one heavy with aggressive stocks. XYZ's stock is trading at $50 per share, and the $50 put is selling for $4 per contract. Mike decides that XYZ is a relatively stable stock but has upside potential. Mike instructs

his broker to sell 10 contracts (representing 1,000 shares of XYZ) and receives $4,000 in his house account (fees and commissions are ignored in this example).

XYZ moves up

If XYZ increases from $50 to $55 prior to the expiration date of the option, the value of the put contracts will decline severely. The option contracts will also decline in value as the expiration date approaches. Since Mike sold someone the right to sell him 1,000 shares of XYZ, if the stock has moved to $55, no reasonable seller will want Mike to purchase their stock at the $50 per share strike price. Rather, the seller will simply sell their shares for more money, $55 per share, in the open market. If the value of the option falls to $0 or expires, which is likely in this circumstance, Mike has just made $4,000.

XYZ moves down

If XYZ decreases from $50 to $40 per share, the value of each put contract on expiration will be $10 per contract, its intrinsic value. Mike is now obligated to purchase 1,000 shares of XYZ from the owner of the put contracts (100 shares per contract x 10 contracts). While purchasing 1,000 shares at $50 per share requires a cash/margin outlay of $50,000, Mike can sell these shares in the open market for $40 per share. Consequently, the net loss is calculated at $10,000. After this $10,000 loss, Mike has a net loss for the entire put scheme of $6,000 ($10,000 loss on the stock sale less $4,000 premium collected).

Mike could invoke a salvaging technique by purchasing the put contracts back for the current market premium, then immediately selling the next successive month's put at the same strike price. Mike would sell the new put contracts for the current market value, which would include additional premium for the time value to expiration. So with an intrinsic value of $10 per contract, the puts might sell for $12 per contract giving Mike another month for the stock price to rise and the receipt of $12,000 into his brokerage account. If the stock were to rise above $50, at expiration the options would expire worthless and the premium is Mike's to keep. Quite obviously, if Mike believes in his research relative to the direction of XYZ's stock price, this cycle could go on through many iterations.

In the example above, the price of the stock moved down by 20%. However, the change in the value of the option was 150% ($10 per share loss - $4 premium / $4 premium). If the stock had moved down to $30 per share, or a 40% decrease, the option would have increased in value by 400%, leading to a $16,000 loss for Mike. Since a stock can only fall to $0, the maximum loss on the sale of a put is the strike price less the option premium. In the example listed above, the maximum loss would be $46,000 ($50,000 total value of underlying stock at strike price - $4,000 premium received).

Selling puts can be very profitable and can provide a solid hedge to an investor's portfolio, but like all option trading, risk looms. While it is possible the stock price underlying the put contracts sold by an investor could fall to $0, it's not likely. However, in the current market environment, anything is entirely possible and has happened many times.

with respect to class actions, while The Private Securities Litigation Reform Act and the State Litigation corporate fraud has inflicted massive losses on the investing public. The provisions of the Securities Reform Act do not directly impact securities arbitration, but the act has indirectly led to an increase in the volume of arbitrations, as many investors have seen their portfolios shrink due to the corporate fraud and analyst conflicts that have seemed omnipresent for the last five years.[34]
We have yet to learn what new legal obstacles will emerge to further obstruct investors, or how effective securities arbitrations will be in recovering their losses. In the meantime, investors seem somewhat shell-shocked, and have yet to articulate a united voice in opposition to the wholesale legislative and judicial assault on the rights and remedies available to them.

"Pay or Play" Offers of Judgment: Are They Applicable to Arbitration Proceedings?

by Melanie S. Cherdack

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Many overzealous defense attorneys are attempting to turn the tables on unsuspecting claimants by making formal offers of judgment under various state's offer of judgment statutes. This tactic is designed to make the claimant jittery, as these statutes generally impose certain penalties on the recipient of the offer, such as attorney's fees or costs, if the ultimate judgment entered is less than the amount of the rejected offer. The applicability of such offers to an arbitration action, however, is doubtful.

The simple answer to the applicability of an offer of judgment statute can be found in the language of each individual statute. Some states, such as New Jersey, have statutes which address the types of proceedings, including certain arbitration actions, in which an offer of judgment is applicable. *See Elrac, Inc. v. Britto*, 775 A. 2d 547, 549 (N.J. Super. A.D.. 2001). In the majority of states, however, the offer of judgment statutes do not address their applicability to an arbitration, and thus an analysis of the statutory language is necessary.

While the case law on this issue is sparse, several courts have concluded that, where a statute is silent on the issue, statutory offers of judgment apply solely to civil actions actually litigated to judgment in court. For example, in *Nunno v. Wixner*, 778 A. 2d 145 (Conn. 2001), the Supreme Court of Connecticut held that the state's offer of judgment statute did not apply to a judgment rendered as a result of a mandatory arbitration. In *Nunno*, the action was initially brought in state court seeking damages for a motor vehicle collision. The plaintiff filed an offer of judgment for $19,000 pursuant to Connecticut's offer of judgment statute.[1] The defendant rejected the offer. The court then referred the case to a mandatory arbitration program for cases below a $50,000 threshold. Under the mandatory arbitration statute, the decision of the arbitrator becomes a judgment of the court if no appeal is taken by way of a demand for a trial de novo. After a hearing, the arbitrator awarded the plaintiff $21,945. The plaintiff then sought from the court an award of interest on the judgment under the offer of judgment statute because the arbitration award exceeded the amount of the rejected offer. The court denied the motion and the Connecticut Supreme Court affirmed the denial.

The Connecticut Supreme Court rejected the plaintiff's argument that the offer of judgment statute applied because the arbitration proceeding was part of an initial civil court action. Because the statute was silent on the issue, the court determined that the use of the terms "after trial" in the offer of judgment statute required that there be a trial and not merely an arbitration proceeding for the statute to apply. The court went on to distinguish the characteristics of a trial versus those of an arbitration proceeding and concluded that the court-mandated arbitration proceeding did not constitute a trial for purposes, of the offer of judgment statute. The *Nunno* court reasoned that despite the legislature's awareness that arbitration decisions can become judgments of a court, there was no reference to arbitrations in the offer of judgment statute. Accordingly, the statute did not apply to an arbitration award.

The argument that a confirmation of an award in court can lead to a "judgment," thus invoking an offer of judgement statute, has been rejected by at least one state court. In *Lane v. Williams*, 621 N.W. 2d 922, the Wisconsin Court of Appeals reversed a lower court award of costs under Wisconsin's offer of judgment

[1] Connecticut's Offer of Judgment Statute, General Statute §52-192 a. states, in pertinent part: "(a) After commencement of any civil action based upon a contract or seeking the recovery of money damages, whether or not other relief is sought, the plaintiff may before trial file with the clerk of the court a written 'offer of judgment' ... ."

statute. In *Lane*, the insured brought a claim against his automobile insurance carrier in court. The court action was stayed upon the motion of the insurance carrier to compel arbitration under its policy which provided for arbitration of coverage issues. The policy additionally provided that the arbitration costs be "shared equally" and stated that the "local court rules governing procedures and evidence will apply." Prior to the arbitration, the insured made a $45,000 offer of judgment to the insurer which was rejected.[2] An arbitration award was entered in excess of the offer of judgment. The insured then sought confirmation of the award in the circuit court, as well as a judgment awarding double costs and interest under Wisconsin's offer of judgment statute. The circuit court ruled that the insured was entitled to double costs under the offer of judgment statute. The appellate court reversed this ruling.

In its decision, the Wisconsin appellate court first addressed whether the insured was entitled to costs under Wisconsin's general prevailing party statute. The Court rejected this argument holding that the mere fact that the action began and ended in the circuit court, did not render the action litigated instead of arbitrated. In its opinion, the court reiterated an earlier holding in *Finkenbinder v. State Farm Mutual Auto Insurance Co.*, 572 N.W. 2d 501 (Wisc. Ct. App. 1997), which denied prevailing party costs after an arbitration was confirmed and concluded "it is not the beginning and the end point of action that are dispositive; rather, the determining factor is whether the action was the subject of a litigated trial court proceeding." Under this same rationale, the appellate court denied the application of the offer of judgment statute stating that because the offer of judgment statute requires a written offer "at least twenty days before trial" it did not apply, because liability was determined through arbitration rather than a trial.

Similarly, the Supreme Court of Alaska has held that penalties provided by its own offer of judgment statute, patterned on Fed. R. Civ. P. 68, the Federal Offer of Judgment Rule[3], are inapplicable to an arbitration. In *Mackie v. Chizmar*, 965 P. 2d 1202 (Alaska 1998), the initial claim was brought in state court seeking damages for emotional distress for a misdiagnosis of a patient as HIV positive. Prior to the trial, the defendant physician made a $25,000 offer of judgment. The plaintiff rejected the offer and, following a jury trial, the judge entered a directed verdict against the plaintiff ruling that she had not shown any physical injury. The verdict was appealed, and the appellate court reversed and remanded the case back to the trial court for further proceedings. On remand, the parties entered into an alternative dispute resolution ("ADR") stipulation, which allowed the trial judge to decide the case based upon a review of the record, to be supplemented by depositions and the parties' oral argument. Following the ADR procedure, the judge found for the plaintiff and awarded $15,000 in damages. Because the judge awarded less than the offer of judgment, the physician moved for attorney's fees and costs, as provided for by Alaska's offer of judgment statute. The trial court denied his request, holding the offer of judgment statute inapplicable.

On appeal, the Supreme Court of Alaska agreed. It held that "[t]he parties' decision to resolve their dispute through an alternative to trial ...invalidated [the physician's] offer in this case." 965 P. 2d at 1204. The court relied on the language of the statute which stated that an offer of judgment may be made "[a]t any time more than 10 days before the *trial* begins." It reasoned that, because the parties signed the ADR stipulation which stated that they were adopting the ADR process "in lieu of the regular trial," they chose to settle their dispute outside of the traditional litigation process and thus were not subject to the offer of judgment statute. The court went on to state that if the parties wished to preserve their rights under the offer of judgment statute when resorting to an alternative dispute resolution procedure, they must explicitly reserve its applicability in their ADR agreement.

The above cases make plain that the use of the word "trial" in a state offer of judgment statute renders the statute inapplicable to an arbitration proceeding.[4] Applying this rationale to a typical arbitration clause in a brokerage firm contract, it appears that offers of judgment are not binding. Many brokerage firm arbitration clauses contain the following language:

- ARBITRATION IS FINAL AND BINDING ON THE PARTIES.
- THE PARTIES ARE WAIVING THEIR RIGHT TO SEEK

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[2] The offer of judgment statute, Wisc. Stat. §807.01(3) provides, in pertinent part:

> After issue is joined but at least 20 days before trial, the plaintiff may serve upon the defendant a written offer of settlement... .

[3] Fed. R. Civ. P. 68 provides, in pertinent part, that :

> At any time more than 10 days before the trial begins, a party defending against a claim may serve upon the adverse party an offer to allow judgment to be taken against the defending party for the money or property or to the effect specified in the offer, with the costs then accrued. . . . If the judgment finally obtained by the offeree is not more favorable than the offer, the offeree must pay the costs incurred after making the offer.

REMEDIES IN COURT, INCLUDING THE RIGHT TO JURY TRIAL.

In executing contracts containing this language, the parties to a securities arbitration waive their rights to a "trial" and instead agree to be bound by the decision of arbitrators. Securities arbitrations are governed by the NASD and NYSE rules where the decision makers are not judges, pre-hearing discovery is limited, and where the formalities regarding evidence and procedure present in a court "trial" are absent at a final hearing. *See In Republic Steel Corp. v. Maddox*, 379 U.S. 650, 664 (1965)(Black, J. dissenting); *McDonald v. West Branch*, 466 U.S. 284 , 291 (1984). Since the arbitration process clearly is not a "civil action" in which there is a "trial," as is required by most offer of judgment statutes, those statutes should be found by most courts to be inapplicable in the context of securities arbitrations.

