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PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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The PIABA Bar Journal is interested in receiving submissions from PIABA members and non-members, including experts, mediators, arbitrators and securities regulators. Manuscripts are reviewed prior to publication, and are accepted for publication based on, inter alia, quality, timeliness and the subject's importance to PIABA and the arbitration/investor-attorney community. Individuals interested in contributing in the future should contact Andrew Stoltmann, Robin Ringo or any member of the Board of Editors. Your comments and contributions are always welcome.

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Summer, 2004 issue of *PIABA Bar Journal* is July 10, 2004. All submissions should adhere to the following format:

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President's Message

Charles W. Austin, Jr.

Charles W. Austin, Jr. is an attorney in Richmond, Virginia whose practice is devoted exclusively to the representation of investors in disputes with the securities industry.

"I'm mad as hell and I'm not going to take it anymore!"

This memorable proclamation by Peter Finch in the 1976 movie "Network" is an appropriate battle cry for investors facing the current litany of abuses of the arbitration system by an industry under siege and intent on limiting its exposure by skewing the arbitration process in any way it can get away with. Fortunately, in recent months, there have been a number of developments which will enable the public investor to staunch this abuse of the system and advance PIABA's mission of "leveling the playing field" for the public investor in arbitration.

CONFIDENTIALITY

As the industry continues to face unprecedented levels of claims, it is increasingly invoking the notion of "confidentiality" in an attempt to prevent public investors from sharing information about firm operations and practices and to conceal from view of the SROs and arbitrators the industry's abuses of the arbitration process itself. This is not a new development, but rather is the result of years of arguments which rest on disingenuous characterizations of otherwise generic compliance materials as "proprietary trade secrets" and the purposeful distortion of that provision in the SICA *Arbitrator's Manual* which provides that "[a]rbitrators must consider all aspects of an arbitration to be confidential."

In response to concerns expressed by PIABA and the hard work of PIABA members on the National Arbitration and Mediation Committee, an article has been published in the April 30, 2004 issue of the NASD *Neutral Corner* addressing the issue of confidentiality and lending some clarity to its function and proper role in arbitration. The article can be found on the NASD's Dispute Resolution website and is supposed to be published in the printed version of the *Neutral Corner* for dissemination to arbitrators in the near future. This article should go a long way toward helping all of us defeat the unreasonable confidentiality demands of industry respondents which have become a staple of current SRO arbitration practice.

Overly broad confidentiality agreements are also increasingly being demanded as a *quid pro quo* of settlement. In response to this growing area of abuse, the NASD has issued *Notice to Members* 04-44 clarifying the extent to which these confidentiality demands can be extracted. It is important that all of us hold the industry well within the parameters the NASD has set. Continued acquiescence to unreasonable industry demands in violation of NASD strictures only contributes to these problems.

SUBPOENAS

The practice of counsel for industry respondents issuing and serving invalid subpoenas has reached epidemic proportions. This attempt to circumvent the law and arbitration rules in order to engage in an overreaching invasion of customer privacy must be stopped. For those of us practicing in the 2, 3rd and 4th Circuits, at least, the law is clear that even arbitrators have no authority under the Federal Arbitration Act to issue third party subpoenas purely in aid of discovery. *See e.g.,* National Broadcasting Co. v. Bear Stearns & Co., 165 F.3d 185 (2d Cir. 1999); Hay Group, Inc. v. E.B.S. Acquisition Corp., 360 F.3d 404 (3d Cir. 2004); Comsat Corp. v. National Science Foundation, 190 F.3d 269 (4th Cir. 1999); and Gresham v. Norris, No. 04-MC-8 (E.D. Va. February 10, 2004).

Every improperly issued subpoena should be met with letters to the recipients of the subpoenas reminding them of the invalidity of the putative subpoena and of any privacy obligations the recipient may have toward your client. PIABA continues to urge the SROs to put a halt to this abusive practice.

EXPUNGEMENTS

In December of 2003, the SEC approved NASD Rule 2130, which endeavors to make it more difficult for brokers to "buy" clean records by demanding expungement as a condition of settlement of cases and to impose guidelines for arbitrators who may, in the past, have operated under the mistaken assumption that every arbitration in which a registered representative prevailed warranted an expungement of the claim from the CRD. Although the new rule only affects cases filed on or after April 12, 2004, it came to PIABA's attention that certain attorneys and firms were already testing the limits of - and the loopholes in - the new rule by demanding as a condition of settlement sworn affidavits from investors completely disclaiming the merits of their claims. This development was troubling to PIABA on many levels, and we immediately brought it to the NASD's attention. Apparently sharing PIABA's concerns, NASDR issued *Notice to Members* 04-43, warning members and associated persons that such attempts to circumvent the new expungement rule will not be tolerated and that it may subject those participating in such a ruse to sanctions.

UNIFORM SUBMISSION AGREEMENTS

While not new, the industry practice of failing and/or refusing to file Uniform Submission Agreements, or alternatively, filing Uniform Submission Agreements which differ in content from the standard form used and approved by the SROs, has become much more widespread over the last few years. An investor's failure to insist that Respondents file a proper and fully executed Uniform Submission Agreement can have significant negative consequences for the investor in post-award proceedings. There is also case law in several jurisdictions which holds that the execution and filing a Uniform Submission Agreement by parties in a case where a request for attorneys' fees has been made satisfies the contractual element of the "American Rule" and thereby vests arbitrators with authority to grant such attorneys' fees.

Again in response to concerns raised by PIABA and its members on the NAMC (not to mention the inability of the industry to justify the indefensible practice of failing/refusing to file proper Uniform Submission Agreements), the NASD issued *Notice to Members* 04-11, reminding members of their obligation to file these agreements and setting forth certain amendments to the Initial Pre-Hearing Conference script for arbitrators to address this situation. I urge you all to read it and insist that a proper Uniform Submission Agreement is submitted by industry respondents in every case.

Mad or not, you don't have to take it anymore. The public investor deserves better. Let's all do our part to ensure they get it.

From the Professor A Hedge Fund Primer

By Joseph C. Long

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After a hiatus of more than a year, this column returns and hopefully will continue as a regular feature of the Journal. For the first article in the resumed series, I have selected the topic of hedge funds which have been in the news a great deal recently, but are not generally understood by most securities practitioners.

Hedge Fund Background

Recently, hedge funds[1] have received a great deal of attention in the press and from state and federal regulators.[2] This interest by the SEC led the SEC staff to complete a study of hedge funds in late 2003.[3] However, hedge funds are not new nor is the investigation of such funds. The funds themselves date back, at least, to 1949,[4] and there have been two previous studies[5] of the hedge fund industry prior to the current SEC Staff Report.[6] The President's Working Group on Financial Markets also reviewed the hedge fund industry in 1999.[7]

The present investor interest

[1] There are both domestic and international hedge funds. U.S. Securities and Exchange Commission Staff Report, "Implications of the Growth of Hedge Funds" 9-10 (Sept. 2003). This subchapter focuses generally on the domestic funds. Offshore hedge funds may be organized or operated by foreign or U.S. financial institutions or their subsidiaries. *Id.* To the extent that these off-shore funds are sold from off-shore to persons in the United States, the funds and the personnel selling them are subject to **both** the federal and state securities registration requirements, the broker-dealer and agent registration requirements, and the anti-fraud provisions. *Id.*

[2] See Testimony of William H. Donaldson, Chairman, United States Securities and Exchange Commission, Concerning Investor Protection Implications of Hedge Funds, Before the Senate Committee on Banking, Housing, and Urban Affairs, 2003 WL 1902915 at *1 (Apr.10, 2003) (hereinafter "Testimony, p. __")

[3] U.S. Securities and Exchange Commission Staff Report, "Implications of the Growth of Hedge Funds" (Sept. 2003)(hereafter "Report, p. __"). The Report can be viewed at http://www.sec/gov/news/studies/hedgefunds0903.pdf. The SEC also held a Round Table on Hedge Funds. In re Hedge Fund Roundtable, File No. 05-007-03 (May 14-15, 2003)(hereinafter Roundtable, p. __") Unfortunately, the full transcript of the Roundtable has not been released by the SEC. However, the transcript provides a good overview of the hedge fund industry since many of the speakers were from that industry and is more critical than the Staff Report.

[4] *Id.* at p.*3. The first hedge fund was the Jones Hedge Fund. 2003 WL 1902915, Testimony, p. *1.

[5] SEC Commissioner Paul S. Atkins reports that the SEC did studies of hedge funds in 1969 and 1992. Remarks of SEC Commissioner Paul S. Atkins Before The ABA Section of Business Law-5th Annual Conference of Private Investment Funds, 2004 WL 724425 at p.*2 (Mar. 2, 2004)(Hereinafter "Remarks, p.__").

[6] Report, p. *3.

[7] 2004 WL 724425, Remarks, p. *2.

on hedge funds is generated, in large measure, by increased interest of institutional investors, such as pension plans, endowments and foundations.[8] These institutional investors are looking for ways to diversify their portfolios to include instruments which stress flexible market approaches to insure an absolute return,[9] in either a rising or falling market.[10]

In addition to institutional investors, hedge funds have traditionally been used by individuals and families of great wealth.[11] These investors presently have approximately $249 billion invested in hedge funds, representing 42 percent of the total assets of the funds.[12]

As a result of the increased interest in hedge funds, they have shown a tremendous growth the last ten years. In 1993, there were approximately 400 hedge funds[13] with assets of $50 billion dollars.[14] Today, the number of funds has grown to between 6,000 and 7,000[15] with assets of $592 billion.[16] These assets, while not large by comparison to the total market value of U.S. corporate equities of $11.8 trillion,[17] represent a tremendous amount to be invested in a largely unregulated segment of the securities industry.[18]

What Is a Hedge Fund?

The obvious starting point for a discussion of hedge funds is to define what a hedge fund is and is not. Unfortunately, like the definition of a security itself, there is no universally accepted definition for a hedge fund.[19] As SEC Chairman Donaldson said:

The term "hedge fund" is undefined, [even under] the federal securities laws. Indeed, there is no commonly accepted universal meaning. As hedge funds gained stature and prominence, though, "hedge fund" has developed into a catch-all classification for many unregistered privately

[8] *Id.*, Executive Summary, p. vii.

[9] Meaning that they will make money in a variety of market environments. *Id*. at 33.

[10] *Id*.

[11] The minimum investment in the funds range from $50,000 to $10 million. *Id*. at 80, n. 272. However, this minimum figure may be waived. Further, the SEC Staff acknowledges that this minimum investment figure has dropped in recent years.

[12] Report, p. *43.

[13] 2004 WL 724425, Remarks, p. *5.

[14] Report, p. *1, n.2.

[15] *Id*. at p.*1, n.4.

[16] *Id*., Executive Summary, p. *vii.

[17] *Id*. at p.*1, n.4.

[18] *Id*. at p *1, n.2.

[19] Report, p. *1.

managed pools of capital. These pools of capital may or may not utilize the sophisticated hedging and arbitrage strategies that traditional hedge funds employ, and many appear to engage in relatively simple equity strategies.[20]

However, as Chairman Donaldson goes on to say, traditional hedge funds can, at least in part, be identified by certain characteristics which most, but not all, hedge funds, possess. The first hedge fund provided probably two of the most common characteristics of hedge funds. It invested **in equities** and **used leverage and short selling to "hedge"** the fund's investment risk from movement in the equity securities markets.[21]

Equity Investments

While investment in stock equities was a badge of the early hedge funds, today hedge funds have expanded their portfolios to include a wide range of investment instruments, including fixed-income securities, convertible securities, currency and future currency trading, exchange-traded futures, over-the-counter derivatives, securities future contracts, commodity options and futures, and other non-security investments.[22]

Leverage

Likewise, the use of leverage and short selling to "hedge" was, and still is, a defining characteristic of a hedge fund. However, modern hedge funds have developed a number of other strategies such as market trend, event-driven, and arbitrage strategies, each of which involves several sub-strategies.[23]

Absolute Return

Another defining characteristic of hedge funds in that they generally employ an absolute return approach to investing. Rather than seeking to maximize profits and risking the taking of losses in bad economic times, the hedge fund seeks to make money in all types of economic conditions and market environments.[24] In contrast, investment companies (mutual funds) attempt to duplicate or exceed the performance of securities indexes or selected classes of assets.[25]

Not a Mutual Fund

Another way to define a hedge fund is by the negative. This involves eliminating certain other certain types of pooled investment vehicles which **are not** hedge funds. A hedge fund is not a registered investment company or mutual fund.[26]

Chairman Donaldson points out that, unlike regulated investment companies or mutual funds, hedge fund investors must commit their money to the hedge fund for an extended period of time.[27] Normally, hedge funds will not

[20] 2003 WL 1902915, Testimony, p. *1.

[21] Report, p. *1.

[22] Report, p. *3.

[23] Report, pp. *34-35.

[24] Report, p. *33.

[25] *Id.*

[26] 2003 WL 1902915, Testimony, p. *3. *See generally*, Report, pp. *5-6.

[27] 2003 WL 1902915, Testimony, p. *3.

allow redemption of an investment without prior notice.[28] There is also a difference in the way mutual funds and hedge funds pay their investment advisor. Mutual funds or registered investment companies normally will base the advisor's fee on a percentage of the assets under management. On the other hand, hedge funds normally will pay both an asset-based fee[29] as well as a performance fee.[30] This performance fee usually is twenty percent or more of the hedge fund's annual profits whether the profits are realized or not.[31] Often, however, this performance fee will be paid only if the hedge fund's annual profits exceed a benchmark figure.[32]

Mutual funds and hedge funds also differ as to their management structure. Many mutual funds will have boards of directors,[33] and a majority of the directors will be outside directors, unaffiliated with the funds investment adviser.[34] Since most hedge funds are organized as limited partnerships, they do not have directors[35] and, if they do, there are no restrictions upon the entire board being affiliated with the investment advisor. As a result, the majority of the directors of hedge funds which have boards will be associated with the fund adviser. Such affiliation creates conflicts of interest, which are often not adequately disclosed.[36]

Hedge funds and their investment advisers are largely unregulated. Mutual funds and their advisers are highly regulated. The unregulated nature of the hedge funds results in a number of important differences. Mutual funds and registered investment companies are subject to extensive operational restrictions.[37] Hedge funds are not. Mutual funds must report their results in a standardized form.[38] Hedge

[28] *Id*. He indicates that some hedge funds will allow investor redemption only once or twice a year.

[29] *Id*. Typically from one to two percent of the assets of the fund.

[30] *Id*.

[31] *Id*. This figure will be established in the management contract and set out in the offering documents for the hedge fund.

[32] *Id*. This may cause a problem if the investment advisor has to register under state law. Section 102(b)(1) of the Uniform Securities Act, in effect bars performance-based fees. In re Colonial Capital Management, LCC, 1998 S.Car. LEXIS 35 (S.C. Sec. Section, Dec. 23, 1998)(Consent order). The Uniform Act does allow fees based upon assets under management as mutual funds do. Unif. Sec. Act §102(b).

[33] Report, pp. *5-6.

[34] *Id*.

[35] 2003 WL 1902915, Testimony, p. *3.

[36] Report, pp. *5-6.

[37] *Id*.

[38] 2003 WL 1902915, Testimony, p. *3.

funds are not required to file any reports. Mutual funds are subject to borrowing and leverage restrictions.[39] Again, hedge funds are not, so that they may leverage their portfolios to a far greater degree.[40] Mutual funds are also subject to diversification requirements.[41] Since hedge funds are not, they may concentrate their portfolios in a handful of investments.[42] This ability, of course, increases their potential exposure to market fluctuations,[43] and makes the hedge fund a much riskier investment.

Not a Private Equity Fund

Nor are hedge funds private equity funds. However, both hedge funds and private equity funds have certain common characteristics. Both are usually organized as limited partnerships. Therefore, both have ownership interests which are clearly securities. But, both usually do not register their securities, relying instead upon the private placement exemption.

The hedge funds and private equity funds also have substantial differences. The private equity fund concentrates their investments in unregistered securities which are usually illiquid. Because the investments are illiquid, unregistered securities, the private equity funds generally commit to long-term investments. The private equity funds are usually organized for fixed periods of time or until the occurrence of a certain event. This fixed term and illiquid nature of private equity fund investments means that the investor has little, if any chance to redeem his investment. Further, there is usually no secondary market for these partnership interests.

Further, the private equity funds usually require their limited partners to commit a specific amount of money to the fund for investment. Since these contributions are normally not required until a specific investment is located, the investors are subject to capital calls by the equity fund's general partner.[44]

Not a Venture Capital Fund

Nor is a hedge fund a venture capital fund. Both types of funds are organized similarly and may attract the same type of investor. However, the venture capital fund generally invests solely in start-up or early stage development companies. Venture capital funds also have the same features which distinguish the private equity fund from the hedge fund. The venture capital fund usually has fixed contribution requirements and engage in long term investments. The management of a venture capital firm is also often involved in the companies in which the fund makes its investments. Further, because of the nature of the venture capital fund's investments, the investor can not redeem his investment, nor is there an organized

[39] *Id*.

[40] *Id*. In actual practice, many hedge funds, however, use little or no leverage.

[41] *Id*.

[42] *Id*.

[43] *Id*.

[44] *See generally*, Report, pp. *7-8.

secondary market where he may sell his interest.[45]

Not a Commodity Pool

Finally, while a hedge fund may invest in commodities, such as foreign currencies, commodity futures, and commodity options, it is not a commodity pool. The commodity pool is like a mutual fund which trades in commodities. As a result, the commodity pool focuses on the making of a profit through the trading of various forms of commodities. The hedge fund, on the other hand, uses commodities as merely another hedge strategy.

Finally, commodity pool and its operators, the investment advisers for the pool, are regulated by the Commodity Futures Trading Commission; while, as has been seen above, the hedge fund and its investment adviser are usually unregulated.[46]

The commodity pool and the hedge fund do have one thing in common. The interests in both commodity pool, whatever form of organization it adopts, and the hedge fund are securities.

Hedge Fund Interests as Securities

While hedge funds are not mutual funds, private equity funds, venture capital funds, or commodity pools, all have one thing in common. Whatever their form of organization is, be it a corporation, limited liability company, or company trust, the interests in each of the funds or pools is a security. Hedge funds are normally organized as a limited partnership, with the fund promoter, or one of its affiliates, serving as the general partner and the investor being a limited partner. As a limited partner, the investor's interest is **always a security.**[47] A limited partnership interest is investment contracts under the *Howey* test.[48]

The *Howey* test requires four elements: (1) That there is an investment of money; (2) in a common enterprise; (3) with the expectation of a profit; (4) to come solely or substantially from the efforts of others. In the case of a hedge fund, the investor gives the partnership money in exchange for his partnership interest. This payment satisfies the first test--the payment of money. The common enterprise is the hedge fund partnership itself. So the second requirement is met. The investor is induced to make the payment for his limited partnership interest by the prospect that he will receive a profit in the form of his share of partnership earnings.

By law, in the case of a limited partnership, he may not participate in the management of the partnership.[49] If he does participate in management, the limited partner ceases to be a limited partner and becomes a general partner.[50] In which case, his interest is no longer a security. Because as a limited partner he can not participate in the

[45] *See generally*, Report, p. *8.

[46] *See generally*, Report, pp. *8-9.

[47] *See generally*, 12 Joseph C. Long, Blue Sky Law § 2:72 (2003) (hereinafter Long, § __) and Joseph C. Long, “Partnerships, Limited Partners, and Joint Venture Interests as Securities, 37 Mo. L. Rev. 581 (1972). State of Kansas v. Stuber, 27 Kan.App.2d 160 (2000).

[48] SEC v. W.J. Howey, 328 U.S. 293 (1946).

[49] Revised Unif. Partnership Act §303 (1976).

[50] *Id.*

management of the partnership, the essentially managerial efforts are performed by others, the general partner or partners. As a result, the last element of the *Howey* test is met.

There is no real dispute that hedge fund interests are securities under the *Howey* test.[51] The question becomes whether the hedge fund interests are exempt from liability.

Current Status of the Securities Regulation of Hedge Funds

As was seen in the last section, the interests in hedge funds are securities. However, these securities are normally not registered with the SEC[52] based upon reliance on the private placement exemption of Section 4(2) of the Securities Act of 1933,[53] or SEC Regulation D, Rule 506.[54] Since securities sold under a true Rule 506[55] offering are covered securities, state regulation of these securities is pre-empted.[56]

The state commissions take the position that if Rule 506 is not completely complied with,[57] there is no pre-emption, and the securities would have to be registered or exempt under the various state acts where the securities are sold.[58] However, since the securities are no longer covered by Rule 506, the Uniform Limited Offering Exemption (ULOE)[59] also should not be available. If any exemption is available, it will normally be the small offering exemption found in Section 402(b)(9) of the

[51] Report, p. *13-14. This is true whether the interests in the hedge funds are limited partnership or limited liability company interests. *Id*.

[52] 2004 WL 724425, Remarks, p. *1.

[53] 15 U.S.C. §77d(2).

[54] 17 C.F.R. §230.506. *See* Report, pp. *13-18. See also In re Wells Fargo Mutli-Strategy 100 Hedge Fund, Inc., 2002 WL 32445121 (S.D.Sec. Div, Int. Op., Oct.11, 2002); In re 2002-005 Mainstreet Advisors, LLC., 2002 WL 654075 (Kan. Sec. Com, Int. Op., April 18, 2002).

[55] Securities Act of 1933, §18A, 15 U.S.C.§77rA. *See* Long, §5:13.

[56] There is no-pre-emption of a Section 4(2) offering, only offerings made under an SEC Rule adopted under Section 4(2). Securities Act of 1933, §18A, 15 U.S.C.§77rA. *See* Long, §5:13. Currently there is only one such rule and that is Rule 506.

[57] *See* Long, §§7:76-7:78.

[58] *See* e.g., In re Alpha Investment Management, Inc., 1994 WL 847828 (Ala Sec. Comm. Sept. 12, 1994)(consent order). *But see* Lillard v. Stockman, 267 F.Supp.2d 1081 (N.D. Okla. 2003); Temple v. Gorman, 201 F.Supp.2d 1238 (S.D.Fla.2002). These cases are simply incorrectly decided. If all that was required for pre-emption was a bald-face statement that the offering was made under Rule 506, then any con artist could avoid state registration by telling the investor that the offering was a private placement under Rule 506. The decision in SEC v. Ralston Purina Co., 346 U.S. 119 (1953), held that the person claiming an exemption has the burden of proving such exemption. The same should hold true under federal pre-emption. If the seller can establish that the offering is qualified under Rule 506, then there would be pre-emption of state registration requirements. However, if the seller can not establish entitlement to the 506 exemption, then there should be no pre-emption.

[59] *See* Long, §§7:85-7:107.

Uniform Act.[60] In any event, there is no pre-emption of the broker-dealer or agent registration requirements for those selling the hedge fund interests.[61]

The hedge funds themselves are usually exempt from registration under the Investment Company Act of 1940, by either Section 3(c)(1),[62] investment companies with less than 100 investors, whose securities were sold in non-public offerings,[63] or Section 3(c)(7),[64] sales only to qualified purchasers[65] in a private placement. The advisers to the hedge funds would be covered by the Investment Advisers Act of 1940, but escape registration thereunder through the *de minimis* exemption of Section 203(b) of the Act,[66] having 15 or fewer clients.[67] One hedge fund is one client.

Increasingly, however, the hedge fund advisers are voluntarily registering with the SEC and the states as investment advisers.[68] There appear to be two reasons for this voluntary registration.[69] First, many institutional investors will not invest unless the investment adviser is registered. Second, such registration can be used in fund advertising leaving an inference of the fund's bona fides.[70]

The voluntary registration of hedge fund investment advisers has not been without its problems. At least two states have taken action to revoke the investment adviser registration of two advisers for conduct in connection with hedge funds.[71] Further, there may be a problem in those states that have the Uniform

[60] Unif. Sec. Act, §402(b)(9). *See generally*, Long, §§ 7:20-7:31. No commissions or other remuneration may be paid in connection with the sale of securities under this exemption. *See* Long, §7:27.

[61] *See* Long, Ch.8.

[62] 15 U.S.C. §80a-3(c)(1). *See* Report, pp. *11-12.

[63] 2003 WL 1902915, Testimony, p. *3.

[64] 15 U.S.C. §80a-3(c)(7). *See* Report, pp. *11-12.

[65] 2003 WL 1902915, Testimony, p. *3 states: "Qualified purchasers are defined to include high net worth individuals (who own certain specified investments worth at least $5 million) and certain companies." Compare this definition with the definition of "accredited investor" found in Regulation D, Rule 501. 17 C.F.R. §230.501. The requirements for "qualified investors" is much higher than for "accredited investors."

[66] 15 U.S.C. §80b-3(b).

[67] *See* Report, pp. *20-22.

[68] In re Veras Investment Partners, 2004 WL 396815 (Tex. Sec. Bd. Feb. 24, 2004); In re Parizek Capital Management, LLC, 2002 WL 31273692 (Ariz. Corp. Comm. Sept. 30, 2002).

[69] 2004 WL 724425, Remarks, p. *8.

[70] *Id.*

[71] In re Veras Investment Partners, 2004 WL 396815 (Tex. Sec. Bd. Feb. 24, 2004); In re Parizek Capital Management, LLC, 2002 WL 31273692 (Ariz. Corp. Comm. Sept. 30, 2002).

Securities Act. Section 102(b) appears to outlaw management fees based upon performance of the fund.[72] Such fees are very common in hedge funds.

The exemption of the interests in the hedge funds, the funds themselves, and their investment advisers, **does not**, however, **exempt all three from the anti-fraud provisions of the securities acts.** The NASD,[73] the SEC,[74] and several state agencies[75] have brought a number of anti-fraud actions against hedge fund advisers.

Hedge Fund Interest May Not Be Exempt

As the SEC Staff Report indicates,[76] most hedge funds will rely upon either the private placement exemption

[72] Unif. Sec. Act , §102(b)(1) which reads:

> It is unlawful for any investment adviser to enter into...any investment advisory contract unless it provides in writing
>
> (1) that the investment adviser shall not be compensated on the basis of a share of capital gains upon or capital appreciation of the funds or any portion of the funds of the client.
>
> The section goes on to provide:
> Clause (1) does not prohibit an investment advisory contract which provides for compensation based upon the total value of a fund averaged over a definite period, or definite dates or taken as of a definite date.

See In re Colonial Capital Management, LLC, 1998 S.Car. LEXIS 35 (S.C. Sec. Section, Exemption Order, Dec. 23. 1998).

[73] On August 18, 2003, the NASD took action against Win Capital Corporation and its principles Steven J. Bayern and Patrick M. Kolenik for anti-fraud violations in connection with Huntington Laurel Partners, L.P., a hedge fund. Earlier, Neil W. Brooks, an NASD registered representative settled charges with the NASD for conducting fraudulent hedge fund scheme. 35 Sec. Reg. & L. Rep. (BNA) 1411 (Aug. 25, 2003).

[74] Since 1999, the SEC has filed 38 enforcement actions against hedge funds or their advisers. Approximately a dozen of these actions were filed within the last eighteen months. These actions encompassed a variety of anti-fraud charges. Report at 73-74. Since the Report was issued, the SEC has filed several new actions. See e.g., SEC v. Goto, CV No. 03-490-JD, (D.N.H. Nov. 17, 2003)(consent order), discussed in SEC Lit. Rel. No. 18456, 2003 WL 22702360 (Nov. 17, 2003); SEC v. Millennium Capital Hedge Fund, L.P., CV-03-1862-PHX-FJM (D. Ariz. Nov. 18, 2993)(consent order), discussed in SEC Lit. Release No.18481, 2003 WL 22849388 (Dec. 2, 2003); In re Robert T. Littell, 2003 WL 22945718 (SEC Cease and Desist Order, Dec. 15, 2003)(consent).

[75] *See e.g.*, In re Ryan J, Fontaine, 2003 WL 23329371 (Ind. Sec. Comm., C&D, Nov. 17, 2003); In re Ronald Yeasley, 2003 WL 1595249 (Tex. Sec. Bd., Emergency C&D, Mar. 18, 2003); In re Ross Funds Group, LLC, 2002 WL 31422504 (Kan. Sec. Comm., Emergency C&D, June 4, 2002). The Massachusetts Division has brought four actions. In re Rahul v. Singh, No. E-2003-54 (Mass. Sec. Div., filed Aug. 13, 2003); In re Michael F. Payne, Futronix Trading LTD., No. E-2003-55 (Mass. Sec. Div., filed Aug. 13, 2003); In re James Pangione, Timothy Rassias, Hercules Capital Mgt. LLC, and Hercules Hedging Fund, L.P., No. E-2003-56 (Mass. Sec. Div., filed Aug. 13, 2003); and In re Stonehouse, No. E-2003-52 (Mass. Sec. Div., filed Sept. 22, 2003). 635 Sec. Reg. & L. Rep. (BNA) 1409 (Aug. 25, 2003).

