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PIABA Bar Journal

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The Bar Journal of the
Public Investors Arbitration Bar Association

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3. Do not indent paragraphs.
4. Put the title of the article at the top followed by the author's name and a short author biography.
5. Do not use footers or headers.
6. Use footnotes rather than endnotes.
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Executive Director's Message

Robin Ringo

Chuck Austin said it best – "PIABA was borne of self-preservation and survival against the onslaught of arguably the most powerful industry in the world intent on depriving its customers of any meaningful opportunity to redress their grievances." This year PIABA celebrates 15 years as an Association. While many public investors may not know it, they are indebted to the individuals who had the foresight to perpetuate the idea of PIABA. In developing the mission statement, purposes and objectives of the Association, they not only identified the focus of the Association but, insured its future growth. And, grow it has; from around 65 in 1990 to 740 in 2005. Yes, PIABA has enjoyed sustained growth throughout its fifteen years of existence, but, growth in the Association pales in comparison to the countless hours members have worked to improve the arbitration process, to create a better playing field for investors. To all these individuals, thank you.

When I came to PIABA more than eight years ago, a primary focus of the PIABA Board was to increase and better the public arbitrator pools at the NASD and NYSE. In the months preceding my employment, they undertook to solicit hundreds of individuals about becoming public arbitrators by mailing letters, applications, and follow-up postcards inquiring as to how these potential arbitrators were progressing through the process. Still, here we are eight years later trying to recruit good public arbitrators at the NASD and NYSE. Since this initial recruitment began, nearly every PIABA president has made it a significant part of his/her agenda to recruit arbitrators. If you are able to do only one thing this year, **RECRUIT AN ARBITRATOR**.

The one thing we can all count on occurring each year is the PIABA Annual Meeting. Preceding the Annual Meeting is the 7th Annual Securities Law Seminar on Wednesday, September 28th where Joe Long will moderate a day-long program on securities law issues. The PIABA 14th Annual Meeting opens at 9:00 a.m. on Thursday, September 29th and concludes at 4:00 p.m. on Saturday, October 1st. For more information about the meeting agendas, visit the PIABA website at www.PIABA.org. Go to PIABA Meetings. Throughout the 13 years of PIABA Meetings, one comment is consistently made - "this is the best meeting I have ever attended". If you will attend only one CLE course this year, make it the PIABA Meeting this Fall. Not only will you earn most, if not all, your required CLE for the year, you are sure to take with you many practice tips for use in your arbitration practice, new friends and a desire to return next year.

Best wishes and I look forward to seeing you in September!

Robin S. Ringo is the Executive Director of PIABA. She may be reached at 1.888.621.7484 or rsringo@piaba.org.

From The Professor: Statutes Of Limitations Don't Apply In Arbitration

By Joseph C. Long

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It is appropriate with the adoption of the new amendments to NASD Rule of Arbitration Procedure 10304[1] to re-visit an issue which may make or break many arbitration claims. This issue is the application of statutes of limitations governing substantive claims in arbitration.

For example, Section 410(e) of the Uniform Securities Act provides: "No person may sue under this section more than two years after the contract of sale."[2] Does this mean that a claim under Section 410 which is brought within the six-year rule of Section 10304 of the NASD Code of Arbitration will be dismissed if it is brought more than two years after the original contract for sale? This issue has been discussed by four other PIABA members in the past[3] and all of whom agree, contrary to popular belief, that statutes of limitations on substantive claims do not apply in arbitration.[4] This conclusion is unanimously supported by the limited case law on the subject.[5]

As our Past President said in his PLI article:

> There is a significant body of law in support of the argument that statutes of

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[1] *See* Approval of Proposed Rule Changes, 2004 WL 2699043 (SEC Nov. 29, 2004).

[2] Uniform Sec. Act (1957) §410(e), 7B Uniform Acts Annot. 643 (1985).

[3] *See* Charles W. Austin, "Having Their Cake and Eating It Too: Motion Practice and the Mongrelization of SRO Arbitration," available on WestLaw as 1399 PLI/Corp. 183, 192 (Dec. 2003); Kenneth R. Jones, "Applicability of Statutes of Limitation in AAA Arbitration," 5 PIABA Quarterly (No. 4) 8 (Dec. 1998); and Martin H. Aussenberg, "NASD Arbitrators Are Not Bound to Apply Statutes of Limitations," 5 PIABA Quarterly (No. 4) 10 (Dec. 1998). I also discussed the issue in Joseph C. Long, "From The Professor: Dispositive Motions", 4 PIABA Quarterly (No. 4) 3, 5-6 (Dec. 1997).

[4] The issue here should not be confused with a similar, but different, issue dealing with enforceability of the agreement to arbitrate. *See e.g.*, *World Brilliance Corp. v. Bethlehem Steel Co.*, 342 F.2d 362 (2d Cir. 1965); *Son Shipping Co. v. De Fosse & Tanghe*, 199 F.2d 687 (2d Cir 1952). The agreement to arbitrate is a contract. Therefore, the statute of limitations on contract actions (frequently six years) controls the ability of a party to force arbitration. However, the statute of limitations here does not run from the date of the contract, but from the date the defaulting party breaches the contract by refusing to arbitrate.

[5] The case law, all non-securities cases, are collected in Annot. Statute of Limitations As Bar to Arbitration Under Agreement, 94 A.L.R. 3d 533 (1979).

> limitations do not apply in arbitration on the theory that an arbitration is not an "action" within the meaning of that word as it is used in the time limitations placed on causes of actions found in most state codes.[6]

There are generally three non-securities cases cited to support this conclusion.[7] They are: (1) *Skidmore, Owings & Merrill v. Connecticut Gen. Life Ins. Co.;*[8] (2) *Lewiston Firefighters Assoc. v. Lewiston*;[9] and (3) *Har-Mar Inc. v. Thorsen & Thorshov, Inc.*[10] In *Skidmore,* the court said:

> Arbitration is not a common-law action, and the institution of arbitration proceedings is not the bringing of an action under any of our statutes of limitations. "Arbitration is an arrangement for taking and abiding by the judgment of selected persons in some disputed matter, instead of carrying it to the established tribunals of justice; and it is intended to avoid the formalities, the delay, the expense and vexation of ordinary litigation. When the submission is made a rule of court, the arbitrators are not officers of the court, but are the appointees of the parties, as in cases where there is no rule of court." [11]

Likewise, in *Lewiston Firefighters Assoc.,* the court held:

> Arbitration is not an action at law and the statute [of limitations] is not, therefore, an automatic bar ....[12]

Finally, in *Har-Mar Inc.*, the court concluded:

> Based upon the special nature of arbitration proceedings and both statutory and common-law meanings of the terms "action", we feel compelled to hold that [the statute of limitations] in §541.05(1) was not intended to bar arbitration of Thorsen's fee dispute solely because such claim would be barred if asserted in an action in court.[13]

Other cases also support this position[14] as

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[6] Charles W. Austin, "Having Their Cake and Eating It Too: Motion Practice and the Mongrelization of SRO Arbitration," available on WestLaw at 1399 PLI/Corp. at 192 (Dec. 2003).

[7] A similar conclusion has been reached as to the words "sue" or "suit." *Cf. Son Shipping Co. v. De Fosse & Tanghe*, 199 F.2d 687 (2d Cir 1952) (There is no time bar because arbitration is not within the term "suit" as used in [the] statute). This holding would cover the language of Section 410(e) of the Uniform Act which talks in terms of "su[ing]".

[8] 25 Conn. Supp. 76, 197 A.2d 83 (Conn. Super. 1963).

[9] 354 A.2d 154 (Me. 1976).

[10] 300 Minn. 149, 218 N.W.2d 751 (1974).

[11] 25 Conn. Supp. at 84, 197 A.2d at 87. *Skidmore* was *cited with approval* in *Dayco v. Fred T. Roberts & Co.***,** 192 Conn. 497, 472 A.2d 780 (1984).

[12] 354 A.2d at 166.

[13] 300 Minn. at 155, 218 N.W.2d at 754. *See also Independent School District v. Holm Bros. Plumbing and Heating , Inc.* 600 N.W.2d 146, 150 (Minn. App. 2003) and *Viking Ins. Co. v. Clayburn*, 1997 WL 396220 (Minn. App. July 15, 1997).

does at least one state statute. The Tennessee statute of limitations which reads:

> The word "action" in this title [statutes of limitations] includes motions, petitions, and other legal proceedings *in judicial tribunals* for the redress of civil injuries.[15]

Unfortunately, the answer is not quite as simple in NASD arbitration. It is clear that the parties or, in this case, the forum can establish its own arbitrability rule or incorporate statutes of limitations by reference. The NASD has exercised this power in Section 10304 of the NASD Code of Arbitration. Section 10304 establishes a two-prong rule. The first sentence establishes the well recognized six-year rule. After stating the six-year rule, the second sentence incorporates some statutes of limitations: "This Rule shall not extend *applicable* statutes of limitations...."[16] The problem is that the language of the second sentence is enigmatic. It obviously incorporates some statutes of limitations but which ones? Most people *assume* that the statute of limitations covering the substantive claim is incorporated. I don't think so. I think the intent is to incorporate statutes of limitations *dealing with arbitrability*.

The key word is "applicable." But what statutes of limitations are "applicable"? It should be clear that statutes of limitations like the Tennessee statute, quoted above, by it own words, would not be "applicable".[17] Likewise, the above cited cases would indicate statutes of limitations governing the underlying substantive causes of action are also not "applicable." Yet, the term should be accorded some meaning.

I believe that the answer to which statutes are "applicable" lies in reading Section 10304 as a whole. Clearly, the first part of the section establishes a six-year rule of eligibility for claims which the NASD will entertain for arbitration under its system. It is now clear from the amendments to Section 10304 that this rule is in no way intended to bar the underlying substantive actions. If the claims are still viable under state law, the NASD's refusal to hear them does not prevent the claimant from subsequently filing an action in court.

I submit that the second sentence also goes to arbitrability rather than governing the viability of the underlying cause of action. If the local state statute of limitations covering arbitrations is shorter than six-years from the date of occurrence or event, then the shorter statute will control. Thus, "applicable" statutes of limitations under the second sentence are those statutes of limitations *which restrict the bringing of an arbitration*, not those effecting the underlying substantive cause of action.

For example, under New York law, the courts have held that the statute of limitations on contracts[18] controls the right to bring

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[14] *See NCR v. CBS Liquor Control, Inc.,* 874 F. Supp. 168 (S.D. Ohio 1993) ("[T]he effect of a statute of limitations is to bar an action at law, not arbitration."); *Carpenter v. Pomerantz*, 56 Mass Ct. App. 627, 631, 634 N.E.2d 587, 590 (1994)("As used in statutes of limitation, the word 'action' has been consistently construed to pertain to court proceedings," citing with approval *Skidmore, Lewiston,* and *Har-Mar.*).

[15] T.C.A. §28-1-101 [Emphasis added], *quoted in* Martin H. Aussenberg, "NASD Arbitrators Are Not Bound to Apply Statutes of Limitations," 5 *PIABA Quarterly* (No. 4) 10 (Dec. 1998).

[16] [Emphasis added.]

[17] Martin H. Aussenberg, "NASD Arbitrators Are Not Bound to Apply Statutes of Limitation," 5 *PIABA Quarterly* (No. 4) 10 (Dec. 1998).

[18] McKinney's CPLR §213(2).

arbitration proceedings since the right to arbitration is purely contractual.[19] Therefore, if an arbitration based upon a substantive claim is not brought within this period, it is barred. Barred not by the statute of limitations on the substantive claim, but rather by the *contract* limitation period.

In New York, the statute of limitations for enforcement of contracts is six years. In *Hammerstein v. Shubert*,[20] a contract to arbitrate disputes was made in 1938. No attempt to arbitrate was made until the early 1950's. The court held that no disputes more than six years old could be arbitrated.

Because the contract period in New York is six years and Section 10304 also provides for a six-year eligibility period, the second sentence of Section 10304 would have no operation. However, in Oklahoma, the contract statute of limitations is *five years*.[21] In such case, the second sentence of Section 10304 would come into play, and arbitration claims would be barred *after five years* rather than the six years provided by the first sentence of Section 10304.

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[19] *See e.g., Hammerstein v. Shubert*, 127 N.Y.S.2d 249 (N.Y. Sup. Ct., New York County, 1953). *See also* Annot. Statute of Limitations As Bar to Arbitration Under Agreement, §4, 94 A.L.R. 3d 533 (1979).

[20] 127 N.Y.S.2d 249 (N.Y. Sup. Ct., New York County, 1953).

[21] 12 Okla. Stat. (2001) §95(1).

ProfLipner's I Love New York (Law) Column: The Courts Finally Decide Who Decides[1]

By Seth Lipner

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Who decides timeliness, the courts or the arbitrators? This issue, which popped up so prominently in the limited partnership era, is still around today. It is a bug that only rarely bites (these days), and the welt usually, but it hurts like hell for the first few months.

Fortunately, the law in this area is now well-defined everywhere. That makes life simpler at least. But cases keep coming nevertheless. So this is stuff you may someday need to know.

There are two timeliness questions that come up in securities arbitration. The first is the so-called "eligibility rule",[2] which, until the recent rule change, acted (according to most courts) as an absolute bar on cases more than 6-years old. Investor attorneys struggled to get the eligibility determination put in the hands of the arbitrators, where greater flexibility was often found. The turning points in that fight, *Painewebber v. Bybyk*[3] and *Smith Barney v. Sacharow*[4] were New York cases, and ubiquity of the New York choice-of-law clause seemed to end the "who decides eligibility" debate. But one firm persisted, abandoning the beloved New York choice argument in favor of an FAA argument.

In *Howsam v. Dean Witter*,[5] the "court decides eligibility" argument was buried by the U.S. Supreme Court. The Court wrote:

> At the same time the Court has found the phrase "question of arbitrability" *not*

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[1] The Author was counsel for some of the litigants whose cases are described here. Copyright 2005 Seth E. Lipner

[2] NASD Code of Arbitration Procedure section 10304 (Time Limitation Upon Submission) provides:

> No dispute, claim, or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act or dispute, claim or controversy. This Rule shall not extend applicable statutes of limitations, nor shall it apply to any case which is directed to arbitration by a court of competent jurisdiction.

[3] 81 F.3rd 1193 (2d Cir 1996).

[4] 91 N.Y.2d 39 (1997).

[5] 537 U.S. 79 (2002).

> applicable in other kinds of general circumstance where parties would likely expect that an arbitrator would decide the gateway matter. Thus " 'procedural' questions which grow out of the dispute and bear on its final disposition" are presumptively *not* for the judge, but for an arbitrator, to decide. . . .
> The presumption is that the arbitrator should decide "allegation[s] of waiver, delay, or a like defense to arbitrability." [citation omitted]. Indeed, the Revised Uniform Arbitration Act of 2000 (RUAA), seeking to "incorporate the holdings of the vast majority of state courts and the law that has developed under the [Federal Arbitration Act]," states that an "arbitrator shall decide whether a condition precedent to arbitrability has been fulfilled." RUAA §§ 6(c), and comment 2, 7 U.L.A. 12-13 (Supp.2002). And the comments add that "in the absence of an agreement to the contrary, issues of substantive arbitrability ... are for a court to decide and issues of procedural arbitrability, *i.e.,* whether prerequisites such as *time limits,* notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate have been met, are for the arbitrators to decide."[6]

Thus ended that entire line of cases. Between the decisions of the N.Y. Court of Appeals and the US Supreme Court, the door to the courts was closed to those seeking a stay of arbitration on the ground that the eligibility period had expired.

Not so the Statute of Limitations. The problem there is that the NY CPLR has a provision authorizing courts to decide that question in advance of arbitration.[7] The procedure must be invoked in a timely manner (before "participation"[8]), but courts are authorized by statute to sometimes consider the expiration of the statute of limitation as a threshold question.

At about the same time that the courts were wrestling with the eligibility rule, they also struggled with the apparent conflict between the FAA (which is silent on the "who decides" limitations" question) and the New York statute. Again, the New York choice-of-law clause was a culprit.

The resolution of the issue turned on the language of the agreement, the courts ruled. The case was *Luckie v. Smith Barney*[9]:

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[6] *Id*. at 85

[7] NY Civil Practice Law and Rules (CPLR) 7502(b) ("Limitation of time"), provides:

> If, at the time that a demand for arbitration was made or a notice of intention to arbitrate was served, the claim sought to be arbitrated would have been barred by limitation of time had it been asserted in a court of the state, a party may assert the limitation as a bar to the arbitration on an application to the court as provided in section 7503 or subdivision (b) of section 7511. The failure to assert such bar by such application shall not preclude its assertion before the arbitrators, who may, in their sole discretion, apply or not apply the bar. Except as provided in subdivision (b) of section 7511, such exercise of discretion by the arbitrators shall not be subject to review by a court on an application to confirm, vacate or modify the award.

[8] CPLR 7503(b) ("Application to stay arbitration") provides:

> Subject to the provisions of subdivision (c), a party who has *not participated* in the arbitration and who has not made or been served with an application to compel arbitration, may apply to stay arbitration on the ground that a valid agreement was not made or has not been complied with or that the claim sought to be arbitrated is barred by limitation under subdivision (b) of section 7502.

(italics added)

[9] 85 N.Y.2d 193 (1995)

> Notwithstanding the Federal policy favoring liberal enforcement of agreements to arbitrate, the FAA should not be construed to "confer a right to compel arbitration of any dispute at any time; it confers only the right to obtain an order directing that 'arbitration proceed in the manner provided for in [the parties'] agreement' " (*Volt Information Sciences v. Leland Stanford Jr. Univ* [citation omitted]). In other words, in recognition of the fact that arbitration is manifestly a matter of contract, and that parties to an arbitration agreement--like all contracting parties--are free to select the terms under which they will arbitrate, the policy established by the FAA is to ensure that private agreements to arbitrate are enforced according to their terms. Accordingly, the parties are at liberty to include a choice of law provision in their agreement, and the parties' choice will be honored unless the chosen law creates a conflict with the terms of, or policies underlying, the FAA. . .
> The parties' choice that New York law would govern "the agreement *and its enforcement* " (emphasis added) indicates their "intention to arbitrate to the extent allowed by [this State's] law," even if application of the State law--and an adverse ruling on a Statute of Limitations claim--would relieve the parties of their responsibility under the contract to arbitrate. . . .[10]

That decision was reaffirmed by the Court of Appeals in *Smith Barney v. Sacharow*, even as the Court was sending eligibility cases to the arbitrators. The Court, however, warned that the *Luckie*-exception was to be narrowly construed:

> *Luckie* was narrowly tailored to the specific framework presented by that case and was not projected as a preclusion against parties freely contracting to submit every part of their disputes to arbitration [citation omitted] The Court noted the strong "Federal policy favoring liberal enforcement of agreements to arbitrate," a policy New York courts have also long promoted, and stated that a choice of law provision in an agreement will not predominate if "the chosen law creates a conflict with the terms of, or policies underlying, the [Federal Arbitration Act]" [citations omitted] The Court determined, however, in that particular instance that "the [relevant CPLR provisions] authorizing the courts to consider a time limitation asserted as a bar to arbitration in connection with an application to compel or stay arbitration do not expressly conflict with any provisions of the FAA".
>
> Furthermore, the Court very significantly demarcated that "[c]learly, under New York law, *statutory* time limitations questions such as those presented on these two appeals -- as opposed to *contractual* time limitations agreed upon by the parties -- are for the courts, not the arbitrators" [citation omitted; emphasis in original]). That effectively differentiates the *Luckie* holding from the instant matters and the analysis that supports the rationale and result we reach here. First, only a NASD contractual time limitation is at issue in these proceedings. Next, the *Luckie* Court was interpreting the specific language of the subject choice of law provision, which applied to the " 'agreement and its enforcement'" [emphasis added by Court]). The Court stated that the arbitration clause "was subject to the parties' additional qualification that New York State law provides the basis of decision for questions concerning *not only the agreement, but more critically, its enforcement* "[emphasis added by Court].[11]

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[10] *Id*. at 201-202.

[11] 91 N.Y.2d at 48.

It was a strained effort at best.

But then the Supreme Court's *Howsam* decision caused there to be hope that the New York Court of Appeals would do away with *Luckie*. Well, no such luck.

On March 25, 2005, in a construction arbitration case, the Court of Appeals reaffirmed *Luckie*, while keeping its ambit very narrow. In *Diamond Waterproofing v. 55 Liberty Corp.*,[12] the Court (after finding that the contract "involved interstate commerce"), stated:

> The "presumption is that the arbitrator should decide 'allegations of waiver, delay, or a like defense to arbitrability' " (see *Howsam v. Dean Witter Reynolds, Inc.*, [citation omitted]) Questions concerning " 'whether prerequisites such as time limits, notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate have been met, are [generally] for the arbitrators to decide' " [citation omitted]).
>
> However, in recognition of the FAA policy that private arbitration agreements be enforced according to their terms [citation omitted], an exception to this rule exists where parties explicitly agree to leave timeliness issues to the court (see *Smith Barney, Harris Upham & Co. v. Luckie* [citation omitted] see also Howsam [citation omitted]). Contracting "parties are at liberty to include a choice of law provision in their agreement" expressing an intention to have the courts determine Statute of Limitations issues (see *Luckie*; see also *Matter of Smith Barney Shearson, Inc. v. Sacharow*, [citations omitted]).
>
> It is well settled that "where parties broadly agree to arbitrate 'any controversy' " arising from their contracts, they may--as with any contract-- add qualifications to that clause by providing that New York law will govern the agreement and its enforcement (Luckie). A choice of law provision, which states that New York law shall govern both "the agreement and its enforcement," adopts as "binding New York's rule that threshold Statute of Limitations questions are for the courts" (id. [emphasis in original]). In the absence of more critical language concerning enforcement, however, all controversies, including issues of timeliness, are subjects for arbitration (see *id.*).
>
> Here, Diamond Systems and Liberty agreed to submit "[a]ny controversy or Claim arising out of or related to the Contract" for arbitration. Their choice of law provision provides only that "[t]he Contract shall be governed by the law of the place where the Project is located." The parties did not express an intent to have New York law govern their agreement's enforcement. Therefore, the timeliness issue should be determined by the arbitrator.

Diamond Waterproofing shows that the words of the contract are indeed "critical". The conflict between two clauses: one to "arbitrate any controversies" and the other restricting which issues get arbitrated, comes in many forms. In such cases, courts turn to general principles of contract interpretation, most notably the one known in latin as *contra proferentum* - ambiguities in the contract are construed against the drafter. Indeed, the *Sacharow* Court ended its decision with the stinging observation:

> We have declared that "this State favors and encourages arbitration as a means of conserving the time and resources of the courts and the contracting parties"

[12] 774 N.Y.S.2d 32 (1st Dept. 2004); *Motion for Leave to Appeal Granted*, 2 N.Y.3d 822, 781 N.Y.S.2d 285 (2004).