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[4] Other state offer of judgment statutes contain even clearer language limiting the applicability of the statute to actions filed in court. For example, Florida's offer of judgment statute applies "[i]n any civil action filed in the courts of this state... ." Fla. Stat. §768.79 (2002).

An Analysis of Merrill Lynch Mutual Fund Holdings of Internet Stocks

by Bob Grosnoff

In view of the recent action taken by the Attorney General of New York, I have performed a search of documents that were filed with the SEC by Merrill Lynch (MER). The documents that I researched in those SEC filings were the semi annual reports of each of the Merrill Lynch Proprietary Mutual Funds and the security holdings of those funds as evidenced by those reports. There were approximately 240 Proprietary Funds on that list. I eliminated all of the municipal bond funds, corporate bond funds, and any other fund that I thought would not hold positions in any of the technology stocks or "Blodget" stocks. I also eliminated any position of less than 10,000 shares, as I did not consider trading below that level to be meaningful. The purpose of my research was to find any trading pattern that Merrill Lynch employed within their Proprietary Funds that was in direct conflict with the information that Merrill Lynch analysts made available to their public clients.

I have found the results of this analysis to be quite astonishing. Many of the securities that MER was continuously recommending that their public clients "buy" or "accumulate" during the periods in question were simultaneously being sold out of the mutual funds in which they were held.

Some of the examples of my research follow. As of May 31, 2000 the MER Focus 20 Fund (F20F) owned 1,050,000 shares of Nortel Networks (NT). From June of 2000 until February 6, 2001 MER issued at least 14 reports on NT. All of the reports reiterated their rating of B-1-1-7. In the report dated January 19, 2001, MER highlighted that "NT delivered on its promises. The company reported Q4 results as expected. We reiterate our buy rating. Revenue for the quarter grew 34 % to 8.82 billion; a bit better than our 8.6 billion estimate." As of May 31, 2001 the F20F had liquidated the entire 1,050,000 position. During the time that MER was publicly urging their Financial Consultants (FC's) to buy NT for their public clients, they were selling. Similarly the Master Internet Strategy Fund (MISF) had a position of 220,900 shares of NT as of July 31, 2000. All of the shares were sold before January 31, 2001. As of September 30, 2000 the Global Technology Fund (GTF) owned 1,523,700 shares of NT. By March 31, 2001 that fund had also sold the entire position. On August 31, 2000 the Fundamental Growth Fund owned 3,768,300 shares. By February 28, 2001 all of the shares were liquidated.

Coverage on Extreme Networks (EXTR) began on February 13, 2001 with a Rating of D-2-1-9. The opinion remained the same until July 10, 2002 when it was upgraded to D-1-1-9. As of May 31, 2000, prior to the initial accumulate rating, MER owned 840,000 shares in the Focus 20 Fund. After the initial buy rating the position decreased to 490,000 shares as of May 31, 2001. I have not checked on any splits in any of the positions in this report. By November 30, 2001 the F20F had liquidated the entire position while still publicly urging their FC's to buy the stock for their clients.

The F20F owned 345,000 shares of Corning Glass (GLW) as of May 31, 2000. From July 14, 2000 until December 15, 2000 at least 16 reports were issued with a 1-1-7 rating. On January 25, 2001 MER dropped the rating to 2-1-7. The May 31, 2001 report showed that the fund had liquidated the entire position in GLW while still maintaining a Buy recommendation to their FC's for their clients.

Applied Micro Circuits (AAMC) had a D-1-1-9 rating on a report dated July 12, 2000. By September 28, 2000 AMCC was added to the "Favored 15" list. MER maintained the rating until November 2000 when it was lowered to a D-2-1-9. As late as February 6, 2001 MER

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still maintained that rating of D-2-1-9. As of May 31, 2000 the F20F owned 400,000 shares. By May 31, 2001 the position increased to 425,000 shares. While still maintaining a Buy on AAMC, MER F20F liquidated this position by November 30, 2001.

An initial report on Juniper Networks (JNPR) was issued on February 13, 2001 with a rating of D-2-1-9. An update was issued on March 14, 2001 and a Q1 report issued on April 12, 2001. All maintained the same rating. However, by May 31, 2000 8 months before the buy rating was issued, MER already had a position of 700,000 shares in the F20F. Before May 31, 2001, the Fund sold 390,000 shares from that position leaving holdings of 310,000 shares. While they were issuing buy reports publicly, MER was selling. By November 31, 2001, while still maintaining their buy rating, MER had disposed of the remaining 310,000 shares from the F20F.

The F20F owned 1,140,000 shares of BEA Systems (BEAS) as of May 31, 2000. At that time MER had no opinion on BEAS. February 21, 2001 MER initiated coverage on BEAS with a "Near Term Accumulate and Long Term Buy rating. According to the May 31, 2001 filing of the Fund the position was now 1,292,500 shares. By November 30, 2001, the Fund had disposed of the entire position of 1,292,500 shares while publicly maintaining the same strong rating.

Fundamental Growth Fund owned 1,170,000 shares of Lucent Technology as of February 29, 2000. By August 31, 2000 all of the shares were sold despite Merrill Lynch continuing the near term "accumulate" and long term "buy" opinion on Lucent. Fundamental Growth also owned 4,500,000 shares of Cisco Systems as of August 31, 2000. All were sold prior to February 28, 2001. Merrill Lynch continually referred to Cisco as a core holding and a tech bellwether during this period of time.

Interestingly, we just received an award that was issued in the first Cisco case in which I was retained as an expert that has gone to hearing. This was a case against Morgan Stanley Dean Witter. Vincent DiCarlo was the attorney and was sensational. Marvin Breen was the expert who testified on the suitability and supervision issues. He too gave terrific testimony. My testimony concerned many of the reports that Mary Meeker issued along with various magazines that quoted Ms Meeker as loving CSCO as her number one stock. I contrasted those glowing reports with the transactions in the MSDW Proprietary Mutual Funds that showed those Proprietary Funds were liquidating CSCO all during the time that Mary Meeker was telling anyone and everyone that CSCO was the best thing since sliced bread. The award was against MSDW and the broker. MSDW also had to pay all of the forum fees and reimburse our client for his filing fees. By the time this article is published Vincent will have presented a Cisco case against Merrill Lynch that is due to be heard on February 25, 2003. I am to testify about MER Proprietary Mutual Fund sales during the time that MER maintained a strong "buy" opinion. Charles Pease and Art Gooding will also testify as to suitability and damages.

Both the F20F and the MISF owned shares in Inktomi (INKT). On April 19, 2000 MER upgraded the opinion on INKT from 2-1 to 1-1. According to the May 31, 2000 filing the F20F already owned 430,000 shares. According to the July 31, 2000 filing the MISF owned 241,400 shares. On 2 January 2001 MER downgraded only the near term rating to "Accumulate" while maintaining the long term "Buy" rating on INKT. By January 31, 2001 MISF had already disposed their holding of 241,400 shares and by May 31, 2001 F20F had disposed of their holdings of 430,000 shares. The Global Technology Fund owned 534,000 shares as of September 30, 2000. By March 31, 2001 all of these shares were also liquidated.

As of March 31, 2001, the Global Technology Fund did not own any shares of Intel (INTC). On April 23, 2001 MER downgraded INTC to a "Near Term Neutral from Near Term Accumulate." After that downgrade MER purchased 1,028,300 shares of INTC that were reported on the September 30, 2001 report. Not only was MER selling into upgrade recommendations, but they were also buying off of downgrade recommendations.

I have in my possession 23 MER research reports on JDS Uniphase (JDSU) dating from September 22, 1999 until March 6, 2001. All of the ratings were C-2-1-9, "Accumulate Near Term, Buy Long Term." As of March 31, 2000 the GTF owned 859,200 shares of JDSU. By September 30, 2000 the position was increased to 934,200 shares. In each report JDSU was one of the top ten holdings of the Fund. The 24th report dated March 28, 2001 shows MER downgrading that rating to "Neutral Near Term" or C-3-1-9. As of March 31, 2001 MER had already disposed of the entire 934,200 shares. Similarly the Fundamental Growth Fund owned 500,000 shares of JDSU as of August 31, 2000. By February 28, 2001 all of these shares had been sold. Obviously MER sold those positions sometime prior to that downgrade.

The GTF owned 1,878,400 shares of Flextronics (FLEX) as of March 31, 2000. On September 7, 2000 MER issued a research report entitled "Strong Demand Leads to Upwardly Revised 2001 Expectations." By September 30, 2000 MER GTF had sold 250,000 shares, and the position was down to 1,628,400. On December 1, 2000 MER stated: "FLEX trades at

just 24x our raised C2001 cash EPS estimate of $1.19, which is a discount to its 45% + compound annual EPS growth rate between F1999-2002E and its 74% growth in F2001." As of March 31, 2001 MER had sold an additional 623,900 shares leaving the position at 1,004,500 shares. By September 30, 2001 the position was liquidated entirely even though MER still maintained the long term Buy rating on FLEX.

Let me move on to the infamous Blodget 24. These are the stocks that MER had very favorable opinions on, while internal e-mails were being sent that simultaneously trashed them. I have in my possession the SEC filings of the MISF for the periods ending July 31, 2000, January 31, 2001, and July 31, 2001. During this period of time, the MISF owned 13 of the 24 stocks on the list of 24. The following chart illustrates the name of the stock and symbol together with the amount of shares owned for the periods ending those that I have stated above. I will also correlate positions held by the Global Technology Fund (GTF) in some of the same securities after the analogy of the MISF Fund.

MASTER INTERNET SECURITIES FUND

STOCK & SYMBOL	July 31, 2000	January 31, 2000	July 31, 2001
America Online (AOL	766,500	630,800	241,200
Yahoo (YHOO)	224,600	156,800	0
Ebay (EBAY)	236,900	236,900	96,500
Homestore.com (HOMS)	153,600	183,100	178,500
Priceline.com (PCLN)	281,300	0	0
CMGI	437,600	0	0
Infospace (INSP)	540,000	0	0
Exodus (EXDS)	606,500	318,600	0
Inktomi (INKT)	241,400	0	0
Real Networks (RNKW)	263,300	0	0
Internet Capital (ICGE)	228,400	0	0
Ariba (ARBA)	224,600	296,200	0
Vertical Net (VERT)	218,000	0	0

MER maintained a buy rating on AOL until October 17, 2001 when it was downgraded near term to a neutral. They had already disposed of most of their position by January 31, 2001. They had disposed of all of it prior to the downgrade. Merrill Lynch Fundamental Growth Fund owned 5,500,000 shares of AOL as of February 28, 2001. By August 31, 2001 FGF had disposed of 4,350,000 shares leaving a position of 1,150,000. YHOO was rated buy until March 8, 2001 when it was downgraded near term to neutral. Again MER MISF had already disposed of this position by January 31, 2000. EBAY was always rated either "Buy" or "Accumulate", but the shares were also sold. PCLN was never rated lower than "Long Term Accumulate" until February 16, 2001. Those shares were sold prior to January 31, 2001. CMGI was sold prior to July 31, 2000 long before the shares were downgraded from "Buy" to "Accumulate" on November 14, 2000. I have 13 research reports on Infospace (INSP) dated from January 25, 2000 until September 15, 2000. The January 25, 2000 report gives the stock a rating of D2-1-9. All of the others carry the upgraded 1-1-9 rating. In spite of this, 540,000 shares of INSP were sold by MISF

prior to July 31, 2000. EXDS was rated "Buy" but the shares were sold. INKT was downgraded from "Accumulate" to "Neutral" on April 3, 2001. Yet 241,400 shares were sold prior to the downgrade. I could not find any information on RNKW.