[76] Report, p. *13-20.

of Section 4(2) of the 1933 Act[77] or its safe harbor provision in Regulation D, Rule 506.[78] If the hedge fund is questioned about its entitlement to the exemption, then the burden of proof is on the hedge fund[79] to prove that it meets each and every requirement of the exemption.[80]

If it fails to establish any one of the requirements of the exemption, then **all the partnership interests** are unregistered and sold in violation of Section 5 of the 1933 Act.[81] As a result, any purchaser of a hedge fund interest may rescind his purchase under Section 12(a)(1) of the 1933 Act.[82]

General Solicitation

As the SEC report indicates under Section 4(2) and SEC Rule 506, hedge fund offerings are vulnerable in two respects.[83] First, in the case of both Section 4(2) and Rule 506, no general solicitation or general advertising can be used in connection with the sale of the hedge fund interests.[84] The SEC Staff believes that many of the hedge funds are violating this requirement, and, therefore are not entitled to the exemption.[85] The Report said:

> We believe that questions exist whether some participants in the hedge fund industry may not be complying with the prohibition on general solicitation and general advertising in private offering and selling hedge funds securities. ... Hedge funds may not engage in any form of general solicitation or general advertising in finding investors. The hedge fund has the burden of proving the availability of the exemption from registration.[86]

The Report further says:

> [T]he issuer and persons acting upon their behalf cannot find investors through, among other things, advertisements, articles, notices or other communications published in a newspaper, magazine or similar media, cold mass mailings [or calls], broadcasts over television or radio, material contained on a web site available to the public or an e-mail message sent to

[77] 15 U.S.C. §77d(2).

[78] 17 C.F.R. §230.506.

[79] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

[80] Henderson v. Hayden Stone, Inc., 461 F.2d 1069 (5th Cir. 1972). This case holds that, if the plaintiff raises the **mere possibility** that one of the elements of the exemption might not have been met, if the defendant can not eliminate this possibility, plaintiff recovers.

[81] 15 U.S.C. §77e.

[82] 15 U.S.C. §77l(a)(1).

[83] Report, p. *14-17.

[84] *Id*. at 16-17.

[85] *Id*. at 86.

[86] *Id*. at 86.

> a large number of previously unknown persons. The restrictions also apply to any meeting or seminar where the participants have been invited by a general solicitation or general advertising.[87]

However, the SEC has taken the position that general solicitation is not present if the investor has a pre-existing, substantive relationship with the issuer of the hedge fund or the broker-dealer offering the interest. In this regard, the Report cautions:

> The relationship must be established at a time prior to the commencement of the private offering, or in the case of a hedge fund, 30 days before the investor can make an investment.[88]

Non-Qualified Investors

Hedge funds are also vulnerable as the result of sales to non-qualified persons. Under the basic Section 4(2) exemption, the fund must account for all its offerees and establish that they are sophisticated investors. If the fund can not do so, or if one of the offerees is not sophisticated, the entire offering becomes unregistered, and the plaintiff recovers.[89]

Under Rule 506, all the **purchasers**, not the offerees, must be either accredited investors (wealthy)[90] or sophisticated (smart).[91] There may be an unlimited number of accredited investors. But the hedge fund, on the basis of a reasonable investigation, must actually believe that there are no more than thirty-five unaccredited, but sophisticated investors in the offering. If there is one non-sophisticated investor, the entire exemption is lost. Likewise, the exemption is lost if there are more than thirty-five non-accredited, sophisticated investors, unless the hedge fund reasonably and actually believes otherwise.

As has been seen earlier, the popular belief is that many marginal hedge funds are selling to non-eligible investors.[92] This claim is supported by an enforcement action filed by the Massachusetts Division of Securities.[93] Further, at least,

[87] *Id*. at 16, citing SEC v. Inorganic Recycling Corp., Lit. Rel. No. 16322, 70 Sec. Doc. 1690, 1999 WL 813835 (Sept. 30, 1999) and In re GCI Capital, Inc., Sec. Act Rel. No. 7904, 2000 WL 1448624 (Sept. 29, 2000). *See also Id*., 2000 WL 1457129. *But see* Lamp Technologies, 1997 WL 282988 (SEC No-action letter, May 29, 1997) and *Id*., 1998 WL 278984 (SEC No-action letter, May 29, 1998), holding no general solicitation where the investors were solicited, pre-qualified and able to access a password protected web site containing information on hedge funds. Investor in such case could purchase interests 30 days after the investor was qualified.

[88] *Id*. at 16.

[89] *See e.g.*, Henderson v. Hayden Stone, Inc., 461 F.2d 1069 (5th Cir. 1972).

[90] *See* Rule 501(a)

[91] With the aid of a purchaser representative. *See* Rule 501(h).

[92] The NASD has brought an enforcement action against Shelman Sec. Corp. and Mark C. Parman, its chairman for the sale of more than $2 million of unregistered hedge fund securities from 1998 until 2000. 35 Sec. Reg. & L. Rep. (BNA) 1409 (Aug. 25, 2003). While the company claimed the private placement exemption, the NASD claimed that the exemption was not available.

[93] In re Rahul v. Singh, No. E-2003-55 (Mass. Div. Sec., filed Aug. 13, 2003).

one civil recovery action has been filed on this basis under the Florida securities act.[94]

Federal Pre-Emption

These state law actions, like all actions based upon state rather than federal securities law, faced one additional hurdle, federal pre-emption. The National Securities Marketing Act of 1996 ("NSMA") pre-empted the right of the states to require registration of certain securities.[95] These securities are referred to as "covered securities."

The Act, however, did not pre-empt in any way the anti-fraud authority of the states. Therefore, the state agencies can continue enforcement action involving fraud. Likewise, private civil recovery actions under the state acts may also continue based on material misstatements or omissions.

Securities offered under the basic private placement exemption of Section 4(2)[96] **are not covered securities.** Therefore, these securities must be registered or exempt at the state level. However, hedge fund securities sold relying upon Regulation D, Rule 506[97] will be covered securities,[98] **if they do, in fact, meet the Rule 506 exemption.**

As has been seen above, under federal law, the person selling the securities has the burden of proof that he is entitled to an exemption from the registration requirement.[99] When challenged by a suit alleging the sale of unregistered securities under the state act, the seller should also have the burden of proving that the securities are "covered securities." To do so, the seller will have to establish that the offering meets each and every requirement of Rule 506. Many hedge fund operators can not meet these Rule 506 requirements because of their offering involving general advertising and solicitation or they have made sales to unaccredited and unsophisticated investors. Further, NSMA allows the states to impose certain notice filing requirements and notice filing fees.[100] The states claim that the failure to file the notice filing with the state destroys both the Rule 506 exemption[101] and covered securities status.[102]

Current reasons for regulatory concern about hedge funds

[94] Dienhart v. Garbe, Case No. CA 03-004269-AG (Fla. Cir. Ct. 15th Jud. Cir., Palm Beach County, filed August 2003). The author is an attorney of record in this case.

[95] Section 18(b) of the Securities Act of 1933, 15 U.S.C. §77r.

[96] 15 U.S.C. §77d(2).

[97] 17 C.F.R. §230.506. Securities sold under Rules 504 and 505 of Regulation D, 17 C.F.R. §§230.504 and 504 are not covered securities.

[98] Section 18(b)(4)(D) of the Securities Act of 1933, 15 U.S.C. §77r(b)(4)(D).

[99] SEC v. Ralston Purina Co., 346 U.S. 119 (1953).

[100] Section 18(c)(2), 15 U.S.C. §15 U.S.C. §77r(c)(2).

[101] At the federal level, failure to file the required Form D **does not result in the loss of the exemption**. Rule 503, 17 C.F.R. §230.503.

[102] *See e.g.*, In re Alpha Investment Management Inc., 1994 WL 847828 (Ala. Sec. Comm. Sept. 12, 1994).

There would appear to be a number of reasons for the concern of state and federal regulators. First, as will be seen below, the hedge fund industry is largely unregulated. In the 1990's there was a new collapse of one of the large hedge funds, Long Term Capital Management.[103] Second, as seen in the last section, hedge funds have shown a tremendous growth in the last ten years.[104]

Finally, the general public, especially middle class investors, have shown a greater interest in investing in hedge funds. This interest comes at a time, when through the use of the internet,[105] the unregistered hedge funds can solicit a large segment of the population.[106] This practice is often referred to as the "retailization" of hedge funds.[107] Along the same line, there has been concern that many unqualified investors will be involved in hedge fund investments indirectly through pension and profit sharing or retirement programs.[108]

These four factors suggest that a review of the unregulated status of the hedge funds is appropriate.[109] This review is what the SEC Staff Report attempted to accomplish. What changes will result from the study remain a matter of debate. At least one SEC Commissioner is on record as believing that little additional regulation is appropriate.[110] The answer should depend on the determination to what extent retailization of legitimate hedge funds has taken place and to what extent scam artists are using hedge funds as the cover for fraudulent operations.

Retailization

There is clearly a popular belief that retailization of hedge funds is taking place, in ever increasing numbers. Whether this popular belief is true is a matter of debate. The NASD thinks so. Mary L. Shapiro, NASD vice chairman and president of regulatory policy and oversight commented: "As hedge funds are increasingly marketed to retail investors, the need to

[103] 2004 WL 724425, Remarks, p. *1.

[104] Report, p. *___.

[105] *See e.g.*, In re Ryan J. Fontaine, 2003 WL 23329371 (Ind. Sec. Div. C&D, Nov. 17, 2003).

[106] *See* 2003 WL 1902915, Testimony, p. *6; 2004 WL 724425, Remarks, p. *4. Such retailization would be improper absent full blown registration of the hedge fund interests because middle class investors are less wealthy and generally less sophisticated than the current hedge fund investors who usually purchase their interests through a private placement. These middle class investors need the protection of a full registration. Chairman Donaldson reports that an increasing number of hedge funds are registering. 2003 WL 1902915, Testimony, p. *4. Even if the funds are registered, there remains the issue of whether hedge fund investments are suitable investments for middle class investors.

[107] *Id*.

[108] *Cf*. In re International Investment Conference, 1985 Ga. Sec. LEXIS 33 (Ga. Sec. Comm'r, Order of Prohibition, June 17, 1985).

[109] There was one completely separate cause for regulatory concern. First, in late 2003, a scandal broke out in the mutual fund industry over "late trading" and "market timing." One of the largest users of these techniques were several large hedge funds. Remarks, p. *5.

[110] 2004 WL 724425, Remarks, pp. *5-*6.

disclose all risks and material facts becomes paramount."[111] Subsequently, the NASD promulgated Notice to Members 03-076 dealing with hedge funds.

The SEC seems to be divided over the issue. Chairman Donaldson reports that an increasing number of hedge funds register their interests with the SEC. In such case, they can be sold to the general public.[112] The SEC's Division of Enforcement has also brought a number of enforcement cases against hedge funds.[113]

On the other hand, the SEC staff, in its investigation of hedge funds, found no wide spread sales to unaccredited and unsophisticated investors. Even so, the SEC Staff warned:

> [T]he increased number of retail investors qualifying as accredited investors raises our concern that hedge funds and broker-dealers might begin to seek out these investors as a new source of capital for hedge funds. We have observed that the minimum qualifications required to invest in some hedge funds has decreased as newer entrants into the alternative investment markets compete for investors. We remain concerned that less sophisticated investors, even those meeting the accredited investment standard, may not possess the understanding or marketing power to engage a hedge fund adviser to provide information to make an informed investment decision.[114]

Finally, there is at least one civil suit based upon a claim of retailization.[115]

The answer to the retailization issue appears to lie in the identification of whether the hedge fund in question is legitimate[116] or a scam. There appears to be little evidence that legitimate hedge funds have in the past sold to unqualified investors. However, the SEC Staff is concerned that this may change in the future. Chairman Donaldson indicates that this is happening to a limited extent in those hedge funds which have registered their securities. Such registration entitles the funds to sell to the general public.

Even if the funds are free to sell to the general public because of the registration, there still remains the question of whether such sales are suitable to the individual investor. Unfortunately, unlike mutual funds which are usually marketed through broker-dealers, hedge funds are normally marketed directly to the client.[117] However, some

[111] 35 Sec. Reg. & L. Rep. (BNA) 1409 (Aug. 25, 2003).

[112] *See* 2003 WL 1902915, Testimony, p. *3.

[113] *See e.g.*, SEC v. Goto, CV No. 03-490-JD, (D.N.H. Nov. 17, 2003)(consent order), discussed in SEC Lit. Rel. No. 18456, 2003 WL 22702360 (Nov. 17, 2003)

[114] Report, p. *81. Subsequently, one of the SEC Commissioners very emphatic cited this Staff finding. 2004 WL 724425, Remarks at p.*_.

[115] Dienhart v. Garbe, Case No. CA-03-004269 AG (Fla. Cir. Ct.). The author is one of the attorneys of record and the case has not yet been resolved.

[116] Even the legitimate hedge funds have been charged with fraud.

[117] Report, p. *44. Usually on the basis of a past personal or advisory relationship. *Id.*

hedge funds do use broker-dealers as sales agents. In such cases, the NASD has reminded the brokers and their agents of their duties to disclose and of due diligence to determine suitability.[118] NASD NTM 03-07 emphasized three obligations of suitability. First, the broker-dealer must balance its sales pitches and materials with risk disclosures and potential disadvantages which hedge funds, in general, or this hedge fund in specific, may present.[119] Second, the broker-dealer must conduct a due diligence investigation on any hedge fund that it is going to recommend. This due diligence obligation:

> [I]ncludes, but is not limited to, investigating the background of the hedge fund adviser, reviewing the offering memorandum and subscription agreements, examining all references, and examining the relative performance of the fund.[120]

Finally, the broker-dealer must determine and believe that the hedge fund investment is suitable for this specific customer. Where the purchase is made through an investment adviser, the broker-dealer must not base this decision on the suitability of the hedge fund purchase to the investment adviser. Nor may the broker-dealer delegate its suitability determination to the investment adviser. The broker-dealer must make its suitability determination **as to the ultimate investor**, based upon the ultimate investor's financial status, tax status, investment objectives and needs, as well as any other pertinent information.[121]

However, there is clear evidence that many unqualified, unaccredited, unsophisticated retail investors are being victimized by scam artists dressing their products up to look like hedge funds, but which have none of the characteristics of a legitimate hedge fund. These are the hedge funds toward which the main state and federal enforcement efforts and private suits are directed.

Scam Hedge Funds

As has been seen in the case of viatical settlements contracts,[122] payphones lease-back contracts,[123] and foreign currency trading,[124] scam artists often move into hot, but little known, legitimate investment areas, taking the name of the legitimate investment, but not its substance for the purpose of conducting a look-a-like fraudulent securities scam. This phenomenon is not new. It started with commodity options,[125] bags of silver and gold coins,[126] and gasoline forward contracts in the

[118] NASD NTM 03-07, “NASD Reminds Members of Obligations When Selling Hedge Funds,” 2003 WL 168271 (Feb. 2003). *See* Report, pp. *25-27.

[119] NASD NTM 03-07, “NASD Reminds Members of Obligations When Selling Hedge Funds,” 2003 WL 168271 (Feb. 2003). *See* Report, pp. *25-27.

[120] *Id*. at 2003 WL 168271 at p *__.

[121] Report, p. *26. *See also* NASD, Rule 2310.

[122] *See e.g.,* Siporin v. Carrington, 200 Ariz. 972, 23 P.3d 92 (App. 2001).

[123] *See e.g.,* SEC v. Edwards, ___ U.S. ___, 124 S.Ct. 892 (2004).

[124] *See e.g.,*, Goldstein v. Mortenson, 113 S.W.3d 769 (Tex. App. 2003).

[125] *See e.g.,* Searcy v. Commercial Trading Corp., 560 S.W.2d 637 (Tex. 1977).

[126] *See e.g.,* People v. Monex, 86 Misc.2d 320, 380 N.Y.S.2d 504 (N.Y. Sup. Ct., N.Y. County, 1975).

1970's. It continues today in such areas as ATM leasing[127] and internet accessing.[128] It is also happening in the hedge fund area as is reflected by a number of federal and state enforcement cases.[129] These look-a-like hedge funds scam should be analyzed like other look-a-like schemes as investment contracts. The substance of all the schemes is the same. The only difference between any of these scams is the underlying product or service used to promote the scheme.

Unfortunately, most of the hedge fund cases that PIABA members and other plaintiff's securities attorneys are likely to see are the look-a-like fund cases. The SEC Staff Report found little evidence that the legitimate hedge fund industry is either selling non-exempt and unregistered securities to the general public or engaging in blatant fraud that the look-a-like funds are. This conclusion seems to be borne out by the enforcement actions taken by both the state securities agencies and the SEC. For the most, these actions have involved the "look-a-like" hedge funds scams rather than the legitimate funds.[130]

The look-a-like funds seem to have a number of common characteristics. As in the typical scheme of this type, their promoters will sell hedge fund interests to any investor who can be recruited by cold calls or other public advertising, without regard to the investor's status as an accredited or sophisticated investor. Likewise, these look-a-like hedge funds will accept investments in amounts of $25,000 or lower.

By way of contrast, as seen above, the legitimate funds do not engage in public advertising, sell only to sophisticated or accredited investors, and require, at least, a minimum investment of a million dollars. Based upon these facts, most of the traditional hedge funds can legitimately claim a private placement exemption from the registration requirement under either Section 4(2) or Reg. D, Rule 506. All three characteristics of the look-a-like funds identified above prevent these funds from

[127] *See e.g.,* In re Cash Link Sys. Inc., 2004 WL 316036 (Tex. Sec. Bd. Feb. 9, 2004).

[128] *See e.g.,* In re Network Serv. Depot, Inc., 2002 WL 31654847 (Mo. Sec. Div., Nov. 18, 2002).

[129] Since 1999, the SEC has filed 38 enforcement actions against hedge funds or their advisers. Approximately a dozen of these actions were filed within the last eighteen months. These actions encompassed a variety of anti-fraud charges. Report at 73-74. Since the Report was issued, the SEC has filed several new actions. See e.g., SEC v. Goto, CV No. 03-490-JD, (D.N.H. Nov. 17, 2003)(consent order), discussed in SEC Lit. Rel. No. 18456, 2003 WL 22702360 (Nov. 17, 2003); SEC v. Millennium Capital Hedge Fund, L.P., CV-03-1862-PHX-FJM (D. Ariz. Nov. 18, 2993)(consent order), discussed in SEC Lit. Release No.18481, 2003 WL 22849388 (Dec. 2, 2003); In re Robert T. Littell, 2003 WL 22945718 (SEC Cease and Desist Order, Dec. 15, 2003)(consent).

See e.g., In re Ryan J, Fontaine, 2003 WL 23329371 (Ind. Sec. Comm., C&D, Nov. 17, 2003); In re Ronald Yeasley, 2003 WL 1595249 (Tex. Sec. Bd., Emergency C&D, Mar. 18, 2003); In re Ross Funds Group, LLC, 2002 WL 31422504 (Kan. Sec. Comm., Emergency C&D, June 4, 2002). The Massachusetts Division has brought four actions. In re Rahul v. Singh, No. E-2003-54 (Mass. Sec. Div., filed Aug. 13, 2003); In re Michael F. Payne, Futronix Trading LTD., No. E-2003-55 (Mass. Sec. Div., filed Aug. 13, 2003); In re James Pangione, Timothy Rassias, Hercules Capital Mgt. LLC, and Hercules Hedging Fund, L.P., No. E-2003-56 (Mass. Sec. Div., filed Aug. 13, 2003); and In re Stonehouse, No. E-2003-52 (Mass. Sec. Div., filed Sept. 22, 2003). 635 Sec. Reg. & L. Rep. (BNA) 1409 (Aug. 25, 2003).

[130] This may change with the allegations which are surfacing that some mutual funds improperly allowed hedge funds to conduct short term investments and after-hours trading in their shares.

sustaining a claim to an exemption from registration.[131] As a result, the interests in the look-a-like funds not only are securities, but are unregistered, non-exempt securities. This fact alone will support a civil action or arbitration to recover the investment.[132]

Another common characteristic of look-a-like hedge funds, as with all these scams, is that most of the money is not invested, but is syphoned off by the promoters for their own use. Such activity is clearly fraudulent and can be the basis of civil recovery. However, some of the money will actually be invested as advertised. Such investment is important, as will be seen below, because it extends the range of potential defendants from whom recovery may be sought.

Toward this end, another characteristic of look-a-like funds may be significant. Legitimate hedge funds normally organize the fund itself as a separate legal entity, either a limited partnership, trust, limited liability company, or corporation. The promoter then serves as the advisor to the fund.

Such separate organization is important in identifying what interests the investor receives. If the fund is a separate legal entity, the investor receives an interest in that entity, and the entity, not the investor, owns the accounts in which the investments are made. This is similar to the way a mutual fund is organized. In the case of a mutual fund, which is a separate legal entity, the investor owns shares in the mutual fund, but not in the mutual fund's investments. The title to the investments are in the name of the mutual fund alone.

In the two look-a-like cases in which the author has been involved in, neither fund was separately organized as a legal entity. Instead the investor's money was co-mingled with other investors' funds and money contributed by the promoter. The co-mingled funds were then placed into brokerage accounts maintained by the promoters with their broker-dealers. Such accounts may be carried by the broker-dealer as an omnibus account which reflects that the broker-dealer realizes the funds come from a source other than the promoter, or they may simply be carried in the name of the promoter.

The significance of this failure

[131] Many look-a-like funds will claim that they are covered by Rule 506. If this claim was legitimate, the hedge fund interests would be “covered securities” and not subject to registration at the state level. However, in practice, the look-a-like funds cannot bear their burden of proving entitlement to the Rule 506 exemption. If they can not sustain their claim to Rule 506 exemption when challenged, the fund interests are unregistered at the federal level. More importantly, the fund interests would not be “covered securities,” and the state are not pre-empted. As a result, their sale would not be exempt from the state registration requirements.

[132] This is the basis of the author’s case in Dienhart v. Garbe, Case No. CA 03-004269 AG (Fla. Cir. Ct.).

to organize the fund as a separate legal entity lies in the ownership of these underlying brokerage accounts. Since there is no separate legal entity, the fund is considered an "unincorporated association."[133] Since an unincorporated association can not hold personal property in its own name, the personal property of the association is owned by the members as tenants in common.[134]

In the context of a look-a-like hedge fund, this means that all members who have contributed money which is traceable to a particular brokerage account are the owners in common of that account. As a result, the member is a client of the brokerage house, and it has the same fiduciary duties under the NASD Rules[135] and common law[136] that it has to other individual customers. Further, the broker-dealer may have sold securities which were unregistered to the account or through material misrepresentations or omissions. The point is that in this situation the broker-dealer is in privity with the customer and will most likely be a seller under the securities act.

Liability for Legitimate Hedge Fund Violations

As always, a plaintiffs' attorney is interested in identifying those people who are both liable and have the ability to pay a judgment. In the case of legitimate hedge funds, the usual "suspects" will be liable.

Where the hedge fund is separately organized as a legal entity, the hedge fund itself passes title to the membership interests and will be liable as "sellers" under either the state or federal acts.[137] Likewise, the promoters of the hedge fund will be held to be "sellers" because they caused the fund to issue the securities.[138] Also, any broker-dealer or registered representative making the sale or involved in the sales process will be liable as "sellers."[139]

[133] Johnson v. Chilcott, 599 F. Supp. 224 (D. Colo. 1984). The tendency is to treat unincorporated associations as partnerships. However, such classification is improper because there is no intent to form a partnership. Further, the difference is important under modern partnership law. The Revised Uniform Partnership of 1997, for the first time, recognizes a partnership as a separate legal entity. RUPA § 201. RUPA §203 then provides that partnership property is owned **by the partnership**.

The older Uniform Partnership Act did not treat the partnership as a separate legal entity. It was nothing more than a collection of the various partners as a group. As a result, Section 25 provided that a partner was a co-owner of partnership property. This co-ownership was known as "tenants in partnership." Treating an unincorporated association as a partnership has little effect if the jurisdiction still has the original Uniform Act. However, it will lead to an improper analysis, if the state has RUPA

[134] *Id*. *See also*, Pells v. State, 20 Fla. 774, 1884 WL 2097 (1884).

[135] Such as know your customer and suitability.

[136] Duty to give information to client which it knows. For example, if the broker-dealer knows that the promoter is running a scam, he would have a duty to rely this information to the fund members.

[137] Section 12 of the 1933 Act, 15 U.S.C. § 771, and Section 410(a) of the Uniform Securities Act. Pinter v. Dahl, 486 U.S. 622 (1988).

[138] SEC v. Murphy, 626 F.2d 633 (9th Cir. 1980).

[139] *Id.*

Further, under Section 15 of the 1933 Act,[140] the promoters of the hedge fund should be considered control persons and liable as such. Likewise, control persons, partners, officers, and directors will secondarily be liable under state law.[141] Also, under Sections 15 and 410(b), liability is secondary and applies to **all sellers**. If the hedge fund employs broker-dealers to market their securities, the control persons, partners, officers, and directors of the selling broker-dealer are also potentially liable. Further, under both Section 15 of the federal act and Section 410(b) of the state acts, the liability of these secondary people is status liability. The identified persons are liable because of their position. They do not have to take part in the violation themselves.[142] Finally, under the state securities acts, Section 410(b) imposes potential liability, subject to affirmative defenses, upon "every **employee** of [the] seller who materially aids in the sale" of the security. This provision will be important because, as noted above, most hedge funds market their own securities directly to the investors without using the services of a broker-dealer.[143]

Liability for Scam Hedge Fund Violations

In the case of a scam hedge fund, many of these usual "suspects" will not be solvent. Therefore, the liability of other possible defendants must be examined. Again, the state acts provide another category of potential defendants.

Section 410(b) imposes potential liability, again subject to affirmative defenses, "every broker-dealer who materially aids in the sale" of the securities. This section is not necessary to impose liability upon broker-dealers and their agents where the hedge fund markets its securities through brokerage houses. These people will already be liable under Section 410(a). However, the liability of clearing brokers under this provision of Section 410(b) is increasingly being recognized.[144] While, as will be seen below, in most cases, the hedge fund deals directly with a **prime broker**, traditional introducing broker-dealers may be used in connection with hedge funds for three reasons.

The hedge fund might get a better price execution through

[140] 15 U.S.C. §77o.

[141] *See e.g.*, Section 410(b) of the Uniform Act.

[142] *See e.g.,* Swenson v. Engelstad, 626 F.2d 421 (5th Cir. 1980), Westlake v. Abrahams, 556 F.Supp. 1330 (N.D. Ga. 1983); Hines v. Data Lines Sys. Inc., 114 Wash.2d 127, 787 P.2d 8 (1990). *See generally*, Long, §9:80 (2003).

[143] Report at 44.

[144] In re Koruga, 2000 WL 3353459 (NASD Arb. Oct. 2, 2000), confirmed sub. Nom. Koruga v. Fiserv Correspondent Serv., Inc., 138 F. Supp.2d 1245 (D. Ore. 2001), aff'd 40 Fed. Appx. 364, 2002 WL 530548 (9th Cir. 2002); In re Kaly, 2002 WL 1722326 (NASD Arb. June 14, 2002), confirmed sub. Nom., Emmett A. Larkin & Co., Case No. 2:02CV641DAK (D. Utah May 19, 2003); In re Peers, 2001 WL 1636289 (NASD Arb. Nov. 8, 2001). *See also* Hirata Corp. v. J.B. Oxford & Co., 193 F.R.D. 589 (N.D. Ind. 2000); Brian P. Stern, "Clearing Firm Liability: Immunity or Exposure in the Wake of A.R. Baron/Bear Stearns and the SRO Amendments, 1997 NASA Law Reports 171; Jeanette Filippone, "Clear Skies for Investors: Clearing Firm Liability Under the Uniform Securities Act," 39 San Diego L. Rev. 1327 (2002); Daphna Abrams, "A Second Look at Clearing Firm Liability," 67 Brook. L. Rev. 479 (2001).

another broker. Likewise, the use of multiple strategies may require the use of brokers having different expertise. Finally, the use of multiple broker-dealers will limit, to some extent, the exposure of the hedge fund's investment strategies. Where multiple introducing brokers are used, the prime broker serves the normal clearing function in clearing the trades and providing the back-office services.

