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PIABA Bar Journal

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The Bar Journal of the Public Investors Arbitration Bar Association

President's Message

Rosemary Shockman

Dear Colleagues:

The past couple of months brought two victories for investors in arbitration. The first involves the NASD six year eligibility rule. The SEC approved modifications to the rule, which will prevent the extinguishment of claims still viable under applicable statutes of limitations. The battle for change to the six year rule has lasted more than ten years. While perhaps not as significant in many of our cases at the moment, this rule change could become important in coming years, as many of the complex products, such as variable annuities with a plethora of confusing features play out.

As I stated in my list serve message, many, many PIABA members contributed to the effort to change the six year rule over the past ten years. Thanks again to all of you.

The second positive development was with the New York Stock Exchange. The NYSE had submitted a rule to the SEC which

The second positive development was with the New York Stock Exchange. The NYSE had submitted a rule to the SEC which

provided for the NYSE to appoint arbitrators unless the parties agreed to list selection. After vehement protest by PIABA, the NYSE withdrew this proposed rule. PIABA's position is that list selction should be the default method, and should be used if the investor requests it. Hopefully, we will see a new rule submission along this line.

PIABA continues to be active in urging resolutions to the ongoing problems with NYSE arbitration. Delay in appointment of arbitrators and setting hearings plague cases. We will be providing the NYSE with input on a discovery guide.

Further efforts are being made to recruit arbitrators. Put it in your New Year's Resolutions. RECRUIT AN ARBITRATOR IN 2005!

Best wishes for a successful and happy New Year.

ProfLipner's I Love New York Law Column: Exculpatory Agreements Involving Fiduciaries

Seth Lipner

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In my last article in this space, the subject was the duty of fiduciaries employed to manage investor monies. The law imposed a high duty on managers and investment advisors who act with discretion, an ongoing duty of prudence, vigilance and professionalism. Damages for breach of this duty are computed according to an actual loss formula, plus disgorgement of fees (See the Fall 2004 PIABA Bar Journal). This article considers a question which logically follows: Can fiduciaries use the agreements they have with their customers to limit customer rights in the event of misconduct?

Securities broker-dealers are not permitted, by NASD rule, to use the agreements they make with their customers to limit their liability. But Investment Advisors, who often are not affiliated with member firms, often use their customer agreements to define and limit their liability. As will be seen, the law of New York is very protective of the customers in such cases.

The law, however, was not always as it is today. Cases in the 1930s held that the duties of fiduciaries was strictly defined and limited by the terms of the indenture.[1] But in *Dabney v. Chase Nat. Bank*[2], the Second Circuit, in an opinion by Judge Learned Hand, held that notwithstanding very narrow definitions of the trustee's duties in an indenture:

> [T]he duty of a trustee not to profit at the possible expense of his beneficiary, is the most fundamental of the duties which he accepts when he becomes a trustee. It is a part of his obligation to give his beneficiary his undivided loyalty, free from any conflicting personal interest; an obligation that has been nowhere more jealously and rigidly enforced than in New York where these indentures were executed.

Speaking of *Hazzard v. Chase Nat. Bank*, Judge HAND wrote:

> That [case] we read only as criticism of practices that had grown up, and not as asserting that the courts of New York had given any countenance to the notion that, so far as a corporation sees fit to assume the duties of an indenture trustee, it can shake off the loyalty

[1] See e.g. *Hazzard v. Chase Nat. Bank*, 159 Misc. 57, 287 N.Y.S. 541, aff'd 257 App.Div. 950, 14 N.Y.S.2d 147, aff'd 282 N.Y. 652, 26 N.E.2d 801, cert. denied 311 U.S. 708, 61 S.Ct. 319, 85 L.Ed. 460 (1936).

[2] 196 F.2d 668 (2d Cir. 1952).

> demanded of every trustee, corporate or individual. We can find no warrant for so supposing; and, indeed, a trust for the benefit of a numerous and changing body of bondholders appears to us to be preeminently an occasion for a scruple even greater than ordinary; for such beneficiaries often have too small a stake to follow the fate of their investment and protect their rights.

The policy expressed by Learned Hand is not limited to the fiduciary duty of loyalty and the avoidance of conflicts - it extends to the duty of prudence as well. In *Beck v. Manufacturers Hanover Trust Co.*[3], the court wrote:

> But it was not loyalty alone among the constellation of fiduciary attributes that was required of the present Trustee, for even if the responsibilities of an indenture trustee may be significantly more narrowly defined than those of an ordinary trustee . . . . It simply does not accord with sound public policy or the ostensible purposes for which an indenture is made and relied upon by its beneficiaries, to allow indenture trustees the benefit of broad exculpatory provisions to excuse their failure to exercise those powers they possess pursuant to the indenture prudently in order to mitigate or obviate the consequences of default.

New York courts routinely express a distaste for exculpatory clauses in consumer contracts of adhesion. See e.g. *Gross v. Sweet*:[4]

> As the cases make clear, the law's reluctance to enforce exculpatory provisions of this nature has resulted in the development of an exacting standard by which courts measure their validity. So, it has been repeatedly emphasized that unless the intention of the parties is expressed in unmistakable language, an exculpatory clause will not be deemed to insulate a party from liability for his own negligent acts [citations omitted]. Put another way, it must appear plainly and precisely that the "limitation of liability extends to negligence or other fault of the party attempting to shed his ordinary responsibility" [citations omitted].
>
> Not only does this stringent standard require that the drafter of such an agreement make its terms unambiguous, but it mandates that the terms be understandable as well. Thus, a provision that would exempt its drafter from any liability occasioned by his fault should not compel resort to a magnifying glass and lexicon. [citations omitted] Of course, this does not imply that only simple or monosyllabic language can be used in such clauses. Rather, what the law demands is that such provisions be clear and coherent (cf. General Obligations Law, s 5-702).

The same concepts carry through to the fiduciary relationship. In *Renz v. Beeman*,[5] the Court wrote:

> Only the most explicit language can protect a fiduciary from liability in a conflict of interest with his Cestuis. See, e. g., Matter of Hubbell, 302 N.Y. 246, 255, 97 N.E.2d 888 (1951). Courts may not

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[3] 218 A.D.2d 1, 632 N.Y.S.2d 520 (1st Dept. 1995).

[4] 49 N.Y.2d 102, 400 N.E.2d 306, 424 N.Y.S.2d 365 (1979).

[5] 589 F.2d 735 (2d Cir. 1978).

> read exculpatory language broadly, lest they unwittingly permit erosion of the fiduciary duty itself. See Wendt v. Fischer, supra, 243 N.Y. at 443-44, 154 N.E.2d 303.[6]

A typical exoneration clause provides that the fiduciary not be liable for errors of judgment, or that he will only be liable for misfeasance and not for nonfeasance. Such was the case in *In re Trusteeship of Williams*.[7] The court stated that the malfeasance/nonfeasance distinction unclear and not determinative. Regarding the "errors of judgment" language, the court wrote:

> Appellant argues that this language cannot aid Norwest because Norwest was negligent in failing to vote to divest the trust of Borden stock, and the language of the exculpatory clause does not exculpate a trustee for negligence…Courts have long distinguished between negligence-type claims and mistakes or "mere errors of judgment." This distinction has existed since before the trust instrument at issue here was created. Thus, we can reasonably assume that the trust creator was aware of these distinctions and could have exculpated a trustee for negligent acts find the intent of the trust's had he wished to do so. Because our task is to creator, and trust instruments are to be strictly construed, we conclude that while the exculpatory clause protects a trustee from liability for "mistakes or errors of judgment," it does not do so for negligent acts.

CONCLUSION

In fiduciary breach cases, the terms of the fiduciary's agreement are important (especially if it contains restrictions). But contract clauses that seek to exculpate a fiduciary for his own negligence are very much disfavored, and are thus almost always "void" under New York law.

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[6]See also *HealthExtras, Inc. v. SG Cowen Securities Corp.*, slip op., Jan 20, 2004 (S.D.N.Y.) (holding that claims were outside the scope of the fiduciary's exculpatory provision)

[7] 591 N.W.2d 743, *746-748 (Minn.App. 1999)(Minnesota is a western suburb of Buffalo)

Attorney Issued Discovery Subpoenas in Arbitration are an Abuse of Process

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Introduction

Counsel for investment fraud victims are engaged in a great debate with counsel for broker/dealers over the use of attorney issued subpoenas in NASD and NYSE arbitration. Counsel for broker/dealers ardently argue that NYCPLR section 7505 and NASD 10322 authorizes them to serve attorney issued subpoenas to third parties for confidential records relating to parties and non-parties without any review by the Panel.

Alas, such arrogance and abuse of process is not authorized by the governing Federal Arbitration Act ("FAA"), New York State law or NASD Rules. As discussed below, attorney issued discovery subpoenas far exceed the narrow limits placed on the use of subpoenas in SRO arbitration. Like an 800 pound gorilla broker/dealers try to throw their weight around to intimidate arbitrators into disregarding the law of subpoenas. Below is a summary of arguments available to those with the nerve to battle the beast.

Statement of Facts

Respondent signed and issued 7 *subpoenae duces tecum* "in the name of the National Association of Securities Dealers ('NASD')" on non-parties. None of Respondent's Subpoenas were signed or issued by the Chairperson.

Incredibly, in its 7 Subpoenas, Respondent seeks private, confidential credit card account and mortgage records pertaining to Claimant and Claimant's wife. Claimant's wife is not even a party to this arbitration. Respondent irresponsibly disseminated Claimant's and Claimant's wife's confidential social security numbers to unrelated third parties.

Respondent also distributed personal credit card account numbers with Claimant's confidential social security numbers in some of its subpoenas. Respondent used Claimant's social security numbers to enable the subpoenaed non-parties to determine whether responsive documents exist while facilitating identity theft.

When Respondent's counsel told Claimant of his intent to issue the illegal subpoenas, Claimant's counsel asked him to follow NASD procedure and submit Respondent's subpoenas to the Chairperson. Respondent flatly refused.

Claimant's Statement of Claim alleges that Respondent fraudulently induced them to purchase the stock based on Respondent's fraudulent research reports and recommendations. Only defenses responsive to Claimant's claims are germane to this arbitration. Claimant's credit card usage has no relationship to any matter in controversy.

The impact of Respondent's Subpoenas is to strip the Chairperson of his jurisdiction to rule on Claimant's objections, as well as his jurisdiction to make a determination about the propriety of each subpoena before they are issued. The damage Respondent's subpoenas are doing to Claimant's reputation, his business relationships, as well as his, is unconscionable and unnecessary.

Summary of Legal Issues

Claimant objects to Respondent's abuse of NASD Arbitration Procedures and its unlawful attempt to usurp the authority of the Arbitrators. Respondent signed a written contract that this arbitration is governed by the NASD arbitration rules. Even an 800-pound gorilla, like Respondent, has an obligation to follow those rules.

NASD Arbitration Rules, the Federal Arbitration Act ("FAA") and New York law prohibit Respondent from rummaging through fraud victims' private records – which have no relationship to any claim or defense – on the off chance Respondent might find something to aid its campaign of blaming the victims of its unconscionable fraud. Respondent's illegal Subpoenas serve only to harass, vex, and embarrass Claimant and his family.

As a matter of law, Arbitrators have no power to approve Respondent's substitution of illegal subpoenas for the NASD Arbitration Rules. *See* below. To do so is evidence of manifest disregard of the law and of partiality. Claimant moves to quash Respondent's Subpoenas on the following grounds:

a. Respondent's Subpoenas are void and unenforceable, since they were not signed or issued by an Arbitrator, as required by the applicable provision of the FAA, 9 U.S.C. §7;

b. Respondent is misusing 7 *subpoenae duces tecum* for general discovery purposes, which is prohibited by New York law, *Bach v. Fahnestock & Co.,* No. 13227-02 (N.Y. Sup. Ct. Jan. 27, 2003);

c. Respondent's Subpoenas are void and unenforceable, since non-party, pre-hearing discovery subpoenas are not permitted in arbitration under §7 of the FAA, *Hay Group, Inc. v. E.B.S. Acquisition Corp.,* 360 F.3d 404, 406-07 (3d Cir. 2004);

d. Respondent's Subpoenas contradict NASD Arbitration Rules, since Respondent issued its Subpoenas without submitting its subpoena request to the Arbitrators for a determination that each subpoena complies with the law before they are issued; and

e. Respondent's Subpoenas are an unreasonable and unnecessary invasion of the privacy of Claimant and non-parties.

Legal Discussion

Introduction

Proof that Respondent is engaged in an unlawful fishing expedition is evident on the face of its Subpoenas, except, **"[i]nstead of using rod and reel, or even a reasonably sized net, [Respondent] would drain the pond and collect the fish from the bottom."** *In re IBM Peripheral EDP Devices Antitrust Litig.,* 77 F.R.D. 39, 42 (N.D. Cal. 1977).

Respondent's Subpoenas make overly broad requests for categories of confidential and personal financial records, including records concerning a non-party, that are not related to the matter in controversy. The time period of Respondent's subpoenas far exceeds the relevant time period for the pending claim, and Respondent has failed to identify the specific account holder for each of its 7 subpoenas.

Subpoenas are not discovery devices. *Matter of Terry D.*, 81 N.Y.2d 1042, 601 N.Y.S.2d 452 (1993). Respondent's reliance on CPLR 7505 and NASD Rule 10322 is misplaced. *Bach, supra*, p. 1-2. **"New York law . . . grants neither arbitrators nor counsel of record the power to issue a *subpoena duces tecum* for purposes of discovery in**

arbitration." *Id.* at p. 2; *see* V. Alexander, *Practices Commentaries*, CPLR §7505, McKinney's at 682 (**"The subpoena power conferred by CPLR 7505 is limited to procuring of evidence for the hearing or trial of the dispute. Depositions and other forms of pretrial disclosure are ordinarily not contemplated in arbitration proceedings"**).

Rather than comply with the FAA, New York law and NASD rules, Respondent illegally disseminated Claimant's confidential social security numbers to identify **possible** accounts, violating the privacy rights of Claimant and Claimant's wife, a non-party. In effect, Respondent has requested non-parties to conduct a general search of their records to determine whether Claimant ever had a relationship with the non-parties.

Even more egregiously, Respondent distributed Claimant's confidential social security numbers **together with** credit card account numbers in three (3) of the subpoenas. Respondent's Subpoenas serve only to humiliate, punish and embarrass Claimant and his family for having the nerve to complain about being defrauded by Respondent. Ask yourself, how you would feel if the brokerage firm you trusted committed a fraud that victimized you, and an arbitrator manifestly disregarded the law and endorsed the firm's unlawful distribution of your most private information, facilitating the theft of your identity? Claimant need not warn the Chairperson about the ease with which identity fraud can occur with an individual's social security and credit card numbers. Respondent has completely disregarded common sense in its relentless campaign to harass Claimant and his family.

Respondent has made no showing that the records exist or would be material to this arbitration, which are mandatory prerequisites to the issuance of any subpoena. The New York Court of Appeals has specifically rejected Respondent's anticipated argument that the subpoenaed records might include material evidence. *Matter of Terry D., supra*.

Respondent is attempting to circumvent the NASD Code of Arbitration and applicable law. A *subpoena duces tecum* is no substitute for the discovery request requirements under NASD Rule 10321 and may not be used to supplement discovery. Respondent wants to substitute its self-interest for the judgment of the Arbitrators by issuing illegal discovery subpoenas to non-parties over Respondent's counsel's signature. As discussed below, Claimant seeks an Order quashing Respondent's 7 void and unenforceable discovery Subpoenas.

The FAA Prohibits Respondent's Attorney-Issued Subpoenas

This arbitration is governed by the FAA, since the dispute involves securities purchased and sold on a national securities market. 9 U.S.C. §1; *Societe Generale v. Raytheon*, 643 F.2d 863, 867 (1st Cir. 1981).

Respondent's attorney-issued subpoenas are invalid under the FAA. Respondent's counsel lacks the authority to compel the production of documents and information through a subpoena. Section 7 of the FAA requires that subpoenas "shall be signed by the arbitrators, or a majority of them." 9 U.S.C. §7. No arbitrator has signed Respondent's Subpoena. Therefore, Respondent's Subpoenas do not comply with the FAA and are an egregious abuse of process.

NASD Rule 10322(a) of the NASD Code of Arbitration does not authorize attorney-issued subpoenas. *Suratt v. Merrill Lynch*, Case No. 03-80502 (S.D. Fla. 2003). The Rule "provides that 'the arbitrators and counsel of record to the proceeding shall have the power of the subpoena process as provided by law.'" *Id.* NASD 10322 "is not an independent grant of power to attorneys in arbitration proceedings, however,

as it allows counsel to issue subpoenas only 'as provided by law.'" *Id.*[1]

Federal Courts have specifically – and unequivocally – rejected attorney-issued subpoenas because they violate §7. The Second Circuit unequivocally held that FAA "section 7 explicitly confers authority only upon *arbitrators*; by necessary implication, the *parties* to an arbitration may not employ this provision to subpoena documents or witnesses." *National Broadcasting Co. v. Bear Stearns & Co., et al.,* 165 F.3d 184, 187 (2d Cir. 1999)(emphasis in original); *Burton v. Bush*, 614 F.2d 389, 390 (4th Cir. 1980)("While an arbitration panel may subpoena documents or witnesses, the litigating parties have no comparable privilege"); *Suratt, supra* ("While the FAA allows *arbitrator-issued* subpoenas, it is silent on the issue of attorney-issued subpoenas. Courts have interpreted this silence to mean that attorney-issued subpoenas in arbitration actions are forbidden").

In *Suratt*, the Court held that, since the FAA governed, arguments that state law permits attorney-issued subpoenas in arbitration were not applicable. "When the FAA conflicts with state law governing arbitration actions, the FAA controls." *Suratt, supra., citing Volt Information Sciences v. Board of Trustees*, 489 U.S. 468, 477, 109 S.Ct. 1248, 1255 (1989).

Under the FAA and NASD arbitration rules, Respondent has the burden of proving its entitlement to the 7 subpoenas. By Respondent issuing subpoenas instead of submitting them to the Chairperson, Respondent has unfairly shifted the burden to Claimant to show improper use rather than leave the burden where it belongs – on Respondent.

New York Law Prohibits Respondent's Use of a *Subpoena Duces Tecum* for General Discovery

Respondent is misusing 7 *subpoenae duces tecum* for "general discovery." Respondent's Subpoenas seek such items as "all account statements, account opening documents and account agreements" for Claimant's credit cards and mortgage records. A *subpoena duces tecum* is not a discovery device. *Matter of Terry D., supra.*
New York courts have rejected Respondent's argument that CPLR §7505 authorizes discovery subpoenas. *Bach, supra*, p. 2. Under the CPLR, arbitrators do not have the power to direct discovery. *De Sapio v. Kohlmeyer*, 35 N.Y.2d 402, 406. **The arbitrator's power to issue a subpoena pursuant to CPLR 7505 is limited to the procuring of evidence for the hearing or trial, not discovery**. *Bach, supra*, p. 1-2; *see Goldsborough v. NYS Dept. Of Correctional Svcs.*, 217 A.D.2d 546, *app. dsmd*, 68 N.Y.2d 834; 7B McKinneys Cons. Law of NY, §7505, Practice Commentaries at p. 682.

Respondent's reliance upon NASD Rule 10322 "is misplaced because that rule[2] grants arbitrators and counsel of record 'the power of subpoena process as provided by law', and New York law as set forth above, grants neither the arbitrators nor counsel of record the power to issue a *subpoena duces tecum* for purposes of discovery in arbitration." *Bach, supra*, p. 2.

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[1] This provision would only have applicability in disputes involving purely intrastate transactions. Under those circumstances, not present here, the FAA would not apply. Since this customer dispute clearly involves the purchase of securities on a national securities market, it involves interstate commerce, triggering the mandatory application of the FAA. 9 U.S.C. §1.

[2] The Court in *Bach* interpreted NYSE Rule 619, which is the equivalent to NASD Rule 10322.

The New York Court of Appeals has affirmed New York's prohibition against discovery subpoenas:
Generally, a subpoena duces tecum may not be used for the purpose of discovery or to ascertain the existence of evidence. Rather, its purpose is to compel the production of specific documents that are relevant and material to facts at issue in a pending judicial proceeding.

Matter of Terry D., supra (internal citations omitted).

Respondent seeks the production of hundreds of confidential records in the vain attempt to possibly discover something of value. The law of subpoenas is intentionally designed to prevent attorneys from abusing the subpoena process in this way. *See American Communications Association, Local 10 v. Retirement Plan*, 488 F.Supp. 479, 484 (S.D.N.Y. 1980); *see also Hay Group*, 360 F.3d at 409.

Pre-Hearing Discovery Subpoenas are not Enforceable against Non-Parties under the FAA

It would be inappropriate for any of the arbitrators to sign and issue Respondent's subpoenas even if Respondent had followed NASD arbitration procedure and submitted the subpoenas to the Chairperson in the first instance.

This arbitration is authorized by the parties' contract to arbitrate before the NASD. The parties' arbitration contract and the FAA are the only sources of jurisdiction for the issuance of a subpoena in this arbitration. *Integrity Ins. Co., in Liquidiation v. Am. Centennial Ins. Co.,* 885 F.Supp. 69, 71 (S.D.N.Y. 1995) ("Because the parties to a contract cannot bind nonparties, they certainly cannot grant such authority to an arbitrator. Thus, an arbitrator's power over nonparties derives solely from the FAA"); *Legion Ins. Co. v. John Hancock Mutual Life Ins. Co.*, No. 01-162, 2001 WL 1159852 at *1 (E.D. Pa.)("It is clear . . . that the [FAA] is the only source of authority for the validity and enforceability of the arbitrators' subpoena [over a nonparty]").

"The only power conferred on arbitrators with respect to the production of documents by a non-party is the power to summon a non-party 'to attend before them or any of them as a witness *and* in a proper case *to bring with him or them* any book, record, document or paper which may be deemed material as evidence in the case.'" *Hay Group, Inc. v. E.B.S. Acquisition Corp.*, 360 F.3d 404, 407 (3d Cir. 2004)(emphasis in original), *citing* 9 U.S.C. §7. **"Nowhere does the FAA grant an arbitrator the authority to . . . demand that non-parties provide the litigating parties with documents during prehearing discovery."** *COMSAT v. National Science Foundation*, 190 F.3d 269, 275 (4th Cir. 1999) (emphasis added).

If Congress had intended to grant arbitrators the power to compel non-parties to produce documents during pre-hearing discovery, "we believe that the drafters would have said so, and they would have then had no need to spell out the more limited power to compel a non-party witness to bring items with him to an arbitration proceeding." *Hay Group*, 360 F.3d at 408-09.

"Thus, Section 7's language unambiguously restricts an arbitrator's subpoena power to situations in which the non-party has been called to appear in the physical presence of the arbitrator and to hand over the documents at that time." *Id.* at 407. Therefore, the law is clear and unequivocal that the FAA does not grant arbitrators the power to issue Respondent's Subpoenas.

Respondent's Subpoenas Disregard the Chairman's Authority to Review Subpoena Applications before Issuance

Respondent is making an end-run around the NASD Arbitration Rules and Procedures. Respondent is unlawfully exceeding the limits of arbitration discovery by issuing void and unenforceable subpoenas to third parties. *Matter of Terry D., supra.* ("Respondent,

however, cannot use the procedural mechanism of a *subpoena duces tecum* to expand the discovery available under existing law"). Had Respondent followed NASD Arbitration Rules and Procedure, Claimant could have at least objected to Respondent's distribution of Claimant's confidential social security numbers and credit card account numbers, and the Chairperson could have prevented Respondent's wanton violation of the Privacy Act. Respondent must follow the same rules that govern Claimant and the Panel in this arbitration – NASD Rules and the FAA. Respondent compounded its misconduct by not submitting its 7 unlawful discovery Subpoenas to the Chairperson, usurping the Chairperson's prerogatives.

Respondent's Invasion of Claimant's Privacy Breached its NASD Duties

Respondent's Subpoenas seek records for non-parties' accounts, which do not relate "to the claim or defense of any party." Fed. R. Civ. P. 26(b)(1); *see Optibase v. Merrill Lynch Investment Mgrs.,* 2003 WL 1587244 at *3 (S.D.N.Y.). Claimant's and Claimant's wife's credit cards and mortgages are not material to the claim that Claimant purchased the stock in reliance on Respondent's fraudulent research reports.

Respondent's Subpoenas constitute an unreasonable and unnecessary invasion of privacy, since the subpoenaed records are not related to the matter in controversy. Claimant's wife is not a party to this arbitration or to the arbitration agreement executed between Claimant and Respondent. Respondent could not formally request the production of documents by Claimant's wife, since she is not a party. However, Respondent has ignored NASD Rule 10321 by unilaterally issuing subpoenas for records unavailable under NASD Discovery Rules.

Respondent has bypassed its obligation to show that the Claimant has or had any accounts at banks, brokerage firms and credit card companies, as a pre-condition to requesting a subpoena. **Nevertheless, in violation of the Privacy Act and in furtherance of its intent to harass Claimant, Respondent irresponsibly distributed the social security numbers of Claimant and Claimant's wife to other third parties without authorization.** The Chairperson should not tolerate Respondent's illegal conduct, which violates Respondent's duty to cooperate in discovery and its duty to "observe high standards of commercial honor and just and equitable principles of trade." NASD Arbitration Rule 10321 and NASD Conduct Rule 2110.

Respondent Knows that its Subpoenas are Void and Unenforceable

Respondent's defiance of the FAA was knowing and intentional. Respondent joined as a moving party in *NBC, supra*, to quash illegal, attorney-signed discovery subpoenas. As noted above, the Second Circuit clearly and unequivocally held that "§7 explicitly confers authority [to issue subpoenas] only upon arbitrators; by necessary implication, the parties to an arbitration may not employ this provision to subpoena documents or witnesses." *NBC, supra* at 187.

Respondent's Continuing and Documented Pattern of Discovery Abuse in Customer Arbitrations

How do you stop an 800 pound gorilla? Respondent's latest discovery abuse against Claimant and his family, including the illegal distribution of their social security and credit card numbers, justifies the imposition of sanctions against Respondent.

NASD has previously censured and fined Respondent after documenting Respondent's pattern of discovery abuse in customer arbitrations. NASD News Release, July 19, 2004. Respondent is abusing the subpoena process, in this arbitration, by issuing illegal subpoenas in violation of the FAA that also exceed the limits of discovery provided by the NASD Arbitration Rules.

Conclusion

There are those who hesitate to take on this fight because they believe that the arbitrators who decide these issues will not spend the time required to read and understand the arguments presented. Instead, they expect that those arbitrators will submit to the 800 pound gorilla.

At times like this, there is an old legal adage worth remembering: "there are no stupid judges, just lawyers who did not explain themselves clearly enough." If you want a level playing field, you must fight for it until the appropriate use of subpoenas are generally understood by arbitrators. Each time the argument is made and won, you are making a contribution toward change.

From The Lone Star State: Texas Supreme Court Applies NASD Rules to FAA Vacatur

Don K. Leufven

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The Texas Supreme Court has adopted the majority "broader rule" for evident partiality of an arbitrator as grounds to vacate an arbitration award. Two of the cases concern the non-disclosure by arbitrators of facts and prior relationships "which might, to an objective observer, create a reasonable impression of arbitrator's partiality."[1] The Court rejected actual bias as a requirement to prove evident partiality.

The cases are known as *Mariner,* which the author of this article briefed and argued, and *TUCO* (pronounced "TWO co"). *Mariner* is an NASD arbitration, governed by the Federal Arbitration Act ("FAA").[2] *TUCO* is an arbitration under a private agreement appointing two arbitrators, who selected a third arbitrator.

I. Why The Texas Supreme Court's Vacatur Decisions Are Important For Other States

First, there is favorable, precedent value of two decisions of the high court of the second most populous state. In addition, both cases give case support and arguments for the "broader rule" of evident partiality (impression of arbitrator partiality), and reject the "narrower rule" (actual bias) of the Second Circuit ("New York rule").

The *TUCO* opinion reads like a law review article dismissing the "narrower rule" of proof of actual bias to show evident partiality. The "narrower rule" been adopted, to one degree or another, in the Second, Fourth, Sixth and Seventh Circuits. The opinion also contrasts that "narrower rule" with the majority "broader rule" of reasonable impression of evident partiality based on arbitrator non-disclosure, adopted in the Ninth, Eleventh, Eighth and D.C. Circuits.[3] Furthermore, *TUCO* cites other states' laws and the rule of the United States Supreme Court in *Commonwealth Coatings Corp.* v. *Continental Cas. Co.*, 393 U.S. 145, 89 S.Ct. 337, 21 L.Ed.2d 301 (1968).

After reviewing the law of U.S. Supreme Court, Circuit Courts and state courts, the Texas Supreme Court found that the majority rule and the rule of the United States Supreme Court under the

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[1] *Mariner Financial Group, Inc. v. Bossley,* 79 S.W.3d 30, 32 (Tex. 2002); *Burlington Northern Railroad Co. v. TUCO, Inc.*, 960 S.W.2d 629 (Tex. 1997).

[2] 9 U.S.C. § 1, *et seq.*

[3] *See Morelight Construction Corporation v. New York City District Counsel Carpenters Benefit Funds*, 748 F.2d 79 (2nd Cir. 1984) ("New York rule"); *Schmitz v. Zilveti*, 20 F.3d 1043 (9th Cir. 1994) ("majority rule"); *TUCO* at 633-35.

FAA require full disclosure by an arbitrator of "non-trivial" facts and relationships concerning witnesses. In short, the failure to make full disclosure establishes evident partiality under the FAA. The Texas Supreme Court also held that the FAA incorporates the NASD arbitrator disclosure rules under the agreement of the parties.

II. Brief Review of Vacatur

To begin a discussion of vacatur for the evident partiality of an arbitrator, here is a quick review of vacatur law and procedure. Those issues have been addressed at length in PIABA and PLI articles, in David Robbins' *Securities Arbitration Procedure Manual,* and in the *TUCO* and *Mariner* decisions themselves. In addition, a case search of terms, including FAA, vacatur and the relevant topic or question, will list federal or state decisions.

A. Jurisdiction.

NASD arbitrations cover interstate commerce and are governed by federal law, not by state arbitration statutes. Surprisingly, the FAA does not create federal question jurisdiction. Thus, all vacatur cases under the FAA must be brought in a state jurisdiction, unless there is federal diversity jurisdiction.

B. Applicable Law.

The FAA is the applicable law for NASD arbitrations, whether the application to vacate or confirm is filed in federal or state court. The FAA provides that a court may vacate the arbitration award "within three months after the award is filed or delivered" in a case "where there was evident partiality or corruption in the arbitrators, or either of them. . . ."[4] The *Mariner* case applies the FAA legal standards for evident partiality of an arbitrator, and this article covers only that ground to vacate an award.

C. Forum.

For cases without complete diversity of citizenship, state court is the only forum for vacatur under the FAA. In a circuit that has not adopted the "broader rule" of evident partiality of an arbitrator (which the Texas Supreme Court determines is the majority rule and United States Supreme Court rule), a party seeking vacatur would file in state court. A party seeking to confirm an award would file in federal court, only if there is diversity jurisdiction. If there is complete diversity, the opposing party in state court could remove the action to federal court.

D. Procedure.

Although federal substantive law applies under the FAA, procedural law of the forum (usually a state court) applies to the vacatur proceeding. The procedural law of the forum applies even when conflicts of law or federal preemption requires the application of non-forum (federal) substantive law. Thus, in Texas, state procedure governs cases to vacate and includes the right to trial by jury of disputed fact issues.

III. The Facts of NASD And FAA Disclosure By An Arbitrator

Since *Mariner* is an ongoing case, the facts and relationship not disclosed by the arbitrator, which are recited by the Texas Supreme Court and First Court of Appeals, cannot be discussed. The case is continuing because the Texas Supreme Court wanted certain facts added to the record from the arbitrator witness. That witness became unavailable when he was called from reserve to active military duty in Afghanistan, and returned to Iraq. The factual allegations of nondisclosure by the arbitrator are as follows:

[4] 9 U.S.C. §§ 10, 12.

Mariner . . . managed the Bossleys' retirement account. After the account incurred substantial losses, the Bossleys sued Mariner. . . for fraud and self dealing. By agreement, the parties arbitrated the dispute under the National Association of Securities Dealers (NASD) Code of Arbitration, which the parties' agreement incorporated. [The panel chair] reported that he had a social relationship with one of the Bossleys' witnesses, but no one objected. More important to this case, the Bossleys' witness list also included . . . an expert witness. [The arbitrator] did not report any conflict with [the expert witness]. . . . About two months [after the arbitration, the expert] was reviewing files at her office when she found a deposition she had given as an expert witness in a malpractice action against [the arbitrator] almost two and half years before the arbitration. In that deposition, [she] testified that [the arbitrator] committed malpractice in seven different ways. The suit was eventually settled, and the settlement documents were sealed. . . . [The expert] did not reveal the relationship because she did not remember [the arbitrator] until two months after the arbitration, and then only made the connection after discovering the deposition transcript while preparing to move offices. . . . [The arbitrator] did not attend her deposition, and. . . she never met or saw [the arbitrator] before the arbitration. [The expert] also testified that she had no further involvement with the malpractice case against [the arbitrator] after that deposition. [5]

IV. The Texas Supreme Court's Application of NASD Rules Under the FAA

The Texas Supreme Court affirmed the court of appeals' judgment reversing the district court's summary judgment, which confirmed the arbitration award. The Court remanded the case to the district court for certain facts not in the summary judgment record. The Texas Supreme Court reached a unanimous decision, but the opinion of the Court was joined by a concurring opinion of four justices.

A. Do the NASD Code of Arbitration disclosure rules affect the grounds for vacating an arbitration award under the FAA?

One issue debated between the Court's opinion and the concurring opinion is whether the NASD Code of Arbitration disclosure requirements affect or enlarge the grounds for evident partiality under the FAA. The Court held that the violation of the NASD rules for arbitrator disclosures establishes evident partiality of an arbitrator under the FAA. The concurring justices had the opinion that the NASD Code could not be considered in defining evident partiality under the FAA because parties could not expand the standard of review under Section 10(a) of the FAA. Thus, the concurrence thought that "failure to comply with the NASD Code is not a basis for setting aside an award under the FAA."[6] The concurrence contended that "the NASD Code does not specify any consequence for failure to comply with its disclosure and investigation requirements after the arbitration is concluded."[7] Thus, the concurring justices would require the NASD to provide post-arbitration remedies for the failure to comply with its Code of Arbitration, including

[5] *Mariner* at 31-33.

[6] *Mariner* at 36.

[7] *Id.*

NASD arbitrator disclosures and investigation requirements.

Arbitration attorneys know that the NASD asserts that it loses jurisdiction of the case after the award is signed and delivered, and the NASD will not correct any errors or failures to comply, except errors of form or calculation. If the Court had refused to enforce the NASD Code requirements under the FAA, and under the parties' agreement to arbitrate, there would not be any post-award remedy for violations of the NASD Code disclosure requirements.

The Court's opinion did not accept the concurring opinion's limitation on NASD rules, and the Supreme Court's opinion incorporated the NASD Code requirements, including Section 10312(a) - (b), as follows:

> (a) Each arbitrator shall be required to disclose to the Director of Arbitration any circumstances which might preclude such arbitrator from rendering an objective and impartial determination. Each arbitrator shall disclose:
>
> > . . . (2) any existing or past financial, business, professional, family, or social relationships that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. Persons requested to serve as arbitrator should disclose any such relationship that they personally have . . . with any individual whom they have been told will be a witness.
>
> (b) Persons who are requested to accept appointment as arbitrators should make a reasonable effort to inform themselves of any interests or relationships described in paragraph (a) above.[8]

B. No waiver of duty to disclose.

The Texas Supreme Court next addressed Mariner's contention that claimants waived the arbitrator's nondisclosure. The Texas Supreme Court distinguished three decisions of the Second Circuit Court of Appeals because the prior relationship that existed between the arbitrator and the expert "was not open and obvious, nor was it a matter of common knowledge. It did not arise from a community of business interests shared by all participants in the arbitration."[9]

It was undisputed that the arbitrator did not report any conflict or prior relationship with the expert. The Texas Supreme Court wanted some additional evidence of the arbitrator's knowledge concerning the arbitrator:

> The summary judgment record here, however, is silent about whether [the arbitrator] remembered [the expert] or ever knew of her. Without some evidence of this, we cannot determine whether the undisclosed relationship is material to the issue of evident partiality. Clearly, the relationship could not have influenced the [the arbitrator's] partiality if, in fact, he was unaware of it during the arbitration. Thus, the state of [the arbitrator's] knowledge about [the expert] is a fact issue material to determining his partiality.[10]

Continuing, the Court held that claimants "could not waive an objection that is based on a prior adverse relationship between [the

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[8] *Mariner* at 31.

[9] *Mariner* at 34.

[10] *Mariner* at 33.

arbitrator] and [the expert] that they knew nothing about."[11] Thus, the Court rejected the view that "would excuse even an arbitrator's knowing concealment of a relationship evidencing partiality as long as there are facts from which the arbitrator can presume the complaining party knew it too. But the whole purpose of an arbitrator's duty to disclose is to avoid this very type of speculative presumption and let the parties to the arbitration make the call."[12]

C. The Texas Supreme Court followed the U.S. Supreme Court rule and the NASD Code.

The Texas Supreme Court adopted the rules for arbitrator disclosure of the United States Supreme Court in *Commonwealth Coatings* and under the NASD Code of Arbitration. It refused to shift the burden of disclosure from the arbitrator to a party. The Texas Supreme Court's holding, based on the majority "broader rule" for evident partially under the FAA, is:

> It is well-established, and the concurring justices acknowledge, that "a neutral arbitrator has a duty to disclose dealings of which he or she is aware 'that might create an impression of possible bias'." 79 S.W.3d at 37 (*quoting Commonwealth Coatings Corp. v. Continental Cas. Co.,* 393 U.S. 145, 149, 89 S.Ct. 337, 21 L.Ed. 2d 301 (1968)). The arbitration agreement here further incorporates the NASD Code, which provides not only that arbitrators should [shall] disclose relationships that "might reasonably create an appearance of partiality or bias," but also that they should make a "reasonable effort" to inform themselves of such relationships. NASD Code of Arbitration Procedure § 10312(a)-(b). Thus, there is no justification . . . to shift the burden of disclosure from the arbitrator to a party.[13]

The Texas Supreme Court's holding misses one word in the NASD Code. The Court's holding states that the NASD Code provides "that arbitrators *should* disclose relationships that 'might reasonably create an appearance of partiality or bias,'. . ."[14] Yet, as quoted earlier in the Court's decision, the NASD Code provides that "each arbitrator *shall* be required to disclose" and that "each arbitrator *shall* disclose . . . relationships that . . . might reasonably create an appearance of partiality or bias" [emphasis supplied].[15]

Whether the arbitrator forgot about the expert witness, after his malpractice settlement was sealed and made confidential, becomes immaterial, if the arbitrator shall [must] disclose relationships that "might reasonably create an appearance of partiality or bias." It is an understatement that an undisclosed sealed, confidential malpractice settlement, made shortly after the expert's deposition concerning arbitrator malpractice, might reasonably create an appearance of partiality or bias. The majority legal standard to vacate is not proof of actual bias. Thus, the arbitrator's failure to disclose the prior relationship with the expert is not excused under the NASD Code, and the Texas Supreme Court

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[11] *Marine*r at 33.