Coverage of ICGE was initiated on August 30, 1999 with a 2-1 rating. They were never downgraded prior to the sale of 228,400 shares prior to July 31, 2000. ARBA was downgraded from 1-1 to 3-1 on April 3, 2001. The stock was rated D-1-1-9 in 11 of the 13 reports that I have. Sometime between January 31, 2001 and July 31, 2001 MISF sold 296,200 shares. It would be interesting to see the exact date those sales occurred to determine if they were also sold prior to the downgrade. 218,000 shares of VERT were sold prior to the downgrade from "Near Term Accumulate to Neutral" on January 8, 2001.

GLOBAL TECHNOLOGY FUND

SECURITY	Mar. 31, 2000	Sept. 30, 2000	Mar. 31, 2001	Sept. 31. 2001
America Online (AOL	924,400	1,332,400	647,500	440,600
CMGI	247,300	0	0	0
DoubleClick (DCLK)	410,900	0	0	0
EBAY	312,000	938,600	0	199,300
Exodus EXDS	453,200	906,400	0	0
Infospace INSP	228,000	456,000	0	0
Inktomi INKT	534,300	534,300	0	0
Internet Capital ICGE	301,200	0	0	0
Priceline PCLN	696,300	0	0	0
Yahoo (YHOO)	544,000	544,000	0	0

MER GTF liquidated 891,800 shares of AOL from Sept. 30, 2000 until Sept. 30, 2001. On October 17, 2001 after they liquidated these shares they downgraded the Near Term rating to "Neutral from Buy." MER GTF liquidated the entire position of 247,300 shares of CMGI prior to Sept. 30, 2000. On November 14, 2000 after they liquidated they downgraded the Long Term rating to "Accumulate from Buy." MER GTF liquidated the entire position of 410,900 shares of DCLK prior to Sept. 30, 2000. On August 7, 2000 they downgraded the Near Term rating from "Buy to Accumulate." On August 7, 2000 MER downgraded the Near Term rating of EBAY from "Buy to Accumulate." Yet they increased their position to 938,600 from 312,000 by September 30, 2000. On Dec. 8, 1999 MER initiated a 1-1 rating on EXDS. Even though they maintained the "Buy" rating on the stock, MER GTF liquidated the entire position of 906,400 shares prior to March 31, 2001. On September 15, 2000 MER issued a report on INSP entitled "Wireless Opportunity is Huge: Still Early Days." They go on to state in the Investment Highlights " We believe that INSP has a huge market opportunity, a powerful vision, and that Go2Net is additive to that vision." Despite that glowing report, MER GTF liquidated the entire position of 456,000 shares between September 30, 2000 and March 31, 2001. MER GTF liquidated the entire position of 534,300 shares of INKT sometime between September 30, 2000 and March 31, 2001. On April 3, 2001 they downgraded the stock to a 3-2 from a 2-1. MER initiated coverage on ICGE on August 30, 1999 with a 2-1 rating. Between March 31, 2000 and September 30, 2000 MER GTF liquidated the entire position of 301,200 shares despite publicly urging their clients to buy the stock. MER GTF liquidated the entire position of 696,300 shares of PCLN between March 31, 2000 and September 30, 2000. On September 27, 2000, after they liquidated the shares, they downgraded the Near Term rating from "Accumulate to Neutral." MER upgraded the Near Term rating on YHOO to "Buy from Accumulate" on August 18,1999. By September 30, 2000 they had accumulated 544,000 shares. Between September 30, 2000 and March 31, 2001 MER GTF liquidated the entire

position. On March 8, 2001, after MER GTF liquidated the shares, they downgraded the Near Term rating to "Neutral from Buy."

Clearly, MER has been publicly urging clients to buy securities while they have been very active sellers of the same securities at or about the same time. Clearly, on some occasions MER is buying securities after publicly downgrading those securities. MER is acting in direct conflict to their public opinions on many securities.

I have most of the price changes that occurred on the date of the MER upgrade or downgrade. Rather than include all of them, I will list some of them as they demonstrate the market power of such a change in rating. By having high ratings on stocks, MER financial consultants create buying interest in those stocks to their public clients while MER is actively selling in the MER Proprietary Mutual Funds. Similarly, when MER lowers the rating on a particular stock selling pressure is exerted on that stock thereby enabling MER Proprietary Funds to buy into the weakness that is created by that lower rating.

Positive report on NT January 19, 2001. Stock up from $36.69 to $40.00
Coverage Initiated on EXTR February 13, 2001. Stock up from $30.69 to $32.38
GLW downgraded on January 25, 2001. Stock down to $56.25 from $70.12
INKT upgraded on April 19, 2000. Stock up to $133.13 from $116.00
INKT downgraded on January 2, 2001. Stock down to $14.56 from 17.88
INTC downgraded on April 23, 2001. Stock down to $30.32 from $32.43
JDSU downgraded on March 28, 2001. Stock down to $19.92 from $23.31
Positive report on FLEX December 1, 2000. Stock up to $29.81 from $25.06
YHOO downgraded on March 8, 2001. Stock down to $17.69 from $20.94
INKT downgraded on April 3, 2001. Stock down to $2.79 from $6.22
ARBA downgraded on April 3, 2001. Stock down to $4.44 from $6.50

It is my opinion that this evidence could be most useful for any PIABA attorney who has any kind of a case against MER where trading in similar stocks took place. I can always expand the database of stocks. All I need are the names, dates of trade, and the research reports when they are available. I have also done a study concerning Mary Meeker and MSDW Proprietary Funds and am not quite finished with a similar undertaking for SSB and Jack Grubman.

Mutual Fund Share Classes and Conflicts of Interest Between Brokers and Investors

by Edward S. O'Neal, Ph.D.

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Most mutual funds sold by brokers are offered as multiple share classes, typically designated as A, B, and C shares.[1] While they represent claims on the same underlying portfolio of investments, the three share classes differ in their expense structures. Specifically, the classes differ with respect to the level and timing of one-time load charges and ongoing annual distribution fees (also called 12b-1 fees). The existence of multiple share classes forces investors to decide not only which mutual fund to purchase, but also which share class is most advantageous. The share class decision is more difficult than might be expected. In a previous study, I derive multiple algebraic equations that must be solved to determine which share class is optimal for a given investor.[2]

The commission arrangements that have evolved to differentially compensate brokers depending on the class of fund shares they sell are not generally disclosed to investors in the mutual fund prospectus.[3] These shrouded compensation schemes are pervasive in the mutual fund industry and give rise to a sharp conflict of interest between fund investors and brokers. Brokers are frequently more richly rewarded for selling investors the wrong share class given the investors' personal investment circumstances. This generally unknown conflict of interest is exacerbated by the fact that the level of sophistication necessary to analytically determine the appropriate share class is beyond the skills of the average investor.

In this short paper, I highlight the conflicts of interest engendered by multiple share class mutual funds. I will begin by briefly discussing the rules adopted by the SEC that led to multiple share classes. I then detail the expense structures and accompanying broker incentive arrangements that are most prevalent in the industry. Finally I illustrate the specific conflicts of interest that multiple share class mutual funds provoke.

Rules 12b-1 and 18f-3

Two rules adopted by the Securities and Exchange Commission under the Investment Company Act of 1940 have combined to spawn multiple share class mutual funds. Rule 12b-1 was adopted in 1980 and allows funds to pay distribution expenses directly out of fund assets. Prior to 1980, all distribution expenses were paid with loads that were usually charged when investors initially purchased fund shares (front-end load) or, less frequently, when shares were redeemed (back-end load). Rule 12b-1 provided an additional avenue for charging investors for distribution and set the stage for fund complexes to re-package traditional loads into a combination of front, back, and annual charges. The annual distribution fees charged pursuant to a fund's 12b-1 plan are often called 12b-1 fees.

In 1995, the SEC adopted rule 18f-3 which broadly allows mutual funds to offer multiple share class mutual funds representing claims on the same underlying portfolio of investments.[4] Prior to the adoption of rule 18f-3, many mutual funds had

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[1] I am indebted to Craig McCann of SLCG, Inc. whose comments and suggestions immensely improved this article.

[2] See Edward S. O'Neal, "Mutual Fund Share Classes and Broker Incentives," *Financial Analysts Journal* 55 September/October 1999, p.76-87.

[3] The more obscure Statement of Additional Information (SAI) often contains details on the commissions brokers receive. The SAI is not sent to investors unless specifically requested and, since most investors do not even know that it exists, investors rarely see this document.

received exemptive orders allowing multiple share classes. Since 1995, most fund complexes that sell shares with loads have formed multiple share classes. For example, Morningstar covers 2,418 load mutual funds in its Principia database as of January, 2003. However, these funds are sold in a total of 9,081 share classes, an average of 3.75 share classes per fund.[5]

Load Structures

Of the 50 largest broker-sold mutual funds in the U.S., 49 are sold in at least three shares classes. For each of these 49, the three primary retail share classes are designated as A, B and C shares. Although the specific magnitudes of expenses differ, the basic share class structures are remarkably similar across funds. A shares have large upfront loads and low 12b-1 fees. B shares have back-end loads and higher 12b-1 fees which step down several years after investment. C shares have small back-end loads and high 12b-1 fees that last for the entire life of the investment. A typical investor expense arrangement and broker compensation scheme is shown in Tables 1 and 2. Note that the column entitled "all other expenses" in Table 1 includes all annual fees except the 12b-1 fee. In this example, this figure is .75%, but this will depend on the specific fund. The magnitudes of the other expenses are fairly uniform across funds though there are some differences.

Table 1
Expense Structures of a Typical Multiple Share Class Mutual Fund

Share Class	12b-1 Fees	Other Expenses	Expens e Ratio	Front-end Load Initial Investment	Load	Deferred Load
A	0.25%	0.75%	1.00%	< $50,000 $50,000 - $100,000 $100,000 - $250,000 $250,000 - $500,000 $500,000 - $1,000,000 > $1,000,000	5.75% 4.50% 3.50% 2.50% 2.00% 0%	0.00%
B	1.00%	0.75%	1.75%	0.00% Converts to A shares after year 8		5% in year 1 4% in year 2 3% in year 3 3% in year 4 2% in year 5 1% in year 6
C	1.00%	0.75%	1.75%	0.00%		1% in year 1 0% thereafter

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[4] Investment Company Act Release No. IC-20915 details the considerations leading to the adoption of rule 18f-3.

[5] In addition to the three standard retail classes, many funds also sell separate institutional share classes and classes that are available to only a select group of investors.

Table 2
Broker Compensation Arrangement

Share Class	Initial Investment	Initial Commission	Trailing Commission
A	< $50,000 $50,000 - $100,000 $100,000 - $250,000 $250,000 - $500,000 $500,000 - $1,000,000 > $1,000,000	5.00% 4.00% 3.20% 2.25% 1.70% 1.00%	0.25%
B	All Amounts	5.00%	0.25%
C	All Amounts	1.00%	1.00%

Class A shares – Front-end Loads. Most load fund companies originally offered only front-end loaded shares. Most fund companies that sell front-end load shares designate them as class A shares. Investors incur a sales charge when they initially purchase these shares. This sales charge is paid to the fund mutual fund company and the remainder of the investor's investment is used to purchase shares in the fund. The mutual fund company then returns the lion's share of the sales charge back to the investor's brokerage firm as compensation for sales efforts. Typically the load will decrease as the size of the initial investment increases, and for very large investments the load may be waived completely.

Most front-end load shares also incur a 12b-1 fee. The 12b-1 fee, expressed as an annual percentage, is deducted periodically from the net assets of the fund and paid to the mutual fund company.[6] The mutual fund company then generally pays the broker most or all of this fee. Since the 12b-1 fee is based on the net assets at the time it is deducted, a broker's compensation from such fees will vary directly with the net asset value of the fund.