> [citations omitted]. Therefore, "New York courts interfere 'as little as possible with the freedom of consenting parties' to submit disputes to arbitration". [citation omitted]
>
> Frankly stated, a contrary result would curtail or divert this progressive and prudent policy favoring arbitration. Parties should be free to opt for this forum outlet and for comprehensive resolution in those settings. Courts should be very hesitant, therefore, to impinge upon the rights and obligations derived from commitments to integrated, relatively speedier and less costly alternative dispute resolution modalities. Lastly, *it would be ironic and anomalous to permit parties from the securities industry, who generally derive benefits from the arbitration method they impose on their thousands of consumers, to elude the comprehensive language of their own industry-drafted arbitration agreements. Having agreed to plenary arbitration, they should not garner that strategic advantage against their aggrieved or dissatisfied customers.*[13]

The formula is thus set and unlikely to change: where the parties agree to arbitrate "any controversy" or the like, the presumption is in favor of the arbitrator deciding statute of limitations. The burden is then on the drafter of the agreement to clearly invoke not just "New York law" but also, in some clear form, New York's peculiar arbitration law.

JP Morgan Securities v. Weisberg[14] is instructive and illustrative. In that case, an investor's arbitration was "temporarily" stayed in an Order to Show Cause. That Order caused a five-month hold-up in getting the arbitration going. But in March 2005, Justice Madden of Supreme Court in New York County vacated the stay and directed the parties to "proceed forthwith to arbitration."

After going through the basic *Luckie* analysis - finding there was no "and its enforcement" language in the NY choice-of-law clause - Justice Madden bolstered her decision by observing that the New York choice-of-clause and the arbitration clause appear (in the agreement) 16 pages apart. The conclusion was, the court wrote, that the two did not bear on each other.

Unfortunately, the welt from JP Morgan's insect bite in this multi-million dollar arbitration has not yet healed. Even though JP Morgan is seeking a permanent stay of only some of Mr. Weisberg's claims, *viz.* the negligence claims (which are subject to a strict 3-year limitations period), the Appellate Division granted a new stay of the entire arbitration pending appeal. Mr. Weisberg will eventually win the "who decides" question, but the insect bite will have cost him 16 months. And some doctor's bills.

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[13] 91 N.Y.2d at 49-50. (Italics added).

[14] No. 114214/04, decided ***, 2005

"Survey Says – SRO Arbitration Unfair"

By Mark A. Tepper

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Introduction – the Theory

Securities arbitration is not a level playing field. During recent hearings in the United States House of Representatives on the fairness of SRO[1] arbitration, Representative Barney Frank put the issue in perspective when he asked: if SRO arbitration is fair, why must it be mandatory?[2]

How can securities arbitration be fair when SRO's instruct their arbitrators that they need not follow the law[3] and that they can frustrate judicial review by not writing reasons for their awards?[4] This type of instruction encourages lawlessness in arbitration by replacing the objectivity of law with the bias and prejudice of individual arbitrators who are not accountable for their reckless conduct.

Such instruction is an example of institutional bias which compromises the integrity of SRO arbitration. As SRO's encourage arbitrators to dish out their own brand of frontier justice, Claimants are being denied their full measure of damages as provided by statute.

The deck is stacked against customers in their arbitrations with brokerage firms. The securities industry has a ringer on every three arbitrator panel – the industry

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[1] "SRO" means "self-regulatory organization" which includes the National Association of Securities Dealers, Inc. ("NASD") and the New York Stock Exchange ("NYSE").

[2] Congressman Frank made his comment, on March 17, 2005, during hearings before the House Committee on Financial Services.

[3] Arbitrators are "not strictly bound by case precedent or statutory law." SICA, The Arbitrator's Manual, January 2001 ed., at 32, a publication of the Securities Industry Conference on Arbitration.

[4] "In NASD training sessions, arbitrators are taught that 'awards that do not contain the panel's reasons are more appropriate. . . .' Written opinions, they are told, are burdensome, time-consuming, and invitations to judicial review – not to mention that arbitrators may not even be competent to write them properly." *Rosenberg v. Merrill Lynch*, 995 F.Supp. 190, 198 (D. Mass. 1998).

arbitrator.[5] Imagine a state criminal court saying that a policeman must be on every criminal jury to explain police work to the other jurors. There are constitutional protections against that in court. But not so for victims of investment fraud who are expected to fight Goliath with one foot in a bear trap.

NASD and NYSE representatives told Congress that their arbitration programs are fair. NASD cited statistics that 55% of arbitration panels find for the Claimant.[6] NASD did not disclose the amount recovered in these "favorable" awards which tells a different story.

Arbitration Survey[7]

Florida has enacted the Florida Investor Protection Act reflecting a public policy to protect Floridians from investment fraud. To achieve its purpose of protecting Floridians and deterring fraud, by defeating all visionary schemes, the Act must be liberally interpreted and vigilantly enforced.[8]

The purpose of this Survey was to investigate whether Florida arbitrators were enforcing the statutory rights provided to investment fraud victims by the Florida Investor Protection Act ("517").

Methodology

When this Survey began on May 12, 2005, there were more than 10,000 awards in the Westlaw arbitration award data base ("FSEC-ARB"). We searched for all arbitration awards where the Claimant requested relief pursuant to 517, in arbitrations between a customer and member and/or associated person, ("517" & "customer"), which narrowed the amount of awards to 605. One-hundred thirty-three of the 605 were stipulated awards, which we eliminated, leaving 472 awards decided by arbitrators.

Arbitrators ruled in favor of the Claimant and awarded damages in only 207 of the 472 arbitration awards. In other words, Claimants had a losing percentage of 56% or a "favorable" percentage of 44% on statutory claims.

Among the 207 "favorable" awards, 154 were decided by three-arbitrator panels; the remaining 53 by a single arbitrator, (154+53=207).

In 53 of these 207 "favorable" awards, or 25.6%, the Arbitrators found a breach of fiduciary duty and/or other violation, but did *not* find a violation of the 517 Statute. Of these 53 awards, 50 were decided by three-arbitrator panels which includes an industry arbitrator; by comparison, a single arbitrator decided the other 3.

In 53 of the 154 arbitrations decided by three arbitrators, which includes an industry arbitrator, 34.4% of the panels found a breach of fiduciary duty, but did not make a

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5 SRO rules mandate that every three arbitrator panel include an industry arbitrator. NASD rules require that the panel include an industry arbitrator for customer disputes with brokerage firms, in excess of $50,000. NASD Rule 10308. NYSE rules require an industry arbitrator on the panel when the customer claim exceeds $25,000. NYSE Rule 607.

6 Testimony of Linda D. Feinberg, President, NASD Dispute Resolution, before the Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises, Committee on Financial Services, United States House of Representatives, March 17, 2005.

7 Special thanks to Evan S. Shenkin who conducted this Survey.

8 *Arthur Young & Co. v. Mariner Corporation*, 630 So.2d 1199, 1203 (Fla. App. 4th Dist. 1994); *Merrill Lynch v. Byrne*, 320 So.2d 436, 441 (Fla. App. 3d Dist. 1975).

statutory 517 finding. In 3 of the 53 arbitrations decided by a single arbitrator, only 5.7%, made a finding of breach of fiduciary duty but failed to make a 517 finding. *See* Table below.

Florida Arbitrations Awarding Damages			
Finding	3-Arbitrators	1-Arbitrator	Total
517 violation	101	50	151
B/F Duty; no 517	53	3	56
Total	154	53	207
Comparison by Percentage			
Finding	3-Arbitrators	1-Arbitrator	Total
517 violation	65.6%	94.3%	72.9%
B/F Duty; no 517	34.4%	5.7%	27.1%
Total	100%	100%	100%

The Similarities between 517 and Breach of Fiduciary Duty

In customer-broker disputes, breach of fiduciary duty and 517 are premised on strikingly similar facts. Under Florida common law, a broker owes its customers the following fiduciary duties, among others:

1. The duty to recommend [investments] only after studying it sufficiently to become informed as to its nature, price, and financial prognosis;
2. The duty to perform the customer's orders promptly in a manner best suited to serve the customer's interests;
3. The duty to inform the customer of the risks involved in purchasing or selling a particular security;
4. The duty to refrain from self-dealing . . . ;
5. The duty not to misrepresent any material fact to the transaction; and
6. The duty to transact business only after receiving approval from the customer.[9]

Under Florida law, breach of fiduciary duty is more difficult to prove than a violation of 517. Proof of breach of fiduciary duty requires evidence that the breach directly or proximately caused the damages.[10] By comparison, proof of loss causation and reliance are *not* required to prove a violation of 517.[11] Neither breach of fiduciary duty nor a violation of 517 requires proof of scienter.[12]

Florida Statute 517 makes it a violation for a brokerage firm and/or its associated person, in connection with the purchase, sale or rendering of any investment advice, directly or indirectly, to obtain money or property by means of any untrue statement of a material fact or any omission to state a material

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[9] *Ward v. Atlantic Security Bank*, 777 So.2d 1144, 1147 (Fla. 3d DCA 2001). The *Ward* Court specifically did not limit the duties owed to a customer.

[10] *Csordas v. Smith Barney,* 1992 WL 426460 (Fla. Cir. Ct.).

[11] *E.F. Hutton v. Rousseff*, 537 So.2d 978, 981 (Fla. 1989); *Waters v. International Precious Metals*, 172 FRD 479, 495 (S.D. Fla. 1996).

[12] *Merrill Lynch v. Byrne*, 320 So.2d 436, 440 (Fla. App. 3rd Dist. 1975).

fact.[13] Thus, under the Florida Statute, failure to perform any one of these fiduciary duties by a broker would establish a violation of 517.[14] Logic dictates that an arbitrator cannot find a breach of fiduciary duty by a broker without finding a violation of 517.[15]

The Florida Investor Protection Act, in sections 517.211(3)-(6), specifies the legal remedy for a violation of the anti-fraud provisions of the Act ("statutory damages") which includes attorney's fees. When a violation is found, Florida and federal courts agree that statutory damages are "automatic" and "mandatory."[16] The Florida statute does not provide for any discretion.[17] It is not left to Judges, juries or arbitrators to fashion a remedy. Florida has a public policy that each victim of securities fraud be treated the same.

The survey shows that a significant percentage of arbitrators are not giving the facts their full legal effect, refusing to apply the Florida Statute even when the facts compel such a finding. This arbitrary and capricious conduct makes a mockery of the Statute and deprives investment fraud victims of their full statutory damages.

Survey's Significance – Eliminate the Industry Arbitrator

The Survey identifies a serious problem with the fairness and integrity of SRO arbitration – the presence of an industry arbitrator dramatically increases the probability that the arbitration panel will not enforce the Florida Investor Protection Act.

In favorable single-arbitrator cases, where there is no industry arbitrator, the arbitrators overwhelmingly (50 / 53, 94%) found a violation of 517. However, in three-arbitrator panel cases, which must include an industry arbitrator, the panels enforced the Florida Investor Protection Act in only two out of every three cases (101 / 154, 66%).

The NASD Code of Arbitration mandates that every dispute in excess of $50,000 must be decided by a three-arbitrator panel, including one industry arbitrator.[18] For disputes decided by a single arbitrator,

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[13] Fla. Stat. §517.301; *Ward v. Atlantic Security Bank*, 777 So.2d 1144, 1147 (Fla. 3d DCA 2001)("Unlike its federal counterpart, a securities fraud claim under section 517.301 may also be brought for fraud 'in connection with the rendering of any investment advice'").

[14] *See Gochnauer v A.G. Edwards*, 810 F.2d 1042 (11th Cir. 1987). The Eleventh Circuit held that Gochnauer proved a breach of fiduciary duty, but not a 517 violation, based on plaintiff's failure to prove reliance causation. Based on the Florida Supreme Court's decision in *Rousseff,* the *Waters* Court held that reliance is not a required element under 517.

[15] Of course, not all breaches of fiduciary duty will constitute violations, such as in the context of the duties majority shareholders owe minority shareholders. However, among those cited by Florida Courts as the duties owed by brokers to their customers, each likely would.

[16] A violation of the consumer protection provisions of the Florida Investor Protection Act, section 517.301, "automatically triggers" a damage award under the "mandatory damages provision of Fla. Stat. §517.211, ..." *Ainsworth v. Skurnick*, 960 F. 2d 939 (11th Cir. 1992). "... [D]amages are automatic in accordance with the provisions of section 517.211." *Skurnick v. Ainsworth*, 591 So. 2d 904, 906 (Fla. 1991).

[17] "Indeed, as the Florida courts have held, '[b]ecause . . . *section 517.211* contains an express civil liability provision, Florida courts need fashion no court-made civil right. They need only follow the clear language of the statute.'" *Hutton v Rousseff*, 537 So. 2d 978, 981 (Fla. 1989).

[18] NASD Rule 10308(b)(1)(B).

NASD Rules provide that the arbitrator list will contain only public arbitrators.[19]

How can SRO arbitration be fair, if the SRO's mandate arbitration before an industry arbitrator? The difference between public and industry decisions is clear-cut – only one in twenty (1/20, 5%) public arbitrators refused to enforce 517, while one in three (1/3, 34%) panels with an industry arbitrator did not enforce 517.

The presence of an industry arbitrator leads to disparate treatment of defrauded investors, which conflicts with due process.

Arbitrators' Obligation to Follow Statutory Law

In its Arbitrator's Manual, SICA[20] mis-informs arbitrators that they are not required to follow statutory law. SICA's mis-information conflicts with the interpretation of the United States Supreme Court as well as the Securities and Exchange Commission ("SEC"). The United States Supreme Court approved securities arbitration of statutory claims predicated on the stated expectation that arbitrators will enforce statutory rights.[21]

SICA's mis-interpretation is responsible for the common mis-perception that arbitrators are not required to follow statutory law. The problem of arbitrators not following the law was one of the bases for the Supreme Court's rejection of mandatory securities arbitration in *Wilko v. Swan*.[22] In its Amicus Brief in *Shearson/American Express, Inc. v. McMahon*,[23] urging the Court to overrule *Wilko*, the SEC recognized the arbitrators would be required to follow the law.[24] This requirement became one of the linchpins of the *McMahon* decision as the Court said:

> Finally, we have indicated that there is no reason to assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to insure that the arbitrators comply with the requirements of the statutes.[25]

Subsequently, the Supreme Court in *Gilmer* said:

> [B]y agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than judicial, forum.[26]

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[19] NASD Rule 10308(b)(1)(A). The single, public arbitrator may request to have the claim decided by a three-arbitrator panel if the amount is less than $25,000. For claims between $25,000 and $50,000, a party in its initial filing or the assigned arbitrator may request a three-arbitrator panel.

[20] SICA stands for "Securities Industry Conference on Arbitration."

[21] *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 232 (1987)(". . . [W]e have concluded that the streamlined procedures of arbitration do not entail any consequential restriction on substantive rights).

[22] *Wilko v. Swan*, 346 U.S. 427 (1953).

[23] *McMahon, supra.*

[24] SEC Amicus Curiae Brief, p.20, *McMahon, supra.*

[25] *McMahon, supra. at 232.*

[26] *Gilmer v. Interstate/Johnson Lane Corp.,* 500 U.S. 20, 26 (1991), quoting *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 628 (1985).

This Survey shows that panels with an industry arbitrator are not applying the Statute as required. The above referenced Supreme Court decisions make clear that, when dealing with statutory claims at least, arbitrators *do* have an obligation to follow the statute. This is important because the claimants in these Survey cases sought damages under the Florida Investor Protection Act. These provisions were developed to discourage improper practices in the securities markets during the 1920's. Today, we are seeing the same types of abuse by the brokerage industry. The securities statutes need to be strictly enforced to curb these current abuses.

We have been unsuccessful in locating an explanation why the SEC permits the SRO's to distribute SICA's Arbitrator's Manual containing provocative mis-information to its arbitrators. According to the SEC, ninety-percent (90%) of arbitration cases received at the SROs in 1997 were filed at the NASD.[27] "[A]lmost all (98%) of 1997 arbitration cases were filed at the NASD and the NYSE."[28]

Conclusion

Witnesses who testified on March 17, 2005 before the House Committee on Financial Services made it clear that practitioners who represented customers have a different perspective on the fairness of SRO arbitration than the NASD and NYSE. NASD and NYSE believe that their arbitration programs are fair.

NASD is a monopoly, by its own admission, as well as by the SEC statistics referenced above. NASD tells its arbitrator applicants that "[w]e handle more than 90% of all securities claims filed involving customers of brokerage firms . . . ."[29]

Monopolies, as business models, are notoriously poor providers of services. Monopolies have little incentive to improve service because demand has no alternative. There needs to be consumer choice, if there is going to be meaningful competition leading to meaningful reform.

SRO's must be made to compete with the AAA,[30] other arbitration forums as well as the courts for its arbitration services. With the advent of competition, market forces will compel reform by leaving investment fraud victims free to choose the fairest and most efficient forum, leading to better arbitration services.

Elimination of the industry arbitrator from three arbitrator panels is an essential reform for removing the appearance of partiality in SRO arbitration. The AAA uses three arbitrator panels in customer disputes with brokerage firms which do not include an industry arbitrator.

This Survey shows that industry arbitrators have a chilling effect on arbitrators' willingness to enforce Florida's Investor Protection Act. It is hard to imagine that a victim of investment fraud would voluntarily agree to have an industry arbitrator on a panel considering his or her dispute with a brokerage firm, which explains why SRO arbitration is mandatory. Industry arbitrators serve no necessary function.

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[27] United State Securities & Exchange Commission, Division of Market Regulation, *Oversight of Self-Regulatory Organization Arbitration (Audit 289*), August 24, 1999, p. 1.

[28] *Id.*

[29] See cover letter sent to prospective arbitrators by NASD's Neutral Relations Supervisor.

[30] "AAA" stands for American Arbitration Association.

The securities industry has a rule that requires brokerage firms to arbitrate customer claims before an SRO whether or not the customer and brokerage firm signed an arbitration agreement.[31] Expanding that rule will go a long way to resolving the unfairness of SRO arbitration. An SRO rule that requires brokerage firms to accept its customer's choice to proceed in SRO arbitration – or an alternate arbitration forum or in the courts – will provide the choice and competition needed to achieve the objective of fair and efficient resolution of customer disputes with brokerage firms.

[31] NASD Rule 10301; NYSE Rule 600.

The Financial Plan: A Target-Rich Environment

By Frederick Rosenberg

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How often have you taken cases in which the claimant was given a financial plan or spreadsheet analysis, showing "conservative" growth at 10%, minus expenses plus inflation yielding a net growth rate over thirty years that miraculously leaves the investors, wealthier than they would have been had they worked over the same period of time. And as they say, "That's conservative".

Unfortunately, the "conservative" part is a blatant misrepresentation. A market investment illustration that utilizes a flat 10% growth rate (0 Standard Deviation) is impossible. The assumption that an investor's return is the average of the annual yields in a volatile market is flat out wrong. The recommendation of using 100% equities or balanced portfolio exclusively to fund monthly expenses will, except in the rarest case, leave the customer penniless within his or her lifetime if the necessary withdrawals exceed 4% annually.

What is at issue here is not the pie-chart allocations, rather it is that most financial planning assumptions are baseless and misleading. Since those assumptions serve as the basis of the respondent's recommendations, you must from the outset, demonstrate how misleading the projections really are. So what is Risk and how is it measured?

Risk & Risk Measurement:
The risk of any investment is typically measured by its volatility, the higher the risk the more volatile its movement in the markets. Volatility is quantified by a statistical measure known as the *standard deviation* (Sdev) of the return rate. A standard deviation of zero would mean an investment has a return rate that never varies, like a bank account paying compound interest at a guaranteed rate.

By contrast, the S&P 500 index has an annual standard deviation of approximately 17% based upon an historical arithmetic mean growth rate of 11%. Within one Sdev the S&P 500 can be expected to fluctuate

between -6% and 28% annually. Within two Sdev the S&P can be expected to fluctuate between -23% and 45%. Statistically, performance will fall within one Sdev sixty-five percent of the time and two Sdev ninety-five percent of the time Illustrating the substantial risk within the so called "conservative" S&P 500.

Importantly, the standard deviation of an index is lower than the average Sdev of each of its components because the Sdev for an index (or fund) is a function not only of the Sdevs of its individual securities, but of the degree of correlation among each security's return. For example, some funds or stocks go up when others go down and some lag well behind in growth or loss. The effect of this "covariance" is to even out and reduce portfolio risk. Two funds each with a standard deviation of 20% will combine to form a portfolio with a lower standard deviation than the average of the two[1], (unless the two funds are correlated exactly). As a result entire portfolio performance can only be measured as a whole.

Beta

Contrary to the common misconception, Beta, (a security's numerical relationship to an index such as the S&P 500) does not truly measure risk, but rather is primarily a forecaster of relative return. A beta of 1.0 means that a security moves in general proportion with an index, higher betas indicates volatility proportionately higher than the index and a lower beta suggests volatility proportionately lower. And, while Beta is used in formulas like the Sharpe Ratio as a component of risk, it tells nothing about the volatility of the underlying index itself. Sdev on the other does provide a measurement of the probability of losses or gains over time based upon historical performance. For this reason Beta is of limited significance.

Expected Return + Volatility:

The main impact of volatility is uncertainty in an investment's performance. This is because Volatility always causes a significant decrease from the expected return. For example, historically, the S&P 500 has an "expected return" of 11% but this is just the arithmetic average of past performance. However, as illustrated by the Ibbotson table below, the arithmetic mean always overstates real growth, typically by 1-3% when measured by the Internal Rate of Return (IRR, also known as the "geometric mean").

The historical variance of that disparity is detailed in the following Ibbotson Chart[2].

Time Period 1969-2003	Geometric Mean	Arithmetic Mean	Std Deviation
Large Cap Growth	9.3%	11.3%	20.6%
Large Cap Value	10.9%	12.3%	17.0%
Mid-Cap Growth	9.7%	12.0%	22.1%
Mid-Cap Value	13.8%	15.5%	19.7%
Small-Cap Growth	9.2%	12.1%	25.2%
Small-Cap Value	15.2%	17.3%	22%
All Growth Stocks	9.3%	11.2%	20.2%
All Value Stocks	11.6%	12.9%	18.2%

This is particularly significant when costs and account expenses are taken into consideration. For example, if the expected outcome is 11.3% but the IRR is actually 9.3%, the percentage of expenses and withdrawals impose far higher hurdles than normally perceived. On a Large Cap Growth portfolio for example, an 8% withdrawal rate with 1.5% expenses effectively trumps all growth. In contrast the arithmetic mean erroneously forecasts 2% net growth.

[1] This is the basis of William Sharpe's "efficient frontier" showing the frontier line as a curve, not a straight line and explaining how adding high-risk securities can actually lower overall portfolio risk.

[2] Ibbotson 2004 Yearbook Classic Edition, page 149.

The Table below utilizes a 10% growth rate to illustrate how volatility negatively affects returns. Column A growth is exactly 10% annually and the IRR matches that outcome. Notice that the standard deviation is 0. Columns B through J illustrate the effect of volatility; e.g. the higher the standard deviation, the greater the variance from the Arithmetic Mean and the lower the IRR to the investor. In the table below, each $1,000 investment has a 10-year, 10% average annual growth rate yet the outcomes vary significantly. Most importantly, this chart illustrates that that the higher the standard deviation the greater the disparity between the arithmetic mean and the IRR. In effect, increasing volatility always lowers returns below the expected return.