[12] *Mariner* at 35.

[13] *Mariner* at 35.

[14] *Id.*

[15] *Mariner* at 31.

refused to shift that disclosure burden from the arbitrator to a party.

V. Conclusion and Practice Tips

As a result of *Mariner* and *TUCO,* and decisions of other states, the NASD has supplemented its arbitrator disclosure forms with a questionnaire about specific relationships and interests of the arbitrator that do not appear on the initial arbitrator disclosure form. Those relationships include professional organizations, such as SIA and PIABA. The new disclosure form is filled out after the panel is selected. If you do not receive a copy of the supplemental disclosures of the arbitrators, you should request them from the NASD counsel or arbitration assistant for your case.

It is also useful to confirm that the arbitrators have reviewed the witness list before attending the arbitration. It is now the sense and experience of the author that some arbitrators do not review or closely review the witnesses until they show up on the first day of arbitration. It is usual that one side's parties, witnesses, expert, or attorneys have traveled to the arbitration hearing from out of town. That was the situation in the *Mariner* arbitration when the arbitrators arrived on the morning of the hearing. It becomes harder for an arbitrator to withdraw gracefully or to announce a conflict or past relationship with a witness on the day of the arbitration, especially if some of the parties, witnesses or attorneys have already traveled from another city or state to begin the arbitration.

Representing Public Pension Funds: Am Emerging Field

Dale Ledbetter

America's pension funds are being ripped off and most of them don't even know it. The stories being uncovered are frightening and the potential government liability could well rival the S&L debacle. What is happening is in large part a classic example of robbing the poor to line the already bulging pockets of Wall Street's fattest cats. The problem is greatest among public funds.

The City of San Diego's problems have been widely publicized. Diann Shipione, one of the fund directors for the City started asking questions about the fund's relationship with its investment consultant, Callan Associates. Frustrated, she concluded, "I was trying to do my fiduciary duty by throwing out a few questions, but there's no way to know what's really going on."

What is going on is enough to turn your stomach. In San Diego, Callan, in its role as "consultant" for which it was being paid $200,000 per year, recommended six large cap growth managers to the city. Interestingly, all six were purchasing consulting services from Callan and were members of the Callan "Institute." Big money was flowing from the managers to Callan. Not only was Callan siphoning off huge fees but their recommendations were certainly suspect. One of the selected managers ranked in the bottom 8% of its peer group category for the previous three years.

The City of Nashville settled a pension fund dispute with UBS Paine Webber for over $10 million. The firm was accused by the city of charging excessive fees for managing its pension fund, understating the risks in the portfolio and failing to provide full and adequate information about investment strategy recommendations. The dispute centered around the firm's performance as consultant to the city's pension fund. The consultant acts as a "gatekeeper" selecting the managers who will be awarded lucrative contracts to manage a funds' investment.

Ted Siedle, president of Benchmark Financial Services and a former SEC lawyer advises pension funds on a variety of money management issues. He has long questioned the role of "consultants" to pension funds, raising serious conflict of interest issues. Siedle, who has been widely quoted in articles in Forbes, the New York Times and elsewhere on consulting firm conflicts and abuses, has identified seven ways consultants financially benefit from the pension funds they advise:

> First, a consultant may receive an expressly stated annual contractual fee or retainer. This fee may be paid directly by the client or indirectly with the fund's brokerage commissions through "soft dollars." In some cases, believe it or not, the

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consultant's fee is structured such that the consultant receives all brokerage fees the fund's portfolio generates. That is, the consultant's fee is limited only by the amount of turnover a pension's portfolio generates.This open-ended or unlimited fee structure is common among broker-consultants at the large wirehouses who tend to prey upon small funds. It obviously encourages the consultant to "churn" managers.

Second, a consultant may receive an agreed upon fee (in addition to an annual retainer) for special projects, such as manager searches or brokerage studies.

Third, a consultant may receive brokerage fees from the fund's money managers related to the accounts they manage for the fund.

Note: Even if trade confirmations do not state the consultant's affiliated brokerage's name that does not mean that the consultant's brokerage has not received the commissions. There are ways to conceal what party ultimately receives the commissions.

Fourth, a consultant may ask for and receive additional brokerage fees from other accounts of the fund's managers. Where the plan sponsor has already instructed managers to direct brokerage fees to the consultant related to the fund's account to pay the consultant's fee on a "soft dollar" basis, the consultant is in a strong position to ask for additional fees from other accounts of the fund's managers. Simply put, the consultant's entitlement to fees related to the fund's account, which has already been established by the client. Soliciting brokerage from other accounts managed by the fund's managers is a popular strategy when the consultant knows he will be questioned by the plan sponsor regarding any brokerage received in connection with the fund's accounts. In this fourth situation the consultant is earning additional compensation from the manager, not the fund itself. However, the consultant's status as gatekeeper to the fund enables the consultant to effectively negotiate with the manager for this additional brokerage. The manager, on the other hand, knows he must keep the consultant happy and hopes to obtain additional assets to manage by giving additional brokerage to the consultant. Therefore, it is appropriate to consider this additional brokerage paid to consultants in estimating the total compensation a consultant derives from its relationship with a fund.

Fifth, the consultant may earn additional brokerage from terminating managers and funding new managers. For consultants that charge "search fees" in addition to annual retainers, both commissions and search fees are possible when they recommend terminating a manager and hiring another. Again, the consultant benefits from "churning" managers.

Sixth, the consultant may receive cash payments from the fund's managers, including venture capital and real estate managers or the custodian. This may be an agreed upon one-time, up-front placement fee and/or an ongoing fee, including a percent of the profits. Where the money management fees are unusual and high, the question arises as to whether the consultant may have received some portion of the manager's fee, one way or another. Recently consultant participation in the fees of defunct hedge funds is attracting scrutiny.

Seventh, the consultant may sell marketing consulting services to managers (including how

managers should market themselves to consultants) and host conferences where managers can meet pension clients of the consultant. Note: The fees consultants charge managers for marketing consulting services and conference attendance are well in excess of usual marketing consulting services and conference fees. For example, while sponsoring a typical investment conference may cost between $5,000 and $10,000, sponsoring a consultant's conference will cost $50,000 or more. With respect to this final category of fees, these fees are not derived from funds directly. However, the consultant's status as gatekeeper to pensions enables it to persuasively solicit such fees and these fees should be included when estimating total consultant compensation derived from funds.

Siedle concluded:

"As a result of all the above devices, the fees pensions actually pay, directly and indirectly, to consultants are ten or more times greater than the amount they think they are paying. It is an elaborate ruse and pension officials almost universally have refused to look behind the facade to examine what s

> really going on..... pension consulting fees today are dramatically understated."

The performance results - impacted by excessive fees, gross mismanagement and blatant conflicts of interest - are abysmal. The taxpayers don't get off unscathed. The Miami Herald recently reported that:

> "The $55 Million Hallandale Beach Police and Fire Pension Fund's returns are so rotten, . . . that the city and state together this year are having to kick in almost $3 Million to shore up the fund. That works out to $244 per taxpayer."

And needless to say there was no vote on this tax increase.

North Miami Beach, like Hallandale, uses Merrill Lynch as its consultant. The results have hardly been bullish. According to the Herald, the North Miami Beach "police and general employee pension funds have grown an average of 0.9 percent a year in the last five years." That compares to a median public plan growth rate of 4.1% a year according to Mercer Investment Consulting.

The Dow Jones News Wire joined those taking a closer look at Merrill's consulting activities. In a May 12, 2004 article, Arden Dale of Dow Jones Newswires wrote:

> Concerns about the dual role and influence of Merrill and other pension advisers are coming to the fore because of the Securities and Exchange Commission examination of the pension consulting business in general.

Michael A. Callaway, Senior Vice President, Consulting Services saw the need to respond on behalf of Merrill. In a letter addressed "Dear Florida Public Fund Client," Callaway defended his firm:

"The suggestion that there is anything improper about Merrill Lynch's execution of securities trades on behalf of our pension consulting clients is simply incorrect. All trades are disclosed, brokers are selected by independent fiduciaries and all recapture or soft dollar benefits accrued to our fund clients.

As you may know, Merrill Lynch Consulting Services is the largest provider of investment consulting services to the Florida public pension fund market. We have been providing these services to our clients in Florida for over 20 years. Throughout those years our goal has been to provide the highest quality and most professional investment advice available to public pension fund trustees. The growth of our business and its longevity are clear evidence of our success in meeting that goal."

Siedle and others vehemently disagree with Callaway's characterization and the close examination being generated from a number of directions promises to ferret out the truth. One of those turning up the heat - although belatedly - is the SEC. Forbes, in an April 19, 2004 article entitled "A Bribe By Any Other Name," questioned the activities of consultants who collected fees from funds for rendering advice while also collecting from the money managers they refer in to the funds. Forbes noted that Mercer (a major consulting firm to almost $500 Billion in public pension clients), and its fellow consultants' claim that the fees from portfolio managers do not "influence its advice about which managers are the best." In what can be described as a major understatement the Forbes article notes:

> "Anybody who remembers how analysts insisted they weren't influenced by their firm's underwriting assignments, or how auditors insisted that tax consulting assignments never clouded their judgments, may be a bit skeptical of such claims,. One skeptic is the Securities & Exchange Commission, which put out a report six years ago describing a cozy "pay-to-play" system in the pension consulting industry."

That's right. You read it correctly - "six years ago." But the SEC is now turning a brighter light on the problem. In addition, private litigants have an opportunity to highlight the abusive practices. The process has begun. Our firm filed a Tennessee claim on behalf of the General Pension Plan of the City of Chattanooga. Several of the Respondents in the Chattanooga case were parties to the Nashville settlement which resulted in the $10.3 million payment referred to above. Following the Nashville settlement, the consultants moved their merry band to MSDW where they continue to deal with pension funds.

The Chattanooga Statement of Claim for in excess of Twenty Million ($20,000,000) Dollars describes in detail the litany of failures, omissions and conflicts which have cost the city's pensioneers:

During the course of a seven (7) year relationship ... the Chattanooga Pension Plan lost in excess of $20 million dollars by virtue of... failure to disclose inherent conflicts of interest which existed in its capacity as consultant to the Chattanooga Pension Plan. In addition, these losses resulted because Respondents (1) breached the fiduciary duties they owed to the Chattanooga Pension Plan; (2) violated numerous state and federal laws; (3) violated the rules and regulations of the NASD and NYSE; and (4) violated the internal rules and regulations of .... More specifically, Respondents failed to disclose all of the payment/compensation arrangements available to the Chattanooga Pension Plan, and only recommended a "soft dollar" arrangement. ... employed improper methods and tactics to gain control over the Chattanooga Pension Plan, misrepresented material facts and omitted to state others to the Chattanooga Pension Plan which resulted in higher commissions and lower returns for the Chattanooga Pension Plan. ... also deviated from the Chattanooga Pension Plan statements of investment objectives ("SIO's") by repeatedly maintaining improper asset allocations, pursuing inappropriate aggressive trading strategies, hiring unqualified and incompetent investment managers, hiring and firing investment managers in a short period of time to gain unjustified additional compensation from self-dealing and investing in unsuitable and inappropriate investments. Respondents combined and conspired with ... in developing a deceptive and fraudulent scheme to derive substantial fees and commissions, all to the detriment of the Chattanooga Pension Plan.

Omission is a recurring theme in pension fund dealings. The Chattanooga Statement of Claim notes that:

> As a result of the omission of these material

> facts, the Chattanooga Pension Plan was deprived of the ability to accurately understand the relationship between it and the Respondents, and as a result, the Chattanooga Pension Plan was unable to make educated and fully informed decisions, ... More importantly,... was able to take advantage of its relationship with the Chattanooga Pension Plan by creating undisclosed fee arrangements that enabled them to reap significant commissions, fees and other benefits, and gain control over all of the transactions concerning the management of the Chattanooga Pension Plan. The foregoing arrangements created by Respondents created material conflicts of interest between the best interests of the Chattanooga Pension Plan and those of Respondents because... and Respondents were thus not independent consultants, which the Chattanooga Pension Plan believed they were. Based upon the "soft dollar" arrangements recommended and implemented by..., Respondents were able to select "aggressive" or "active" managers for the Chattanooga Pension Plan who would be faithful to a trading strategy consistent with ... demands and Respondents' interests, rather than consistent with the Chattanooga Pension Plan's objectives and needs. This "aggressive" or "active" strategy was only beneficial to... and Respondents because by reason of the "soft dollar" arrangement, they received substantial and excessive commission income.[1]

Soft dollar arrangements are a favorite device of consultants to gain entry into a fund. "We'll do it for free," is the opening line. These firms know that soft dollar arrangements almost always result in excessive payments, not cost savings. [Note: The SEC defines "soft dollar" practices as arrangements under which products or services other than execution of securities transactions are obtained by an adviser from or through a broker-dealer in exchange for the direction by the adviser of client brokerage transactions to the broker-dealer.]

Analyzing a pension fund case is different and more complex than in a typical situation involving an abused investor. Most funds made and are still making money. Nashville made money but showed that the excessive fees it was paying belonged to the city workers not to the "trusted adviser." The analysis requires not just looking at portfolio performance but every detail of the consulting contract and the arrangements with individual managers, the selection process, disclosures (or the lack thereof) and compliance with written investment policies.

Identifying and tracing the money flow is a daunting, but revealing, challenge. Following the money trail down a labyrinth of twists and turns is comparable to chasing skillful money launderers!

The individuals who deal with pension funds are generally among the highest compensated marketeers at every major Wall Street firm. Transparency? There is almost none. The key to successfully pursuing the funds that belong to firemen, policemen and garbage workers, whether retired or looking forward to retirement, is, as Seth Lipner, is fond of saying "old-fashioned hard work".

Getting the cases is the first challenge. It is all about politics. Many elected officials, city attorneys and pension board members are concerned about bringing "friendly-fire" in on

[1]..., a more "passive" or indexed investment strategy would have reduced the commissions earned by ... reduced investment advisory fees and it would have increased the Chattanooga Pension Plan's returns. This should have been the true goal of an "independent' or "objective" consultant.

themselves, They need to be educated that they are the victims and that they have a fiduciary duty to investigate - to follow the trail of deceit and to represent the best interest of their retirees and current employees.

Getting an audience requires an effective entre and be forewarned that the "consulting" industry is well-armed and fully prepared to protect its golden goose.

Once you are invited to investigate, the process, as mentioned earlier, goes well beyond a portfolio performance review. It involves analyzing every agreement, arrangement, relationship, contract, wink and nod deals, etc. The list can go on and on because the consultants, especially the wirehouse consultants, are masters at creating new and ever-increasing sources of cash flow. From these arrangements you have to sniff out the arrangements and then develop the factual evidence.

Then, and only then, are you ready to do a performance analysis of the portfolio. Remember, the fees involved here are so large that even an "acceptable" performance does not negate liability. These exorbitant fees, hidden costs and a lack of transparency, take money out of the pockets of those who deserve it - the pensioneers. Remember, also, that money compounds negatively as well as positively. For example, $10 million wrongfully taken from a pension find, even at a 4% annual return, produces $32,433.975 over 30 years. The Claimants' Bar needs to play an aggressive role in putting those dollars where they rightfully belong.

This area is just beginning to emerge as an area of opportunity for dedicated defenders of claimant's rights. But Wall Street and its private consulting brethren will put up unimaginable resistance. For years, this has been one of their undisturbed playgrounds, a fertile field of activity ignored by regulators and by the aggressive intrusion of lawyers willing to fight for the rights of those who have served as faithful public servants and now want what is rightfully theirs.

That is about to change.

Contract Claims: Holding Firms To Their Promises

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There is no obligation under the NASD Code of Arbitration to specify particular theories of liability.[1] This informality can lead to arbitral confusion.

Panels may credit broad themes of customer fault, third party blame and other common defenses in ways that cannot be reconciled with the governing law. A defense to some portion of the presented claims (such as negligence claims), is not necessarily a defense to other claims.[2] Prophylactic measures are in order.

Although it is not a potential springboard for exemplary damages, articulating contract claims can be one way to manage misdirected defense arguments. A panel that might not be receptive to proof of breach of fiduciary duties or other intentional torts, might nevertheless disregard a defense theme of customer negligence and issue an award based upon articulated contract claims. Statute of limitations or related laches defenses can be met with contract claims governed by longer limitations periods[3] among other arguments. In addition to addressing specific defense issues and depending on the strength of the record, the contract claims on the failure to provide the benefit of the bargain to the customer can provide a powerful case theme.

There is No Disputing the Existence of A Contractual Relationship

While firms may fight to the death over the existence of fiduciary duties and quibble about the extent of common law duties undertaken in a particular case,[4] retail investors do not usually have a difficult time establishing

[1] For example, Rule 10314(a) of the NASD Code requires only that "[t]he Statement of Claim shall specify the relevant facts and the remedies sought." NASD "pleading" requirements are more liberal than even the simple notice pleading standards embodied in Rule 8 of the Federal Rules of Civil Procedure.

[2] As 7th Circuit Judge Posner has explained in an April 2004 ruling, "**[a]s countless cases affirm, a victim's negligence is not a defense to an intentional tort, such as fraud.** For that matter, it is no longer a complete defense to an unintentional tort, having been replaced by the partial defense of comparative negligence." *Williams Electronics Games, Inc. v. Garrity*, 366 F.3d 569, 573 (7th Cir. 2004) (internal citations omitted and emphasis added). As the procedural history underlying *Williams* shows, this problem is not unique to SRO arbitration. Of course, it may be a more frequent and serious problem in that arbitrating investors do not have the benefits of reasoned awards, experienced judges or a bona fide appellate review to remedy related errors.

[3] *See Klock v. Lehman Brothers Kuhn Loeb, Inc.*, 584 F. Supp. 210, 218-22 (S.D.N.Y. 1984) (applying contracts limitations period to claim that brokerage firm incurred contractual obligation to plaintiff to follow common-law and statutory duties to handle customer's account with due care and diligence and to supervise its employees).

[4] *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Millar,* 274 F. Supp.2d 701, 708 (W.D. Pa. 2003) (duty to customer with non-discretionary account was determined by the particular broker-client relationship.); *Vannest v. Sage, Rutty & Co.*, 960 F. Supp. 651, 655 (W.D.N.Y. 1997) (fiduciary duties arise depending on the particular relationship).

the existence of a contractual relationship. Express and implied duties arise from traditional retail brokerage relationships[5] and the fiduciary and common law duties spring from the contractual relationship itself. It can get more interesting in determining what particular contractual duties are at issue. Breach of suitability rules and other industry standards may also constitute evidence of breach of contract. *See Komanoff v. Mabon, Nugent & Co.*, 884 F. Supp. 848, 859-60 (S.D.N.Y. 1995) (no separate private right of action under SRO rules, but failure to comply with SRO rule is breach of contract where customer agreement provides for compliance); *Iowa Grain v. Farmers Grain and Feed Co.*, 293 N.W.2d 22, 24-25 (Iowa 1980) ("A broker's covenant with its customer that it will follow exchange rules and customs establishes a contractual duty to the customer.").

Start with the Four Corners

As suggested by *Komanoff* and *Iowa Grain,* if an investor is going to articulate a contract theory, it is helpful to reconcile the claims with the four corners of written customer agreements and the plain language of other documents evidencing the parties' promises. With contract claims come contract defenses.[6] Be mindful of any specific language limiting duties and obligations and imposing customer duties in framing your arguments. Obviously, the firms did not intend to maximize the opportunities to construe their form agreements as making express promises that could provide the basis for customer claims. Customer agreements are an essential starting point, but should not be an ending point. Customers can also assert a claim as a third party beneficiary of the firm's contractual undertakings as an NASD member firm, included to abide by industry rules.[7]

Of course, there may be separate agreements for each account and multiple amendments to specific contractual terms or contract schedules. Do not be surprised if the customer agreement creates a right for the firm to make unilateral amendments upon written notice: "Merrill Lynch may in its sole discretion modify any of the Services, subject to the amendment provisions of paragraph 12." Obtaining any such amendments and the details of their timing is a suitable subject for discovery. Even without later amendments, customer agreements are classic contracts of adhesion that are almost never negotiated. Typically, firms have drafted the terms and conditions to narrow express promises and reserve considerable discretion on many issues. As discussed below, with the retention of discretion comes responsibility to act in good faith and deal fairly.[8]

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[5] *See, e.g. Kaplan v. First Options of Chicago, Inc.* , 143 F.3d 807, 818 (3d Cir. 1998) (liability could be premised on implied duty of good faith and fair dealing); *Merrill Lynch, Pierce, Fenner & Smith v. Perelle,* 514 A.2d 552, 561 (Pa. Super. 1986) (acknowledging express and implied contractual duties in customer-brokerage firm relationship).

[6] The enforceability of exculpatory clauses in retail brokerage or investment advisory agreements is beyond the scope of this article.

[7] *See, e.g., Washington Square Securities, Inc. v. Aune*, 253 F. Supp.2d 839 (W.D.N.C. 2003) (investors third party beneficiaries of member's NASD membership agreement), *aff'd,* 385 F.3d 432 (4th Cir. 2004).

[8] "Problems relating to good faith performance typically arise where one party to the contract is given broad discretion in performance. The dependent party must then rely on the party in control to exercise that discretion fairly." *Dayan v. McDonald's Corporation*, 466 N.E.2d 958, 971 (Ill. App. 1984).

An investor may have damages arising from an express promise in the customer agreement even beyond compliance with industry rules. Do not hesitate to seize upon the failure of the firm to deliver the benefit of the contractual bargain to its customers. If the customer agreement states that the customer is entitled to receive specified products and services and the firm or its broker did not deliver (or deliver in good faith), it may be the basis for a contract claim. See if the contract issues can be coordinated with the overall themes and damages at issue in your case.

For example, as part of Merrill Lynch's unlimited advantage plan (percentage fee of defined account assets), the customer has a right without further charge to obtain upon request an investment plan from an affiliated financial planning group ("Financial Foundation Report"). This is clear from the plain language of at least one iteration of the unlimited advantage form contract. Did the customer get the benefit of the bargain where the investment recommendations and portfolio management by the broker were sharply at odds with the plan set forth in the Financial Foundation Report provided as an express part of the promised services? Did the customer get the benefit of his contractual bargain where the client never got a copy of the customer agreement, never heard from the broker or the firm about the availability of a planning products or a Financial Foundation Report and instead was on the receiving end of an unwritten "financial plan" prepared by a broker never trained in financial planning?

How Did Respondents Sell Their Services?

Some of the best ammunition for a contract claim can come from the firm's marketing documents and from anecdotal evidence on how the broker and firm sold their services to your client. What skills and promises where made in general advertising campaigns, internet web pages and customer statement-stuffer marketing brochures? The details of how the broker and firm won your client's business and trust can constitute the basis for a contract claim. Does the broker's letterhead or card identify him as a corporate officer ("Vice President – Investments") or include a reference to financial planning credentials? Is he identified on monthly statements and correspondence as an order taking "broker" or as a "financial consultant" or "financial advisor"? Review the record to determine what particular promises where made directly to your client and what can be presented fairly to the panel as the services promised. *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Millar,* 274 F. Supp. 2d 701 (W.D. Pa. 2003) (affirming arbitration award where Merrill Lynch "clearly failed to deliver the services it promised"). Did the firm deliver on its promises?

Introductory letters from branch managers often include promissory language[9] that can provide a central theme:

- The Branch Manager's introductory letter emphasized that the firm was committed to provide "the best service possible" and emphasized its "full access to [the firm's] broad range of information and services. . . ." The letter referenced the importance of the relationship with the firm's financial consultants and specifically pledged that the assigned "financial advisors" would use the firm's resources "to alert you to new opportunities **and advise you on changing market conditions and how they might affect your investments** (emphasis added)."

- In direct branch office mailing to an expressly documented "moderate risk" client exercising stock options, the firm promised to use its experience "to advise on ways to get the best returns on investments, **all while concentrating on lower risk** and lower tax implications."

Did the client get the benefit of the bargain when he accepted the firm's recommendations to employ a risky exercise and hold (with margin) strategy that concentrated most of his net worth in one volatile stock?

Firm marketing brochures can be a key to making a record of the promises made by the firm. An SSB marketing brochure issued in 2000 emphasized the expertise, industry and availability of SSB's Wall Street analysts to support its brokers:

> **Our Financial Consultants are supported by the expertise of Salomon Smith Barney's top-rated research analysts**, first-place winners in THE Wall Street Journal's "2000 Best on the Street Analysts Survey." Domestically, our analysts track 98% of the S&P 500 industry sectors and more than 2,600 companies worldwide. **Salomon Smith Barney analysts dig deep to anticipate industry and market trends** and identify investment opportunities. You **can access many of their findings in research commentaries online or in any of the hundreds of strategy reports** we produce each year. (emphasis added).

Did SSB and its Research Division provide the benefit of this bargain?

Similarly, Merrill Lynch marketing materials to unlimited advantage investors in recent years are filled with promissory language on the nature of the services it was providing with a strong theme of fiduciary language. Hunt down these kind of promises (which may echo strong "trust" and "fiduciary" language from firm compliance materials) and provide them to the panel. See what the respondents' representatives have to say about these promises and this language. Compare this record with the Answer and the firm's posture in its opening and submitted memoranda of law.

Duty of Goof Faith and Fair Dealing

The general rule is that a covenant of good faith and fair dealing is implied in every contract. *See Dayan*, 466 N.E.2d at 971 ("In Illinois, as in the majority of American jurisdictions, a covenant of good faith and fair dealing is implied in every contract absent express disavowal."). While subject to various limitations, this implied duty has broad applicability and is particularly appropriate in the context of retail brokerage relationships and the one-sided customer agreements in common use. Indeed, because of overlapping and closely parallel duties flowing from statutory anti-fraud provisions,[10] common law duties of candor and related industry rules,[11] it should be hard for any respondent firm to argue that it did not owe a duty of good faith and fair dealing in providing services to public investors.
It can be a flexible standard and the Restatement (Second) of Contracts can likely provide some helpful language that will apply to your case. For example, comment (d) to Restatement (Second) of Contracts Section 205 is useful in describing the broad scope of the implied duty good faith performance:

> *d. Good faith performance.* Subterfuges and evasions violate the obligation of

[10] **"Those who choose to speak, however, must speak honestly and not in half truths, in bad faith**, or without a reasonable basis for their statements. When a person speaks, but chooses to omit information, the liability for that omission will be judged by its materiality. The SSB Defendants were in the business of speaking to the public about stock values. They spoke forcefully and frequently about the value of WorldCom. Having spoken, the SSB Defendants may be held accountable for any material omissions in those statements." *In re WorldCom, Inc. Securities Litigation*, 294 F. Supp. 2d 392, 428 (S.D.N.Y. 2003) (citations omitted and emphasis added).

[9] When you [illegible] language as mere "puffing," follow-up with the [illegible] record and ask the witness [illegible] he agrees with his counsel that it was just "puffing." Ask the witness to define puffing. By "puffing," did he understand that term to refer to exaggeration of the truth for purposes of marketing? Perhaps the witness can help make a full record of what statements were puffing and what were accurate?

[11] *See, e.g.,* NASD Rule 2110 "Standards of Commercial Honor And Principles of Trade" ("A member, in the conduct of his business, shall observe high standards of commercial honor and just and equitable

> good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt *or* may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and the interference with or failure to cooperate in the other party's performance.

Have respondents evaded the spirit of the bargain that was promised? Can you make the case that the broker or firm lacked diligence? Did they slack off? Half truths do not cut it: Restatement comment (d) makes clear that fair dealing requires more than honesty and far more than evasive half truths. Even credible testimony that the broker erroneously believed its conduct to be justified is not an excuse for objectively bad faith conduct.

Broker is Not a Contracting Party

If you have named a broker and want to give the panel a theory under which they can let the broker off the hook and still make an award, contract claims can help. The firm, and not the broker, is the contracting party. While there may be imposition of joint and several liability against both broker and firm on common law claims, in the right case you might get points for candor and mercy by confirming to the panel that it can properly make an award against the firm only premised solely on contractual claims.

One Way to Say It

The firm undertook express and implied contractual duties, including a duty of good faith and fair dealing and specific duties arising from its express promises in written and oral communications. Pursuant to the client's customer agreement and as a third party beneficiary of the firm's contractual undertakings as an NASD member firm, the firm was under express and implied contractual duties to abide by industry rules, including know your customer and suitability rules.

The firm failed to deliver on the promises it made, depriving its customer of the benefit of the contractual bargain. In breach of its contractual duties, the firm failed to act in good faith and deal fairly. It materially breached its most basic contractual obligations, including its obligations to provide professional and sound investment recommendations and advices consistent with its customer's financial circumstances and risk tolerance. The firm breached its contractual duties to comply with regulatory and SRO rules regarding the supervision of its retail brokers. As a direct result of the misconduct described in this Statement of Claim in breach of the firm's contractual duties, its customer suffered substantial losses."

How To Examine The Adverse Broker In An Arbitration Case

James D. Keeney

In most customer arbitration cases, the broker is a challenging witness for the claimant's attorney. Brokers are typically smooth salesmen, and present a good appearance to the panel. Unlike their customers, brokers often have taken contemporaneous notes (or created them after the fact) to justify their actions. Most Claimant's attorneys call the broker first, but this strategy can backfire if the broker is able to offer convincing explanations and maintain a cool demeanor. A vigorous and effective adverse examination by the Claimant's attorney, therefore, is essential. It can do much to undercut the broker's advantages and prepare the panel to adopt a favorable view of the customer's own testimony.

In the fall of 2003, the author obtained several examples of effective broker cross-examination outlines, examples and techniques from fellow PIABA attorneys and reviewed other examples in his own files in preparation for a series of upcoming arbitration hearings. One of these cases, tried before a New York Stock Exchange panel, yielded a transcript from which the following examples are taken. The case included issues that come up repeatedly in NASD and NYSE arbitration cases, and thus provides examples of how one can deal with some of those issues. As the examples demonstrate, thorough preparation is a critical precondition to eliciting many useful admissions.

A. *Challenge the broker's expertise.*

Brokers have a lot of experience convincing people that they are experts. Often, they really are not. Review of the broker's CRD is critical. If the broker graduated from a top business school, got training at a good wire house, and passed his Series 7 licensing exam on the first try with a score of 95, there is little to be gained by cross-examining his qualifications. Most of the brokers we face, however, have weaknesses that ought to be exposed using the CRD information and whatever other else may be available, as shown in the following examples.

1. *If the broker is not a genius, make sure the panel knows it at the outset:*

> Q: When did you first enter the securities industry?
> A: The summer of 1987.
> Q: Did you pass your Series 7 examination to become a registered representative the first time you took it?
> A: No, I passed on the second try.

2. *Expose his limited background:*

> Q: Tell us about what kind of training you received at Stuart James Company.
> A: Well, the first few months I worked at Stuart James, I actually didn't work as an

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advisor. I worked for a senior advisor, one of the larger producers in the office. So I worked under him. I handled all his book work, correspondence. I basically did all of the administrative portion of the job.

Q: Were you registered at that time?

A: I was.

Q: So you were in effect a registered sales assistant—

A: Yes.

Q: -- during that period?

3. *Expose his lack of serious training:*

Q: You received, I guess, on-the-job training when you were working as a registered sales assistant. And then you said there is some kind of --- I assume that was just a book that you studied for your Series 7?

A: I also took a course.

Q: How long did that course last?

A: A week.

Q: Okay. What type of training is this that you mentioned, did it involve the regulations of the NASD, the New York Stock Exchange, the SEC particularly?

A: Yes, it did.

Q: How long was the training?

A: The training was a week.

Q: Did it also involve sales training?

A: Yes, it did.

Q: How much of the week was sales training versus training in the securities, laws and regulations?

A: I'd ---

Q: Approximately?

A: I'd say it was a 50/50 split.

4. *If he cut his teeth at a lower tier firm, be sure the panel learns about it:*

Q: How long did you stay at Stuart James?

A: Roughly two years.

Q: Why did you leave there?

A: It was not the environment where I thought I could be a good financial advisor. There was a lot of pressure to sell penny stocks as opposed to other types of investments, mutual funds, unit trusts. They were a market maker and specific stocks they underwrote. And there was a fair amount of pressure to push internal products.

Q: Do you know if they ever got in trouble with regulatory authorities about those things?

A: They did.

Q: Were they eventually put out of business by the regulators?

A: They weren't really put out of business. They did receive some sanctions. And to the best of my ability, they changed the names of the firm and to this day, continue in business, under a couple of different names.

5. *If you have enough ammo, do it again:*

Q: Okay. Now, after you left Stuart James, I understand you worked briefly at National Securities Corporation in Winter Park for about six months?

A: Correct.

Q: Why did you stay for such a short time there?

A: I was offered a job with a savings and loan that had an investment division that I thought was a much better opportunity, a much better platform. Was access to a much larger client base, and it was also located near the Daytona/Ormond Beach area where I wanted to live.

Q: Why did you leave them after six months?

A: The RTC took them over and quickly--- they were liquidated within a very short period of time. It was quite a shock to us.

Q: And went bankrupt?

A: No, they were already in receivership. And ---

Q: They were already in receivership when you took the job?

A: Correct. I was sent up to Buffalo for training where our class of trainees was assured, don't worry, we will come out of receivership. We were receiving signs that we don't think we will have a situation where we're liquidated.

Q: But they were?

A: They were not liquidated when I quit them.

B. *Expose the Respondents' lack of concern for their customers' interests.*

Show how the firm ignores customers' interests by showing how it routinely measures success:

Q: Were you considered a big producer in that office?
A: I was not a – I was at the time probably the 3rd or 4th largest producer in that office.
Q: By producer, of course, that doesn't refer to how well your clients were doing. That refers to how well you in the firm were doing, isn't it?
A: That refers to trailing production.
Q: The commissions that you and the firm were receiving from the clients?
A: Correct.
Q: So you could have been the third highest producer, but your clients could have had the third worse results, right?
A: I don't think that's a fair characterization, no but ---
Q: Did you even measure your clients' success with investments versus other clients in the office?
A: No. That's not done in our industry.

C. *Get the Broker to admit that his conduct is governed by state and federal law, and by NASD and NYSE Rules.*

Arbitrators need to understand and keep in mind that the securities industry is highly regulated and that brokers, based on state and federal licensing requirements, are required to abide by strong sets of disciplinary rules. Clever defense attorneys can often confuse these issues, leaving the arbitrators uncertain whether a particular rule should be applied or not. A good way to minimize this problem is to review salient aspects of the broker's training and obtain direct admissions helpful to the claimant's case.

1. *Sometimes this is easy:*

Q: Now, would you agree that your conduct is governed at all times by the rules of the New York Stock Exchange, the SEC, the NASD, and the Florida Division of Securities?
A: I believe so.
Q: And above all as an investment professional and as an employee of a New York Stock Exchange member firm, would you agree that you are required to observe high standards of commercial honor and just equitable principles of trade as described in New York Stock Exchange Rule 401?
A: That's reasonable.
Q: In fact, you probably learned that in your training, didn't you?
A: Yes, we did.
Q: Would you agree that the securities industry is a closely regulated and honest industry, and this is to provide safeguards to ensure that proper disclosures are made to investors?
A: Yes.

2. *Sometimes it is more difficult and time-consuming; but a dogged persistence by the claimant's lawyer can often yield a good reward:*

Q: Q: Before you got your Series 7 test, I think I mentioned the outline put out by the New York Stock Exchange. I'd like you to look at a document, it's not in the book. But it's punched so that it can be put into the end of the book. And we'll mark it Exhibit Number 30.
A: If you'd look at that and I'll have copies for each of the arbitrators also.

(Respondent's Attorney): Was this previously produced in the course of discovery? I don't see a Bates number on this.

(Claimant's Attorney): No, I don't believe this was. This is really in the nature of a legal document, I believe put out by the Exchange. There will be a number of legal documents and interpretations, rules and so forth that are not really evidence in the sense of

documents that are exchanged.

(Respondent's Attorney): I'm going to object to this. This isn't a legal document. This is an outline of how to prepare for the Series 7 exam. This does not have a course of law, this is not the rules and regulations of the New York Stock Exchange or the NASD, and this wasn't previously provided to us in the course of discovery. So I will object to this.

(Claimant's Attorney): It's a document produced by the New York Stock Exchange. In any event, this is an adverse witness to my clients employed by the opponent, and the rule for exchanging documents has an exception for documents that are to be used in cross-examination, that's really what this is, so I'd request that it be allowed on that basis.

(Respondent's Attorney): I simply point out that this isn't cross-examination. This direct examination of the first witness they called in this case. I haven't seen the document, and I contend --- You know, I'm looking through this now. This is really sample questions on how you might prepare, basically a guideline of how to prepare for the Series 7 exam.

(Claimant's Attorney): The only page I'm interested in is the section called "Critical functions and tasks of the registered representative." It is a distillation of all the securities laws that relate to the securities representative on what they're supposed to be doing under all of these regulations that the Exchange puts out.

(Respondent's Attorney): If this was going to be so relevant, I should have received this before today. You had a 20 day deadline. We've been pretty lenient producing stuff prior to today. In fact, I was ordered to produce things this morning. But I haven't seen this before. This is not cross-examination. This is not law. This is not rule. This is a brochure, a pamphlet, and I object to it being produced in evidence today.

(Claimant's Attorney): I can withhold it until I cross-examine this witness later. It just seems like it would be good to put it in at this time to keep the testimony in good order. But I'll defer to whatever the panel wishes on this.

(Chairman): We'll retreat to our little room, and we'll have an executive session.

(Claimant's Attorney): I hate to make you do that. I'll just withdraw it at this point. I'll bring it in later. I don't want to disrupt all of this and slow us all down.

(Chairman): All right. Just continue.

Q: Without looking at that document, sir, did you learn of the seven critical functions and tasks of a registered representative when you were preparing for your Series 7 exam?
A: Yes.
Q: Do you know what they are?
A: Not off the top of my head. I, you know, know components of them.
Q: Is there anything that would refresh your recollection about what they seven critical elements are? This is not a memory contest. Would you like to see a New York Stock document to refresh your recollection?
A: Yeah, that would be fine.