Contrary to the assertions of clearing brokers, NYSE Rule 381, by its own terms, does not protect the clearing broker from liability for breaking either federal or state law. Therefore, the Rule does not shield the clearing brokers from potential liability under Section 410(b) of the Uniform Act.

Prime Brokers

The SEC Staff Report indicates that most hedge funds enter into prime brokerage agreements with one or more full service broker-dealers to actually handle their purchase and sale transactions.[145] Prime brokers agreements are in many ways similar to clearing brokerage agreements. However, prime brokerage agreements differ in that, in the case of hedge funds, there is no introducing broker as in the case of a clearing agreement.

The entire prime brokerage industry is based upon a no-action letter from the SEC. This letter, **Prime Broker Committee Request**,[146] was technically only good until the end of 1994. However, it was extended year by year until the SEC made it final in 2002.[147] The original letter outlines the conditions which the prime broker must meet in order to receive protection similar to that obtained by NYSE Rule 381. The requirements of the prime broker letter are similar, but not identical, to those of NYSE Rule 381. Therefore, the letter must be read carefully.

It should be obvious that Section 410(b) of the Uniform Act may also be used to impose secondary liability upon the prime brokers who handle hedge fund transactions. They are broker-dealers who aided in the transaction. As in the case of clearing brokers, the prime brokers may claim the protection of NYSE Rule 381. However, as Rule 381 does not protect the clearing brokers from liability under Section 410(b) of the Uniform Act, it should not protect prime brokers either. The prime broker letter also makes clear that the prime brokers are not protected from liability under Section 410(b).[148]

Brokers Involved with Hedge Fund Organization

The Report also indicates that the small hedge funds often only have an agreement with a single broker-dealer, who often assist in the start up of the hedge fund and make investments therein. This creates obvious conflicts of interests, which often are not disclosed.

[145] Report at 53.

[146] Report at 53, n. 185.

[147] 1994 WL 808441 (SEC No-Action Letter Jan. 25, 1994).

[148] Prime Brokers, 2002 WL 1277045 (SEC No-Action Letter June 11, 2002).

ProfLipner's "I Love New York Law"-Vacatur In New York: Arbitrator Misconduct

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Recent published decisions have shown an increased propensity on the part of New York's courts, both state and federal, to vacate arbitration awards. More than a few awards were vacated for manifest disregard, even as the Second Circuit seems to have stepped back from its 1997 Halligan decision.[1]

The courts have in general been critical of arbitrators who make awards which seem dubious and lack reasons, and there have been several cases which resulted in remands to arbitration panels. In *Tripi v. Prudential Securities, Inc.,* a federal district judge vacated and remanded to the arbitrators (for explanation or modification) an award that she found "bizarre", because it found liability, but awarded only a miniscule percentage of the damages sought.[2] In another such case, *Sawtelle v. Waddell & Reade Inc.*,[3] a New York trial judge vacated (for a second time)[4] a disproportionately high punitive damage award, but this time ordered that the remand be heard by a new arbitration panel.

This judicial assertiveness, of course, can be either good or bad, depending upon which side one views the award from. But this judicial assertiveness is also a message to arbitrators that someone is indeed watching what they do, and lawyers need to consider vacatur, not just after the award is rendered, but also preserving rights as the arbitration proceeds.[5]

This article is thus directed to the standards for vacating an award in New York. Challenges to an arbitration award are basically divided into two (2) categories: procedural and substantive. This article concerns the procedural challenges, including arbitrator

[1] H*alligan v. Piper Jaffray, Inc.* 148 F.3d 197 (2d Cir. 1998); *GMS v. Benderson*, 326 F.3d 2003); *Westerbeke Corp. v. Daihatsu Motors Co., Ltd.*, 304 F.3d 200 (2d Cir. 2002).

[2] *Tripi v. Prudential Securities, Inc.,* 2003 WL 22208351 (S.D.N.Y. 2003); See also *Hardy v. Walsh Manning Securities LLC., 341 F.3d 126 (2*d Cir. 2003)

[3] NY County Supreme Court, No. 115056, decided January 22, 2004 (Stallman, J.)

[4] 754 N.Y.S.2d 264 (1 Dept. 2003)

[5] A trial attorney is always considering preservation issues, but arbitration attorneys may not always think in that mode as the proceeding unfolds. Indeed, the issue of preserving vacatur rights can extend all the way back to forum selection, because of the NASD's use of an inferior taping equipment to make a record, in comparison to the NYSE's use of a court reporter. No serious vacatur motion can proceed without a transcript of the hearing being presented to the court.

misconduct, the refusal to hear evidence, and arbitral bias. The second category of vacatur grounds, principally manifest disregard, will be the subject of a subsequent article.

ARBITRATOR MISCONDUCT

Section 10 of the Federal Arbitration Act provides the following grounds for vacatur:

- Where the award was procured by corruption, fraud, or undue means.
- Where there was evident partiality or corruption in the arbitrators, or either of them.
- Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced. [6]

The New York Civil Practice Law and Rules Section 7511(b)(1) is the same. It states that an "award shall be vacated . . . if the court finds that the rights of [a] party were prejudiced by:

- corruption, fraud or misconduct in procuring the award; or
- partiality of an arbitrator appointed as a neutral, except where the award was by confession [7]

Serious allegations of fraud and corruption are rare if not unheard-of in securities arbitration. In any event, no cases could be located involving such allegations in the context of securities arbitration, and this article will thus focus on the other three areas – refusal to hear evidence, refusal to grant an adjournment, and "evident partiality".

Refusal to hear pertinent and material evidence is a recognized form of arbitrator misconduct justifying vacatur, expressly under the Federal Arbitration Act and implicitly under CPLR 7511(b)(1)(i). [8] Of course, the refusal to hear evidence must amount to "prejudice" – not every refusal will suffice. [9]

Similarly, refusal to grant an adjournment would be considered, under the CPLR, to be "misconduct", and the FAA specifies it as a ground. The leading case is from the First Circuit, *Hoteles Candado Beach*, and it holds that the refusal to grant and adjournment in the face of a reasonable excuse for the inability to proceed (the party's wife had cancer) is ground for vacatur. Both types of "refusal" cases (i.e.,

[6] In addition, the Act provides two other grounds that are beyond the scope of this article because they are inapposite to securities arbitration. They are "where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final, and definite award upon the subject matter submitted was not made," and "[w]here an award is vacated and the time within which the agreement required the award to be made has not expired the court may, in its discretion, direct a rehearing by the arbitrators.

[7] The statute, like the F.A.A. adds "or an arbitrator, or agency or person making the award exceeded his power or so imperfectly executed it that a final and definite award upon the subject matter submitted was not made; or failure to follow the procedure of this article, unless the party applying to vacate the award continued with the arbitration with notice of the defect and without objection."

[8] See *Professional Staff Congress/CUNY v. Board of Higher Education of New York City*, 39 N.Y.2d 319, 383 N.Y.S.2d 592 (1976). See generally V. Alexander, Practice Commentary C7511:3 (1998). See also 9 U.S.C. 10(a)(3)(an award [may] be vacated "where the arbitrators were guilty of misconduct . . . in refusing to hear evidence pertinent and material to the controversy; or of any other misbehavior by which the rights of any party have been prejudiced.").

[9] An example one which did suffice, and in which the Second Circuit made an elaborate analysis showing why ithe refusal was material, is *Tempo Shain Corp. v. Bertek, Inc*, 120 F.3d 16 (2d Cir. 1997)

"to hear evidence" and "to grant an adjournment") often set the standard as a denial of fundamental fairness. [10]

"Partiality of an arbitrator", as it is termed in CPLR 7511(b)(1)(ii), or "evident partiality" in F.A.A. terms, is the next commonly-alleged ground. While prejudice is again a requirement, the appearance of impropriety is often cited as a major concern here. [11] That presents a gap in the logic of the law – in cases where the appearance of impropriety (but not outright partiality) is alleged, how can one prove "prejudice"? Nevertheless the cases do stress "prejudice". In *Goldfinger v. Lisker*, [12] the Court of Appeals explained in strong terms why these grounds for vacatur exist, and appeared to tie that rationale to "prejudice":

> Precisely because arbitration awards are subject to such judicial deference, it is imperative that the integrity of the process, as opposed to the correctness of the individual decision, be zealously safeguarded. Arbitration by its nature contemplates a less formal environment than the judicial forum *(see, Matter of Silverman [Benmor Coats],* 61 NY2d, at p 308, *supra; see also, Bernhardt v Polygraphic Co.,* 350 US 198, 203 & n 4), and accordingly, arbitrators are not held to the standards prescribed for members of the judiciary. Nevertheless, arbitrators must take a formal oath (CPLR 7506 [a]), are expected to "faithfully and fairly" hear the controversy over which they have been chosen to preside (CPLR 7506 [a]; *Matter of Siegel [Lewis],* 40 NY2d, at p 689, *supra)* and ought to conduct themselves in such a manner as to safeguard the integrity of the arbitration process.
>
> Arbitrators must afford the parties the opportunity to present evidence and to cross-examine witnesses and may act only upon proof adduced at a hearing of which due notice has been given to each party (CPLR 7506 [b], [c]; *Matter of Delmar Box Co. [Aetna Ins. Co.],* 309 NY 60, 64; *Matter of Penn Cent. Corp. [Consolidated Rail Corp.],* 56 NY2d 120, 127). . . .
>
> Although courts generally will not interfere with the judgment of arbitrators, arbitration awards are not to be confirmed without question where there is evidence of misconduct prejudicing the rights of the parties. CPLR 7511 provides in pertinent part that an arbitration award shall be vacated if the court finds that the rights of the complaining party were prejudiced by corruption, fraud, or misconduct in procuring the award. . . .

But despite the language about "prejudice" in *Goldfinger*, the Court's clear emphasis was on the policing role that judges play in arbitration – and how the courts are duty-bound to preserve the integrity of the arbitration process above all else. Thus, First Department explained, in *Matter of Fischer,* that "basic,

[10] See e.g. *Hoteles Candado Beach v. Union de Tronquistas*, 763 F.2d 34 (1st Cir. 1985); *Roche v. Local 32B-32J Service Employees Int'l Union,* 755 F.Supp. 622, 624 (S.D.N.Y.1991)

[11] See, e.g. *Matter of Fisher,* 106 A.D.2d 314, 482 N.Y.S.2d 761 (1st Dept.1984); *Matter of Kern v. 303 East 57th Street Corp.,* 204 A.D.2d 152, 153, 611 N.Y.S.2d 547 (1st Dept. 1994).

[12] 68 N.Y.2d 225, 508 N.Y.S.2d 159 (1986), amendment granted in part, 69 N.Y.2d 729, 512 N.Y.S.2d 368, amendment denied in part, 69 N.Y.2d 1036, 517 N.Y.S.2d 939

fundamental principles of justice require complete impartiality on the part of the arbitrator and mandate that the *proceedings be conducted without any appearance of impropriety*".[13] That Court also has stated that the particular facts and circumstances of each case must be examined to reach an appropriate determination as to whether arbitrator misconduct or bias exists.

Indeed, courts have considered, and granted vacatur based upon the appearance of arbitrator bias or partiality, even without direct proof of "prejudice". For instance, in *Matter of Kern*, [14] an award was vacated based upon an improper communication between the arbitrator and a third party to the arbitration (just as is the case here), in part because the arbitrator failed to disclose the "nature of the communication." The Court wrote:

> The failure of the [arbitrator] to disclose the existence and nature of the communication by the [non-party] Morgan Guaranty Trust Company representative raises, under the particular circumstances herein, a question of possible bias or partiality, since the [arbitrator's] name was referred to Morgan Guaranty by the petitioners' attorney well before the panel's deliberations had begun and this was made known to the [arbitrator]. Consequently, the integrity of the process appears to have been compromised. [15]

The clear import of this passage from *Kern* is that prejudice can be presumed from the appearance of bias.

The standard of review for the disqualification of arbitrators is, indeed, whether the arbitration process is free of bias or the appearance of bias. [16] When the courts speak of "prejudice" in this context, they seem to be pointing more toward concepts of "materiality" or importance. Thus, proof of actual harm ought not be required. [17] In such cases, a defense to vacatur based upon a review of the evidence in the record (and a claim that that evidence supports the arbitration result regardless of the bias) ought not to be allowed. As the *Goldfinger* court explained: "it is imperative that the integrity of the process, as opposed to the correctness of the individual decision, be zealously safeguarded."

[13] 106 A.D.2d 314, 315-316, 482 N.Y.S.2d 761 (1st Dept. 1984)(italics added); See also *Montague Pipeline Technologies Corp. v. Grace-Lansing*, 656 N.Y.S.2d 656 (2nd Dept. 1997).

[14] *Matter of Kern v. 303 East 57th Street Corp.,* 204 A.D.2d 152, 153, 611 N.Y.S.2d 547 (1st Dept. 1994).

[15] *Id.* at 153. See also *Rothman v. RE/MAX of New York, Inc.*, 183 Misc.2d 402, 703 N.Y.S.2d 666 (Sup.Ct.Suffolk Cty. 1999), *rev on other grounds*, 274 A.D.2d 520, 711 N.Y.S.2d 477 (2nd Dept. 2000).

[16] See generally *Commonwealth Corp. v. Continental Co.,* 393 U.S. 145, 89 S.Ct. 337, 21 L.Ed.2d 301; *Matter of Excelsior 57th Corp.* [*Kern*], 218 A.D.2d 528, 630 N.Y.S.2d 492 (1st Dept. 1995); *Rabinowitz v. Olewski,* 100 A.D.2d 539, 473 N.Y.S.2d 232 (2nd Dept. 1984); *Labor Relations Section of the Northern New York Builders Exchange, Inc. v. Gordon*, 41 A.D.2d 25, 27, 341 N.Y.S.2d 714 (4th Dept. 1973)("an arbitrator, like a judge, must not only be impartial but must be beyond reasonable suspicion of partiality, and this is so . . . because an arbitration award is not review able by a court for errors of fact or law.")

[17] See Revised Uniform Arbitration Act, Official Comment on Section 23(a)(2), at para 1. The RUAA can be found at http://www.law.upenn.edu/bll/ulc/uarba/arbitrat1213.htm

AN ARGUMENT FOR STRICT SCRUTINY

Public investors are required by the adhesion contracts used in the securities industry to arbitrate at one of the two so-called self-regulatory organizations – NASD or the NYSE organizations in which the brokerage firm respondents are influential members. In *MVAIC v. Aetna,*[18] the Court of Appeals has stated that the standard of review of an arbitration award is determined in part by whether the arbitration was voluntary or mandatory. Given the mandatory and monopolistic nature of securities arbitration, a higher level of judicial scrutiny should apply in this consumer-arbitration case than in the usual business-to-business commercial case. The appearance of fairness, as well as fairness itself, would best be served by such scrutiny.

CONCLUSION

The manner in which arbitrators conduct themselves and conduct the hearing are important to courts reviewing awards. Not only a showing of actual bias, but also a showing of improper appearance, can influence a court at the vacatur stage.

[18] 89 N.Y.2d 214, 223, 652 N.Y.S.2d 584, 674 N.E.2d 1349 (1996)

Practitioner's Column-The New Code of Ethics for Arbitrators

"Standards for Those Who Judge"

David E. Robbins

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Introduction

They are as immune from lawsuits as judges, jurors and administrators. They aren't required to set forth the reasons for their decisions and, indeed, are discouraged from doing so. Their Awards, by and large, are set in stone. During the hearing, they often ask witnesses the kinds of questions a party's attorney is afraid to ask for fear of getting the "wrong" answer. Most are attentive, objective and diligent, while others are diffident, secretly biased or obtuse. Their unpredictability is the primary motivation for the growing acceptance of mediation. They are frequently asked to judge the conduct of brokers, firms and customers based on equitable principles as opposed to hard-and-fast rules and statutes. Yet few, I imagine, know that in 2004 significant revisions to the 1977 *Code of Ethics for Arbitrators in Commercial Disputes* became effective.

The revised Code not only affects the way in which arbitrators *should* conduct themselves during all stages of a proceeding, but it also provides benchmarks by which parties and practitioners can judge arbitrator conduct. Compliance with the Code assures parties a better chance of receiving a full and fair opportunity to be heard. Its violation, even unintentionally, can result in overturning an arbitration Award. According to the preamble of the new version, the "Code sets forth generally accepted standards of ethical conduct for the guidance of arbitrators and parties in commercial disputes." What are those standards, the standards by which to judge the arbitrators?

The Revised Code – An Overview

This article highlights key provisions of the Code (the full text of which can be found on the AAA's Web site: www.adr.org). First, however, a summary of each of the 10 "canons" is in order. By the way, what is a canon? *The American Heritage Dictionary* defines the word, in part, as a secular law, rule, or code of law; an established principle, such as the canons of polite society; a basis for judgment; a standard or criterion; or, the works of a writer that have been accepted as authentic. Much can be gleaned by the titles alone of the canons. The first seven start with the phrase "An arbitrator should":

1. Uphold the integrity and fairness of the arbitration process.
2. Disclose any interest or relationship likely to affect impartiality or which might create an appearance of partiality.
3. Avoid impropriety or the appearance of impropriety in communicating with parties.
4. Conduct the proceedings fairly and diligently.

5. Make decisions in a just, independent and deliberate manner.
6. Be faithful to the relationship of trust and confidentiality inherent in that office.
7. Adhere to standards of integrity and fairness when making arrangements for compensation and reimbursement of expenses.

The remaining three canons provide that:

8. An arbitrator may engage in advertising or promotion of arbitral services which is truthful and accurate.
9. Arbitrators appointed by one party have a duty to determine and disclose their status and to comply with this Code, except as exempted by Canon X.
10. The last canon sets forth exemptions for arbitrators appointed by one party who are not subject to the rules of neutrality.

CANON I.

AN ARBITRATOR SHOULD UPHOLD THE INTEGRITY AND FAIRNESS OF THE ARBITRATION PROCESS.

This Canon provides, among other things, that a person should only accept appointment as an arbitrator if the person is fully satisfied that he or she: (1) can serve impartially; (2) can serve independently from the parties, potential witnesses and the other arbitrators; (3) is competent to serve; and, (4) can be available to commence the arbitration in accordance with the requirements of the proceeding and thereafter to devote the time and attention to its completion that the parties are reasonably entitled to expect. This has always been a problem at SRO arbitrations, especially in the Northeast in the winter months, when many arbitrators fly south for months, and in the summer, when arbitrators take vacations.

This Canon states that an arbitrator should make all reasonable efforts to prevent delaying tactics, harassment of parties or of other participants, or any other abuse or disruption of the arbitration process. However, the Canon also states:

> During an arbitration, the arbitrator may engage in discourse with the parties or their counsel, draw out arguments or contentions, comment on the law or evidence, make interim rulings, and otherwise control or direct the arbitration. These activities are integral parts of an arbitration.

CANON II.

AN ARBITRATOR SHOULD DISCLOSE ANY INTEREST OR RELATIONSHIP LIKELY TO AFFECT IMPARTIALITY OR WHICH MIGHT CREATE AN APPEARANCE OF PARTIALITY.

This second Canon is divided into eight parts which primarily focus on what an arbitrator should do – disclosure wise - before accepting appointment and what he or she should do when one or more parties objects to the arbitrator's sitting on the case.

The first part of this second Canon sets forth *the disclosures an arbitrator should make* before accepting appointment:

(1) Any known direct or indirect financial or personal interest in the outcome of the arbitration.

(2) Any known existing or past financial, business, professional or personal relationships which might reasonably affect impartiality or lack of independence in the eyes of any of the parties. For example, prospective arbitrators should disclose any such relationships which they personally have with any party or its lawyer, with any co-arbitrator, or with any individual whom they have been told will be a witness. They should also disclose any such relationships involving their families or household members or

their current employers, partners, or professional or business associates that can be ascertained by reasonable efforts.

(3) The nature and extent of any prior knowledge they may have of the dispute. While arbitrators can and should have a general understanding of the issues they will be asked to decide - such as a securities attorney understanding how orders are executed - arbitrators should not have a knowledge of the particular controversy such that they do go into the hearing with their minds made up already.

This obligation to disclose is not absolute and the second provision of this Canon recognizes this. It states that persons who are requested to accept appointment as arbitrators should make a *reasonable effort* to inform themselves of any interests or relationships. The obligation to disclose interests or relationships is a continuing duty.

What if an arbitrator is requested by all the parties to withdraw? This Canon states that, in that event, the arbitrator must do so. However, if the arbitrator is requested to withdraw by less than all of the parties because of alleged partiality, this Canon provides that the arbitrator should withdraw unless either of the following circumstances exists:

(1) An agreement of the parties, or arbitration rules agreed to by the parties, or applicable law establishes procedures for determining challenges to arbitrators, in which case those procedures should be followed; or

(2) In the absence of applicable procedures, 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.

CANON III.

AN ARBITRATOR SHOULD AVOID IMPROPRIETY OR THE APPEARANCE OF IMPROPRIETY IN COMMUNICATING WITH PARTIES.

This Canon deals with the appearance of propriety in arbitrator communications of all kinds with the parties. It is based on common sense and the need for all parties to the controversy to believe they are being treated equally. It provides that neither a prospective nor sitting arbitrator should discuss the case with any party in the absence of any other party. This Canon provides the following circumstances for permissible communications:

(1) **Questions** When the appointment of a prospective arbitrator is being considered, that person (a) may ask about the identities of the parties, counsel, or witnesses and the general nature of the case; and (b) may respond to inquiries from a party or its counsel designed to determine his or her suitability and availability for the appointment. Such a direct dialogue will not take place in an NASD or NYSE arbitration because, at this stage, all such communications are done through an arbitration staff person. However, parties may submit questions to the staff for dissemination to the prospective arbitrators concerning the arbitrators' experience in particular cases and the arbitrators' general proclivity on certain issues involved in the dispute.

(2) **Tripartite Panels** In an arbitration in which the two party-appointed arbitrators are expected to appoint the third arbitrator, each party-appointed arbitrator may consult with the party who appointed the arbitrator concerning the

choice of the third arbitrator. This will only take place at the AAA if the arbitration agreement provides for such selection of arbitrators.

(3) **Logistics** This Canon provides that discussions may be had with a party concerning such logistical matters as setting the time and place of hearings or making other arrangements for the conduct of the proceedings. Again, if this happens at all, it will be during an AAA case, since almost all SRO cases are administered through SRO staff.

(4) **Party Absence** If a party fails to be present at a hearing after having been given due notice, or if all parties expressly consent, the arbitrator may discuss the case with any party who is present.

CANON IV.

AN ARBITRATOR SHOULD CONDUCT THE PROCEEDINGS FAIRLY AND DILIGENTLY.

This Canon sets the *due process standards* for fully and fairly conducting arbitration hearings.

(1) **Courtesy** The arbitrator should conduct the proceedings in an even-handed manner; should be patient and courteous to the parties, their representatives, and the witnesses; and, should encourage similar conduct by all participants.

(2) **Full Hearing** The arbitrator should afford to all parties the right to be heard and due notice of the time and place of any hearing. He or she should allow each party a fair opportunity to present its evidence and arguments.

(3) **Counsel** The arbitrator should not deny any party the opportunity to be represented by counsel or by *any other person* chosen by the party. Thus, this Canon allows a party to be represented by a non-attorney.

(4) **Absence of Party** This Canon provides that if a party fails to appear after due notice, the arbitrator should proceed with the arbitration when authorized to do so, but only after receiving assurance that appropriate notice has been given to the absent party.

(5) **The Rest of the Story** Arbitrators are not passive vessels or potted plants. This provision of Canon IV provides that when the arbitrator determines that more information than has been presented by the parties is required to decide the case, it is not improper for the arbitrator to ask questions, call witnesses, and request documents or other evidence, including expert testimony.

(6) **Settlement Discussions** This provision states that although it is not improper for an arbitrator to suggest to the parties that they discuss the possibility of settlement or the use of mediation, an arbitrator should not exert pressure on any party to settle or to utilize other dispute resolution processes.

(7) **One for All** The final provision in this Canon deals with chairpersons who sometimes forget that there are other arbitrators on the panel. It states that co-arbitrators should afford each other full opportunity to participate in all aspects of the proceedings. In a Comment to this provision, the Code states that it is not intended to preclude one arbitrator from acting in limited

circumstances (e.g., ruling on discovery issues) where authorized by the agreement of the parties, applicable rules or law.

CANON V.

AN ARBITRATOR SHOULD MAKE DECISIONS IN A JUST, INDEPENDENT AND DELIBERATE MANNER.

Arbitration Awards can be vacated if the arbitrators exceeded their authority in deciding an issue that was not contained in the original pleadings or amended pleadings or in awarding damages that were not sought by a party. This Canon deals with the proper way arbitrators must decide cases. It states that arbitrators, after careful deliberation, should decide all issues submitted for determination and no other issues.

CANON VI.

AN ARBITRATOR SHOULD BE FAITHFUL TO THE RELATIONSHIP OF TRUST AND CONFIDENTIALITY INHERENT IN THAT OFFICE.

Canon IV concerns the confidentiality of arbitration proceedings. Its first dictum is that an arbitrator may not use confidential information acquired during the arbitration proceeding to gain personal advantage or advantage for others, or to affect adversely the interest of another. The arbitrator must, under this Canon, keep confidential all matters relating to the arbitration proceedings and decision. However, this Canon also provides that an arbitrator may obtain help from an associate, a research assistant or other persons in connection with reaching his or her decision. Such measures may only be taken if the arbitrator informs the parties of the use of such assistance and such persons agree to be bound by the provisions of this Canon.

CANON VII.

AN ARBITRATOR SHOULD ADHERE TO STANDARDS OF INTEGRITY AND FAIRNESS WHEN MAKING ARRANGEMENTS FOR COMPENSATION AND REIMBURSEMENT OF EXPENSES.

At the AAA, before the arbitrator finally accepts appointment, the basis of payment should be established, including any cancellation fee, compensation in the event of withdrawal and compensation for study and preparation time, and all other charges. Except for arrangements for the compensation of party-appointed arbitrators, all parties should be informed in writing of the terms established.

This Canon provides that in proceedings conducted under the rules or administration of an institution that is available to assist in making arrangements for payments – such as the NASD or NYSE - communication related to compensation should be made through the institution. Importantly, this Canon warns arbitrators that they should not, absent extraordinary circumstances, request increases in the basis of their compensation during the course of a proceeding.

CANON VIII.

AN ARBITRATOR MAY ENGAGE IN ADVERTISING OR PROMOTION OF ARBITRAL SERVICES WHICH IS TRUTHFUL AND ACCURATE.

This is a new Canon. It provides that advertising or promotion of an individual's willingness or availability to serve as an arbitrator must be accurate and unlikely to mislead. Further, any statements about the quality of the arbitrator's work or the success of the arbitrator's practice must be truthful. This Canon states that advertising and promotion must not imply any willingness to accept an appointment otherwise than in accordance with the Code of Ethics.

The Comment to this Canon states that it does not preclude an arbitrator from printing, publishing, or disseminating advertisements conforming to these standards in any electronic or print medium, from making personal presentations to prospective users of arbitral services conforming to such standards or from responding to inquiries concerning the arbitrator's availability, qualifications, experience, or fee arrangements.

Balance of the Canons

The balance of the Canons deals with party-appointed arbitration panels, which take place in a distinct minority of securities arbitrations administered by the AAA only. These Canons are all new to the Code of Ethics.

CANON IX.

ARBITRATORS APPOINTED BY ONE PARTY HAVE A DUTY TO DETERMINE AND DISCLOSE THEIR STATUS AND TO COMPLY WITH THIS CODE, EXCEPT AS EXEMPTED BY CANON X.

The first part of this Canon explains such panels. It states that in some types of arbitrations in which there are three arbitrators, it is customary for each party, acting alone, to appoint one arbitrator. The third arbitrator is then appointed by agreement either of the parties or of the two arbitrators, or failing such agreement, by an independent institution or individual. However - and this is a new provision in the Code of Ethics - in tripartite arbitrations to which this Code applies, all three arbitrators are *presumed to be neutral* and are expected to observe the same standards as the third arbitrator.

However, this Canon recognizes that there are certain types of tripartite arbitrations in which it is expected by all parties that the two arbitrators appointed by the parties may be predisposed toward the party appointing them. Those arbitrators - referred to in this Code as "Canon X arbitrators" - are not to be held to the standards of neutrality and independence applicable to other arbitrators. Canon X describes the special ethical obligations of party-appointed arbitrators who are not expected to meet the standard of neutrality.