The bottom line is that for any portfolio, the IRR will be less, sometimes significantly less, than the percentage generally projected as the expected "average" growth rate[3]. Furthermore, the greater the volatility (as measured by Sdev), the greater will be the disparity between the Arithmetic Mean and the lower IRR.

Monthly Analysis is Usually Required to Assess Risk for Income Accounts

The short-term dangers of volatility are real and even an excellent long-term investment portfolio can be a disaster if the time horizon is short. Unfortunately, an investor's short-term risks are literally ignored by projections based upon annual returns. The monthly Sdev of the S&P 500[4] is 4.9% from its .92%[5]

Illustration of Effect of Volatility on Returns

	A	B	C	D	E	F	G	H	I	J
Investment	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)	(1,000)
Year 1	10%	50%	40%	-15%	30%	20%	25%	20%	15%	12%
Year 2	10%	-30%	-20%	35%	-10%	30%	-5%	0%	5%	8%
Year 3	10%	50%	40%	-15%	30%	-16%	25%	20%	15%	12%
Year 4	10%	-30%	-20%	35%	-10%	6%	-5%	0%	5%	8%
Year 5	10%	50%	40%	-15%	30%	-2%	25%	20%	15%	12%
Year 6	10%	-30%	-20%	35%	-10%	24%	-5%	0%	5%	8%
Year 7	10%	50%	40%	-15%	30%	-2%	25%	20%	15%	12%
Year 8	10%	-30%	-20%	35%	-10%	30%	-5%	0%	5%	8%
Year 9	10%	50%	40%	-15%	30%	-12%	25%	20%	15%	12%
Year 10	10%	-30%	-20%	35%	-10%	22%	-5%	0%	5%	8%
End Value	2,594	1,276	1,762	1,990	2,192	2,309	2,361	2,488	2,567	2,589
Arithmetic Average	10%	10%	10%	10%	10%	10%	10%	10%	10%	10%
IRR	10.00%	2.47%	5.83%	7.12%	8.17%	8.73%	8.97%	9.54%	9.89%	9.98%
Std Dev	0.0%	43.8%	32.9%	27.4%	21.9%	17.5%	16.4%	11.0%	5.5%	2.2%
$ Reduction per Sdev		(1,317)	(831)	(604)	(401)	(285)	(232)	(105)	(27)	(4)
% of Expected Outcome		49.2%	67.9%	76.7%	84.5%	89.0%	91.0%	95.9%	99.0%	99.8%

[3] "The geometric mean is backward-looking, measuring the change in wealth over more than one period. On the other hand, the arithmetic mean better represents a typical performance over single periods….In general, the geometric mean for any time period is less than or equal to the arithmetic mean…". Ibbotson 2005 yearbook at page 106.

[4] 17% annual SDEV divided by the square root of 12(the number of periods in a year).

monthly mean. In any month therefore, monthly returns can be expected to fluctuate between -4% and 5.8% two-thirds of the time (1 Sdev) and between –9% and 10.2% (2 Sdev) ninety-five percent of the time. That's monthly! This risk level exceeds the risk-tolerance of most income investors.[6]

What type of Projection is appropriate?

Instead of using the erroneous and misleading zero standard deviation, 10% growth projection, the appropriate model should be a probability forecast utilizing the proposed investment allocations to disclose to the investor the probability of accomplishing his objectives and the risk of a negative outcome.

The Monte Carlo Simulation:
A probability simulation is very straight forward and is based upon readily known inputs such as average return and Sdev permitting a probability forecast of expected outcomes that incorporates variables that affect return, such as costs, interest rates, withdrawals, and debit balances. I utilize a Monte Carlo simulator to randomly assign a growth or loss rate for each period based upon the historical mean and standard deviation for each period in the forecast. The process is repeated for sufficient iterations to produce a spread of outcomes, which are then stratified by percentile.

The Regulatory Defense,

NASD Rule 2210(d)(2)(N) Predictions and Projections.

> In communications with the public, investment results cannot be predicted or projected. Investment performance illustrations may not imply that gain or income realized in the past will be repeated in the future. However, for purposes of this Rule, hypothetical illustrations of mathematical principles are not considered projections of performance; e.g., illustrations designed to show the effects of dollar cost averaging, tax- free compounding, or the mechanics of variable annuity contracts or variable life policies."

IM-2210-6. Requirements for the Use of Investment Analysis Tools[7]

This IM appears to overturn an unarticulated 2210(d)(2)(N) prohibition against the use of simulations, an interpretation Respondents will likely echo when explaining why they failed to adequately explain risk, e.g. respondents claim they were legally prohibited by rule from discussing outcomes.

The new IM, adopted in February, now authorizes the use of simulations under prescribed rules and may serve as a statutory demarcation of liability. But, what impact on cases originating prior to its adoption? If the Respondents used the approved but typically misleading growth illustrations prior to February 2005, can they rely on 2210(d)(2)(N) prohibitions as to defense to allegations that they failed a duty to disclose risk? Or, can Claimants successfully argue that respondents use of typical forecasts is demonstrably misleading under 2210 generally and absent complete risk disclosure, the investor will be wrongfully mislead?[8]

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[5] 11% annual growth divided by 12 months equals .92% mean growth per month.

[6] Exhibit B: Monthly fluctuations in S&P 500.

[7] Read IM-2210-6. Requirements for the Use of Investment Analysis Tools. Newly adopted interpretations overriding "prohibition" on use of tools?

[8] Exhibit A: IM-2210-6. Requirements for the Use of Investment Analysis Tools.

Investment Strategies

The Myth of the Balanced Account:
The balanced account, often illustrated by a pie chart, is an account invested across multiple asset classes, such as fixed income, equities & cash in specific proportions, typically for long-term. Unfortunately, brokers and planners err badly in balancing accounts where the objectives are more near term. Income and retirement accounts fall into that category.

Most retirement (income) accounts will suffer substantial losses with a portfolio balanced between equities and fixed income if withdrawal rates exceed 4% annually. Take for example a portfolio split evenly between equities and fixed income. If the fixed income portion of the conservatively yields 5%, the equities portion would therefore need to return 15% every year to produce average annual portfolio growth of 10% after fees and commissions. Fifteen percent on equities requires performance four points higher than the S&P 500 average, a result that cannot happen consistently over time.

For the retiree, this spells disaster because half the 10% projected growth must be generated by higher risk, higher volatility equities that need to perpetually grow faster than the S&P 500. Retirees therefore will need to liquidate equities to generate necessary distributions and this undermines the underlying growth strategy that depends upon holding onto assets "long-term" to overcome short-term volatility. As can be seen in the table above, volatility results in IRRs far lower than the arithmetic average, typically by 2%. For balanced accounts therefore, the equities portion needs to consistently average 17% to overcome the return-lowering effect caused by high volatility. Meanwhile, by liquidating shares to support income needs, those shares cannot participate in recovery of the markets leaving the investor with fewer and fewer shares every year.

This is not simply my opinion. The excellent T Rowe Price website calculator is an outstanding proof source (http://www3.troweprice.com/ric/RIC). For example, on a 300,000 account (60% equities, 30% bonds, 10% cash) has a better than 50% chance of running out of money, assuming $1590.00 monthly withdrawals (6.36%). To achieve a 99% probability of success, the investor cannot withdraw no more than $930.00/mo, roughly 3.7%/yr[9]. This flies in the face of financial plans that typically use 8%-10% withdrawals in their forecast. At those withdrawal levels, absent extraordinary market performance, the investor is assured of disaster, e.g. running out of money during his remaining years. If the customer's requirements were $2,000/month (8%,) there's a near 90% probability of a retiree running out of money prematurely.

This problem is rampant in cases not only involving the elderly, but for employees considering early buyouts from their employer. Based upon the T Rowe Price model, an investor withdrawing more than 4% of his investment annually ($1,000 /month on a $300,000 account) significantly increases the chances of running out of money to the point of it becoming a certainty. Most financial plans incorporate aggressive withdrawal assumptions with 0 Sdev forecasts that ignore the volatility that predictably erodes returns.

Double Edged Sword?

The idea that a balanced portfolio is unsuitable for an income account contradicts some very basic assumptions for both Claimants and Respondents, particularly for portfolios paying out in excess of 4% annually. It certainly changes the grounds rules in "Well Managed Account" theories. But since most retirees primarily fear outliving their money, safety of principal is paramount.

---

[9] Exhibit D: T Rowe Price on-line Calculator.

That risk is amplified in a 100% equities or a balanced portfolio compared with portfolio of 100% fixed income if principal is invaded only slightly each year. But, one cannot argue in favor of balancing an account that needs to distribute in excess of 4% annually without substantially increasing equities in the portfolio thereby increasing short-term risk and volatility.

Margin

It is common understanding that leveraging a securities account increases return at the expense of increased risk. In the example below, a $1 million portfolio invested in the S&P 500, with an Sdev of 17% will range between –23% and 45% in any year. On the unleveraged portfolio the outcomes range between $770,000 and $1,450,000. With 50% margin debt, that range widens to $540,000 to $1,900,000. See chart below.

		2 Sdev @17%	
		-23%	45%
Unleveraged			
$ 1,000,000		(230,000)	450,000
	Outcome Range	**770,000**	**1,450,000**
Leveraged			
$ 2,000,000		(460,000)	900,000
	Pre Debit Range	1,540,000	2,900,000
	Debit 50%	(1,000,000)	(1,000,000)
	Outcome Range	**540,000**	**1,900,000**

Account Expenses:

As discussed in the "Expected Return + Volatility" section above, account expenses are particularly significant in margined accounts. Because of historic volatility, conservative long-term growth portfolios are inappropriate for leveraging. Aggressive portfolios that are leveraged experience wider swings in possible outcomes. Moreover, over the long-term, account expenses will consume a substantial portion of any gains and exacerbate losses in periods of market declines.

Inflation:

Without going into unnecessary detail, the effect of losing buying power through inflation is often preferable to the risk associated with growth equities for many investors. In many financial plans, merely overcoming inflation requires 3%+. But utilizing an unrealistic inflation rate such as 4% will substantially overstate projected needs resulting in overly aggressive assumptions when compared with the average 3% CPI. In truth, the conservative portfolio should utilize far lower CPI assumptions, such as 2% because much of a retiree's expenses are fixed costs or reduced because of lifestyle changes and Medicare.

Merrill's Financial Foundation Report- a contrast in disclosure

The typical Financial Foundation Report is one of the financial plans that even vainly attempt to clearly discuss risk. Unfortunately it fails when it counts.

An FFR early typically states very simple objectives,

- **To maintain a $_________ annual retirement lifestyle**
- **To minimize estate shrinkage and preserve asset for your heirs**
- **To ensure survivor income**
- **To provide sufficient income in the event of disability**
- **Etc.**

In its "Risk" section, the FFR describes and contrasts historical compound returns utilizing Ibbotson graphs (based upon historical standard deviations for each asset style) to show the ranges of potential outcome associated with different investment styles over time. But, despite all the discussion of

risk, the FFR concludes with wealth table that completely ignores risk by forecasting an impossible and misleading 10% zero standard deviation growth rate forever, while intentionally failing to disclose the significant and negative impact of fees and expenses on forecasted growth or disclaiming that the growth projections are not based upon the plan's proposed asset allocations.

Conclusion

It is often argued that the extreme losses occurring between 2000 and 2003 were the result of a "Perfect Storm" in the markets, and that nobody, including sell-side analysts could have predicted the market collapse or accounting scandals. The argument is fallacious however. For decades, the Sdev of the S&P 500 fluctuated at nearly 5% per month, [10] a clear and present sign of very high risk.

Based upon historical volatilities in the S&P 500, not only are such losses foreseeable, but also the risks are eminently quantifiable. "Regression Analysis" of the historical behavior of markets explains this. For example the S&P 500 has an average growth rate of 11% over 75 years with an Sdev of 17%. Over time, markets will average out or "Regress to the Mean" and to the extent that growth rates substantially exceed its average, the S&P 500 will inevitably under-perform its historical average to bring performance back into line. The only question is when.

Between 1995-1999, the S&P averaged returns of 28%. By 2000, regression became practically inevitable and volatilities rose to new heights. Investing in securities with known Sdevs and average returns made the risks eminently predictable.

Finally, much of what's discussed in this article is supported by materials available from the recognized authority in market statistics, Ibbotson, and can be found in their 2005 Yearbook. I advise its purchase for every one trying these types of cases as an authority and bible for cross-examination.

[10] Exhibit B.

RISK

All investments are subject to risk. Risk refers to the possibility that an investment could decline in value or provide an investment return lower than the rate of inflation.

VOLATILITY

An important measure of risk is the volatility associated with an asset allocation or investment vehicle. Volatility indicates the degree to which the return of a portfolio fluctuates up or down around its average return. All investments have some level of upside and downside volatility. The range of fluctuation is generally indicated as an annual percentage. The higher the percentage, the higher the volatility, hence the greater risk.

The following graph illustrates that the proposed model would have experienced less volatility than the Standard & Poor's Composite Stock Price Index (S&P 500® Index). This index represents an allocation of 100% equities, which is considered to be an allocation with a substantial amount of risk.

ANNUAL RATES OF RETURN*

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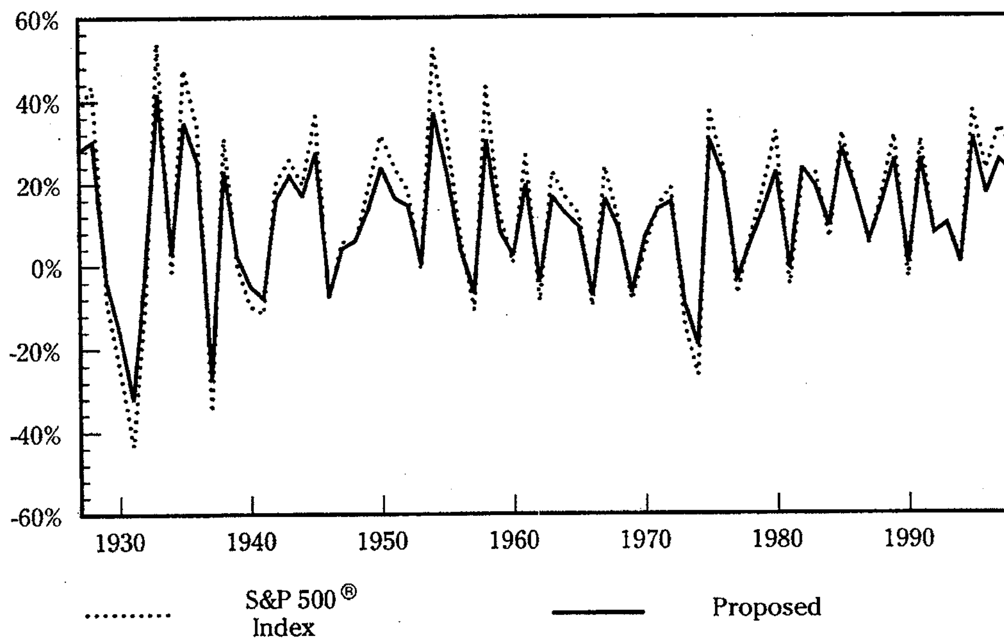

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The length of time you maintain an allocation can help reduce volatility over time. Therefore, by holding a position for a longer time horizon, you may reduce the overall risk associated with the allocation while taking advantage of a higher potential average rate of return.

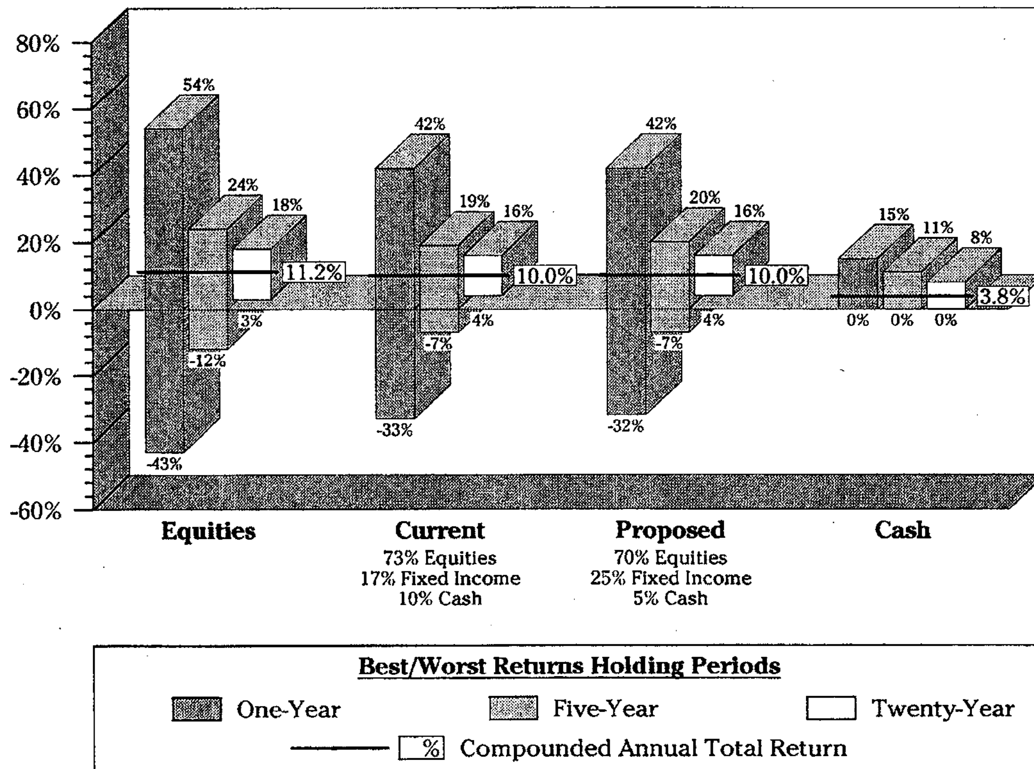
The following graph displays the best and worst compounded returns over various holding periods for:

- equities;
- cash;
- your current allocation;
- your proposed allocation.

The average annual return for the entire time period is also included.

This graph illustrates that while your current allocation may have generated a higher average rate of return over a long-term time horizon than your proposed allocation, it also may have been subject to greater risk during shorter holding periods.

RISK VS. RETURN* OVER TIME
1926 — 1998



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When selecting an allocation, it is important to consider how the proposed allocation may impact your ability to achieve your various financial goals.

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Your retirement analysis assumes you maintain your current asset allocation.

From an asset allocation perspective, reallocating to the proposed model may not have a significant impact on your achievable retirement lifestyle.

ADDITIONAL RETIREMENT INFORMATION

YOUR RETIREMENT LIFESTYLE
PROPOSED ASSET ALLOCATION

Year	Retirement Income	Return on Investment	Total Income (After Tax)	Anticipated Expenses	Annual Surplus (Deficit)	Remaining Balance: Portfolio and Other Assets	Remaining Balance: Retirement Assets
Starting Balance						**$392,424**	**$2,320,136**
2008	$61,657	$24,305	$85,962	$140,431	–$54,469	$337,955	$2,524,888
2009	$62,327	$21,127	$83,454	$144,784	–$61,330	$276,625	$2,747,709
2010	$63,019	$17,458	$80,477	$149,272	–$68,795	$207,830	$2,990,194
2011	$55,516	$11,773	$67,289	$153,900	–$86,611	$192,769	$3,160,462
2012	$55,427	$10,905	$66,332	$158,671	–$92,339	$177,057	$3,338,951
2013	$55,334	$10,002	$65,335	$163,589	–$98,254	$160,803	$3,525,969
2014	$55,220	$9,068	$64,287	$168,661	–$104,373	$144,079	$3,721,836
2015	$55,098	$8,110	$63,208	$173,889	–$110,681	$126,995	$3,926,894
2016	$54,973	$7,134	$62,108	$179,280	–$117,172	$109,669	$4,141,510
2017	$54,896	$6,154	$61,050	$184,837	–$123,788	$91,479	$4,367,271
2018	$54,273	$5,109	$59,382	$190,567	–$131,185	$71,686	$4,603,596
2019	$78,189	$4,005	$82,194	$196,475	–$114,281	$73,914	$4,852,502
2020	$78,845	$4,125	$82,970	$202,566	–$119,596	$76,897	$5,114,947
2021	$79,796	$4,294	$84,091	$208,845	–$124,755	$79,951	$5,393,878
2022	$80,519	$4,461	$84,980	$215,319	–$130,339	$83,571	$5,688,930
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2027	$75,946	$14,326	$90,272	$250,828	–$160,556	$467,984	$6,816,675
Last 5 Years							
2037	$85,540	$166,060	$251,600	$340,379	–$88,780	$3,508,041	$6,086,820
2038	$86,831	$186,717	$273,547	$350,931	–$77,384	$3,910,294	$5,889,053
2039	$88,165	$208,194	$296,359	$361,810	–$65,451	$4,327,992	$5,669,494
2040	$89,547	$230,516	$320,063	$373,026	–$52,963	$4,761,281	$5,426,930
2041	$91,002	$253,714	$344,716	$384,590	–$39,874	$5,209,041	$5,162,238

NOTES

CASH

U.S. Treasury Bills: 1928 - Present (Ibbotson) T-Bills are direct obligations of the United States Treasury. The returns shown on the rate of return graphs are compiled from the yields available from the weekly auction of Treasury Bills with a maturity of 30 days. These returns can be used as a proxy for "cash and equivalents."

EQUITIES

Standard and Poor's 500 Composite Stock Price Index: 1928 - Present (Ibbotson) The S&P 500® Index is an index of industrial, public utility, financial and transportation stocks with income reinvested. It can be used as a proxy for the domestic stock market and is a generally used performance benchmark for equity portfolios. "S&P 500" is a registered trademark of The McGraw-Hill Companies.

FIXED INCOME

Intermediate Corporate Bonds Index: 1928 - 4th Q. 1989 (Ibbotson) Index of domestic corporate bonds with 5 to 15 years to maturity, all grades. The criteria for the inclusion in this index are:

- Face value of at least one million dollars;
- Bond maturity of over one year;
- Bond as a publicly held obligation of a U.S. based company or subsidiary whose operations are primarily in the U.S.

Intermediate Bonds Index: 1990 - Present (Ibbotson) This Solomon Longterm Bond index includes all publicly issued, fixed rate, nonconvertible investment grade domestic corporate debt and yankee bonds. All issues have at least one year to maturity and an outstanding par value of at least $25 million. Price, coupon and total return are reported on a month-end to month-end basis. All returns are market value weighted inclusive of accrued interest.

HISTORICAL PERFORMANCE DATA

Recognizing that past performance does not guarantee or indicate future results, and that performance of indexes differ from actual portfolios, data presented including data relating to proposed asset allocation is based on the historical performance of various indexes representing asset classes. There is no correlation between the index and a client's portfolio consisting of securities. indexes do not reflect transaction costs. If available, an actual investment in these indexes, or in the securities comprising these indexes, would require an investor to incur transaction costs and performance would be reduced by such costs.