(Claimant's Attorney): Counsel?
(Respondent's Attorney): Very good.

(Claimant's Attorney): So this is the document we just marked as number 30. And then we'll pass out copies to the group.

(Respondent's Attorney): While you're doing this, why don't you direct us to a page so I can ---

(Claimant's Attorney): Yes, page 3.

(Chairman): At this moment we are accepting page 3?

(Respondent's Attorney): We'll accept it. Enough of the shenanigans, let's accept it and deal with it.
(Chairman): Okay.

Q: Would you tell me, or if you'd just like to read from the document, the seven critical functions and tasks of the registered rep according to the New York Stock Exchange document there?

C. *Establish the Broker's procedure for taking notes.*

Customers rarely have any notes of their conversations with their broker. Brokers usually have notes or if not, they miraculously "find" notes shortly before the hearing, or even half way through it. In order to minimize the damage these notes can cause, it is essential to establish at the outset the procedures by which notes can be created, modified or deleted from the firm's records.

Probe the procedure, with emphasis on the firm's requirements for note taking, and the possibilities for alteration, loss, and after-the-fact creation of notes:

Q: Let me ask you about your system of taking notes for a moment. When Morgan Stanley – when you were hired by Morgan Stanley, did they provide you with something called a daytimer?
A: They did. A:
Q: Can you describe to the panel what that daytimer was at that time?
A: At that time, it was just a regular calendar. It hadQ: the days of the weeks broken down by months and then it had a small area for notes.

(Respondent's Attorney): I've lost track. What time period is this?

(Claimant's Attorney): When he first started with Morgan Stanley.

(Respondent's Attorney): What year was that?

(Claimant's Attorney): I believe it was 1990.

(The Witness): 1990

Q: And did it become your custom and practice to take notes of significant events and conversations relating to your customers' accounts in that daytimer?
A: We were.
Q: Were those daytimers given to all the registered reps in the office?
A: I believe so.
Q: Did somebody collect those daytimers from you every year?
A: At the end of the year, yes.
Q: Do you know what – for what purpose those daytimers were collected?
A: Just as an official record.
Q: Do you know how many years after that they were kept?
A: I'm not sure. I believe they're kept for several years. But I don't know the exact number of years.
Q: Were those daytimers available to you if a customer complained, so you could go back and get your notes from a particular date and see what you thought had happened that date?
A: Yes.
Q: So that was one of the reasons for keeping the daytimers?
A: Correct.
Q: Now, at some point did you begin to use some other form of calendar?
A: I did.
Q: When did that happen?
A: About 1993, I started using a program called Brokers Ally.
Q: Brokers Ally. And who provided that program to you, did you purchase it yourself?
A: I purchased it myself.
Q: And did you use that on your personal computer or a computer at the office, or both?
A: Both.
Q: Did you have a computer at your home separate from your computer at the office –
A: I did.
Q: -- at that time? Was this a laptop or a stand-alone?
A: Just a stand-alone.
Q: Now, did that system of keeping track of your calendar and notes change after 1993?
A: It did. In 1998, I converted my database to an ACT program.
Q: ACT, A-C-T?
A: Correct.
Q: What is that?
A: Its just a different database program of – I thought it was a little

better, and it didn't crash my computer as much as Brokers Ally did.
Q: Was this also something that you purchased on your own?
A: I did.
Q: And did you maintain this both at your office and at your home?
A: I would take backups to my home. Yes.
Q: So you used it at the office and backed it up at home –
A: (The Witness Nods Head.)
Q: --or backed it up at the office and then took it home –
A: (The Witness Nods Head.)
Q: Okay. How long did you continue to use that method of calendar?
A: I use it until this day.
Q: Now, that's what you've done on your own. Has Morgan Stanley provided you any other alternative method of calendaring or keeping your notes that you're supposed to be using at the office?
A: They do. If you don't have the ability to pay for one, we have Microsoft Outlook. It would be hard to use, but I believe people have used it.
Q: Does the company pay for that if people want to use that?
A: It's on the workstation.
Q: Are they allowed to download the database from that and take it home?
A: I'm sorry?
Q: If you have Microsoft Outlook on your workstation at the office, are you allowed to download your customer information and take it home?
A: I don't know if we have rules against that. I suspect people do.
Q: Now, did there come a time when Morgan Stanley stopped passing out those paper daytimers every year?
A: No, I believe there are still people in the offices who prefer to use a paper daytimer.
Q: So now you just have to pick one or the other, it's up to you?
A: Correct.
Q: You don't have to do both simultaneously?
A: I don't.
Q: Did you ever do both of them simultaneously after – lets say after 1998 when you started using the ACT program?
A: No.

Do not forget to ask about the sales assistant's role:

Q: Now, you have a legal – not a legal, but an assistant named Linda someone, I think?
A: Linda Doe.
Q: Linda Doe. Does she also have a way to tap into that same electronic calendar that you have?
A: She does.
Q: It is a database that's available to both of you while you're at the office?
A: It's networked between our workstations.
Q: Okay. Now, you can erase or cross out entries in a paper daytimer. Can you change entries in your electronic daytimer?
A: Yes.
Q: Is there any type of audit trail to show whether an entry was changed later?
A: I have no idea.
Q: Would there be any way to tell when you wrote, when you actually wrote a particular note that's in your database?
A: Generally it will time – put a time and date on it.
Q: Sort of time stamps it?
A: Correct.
Q: Does that --- is there any way to tell whether the entry has been revised either by you or your assistant?
A: Not that I no of.
Q: Is there any way to tell how many times the entry was later revised by anyone, or on what dates?
A: I really --- I don't know.

(*Throughout the remainder of the examination, return repeatedly to the lack of notes produced to support the broker's assertions.)*

D. *Dissect the New Account Form Information.*

Customers rarely understand the role or importance of a New Account Form, yet this form can often make or break your case. If the New Account Form directly shows the customer's objectives, and the objectives do not

match the broker's recommendations, the claimant's attorney needs to make the most of this critical admission by the broker and the firm. If the broker incorrectly noted the objective in the firm's records, it is important to establish this fact as well.

1. *Expose inaccuracies in the new account information upon which the firm's entire supervision of the broker, the account and the trades was based:*

Q: Okay. So once again on page 206, the financial information there, if I understand you correctly, that is information you believe you put into the Merlin system at the time the first account was opened in May of 2000?
A: Correct.
Q: And that says income, $75,000, that would be annual income –
A: Correct.
Q: -- I presume? Liquid assets, $40,000?
A: Correct.
Q: And net worth, $400,000?
A: (The Deponent Nods Head.)
Q: And the tax bracket says zero?

(Respondent's Attorney): You have to answer that out loud so they can get it down.

(The Witness): Yes. Yes. Tax bracket zero. It shouldn't come out zero. It should calculate in a tax bracket. Generally given on that income, it would come up to 28 percent.

2. *Tie down the broker's responsibility for any errors:*

Q: Was that information once it had been put into the system, was it available to you on your screen to double-check it?
A: Correct.
Q: So if you saw the zero percent tax bracket, you would have had an opportunity to correct that?
A: If I'm in Merlin, yes, I could.

3. *Establish what the broker reported as the account objective(s):*

Q: Now, lets look at some of the other information on here. Client profile. There is a client objective and it says: List in order of priority income, capital appreciation, and so forth. That information, I assume was also put into Merlin, correct?
A: It was.
Q: Now, that actually appeared on the Merlin printout that we saw. It was an indication that the primary objective was capital appreciation and secondary was income?
A: Correct.
Q: Do you know for sure whether there was any other objective input originally that might have been changed later?
A: Not to my knowledge, no.

4. *Show how the customer's real objectives differed from what the broker reported to the firm:*

Q: These clients, according to the opening statement that your attorney made, I assume you agree with this, that these clients had a few years until they could collect Social Security –
A: Correct.
Q: -- at least? Mrs. Customer was I think 57, Mr. Customer was 59 or so, and they couldn't collect Social Security at least until he was 62, correct?
A: Correct.
Q: And if they wanted full Social Security they would have to wait longer?
A: Correct.
Q: So they needed – for the first few years at least, they needed a lot of income if he was going to retire and give up his $75,000 a year salary, right?
A: They needed income, yes.
Q: And then later after the Social Security started kicking in and perhaps they found alternative employment of some kind one or the other or both of them, at that point they might not need as much Income, right?
A: Correct.

E. *Get the Broker to admit his responsibility to update the account information and objectives.*

Often, a customer's personal and financial circumstances change dramatically after the account is opened. Retirement, loss of job, death

of a spouse, can render the initial account objective completely obsolete.

1. *Establish how the account information and investment objectives changed over time:*

Q: Does this new account form show the same dates of birth for Mr. Customer and Mrs. Customer as the earlier new account form we looked at for the first account?
A: I believe they do.
Q: Does it show the same income?
A: It does.
Q: Now, in fact, Mr. Customer had already had his last day of work before this IRA account was opened, hadn't he?
A: It was right around that time that he retired, right around that time. He ended up taking a paycheck later into the fall.
Q: I believe a moment ago when I was writing on the board there you volunteered the day of July 7th was his last day of work?
A: You asked for an approximation. That's what I gave.
Q: In any event, at the time he retired, his income was ending and you knew that, didn't you?
A: We knew that his Walgreen's income was coming to an end, yes. We knew he had more sick pay or sick leave and time to take him through the fall.

2. *Once the foundation has been laid, walk the broker through all of his failures to obtain and update the essential supervisory information:*

Q: So if the clients' income from employment completely ended, it would be proper to update that financial data to reflect zero instead of 75,000, wouldn't it?
A: When that happened, yes, but that's not what had happened. There was --- even that we were going to take income through the fall of 2000 from what was left from his Walgreen's, and he would begin immediate distributions starting at 59 and a half.
Q: So those would then become his income at that time?
A: That would become his income.
Q: But he wasn't going to distribute $75,000, was he?
A: That was not the intent.
Q: So based upon what he told you, I think you said earlier you trusted your client, if he told you something, you believe it was true, and you relied on it. If he told you, I'm going to take out 37,000 a year, why didn't you put $37,000 into this Merlin system?
A: We don't update accounts just every single time, you know. Generally we do quarterly reviews, semiannual reviews, and at that time we make adjustments.
Q: But in this case, you never changed that $75,000 figure, did you, the whole time the account was opened for almost two years?
A: I would have to see what it was at the end. This is --- You're asking me to recall what was in our Merlin system two-and-a-half years ago.
Q: No, I'm asking you to produce information about what was on your new account form at any time that this account was opened?
A: Well, as of the time this account was printed, the information was accurate, I'm assuming you're asking me about this.
Q: Well it says here printed at the bottom, I think it says, internal use only, October 2nd, 2002.
A: The account had been closed, so it had to go back and was reopened just to print this.
Q: So the last entry in the account showed the income at $75,000, right?
A: That's correct.
Q: Doesn't that indicate to you you never changed it from the time you opened the first account right to the end of the time the last account was closed?
A: That's true.
Q: And you had an obligation to change it, but you didn't do it?
A: Correct.

Q: All right. Same would be true with the tax bracket, wouldn't it, zero percent? We see that once again like we saw with the other account when you opened it?
A: Same answer. The zero percent is the Merlin --- I mean, nobody expected zero percent as a tax bracket our client's in. That was something for some reason Merlin printed out zero.
Q: So it was either a glitch in the system or a failure of input or information?
A: Correct.
Q: And whichever it was, no one ever corrected it for the entire time that these two accounts were opened?
A: To the best of my knowledge.
Q: Let's look at the liquid assets. You mentioned $40,000 was the liquid assets when they opened the first account. That was the $42,000 check they got from selling their house that they put into the Active Assets Account, right, or you don't know for sure, but ---
A: No, I don't know that for sure.
Q: Okay. But anyway, there was $42,000 in cash that came into the first account in May of 2000. When this IRA account was opened, this still showed $40,000 as the liquid assets that they had?
A: Correct.
Q: Even though we just saw going through the other account that there was $72,000 in the other account? After a few more months, additional deposits were added, right?
A: Correct.
Q: And it appears that this number was never changed during the time that these accounts were opened?
A: To the best of my knowledge, yes.
Q: All right. And the same would be true of the net worth, the $400,000 net worth was never corrected to the lower figure of about 320 which was really more what they had had, right?
A: Correct.
Q: And the account objectives: Those stayed the same for the entire years that the account was opened?
A: It did.
Q: Capital appreciation and income?
A: Correct.
Q: So even though when you started with the first account, Mr. Customer was still working and earning 75,000 a year. When you opened the second account, he was retired, and later he actually got his very last dollar from Walgreen's and began relying exclusively on these accounts for income, this capital appreciation objective was never changed?
A: It was not.

F. *Walk the broker through his violations of specific NASD rules and guidelines*

1. *If he advised them to mortgage their residence and invest the proceeds, get him to admit the relevant facts:*

Q: Do you recall whether one of their goals was to reduce their monthly expenses as retirees?
A: One of their goals as far as a financial goal ---
Q: Yes.
A: -- to reduce expenses?
Q: Right.
A: Yes. I think they'd said that when they go to purchase a new home, they wouldn't be buying a home the size that they had before. That it wouldn't ---
Q: They were going to downsize –
A: Exactly.
Q: -- to a less expensive home?
A: Correct.
Q: And that would make it possible for them to live on a little less, wouldn't it?
A: Correct.
Q: Did they tell you that they were initially thinking they would buy the smaller home outright with the profits from the bigger home when they sold it?
A: I don't recall them saying that.
Q: Did you make any daytimer notes about anything relating to that?
A: I believe we talked about in my notes, we discussed the pros and cons of paying cash for the home.

Q: When you discussed the advisability of taking out a mortgage, what were you proposing they would do with the money that they had as a result of taking out the mortgage?
A: We were talking about investing the money.
Q: What rates of return did you talk to them about?
A: I talked to them about the rates of return that historically you'd see in the stock market, what – you know, that while I couldn't guarantee performance, if the managers who were managing their money did a reasonable job, we could see reasonable rates of return, anywhere from 8 to 10 percent, if we had decent markets.
Q: If they were only going to get 8 to 10 percent investing their money, and then they'd have to pay tax on that 8 to 10 percent, how could that possibly be economical to borrow money at 8 percent or higher for their home?
A: Well, one, they would get an itemized deduction against it. And two, you know, we were hoping to outperform 8 percent over time.
Q: But you didn't make a recommendation one way or the other?
A: I told them that generally over a long period of time in discussing long rates of return, that stocks outperformed real estate over a long period of time.

2. *Get the broker to help you set the stage for cross-examination of the BOM regarding the sloppy supervision in violation of NASD Rule 3110:*

Q: Do you recognize that document?
A: That is a document I've only seen in discovery. That's a manager's, what's called a CAR report.
Q: Okay, and what does this document show?
A: This document shows – From what has been explained to me by Counsel, a CAR report is triggered when, based on the percentage of an account, there's commissions generated, a higher – you know, I don't know what their formula is, I don't know what their criteria. But in this case, because there were mutual funds bought and it generate a commission of 4.9 percent, it generated a CAR report.
Q: Now look above where the statistical transaction data appears in the section that starts with client name Dean Witter Reynolds, custodian for Mr. Customer. Does that show the new account information that was inputted into the Merlin system?
A: It's still showing the same thing we talked about a few minutes ago. It's still showing the $400,000 net worth, the income at 75. And liquid assets at 40.
Q: So there's some significant errors in that data, wouldn't you agree?
A: I think that's what we talked about earlier.

3. *Be sure to elicit his admission of the amount of commissions he and his firm received as a result of the challenged trading activity.*

Q: And it shows, does it not, that you received a commission of, or earned a commission of $11,600 for yourself and your firm that month?
A: For that, yes, the firm received that commission.

G. *Use the broker to lay the foundation for discovery sanctions*

1. *Get the broker to admit that he ignored the Claimant's discovery request:*

Q: Well, let me get something clear. We've requested in discovery copies of the new account forms, and we were told "Oh, we don't have them anymore, it's all in the computer." So we said, "Well, let's have the computerized version of it." And this on page 206 and 207 I think was what was produced to us. Now, do you know of something else that gives the new account form information that we could get?
A: Only what's in the Merlin system.

Q: Well, do you know how one can get the information from the Merlin system to produce all this relevant information about the customer?
A: I would assume our IT people have access to that.
Q: Did you yourself make any requests in this case to make sure we got that information in response to our production request?
A: No, I didn't.
Q: Do you know of anybody else at Morgan Stanley who did?
A: No, I don't.
Q: And did anybody ask you to make sure that that happened, that somebody got the Merlin system to print out the relevant information about these customers that was put into it at the time the first account was opened?
A: No.

2. *Use the broker to identify witnesses that ought to have been disclosed but were not:*

Q: What I'm getting at, is there any way that someone looking at this from the outside, like these arbitrators today, can know who actually was responsible for putting in the information that got into Merlin for this new account?
A: Yes. You review our computer records and see that it had to come from the terminal, yes.
Q: Well, we asked for the computer records and this is all we got. Are there other computer records we can review?
A: I'm not the person to answer that question.
Q: Who would be?
A: I would assume people who work in our technology department.

3. *Force the broker to admit that he failed to produce relevant information:*

Q: Now, you were giving them financial planning services. Did you ever write down on a piece of paper what their assets were?
A: I'm sure I took some notes so that when we go to input it into Merlin, I would come --- that's how I came up with those figures.
Q: But you don't have those notes anymore?
A: No. We're moving to, you know, less and less paper, so we use Merlin as our source of, you know, inputting data.
Q: You weren't able to get these notes out of the Merlin system as of yet?
A: We have not produced them out of the Merlin system as of yet.
Q: Has anybody asked you to produce them?
A: Nobody's asked me to produce them.
Q: Have you asked anybody else to do it?
A: If I would have known you were going to be asking for it, yes, I think we should have. You know, I would have liked to have had it.
Q: You agree it would be relevant to this case.
A: It could be, yes.

H. *Give the broker enough rope to demonstrate his own negligence*

Q: Q: As an insurance salesman, have you ever sold anybody a health insurance policy or long-term care insurance policy?
A: No, I have not.
Q: Have you had any training about those kinds of policies?
A: I have, but I try and stay away form those types of sales. It's --- I generally, when a client comes to me and says, hey, I want life insurance, I want long-term care insurance, I usually bring in someone who specializes in insurance.
Q: Did you during the course of reviewing this budget with Mr. and Mrs. Customer ever suggest to them that they might need long-term care insurance?
A: Long-term care insurance is probably something that came up. I don't remember specifics of what Mr. Customer was vague about what his medical conditions were. And I just explained to them that long-term care insurance did tend to be rather expensive and prohibitive if you had any kind of prior medical conditions. But I didn't go off into --- you know, that is not what I did with a lot of clients. Long-term care

insurance wasn't one of the things I focused on.
Q: Did you have any experience in counseling people about to retire regarding how much they're going to have to spend to replace health insurance from an employer like Walgreen's?
A: I've had some experience, you know. It's not something that I, you know, can go and say that I have, you know, calculation tables and insurance industry data shows, you know, this is how much you're going to need. We did know that there were going to have to be Cobra payments made between the time they retired and until the Q: time they went on Medicare.
Q: When would that be?
A: 65.
Q: So they'd have --- Mr. Customer would have six years to make Cobra payments?
A: Correct.
Q: Of course, Cobra only goes for 18 months, doesn't it?
A: On most, and then they would have had to have sought some other insurance.
Q: And that's even more expensive, isn't it?
A: It can be, depending on how you choose to insure it. Not necessarily.
Q: Is it fair to say, though, that you never had any kind of a detailed discussion with them about the line items in this budget really?
A: Not that's --- you know, when we got this back, we talked about this. We talked about, this is what you're going to be able to do. That's why I get it written.
Q: You never advised them that this was unrealistic?
A: No, I didn't. I don't know if that's unrealistic. I have to --- believe that my client is telling me the truth about what they know.

I. *Get the broker to admit the importance of asset allocation*

1. *Use the NASD and/or*Q: *firm websites:*

Q: Before the break, Mr. Broker, we were talking about asset allocation, and I think during your testimony earlier you mentioned Ibbotson as a source of asset allocation that you're familiar with. He's a recognized authority in that field, correct?
A: Correct.
Q: And in fact I think some of his information is published on the NASD website, for example? Their information about the importance of asset allocation. Have you ever seen this?
A: I haven't seen that specific ---
Q: But you're generally aware that asset allocation is the most important decision that an investor can make, right?
A: It is one of the most important investment decisions.
Q: What percentage of the performance of a portfolio comes from the asset allocation decision according to the material you are familiar with?
A: There's a study that was done, and according to this study, and I know the study you're referring to, is widely published, 91 percent of returns are made from asset allocation decisions.

2. *If he sold proprietary funds, use that fact against him:*

Q: Now, in a case like this one where you've put all the funds into Morgan Stanley proprietary mutual funds, I believe your counsel mentioned at the beginning that one of the reasons for doing that was that you could then have direct access to these fund managers and to the information about what is in the funds; is that right?
A: That's partially correct.
Q: Yeah. If you were to put them into the funds of some outside company that doesn't have a relationship with Morgan Stanley, you'd have to go to Morningstar like anybody else if you want to try to figure out what was inside one of those funds, wouldn't you?
A: Yes.
Q: But in a Morgan Stanley fund, it's right on your computer screen on

your desk that you could look and see what percentage is in bonds versus stocks at any given time, right?
A: It's published generally quarterly.
Q: But if you want, you can pick up the phone and call the fund manager and find out what it is today, can't you?
A: On most funds where we have internal managers, yes.

J. *Get him to admit he ignored asset allocation*

1. *When picking the investments he sold the customer:*

Q: Now, at the time you made – Stop there for a moment. At the time you made these various mutual fund purchases in that account, did you figure out what percentage of this money was going to go into equities versus bonds?
A: I was running, you know, just a calculation in general. We were gong to keep some in money market. We are looking of a range of overall managing the portfolio, what's always in the account isn't everything. There's funds held outside there, so we caution clients, hey, make sure you have funds outside the account, so we were looking at the targets we'd talked about, 70 percent or so in, 60 to 70 percent in equities.
Q: Again, you never made any note of that so-called target in your daytimer or anyplace else, did you?
A: No, I did not.
Q: You can't point to any written document you sent to my client that said this is, or gave my client that says this is our target for investment of your money.
A: No, I did not.
Q: Well, is it your understanding then that when recommending funds, you have no control at all over the total percentage of equities that your clients are going to get from this – from all these funds put together?
A: I don't have total control. I have some say-so in how it's put together. But a lot of times – in different mutual funds, there are times when the manager will have only, say, 40 or 50 percent of its assets in stocks. The rest in bonds and money market. He will make that asset allocation call. Now, there's other funds we know where we can reasonably expect that they're going to have a fairly high amount of the funds in equity.
Q: Well, these example plans that we show here do seem to propose very specific asset mixes. For instance, look at page 522 in tab 6. That appears to show that the customer initially had an asset mix of 100 percent cash, and their proposal was very specific pieces of the pie, a certain percentage in Treasury notes and CDs, a certain percentage in intermediate term government bonds and so forth. Now, those could have been mutual funds, Morgan Stanley mutual funds, couldn't they?
A: Possibly.
Q: But they would have been funds that had some specific parameters on how much of their money had to be in bonds?
A: That's possible, yes.
Q: You didn't select funds of that kind for my clients, you selected funds that had a wide range of options, they could move from stocks back to bonds at their whim virtually?
A: Correct, on some the funds, yes.

2. *Pin him down on his continuing failure to rebalance the account*:

Q: So did you make any determination of the percentage of equities that my clients had in this portfolio at any time around December 2002?
A: I was looking at overall, you know, where my clients who were invested this way, were we starting to see money move to bonds and cash, and yes, we were seeing that happen. Not specifically in their account where we could look at it and say, okay, the cash portion of this account based on just what's in the money market is X, but in looking

at, okay, they've got diversification between all these managers and we're starting to see these managers lighten up on stocks.
Q: Is the answer to my question that you did not make any calculation to determine the percentage of equities in the portfolio?
A. No, no. I didn't go through this specific account in December and say that's where we're at.

K. *Finish on one or two strong points that reinforce and return to the theme of your case, if possible.*

In this case, the theme is that undue pressure to gather assets and illegal incentives to sell proprietary mutual funds blinded the broker to his customers' true investment needs and objectives:

Q: But now when Mr. and Mrs. Customer came to you for advice and they told you they were thinking about retiring, they were worried. They wanted advice on whether it would work, and you told them you thought they could earn money from their investments that would generate the income they needed. You knew that this would involve Mr. Customer quitting his Walgreen's job, taking the money out in cash, and investing it at Morgan Stanley, right?
A: Correct.
Q: If you had given them the advice, "Mr. and Mrs. Customer, let me tell you, you cannot really yet afford to retire; you really should wait another year; two years, three years, then maybe you could meet these retirement goals; but if you try to retire right now, it's going to be very, very, risky; you have to get very, very, aggressive." If you'd given them that kind of advice instead of whatever advice you did give them, would you have earned an $11,600 commission?
A: No, but that's of course hindsight.
Q: Are you aware that the NASD made findings to the effect that Morgan Stanley was operating unlawful sales contests to encourage and pressure their registered reps to sell proprietary funds?

(Respondent's Attorney): Object to this line of questioning. It sounds like we're going down the road of --- I think everybody's aware just recently there was an NASD determination regarding sales contests. If we're going down that road, I ask we keep it specifically to sales contests, if there were any going on in this office with regard to these customers.

(Claimant's Attorney): Fair enough.

(Respondent's Attorney): Okay.

Q: According to --- Let me see if we can find the chart. According to Appendix A of the NASD letter of acceptance, waiver, and consent with Morgan Stanley, there was one national contest. Contest period was October 30th, 1999, to October 26, 2000. Do you recall being a part of that contest?
A: No.
Q: That particular contest according to the appendix sent approximately 900 winners to 1 of 2 conferences at the Venetian in Scottsdale, Arizona. Is that where you went for your conference?
A: I did go to the conference at the Venetian.
Q: But your testimony, it had nothing to do with your sale of eligible products.
A: I don't know the exact criteria for how you qualified for the Venetian trip. I'm not sure. I was surprised when I got an e-mail that said I was being invited to this conference. This was not a conference that was a reward, for selling funds. This was a conference where you find we had speakers from our investment banking division, from our – in fact, many of the fund managers that we had spoke at these conferences, and we also got continuing education credits for our insurance and other licenses.

Q: Would you deny that --

(Respondent's Attorney): Again, are you entering this document in evidence that you're starting to quote from?

(Claimant's Attorney): Yes, I am going to.

(Respondent's Attorney): And what is it?

(Claimant's Attorney): It's a letter of acceptance, waiver, and consent from NASD to Morgan Stanley signed by both NASD and Morgan Stanley, and it indicates Morgan Stanley paid a $2,000,000 fine for the contest violations.

(Respondent's Attorney): Can I take a look at that before we go –

(Claimant's Attorney): Certainly may. And here's the appendix, portion of the appendix.

(Claimant's Attorney): I think this document speaks for itself. I don't think we'll need additional testimony describing what it says. With that, I believe I'm finished. I thank you for your attention, panel.

Conclusion

Examining a broker can be challenging, but with adequate preparation and a little good luck, it can be a satisfying and rewarding experience for both the customers and their attorney. A good examination of the broker can go far to educate the arbitration panel members and put them into the right frame of mind to render an adequate award.

The Calculation Of Damages In Taking Away Cases

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There are times when an owner is deprived of the reasonable use of an investment - such as in real estate when an asset is temporarily “taken away” - as a result of restrictions being placed on the use of the land by a municipality, a state or the federal government. Then, when the investment is later “returned” after the restrictions are eased or eliminated, to what extent is the owner entitled to an award to compensate for the temporary taking? What is a damages model that is reasonable and appropriate?

Although there is no apparent “bright line” for determining damages calculations in taking away cases, three guideposts are proposed to assist in determining Lost Return Damages and Diminution Damages. Likewise, I have provided three measures of Post-Taking Damages that may be reasonably applied to each of the three proposed Lost Return Damages and Diminution Damages Models. Although this paper contains several alternative calculations, I have indicated which of the alternatives I believe would be the most reasonable and appropriate.

I. WHAT ARE THE ELEMENTS OF THE DAMAGES MODEL?

The following comprise the elements of the Damages Model (these elements will be explained later step-by-step):

Temporary Taking Damages (TTD) + **Post-Taking Interest (I) on the Temporary Taking Damages from Date Returned to the Present**

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Temporary Taking Lost Return Damages Date Taken (Or Other Dates) To Date Returned | **Temporary Taking Diminution Damages Date Taken (Or Other Dates) To Date Returned** | |

(X times R + **Δ)** + **TTD times I**

To create and construct a Damages Model, one has to render an opinion as to the reasonableness and appropriateness of the following:

- First, what is the value that was taken, or, in other words, the difference between the unrestricted value and the restricted value of the asset ("X")?
- Second, what is a reasonable market rate of return ("R") for an investment for the time period(s) beginning with the date of the taking and ending with the date that the property was "returned?"
- Third, what are the temporary taking damages for the investment, valued as of the date the property was "returned" ("X" times "R")?

Fourth, what are the temporary taking diminution damages ("Δ")?

- Fifth, what is the reasonable interest rate ("I") that would apply to the temporary taking damages ("TTD") from the date the property was returned to the present (or the date of judgment)?
- Sixth, what are the total damages ("TTD" plus ["TTD" times "I"])?

In this paper, I have generated a Damages Model, containing three elements of damages:

(1) "lost return" damages (valued as of the date returned),
(2) "diminution" in value damages (valued as of the date returned), and
(3) post-taking interest/return on those two elements (valued from the date returned to the present).

II. THE ELEMENTS OF THE DAMAGES MODEL (STEP-BY-STEP)

A. Lost Return Damages (From the Taking Date to the Return Date):

The first element of the temporary taking damages is the "lost return"[1] on the plaintiff's investment. The formula used by the courts (in general terms) is as follows: take the value of the property unrestricted by any governmental interference minus the value of the property with the governmental interference or restrictions (hereinafter "X") multiplied by a market rate of return (hereinafter "R") for the period of the interference. Stated differently, start with what was "taken" by the governmental restriction (i.e., the reduction in value of the property or "X") and assume that such taken value ("X") would have received a reasonable market return ("R") for the temporary taking period.[2]

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[1] *Wheeler v. City of Pleasant Grove,* 833 F.3d 267 (11th Cir. 1987), describes the test as follows: "the landowner should be awarded the market rate return computed over the period of the temporary taking on the difference between the property's fair market value without the regulatory restriction and its fair market value with the restriction."

[2] Sometimes the market return is equivalent to (and can be easily measured by) the lost "rental" value of the property during the temporary taking period. But in the instant case, the property was vacant and had no equivalent rental value. Accordingly, it is presupposed that the property could have been sold, and the income used to generate a reasonable rate of return. In *520 East 81st Street Associates v. State of New York,* 99 N.Y.2d 43, 750 N.Y.S.2d 833 (N.Y. 2002), *on remand,* NYLJ, Sept. 21, 2004, p. 18 (N.Y. Court of Claims 2004), the court assumed in calculating the lost return damages that the property could have been sold at the beginning of the taking period (that would have been its highest and best use) and thus the landowner would then have been entitled to "interest" on those sales proceeds for the duration of the taking. The court used the terms "interest" and "appropriate rate of return" interchangeably.

In the event that a court determines that multiple time periods are applicable, the expert should provide calculations for the different time periods. Thus, as alternative possible temporary taking periods, the appraisers should be asked to determine the valuations as of those various dates (including the unrestricted value), and damages should be determined by the expert based on the appropriate market rate of return and total return for the corresponding periods.

The appraisers should determine the viable permitted use or utility of the property as restricted. Absent any viable permitted use or utility during the taking period, the appraisers may select a value of zero, as restricted, for the asset until it is reclaimed by the owner.

Thus, the following table is the formula (and proposed template) for the value of the variable "X" (i.e., the difference in the value of the property unrestricted and restricted by the taking government agency) as of various dates.

How does one determine the reasonable market rate of return ("R"), as well as determine the formula for calculating the total lost return as the "return" date of the asset? The courts measure the lost return damages based upon the present value calculation of "X" times "R" at the end of the taking period when the restrictive use was removed.[3]

To determine the rate of return ("R") for the temporary regulatory taking of a plaintiff's property, I have chosen one rate that I believe is the most reasonable "market rate of return," but I have also provided two alternative rates of return.

1. Primary Market Rate of Return: Blend of Standard and Poor's 500 Index and Lehman Brothers Aggregate Bond Index

TABLE 1.
FORMULA FOR THE VARIABLE "X"

Formula: **Unrestricted Value - Restricted Value = X**

Date	Unrestricted Value	less	Restricted Value	equals	"Taken" By Restriction "X"
1					
2					
3					
4					
5					

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[3] In *Independence Park Apartments v United States*, 2004 U.S. Claims Lexis 222 (U.S.Ct.Fed.Claims 2004), in order to arrive at a present value on the final date of the temporary taking period, the lost rental income had to be reverse-discounted. As the methodology used in this paper assumes a sale at the beginning of the taking period and applies a market rate of return based upon a blended rate of 60 percent of the Standard and Poor's 500 and 40 percent of the Lehman Brothers Aggregate Bond Index (as well as other similar measurements) as of the "return" date (and not upon "lost rents" or "lost profits"), a present value is able to be determined without the necessity of compounding or reverse-discounting.

The primary rate of return is based on a combination of indices[4] of the Standard and Poor's 500 Index[5] of stocks (weighted 60 percent) and the Lehman Brothers Aggregate Index[6] of bonds (weighted 40 percent).[7] These indices are broadly diversified and include stocks that are generally of secure, conservative companies and bonds that are government and corporate bonds investment-grade[8] quality or better. This rate is the most reasonable approximation of the "market rate of return," because it captures a diverse and broad segment of the market, and, as such, represents the prevailing market rates in reasonably risked investments.

Given the restricted/ unrestricted difference in value of "X," and multiplying "X" by the above-noted blended rate of return ("R") of the Standard and Poor's 500 (weighted 60 percent) and the Lehman Brothers Aggregate Bond (weighted 40 percent) Indices, equals the total "lost return damages" between the determined periods.

The following table is a

TABLE 2.
SUMMARY OF LOST RETURNS DAMAGES USING PRIMARY RATE OF RETURN FOR ALL FIVE TAKING PERIODS

	Period Beginning 1	Period Beginning 2	Period Beginning 3	Period Beginning 4	Period Beginning 5
"X"					
"R"	**%**	**%**	**%**	**%**	**%**
Lost Return Damages					

Note: The "R" in this table represents an approximate annual *compounded* rate that would have achieved the same rate of return for the five temporary taking periods.

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[4] An index is a hypothetical portfolio of specified securities (common examples are the Dow Jones Industrial Average and the Standard & Poor's 500), whose performance is often used as a benchmark in judging the relative performance of securities such as mutual funds and stocks.

[5] Standard & Poor's is the world's foremost provider of independent credit ratings, indices, risk evaluation, investment research, data and valuations the Standard and Poor's 500 Index is an unmanaged market capitalization weighted price index composed of 500 widely-held common stocks listed on the New York Stock Exchange, American Stock Exchange and Over-The-Counter market.

[6] Lehman Brothers is the world's leading provider of fixed income benchmarks. Its Global Family of Indices are used by over 90 percent of U.S. investors, a majority of large European investors and a growing share of Asian investors. The Lehman Brothers Aggregate Bond Index is an index comprised of approximately 6,000 publicly traded bonds, including U.S. government, mortgage-backed, corporate and Yankee bonds with an average maturity of approximately 10 years.

[7] Source of data for the Standard and Poor's 500 and Lehman Brothers Aggregate Bond Indices is Thomson Financial Company. Thompson Financial provides integrated information and technology applications in the global financial services industry and is a reliable source for such data. Thomson Financial 2003 revenues were $1.5 billion and it employees 7,700 workers in 22 countries. It is a source widely used by financial practitioners.

[8] Bonds that are rated in the top four categories by commercial credit rating companies. Standard &Poor's classifies investment-grade bonds as BBB or higher, and Moody's classifies investment grade bonds as BAA or higher.

template showing the results of the measure of total "lost return damages" for five periods.

2. Alternative Market Rates of Return: Bond Index and New York Statutory Interest Rate

I have calculated and included two alternative rates of return. Although I believe the above-described "blend" is the most appropriate, the alternatives show the returns using more conservative rates. These latter conservative rates are, in my opinion, less appropriate investment rates, primarily because these latter rates do not reflect the broader market segment as does the blended rate.

The first alternative approach would be to solely utilize the Lehman Brothers Aggregate Bond Index, which would be more conservative than the above-noted blended rate of the Standard and Poor's 500 (60 percent weight) and the Lehman Brothers Aggregate Bond (40 percent weight). The limitation of the use of the Lehman Brothers Aggregate Bond Index (100% weight) as a market rate of return is that it is narrower in scope in capturing the broader market (by focusing solely on the bond market) that is reflected in the above-noted blended rate.

The second approach is to use the state statutory interest rate (e.g., 9 percent in the case of New York State), and apply this rate to the Lost Return Damages. I understand that some courts might consider this rate a minimum, presumptively valid rate of return.[9] I also understand that the statutory rate is generally simple interest and is not compounded. However, when you take non-compounded simple interest, particularly over a long period of time coupled with the impacts of inflation, you are not getting a reasonable present value. For this reason, I believe the Standard and Poor's 500 and Lehman Brothers Aggregate Bond Indices blended rate is a more appropriate rate of return particularly for a lengthy period of time because the rate reflects present value as of the "return" date. Compounding

[9] In *520 East 81st Street Associates v. The State of New York*, 99 N.Y.2d 43, 750 N.Y.S.2d 833 (N.Y. 2002), *on remand*, NYLJ, Sept. 21, 2004, p. 18 (N.Y. Court of Claims 2004), the 2002 ruling by the New York State Court of Appeals found that the fixed, 9 percent statutory rate (applicable to state-court actions) was "presumptively reasonable unless the claimant rebut the presumption with evidence of prevailing market rates establishing that the statutory rate is so unreasonably low as not to constitute just compensation." The lower court's subsequent decision on remand (dated 2004) found that 9 percent was in fact too low and that 11 percent (based on a blended Standard and Poor's and Lehman Brothers Aggregate Bond Indices, weighted 60 percent/40 percent respectively) was more appropriate. I have nonetheless shown what the results would be using the 9 percent statutory rate applicable in New York state courts.

interest is implicit in the blended rate, and as such, is a more accurate measure of present value.

The following table is a template of the summary of the lost return damages under the two alternative rates of return.