How should a party-appointed arbitrator determine whether he or she will be considered a neutral arbitrator? This Canon provides that a party-appointed arbitrator has an obligation to ascertain, as early as possible but not later than the first meeting of the arbitrators and parties, whether the parties have agreed that the party-appointed arbitrators will serve as neutrals or whether they will be subject to Canon X, and to provide a timely report of their conclusions to the parties and other arbitrators.

CANON X.

EXEMPTIONS FOR ARBITRATORS APPOINTED BY ONE PARTY WHO ARE NOT SUBJECT TO RULES OF NEUTRALITY.

With Respect to Canon I - Canon X arbitrators should observe all of the obligations of Canon I subject only to the following provisions:

1. They may be predisposed toward the party who appointed them but in all other respects are obligated to act in good faith and with integrity and fairness. For example, they should not engage in delaying tactics or harassment of any party or witness and should not knowingly make untrue or misleading statements to the other arbitrators.
2. The provisions of Canon I that relate to partiality, relationships, and interests are inapplicable to Canon X arbitrators.

May a party-appointed arbitrator engage in communications with the neutral arbitrator in the absence of the other party-appointed arbitrator? No, according to this Canon. Unless otherwise agreed by the arbitrators and the parties, a Canon X arbitrator may not communicate orally with the neutral arbitrator concerning any matter or issue arising or expected to arise in the arbitration in the absence of the other Canon X arbitrator. If a Canon X arbitrator communicates in writing with the neutral arbitrator, this Canon requires the party-appointed arbitrator to simultaneously provide a copy of the written communication to the other Canon X arbitrator.

When Canon X arbitrators communicate orally with the parties that appointed them concerning any matter on which communication is permitted under this Code, *are the arbitrators obligated to disclose the contents of such oral communications to any other party or arbitrator?* No, according to this Canon. Nor are Canon X arbitrators who communicate in writing with the party who appointed them required to send copies of any such written communication to any

Conclusion

In the 27 years between the first appearance of the *Code of Ethics for Arbitrators* and the enactment of its revisions in 2004, much has changed in the arbitration of commercial disputes, especially in the securities field. At the AAA, it used to be that arbitrators charged no fee for the first hearing day. When the Code first went into effect, very few customer securities arbitrations were being administered by the self-regulatory organizations or the AAA.

The revised Code of Ethics maintains the same high standards expected of arbitrators, standards which most arbitrators practice without having read the Code. However, if practitioners are concerned about the manner in which a particular arbitrator is administering a case, he or she should consult the Code of Ethics to determine whether that arbitrator's conduct is inconsistent with those standards. If that awareness of impropriety takes place *during* the course of a case, it is best to contact the staff administrator, with notice to your adversary. If that realization does not take place until *after* the issuance of the Award, practitioners are advised to act quickly since in most jurisdictions, arbitration Awards may not be challenged after 90 days. In challenging an arbitration Award, it may be appropriate to cite provisions of the *Code of Ethics for Arbitrators* since it sets the standards for arbitrators.

View from the West - Unpaid Securities Arbitration Awards: Proposed Solutions to the Problem

by Scot Bernstein [1] [2]

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That this article is necessary is a travesty. The problem it addresses should not exist.

The Problem of Unpaid Awards

Let's start with rock-bottom basics. People work hard. They accumulate wealth. They need help from people they can trust to manage that wealth and help them invest appropriately and avoid unnecessary risk. They need that level of service because they need and want financial security and the ability to retire or to stay retired. They need that level of service because they don't have the time, the training, the knowledge or the self-confidence to perform those tasks on their own.

An industry exists to serve that need. It is called the securities industry. The securities industry holds itself out as providing exactly what people need—knowledgeable advice that they can trust and rely on, with investments carefully selected to provide the financial security or rewards they need. The industry's advertisements give assurances of "traditions of trust," personal care and solid results that allow people to enjoy life instead of worrying about their money. People who entrust their financial affairs to the securities industry will say, "Thank you, Mr. Broker."

Unfortunately, members of the securities industry often do not act on a par with the trust that their clients repose in them. Disputes arise. Sometimes the misconduct is simply negligent; sometimes it is downright criminal.

A system exists for adjudicating disputes about securities industry members' conduct. It is called "securities arbitration." Almost without exception, clients of securities firms are forced to use securities arbitration to resolve any disputes regarding their accounts. Industry members have incorporated arbitration clauses in the basic documents they use to open securities accounts. As a condition of doing business with a securities firm, the documents require people to give up their right to go to court, where the dispute would be decided by a judge and jury.

But the whole point of trusting someone with your finances

[1] This article reflects the views of its author and does not necessarily reflect the views of the Public Investors Arbitration Bar Association or its directors or officers.

[2] I appreciate the numerous ideas and suggestions provided by C. Thomas Mason III. His scholarship was a great help in the writing of this paper. I am grateful as well for thoughtful comments on earlier versions of this paper from J. Pat Sadler, Mark Maddox and Trish Butler. And Robert Banks' comments on clearing firm liability were invaluable.

is lost if the industry does not assure that its members are themselves financially responsible and that, if you prevail in your dispute, your award will be paid. It is the height of hypocrisy for members of the securities industry to advertise that they will be responsible with people's money and financial security when they themselves are financially irresponsible.

Yet that is the inexcusable situation in which we find ourselves. For 2001, the last full year for which data are available, more than half of the dollar volume of arbitration awards remains unpaid.[3] For the first three months of 2003 alone, awards totaling more than $30 million remain unpaid.[4] This is not a new problem, and it does not depend on the strength of the stock market. The GAO found more than $129 million of unpaid awards in 1998, during the height of the 1990s' bull market.[5] Whether the market is up or down, consumers are getting stiffed by securities industry members to whom they entrusted their finances.

In the 1930s, the securities industry persuaded Congress to permit it to "self-regulate."[6] The need for strict regulation

[3] *Follow-up Report on Matters Related to Securities Arbitration*, U.S. General Accounting Office Letter to Congressional Requesters John D. Dingell and Edward J. Markey, GAO 03-162R, p. 3, 9 (April 11, 2003) ["GAO 2003"]. GAO 2003 was a follow-up to the GAO's earlier report, *Securities Arbitration: Actions Needed to Address the Problem of Unpaid Awards*, U.S. General Accounting Office, GAO/GGD-00-115 (June 2000) ["GAO 2000"].

[4] Susan Pulliam, Susanne Craig and Randall Smith, *How Hazards for Investors Get Tolerated Year After Year: Corporate Board Minutes are Altered; Judgments in Arbitration Go Unpaid*, WSJ Online (Feb. 6, 2004), p.1.

[5] GAO 2000 at p. 34.

[6] The Maloney Act of 1938, Pub. L. No. 75-719, 52 Stat. 1070 (1938) (codified at 15 U.S.C. § 78o-3), gave legislative authorization to the establishment of a national securities association, the NASD. The NASD proudly proclaims that it "is not an organization which was imposed upon the investment banking and securities business by Congress or by the Securities and Exchange Commission. The privilege of self-regulation was actively sought by the securities business." NASD MANUAL (CCH) ¶ 101 (History and Organization of the NASD). The SEC stated in its Special Study in 1963, "There are, no doubt, many other instances in which the policy of entrusting a degree of social control to 'private' groups has been adopted, but securities regulation is unique in featuring self-regulation as an essential and officially sanctioned part of the regulatory pattern." SEC, REPORT OF SPECIAL STUDY OF SECURITIES MARKETS, H. R. Doc. No. 88-95, pt. 4, at 501 (1963) ["SPECIAL STUDY"].

of the securities industry was glaringly obvious at the time. The nation was in the midst of the Great Depression, which was brought about in part by the securities industry's excesses.[7]

"Self-regulation" does not mean that each broker-dealer regulates itself. It means that the whole industry must regulate each and all of its participants. Self-regulation is regulation. If the industry does not regulate itself – including its worst actors – it is not doing the job.

Part of the regulatory job is assuring the financial responsibility of members in all contexts, including dispute resolution in arbitration or elsewhere. Those who wish to manage the financial security of others must demonstrate financial responsibility themselves. Allowing a company capitalized with $5,000 to manage millions of dollars for consumers shocks the conscience. That the current regulatory scheme can allow that company to walk away without paying for the consequences of its misconduct is unfathomable.

Consumers are shocked when they discover that the company they trusted has no money to repay them. They are shocked to learn that companies in a supposedly "highly regulated industry" are permitted manage tens and hundreds of millions of dollars for the public without any insurance. The typical financial consumer carries liability insurance through homeowner's and auto policies at a minimum. Business owners carry liability insurance and a variety of other coverages. In most states, drivers are required to provide evidence of financial responsibility in order to keep their drivers licenses. Yet the securities industry permits its members and employees to risk people's life savings without any insurance or investor guarantee fund at all. As a result, part of the self-regulatory function is failing critically: all too often, people who prove that an industry member erred receive nothing back.

Unpaid awards are glaring evidence of a "market failure" in self-regulation. Neither the free market nor the securities industry's self-regulatory "conscience" has protected consumers against or compensated them for the errors and predations of securities industry participants.

Self-regulation is both a privilege and a responsibility. If the industry wants to self-regulate, it must fix what is broken in its system of financial accountability. If the securities industry is unwilling (and this clearly is a failure of will, not of ability) to fix the problem from within, the SEC, state regulators, and ultimately Congress must impose discipline from outside.

[7] The U.S. Supreme Court explained the importance of this body of law – the importance of *not* allowing *laissez faire* or *caveat emptor* to govern capital markets – in *Silver v. New York Stock Exchange*, 373 U.S. 341, 366, 83 S.Ct. 1246, 1262, 10 L.Ed.2d 389 (1965) (footnotes omitted):

"The Investment Advisers Act of 1940 was the last in a series of Acts designed to eliminate certain abuses in the securities industry, abuses which were found to have contributed to the stock market crash of 1929 and the depression of the 1930's. It was preceded by the Securities Act of 1933, the Securities Exchange Act of 1934, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company Act of 1940. A fundamental purpose, common to these statutes, was to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry. As we recently said in a related context, 'It requires but little appreciation ... of what happened in this country during the 1920's and 1930's to realize how essential it is that the highest ethical standards prevail' in every facet of the securities industry."

In 1963, the SEC's Special Study argued that "those entering the securities business as entrepreneurs should have such sense of commitment to their business as is likely to produce responsible, reliable operations."[8] The SEC also found that broker-dealers operating with limited capital committed a "disproportionate number" of SEC rule violations.[9]

Forty years later, the industry still lacks financial accountability to the public. The GAO found in 2003, just as the SEC did in 1963, that firms with limited capital and little sense of responsible, reliable operations produced the greatest number of problems. "The majority of unpaid awards in both 1998 and 2001 resulted from brokers leaving the securities industry."[10] The GAO acknowledged the seriousness of the situation: "[T]he extent to which awards are unpaid by defunct brokers shows that unpaid awards … [are] still a serious problem that can affect investors' confidence in arbitration and potentially the securities markets and discourage attorneys from taking investors' cases."[11]

Make no mistake: allowing an award to go unpaid does not mean that nobody bears the cost of the miscreant behavior that led to it. That cost, that loss, always will be borne by somebody. The only question is who.

Right now, if the miscreants themselves do not pay the awards, the costs of their misconduct are borne by their victims.[12] And who are the victims? Ordinary Americans. Some are elderly. Some are retired. Some are in their working years. Some want to put their children through college. What they have in common is that they made one mistake: they trusted the wrong brokerage firm, the wrong broker, the wrong adviser. They did nothing to deserve the churning, the pump-and-dump schemes, the Ponzi schemes and the other forms of theft and wrongdoing that the industry perpetrated upon them. They had no duty or power to regulate the securities industry or to prevent misconduct from happening. They should not have to bear the cost of the industry's self-regulatory failures.

The time has come to end the industry's harmful and insulting self-regulatory failure. Securities laws and regulations exist to protect consumers, not to punish them. America's ninety-one million investors demand accountability. Self-regulation is a means to an end, not an end in itself. If the securities industry cannot or will not self-regulate appropriately and competently, it must give up the privilege.

Securities markets depend on investor confidence. Payment of securities arbitration awards is essential in the immediate sense to compensate the victims of the securities industry's missteps. It is essential over the longer

[8] SEC SPECIAL STUDY, at 48.

[9] Id. at 84-85, 91.

[10] GAO 2003, at 3. The GAO calculated in both studies that around 80% of unpaid consumer awards involved defunct brokerage firms or individual brokers.

[11] GAO 2003, at 14.

[12] The Securities Industry Association ("SIA") and the SEC have argued that various methods of guaranteeing payment of unpaid awards would increase costs for broker-dealers and investors. See GAO 2000, at 40-43. The argument is cynical and disingenuous. Who do the SIA and the SEC think is bearing the cost of unpaid awards currently?

term to deter the misconduct that caused the losses. Most importantly, public knowledge that wrongs will be compensated and deterred is essential to long-term investor confidence in the integrity of the capital markets themselves.[13] Without that critical mass of investor confidence, the markets cannot exist and cannot do their job.

If investor confidence is to be maintained, it is essential that there be absolute assurance that arbitration awards will be paid, that the industry will pay the full price when it harms investors through its own wrongdoing, and that no investor who wins an arbitration award ever will be turned away empty-handed while a laughing securities industry malefactor displays its empty pockets. The current nonsense must stop.

Proposed Solutions to the Problem of Unpaid Awards

Investor representatives and regulators have proposed a number of possible solutions to the problem of unpaid arbitration awards. I address six of those approaches in a non-quantitative way below. The first two are utterly worthless. I mention them only in the interest of completeness. The third and fourth have potential but have problems that render them incomplete or otherwise limit their usefulness as solutions. The fifth and sixth, in contrast, offer practical and thorough solutions to the unpaid award problem, a problem that never should have been allowed to exist.

1. Increasing Broker-Dealers' Minimum Net Capital Requirements. This proposed "solution" is ridiculous. What makes it a non-starter is that the minimum net capital cannot be increased to anything approaching the level necessary to fund a smaller firm's potential liabilities. Put differently, most any figure that anyone can suggest will be simultaneously too small and too large.

Some examples will make this clear. Picture, if you will, a firm that has minimum net capital of $5,000. How high will the new minimum be set? $50,000? That would be inadequate to pay any but the smallest awards. But you can bet your bottom dollar that a $50,000 minimum net capital requirement would bring forth a hailstorm of protest from the horde of small firms that make up the majority of the NASD's membership. An attack on small business, they'd charge.[14] How about $500,000? That would cover most awards but would not touch the damage that can be done to multiple customers by a single rogue broker. And at half a million dollars, it would be surprising if more than a tiny percentage of small broker-dealers could even stay in business. In short, any figure that is proposed will be simultaneously too small to solve the problem and too large to be affordable to those who must pay it.

At its best, the proposal to solve the unpaid awards problem by increasing minimum net capital is nothing more or less than a requirement that everyone in the industry self-insure by

[13] "[C]ontinued unpaid awards, regardless of how effective and fair the arbitration process may be, could negatively affect investors' confidence in arbitration and potentially the securities markets in general." GAO 2003, at 13, 14.

[14] The smaller firms would have a point. While many recidivist offenders ply their trade at small firms with low minimum net capital requirements, there are legitimate firms in that category as well. Such firms ought to be able to exist, lest the industry become even more of an oligopoly than it already is. But the bill for protecting small business should not be paid by the most vulnerable and defrauded of investors. Rather, a more socially responsible approach would be to adopt risk-spreading approaches that make it possible to keep entry barriers low while simultaneously assuring that the industry as a whole is financially responsible on a level commensurate with the harm it can cause. See potential solutions 5 and 6, below.

having sufficient net capital to fund all reasonably foreseeable liabilities. It is to that extent archaic. The idea that individuals and entities should self-fund all potential adverse consequences of their activities was solved long ago by the invention of insurance and the creation of markets in risk. [15] No one would suggest seriously that the problem of unpaid automobile accident verdicts should be solved by requiring all drivers to set aside $300,000 cash as a reserve for liability. Instead, mandatory insurance has been the obvious solution to that problem. It is one of the approaches with some promise here as well, as described in item 5.

As bad as this proposal is, it is better than the status quo, in which the entire cost of unpaid awards is paid, in effect, by defrauded investors. There is no justification for requiring those individuals to fund the industry's failures. They should not be punished for reposing trust in an industry that invites trust. They should not be impoverished for attempting to claim the economic benefits of specialization by delegating the task of managing their savings.

As mindless a "solution" as increasing minimum net capital is, it is not the worst. For that, you have to read about . . .

2. "Investor Education." The U.S. General Accounting Office's 2003 report on matters related to securities arbitration[16] contains a discussion of the unpaid award problem. It also contains, as an attachment, a comment letter from the SEC. The SEC's comment letter – I'm not making this up – contains the following statement:

> "In addition, SEC, NASD and New York Stock Exchange educational materials were amended to alert investors to the risk of unpaid awards, and to reinforce the message that investors should investigate before they do business with a particular firm." [17]

The SEC evidently thinks it's doing its job as long as it informs investors that, if they are ripped off and they prove it by winning an arbitration award, they might not get any actual money back. Apparently, investors – not all investors, just the few who actually will receive and read and understand the implications of the "educational materials" – are supposed to investigate firms' finances and guess whether the firms will be able to respond in damages in the event they bring a claim and obtain an award years in the future.

A non-securities analogy will help put this in perspective. Houses occasionally catch on fire, with resulting losses of lives and property. What do fire departments do about this? They fight fires. They actually go out and extinguish fires and rescue people, sometimes at substantial risk to themselves.

Fire departments prevent fires, too. If their inspections reveal that individuals or businesses are doing things that increase the risk of a fire, they point out the problem and require that the dangerous condition be corrected to comply with fire regulations. In other words, they actually apply their expertise to the suppression and prevention of fires.

[15] Insurance first appeared thousands of years ago, by at least one account. See Gareth Marples, *The History of Insurance: Risk Through the Ages,* http://www.the-history-of.net/the-history-of-insurance.html.

[16] GAO 2003.

[17] Id. at 18.

Now suppose a fire department, aware that houses were burning down occasionally, decided to fulfill its obligations to the public by doing an "educational outreach." This time, though, instead of telling people what they were required to do to prevent fires, the entire program would consist of warning the public that houses occasionally catch on fire and that lives and property can be lost as a result. What would people think about a fire department that thought it was fulfilling its obligations by doing that?

Does the SEC put out fires by rooting out the worst frauds and ousting their perpetrators from the industry? It does occasionally. But it's significant that the worst scandals of the last decade – boiler room pump-and-dump schemes, Wall Street stock analysts lying to the public to increase their firms' investment banking profits, mutual fund late trading violations – have been caught by state securities regulators and law enforcement authorities rather than the SEC.[18]

The SEC has let some big fires burn out of control. Has it at least taken steps to make sure that those who are burned have a reliable way to be compensated for the harm done by the SEC's errant charges? No. It thinks it can do its job by telling people they might get burned.

The most troubling aspect of this is that there are people who have no chance of being reached by the "investor education."[19] Those individuals most in need of protection, those most vulnerable to depredation by the industry's miscreants, will have "investor education" to thank for their poverty. It would be more honest for the SEC simply to announce that, with respect to frauds committed by underinsured and undercapitalized broker-dealers, it has decided to abrogate the securities laws and return to the bad old days of *caveat emptor*.

Now that we've discussed and dismissed two ridiculous proposals, let's look at some solutions that actually have some potential.

3. SIPC Reform. Reforming the Securities Investor Protection Corporation ("SIPC") to require its insurance pool to pay all unpaid arbitration awards has at least some theoretical appeal. SIPC's risk pool currently exceeds $ 1.2 billion,[20] more than twenty times the total unpaid awards for the last full year for which

[18] State regulators' effectiveness and the SEC's ineffectiveness may be the real reason for Morgan Stanley's and other large Wall Street firms' attempt last summer to tie the hands of state enforcement authorities. The measure, which appeared in HR 2179 at the subcommittee level, would have preempted state securities laws. It was stopped by a vigilant public. But at a time when the securities industry is crawling with scandal, it is appalling that the measure got as far as it did. That the SEC took "no position" on the measure is disgusting as well. Perhaps it would be better if the SEC were more concerned with protecting investors and less concerned with protecting its turf against state regulators who obviously are doing a better job at protecting the public. See Kathleen Day, *Brokerage Settlement Leaves Much Unresolved*, Washington Post (April 30, 2003), page E01; and Gretchen Morgenson, *As Scandals Still Flare, Small Victories for Investors*, New York Times (September 21, 2003).

[19] Readers should ask themselves if they were aware of the SEC's education initiative. The author of this article was not. If lawyers who emphasize securities arbitration matters in their practices were not aware of the SEC's educational materials, what are the chances that an actual investor, the kind of investor who is vulnerable to predation by bucket shops and the like, will be protected by them?

[20] Securities Investor Protection Corporation 2003 Annual Report, available online at http://www.sipc.org/pdf/2003_Annual_report.pdf and http://www.sipc.org/pdf/2003_Fin Statements.pdf.

data are available.[21] And it already has administrative staff in place. (This latter point has a serious downside that will be discussed below.)

Exposing SIPC to losses from more generalized brokerage industry wrongdoing could have the potential additional salutary effect of ousting the worst miscreants from the industry. For this to work, however, SIPC would need the right to deny coverage to a broker-dealer whose practices or personnel it deemed excessively risky and thereby to render it unlawful for the broker-dealer to operate.

Covering additional exposures might be expected to require an increase in broker-dealers' SIPC premiums. Given the enormous size of SIPC's existing reserves, however, the amount of the increase might be quite small. More importantly, it is both fairer and better for public confidence in the markets for the securities industry to bear the costs of its self-regulatory failures than for it to be permitted to dump those costs on an unsuspecting public.

The more nettlesome problem – the one mentioned parenthetically in the first paragraph of this section – is SIPC's pervasive corporate culture of denying claims. In its liquidations of broker dealers, SIPC frequently spends more money on lawyers' fees, trustees' fees and other administrative costs than it spends compensating investors.[22] Thus, if SIPC is going to be taken seriously as a solution to the problem of unpaid awards, reform will have to include a radical change in its corporate culture. Given the resistance of corporate cultures to change, that may require significant personnel changes as well as unambiguous legislative and regulatory directives.

4. Clearing Firm Liability. Clearing firms often escape liability for introducing firms' misconduct in customers' accounts. Broadening their liability for introducing firm misconduct is another potential solution to the unpaid award problem. It is, however, an incomplete solution. While most broker-dealers that fail to pay awards probably utilize the services of clearing firms, not all do. Even among those that do, not all problem transactions involve the clearing firm.[23] Thus, many claims will not implicate clearing firms at all. To the extent that those claims turn into unpaid awards, that portion of the unpaid award problem will not be remedied by any amount of clearing firm liability reform.

That incompleteness as a solution does not mean that clearing firms should continue to receive preferential treatment from courts and arbitrators. Preferential treatment never made sense from a logical, legal or policy perspective. Rather, it is a judicial error that, once established, has proven tenacious.

The clearing firms' favored treatment, where it occurs, does not arise from any statutory recognition of a difference between clearing broker-dealers and other broker-dealers. Federal and state securities statutes make no such distinction. In fact, they do not even define "clearing firm."

[21] GAO 2003, at 3, 9.

[22] Securities Investor Protection Corporation 2003 Annual Report, available online at http://www.sipc.org/pdf/2003_Annual_report.pdf and http://www.sipc.org/pdf/2003_Fin_Statements.pdf.

[23] For example, a sale of limited partnership interests or unregistered promissory notes would be unlikely to involve the clearing firm.

Instead, the preferential treatment finds its roots in the clearing agreement's allocation of duties and responsibilities between the clearing firm and the introducing broker. The NYSE has given an imprimatur of respectability to those agreements through its Rule 382. But that allocation is a matter between the two firms, one clearing and one introducing. In and of itself, it cannot bind third parties, such as public customers, who have not assented to it.

Indeed, in its enforcement action against Bear Stearns Securities Corporation for its role in the AR Baron fraud, the SEC determined that Rule 382 has no bearing on investors' rights under the federal securities laws. The SEC stated as follows:

> While these rules permit an allocation of responsibility for various functions between the introducing firm and the clearing firm, the Commission has emphasized in the release adopting the 1982 amendments to New York Stock Exchange Rule 382, that "no contractual arrangement for the allocation of functions between an introducing and carrying organization can operate to relieve either organization from their respective responsibilities under the federal securities laws and applicable SRO rules." Exchange Act Rel. No. 18497 (Feb. 19, 1982).[24]

Investors' rights under most states' securities laws should be similarly unaffected, because the New York Stock Exchange rules do not preempt state securities laws.

Generally, however, the customer's agreement with the introducing firm contains an express agreement to the allocation of responsibilities. Clearing firms argue that that agreement acts as a limitation on the kinds of errors for which the clearing firm will be liable. By making that argument, however, they are asserting that the agreement acts as a pre-dispute waiver of the clearing firm's liability for harm arising from its violations of state and federal securities laws.

The problem with the clearing firms' argument is that waivers of liabilities arising under federal and state securities laws are unenforceable. See, *e.g.*, section 14 of the Securities Act of 1933 (17 U.S.C. section 77n)[25]; section 29(a) of the Securities Exchange Act of 1934 (17 U.S.C. section 78cc(a))[26]; California Corporations Code section 25701[27]; and Uniform Securities Act section 509(l).[28]

[24] *In re Bear, Stearns Sec. Corp*., 1999 WL 569554 at 4 (SEC Aug. 5, 1999).

[25] Section 14 of the Securities Act provides as follows: "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void."

[26] Section 29(a) of the Exchange Act provides as follows: "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."

[27] California Corporations Code section 25701 provides as follows: "Any condition, stipulation or provision purporting to bind any person acquiring any security to waive compliance with any provision of this law or any rule or order hereunder is void." And see *Hall v. Superior Court* (1983) 150 Cal.App.3d 411, 197 Cal.Rptr. 757 (rejecting choice of law agreement that would have displaced California securities law).

[28] Uniform Securities Act section 509(l) provides as follows: "(l) [**No contractual waiver.**] A condition, stipulation, or provision binding a person purchasing or selling a security or receiving investment advice to waive compliance with this [Act] or a rule adopted or order issued under this [Act] is void."

Waivers of common law rights in California do not fare much better.[29] Thus, as a matter of law and the clear legislative policy choice the law reflects, exculpatory language should not protect clearing firms even if customers agree to the limitation. Casting the illegal waiver as an "allocation of responsibilities" should not change the result. All that should matter is the legal effect. Courts should not be fooled by the way in which it is phrased.

Clearing firms made the micro cap stock frauds of the 1990s possible. In an extensive report on micro cap fraud, New York Attorney General Dennis Vacco stated that "[m]icro-cap brokerage firms can only exist by processing their transactions through the road provided by the clearing firms."[30] The key to those operations was the ability to spring up, steal money from customers through pump-and-dump schemes, and disappear before significant numbers of customers could collect on their arbitration awards. If they had been more broadly liable for the misconduct of their introducing firms, the clearing firms might have been far more reluctant to lend their names, reputations, services and market access to those boiler rooms. The result undoubtedly would have been far less micro cap fraud than actually occurred. And even if, contrary to intuition, that broader liability had not reduced the volume of fraud, it would have compensated savers for losses they incurred as a result of the frauds that the clearing firms made possible.

Like the recovery fund, mandatory insurance and SIPC reform (proposed solutions 6, 5 and 3), broader clearing firm liability has the potential to prevent harm. If clearing firms had greater liability for misconduct in their customers' accounts, they would be forced either (1) to be far more cautious about entering into clearing arrangements with introducing firms or (2) to require their introducing firms to purchase liability

[29] California Civil Code section 1668 states as follows: "All contracts which have for their object, directly or indirectly, to exempt one from responsibility for his own fraud, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law."

See *Blankenheim v. E.F. Hutton & Co., Inc.* (1990) 217 Cal.App.3d 1463, 266 Cal.Rptr. 593: "a contract which exempts a party from liability for his own positive assertions, made in a manner not warranted by the information, which are untrue, is against the policy of the law. In the present case, the hold-harmless agreements attempted to exempt E.F. Hutton from all responsibility for its own misrepresentations. It follows that such an agreement is void as against the policy of the State of California."

See also California Civil Code section 3513: "Any one may waive the advantage of a law intended solely for his benefit. But a law established for a public reason cannot be contravened by a private agreement."

Additionally, see *County of Riverside v. Superior Court* (2002) 27 Cal.4th 793, 42 P.3d 1034, 118 Cal.Rptr.2d 167 (construing the statute and concluding, "The waiver of an important right must be a voluntary and knowing act done with sufficient awareness of the relevant circumstances and likely consequences.").