For the load structure in Table 1, A-share investments up to $50,000 incur a front-end load of 5.75% and a 12b-1 fee of .25% per year. The broker is compensated with 5.00% of the initial total investment and is paid the full .25% 12b-1 fee as a trailing commission in each year that the investment is held. For an investor with $10,000 to invest, the total investment in fund shares would be $9,425. Of the $575 front-end load, the broker would receive $500 and the mutual fund company would keep $75. In each subsequent year, the broker would receive .25% of the then-current value of fund shares as a trailing commission.

For investments greater than $50,000, the investor pays a smaller front-end load and the broker receives a smaller percentage of the investment as an initial commission. The dollar breakpoints shown in Table 1 are fairly common in the fund industry. Since an initial investment of $50,000 in a single fund is prohibitive for some investors, fund families have instituted two mechanisms by which investors might receive reduced front-end loads without meeting the minimum breakpoints on each A-share mutual fund investment: Letters of Intent and Rights of Accumulation.

A Letter of Intent (LOI) allows an investor to commit to a minimum dollar amount of fund purchases over a specified time period. The fund investor's total committed purchases

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[6] I use the term "mutual fund company" broadly here to mean the group of affiliated subsidiaries that generally provide advisory, distribution, and transfer agent services to the mutual fund. The subsidiary that acts as a fund wholesaler, collecting loads and paying brokers, is the fund distributor.

rather than the size of the individual investments is used to determine the front-end sales charge on all purchases of the fund. For example, a fund investor might commit to purchasing $10,000 in fund shares per month over a one-year period. In such a case, the fund will use $120,000 (12*$10,000) in determining the front-end load the investor would pay on each of the 12 monthly $10,000 fund purchases. In the example in Table 1, this particular LOI would allow the investor to pay the 3.50% load.

A Right of Accumulation allows family members to aggregate fund share purchases to achieve lower front-end loads. Consider a husband and wife that each has $50,000 to put into a fund. A right of accumulation would allow both of them to be subject to the front-end load applicable to a $100,000 purchase even though the purchases are made in different accounts. Most rights of accumulation apply to spouses and children. Some fund families also allow accumulation of parents, their children and their grandchildren.[7]

Class B Shares - Deferred Loads. Class B shares do not charge an upfront load, but rather charge a deferred load in the event that an investor redeems shares within a certain period of time. The deferred load, officially termed a Contingent Deferred Sales Charge (CDSC), typically decreases each year that the investment is held. This load will often decline to zero within a six-year period. If an investor redeems shares, the deferred load is calculated as a percentage of the lesser of current net asset value or the original cost of shares being redeemed.

Though no load is paid initially by the investor to purchase the fund shares, the mutual fund company pays a sales commission to the broker. The sales commission is generally comparable to the commission that the broker receives from the sale of A shares.

Like A shares, B shares incur a distribution fee that is deducted from the net assets of the fund and paid to the mutual fund company. This fee is usually higher than the distribution fee associated with A shares. However, the mutual fund company keeps a greater proportion of this annual fee and pays the broker an amount that is comparable to what is paid on A shares. The proportion of the annual distribution fee that the mutual fund company keeps offsets the sales commission that was originally paid to the broker in the absence of a load charge to the investor.

B shares convert into A shares after a number of years (usually 8 years). This conversion feature is advantageous to investors because it reduces the 12b-1 fee and hence the expenses of the fund after conversion.

The B share example in Table 1 has a CDSC that declines from 5% to 0% in six years. For the first eight years of investment, the 12b-1 fee is 1% per year. The shares then convert to A shares in the eighth year and the 12b-1 fee becomes .25% per year. An investor's entire initial investment in B shares is put into shares of the fund. For a $10,000 initial investment, the broker receives a commission of $500 from the mutual fund company. The mutual fund company recoups this initial commission through the annual 12b-1 fees. Whereas the investor is charged a 1% annual 12b-1 fee, the broker only receives .25% per year. The mutual fund company keeps the remaining .75% per year until conversion to offset the initial commission.

Class C Shares - Level Loads. Class C shares are often called "level load" shares. These shares generally have a small deferred sales charge that reduces to zero after the first year. Just as with B shares, the mutual fund company pays the broker a sales commission even though the investor pays no initial load. The commission paid to the broker is typically less than that associated with A or B shares.

The 12b-1 fee paid on C shares is generally the same as that incurred on pre-conversion B shares. The fee is levied against the net assets of the fund and is paid to the mutual fund company. The mutual fund company then pays a percentage of the 12b-1 fee to the broker. The amount paid to the broker is greater than that paid in association with B shares. Therefore, even though the distribution fee paid by the investor may be the same with B and C shares, the fee is split differently between the mutual fund company and the broker. C shares do not have conversion features.

The entire $10,000 investment is used to buy shares in the C share example illustrated in Table 1. The broker receives a $100 initial commission, and each year thereafter he receives a 1% trailing commission. C shares do not convert to A shares, so the 1% 12b-1 fee lasts for the life of the investment.

Investor Preferences

With multiple share class funds, the underlying assets are the same regardless of class. Since the only differences between classes are the magnitudes and timing of loads and

[7] Oppenheimer Funds allows such accumulation.

distribution fees, the analysis of investor preferences for the different share classes can be reduced to an examination of the differential effects of the share class fees on investment returns. Three generalizations can be made about the appropriateness of these share classes: 1) Investors with large amounts to invest should buy A shares. In most cases, reaching the first breakpoint in the load schedule for A shares makes them preferable to B share investments. 2) Investors with short-term holding periods should buy C shares. The high loads associated with A and B shares make short-term trading in those share classes prohibitively expensive.[8] 3) Although not apparent without performing calculations, there is generally very little difference to investors between purchases of A shares below the first breakpoint and purchases of B shares. These results are derived in my previous analysis and hold for most multiple share class mutual funds.[9]

Broker Incentives

Brokers who sell mutual funds are compensated with combinations of upfront and trailing commissions. Though the mutual fund company pays the broker, the payments come from the loads and distribution fees charged to the investor. Total broker compensation on a sale of mutual fund shares can be calculated as the present value of all commissions generated from the fund shares. I have derived the equations and appropriate assumptions for calculating the monetary incentives for mutual fund brokers.[10]

Essentially, brokers prefer higher commissions to lower commissions, and they prefer upfront commissions to trailing commissions of similar magnitude. These two principles combine to generate the following broker incentives with respect to multiple share class mutual funds: 1) Brokers are paid more when they sell B shares to large investors than when they sell A shares even though the investors would benefit from being sold the A shares. 2) Brokers are paid more when they sell investors with short holding periods A or B shares rather than C shares even though these investors would be better served with C shares. 3) Brokers are indifferent between A and B shares when the investment amount is below the first breakpoint.

Two Examples

A shares vs. B shares. If we make some assumptions about investor holding periods and initial investment amounts, we can determine which share classes are correct for investors. This exercise requires that we calculate the wealth that an investor would accumulate in each share class given our assumptions. Table 3 presents such an analysis for the A and B shares detailed in Table 1. In this particular example we make the assumption that the return on the underlying assets of the fund is 12% per year. Investors will not realize this return because annual expenses are deducted. For example, an A-share investor would realize 11% per year (12% minus the 1% annual expense ratio). The subsequent results are not affected for any reasonable assumption of investment return. It is worth mentioning that this exact share class structure is that of Putnam Vista fund, a $3 billion equity mutual fund.

Table 3
Comparison of Redemption Amounts in A and B Share Mutual Fund

Initial Investment	Share Class	1	3	5	8
$10,000	A	$10,450	$12,848	$15,796	$21,533 *
$10,000	B	$10,454 *	$12,925 *	$15,973 *	$21,498
$50,000	A	$52,945 *	$65,093 *	$80,028 *	$109,094 *
$50,000	B	$52,269	$64,624	$79,865	$107,492
$100,000	A	$106,999 *	$131,549 *	$161,731 *	$220,472 *
$100,000	B	$104,538	$129,248	$159,731	$214,983
$250,000	A	$270,270 *	$332,280 *	$408,518 *	$556,891 *
$250,000	B	$261,345	$323,120	$399,326	$537,458
$500,000	A	$543,312 *	$667,968 *	$821,225 *	$1,119,494 *
$500,000	B	$522,690	$646,239	$798,653	$1074916
$1,000,000	A	$1,108,800 *	$1,363,200 *	$1,675,969 *	$2,284,682 *

$1,000,000	B	$1,045,380	$1,292,479	$1,597,306	$2,149,833

* Indicates preferred share class for specific holding period and initial investment
Holding period in years

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[8] It should be noted that mutual funds are not generally appropriate for short-term trading strategies.

[9] Edward S. O'Neal (1999), *supra* note 1.

[10] *Ibid.*

Note that for most investment amounts, A shares are the preferred share class. The exception is for small investments and shorter holding periods. For investments under $50,000 and holding periods of 1, 3, or 5 years, B shares for this specific expense structure are slightly better than A shares. However, the differences are small. Investors who have enough to meet even the first breakpoint are better off in all circumstances in A shares. Indeed, it seems inappropriate that investors are even given the option to purchase high levels of B shares.[11] The advantage of A over B shares increases as the amount of the initial investment increases.

An extremely important point in this analysis is that investors can qualify for reduced A share loads based on the entire amount they have to invest in mutual funds, not just the amount put into each specific mutual fund through Letters of Intent or Rights of Accumulation. For example, an investor with total investable wealth of $300,000 could divide the investment among as many as funds in the same fund family as seems appropriate for asset allocation purposes and receive the reduced front-end load of 2% on all A share purchases.

The same sort of analysis can be conducted to determine which class of fund shares the broker is paid the most for selling. For low levels of investment, there is virtually no difference in the compensation that brokers receive for selling A versus B shares. For any investment amount that would receive the A-share reduction in load (even at the first breakpoint), the broker is paid more for selling B shares. As the total investment amount increases through each breakpoint, the advantage of B shares vis à vis the broker's monetary compensation increases.

The possibility for broker misconduct is obvious. Since brokers receive higher commissions for selling large quantities of B shares, they may recommend B-share investments in lieu of A shares. Or, they may recommend spreading investments across a number of different A shares or B shares in different fund families such that the total investment amounts in each fund family do not reach the breakpoints that ultimately reduce broker payouts. Brokers may argue that spreading fund investments across families leads to greater diversification benefits than investing within a single family. This contention is unfounded – I am aware of no study, academic or otherwise, that confirms this notion. The larger fund families frequently offer a plethora of funds that span all feasible asset classes. For example, the Franklin Templeton fund family offers 89 funds, the MFS fund family offers 70 and AIM offers 56.[12] In addition, expert analysis can demonstrate that portfolios of funds built with funds from a single family have extremely high correlations with portfolios holding funds from multiple families.

C shares. In the previous example, only A and B shares were considered. I treat them initially because the vast majority of load mutual fund assets are invested in these two share classes (classifying load funds into the 3 typical retail classes shows that 92.2% of load fund assets are in A and B shares).[13] Table 4 presents the same numbers as table 3, but also includes C shares. The results here are illuminating. Most importantly, C shares are preferred for shorter holding periods for many investment levels. The ability to avoid a load by holding for just over one year is valuable for short-term traders. For any investment amount, A shares are preferable for holding periods of 8 years or longer. As the initial investment increases, the advantage of lower reduced front-end loads on A shares begins to make them preferred even to C shares for shorter-term investments. For example, an investment of $500,000 is better put into A shares if the holding period is three years or longer.

Also of interest is that when C shares are considered, B shares are never the best choice! Recall that B shares were only preferred to A shares for investments under $50,000 and for shorter holding periods. The introduction of C shares into the analysis removes any situation where B shares are best.

[11] Some mutual fund companies have mechanisms in place to question brokers about large sales of B shares and, in some cases, to disallow such purchases.

[12] These numbers are drawn from Morningstar Principia, January, 2003.