The source of Historical Performance Data is Benchmark Plus Data, Ibbotson Associates, Chicago. All rights reserved.

INFLATION

Inflation Rate (Ibbotson)

Source

1978 - Present	Consumer Price Index for all Urban Consumers, not seasonally adjusted (CPI) from the U.S. Department of Labor, Bureau of Labor Statistics, Washington, D.C. CPI measures inflation, which is the rate of change of consumer goods prices. CPI commodity prices are collected during the month.
1928 - 1977	CPI, U.S. Department of Labor, Bureau of Labor Statistics.

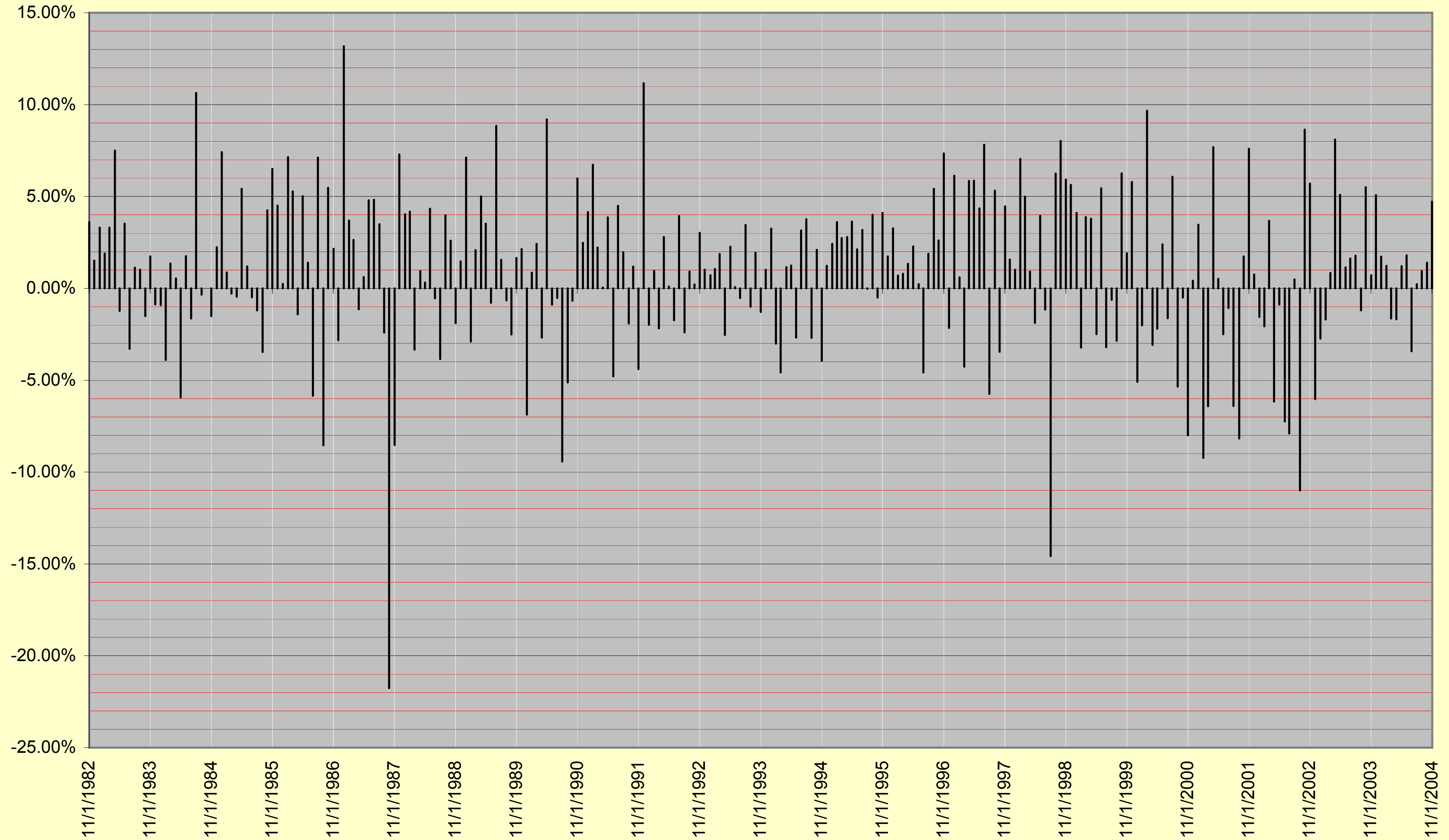
SPECIAL CONDITIONS

Your Financial Foundation report is based on the following special conditions:

INVESTMENT ASSET INFORMATION

Your investment rate assumptions are:

Inflation Rate	3.1%				
Cash	4%	Equity	10%	Other	4%
Tax-Free	5%	Taxable	6.5%	Tax-Deferred	


S&P 500 Index (^GSPC) 11/82 - 11/04 Monthly % Change
Mean Monthly Growth .92% - Monthly Standard Deviation 4.96%
Raw Data souce: Finance.Yahoo.Com
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
-25.00%
11/1/1982
11/1/1983
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11/1/1986
11/1/1987
11/1/1988
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11/1/1999
11/1/2000
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11/1/2004

NASDAQ 100(^NDX) 11/84 - 11/04 Monthly % Change
Raw Data souce: Finance.Yahoo.Com
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25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
-25.00%
-30.00%
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11/1/2004

Exhibit D /

Retirement Income Calculator

›RESULTS | SUCCESS | ›PORTFOLIO

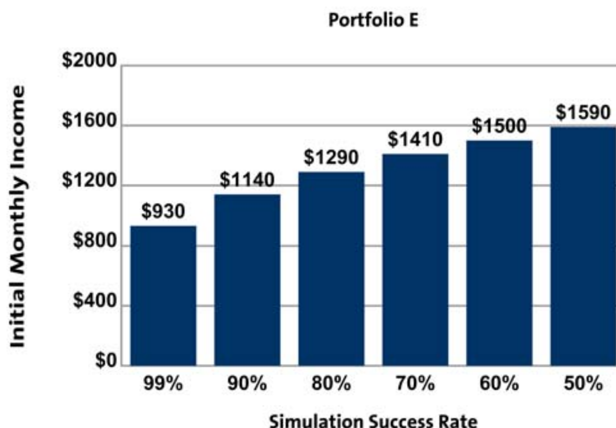
Key Financial Information

1. Start Age — 65 Years
2. Retirement Length — 25 Years
3. Marital Status — Married
4. Retirement Assets — $300,000
5. Monthly Income Goal — $2,000
6. Portfolio — E (60/30/10)
7. Simulation Success Rate — ALL

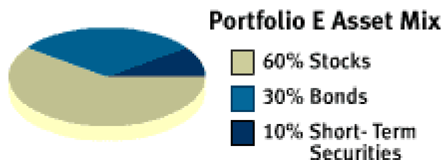
Calculate

Important Assumptions and Information for This Calculator

For your chosen portfolio, compare the different initial monthly income amounts associated with each simulation success rate. Select a different **portfolio** in the box to the left and see how the initial monthly income amounts change for each **simulation success rate**.



Simulation Success Rate represents the likelihood that your assets will last for your Retirement Length when you select an investment portfolio and a withdrawal amount. Click on **each** bar in the graph above to **view an explanation** of the individual bar and a **graph of the simulations** used to calculate your result (displaying 25 representative scenarios).



Questions about your retirement investments?

Our Investment Specialists can offer you answers on a variety of different topics, including accumulating money for retirement, allocating your investments to match your time horizon and risk tolerance, or ensuring you have an adequate income stream once you retire.

Call 1-800-831-1432 to have your questions answered.

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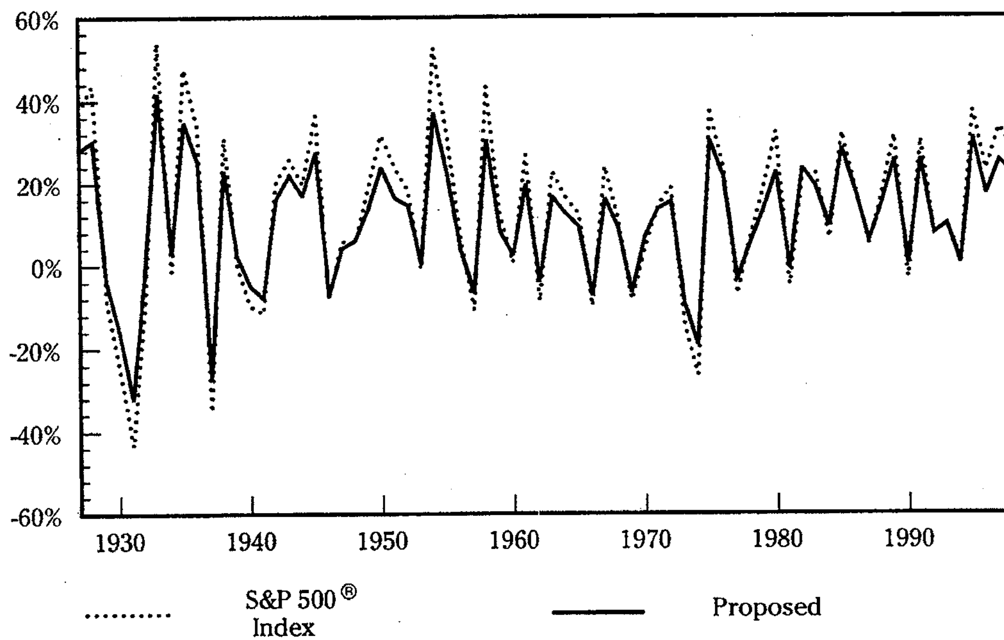

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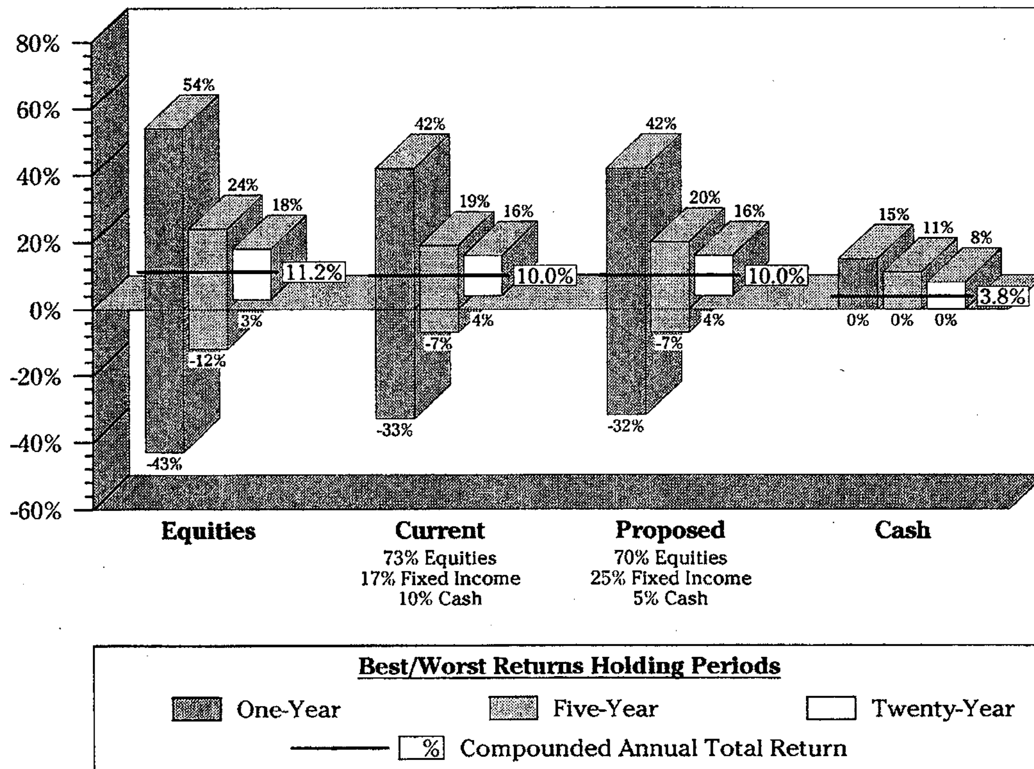

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U.S. Treasury Bills: 1928 - Present (Ibbotson) T-Bills are direct obligations of the United States Treasury. The returns shown on the rate of return graphs are compiled from the yields available from the weekly auction of Treasury Bills with a maturity of 30 days. These returns can be used as a proxy for "cash and equivalents."

EQUITIES

Standard and Poor's 500 Composite Stock Price Index: 1928 - Present (Ibbotson) The S&P 500® Index is an index of industrial, public utility, financial and transportation stocks with income reinvested. It can be used as a proxy for the domestic stock market and is a generally used performance benchmark for equity portfolios. "S&P 500" is a registered trademark of The McGraw-Hill Companies.

FIXED INCOME

Intermediate Corporate Bonds Index: 1928 - 4th Q. 1989 (Ibbotson) Index of domestic corporate bonds with 5 to 15 years to maturity, all grades. The criteria for the inclusion in this index are:

- Face value of at least one million dollars;
- Bond maturity of over one year;
- Bond as a publicly held obligation of a U.S. based company or subsidiary whose operations are primarily in the U.S.

Intermediate Bonds Index: 1990 - Present (Ibbotson) This Solomon Longterm Bond index includes all publicly issued, fixed rate, nonconvertible investment grade domestic corporate debt and yankee bonds. All issues have at least one year to maturity and an outstanding par value of at least $25 million. Price, coupon and total return are reported on a month-end to month-end basis. All returns are market value weighted inclusive of accrued interest.

HISTORICAL PERFORMANCE DATA

Recognizing that past performance does not guarantee or indicate future results, and that performance of indexes differ from actual portfolios, data presented including data relating to proposed asset allocation is based on the historical performance of various indexes representing asset classes. There is no correlation between the index and a client's portfolio consisting of securities. indexes do not reflect transaction costs. If available, an actual investment in these indexes, or in the securities comprising these indexes, would require an investor to incur transaction costs and performance would be reduced by such costs.

The source of Historical Performance Data is Benchmark Plus Data, Ibbotson Associates, Chicago. All rights reserved.

INFLATION

Inflation Rate (Ibbotson)

Source

1978 - Present	Consumer Price Index for all Urban Consumers, not seasonally adjusted (CPI) from the U.S. Department of Labor, Bureau of Labor Statistics, Washington, D.C. CPI measures inflation, which is the rate of change of consumer goods prices. CPI commodity prices are collected during the month.
1928 - 1977	CPI, U.S. Department of Labor, Bureau of Labor Statistics.

SPECIAL CONDITIONS

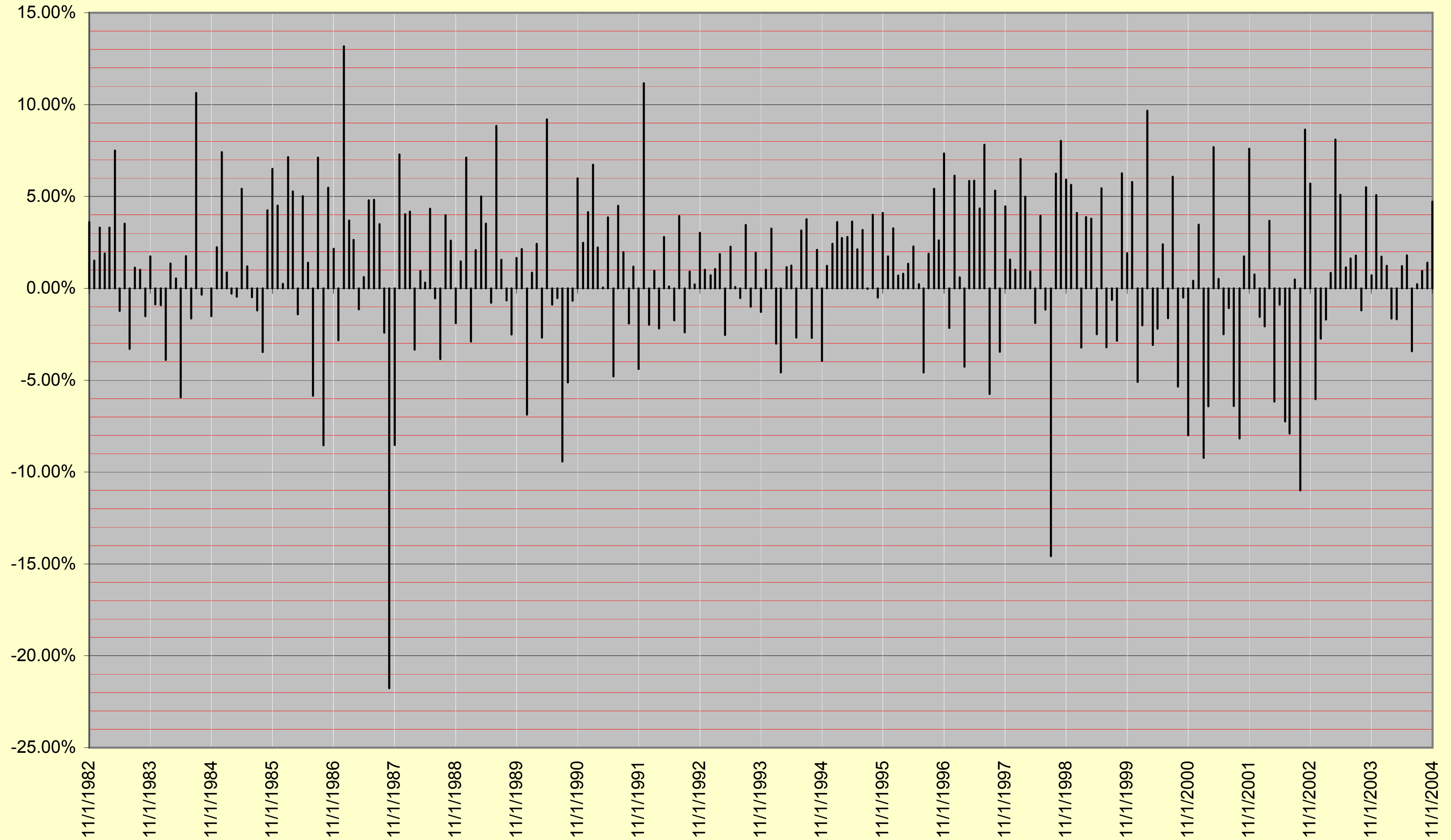
Your Financial Foundation report is based on the following special conditions:

INVESTMENT ASSET INFORMATION

Your investment rate assumptions are:

Inflation Rate	3.1%				
Cash	4%	Equity	10%	Other	4%
Tax-Free	5%	Taxable	6.5%	Tax-Deferred	

Exh C Monthly Indeces 1 of 2



NASDAQ 100(^NDX) 11/84 - 11/04 Monthly % Change
Raw Data souce: Finance.Yahoo.Com
30.00%
25.00%
20.00%
15.00%
10.00%
5.00%
0.00%
-5.00%
-10.00%
-15.00%
-20.00%
-25.00%
-30.00%
11/1/1985
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11/1/1987
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11/1/2004

Exhibit D /

Retirement Income Calculator

›RESULTS | SUCCESS | ›PORTFOLIO

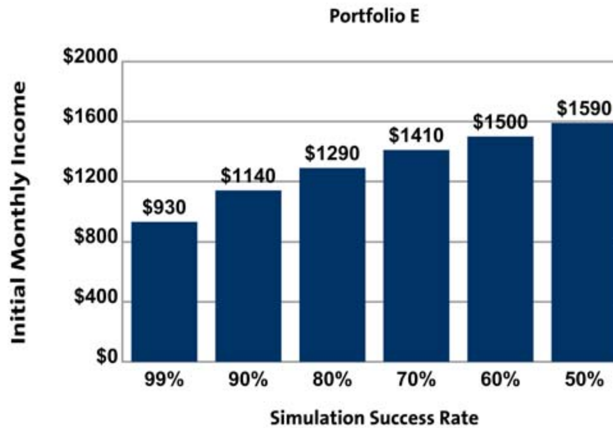
Key Financial Information

1. Start Age — 65 Years
2. Retirement Length — 25 Years
3. Marital Status — Married
4. Retirement Assets — $300,000
5. Monthly Income Goal — $2,000
6. Portfolio — E (60/30/10)
7. Simulation Success Rate — ALL

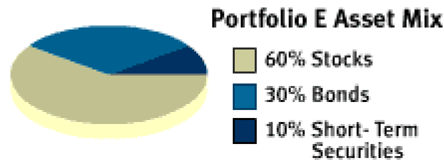
Calculate

Important Assumptions and Information for This Calculator

For your chosen portfolio, compare the different initial monthly income amounts associated with each simulation success rate. Select a different **portfolio** in the box to the left and see how the initial monthly income amounts change for each **simulation success rate**.



Simulation Success Rate represents the likelihood that your assets will last for your Retirement Length when you select an investment portfolio and a withdrawal amount. Click on **each** bar in the graph above to **view an explanation** of the individual bar and a **graph of the simulations** used to calculate your result (displaying 25 representative scenarios).



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PIABAns Got California In Line - Now Go Thou and Do Likewise

By James V. Weixel, Jr.

For years, California has been a noticeable holdout in securities law. At least 40 other American jurisdictions have adopted at least some significant part of the Uniform Securities Act. California, however, has steadfastly refused to join the pack, choosing instead to rely upon the Corporate Securities Act of 1968 (part of the Corporations Code) to regulate securities.

The 1968 Act lacks many of the investor protections of the Uniform Act, an area in which California has long resisted change. So even as one example of misconduct in the securities industry after another continued to grab the headlines during the early 2000's, few saw any hope for similar changes in California. Fortunately, a few PIABA members had different ideas.

A. You Can Move Mountains – Get Involved

Since the mid-1990s, I have been involved in the Conference of Delegates of California Bar Associations, which meets annually to debate legislative proposals submitted by the state's many bar associations. As the preparations for the 2003 Conference began, I circulated a request to California PIABA members, asking for ideas on what changes they wanted to see in our local securities laws.

The response was immediate. Two problems came to the fore: (1) that California, unlike the majority of jurisdictions that follow the Uniform Act, does not recognize a private cause of action for rescission of a transaction on the grounds that it was effected through an unlicensed broker; and (2) that California's statute of limitations for securities fraud was shorter than the recently enacted change to federal law in the Sarbanes-Oxley Corporate Responsibility Act of 2002. These seemed like two points that obviously needed fixing.

In preparation for the 2003 Conference of Delegates, I drafted and submitted two

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resolutions that would accomplish these changes. The resolutions were approved at the 2003 Conference, and thereafter caught the eye of the Conference's lobbyist in Sacramento. These resolutions were introduced during the 2003-2004 legislative session by Assembly member Lou Correa (D-Santa Ana) as Assembly Bill No. 2167. The measure passed both houses of the Legislature handily and was signed by the Governor on September 18, 2004. The provisions of the bill took effect on January 1, 2005.