[30] New York State Attorney General Dennis C. Vacco, *Report on Micro-cap Stock Fraud*, Bureau of Investor Protection and Securities (December 1997), Chapter 0. See also the extensive discussion of clearing house practices in chapter 8 of that document. And see *Clearing Firms, the Uniform Securities Act and Koruga v. Fiserv Correspondent Services, Inc.*, PLI Securities Arbitration 2001 (August 2003).

insurance. Either way, miscreant firms and new firms staffed excessively by personnel with undesirable compliance histories would find it impossible or prohibitively expensive to establish the clearing relationships necessary to their existence. Thus, certain kinds of frauds – including micro-cap / boiler room frauds like those of the 1990s – would become far more difficult to perpetrate. But the benefit would be short-lived if other frauds not dependent on clearing services took their place. Thus, the reform could turn out to morph fraud rather than reducing it.

There is no reason in law or social policy for the preferential treatment of clearing firms to continue. Reform is desirable on that ground alone. For the reasons above, however, this cannot serve and should not be viewed as an acceptably complete solution to the problem of unpaid awards.

5. Mandatory Insurance. This approach has the advantages of being familiar, conceptually simple and reasonably well understood. While it does not offer all of the advantages of the recovery fund (approach number 6, below), it is a practical and potentially complete solution to the problem of unpaid awards.

There are no real arguments against this approach. Lacking factual or rational objections, some detractors have tried to suggest in meetings between industry representatives and the investor bar that no insurance company would be willing to write errors and omissions policies for brokerage firms. The fallacy of that position is evident on its face: broker-dealer liability policies already exist. Several large insurance carriers write them. They have been available for years.

Many broker-dealers and representatives already are covered by errors and omissions policies.[31] "High-payout" brokerage firms are particularly likely to have insurance coverage.[32] So are responsible smaller firms. The suggestion that the insurance industry will not be interested in an even larger book of business is absurd. Indeed, making coverage mandatory should make the field more attractive to insurers, because it would eliminate the adverse selection problem that arises when insureds are permitted to decide who buys coverage and who does not.

A representative of Marsh & Co., a huge insurer interested in this market, stated at the NASD's Fall Securities Conference in 2002 that Marsh's actuaries calculate that premiums per registered representative would drop industry-wide under a program of mandatory insurance. She also said that Marsh and other insurers have been trying for years to interest the NASD in such a program, but that they have met with indifference and rejection.[33]

The reasons why the NASD does not require all of its members to carry errors and omissions insurance or otherwise show proof of financial responsibility appear to be inertia and politics.

Enhancing investor protection has not entered the discussion. It's time that it does.

[31] See, generally, Scot Bernstein, *Broker Liability Insurance from the Claimant's Perspective*, *PLI Securities Arbitration 2003*, August 2003.

[32] It is easy to understand why high-payout firms frequently make sure that they are covered by errors and omissions insurance. High-payout broker-dealers typically have numerous small (often one-person) offices that pay all of their own expenses and, in return, receive eighty to ninety percent of the commissions that they generate. The broker-dealer, with its correspondingly small percentage of the commissions from its representatives' operations, understandably will insist upon having the risks of those operations covered by insurance.

[33] C. Thomas Mason, personal communication.

Some firms undoubtedly would be exempt from a mandatory insurance program by virtue of their ability to self-insure. That is acceptable as long as the financial standards are appropriate.[34]

The fact that insurance for some firms will be very expensive because of their disciplinary and/or claims histories or the histories of their personnel is acceptable as well. If the discipline of insurance underwriting prevents rogue firms and problem brokers from remaining in the industry and mishandling people's life savings, it will solve a large problem that the SEC has been unable to fix. And it will be using a market mechanism to achieve its result, leaving regulatory budgets unimpaired.[35]

The mandatory insurance approach is consistent with public expectations. I cannot count the number of times that my potential and new clients – and numerous others in casual conversations – were astonished to learn that stockbrokers are not required to carry liability insurance.

A further advantage is that a mandatory insurance requirement, once adopted, may be more secure in its continued existence than other proposed solutions to the problem of unpaid awards. It would not be surprising to see the securities industry attempt to end any solution that is adopted as soon as it senses that the political heat is off or that the public is otherwise occupied. After all, the securities industry collectively saves tens of millions of dollars each year by not paying awards. But if the securities industry attempts to terminate a mandatory insurance requirement, it will face a hurdle in addition to public opposition: the insurance industry's financial incentive to keep its market intact.

For mandatory insurance to succeed as a long-term solution, regulators and the public would have to prevent it from acquiring characteristics contrary to its purpose. For example, insurance companies' corporate culture of denying claims whenever and wherever possible would have to be subjected to tight controls. One such control would be to adopt a standard policy form with very limited exclusions.

But insurance companies will only go so far in eliminating exclusions. Traditional concerns of insurance economics, most notably moral hazard,[36] will govern their willingness to accept certain policy provisions. Deliberate fraud

[34] For an analysis of the interplay between assets and insurance, see Steven Shavell, *Minimum Asset Requirements and Compulsory Liability Insurance As Solutions to the Judgment-Proof Problem,* NBER Working Paper No. w10341, http://papers.nber.org/papers/W10341, March 2004.

[35] Regulators would need to share relevant information with the insurers. Shavell reminds us, "Liability insurance requirements tend to improve parties' incentives to reduce risk when insurers can observe levels of care, but dilute incentives to reduce risk when insurers cannot observe levels of care." Id.

[36] One participant in discussions among regulators, securities industry representatives and the investor bar has suggested that the possible increased willingness of investors' lawyers to accept cases made collectible by successful reform of the unpaid award problem (such as cases against bucket shops and the like) would constitute a "moral hazard." The remark demonstrates a misunderstanding of the meaning of moral hazard. Moral hazard refers to the increased tendency of individuals and entities to engage in loss-prone activities when insurance will cover the resulting losses. Any increase in attorneys' willingness to represent victims of securities industry fraud and wrongdoing clearly does not fit the definition. More importantly, if regulators or the industry are suggesting that it is somehow immoral to represent victims of securities industry predation – many of whom are elderly retirees – something is very wrong. Indeed, if there is a moral hazard at all, it is on the part of an industry that begged for the opportunity to self-regulate and then failed abjectly in doing so because defrauded investors were absorbing the cost of (and thus were acting as a *de facto* insurance policy covering) many of the industry's self-regulatory failures.

is commonly excluded from insurance on the reasonable public policy ground that a wrongdoer should not be able to shift the burden of his own intentional misconduct. Yet fraud, theft, and other commonly excluded wrongs are among the very harms against which consumers need protection.

Some litigation over coverage issues will be inevitable, and some investors will be left with uncollectible awards as a result. Further, coverage battles and political and regulatory controversies over the contents of the standard policy might be expected to increase over time, as insurance companies slowly and inexorably pressure regulators to allow policies that are ever more protective of the insurers' interests and correspondingly less protective of investors.

Other coverage gaps may arise as well. Consider, for example, the lack of coverage and the unpaid awards that will result when a broker-dealer does not keep its insurance in force and continues its operations illegally for a period of time.

A license suspension for nonpayment of premiums, even if quick, will not be instantaneous. The result will be that some awards will go unpaid.

Mandatory insurance also shares one of the problems discussed above regarding net capital requirements: How much is enough? Arbitrary coverage amounts, like $1 million per incident and $5 million per year, inevitably will be too little to provide compensation when the representative or firm has multiple victims or when the misconduct harmed large accounts, like pension funds. Securities regulators evaluating a mandatory errors and omissions insurance program should not repeat the mistakes made in mandatory auto insurance programs. More complex formulae, such as uniform basic levels with increased coverage amounts based on assets under management, would provide better investor protection. However, insurance coverages that depend on individual members' self-reporting of fluctuating values are inevitably fraught with trouble.

Coverage disputes, policy cancellations, policy limits, and policy restrictions have the potential to make mandatory insurance a less complete and less desirable solution than the recovery fund approach described below in item 6. That said, however, mandatory insurance remains a good and relatively thorough approach, probably the second best solution to the securities industry's absurd problem.

6. Recovery Fund. The simplest, most thorough, and probably best approach would be to require each of the more than 650,000 registered representatives in the United States to contribute annually to a recovery fund for unpaid awards.[37] Even an annual contribution of just $200 per registered representative would raise more than $130 million each year.[38] That number will exceed the total unpaid awards if the problem continues at the first-quarter 2003 rate of $120 million per year.

Thus, the per capita contribution that enables the industry to clean up its own mess is minimal – a small price to pay for the privilege

[37] The NASD website states that "[r]oughly 5,500 brokerage firms, nearly 90,000 branch offices, and more than 650,000 registered securities representatives come under our jurisdiction." The page so stating is available at http://www.nasd.com/member_info/member_ov.asp.

[38] The entire first year's funding could be satisfied by a contribution from the salary of a single securities industry professional: NYSE president Richard Grasso.

of participating in a lucrative industry.[39] That alone makes the recovery fund a desirable solution to the problem. It is difficult to imagine, for example, that an insurance policy offering broad coverage and high limits could be offered at a lower per-capita cost.

The recovery fund approach will work on a long-term basis, however, only if it has political permanence. It must become something of a sacred cow, an essential component of capital markets that want to remain the envy of the world. Regulators and America's 91 million investors[40] therefore must demand that the industry not be permitted to reduce or eliminate mandatory recovery fund contributions, something the industry otherwise might be expected to attempt as soon as the political heat is off.

Further, exemptions from the obligation to contribute to the fund must be nonexistent or extremely limited. Large Wall Street firms undoubtedly will argue that, because they can afford to pay the awards against them, their representatives should not be required to contribute.[41] But if too many registered representatives are exempted from making contributions to the fund, the contributions required of those remaining in the pool may become so large as to make the concept nonviable. This is the proposed fund's analog to the classic problem of insurance pool economics known as adverse selection. Breadth of the pool is essential to its survival.

It also is fair. If the industry is to be allowed to continue to self-regulate, it cannot selectively impose the cost of its most inexcusable mess on those members of the public whose only mistake was to trust miscreants that represent the failure of that self-regulation. Indeed, any scheme of self-regulation that does not include a means of covering those losses is inherently incomplete and thus defective.

An additional characteristic necessary to keep the fund viable will be some sort of size limit on single-case recoveries. Otherwise, one or a few very large awards could bankrupt the fund.

Consistent with limitations on claim size, the fund's design also should include a decision regarding whether and to what extent punitive damages will be treated differently from compensatory damages. One approach would be to provide that the fund would pay punitive portions of

[39] The website for Registered Rep magazine, a securities industry magazine catering to registered representatives of broker-dealers, states as follows: "Generally speaking, brokers are rewarded well for their efforts, according to the survey. Respondents have an estimated average income of $180,300 and an estimated average household net worth of $1,072,000." Samaripa, Janis, *Your World*, Registered Rep (Nov. 1, 2000), available at http://registeredrep.com/mag/finance_world/index.html.

[40] The Investment Company Institute states that mutual funds alone boast 91 million American investors: "Today, more than 91 million investors in over 53 million U.S. households own mutual fund shares." *Statement of the Investment Company Institute on the U.S. Securities and Exchange Commission's Appropriations for Fiscal Year 2005*, Investment Company Institute Mutual Fund Connection (March 31, 2004). The statement is available online at http://www.ici.org/issues/fserv/04_house_budg_tmny.html.

[41] The large firms can be expected to trot out their usual "moral hazard" argument as well. They will assert that a fund that covers liabilities of small firms creates an incentive for those who run small firms to take excessive risks. The weakness of the large firms' argument is self-evident: it was the firms themselves that asked for the right to self-regulate. With the benefits of the right to self-regulate go the burdens. It will be incumbent upon the industry to exercise its self-regulatory power to prevent the abuse that purportedly will be incentivized by the supposed "moral hazard." What is not acceptable is the status quo, in which the industry expects those it defrauds to bear the burden of its self-regulatory failures.

awards only after it had satisfied all of its other payment obligations for the calendar year. A modified version of this would subject only a portion of punitive damages – for example, the amount of punitive damages exceeding one hundred percent of the compensatory portion of an award – to such a limitation.

Apart from limitation rules with relatively automatic and non-subjective application, however, the fund's administration should be kept as simple and inexpensive as possible. Second-guessing of arbitration awards should not be permitted; the fund's procedures should not create new standards for *de facto* vacatur not found in the Federal Arbitration Act. Rather, arbitration awards that are not paid by respondents should be paid by the fund as a matter of course.

The fund, in turn, should become the owner of the portion of the award that it has paid and should have a priority lien against the respondents' assets for those sums. That will enable the fund to pursue miscreant brokers aggressively for the amounts it has paid, much as an insurance company is subrogated to the claims of its insureds. Further, nonpayment of the subrogated claim to the fund should carry the same consequences for the nonpaying respondent as nonpayment of any other award: suspension from the industry.[42]

Perhaps most importantly, the staffing and corporate culture of the fund should reflect unyieldingly its purpose of making good on the industry's obligations. Personnel trained in a corporate culture of denying claims should have no role in the fund's organization or structure and should be kept far, far away.

Geographic Scope of the Proposed Solutions

Investors nationwide are harmed and unable to collect on arbitration awards. Because of that, there might be a tendency to think that the solutions described above must be adopted on a national or industry-wide basis. Apart from reforming SIPC, however, that isn't necessarily so. Indeed, the demonstrated glacial speed and general ineffectiveness of the SEC and the federal government in protecting investors, particularly since the midterm-elections of 1994, make it imperative that states explore actions they may be able to take to protect their own citizens.

That exploration should include careful consideration of the potential impact of NSMIA. A state adoption of the recovery fund approach, for example, might need to be funded through registered representatives' state license fees, rather than being funded separately. What is clear, though, is that states need to take whatever action they can to protect their citizens from predation by an industry that refuses to take responsibility for the harm that some of its members inflict on the public.

Conclusion

This article has explored six proposed solutions to a problem that should not even exist: the inability of the industry that handles people's life savings to pay for fully half of the judgments against it for its misconduct. The last two approaches – mandatory insurance and a recovery fund – are the most all-encompassing, thorough and practical. They are the most beneficial to the investing public and, by virtue of the legitimate trust they will engender, the securities industry and the capital

[42] Some industry participants will object to this feature because it offers them no protection against liability, and they may prefer mandatory insurance for that reason. But that preference should not drive the choice. Those industry participants who desire protection against risk are free to purchase insurance voluntarily.

markets. That does not mean, however, that at least one of the other approaches – an expansion of clearing firms' liability for the harm they make possible – should not occur simultaneously.

Unpaid awards are a huge and inexcusable problem – a problem that must be solved.

Commodities Corner: New Disclosure Duties for a Futures Commission Merchant or an Introducing Broker?

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The Commodity Exchange Act ("CEA"), CFR § 1.55 (futures) and §33.7 (options) require that a futures commission merchant or an introducing broker may not open an account for a customer until the customer is furnished with a separate written risk disclosure statement by the futures commission merchant or the introducing broker, who must then receive a signed acknowledgment from the client that he/she has read the disclosure statement and understands it.

In addition to the standard risk disclosure, the discussions between the broker and the customer must be reviewed to ensure that the customer is fully aware of risk of trading and is not being defrauded. A substantial body of case law, federal appellate and district court decisions pertaining to futures transactions as well as Commodity Futures Trading Commission ("CFTC") decisions, has recognized that statements by brokers to customers, relating to predictions of possible profits, do not amount to actionable misrepresentation. Only statements of material fact, not 'puffery,' opinion, or other subjective or obviously exaggerated claims, may constitute actionable fraud. *In the Matter of Staryk*, Comm. Fut. L. Rep. (CCH) ¶26,701, n. 67 (Initial Decision June 5, 1996), affirmed in part and reversed in part, *In the Matter of Staryk*, Comm. Fut. L. Rep. (CCH) ¶27,206 (CFTC Dec. 18, 1997).

The United States Supreme Court defined materiality in the landmark securities case of *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976), which held that a statement is material if:

> [T]here is a substantial likelihood that a reasonable [investor] would consider [the information] important in deciding how to [act]. . . .Put another way, there must be a substantial likelihood that the disclosure of the [information] would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. *TSC Industries, Inc.* at 449.

Numerous futures cases have held that profit projections and statements of opinion, which are not misleading to reasonable customers when reviewed in light of the total mix of information supplied to the customer, do not constitute actionable fraud. *(Johnson v. Don Charles & Company*, Comm. Fut. L. Rep. (CCH) ¶24,986 (CFTC Jan. 16, 1991)); (AP statements that he was a professional experienced in commodities; (2) that he would look out for [their] investment; and (3) that he would know how to get [them] out of a bad trade so that

[they] would not lose their investment did not amount to a materially deceptive description of risk); *Balistreri v. Concorde Trading Group, Inc. and Brandon*, Comm. Fut. L. Rep. (CCH) ¶28,440 (CFTC Dec. 29, 2000) (AP's statements emphasizing potential profits which if considered in isolation, might suggest that [AP] improperly focused complainant's attention on potential profitability and thus vitiated the importance of understanding the risks attendant to these markets. However, the court considered the total mix of information and held that isolated statements about potential profits that do not vitiate the risk disclosures, and that do not induce a customer to disregard those risks, cannot be the basis for a recovery); *Udiskey v. Commodity Research Corporation*, Comm. Fut. L. Rep. (CCH) ¶27,599 (April 2, 1999), *affirmed, Udiskey v. Commodity Research Corporation*, Comm. Fut. L. Rep. (CCH) ¶29,255 (December 16, 2002); (AP was an unabashed optimist in promoting his “conservative” strategy of trading futures and options and that his flier promoted trading methods as “low risk.” He further touted commodities speculation as an “appealing” business opportunity for his students seeking new employment “if properly done.” The ALJ held that without more, however, these claims and opinions remain too vague, general, soft and subjective to constitute actionable fraud. Even the term "low risk" has little definite meaning (either as an opinion, conclusion or a claim) unless evaluated within the larger context in which it was used and explained. The ALJ noted that the complainant had received an NFA pamphlet discussing trading along with the seminar materials prior to trading. The language in the pamphlet repeatedly highlighted the risks associated with trading commodity contracts in plain language. Moreover, the complainant received and signed the CFTC Risk Disclosure Document and a Futures Commission Merchant Customer Agreement which also disclosed risk. The ALJ noted that case law presumes that a customer who signs a risk disclosure acknowledgment has read and understood the disclosure document's contents. Viewing the total mix of information in this way, the ALJ concluded Complainant was not misled about the risks of trading); *Indemnified Capital Investments v. R.J. O'Brien & Assoc.,* 12 F.3d 1406, 1413 (7th Cir. 1993)(statements about highly successful trading ability construed as nothing more than opinion); *Sudol v. Shearson Loeb Rhoades Inc.,* Comm. Fut. L. Rep. (CCII) ¶22,748 at 31,119 (CFTC Sept.30, 1985) (misrepresentation about the size of a futures contract not material to offset the risk disclosures and transmittal of pertinent financial information); *Magill v. International Trading Group Ltd, et at,* Comm. Fut. L. Rep. (CCH) ¶24,095 (Initial Decision Jan. 6, 1988) (statements that the price of oil and gold would drop, supported by newspaper articles making similar predictions, found not actionable because the statements were opinion and therefore did not rise to the level of a promise); *Jennings v. First Commodity Corporation of Boston, et a!.,* Comm. Put. L. Rep. (CCH) ¶23,727 (Initial Decision July 15, 1987) (statements by broker that he could make customer money and enough money to change her lifestyle not actionable because of signed Risk Disclosure document and subsequent telephone call from representative of brokerage house informing her that she could lose all or part of her investment).

Federal courts in securities cases have also ruled that broker profit predictions are opinions, amount to nothing more than puffing, and do not make a solicitation fraudulent: *Zerman v. Ball 735* F.2d 15, 21 (2d Cir. 1984) (holding broker's statement that bonds constituted a "marvelous" investment to be non-actionable under the federal securities laws); *Marchese v. Nelson,* 809 F. Supp. 880, 888 (C.D. Utah 1993) (holding broker's statements that stock was just as good as another stock, that it was "hot on the market" and that it could do just as well as the money market did not constitute misrepresentations; "Statements of opinion predicting future success based on historical and factual bases are not actionable under Rule l0b-5"); *Newman v. L.F. Rothschild,* 651 F. Supp. 160, 163 (S.D. N.Y. 1986) (holding broker's statements that "I'm the best in the business", "I'll make money for you", and the customer would "make good money" on a security to be non-actionable under the federal securities laws); *Rotstein V. Reynolds & Co.,* 359 F Supp. 109, 113 (N..D. Ill.1973) (holding broker's statements that a security was "red hot", and it was impossible to lose money by investing in a security to be non- actionable under state and federal securities laws); *Bowman v. Hartig,* 334 F. Supp. 1323, 1328 (S.D.N.Y. 1971) (holding broker's statements that the broker's primary purpose is to make money for the customer and the customer would make "substantial profits without extraordinary speculative risk" to be non-actionable under the federal securities laws).

R.J. Fitzgerald & Co., Inc.

As it currently stands, the case of *Commodity Futures Trading Commission v. R.J. Fitzgerald & Co., Inc., et al.* 173 F. Supp. 2d 1295 (M.D. Fla 2001), 310 F. 3d 1321 (11th Cir. 2002) has added additional disclosure requirements to be given to the customer. As discussed below, after the U. S. District Court for the Middle District of Florida ruled in favor of the brokerage house, the U. S. Court of Appeals for the Eleventh District reversed the decision and found the brokerage house liable for misrepresentation. The brokerage house has petitioned for a rehearing en banc, and a ruling on the petition is still pending.

Procedural Background

R.J. Fitzgerald & Co. (“RJFCO”) began operations in 1992 as a full service “introducing broker” that serviced small retail customers with little or no experience in commodities markets. RJFCO cleared its trades through Iowa Grain Company, a registered futures commission merchant. The only unique feature about RJFCO from other introducing brokers was that it used one team of sales brokers for generating customers via telephone calls and a separate team of brokers and traders to do the actual trades and monitor accounts. In 1999, the CFTC filed an enforcement action against RJFCO, Raymond Fitzgerald (sole shareholder, principal and operator), Leiza Fitzgerald (reviewing training materials and trained brokers), Chuck Kowalski (chief market analyst) and Greg Burnett (supervisor of brokers), alleging that they were involved in fraudulent solicitations to attract potential customers in the United States to invest in commodity options. The Complaint was dismissed for failure to plead fraud with particularity.

The CFTC then filed a detailed 138 page Amended Complaint which alleged that Defendants, or some individual Defendants, violated the Act by: (1) committing fraud by misrepresentation or omission of material facts in connection with the solicitation, maintenance, or execution of commodity futures transactions; (2) operating an introducing brokerage firm to cheat, defraud, deceive, or attempt to cheat, defraud or deceive clients; (3) trading client accounts excessively in order to generate commissions without regard to customer interests ("churning"); (4) failing to provide risk disclosure statements prior to the opening of RJFCO customer accounts; and (5) failing to supervise firm personnel diligently. Defendant Raymond Fitzgerald was charged with controlling person" liability” under the Act. After some of the claims were dismissed on summary judgment, the parties conducted a bench trial before a Magistrate Judge between February 26- March 19, 2001. The District Court ruled on May 18, 2001.

I. The DISTRICT COURT FOR THE MIDDLE DISTRICT OF FLORIDA

The District Court found that even though RJFCO used two sets of brokers, there was nothing nefarious or improper about the arrangement. Every new employee of RJFCO received a copy of the firm's compliance manual and there were adequate procedures in place to ensure that brokers followed the mandates of the compliance standards.

RJFCO brokers had a firm policy against guaranteeing profits, and although some of its experience, credentials and services offered and rendered was somewhat exaggerated by puffing, there were no false, misleading or deceptive information disseminated. The firm had few complaints against it.

Iowa Grain's principal compliance officer pre-approved all promotional material that was at issue in the CFTC claims of wrongdoing. RJFCO consistently required all of its customers to read and endorse the CFTC Risk Disclosure statement prior to opening an account. All of the individual customer witnesses for the CFTC had received and had an opportunity to read the RJFCO risk disclosure booklet. There was no evidence at trial that anyone at RJFCO downplayed the risk disclosures.

All new account forms were reviewed and approved by RJFCO and Iowa Grain prior to any trading in an account. It was not proven that the firm's win/loss record was any worse than any other firm in the industry nor was there any evidence that the firm claimed that it had a superior win/loss record.

Customer Solicitation Devices

At the heart of the CFTC's case were two solicitation devices used by RJFCO to potential customers: the Commercial and the Seminar.

The Commercial

The Commercial stated that the El Nino weather phenomenon had materialized where expected and that if patterns continue, the effects could be devastating, drastically altering the supply and demand for corn and that with the giant developing nations such as China and Russia badly in need of grains and world grain supplies put to the test, conditions may exist for profits to reach 200 to 300 percent. The commercial further asserted that "the potential of the corn market may never be greater." RJFCO's Commercial touted using a synthetic futures position, using both puts and calls in a combined trading strategy. Because the synthetic futures strategy required twice as many contracts to be placed in a customer's account, it generated twice the commission.

The script, originally drafted by an advertisement agency, was edited by Raymond Fitzgerald to add additional risk disclosures. The amended script was approved by Iowa Grain's compliance officer. The Commercial ran on CNBC for the first half of March, 1998.

The CFTC's case contained little direct evidence through customers. RJFCO had over 1200 customers during the relevant period. Yet the CFTC offered only the testimony of seven customers to establish a pattern or practice of fraud. The District Court did not find the testimony of the RJFCO customers to be fully credible. The CFTC also offered the testimony of several traders. The Court found their testimony to be of limited assistance.

The CFTC's expert opined that the two-pronged structure of the synthetic future, coupled with the commissions, rendered the scheme incapable of delivering a profit for customers regardless of whether corn prices increased or not and that the only reason for such a strategy was to generate commissions. The Court disagreed, pointing out that RJFCO recommended the selling of puts in part to generate funds for the client accounts to provide some margin in the likely event of market volatility. Further, the funds generated on the sale of the options generated enough money to pay for or substantially offset the RJFCO commissions on one side of the transaction. The

Court also found that the strategy was implemented to generate profits for customers, and it could have done so had the price of corn risen as expected.

Contrary to RJFCO's predictions, corn prices plummeted during the crucial time period. RJFCO contacted the clients to inform them of the declining position and recommended closing the positions as the risk of losing with a negative balance was getting too high. All customer positions were closed. As a result, none of the customers sustained losses above the cost of the synthetic futures recommendation but virtually all of RJFCO's customers lost all or substantially all of their investments.

The Court noted that merely recommending a misguided trading strategy is not per se actionable, however. The CFTC had a duty to prove that RJFCO or individual defendants intended to cheat or defraud customers associated with this trading recommendation. The District Court did not find any intent to defraud customers by recommending the synthetic futures trading strategy.

At the close of the CFTC's case, the District Court entered a directed verdict in favor of Defendants on the issue of whether the Commercial was fraudulent and violated the CEA. The District court addressed the Commercial again in its opinion issued after the bench trial, stating that the Commercial was not misleading or deceptive.

The Promotional Seminar

The CFTC alleged that an RJFCO Seminar had violated the CEA. The Seminar, developed by Leiza Fitzgerald and RJFCO brokers, informed customers that the weather patterns, political events, and historical price trends could affect the prices of certain commodities. Customers were also told that they could take advantage of technical analysis and fundamental market moves. The Seminar drew a distinction between futures, which it classified as highly aggressive, and options on futures, which it stated allowed investors to define risk and limit losses to the cost of the option while providing unlimited profit potential. The Court did not find that there was anything patently or latently misleading or deceitful about the profit illustrations suggesting that investors could make high rates of return because there were ample disclosure regarding the high risk of trading. In fact, the Court noted that Defendants established that such illustrations were similar to those used by the National Futures Association in their publications. The District Court concluded that the Seminar did not violate the CEA.

Fraudulent Solicitations

The CFTC had alleged that RJFCO and Raymond Fitzgerald were liable for fraud in that brokers were instructed to make misrepresentations and material omissions in their solicitations with customers. The District Court found no merit to this allegation. Next, the CFTC alleged that brokers committed fraud by failing to disclose the firm's trading record. The District Court, citing the 11th Circuit, stated that since the firm sent out risk disclosure documents and since the CFTC failed to prove that RJFCO's trading record was any different from any other firm in the industry or that RJFCO's brokers represented that their firm had a superior trading record, which would have given rise to a duty to disclose the firm's track record, there was no fraud.