[13] *Ibid.*

Table 4 Comparison of Redemption Amounts in A, B and C Share Mutual Fund					
Initial Investment	Share Class	1	3	5	8
$10,000	A	$10,450	$12,848	$15,796	$21,533 *
$10,000	B	$10,454	$12,925	$15,973	$21,498
$10,000	C	$10,894 *	$13,325 *	$16,134 *	$21,498
$50,000	A	$52,945	$65,093	$80,028	$109,094 *
$50,000	B	$52,269	$64,624	$79,865	$107,492
$50,000	C	$54,470 *	$66,623 *	$80,672 *	$107,492
$100,000	A	$106,999	$131,549	$161,731 *	$220,472 *
$100,000	B	$104,538	$129,248	$159,731	$214,983
$100,000	C	$108,940 *	$133,245 *	$161,344	$214,983
$250,000	A	$270,270	$332,280	$408,518 *	$556,891 *
$250,000	B	$261,345	$323,120	$399,326	$537,458
$250,000	C	$272,349 *	$333,113 *	$403,360	$537,458
$500,000	A	$543,312	$667,968 *	$821,225 *	$1,119,494 *
$500,000	B	$522,690	$646,239	$798,653	$1,074,916
$500,000	C	$544,698 *	$666,226	$806,720	$1,074,916
$1,000,000	A	$1,108,800 *	$1,363,200 *	$1,675,969 *	$2,284,682 *
$1,000,000	B	$1,045,380	$1,292,479	$1,597,306	$2,149,833
$1,000,000	C	$1,089,396	$1,332,453	$1,613,440	$2,149,833

* Indicates preferred share class for specific holding period and initial investment
Holding period in years

Broker compensation on C shares is dependent to a greater extent on trailing commissions than the higher initial commissions paid on A and B shares. Since the trailing commissions last throughout the life of the investment, over long terms, brokers can receive greater remuneration by selling investors C shares rather than A shares. Some brokers refer to building a book of C-share clients as “annuitizing” their business. As with the A share/B share conflict, the adverse incentives with respect to C shares is clear. Longer-term investors are better off in A shares but brokers are paid more by having long-term clients in C shares. An additional point is that broker incentives are dependent on how long the broker expects to maintain his clients. A broker nearing retirement will have greater incentives to sell A or B shares regardless of client expected holding periods since the broker will not be employed long enough to garner the higher long-run payoffs of C shares.

Discussion

The preceding analysis can be conducted for any multiple share class mutual fund and the results will be similar. Unfortunately, investors must have a certain degree of financial sophistication to carry out these calculations. A simple glance at the different expense structures such as those in Table 1 is insufficient for determining the optimal share class. This complexity in share class arrangements generally necessitates the broker’s involvement in the share class decision. In a situation where the interests of the broker and investor are perfectly aligned, this involvement would be copasetic. However, the compensation schemes that brokers face promote adverse incentives for selling share classes.

Conflicts such as these are potentially damaging to the mutual fund industry. Different share classes do not represent different fundamental investments – only how investors pay distribution expenses – primarily commissions to their broker - is different. Most investors (especially those that employ a financial professional for mutual fund investments) are not financially sophisticated enough to understand the impacts on investment returns of expenses which vary in both magnitude and timing. These investors must rely on their broker for advice on the most appropriate share class. While most brokers will likely fulfill their fiduciary responsibility and put the client’s best interests ahead of their own, the possibility remains that a broker’s advice may be

compromised by financial incentives that conflict directly with those of the investor. The mutual fund industry has built a stellar reputation over the 60 years since the passage of the Investment Company Act of 1940, based largely on the lack of tarnishing scandals and lawsuits in the industry. The existence of such blatant adverse incentives under conditions where investors are lacking understanding can only serve to undermine the confidence that investors have in the fund industry.

The potential for conflicts of interest with annual distribution fees is not a new revelation. Trzcinka and Zweig (1990) give a complete historical perspective of the circumstances surrounding the adoption of rule 12b-1 by the SEC.[14] They document that prior to the adoption of rule 12b-1 in 1980, the SEC had generally opposed allowing funds to pay for distribution expenses out of fund assets due to possible conflicts of interest between the advisor and investors. The anticipated benefit of rule 12b-1 was that an increase in sales initiatives would ensue, stemming the tide of net redemptions that had characterized the fund industry from 1972 through 1979. The high levels of redemptions were posited to affect the manager's ability to achieve maximum investment returns and to increase expense ratios due to the resulting decrease in assets. It was decided that the potential benefits of such a rule outweighed the drawbacks, specifically the potential conflicts of interest. Subsequent to the passage of rule 12b-1, the mutual fund industry has undergone unprecedented growth. Whether this growth is due in part to rule 12b-1 is beyond the scope of this study. However, it is important to note that much of the growth of mutual fund assets can be attributed to direct-market funds which often are sold without 12b-1 fees.

Given that the different compensation schemes for brokers provoke broker preference for selling one share class over another, an obvious solution would be to require brokers to be compensated equivalently regardless of the share class they sell. This arrangement would shift risk onto the mutual fund company. The current system allows mutual fund companies to compensate brokers differentially with little risk since distribution expenses are charged to investors and a portion is directly funneled to brokers.[15] If fund companies allowed different share classes to be sold, but compensated brokers equivalently regardless of share class, mutual fund companies would face the risk that distribution expenses charged to investors might fall short of promised broker commissions for some share classes.

Conclusion

Multiple share class mutual funds have proliferated since the SEC adopted rule 18f-3 under the Investment Company Act to allow mutual funds to offer shares representing claims on the same underlying assets with different distribution arrangements. Numerical analysis can allow investors to determine which share class is most advantageous. Multiple share class distribution arrangements also cause mutual fund brokers to be differentially compensated based on the class of shares they sell. Brokers have monetary incentives to steer large investors away from share classes with load-reducing breakpoints and to steer short-term investors to high-load, low annual fee classes. This conflict of interest between fund investors and brokers is most dangerous when brokers advise relatively uninformed investors who likely make up a significant fraction of investors who retain advisors on mutual fund investments.

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[14] *See* Trzcinka, Charles and Robert Zweig, 1990, "An Economic Analysis of the Cost and Benefits of SEC Rule 12b-1", *Monograph Series in Finance and Economics* (Salomon Brothers Center for the Study of Financial Solutions, New York University, New York, NY).

[15] There are some risk associated with B shares for mutual fund companies, Mutual fund companies pay brokers an upfront commission without receiving a load, depending on future 12b-1 fees to recoup the broker commission. Legally, 12b-1 fees can be discontinued by a vote of the fund's directors. Such a vote is rare, but would leave the mutual fund company without a mechanism to recover paid commissions. *See* Plesset, Rochelle Kauffman, and Diane E. Ambler, 1997, "The Financing of Mutual 'B Share' Arrangements", *The Business Lawyer*, 52, 1385-1429.

View from the West: Should You Challenge an Arbitrator for Cause or Make a Motion or Request for Recusal?

by Scot Bernstein and Tracy Pride Stoneman

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The Fall 2002 "View from the West" addressed causal challenges and included an example of a causal challenge letter that was successful. All too often, however, attorneys representing public customers have their causal challenges denied by the securities industry forum administering the arbitration. Whether at the NYSE or the NASD, the result frequently is the same: a clearly meritorious challenge is denied.

To make matters worse, many attorneys who represent investors will confirm that the industry arbitration fora are far more sympathetic to the securities industry's causal challenges than to those of investors. Thus, the strong sense among attorneys representing public investors is that there is a great disparity between the industry's relatively good chances of succeeding with a causal challenge and an investor's relatively poor chances of doing so.

It all is enough to make one wonder whether there might be a better way to approach problems of this kind. Some years ago, both of the authors independently concluded that there was a better way: a motion or request seeking recusal directed to the arbitrator instead of a challenge for cause directed to the forum.

The problem with causal challenges is that securities industry self-regulatory organization ("SRO") personnel might tend to defend arbitrators whom they know and like and to disbelieve assertions that those arbitrators might be biased or unfair. The arbitrators themselves, on the other hand, might be more inclined to withdraw from cases in which they do not feel that all parties and all of the other arbitrators desire their involvement. While the SROs might feel obliged to defend their arbitrators, the last thing most arbitrators will want is to be perceived as clinging to an assignment when the ethically cautious and upstanding thing to do would be to step aside.

Like challenges for cause, motions or requests to recuse can be made at any stage in the proceedings, as early as the arbitrator's appointment or as late as the hearing itself.

Mr. Bernstein has made a number of successful motions to recuse, generally within a short time after an arbitrator's appointment. On one occasion several years ago, Mr. Bernstein requested that a newly-appointed arbitrator recuse himself when voir dire directed to that arbitrator revealed that the arbitrator's law firm had performed insurance defense work for AIG. Mr. Bernstein asserted that the respondent broker-dealer was insured by AIG, and that the arbitrator therefore would have a conflict of interest if he were to sit on a case in which he would be asked to assess damages that ultimately would be paid by his firm's former and possible future client. Respondent's counsel opposed the recusal request; but he did not deny that his client was insured by AIG. The arbitrator recused.

Ms. Stoneman became aware of a problem with an arbitrator during a pre-hearing conference in which the industry arbitrator told her that "[y]our client should have just put his money under his mattress." Ms. Stoneman respectfully asked the arbitrator to remove himself from the panel. He declined. She then went to the NYSE and requested that the forum remove the arbitrator from both the panel and the arbitrator pool. To the NYSE's credit, it did both.

At the other end of the spectrum, Ms. Stoneman was in the second day of an arbitration hearing when several comments by the industry arbitrator prompted her to ask the industry arbitrator to remove himself

from the panel. He refused. Ms. Stoneman then asked the other two arbitrators to consider the issue. After a long recess, the three arbitrators returned and the industry arbitrator announced that he would withdraw.

To date, motions or requests for recusal have served both of the authors well. While a securities industry forum or an SRO may not be overly concerned about whether the parties are satisfied with the arbitrators or whether the arbitrators come through the proceeding with their reputations intact, the arbitrators may care a great deal about those concerns. Certainly one would think that they should.

Something undesirable happening in an arbitration -- something that results in vacatur of the award, for example -- may not do much harm to an SRO's reputation. An SRO handling hundreds or thousands of arbitration cases each year can be expected to have a few awards vacated, and the public is aware of that. But if something about an individual arbitrator has the appearance of impropriety and an award is vacated as a result, the event may leave an indelible mark on the arbitrator's career as a neutral.

The letters below arise in a pending NYSE arbitration case in which the co-authors of this article are co-counsel for the claimant. In that case, both parties agreed to the NYSE's random list selection option. After the parties reached that agreement, the California arbitrator disclosure rules took effect. The NYSE refused to appoint arbitrators in California, so the claimant elected to have the hearing of the case take place in Portland, Oregon. List selection proceeded.

Striking and ranking the first and second lists yielded two public arbitrators and no industry arbitrator. Thus, a randomly-appointed industry arbitrator was introduced to the parties at the initial pre-hearing telephone conference.

The industry arbitrator had a disclosure to make: a few years ago, the company she served as president was represented in an employment dispute by our opposing counsel, Morgan Stanley's attorney in the present case.

The authors challenged the industry arbitrator for cause. Astonishingly, the NYSE denied the challenge. Apparently, the NYSE bought into the respondent's argument that the representation five years before did not create an appearance of impropriety. Indeed, the NYSE seems to have thought it was not even a close question, for the NYSE's own "Guidelines for Classification of Arbitrators" (the "Guidelines"), contained in Article IX of the NYSE Constitution, state that

> "[a]ny close question on arbitrator classification or on challenges for cause shall be decided in favor of public customers."

So the authors had no choice but to go directly to the arbitrator and ask her to recuse.

The vigor with which Morgan Stanley has fought the claimant's causal challenge and subsequent efforts to seek recusal are far beyond the norm. That level of intensity suggests a belief by the respondent that the arbitrator will be a lot better than neutral. Otherwise, there would be no reason to fight so hard to keep her on the panel.