B. Diminution Damages:

In addition to the "lost return," the plaintiff would like to believe that his or her temporary taking damages will also include any "diminution in value" of the property as measured by subtracting the appraisers' value at the end of the taking from the value at the beginning to obtain the overall diminution (hereinafter "Δ") - in this example, from the beginning of the taking period (or another date as appropriate) to the end of the period. In many cases when government temporarily "takes" property, the property will retain its value (or even increase its value) when the property is "given back" to the landowner. In those cases, the courts only measure damages based on the "lost return" as described above. But in other cases, if the property has diminished in value from the beginning to the end of the taking, the courts may add that "diminution" to the "lost return" to make the landowner whole.[10] The plaintiff would want to believe that the court will hold the government entity liable for that diminution in value and will add that diminution to the "lost return" damages sustained as of the date of the property's "return." That "diminution" damage calculation is a simple one that is made by subtracting the appraisers' value at the end of the taking from the value at the beginning to get the overall diminution. In some cases, the appraisers may determine that the value at the end of the taking was zero, because the property had lost all utility by the time it

TABLE 3.
SUMMARY OF LOST RETURN DAMAGES USING ALTERNATIVE RATES OF RETURN FOR ALL FIVE TAKING PERIODS

Summary	**Lehman Brothers Aggregate Bond Index (100 percent weight) (Used To Calculate Lost Return Damages)**				
	Period Beginning 1	**Period Beginning 2**	**Period Beginning 3**	**Period Beginning 4**	**Period Beginning 5**
"X"					
Lost Return Damages					

Summary	**9 Percent Statutory New York State Interest Rate (Used To Calculate Lost Return Damages)**				
	Period Beginning 1	**Period Beginning 2**	**Period Beginning 3**	**Period Beginning 4**	**Period Beginning 5**
"X"					
Lost Return Damages					

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[10] In *520 East 81st Street Associates v. The State of New York*, 99 N.Y.2d 43, 750 N.Y.S.2d 833 (N.Y. 2002), on remand, NYLJ, Sept. 21, 2004, p. 18 (N.Y. Court of Claims 2004), New York's highest court found that the proper measure of damages was both the "diminution" damages as well as the "lost return" damages.

was "returned" (e.g., if upon its "return" yet another government agency has placed restrictions upon the property).

Table 4 shows a template for the diminution damages applicable to each temporary taking period.

C. Temporary Taking Damages As of the "Return" Date

As described above, the total temporary taking damages ("TTD") for each period is the combination of the Lost Return Damages and the Diminution Damages. The following provides an illustration of the formula used to determine the TTD (Table 5).

Applying this formula, the Temporary Taking Damages for the principal periods, valued as of the return date, using the preferred blend of the Standard & Poor's 500 and Lehman Brothers Aggregate Bond rate of return, is the total of the lost return plus the diminution damages.

Table 6 is a template of the Summary of Temporary Taking Damages (TTD) using all three alternative rates of return ("R") described above. As mentioned earlier, the three different rates ("R") utilized to calculate Lost Return Damages are: (1) blended rate of the Standard & Poor's 500 (weighted 60 percent) and the Lehman Brothers Aggregate Bond (weighted 40 percent) Indices, (2) the rate of only the Lehman Brothers Aggregate Bond Index, and (3) the 9 percent statutory New York State interest rate.

D. Post-Taking Interest

For the time period after the temporary taking, it is necessary to determine what reasonable interest rate (hereinafter "I") would apply to the damages that were incurred during the temporary taking period. This element completes the Damages Model.

There is no "fixed" pre-judgment (post-taking) interest rate in "takings" cases. The Federal Courts have a minimum interest rate

TABLE 4.
FORMULA FOR DIMINUTION DAMAGES

Formula for Diminution Damages:

Beginning Value	less	End Value	=	Diminution Damages (" ".

Date	Beginning Value	less	Ending Value	equals	Diminution Damages
1					
2					
3					
4					
5					

TABLE 5.
FORMULA FOR TEMPORARY TAKING DAMAGES

Formula for Temporary Taking Damages:

Lost Return Damages	plus	Diminution Damages	=	Temporary Taking Damages
X x R	+	Δ	=	TTD

TABLE 6.
SUMMARY OF TEMPORARY TAKING DAMAGES FOR ALL THREE ALTERNATIVE RATES OF RETURN AND ALL FIVE TAKING PERIODS

Summary of Temporary Taking Damages Applying Standard & Poor's (60 Percent Weight) and Lehman Brothers Aggregate Bond (40 Percent Weight) Indices

Beginning Date	Lost Return Damages	plus	Diminution Damages	equals	Temporary Taking Damages
1					
2					
3					
4					
5					

Summary of Temporary Taking Damages Applying Lehman Brothers Aggregate Bond Index (100 Percent Weight)

Beginning Date	Lost Return Damages	plus	Diminution Damages	equals	Temporary Taking Damages
1					
2					
3					
4					
5					

Summary of Temporary Taking Damages Applying 9 Percent Statutory New York State Interest Rate

Beginning Date	Lost Return Damages	plus	Diminution Damages	equals	Temporary Taking Damages
1					
2					
3					
4					
5					

that they can apply to pre-judgment damages (by using the post-judgment interest rate). However, in "takings" cases, the plaintiff can show that the statutory rate would not be a reasonable return to provide appropriate compensation for the plaintiff.

While the calculation of the post-taking interest would usually run through the anticipated date of the completion of the trial, in this paper I have stated that post-taking interest would run through the "present" time.

For the purposes of determining rates of return or interest rates, I have chosen the ten-year Treasury STRIPS rate as the most appropriate rate given the length of the period at issue (using approximately ten years as my example). I would also calculate the interest using two alternatives: the statutory state interest rate and the one-year Treasury note rate[11] used under some federal statutes.

[11] Source: Thomson Financial Company from the U.S. Federal Reserve.

1. Primary Interest Rate: Ten-Year Treasury STRIPS

I have selected the ten-year Treasury STRIPS[12] interest rate as an appropriate measure of post-taking interest for this hypothetical case. This is because ten-year Treasury STRIPS provides a reasonable approximation of the rate of interest that a prudent investor might have obtained to produce a reasonable return while maintaining the safety of principal. The use of the ten-year Treasury STRIPS rate is also appropriate due to the fact that these securities approximately match the duration of the hypothetical time period at issue (approximately ten years) as opposed to a shorter-term rate (such as one-year Treasury STRIPS).

The interest on the ten-year Treasury STRIPS is to be calculated based upon the annual average of the daily yield rate on ten-year Treasury STRIPS available on the "return" date, which rate is used through the year-end. Thereafter, interest is calculated based upon the annual average of the daily yield rate on ten-year Treasury STRIPS available annually at year-end. For example, at year-end 1995, the yield available is applied to year 1996 interest; at year-end 1996, the yield available is applied to year 1997 interest, etc. Yield prices data on ten-year Treasury STRIPS can be obtained from Bloomberg L.P.[13]

Support for using the ten-year Treasury STRIPS can be found in *Independence Park Apartments v. United States*, 2004 U.S. Claims Lexis 222 (U.S.Ct.Fed.Claims 2004). The court there chose to apply the annual average of the daily yield rate of ten-year Treasury STRIPS rate for the entire period after the taking, noting that it was appropriate for a lengthy period. This measure satisfies the duration involved in the hypothetical case presented here, and provides a reasonable return with a range of rates, while maintaining the safety of principal.

In the above-noted decision, compounding of the interest rate was determined to be appropriate. Certainly, the value of one dollar ten years ago is not equal to one dollar in year 2005, and compounding compensates the plaintiff for this inequity.

For the primary taking period, if we apply the ten-year Treasury STRIPS rates to (a) the Lost Return Damages (using the primary rate of return) and (b) the Diminution Damages, the interest accrued between the "return" date and the present date is the total post-taking interest.

Adding the post-taking interest (from the "return" date and the present date) to the temporary taking damages (as of the "return" date) brings the total Lost Return Damages (with interest to the present date) and Diminution Damages (with interest to the present date). Combining those two elements of the damages brings us to the total damages, with interest.

Table 7 shows a template of post-taking interest calculations for each alternative taking period, using the primary rate of return (the blended Standard & Poor's 500 and Lehman Brothers Aggregate Bond Indices rate), and applying the ten-year STRIPS rate to calculate the interest between

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[12] STRIPS is an acronym for Separate Trading of Registered Interest and Principal Securities. A book-entry system operated by the Federal Reserve permits separate trading and ownership of the principal and coupon portions of selected Treasury securities. It allows the creation of zero coupon Treasury securities from designed whole bonds.
electronic communications, with 8,000 employees in over 125 countries.

[13] Bloomberg, L.P. is the source of the ten-year Treasury STRIPS information. Bloomberg, L.P. is a highly-regarded provider to the global business community of real-time pricing, historical pricing, data, analysis and electronic communications, with 8,000 employees in over 125 countries.

TABLE 7.
SUMMARY OF POST-TAKING INTEREST USING PRIMARY RATE OF RETURN AND TEN-YEAR TREASURY STRIPS RATES FOR POST-TAKING INTEREST RATE

	Period Beginning 1	Period Beginning 2	Period Beginning 3	Period Beginning 4	Period Beginning 5
Lost Return (as of "Return" Date)					
Diminution (as of "Return" Date)					
Interest on Lost Return (between "Return" Date and Present Date)					
Interest on Diminution (between "Return" Date and Present Date)					
Total Interest (between "Return" Date and Present Date)					
Total Lost Return with interest (as of Present Date)					
Total Diminution with Interest (as of Present Date)					
TOTAL DAMAGES WITH INTEREST					

the "return" date and the present date.

2. Alternative Post-Taking Interest Rates

One can also calculate the post-taking interest using alternative rates that, depending on the circumstances, the courts may deem to be appropriate. The two I have selected are the state statutory rate (for example, New York State Statutory rate of 9% simple interest) and the one-year Treasury rates (compounded interest).

While I understand that a state rule is not binding in a Federal action, as a guidepost I have calculated and presented the interest using the state rate to the Court. In *520 East 81st Street Associates v. State of New York*, 99 N.Y.2d 43, 750 N.Y.S.2d 833 (N.Y. 2002), *on remand*, NYLJ, Sept. 21, 2004, p. 18 (N.Y. Court of Claims 2004), the New York State Court awarded the statutory interest of 9 percent for the post-taking period.

Additionally, I have calculated the damages using the one-year Treasury yields as an extremely conservative interest rate. The basis of providing damages calculations based upon using one-year Treasury yields comes from the following two sources:

- In 28 U.S.C. § 1961,[14] this section entitles parties to *post judgment* interest measured by the one-year treasury yield.[15]
- In 40 U.S.C. § 3116,[16] this section provides an interest rate for taking cases against

the Federal government, measured by the one-year treasury yield (and compounded when the period is longer than one year). The following table is a template that summarize the post-taking interest damages utilizing the two alternative interest rates, for each of the five taking periods, as applied to the temporary taking damages based on the primary rate of return.

TABLE 8.
SUMMARY OF POST-TAKING INTEREST USING PRIMARY RATE OF RETURN AND ALTERNATIVE POST-TAKING INTEREST RATES

Post-Taking Interest
Using 9 Percent Statutory New York State Interest Rate (Simple Interest)

	Period Beginning 1	Period Beginning 2	Period Beginning 3	Period Beginning 4	Period Beginning 5
Lost Return (as of "Return" Date)					
Diminution (as of "Return" Date)					
Total Lost Return with interest (as of Present Date)					
Total Diminution with interest (as of Present Date)					
TOTAL DAMAGES WITH INTEREST					

[14] 28 U.S.C. § 1961: this section entitles parties to post judgment interest measured by the one-year Treasury yield. This section is not dispositive of the pre-judgment interest rate, but only creates a formula for determining interest from the date of judgment forward. I understand that some courts have nonetheless looked to this section and used it as a "minimum rate" in cases where pre-judgment interest is awarded but that the plaintiff is nonetheless entitled to show that a higher rate is more appropriate.

[15] Treasury one-year yield is an average reflecting the annualized monthly yield on all actively traded Treasuries maturing in 1 year adjusted for constant maturity in the secondary market. The Treasuries are guaranteed by the U.S. Government as to payment of principal and interest.

[16] 40 U.S.C. § 3116: This section also is not dispositive for a case where the plaintiff taking claim is against a Town, not against the Federal government. Even where this section is application, however, I understand that some courts have found that it only provides a minimum measure.

Post-Taking Interest
Using Treasury Note - One-Year Yield (Interest Compounded)

	Period Beginning 1	Period Beginning 2	Period Beginning 3	Period Beginning 4	Period Beginning 5
Lost Return (as of "Return" Date)					
Diminution (as of "Return" Date)					
Total Lost Return with interest (as of Present Date)					
Total Diminution with interest (as of Present Date)					
TOTAL DAMAGES WITH INTEREST					

III. SUMMARY OF DAMAGES

To summarize and illustrate the various elements of damages discussed above, the following comprises the Damages Model:

Temporary Taking Damages (TTD) + **Post-Taking Interest (I) on the Temporary Taking Damages from Date Returned to the Present**

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Temporary Taking Lost Return Damages Date Taken (Or Other Dates) To Date Returned

Temporary Taking Diminution Damages Date Taken (Or Other Dates) To Date Returned

(X times R + Δ) + TTD times I

The following table is a template to summarize the damages elements for all five hypothetical alternative taking periods, all three alternative rates of return, and all three alternative post-taking interest rates.

Although the total damages are based on what I believe is the most reasonable and appropriate rate of return ("R") and post-taking interest rate ("I") in this hypothetical case, I would include detailed calculations of the various damages elements based on the three different rates of return (as appropriate to a particular case), the three different post-taking interest rates (as appropriate to a particular case), and five different taking periods (in the case of this hypothetical) as possible alternative periods. In other words, exhibits presented would calculate the various elements of the damages based on 45 permutations of the alternative rates and periods. Needless to say, the facts and circumstances of a particular case would dictate the appropriate rate of return, the post-taking interest rate and the time period(s).

TABLE 9.
TABLES SUMMARIZING DAMAGES ELEMENTS USING THREE ALTERNATIVE RATES OF RETURN AND THREE ALTERNATIVE POST-TAKING INTEREST RATES, FOR ALL FIVE TEMPORARY TAKING PERIODS

Summary of Damages Elements Using following Assumptions:
Post-Taking Interest Rate: 9 Percent Statutory New York State Interest Rate (Simple Interest)
Rate of Return: Blended 60 Percent Standard and Poor's 500 and 40 Percent Lehman Brothers Aggregate Bond Indices previously utilized to determine Lost Return Damages.

	Temporary Taking Period Beginning 1	Temporary Taking Period Beginning 2	Temporary Taking Period Beginning 3	Temporary Taking Period Beginning 4	Temporary Taking Period Beginning 6
Lost Return as of "Return" Date					
Diminution Damages as of "Return" Date					
Lost Return with Interest to Present Date					
Diminution Damages with Interest to Present Date					
TOTAL DAMAGES					

Collateral Estoppel Effect of Arbitration

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Introduction

Public policy favors arbitration because it is thought to be an inexpensive and speedy alternative to litigation based on an agreement between the parties to avoid the judicial process. Due to broad interpretation and application of arbitration clauses and very deferential appellate review in favor of referring disputes to arbitration, many would-be lawsuits have been converted into arbitration proceedings. Thus, arbitration also conserves judicial resources by strictly holding parties to their agreements to arbitrate, rather than litigate, their disputes.

Collateral estoppel also aids judicial economy by preventing a party from relitigating issues that were actually decided and necessary to the outcome of a prior proceeding.[1] Although different courts and jurisdictions phrase the elements differently, collateral estoppel generally requires that

◊ The party against whom the doctrine is invoked was a party, or in privity with a party, to the prior adjudication;
◊ The issue presented is identical to the issue previously litigated;
◊ The issue was fully and vigorously litigated in the prior proceeding;
◊ The issue was necessarily decided in the prior proceeding; and,
◊ Application of the doctrine is not inappropriate or unfair.[2]

Thus collateral estoppel treats one or more issues in the present litigation as conclusively decided based on the argument, litigation, and decision of that same issue, by that same party, in a prior proceeding — in other words, a losing party is prevented from re-litigating an issue already decided.

Application of collateral estoppel is not limited to prior judicial proceedings, but may be based on other proceedings, such as administrative hearings,

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[1] *Parklane Hosiery Co. v. Shore*, 439 U.S. 322, 326 n.5 (1979).

[2] *E.g., Harrison v. Eddy Potash, Inc.*, 248 F.3d 1014, 1022 (10th Cir. 2001); *Universal Am. Barge Corp. v. J-Chem, Inc.*, 946 F.2d 1131, 1136 (5th Cir. 1991).

in certain cases.[3] This article will focus on the collateral estoppel effect of a prior arbitration, whether the subsequent proceeding is a lawsuit or another arbitration.

Court Application of Collateral Estoppel Based on Prior Arbitration

The collateral estoppel effect of a prior arbitration is "far from certain".[4] But, some courts and commentators have opined that, when the prior arbitration afforded basic elements of adjudicatory procedure, such as the opportunity to present evidence, the determination of issues by an arbitration panel should be treated as conclusive in subsequent proceedings, as would similar decisions by a court of law.[5] As the Restatement notes:

> A determination of an issue does not preclude litigation of that issue if: (a) According preclusive effect to determination of the issue would be incompatible with a legal policy or contractual provision that the tribunal in which the issue subsequently arises be free to make an independent determination of the issue in question, or with a purpose of the arbitration agreement that the arbitration be specially expeditious; or (b) The procedure leading to the award lacked the elements of adjudicatory procedure [required for administrative decisions to have res judicata effect]

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[3] *Astoria Fed. Sav. & Loan Ass'n v. Solimino*, 501 U.S. 104, 107–08(1991) (stating in dicta that "[w]hen an administrative agency is acting in a judicial capacity and resolves disputed issues of fact properly before it which the parties have had an adequate opportunity to litigate, the courts have not hesitated to apply res judicata to enforce repose") (quoting *United States* v. *Utah Constr. & Mining Co.,* 384 U.S. 394, 422 (1966)). Administrative determinations reflecting policy choices in quasi-legislative proceedings are not given the preclusive effect bestowed upon administrative determinations in quasi-judicial proceedings. *Second Taxing Dist. v. FERC*, 683 F.2d 477, 484 (D.C. Cir. 1982). Therefore, in order for the determination of the administrative agency to have preclusive effect, the agency must have been exercising its judicial power rather than its legislative power.

Collateral estoppel may not apply where the prior proceeding employed a higher legal standard. *Clark v. Bear Stearns & Co*., 966 F.2d 1318, 1320-22 (9th Cir. 1992) (holding that plaintiff's failure to prove common law fraud by clear and convincing evidence in prior arbitration did not collaterally estop his lawsuit under the securities laws which required proof of fraud by a preponderance of the evidence); *Young & Co. v. Shea*, 397 F.2d 185, 188–89 (5th Cir. 1968) (refusing to apply collateral estoppel in administrative hearing for compensation under the Longshoremen's Act, which requires only a showing of injury, based on worker's inability to demonstrate that he sustained an injury by a preponderance of the evidence in prior lawsuit).

[4] *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 222 (1985) ("We believe that the preclusive effect of arbitration proceedings is significantly less well settled than the lower court opinions might suggest . . . . [I]t is far from certain that arbitration proceedings will have any preclusive effect on the litigation of nonarbitrable federal claims."). *But cf. Boguslavsky v. Kaplan*, 159 F.3d 715, 720 (2d Cir. 1998) ("[C]ollateral estoppel can be predicated on arbitration proceedings.").

[5] *Greenblatt v. Drexel Burnham Lambert, Inc*., 763 F.2d 1352, 1360 (11th Cir. 1985) (citing RESTATEMENT (SECOND) OF JUDGMENTS § 84(3) & cmt. (c)); *see also* G. Richard Shell, *Res Judicata and Collateral Estoppel Effects of Commercial Arbitration*, 35 UCLA L. REV. 623, 649 (1988).

> prescribed in § 83(2).[6]

Commentators favor giving arbitration proceedings res judicata effect in most instances, but would apply collateral estoppel more narrowly, only where the prior proceeding had sufficient procedural mechanisms to provide for an adjudication rather than a mediation of the dispute. The Restatement commentary elaborates on the minimum procedural requirements necessary for an arbitral determination of an issue to have res judicata and collateral estoppel effect.

> Assuming that the arbitration procedure has the elements of validity and has become final, it should be accorded claim preclusive effect unless a scheme of remedies requires that it be denied such effect. Arbitration procedure usually involves an impartial decision-maker, decision according to rules applied on the basis of evidence and legal argument, and the principle of finality. Procedure varying even with regard to these elements may have been agreed upon, however. *If the procedure is not so radically unfair as to justify nullifying the agreement to abide by it, the award is given conclusive effect as a product of the agreement of the parties.* On the other hand, if the procedure is virtually formless, particularly if it has no rule of finality, the agreement may be interpreted as being simply a mediation agreement . . . . Giving claim preclusive effect to an arbitration award does not necessarily imply that such an award should also be given issue preclusive effects. It is coherent to treat an arbitration proceeding as wholly self-contained, conclusive as to the claims represented in the award but inoperative beyond them. *When the arbitration procedure leading to an award is very informal, the findings in the arbitration should not be carried over through issue preclusion to another action where the issue would otherwise be subjected to much*

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[6] RESTATEMENT (SECOND) OF JUDGMENTS § 84(3). Section 83(2) of the Restatement lists the essential elements required for an administrative determination to have res judicata effect:

a) Adequate notice to persons who are to be bound by the adjudication . . . ;

b) The right on behalf of a party to present evidence and legal argument in support of the party's contentions and fair opportunity to rebut evidence and argument by opposing parties;

c) A formulation of issues of law and fact in terms of the application of rules with respect to specified parties concerning a specific transaction, situation, or status, or a specific series thereof;

d) A rule of finality, specifying a point in the proceeding when presentations are terminated and a final decision is rendered; and

e) Such other procedural elements as may be necessary to constitute the proceeding a sufficient means of conclusively determining the matter in question, having regard for the magnitude and complexity of the matter in question, the urgency with which the matter must be resolved, and the opportunity of the parties to obtain evidence and formulate legal contentions.

> *more intensive consideration.*[7]

By this standard, when the arbitration procedure is formal and provides sufficient procedural structure for an adjudication of the claim, it may be given issue preclusive as well as claim preclusive effect.[8] Accordingly, investor arbitrations following the procedures established by the National Association of Securities Dealers (NASD),[9] the New York Stock Exchange (NYSE),[10] the American Arbitration Association (AAA),[11] and similar groups may provide an appropriate basis for the application of collateral estoppel in subsequent proceedings. It should be noted that collateral estoppel does not require that the prior decision of the issue is final, but only that "the conclusion in question is procedurally definite".[12] Thus, confirmation of the arbitral award in a court of law is not necessary for it to have preclusive effect so long as there has been a final determination on the merits in

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[7] RESTATEMENT (SECOND) OF JUDGMENTS § 84, cmts. (b)&(c) (emphasis added).

[8] *See id.* It is worth noting that although the parties in *Greenblatt* made a record of the arbitration, that is not required for the proceeding to have collateral estoppel effect — "The operative test is simply that the arbitration be 'adequate' to protect the statutory interest." G. Richard Shell, *Res Judicata and Collateral Estoppel Effects of Commercial Arbitration*, 35 UCLA L. REV. 623, 655 n.162 (1988).

In *BBS Norwalk One v. Raccolta, Inc.*, the court refused to grant preclusive effect to an arbitral decision delivered without opinion, but stated that the defendant could still meet its summary judgment burden if

> they submit the entire arbitration record (testimony, exhibits, and the oral and written submissions of counsel) to the district court, and if that record demonstrates that the only conclusion a fair-minded jury could reach is that the arbitrator denied [the plaintiff's] claim on the merits. Rule 56(e) will then require [the plaintiff] to show, by specific references to the arbitration record, that the arbitrator denied its claim for other reasons, or that at least a genuine issue exists on that point.

117 F.3d 674, 678 (2d Cir. 1997).

[9] *See, e.g.,* NASD CODE OF ARBITRATION PROCEDURE §§ 10316 (Representation by Counsel), IM-13017 (Closing Arguments), 10322 (Subpoenas and Power to Direct Appearances), 10323 (Evidence).

[10] *See, e.g.*, NEW YORK STOCK EXCHANGE ARBITRATION RULES 614 (Representation by Counsel), 619 (General Provisions Governing Subpoenas, Production of Documents, etc.), 620 (Evidence)

[11] *See e.g.*, AMERICAN ARBITRATION ASSOCIATION, *Commercial Arbitration Rules*, Rules R-24 (Representation), R-30 (Conduct of Proceedings), R-31 (Evidence); *see also id., Supplementary Procedures for Securities Arbitration*, Rule 1 ("The Commercial Arbitration Rules of the American Arbitration Association (AAA), together with these Supplementary Procedures, shall apply whenever the parties' arbitration agreement refers to the Securities Arbitration Rules of the American Arbitration Association, or where the parties mutually agree to utilize these Procedures to resolve a securities or commodities dispute.").

[12] *Van Dyke v. Boswell, O'Toole, Davis & Pickering*, 697 S.W.2d 381, 385 (Tex. 1985) (citing RESTATEMENT (SECOND) OF JUDGMENTS § 13, cmt. g).

the prior arbitration.[13]

Special Issues Where the Subsequent Proceeding is Another Arbitration

Each of the elements of collateral estoppel creates special problems when the prior adjudication is arbitration rather than a lawsuit. However, none of these provide any significant impediment to a fair application of the doctrine.

Identity of Issues: Identity of issues is the cornerstone of collateral estoppel — if the issues are not the same, there is no prior adjudication of the issue in the subsequent proceeding on which to treat it as having already been conclusively proven. In arbitration, collateral estoppel may be applied to prevent litigation of liability and damages issues already determined based on the same conduct.[14] Identity of issues will not exist when the prior arbitration addressed different conduct or a different type of sanction. For example, the NASD's decision to not pursue disciplinary proceedings against an individual had no bearing on that broker's liability in an arbitration brought by an investor because the NASD did not consider in its disciplinary proceeding whether the broker's misconduct created financial liability to the investor.[15]

Issue Was Actually, Fully, and Vigorously Litigated in the Prior Proceeding:

Although the lack of a written record is not necessarily required to give a prior arbitration collateral estoppel effect, a record will make it easier to demonstrate that the issue was in fact fully and vigorously litigated in the prior proceeding. The "Full and Vigorous Litigation" requirement does not require impassioned rhetoric or extensive and intricate defensive maneuvers by the party to be estopped as a default judgment, in some circumstances, may support the application of collateral estoppel.[16] The court in *In re Bush* stated:

> Where a party has substantially participated in an action in which he had a full and fair opportunity to defend on the merits, but subsequently chooses not to do so, and even attempts to frustrate the effort to bring the action to judgment, it is not an abuse of discretion for a district court to apply the doctrine of collateral estoppel to prevent further litigation of the issues resolved by the default judgment in the prior action. Bush had ample warning from the prior court and could reasonably have foreseen the conclusive effect of his actions. In such a case, collateral estoppel

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[13] *Jacobson v. Fireman's Fund Ins. Co.*, 111 F.3d 261, 267-68 (2d Cir. 1997) (applying New York law); *Scurlock Oil Co. v. Smithwick*, 724 S.W.2d 1, 6 (Tex. 1986) (adopting RESTATEMENT (SECOND) OF JUDGMENTS § 13 and holding that "a judgment is final for the purposes of issue and claim preclusion 'despite the taking of an appeal unless what is called an appeal actually consists of a trial de novo'").

[14] *See Universal Am. Barge*, 946 F.2d at 1136 (applying collateral estoppel doctrine to preclude relitigation of liability and damages issues in indemnity suit based on prior arbitration brought by a different claimant); see also Dundon v. Komansky, 15 Fed. Appx. 27, 29-30 (2d Cir. 2001) (holding that investors were collaterally estopped from brining securities claims based on same conduct that was the subject of prior and unsuccessful arbitration).

[15] *Perpetual Secs., Inc. v. Tang*, 290 F.3d 132, 139 (2d Cir. 2002).

[16] *See In re Bush*, 62 F.3d 1319, 1325 (11th Cir. 1995).

> may apply to bar relitigation of the issues resolved by the default judgment.[17]

Under the federal rule, a default judgment ordinarily will not support the application of collateral estoppel because "in the case of a judgment entered by confession, consent, or default, none of the issues is [sic] actually litigated".[18] However, the court also noted authority to the contrary:

> Collateral estoppel applies only to those issues which were "actually" or "fully" litigated in the prior action. However, this rule does not refer to the quality or quantity of argument or evidence addressed to an issue. It requires only two things: first, that the issue has been effectively raised in the prior action, either in the pleadings or through development of the evidence and argument at trial or on motion; and second, that the losing party have had "a fair opportunity procedurally, substantively and evidentially" to contest the issue. The general rule therefore is that subject to these restrictions default judgments do constitute res judicata for purposes of both claim preclusion and issue preclusion (collateral estoppel).[19]

Issue was Necessarily Decided in the Prior Proceeding: Determining that the issue has, in fact, already been decided, may be more difficult in more complex disputes, as the panel in the prior arbitration may have several grounds on which to base its decision. Courts and commentators have noted that the lack of a written decision may make it more difficult to ascertain whether the issue was in fact decided.[20]

Application of Collateral Estoppel is not Inappropriate or Unfair: Collateral estoppel is at its core an equitable doctrine, and its application rests in the discretion of the authority in the subsequent proceeding.[21] This means that it is never certain that a court will grant collateral estoppel effect to a prior adjudication, even if all the elements are met. This uncertainty is more pronounced when the subsequent proceeding is another arbitration as arbitrators are not strictly charged with following the formal rules of evidence, but to apply generalized notions of fairness based on principles of materiality,

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[17] *Id.* (footnote omitted).

[18] *Id.* at 1323.

[19] *Id.* (quoting *Overseas Motors, Inc. v. Import Motors, Ltd.*, 375 F.Supp. 499, 516 (E.D. Mich. 1974)).

[20] *See Universial Am. Barge*, 946 F.2d at 1137 (stating that the court's decision whether to give preclusive effect to arbitral findings "keeps the risk of prejudice at an acceptable level, at least when the arbitral proceedings state issues clearly, *and the arbitrators set out and explain their findings in a detailed written memorandum*") (emphasis added); *Friedman*, 55 FORDHAM L. REV. at 672 (stating that because arbitrators are typically not required to make written findings of fact or state the basis of their decisions, the procedural adequacy of the arbitral process may be called into question).

[21] *United States v. Kaytso*, 868 F.2d 1020, 1022 (9th Cir. 1989) (noting that "even when the elements of collateral estoppel are present, the decision whether to apply the doctrine is within the [court's] discretion").

relevance, and privilege.[22]

Further, arbitrators are not strictly charged with following the substantive law. Substantive appellate review of arbitration is extremely deferential, allowing the reversal of an award only where there was "manifest disregard of the law" by the arbitrators. Thus, an arbitrator's refusal to give preclusive effect to a prior arbitration, like most other decisions he makes, is likely to be unreviewable. In any event, it is unlikely that an arbitrator in a subsequent proceeding will be *required* to give preclusive effect to a decision in a prior arbitration.[23]

Several courts have given collateral estoppel effect to arbitral decisions. Most Recently, in *Manion v. Nagin*, the plaintiff was collaterally estopped from asserting certain claims against individual members of an association based on adverse fact findings in his arbitration against the association itself.[24] Manion was fired as executive director of Boat Dealers' Alliance ("BDA") and sued for wrongful termination and improper conversion of his stock in BDA.[25] The court referred Manion's claims to

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[22] *See, e.g.*, NASD CODE OF ARBITRATION PROCEDURE § 10323 ("The arbitrators shall determine the materiality and relevance of any evidence proffered and *shall not be bound by rules governing the admissibility of evidence*.") (emphasis added); NEW YORK STOCK EXCHANGE ARBITRATION RULE 620 ("The arbitrators shall determine the materiality and relevance of any evidence proffered and *shall not be bound by rules governing the admissibility of evidence*.") (emphasis added); AMERICAN ARBITRATION ASSOCIATION, *Commercial Arbitration Rules*, R-31 ("The parties may offer such evidence as is relevant and material to the dispute and shall produce such evidence as the arbitrator may deem necessary to an understanding and determination of the dispute. *Conformity to legal rules of evidence shall not be necessary* . . . . The arbitrator shall take into account applicable *principles* of legal privilege, such as those involving the confidentiality of communications between a lawyer and client.") (emphasis added).

But see Beth H. Friedman, *The Preclusive Effect of Arbitral Determinations in Subsequent Federal Securities Litigation*, 55 FORDHAM L. REV. 655, 672-73 (1987) ("The question of the procedural adequacy of the arbitral process, however, remains relevant to the question of whether the arbitration can sufficiently safeguard the federal litigants' statutory rights under Rule 10b-5 and thereby carry preclusive weight in a judicial forum. Securities arbitrators are not bound by formal rules of evidence. While an arbitration panel has the power to subpoena documents or witnesses, the parties to the arbitration lack the advantage of discovery. Arbitrators need not make written findings of fact nor state the reasons underlying their decision. Finally, judicial review of arbitration awards is extremely limited. An arbitration conducted under these limitations, therefore, may not fully guarantee that the parties' federal securities claims are adequately protected.") (footnotes omitted).

[23] *See Int'l Union UAW v. Dana Corp.*, 278 F.3d 548, 555-56 (6th Cir. 2002) (holding that arbitrator was not bound to interpretation of collective bargaining agreement clause of prior arbitrator and stating that "the best approach is to refrain, as a general rule, from requiring an arbitrator to give res judicata, collateral estoppel, or other preclusive effect to decisions in earlier arbitrations"); *R.M. Perez & Assocs. v. Welch*, 960 F.2d 534, 540 (5th Cir. 1992) (holding that arbitrator did not manifestly disregard the doctrine of collateral estoppel); *see also, e.g., Brotherhood of Maintenance of Way Employees v. Burlington N. R.R.*, 24 F.3d 937, 940 (7th Cir. 1994) (noting that the preclusive effect of a prior arbitration is a matter to be determined by the arbitrator in the subsequent proceeding); *Gen Comm'n of Adjustment v. CSX R.R. Corp.,* 893 F.2d 584, 593, n.10 (3d Cir. 1990) (same).

[24] 2004 U.S. App. LEXIS 26100 (8th Cir. Dec. 16, 2004).

[25] *Id.* at *3. Manion's wife was also terminated. They sued the BDA and individual members, alleging tortuous interference with contract, conversion, securities fraud, breach of fiduciary duty, unjust enrichment, tortuous interference with prospective business relationships, and conspiracy. Id.

arbitration pursuant to his employment contract, and, following a lengthy hearing and compilation of a voluminous record, the arbitrator released a 31-page decision and interim award that included specific findings of fact that BDA was legally justified in terminating Manion because of at least three instances of bad faith on his part and that Manion had no valid conversion claim as to his BDA stock.[26] The final award incorporated the interim award and its findings of fact, and after accounting for past due wages, dividends, Minion's overpayments to himself, and attorney fees, determined that Minion owed BDA over $250,000.[27] The Eighth Circuit held that Minion was collaterally estopped from pursuing claims against individual BDA members based on the fact findings of the arbitration: claims for tortuous interference with contract could not be sustained given the arbitrator's decision that BDA did not breach the employment contract, and claims for securities fraud and conversion fell because of the arbitrator's finding that Minion still held title to his 90 shares of stock.[28]

Similarly, in *Coffey v. Dean Witter Reynolds, Inc.*, after the claimant's state law securities claims were severed from her federal suit she re-filed them in state court only to have them referred to arbitration.[29] Later, her federal claims were also referred to the same arbitration panel as her state law claims.[30] The arbitration panel rejected her state law claims and also found for Dean Witter on her federal claim, and state and federal courts confirmed the award and dismissed her federal claims.[31] The federal court's confirmation was reversed because the federal claims should not have been referred to arbitration, and remanded for further proceedings.[32] Following remand, the district court found that the arbitration panel's dismissal of Coffey's state law claims collaterally estopped her federal claims.[33] The Tenth Circuit affirmed, finding that the same fact issues supported the state and federal securities claims; thus, collateral estoppel prevented her from having a second chance to prove the

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[26] *Id.* at *3-5.

[27] *Id.* at *7.

[28] *Id.* at *16. The court also found that the breach of fiduciary claim was barred by collateral estoppel because it relied on the same basis as the tortuous interference with contract, conversion, and securities fraud claims. *Id.* The court held that the tortuous interference with prospective business relationship was unduly vague and that the conspiracy claims was unsupported by an underlying tort. *Id.* at *16-17.

[29] 961 F.2d 922, 923 (10th Cir. 1992).

[30] *Id.*

[31] *Id.* at 924.

[32] *Id.*

[33] *Id.* at 924-25.

same fact issues.[34]

In *Universal American Barge Corp. v. J-Chem Inc.*, the Fifth Circuit held that the prior arbitration had preclusive effect in a subsequent indemnity suit.[35] Following a fire aboard a cargo ship, an arbitration determined that Universal breached several duties, the fire was caused by J-Chem's improper application of insecticide, and that Universal was liable for cargo damage totaling $3.8 million.[36] Based on this arbitration, Universal obtained summary judgment against J-Chem, precluding re-litigation of J-Chem's fault in causing the fire.[37] The Fifth Circuit held that J-Chem had been properly "vouched-in" to the arbitration and could be collaterally estopped from re-litigating the total amount of damages and the cause-in0fact of the fire; however, other issues of fault, the duty to indemnify, and damages apportionment were not precluded because they had not been fully and fairly litigated".[38]

Conclusion

The benefits of arbitration include quicker resolution of disputes through less formal procedures. The disadvantages of arbitration include the lack of meaningful substantive appellate review, apparent inconsistencies, and the lack of any real precedent binding upon the panel members.[39] Giving issues decided in one arbitration preclusive effect in subsequent proceedings involving that same party enhance the benefits of arbitration, particularly when the subsequent proceeding is another arbitration, while minimizing the disadvantages — summary disposition of issues already fairly decided by this same process also provides a sort of "law of the case" for subsequent

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[34] *Id*. at 925-27.

[35] 946 F.2d 1131 (5th Cir. 1991).

[36] *Id*. at 1135. J-Chem declined to be part of the arbitration; Universal sued J-Chem for indemnity during the pendency of the arbitration. *Id*.

[37] Id. at 1136.

[38] Id. at 1142-43.