This change did not come about at the hands of powerful organizations with armies of lobbyists and brimming war chests. Rather, a few PIABA members noticed a hole in California law that they wanted to see fixed, and others contributed their knowledge, suggestions, time, and support to see it through.[1]

There is no reason you can't do likewise. If your state has a statutory problem that has been a burr under your saddle, get involved with a local bar association, practice group, or other organization and get your ideas into writing. You'd be surprised at how much attention you can get with a well-drafted proposal. You might just be able to change your state's laws for the better.

B. Cause of Action for Rescission or Damages Against Unlicensed Brokers

One of the most salient differences between California law and the Uniform Securities Act was that the Uniform Act explicitly provides a cause of action against an unlicensed broker who effects a securities transaction. The Uniform Act allows a customer to rescind the transaction, or to recover appropriate damages if the customer no longer holds the security.[2]

California, on the other hand, did not have such a provision. Before the enactment of the Corporate Securities Act, the California courts did recognize a private right to rescind a trade effected by an unlicensed broker.[3] However, since the enactment of the Corporate Securities Act, there have been no reported decisions in which a California court has recognized a rescissionary cause of action.

For decades, therefore, a California investor who purchased securities through an unlicensed broker had to seek rescission through some other remedy, such as a fraud action. Of course, this meant proving scienter and all of the other elements of fraud, with the attendant burden of proof and often difficult pleading requirements.

Assembly Bill No. 2167 filled this hole in California law. The bill added new Section 25501.5 to the Corporations Code to allow an investor to rescind a transaction that was effected through an unlicensed broker-dealer. Section 25501.5 contains several significant provisions, which are outlined below.

Definition of "broker-dealer"

The first task in asserting a claim under Section 25501.5 is determining that the defendant or respondent is actually a "broker-dealer" subject to the statute. Most securities practitioners tend to think of a "broker-dealer" in the context of a brokerage firm. However, the statute should not be

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[1] Special thanks should go to PIABA members Scott Shewan for the original idea, Scot Bernstein for working with the staff at the California Legislature and the California Department of Corporations, and Tom Mason for his profound analysis of the bill and his suggested amendments.

[2] Uniform Securities Act, § 509.

[3] *See, e.g.*, *Rhode v. Bartholomew,* 94 Cal.App.2d 272 (1949); *Brandenburg v. Miley Petroleum Exploration Co.,* 16 F.2d 933 (N.D. Cal.1926).

read so narrowly.
Under California law, a "broker-dealer" is defined as "any person engaged in the business of effecting transactions in securities in this state for the account of others or for his own account."[4] This definition has been construed as applying to any person who has any involvement, however slight, in the negotiation and/or execution of a securities transaction. The only exception is where the subject simply brings the parties to the transaction together and takes no part in the discussion or negotiation of the matter.[5] The definition does not apply to the parties themselves, as a specific exception is provided for "[a]ny person insofar as he buys or sells securities for his own account, either individually or in some fiduciary capacity, but not as part of a regular business."[6]

It is probable, therefore, that most any person who had a hand in the transaction, other than simply introducing the parties, will be considered a "broker-dealer" under California law, and thus subject to the provisions of section 25501.5.

Rescission

The biggest change wrought by Section 25501.5 is the creation of a private right of action for the rescission of a transaction effected by an unlicensed broker-dealer.[7] An investor who purchases a security from an unlicensed broker may rescind the transaction, tender the security, and recover the consideration paid plus interest at the legal rate[8], less any income received on the security.[9] A seller, on the other hand, may rescind the transaction, tender the consideration plus interest at the legal rate, and recover the security itself plus any income received on the security since the time of sale.[10]

The statute also allows the investor to recover damages in the event that the investor or the broker-dealer no longer holds the security when the claim arises. These damages are reckoned under the "rescissionary" method that has been accepted by a number of courts, in accordance with the policy that the defrauded investor should be made whole even if a strict rescission is no longer possible due to the subsequent disposal of the security.[11] Section 25501.5 thus provides that if the plaintiff or defendant no longer owns the security (and is thus unable to tender it), the investor may recover damages that essentially mirror the statute's rescission remedies.
For a purchaser, this means that damages

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[4] § 25004, subd. (a).

[5] *Lyons v. Stevenson,* 65 Cal.App.3d 595, 605 (1977), *citing* 9 Cal.Jur.2d, Brokers, § 26, p. 164. However, at least one pre-Act case stated that even just bringing the parties together is within the definition of a "broker." (*Rhode, supra,* 94 Cal.App.2d at p. 278.)

[6] § 25004, subd. (a)(4).

[7] § 25501.5, subd. (a)(1).

[8] 10% (unless otherwise stipulated) for claims on contracts entered into after January 1, 1986 (Cal. Civ. Code, § 3289, subd. (b)); 7% for all other non-contract claims (Cal. Const., art. XV, § 1).

[9] § 25501.5, subd. (a)(2).

[10] § 25501.5, subd. (a)(3).

[11] Cf. § 25501 (permitting rescission or comparable damages in securities fraud actions); *see also Randall v. Loftsgaarden,* 478 U.S. 647 (1986); *Ambassador Hotel Co., Ltd. v. Wei-Chuan Investment,* 189 F.3d 1017 (9th Cir. 1999).

are measured as the difference between the purchase price of the security plus interest at the legal rate from the date of purchase, and the value of the security when disposed of by the plaintiff plus the income received during the time the plaintiff held the security.[12] For a seller, it means that the recoverable damages are equal to the value of the security at the time the complaint was filed plus any income received by the defendant, less the sale price of the security plus interest at the legal rate from the date of sale.[13]

Discretionary Award of Attorney Fees and Costs

In just one sentence, Section 25501.5 gives investors and their counsel a powerful incentive to pursue claims against unlicensed brokers. The statute permits a court to award reasonable attorney's fees and costs to an investor who prevails in a claim against an unlicensed broker.[14] This provision recognizes that a plaintiff or claimant who successfully rescinds a transaction with, or recovers damages from, an unlicensed broker often fails to realize the full benefit of the victory, since attorney's fees will often consume a sizeable portion of the recovery. In cases where a pure rescission is sought, the fees will even come directly out of the investor's pocket, since the actual monetary recovery may be minimal.

An award of attorney's fees against an unlicensed broker has long been a staple of the Uniform Act.[15] Subdivision (b) now brings California law into line with the Uniform Act in that respect too.

C. Award of Additional Damages

One provision that the Legislature added to A.B. No. 2167 was to include unlicensed broker-dealers in the roster of unlicensed professionals against whom treble damages can be sought. This added provision also authorizes an award of attorney fees to an investor who recovers from an unlicensed broker.

Section 1029.8 of the Code of Civil Procedure provides that damages shall be trebled in cases in which a consumer has conducted a transaction through an unlicensed professional. The statute also allows the court to award reasonable attorney fees and costs in favor of a prevailing consumer. Assembly Bill No. 2167 added unlicensed broker-dealers to the list of persons subject to these damages and awards.[16]

However, the additional damages provided for in section 1029.8 are modest at best. The statute limits an award of treble damages to $10,000. Although this does provide some relief to investors, it certainly does not create a bonanza for recovery. The real benefit of A.B. No. 2167, of course, is in the provision for attorney fees and costs.

D. Statute of Limitations Conformed to Sarbanes-Oxley

Until the passage of A.B. No. 2167, California had a "one year/four year" statute

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[12] § 25501.5, subd. (a)(4).

[13] § 25501.5, subd. (a)(5).

[14] § 25501.5, subd. (b).

[15] Uniform Securities Act, § 509, subd. (b)(1).

[16] A.B. No. 2167, § 1 (Reg. Sess. 2003-2004).

of limitations for securities fraud actions – that is, the plaintiff was required to file suit within one year of discovering the facts constituting fraud, and in no case more than four years after the commission of those acts. Even after Sarbanes-Oxley (which provided for a two year/five year window) came into being, the shorter California limitations period continued in effect.

Assembly Bill No. 2167 amended section 25506 of the Corporations Code to mirror the two year/five year limitations and repose period of Sarbanes-Oxley. The statute applies to all suits filed on or after January 1, 2005. For suits filed before that date, the old one year/four year rule will continue in effect.

In the coming year, the California courts will likely be required to tackle the issue of whether the new statute revives previously stale claims. Ordinarily, absent a clear legislative expression to the contrary, the California courts have held that a new statute of limitations does not revive claims that were extinguished under a previous, shorter limitations period.[17]

However, A.B. No. 2167 is somewhat different. The determinative factor in deciding which limitational period to apply is spelled out right in the statute. If the action is filed after the effective date of A.B. No. 2167, the new statute of limitations applies. If an action was pending before the effective date, the old statute governs. Therefore, it may be argued that newly filed claims will be timely even if the claims asserted therein would have been stale had the action been filed before the beginning of 2005. Only time will tell as to whether the courts will eventually agree.

Conclusion

We on the Left Coast have spent a lot of time patting ourselves on the back for usually being in front of national trends. This time, however, it took us a little longer than normal to get into the prevailing mindset. Finally, though, California investors have been given some potent defenses against unlicensed brokers, and will have the same amount of time to press their state-law securities claims as they do under federal law.

And don't forget – there is no reason why individual PIABA members can't have a part in changing their own states' laws. Don't think that you can't effect change just because you're not a legislator or a lobbyist. Anyone with a bright idea, a sense of organization, and a little persistence can make a big difference.

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[17] *See, e.g.*, *Krupnick v. Duke Energy Morro Bay, L.L.C.,* 115 Cal.App.4th 1026, 1029-1030 (2004) (construing effect of 2002 amendment to Code of Civil Procedure section 335.1, governing personal injury and wrongful death actions).

From the Lone Star State Picking Your Battles: A Guide to Selecting Causes of Action Under Texas Law to Recover for Suitability Violations

By Nelson S. Ebaugh and Grace D. O'Malley

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One of the most common defenses to a suitability claim is that the investor ratified the unsuitable transactions. Fortunately for investors in Texas, a broker cannot raise ratification as a defense to a claim under the Texas Securities Act or the Texas Deceptive Trade Practices Act.[1] As a consequence, with artful drafting of the statement of claim, the investor's attorney can take the wind out of the broker's sails by only pleading causes of action that cannot be assailed by the ratification defense.

The above illustration is only one example of selecting particular causes of action to assert on an investor's behalf in Texas. This article examines over a half-dozen causes of action available to investors in Texas and highlights the pros and cons of each. By understanding the pros and cons of each cause of action, the investor's attorney can tailor the statement of claim to avoid the broker's anticipated defenses.

I. The SRO Suitability Doctrines

Before deciding which claims should be asserted against a broker for unsuitable recommendations, it is essential to understand the origin of a private plaintiff's right to relief for a broker's unsuitable recommendations. In the early twentieth century, self-regulatory organizations ("SROs"), such as the NASD and the NYSE, perceived a need to require brokers to make suitable recommendations to their customers. Consequently, the NYSE adopted the "know your customer" rule[2] in 1909 and the NASD adopted the "suitability" rule[3] in 1939. Although worded differently, the purpose of each of these rules is to ensure that brokers make suitable recommendations to their customers. The NASD "suitability" rule is the

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[1] *Duperier v. Texas State Bank*, 28 S.W.3d 740, 753 (Tex. App.– Corpus Christi 2000), *pet. dism'd by agmt* (holding that the common law defense of ratification will not save a transaction which violates a statute); *LSR Joint Venture No. 2 v. Callewart*, 837 S.W.2d 693, 699 (Tex.App.—Dallas), *writ denied.*

[2] NYSE Rule 405; Hoblin, *A Stock Broker's Implied Liability To Its Customer For Violation Of A Rule Of A Registered Stock Exchange,* 39 Fordham. L. Rev. 253, 261 (1970) (stating that rule was adopted in 1909).

[3] NASD Rule 2310, formerly art. III ,§ 2 of the NASD Rules of Fair Practice (effective July 15, 1939).

most cited of these two rules.

Pursuant to NASD Rule 2310, the "suitability" rule, brokers owe their customers a duty to make suitable investment recommendations. In order to fulfill this duty, brokers must first determine their customer's financial profile and investment objectives. In doing so, brokers must "examine (1) the customer's financial status, (2) the customer's tax status, (3) the customer's investment objectives, and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[4] Subsequently, the broker must "tailor his recommendations to the customer's financial profile and investment objectives,"[5] that is, make suitable investment recommendations to the customer.

If a broker breaches any of the suitability duties listed above, then the broker is subject to an NYSE or NASD enforcement action, which may result in license suspension and/or monetary sanctions.[6] As explained in more detail below, courts generally do not recognize a cause of action based solely upon the breach of an SRO rule.

Nonetheless, the SRO rules play a crucial role in private causes of action seeking redress for unsuitable recommendations. The Fifth Circuit has held that SRO rules provide useful guidelines for identifying the fiduciary duties that brokers owe their clients.[7] As stated by the Northern District Court of Texas in *Lange v. H. Hentz & Co.*,[8] "the NASD Rules may be used as evidence of the present standard of care which the NASD member should achieve. [In addition, the] NASD rules are admissible on the issue of what fiduciary duties are owed by a broker to an investor."

II. Is there a Private Cause of Action for the Violation of an SRO Suitability Rule?

The answer to this question depends upon the jurisdiction in which the investor filed suit. If the investor filed suit in Texas, the answer is probably "no."

In *Miley v. Oppenheimer & Co.*, the U.S. Court of Appeals for the Fifth Circuit declined to opine on whether a plaintiff may allege a private cause of action for violation of the suitability rule;[9] however, two federal district courts and one state court in Texas have taken a position on the issue.[10] The U.S. District Courts for the Northern and Southern Districts of Texas and at least one Texas state court have declined to recognize such an action.[11]

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[4] NASD 2310(b).

[5] *In re F.J. Kaufman*, 50 S.E.C. 164, 168 (1989).

[6] *E.g.*, *NASD Dep't of Enforcement v. Howard*, 2000 WL 1736882 (N.A.S.D.R.).

[7] *Miley v. Oppenheimer & Co.,* 637 F.2d 318 (5th Cir. 1981).

[8] 418 F. Supp. 1376, 1384 (N.D.Tex. 1976).

[9] *Miley, supra* note 7.

[10] *Porter v. Shearson Lehman Bros., Inc.*, 802 F. Supp. 41, 63 (S.D. Tex. 1992); *Cook v. Goldman, Sachs & Co.*, 726 F. Supp. 151, 156 (S.D. Tex. 1989); *Lange v. H. Hentz & Co.*, 418 F. Supp. 1376, 1384 (N.D. Tex. 1976); *Mercury Inv. Co. v. A.G. Edwards & Sons*, 295 F. Supp. 1160, 1163 (S.D. Tex. 1969); *Millan v. Dean Witter Reynolds, Inc.*, 90 S.W.3d 760, 767 (Tex.App.--San Antonio 2002).

[11] *Porter* at 63; *Lange* at 1384; *Mercury Inv. Co.* at 1163; *Millan* at 767.

In *Porter v. Shearson Lehman Bros., Inc.*, the U.S. District Court for the Northern District of Texas observed that when Congress drafted the Securities Exchange Act of 1934 it specifically omitted any language allowing private causes of actions for violations of private dealer association rules.[12] The Court concluded that the private association rules of entities such as the NASD are merely guidelines—not rules "developed under the authority of the SEC, a statute or a law."[13] Therefore, there is not a private right of action for the violation of an SRO rule.

There is however, one federal district court in Texas that has taken the opposite position on whether a private cause of action may be asserted for the violation of any of the SRO suitability rules. In *Cook v. Goldman, Sachs & Co.*,[14] the Southern District of Texas held that a claimant does have a private cause of action for violation of the SRO rules. In so holding, the Court adopted the reasoning used by other circuits which have recognized a private cause of action for violation of an SRO rule.

There few courts throughout the nation which have considered this issue because unsuitability claims must typically be asserted in arbitration, rather than in court. Those courts that have weighed in on the issue tend to hold, as in most Texas courts, that the SRO Rules do not give rise to an implied cause of action.[15]

In sum, although there is some authority in Texas for an implied cause of action under the SRO rules, counsel who assert such claims are certain to face a motion to dismiss based on the contrary decisions in Texas. It is understandable that an investor's counsel would seek recovery under such a cause of action because brokers are liable under the SRO suitability rules without proof of scienter or reliance. However, it might appear that the investor's counsel is overreaching by seeking recovery under a claim that most courts reject.

III. Common Law Fraud, Statutory Fraud, and Rule 10b-5

Due to the fact that an implied cause of action generally is not recognized under the SRO rules, counsel for the aggrieved investor often turns to claims for common law fraud, statutory fraud, and Rule 10b-5 violation. It is not surprising that they turn to such claims. Unsuitable recommendations are actionable under these claims because the brokers have misrepresented the suitability of certain securities or a particular trading strategy. However, common law fraud, Rule 10b-5, and statutory fraud require proof of scienter and reliance, so these claims are often inappropriate for seeking recovery for damages caused by unsuitable recommendations.

Brokers usually do not make unsuitable recommendations with the intent to defraud their customers. Instead, brokers often inadvertently make unsuitable recommendations. For instance, a rookie broker just learning the trade may not realize that a particular recommendation is unsuitable. Claims against the broker for common law fraud, statutory fraud, and Rule 10b-5 violations would fail because the broker did not act with the requisite scienter.

Regarding justifiable reliance, this element is

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[12] *Porter* at 63.

[13] *Id.*

[14] 726 F. Supp. 151, 156 (S.D. Tex. 1989).

[15] *See* 54 A.L.R. Fed. 11, Private Federal Right of Action Against Brokerage Firm for Violation of Exchange or Dealer Association Rule.

almost always contested in an unsuitability case. Brokers usually deliver prospectuses to their customers, which, if read, could have revealed the brokers' misrepresentations. When any claim requiring proof of reliance is asserted against the broker, the broker will argue that the investor had a duty to read the prospectus and because the investor failed to read it, the investor could not have reasonably relied upon the broker's misrepresentations. To the dismay of most investors, the majority of courts agree with this reasoning.[16]

It is not surprising that most investors do not read the dense prospectuses and other documents that their brokers gave to them. In fact, most investors seek assistance from a broker because they do not have time to read these dense prospectuses, or the ability to understand them. Consequently, most investors face an uphill battle if they are required to prove reliance in order to recover losses caused by unsuitable recommendations.

IV. Claims that do not Require Proof of Scienter or Reliance

Fortunately for investors, there are several claims that do not require proof of scienter or reliance and that may be used to recover damages resulting from unsuitable recommendations. Those claims are discussed below.

A. Breach of Fiduciary Duty

The breach of fiduciary duty claim is the workhorse claim in unsuitability cases. Generally, this claim should be asserted in every suit to recover for unsuitable recommendations. The main advantage of this claim is that it simply requires proof of the following: (1) the existence of a fiduciary duty between the plaintiff and the broker; (2) the breach of that duty; and (3) the defendant's breach resulted in (a) injury to the plaintiff, or (b) benefit to the defendant.[17] Conspicuously absent is the requirement to prove scienter or reliance.[18] These elements are not needed to prevail on a breach of fiduciary duty claim.[19]

That is not to say that proving a breach of fiduciary duty claim is clear-cut or easy. Although the Fifth Circuit and Texas courts generally recognize that a broker owes his customer a fiduciary duty, the scope of that duty is typically the most contentious issue in an unsuitability case.

The scope of a broker's fiduciary duty to make suitable recommendations varies significantly depending upon the control that the broker exercises over his customers and their accounts. For instance, if the broker is simply an order-taker, and never makes any recommendations to his customers, then he has no duty to make suitable investment recommendations.[20] On the other hand, if the broker has discretionary authority over his customers account, then the broker owes the

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[16] *See, e.g., Porter*, *supra* note 10, at 57-58.

[17] *Hawthorne v. Guenther*, 917 S.W.2d 924, 934-35 (Tex. App.–Beaumont 1996, *writ denied*).

[18] *Hendricks v. Thornton*, 973 S.W.2d 348, 360 (Tex. App.--Beaumont 1998, *pet. denied*) (superseded by statute on other grounds) ("reliance is not an element of . . . breach of fiduciary duty").

[19] *Upchurch v. Albear*, 5 S.W.3d, 274, 283 (Tex. App.--Amarillo 1999, *pet. denied*).

[20] *Martinez Tapia v. Chase Manhattan Bank*, 149 F.3d 404, 412 (5th Cir. 1998); *Romano v. Merrill Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 530 (5th Cir. 1987).

customer a continuing fiduciary duty to monitor the customer's account and make suitable investment recommendations whenever appropriate.[21]

In the middle of these two extremes is the most common relationship between brokers and their customers—the nondiscretionary accounts. Most customers open nondiscretionary accounts with full service brokerage firms. In these nondiscretionary accounts, a fiduciary duty only arises when the broker makes a recommendation and ceases immediately after the completion of the trade.[22] Consequently, the broker only has an intermittent duty to make suitable recommendations and such duty only arises periodically during his relationship with the customer. This intermittent duty is in contrast to the continuing duty that a broker owes to customers with discretionary accounts.

Although the above described nondiscretionary/discretionary dichotomy serves as a useful guideline for identifying the duties that a broker owes his client, it is only a starting point for evaluating the broker's duties owed to his customer. For example, the Fifth Circuit, hesitant to allow form over substance, has stated that the nature of the fiduciary duty a broker owes to his customer is very fact-based.[23] The Fifth Circuit noted that whether or not the account was discretionary is but one factor to be considered in this fiduciary duty analysis and that other factors such as the degree of trust that the customer placed in the broker and the intelligence and personality of the customer should also be considered in the analysis.[24]

Lastly, it is important to note that oftentimes the relationship between a broker and a customer holding a nondiscretionary account may evolve, and the account may begin to resemble a discretionary account. In these instances, courts may deem that the broker owes the same fiduciary duty to a customer with a nondiscretionary account as he would to a customer with a discretionary account.

B. Breach of ERISA Fiduciary Duty

As with the state law cause of action for breach of fiduciary duty, a breach of ERISA fiduciary duty claim does not require proof of scienter or reliance. However, only an ERISA-governed plan may assert this claim. Additionally, the broker must be an ERISA-defined fiduciary.

Often the most contentious issue in a breach of ERISA fiduciary duty claim is whether the broker is a fiduciary under ERISA. Brokers are generally considered fiduciaries under ERISA if they render investment advice for a fee. When a nondiscretionary account is involved, the analysis can become complicated.[25] If the broker is indeed an ERISA fiduciary, then he owes the following general duties: (1) to exercise the care of a prudent fiduciary and (2) to diversify plan investments.[26]

If an investor can establish a prima facie

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[21] *In re Rea*, 245 B.R. 77, 89-90 (Bankr. N.D. Tex. 2000).

[22] *Hand v. Dean Witter Reynolds, Inc.*, 889 S.W.2d 483, 493-94 (Tex. App.–Houston [14 Dist.] 1994).

[23] *Romano v. Merrill, Lynch, Pierce, Fenner & Smith*, 834 F.2d 523, 530 (5th Cir. 1987) (*citing Clayton Brokerage Co. v. Commodities Futures Trading Comm'n*, 794 F.2d 573, 582 (11th Cir. 1986).