Two letters follow. The first is the claimant's motion to recuse. The second is the claimant's reply to the respondent's opposition to the motion. While these letters are not forms in any literal sense, the authors hope that they will provide at least some useful and reusable text as they outline the arguments that the claimant made.

The letters have been altered slightly to eliminate or replace a few key names. The claimant's name, wherever it appeared, has been replaced by "[claimant]." The arbitrator's name has been replaced by "[arbitrator]." Opposing counsel's name has been replaced by "[opposing counsel]." And certain other names have replaced by a double backslash ("\\").

With that introduction, here are the letters.

First, the Motion to Recuse

\\
\\ [title]
New York Stock Exchange, Inc.
20 Broad Street
New York New York 10005-2601

Re: [Claimant] **v. Morgan Stanley, NYSE Case Number 2002-**

Dear \\:

Please immediately convey to Arbitrator [arbitrator] the Claimant's request that she recuse herself. The disclosure that [arbitrator] and Respondent's counsel [opposing counsel] made during the recent pre-hearing conference regarding their prior professional contact gives Claimant and his counsel discomfort and serious doubt about [arbitrator]'s neutrality. Claimant therefore requests that [arbitrator] withdraw for each and all of the following reasons.

1. The Arbitrator's Prior Relationship with Respondent's Counsel Has the Appearance of Partiality or Bias

[Arbitrator]'s prior business relationship with Respondent's counsel "reasonably create[s] an appearance of partiality or bias" as set forth in NYSE Rule 610. That rule contemplates that "past"

business relationships may give rise to an appearance of partiality or bias. It does not matter whether the relationship in question occurred seven years ago, five years ago, or three years ago. It was recent enough that both Respondent's counsel and [arbitrator] remembered each other in the pre-hearing conference. Claimant's discomfort and his doubts about an arbitrator's neutrality cannot be magically erased by a few extra ticks of the clock.

[Arbitrator]'s termination of her relationship with her former employer in the last week or so is immaterial as well. It is the relationship itself -- the fact that it existed at all -- that gives rise to the appearance of partiality or bias. That appearance does not change merely because [arbitrator] has just resigned.

This is not a situation in which some other lawyer in [opposing counsel]'s large law firm represented [arbitrator]'s company. The attorney who represented [arbitrator]'s company was [opposing counsel] himself. And [arbitrator] was not some low-level functionary, either. Rather, she was the president of the company.

It was [arbitrator]'s company that was sued for wrongful termination of an employee. Since [arbitrator] was the company's president, the allegedly wrongful conduct occurred on her watch. Indeed, the disclosures during the pre-hearing conference included the fact that [arbitrator] was a witness in that case. Thus, she had an opportunity to work with and be prepared for her testimony by [opposing counsel]. As president, [arbitrator] undoubtedly discussed other aspects of that case with him as well. Moreover, [arbitrator] clearly trusted [opposing counsel], for if she had not, [opposing counsel] would not have been representing the company.

It is astonishing that the NYSE expects the Claimant to be comfortable with all of this. [Claimant] does not know and cannot know the details of the relationship between Arbitrator [arbitrator] and Respondent's counsel. That is the problem. And now the NYSE -- an association of which Respondent, not Claimant, is a member -- is asking [claimant] to put his blind trust in its arbitrator's neutrality, notwithstanding her prior relationship of trust and confidence with Respondent's counsel and all of its known and unknown details. [Claimant] has suffered greatly because he trusted the Respondent. He is not willing to trust Respondent's association's assurances about the neutrality of this arbitrator.

2. The Code of Ethics for Arbitrators Requires [Arbitrator] to Withdraw

Pursuant to the NYSE's "Guidelines for Classification of Arbitrators" (the "Guidelines"), contained in Article IX of the NYSE Constitution, [arbitrator] is bound by the American Bar Association's Code of Ethics for Arbitrators (the "Code of Ethics"). Let us look first at the Guidelines:

"Guidelines for Classification of Arbitrators

In order to insure continued investor confidence in the arbitration process, the New York Stock Exchange has adopted the following polices with regard to the classification of securities industry and public arbitrators and to **the exercise of challenges for cause:**

. . .

6. All arbitrators shall read and become familiar with the Code of Ethics for Arbitrators developed by the American Bar Association and the American Arbitration Association."

That cross-reference in the Guidelines makes the Code of Ethics a part of the parties' agreement. The part of the Code of Ethics that addresses recusal and withdrawal upon the request of one party to a proceeding is Canon II E. That canon provides in relevant part as follows:

Canon II

An arbitrator should disclose any interest or relationship likely to affect impartiality or which might create an appearance of partiality or bias.

. . .

E. . . . In the event that an arbitrator is requested to withdraw by less than all of the parties because of alleged partiality or bias, the arbitrator should withdraw unless either of the following circumstances exists.

1. If an agreement of the parties, or arbitration rules agreed to by the parties, establishes procedures for determining challenges to arbitrators, then those procedures should be followed; or,

2. if the arbitrator, after carefully considering the matter, determines that the reason for the challenge is not substantial, **and** that he or she can nevertheless act and decide the case impartially and fairly, **and that withdrawal would cause unfair delay or expense to another party or would be contrary to the ends of justice.**

[Emphasis added.]

Canon II E 1 takes us right back to the parties' agreement and the NYSE Arbitration Rules. But the parties' agreement and the NYSE

Arbitration Rules establish no procedures applicable to this recusal request -- no procedures, that is, apart from the Guidelines' cross-reference right back to the Code of Ethics. Thus, looking exclusively to Canon II E 1 to solve this problem causes cross-referencing back and forth between the canon and the NYSE Rules *ad infinitum*. It is what computer programmers call an "infinite loop." This renders Canon II E 1 devoid of meaning. Accordingly, Canon II E 2 provides the only substantive guidance in this situation. [Arbitrator] therefore can remain on the panel only if she can satisfy the second item above, Canon II E 2, in all respects.

Canon II E 2 establishes a three-prong conjunctive test. [Arbitrator] must satisfy all three conditions in order to pass that test.

The third prong is the one she cannot pass. The initial case management conference in this matter was held just two weeks ago. A hearing has been scheduled. It is months away. A second pre-hearing conference has been scheduled as well, but that will be presided over by the panel chair only -- the industry arbitrator will not even participate.

As a result, replacing [Arbitrator] at this early date requires only the appointment of an arbitrator who is available on the scheduled hearing dates. Replacing [arbitrator] therefore cannot cause any unfair delay or expense to any party. Nor is there any basis to argue that replacing her would be contrary to the ends of justice. Thus, even if [arbitrator] could say with a straight face that the reason for Claimant's challenge were not substantial and that she could remain impartial and fair, she cannot satisfy the third prong of Canon II E 2 of the Code of Ethics. It is simply too easy to replace her at this early stage in the proceedings. The Code of Ethics therefore requires [arbitrator] to withdraw.

3. [Arbitrator] Should Withdraw Even If She Thinks This Is A Close Question

It is amazing that the NYSE even would have thought about denying the causal challenge in the current environment of growing distrust of arbitration. As recently as January of this year, the NASD was lambasted by a New York court for failing to disqualify an arbitrator. See *Glynn v. First Allied Securities, Inc.*, New York Law Journal, January 30, 2003. The *Glynn* court stated that it was "extremely disappointing and distressing . . . that the NASD has not as a matter of discretion disqualified [the challenged arbitrator] to dispel any potential future problems and ensure the integrity of its proceedings." The Court went on to state that it was "a mystery to the Court why the NASD would not . . . rectify the problem before issuance of an award."

The court continued, stating as follows:

> "The NASD should make every effort to ensure that the integrity of its arbitration proceedings is beyond reproach. See, Matter of Shomron [Fuks], 286 A.D.2d 587, 589 (1st Dep't 2001) (because courts defer to arbitration awards **"'it is imperative that the integrity of the process, as opposed to the correctness of the individual decision, be zealously safeguarded'"** [quotation omitted]), lv. denied 97 N.Y.2d 607 (2001)."

[Emphasis added.]

The NASD's conduct and the resulting published and well-publicized opinion gave SRO arbitration a black eye. Keeping the challenged arbitrator on this panel, with her history of representation by Respondent's counsel, has the potential to do the same. Significantly, after the New York court's opinion became public, the NASD reversed its position and removed the challenged arbitrator. The black eye could have been prevented if the NASD had made that correct decision in the first place.

All of this is made worse by the NYSE's failure to follow its own guidelines in this matter. The NYSE's "Guidelines for Classification of Arbitrators" -- contained in Article IX of the NYSE Constitution and already quoted in part above -- provide as follows:

> **"7. Any close question** on arbitrator classification or **on challenges for cause shall be decided in favor of public customers."**

[Emphasis added.]

This situation does not present a close question; [arbitrator] should have been removed from the arbitration panel immediately upon the Claimant's request. What the NYSE's Guideline 7 adds to the analysis is that, even if [arbitrator] believed a relationship of client and counsel presented a "close question," she still would be obligated to recuse herself and step aside.

4. The Respondent's Zealousness Supports Claimant's Argument

Claimant's concerns about [arbitrator]'s neutrality and fairness have been exacerbated by the zealousness with which Morgan Stanley and [opposing counsel] have argued for her retention. I note that [opposing counsel] penned two separate pieces of correspondence in support of [arbitrator]'s participation on the panel in quick succession and

without even waiting for a response from the Claimant. That apparent eagerness on [opposing counsel]'s part suggests that there is something more involved and that he and/or Morgan Stanley wants [arbitrator] on this panel very badly. Can you blame [claimant] for being uncomfortable under these circumstances? Wouldn't any investor feel uncomfortable with something like this going on? Indeed, isn't this the very sort of appearance of partiality and bias that led California to pass a law regarding arbitrator disclosure?

5. Claimant Disqualifies [Arbitrator] Pursuant to California Arbitrator Ethics Statutes

All of this brings us to the final point of this letter. It is our understanding that [arbitrator] is in California. She therefore is subject to the California Judicial Council's Ethics Standards for Neutral Arbitrators (the "California Ethics Standards"). She cannot avoid those standards by the simple expediency of stepping out of state for the hearing, a few days near the end of a year of pendency of the case. Indeed, Standard 4(a) of the California Ethics Standards provides as follows:

> "Standard 4. Duration of duty
>
> (a) Except as otherwise provided in these standards, an arbitrator must comply with these ethics standards from acceptance of appointment until the conclusion of the arbitration. "

If the NYSE has not informed [arbitrator] of her obligation under California law to comply with the California Ethics Standards, it has done her a disservice. She has a right to know about her legal obligations. Our concern, however, is with our client's rights. [Arbitrator] has not made all of the disclosures required by the California Ethics Standards. Moreover, the disclosure she did make renders her unacceptable to Claimant. Thus, Claimant exercises his right to disqualify [Arbitrator] from the arbitration panel under section 1281.91 of the California Code of Civil Procedure.

While there may be cases in which [arbitrator] will be an appropriate arbitrator, this is not one of them. She must withdraw from this case and arbitrate another day. And the NYSE must appoint, at random, another arbitrator who is available on the hearing dates set for this matter.

Sincerely,
Tracy Pride Stoneman

cc: \\

\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\\

Next, the Reply to Respondent's Opposition

\\
\\ [title]
New York Stock Exchange, Inc.
20 Broad Street
New York, New York 10005

VIA FACSIMILE ONLY TO 212-656-2727

Re: [Claimant] v. Morgan Stanley, NYSE Case Number 2002-

Dear \\:

This letter will address the hodgepodge of incorrect legal arguments contained in Respondent's letter dated April 15, 2003. Before we address those matters, however, permit us an observation. True to our assertion in our April 7 letter, [opposing counsel] has made one thing very clear: Morgan Stanley is extremely eager to have arbitrator [arbitrator] on this panel.