[39] One commentator has stated:

> Referee trials, however, graft the private aspects of arbitration onto the public aspects of judicial proceedings. A referee's decision has all the authority of a judicial determination but is made within the private context normally associated with arbitration. Lacking the judge's ultimate responsibility to the public, the referee is interested only in solving the problem before him in order to maximize the satisfaction of the litigants who hired him. Whereas rulemaking has to be a dynamic and forward-looking part of the ongoing creation of substantive law for the guidance of society, problem solving is entirely static. A problem-solving approach to litigation involves an application of the existing rules but does not contribute to the advance of legal doctrine. Any significant shift of litigation to reference trials would adversely affect society as cases that would have been part of an important development in the law are decided through a mechanical application of principles that may not reflect current legal developments.

Note, The *California Rent-A-Judge Experiment: Constitutional and Policy Considerations of Pay-As-You-Go Courts*, 94 HARV. L. REV. 1592, 1612 (1981) (footnotes omitted).

proceedings involving the same or similar conduct by or on behalf of the same principal.

Expert's Corner: Optimal Exercise of Employee Stock Options and Securities Arbitrations

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We have previously shown that advice to hold shares acquired from the exercise of employee stock options for one year in order to achieve long term capital gains treatment is almost always unsuitable for large, concentrated positions.[1] In this paper, we extend our previous analysis of employee stock options and show that advice to hold unexercised options can be equally unsuitable.

1. Introduction

The failed *exercise and hold* investment strategy has spawned widespread litigation and regulatory action.[2] Under the exercise and hold strategy, employees were encouraged to exercise their employee stock options and hold the acquired shares for one year to achieve long term capital gains treatment, often exposing the employee to extraordinarily high levels of concentration risk. In many cases the employees were exposed to leverage risk as well, either because they borrowed to exercise the options or because taxes associated with exercise of the options were to be paid later. As might be expected in light of the high levels of risk, many of these individuals suffered severe economic losses.

Most of these exercise and hold cases involve erroneous tax analysis and sometimes the tax benefits of the strategy were completely illusory. When a genuine tax advantage did exist, it was typically inadequate to justify the extraordinarily high level of risk. In short, the strategy was almost always indefensible. The damages sought have typically been the amount by which the acquired shares declined after the exercise while they were being held to achieve long term capital gains treatment – perhaps adjusted for general market declines or for the losses which could not have been avoided by some form of hedging strategy.

While most employee stock option securities arbitrations have focused on the loss in value of acquired shares that were being held for preferential tax treatment, cases involving the loss in value of vested but unexercised options are also being litigated. Unexercised employee stock options sometimes attain great value and these options may represent almost all of the employee's wealth. Although the employee did not make an out-of-pocket cash payment to acquire the stock options, but instead earned them through labor market transactions, the options are wealth that must be managed with as much care as any other valuable investment

[1] *See* Craig McCann and Dengpan Luo "The Suitability of Exercise and Hold," *Securities Arbitration 2002 Handbook,* PLI, available at www.slcg.com.

[2] See "Outrage is Rising as Options Turn to Dust" *The New York Times*, March 31, 2002. Also, http://www.dfi.wa.gov/sd/orders/S-02-030-03-SC001.pdf.

assets. Failure to manage investment risk with respect to this option wealth is an error no less egregious than failure to diversify a concentrated stock position.

The issues presented in *un-exercise* and hold cases are similar to the issues involved in exercise and hold cases. Unexercised options can expose the holder to concentration risk and leverage risk. The value of unexercised options rises and falls with the employer's stock price. If the employer's stock price drops significantly more than the broad stock market, the loss in stock option value from not exercising vested options and diversifying can be substantial.

The problem faced by an option holder is similar to the problem of an investor holding a concentrated stock position, but with important differences. Employees can exercise options and sell the shares, but generally cannot sell the options. Also, the tax considerations in continuing to hold a stock option are more complex than for the decision to continue to hold shares of stock.

2. Exchange Traded Call Options

Employee stock options are similar to exchange traded call options in their main economic features. Call options give investors the right to buy stock at a predetermined price in the future.[3] The difference between the underlying stock's current price and the strike price of the option is referred to as the *intrinsic value* of the option or, in connection with employee stock options, the *bargain element*. For instance, the intrinsic value of an option with a strike price of $20 when the stock is selling for $50 is $30. We can think of intrinsic value as a measure of the profit the option holder would secure if she exercised the option and sold the shares at the price at which the stock is currently trading.

Exchange traded stock options typically sell for more than their intrinsic value. In fact, options which are out of the money, that is options with strike prices greater than the current stock price, sell at positive prices. The difference between the market value of an option and its intrinsic value is the option's *time value*. Unless the option is about to expire, time value is a positive number. This means the price at which the exchange traded option can be sold (intrinsic value plus time value) is greater than the profit that can be secured by exercising the option and selling the stock (intrinsic value alone). Accordingly, it is virtually never optimal to exercise exchange traded options before expiration.[4] If an investor no longer wants to hold the option she can realize more by selling the option than she can by exercising it.

Time value has two components. The option holder can defer paying the strike price into the future. For example, the owner of an option to buy stock currently worth $50 at any time in the next year for $20 could exercise the option today paying $20 or could earn the risk free rate of return for 1 year and then pay $20. Either way the investor has the stock in one year but the investor who deferred exercise pays $20 in future dollars rather than $20 in current dollars. This component of time value is essentially equal to the value of receiving an interest-free loan of the exercise price of the option, adjusted for the probability that the option will in fact be exercised. The time value of an option also reflects the fact that by not exercising the option the investor can avoid having paid $20 for stock that later –

[3] Most exchange traded call options can be exercised at any time before they expire. Options which can be exercised prior to expiration are called "American" options. Options that can be exercised only at the end of the option term are called "European." These terms are historical rather than geographically accurate, as both styles of options can be found on both continents.

[4] An exception to this general rule occurs when the stock is about to pay a dividend that exceeds the remaining time value of the option. In this situation the optimal strategy is to exercise the option in time to capture the dividend. Normally this situation occurs, if at all, only very close to the expiration date of the option.

but before expiration – turns out to be worth less than $20. In other words, the option holder is protected against the loss she would suffer as a shareholder if the stock price is below the exercise price of the option on the expiration date of the option.

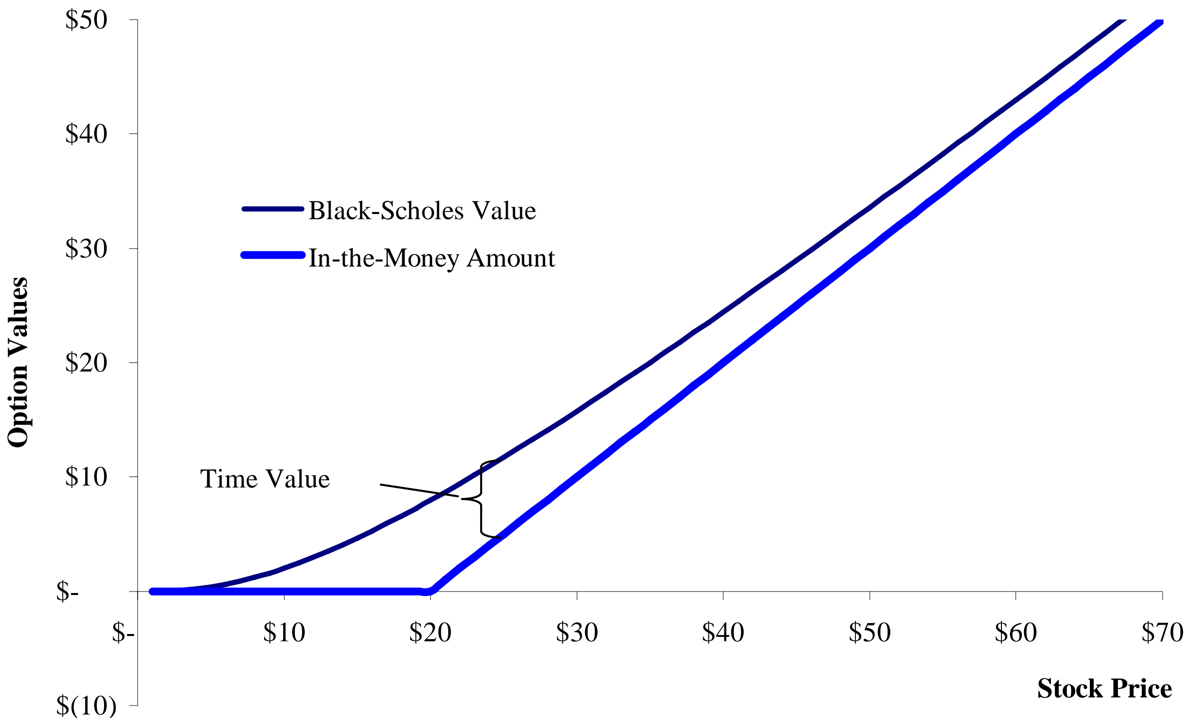
Other things equal, an option's time value is lower the more the underlying stock's price rises above the exercise price of the option. *See* Figure 1. The upper line in the chart is the Black-Scholes value of a stock option with a $20 strike price for various values of the underlying stock. The lower line is the amount the option is in the money. The distance between these two lines is the time value of the option.[5]

3. Employee Stock Options

Public companies frequently grant their employees options to buy company stock in the future at a *strike price* equal to the company stock price on the day the options are granted. The options cannot be exercised until they *vest*, usually after three or four years, and expire if they are unexercised after a stated period, which is often ten years.

Employee stock options are worth less than the value they would have as exchange traded options because they can't be sold and must be exercised while the holder is an employee. Employees forfeit the options if the employees separate from their employers before the options vest or while vested options are underwater. Employees also exercise earlier than would be optimal

Figure 1
Black-Scholes Option Values Always Exceed Option's In-the-Money Amount



[5] The chart is a snapshot of values the option can have at a particular time if we make different assumptions about the stock price at that time, rather than an indication of the values the option can have over a period of time.

because of liquidity needs. Models used to value exchange traded options can be easily adapted to value employee stock options. The two most common models for valuing options are the Black-Scholes and the binomial options pricing models.[6] Both can be adapted to deal with the lack of transferability/marketability of employee stock options.

It is not unusual to see employee stock options that are deep in the money after only a small fraction of that ten-year period has elapsed. A deep in the money option is economically similar to owning outright the number of shares that would result from a "sell to cover" strategy, where the employee exercises the option and sells enough shares to cover the exercise price and the tax liability.

Employees who exercise stock options are usually able to sell the shares at the same time or shortly thereafter. Employees who sell the shares receive cash proceeds they can invest in a diversified portfolio. Those who hold most or all of the shares after exercising options (the exercise and hold strategy) are usually exposed to a much higher level of investment risk.

The level of risk depends partly on the *volatility* of the employer's stock, in other words, its tendency to move up and down rapidly. Equally important is the overall level of diversification in the employee's portfolio. If someone acquires $100,000 worth of her company's stock, we need to know what other investments she holds before we can determine her level of *concentration risk*. If her other assets consist of $1.9 million worth of stocks in a well diversified portfolio, the company stock represents only 5% of her assets and exposes her to little concentration risk. If she has no other assets, or if her other assets are not well diversified, concentration risk is an important issue that should be addressed promptly.

Other things being equal, investors in general prefer investments that expose them to less risk. As a result, riskier investments generally offer a higher expected rate of return to compensate the investor for the added risk. The stock market places no value on risk that can be eliminated through diversification, however. The added risk associated with holding a concentrated position in a single stock is not associated with a higher expected rate of return. In other words, concentration risk is *uncompensated* risk. When an investor fails to diversify, she misses an opportunity to reduce risk without reducing her expected rate of return, or to increase her expected rate of return without increasing risk. Either way, she is leaving money on the table. The elimination of uncompensated risk is one of the most important principles of portfolio management.

Investors who take uncompensated risk, while keeping their overall level of risk within reasonable levels, are likely to have poor investment performance but unlikely to suffer extreme losses. The main problem with both the exercise and hold and the un-exercise and hold strategy is that they often expose investors to an unduly high overall magnitude of investment risk.

There is no accepted formula for determining the appropriate level of investment risk. Two pieces of advice are fairly standard, however. First, as indicated above, stock investments should be broadly diversified. Second, most investors should keep their risk exposure below the level represented by 100% exposure to the stock market by investing in more conservative investments such as investment grade bonds. Based on these

[6] An early discussion of the application of these models to valuing employee stock options can be found in Craig J. McCann, "How (and Why) Companies Should Value Their Employee Stock Options," *Journal of Applied Corporate Finance,* vol. 7, no. 2 Summer 1994 pp. 91-99. The latest in valuing employee stock options can be found at John Hull and Alan White, "How to Value Employee Stock Options" *Financial Analysts Journal*, January/February 2004, p. 114.

principles, it is fair to suggest that the risk level associated with the overall stock market (which is equivalent to a well diversified portfolio invested 100% in stocks) represents a high level of risk.

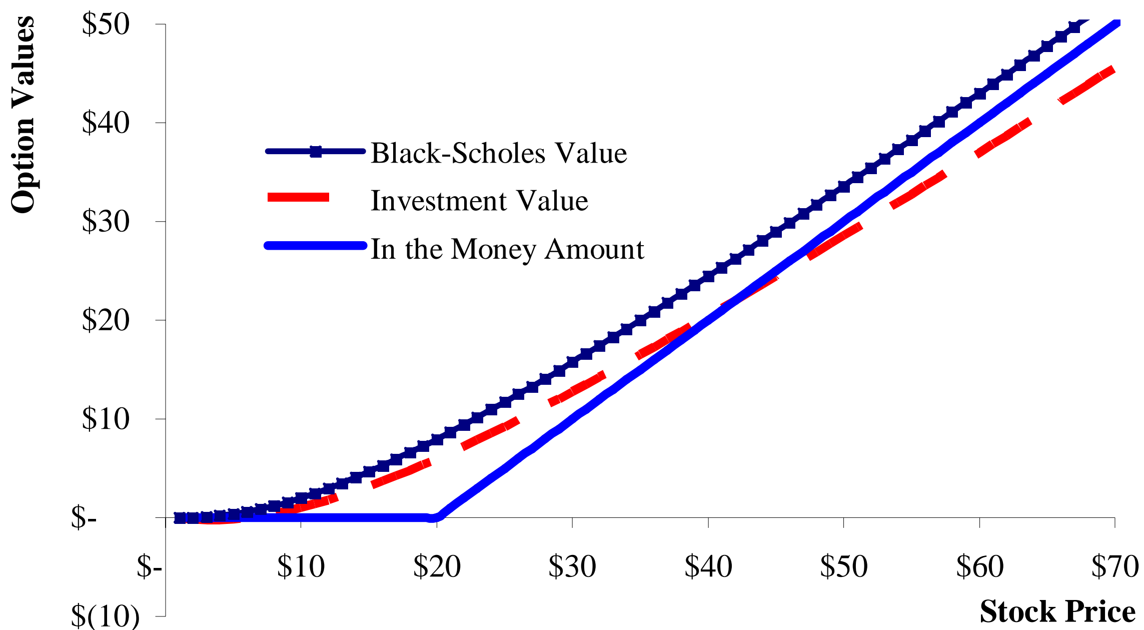
Seen in this light, the benefits of diversification become obvious. An employee holding deep in the money options typically has a substantial amount of wealth in the form of a leveraged investment in a concentrated position that exposes her to an unsuitable level of risk. If she could, the correct course of action would clearly be to sell the option for its full value and use the net proceeds to make more suitable investments. That course of action is generally not available for employee stock options, so the employee must consider an alternative. By exercising the option and selling the stock, the employee can eliminate the uncompensated risk associated with the concentrated position, often at a cost that is smaller than the cost of hedging that loss for a single year (e.g. the purchase price of put options for that period).

The cost of diversification is the abandonment of the option's remaining time value. If the employee stock option is deep in the money, the cost of abandoning the remaining time value of the option is relatively small, even if the option will not expire for several more years. Unless the employee holds other investable wealth large enough to diversify away much of the risk inherent in the option, the benefit of liquidating the option and reinvesting the proceeds is far greater than the cost of abandoning the time value of the option.

4. Optimal Exercise

Optimal exercise balances the benefits of diversification against the destruction in remaining option value. The tradeoff is pictured in Figure 2. The line labeled "Investment Value" is the Black-Scholes value of the option reduced by a penalty for the lack of diversification. The option's Investment Value is its value to the employee as a continuing investment. If the Investment Value is less than the Intrinsic

Figure 2
Optimal Exercise As A Function of Current Stock Prices



Value the option should be exercised. If the Investment Value is greater than the Intrinsic Value (i.e. the net proceeds which can be realized from exercising the option) the option should be held unexercised.

If the options are a small part of the employee's wealth – wealth that is itself well diversified – the Investment Value will be quite close to the Black-Scholes value and early exercise will seldom be optimal. On the other hand, if the options are a significant fraction of the employee's wealth, the Investment Value line can move below the amount the option is in the money. In other words, the value of the option as a continuing investment is less than the profit that can be secured by exercising the option and selling the shares. When this happens, the employee should exercise the options.[7]

At one extreme then, if an option is deep in the money and represents a significant fraction of the employee's wealth, the option should be exercised early and the acquired shares sold. At the other extreme, options which are at or near-the-money and with considerable time left to expiration should not be exercised since the option value significantly exceeds the value of the diversified portfolio which can be purchased with the net benefit from exercising the option. At some intermediate stock price, prudent investors are indifferent between exercising the NQSOs and holding the unexercised options. The precise determination of this threshold price is beyond the scope of this paper as most *un-exercise* and hold cases will involve options which were left unexercised even though they were deep in the money and represented a large fraction of the employee's wealth.

5. Taxes

Early exercise of stock options has an additional cost because the employee must pay the income tax associated with the exercise and this payment could have been deferred by delaying the exercise. The benefit is much smaller though than commonly believed, and far too small to justify exposure to extraordinarily high levels of risk.

Tax deferral is often described as a benefit equivalent to receiving an interest-free loan. Yet careful analysis of the tax consequences faced by an option holder reveals that deferral in this situation is not equivalent to an interest-free loan. We can illustrate this point with a simplified example where the option is so deep in the money that the exercise price is effectively equal to zero. We use an assumed income tax rate (combined federal and state) of 40%. If the employee exercises the stock option for $100,000 worth of stock now, she will pay $40,000 in tax and secure only $60,000 of investable proceeds. Is she better off postponing the exercise of the option, so that she has the full $100,000 working for her?

Consider what happens if she holds the option long enough for the stock price to double. The amount she can realize by exercising the option at that point is $200,000, but the tax is $80,000. She has net proceeds of $120,000, which is the same amount she would have if she exercised the option earlier and obtained the same investment performance (a 100% increase) from investment of the $60,000 proceeds. In other words, if we assume that the return to a diversified investment is the same as to the single stock, she did not keep the entire $100,000 working for her; 40% of that amount was working for the government, even though the tax would not be due until she

[7] Employees' wealth, fully considered, often includes a lot of risk associated with their employer or their employers' industries. While some senior executives may have significant investment portfolios we find that rank and file employees with substantial wealth as a result of employee stock options typically have few other investments. If employees exercise options on margin and hold the acquired shares and/or generate future tax liabilities, their employers' stock can often be more than 100% of the employees' net invested assets. For present purposes we consider only thickly traded securities and employee stock options but could also include as wealth thinly traded assets like real estate and illiquid assets such as human capital.

exercised the option.

In our example above, postponing the exercise of the option permits her to secure $120,000 after payment of all income tax. If she exercised the option earlier and achieved the same pre-tax investment performance, she would potentially owe tax on the $60,000 of growth in the value of her investment during the period after the exercise of the stock option. Postponing the exercise of the stock option produces a tax benefit equivalent to the opportunity to invest the net after-tax proceeds tax-free. This is true for both nonqualified stock options and incentive stock options ("ISOs"); the difference is in the amount of after-tax proceeds (due to potential tax benefits from ISOs) rather than the nature of the benefit of deferring the exercise of the option.

Tax-free investing over a long period of time, as in a Roth IRA, can significantly enhance the owner's wealth. Yet the difference in rates of return is not great enough to justify the extraordinary level of risk associated with a heavy concentration in a single stock. In a taxable investment account, it is generally possible to postpone indefinitely income tax on much of the growth in the form of unrealized capital gains. Realized gains may be offset with realized losses, and gains that are not offset are subject to a low rate of tax if the assets have been held more than a year.[8] Capital gains on assets held at death escape income taxation altogether. The low effective rate of tax on investment earnings diminishes the value of an opportunity to invest tax free.

Using crude but realistic estimates, we might assign a pre-tax expected return of 10% to stock investments in general and assume an effective federal income tax rate of 15% on investment income produced by stock investments. In this case, the performance benefit of the deep-in-the-money stock option over a diversified investment that performs the same as the stock underlying the option would be the difference between 10% and 8.5%, the after-tax return of the two investments. Compounded over many years, a difference of this magnitude would be of significant benefit to an investor. Yet the magnitude of the advantage in expected return is not nearly great enough to justify the risk associated with a concentrated position. Investors routinely give up as much as 400 basis points of expected return in exchange for the much smaller risk reduction associated with moving investments out of stocks and into bonds. They can much more easily afford to give up 150 basis points of expected return to achieve a far greater reduction in risk as they move from a concentrated stock position to a diversified portfolio.

6. Taxes and the Exercise and Hold Strategy Revisited

Individuals who hold shares after exercising employee stock options are often highly concentrated in the employer's stock. Apart from these shares, they may have additional exposure through unexercised options or stock held in other accounts, including retirement accounts.[9] Even without such additional exposure, the level of risk they experience may be more than double the risk of the overall stock market. This risk may be further magnified by leverage if the individual borrowed to exercise the option or has an unpaid tax obligation as a result of the option exercise. These numbers translate into the potential for huge losses. An investment in the overall stock market would rarely lose more than 30% of its value in a single year. Many individuals using the exercise and hold strategy for large stock option profits have lost 60% of their wealth in a year,

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[8] Qualified dividend income is now also subject to the lower rates that apply to long-term capital gains.

[9] While we do not address the issue here, it is worth noting that employees have further indirect exposure to stock risk as a result of working for the company, because events adversely affecting the company's stock may also adversely affect the company's compensation arrangements or decisions to reduce workforce size.

with even greater losses not uncommon.

These losses spring from a strategy that entails extraordinarily high risk without promising higher than average investment returns. Ignoring taxes, the strategy is plainly unwise from an investment point of view. The question then is whether tax considerations provided a justification for the strategy.

The tax treatment of NQSOs is simple. An employee who receives NQSOs does not recognize any income until the options are exercised. When the options are exercised, the difference between the value of the shares acquired and the exercise cost is taxed as ordinary income and the tax basis for the acquired shares is set to the current value of the acquired shares. As a result, the employee can sell the shares without incurring any additional tax cost, using the proceeds to eliminate any leverage incurred in the exercise of the option and make investments that do not entail high levels of uncompensated risk. Apart from transaction costs, which are usually trivial in relation to the benefit of risk reduction, there is no reason for the employee to hold shares after exercising a nonqualified stock option.

Perversely, some financial advisors have recommended that employees exercise NQSOs early and hold the acquired shares for one year to convert more of the anticipated increase in the stock value from intrinsic value at the time of the exercise which will be taxed at current income tax rates into capital gains which will be taxed at the lower, long term capital gains rates. This strategy not only unnecessarily exposes the employee to uncompensated risk, it destroys significant option value as the options are exercised prematurely.

In contrast with NQSOs, incentive stock options provide the potential for a genuine tax advantage if shares are held after exercise of the option. If the employee holds shares long enough to satisfy a special holding period (usually one year[10]), the option profit is converted from ordinary income, taxed at rates up to 35%, to long-term capital gain, taxed at a maximum rate of 15%. This rate conversion can significantly boost the after-tax expected return from holding the shares for the required period. The strategy of holding at least some of the shares is not so clearly flawed that it should be rejected out of hand. Yet many employees have suffered severe losses as they pursued this strategy to excess. The errors that led to these financial disasters stemmed from a failure to appreciate the lofty risk levels and, here again, faulty tax analysis.

Cases involving the exercise and hold strategy for ISOs often involve even more risk than NQSO cases. The reason is that there is no income tax withholding upon exercise of an ISO, even though tax liability under the alternative minimum tax (AMT) can be substantial. Employees who exercise NQSOs often sell enough shares to cover the income tax withholding. If they borrow to cover the withholding, they are likely to encounter a margin call. The forced sale may come as an unwelcome surprise, but may prevent an even greater disaster as the stock continues to decline. Employees who exercise ISOs can postpone the tax payment until the following April. They do not have to sell shares to meet a withholding requirement, so they may decide to hold all the shares. Once the AMT liability from exercising the option becomes fixed, this unpaid tax represents hidden leverage. There will not be a margin call when the stock price declines. As a result, employees have been known to hold shares until the value fell below the amount needed to pay the tax liability, exposing the employees' other assets to the tender mercies of IRS collection agents. Advisors assisting these employees should have alerted the employees to the excessive level of risk and

[10] The employee must also hold shares until at least two years after the date the option was granted. This requirement is moot in the usual situation where the employee exercises the option more than a year after the grant date.

urged them to sell some or all of the shares.

These losses are all the more lamentable because they are based in part on faulty tax analysis. When the bargain element of an incentive stock option is large relative to other income, the tax benefit of holding stock extends to only a portion of the shares. An employee who holds additional shares incurs greater risk without the possibility of an increased tax benefit. Under the tax rates in effect before 2001, many employees could have sold as many as 40% of the shares obtained upon exercise of an ISO immediately upon exercise of the option without forgoing any tax savings.[11] In addition, many of these employees (and their advisors) overlooked an opportunity to reduce their tax exposure through a disqualifying disposition late in the year of exercise.[12] In short, even assuming it made sense to take whatever risk was necessary to attain the maximum tax benefit available from the exercise and hold strategy, these employees took *far more* risk, without any possibility of attaining additional tax benefits.

7. Conclusion

Employees holding highly appreciated stock options are exposed to extraordinarily high levels of investment risk except when they also hold enough other investable assets to provide adequate diversification. Inevitably, many of those who were exposed to these high levels of risk suffered grievous losses. The strategy of holding deep in the money stock options leading to these losses was not justified by stock option economics or the benefit of tax deferral.

[11] Under current (2004) tax rates, the tax benefit of *exercise and hold* may extend to only 35% of the shares acquired upon exercise of an ISO.

[12] AMT liability does not become fixed until December 31 of the year of exercise.

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Expert's Corner: After The Ball Is Over: Investor Remedies In The Wake Of The Dot-Com Crash And Recent Corporate Scandals

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The technology and telecommunications boom made fools of all of us. From the corporate executives who promised results that in hindsight seem absurd to the ordinary day traders…all were overcome with a complex mixture of credulity, jealousy, vanity, and greed. In between were the enablers -- the regulators, bankers, analysts, consultants, accountants, lawyers, credit agencies and journalists who could have done something to stop the madness, but did nothing until way too late.[1]

1. The Bursting Bubble

As the millennium approached about half the households in America owned stock[2] and many of them had substantial savings and retirement funds invested either directly or indirectly in the equity markets.[3] Some of those investors had experienced phenomenal gains during the run-up of share prices during the late 1990s, while others were only just getting into the market, enticed by the rapid stock appreciation that looked like it would never end.[4]

But beginning in April, 2000 came a swift downturn that left investors reeling. The Dow would eventually lose almost one third of its value, and the high flying NASDAQ index would crash unbelievably worse, tumbling from over 5,000 to just about 1100. It left shareholders in the tech companies traded there with, on average, only about 20% of the value they had several years earlier.[5]

At first the bursting bubble just seemed like another chapter of the manic-depressive cycle of stock rading, [6] a long-overdue correction for all the "irrational

[1] Jonathan A. Knee, *House of Gas*, N.Y. Times, Oct. 26, 2003 (Book Review at 14).

[2] Andrew Leckey, *Damage Claims Rising Among Hard-Hit Investors*, Mil. J. Sentinel, Mar. 13, 2003, http://www.jsonline.com/bym/invest/mar03/125085.asp

[3] Richard Dooling, *A Fraud by Any Other Name,* N.Y. Times, May 4, 2003, Sec. 4 at 13.

[4] Ruth Simon, *With Wall Street on the Defensive, Claims Against Brokers Surge,* Wall St. J., May 27, 2003, at 1.

For a confessional tale by a prominent mathematician who suffered substantial losses during this period because of his hapless investment in Worldcom stock *see* John Allen Paulos, A Mathematician Plays the Stock Market (2003).

[5] For an in depth analysis of the performance of the Dow Jones index *see* Dow Jones Index - Industrial Averages, http://www.djindexes.com/jsp/avgStatistics.jsp For similar information on the NASDAQ *see* http://www.nasdaqnews.com/dynamic/stats.asp

[6] "I can't think of a previous boom period, whether it was the 20s, the 60s or the 80s, where it hasn't ended up a bloody mess, with declining asset values and cases of fraud" Kurt Eichenwald, *After a*

exuberance"[7] that led purchasers to bid the price of stocks in unproven companies to exorbitant heights. But then commentators began to focus more intensely on what had driven the speculative surge of the late 90s and the groups that had engineered and rofited from it. Under that analysis, it seemed that ordinary investors had been the victims of a pervasive "pump and down" sting that took $6 trillion of the wealth they had placed in the capital markets and transferred it to corporate and securities-industry insiders.[8]

That devastating indictment, however, provoked a contrary explanation premised on W.C. Field's famous insight that you can't cheat an honest man.[9] According to that theory, greedy investors had no one to blame but themselves by expecting astronomical returns and had gotten their just deserts for failing to exercise the ordinary prudence required when entrusting money to high-risk ventures.[10]

2. A String of Corporate Scandals

Boom, There Will Be Scandal, Count on It, N.Y. Times, Dec. 16, 2002 *quoting* Charles R. Geist, a Wall Street historian and author of Wheels of Fortune, a history of the futures markets.

The stock market's surge in late 2003 made some feel that things had never changed. As one commentator wrote:

At times it felt as if the bubble of the 1990s had never burst and investors had not learned the lessons the collapse was supposed to have imparted. Once again, investment bankers were peddling unproven stocks and brokers and their clients were panting to get a crack at quick profits. Patrick McGeehan, *What Bubble? Wall Street's Fever Spikes Again*, N.Y. Times, Dec. 14, 2003, Sec. 4 at 2.

[7] The famous phrase, of course, comes from a speech by Federal Reserve Chairman Alan Greenspan in December, 1996. Among other things it provided the title of a fine book on the boom years by Robert Shiller, Irrational Exuberance (2000). *See also supra* note 1 and accompanying text.

[8] Simon, *supra* note 4. *See also* James Surowiecki,, *The Financial Page, In Wall Street We Trust*, *The New Yorker,* May 26, 2003, at 40.

Public filings have disclosed large-scale selling by corporate insiders and early-stage investors in technology stocks in the months immediately before the NASDAQ crash. Mark Maremont, Terzah Ewing, and Laura Saunders Egodigwe, *First in Line: Founding Investors and Insiders Unload Tech Shares Before Fall,* Wall St. J., Apr. 19, 2000.

A follow-up story told of a "$100 million club," an elite group of at least 50 insiders at NASDAQ companies who collected immense fortunes in such sales. As one commentator described the phenomenon: "It amounts to a huge transfer of wealth from ordinary investors to those on the inside…the little old lady in Dubuque, Iowa with the mutual fund in tech stocks is financing the Internet entrepreneur's mansion on the Pacific Palisades," Mark Maremont and John Hechinger, *If Only You Had Sold Some Stocks Earlier*, Wall St. J., Mar. 22, 2001 *quoting* William Braman, chief investment officer at John Hancock Funds in Boston.

[9] The movie of that title was released in 1939 starring Fields as the quick-witted, mean-spirited degenerate drunk Larson E. Whipsnade. http://us.imdb.com/title/ttoo32152/

[10] *See supra* note 1 and accompanying text. *See also* Paulos, *supra* note 4.

See also Stan O'Neal, *Risky Business*, Wall St. J., Apr. 24, 2003, at A16 where the CEO of Merrill Lynch, Inc. discussed the need for investors to accept the risks inherent in our economic system.

Then in the fall of 2001 came revelations of an unprecedented string of corporate and accounting malfeasance that had fraudulently fueled the market boom. It began with the disclosure that Enron had manipulated its profits by improperly hiding debt in off-book partnerships at the same time that it was manipulating the California and Texas energy markets.[11]

By the end of 2002 over two dozen large public companies admitted inflating their revenue by improper accounting practices,[12] while many of their top executives like Dennis Koslowski of Tyco,[13] lived opulent life-styles at their shareholders' expense. Such chicanery was facilitated by the firms' outside accountants like Arthur Andersen who shredded documents when the SEC began investigating their auditing of Enron.[14]

As these shenanigans were exposed, it became increasingly more apparent that they were condoned by captive boards of directors[15] and abetted by the deregulation of two sectors that had led the spiking market, telecommunications and finance.[16] The recent resignation of NYSE chairman Richard Grasso reinforced outrage about such lax oversight when it came to light that the big boards' directors had only a vague understanding how the lush compensation package they had unwittingly handed Grasso might compromise the man charged with policing their industry's trading practices.[17]

But the most shocking

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[11] *See* Bethany McLean and Peter Elkind, *The Smartest Guys in the Room: The Amazing Rise and Scandalous Fall of Enron.* (2003); Rebecca Smith and John R. Emshwiller, *24 Days: How Two Wall Street Journal Reporters Uncovered the Lies That Destroyed Faith in Corporate America* (2003).

For good discussions of the criminal charges pending against various Enron executive *see* Jeffrey Toobin, *End Run at Enron*, *The New Yorker,* Oct. 27, 2003 at 48; Kurt Eichenwald, *Enron's Many Strands: The Strategy*, N.Y. Times, Oct. 3, 2002, Sec. C at 4; and John R. Emshwiller and Ann Davis, *Tiny Transaction Is Big Focus of Prosecutors in Enron Case*, Wall St. J., Nov. 10, 2003 at 1.

[12] Penelope Patsuris, *The Corporate Scandal Sheet, Forbes.com* Aug. 26, 2002 http://www.forbes.com?home/2002/07/25/accountingtracker.html

For a good description of one of the most notorious of these accounting scandals, WorldCom, *see* Peter Elstrom, *How to Hide $3.8 Billion in Expenses*, *Bus. Week* , June 28, 2002.

[13] Andrew Ross Sorkin, *Ex-Tyco Chief, Free Spender, Going to Court,* N.Y. Times, Sept. 29, 2003, Sec. 1 at 1.

[14] For that action Andersen was convicted of obstruction of justice., Kurt Eichenwald, *Andersen Guilty in Effort to Block Inquiry on Enron,* N.Y. Times, June 16, 2002, Sec. 1, p 1.

For a discussion of the general reliability of audited financial reports *see* Kurt Eichenwald, *Pushing Accounting Rules to the Edge of the Envelope* N.Y. Times Dec. 31, 2002, Sec. C page 1.

[15] As one piece recently put it: "Too many boards are stuffed with yes men who question little that their chief executives suggest, " *Special Report*, *The way we govern now - Corporate Boards*, The Economist, Jan. 11, 2003.

[16] John Cassidy, *Goodbye to All That*, *The New Yorker,* Sept. 15, 2003 at 92, 94.

[17] Kurt Eichenwald, *In a String of Corporate Troubles, Critics Focus on Boards' Failings*, N.Y. Times, Sept. 21, 2003, Sec 1 at 1; Gretchen Morgenson, *As Scandals Flare, Small Victories for Investors,* N.Y. Times, Sept. 21, 2003, Sec. 3 at 1.

disclosures of deceitful conduct by the securities industry came this spring in a long-awaited global settlement spearheaded by New York attorney general Eliot Spitzer.[18] Ten of Wall Street's largest investment banking firms agreed to pay $1.4 million in penalties to settle charges of fraudulent practices which they engaged in during the go-go market of the late 90s.[19] Spitzer's investigation found myriad instances where market analysts had distorted their research reports or stock ratings to win investment banking business for their firms or in other ways curry favor with their corporate clients.[20] For their deceit, the analysts were awarded huge bonuses.[21]

The most prominent examples of this unscrupulous activity were the activities of two analysts who had become financial celebrities during the market bubble—Henry Blodget and

[18] Attorney General Spitzer's statement on the global settlement is found at http://www.oag.state.ny.us/press/statements/global_resolution.html The basic facts that Spitzer's investigation of Merrill Lynch, Inc. uncovered are laid out in an affidavit by Eric R. Dinallo, the Chief of the Investment Protection Bureau of the New York State Department of Law, http://www.oag.state.ny.us/press/2002/apr/Merrill.pdf

For a fine article on the work by Spitzer, Dinallo, and the New York Attorney General's Office *see* John Cassidy, *The Investigation: How Eliot Spitzer Humbled Wall Street, The New Yorker*, Apr. 7, 2003 p. 54.

Spitzer's state investigation outdid the work of the federal agency charged with protecting investors, the Securities and Exchange Commission. As one commentator has recently noted about the SEC's lagged enforcement efforts: "…in recent years the Securities and Exchange Commission lost its watchdog soul to the interests it was created to regulate and is currently in search of it…" Michael Janeway, *The Lord of Springwood*, N.Y. Times, Dec. 21, 2003, Section 7 at 10 reviewing *Franklin Delano Roosevelt* by Conrad Black.

[19] Stephen LaBaton*, 10 Wall St. Firms Settle with U.S. in Analyst Inquiry* , N.Y. Times Apr. 29, 2003, Sec. 1 at 1; Gregory Zuckerman and Suzanne Craig, *Wall Street Pays the Price: $1.4 Billion,* Wall St. J. Apr. 29, 2003, at C1.

Reviewing the settlement one commentator put it bluntly: "What jumps off the page in these documents is the Wall Street firms' disregard for the individual investors in pursuit of personal benefit." Gretchen Morgenson, *In a Wall St. Hierarchy, Short Shrift to Little Guy*, N.Y. Times, Apr. 29, 2003, at C1.

The settlement created a $387.5 million restitution fund for investors and mandated that the firms pay $432.5 million over five years into an independent-research fund designed to provide unbiased research to investors. Jeff D. Opdyke and Ruth Simon*, How You Come Out in Wall Street's Deal*. Wall St. J., Apr. 29, 2003, at D1

[20] Randall Smith, Suzanne Craig, and Deborah Solomon, *Heard on the Street* , Wall St. J. Apr. 29, 2003, at C1.

Five of the brokerage firms actually paid others to issue glowing research reports of companies the firms had underwritten, Gretchen Morgenson, *Shopping Spree By the Famous 5*, May 4, 2003, Sec. 3 at 1.

[21] One senior analyst receiving a $160,000 salary earned a bonus of $3.8 million. Another analyst with a similar salary earned a $3 million bonus. Bert Caldwell, *Wall Street Practices Maddening*, The Spokesman-Review, May 11, 2003, at D1.