Duty to Disclose Risk

The CFTC alleged that the Defendants failed to provide adequate risk disclosure for options on futures trading pursuant to CFR §33.7. The District Court, again citing 11th Circuit caselaw, opined that once a customer signs and acknowledges that he or she receives full disclosure of risk and understands it (Risk Disclosure Document), a presumption of compliance is created in favor of the broker. The presumption can be vitiated by a showing that the broker made misrepresentations about risk to customers which undermines the importance of the risk disclosures. There was no evidence presented which downplayed the risk disclosures.

II. THE U.S. COURT OF APPEALS FOR THE ELEVENTH CIRCUIT

A. The Majority Opinion

The Commercial

The Appellate Court majority stated that whether a misrepresentation had been made depends on the "overall message" and the "common understanding" of the information conveyed. Similar to securities law, scienter is met when the defendant's conduct involves "highly unreasonable omissions or misrepresentations …that present a danger of misleading [customers] which is either known to the Defendant or so obvious that Defendant must have been aware of it."

A factor that the Appellate Court considered important to its reasoning was that the CEA was a remedial statute that was for the purpose of protecting the individual investor who may not have any knowledge of the commodities markets. Such remedial statutes are to be read liberally to protect the individual participant.

The Court concluded that the Commercial overemphasized profit potential and downplayed risk of loss, presenting an unbalanced image to the customer. The Commercial stressed that enormous profits could be made on options on futures contracts by looking at known and expected weather patterns, more specifically it affirmatively represented to potential customers that El Nino had struck "where e*xpected*" and that if the "*patterns continue*" "*huge profits*" could be realized while only using boilerplate risk disclosure language. Furthermore, viewers of the Commercial were told to call "now" because such an opportunity may not occur again.

The Appellate Court agreed with the CFTC that the fact that the Commercial had a general risk disclosure statement did not automatically preclude liability under the CEA where the overall message is clearly misleading and objectively misleading or deceptive. Such an exacting standard would thrust the door of deception wide open, allowing clearly misleading statements to escape CFTC enforcement and giving brokers free reign to abuse their knowledge by subtly manipulating customer beliefs about the functioning of commodities markets, afforded safe haven so long as no actual "guarantee" is made.

Having determined that the Commercial contained misleading and deceptive statements, the Court then concluded that the Defendant acted recklessly by ignoring previous rulings by the courts and the CFTC to condemn (1) the use of profit expectations on commodities options to weather events, seasonal trends and historic highs; (2) suggesting that the commodities market can be correctly timed to generate large profits; and (3) substantially inflating option profit expectations while downplaying risk.

The Appellate Court stated that because a reasonable listener's choice making process would be substantially affected by emphatic statements of profit potential and by statements that the present day offers an opportunity like no other to make money in the corn market. Such language obscures the important distinction between the possibility of substantial profit and the probability that it will be earned.

The Promotional Seminar

Like the Commercial, the Appellate Court reasoned, the Seminar, when viewed in its entirety, suggested to a reasonable listener that the Defendant had a reliable strategy for increasing profits and limiting losses by looking at historical movements and known and expected seasonal patterns. The Appellate Court also focused on language in the Seminar that options provided a "limited risk", suggesting that "greed" is a major reason people don't make money in commodities and that a customer "will *never* go *broke* taking a *profit*." Such representations, despite the use of risk disclosure material, alter the mix of relevant information available to the potential commodity option investor, creating a distinctly unbalanced overall presentation that gives the impression that customers were going to make money.

Fraudulent Omission – Non-Disclosure of the Firm's Success Record

In addition to finding liability based on the language of the Commercial and the Seminar, the Appellate Court found additional violations of the CEA because the Defendant spoke of enormous profit potential without simultaneously informing potential customers that more than 95% of the firm's customers lose money[1]. Such a disclosure, said the Court, would have gone a long way to balancing the representation that the market was ripe for huge profits of 200-300% and that such opportunities might not exist again.

The Appellate Court disregarded the reasoning of the lower court that there was no evidence that any other firm in the industry did any better than RJFCO or that RJFCO affirmatively represented that it had an attractive success rate. The Appellate Court stated that what other firms did was irrelevant. The CEA did not foster a "race to the bottom". What was important was that the investor would want to know this information prior to trading with RJFCO. The CEA protects the rights of individual investors from being misled in the highly risky arena of commodities investments, and freedom of choice is eviscerated if decision –altering information is withheld.

A concurring opinion agreed with the majority opinion that it is misleading to speak of a limited risk option and 200-300% profits without also telling the reasonable listener that the overwhelming bulk of the firm customers lose money.

B. The Dissenting Opinion

The dissenting opinion was critical of the majority opinion and the cases it cited. It stated that the majority opinion cases were not applicable. RJFCO did not state, as in the cited cases relied upon by the majority, that the likelihood of profits was practically guaranteed. RJFCO discussed the possibility of profits, not the probability of profits. Nor did RJFCO downplay or minimize the degree of risk involved in investing in commodity options.

The Commercial, according to the dissent, had sufficient risk disclosures and contained conditional language about the possibility of profits. The Seminar likewise contained sufficient risk disclosures and the examples that were used for possible trading profits were similar to those used by the National Futures Association in its publications. Suggesting profits from correctly timing the commodities markets does not necessarily amount to fraud and the majority's phrase "substantially inflating option profit expectations while downplaying risk of loss" is too vague and abstract a standard to be of use as a guideline to commodity brokerage firms that wish to advertise.

Finally, the dissent argued that RJFCO had no affirmative duty to disclose its trading record. The cases cited by the majority suggested that such an affirmative duty arises only when the firm's statements pertaining to its performance would be misleading if a track record would not be disclosed. Since RJFCO never made any bold misrepresentations regarding its track record, there was no duty to disclose its track record.

[1] RJFCO's president, Raymond Fitzgerald, testified that more than 95% of Defendants' customers lost money.

CONCLUSION

As previously stated, *R.J. Fitzgerald & Co., Inc.* is still pending awaiting a ruling by the U.S. Circuit Court of Appeals for the Eleventh Circuit on RJFCO's petition en banc. What is clear is that there are two very different interpretations as to what must be disclosed by a futures commission merchant or an introducing broker to a customer who wishes to trade futures or options on futures. If the Eleventh Circuit Court of Appeals accepts the petition to hear the matter en banc, and if it reverses the majority opinion and accepts the reasoning of the lower court and the dissent, then it would appear that prior precedent would once again prove applicable. Then again, the Eleventh Circuit Court of Appeals could let the majority opinion stand. It could also hear the matter en banc and apply some but not all of the majority decision's reasoning. Whatever the outcome, the decision could cause other federal Circuit Courts to weigh in with their own pronouncement on the disclosure duties a futures commission merchant or an introducing broker has to its customers.

Pitfalls of an ERISA 404(c) Defense - Employers' Potential Liability for Employee-Directed Retirement Plans

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ERISA 404(c) retirement plans have grown tremendously in popularity over the last several years due to the very attractive ability of employers[1] to avoid liability for plan losses caused by the employees' own selection of investments from a menu of options provided by the employer. ERISA 404(c) provides an escape hatch for an employer to avoid liability for most types of losses sustained in an employees' retirement plan where the employee has had the fair opportunity to select investments in a qualifying plan. There are a number of requirements that must be met for a plan to qualify as a 404(c) plan, however, and in the event that they are not satisfied, an employer may be on the hook for catastrophic losses that could otherwise have been avoided by establishing a proper 404(c) plan. This article provides a brief overview of the requirements for establishing a 404(c) plan, and the potential areas of liability for plan fiduciaries in the context of ERISA 404(c) plans.

What constitutes an ERISA 404(c) Plan

A large percentage of employee retirement plans are intended to be ERISA 404(c) plans, which constitute the fastest growing category of employee retirement plans today.[2] These plans are established as individual account plans and typically include a pre-tax contribution by a participating employee coupled with some sort of contribution to the account by the employer. [cite] ERISA Section 404(c) alleviates a fiduciary of liability for losses in the individual accounts if the plan participants can exercise control over the assets in their accounts and the plan participants actually do exercise control over their accounts; this limitation on liability applies only to losses caused by the participant's

[1] For purposes of this article, the terms fiduciary, plan fiduciary, and employer are used interchangeably; likewise with respect to the terms beneficiary, plan participant, and employee. There is a significant body of law related specifically to the issue of who or what constitutes a fiduciary under ERISA, which is not addressed here. *See, e.g.*, 29 U.S.C. ' 1002 (21)(A); *In re Enron*, 284 F. Supp.2d 511, 543-44 (S.D. Tx. 2003).

[2] *See In re Enron*, 284 F. Supp.2d at 575, n.75; Jefferson, Regina, *Rethinking the Risk of Defined Contribution Plans*, 4 FLA. TAX REVIEW 607, 627 (2000) ("Participant directed plans cover approximately 25 million employees . . . ."). One reason 404(c) plans may be growing in popularity is that the Department of Labor issued regulations, finalized in 1992, that clarified what constitutes a qualifying plan; prior to 1992, it was unclear just what an employer's potential liability for employee-directed plans was. *See* Medill, Colleen, *Stock Market Volatility and 401(k) Plans*, 34 U. MICH. J. LAW REFORM 469, 477 (2001).

exercise of control.[3]

Pursuant to the Department of Labor regulations, there are a number of factors that must be present for a plan to qualify as a valid 404(c) plan, thereby entitling the plan fiduciary to great relief from potential liability. The Department of Labor regulations [hereinafter "the Regs"] set forth "the kinds of plans that are ERISA section 404(c) plans", "the circumstances in which a participant or beneficiary is considered to have exercised independent control over the assets in his account as contemplated by section 404(c), and the consequences of a participant's or beneficiary's exercise of control."[4]

The Regs establish quite clearly that a qualifying 404(c) plan "provides an opportunity for a participant or beneficiary to exercise control over assets in his individual account . . . and [p]rovides a participant or beneficiary an opportunity to choose, from a broad range of investment alternatives, the manner in which some or all of the assets in his account are invested."[5] The qualifications do not end here, however, as the Regs go on to define nearly every term used within both Section 404(c) itself,[6] and those within the Regs. What may appear at first glance to be a rather simple standard to meet, becomes more and more complicated.

Opportunity to Exercise Control and Sufficient Information

While one may believe that an opportunity to exercise control is a self-defining term, the Department of Labor has imposed a number of conditions upon this phrase as it applies to an ERISA 404(c) plan. In order to give a plan participant a fair opportunity to exercise control over his or her plan assets, a fiduciary must both provide a participant with a "reasonable opportunity to give investment instructions" to a person who is obligated to carry out same, and provide or make available to a participant "sufficient information to make informed decisions with regard to investment alternatives available under the plan . . . ."[7] It is important to note that there is no obligation on a fiduciary to provide investment advice to participants.[8]

A plan may, by its terms, impose certain permissible restrictions on a participant's ability to give instructions or exercise control without violating ERISA or causing the participant to lose the opportunity to exercise control. For example, a plan may impose charges for reasonable expenses, permit a fiduciary to decline instructions given by a participant if those instructions violate the terms of the plan or would be prohibited under applicable provisions of the tax code or other sections of ERISA, or

[3] 29 U.S.C. ' 1104(c)(1). Section 404(c) states:
In the case of a pension plan which provides for individual accounts and permits a participant or beneficiary exercise control over assets in his account, if a participant or beneficiary exercises control over the assets in his account (as determined under regulations of the Secretary) -
(A) such participant or beneficiary shall not be deemed to be a fiduciary by reason of such exercise, and
(B) no person who is otherwise a fiduciary shall be liable under this part for any loss, or by any reason of any breach, which results from such participant's or beneficiary's exercise of control.

[4] 29 C.F.R. 2550.404c-1(a)(1).

[5] 29 C.F.R. 2550.404c-1(b)(i-ii).

[6] 29 U.S.C. 1104(c)(1).

[7] 29 C.F.R. 2550.404c-1(b)(2)(i)(A-B).

[8] *See* 29 C.F.R. 2550.404c-1(c)(4).

limit the frequency of transactions participants may initiate.[9] Even these limitations carry more specific restrictions. Reasonable expenses may be charged so long as the beneficiary is informed periodically of the actual expenses incurred in his or her account.[10] The frequency of transactions may be limited, but must permit a participant to "give investment instructions with a frequency which is appropriate in light of the market volatility to which the investment alternative may reasonably be expected to be subject."[11] Generally, this requirement means that a participant must have the opportunity to give investment instructions (that must be followed) at least once every three months.[12]

The second prong of what constitutes a 404(c) plan is somewhat more complex. A plan qualifies as a 404(c) plan only if "the participant . . . is provided or has the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan, and incidents of ownership appurtenant to such investments."[13] The Regs set forth a number of factors that are required in order to satisfy this standard, including: an explanation that the plan is intended to constitute a 404(c) plan and that the fiduciaries may be relieved of liability for any losses that result from the participant's investment instructions; a description of the available investment alternatives, including "a general description of the investment objectives and risk and return characteristics . . ., including information relating to the type and diversification of assets comprising the portfolio of the designed investment alternative"; the identity of any retained investment managers; an explanation of the instructions that may be given by a participant, and any limitations that apply to such instructions; a description of costs and fees associated with transactions; the name, address, and phone number of the plan fiduciary; in the case of plans that permit investments in employer stock, information concerning procedures to protect confidential information and the name, address, and phone number of the plan fiduciary responsible for overseeing compliance with those procedures; the most recent prospectus for the investment;[14] materials regarding voting, tender, or other rights of shareholders in the investments.[15] In addition to these mandatory requirements, a plan fiduciary must also give to participants "either directly or upon request": a description of annual operating expenses of each investment that "reduce the rate of return to participants and beneficiaries, and the aggregate amount of such expenses expressed as a percentage of average net assets of the designated investment alternative"; prospectuses, financial statements, and reports that are provided to the plan; a breakdown of the assets held by each plan investment; information concerning the past and current performance, net of expenses, of investments available under the plan; the value of the shares of the investments held in the participant's own

[9] *See* 29 C.F.R. 2550.404c-1(b)(2)(B)(2)(ii)(A-C).

[10] 29 C.F.R. 2550.404c-1(b)(2)(B)(2)(ii)(A).

[11] 29 C.F.R. 2550.404c-1(b)(2)(B)(2)(ii)(C).

[12] 29 C.F.R. 2550.404c-1(b)(2)(B)(2)(ii)(C).

[13] 29 C.F.R. 2550.404c-1(b)(2)(B).

[14] This applies to investments subject to the Securities Act of 1933. *See* 29 C.F.R. 2550.404c-1(b)(2)(B)(1)(viii).

[15] 29 C.F.R. 2550.404c-1(b)(2)(B)(1)(i-ix).

account.[16]

A participant will not be deemed to have exercised control, however, if he or she is subjected to "improper influence" by a fiduciary with respect to an individual transaction, if the fiduciary has concealed material, non-public facts concerning the investment, or if the plan participant is not legally competent at the time instructions were given.[17]

Broad range of investment alternatives

In addition to providing plan participants with an opportunity to exercise control over their plan assets and with sufficient information about the plan and the investment alternatives available, a fiduciary must give plan participants a "broad range of investment alternatives."[18] To qualify as a broad range, the investments must permit the individual participant to "materially affect the potential return on amounts in his individual account with respect to which he is permitted to exercise control and the degree of risk to which such amounts are subject."[19] There must be at least three investment alternatives available to the participant, each of which is diversified on its own and has different risk and return characteristics than the other investment alternatives.[20] The participant must be able "to achieve a portfolio with aggregate risk and return characteristics at any point within the range normally appropriate for the participant or beneficiary" through the investments available to the participant.[21] Finally, the investment alternatives must provide the participant with an opportunity to diversify the plan assets sufficiently to reduce the risk of large losses[22]. The Regs accordingly specify what constitutes a sufficiently broad range of investment alternatives to satisfy ERISA's standard.[23]

What is the significance of qualifying as an ERISA 404(c) Plan?

In general, a plan fiduciary owes the plan participants a duty of loyalty, a duty of prudence in selecting the

[16] 29 C.F.R. 2550.404c-1(b)(2)(B)(2)(i-v).

[17] 29 C.F.R. 2550.404c-1(c)(2)(i-iii).

[18] 29 C.F.R. 2550.404c-1(b)(ii).

[19] 29 C.F.R. 2550.404c-1(b)(3).

[20] 29 C.F.R. 2550.404c-1(b)(3)(A-B(1)(2)).

[21] 29 C.F.R. 2550.404c-1(b)(3)(B)(3). Unfortunately, even if presented with the opportunity to achieve diversification, many investors fail to do so. *See* Medill, *supra* note 2, at 477.

[22] 29 C.F.R. 2550.404c-1(b)(3)(B)(4) and (C). "Look-through" investment vehicles, such as mutual funds or unit investment trusts, generally are appropriate alternatives for participants, particularly when that may be the only means to achieve diversification due to a small amount of assets in the plan. *See id.* Whether a particular look-through investment is appropriate as a plan alternative should be evaluated on a case by case basis.

[23] *See* 29 C.F.R. 2550.404c-1(b)(3); 29 C.F.R. 2550.404c-1(b)(i-ii).

investment options available, and a duty to "act for the exclusive purpose of providing benefits to the plan beneficiaries." [24] A fiduciary is personally liable for all losses caused by a breach of one of these duties.[25] The duties of an ERISA fiduciary also derive to some extent from common law. [26] Clearly, the standard for an ERISA fiduciary is quite high. Section 404(c), however, relieves the fiduciary from liability for certain losses sustained in a 404(c) plan. [27]

Section 404(c) acts as an affirmative defense to an action brought by plan participants for a breach of fiduciary duty.[28] If the employer fails to establish a qualifying plan, which, based upon the language contained in the Regs, is a question of fact to be determined by a court, [29] then the employer remains liable for all losses caused by a breach of fiduciary duty. [30] A failure to establish a qualifying 404(c) plan, however, does not in and of itself create a cause of action for an employee. [31] A plan participant must be able to demonstrate that the plan fiduciary caused losses to the plan through a breach of his or her fiduciary duty, such as by failing to diversify plan assets or otherwise violating one of the fiduciary's duties. [32] It is the fiduciary who bears the burden of proof in demonstrating that the plan qualifies as a 404(c) plan. [33] To the extent that a plan fiduciary establishes that the plan is a 404(c) plan, and to the extent any losses sustained in a participant's account were due to that participant's affirmative exercise of control, then the fiduciary bears no liability for those losses.

Potential areas of liability for fiduciaries of ERISA 404(c) plans.

Perhaps the greatest area of liability for plan fiduciaries of 404(c) plans relates to the potential failure to create a qualifying plan. As set forth

[24] *Rankin v. Rots*, 278 F. Supp.2d 853, 871 (E.D. Mi. 2003) (quoting ERISA ' 404(a), 29 U.S.C. ' 1104(a)).

[25] *See id.*

[26] *See id.*

[27] 29 U.S.C. ' 1104(c)(1).

[28] *See In re Unisys*, 74 F.3d 420, 446 (3rd Cir. 1996).

[29] The Regs use such terms as "reasonable opportunity," "reasonable restrictions," and "depends on the facts and circumstances of the particular case," all of which indicate that courts must have significant discretion in determining whether a plan qualifies as a 404(c) plan or a participant exercised control over his or her account. *See generally* 29 C.F.R. ' 2550.404c-1.

[30] *See In re Enron*, 284 F. Supp.2d 511, 578 (S.D. Tx. 2003) ("If a plan does not qualify as a ' 404(c), [sic] the fiduciaries retain liability for all investment decisions, *including decisions by the Plan participants.*) (emphasis added).

[31] *See* Medill, *supra* note 2, at 481.

[32] *See id.* at 481-82.

[33] *See id.* at

above, there are a number of requirements that must be met in order to establish a valid plan, and the failure to satisfy even one of them is fatal to the plan. As a result, the fiduciary is responsible for all losses sustained by a breach of duty, even if the losses were caused by a participant's own selection of investments. [34]

Once a qualifying plan has been established, the employer is not necessarily off the hook for losses sustained in the plan. There may remain a question as to whether losses sustained in a 404(c) plan were caused by the participant's exercise of control over the assets, or by some other factor. For example, if the plan fiduciary failed to identify and select the most economical[35] service provider for the participants, then all accounts within the plan would perform much more poorly over several years due to the payout of excessive fees. [36] While a difference between a .2% and 1.2% expense ratio may seem minuscule to a plan fiduciary shopping for particular investments, such a difference will make a significant impact on returns in individual accounts. [37] The difference will be caused not by a plan participant's exercise of control, but by the fiduciary's poor choice of providers.

Another potential area of liability is for accounts in which employee contributions sit in default investments. Often, the default investment for 404(c) plans is a money market fund that provides a relatively low rate of return, but safety of principal. [38] The pitfall with this arrangement is that the protections of 404(c) do not attach to the fiduciary until an employee actually takes affirmative action to select investments. [39] As a result, a participant who lets his or her plan assets sit idle in a low-paying money market fund, never giving a single investment instruction, could be found in a very uncomfortable situation at retirement time with inadequate funds. Because the employee took no action to trigger 404(c), the fiduciary may be liable for the employee's lost opportunity. [40] A cautious fiduciary would seek out a different default option that would provide employees with a relatively safe investment option that would generate a higher return over a longer period of time, or obtain an affirmative instruction from the employee directing the funds to a money market account. [41]

CONCLUSION

For the employer to have available the affirmative defense of ERISA 404(c) and to avoid liability for losses in employee plans, it is essential that the employer exercise a great deal of care in selecting a plan administrator that focuses on administering such plans and stays abreast of recent changes in the law. An employer must do more than provide account statements, prospectuses, and a menu of investment options to enjoy the benefits of section 404(c). If an employer attempts, but fails, to establish a qualifying 404(c) plan, then the employer may have created the potential for much greater liability by surrendering the exercise of control over the selection of investments for individual employees, thereby permitting the employee to select investments that are wholly inappropriate for his or her needs while still being liable for any losses sustained. The result could obviously be quite disastrous for the employer. It is therefore essential that an employer exercise great care in selecting a plan administrator and delegating fiduciary functions and seek out an administrator that is both skilled in implementing and monitoring 404(c) plans, and that stays up to date on relevant changes and interpretations of the applicable regulations.

On the other hand, establishing a qualifying 404(c) plan does not necessarily absolve an employer of all responsibility for losses sustained in employee accounts. An employer remains liable for losses caused by his or her breach of duty, but not losses caused by the participant's exercise of control over the account. As this appears to be a developing area of law, a cautious fiduciary would closely follow any new interpretations of the ERISA regulations issued by courts to monitor this area of exposure and take any appropriate steps to minimize risk. In the meantime, a fiduciary should shop carefully for plan administrators and service providers and scrutinize participant investment options for employees before making a selection to see that he or she is providing participants with the best deal available. Looking at expense ratios, management fees, transaction fees, and performance of investments, both prior to selection and as an ongoing process, is a critical function of a 404(c) fiduciary. A cautious employer should also consider what the best default investment option is for employees who fail to make an affirmative designation for investments in their accounts, so that those employees do not suffer a significant loss of opportunity several years later.

Monte Carlo Models- Calculators That Reduce Investment Uncertainty

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I. INTRODUCTION

Thanks to recent advances in low-cost computing power, virtually anybody can now use a personal computer to help make financial decisions regarding determining how much to withdraw from a retirement portfolio and how to allocate investments among asset classes. However, what many investors fail to realize is that the output from such computer programs is only as good as the assumptions utilized by the investor and computer program. Before relying on the withdrawal rate or asset allocation output from any financial planning computer program, investors must familiarize themselves with the problems concerning traditional "Deterministic"[1] computer program models and the advantages of utilizing new-age "Monte Carlo"[2] computer program models.

II. PROBLEMS WITH DETERMINISTIC MODELS

For the average investor, determining the maximum monthly amount to withdraw from his or her retirement account seems relatively simple. Most investors believe that all they need to do is find a computer software program with retirement planning functions, plug in data pertaining to their retirement age, life expectancy, current savings, and expected rate of return and rely on the program's output to tell them how much they can safely withdraw each month. For example, consider a 65 year old retiree with a $1,000,000 401(k) account, who estimates that his life expectancy is 90 years of age and his investments will earn an average annual rate of return of 10.5% during his retirement years. After the retiree inputs his data into his Microsoft Money Retirement Planner software program, the program tells him that he can withdraw $9,105 per month from his 401(k) from age 65 to age 90. Therefore, his withdrawal rate equals approximately 11% of his 401(k) account value at age 65.

This type of analysis, however, may severely understate the investor's risk of depleting his funds before life expectancy. This is because the Microsoft Money Retirement Planner program, like most retirement planning calculators, are

[1] Deterministic models assume that an investor will earn the same rate of return every year. An example of a Deterministic model is a standard financial calculator.

[2] Monte Carlo models do not assume an investor will earn the same rate of return every year. Rather, Monte Carlo models calculate the probability distribution of a forecast outcome. These models represent a major advance in reducing investment uncertainty.

directing the funds to a money market account.[41]

CONCLUSION

For the employer to have available the affirmative defense of ERISA 404(c) and to avoid liability for losses in employee plans, it is essential that the employer exercise a great deal of care in selecting a plan administrator that focuses on administering such plans and stays abreast of recent changes in the law. An employer must do more than provide account statements, prospectuses, and a menu of investment options to enjoy the benefits of section 404(c). If an employer attempts, but fails, to establish a qualifying 404(c) plan, then the employer may have created the potential for much greater liability by surrendering the exercise of control over the selection of investments for individual employees, thereby permitting the employee to select investments that are wholly inappropriate for his or her needs while still being liable for any losses sustained. The result could obviously be quite disastrous for the employer. It is therefore essential that an employer exercise great care in selecting a plan administrator and delegating fiduciary functions and seek out an administrator that is both skilled in implementing and monitoring 404(c) plans, and that stays up to date on relevant changes and interpretations of the applicable regulations.

On the other hand, establishing a qualifying 404(c) plan does not necessarily absolve an employer of all responsibility for losses sustained in employee accounts. An employer remains liable for losses caused by his or her breach of duty, but not losses caused by the participant's exercise of control over the account. As this appears to be a developing area of law, a cautious fiduciary would closely follow any new interpretations of the ERISA regulations issued by courts to monitor this area of exposure and take any appropriate steps to minimize risk. In the meantime, a fiduciary should shop carefully for plan administrators and service providers and scrutinize participant investment options for employees before making a selection to see that he or she is providing participants with the best deal available. Looking at expense ratios, management fees, transaction fees, and performance of investments, both prior to selection and as an ongoing process, is a critical function of a 404(c) fiduciary. A cautious employer should also consider what the best default investment option is for employees who fail to make an affirmative designation for investments in their accounts, so that those employees do not suffer a significant loss of opportunity several years later.

[41] *See id.* at 519, 541. Professor Medill suggests index funds, balanced funds, or so-called "lifecycle" funds, which correspond to the age of the participant to determine appropriate risk characteristics as alternative default investment vehicles. *See id.*

Viewing the illustration allows us to make a couple of key observations. First, at the portfolio's low point on 12/31/74, the portfolio's market value was down to approximately two-thirds of its original value. Second, on 12/31/81, twelve years after the original $1,000,000 investment was made, the portfolio's market value was still below its original value even though the investor was withdrawing only 6% of his original investment of $1,000,000 from a portfolio with an *average* annual return of 10.5%. These observations lead us to conclude that it is possible for an investor to deplete his funds before his designated withdrawal period ends even if the investor's initial withdrawal rate (e.g., 6%) is *below* the average annual rate of return earned on his investments (e.g., 10.5%) during the withdrawal period (e.g., 25 years). Therefore, it is highly probable that an investor may deplete his funds before his designated withdrawal period ends if the investor's initial withdrawal rate (e.g., 11%) is *above* the average annual rate of return earned on his investments (e.g., 10.5%) during the withdrawal period (e.g., 25 years).

The reason that Deterministic models may overstate withdrawal rates and, thus, understate withdrawal risk lies in the fact that Deterministic models assume that a *constant* rate of return is earned throughout the assumed life of the portfolio. In other words, Deterministic models assume that a portfolio, which is expected to earn an average annual return of 10.5% over the life of the portfolio, will generate a 10.5% return *each and every year*. What this method ignores, of course, is the standard deviation[7] of the portfolio. Specifically, Deterministic models fail to measure how the volatility of a portfolio in the early years may have a dramatic affect on the sustainability of withdrawals in the later years.[8]

For example, assume that an investor with a $100,000 portfolio withdraws $10,000 (10%) per year for ten years from a portfolio under three different market scenarios. Also, assume that under each scenario the portfolio has the same average annual rate of return. Below are the results:[9]

[7] Standard deviation is a statistical measure of how far actual returns deviate from the mean (average annual) return.