There must be some reason for this. In decades of law practice, I never have seen a party work so hard to fight another party's causal challenge; and I never have seen a party try so hard to cajole an arbitrator who ethically should recuse into staying around. Usually, both parties want arbitration awards to be as clean and non-vacatable as possible. A vacatur means that the arbitration wasted not only the parties' time and resources but the time and resources of the other arbitrators as well.

Indeed, causal challenges and motions to recuse (they aren't the same thing, despite Respondent's attempts to equate them) really are between the arbitrator and the challenging or moving party. When the other party, early in the proceedings, pushes the questioned arbitrator to stay on board, it invariably raises the very reasonable suspicion that something else is going on. If ever there is to be an appearance of impropriety, that sort of behavior brings it into focus.

That observation having been made, the Respondent's scattergun arguments provide plenty of text but little substance. The following paragraphs address them.

This is a Motion for Recusal

Early and repeatedly in its letter, Respondent attempts to blur the distinction between causal challenges and motions for recusal. It pretends that, once a New York Stock Exchange staff attorney – an employee of a securities industry trade association – has ruled on a challenge for cause, that is the end of the matter, the unappealable, unstoppable word from on high.

The reality is otherwise. A challenge for cause is addressed to the New York Stock Exchange. A request for recusal is directed to the arbitrator herself.

The arbitrator has a veto on her own service. It is the arbitrator whose reputation depends on her adherence to the Code of Ethics for Arbitrators. It is the arbitrator whose reputation suffers if she clings to an assignment from which she should exercise caution, avoid the appearance of impropriety, and withdraw.

The NYSE may not care one whit whether word gets out and the arbitrator's reputation suffers. The NYSE may care far more about the interests of its larger members than it cares about anyone else, whether arbitrator or investor. But the arbitrator has a right to feel otherwise. Indeed, arbitrators frequently choose to withdraw when they do not have the confidence of all parties, even though the NYSE or the NASD, with their own very different motivations, might previously have denied a challenge for cause.

The Arbitrator Must Receive The Motion

The ultimate bit of ridiculousness in Respondent's argument comes at both the beginning and the end of its letter, in which it requests that the recusal request not even be shown to the arbitrator. I heard an attorney for a broker-dealer make a suggestion like that only once before – unsuccessfully, of course. That was in 1993 or 1994, and I figured that it was a fluke that I never would hear repeated. Yet here it is again. Claimant's motion for recusal is directed to the arbitrator. The NYSE has no right to hijack it, even if doing so would be in its member's interest.

The Prior Attorney-Client Relationship Obligates [Arbitrator] to Withdraw

Respondent's counsel next argues that, because he last represented [arbitrator]'s company more than three years ago, there can be no disqualification based on a past business relationship. He tries to base that argument on *The Arbitrator's Manual*.

But Respondent's argument fails for several reasons. The first is that, as Respondent admits, the three years is but an **example** from *The Arbitrator's Manual*. It is not a cut-off or a bright-line test. It is disingenuous for Respondent to suggest otherwise.

It is no more honest for Respondent to describe the relationship – which occurred in the context of a case that [opposing counsel] fought for [arbitrator]'s company five years ago -- as "long ago." Nor does Respondent enhance its credibility by describing [arbitrator] as just "an employee" when the reality is that she was the president of the company.

Respondent compounds its credibility problem by asserting later in its letter that [arbitrator] is no longer an employee, glossing over the fact that she was the company's president until just a few weeks ago. Maybe Respondent's disingenuousness should not come as a surprise. If honesty and credibility were important to Morgan Stanley, it would not find itself in a position of agreeing to pay a fifty million dollar fine as partial penance for its deception and abuse of the public.

The president/counsel relationship is problematic for still another important reason. [Arbitrator], the company over which she presided and [opposing counsel] all undoubtedly will assert attorney-client privilege regarding all of their prior communications. They will assert the privilege because it was [opposing counsel]'s representation of [arbitrator]'s company in a litigation matter that gave rise to those communications. But there is no reason to believe that the subject matter of the conversations between [arbitrator] and [opposing counsel] was limited strictly to the prior litigation. It would be unusual if conversations between counsel and the president of a corporate litigant were confined to a single topic.

Only [arbitrator] and [opposing counsel] know what they discussed. Only they know the full details of the relationship. That is the crux of the problem. Claimant and his counsel do not know and most likely never will know what was said. Reassurances from the arbitrator and opposing counsel, the lone parties to those private conversations, give Claimant no comfort. [Arbitrator] simply cannot ask for the Claimant's blind trust under these circumstances. She must live up to her ethical obligations, step off the panel, and allow an arbitrator with an unquestioned history to assume her place. She must reserve her arbitral skills for cases where there is no prior relationship to create an appearance of impropriety.

Respondent's argument also sidesteps its primary problem: this is a motion to recuse. The standards that the Arbitrator's Manual and the NYSE Arbitration Rules put forth for causal challenges are not the exclusive rules governing arbitrators' decisions on motions to recuse. Rather, the latter are subject to ethical rules guiding arbitrator conduct – in this case, the Code of Ethics for Arbitrators -- as well as all applicable law and the arbitrator's own right to develop a reputation for leaning toward conduct that is more ethical rather than less so.

A Prior Causal Challenge Does Not Preclude a Motion to Recuse

Respondent next argues that, once a causal challenge has been made, a party is not able to go directly to an arbitrator and request that the arbitrator withdraw. The

Respondent's assertion is nonsense. It has put forth no authority to support its bald assertion; it cannot, for there is none.

The NYSE's Decision Does Not Obligate The Arbitrator to Remain on the Panel

Respondent's next argument is yet another attempt to equate recusal motions with causal challenges. The two are different. They are not even addressed to the same party. No amount of arm-waving by Respondent can make them the same.

Beyond that, the Respondent's suggestion that the arbitrator should ignore the right and ethical because the NYSE has not seen fit to act is absurd. The NYSE is not subject to the Code of Ethics for Arbitrators. The arbitrator is. Indeed, the NYSE's own constitution says that it is the arbitrators – not the NYSE itself – who are obligated to "read and become familiar with the Code of Ethics for Arbitrators." If the arbitrator refuses to withdraw where there is the appearance of impropriety, it is her reputation that suffers.

Arbitration is not a Briar Patch

Respondent next has the gall to suggest that Claimant should prefer to keep [arbitrator] on the panel on the theory that she will "'bend over backwards' at the hearing to demonstrate impartiality to the complaining party to the detriment of the party opposing removal." Those are the Respondent's words, not ours. The fact that Respondent even would make an argument like that demonstrates just how far the Respondent is willing to go in its efforts to keep this arbitrator on the panel. It makes the Claimant more fearful of this situation, not less so.

Claimant is entitled to an arbitrator who actually is impartial, not one who would have to "bend over backwards" to try to look impartial. Beyond that, if Respondent's counsel really thought that keeping [arbitrator] on the panel would be "to the detriment of" his client, he would be duty-bound to seek her removal himself. He has not done so.

Respondent's argument is like the rabbit professing fear of the briar patch. Claimant doesn't want a briar patch. He wants a level playing field. The field cannot be level when it is tilted under the weight of an arbitrator who chose Respondent's counsel to represent her company's interests a few short years ago.

[Arbitrator] is in California and Must Comply With California Law

The next area of controversy arises out of [arbitrator]'s failure to comply with section 1281.91 of the California Code of Civil Procedure. First, Respondent asserts that the argument is waived if not made in the initial causal challenge. Respondent's counsel made that rule up out of whole cloth. He undoubtedly knows that NYSE Arbitration Rule 609 states that "there shall be unlimited challenges for cause." Causal challenges are unlimited for good reason: to protect the integrity of the process. The idea is to make sure that cases are not decided by biased arbitrators and to avoid even the appearance of impropriety. No amount of attempted rulemaking by Respondent's counsel can change that. And just as the NYSE Arbitration Rules place no limits on challenges for cause, they also place no limit on recusal requests.

Next, Respondent misrepresents in several respects the import of the Portland hearing situs. First, he suggests that this arbitration is not subject to California law. But he is off the mark. Thanks to Standard 4, *arbitrators* in California are subject to the Ethics Standards and must make all disclosures required by law. Only the hearing of this case will take place outside of California. The rest of this arbitration – all discovery, all pre-hearing conferences, all briefing and oral arguments concerning motions, all decisions regarding motions – will take place ***in California.***

If [arbitrator] serves, she will be in California during the entire case save a few days near the end. For the reasons stated in Claimant's April 7 letter, [arbitrator] is subject to California's Ethics Standards for Neutral Arbitrators and must comply with them. Failure to do so is a violation of law and may be enjoined under section 17200 *et seq.* of the California Business and Professions Code.

Respondent then states that Claimant agreed to waive the California arbitrator disclosure requirements by electing to proceed with a hearing outside of California. The Respondent states that, if the Claimant did not wish to waive those rights, he could have insisted upon a hearing in California.

Respondent's statement is just plain false. Respondent knows full well that, in order to proceed in California, Claimant would have had to sign a written waiver of his rights under the California arbitrator disclosure law. But the Claimant was unwilling to waive rights put in place for his and the public's protection by the elected representatives of thirty million people. So he moved ***the hearing of*** his case to Oregon, in keeping with the NYSE's rule allowing him to do so. California arbitrators sitting on this case remain subject to California laws and must conduct themselves accordingly. Failure to do so is illegal and can be enjoined.

Finally, in its parting shot, Respondent's footnote 2 makes reference to the NYSE's position that California's arbitrator disclosure

rules do not apply to NYSE arbitration. But Respondent, as one of the NYSE's most prominent members, undoubtedly is aware that the NYSE, which felt strongly enough about that position to advance it in federal court, got tossed out of court. The standards apply, even if the NYSE wishes they did not.

It would not surprise me to see Respondent's counsel reply to this letter. Indeed, this correspondence could go on indefinitely. But there is one fact, one glaring reality, that Respondent never will be able to overcome: this arbitrator does not have the confidence of both parties to this dispute. Right now – when she can be replaced by a randomly-selected industry arbitrator with no inconvenience to either party – she has no ethical way to cling to this assignment. She must withdraw.

Claimant reiterates his demand that his April 7, 2003, letter – and now this one as well – be forwarded to [arbitrator] immediately.

Very truly yours,

Scot D. Bernstein

SDB:msw

cc: \\

Recent Arbitration Awards

by Ryan Bakhtiari

Mr. Bakhtiari is an attorney with the law firm of Aidikoff & Uhl in Beverly Hills, CA. His email address is RBAKHTIARI@aol.com and he can be reached at 310.274.0666.

Kyong Il Kym Dobson v. A.G. Edwards & Sons, Inc. and Leon David Clayton, NASD Case No. 02-00300

Claimant asserted the following causes of action: failure to supervise, respondeat superior, breach of fiduciary duty, failure to execute, breach of contract, negligence, negligent misrepresentation, breach of the implied covenant of good faith and fair dealing, violation of state securities laws, NASD rules of fair practice and NYSE rules involving the sale of stock restricted under Rule 144. Claimant requested compensatory damages, interest, costs and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimant's claims and costs. Respondents filed a counter claim requesting that Claimant indemnify Respondents for any damages recovered from Respondents, costs and attorneys fees.

1. The panel found Respondent A.G. Edwards liable to Claimant for $268,762.50 in compensatory damages.

2. The panel found Respondent A.G. Edwards liable to Claimant for $43,000 in attorneys fees pursuant to California Civil Code Section 1717 and the attorney fee provision found in the Total Asset Account Agreement and the various Client Representation Letters.

3. The panel denied the claims against Respondent Leon David Clayton.

A.G. Edward's counsel took the unusual step of filing a counterclaim for contractual indemnity seeking attorneys fees and costs for Claimant's claim against Respondents for failing to timely remove the restrictive legend and sell 144 stock. The counterclaim was denied by the panel and contributed to the award of attorneys fees received by Claimant. This award reaffirms that broker-dealers have a duty to promptly handle a client's request to clear and sell their restricted stock.