[24] *Id.*

[25] *See* § 3(21)(A)(ii) of the Employee Retirement Income Security Act of 1974 (E.R.I.S.A.), 29 U.S.C.A. §1002(21) (specifically enumerating three criteria in order for an individual to be considered a fiduciary under ERISA); *See also* Labor Reg. § 2510.3-21(c)(1); Treas. Reg. § 54.4975-9(c)(1) (specifically enumerating two criteria to be satisfied in order for a broker or adviser to be considered a fiduciary over a nondiscretionary account).

breach of ERISA fiduciary claim, the investor is generally in a good position. Typically, the defendant may not assert equitable defenses such as estoppel, waiver, or ratification to defend against a breach of ERISA fiduciary claim.[27]

C. Texas Securities Act

A claim for violation of the Texas Securities Act is an excellent claim to recover damages resulting from unsuitable recommendations. The anti-fraud provision of the Texas Securities Act imposes liability on brokers who misrepresent the suitability of securities to their customers, as well as brokers who fail to disclose the unsuitability of securities that they recommend.[28]

This claim not only disposes of the requirement of scienter and reliance,[29] it is also unassailable to common law defenses.[30] Brokers accused of making unsuitable recommendations often rely on the following affirmative defenses to avoid liability: ratification, waiver, and estoppel. However, under the Texas Securities Act, the aforementioned defenses are invalid.[31] Under the Texas Securities Act, the only valid defenses are those two provided for in the statute itself. Those two statutory defenses are: "(a) the buyer knew of the untruth or omission, or (b) the offeror or seller did not know and, in the exercise of reasonable care, could not have known of the untruth or omission."[32] Understandably, the absence of all common law defenses significantly clears the path for a plaintiff attempting to prove liability under the Texas Securities Act. In addition, the Texas Securities Act contains an anti-waiver provision.[33]

Because the Texas Securities Act does not require proof of scienter or reliance and is unassailable to common law defenses, it is an excellent claim to bring on behalf of investors. As if those qualities were not good enough, the Texas Securities Act enjoys one

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[26] 29 U.S.C. §1104(1)(B)-(C). Note that the Seventh Circuit went so far as to hold that a broker's fiduciary duty to ERISA plans is not just to render prudent advice to the trustees, but also to refrain from misleading the ERISA trustees. *See Wolin v. Smith Barney, Inc.*, 83 F.3d 847, 849-850 (7th Cir. 1996).

[27] *Openshaw v. Cohen, Klingenstein & Marks, Inc.,* 320 F. Supp.2d 357, 364 (D. Md. 2004) (Disavowing the following affirmative defenses: estoppel, waiver, ratification, assumption of the risk, contributory negligence, and recklessness); *Williams v. Provident Inv. Counsel, Inc.*, 279 F. Supp.2d 894, 906-07 (N.D. Ohio 2003).

[28] *In re Westcap Enerprises,* 230 F.3d 717, 729 (5th Cr. 2000).

[29] *Busse v. Pacific Cattle Feeding Fund # 1, Ltd.*, 896 S.W.2d 807, 815 (Tex. App.--Texarkana 1995, *writ denied*) ("The Texas Securities Act does not require proof of scienter."); *Geodyne Energy Income Prod. P'ship I-E v. Newton Corp.*, 97 S.W.3d 779, 783 (Tex.App.-Dallas 2003, *pet. granted*) ("The TSA does not require the buyer to prove reliance"); Granader v. McBee, 23 F.3d 120, 123 (5th Cir.1994) ("Reliance is not required in a Section 33 action"). *But see Gutierrez v. Cayman Islands Firm of Deloitte & Touche*, 100 S.W.3d 261, 275 (Tex. App.--San Antonio 2002)("The law is not clear whether reliance is an element of a cause of action based on a violation of the Texas Securities Act.").

[30] *See generally Duperier v. Texas State Bank*, 28 S.W.3d 740 (Tex. App.—Corpus Christi 2000, *pet. dism'd*).

[31] *Duperier* at 752-755.

[32] Texas Securities Act, Art. 581-33(a)(2).

[33] Tex. Rev. Civ. St. Art. 581-33L.

other characteristic that distinguishes it from all other claims: an investor is not required to prove loss causation under the Texas Securities Act.

If the market performs poorly during the period in dispute, the broker's attorney will argue that the broker is not responsible for the losses incurred due to the market's general decline. Instead, the broker should only be responsible, if at all, for the damages directly caused by the unsuitable recommendation. Pursuant to *Duperier v. Texas State Bank*, this defense is not available under the Texas Securities Act.[34] Once liability under the Texas Securities Act is established, damages should equal the investor's out-of-pocket loss, without any adjustment for market decline.

At first blush, this may seem counterintuitive. Under most claims, the broker is not penalized for general market decline. To protect the broker, the "customer's 'gross economic loss' is reduced by the percentage decline in the market during the period in question as measured by a reputable market index, such as the Dow Jones Industrial Average or Standard & Poor's 500 Index."[35] The purpose of the federal statute upon which the Texas Securities Act was modeled, however, was to serve as "a heightened deterrent against sellers who make misrepresentations by rendering tainted transactions voidable at the option of the defrauded purchasers regardless of whether the loss is due to the fraud or to a general market decline."[36] Considering the purpose of creating this heightened deterrent, the omission of loss causation in the Texas Securities Act is more understandable.

In sum, the ease of proving a Texas Securities Act violation and the absence of loss causation as an element of proof makes this cause of action quite potent.

D. Negligence

A negligence claim is similar to a breach of fiduciary duty claim because each claim requires proof that the broker owed a duty, the broker breached that duty, and the breach resulted in injury to the plaintiff. The only distinction is that an investor asserting a negligence claim must prove that the broker owed him a negligence duty instead of a fiduciary duty. "A duty, in the context of a negligence claim, is a legally enforceable obligation to comply with a certain standard of conduct."[37]

At least two federal courts in Texas have held that the NASD suitability rule may be used to show evidence of negligence.[38] In *Lange v. H. Hentz & Co*, the District Court for the Northern District of Texas held that "the NASD Rules may be used as evidence of the present standard of care which the NASD member should achieve."[39]

Only a few Texas appellate courts have considered which negligence duties a broker owes an investor. In *Hand v. Dean Witter Reynolds, Inc.*,[40] the 14th Court of Appeals focused on the existence of the principal-

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[34] *Duperier*, at 753.

[35] Nancy E. Reich, *Proving Damages Caused by Securities Brokers' Excessive, Unsuitable, or Unauthorized Trading*, 35 **Am. Jur. Proof of Facts 3d** 161, § 12.

[36] *Casella v. Webb*, 883 F.2d 805, 809 (9th Cir.1989).

[37] *Hand v. Dean Witter Reynolds, Inc.*, 889 S.W.2d 483, 491 (Tex.App.--Houston [14th Dist.] 1994, *writ denied*).

[38] *Lange, supra* note 10; *Mercury Inv. Co., supra* note 10, at 1163.

[39] *Lange, supra* note 10.

[40] *Hand, supra* note 22.

agency relationship between the broker and the investor as determinative of which duties the broker owes an investor. In conclusion, the Court in *Hand* held that a broker does not always owe an investor a duty to accept requested trades.[41] In *Edward D. Jones & Co. v. Fletcher*,[42] the Texas Supreme Court held that the broker did not have a duty to ascertain the investor's mental capacity before assisting her with a securities transaction.

Although a negligence claim is preferable to claims that require proof of scienter, it still has its drawbacks. Because it is a common law claim, it is subject to the numerous common law defenses. For instance, quite often a negligence claim will raise the affirmative defense of comparative negligence. As most experienced practitioners know, even if the investor was not comparatively negligent, the broker's attorney may nonetheless gain some ground with this affirmative defense.

E. Breach of Contract

The breach of contract claim is often pled because so many courts do not recognize a private cause of action under the SRO rules. The crux of this claim is that the agreement between the investor and the broker contained a clause essentially providing that the broker will comply with SRO rules. If the broker violates the SRO rules, such as the suitability rule, the investor may then claim that the broker breached the agreement by violating one of the SRO rules incorporated in the contract. Of course, this claim hinges upon whether or not the agreement between the investor and the broker contains such a provision.

Although often pled, there is scant case law interpreting this cause of action in the context of a suitability violation. Neither federal nor state courts in Texas have construed this claim in the context of a suitability violation.

A few courts outside of Texas have opined on such breach of contract claims.[43] For example, in *Komanoff v. Mabon, Nugent & Co.* the United States District Court for the Southern District of New York held that, despite the fact that there is no implied private right of action for an SRO violation, a plaintiff could still sue the broker for breach of contract when the contract contained language stating that the brokerage firm was required to comply with the NYSE suitability rule.[44]

The largest drawback to the breach of contract claim is that it is vulnerable to common law defenses. As explained above and below, statutory claims are typically preferable because common law defenses generally may not be used to defend against statutory violations.

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[41] *Id.* at 494.

[42] *Edward D. Jones & Co. v. Fletcher*, 975 S.W.2d 539 (Tex. 1998).

[43] *Siedman v. Merrill*, 465 F. Supp. 1233, 1236 (S.D.N.Y. 1979) (noting that the broker's violation of the New York Stock Exchange rules can be remedied by state law actions for breach of contract and negligence); *Hofmayer v. Dean Witter & Co.*, 459 F. Supp. 733, 739 (N.D. Cal. 1978) (holding that the plaintiff should have separated its claim into two claims, one for breach of contract for failing to abide by the contractual language requiring compliance with the CBOT and Chicago Mercantile Exchange rules and one for a violations of these SRO rules); *Komanoff v. Mabon*, Nugent & Co., 884 F. Supp. 848, 859-60 (S.D.N.Y. 1995).

[44] *Komanoff* at 860.

V. The Kitchen Sink

Besides the claims addressed above, there are a couple of additional claims that an investor may assert against a broker who made unsuitable recommendations. These claims do not fit neatly into either of the two broad categories discussed above. Negligent misrepresentation and violation of the Texas Deceptive Trade Practices Act ("DTPA") each require proof of reliance. However, scienter is only occasionally an element of a DTPA violation and is never an element of a negligent misrepresentation claim.

A. Negligent Misrepresentation

The claim for negligent misrepresentation is an excellent arrow in a claimant's quiver. There is no scienter element in a negligent misrepresentation claim, consequently making it easier to prove. The elements of a negligent misrepresentation claim are: "(1) the representation is made by a defendant in the course of his business, or in a transaction in which he has a pecuniary interest; (2) the defendant supplies 'false information' for the guidance of others in their business; (3) the defendant did not exercise reasonable care or competence in obtaining or communicating the information; and (4) the plaintiff suffers pecuniary loss by justifiably relying on the representation."[45]

To date, there are no reported decisions in Texas where an investor successfully recovered damages for unsuitable recommendations under a negligent misrepresentation claim. Nonetheless, this claim is routinely pled in securities litigation and arbitration where the principle issue is suitability.[46]

One of the advantages of a negligent misrepresentation claim is that while honesty and good faith are defenses to fraud they are not for this claim.[47] Of particular note is that contributory negligence is arguably not a defense to a negligent misrepresentation claim in Texas.

Only one appellate court in Texas has held that contributory negligence is a defense to a negligent misrepresentation claim. In *Sloane*, the Tyler Court of Appeals did so in a footnote where it stated "presumptively and without any analysis that '[c]ontributory negligence is a defense to the cause of action for negligent misrepresentation.'"[48] Although this issue was argued on appeal in *D.S.A., Inc. v. Hillsboro Indep. Sch. Dis.*, the Waco Court of Appeals did not reach this issue because it was not preserved for review.[49] The Waco Court of Appeals did note, however, that several jurisdictions have held that contributory negligence is not a defense to negligent misrepresentation because "a party who misrepresents facts to another while reasonably expecting that party to rely upon those facts should not be permitted to benefit from a comparative negligence instruction."[50]

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[45] *Federal Land Bank Ass'n of Tyler v. Sloane*, 825 S.W.2d 439, 442 (Tex. 1991).

[46] *E.g. Mallia v. PaineWebber, Inc.*, 889 F.Supp. 277, 282-283 (S.D.Tex. 1995).

[47] *D.S.A., Inc. v. Hillsboro Indep. Sch. Dist.,* 973 S.W.2d 662, 664 (Tex. 1998).

[48] *D.S.A., Inc. v. Hillsboro Indep. Sch. Dist.*, 975 S.W.2d 1, 18 (Tex.App.-Waco 1997), *rev'd on other grounds*, 973 S.W.2d 662 (Tex.1998) (*citing Federal Land Bank Ass'n. of Tyler v. Sloane*, *supra* note 44.)

[49] *D.S.A., Inc.*, 975 S.W.2d at 19.

[50] *Id.* at 18.

B. Texas Deceptive Trade Practices Act

Counsel for the investors should not forget the availability of the DTPA to recover damages for investors who are victims of unsuitable recommendations.[51] Although the DTPA requires proof of reliance (only if using a basis under section 17.46(b)), it often does not require proof of scienter.[52] Similar to a claim under the Texas Securities Act, a claim under the DTPA is generally unassailable to common law defenses.[53]

There is one significant downside to this claim. Texas Courts are split as to whether investors have standing under the DTPA to allege a cause of action under the DTPA against a broker.[54] In fact the majority of Texas courts have held that investors may not allege a DTPA claim against a broker.[55] Consequently, counsel for the investor may face a motion to dismiss based on the majority's holding. The consequence of such motions may be inconsequential, but it might also appear that the investor is overreaching and lessen his credibility before the judge or arbitration panel. Arbitration panels have, however, granted awards based on the violation of the DTPA.[56]

VI. Sophistication

As explained above, each of the above claims has certain advantages and disadvantages that depend upon the proof that is required to establish a claim and the defenses that may or may not be an obstacle to prevail on a claim. Despite the variations of all the above described claims, they all have one aspect in common: If the customer is a sophisticated investor, then the customer's sophistication may hinder his claims against the broker.

In claims requiring proof of reliance, the broker will argue that because the investor was sophisticated, then he could not have reasonably relied upon the misrepresentation.[57] If the claim is one for breach of fiduciary duty or negligence, then the broker will argue that the scope of duty owed to the investor should be construed narrowly. Finally, investors seeking recovery under the Texas State Securities Act will be barred under the statutory defense that prohibits recovery if the investor knew of the misrepresentation.

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[51] Note that a DTPA claim is actionable for investment advice/services in connection with securities. It is not actionable just for the sale of securities.

[52] *See generally Smith v. Baldwin*, 611 S.W.2d 611, 616-17 (Tex. 1980) (identifying which provisions of the DTPA require proof of scienter.)

[53] *In re Norplant Contraceptive Prods. Litigation*, 165 F.3d 374, 377 (5th Cir. 1999) (observing that Texas courts have generally disavowed the applicability of common law defenses to the DTPA, but that a few common law defense to the DTPA have been recognized).

[54] *See generally* Mark C. Watter, *The Applicability of the Texas Deceptive Trade Practices Act to Securities Cases*, 64 Tex. B.J. 542 (2001).

[55] *See Id.*; *But see Prudential Secs. Inc. v. Shoemaker*, 981 S.W.2d 791 (Tex.App.-Houston [1st Dist.] 1998).

[56] *See, e.g., In re Robert Fitts, et al v. Stratton Oakmont, Inc.*, 1997 WL 877060 (NASD).

[57] Keith A. Rowley, *Cause of Action for Securities Fraud Under Section 10(b) of the 1934 Securities Exchange Act and/or Rule 10b-5*, 9 Causes of Action 2d 271 (2003) ("Plaintiff's sophistication and/or experience as a purchaser and/or seller of securities may rebut her reasonable reliance on the defendant's material misrepresentation or omission.").

VI. Conclusion

In sum, investors in Texas are fortunate to have so many claims at their disposal to recover damages for unsuitable recommendations. However, if the investor alleges all of the above described claims at once, the judge, jury, or arbitration panel may be easily confused and find it harder to conclude the existence of liability under any of the claims. Counsel who consider the numerous options to recover damages against brokers for unsuitable recommendations will serve their clients better if they choose their claims wisely.

At some point, the investor's attorney may wonder if focusing on the nuances of each of these claims is worthwhile given that arbitrators "are not strictly bound by case precedent or statutory law."[58] Although arbitrators do possess significant latitude when it comes to following the law, an arbitrator's decision is still subject to judicial review if it shown that the arbitrator exhibited a manifest disregard for the law.[59] A gentle reminder of possible judicial review raised during the closing argument may help the arbitrators focus on the law that supports the investor's case.

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[58] *See* **Arbitrator's Manual** ("Arbitrators are not strictly bound by case precedent or statutory law. Rather, they are guided in their analysis by the underlying policies of the law and are given wide latitude in their interpretation of legal concepts.").

[59] *See Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 259(1987) ("Judicial review is still substantially limited to the four grounds listed in § 10 of the Arbitration Act and to the concept of 'manifest disregard' of the law." *See also, Kergosien v. Ocean Energy, Inc.*, 390 F.3d 346, 355 (5th Cir. 2004) ("[M]anifest disregard for the law "means more than error or misunderstanding with respect to the law. The error must have been obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator. Moreover, the term 'disregard' implies that the arbitrator appreciates the existence of a clearly governing principle but decides to ignore or pay no attention to it.").

Preserving Claims For Attorney Fees In NASD Dispute Resolution Arbitrations

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Prevailing parties in Florida securities arbitrations have the absolute right to have courts decide their entitlement to attorney's fees. Most arbitrating parties, however, unknowingly forego that right to their detriment. This article examines results of current attorney's fee claims in NASD Dispute Resolution (NASDDR) arbitrations, the probable reasons for such results, and the applicable law. It then offers a simple solution for parties to preserve claims for prevailing party attorney's fees.

Recent Award Statistics

The author examined all NASDDR awards in non-settled Florida cases issued during the period between January 1, 2004 and June 30, 2004 in which at least one party made a claim for attorney's fees or reserved jurisdiction for a court to decide the entitlement to or the amount of attorney's fees to be awarded. During that period, there were 184 such cases. Of these, twenty involved contractual disputes between securities industry members or between member firms and their employees, some also containing statutory damage claims for back wages. The remaining 164 disputes each contained at least one statutory claim by a public investor against an NASD member firm. Most of these statutory claims involved allegations of securities fraud, while the remainder alleged civil theft. Of the pool of 184 decided cases, only 38 (21%) resulted in attorney's fee awards or referrals to a court to determine entitlement to or the amount of attorney's fees. In only one case did a party reserve jurisdiction to have a court decide the issue of attorney's fees.[1]

[1] Speculation on the reasons why attorney's fee claims fare so poorly is beyond the scope of this article.

Even if these statistics are grossly understated because perhaps litigants in court are able to set aside the arbitrators' attorney's fee determinations, a twenty-one percent success rate for attorney's fee claims made to arbitration panels is very low. This statistic begs the question why arbitrating parties would submit the determination of a purely legal issue like a claim for attorney's fees to an NASDDR arbitration panel when Florida law gives them the right to have that issue decided by a court in a subsequent proceeding. Part of the answer to this question may involve the training of civil litigators to plead all possible claims or defenses under penalty of waiver,[2] which, if combined with unfamiliarity with the distinct procedures of arbitration, may operate to deprive a prevailing party of a potentially significant property right: the party's right to prevailing party attorney fees.

Florida Law on Attorney's Fees under the Uniform Arbitration Act

The Florida Supreme Court allows trial courts in arbitration award confirmation proceedings to award prevailing party attorney's fees for the arbitration proceedings and for the award confirmation proceeding in court, provided that there is a contractual provision or statute authorizing an award of attorney's fees.[3] What is clear in Florida is that unless the parties confer jurisdiction on the arbitration panel, the arbitrators do not have the authority to decide the issue of attorney's fees. The determination of this issue is the province of the court.

The Florida Arbitration Code, Fla. Stat. Sections 682.01, *et seq.* (FAC)[4] created a discrete procedural scheme for the conduct of all Florida domestic arbitrations. There are other statutory arbitration schemes in Florida for specific industries and proceedings having distinct procedural schemes.[5] Because there is no industry-specific arbitration scheme for securities industry disputes in Florida, NASDDR arbitrations conducted in Florida operate under the FAC. Section 682.11 of the FAC excludes from operative authority an arbitrator's determination of attorney's fees. Section 682.11 provides:

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[2] For example, the failure to set forth a claim for attorney's fees in a pleading or motion to dismiss in Florida civil litigation constitutes a waiver. *Green v. Sun Harbor Homeowners' Association, Inc.*, 730 So.2d 1261, 1263 (Fla. 1988).

[3] *Ins. Co. of N. America v. Acousti Eng. Co. of Fla.*, 579 So.2d 77 (Fla. 1991) (Adopting opinion in *Fewox v. McMerit Const. Co.*, 556 So.2d 419 (Fla. 2d DCA 1990)). In *Moser v. Barron Chase Securities, Inc.*, 783 So.2d 231 (Fla. 2001), the Florida Supreme Court interpreted § 517.211(6), the attorney's fee provision of the Florida Securities and Investor Protection Act (FSIPA), *to require* an award of attorney's fees in a securities arbitration when the investor is the prevailing party under FSIPA, holding that "[i]t would be an empty victory for [a claimant] to have prevailed in obtaining redress from her broker who violated the consumer protection provisions of the securities law if she now had to use recovered investment to pay the fees to her lawyer made necessary by defendant's violations of its statutory duty;" citing *Kirchner v. Interfirst Capital Corp.*, 732 So. 2d 482 (Fla. 5th DCA 1999) (where a securities arbitration panel finds liability under FSIPA against a broker, the court is required to award attorney's fees).

[4] The Florida Arbitration Code is Florida's version of the Uniform Arbitration Act (1956). Section 682.11 of the Florida Arbitration Code is identical to Section 10 of the Uniform Arbitration Act (1956).

[5] For some examples, international arbitrations, motor vehicle sales warranty arbitrations, and court-annexed and private arbitrations all have their own distinct statutory procedural schemes.

> Fees and expenses of arbitration**.** Unless otherwise provided in the agreement or provision for arbitration, the arbitrators' and umpire's expenses and fees, together with other expenses, **not including counsel fees**, incurred in the conduct of the arbitration, shall be paid as provided in the award. (Emphasis added).

By the terms of Section 682.11, the subject matter jurisdiction of an arbitration panel to award fees and expenses of the proceeding extends only to the panel's expenses and fees and other expenses it has determined to award. Payment of those items is enforceable by the "shall be paid" phrase in the statute. However, the statute expressly carves out the subject matter jurisdiction of the panel to award attorney's fees. Therefore, pursuant to the statute's exception for determinations of "counsel's fees" and its affirmative mandate that other expenses and fees "shall be paid," it is implied that "counsel fees" do not have to be paid if provided for in the award. Attorney's fee awards in a FAC arbitration therefore are unenforceable; indeed, the determination of an issue for which the panel lacks subject matter jurisdiction would be void.[6]

Whether an arbitration panel acts beyond its jurisdiction and makes a void ruling by granting or denying a claim for attorney's fees has not been made clear by the courts. All but three of the cases in the sample of 184 described above involved determinations by arbitration panels of the appropriateness of awarding attorney's fees. Of the three exceptional cases, in two cases the parties stipulated to the jurisdiction of the panel to determine attorney's fees, and in the third case one of the parties reserved the right to have the issue of attorney's fees determined by a court. In the absence of a finding in the majority of the awards that the parties conferred jurisdiction on the panel to decide the issue of attorney's fees or without a reservation of jurisdiction by a party being part of the award, it appears, albeit without the benefit of the record from each case, that almost all of the sampled cases involved void determinations by the panel on the ancillary issue of attorney's fees.