Jack Grubman.[22] Blodget, Merrill Lynch's leading tracker of internet stocks, was publicly touting shares in companies that he was privately deriding in his personal e-mails as "junk."[23] And proving that there are all sorts of ways to be bribed, one of Grubman's many inflated stock valuations was a rating he gave to a company in exchange for admission of his children to an elite private school.[24]

3. <u>Regulating the Conflicted Securities Industry</u>

But in the largest sense, these pervasive fraudulent practices can be seen as the invidious results of the inherently conflicted position occupied by investment bankers and brokers. Stock traders and jobbers make money, very good money, by selling the shares of companies to the public, thus purporting to serve two masters with very different interests. Their corporate clients want to sell their shares for the highest price while the public customers who buy them want fairly-valued, quality investments.[25]

Securities, unlike other items of investment property such as real estate, have no intrinsic value in themselves. Rather they represent the right to something of value.[26] Stock purchasers, therefore, have to have particular confidence in their brokers and those salesmen, in turn, seek to foster such a relationship of reliance. For instance, in its promotional material Merrill Lynch speaks of its "tradition of trust" where the interests of clients come first.[27] Yet brokers are typically compensated by commission.[28] As the skeptical insight goes, when a broker recommends a stock, you don't know whether he thinks it's in your best interest to buy it, or he just needs the sale to make a car payment.

Because of this obvious conflict of interest and because securities are such intricate merchandise (a pure

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[22] Editorial, *Finding Fraud on Wall Street*, N.Y. Times Apr. 29, 2003 at A30. Both Grubman and Blodget agreed to lifetime bans from the securities industry in the Global settlement and paid fines totaling $19 million.

[23] Dinallo, *supra* note 18, at 12. *See also* In re Merrill Lynch & Co., Inc. 273 F.Supp.2d. 351, 381 (S.D.N.Y. 2003).

[24] Cassidy, *supra* note, 18.

[25] Surowiecki, *supra* note 8.

[26] Thomas Lee Hazen and David L. Ratner, <u>Securities Regulation</u> (6th ed.) (2003) at 1.

[27] Pat Huddleston II, Rhon E. Jones, Jason L. Nohr, *Fraud in the Boardroom: Protect Investors From Brokers,* 39 Apr. Trial, 38. (2003).

The brokerage business usually involves a personal relationship. "An investor who has his money with Merrill Lynch forms a bond with his broker, not the firm." Surowiecki, *supr*a note 8.

Of late, brokerage firms have taken to a new form of advertising, purchasing the rights to name football fields*, e.g*. Edward D. Jones stadium where the St. Louis Rams play and Raymond James stadium, home of the Tampa Bay Buccaneers.

[28] Stephen J. Friedman, *A Comment on Judge Selya's* Arbitration Unbound: *The Legacy of McMahon*, 62 Brooklyn L. Rev. 1495, 1496 (1996).

bundle of rights, not a discrete piece of solid property) [29] the law has highly regulated their sale. The basic legal mandate is that anyone participating in the marketing of securities must reveal all relevant facts about them.[30]

This regime of full disclosure is encapsulated in the SEC's renowned Rule 10b-5[31] promulgated under authority given it in the Securities Exchange Act of 1934.[32] It is a criminal provision prohibiting all deceitful practices and schemes to defraud in connection with the purchase and sale of securities.[33] For almost sixty years Courts have also implied a private right of action from that rule, allowing defrauded investors to use it to recover damages.[34] In addition, the practices of brokers and all who underwrite the sale of securities are highly regulated by the SEC and by the self-regulatory agencies of which they are members, most prominently the New York Stock Exchange (NYSE) and the National Association of Securities Dealers (NASD).[35]

As Holmes famously observed, all our notions of civil and criminal liability are probably rooted in a primal desire to take revenge on those who have injured us.[36] In that vein, the reasons to allow investors to recover from those who have cheated them are obvious. In addition, one doesn't have to cite the Ten Commandments[37] or the categorical imperative[38] to prove that fraud is bad. Furthermore it seems that law and economics types belabor the obvious when they assert that situations involving asymmetrical understandings of information distort markets.[39]

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[29] *See supra* note 26 and accompanying text.

[30] *Id*. at 2.

[31] 17 C.F.R. 240.10b-5

[32] The enabling Section here is 10(b), 15 U.S.C. Section 78j(b).

[33] For a good general discussion of the jurisprudence of Rule 10b-5, *see* Thomas Lee Hazen, The Law of Securities Regulation (4th ed., 2002) 568-628.

[34] The first such case was Kardon v. Nat'l Gypsum Co., 69 F. Supp. 512 (E.D. Pa.1946) and the Supreme Court upheld that right in Superintendent of Ins. v. Bankers Life & Cas. Co. 404 U.S. 6, 13 n.9 (1971) and Herman and McClean v. Huddleston, 459 U.S. 375, 380 (1983).

[35] *See generally*, Hazen, *supra* note 33, at 758-68

[36] Oliver Wendell Holmes, Jr., The Common Law 2-5. (1881).

[37] "You shall not steal." Ex. 20:15.

[38] "I should never act in such a way that I could not will that my maxim should be a universal law." Immanuel Kant, *Introduction to the Metaphysics of Morals, in* Ethics (Oliver Johnson ed. 8th ed. 1999) at 194-95.

[39] Cassidy, *supra* note 16, at 94, cites the work of Nobel award winning economist Joseph Stiglitz for that proposition. He also discussed Stiglitz's forthcoming book on the boom and bust The Roaring Nineties. There the author sums up the evils that propelled the market's surge in the late 90s with this statement: "Accounting standards were allowed to slacken, deregulation was mindlessly pursued, and corporate greed indulged."

4. The Supreme Court Turns Away from Investor Protection

In roughly the two decades between the mid 70s and the mid 90s, however, the federal securities laws became progressively less friendly to the claims of investors.[40] This occurred through both new legislation and judicial interpretation of existing statutes.

First, in a string of opinions in the 1970s the Supreme Court imposed new restrictions on private claims brought under Rule 10b-5. Those cases required that the plaintiff allege that an actual purchase or sale of securities had occurred,[41] that the defendant acted with scienter,[42] and that actual deception had been involved by way of either a misrepresentation or a non-disclosure of material fact.[43]

The first decision ruled out 10b-5 claims arising from a fraud that caused an investor to refrain from selling or buying a particular security. The second meant that mere negligent misrepresentation was no longer actionable under that provision of the federal securities laws.[44] And the third decision demanding actual deception seemed to preclude claims not involving actual misstatement or concealment of material fact.[45]

Later rulings from the High Court and lower federal appellate courts provided additional barriers to investor suits. One from the Supreme Court shortened statutes of limitations in securities fraud cases.[46] A decision from the Second Circuit condoned egregious puffery by a broker like "this is a marvelous investment" on the grounds that it was either not material or the investor's reliance on such statements was unjustified.[47] And an opinion from the Seventh Circuit appeared to apply a very narrow version of the parol evidence rule to disregard blatantly false oral statements by a broker that were negated by boiler plate disclosures in written documents supplied to the investor.[48]

Those unhelpful rulings were capped off by two Supreme Court decisions in the mid 1990s that further slammed

[40] For an excellent summary of these trends *see* Marc I. Steinberg, *Securities Arbitration: Better for Investors than the Courts,* 62 Brooklyn L. Rev. 1503 (1996)

[41] Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975).

[42] Ernst & Ernst v. Hochfelder, 425 U.S. 185 (1976).

[43] Santa Fe Industries v. Green, 430 U.S. 462 (1977).

[44] The *Hochfelder* Court left open the possibility that reckless behavior might be sufficient for civil liability under Rule 10b-5. *Hochfelder,* 425 U.S. at 194 n. 11.

[45] As to how this might affect certain claims against brokers for breach of fiduciary duty or under the "shingle theory," *see infra* note 112 and accompanying text.

[46] Lammpf. Pleva, Lipkind, Prupis & Petigrow v. Gilbertson, 501 U.S. 350 (1991).

[47] Zerman v. Ball, F.2d 15, 21 (2d Cir. 1984); For a fine critique of this defense *see* Jennifer O'Hare, *The Resurrection of the Dodo: The Unfortunate Re-emergence of the Puffery Defense in Private Securities Fraud Actions*, 50 Ohio St. L. J. 1697 (1998).

[48] Acme Propane, Inc. v. Tenexco, Inc., 844 F.2d 1317, 1325 (7th Cir. 1988); See also Zorbest v. Coal-X, Inc., 708 F.2d 1511 (10th Cir. 1983).

the courthouse door on meaningful investor claims. First the Court gave an overly restrictive interpretation to an express cause of action that might have provided liability for fraud in the sale of securities upon a lesser showing of intent than the scienter requirement of 10b-5.[49] Then it interpreted 10b-5 itself as precluding a remedy against those who are secondarily responsible for a securities fraud, directly ruling out aiding and abetting liability[50] and, according to most readings, respondeat superior claims as well.[51]

On top of all these judicial wounds, a newly Republican controlled Congress also stepped in to give investors the federal coup de grace with the passage, over President Clinton's veto, of the Private Securities Litigation Reform Act (PSLRA) in 1995.[52] The legislation contained a host of restrictions on claims under the federal securities laws, particularly a more stringent legislative reinforcement of Federal Rule of Civil Procedure 9(b)'s[53] requirement that fraud be plead with particularity.[54]

5. Some Promise of Investor Relief in the Enron Litigation

Those restrictive developments put up some stiff barriers for investors seeking relief for the egregious frauds perpetrated during the recent market bubble. Yet preliminary results in one such suit arising out of the Enron scandal[55] evince a residuum of judicial sympathy for shareholder rights.

Investors there who had purchased Enron's publicly traded securities for a period of time before the firm's collapse brought a class action against a host of defendants connected with the company.[56] Included were not only the bankrupt firm's former lead officers and directors, but also its lawyers and auditors. Particularly targeted were banks that had provided a myriad of financial services to Enron such as underwriting its securities and making loans to many of the so-called "special purpose

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[49] Gustafson v. Alloyd Co., 513 U.S. 561 (1995). The provision is Section 12(a)(2) of the Securities Act of 1933, 15 U.S.C. 77l(a)(2). In *Gustafson* the Court held that provision only applicable to material misstatements or omissions in SEC registered public offerings.

[50] Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A., 511 U.S. 164 (1994).

[51] *See Central Bank*, 511 U.S. at 200 n. 12 (Stevens, J. *dissenting*)

[52] 15 U.S.C. Sec. 782, *amended by* Pub. L. No 104-67, 109 Stat. l737 (1995). The legislation amends the Securities Act of 1933 (Securities Act) and the Securities Exchange Act of 1934. (Exchange Act).

[53] Fed. R. Civ. P. 9(b)

[54] The PSLRA added that provision to the Exchange Act as new Section 21D(b). Among other restrictions, the PSLRA requires that discovery be stayed while any motion to dismiss is pending. In effect, it thus forecloses a plaintiff from satisfying the "specificity" provision by ascertaining facts through discovery.

In 1998 Congress pre-empted class action suits for securities fraud in state courts by enacting the Securities Litigation Uniform Standards Act (SLUSA) Pub. L. No. 105-353, 112 Stat. 3227 (1998), thus making the restrictive provisions of the PSLRA applicable to all such suits.

[55] In re Enron Corporation Securities, Derivative & ERISA Litigation, 235 F.Supp.2d 549 (2002).

[56] *Id*. at 141.

entities" (SPEs) that had important, but undisclosed relationships with the company.

Counsel for lead plaintiffs, the renowned Bill Lerach, filed a complaint of nearly 500 pages[57] that characterized Enron's operations as "an enormous Ponzi scheme, the largest in history."[58] It alleged that the company purported to be generating income from arms-length transactions with SPEs that it in fact controlled.

The resulting phony revenue kept the company's stock price artificially high. It was thus able to sustain its operations by constantly raising fresh cash through a number of public securities offerings. In addition to vastly enriching all the Enron insiders, those bogus dealings generated huge fees for the company's bankers, lawyers, and outside accountants who allegedly were all complicit in the on-going fraud.[59]

Lerach has publicly stated that the banks, lush with cash from the boom times, are his principal target and has set his sights on a multi-billion dollar recovery.[60] Thus the motions to dismiss filed by the secondary defendants constituted a crucial phase in the litigation.

There they raised a raft of arguments that their liability was precluded by the jurisprudence of securities litigation as it had developed over the last several decades. Chief among them was that their status as secondary defendants made them, at most, "aiders and abettors" of the fraud and thus impervious to a Rule 10b-5 federal claim under the *Central Bank* decision.[61]

Lead plaintiff countered that argument with this assertion:

"The key to the Enron mess is that the company was allowed to give misleading financial information to the world for years."[62] And that could only be done by the "active and knowing involvement"[63] of the company's lawyers, accountants, and bankers. Further, as motivating evidence of their full participation in the fraud, lead plaintiff cited the spectacular fees gained by those defendants, particularly by the banks, from their "long gravy train of lucrative underwriting of Enron stock and bond offerings."[64]

In response to those arguments, the Court, in a lengthy opinion, analyzed the allegations of wrongful conduct made in the complaint against each of the defendants. It found, for the most part, that the plaintiffs

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[57] Jeffrey Toobin, *The Man Chasing Enron*, *The New Yorker*, Sept. 9, 2002 at 86.

Lerach, a partner in the firm of Milberg, Weiss, Bershad, Hynes & Lerach, LLP, has issued his own report on the recent scandals, William S. Lerach, *Plundering America: How American Investors Got Taken for Trillions by Corporate Insiders*, at http://www.milberg.com/pdf/news/plundering_america.pdf

[58] *In re Enron*, 235 F.Supp.2d at 619.

[59] *Id.*

[60] Toobin, *supra* note 57.

[61] *See supra* note 50 and accompanying text.

[62] *In re Enron*, 235 F.Supp.2d at 636.

[63] *Id.*

[64] *Id.*

had met their pleading standards by alleging, with the requisite particularity, [65] that each defendant was potentially culpable for its primary involvement in the fraud.

As to most of the banks, that was evidenced by the charges that they knew Enron was falsifying its publicly-reported financial results. Yet they actively kept the scheme going by making loans to the company to keep it afloat and underwriting the sale of its securities to the public to bring in fresh cash.[66]

Similarly the Court refused to dismiss both Enron's lawyers[67] and its auditors[68] finding that according to the allegations stated they could also have knowingly participated in the fraud. Not only did the attorneys provide advice on the structuring of almost every bogus transaction, but they also publicly condoned them by giving their opinion that they were bona fide dealings.
As to the auditors, the firm of Arthur Andersen, which reaped approximately $50 million in annual fees from Enron, [69] gave clean opinions to the company's financial statements despite allegedly knowing that they contained numerous falsehoods. Most blatantly, Andersen condoned the non-disclosure of the various SPEs that Enron created to hide its debt even though those obligations would become an immediate liability for Enron if the company's stock price fell below a certain level. Enron's audited financial statements contained no mention of those potential liabilities.[70]

In a subsequent opinion, the Court held that the individual partners of Andersen who had worked on the Enron account could not be held liable individually under 10b-5.[71] the facts of their personal participation and putative scienter had not been alleged with the heightened pleading standards required by the PSLRA.[72]

Yet they would nonetheless be held in the case as defendants because they could be responsible as control persons of Andersen under Section 20(a) of the Exchange Act.[73] Such liability required no actual showing of personal fraud that would necessitate particularized pleading under the PSLRA.[74]

In like fashion, a later opinion also refused to dismiss Enron's outside directors even though no specific facts of their knowing participation in the fraud had been alleged.[75] they, like the individual Andersen

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[65] *See supra* notes 53-54 and accompanying text.

[66] *In re Enron*, 235 F.Supp.2d at 636-56.

[67] *Id*. at 656-68.

[68] Id. at 672-85.

[69] *Id* at 672.

[70] *Id*. at 680-84.

[71] In re Enron Corp. Securities, Derivative and ERISA Litigation, 2003 WL 230688 (S.D. Tex) 1-7.

[72] *See supra* note 53-54 and accompanying text.

[73] 15 U.S.C. Sec. 78t(a).

[74] *In re Enron Corp*. 2003 WL at 8-20.

[75] In re Enron Corp. Securities, Derivative & ERISA Litigation, 258 F. Supp.2d 576, (S.D. Tex. 2003).

partners,[76] could be held liable as control persons of Enron. In addition, they still could face liability under Section 11 of the Securities Act[77] for the false statements contained in Enron's SEC registration statements under a mere negligence standard.[78]

And one month later the Court issued an additional ruling refusing to dismiss key members of Enron's day-to-day management team.[79] In addition to ample particularized pleading of their knowing involvements in the company's multiple fraudulent transactions, [80] they, like the outside directors, were also potentially liable as control persons of Enron.[81] Further, there was substantial evidence that those individuals had made enormous profit from personal sales of Enron stock that could constitute insider trading.[82]

6. <u>Mixed Results in Market Fraud Litigation</u>

In another series of federal court actions growing out of those scandals, however, plaintiffs have not fared so well. Those suits targeted Merrill Lynch, one of the major securities firms that sponsored and allegedly profited from fraudulent research reports by its analysts, among them the notorious Henry Blodget.

In one action, non-clients of Merrill, Lynch alleged that the firm's fraudulent reports about stocks they held caused them substantial losses when the prices of those securities collapsed with the bursting of the internet bubble.[83] In another, investors in mutual funds sponsored by Merill Lynch sought damages for losses which they claimed resulted from the firm's

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[76] *See supra* note 73 and accompanying text.

[77] 15 U.S.C. Section 77k

[78] *In re Enron*, 258 F.Supp.2d at 595.

The exact defense requires that defendants in a Section 11 claim prove affirmatively that they acted with the requisite "due diligence" to investigate the truth of the assertions made in the registration statement. Section 11(b)(3) of the Securities Act; 15 U.S.C. Sec. 77k(b)(3).

[79] In re Enron Corp. Securities, Derivative & ERISA Litigation, 2003 WL 21418157 (S.D. Tex.).

[80] *Id*. at 3.

[81] *Id passim*

[82] *Id*. The allegation here is that the insider defendants sold stock after becoming aware of adverse information about the company's scheme to defraud when such information was not available to the public. This violates Section 10(b) and Rule 10b-5 of the Exchange Act., 15 U.S.C. Section 78j(b), 17 C.F.R. Section 240.10b-5.

In response to disclosure of the Enron fraud, the federal government launched a massive white-collar criminal investigation. Although Enron's former Treasurer has plead guilty, one noted commentator is skeptical that the government will be able to obtain criminal convictions of Enron's top management. Toobin,, *supra* note 11.

For an interesting report on how prosecutors are focusing on one small transaction as the heart of their case against some of the top insiders, *see* Emshwiller, *supra* note 11.

[83] In re Merrill, Lynch & Co., Inc. 273 F. Supp.2d 351 (S.D.N.Y. 2003)

misleading and compromised research reports on stocks in the fund.[84]

The Court began its opinion in the action by Merrill's non-clients by leaving no doubt that it regarded their claims with scant sympathy:

> The record clearly reveals that plaintiffs were among the high-risk speculators who, knowing full well or being properly chargeable with appreciation of the unjustifiable risks they were undertaking in the extremely volatile and highly untested stocks at issue, now hope to twist the federal securities laws into a scheme of cost-free speculators' insurance.[85]

The Court went on to note that none of the investors claimed to have actually read the allegedly false reports.[86] Instead they sought to establish their reliance on the misleading information by the fraud-on-the-market theory which holds that most publicly available information is reflected in a stock's market price.[87] Yet the Court found that the plaintiffs' complaint lacked many elements of a cognizable claim under Rule 10b-5.

Principal among those deficiencies was a failure to plead loss causation with specificity. Even though the alleged misrepresentations may have artificially inflated the price of the securities, there was no showing that they caused the stock's precipitous decline in value.[88] That happened when the internet bubble burst, well before the fraudulent nature of Merrill Lynch's reports became known.[89]
In addition, the Court found that since the research reports were statements of opinion, the plaintiffs had not met the standards of specificity in their pleading to establish that the defendants did not reasonably believe them to be true.[90] Also flowing from the reports' nature as opinions, the "Bespeaks Caution" doctrine protected

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[84] In re Merrill, Lynch & Co., Inc. 272 F. Supp.2d. 243 (S.D.N.Y. 2003).

[85] *In re Merrill Lynch*, 273 F.Supp 2d at 358.

The remainder of the Court's opening remarks are even more scathing:

Seeking to lay the blame for the enormous Internet Bubble solely at the feet of a single actor, Merrill Lynch, plaintiffs would have this Court conclude that the federal securities laws were meant to underwrite, subsidize, and encourage their rash speculation in joining in a freewheeling casino that lured thousands obsessed with the fantasy of Olympian riches, but which delivered such riches to only a scant handful of lucky winners. Those few lucky winners, who are not before the Court, now hold the monies that the unlucky plaintiffs have lost fair and square-and they will never return those monies to plaintiffs. Had plaintiffs themselves won the game instead of losing, they would have owed not a single penny of their winnings to those left to hold the bag (or to defendants). *Id.*

[86] *In re Merrill Lynch*, 273 F.Supp. 2d.at 358

[87] *Id.*

[88] *Id.* at 361-64

[89] *Id.*. at 58-59.

[90] *Id.* at 368-75.

them from liability if inaccurate because they were accompanied by cautionary language.[91]

Even the fraud-on-the-market theory was at least partially inapplicable, the Court said, because the market was fully aware of many of the conflicts tainting the recommendations that the defendant allegedly failed to disclose.[92] The Court also took a narrow view of the one-year statute of limitations, finding that the plaintiffs were on inquiry notice of the basic facts underlying their claim before that time and therefore precluded from legal action now.[93]

The investors in Merrill's mutual funds fared no better in their suit, where they too claimed damages based on the firm's false research reports and undisclosed conflicts of interest.[94] Once again, the Court found that the plaintiffs had not proven that their losses were caused by the alleged misrepresentations as required in Rule 10b-5 actions.[95]

The Court there likewise held that the plaintiffs had failed to state claims under certain provisions of the federal securities laws because, among other things, the defendants had no duty to disclose the allegedly omitted information[96] and the complaint did not plead their scienter with the requisite specificity.[97] Similar actions based on allegedly false statements in other research reports[98] and in connection with other Merrill-sponsored funds[99] were also dismissed by the Court for much the same reasons.

Investors found more promise of relief in a major consolidated action challenging the practices of a number of investment banks that drove up the price of initial public offerings which they underwrote.[100] At issue here were the actions of those financial institutions in connection with over three hundred high-tech and internet companies which they took public during the boom.

Plaintiffs alleged a wide-spread scheme to allocate the

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[91] *Id*. at 375-77. *See supra* note 48 and accompanying text for a judicial opinion on a similar issue where the Court found that cautionary language in the documents furnished investors negated certain oral misrepresentations made in connection with the sale of securities. For a fine article on this topic *see* Jennifer O'Hare, *Good Faith and the Bespeaks Caution Doctrine: It's Not Just a State of Mind,* 58 U. Pitt. L. Rev. 619 (1997).

[92] *Id*. at 375.

[93] *Id*. at 378-82. *See supra* note 46 and accompanying text.

[94] *See supra* note 84 and accompanying text.

[95] *In re. Merrill Lynch*, 272 F.Supp.2d at 260-61.

[96] *Id*. at 248-52.

[97] *Id* at 261.

[98] In re Merrill Lynch & Co Research Reports Securities Litigation, 2003 WL 22451064 (S.D.N.Y. 2003).

[99] In re Merrill Lynch & Co., Inc. Research Reports Securities Litigation, 2003 WL 22451060 (S.D.N.Y. 2003).

[100] In re Initial Public Offering Securities Litigation, 241 F. Supp.2d 281 (S.D.N.Y. 2003).

initial shares in those "hot issues" that required the purchasers to resell the stock in the aftermarket to artificially push up their prices.[101] The plan also obliged those sellers to kick-back part of their profit to the allocating underwriters. To cover up the scheme, the defendants allegedly made misleading statements in their offering documents.

The Court sustained a majority of the plaintiffs' claims finding that "the scheme offends the very purpose of the securities law…."[102] Since the fraud occurred in connection with false and misleading statements made in SEC registration statements, claims under Section 11 of the Securities Act were proper as also were actions under Section 15 against those who controlled violators of that provision.[103]

In similar fashion, the Court also upheld claims under Section 10(b) for both material misstatements and market manipulation. As to most of the defendants, the plaintiffs met their burden of pleading with particularity both as to the underlying fraudulent statements and practices and the requisite scienter. Plaintiffs were also able to show to the Court's satisfaction that they suffered significant financial loss based on the inflated prices they paid for the securities as opposed to their true value.[104]

7. **Customer Claims Against Brokers**

In light of the uncertainty of shareholder recovery in those class action suits, a more promising alternative for individual investors may be a direct claim against the broker who sold them the securities. Brokers, of course, are agents for their customers, the principals, and therefore they have the legal duties incumbent in such a relationship.[105] But many Courts have gone beyond agency law to find that a fiduciary relationship exists in this context[106]—particularly when an unsophisticated client places his trust in a broker expecting that she has superior knowledge and skill about investments.[107]

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[101] *Id* at 293-95.

[102] *Id* at 295.

[103] *Id* at 296.

[104] *Id* at 296-98.

In a news commentary after the ruling, one prominent Wall Street analyst ventured the opinion that the 50 financial firms named in the case might be willing to settle the matter for $3 billion in total damages. Steve Maich, *Wall Street Readies to Pay Up Again*, Financial Post, Feb. 21, 2003.

[105] Those duties include loyalty, good faith, obedience to instructions, and the use of reasonable skill, care, and diligence. Carol R. Goforth, *Stockbroker Duties to Their Customers*, 33 St. L. U. L. J. 407, 410 (1989); *See also* Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker Dealer Liability For Breach of Fiduciary Duty,* 23 J. of Corp. L. 65, 75 (1997).

[106] Goforth, *supra* note 105, at 417-31; Weiss *supra* note 105. On the fiduciary obligations of brokers generally *see* Hazen, *supra* note 33, at 828-31.

[107] Goforth, *supra* note 105, at 422-29, See also Donald C. Langevoort, *Fraud and Deception by Securities Professionals*, 61 Tex. L. Rev. 1247, 1249-50 (1983).

Such a duty is reinforced when a broker is in control of the client's account.[108] This can exist either explicitly as when the customer has given the broker discretionary trading authority[109]-- or more often by a state of affairs giving the broker effective control as when she knows that the customer is inexperienced and will be relying on her recommendations.[110]

And these considerations are augmented by a parallel supposition that takes into account the professional nature of the securities business. It recognizes that brokers hold themselves out as implicitly representing that they will deal fairly with their customers.[111]

For instance, customers have a right to expect that brokers will have a reasonable basis for the stock purchases they recommend.[112] The SEC has dubbed this the "shingle theory"[113] and using its authority under the anti-fraud provisions of the Exchange Act, the Commission has applied it to discipline securities professionals for a host of abusive activities toward their clients.[114]

Almost all customer actions charge that their brokers have breached those duties. In addition, they usually involve one or more of the following four substantive claims which can be conveniently, albeit a bit prejudicially, summarized under the acronym SCUM.[115] They are: 1) suitability, 2) churning, 3) unauthorized trading, and 4) misrepresentation.

Suitability claims typically charge that a broker has recommended that a client invest in securities that are inappropriate for her financial situation—usually because the securities were too risky given the client's age and resources.[116] Relevant here are NYSE[117] and NASD[118] rules that require respectively

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[108] Mark C. Jensen, *Abuse of Discretion Claims Under Rule 10b-5: Churning, Unsuitability and Unauthorized Transactions*, 18 Sec. Reg. L. J. 374, 377-80; (1991), Goforth, *supra* note 105, at 427-29.

[109] Goforth, *supra* note 105, at 422-25.

[110] *Id* at 425-27

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[111] Barbara Black and Jill I. Gross, *Making It Up as They Go Along: The Role of Law in Securities Arbitration,* 23 Cardozo L. Rev. 991, 1004 (2002); Weiss, *supra* note 106, at 88.

[112] Roberta S. Karmel*, Is the Shingle Theory Dead*? 52 Wash. & Lee L. Rev. 1271, 73. (1995).

[113] The term was originally coined by Professor Louis Loss: "The theory is that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public." Louis Loss, *The SEC and the Broker-Dealer*, 1 Vand. L. Rev. 516, 518 (1948).

[114] *See generally* Hazen, *supra* 33 106, at 831-33. Karmel, *supra* note 112, at 1278-92.

[115] Black, *supra* note 111, at 1006.

[116] *See generally* Hazen supra note 33, at 833-39; Jensen, *Abuse of Discretion Claims Under Rule 10b-5: Churning, Unsuitability, and Unauthorized Transactions*, supra note, 108 at 380-90; Janet E. Kerr*, Suitability Standards: A New Look at Economic Theory and Current SEC Disclosure Policy,* 16 Pac. L. J. 805 (1985).

For more specialized approaches to this problem taking into account the sophisticated nature of certain investors *see* Norman S. Poser, *Liability of Broker-Dealers for Unsuitable Recommendations To Institutional Investors*, 2001 B.Y.U. L. Rev. 1493 (2001); Stuart D. Root, *Suitability - The Sophisticated Investor - And Modern Portfolio Management*, 1991 Colum. Bus. L. Rev. 287 (1991).

that brokers know their customers and have reasonable grounds to believe that their recommendations are appropriate for their needs.

But how far does this responsibility go? Some decisions would appear to hold brokers to the highest duty, making them liable for the losses caused by customers' unsuitable investments even when the clients had voluntarily chosen to disregard the brokers' advice that the securities were inappropriate for them.[119] This has been called the "dram shop" approach--analogizing to the old common law rule that made tavern owners liable for all resulting damages if they continued to serve obviously inebriated patrons.[120]

The SEC has recently come close to approving that understanding when it held in a disciplinary proceeding:

> Even if we were to accept the broker's view that these clients wanted to speculate and were aware of the risks….the Commission has held on many occasions that the test is not whether the customers considered the transactions in their account suitable, but whether the broker fulfilled the obligation he assumed when he undertook to counsel them by making only such recommendations as would be consistent with their financial situation and needs.[121]

Churning is the second typical complaint made by customers against their brokers. It is evidenced by a pattern of large or frequent trading in accounts over which brokers have actual or de facto discretionary power.[122] Such trades typically make little profit for the customer but garner substantial commissions for the broker and his house.[123] This allegation is closely tied to a claim that the broker has breached his fiduciary duty because in both he must be said to control the account.[124]

Unauthorized trading claims frequently arise out of the

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[117] New York Stock Exchange Rule 405.

[118] Art. III, Sec. 2, NASD Rules of Fair Practice. As to when a Rule 10b-5 private right of action may arise under these provision *see* Hazen, *supra* note 33, at 835-36.

[119] Lewis D. Lowenfels and Alan R. Bromberg, *Beyond Precedent, Arbitral Extensions of Securities Laws*, 57 Bus. Law. 999, 1011-13 (2002) Such an approach could be characterized as strongly paternalistic. See Kronman, *Paternalism and the Law of Contracts*, 92 Yale L. J. 763 (1983).

[120] Lowenfels, *supra* note 119, at 1001.

[121] In re application of Rangen, 52 SEC 1304, 1308 (1977).

[122] Jensen, *supra* note 116, at 377-80.

[123] In the words of one Court, evidence of excessive trading showed at best "a reckless disregard for the investor's investment concerns and at worst an outright scheme to defraud the client." Mihara v. Dean Witter Co., 619 F.2d 814, 821 (9th Cir. 1980).

[124] Even when the customer exercises formal control over the account, churning is actionable upon a showing of de facto control by the broker, "if the customer is unable to evaluate the broker's recommendations and to exercise an independent judgment." Follansbee v. Davis, Skaggs & Co., 681 F.2d. 673, 676-77 (9th Cir. 1983).

same facts that give rise to a charge of churning.[125] Such activity, of course, directly violates a broker's duty as an agent to execute only those transactions authorized by his principal, the client.[126]

Misrepresentation is the fourth typical claim brought against brokers. Outright misstatements and omissions of material facts are directly actionable under the federal securities laws if there is a showing of scienter.[127] That state of mind may be established by either intentional or recklessly fraudulent activity by the broker.[128]

The Supreme Court of California, however, has gone a step further and recently upheld its common law rule that an action may be maintained for negligent misrepresentation in the sale of corporate stock.[129] Such a claim does not require a showing of scienter, but only "an assertion as a fact which is not true by one who has no reasonable grounds for believing it to be true."[130]

8. <u>Arbitration as a More Promising Forum</u>

In the middle of delivering plenty of bad news to securities plaintiffs over the last several decades, [131] the Supreme Court seemed to further exacerbate investor woes by relegating all claims against brokers to an arbitration system run by the securities industry. In a line of cases from the 1980s, the foremost of which was Shearson v. MacMahon, [132] the High Court held that the mandatory arbitration provisions contained in

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[125] Jensen, *supra* note 116, at 375.

[126] Restatement (Second) of Agency Section 402(g) makes an agent liable for misuse of his principal's money or property including conduct which deviates substantially from the agent's authority in a sale or purchase.

Failure to disclose such trading also constitutes fraud under Section 10(b) and Rule 10b-5 of the Exchange Act. Nye v. Blyth, Eastman, Dillon & Co, 588 F.2d 1189, 1196-97 (8th Cir. 1978).

[127] Black*, supra* note 111, at 1006. *But see supra* notes 47-48 and accompanying text.

[128] *See supra* note 42 and accompanying text.

[129] Small v. Fritz, 30 Cal.4th 167 (2003).

[130] *Id*. at 172. *See* Section 552 of the Restatement (Second) of Torts for a parallel definition of the common law Tort of negligent misrepresentation.

See also infra notes 162-166 for additional state securities provisions that are more investor-oriented than federal law.

[131] *See supra* notes 40-51 and accompanying text.

[132] 482 U.S. 220 (1987)

A harbinger of the MacMahon ruling was Dean Witter Reynolds, Inc. v. Byrd, 470 U.S. 213 (1985) where the Court ruled that when federal securities claims and state claims are brought in one suit, a contract to arbitrate the state claims will be enforced.

The question whether customers actually consent to arbitration when entering into these agreements with their brokers has become a non-issue. *See* Richard E. Speidel, *Contract Theory and Securities Arbitration: Whither Consent?*, 62 Brooklyn L. Rev. 1335 (1996); Jeffrey W. Stempel, *Bootstrapping and Slouching Toward Gomorrah: Arbitral Infatuation and the Decline of Consent*, 62 Brooklyn L. Rev. 1381 (1996).

virtually all agreements between brokerage houses and their customers are enforceable.

That was an about-face by the Court from a previous decision in the early 1950s, Wilko v. Swan,[133] where it had ruled that such contractual clauses were void as contrary to certain provisions in the securities acts. Those sections nullified any stipulations "to waive compliance with any provisions"[134] of those statutes. The *Wilko* Court buttressed its ruling by citing the avowed policy of the securities acts to protect investors from the disadvantageous nature of their relationship with the securities industry.[135] Such an outlook, according to *Wilko*, contemplated that disgruntled investors should have a wide choice of fora where they could seek relief apart from compulsory arbitration that could lessen the effectiveness of their potential remedies.[136] Among other things, such a non-judicial venue might put them at the mercy of the subjective opinions of arbitrators by not affording them any written record of their proceedings and leaving them with a sharply limited right to appeal adverse decisions.[137]

But the *MacMahon* Court held that the no-waiver provisions were only applicable to the substantive rights afforded securities purchasers under the Acts.[138] Its broader interpretation of them in *Wilko* as also covering procedural rights had to be understood in light of the then prevalent mistrust of arbitration.[139] For years the SEC believed that arbitration would not adequately protect investor rights, the Court noted. However the Commission had recently adopted a more favorable view of that process that was premised in part on the expanded power that Congress had given it to oversee arbitration.[140]

Likewise the Court itself found in *MacMahon* that "the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights."[141] And it concluded its opinion by

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[133] 346 U.S. 427 (1953).

Since *Wilko* technically dealt with a claim brought under the Securities Act of 1933, it was distinguishable from the *MacMahon* action which was a 10b-5 claim under the Securities Exchange Act of 1934. Two years after *MacMahon* however, the Court directly overruled *Wilko* by holding that claims under the Securities Act were also subject to arbitration in Rodriguez de Quijas v. Shearson American Express, 490 U.S. 477 (1989).

[134] Section 14 of the Securities Act, 15 U.S.C. Section 77n. The parallel provision in the Exchange Act is Section 29(a) 15 U.S.C. Section 78cc(a).

[135] *Wilko*, 344 U.S. at 430-31.

[136] Id. at 431.

[137] *Id.* at 435-37.

[138] 482 U.S. at 220, 227.

[139] *Id.*

[140] *Id.* at 233.

[141] *Id.* at 231.

finding that concerns over the limited nature of appellate review were unwarranted because "there is no reason to assume at the outset that arbitrators will not follow the law."[142]

Justice Harry Blackmun who had frequently dissented from the Court's earlier rulings that narrowed investor rights, [143] also spoke for the four justices in *MacMahon* who opposed the majority's ruling.[144] As one of his former law clerks, Professor James Fanto, has noted, Blackmun's opinion expressed a "populist skepticism of the securities industry"[145]—as appropriate then as ever, the Justice believed, in the late 80s era of abusive merger mania. Justice Blackmun also remained unconvinced that the streamlined procedures of arbitration would give plaintiffs a fair shake and expressed his belief that the industry-run process was "slanted" against investors.[146]

Perhaps telling tales out of school, Professor Fanto wrote how Justice Blackmun would discuss the opinions of his judicial colleagues with his clerks. Apparently drawing on insights garnered there, Fanto analyzed the majority opinion in *MacMahon* as the product of an "activist conservative majority" that had solidified with the appointed of Justice Scalia just before the case was argued.[147]

The SEC's own flip-flop to now support compulsory arbitration which the Court found persuasive was itself a product of political forces, added Fanto. It came at a time when the Commission was actively pursuing a policy of deregulation to counter charges that its stringent rules were hindering capital formation.[148]

But contrary to Justice Blackmun's dire intuition, the law of unintended consequences appears to have gone into operation here to save investors. Five years after *MacMahon*, a study by the GAO found that they were not being disadvantaged by the process of compulsory arbitration.[149] And most studies since that time have only reinforced that view.[150]

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[142] *Id.*

[143] *See e.g.* note 42 and accompanying text.

[144] 482 U.S. 220, 241.

[145] James A. Fanto, *Justice Blackmun and Securities Arbitration: MacMahon Revisited*, 71 N.D. L. Rev. 145, 146 (1995).

[146] *Id.* at 157. *See MacMahon*, 482 U.S. at 260.

[147] Fanto, *supra* note 145, at 157.

[148] *Id.* at 159.