Claimant's Counsel - Brett Alcala, Esq. of Alcala Law Firm

Respondents' Counsel - Michael Pulliam, Esq. of Steefel Levitt & Weiss

Claimant's Expert - Robert Weinman
Respondents' Expert - John Maine

Hearing Situs - San Francisco, California

Arbitrators - William J. Petzel, J.D., Public/Chairman; Charles B. Stark, Jr., Public; Andrew R. Epstein, Industry

Ellen Finkelstein v. Roan-Meyers Associates, LP and Eric Noveshen, NASD Case No. 02-00160

Claimant asserted the following causes of action: violations of Florida Statutes 517.301 and 517.211 for churning and fraud, breach of fiduciary duty, common law fraud, negligent supervision, respondeat superior, negligence and breach of the NASD Rules of Fair Practice and NYSE Rules involving the purchase of high tech stocks in Claimant's IRA and the use of margin to purchase high tech stocks in Claimant's other accounts. Claimant requested compensatory damages, interest, punitive damages, costs and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimant's claims.

Prior to the hearing the panel granted Claimant's Motion to Bar Defenses of Respondents and granted Claimant's Motion to Strike Answer of Respondents. Thereafter, Respondents filed motions to reschedule the hearing, to permit

Respondents to put on defenses and witnesses. All motions were denied by the panel.

1. The panel found Respondents jointly and severally liable to Claimant for $125,000 in compensatory damages plus interest at the statutory rate from March 30, 2001 until the Award is paid in full. Damages are awarded pursuant to Florida Statutes Sections 517.301 and 517.211 and the common law causes of action.

This case and award is significant because the panel barred Respondents from presenting evidence and witnesses at the arbitration hearing as a sanction for their failure to respond to the statement of claim or discovery propounded by Claimant. Respondents' counsel appeared at the arbitration hearing and was allowed to cross-examine Claimant's witnesses and present and opening statement and closing argument.

Claimant's Counsel - Melanie S. Cherdack, Attorney at Law of Genovese Joblove & Battista

Respondent's Counsel - Charles Lake, on behalf of Roan-Meyers and Delmer C. Gowing, III, Esq. on behalf of Eric Noveshen

Claimant's Expert - Eric Norstedt
Respondents' Expert - None

Hearing Situs - Boca Raton, Florida

Arbitrators - Steve E. Eisenberg, Public/Chairman; Jerold Levine, Public; Carl J. Hegner, Industry

William Hamilton Hall et al. v. Morgan Stanley Dean Witter and Joseph Paul Schlater, NASD Case No. 02-00300

Claimants asserted the following causes of action: suitability, fraud, deceit, omission of material fact, negligent misrepresentation, breach of fiduciary duty, breach of the implied covenant of good faith and fair dealing, violation of Securities Exchange Act of 1934 and failure to supervise. Claimants requested compensatory damages, interest, punitive damages, costs and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims and costs.

1. The panel found Respondents jointly and severally liable to Claimant for $1,766,000 in compensatory damages.

The Claimants in this matter allege an unsuitable hedge of their concentrated America Online ("AOL") concentrated stock holdings received as a result of employment with AOL. Respondents induced Claimants to purchase a Prepaid Forward Contract by exchanging $7.1 million of their AOL stock for $4.975 million in cash. Claimants alleged and proved that the Prepaid Forward Contract provided no significant benefit to Claimants. This is the first known case where a brokerage firm has been held liable for recommending and implementing a hedging/defensive strategy that was unsuitable.

Claimants' Counsel - Cary S. Lapidus, Esq. of Law Offices of Cary S. Lapidus

Respondent's Counsel - Gilbert R. Serota, Esq. of Howard Rice Nemerovski Canady Falk & Rabkin
Claimant's Expert - Richard Zack and James Sommer

Respondents' Expert - Allen Rockler and Lyell Ekdahl

Hearing Situs - San Francisco, California

Arbitrators - James H. Schilt, Public/Chairman; Walter J. Huntley, III, Public; Neil G. Clem, Industry

Aleks Horvat and Michel Horvat v. Merrill Lynch, Pierce, Fenner & Smith, Inc., NASD Case No. 01-02577

Claimants asserted the following causes of action: breach of fiduciary duty, breach of contract, unsuitability, unauthorized trading, churning, fraud, constructive fraud, violation of state and federal securities laws and failure to supervise involving the trading in SDL, Inc., Broadcom Corp., PMC Sierra and other technology related securities. Claimants requested compensatory damages, lost opportunity costs, interest, punitive damages, costs and attorneys fees.

Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims and costs.

1. The panel found Respondent Merrill Lynch liable to Claimant Aleks Horvat for $1,884,463 in compensatory damages. The panel found Respondent Merrill Lynch liable to Claimant Michel Horvat for $253,156 in compensatory damages.

2. The panel ordered that the Award shall bear interest at a rate of 6 percent on any unpaid balance 30 days after receipt of the Award and on any balance that remained unpaid after a court denies any motion to vacate.

This claim was based on Merrill Lynch's failure to recommend suitable securities and follow an

agreed upon trading strategy in the accounts of Claimants. Claimants alleged and proved that Merrill Lynch failed to implement any stop loss discipline or risk management strategy in the accounts, over concentrated the accounts in the technology sector, traded without prior authorization and excessively traded Claimants accounts. Merrill Lynch argued that Claimants were successful and sophisticated customers that would have sustained similar or greater damages compared to the actual losses they suffered because the technology market and NASDAQ declined over the same time period. This "market adjusted damages" defense was rejected by the panel. Merrill Lynch argued that Claimant Aleks Horvat ratified the activity by keeping a running profit and loss schedule in a Quicken computer program, by speaking to the broker daily, by the heavy email traffic between Claimant Aleks Horvat and the broker and by failing to complain. The panel rejected the ratification defense. This case is significant for both the size of the award and the panel's rejection of the ratification and market adjusted damage defense.

Claimants' Counsel - Robert A. Uhl, Esq. and Ryan K. Bakhtiari, Esq. of Aidikoff & Uhl

Respondent's Counsel - Thomas L. Taylor, III, Esq. and Alan Petlak, Esq. of Morgan, Lewis & Bockius, LLP

Claimant's Expert - Edward Horwitz
Respondents' Expert - John Bates of Bates Private Capital

Hearing Situs - Los Angeles, California

Arbitrators - Jerry Ellner, Public/Chairman; Leonard M. Vosen, Ph.D., Public; Walter W. Klosterman, Industry

Steven Isaacson v. H&R Block Financial Advisors, Inc. and Evan C. Hunt, NASD Case No. 01-05343

Claimant asserted the following causes of action: fraud, unauthorized trading, negligence, misrepresentations and omissions, unsuitable investment recommendations, failure to supervise, violations of the Illinois Securities Act of 1953 and NASD Conduct Rules, breach of contract, constructive fraud, breach of fiduciary duty in connection with purchases of VA Linux Systems, Inc. IPO. Claimants requested compensatory damages, interest, punitive damages, costs and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimant's claims.

1. The panel found Respondent H&R Block solely liable to Claimant for $27,693.90 in compensatory damages plus interest at 10 percent from December 10, 1999 to January 21, 2003.

2. The panel found Respondent H&R Block solely liable to Claimant for $12,109.44 in attorneys fees pursuant to 815 ILCS 5/13 Sec. 13A(1).

This award is important because the single arbitrator panel held H&R Block liable for placing a market order on a "hot" IPO. The resulting market order for 1,000 shares was filled at $248 per share which placed approximately 50 percent of the Claimant's net worth in a single security.

Claimants' Counsel - Andrew Stoltmann, Esq. of Maddox, Koeller, Hargett & Caruso

Respondent's Counsel - Lisa S. Fildes, Attorney at Law and Howard Klausmeier, Esq. of H&R Block Financial Advisors

Claimant's Expert - None

Respondents' Expert - None

Hearing Situs - Chicago, Illionis

Arbitrators - Frank A. Dusek, CPA, Public/Chairman

Florence Ziehm and Donna Shantz v. Linsco/Private Ledger Corp. and Terry Gourley, NASD Case No. 01-06809

Claimants asserted the following causes of action: fraud, negligence, unsuitable investment recommendations, failure to supervise, violations of the Illinois Securities Act of 1953 and NASD Conduct Rules, breach of contract, constructive fraud, breach of fiduciary duty, negligence, and respondeat superior in connection with transactions in 3dshopping.com stock. Claimants requested compensatory damages, interest, punitive damages, costs and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims, costs and attorneys fees.

1. The panel found Respondents jointly and severally liable to Claimant Florence Ziehm for $63,547 in compensatory damages, $63,547 in punitive damages, $21,161 in attorneys fees and $2,137 in costs

2. The panel found Respondents jointly and severally liable to Claimant Donna Shantz for $40,266 in compensatory damages, $40,266 in punitive damages, $13,408 in attorneys fees and $2,137 in costs.

3. The panel assessed all forum fees against Respondents jointly and severally.

This award is significant because of the size of the total award of $246,469 relative to the compensatory damages of $75,981 sought by the Claimants.

Claimants' Counsel - Andrew Stoltmann, Esq. of Maddox, Koeller,

Hargett & Caruso

Respondent's Counsel - David J. Freniere, Esq. and Amanda M. Candelmo, Attorney at Law of Linsco/Private Ledger Corp.

Claimant's Expert - None

Respondents' Expert - None

Hearing Situs - Chicago, Illionis

Arbitrators - Stephen E. Smith, Esq., Public/Chairman; Hon. Michael S. Jordan, Public; Ann Wilhelmina Kuppe, Industry

Announcements From The PIABA Office

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Upcoming Events:

PIABA Analyst Meeting, June 28, 2003. O'Hare Hilton, Chicago, Illinois.

PIABA Board of Directors Meeting, July 19-20, 2003. The Heathman Hotel, Portland, Oregon.

PIABA 12th Annual Meeting and *Securities Law Update*, October 22 - 26, 2003. La Quinta Resort, La Quinta, California.

Annual Business Meeting, October 23, 2003 from 11:45 a.m. - 1:45 p.m.. La Quinta, Resort, La Quinta, California.

For more information pertaining to upcoming PIABA meetings, contact the PIABA office or visit the PIABA website at www.PIABA.org.

New Members:

(since publication of Winter 2002 issue of *PIABA Bar Journal*)

Aismara Abreu	(215) 735-0195
Michael Addison	(813) 223-2000
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Jeremy Chalmers	(601) 656-2152
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Kevin P. Conway	(212) 938-1800
Theodore Davis	(718) 789-6789
Heath Denoncourt	(850) 681-6416
Michael Deutsch	(212) 682-3939
Michael B. Dubin	(215) 887-2658
Wade Eaton	(585) 232-3730
David Ennis	(239) 732-7775
Wesley H. S. Everett	(919) 942-8002
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Thomas Frost	(619) 696-9500
David Graven	(030) 792-5595
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Jonathan Greene	(561) 393-9733
Stuart I. Grossman	(305) 536-1112
Debra Hayes	(713) 622-7271
Chad Hemmat	(303) 839-5000
John F. Hill	(330) 376-4558
Stephen Krosschell	(727) 524-8486
Jeffrey Kruske	(913) 648-3220
Charles S. Liberis	(850) 438-9647
Jack Lurton	(850) 432-2451
Michael B. Lynch	(732) 246-7080
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Angela Hayden Magary	(617) 542-0896
Mark Mahoney	(920) 984-4529
Helen Mangano	(914) 779-0332
Dan Mars	(601) 656-2152
Gary E. Martinelli	(413) 745-4677
Steven M. McCauley	(859) 233-1805
Wm. Jemison Mims, Jr.	(850) 435-7062
J. Anthony Penry	(919) 833-9449
Matthew Pero	(213) 627-5300
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Michael Piazza	(972) 938-7279
Michael Radford	(615) 370-9448
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Thomas Andrew Schultz	(949) 640-8222
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