A party can waive its right to have a court determine the attorney's fee issue by stipulating to confer jurisdiction upon the panel to decide that issue.[7] With the record of successful applications for attorney's fees to arbitration panels hovering around 21%, and given the right to have such determinations made in a court, which is bound to follow the law and which is subject to appellate review, why would a litigant stipulate to confer jurisdiction on the panel?

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[6] Both the Federal Arbitration Act, 9 U.S.C. § 1, *et seq*., and the Florida Arbitration Code contain time limits to confirm, vacate, modify, or correct an arbitration award. A void determination on an ancillary matter like attorney's fees would need to be challenged at some point during confirmation proceedings or the void determination would become binding. Presumably, the ground would be that the arbitrators exceeded their jurisdiction and awarded upon a matter not submitted to them. The time limits are short to commence confirmation/vacation proceedings to challenge the award. 9 U.S.C § 12 contains a three month time limit. Fla. Stat. §§ 682.13 and 14 contain a 90 day time limit. These time limits could distinguish the timing in civil litigation wherein a determination made by a court lacking in subject matter jurisdiction is void and can be attacked at any time, directly or collaterally. *Malone v. Meres*, 109 So. 677 (Fla. 1926). A waiver of a voidable defect in a judgment can only occur if the objection to the judgment is not made before the proceedings have become final. *Id*.

[7] *Turnberry Associates v. Service Station Aid, Inc.*, 651 So.2d 1173 (Fla.1995).

Joint stipulations by the parties are very rare and certainly unwise in this environment. The danger with pleading and arguing the appropriateness of an award of attorney's fees before an arbitration panel is that it depends on which Florida jurisdiction the award confirmation proceeding will be brought because the courts in Florida are split on the issue whether parties can be deemed to have waived the right to court determination of attorney's fee awards by their conduct. This is a trap for civil litigators accustomed to pleading all causes of action and all relief including attorney's fees. Doing what is prudent in civil litigation may result in a finding in a confirmation proceeding that the party waived its right to court determination by its conduct. Proper case planning, therefore, is essential.

The First DCA has held that by its pleadings and oral argument and by its signing of an NASDDR Uniform Submission Agreement (USA)[8] a party can effectuate a waiver of the right to have a court determine the fee issue.[9] The Third and Fourth DCA's disagree and hold that the execution and submission of a USA, the pleading of attorney's fees, and the claim for fees before the arbitration panel are not enough to waive the right to have a court decide the issue.[10] These courts require a stipulation on the record or a finding made based upon substantial competent evidence that the parties' agreement to confer jurisdiction on the panel before a waver of the right to court determination will be found.[11] In other words, in the First DCA, a party can unilaterally waive its right to court determination if the opposing party happens to file a Form USA and also make a claim for attorney's fees, whereas in the Third and Fourth DCA's a waiver must be made jointly between by the parties[12] (and there is mercy for mistaken pleading). Until the conflict between the District Courts of Appeals has been resolved, arbitrator determinations of attorney's fee issues in the Third and Fourth DCA's are almost always going to be void, subject to the

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[8] The NASDDR form USA states that "The undersigned parties hereby submit the present matter in controversy, as set forth in the attached statement of claim, answers, and all related counterclaims and/or third-party claims which may be asserted, to arbitration . . " NASDDR does not allow the parties to modify the form USA. *See* NASD Rule 10314; NASD Notice to Members 04-11.

[9] *Cassedy v. Merrill Lynch, Pierce Fenner & Smith, Inc.*, 751 So.2d 143 (Fla. 1st DCA 2000). *Cassedy* will no doubt promote litigation on the issue of whether a stipulation was knowingly entered. Stipulations obtained by a party's mistake are unenforceable. *Cunningham v. Standard Guar. Ins. Co.*, 630 So.2d 179 (Fla. 1994). A "stipulation" imposed upon a party by the mere signing of a USA, by its action of claiming for fees, and without knowledge that arbitrators lack subject matter jurisdiction on this issue as a matter of statute, would be a stipulation obtained by mistake and should be unenforceable.

[10] *GCA, Inc. v. 90 S.W. 8th St. Enterprises, Inc.*, 696 So.2d 1230 (3d DCA 1997) (requiring stipulation or specific finding based upon substantial, competent evidence of parties' agreement to waive court determination); *D.H. Blair & Co. v. Johnson*, 697 So.2d 912 (Fla. 4th DCA), *review dismissed*, 728 So.2d 202 (Fla. 1998), *cert. denied*, 119 S. Ct. 1460 (1999) (holding that where both parties signed USA's and both pleaded attorney's fees that this does not constitute an express waiver).

[11] Presumably, nothing short of a joint oral stipulation on the record or the submission of a written joint stipulation by the parties would constitute an express waiver in the majority jurisdictions.

running of statutory time limits to vacate, modify, or correct the award.[13 14]

Possible Procedural Remedy

How can a party in this environment best preserve a claim for attorney's fees for determination by a court? There are several options to preserve the record for the award confirmation proceeding and the use of all of them is recommended.

The place to start is to reserve jurisdiction for a court to determine attorney's fees is in the party's arbitration pleadings. An additional option is submit to NASDDR a stand-alone notice containing the following language or similar language:

[CLAIMANT'S] [RESPONDENT'S] NOTICE OF RESERVATION OF RIGHTS UNDER FLORIDA LAW

> [Party Name] hereby reserves his/her/its rights pursuant to Florida Statute § 682.11 to have a court of competent jurisdiction decide whether any party in this arbitration proceeding is entitled to an award of attorney's fees and the amount thereof, if any.
>
> This Notice of Reservation of Rights is intended to be a part of the record of this proceeding for all purposes. This Notice of Reservation of Rights shall not be construed as having been withdrawn by any action or conduct of [Party Name] except by my submission in this arbitration proceeding of a corresponding written waiver and notice of withdrawal.

____________ ________________
Dated Party Name

One benefit of filing a stand-alone notice is that NASDDR typically mechanically documents the date and title of the filed document in the procedural summary of the ensuing award. Then, no matter what else the award may say about attorney's fees, the notice of reservation of rights should be reflected in the award's procedural history, and a reviewing court will not have to sift through the pleadings

[12] Conceivably, depending on the language of the pre-dispute arbitration agreement, a party could contend that by signing an account opening agreement the parties have expressly waived their rights to have a court decide any part of their dispute. While most securities account documents make substantial disclosures about the party's waiver of a right to a jury trial, for example, I have never seen one that made any disclosure about the waiver of a statutory right to have a court decide the issue of attorney's fees.

[13] A void or voidable award or a void or voidable ancillary determination in an award on the issue of attorney's fees can become enforceable if not challenged during the award confirmation proceeding.

[14] Curiously, some attorneys in NASDDR arbitrations in Boca Raton, Florida are known to plead for attorney's fees but then ask the panel only to make a finding of statutory liability and to reserve jurisdiction for a court to determine attorney's fee issues. This may be a dangerous practice for their clients' pending cases if the Florida Supreme Court one day resolved the conflict between the District Courts of Appeal in favor of the First DCA. Also, if this practice is widespread, then the implication is that these attorneys routinely seek to void or modify the arbitration awards during the subsequent award confirmation proceedings, and of course, that should drastically change the attorney's fee award statistics mentioned at the beginning of this article insofar as those results imply that prevailing parties are not successful at ultimately obtaining attorney's fee awards.

and the transcript of the proceeding to confirm a party's reservation of jurisdiction for the court to determine attorney's fees. If the notice of reservation of rights is not reflected in the award, the party could obtain from NASDDR a copy of the filed notice as evidence of the filing for attachment to the party's award confirmation proceeding application.

During opening and closing statements, the parties should announce on the record their intention to have the panel make a finding of a statutory violation, or a finding of a lack of one, and to have a court determine the attorney's fee issues. Because NASDDR arbitration proceedings typically are magnetically taped, sometimes there are failures to record parts of the record or the record at times may be inaudible. Then the pleadings and the notice of reservation of jurisdiction may be the only available evidence to establish the party's intention to reserve jurisdiction.

Also, parties should not take other actions inconsistent with their reservation of jurisdiction. A party making a reservation of jurisdiction in the arbitration proceeding should, for example, refrain from pleading relief for attorney's fees, should not offer evidence of the party's attorney's fees, and should not request an award of attorney's fees on the record during the arbitration hearing. Indeed, where statutory attorney's fees may be available to prevailing parties, the parties should focus on the merits of the case and in obtaining a commitment from the panel to make or not make a finding of a statutory violation in the award. The finding in the award of a statutory violation or lack of proof of a statutory violation can later be used as the basis for an award of attorney's fees in an award confirmation proceeding. That is the forum in which to plead and prove a claim for attorney's fees.

Impact of Possible Change in Arbitration Procedure

The Uniform Arbitration Act was revised in 2000 (the "Revised Act") by its drafters, the National Conference of Commissioners on Uniform State Laws. The Revised Act has been adopted by nine states but not by Florida. Revised Act Section 21 provides that:

> (b) An arbitrator may award reasonable attorney's fees and other reasonable expenses of arbitration if such an award is authorized by law in a civil action involving the same claim or by the agreement of the parties to the arbitration proceeding.

If the Revised Act is adopted in Florida, a prevailing party's right to have a court determine the issue of attorney's fees will probably be lost in most cases. If arbitration panels are given authority to award attorney's fees, it is unlikely that such panels will suddenly start awarding prevailing party attorney's fees. Prevailing parties in Florida NASDDR arbitrations would be better off in the current statutory arbitration scheme.

Conclusion

Attorneys should carefully consider their actions in a securities arbitration because their conduct could confer jurisdiction on the arbitration panel to determine the issue of entitlement to and the amount of attorney's fees. With the poor record of attorney's fee awards by arbitration panels, parties' property rights to fee awards are being unnecessarily thrown away. This result is easily avoidable with proper case planning.

Mediating Securities Disputes: Ten Tips for a Successful Negotiation[1]

By Bette J. Roth, Esq.

Bette J. Roth is a mediator and arbitrator, as well as the Executive Director of the Middlesex Multi-Door Courthouse in Cambridge, Massachusetts (www.multidoor.org). Ms. Roth was a litigation attorney for eight years, with the Securities and Exchange Commission and in private practice in San Francisco, before devoting her practice to dispute resolution in 1992. Since then, she has mediated or arbitrated more than 600 securities, employment, commercial, and construction disputes. Ms. Roth has lectured and published extensively on dispute resolution, and is the coeditor of the two-volume text, The Alternative Dispute Resolution Practice Guide (West Group 1993-2005). Any questions or comments can be emailed to brneutral@rcn.com.

As the number of securities arbitrations has increased during the past few years, so have the numbers of investors, registered representatives, broker dealers, issuers, and transfer agents mediating their customer, intra-industry, employment, and shareholder disputes. Why? Because mediation saves everyone significant costs, including attorney's fees, arbitration forum and hearing session fees, and lost business opportunities due to time spent arbitrating. It also offers a confidential resolution (versus the discoverable NASD award), the elimination of stress, and a swift return to more productive business. Finally, mediation allows the parties to control the outcome of their case, rather than leaving it for a panel of arbitrators to decide. Therefore, it makes good sense to consider the possibility of a mediated settlement as soon as the parties are able to discuss meaningfully the evidence in their case.

Despite its informality and flexibility, mediation requires planning, preparation and hard work. Many issues affect each side's ability to reach their best possible settlement. Although a good mediator will work through issues that surface during mediation, pre-mediation preparation is key. This essay addresses factors to consider in preparing for the mediation process.

1. Getting your opponent to the table

The first challenge in the process may well be how to get your opponent to agree to mediate. Don't be timid; suggesting mediation should be seen as a sign of confidence, not one of weakness. One might suggest that since both sides feel so strongly about their respective positions, they could benefit by a neutral third party's input. Point out the merits: mediation shortens the litigation process, allows the parties to control the outcome, and reduces costs for everyone. Not to mention the unique opportunity it provides to communicate directly with the

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1. Copyright 2005 Bette J. Roth, Esq. Portions of this article appeared in Vol. 50, #5 October 2004 of *The Practical Lawyer* (ALI-ABA).

"responsible" individuals on the other side, rather than continuing a dialogue "filtered" through each side's counsel.

Additionally, the odds are overwhelming that a mediation session will conclude with a signed agreement – either a Memorandum of Understanding or final Settlement Agreement and Releases – since most reputable mediators settle more than 90% of their cases. Finally, mediation is voluntary: if either side feels the process isn't productive, they can terminate it at any time and continue to arbitrate the case.

2. Select the best mediator for your dispute

Mediator selection is critical to the outcome of the process. The mediator sets the tone and the pace of the mediation, and will be largely responsible for its success or failure.

It takes considerable skill to step into a complex securities case, untangle bitter parties, and guide them to an amicable resolution. The securities industry is highly regulated with specific laws, rules, and industry practices. An understanding of the industry is critical for the mediator to evaluate credibly the various possible alternatives. Find someone with the ability and expertise to get the job done.

Many organizations -- public, private and quasi-public such as the NASD -- provide referrals for excellent mediators. Review the CVs of any proposed mediators for their securities and mediation experience. Don't be shy about contacting the mediator and asking for references; any quality mediator would be happy to provide several. Questioning the references and the mediator directly will also give you a sense of whether or not his or her style and demeanor is the right mix for the parties in the case.

3. Always consider mediators proposed by the other side

There seem to be two schools of thought regarding mediators proposed by the opponent:

1) always consider someone suggested by the other side;
2) never consider someone suggested by the other side.

The first comes from an attitude of confidence, thinking that since your case is so strong, you just need the mediator to understand it and communicate its strengths to the other side. Since your opponent already respects the mediator, he or she is more likely to succeed in "enlightening" the other side about the strengths of your case.

The other way of thinking – that any mediator recommended by the opponent must be favoring them – comes from a misconception of the mediator's role and ignorance of the process itself. This view presupposes a process – not mediation – in which the "mediator" starts with a specific settlement goal and then moves the parties to it. It also accepts as logical the premise that mediators would prefer to risk their professional reputation for more business from one side than enhance their professional reputation by doing excellent work for both sides.

Good mediators never start the process with a particular settlement in mind. Rather, the mediator's understanding of the case evolves along with the parties', as they work through the negotiation process. Many mediators, even the most "evaluative" ones, refuse to suggest a specific settlement proposal until the very end of the mediation, and then will do so only at the request of the parties. Learn to trust the process; good mediators work for both sides to reach resolution.

4. Know your case

Never mediate without adequate preparation. Conduct enough discovery and analysis to evaluate meaningfully your case for settlement and to be able to present it

persuasively through the mediator to the other side.

Some parties believe that mediation will save them money by allowing them to settle without any discovery. Others attempt to use the mediation session to obtain discovery. Neither approach is recommended.

Skimping on preparation can make you the target of bluffing or leave you disadvantaged in evaluating settlement proposals. Consider a customer case involving claims of unauthorized trading. The registered representative has evidence of conversations with the customer before or after each trade, indicating the trades were authorized or ratified. In mediation, he makes an offer reflecting this fact, but the customer does not know of this evidence and cannot fully evaluate the offer. It is easy to miss the value of a case without knowing the critical evidence.

On a related issue, do not misuse the mediation process. Using mediation to obtain discovery or "see what the other side's case is about" is not negotiating in good faith. Not only will it derail settlement, but it will leave the other side questioning your ethics and credibility. Additionally, most mediators will terminate the proceeding if they believe one side is misusing the process.

5. Don't overspend on discovery, experts or trial preparation

Although you should discover the critical facts before mediation, be realistic about the size of the case in light of your client's interests. Mediated settlements involve financial decisions and appropriate cost-benefit analyses. Spending more than necessary before the mediation may restrict your ability to settle. For example, a customer in an unauthorized trading case lost $20,000. His counsel hired an expert to analyze the account at a cost to the client of more than $6,000. After legal fees of $4,000, he needs an offer greater than $10,000 just to recoup his expenses, which may compromise his settlement opportunity. Limit the discovery and expert investigation to what is necessary to value the case for settlement.

Also keep in mind the timing of the mediation. Schedule the session far enough in advance of the arbitration to avoid spending time and money on hearing preparation. Just as with discovery, the dollars spent on hearing preparation are dollars taken off of the table for settlement. In addition, a last minute cancellation of the arbitration can result in forum penalty fees.

6. Share your damage analysis and expert reports with the other side

There are compelling reasons to share your damage analysis with the other side before the mediation. If it relates to your settlement proposal, it is in your client's best interest for your opponent to understand it. Share it in advance so they don't waste time during the mediation session studying it for the first time. There should be no harm in producing it at this juncture; if it would have been used in arbitration, you would be required to share it with the other side before the hearing anyway.

You can avoid surprises in mediation by also sharing your expert reports or legal theory of damages in advance. As an example, in a case involving claims of unsuitability and unauthorized trades, the customer lost $250,000. The customer's counsel believed the losses should be adjusted upward for missed opportunities in the bull market. The parties did not share their expert reports or legal theories before the mediation.

At the mediation, the customer's counsel demanded $1 million for the lost opportunity. The broker's counsel believed the maximum exposure to be $250,000 in an out-of-pocket analysis, and offered $45,000. After a lengthy private session with the mediator, the customer reduced his demand to $600,000, at which point it became apparent that resolution would not happen without a

common understanding on the methodology for calculating damages.

The session ended with an agreement that the parties would brief each other and the mediator on the applicable measure of damages and schedule another mediation session to follow the exchange of that information. Had they shared their damage theories in advance, they could have negotiated more efficiently -- and possibly resolved the case -- during the first scheduled session.

7. Be mindful of pre-mediation "negotiations"

Occasionally, parties decide to exchange settlement proposals before the start of the mediation, hoping to speed up the process. While the general exploration of settlement possibilities is always encouraged, parties should be mindful of how these negotiations may impact the subsequent mediation. Occasionally, the negotiation of specific proposals may result in an impasse before the mediation starts (creating a formidable challenge for the mediator), or it causes the parties to conclude that settlement is impossible and they forego the mediation.

For example, the lawyers in a large shareholder market manipulation case started to negotiate before the mediation session. The shareholders' counsel assessed damages at more than $3 million, and demanded $2.1 million. He believed he told his opponent that his clients will not settle at mediation for less than $1 million.

Meanwhile, the defendant corporation had increasing financial problems. It was filing for bankruptcy and its insurance coverage was being depleted between defense costs and the settlement of other claims. Its counsel offered $500,000 to the shareholders. He believed he told plaintiffs' counsel that his client will not settle at mediation for much more than that.

At mediation, plaintiffs' counsel expected the defendant to offer in the $1 million range and the defendant's counsel expected the plaintiffs to accept an offer in the $500,000 range. Both sides were surprised and disappointed with each other, based on their pre-mediation negotiations. Indeed, they reached an impasse before the mediation even started. It took the mediator considerable time and effort at the start of the session to get the parties back on track.

In another case involving claims of wrongful termination of a the registered representative, his lawyer presented his demand of $100,000 based on commissions owed, other financial benefits lost in the termination, and emotional distress. Counsel for the brokerage firm valued the case at around $10,000 for commissions owed, believing that the termination was justified. Finding the demand so unreasonable, the brokerage firm decided that the case couldn't possible settle in mediation and cancelled the session -- foreclosing any possibility of settlement.

In this example, had the parties not exchanged specific numbers in advance, they would have started the mediation with those numbers as their initial settlement proposals. Although the chasm seemed insurmountable to the parties in their direct negotiations, it is something that experienced mediators face -- and successfully address -- every day.

8. Never decide on your firm bottom line before the mediation

Many times, counsel and their clients decide on their bottom before the mediation starts and hope that the mediator will succeed in moving the other side to it. This approach overlooks the potential of the mediation process, and compromises their chances of settlement by drawing a line in the sand before the mediation has started.

Rather than deciding on a firm bottom line in advance, parties are advised instead to consider a range of options, keeping in mind

that once the mediation starts, they will be challenged to re-evaluate those options.

What matters in mediation is not where the parties start, but where they end. In between is hard work, education, negotiation, and compromise. The process itself creates a momentum that intensifies as the parties negotiate over a period of hours. Settlement might not be apparent to the parties until the final stages of the mediation process, so be prepared to tough it out before then. Patience is almost always rewarded with a settlement that reflects the interests of both sides.

9. Bring the right people to the session

Who attends the mediation can make the difference between success and failure. Bring the person with the authority to make the ultimate settlement decision. Telephone availability is not as effective as live participation when it comes to hours of negotiation. If it is the only option, however, make sure he or she is available as needed, so that the communication doesn't disrupt the flow of the session.

If it is not possible to bring the ultimate decision maker(s) because it is a committee or a board of individuals, bring someone with enough influence in the organization so that his or her recommendations will likely be followed once the session has ended.

Leave behind "witnesses," particularly if they might be volatile or further strain the relationship between the parties. However, if the case is very complex or if the credibility of key players is particularly critical, consider bringing in the appropriate individual to present specific information. Keep in mind, however, that the goal of mediation is settlement; parties do not "win" on their evidence. Accordingly, keep any such presentations brief and informal.

Do not bring friends or non-party family members. Although other individuals may want to attend the mediation to show support, they also come with their own perspectives, interests, and opinions about how the case should resolve. Adding these to the mix can derail a negotiation.

If there is any question about whom to bring, ask the mediator in advance and resolve the issue before the session starts.

10. Be ready to show respect

Mediation is a unique adversarial process. Although you will be educating the mediator and the opponent about the strengths of your case, don't compromise your chances for settlement with bombastic language, insults, and disrespect. Start the session with respect for the process and for the other side. Always present rational proposals that can be justified, and let the mediator use them to move the other side. Always consider your opponent's proposals. The old adage, "there are two sides to every story" rings true in this process where settlement often involves an understanding of the other side's perspective. An open mind will go a long way in reaching settlement.

New SEC Guidelines On Hedge Funds: Designed To Protect The Investing Public

By Katy Peng and Arthur Chen

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INTRODUCTION

The Securities and Exchange Commission (the "Commission") has recently adopted a new rule and several rule amendments under the Investment Adviser Act of 1940s (the "Adviser Act"). In its effort to utilize the authority granted by the Adviser Act, which protects hedge fund investors as well as the integrity of our nation's securities markets, the new rule and amendments require advisers of certain private investment pools ("hedge funds") to register with the Commission by February 1, 2006. More specifically, this new provision will apply only to advisers whose hedge funds accept new money from new investors on, or after, February 1, 2006, or from those already in the fund only if the new money is not subject thereafter to a two-year lock up.