[8] Peterson, Matthew and Scott Welch, "Even the Odds," Investment Advisor, August 2000, p. 80.

[9] The illustration assumes annual compounding and that $10,000 is withdrawn from the portfolio on the last day of each year.

"Deterministic" models.[3] These calculators assume that the investor will earn the *same* return *each and every year*. However, according to Wall Street Journal personal finance columnist Jonathan Clements, "the world is a whole lot messier than that with returns coming in an unpredictable mix of dazzling gains and rotten results."[4]

In order to understand how severely Deterministic model calculators may understate risk, it is helpful to view an illustration conducted by Massachusetts Financial Services (MFS) at the request of financial planning author and syndicated columnist Nick Murray.[5] Murray asked MFS to run an illustration of a 25-year, $60,000-per-year, systematic withdrawal plan from a $1,000,000 hypothetical investment in stock mutual fund Massachusetts Investors Trust. Also, Murray asked MFS to assume that the investment was made at the beginning of 1971 and that $60,000 was withdrawn at the end of that year and every year thereafter. (The *average* annual rate of return for the mutual fund during the 25-year period was approximately 10.5%.) Furthermore, Murray requested that MFS assume no initial sales charges were levied, a 0.35% 12b-1 charge was levied, taxes were paid from another source, and capital gains and dividends were reinvested. Below is a summary of MFS's illustration:[6]

Period	Invest	Withdrawal	Market Value
01/01/71	$1,000,000	$ 0	$1,000,000
12/31/71		60,000	972,171
12/29/72		60,000	1,168,358
12/31/73		60,000	947,350
12/31/74		60,000	666,059
12/31/75		60,000	812,105
12/31/76		60,000	940,261
12/31/77		60,000	788,997
12/29/78		60,000	807,691
12/31/79		60,000	897,161
12/31/80		60,000	1,087,908
12/31/81		60,000	968,126
12/31/82		60,000	1,090,286
12/30/83		60,000	1,228,854
12/31/84		60,000	1,287,368
12/31/85		60,000	1,476,499
12/31/86		60,000	1,838,941
12/31/87		60,000	1,916,311
12/30/88		60,000	2,055,276
12/29/89		60,000	2,737,679
12/31/90		60,000	2,674,976
12/31/91		60,000	3,354,874
12/31/92		60,000	3,542,941
12/31/93		60,000	3,838,433
12/30/94		60,000	3,739,333
12/29/95		60,000	5,150,495

[3] Clements, Jonathan, "Retirement Models That Let Reality Bite," The Wall Street Journal, February 20, 2001, p. C1.

[4] Id.

[5] Murray, Nick, The Excellent Investment Advisor (1996), pp. 326-327.

[6] Id.

that an investor will deplete her funds before the end of her distribution period.[16]

Monte Carlo models have been around for more than 50 years.[17] The mathematics used in Monte Carlo models originated in Stansislaw Ulam and John von Neuman's simulations for building the atomic bomb during World War II.[18] Recently, Monte Carlo models were used to assist urban planners with predicting traffic patterns and institutional investment managers with forecasting probable investment outcomes.[19] Ulam named the method "Monte Carlo" after a relative who often visited Monaco's casinos.[20]

Thanks to recent advances in low-cost computing power, Monte Carlo models are now available to individual investors. For example, Financial Engines, a Web-based financial planning service co-founded by Nobel Laureate William Sharpe, has developed a Monte Carlo model.[21] In addition, mutual fund manager T. Rowe Price & Associates has a Monte Carlo model on its website (www.troweprice.com) which investors can use free of charge.

Like Deterministic models, Monte Carlo models account for factors such as monthly or annual average rates of return based upon historical estimates. However, unlike Deterministic models, Monte Carlo models generate hundreds or thousands of different scenarios by randomly changing the sequence of monthly or annual average returns. Once the scenarios are generated, Monte Carlo models then indicate the odds of reaching a particular outcome.

Even with identical inputs, the outputs generated by Monte Carlo models can vary substantially from the outputs generated by Deterministic models. Monte Carlo models also underscore the risks of relying too heavily on outputs generated by Deterministic models. Sam Savage, senior research associate at Stanford University, uses the following example:

A recent retiree has a $200,000 portfolio invested in the Standard & Poor's 500-stock index and she would like to tap into that sum over a 20-year period. How much can she withdraw each year? Since the S&P has an average annual return of 14% since 1952, her adviser suggested taking out some $32,000. However, the risk of hitting a string of bad years early can easily upset the estimate. For instance, if she had started her $32,000 withdrawals during a period as bad asthe stock-market returns of the mid-1970s, she would have run out of money in eight years.[22]

IV. OUTPUT VARIANCES BETWEEN DETERMINISTIC AND MONTE CARLO MODELS - A HYPOTHETICAL CASE STUDY

In order to illustrate how

[16] Clements, p. C-1.

[17] Farrell, Christopher, "A Better Way to Size up Your Nest Egg." Business Week, January 22, 2001, p. 100.

[18] Id.

[19] Hube, Karen, "Monte Carlo Financial Simulator May Be a Good Bet for Planning," The Wall Street Journal, April 27, 2000, p. C1.

[20] Id.

[21] For more information go to www.financialengines.com.

[22] Farrell, p. 100.

Bull Market First[10]

Year	ROR[12]	YEV[13]
0		$100,000
1	35%	$125,000
2	30%	$152,500
3	25%	$180,625
4	20%	$206,750
5	15%	$227,763
6	5%	$229,151
7	0%	$219,151
8	-5%	$198,193
9	-10%	$168,374
10	-15%	**$133,118**
Avg. Return = 10%		

Bear Market First[11]

Year	ROR	YEV
0		$100,000
1	-15%	$75,000
2	-10%	$57,500
3	-5%	$44,625
4	0%	$34,625
5	5%	$26,356
6	15%	$20,310
7	20%	$14,372
8	25%	$7,965
9	30%	$354
10	35%	**$0**[14]
Avg. Return = 10%		

Same Return Each Year

Year	ROR	YEV
0		$100,000
1	10%	$100,000
2	10%	$100,000
3	10%	$100,000
4	10%	$100,000
5	10%	$100,000
6	10%	$100,000
7	10%	$100,000
8	10%	$100,000
9	10%	$100,000
10	10%	**$100,000**
Avg. Return = 10%		

As the proceeding example illustrates, a Deterministic model, which assumes that the same return is realized each and every year, would have substantially understated the *risks* in our bear market first scenario since the investor's portfolio would have been completely depleted by year ten. Also, a Deterministic model would have understated the *results* by approximately one-third in our bull market first scenario. Note that the annual returns under the bull market first and bear market first scenarios are precisely the same. However, the returns occur in exact opposite sequences.

III. MONTE CARLO MODELS - CALCULATORS THAT REDUCE INVESTMENT UNCERTAINTY

Since Deterministic models ignore the potential sequences of investment returns, many investors are turning to computer "Monte Carlo" models to reduce uncertainty within their portfolios. Despite their name, Monte Carlo models represent almost the exact opposite of gambling. The models are powerful statistical tools that allow investors, managers, and planners to examine the performance of portfolios under hundreds or thousands of different scenarios and, thus, increase the accuracy and reliability of financial projections.[15] These models won't offer a simple thumbs up or thumbs down on an investor's distribution strategy. Instead, the models focus on how *probable* it is

[10] Bull markets involve rising stock prices.

[11] Bear markets involves falling stock prices.

[12] ROR = annual rate of return

[13] YEV = year end market value of portfolio

[14] Only $478 ($354 x 1.35) could be drawn from the portfolio in year 10.

[15] Peterson, p. 78.

widely the output can vary between Deterministic and Monte Carlo models, it is helpful to look at a hypothetical case study. For example, suppose a recently retired 65-year-old married female wants to know how much she can conservatively withdraw from her IRA each month and how she should efficiently divide her retirement portfolio among various asset classes. Currently her IRA asset allocation consists of the following: 38% in large-cap stock mutual funds, 12% in small-cap stock mutual funds, 10% in international stock mutual funds, 20% in investment-grade domestic bond mutual funds, 6% in high-yield bond mutual funds, 4% in international bond mutual funds, and 10% in money market mutual funds.[23] Suppose also that the retiree inputs her information into both the Microsoft Money Retirement Planner, a Deterministic model, and the T. Rowe Price Retirement Income Calculator, a Monte Carlo model.

A. Key Inputs, Assumptions, and Outputs Associated with the Deterministic Model

Below are the key inputs, assumptions, and outputs associated with the Microsoft Money Retirement Planner Deterministic model:

1. Key inputs provided by the retiree [24]

1. *The retiree will begin monthly withdrawals at age 65.*

2. *The retiree will make monthly withdrawals for 30 years.* This will enable the retiree to take monthly withdrawals until age 95, which is approximately eight years beyond her life expectancy.[25] Many financial planners advise choosing a life expectancy figure five to ten years beyond actual life expectancy to reduce the risk of the retiree prematurely depleting her retirement assets.[26]

3. *The retiree's assets total $500,000 at age 65.*

4. *The retiree's expected annual rate of return is 6.95%.* The retiree arrived at an expected annual rate of return of 6.95% by calculating a weighted average annual expected *net* rate of return based upon her current asset allocation, projected *gross* average annual returns for each asset allocation category, and the Lipper average expense ratios for each comparable no-load mutual fund category. As previously mentioned, her current asset allocation consists of 38% in large-cap stock funds, 12% in small-cap stock funds, 10% in international stock funds, 20% in investment-grade domestic bond funds, 6% in high-yield bond funds, 4% in international bond funds, and 10% in money market funds. The projected average annual expected gross rates of return for

[23] More generally, her asset allocation consists of 60% stocks, 30% bonds, and 10% money markets funds.

[24] Italicized words comprise key inputs. Non-italicized words comprise explanations of key inputs.

[25] Quinn, Jane Bryant, Making the Most of Your Money, Simon & Schuster, New York (1997), p. 1026.

[26] Littell, David and Kenn Beam Tacchino, Planning for Retirement Needs, The American College, Bryn Mawr, Pennsylvania (2002), p. 424.

each asset class used in computing the average annual expected net rate of return for her portfolio include the following: 9% for large-cap stocks, 10% for small-cap stocks, 10% for international stocks, 6% for investment-grade domestic bonds, 7.5% for high-yield bonds, 6% for international bonds, and 4% for money market securities.

The Lipper average expense ratios for each comparable no-load mutual fund category used in computing the average annual expected net rate of return for the portfolio include the following: 1.09% for large-cap stock funds, 1.17% for small-cap stock funds, 1.21% for international stock funds, 0.72% for investment-grade domestic bond funds, 0.82% for high-yield bond funds, 0.96% for international bond funds, and 0.61% for money market funds.[27]

Therefore, the weighted average annual expected net rate of return was calculated as follows:

	(A)	(B)	(A) - (B)
FUND	**EXP GROSS ROR**[28]	**EXP EXPENSE RATIO**[29]	**EXP NET ROR**[30]
LCS[31]	9%	1.09%	7.91%
SCS[32]	10%	1.17%	8.83%
IS[33]	10%	1.21%	8.79%
IGDB[34]	6%	0.72%	5.28%
HYB[35]	7.5%	0.82%	6.68%
IB[36]	6%	0.96%	5.04%
MM[37]	4%	0.61%	3.39%

FUND	**EXP NET ROR**	**WEIGHTING**[38]	**(A) x (B)**
LCS	7.91%	.38	3.01%
SCS	8.83%	.12	1.06%
IS	8.79%	.10	0.88%
IGDB	5.28%	.20	1.06%
HYB	6.68%	.06	0.40%
IB	5.04%	.04	0.20%
MM	3.39%	.10	0.34%
WEIGHTED AVERAGE ANNUAL EXPECTED NET RATE OF RETURN			**6.95%**

[27] T.Rowe Price Retirement Income Calculator http://www.troweprice.com/retailHome/0,,pgid=retailHome,00.html

[28] Expected gross average annual returns for each fund. Gross average annual returns do not take into account fund expenses.

[29] Lipper average expenses ratios for each comparable fund category.

[30] Expected net average annual returns for each fund. Net average annual returns take into account fund expenses.

[31] Large-cap stock fund.

For the Monte Carlo model, the retiree used T. Rowe Price Associates' Retirement Income Calculator. The calculator helps retirees estimate the maximum monthly withdrawal they can afford to take without significantly risking depleting their retirement funds before life expectancy. The Retirement Income Calculator provides retirees with probabilities that their investments will last for their lifetimes. The lowest probability that the model will calculate is 50%. Below are the key inputs, assumptions, and outputs associated with the Monte Carlo model:

1. Key inputs provided by the retiree

1. *The retiree will begin monthly withdrawals at age 65.*

2. *The retiree will make monthly withdrawals for 30 years.*

3. *The retiree's IRA assets total $500,000 at age 65.*

4. *The retiree's current asset allocation consists of the following: 38% in large-cap stock funds, 12% in small-cap stock funds, 10% in international stock funds, 20% in investment-grade domestic bonds funds, 6% in high-yield bond funds, 4% in international bond funds, and 10% in money market funds.*

5. *The retiree is married.*

6. *The retiree wants a 90% simulation success rate.* In other words, the retiree wants to determine which asset allocation and initial withdrawal rate provides a 90% probability of avoiding depletion of her retirement assets before age 95.

2. Key assumptions made by the Monte Carlo model [39]

1. *The initial withdrawal amount increases by 3% each year for inflation.*

2. *The assumed average annual expected gross rates of return for each asset class are exactly the same as those used in determining the weighted average annual expected net rate of return for the Deterministic model.* [40]

3. *The assumed mutual fund expense ratios are exactly the same as those used in determining the weighted average annual expected net rate of return for the Deterministic model.* [41]

4. *The Monte Carlo simulation technique looks at a wide variety of potential market scenarios that take fluctuating market returns into account.* Instead of basing calculations on just one average rate of return, the model generates 500 computer simulations of what may actually happen to a retiree's assets over a given time period. Each simulation includes up and down markets of various lengths, intensities, and combinations. In addition, the model looks at a retiree's monthly withdrawal amount in these simulations to determine the likelihood that it could be sustained to a retiree's projected life expectancy. For example, if a retiree has a 90% simulation success rate, then, out of 500 simulations, the retiree's funds would last until projected life expectancy in 450 simulations. Correspondingly, the retiree's funds would be depleted before life expectancy in 50 simulations.

[39] T. Rowe Price Retirement Income Calculator
http://www.troweprice.com/retailHome/0,,pgid=retailHome,00.html

[40] See p. 11.

[41] Id.

2. Key assumptions made by the Deterministic model

1. *The retiree earns the same rate of return (6.95%) each year.*

2. *The model's simulation success rate is 100%.* In other words, so long as the portfolio earns an average annual return of 6.95% and the retiree takes monthly withdrawals that do not exceed the maximum monthly withdrawals allowed by the Deterministic model, the retiree should not run out of money before she turns age 95. As previously mentioned, the consideration of only the expected average annual return and, thus, the failure to consider the expected possible sequences of annual returns, is a major flaw in the Deterministic model.

3. *The initial withdrawal amount is increased by 3% each year for inflation.*

3. Key outputs provided by the Deterministic model

1. *The retiree can withdraw $2,327 per month from her IRA at age 65.* As previously mentioned, the initial withdrawal rate will increase by 3% each year. Assuming her portfolio earns an average annual rate of return of 6.95%, the model implies that she has a 0% chance of running out of money before age 95.

2. *The retiree's preferred asset allocation is 100% small-cap stocks.* Deterministic models prefer portfolios with high average annual expected net rates of return because they assist the models in generating high initial monthly withdrawal rates. Therefore, a portfolio invested entirely in a small-cap stock fund would be preferred over other asset allocations because a 100% small-cap stock allocation results in the highest average annual expected net rate of return. Placing 100% of her IRA dollars into a small-cap stock fund will increase the retiree's average annual expected net rate of return from 6.95% to 8.83%. Thus, according to the Deterministic model, the retiree's initial monthly withdrawal rate will increase from $2,327 per month to $2,769 per month. However, the Deterministic model fails to take into account that placing 100% of the retiree's dollars in a small-cap stock fund may increase the retiree's likelihood of depleting her retirement funds before age 95 since a 100% small-cap stock portfolio is more volatile than the retiree's current portfolio.

B. Key Inputs, Assumptions, and Outputs Associated with the Monte Carlo Model

[32] Small-cap stock fund.

[33] International stock fund.

[34] Investment-grade domestic bond fund.

[35] High-yield bond fund.

[36] International bond fund.

[37] Money market fund.

[38] Each fund's current weighting within the IRA.

Table 1

Key Information	**Deterministic Model**	**Monte Carlo Model**
Start Age	65	65
Retirement Length	30 years	30 years
Retirement Assets	$500,000	$500,000
Stock%/Bond%/Money Market%	60/30/10	60/30/10
Simulation Success Rate	100%	90%
Maximum Initial Monthly Withdrawal	$2,327 (indexed for inflation)	$1,600 (indexed for inflation)

Table 2 shows the simulation success rate, as computed by the Monte Carlo model, for a retiree who decided to withdraw the maximum monthly withdrawal allowed by the deterministic model ($2,327 per month (indexed for inflation)) from her IRA. According to the Monte Carlo model, withdrawing $2,327 per month (indexed for inflation) from an IRA would result in a more than 50% chance of the retiree running out of money before age 95.[43]

Table 2

Key Information	**Deterministic Model**	**Monte Carlo Model**
Start Age	65	65
Retirement Length	30 years	30 years
Retirement Assets	$500,000	$500,000
Stock%/Bond%/Money Market%	60/30/10	60/30/10
Maximum Initial Monthly Withdrawal	$2,327	$2,327
Simulation Success Rate	100%	less than 50%

[43] The T. Rowe Price Retirement Income Calculator does not compute simulation success rates for maximum initial withdrawal rates with less than a 50% chance of succeeding. A $2,150 maximum initial monthly withdrawal rate would have a simulation success rate of exactly 50%.

5. *The model develops its 500 hypothetical simulations by relying on the normal distribution of past returns.* Normal distributions of returns are represented by the familiar bell curve, which is commonly used to depict the distribution of data points. Expected returns lie closer to the average or mean, while deviations appear in the "tails" of the curve representing extreme events that are possible but not expected to occur very often.

6. *Each year, assets are re-balanced to bring them back to the appropriate model asset allocation, and at approximate five-year intervals, the retiree's entire portfolio is shifted to the next more conservative asset allocation.*

7. *The model treats all assets as if they were held in tax-deferred accounts.* Correspondingly, all projections of monthly withdrawals are pretax.

8. *The model will assume a distribution of no more than the projected monthly withdrawal amount unless minimum required distribution rules[42] require a distribution in excess of that amount.* For the purpose of determining minimum required distributions, the model assumes that spouses are of the same age and life expectancy.

3. Key outputs provided by the Monte Carlo model

1. *Assuming a 90% simulation success rate, the retiree can withdraw $1,600 per month at age 65.* The initial withdrawal rate can increase by 3% each year. The retiree has a 10% probability of depleting her funds before age 95.

2. *Assuming a 90% simulation success rate, the retiree's current asset allocation is* ***one of*** *a number of asset allocations that would be considered efficient.* Other efficient portfolios would include portfolios with the following asset allocations:

   (1) 25% stock funds, 40% bond funds, 35% money market funds,

   (2) 40% stock funds, 40% bond funds, 20% money market funds, and

   (3) 80% stock funds, 20% bond funds, 0% money market funds.

C. Hypothetical Case Study - A Summary

Table 1 provides a summary of the inputs and outputs associated with the Deterministic and Monte Carlo models. As the table indicates, the maximum allowable initial monthly withdrawal computed by the Deterministic model exceeds the maximum initial monthly withdrawal computed by the Monte Carlo model by $727. Also of note, is the fact that the Monte Carlo model estimates that, even if the retiree makes monthly withdrawals significantly lower than those allowed under the Deterministic model, the retiree still has a 10% chance of depleting her retirement funds before age 95. On the other hand, the Deterministic model inaccurately assumes that the retiree has a 0% chance of depleting her retirement funds before age 95 as long as the retiree's portfolio earns the expected average annual net rate of return.

[42] Minimum annual distributions from IRAs must begin by April 1 of the year after the IRA owner turns age 70 ½. Factors that affect the amount of an IRA owner's minimum distributions include the dollar value of the IRA account and the life expectancies of the IRA owner and her beneficiaries.

Mastering Prudent Investment Practices – Step-by-Step Guidelines for Investment Professionals

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By Stuart Ober, AIFA ™

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Where can you turn to find a structured fiduciary process that will leave you confident that the critical components of an investment strategy have been properly implemented?

"Prudent Investment Practices: A Handbook for Investment Fiduciaries,"[2] written by the Foundation for Fiduciary Studies, and edited by the Personal Financial Planning Division of the American Institute of Certificate Public Accountants is an important tool for attorneys involved in securities arbitration and litigation and fiduciaries who want to stay out of the courts.

This Handbook was developed to serve as a "foundation for prudent investment fiduciary practices." It provides its readers with an organized process for rendering informed and consistent fiduciary decisions. The primary purpose of the Handbook is to outline the practices ("Practices") that define a prudent process for investment fiduciaries.

The Handbook primarily addresses ERISA (the Employee Retirement Income Securities Act for qualified retirement plans), UPIA (the Uniform Prudent Investor Act for private trusts and possibly foundations and endowments), and MPERS (the Uniform Management of Public Employee Retirement Systems Act which may impact state, county, and municipal retirement plans). This paper covers, and quotes extensively from, the basic tenets of the Handbook.

I. EXECUTIVE SUMMARY

The role played by fiduciaries is one of the most important, yet most misunderstood, in which investment professionals participate. And it is likely, considering the complexity of the role of fiduciaries, that lawsuits alleging misconduct will continue.

The key to fiduciary liability is basic: It's not whether you win or lose, but how you play the game. Liability of the fiduciary is determined by whether prudent investment practices are followed, and not by investment performance. Prudence is demonstrated by the *process* through which investment decisions are made, and not by *performance.*

It should be noted that even conservative and traditional

[1] *Bussian v. RJR Nabisco,* 223 F.3d 235, 295 (5th Cir. 2000). They do not permit fiduciaries to ignore grave risks to plan assets, stand idly by while participants' retirement security is destroyed, and then blithely assert that they had no responsibility for the resulting harm.

[2] Prudent Investment Practices: A Handbook for Investment Fiduciaries", written by the Foundation for Fiduciary Studies, edited by the American Institute of Certified Public Accountants, and legal review by Reish Luftman McDaniel & Reicher, 2003.

V. CONCLUSION

Clearly, Monte Carlo models represent an improvement over Deterministic models in reducing investment uncertainty. However, Monte Carlo models are not crystal balls and will never eliminate all investment uncertainty. For example, since the assumed average annual rates of return chosen for a Monte Carlo model are based on historical returns, the assumed returns will likely not precisely reflect the actual returns realized by the portfolio during the withdrawal period.

Despite this limitation, Monte Carlo models are far more realistic measures of financial risk and reward than Deterministic models. Furthermore, recent advances in low-cost computing power are making Monte Carlo models affordable to nearly all investors. The failure to utilize Monte Carlo models will likely subject investors to more risk than Deterministic models allow them to recognize.

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investments may not measure up if a sound process is missing, while aggressive and unconventional investments that are arrived at by a sound process can meet the standard.

The Handbook covers twenty-seven Practices that define a prudent investment process. Another handbook to accompany the Practices, "Legal Memorandums for Prudent Investment Practices,"[3] written by the Foundation for Fiduciary Studies with legal review by Reish Luftman McDaniel & Reicher, cites specific legal references for each of the twenty-seven Practices.

In this paper, as in the Handbook, a distinction will be made between what represents a practice that is generally accepted in the investment industry and what is required by law. An **industry best practice** from the Handbook will be highlighted in **bold** type in the text to distinguish the practice from legal requirements. The Practices are noted in *italics.*

II. DEFINITIONS

A. Definition of a Fiduciary

A fiduciary is generally defined as a person who

- Manages property for the benefit of another;
- Exercises discretionary authority or control over assets; and/or
- Acts in a professional capacity of trust, and renders comprehensive and continuous investment advice.

B. Definition of the Duty of the Fiduciary

According to the Handbook, the primary duty of the fiduciary is "to manage a prudent investment process, without which the components of an investment plan cannot be defined, implemented, or evaluated."

III. PRACTICES MATRIX

The Practices outlined in the Handbook are intended to define a prudent investment process from beginning to end. The Practices Matrix has been constructed as follows:

The vertical axis is the Uniform Fiduciary Standards of Care – those seven standards that are common to the three legislative acts that shape investment fiduciary standards – ERISA, UPIA, and MPERS:

1. Know standards, laws, and trust provisions.
2. Diversify assets to specific risk/return profile to client.
3. Prepare investment policy statement.
4. Use "prudent experts" (money managers) and document due diligence.
5. Control and account for investment expenses.
6. Monitor the activities of "prudent experts."
7. Avoid conflicts of interest and prohibited transactions.

The horizontal axis of the Matrix is the Five-Step Investment Management Process:

1. Analyze Current Position – Step 1.
2. Diversify – Allocate Portfolio – Step 2.
3. Formalize Investment Policy – Step 3.
4. Implement Policy – Step 4.
5. Monitor and Supervise – Step 5.

These two axes frame the prudent investment process. For each cell of the Matrix, one or more Practices are identified. The complete Practices Matrix which is the "Guide to Investment Fiduciary Practices "appears at the end of this paper.

[3] "Legal Memorandums", written by the Foundation for Fiduciary Studies, legal review by Reish Luftman McDaniel & Reicher, 2002.

IV. THE PRACTICES

A. Step 1 - Analyze Current Position

1. The Practices

A fiduciary's first step is to review and analyze all the pertinent documents relevant to establishing and managing the account. The fiduciary must set goals that are consistent with the portfolio's resources. Written documentation is necessary to prove that such a framework has been established.

Fiduciaries are responsible for the general management of the investments. A fiduciary may, if statutes and provisions permit, delegate certain decisions to others, such as professional money managers and consultants.

The following are the Practices associated with "Analyze Current Position" – Step 1:

Practice No. 1.1
Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements.

Practice No. I. 2
Fiduciaries are aware of their duties and responsibilities.

Practice No. 1.3
Fiduciaries and parties in interest are not involved in self-dealing.

Practice No. 1.4
Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.

Practice No. 1.5
There is documentation to show timing and distribution of cash flows and the payment of liabilities.

Practice No. 1.6
Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement.

2. Practical Application – Industry Best Practice

The following documents, at a minimum, should be reviewed and analyzed:

- **The Investment Policy Statement ("IPS"), written minutes, and/or files from investment committee meetings. (See also Practice No. 3.1).**
- **Trust agreements and amendments. (See also Practice No. 1.2).**
- **Brokerage and custodial agreements. (See also Practices Nos. 4.4 and 5.3).**
- **Service agreements with investment management vendors (custodians, money managers, investment consultants, actuaries, accountants, and attorneys). (See also Practice No. 1.4).**
- **Information on retained money managers and investments – such as the ADV of each account manager and prospectuses for all mutual funds. (See also Practice No. 4.1).**
- **Investment performance reports from money managers, custodians, and/or consultants. (See also Practice 5.1).**

B. Step 2 – Diversify – Allocate Portfolio

1. The Practices

The fiduciary is required to state the presumptions that are being used to model, or replicate, the probable outcomes of an investment strategy. There is no requirement, or expectation, that the fiduciary be able to forecast future returns. The fiduciary should prepare a time horizon, and to choose the appropriate combination of asset classes that optimizes the identified risk and return objectives, consistent with the portfolio's time horizon.

The following are the Practices associated with "Diversify – Allocate Portfolio" – Step 2:

Practice No. 2.1
A risk level has been identified.

Practice No. 2.2
An expected, modeled return to meet investment objectives has been identified.

Practice No. 2.3

An investment time horizon has been identified.

Practice No. 2.4
Selected asset classes are consistent with the identified risk, return, and time horizon.

Practice No. 2.5
The number of asset classes is consistent with portfolio size.

2. Practical Application – Industry Best Practice

An investment strategy must be appropriate to the identified level of risk – it can fail by being too aggressive or too conservative.

It is important to determine the "hierarchy of decisions," from the most important to the least: (1) What is the time horizon of the investment strategy? (2) What asset classes will be considered? (3) What will be the mix among asset classes? (4) What sub-asset classes will be considered? (5) Which managers/funds will be selected?