[149] United States General Accounting Office, Securities Arbitration: How Investors Fare 6 (GAO/GGD-92-74) (May 1992).

[150] Most prominent was Report of the Arbitration Policy Task Force to the Board of Governors, National Association of Securities Dealers, Inc. (1995-96 Transfer Binder) Fed. Sec. L. Rep. (CCH) Para 85, 735 (Jan. 1996) referred to generally as the "Ruder Report" because it was authored by a committee chaired by former SEC chairman David Ruder. Although the report recommended a number of changes to the arbitration process, including better training for arbitrators, it found "…securities arbitration continues to provide clear and significant advantages over the civil litigation system it has replaced." at 87,433.

Arbitration has turned out to be a forum quite favorable for investors[151] and the reason for that surprising outcome is largely owing to the nature of that method itself.

Seeking to allay fears that this industry-run course of action would be unfair to petitioners, the *MacMahon* court stated that it had no reason to believe that panels would not follow the law.[152] But that bow to the "rule of law" was really no help to investors since the trend in securities law had been moving against them. As we have discussed,[153] federal appellate decisions and legislative enactments had been steadily unfavorable to plaintiffs since at least the mid-1970s.

For instance, the scienter element now required by the Federal Courts in 10b-5 claims precludes actions there based on mere negligence[154] and the strict pleading standards codified by Congress make it difficult for plaintiffs to state a sustainable cause of action for securities fraud.[155] And most troubling for disgruntled investors bringing SCUM claims against brokers, respondeat superior liability seems to be ruled out against deep-pocket respondents like the houses that employed them as their sales force.[156]

The distinct advantage of arbitration over litigation, however, is its equitable nature. The Arbitrator's Manual published by the NASD which all arbitrators receive begins with this quote from that great philosopher of justice, Aristotle:

> Equity is justice in that it goes beyond the written law….It is equitable to prefer arbitration to the law court, for the arbitrator keeps equity in view, whereas the judge looks only to the law, and the

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See Steinberg,, *supra* note 40, at 1996 where the author states: "…mounting evidence shows that many investors emerge victorious from arbitration, even recovering punitive damages in appropriate cases." *See also* Deborah Masucci*, Securities Arbitration--A Success Story: What does the Future Hold?* 31 Wake Forest L. Rev. 183 (1996).

[151] Approximately 60% of the shareholder claims filed in arbitration in the 1990s were settled by brokerage houses. But as one commentator has noted: "With the number of claims rising and bottom lines shrinking due to the bear market, brokers and their firms are defending themselves against investors' claims more vigorously than ever. In 2002, the percentage of claims settled fell to 37% as compared to 44% in 2001." Paul Joseph Foley, *The National Association of Securities Dealers' Arbitration of Investor Claims Against Its Brokers: Taming the Fox that Guards the Henhouse*, 7 N.C. Banking Inst. 239, 253. (2003).

The author there also noted that when claims proceed to full adjudication before NASD arbitration panels, investors were awarded compensation between 53% and 61% of the time in the past five years. *Id*.

[152] *See supra* note 142 and accompanying text.

[153] *See supra* notes 40-54 and accompanying text.

[154] *See supra* notes 42, 44 and accompanying text.

[155] *See supra* notes 52-53 and accompanying text.

[156] *See supra* notes 50-51 and accompanying text.

reason why arbitrators were appointed was that equity might prevail.[157]

Following that dictum a seasoned Wall Street practitioner gives this current description of the jurisprudence of arbitration: "It's a rough sense of justice…. If they want to give an award to someone they feel was victimized, they'll find a way, even if prior cases don't clearly support their decision."[158]

In addition, state securities and common law claims that would be precluded by current federal law are viable in arbitration. For instance, liability by negligent misrepresentation apart from any showing of scienter[159] and recovery under a common law respondeat superior theory are perfectly valid there despite federal case law that might not permit them.[160]

Furthermore, most state securities codes ease the burden of pleading and proof that federal plaintiffs must establish to recover in such cases. Most importantly the federal element of loss causation is substantially lessened under most state law.[161] For instance, Section 509(b) of the Uniform Securities Act[162] parallels Section 12(a)(2) of the Securities Act of 1933, but unlike the federal law[163] it provides for civil liability for all kinds of fraudulent statements, not just those contained in a registered public offering.[164] And unlike the current requirements of federal 10b-5 actions, [165] there is numerous case law under the precursor to Section 509(b) holding that neither reliance nor causation is an element of that action.[166]

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[157] Securities Industry Conference on Arbitration, The Arbitrator's Manual 2 (2001) quoting Domke on Aristotle at http://www.nasdadr.com/pdf - text/arb_manual.pdf.

Aristotle's notion was that equity had to exist to remedy situations where the law produced an unjust result. Aristotle, The Nicomachean Ethics 315 (H. Rackham trans., Harv. Univ. Press, 1934) *See also*, Roger A. Shiner, Aristotle's Theory of Equity, 27 Loy. L.A. L. Rev. 1245 (1994).

As a great American writer summed up the inadequacies of our legal system: "The law isn't justice. It's a very imperfect mechanism. If you press the right buttons and are also lucky, justice may show up in the answer. A mechanism is all the law was ever intended to be." Raymond Chandler, The Long Goodbye 56 (1953)

[158] Brooke A. Masters, *Investors v. Brokers: Meting Out Quick Justice in Murky World of Arbitration,* Washington Post, July 15, 2003, at E01. The quote is attributed to Gregory J. Wallace of the law firm Kaye Scholer LLP.

[159] *See supra* notes 129 and 130 and accompanying text.

[160] *See supra* notes 40, 42 and 50-51 and accompanying text.

[161] *See e.g. supra* notes 88-89 and accompanying text.

[162] Uniform Securities Act (U.L.A.) Section 509(b).

[163] *See supra* note 49 and accompanying text.

[164] *See* Uniform Securities Act *supra note* 162, Official Comments Note 3.

[165] *See e.g. supra* notes 88-89 and accompanying text.

[166] Kaufman v. I-Stat Corp. 754 A.2d 1188 (2000); Rich v. Robinson-Humphrey Co., 748 So. 2d 861 (Ala. 1999); Gerhard W. Gohler, IRA v. Wood, 919 P.2d 561 (Utah, 1996).

This wide discretion afforded arbitrators is buttressed by the limited review to which their rulings are subject. Panels are not even required to write an opinion justifying their decisions[167] making it even harder for the losing party to show that they have acted with manifest disregard of the law, the only real substantive basis for appeal.[168]

Also auguring in petitioners' favor is the expedited and relatively inexpensive nature of this form of dispute resolution.[169] As opposed to full-blown litigation where the "search for exquisite procedural fairness has produced a judicial process so cumbersome that ordinary people want to avoid using it,"[170] there is not much motion practice in securities arbitration[171] and discovery is limited. Its rules mandate an exchange of prescribed documents, [172] but depositions are rare.[173]

In addition, arbitrators are disposed to hear out the stories of the parties in person in a relatively informal setting where the strict rules of evidence don't apply.[174] As a former SEC Commissioner has approvingly stated, the system is designed to deal with "the very human kind of problems" arising from "the special relationship between retail securities firms and their customers."[175]

And since the securities industry subsidizes the cost of these proceedings and other savings arise from the limited pretrial practice and rights to appeal,[176] this forum is more hospitable than litigation to the small financial disputes that are often likely to crop up in this context.[177] It thus offers investors not only a relatively speedy forum to

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[167] Master, *supra* note 158. Along those lines, the arbitrators are only required to state in their award "a summary of the issues including the type(s) of any security or product in controversy." Securities Industry Conference on Arbitration, *Arbitration Procedures*, http://www.nasdadr.com/pdf-text/arb_procedures.pdf

In fact, a large majority of arbitration awards do not contain any legal opinion justifying the decision. Black, *supra* note 11, at 1028.

[168] *Id*. at 1030-35. Other grounds include bias or malfeasance. *See* Master, *supra note* 167.

[169] The Ruder Report, *supra* note 150, so found. As the chair put it, "Stated generally, the parties to arbitration seek a fair, relatively speedy and relatively inexpensive means of resolving disputes." David S. Ruder, *Elements of a Fair and Efficient Securities Arbitration System*, 40 Ariz. L. Rev. 1101 (1998).

[170] Freedman, *supra* note 28, at 1500.

[171] *See generally* Marilyn Blumberg Cane and Patricia A. Shub, Securities Arbitration, (1991) 58-61

[172] *See generally* Arbitration Procedures, *supra* note 167, at 17-21.

[173] Blumberg, *supra* note 171, at 63.

[174] *Id*. at 64.

[175] Freedman, *supra* note 28, at 1496.

[176] J. Kirkland Grant, Securities Arbitration for Brokers, Attorneys, and Investors, 96-98 (1994).

[177] The arbitration process run by the Securities Industry also offers a Simplified Arbitration Procedure for small claims, *see* Arbitration Procedures, *supra* note 167, at 8; see also Ruder, *supra* note 169, at 3-4.

resolve their claims and recover their losses,[178] but it also holds out the possibility of a therapeutic remedy[179] by giving them a meaningful "Day in Court" to seek vindication for what may be a highly personalized breach of their trust.[180]

The results of these adjudications are most likely to turn on the particular dynamics that have been established between the individual customers and their brokers. The number of trades and the quality of investments can easily be shown by indisputable records and rating systems. Where these cases get interesting and can present some real drama is in determining the nature of the customers' consents to the trades or their after the fact ratification of the transactions.[181]

As has been noted, brokers are typically compensated by commission and therefore their financial interest, at least in the short run, is on "making the sale."[182] The federal securities laws have, from their earliest days, recognized that reality. In his message accompanying the proposed legislation that would become the Securities Act of 1933, President Franklin Roosevelt urged Congress to recognize that "every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information."[183] Because of the intricate nature of those financial instruments, [184] federal law therefore reverses the traditional presumption of caveat emptor and makes sellers disclose to any potential purchasers all material facts about the investments they offer.[185]
In SCUM claims, the volitional nature of the customers' decisions is often the ultimate issue.[186] The age, education, and business experience of

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[178] *See supra* note 169 and accompanying text.

[179] *See* Judging in a Therapeutic Key: Therapeutic Jurisprudence and the Courts (ed. Bruce J. Winick and David B. Wexler) (2003); *see also* Amy D. Ronner*, Songs of Validation, Voice, and Voluntary Participation: Therapeutic Jurisprudence, Miranda and Juveniles*, 71 U. Cin. L. Rev. 89 (2002).

[180] Freedman, supra note 28, at 1496.

[181] Thompson v. Smith Barney, 709 F.2d 1413 (1983);

See also Langevoort, supra note 107, at 1281. For a good general discussion about other defenses that may be raised here such as laches, estoppel, and waiver *see* Thomas E. Geyer, Michael P. Miglets, and Keith A. Rowley, *Civil Liability and Remedies in Ohio Securities Transactions*, 70 U. Cin. L. Rev. 939, 993-94 (2002).

[182] *See supra* note 28 and accompanying text.

[183] Franklin D. Roosevelt, *Message from the President of the United States*, March 29, 1933 *in* Legislative History, Securities Act of 1933, Vol. 2, item 15 (compiled by J.S. Ellenberger and Ellen P. Mahar) (1973).

Despite its current soul-searching, "…the S.E.C. remains one of Franklin D. Roosevelt's and his New Deal's most signal and durable achievements…."Janeway, *supra* note 18.

[184] *See supra* note 26 and accompanying text.

[185] *See supra* notes 29-30 and accompanying text.

[186] Many times this comes back to the issue of whether the broker has "control" over the account. *See supra* notes 108-110 and accompanying text.

the particular investor are all relevant.[187] However, a customer may have been seeking a higher return than would have been prudent given the concomitant risk.[188] Deeply philosophical questions may then arise about just what constitutes a freely chosen course of conduct and how much individuals should be held accountable for their own initial decisions or for their failure to promptly object to improper treatment.[189]

Further complicating that question are the many documents like prospectuses, research reports, confirmations, and monthly statements that customers typically get from brokers.[190] They will require careful reading if they are to be fully understood and even then despite the SEC's recent plain English crusade, [191] their jargon may be incomprehensible to the lay investor.[192]

In addition, clients who have a trusting relationship with their broker or are preoccupied with other matters are not likely to give them full consideration.[193] Only when the investments have declined in value will the customers or their lawyers carefully examine them.

Against that background, the judgment of the arbitrators takes on paramount importance. Many who serve on these panels are retired lawyers or other business professionals.[194] They are thus typically much better informed about the securities industry and its relevant law than an ordinary jury and they often take an active role in the proceedings, asking questions of both sides during the proceedings.[195]

Many say they try to bring common sense and community standards, as they understand them, to the disputes before them.[196] One member of each three person panel must be from the securities industry.[197] Even then, however, any

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[187] Leckey supra note 2; Thus the investment sophistication of the claimant is often at issue in these disputes. Howard L. Nations*, Fraud in the Board Room: Remedies for Defrauded Investors,* 39 Apr Trial 44, 45 (2003).

[188] As one commentator put it: "Cases turn on whose idea it was at the time to make the investments. We find investors were happy when the stock market was high, but then they develop amnesia." Edward Mason, *Brokers Face Rash of Angry Investors,* Boston Bus. J. , June 9, 2003.

[189] *See supra* notes 120-21 and accompanying text.

[190] *See* Black, *supra* note 111, at 1037.

[191] Securities Act Rule 421. See also Sec. Act Rel. No. 33-7497 (SEC Feb. l6, 1998).

[192] *See e.g.* Davis v. Merrill Lynch, Pierce Fenner & Smith, 906 F. 2d 1206, 1213 (9th Cir. 1990); *Mihara*, 619 F.2d at 822.

[193] As pointed out earlier, brokerage firms encourage such a trust relationship. *See supra* note 27 and accompanying text. In *Mihara*, the brokerage firm put this statement in the manual it distributed to its account executives: "Our client has a right to believe and trust you." *Id*

[194] Masters, *supra* note 158.

[195] *Id.*

[196] *Id.*

[197] *See* Arbitration Procedures, *supra* note 167, at 6.

professional empathy such a panelist might have with the respondents may be counterbalanced by a desire to rout out the "bad apples"[198] in the business to maintain public confidence in the system.

The Global settlement reached against analysts and their firms should also aid petitioners in their claims because it lays out many of the deceitful recommendations actually made by the brokerage firms.[199] Documentation of those findings is available to the public. In the SEC consent decree, the firms agree to sanctions without admitting violations, so no formal issue preclusion will apply. Yet if an investor can show that she bought a particular stock from a brokerage house which induced her purchase by means of such a fraudulent research report, liability can be almost a certainty.[200]

And even if a securities firm was not directly involved in the initial distribution of such a stock, a showing of any reliance by a broker on such tainted reports can at least raise an inference of negligent misrepresentation.[201] The lack of extensive discovery in these proceedings may handicap petitioners from adducing evidence that a particular brokerage firm participated in a scheme to defraud its customers or was at least negligent in protecting their interests.[202] Each case of course will turn on its individual facts concerning such issues as well as the particular customer's sophistication and appetite for risk.[203]

9. <u>Claims that May Not Prevail in Arbitration</u>

Certain cases however may elicit little sympathy from an arbitration panel. One such instance would be a mere "holding claim" where the customer's only charge is that his broker failed to get him out of a stock at its historic high.[204] While the customer may have been induced to make an investment in such a security by a breach of the broker's fiduciary duty, it may hard to prove that all his losses were caused when the stock price collapsed.[205] A burst bubble is after all just a stock gone back to its rightful

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[198] Freedman, *supra* note 28, at 1497.

[199] Mason, supra note 188.

[200] *Huddleston et al., supra* note 27, at 38. Lowenfels, *supra* note 119, at 1022 points out that this type of liability can also be established when a broker relying on such a fraudulently optimistic report advises a client not to sell a stock in a declining market.

[201] Masters, *supra* note 158.

[202] *See supra* notes 172-73 and accompanying text.

[203] As one commentator put it: "If the investor said in his opening document his objective was speculation, there won't be a strong case against a broker who put him in high-risk stocks….But if the investment objective was retirement security and preservation of capital and he was put in high-risk stocks, it's a strong case. Leckey *supra* note 2, *quoting* Harry Miller, securities attorney and founder of the Securities Fraud and Investor Protection Resource Center in Boston.

[204] *But see* Lowenfels, *supra* note 200, for a different result when a broker induces a customer to hold a stock relying on a tainted research report.

[205] Under many state securities laws, however, loss causation is not an element required for recovery. *See supra* note 161-66 and accompanying text. Yet the equities of such a situation would not seem to favor recovery.

price.

Nor may customers who were sucked in at the market's high points be able to show actual ill-gotten profits by their brokers. The customers at that time most likely bought their stock from knowledgeable insiders who were taking their profits—potentially the real culprits in the transaction.[206] In the same vein, it may be hard for disgruntled investors to show that their brokers had any reason to disbelieve the tainted research reports received from corrupt stock analysts.[207]

10. Conclusion

Nonetheless a pervasive aura of lax practices existed throughout the securities industry during the late 90s boom, especially among brokerage firms that underwrote the high-flying stocks of that era. Notorious examples have come to light of analysts who were fired for their skepticism about the value of companies like Enron because such honest assessments might cause their firms to lose millions of dollars in investment banking fees.[208]

How then, can we separate the "truly dishonest from the merely delusional?"[209] Arbitration panelists, like Supreme Court justices, read the newspapers. As financially savvy individuals, they will be aware of all this background as they sort through the claims of investors—seeking to give an appropriate recovery to those who were fraudulently sucked into this maelstrom.

The $1.4 billion settlement fine is just a small portion of the gigantic profits earned by the securities industry during this extraordinary bubble. Awarding rightful remedies to investors will be complicated, but the arbitration process, as it has evolved in the last decade, offers the best opportunity for aggrieved investors to find swift and meaningful justice.

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[206] *See supra* note 8 and accompanying text.

[207] Such a showing of fault would be required to prove negligent misrepresentation. *See supra* note 128 and accompanying text.

[208] The story of John Olson, an analyst from Merrill Lynch, who appears to have been fired for his pessimistic views about Enron is a sad case in point. McLean, *supra* note 11, from an excerpt of that book in *Fortune* Oct. 27, 2003 at 88.

[209] Knee, *supra* note 1.

Recent Arbitration Awards

Keith Fraser

Michael and Katrina Rooney et al. v. Wachovia Securities, LLC, Morton Rudin and Bruce Weigand
NASD Case No. 03-00704

Claimant alleged that Respondents improperly purchased Class B mutual funds in Claimants' accounts using margin and improperly engaged in mutual fund switching. Claimants alleged that Respondents engaged in the wrongful conduct for the sole purpose of generating commissions, margin interest and fees. Claimants also alleged that Respondent Wachovia and Weigand failed to properly supervise the broker, Respondent Rudin.

Claimants asserted the following causes of action: fraud; breach of fiduciary duty; negligent supervision; violations of federal and state securities laws and NASD and NYSE Rules. Claimant requested compensatory damages, punitive damages, interest, costs, and attorney fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims, an order of expungement of the statement of claim from Rudin's and Weigand's CRD record, and costs.

1. The panel found Respondents Wachovia Securities, LLC, Bruce Weigand and Morton S. Rudin, jointly and severally liable to Claimants the sum of $188,944.04 in compensatory damages.

2. The panel found Respondents Wachovia Securities, LLC, Bruce Weigand and Morton S. Rudin, jointly and severally liable to Claimants the sum of $377,988.08 in punitive damages.

3. The panel denied Respondents' request for expungement.

The award is significant because of the large punitive damage award based on the improper sale of Class B mutual funds.

Claimants' Counsel - Bruce D. Oaks, Esq., and Richard B. Fosher, Esq., of Oakes & Fosher, LLC, St. Louis, Missouri.

Respondents' Counsel - Thomas Fleming, Esq., of Jones, Bell, Abbott, Fleming & Fitzgerald. LLP, Los Angeles, California.

Claimants' Expert - Alan Sher and Dr. Edward O'Neal

Respondents' Expert - Jay Rosen and Steve McGinnis

Hearing Situs - Los Angeles, California

Arbitrators - Daniel J. McCarthy, Jr., Chairman; Susan Vernon Wood, Esq., Public; Sharon Clanton, Industry

Keith Fraser is an attorney with the law firm of Aidikoff & Uhl in Beverly Hills, California. His email address is keithdfraser@aol.com and he can be reached at (310)274-0666

Jonathan Rapore et al. v. Royal Alliance Securities, Inc., Robert Levine and Joseph Neri
NASD Case No. 03-01671

Claimants alleged that Respondents recommended and purchased aggressive, high risk mutual funds and other securities which were unsuitable for claimants based on their investment objectives.

Claimants asserted the following causes of action: breach of fiduciary duty; constructive fraud; failure to supervise; violations of federal and state securities laws and NASD and NYSE Rules. Claimant requested compensatory damages, consequential and lost opportunity damages as well as interest, costs, and punitive damages.

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

1. The panel found Respondents Royal Alliance, Joseph Neri and Robert Levine jointly and severally liable to Claimants for $554,620.00 in compensatory damages.

The award is significant because of the large size of the award and because the panel rejected Respondent's defense that Claimant, an attorney, was a sophisticated investor that knowingly approved of the high risk investments in the accounts.

Claimants' Counsel - Philip M. Aidikoff, Esq. and Orousha Brocious, Attorney at Law of Aidikoff & Uhl, Beverly Hills, California.

Respondents' Counsel - Charles Murray, Esq., of Lewis Brisbois, Bisgaard & Smith LLP of San Francisco, California and Peter Brown Dolan, Esq., of the Dolan Law Firm, Los Angeles, California

Claimants' Expert - Douglas Schulz

Respondents' Expert - Glen Wittington

Hearing Situs - Los Angeles, California

Arbitrators - John J.Costello, Chairman; Howard A. Emirhanian, Public; Robert P. Clifford, Industry

Eugene J. Murdock v. Merrill Lynch, Pierce Fenner & Smith, Inc.
NYSE Docket No. 2003-011900

Claimant alleged that Respondent Merrill Lynch recommended unsuitable securities and concentrated Claimant's retirement assets in aggressive growth stocks in the technology sector. Claimant also alleged that Merrill Lynch failed to properly monitor the Claimant's accounts.

Claimant asserted the following causes of action: fraud; negligence; breach of fiduciary duty; breach of contract; violations of the Georgia Fair Business Practices Act of 1975; violations of federal and state securities laws and NASD and NYSE Rules. Claimant requested compensatory damages, as well as interest, costs, and attorney fees.

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

1. The panel found Respondent Merrill Lynch liable based on negligence and ordered Merrill Lynch to pay Claimant $500,000 in compensatory damages including $100,000 in attorney fees.

2. The panel found Respondent Merrill Lynch liable to Claimant for $25,000 in costs.

The award is significant because the panel found Merrill Lynch liable on a negligence theory and rejected Merrill Lynch's defenses that, in a non-discretionary account, it had "no continuing duty to keep abreast of financial information that may affect a customer's portfolio, or to inform a customer of developments that could influence their investments."

Claimants' Counsel - Tracy Pride Stoneman, Attorney at Law of Tracy Pride

Stoneman, PC, Westcliffe, Colorado.

Respondents' Counsel - Terry R. Weiss, Esq. of Sutherland, Asbill & Brennan LLP, Atlanta, Georgia

Claimants' Expert - Nicholas Vu on damages only

Respondents' Expert - None

Hearing Situs - Atlanta, Georgia

Arbitrators - John H. Beach; Joseph Carlisi; Joseph N. Miller

Helen McDonald, Frank McDonald and David McDonald v. Stifel, Nicholas & Co.
NASD Case No. 04-00479

Claimants maintained numerous individual, joint and retirement accounts with Respondent Stifel and alleged that Respondents recommended the purchase of aggressive growth stocks concentrated in the technology sector which were unsuitable for Claimants' investment objectives of income and safety of principal.

Claimants asserted the following causes of action: fraud; breach of fiduciary duty; negligence; negligent supervision; violations of federal and state securities laws and NASD and NYSE Rules. Claimant requested compensatory damages of $275,000, punitive damages, interest, costs, and attorney fees.

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

1. The panel found Respondent Stifel liable to Claimants the sum of $150,036 in compensatory damages.

2. The panel found Respondent Stifel liable to Claimants the sum of $150,036 in punitive damages.

3. The panel found Respondent Stifel liable to Claimants the sum of $65,700 in attorney fees.

4. The panel found Respondent Stifel liable to Claimants the sum of $9,939 in costs.

5. The panel ordered that Respondent Stifel pay all the forum fees which totaled $10,125.

The award is significant because of the large punitive damage award and the award of attorney fees and costs.

Claimants' Counsel - Bruce D. Oaks, Esq., and Richard B. Fosher, Esq., of Oakes & Fosher, LLC, St. Louis, Missouri.

Respondents' Counsel - Jeffrey Jamieson, Esq., of Blackwell, Sanders, Peper, Martin LLP of St. Louis, Missouri.

Claimants' Expert - Douglas Nachman

Respondents' Expert - Paul Moulden of Economic Analysis Group

Hearing Situs - St. Louis, Missouri

Arbitrators - Richard H. Potter, Chairman; D. Richard Dennis, Public; Mark E. Kessinger, Industry

Donna Mansour v. A.G. Edwards & Sons, Inc. and Ted Mendoza
NASD Case No. 03-07024

Claimant alleged that Respondents recommended and purchased unsuitable "Defined Stock Portfolios" in Claimant's account which were concentrated in volatile aggressive growth stocks.

Claimant asserted the following causes of action: fraud; breach of fiduciary duty; negligent misrepresentation, failure to supervise; elder abuse and violations of federal and state securities laws and NASD and NYSE Rules. Claimant requested compensatory damages of $300,000 plus interest or, in the alternative, rescission plus interest. Claimant also sought punitive damages, costs, and attorney fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of

Claim and requested dismissal of Claimants' claims, an order of expungement of the statement of claim from Respondent Mendoza's CRD record, and costs.

1. The panel found Respondent A.G. Edwards & Sons, Inc., liable to Claimants the sum of $120,000.00 in compensatory damages.

2. The panel found Respondent Ted Mendoza liable to Claimants the sum of $25,000.00 in compensatory damages.

3. The panel found Respondent A.G. Edwards & Sons, Inc., liable to Claimants the sum of $25,000.00 in attorney fees.

The award is significant in that the panel awarded attorney fees pursuant to *Marshall & Co. v. Duke*, 114 F.3d 188 (11th Cir. 1987).

Claimants' Counsel - Dennis R. Villavicencio, Esq., of Akins & Villavicencio, LLP, Carlsbad, California.

Respondents' Counsel - James Browning, Esq. and M. Jane Matoesian, Esq., of A.G. Edwards, & Sons, Inc., St. Louis, Missouri.

Claimants' Expert - Ross Tulman

Respondents' Expert - None

Hearing Situs - Los Angeles, California

Arbitrators - Anthony D. DeToro, Esq., Chairman; David Menaker, Public; Ronald F. Rybandt, Industry

Dennis and Barbara Higginbottom v. Morgan Stanley DW, Inc.
NASD Case No. 03-03659

Claimants alleged that Respondent Morgan Stanley recommended that Claimants invest their retirement assets with outside money manager which invested in unsuitable securities.

Claimants asserted the following causes of action: breach of fiduciary duty; constructive fraud; failure to supervise; violations of federal and state securities laws and NASD and NYSE Rules. Claimant requested compensatory damages, consequential and lost opportunity damages as well as interest, costs, and punitive damages.

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

1. The panel found Respondent Morgan Stanley liable to Claimants for $507,968.00 in compensatory damages.

The award is significant because the panel rejected Morgan Stanley's primary defense that they were not responsible for the investments purchased by the outside money managers..

Claimants' Counsel - Philip M. Aidikoff, Esq. and Orousha Brocious, Attorney at Law of Aidikoff & Uhl, Beverly Hills, California.

Respondents' Counsel - Gilbert Serota, Esq. of Howard Rice, Nemerovski, Canady, Falk & Rabin of San Francisco, California

Claimants' Expert - None

Respondents' Expert - None

Hearing Situs - Los Angeles, California

Arbitrators - Alan Stamm, Esq., Chairman; Newton Waldman, Esq., Public; David Holt, Industry

R. Vance Hall and Marilyn Clark Hall v. A.G. Edwards & Sons, Inc. and James Wiklund
NASD Case No. 03-04043

Claimant alleged that Respondents recommended and purchased unsuitable stocks and mutual funds for Claimants' accounts.

Claimants asserted the following causes of action: fraud; breach of fiduciary duty; negligence and unsuitability. Claimant requested compensatory damages, punitive damages, interest, costs, and attorney fees.

Respondents denied the allegations of wrongdoing set

forth in the Statement of Claim and requested dismissal of Claimants' claims.

1. The panel found Respondents A.G. Edwards & Sons Inc., liable to Claimants in the sum of $275,000 in compensatory damages and interest.

The award is significant because it was based on a "well managed account" theory. In addition, the panel rejected Respondent's defense that the Claimants did not experience any net out of pocket losses because earlier gains in the accounts offset any later capital losses.

Claimants' Counsel - Ron Leaders, Esq., of Buckley & Leaders, Vashon, Washington.

Respondents' Counsel - Michael Naccarato, Esq., in house counsel for A.G. Edwards & Sons, Inc., St. Louis, Missouri.

Claimants' Expert - Barry Estell, Kansas City

Respondents' Expert - None

Hearing Situs - Kansas City, Missouri

Arbitrators - Keith Martin, Chairman; Richard D. Sewell, Public; Roland E. Hecht, Industry

Cases & Materials

Charles W. Austin, Jr.

Charles W. (Chuck) Austin, Jr., Richmond, Virginia, is a director of PIABA and a member of its executive committee. His practice is dedicated exclusively to the representation of investors in disputes with the securities industry.

FEDERAL COURTS

First Circuit

In re Citigroup, Inc. CAP Litigation, 376 F.3d 23 (1st Cir. 2004)

The district court found that the corporation implicitly waived its right to arbitrate by participating in the litigation, unduly delaying assertion of its arbitration right, and prejudicing plaintiffs. It was not until the corporation filed its motion to stay arbitration that the corporation actually asserted its right to arbitration. The instant court found that there was no excuse for the delay. The delay of more than three years after the filing of the complaint and of 18 months after class certification were sufficient to waive the corporation's right to arbitrate, as long as the delay was prejudicial to plaintiffs. The corporation's argument that plaintiffs were not prejudiced because only five interrogatories were answered which were relevant to the class members with arbitrable claims was unavailing because it failed to account for the costs already incurred in discovery to all of the class members and the delay in invoking its arbitration rights; both of which caused the class members with arbitrable claims prejudice. The corporation invoked the litigation machinery. The corporation could not have overcome the prejudice suffered by plaintiffs due to its delay.

Richard C Young & Co., Ltd v. Morris Leventhal, *et al*, 389 F.3d 1 (1st Cir. 2004)
Appeal of ruling by USDC Mass. that forum selection clause in California investors' arbitration agreement which provided that arbitration be held before the AAA in Boston did not require that the arbitration be held in Boston, but only that the claim be filed with the AAA office in Boston. Appeals court reversed the trial court, holding that the dispute between the parties over the location of the arbitration raised not a question of arbitrability but a procedural question and was therefore for the arbitrator, not the court. The disagreement over the interpretation of the so-called forum selection clause was one in connection with the agreement and hence one the parties agreed to submit to arbitration. Since the dispute between the parties was concededly arbitrable, determining the place of the arbitration was simply a procedural matter and hence for the arbitrator. The district court lacked power to interpret the forum selection clause.

Second Circuit

In re Enterprise Mortgage Acceptance Co. LLC Securities Litigation
Docket Nos. 03-9261, 03-9265, 04-0392
(2d Cir. December 6, 2004)

Sarbanes-Oxley does not revive previously expired securities fraud claims.

Credit Suisse First Boston v. Groves,
333 F. Supp. 2d 229
(SDNY 2004)

CSFB sought to compel respondent, one of its former employees, to arbitrate a dispute between the parties under the auspices of JAMS, and to discontinue the NYSE arbitration that the employee had initiated. The employee opposed the petition and made a reciprocal application. The issue before the court was which arbitral forum was proper. The bank, as a member organization of the NYSE, was subject to the NYSE's rule 347 requiring it to arbitrate, "at the instance of any such party," employment controversies with its registered representatives. The employee was subject to the bank's employment dispute resolution program (EDRP). The EDRP provided for conflicts between a forum designated in the EDRP's arbitration forum selection clause and a forum designated in some other arbitration agreement between the parties (such as the NYSE rule) by giving priority to the EDRP forum unless the other forum was legally required to the exclusion of all other rules and forums. The court found that the execution of the EDRP by the CSFB employee was a waiver of his right to compel arbitration before the NYSE, and the NYSE arbitration the employee initiated after executing the EDRP was therefore a nullity. Thus, when the employee became a party to the EDRP which provided for arbitration before a non-NYSE forum, he waived the right to elect a NYSE forum.
CSFB's petition was granted. The employee's application to compel NYSE arbitration and enjoin JAMS arbitration was denied. His NYSE arbitration was stayed and the stay of the JAMS arbitration was vacated. The employee was directed to arbitrate his claims against the bank under the JAMS procedures.

Ruei-Chan v. Merrill Lynch,
No. 04 Civ. 488,
2004 U.S. Dist. LEXIS 18594
(SDNY Sept. 7, 2004)

Another nail in the coffin of the "manifest disregard of the evidence" standard *a la* Wallace v. Buttar. "The United States Court of Appeals for the Second Circuit does not recognize manifest disregard of the evidence as a proper ground for vacating an arbitrator's award. Only the doctrine of manifest disregard of the law, which doctrine holds that an arbitral panel's legal conclusions will be confirmed in all but those instances where there is no colorable justification for a conclusion, is recognized. To the extent that a federal court may look upon the evidentiary record of an arbitration proceeding at all, it may do so only for the purpose of discerning whether a colorable basis exists for the panel's award so as to assure that the award cannot be said to be the result of the panel's manifest disregard of the law."

In re Randall S. Appel,
315 B.R. 645 (EDNY 2004)

In an adversary proceeding, appellant debtor sought judicial review of that portion of the order of the United States Bankruptcy Court for the Eastern District of New York that granted summary judgment in favor appellees and declared that the debtor was not entitled to discharge a debt under 11 U.S.C.S. § 523.

Prior to the debtor filing for Chapter 7 bankruptcy, appellees commenced a NASD arbitration proceeding against the debtor alleging not only federal and state statutory violations, but also claims for breach of contract, breach of fiduciary duty, breach of duty of loyalty, negligence, and common law fraud. The debt in question was the arbitration award made to appellees. The bankruptcy court ruled that the debtor was collaterally estopped from relitigating the issues that were previously determined after years of litigation in arbitration. The parties agreed that Florida law controlled the applicability of collateral estoppel. The actually litigated element of collateral estoppel was met even though the debtor was precluded by the arbitration panel from offering evidence.

His preclusion resulted from his failure to respond to three prior orders throughout the arbitration. The findings made by the arbitration panel were plainly a critical and necessary part of the arbitration award and the determination that the debtor had defrauded the appellees. The elements of § 523(a) were critical and necessary to the arbitration award, so the order of the bankruptcy court was affirmed.

Third Circuit

Matyuf v NASD Dispute Resolution,
Civil Action No. 04-540
2004 U.S. Dist. LEXIS 25174
(W.D. Pa. October 4, 2004).

Prevailing claimant in arbitration filed suit against NASD-DR to vacate award of forum fees against her on the grounds that the fees bore no "reasonable relationship" to the costs incurred by the NASD-DR to conduct the Plaintiff's arbitration, and were otherwise "unjust, inequitable[,] and unconscionable."

Magistrate recommended dismissal of suit for lack of subject matter jurisdiction and failure to state a claim upon which relief can be granted. Characterizing the complaint as "nothing more than a thinly-veiled collateral attack on the reasonableness of the fee schedule contained in the NASD's CAP, the court noted that, pursuant to Section 25 of the Exchange Act, the "exclusive means to challenge an SEC-approved NASD rule in federal court is through filing a petition to the U.S Court of Appeals . . .within 60 days of . . . approval of the rule" by the SEC, and dismissed the action for lack of subject matter jurisdiction. Going further, the Magistrate found that, even if the court had jurisdiction to entertain the complaint, claimant failed to state a claim under the Pa. Uniform Arbitration Act, because the award of forum fees was not alleged to be the result of any wrongdoing by the arbitrators or opposing party, but rather the wrongdoing of the NASD in propounding an "unreasonable forum fee schedule and by submitting to the SEC a "false or misleading 'costing study' . . .which grossly overstated [the] costs of conducting arbitration hearings . . ."

Fourth Circuit

Washington Square Securities v. Aune, *et al*,
385 F.3d 432 (4th Cir. 2004)

ETS Payphone case in which Washington Square sought declaratory relief in U.S. District Court in North Carolina that it could not be compelled to arbitrate investors claims on the grounds that they were not "customers" of Washington Square within the meaning of NASD CAP Rule 10101. Applying North Carolina contract and agency principles, the district court determined that Washington Square was bound to arbitrate by virtue of its membership in the NASD, and dismissed the action. The 4th Circuit affirmed the district court's ruling, albeit on different reasoning.

Although the district court ruled that Washington Square was obligated to arbitrate its claim, it found that there was no presumption in favor of an obligation to arbitrate because there was no signed customer agreement containing an arbitration agreement. The 4th Circuit disagreed with this ruling, holding that "[t]he obligation and entitlement to arbitrate does not attach only to one who has personally signed the written arbitration provision," but rather, that well-established common law principles dictate that in an appropriate case a nonsignatory can enforce, or be bound by, an arbitration provision within a contract executed by other parties, and that the NASD Code constitutes an "agreement in writing" under the Federal Arbitration Act which binds Washington Square, as an NASD member, to submit an eligible dispute to arbitration upon a customer's demand.

The Court also engaged in a relatively detailed analysis of the meaning of the clauses "between a customer and a member and/or associated person" and "arising in connection with the business of such member or in connection with the activities of such associated persons,"

under CAP Rule 10301. The Court found both of those clauses ambiguous, but because they *could be* interpreted to apply to the customer's claims, the general presumption in favor of arbitration must prevail.