The acronym "TREAT" defines the key fiduciary inputs to the asset allocation strategy:

T – Tax status,
R – Risk level,
E – Expected return,
A – Asset class preference, and
T – Time horizon.

C. Step 3 – Formalize Investment Policy

1. The Practices

One of the most critical functions of the fiduciary is to prepare and maintain the investment policy statement ("IPS"). The IPS is the formal, long-range strategic plan that allows the fiduciary to coordinate the management of the investment program. The IPS is the blueprint, the business plan, and the essential management tool for directing and communicating the activities of the portfolio.

The IPS should be flexible and responsive to a dynamic financial environment, be clear and concise enough to be implemented by a third party, and yet not be so detailed as to require constant revisions. The IPS should address the management of each of the Uniform Fiduciary Standards of Care (the vertical axis of the Practices Matrix)

The following are the Practices associated with "Formalize Investment Policy" – Step 3:

Practice No. 3.1
There is detail to implement a specific investment strategy.

Practice No. 3.2
The investment policy statement defines the duties and responsibilities of all parties involved.

Practice No. 3.3
The investment policy statement defines diversification and rebalancing guidelines.

Practice No. 3.4
The investment policy statement defines due diligence criteria for selecting investment options.

Practice No. 3.5
The investment policy statement defines monitoring criteria for investment options and service vendors.

Practice No. 3.6
The investment policy statement defines procedures for controlling and accounting for investment expenses.

Practice No. 3.7
The investment policy statement defines appropriately structured, socially responsible investment strategies (when applicable).

2. Practical Application – Industry Best Practice

The fiduciary is required to manage investment decisions with a reasonable amount of detail. Through a carefully prepared IPS, the fiduciary can: (1) avoid unnecessary differences of opinion and the resulting conflicts; (2) minimize the possibility of missteps due to a lack of clear guidelines; (3) establish a reasoned basis for measuring compliance; and (4) establish and communicate clear and reasonable expectations

with participants, beneficiaries, and investors.

A fiduciary is required to define the due diligence process and criteria for selecting investment managers. The requirement for fiduciaries to define due diligence criteria for selecting money managers is implicit in ERISA case law and ERISA fiduciary requirements.[4]

Monitoring should include (1) quarterly performance reports indicating how well the funds and managers are performing relative to the objectives set forth in the IPS (see also Practice No. 5.1), (2) annual review determining whether there have been any material changes in the objectives, goals, or risk/return profile (see also Practices No. 1.1 and 2.4), (3) review of the custodial statement for accuracy and determine whether money managers are seeking best execution on trades (see also Practice No. 5.3), and (4) identify specific performance criteria and objectives for each money manager and/or mutual fund.

D. Step 4 – Implement Investment Policy

1. The Practices

While fiduciary law does not expressly require using professional money managers, fiduciaries will be held to the same expert standard of care, and their activities will be measured against those of investment professionals.[5]

The fiduciary's liability associated with managing the portfolio's assets may be reduced if safe harbor rules are adopted. If investment decisions are being managed by a committee and/or by an investment advisor, there are five generally recognized provisions to the safe harbor rules:

1. Use prudent experts to make the investment decision.
2. Demonstrate that the prudent expert was selected by following a due diligence process.
3. Give the prudent expert discretion over the assets.
4. Have the prudent expert acknowledge his or her co-fiduciary status.
5. Monitor the activities of the prudent expert to ensure that the expert is performing the agreed upon tasks. (See also Practices Nos. 5.1-5.5).

The following are the Practices associated with "Implement Investment Policy" – Step 4:

Practice No. 4.1
The investment strategy is implemented in compliance with the required level of prudence.

Practice No. 4.2
The fiduciary is following applicable "Safe Harbor" provisions (when elected).

Practice No. 4.3
Investment vehicles are appropriate for the portfolio size.

Practice No. 4.4
A due diligence process is followed in selecting service providers, including the custodian.

2. Practical Application – Industry Best Practice

The prudent fiduciary should do what one does best and delegate (when trust documents permit) the

[4] In re Unisys Savings Plan Litigation, 74 F.3d 420, 19 E.B.C. 2393 (3rd Cir.), *cert. denied*, 510 U.S. 810, 117 S.CT. 56, 136 L.Ed.2d 19 (1996) and ERISA §404(a)(1)(B).

[5] ERISA, §402(c)(3), §403(a)(1) and (2), and §404(a)(1)(B); UPIA §2(c), §2(f), and §9(a)(1-3); and MPERS §6(a), §6(b)(1), §6(b)(3), §7(3), and §8(a)(1).

rest to professionals. The fiduciary should demonstrate that a due diligence process was followed in selecting each investment option.

Due diligence for manager selection should consider the following:

1. **Performance relative to peer group.**
2. **Performance relative to assumed risk.**
3. **Inception date of product.**
4. **Correlation to specified index.**
5. **Assets under management.**
6. **Holdings consistent with style.**
7. **Expense ratios or fees.**
8. **Stability of the organization.**

E. Step 5– Monitor and Supervise

1. The Practices

The monitoring function should occur, not only across strict examination of performance, but across all policy and procedural issues, and should be ongoing. The fiduciary has a continuing duty to exercise reasonable care, skill, and caution.

The following are the Practices associated with "Monitor and Supervise" – Step 5:

Practice No. 5.1
Periodic reports compare investment performance against an appropriate index, peer group, and IPS objectives.

Practice No. 5.2
Periodic reviews are made of qualitative and/or organizational changes of investment decision-makers.

Practice No. 5.3
Control procedures are in place to periodically review policies for best execution, soft dollars, and proxy voting.

Practice No. 5.4
Fees for investment management are consistent with agreements and with the law.

Practice No. 5.5
"Finder's fees," 12b-1 fees, or other forms of compensation that have been paid for asset placement are appropriately applied, utilized, and documented.

2. Practical Application – Industry Best Practice

Performance objectives for each investment decision-maker, and/or money manger, should be established and recorded by the fiduciary in the investment policy statement. Investment performance should be evaluated in terms of an appropriate market index and the relevant peer group.

The investment policy statement should describe the actions to be taken when an investment decision-maker fails to meet established criteria. (See also Practice No. 3.5).

Money manager fees vary widely, depending on the asset class to be managed, the size of the account, and whether the funds are to be managed separately or placed into a commingled or mutual fund. Usually fees are charged in terms of basis points (100 basis points equals 1.0%) and are applied to the market value of the portfolio at the end or the beginning of the calendar quarter. Fees often decline with increasing asset size.

V. FIDUCIARY CODE OF CONDUCT

A helpful guide to the fiduciary is found in The Center for Fiduciary Studies' Fiduciary Code of Conduct:

- If you're going to do it – Do it right.
- As you manage investment decisions: Document the process; Hire competent professionals; Monitor results; and Always remember you have been entrusted with someone else's money.
- Never invest in something you don't understand or that is difficult to value. Know what you're paying for – Don't hire the fox to count the chickens.
- Understand that, when everyone is talking about

making a killing – The market already is dead.
- Cautiously approach investments that promise superior results. Believe in the statement – The past is not necessarily indicative of future performance.
- Relish the opportunity to be a steward of sound investment practices for, in the end, it's *procedural prudence*, not performance, that counts.

VI. CONCLUSION

The Practices offer a flexible process for the successful management of investment decisions, and help the fiduciary understand that no investment is good or bad *per se*. Yet, the intelligent and prudent management of investment decisions also requires the fiduciary to maintain a rational and disciplined investment program.

The Handbook shows that being a fiduciary is about *process prudence* and not about *performance*. This ultimately may be the most important lesson the Practices can teach those who have the legal responsibility for managing someone else's money.

GUIDE TO INVESTMENT FIDUCIARY PRACTICES

Step One:
Analyze Current Position

1.1 Investments are managed in accordance with applicable laws, trust documents, and written investment policy statements.
1.2 Fiduciaries are aware of their duties and responsibilities.
1.3 Fiduciaries and parties in interest are not involved in self-dealing.
1.4 Service agreements and contracts are in writing, and do not contain provisions that conflict with fiduciary standards of care.
1. 5 There is documentation to show timing and distribution of cash flows and the payment of liabilities.
1. 6 Assets are within the jurisdiction of U.S. courts, and are protected from theft and embezzlement.

Step Two:
Diversify – Allocate Portfolio

2.1 A risk level has been identified.
2.2 An expected, modeled return to meet investment objectives has been identified.
2.3 An investment time horizon has been identified.
2.4 Selected asset classes are consistent with the identified risk, return, and time horizon.
2.5 The number of asset classes is consistent with portfolio size.

Step Three:
Formalize Investment Policy

3.1 There is detail to implement a specific investment strategy.
3.2 The IPS defines duties and responsibilities of all parties involved.
3.3 The IPS defines diversification and rebalancing guidelines.
3.4 The IPS defines due diligence criteria for selecting investment options.
3.5 The IPS defines monitoring criteria for investment options and service vendors.
3.6 The IPS defines procedures for controlling and accounting for investment expenses.
3.7 The IPS defines appropriately structured, socially responsible investment strategies (when applicable).

Step Four:
Implement Investment Policy

4.1 The investment strategy is implemented in compliance with the required level of prudence.
4.2 The fiduciary is following applicable "Safe Harbor" provisions (when elected).
4.3 Investment vehicles are appropriate for the portfolio size.
4.4 A due diligence process is followed in selecting service providers, including the custodian.

Step Five:
Monitor and Supervise

5.1 Periodic reports compare investment performance against appropriate index, peer group, and IPS objectives.
5.2 Periodic reviews are made of qualitative and/or organizational changes of investment decision makers.
5.3 Control procedures are in place to periodically review policies for best execution, soft dollars, and proxy voting.
5.4 Fees for investment management are consistent with agreements and the law.
5.5 "Finders' fees," 12b-1 fees, or other forms of compensation that may have been paid for asset placement, are appropriately applied, utilized, and documented.

UNIFORM FIDUCIARY STANDARDS OF CARE	Step 1 Analyze	Step 2 Diversify	Step 3 Formalize	Step 4 Implement	Step 5 Monitor
1. Know standards, laws, and trust provisions.	1.1 – 1.6	1.5	3.1, 3.2, 3.7	1.1, 4.2	1.5, 5.1, 5.2
2. Diversify assets to specific risk/return profile of client.	1.1, 1.5	2.1 – 2.5	3.1, 3.3	4.1	3.3, 5.1
3. Prepare investment policy statement.	1.1, 1.5, 3.1, 3.2	3.3	3.1 – 3.7	4.1 – 4.4	3.5 – 3.7, 5.1
4. Use "prudent experts" (money managers) and document due diligence.	1.2, 4.1, 4.2	4.1	3.1, 3.2, 3.4	4.1 – 4.4	5.1 – 5.3
5. Control and account for investment expenses.	4.3, 5.4, 5.5	2.5	3.1, 3.6	4.3, 4.4, 5.3 – 5.5	5.3 – 5.5
6. Monitor the activities of "prudent experts."	1.4, 5.1	3.3, 5.1 – 5.3	3.1, 3.5 – 3.7	5.1 – 5.4	5.1 – 5.5
7. Avoid conflicts of interest and prohibited transactions.	1.1, 1.3, 1.4, 1.6	1.6	3.2, 3.7	1.3	5.5

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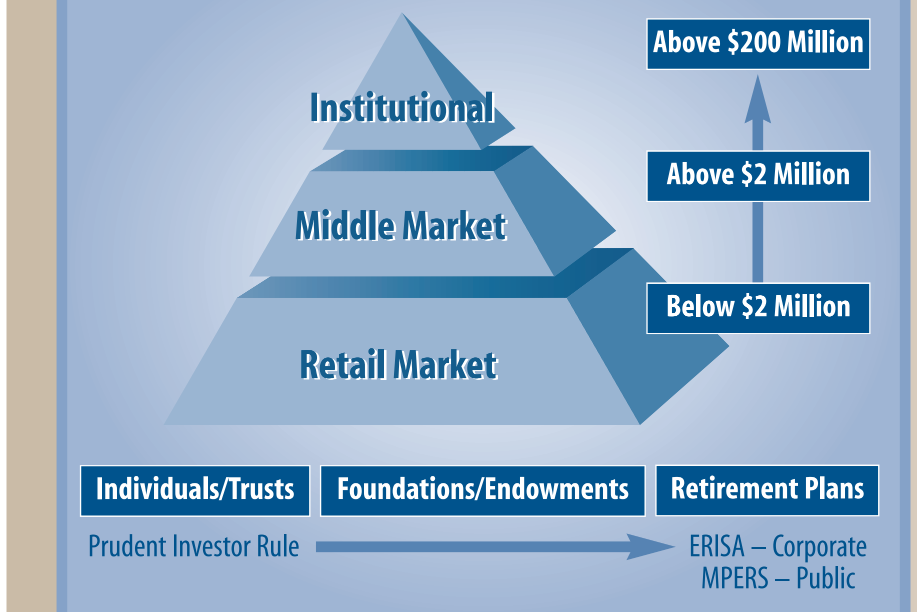
THE MANAGEMENT OF INVESTMENT DECISIONS

Vertical and Horizontal Investment Process



Institutional

Middle Market

Retail Market

Above $200 Million

Above $2 Million

Below $2 Million

Individuals/Trusts

Foundations/Endowments

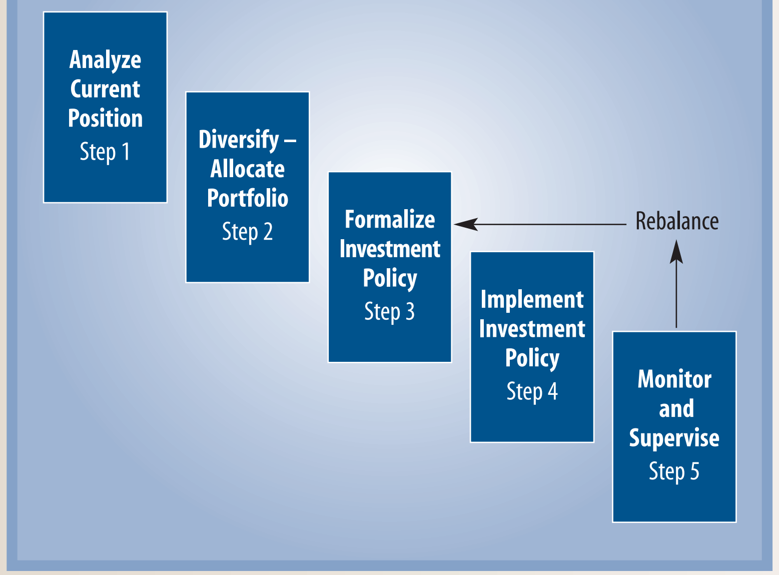
Retirement Plans

Prudent Investor Rule → ERISA – Corporate
MPERS – Public

Uniform Fiduciary Standards of Care

1. Know standards, laws, and trust provisions.
2. Diversify assets to specific risk/return profile of client.
3. Prepare investment policy statement.
4. Use "prudent experts" (money managers) and document due diligence.
5. Control and account for investment expenses.
6. Monitor the activities of "prudent experts."
7. Avoid conflicts of interest and prohibited transactions.

The Five-Step Investment Management Process



Analyze Current Position
Step 1

Diversify – Allocate Portfolio
Step 2

Formalize Investment Policy
Step 3

Implement Investment Policy
Step 4

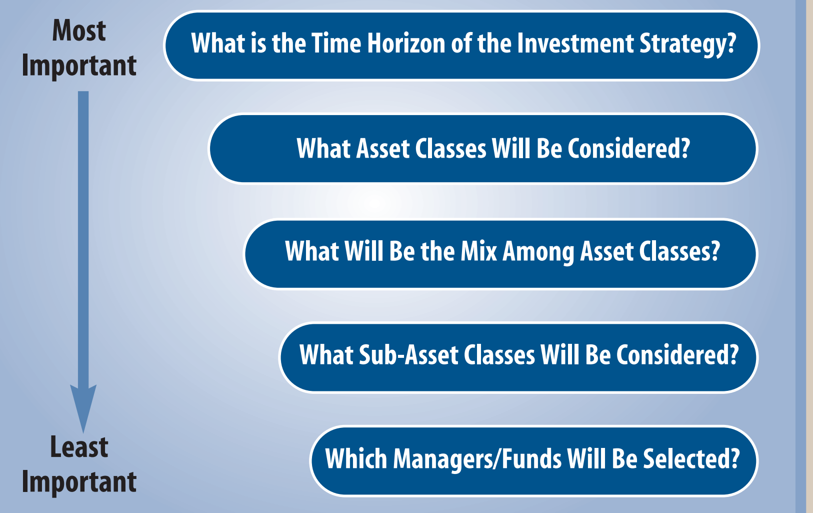
Monitor and Supervise
Step 5

Rebalance

Due Diligence for Manager Selection

1. Performance relative to peer group.
2. Performance relative to assumed risk.
3. Inception date of product.
4. Correlation to peer group.
5. Assets under management.
6. Holdings consistent with style.
7. Expense ratios or fees.
8. Stability of the organization.

The Hierarchy of Decisions



Most Important

What is the Time Horizon of the Investment Strategy?

What Asset Classes Will Be Considered?

What Will Be the Mix Among Asset Classes?

What Sub-Asset Classes Will Be Considered?

Which Managers/Funds Will Be Selected?

Least Important

Asset Allocation Variables

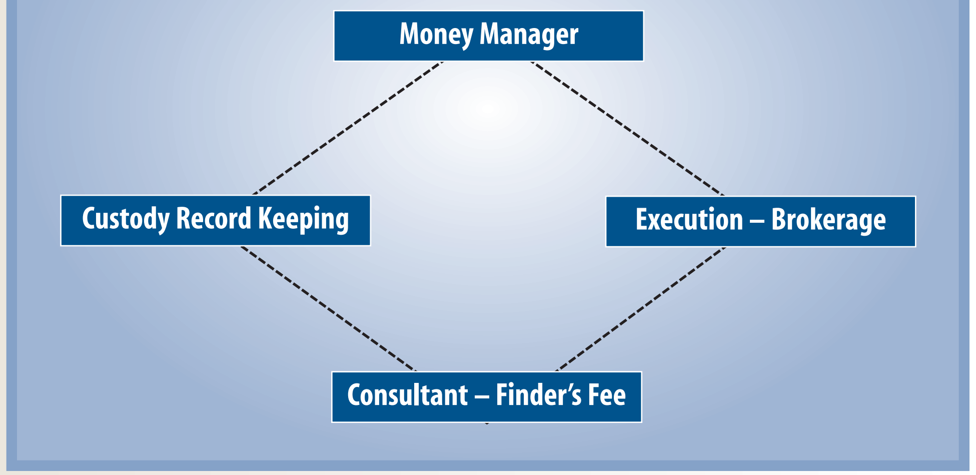
- **T** Tax Status
- **R** Risk Tolerance
- **E** Expected Return
- **A** Asset Class Preference
- **T** Time Horizon

"Safe Harbor" Rules

1. Use "prudent experts."
2. Apply a due diligence process for selecting "prudent experts."
3. Give selected "prudent experts" investment discretion.
4. Have "prudent experts" acknowledge cofiduciary status in writing.
5. Monitor activities of the "prudent experts."

Unbundling Fees and Expenses

"Bundled fees" should be broken down so that a proper evaluation can be made – various costs can be obscured or moved to create apparent savings.



Money Manager

Custody Record Keeping

Execution – Brokerage

Consultant – Finder's Fee

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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.

Mae C. Annandale, et al. v. Linsco Private Ledger and Eugene F. Blair
NASD Case No. 02-06895

Claimants alleged that Respondents recommend the purchase of unsuitable variable annuities for Claimants which were invested in aggressive mutual fund subaccounts. Claimants requested compensatory damages, interest, costs, punitive damages and attorneys fees.

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

1. The panel found Respondents jointly and severally liable to Claimants for $237,500 in compensatory damages. The cost of the hearing was assessed equally against Respondent Linsco and Respondent Blair.

The award is a significant recovery in a variable annuity case involving the unsuitable allocation of the annuity subaccount investments and Respondent Linsco's failure to supervise Eugen Blair.

Claimants' Counsel -
Jason L. Nohr, Esq. of Huddleston & Nohr
Respondents' Counsel –
Jo Lanier Meeks, Esq. of Pursley Lowery Meeks, LLP
Claimants' Expert –
John Duval
Respondents' Expert - None
Hearing Situs –
Atlanta, Georgia
Arbitrators -
William E. Zachary, Jr., Esq., Public/Chairman
Frank A. Lightmas, Jr., Esq., Public
Perry L. Taylor, Jr., Esq., Industry

Shep Alster, et al. v. A.G. Edwards & Sons, Inc.
NASD Case No. 02-05060

Claimants asserted the following causes of action: failure to supervise, misrepresentation, suitability, negligence, violation of Section 517.301 of the Florida Statutes, breach of contract, breach of fiduciary duty and common law fraud involving the purchase and sale of securities in Claimants' accounts. Claimants requested compensatory damages, interest, costs, punitive damages and attorneys fees.

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

1. The panel found Respondent liable for $281,988 in compensatory damages and 6 percent post-judgment interest until the award is paid in full.

Claimants' Counsel -
Scott Silver, Esq. of the Law Offices of Darren C. Blum

Respondent's Counsel –
David M. Minnick, Esq. of A.G. Edwards & Sons, Inc.
Claimants' Expert - None
Respondent's Expert - None
Hearing Situs –
Tampa, Florida
Arbitrators -
Allen J. Kaplan, Esq., Public/Chairman
Abe Mintz, Public
David Newman, Industry

Jack and Marlene Farbstein v. Wachovia Securities, LLC
NASD Case No. 02-06567

Claimants asserted the following causes of action: breach of contract and warranties, promissory estoppel, negligence, misrepresentations and suitability. The Claimants alleged that upon gaining control of the account, Respondent recommended the sale of Claimants' conservative bond portfolio and replaced it with high risk and speculative securities that were unsuitable. Claimants requested compensatory damages, interest, costs, punitive damages and attorneys fees. Respondent denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims, attorneys fees and costs.

1. The panel found Respondent Wachovia liable for $300,000 in compensatory damages and interest at 6 percent from September 11, 2002 to February 26, 2004.

2. The panel found Respondent Wachovia liable for $35,000 in attorneys fees pursuant to Texas statute and case law.

The award is a significant because it represents a return of significant compensatory damages as well as an attorney fee award pursuant to Texas law. In addition, the cost of the hearing was assessed against Wachovia.

Claimants' Counsel –
Samuel B. Edwards, Esq. of Shepard, Smith & Edwards, PC
Respondent's Counsel –
Jack D. Ballard, Esq. of The Ballard Law Firm
Claimants' Expert –
Jerrod Sumners
Respondent's Expert –
Tom Posey, Chris Kilmer, John Nigg
Hearing Situs –
Houston, Texas
Arbitrators -
J. Randle Henderson, Esq., Public/Chairman
Frank M. Romano, Public
Thomas H. Griffin, Industry

Shafiq Hasan, et al. v. First Union Securities a/k/a Wachovia Securities Inc.
NASD Case No. 02-07847

Claimants asserted the following causes of action: breach of fiduciary duty, constructive fraud, misrepresentation, suitability, violation of federal and state securities laws and failure to supervise. Claimants requested compensatory damages, interest, costs and punitive damages.

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 liable to Claimant Shafiq Hasan, Trustee of the Pro-Guard International, Inc. Pension Fund for $91,561 and 5 percent interest from April 9, 2001 until the award is paid in full.

2. The panel found Respondent liable to Claimant Pro-Guard International, Inc. for $242,676 in compensatory damages and 5 percent interest from April 9, 2001 until the award is paid in full.

3. The panel found Respondent liable for $8,500 as reimbursement of Claimants' expert witness fees.

The award is significant because Claimants argued that First Union failed to monitor their portfolio in a declining market by not selling or otherwise hedging their losing positions.

Claimants' Counsel --
Robert A Uhl, Esq. and Orousha Brocious, Attorney at Law of Aidikoff & Uhl
Respondent's Counsel –
Michael J. Abbott, Esq. of Jones, Bell, Abbott, Fleming & Fitzgerald
Claimants' Expert –

Bob Grosnoff
Respondent's Expert - None
Hearing Situs –
Los Angeles, California
Arbitrators -
Alan Stamm, Esq., Public/Chairman
James S. Carlson, Public
Gerald Tambe, Industry

Carla J. Lopez et al. v. Merrill Lynch, Pierce, Fenner & Smith, Inc. and Donald C. Korkow
NASD Case No. 02-04422

Claimants asserted the following causes of action: violation of federal and state securities laws, violations of the Texas Deceptive Trade Practices Act, negligence, breach of contract, breach of fiduciary duty, fraud and failure to supervise. The causes of action related to the alleged advise surrounding Claimants' exercise of Allegiance Telecom employee stock options and the holding of the stock. Claimants alleged that Respondents failed to diversify the position while placing the stock on margin to pay for the cost of exercise and taxes without fully explaining the risks of this strategy. Claimants requested compensatory damages, interest, costs, punitive damages and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims, attorneys fees and costs. Respondents filed a counterclaim for $21,507 for an unpaid margin balance.

Prior to the hearing Respondents filed a motion for a more definite statement, motion to sever and motion to dismiss which were denied.

1. The panel found Respondent Merrill Lynch and Donald Korkow jointly and severally liable for $5,991,000 in compensatory damages and 10 percent interest from February 3, 2004 until the award is paid in full.

2. The panel found Respondent Donald Korkow liable for $400,000 in compensatory damages and 10 percent interest from February 3, 2004 until the award is paid in full.

3. The panel found Claimant/Counter-Respondent liable for $21,507 and 10 percent interest from February 3, 2004 until the award is paid in full.

The award is significant for the panel's imposition of compensatory damages which were three times Claimants' out of pocket losses. This award is a significant recovery in size in an exercise and hold case involving employee stock options.

Claimants' Counsel -
Jeffrey A. Feldman, Esq.
Respondents' Counsel –
Reece Bader, Esq. of Orrick, Herrington & Sutcliffe
Claimants' Expert –
Craig McCann and Bill Jones
Respondents' Expert –
David Rosedahl and Dr. Chudozie Okongwu
Hearing Situs –
Dallas, Texas
Arbitrators -
K. Steve Kimball, CFA, Public/Chairman
Ronald Luther Johnson, Public
Kurt L. Smith, Industry

John Murray, et al. v. Prudential Securities, Inc.
NASD Case No. 02-07528

Claimants asserted the following causes of action: breach of fiduciary duty, constructive fraud, misrepresentation, suitability, violation of federal and state securities laws involving the recommendation of aggressive growth mutual funds. The Murrays who are retired, alleged that Prudential purchased shares of Strategic Partners Focused Growth and Strategic Partners New Era Growth. At the time of purchase these funds had no proven track record and were unsuitable for the Murrays risk tolerance and investment objectives of preserving the capital they had saved for more than 30 years. Claimants requested compensatory damages, interest, costs, punitive damages and attorneys fees.

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

1. The panel found Respondent Prudential liable for $158,336 in compensatory damages and interest at 10 percent from November 1, 2002 to December 19, 2003.

2. The panel found Respondent Prudential liable to Claimant's for $63,000 in attorneys fees pursuant to *Coutee v. Barington Capital Group*, 2003 WL 21730625 (9th Cir. 2003).

The award is a significant because it represents a full return of the Murray's losses plus interest at 10 percent, refund of their NASD costs and $63,000 in attorneys fees. In addition, the cost of the hearing was assessed against Prudential.

Claimants' Counsel -
Ryan K. Bakhtiari, Esq. of Aidikoff & Uhl
Respondent's Counsel –
Christopher Kondon, Esq. of Kirkpatrick & Lockhart
Claimants' Expert –
Stephen Butler of Butler, Adams, Karpesh & Associates
Respondent's Expert - None
Hearing Situs –
Los Angeles, California
Arbitrators -
Douglas J. Rovens, Esq., Public/Chairman
Sherry L. Robinson, Public
Dawn M. Kirchner, CFP, Industry

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April Taylor, Office Assistant
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Website: www.PIABA.org

Upcoming Events:

PIABA Board of Directors Meeting, July 17-18, 2004, San Francisco, California.

PIABA 13th Annual Meeting and *6th Annual Securities Law Update*, October 20 - 24, 2004. Hyatt @ Coconut Pointe. Bonita Springs, Florida.

Annual Business Meeting, October 21, 2004. Hyatt @ Coconut Pointe. Bonita Springs, Florida.

PIABA Board of Directors Meeting, October 24, 2004. Hyatt @ Coconut Pointe. Bonita Springs, Florida.

PIABA Board of Directors Meeting, March 5-6, 2005. (This is a date change.) Location to be announced.

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