Fifth Circuit

Crusius v AIG SunAmerica Life,
2004 U.S. Dist. LEXIS 23525 (W.D. Tex., Nov. 16, 2004)

Plaintiff filed action in court arising out of the conveyance of plaintiff's money to defendant for the purchase of an annuity, which plaintiff claimed was never authorized and, therefore, that the purchase was void and in violation of state law. After filing the court claim, plaintiff also instituted an arbitration proceeding against member firm and its registered rep through whom the purchase was made and who were not parties to the court claim. The arbitration panel ordered the brokers to return the money and also awarded exemplary damages. Plaintiff admitted that the arbitration panel found in his favor based on the operative facts, but nonetheless relied on the same facts to bring claims against defendant for conversion, unjust enrichment, exemplary damages, attorneys fees, and pre-judgment interest. In granting defendant's motion for summary judgment, the court held that the claims were barred by collateral estoppel. The court held that the arbitral procedures afforded plaintiff due process. The court also held that the remedies plaintiff sought were the same and based on identical facts as those plaintiff sought in the arbitration proceeding and that the action raised no federal interests warranting special protection.

Sixth Circuit

In re Donahue Securities, Inc.,
Case No. 01-1027, SIPA Liquidation, Adversary Case No. 02-1381
2004 Bankr. LEXIS 1609 (S.D. Ohio, October 7, 2004)

Adversary proceeding instituted by Plaintiff, the SIPA trustee, on behalf of the Securities Investor Protection Corporation, against three former employees of debtor investment company - all of whom were licensed as registered representatives. The owner of the investment company had been convicted of wire fraud. The SIPA trustee alleged that defendants were negligent in performing their duties as employees, that defendants breached a fiduciary duty to the customers when they failed to discover or prevent the owner's fraud, and that defendants, as employees and registered representatives, could be held legally responsible under established common law principles.

Defendants moved to dismiss the claim under FRCP 12(b)(6). The court granted defendants' motion to dismiss. Defendants could not be held liable for common law negligence. The common law imposed a duty of care for customers upon stockbrokers and not upon the employees of a broker-dealer. There was no "good Samaritan" duty to report someone else's fraudulent activities, absent some special relationship. Nothing in Ohio law established a fiduciary relationship between a broker-dealer's employees and the firm's clients that would have enabled a client to sue the employee for an alleged breach of that duty to the firm. Plaintiff lacked the requisite standing to sue defendants since no law allowed a customer to sue an employee by asserting rights belonging to the employer.

Seventh Circuit

Lee v. McDonald Securities,
No. 04 C 2886,
2004 U.S. Dist. LEXIS 19293 (N.D. Ill., Sept. 27, 2004)

Action by registered rep to vacate arbitration award in favor of member firm against terminated registered rep for repayment of "forgiveable loan" on the grounds that arbitrators exceed their powers and manifestly disregarded the law. In support of his claim the employee argued that: (1) his termination was arbitrary, and an arbitrary termination could not provide the basis for the firm's right to repayment of the promissory loan; (2) the

terms requiring him to repay the loan following his termination were not enforceable because they were not supported by consideration; and (3) the arbitration panel refused to consider pertinent and material evidence to his defense.

The Court found that none of those arguments supported his assertion that the arbitration panel exceeded its powers or manifestly disregarded the law. The employee's first two arguments were nothing more than claims that the arbitration panel wrongly decided the facts or improperly applied the law. The significant aspect of the decision revolves around the the terminated employees third argument: That the arbitrators engaged in misconduct by refusing to hear pertinent and material evidence. Plaintiff argued that the panel's denial of his motion to compel evidence regarding the productivity of his co-workers, impeded his ability to prove that he was fired arbitrarily.

The court found that the panel did not engaged in misconduct sufficient to justify vacatur of the Award. "Not all failures to receive relevant evidence constitute misconduct, requiring a court to vacate an arbitration award." "In order to vacate an arbitration award on the basis of an error in excluding evidence, the error must "so affect[] the rights of a party that it may be said that he was deprived of a fair hearing." "Such misconduct occurs when an arbitration panel fails to employ 'basic notions of fairness and due process' and 'grossly and totally block[s]' a party's right to be heard." The evidence that plaintiff was not allowed to compel during discovery related to his argument that co-workers, who were not fired, were less productive than he and, therefore, defendant's reason for his termination was pretextual. The Court held that, even if the arbitration panel had wholly refused to hear evidence on this issue, it could not find that it so affected plaintiff's rights as to deprive him of a fair hearing because defendant argued during the arbitration hearing that plaintiff's termination was not only due to lower than expected production, but also due to compliance issues and a customer complaint. More importantly to the court was the fact that plaintiff admitted that his right to be heard on this issue was not grossly and totally blocked. He presented this argument and the panel admitted into evidence, over defendant's objection, a document evidencing the productivity of employees in defendant's Chicago office. The panel did not violate tenets of fairness nor completely block plaintiff's right to be heard and, thus, the denial of his motion to compel is not proper grounds to vacate the arbitration award.

In re: Nicholas William Betzold, Jr., 316 B.R. 906; 2004 Bankr. LEXIS 1723 (N.D. Ill. October 14, 2004)

Movants were debtor's former partners. Prior to the debtor's filing bankruptcy, the partners filed a state court action against the debtor, and the state court compelled arbitration. The arbitrator found against the debtor as to liability, and all that remained was a motion for reconsideration and a decision as to damages. The partners moved for relief from the automatic stay so that the arbitration proceedings could be completed.

The bankruptcy court held that if it were to stop the arbitration and revisit the issues directed to be arbitrated, it would essentially be setting aside the state court's decision to compel the arbitration. Moreover, the debtor was in essence asking the bankruptcy court to interject itself into the state-court directed arbitration and the state court appellate processes that followed an arbitration award. Such action would have been a clear violation of the Rooker-Feldman doctrine. Accordingly, the bankruptcy court had no subject matter jurisdiction by virtue of the Rooker-Feldman doctrine. Even if the Rooker-Feldman doctrine did not apply, the bankruptcy court would have nonetheless found cause to modify the stay under the United States Court of Appeals for the Seventh

Circuit's Fernstrom opinion. Given the advanced stage of the arbitration, the prejudice to the partners in not lifting the stay far outweighed the prejudice, if any, to the debtor. Moreover, the debtor himself had asked the state court to compel the arbitration. Finally, there were strong federal and state policies favoring arbitration.

McDonnell v. Allstate Life Insurance Co.
Case No. 04 C 3076,
2004 U.S. Dist. LEXIS 21822
(N.D. Ill., Oct. 21, 2004)

Investor filed suit against defendant insurance company for breach of contract, breach of the covenant of good faith and fair dealing, conversion, and breach of fiduciary duty alleging that the company wrongfully changed its policies regarding the transfer of monies between his investment alternatives in his variable annuity, thereby causing him to lose profits. The investor further alleged that the company failed for nearly a month to comply with his request to transfer the majority of his monies to another annuity product, during which time the value of his annuity dropped significantly.. The company filed a motion to dismiss the claims for breach of good faith and fair dealing, conversion, and breach of fiduciary duty.

The court held: (1) the investor failed to state a claim for breach of the covenant of good faith and fair dealing because his claim did not involve an insurer's obligation to settle with a third party who had sued a policy holder; (2) the investor failed to state a claim for conversion because an action for conversion of funds could not be maintained to satisfy the mere obligation to pay money; and (3) the investor's allegations--that the company was responsible for transferring funds between the various investment options pursuant to the investor's request but failed to do so, thereby resulting in lost profits--sufficiently alleged a claim for breach of fiduciary duty.

Ninth Circuit

Theis Research v Brown & Bain, 386 F.3d 1180
(9th Cir. 2004)

Appeal from the ND of California. The Ninth Circuit appears, at first blush, to answer the question of how the “amount in controversy” is calculated for the purposes of invoking federal court jurisdiction in a post-award vacatur action: The amount claimed in the underlying arbitration or the amount of the award sought to be vacated? Unfortunately, a poorly written opinion in this case leaves the practitioner with no definitive answer and almost dictates that this issue will have to be decided again at some future date.

The opinion begins with language which promises to answer the question. “We conclude that the amount at stake in the underlying **litigation**, not the amount of the arbitration award, is the amount in controversy for purposes of diversity jurisdiction, and thus the district court had jurisdiction under 28 U.S.C. § 1332” (emphasis added). Unfortunately, when one reads the facts and procedural history of this case, it is not altogether clear what the Court meant to say with this preceding conclusory sentence.

Theis filed a vacatur motion in federal court styled “ ‘COMPLAINT FOR BREACH OF PROFESSIONAL AND FIDUCIARY DUTY, LEGAL MALPRACTICE, AND FRAUD: APPLICATION AND NOTICE OF MOTION TO VACATE ARBITRATION AWARD.’ Theis also demanded a jury trial. The claims Theis set forth in its complaint sought compensatory damages of $ 200 million, plus ‘exemplary and punitive damages,’ " which mirror the claims made and damages sought in the underlying arbitration. Theis was awarded nothing in the underlying arbitration.

The trial court granted summary judgment to Brown & Bain on its motion to dismiss Theis’ motion to vacate on the grounds that the arbitration award of $0 failed to meet the jurisdictional minimum to invoke diversity jurisdiction and at the same time, granted Brown & Bain’s Motion to

Confirm and Motion for Summary Judgment on the claims asserted by Theis in the District Court. Theis appealed. Among other things (although the opinion does not say this), Theis - who had originally filed in the trial court - did not like the way things turned out there and appears to have argued on appeal that the very court he filed in lacked subject matter jurisdiction to make the rulings it did.

The Ninth Circuit reversed the grant of summary judgment for lack of jurisdiction. Based on the following excerpts, the Court's ruling appears to rest on the fact that, in addition to moving for *vacatur*, Theis also requested $200 million in damages, which happened to mirror what he had unsuccessfully sought in the underlying arbitration.

*The question presented to us thus boils down to whether **the $200 million Theis sought to recover by its complaint** is the amount in controversy under 28 U.S.C. § 1332(a), or whether the amount in controversy must be measured by the zero dollar arbitration award Theis sought to vacate. We are satisfied that the amount in controversy is **the amount Theis sought to recover by its complaint**.*

*In the present case, the arbitration award was for zero dollars. Theis initially filed in the district court a motion to vacate that award, coupling that motion with a complaint that alleged substantially the same claims Theis had asserted in the arbitration. Theis's prayer for relief **in its district court complaint** was for $200 million plus "exemplary and punitive damages," which on the face of the complaint satisfied the $75,000 monetary threshold for diversity jurisdiction.*

*Theis argues, however, that we should ignore the claims it asserted in its district court complaint because those claims were "non-substantial" as evidenced by the district court's eventual dismissal of them as barred by res judicata. We reject this argument. To treat Theis's claims as non-substantial simply because they were eventually dismissed as being barred by res judicata would retroactively preclude jurisdiction in any action in which the affirmative defense of res judicata was asserted and successfully maintained. The question is not whether B&B;was successful in its res judicata defense. The question is whether the amount of damages Theis claimed **in its complaint** was asserted in good faith; if so, that amount controls for purposes of diversity jurisdiction. St. Paul Mercury Indem. Co. v. Red Cab Co., 303 U.S. 283, 288-89 (1938).*

There is nothing on the face of Theis's complaint, nor in the record before us, to suggest that the claims Theis asserted in the district court were not asserted in a good faith belief in the validity of those claims, notwithstanding that it turned out Theis's good faith belief was misplaced. See id.; see also Budget Rent-a-Car, Inc. v. Higashiguchi, 109 F.3d 1471, 1473 (9th Cir. 1997) (dismissal for lack of jurisdiction not proper if claim exceeding jurisdictional amount is made in the complaint in good faith, even when later events reduce the amount recoverable).

*Our conclusion that we measure the amount in controversy by the amount at stake in the underlying litigation is consistent not only with American Guaranty from this circuit, but with decisions from other circuits as well. In the Eleventh Circuit's decision in Baltin v. Alaron Trading Corp., 128 F.3d 1466 (11th Cir. 1997), the Baltins sought to undo an arbitration award under which they were required to pay Alaron Trading $36,284.69. Id. The court held that the then jurisdictional minimum of $50,000 was not met because "[t]he maximum remedy sought by the Baltins was the vacatur of the arbitration award of $36,284.69." Id. **Because neither the Baltins nor Alaron Trading sought additional damages**, the amount in controversy was limited to the amount of the arbitration award. See id. & n.16.*

*Although neither Theis nor B&B asked that the arbitration proceedings be reopened, **Theis sought to obtain by its district court complaint***

substantially what it had sought to obtain in the arbitration*.*

(emphasis added).

Based on a careful reading of this opinion, it is not at all clear that - had Theis not coupled his request to vacate the award with a jurisdictionally sufficient request for monetary damages - the 9th Circuit would have ruled that the trial court had jurisdiction based solely on the amount requested in the underlying arbitration. As such, the question of whether the amount of the claim in the underlying arbitration or the amount of the award is the basis of determining "amount in controversy" in resolving the question of determining diversity jurisdiction does not appear to have been answered by this case.

Eleventh Circuit

Multi-Financial Securities Corp. v. King, 386 F.3d 1364 (11th Cir. 2004)

"Selling away" case. Allegedly upon the recommendation of registered representative of member-firm - and, at least in part due to the registered rep's affiliation with the member firm, investor purchased unregistered shares of Panamanian company which ultimately went bankrupt. Investor never opened account with member firm, and there was evidence that registered rep never discussed either the investor nor the subject investments with anyone at member firm. After investor filed arbitration, member firm filed action for declaratory relief that investor was not a "customer" of member firm who could compel arbitration of her claim. Trial court ruled that "a customer's direct dealings with an associated person of an NASD member are sufficient to compel an NASD member into arbitration." Eleventh Circuit affirmed trial court's ruling.

MONY Securities v Bornstein, 390 F.3d 1340 (11th Cir 2004)

Viatical "selling away" case. Court held that the combined requirements of NASD CAP Rules 10101 and 10301(a) create a two-part test for determining whether an investor may compel arbitration: An investor must show that his or her claim involves a dispute between a member and a customer or an associated person of the member and a customer, and that the claim arises in connection with the business activities of the member or in connection with the activities of the associated person. Eleventh Circuit upheld trial court's grant of summary judgment in favor of investors' right to compel arbitration on 2 general grounds: (1) since investor was a customer of MONY's registered rep, they were customers of MONY for purposes of CAP Rule 10101; and, (2) claim of negligent supervision against MONY brought claim within the meaning of a dispute "aris[ing] in connection with the business activities of the member or in connection with the activities of the associated person" for the purposes of compelling arbitration.

STATE COURTS

California

Alan v. L.A. County Superior Court, *et al*
No. B178840, 2004 Cal. App. Unpub. LEXIS 11650
(Cal. App. 2d Dist., 12/21/04)
UNPUBLISHED

Latest in the series of cases attempting to resolve the problems arising as the result of the enactment of the California Arbitrator Standards and their applicability and effect on SRO arbitration. Somewhat convoluted opinion which appears to hold that, if the NASD requires a waiver of the Cal Arb Standards and a party refuses to give one (and the NASD won't conduct the arbitration without one), the case will go to trial.

Connecticut

Sultar, *et al* v. Merrill Lynch, *et al*
2004 Conn. Super. LEXIS 3003 (Oct. 13, 2004)

Customers filed for arbitration and Respondents asked the arbitration panel to dismiss the arbitration because plaintiffs allegedly failed to comply with discovery. The panel granted dismissal.

Plaintiffs asked the arbitration panel (rather than a court) to vacate the dismissal. The arbitration administrator alerted plaintiffs that the motion to vacate filed with the panel would not toll any time limits for filing a motion to vacate in court. The panel denied the motion and plaintiffs thereafter applied to the court under Conn. Gen. Stat. § 52-418 to vacate the arbitration award. Respondents moved to dismiss due to untimeliness.

The court found that the 30-day time limit under Conn. Gen. Stat. § 52-102(b) for filing a motion to vacate was an issue of subject matter jurisdiction, and that time limit was not tolled by plaintiffs' motion to vacate before the arbitration panel. Because plaintiffs' motion was untimely, the court lacked jurisdiction and dismissal was required. Moreover, the 3-month time limit under § 12 of the Federal Arbitration Act was a procedural rule that applied to federal court cases, and did not prevent application of the 30-day time limit under Conn. Gen. Stat. § 52-102(b), because the Connecticut provisions did not undermine the overriding purpose of the FAA.

Indiana

Acclerated Benefits Corp. v Peaslee
818 N.E.2d 73 (Ind. App. 2004)

Viaticals are "securities" within the meaning of the Indiana Securities Act.

New Jersey

Del Piano v Merrill Lynch
2004 N.J. Super. LEXIS 387 (N.J. Super. Ct. App.Div., Nov. 3, 2004)
UNPUBLISHED

Appeal by Merrill Lynch of trial court's vacatur of NASD arbitration award on the grounds of "evident partiality" due to non-public arbitrator's failure to disclose that his employer, Deutsche Bank, was the co-lead underwriter on the stock at issue in the case. Appellate division reversed the trial court's ruling. The opinion is notable for its extensive discussion of the factors which constitute "evident partiality," including application of an "appearance of impropriety" standard, the duty of arbitrators to make "reasonable inquiry" as to potential conflicts of interest prior to accepting appointment and the impact of the failure to make reasonable inquiry on a finding of "evident partiality" sufficient to set aside an award.

New York

Sawtelle, *et al* v. Waddell & Reed, *et al*
2004 NY Slip Op 24476
2004 N.Y. Misc. LEXIS 2357 (2004)

This latest round in a 7+ year old war over a $25 million punitive damages award raises a novel issue: May the New York Supreme Court order a conditional remittitur in an arbitration proceeding?

By order and judgment dated May 31, 2002, the trial court modified an arbitration award issued in favor of Sawtelle, and as modified, confirmed the award. That award included a provision for punitive damages in the amount of $ 25 million. On appeal, the Appellate Division, First Department, modified the trial court's order by granting respondents' cross motion to vacate the punitive damages award; affirmed the order except as modified; and remanded the matter to the original panel of arbitrators for reconsideration of the issue of punitive damages.

Upon reconsideration, the arbitration panel accepted voluminous written submissions, held a one-day hearing, and issued a second award. The second award changed the phrase "after Claimant was terminated, Respondents orchestrated a campaign of deception...," which appears in the initial award, to the phrase "after Claimant was terminated, Respondents orchestrated and conducted a horrible campaign of deception, defamation and persecution of Claimant...," and again awarded punitive damages of $ 25 million. Sawtelle moved to confirm the second award, and respondents moved to vacate it. By order, dated January 22, 2004, the trial

court vacated the second award and ordered that the matter be submitted to a new panel of arbitrators.

After 2 arbitrations (according to the opinion, the transcript in the first arbitration ran 10,000 pages and legal fees in excess of $700,000), 2 vacatur actions and 2 appeals - and faced with the prospect of more - Sawtelle petitioned the trial court to modify it's second order to provide for a remittitur of the award to bring it into line with punitive damages standards rather than force the parties to undergo yet another arbitration. The court acknowledged that, while Sawtelle's request made sense, neither the FAA nor New York's CPLR permitted it to do so.

Morgan Stanley DW, Inc. v. Afridi
2004 N.Y. App. Div. LEXIS 15485
(N.Y. App. 1st Dept., Dec. 21, 2004)

Customer brought claim in arbitration against both member firm and registered representative, customer's son, alleging that MSDW was liable under *respondeat superior* for actions of registered rep and directly liable for negligent supervision of registered rep. NASD arbitration panel denied all claims against registered rep, but entered award against MSDW without reciting basis for award. MSDW moved to vacate award on the grounds that, in light of denial of claims claims against registered rep, panel's award "manifestly disregarded the law" and constituted "an inherently contradictory and completely irrational result."

The trial court granted MSDW's motion to vacate. Appellate court reversed the trial court's ruling on two grounds: (1) Since Morgan Stanley's counsel never argued to the arbitrators that applicable law required either a finding of liability against both Morgan Stanley and Adel or, alternatively, dismissal of the claims against both, and since the doctrine of "manifest disregard of the law" requires that "the record show that the arbitrator knew of the relevant [legal] principle, appreciated that this principle controlled the outcome of the disputed issue, and nonetheless willfully flouted the governing law by refusing to apply it," MSDW's claim of "manifest disregard" must fail; and, (2) To the extent the FAA permits vacatur of an arbitration award on the ground that it is irrational, the arbitrators may have found that Morgan Stanley was guilty of direct negligence, and, if so, they rationally could have concluded that Morgan Stanley's culpability for its negligence was so much greater than the registered rep's culpability for his that the firm should be held solely liable for Afridi's losses.

North Carolina

White v. Consolidated Planning, et al
603 S.E.2d 147
(N.C. App. 2004)

The cause of action arose as a result of one of the insurance company's agents misappropriating the customer's annuity fund for his own gambling habit. The trial court granted defendant insurance company's motion to dismiss the customer's claims for negligent hiring, breach of fiduciary duty, constructive fraud, and conversion and granted summary judgment to the insurance company on the customer's claims for negligence, conversion, fraud, and unfair and deceptive trade practices. The appellate court reversed the dismissal of the claims for negligent hiring and breach of fiduciary duty and affirmed the dismissal of the constructive fraud claim. The court reversed the grant of summary judgment on the fraud, conversion, negligence, and unfair and deceptive trade practices claims but held that genuine issues of material fact existed as to the application of equitable estoppel to the time-barred conversion and negligence claims.

WMS, Inc., *et al* v. Weaver, *et al*
602 S.E.2d 706
(N.C. App. 2004)

Non-securities case. Even though North Carolina law is clear that attorneys' fees are not available in arbitration

absent agreement of the parties and even though the parties had not made such an agreement, the arbitration panel's award of attorneys' fees will not be vacated because complaining party failed to object during the arbitration to the prevaling party's request for attorneys' fees and therby waived their rights under North Carolina statutory prohibition against the award of attorneys' fees.

Ohio

Featherstone v. Merrill Lynch
2004 Ohio 5953, 2004
Ohio App. LEXIS 5387
(Ohio Ct. App. Dist.9, Nov. 10, 2004)

Discussion of waiver of right to arbitrate under Ohio law.

Hollinger, *et al* v. KeyBank, *et al*
2004 Ohio 7182
(Ohio Ct. App. Dist.9, Dec. 22, 2004)

Eighty-three individual investors filed a putative class action suit against Key Bank asserting claims of fraud and civil conspiracy in connection with what the investors contended was the Bank's aiding and abetting a scheme to defraud them. Bank moved to stay the proceeding pending arbitration, asserting that investors, as Keybank customers, had each signed a deposit account agreement which contained an arbitration provision. The trial court disagreed that the allegations fell within the scope of the arbitration provision and appeals court affirmed.

Texas

Gililland v. Taylor Investments,
No. 11-03-00175-CV
2004 Tex. App. LEXIS 8521
(Tex. App. Dist. 11, 9/23/04)

The investors, Taylor Investments, filed an action alleging that the financial consultant made false representations that he would personally supervise and monitor the accounts. The financial consultant filed a motion to stay and compel arbitration, which was denied. The trial court did not specify whether it denied the motion pursuant to the Texas General Arbitration Act or the Federal Arbitration Act. The appellate court held that the trial court erred in denying the motion to compel arbitration.

First, the court determined that the FAA was applicable and that mandamus was the appropriate remedy, because "commerce" under the FAA is broadly construed. The issue is not whether the parties' dispute affects interstate commerce, but whether their dispute concerns a transaction that affects interstate commerce. The FAA does not require a substantial effect on interstate commerce; rather, it requires only that commerce be involved or affected.the account agreement provided for the purchase of securities and that the sale of securities involved interstate commerce. Next, the court determined that the financial consultant, although not a signatory to the agreement, had the right to enforce the arbitration provision because the claims related to his behavior as an agent of the firm. Finally, the court held that the claims fell within the scope of the agreement.

AROUND THE SROs

NASD

Notices to Members

04-89 NASD Alerts Members to Concerns When Recommending or Facilitating Investments of Liquefied Home Equity

04-86 SEC approves NASD Interpretive Material to Rule 2210 regarding member firms' use of investment analysis tools; Effective 2/14/05

04-81 SEC Approves New NASD Qualification Requirements for Supervisors of Research Analysts; Compliance Date: No Later Than August 2, 2005

04-79 SEC Approves New Chief Executive Officer Compliance Certification and Chief Compliance Officer Designation Requirements; Compliance Date: December 1, 2004

04-72 Impermissible Use of Negative Response Letters for the Transfer of Mutual Funds and Variable Annuities

04-71 SEC Approves New Rules and Rule Amendments Concerning Supervision and Supervisory Controls; Effective Date: January 31, 2005

National Adjudicatory Council Decisions

Dept. of Enforcement v. VMR Securities & Ficeto
No. C02020055
(Dec.2, 2004)

Respondents failed to reasonably supervise a registered representative who engaged in excessive and unsuitable trading in three customer accounts. Held, findings affirmed and sanctions modified.

Fines and Sanctions

Citigroup Global Markets, Inc. submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $250,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it made available to its customers fact cards, sales presentations, sales decks and prospecting letters regarding hedge funds and funds of hedge funds that listed a targeted rate of return without providing a sound basis for evaluating the target, improperly used hypothetical returns in charts or graphs, and/or failed to include adequate risk disclosure. (NASD Case #CAF040077)

Fiserv Investor Services, Inc. submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $20,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that the firm, acting through an individual, failed to report transactions in municipal securities and to establish a reasonable supervisory system, including but not limited to, the establishment and maintenance of written procedures reasonably designed to ensure the firm reported transactions involving municipal securities. (NASD Case #C06040032)

Harris Nesbitt Corp., f/k/a BMO Nesbitt Burns Corp. submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $125,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it implemented a procedure for investment banking to review research reports, but failed to establish and maintain adequate systems and safeguards to prevent investment bankers from making inappropriate comments regarding research reports. (NASD Case #CAF040074)

Miramar Securities, LLC. submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $10,000, and required to implement within 90 days its written supervisory procedures with respect to the handling of discretionary accounts and retention of all electronic correspondence. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that the firm, through its Web site, stated that they created a premier investment bank and that a corporate finance division was created to provide strategic advice and capital-raising services to its clients when, in fact, the firm was not and had never been an investment bank, and had never been approved for corporate financing and did not have a corporate finance division. The findings also stated that the firm allowed a broker who prepared and distributed research reports for another firm to brokers, investment company personnel, and investors to have discretionary authority for customers who purchased shares in companies on which his other firm released research reports; this broker made transactions in these companies 30 days before and five calendar days after the publication of research reports on the companies. The findings also stated that the firm failed to enforce its written supervisory procedures concerning the handling of discretionary accounts and review of all incoming and outgoing

electronic correspondence by a principal. (NASD Case #CAF040080)

Northwestern Mutual Investment Services, LLC, Thomas Garland Lipscomb, III and Daniel Edward Brunette submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $1,000,000, and required to file with NASD's Advertising Regulation Department all institutional sales materials used for educational purposes relating to internal seminars and training sessions about variable life insurance products prior to their first use for one year from the date of acceptance of this AWC. The firm was also required to provide notice to all current firm registered representatives that attended Lipscomb's seminars from May 18, 1998, through October 22, 2001, that explains the deficiencies identified in this AWC of the seminars. Lipscomb was censured, fined $250,000, suspended in any capacity for 30 business days, and ordered to requalify as a Series 6 investment company products/variable contracts representative. Brunette was censured, fined $10,000, and suspended in any capacity for five business days. Without admitting or denying the allegations, the firm, Lipscomb, and Brunette consented to the described sanctions and to the entry of findings that Lipscomb conducted training seminars for firm sales agents that emphasized the investment aspects of a variable life insurance while downplaying the insurance aspects, presented a simplistic and inaccurate depiction of its tax implications, and failed to describe sufficiently the risks of using the policy in the manner he recommended. The findings also stated that the firm was aware of concerns with Lipscomb's seminars but failed to take adequate action to address these concerns nor was Lipscomb disciplined by the firm for failing to make requested changes to the seminar. NASD also found that Brunette failed to describe clearly the variable life insurance policy in letters to public customers and the firm, despite knowing that Brunette had used inappropriate terms in communications with public customers, failed to take adequate and timely action to monitor and supervise his written correspondence with customers. In addition, NASD found that the firm failed to retain e-mails for three years, or for the first two years in an accessible place. Lipscomb's suspension began October 18, 2004, and will conclude at the close of business November 26, 2004. Brunette's suspension began October 18, 2004, and concluded at the close of business October 22, 2004. (NASD Case #CAF040075)

Trautman Wasserman & Company, Inc. and Gregory Owen Trautman submitted an Offer of Settlement in which the firm was fined $100,000. Trautman was fined $200,000, including disgorgement of $135,000 of commissions in partial restitution to public customers, suspended from association with any NASD member in any capacity for 31 days, suspended from association with any NASD member as a Series 24, general securities principal for six months, and barred from association with any NASD member as a Series 55 equity trader. Without admitting or denying the allegations, the firm and Trautman consented to the described sanctions and to the entry of findings that the firm, acting through Trautman, offered a special sales credit to its registered representatives for selling a security and, either intentionally or recklessly failed to disclose or to take any steps to cause to be disclosed to public customers the special sales credit offered to the firm's registered representatives, depriving the customers of the knowledge that the registered representatives might be recommending stock based upon the their own financial interest rather than the investment value of the security. NASD also found that the firm failed to report to NASDAQ principal purchases and sales of the security. In addition, NASD found that the firm inaccurately reported securities transactions, failed to identify the report as an aggregate transaction, and

reported the times of securities purchases to the Nasdaq Stock Market for which the corresponding order memoranda reflected a later time. Moreover, NASD found that the firm was a market maker in penny stocks and effected transactions with public customers in the stocks although the stocks did not qualify for a transactional exemption from the Securities and Exchange Commission's (SEC) penny stock rules. The firm also failed to furnish the customers with the requisite risk disclosure document relating to the penny stock market and disclose the inside bid/outside offer quotations; failed to disclose the amount of compensation received by the firm and registered representatives; failed to give purchasing customers the requisite written statement relating to price determinations and market and price information for the penny stocks; and failed to properly approve the accounts for transactions in penny stocks for non-established customers and to receive the required purchase agreement. Moreover, NASD found that the firm's written supervisory procedures were not reasonably designed to achieve compliance with Regulation M of the Securities Exchange Act of 1934. Trautman's suspension in a principal capacity began November 1, 2004, and will conclude April 30, 2005. Trautman's suspension in all capacities began November 1, 2004, and will conclude at the close of business December 1, 2004. (NASD Case #C3A030049)

American Express Financial Advisors, Inc. submitted a Letter of Acceptance,Waiver, and Consent in which the firm was censured and fined $400,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to file with NASD's Advertising Regulation Department within 10 days of publication or first use, advertising and sales literature it used with the investing public. The findings also stated that the firm failed to obtain the written approval by a principal of pieces of advertising and sales literature prior to use with the investing public. NASD also found that the firm failed to establish, maintain, and enforce a supervisory system and procedures reasonable designed to achieve compliance with federal securities laws and NASD rules. In addition, NASD determined that the firm failed to monitor consistently and to enforce policies and procedures relating to advertising and sales literature. (NASD Case #CAF040072)

Edward D. Jones & Co., submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $200,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it encouraged its representatives to recommend the use of margin loans to public customers and failed to establish and maintain a supervisory system, including written supervisory procedures, reasonably designed to deter and prevent its representatives from making unsuitable recommendations regarding the use of margin loans in client accounts as a result of its bonus plan. (NASD Case #C07040079)

Edward D. Jones The SEC, NASD and the New York Stock Exchange (NYSE) settled enforcement proceedings against Edward D. Jones & Co., L.P., related to allegations that the firm failed to adequately disclose revenue sharing payments that it received from a select group of mutual fund families that the firm recommended to its customers and ran impermissible and undisclosed sales contests to promote certain funds. As part of the settlement of all three proceedings, Edward Jones will pay $75 million in disgorgement and civil penalties. All of that money will be placed in a Fair Fund for distribution to Edward Jones customers. Edward Jones also agreed to disclose on its public Web site information regarding revenue sharing payments and hire an independent consultant to review and make recommendations about the

adequacy of Edward Jones' disclosures.

SunAmerica Securities, Inc. submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $35,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that the firm failed and neglected to establish, maintain, and enforce adequate written supervisory procedures governing the review of transactions in which branch managers dealt directly with customers. The findings also stated that, although the firm's procedures called for an independent principal review of transactions effected by branch managers, the procedures were not adequately documented or properly communicated to branch managers. (NASD Case #C05040051)

UBS Financial Services, Inc. submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $85,000, and required to file with NASD's Advertising Regulation Department within 30 days of the effective date of this AWC, all presentations, quarterly client letters, fact sheets, and quarterly performance updates relating to privately placed registered investment companies that the firm currently is using on the date of acceptance by the National Adjudicatory Council (NAC) of this AWC. The firm also agreed that, upon receipt of comments from NASD on any of the filed materials, unless notified other wise by NASD, it shall take all reasonable steps to withhold or cause to be withheld such material until further publication until the changes specified by NASD have been made, and such material will be revised and re-filed prior to any use, unless otherwise agreed to by NASD at its sole discretion. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it distributed sales literature regarding privately placed registered investment companies to its public customers that did not comply with NASD rules in that the pieces did not have adequate risk disclosure. The findings also stated that, although the pieces of sales literature were accompanied by offering documents and other sales literature that did include risk disclosure, such disclosure did not cure the violations since each piece of sales literature must independently comply with the standards of NASD Rule 2210(d)(1)(A). NASD also found that the sales presentation stated that the fund was seeking a targeted rate of return without providing a substantiated basis for the target to enable investors to evaluate it. (NASD Case #CAF040051)

Raymond James Financial Services, Inc. submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured and fined $10,000. Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that it failed to enforce a supervisory system and written supervisory procedures reasonably designed to achieve compliance with applicable securities laws, regulations, and NASD rules regarding the formation and maintenance of a partnership with a public customer of the firm. (NASD Case #C8A040107)

Sigma Financial Corporation NASD censured and fined Sigma Financial Corporation of Ann Arbor, MI and its president, Jerome Rydell, $135,000 for violating NASD's Code of Arbitration Procedure—by frivolouslypursuing legal action against an elderly couple who had won an arbitration award against the firm. In addition, Rydell was suspended for 10 business days in all supervisory capacities. Sigma has reimbursed the elderly couple for the $110,000 in attorney fees and costs they incurred in defending themselves for three years. Sigma must also notify NASD prior to taking any legal action against customers in federal or state court.

NYSE

Hearing Panel Decisions

HSBC Securities
No. 04-190 (Dec. 15, 2004)

Violated Exchange Rule 440 and SEC Rule 17a-4(b)(4) by failing to preserve electronic communications; violated Exchange Rule 342 by failing to reasonably supervise operational and technological activities relating to retention of electronic communications; violated Exchange Rule 351 by not promptly reporting violation – Consent to censure and $500,000 fine.

Morgan Stanley DW, Inc.
No. 04-185 (Dec. 15, 2004)

Violated Exchange Rule 342 by failing to provide for appropriate supervision of certain business activities and by failing to provide for proper implementation of adequate systems and procedures to ensure adequate supervision of certain customer accounts; violated Exchange Rule 405 by failing to use due diligence relative to certain customer accounts and to supervise diligently accounts handled by two registered representatives; violated Exchange Rule 440 and Regulation 240.17a-3 of the Exchange Act by failing to maintain complete and accurate books and records related to this matter – Consent to censure and $6 million fine.

Morgan Stanley DW, Inc.
No.04-184 (Dec. 9, 2004)

Violated Exchange Rules 401 and 476(a)(6) by failing to ensure delivery of prospectuses in connection with certain sales of securities; violated Exchange Rule 476(a)(11) by failing to timely and accurately file Daily Program Trade Reports; violated Exchange Rule 440B and Regulation 10a-1 of the Exchange Act by erroneously executing certain sell orders on a minus tick for securities in which the Firm held a short position; violated Exchange Rule 351 by failing to timely submit Forms RE-3 in connection with certain matters; violated Exchange Rule 345 and Exchange Act Regulations 17f-2 and 17a-3(12)(i) by hiring certain individuals subject to statutory disqualification and failing to file fingerprint cards for certain non-registered employees; violated Exchange Rule 123C by failing to comply with requirements concerning certain Market-on-Close and Limit-on-Close orders; violated Exchange Rules 472, 342.16 and 342.17 concerning supervision of certain incoming and/or outgoing communications; violated Exchange Rule 342(a) and (b) by failing to reasonably supervise certain activities – Consent to censure, $13 million fine, and an offer of opportunity to clients to rescind certain purchases of securities.

Piper Jaffray & Co.
No. 04-180 (Nov. 23, 2004)

Violated Exchange Rule 342 by failing to reasonably supervise with respect to certain business activities; violated Exchange Rule 410 by failing to make and preserve certain required records relating to customer orders executed on the Exchange Floor and failing to obtain appropriate written supervisory approval for account designation changes; violated Exchange Rule 472 by issuing unapproved communications to the public and failing to make required disclosures; violated Exchange Rule 351(d) by failing to accurately and promptly report information regarding customer complaints; violated Exchange Rule 408(b) by failing to give discretionary accounts frequent appropriate supervisory review; violated SEA Regulations 240.17a-3 and 240.17a-4 and Exchange Rule 440 by failing to make and maintain required and timely records relating to the designation and execution of customer orders, and cancel and rebill forms used to accomplish post-execution account designation changes – Consent to censure, $250,000 fine and an undertaking.

Advest, Inc.
No. 04-179 (Nov. 23, 2004)

Violated SEA Regulation 15c3-1 by failing to properly compute net capital; violated SEA Regulation 15c3-3 by failing to have sufficient funds in its Special Reserve Bank Account and by improperly

computing its Customer Reserve Formula; violated SEA Regulation 17a-5 and Exchange Rule 476(a)(10) by filing inaccurate FOCUS Report; violated SEA Regulations 17a-3 and 17a-4 and Exchange Rule 440 by failing to make or preserve certain required records; violated Exchange Rule 472 by failing to approve certain communications and by issuing certain unclear research reports; violated Exchange Rule 405 by failing to diligently supervise certain customer accounts; violated Exchange Rules 401 and 405 by failing to review certain customer account addresses; violated Exchange Rule 351(d) by failing to properly report various customer complaints; violated Section 220.8(c) of Regulation T by allowing several customers to purchase and sell securities prior to making payment and by allowing a customer to trade his account through a restriction; violated Exchange Rule 431 and Section 220 of Regulation T by causing improper extension of credit to customers; violated Exchange Rules 401 and 440 by improperly allowing several securities to remain in one of its offices instead of immediately forwarding them to main office for recording in the owner's account; violated Exchange Rule 304 by failing to properly register various directors of the Firm; violated Exchange Rule 401 by failing to place several securities involved in secondary offerings on the Restricted List; violated Exchange Rule 343 by occupying an office with a corporation engaged in securities business without Exchange permission; violated Exchange Rule 345.12 by failing to ensure updating of a registered employee's Form U-4; violated Exchange Rule 342 by failing to reasonably supervise to prevent certain violations of Exchange Rules and federal securities laws – Consent to censure and $300,000 fine.