In its publication of the new rule and amendments, titled "Registration Under the Advisers Act of Certain Hedge Funds"[1], the Commission clarified some of the issues raised by the new rule. Specifically addressed were issues concerning continuing investors in private funds as clients, operation of the exemption from the "look through" requirement for private funds with a two-year lock-up, treatment of offshore advisers and funds, and application of revisions to the recordkeeping, custody and performance fee rules. A copy of this release is available at www.sec.gov/rules/final.shtml.

DISCUSSION

A. Rationale For The Proposal

Due to growing concerns over the growth of U.S. hedge funds, "hedge fund fraud," and "retailization" of hedge funds, the Commission has become increasingly worried about its limited ability to regulate hedge funds. According to the Commission's estimates, there are now $870 billion in

[1] Release No. IA-2333 ("Release").

assets spread across approximately 7,000 hedge funds.[2] The growth rate of funds steadily increased to over 30% last year, evidence that the hedge fund industry has become a significant investment vehicle in securities markets. This tremendous growth has been accompanied by a substantial increase in hedge fund fraud enforcement cases. Notwithstanding the much-publicized "late trading" and inappropriate "market timing" practices, the release also cited instances of overstating performance, payment of unnecessary and undisclosed brokerage commission arrangements and misappropriation of client assets. Notably, while advisers should review their valuation and "soft dollar" practices in light of the Commission's focus on these issues, many instances of fraud cited by the Commission involve fraud that do not necessarily indicate a Commission initiative questioning accepted valuation and commission practices.[3]

Among the reasons listed by the Commission, "retailization" of hedge funds is the most convincing reason for justifying the rule's increase in investment adviser regulation. The Commission noted that due to the increase in exposure of small investors, directly or indirectly, to hedge funds through various investment vehicles (such as registered funds of hedge funds or increased investment by pension funds)[4], the private adviser exemption should no longer apply to certain hedge fund advisers. The private adviser exemption was designed to cover only advisers with a small number of clients, not to allow advisers with numerous clients to avoid registration by pooling clients together into a pooled investment vehicle. Furthermore, the Commission asserted that due to insufficient information about hedge fund advisers and the lack of an oversight program, it cannot effectively deter or detect fraud by unregistered hedge fund advisers at an early stage.

B. Before The Changes

Section 203(b)(3) of the Adviser Act exempts some investment advisers from registration with the Commission if, during the course of a 12-month period, they have fewer than 15 clients and met other criteria. Under the previous Rule 203(b)(3)-1 of the Adviser Act, a legal organization (such as a private investment fund with several owners) that receives investment advice based on its investment objectives, rather than the individual investment objectives of its owners, is treated as a single client. Under this rule, private investment fund managers that comply with the other terms of §203(b)(3) have been permitted to advise up to 14 private funds in any 12-month period without registering under the Adviser Act.[5]

[2] Release at Section I.A.

[3] While not listed as a type of fraudulent activity discovered by the Commission, the release notes that the Commission is also concerned that some hedge fund advisers may be pursing strategies that are inconsistent with disclosure provided to investors.

[4] While not discussed outright, the release implicitly rejects regulation of the "retail" investors' direct exposure to hedge funds and opts instead to pursue regulation of the entire industry. As Commissioners Glassman and Atkins note in their dissent, registered funds of hedge funds already must be managed by a registered investment adviser and are subject to the requirements of the Investment Company Act. Similarly, pension plans are generally managed by a professional adviser which is subject to Department of Labor or state oversight.

[5] The investment adviser regulations of certain states do not contain a similar *de minimis* exemption. Accordingly, depending on where its place of business is located, a private fund adviser may already by subject to investment adviser registration under state law. The state regulators may modify their rules to adopt "look through" provisions similar to the New Rule.

C. The Changes

1. The New Look Through for Private Funds

The Commission in adopting this new rule and amendments now requires investment advisers to "look through" a "private fund" and count each owner within the private fund as a client for purposes of determining whether they meet the 14-client exemption. This new rule defines a private fund as a company: (i) that would be an investment company under §3(a) of the Investment Company Act of 1940, as amended, ("the Investment Company Act") but for the exception provided from that definition by either §3(c)(1) or §3(c)(7) of the Investment Company Act,[6] (ii) that permits its owners to redeem any portion of their ownership interest within two years of the purchase of such interests, and (iii) in which interests have been offered based on the investment advisory skills, ability or expertise of the investment adviser.

The exemption allowing advisers to have 14 or fewer clients requires that the adviser count all persons who have been clients at any time during the preceding 12 months. The Commission will only apply the new look-through counting rule prospectively, without regard to this "look back" provision for the period leading up to the February 1, 2006 compliance date.[7] As a result, an adviser will need to look through a private fund only on or after February 1, 2006 to determine whether registration is required.

2. The Two-Year "Lock-Up"

The newly adopted rule provides that for the purpose of the look-through provision, any fund that does not permit redemption of interests within two years of purchase is not a private fund.[8] The Commission clearly stated that hedge fund advisers only need to apply the two-year lock-up test to new investments, whether by new or existing investors, made on or after the compliance date of February 1, 2006.[9]

The two-year redemption test must be applied separately to each interest purchased or to the amount of capital contributed by an investor in the fund, not just to the investor's initial investment. However, this does not apply to the reinvestment of distributed capital gains or income.[10] Under this new rule, the lock-up period begins anew when an investor is permitted to exchange his or her interest in one fund for an interest in another fund managed by the same adviser. Nonetheless, the rule permits a fund to offer

[6] §3(c)(1) of the Investment Company Act exempts from registration any issuer the securities which are beneficially owned by not more than 100 persons and that does not make a public offering of its securities. §3(c)(7) exempts from registration any issuer with outstanding securities of which are owned exclusively by persons who, at the time of acquisition of such securities, are "qualified purchaser," and that does not make a public offering of such securities. Private investment funds, including hedge funds (private equity funds are venture capital funds) generally rely on one of these exemptions.

[7] Release at n. 273.

[8] In Release at Section II.E.2., the Commission notes that the exemption from the definition of private fund for funds not permitting redemptions within two years of purchase is designed to exclude advisers to venture capital and private equity funds from proposed registration requirements. This exemption is based, the Commission stated, in the facts that the Commission has not encountered significant enforcement problems with advisers with respect to their management of these types of funds.

[9] Release at Section III.

[10] The two-year test may be applied to accounts of investors on a "first in, first out" basis. Release at Section II.E.2., and n. 231.

redemption rights under extraordinary circumstances without being considered a private fund under the rule.[11] The Commission interpreted extraordinary circumstances as: (i) continuing to hold the investment until it becomes "impractical or illegal," (ii) the owner dies or becomes totally disabled, (iii) key fund adviser personnel die, become incapacitated, or cease to be involved in the management of the fund for an extended period of time, (iv) the fund merges with another entity or is reorganized, or (v) redemption is necessary to avoid a materially adverse tax or regulatory outcome, including the need to avoid fund assets from being considered "plan assets" for purposes of the Employee Retirement Income Security Act of 1974.[12]

3. Offshore Advisers

The Commission stated that offshore advisers as domestic advisers are subject to the same look-through requirements if they have more than 14 investors in a private fund or other advisory clients who are U.S. residents. Thus, many advisers to offshore hedge funds will need to register as investment advisers under the Adviser Act unless, for example, they avail themselves of the lock-up provision discussed above. These look-through requirements will not apply to offshore advisers or to public funds that make public offerings of their securities in a country other than the United States and are regulated as public investment companies under the laws of a country other than the United States. Under those circumstances, these funds are excluded from the definition of "private funds."[13]

To determine whether an investor is a U.S. resident, an adviser may generally look: (i) in the case of individuals, to their residence, (ii) in the case of corporation and other business entities, to their principal office and place of business, (iii) in the case of personal trusts and estates, to a rule set out in Regulation S under the Securities Act of 1933, and (iv) in the case of discretionary or non-discretionary accounts managed by another investment adviser, to the location of the person for whose benefit the account is held.[14] The determination of a client's residency is made at the time of the client's investment in the offshore private fund.[15]

Since the $25 million minimum asset-under-management threshold for registering as an investment adviser under the Adviser Act does not apply to offshore advisers, the Commission decided to close the loophole. It requires any offshore adviser with more than 14 clients residing within the United States

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[11] Rule 203(b)(3)-1(d)(2)(i).

[12] Release at n. 240.

[13] The Commission did not clarify what constitutes a public investment company regulated under the laws of another jurisdiction, but noted that in some jurisdictions hedge funds may be publicly offered, which will require a case-by-case determination as to whether the fund is in fact a "public investment company." The Commission also did not clarify whether the determination of whether a "public offering" exists would be made by reference to U.S. law or the law of another jurisdiction.

[14] Release at Section II.D.4.a., and n. 201. The Commission did not provide further clarification as to how to treat foreign subsidiaries of U.S. corporation.

[15] Rule 203(b)(3)-1(b)(7). It appears from the language of this new rule that advisers relying on the offshore adviser exception will need to make the determination each time an investor adds to its investment in the offshore fund. The Commission did not provide guidance on whether the adviser needs to continue to make the residence determination for reinvestment of capital gains and income.

during the preceding twelve months to register with the Commission as an adviser, irrespective of the value of the assets it has under management.[16]

Offshore advisers to offshore hedge funds will be permitted to treat the hedge funds as their clients for all purposes of the Adviser Act excluding those of the 14-client exemption and certain anti-fraud provisions, provided that (i) the adviser has its principal office and place of business outside the United States, and (ii) the fund is organized or incorporated under the laws of any jurisdiction other than the United States. Consequently, if an offshore adviser satisfies these requirements it will not be subject to Rule 206(4)-2 (the "Custody Rule"), Rule 206(4)-6, the proxy voting rule, or Rule 206(4)(7), which requires compliance procedures and designation of a compliance officer.[17] Registered offshore advisers required to register under the Adviser Act must keep certain books and records,[18] and will remain subject to inspection by the Commission staff. The inspection will include "all records of any registered adviser."[19]

4. Funds of Funds Investors

In determining whether the adviser has more than 14 clients, a hedge fund adviser that advises a private fund whose investors include a fund of funds that is, itself, a "private fund" must look through "top-tier" private fund and count each investor in the top-tier fund as a client.[20]

5. Registered Investment Companies as Hedge Fund Investors

Rule 203(b)(3)-2(b) requires advisers of private funds to look through any registered investment company owning interests in the hedge fund and to count the investors within the registered investment company as clients of the adviser. Because registered investment companies have more than 14 investors, the practical implication of this provision will be to require registration of advisers to hedge funds that permit registered investment companies to own their shares.[21]

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[16] A domestic adviser may exclude assets under management attributable to non-resident investors for the purposes of determining whether the adviser meets the $25 million threshold to register with the Commission.

[17] In the proposed release, IA-2266 (July 20, 2004), the Commission indicated that U.S. advisers will not be permitted to establish a non-U.S. shell subsidiary to manage offshore hedge funds, as that would violate §208(d) of the Adviser Act, which prohibits any person from doing indirectly anything that would be unlawful for such person to do directly. Advisers with no affiliates, employees or other physical presence in the United States would presumably be able to rely on the exemption for offshore advisers. It may be difficult, however, to apply this exemption to advisers with more than a nominal presence in the United States.

[18] The Commission cited prior no-action relief concerning recordkeeping obligations of registered advisers that are located offshore. Under that series of no-action letters, the Commission staff has permitted certain exceptions from recordkeeping requirements under the Adviser Act. *See, e.g. Royal Bank of Canada*, SEC staff no-action letter (June 3, 1998).

[19] Release at n. 217.

[20] This new rule does not require the adviser to the underlying fund to receive information as to the precise number or identifies of the top-tier investors other than that the top-tier fund has more than 14 owners. *See* the Release Section II.D.3., n. 196.

6. "Track Records"

Under Rule 204-2(e)(3), any statements made by a registered adviser concerning fund performance must be supported by documentation. Such records must be retained for a period of five years after the performance information is last used. For a period prior to its registration, a hedge fund adviser may continue to use performance information even if the adviser has not retained the necessary supporting information as required by Rule 204-2. However, the adviser is required to retain whatever records it does have and any records in the adviser's possession as of February 10, 2005. In response to comments, this exemption has been expanded to apply to the performance history of any account managed by an adviser of a private fund and not just the performance of the private fund. As noted above, the relief covers records made during the period before the February 10, 2006 compliance date. This relief is available only to advisers of private funds that register after the February 10, 2005 effective date, and not to advisers voluntarily registering before that date.

Additionally, for purpose of Section 204 of the Adviser Act, the recordkeeping rule has also been amended to state that the books and records of an adviser include the records of any private funds for which such adviser acts as general partner, managing member or acts in any similarly capacity.

7. Performance Fees

Registered investment advisers are generally prohibited from charging a performance fee, such as capital gain or appreciation, to clients who are not "qualified clients." Generally, qualified clients are investors, either individuals or companies, that invest at least $750,000 with an investment adviser or that have a net worth of $1.5 million at the time of the investment.[22]

The amendments included a "grandfather" provision to allow hedge fund advisers that are required to register pursuant to the new rule to avoid disrupting existing fee arrangements with their clients. Those eligible under this provision are investors in a private fund that were investors before February 10, 2005, provided that the adviser was not required to register with the Commission. Without this exemption, investors that are not qualified clients would need to withdraw from the investment fund before the adviser registered under the Adviser Act, or else the adviser would need to forego charging those investors a performance fee.[23] Grandfathered investors will be permitted to retain or add to their accounts, but not open new investment accounts in the hedge fund or in other hedge funds managed by the same adviser. This relief is available only to advisers that register after February 10, 2005, the effective date of this new rule; it is not available to advisers that voluntarily register before that date.

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[21] The Commission noted in the Release at n. 196 that the underlying hedge funds need not "receive information as to the identities" of the registered fund's investors. The hedge fund adviser must determine, on a periodic basis, whether the registered investment company has sufficient ownership to cause the adviser to need to register with the Commission. This provision may be particularly burdensome for foreign advisers who have registered investment company investors in a foreign, unregistered fund pursuant to *The France Growth Fund* no-action letter (July 15, 2003), as they may not normally apply U.S. look-through rules.

[22] Rule 205(3)(d)(1).

[23] Private investment funds exempted from investment company registration pursuant to §3(c)(7) of the Investment Company Act are not subject to the restriction on performance fees.

8. Expansion of an Exemption in the Custody Rule

An exemption available to pooled investment vehicles under the Custody Rule has also been modified to provide additional relief to funds of funds. Previously, advisers to pooled investment vehicles (such as private funds) were not required to comply with the surprise audit and reporting requirements of the Custody Rule if they distributed audited financial statements prepared in accordance with generally accepted accounting principles to all fund investors within 120 days of the end of the investment vehicle's fiscal year. As amended, effective January 10, 2005, the Custody Rule will extend the required delivery date from 120 days to no later than 180 days after the end of the fiscal year for any "fund of funds," a pooled investment vehicle invests at least 10% of its total assets in other pooled investment vehicles that are not related persons to the fund of funds, its adviser, or general partner. This new change is designed principally for funds of funds since such funds often are unable to meet the 120-day deadline. Primarily, this occurs because they cannot complete their financial statements until they receive financial statements from all the funds in which they are invested during the preceding year.[24] Please note that the extension of the period to 180 days does not apply to pooled investment vehicle generally, but only to funds of funds.

9. State Registration Requirements

The new rule and amendments do not alter the minimum assets that an investment adviser must have to be required to register with the Commission. Accordingly, advisers with less than $25 million under management will continue to be ineligible for Commission registration (except offshore advisers, as described above). Such advisers may be required to register under applicable state law.[25] Advisers with between $25 and $30 million in assets under management are eligible to register voluntarily with the Commission. The revised Rule 222-2 and 203A-3 clarified that advisers and Supervised Persons of advisers for the purposes of those rules count clients as provided in Rule 203(b)(3)-1 without applying the look-through provisions of Rule 203(b)(3)-2.[26]

10. Form ADV

The Commission has modified Form ADV Part IA Item 7.B. and Schedule D Section 7.B. to require disclosure of the status as an adviser to a "private fund," as defined in Rule 203(b)(3)-1.[27] The modification will be incorporated in the IARD electronic filing system Form ADV for registered investment

[24] Amended Rule 206(4)-2(c)(4) looks to the definition of "Related Person" found in Form ADV for purposes of the "fund of funds" definition. In the Release, the Commission stated that the relief did not extend to funds that are not "funds of funds" because such funds might then take 180 days to complete their audits. Thus, funds of funds investing in such underlying funds would face the same timing problem in completing their own audits.

[25] Investment advisers located in state with a *de minimis* exemption from investment adviser registration may be able to continue to rely on such exemption. While such state may follow the Commission's lead and adopt a similar "look through" rule, there may be a significant time-lag until that occurs.

[26] Under the original proposed rule, officers and employees of advisers firms becoming subject to registration with the Commission in many cases would also have become subject individually to registration with the states. In most states, registration of individuals includes testing and other state compliance requirements. In addition, the Commission has modified the rule amendments to preserve the federal preemption of state law which limits the power of the states to require registration of out-of-state advisers not registered with the Commission.

adviser on March 8, 2005. All currently registered investment advisers must amend their Form ADV in their next filing, thereafter, but no later than February 1, 2006.

Additionally, under Section 7.B. of Schedule D, the hedge fund adviser must disclose information such as the name of the fund; name of the general partner or manager of the private fund; whether the clients of the fund was solicited to invest in the private fund; percentage of clients that have invested in private fund; minimum investment commitment required by limited partner, member or other investors of the private fund; and current value of assets invested in the private fund.

CONCLUSION

These newly enacted requirements and heightened standards of conduct will serve to protect the investing public in this previously, largely unregulated area of the financial market. It is essential that people dealing in the area of hedge funds be aware of the recent changes by the Commission, and act accordingly. Those that do not may run the risk of forfeiting fees in some situations, or more extreme action by the Commission in more serious violations.

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[27] Upon registration, the adviser will be subject to numerous Commission rules including: (i) the requirement to create, file and keep current Form ADV, (ii) the recordkeeping requirements of Rule 204-2, (iii) the performance fee requirements of Rule 205-3, (iv) the custody requirements of Rule 206(4)(2), (v) the solicitor requirements of Rule 206(4)-3, (vi) the proxy voting requirements of Rule 206(4)-6, (vii) the requirement to designate a compliance officer and adopt compliance procedures of Rule 206(4)-7, and (viii) the requirement to have a Code of Ethics found in Rule 204A-1, among others. In addition, although advisers to private funds will have until February 1, 2006 to become registered, advisers must keep performance records in compliance with the existing rules on and after February 10, 2005.

Broker Dealer Liability: Investment Adviser Misconduct

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Whether, and to what extent, an introducing broker dealer may be liable for the misconduct of an investment adviser retained by a customer is an issue arising with increasing frequency. Where a customer has provided discretionary authority to the investment adviser, who then trades the customer's account through brokers employed by the broker dealer, virtually all broker dealers will assert that their responsibility to their customer is limited to "faithfully executing" that customer's agent's instructions.

There are several theories available to aggrieved customers of investment advisers asserting claims against broker dealers. They include both derivative liability theories and independent liability theories. In all cases, however, the inquiry is intensely fact-specific. A broker dealer has a duty to exercise reasonable care, skill, and diligence in the performance of its obligations to its customers. The extent of these obligations where an investment adviser is involved depends on the facts of each case. Such facts include the extent of the broker dealer's involvement in the management of the customer's accounts, the type of relationship between the broker and the investment adviser, the degree of the customer's reliance on the broker or his own investment adviser, and the customer's sophistication.

Investment Advisers Generally

The conduct of investment advisers is governed by state and federal law. The statutes define an investment adviser as

> any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities[.][1]

The law requires investment advisers to be registered.[2] Consequences for failure to be registered include rescission of contract (consideration paid for advice given in violation with interest from the date of payment, actual damages caused by such advice, plus costs of the action and reasonable attorney fees) and criminal penalties.[3]

Broker Dealer Interaction with Investment Advisers

1. Derivative Liability Theories

Broker dealers interact with investment advisers in a number of different ways. Some broker dealers have "in-house" advisory services by which the funds of its customers are managed for a fee, usually represented by a percentage of assets under management. The investment advisers direct the trading in the accounts through a licensed stockbroker who, theoretically, acts as a "mere order taker." Other firms maintain more or less established relationships with "independent" investment advisory firms; the broker dealer may maintain a list of "approved" investment advisory firms. Regardless, the nature and extent of the relationship between the broker dealer and the investment adviser is critical to determining the responsibility of the broker dealer for the investment adviser's conduct.

In some cases, the investment adviser may be viewed as the broker dealer's agent, for whose acts the broker dealer may be liable under principles of *respondeat superior*. Whether such principles apply depends both upon the facts and upon the forum state's agency laws as well as applicable securities laws.

In *Kaufman v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,*[4] investors alleged various securities law violations, as well as common law claims, against their investment adviser and Merrill Lynch. Merrill Lynch argued that the investment adviser had complete control over the investment decisions and that Merrill Lynch therefore owed no duty beyond simply executing unsolicited orders.[5] The court denied Merrill Lynch's motion for summary judgment, holding that factual issues existed with respect to the "degree of sophistication of the plaintiffs, the extent of the reliance of the plaintiffs on Merrill Lynch and [the broker], and the degree of involvement of Merrill Lynch and [the broker] with [the investment adviser] and the plaintiffs."[6] The court noted that the investors were unsophisticated, that Merrill Lynch placed the investment adviser on its list of approved investment advisers, that the broker dealer advised the investment adviser almost daily on trades, that Merrill Lynch derived substantial commissions from its frequent transactions in the accounts, that the investors relied on Merrill Lynch's reputation, and that the investors believed that the investment adviser worked closely with Merrill Lynch.[7] The court concluded that

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[1] Investment Advisers Act of 1940, 15 U.S.C.A. § 80b-2(a)(11) (2004); *accord* Uniform Securities Act § 102(15) (amended 2002) (2004).

[2] *See* 15 U.S.C.A. § 80b-3(a); *accord* Uniform Securities Act § 403(a).

[3] *See* Uniform Securities Act §§ 509(f)(1), 508; *see also* 15 U.S.C.A. §§ 80b-3(i) -(k), 80b-17.

[4] 464 F. Supp. 528 (D. Md. 1978).

[5] *See id.* at 535. However, the court would not hold as a matter of law that the execution of a limited power of attorney relieves the broker dealer of its responsibilities to the customer. *See id.*

[6] *Id.* at 536.

[7] *See id.* at 535.

Merrill Lynch and its broker may have been "significantly involved in these transactions beyond mere execution of orders."[8]

In *Ruiz v. Charles Schwab & Co.*,[9] an investor sued Schwab and an investment adviser for alleged churning and misrepresentations. Schwab allegedly recommended the investment adviser to the plaintiff.[10] Although the investment adviser was not a Schwab employee, he received "VIP status" based on the amount of commissions generated and was given access to Schwab's VIP lounge where he met with customers.[11] Despite the fact that the investment adviser signed a LPOA which explicitly stated that he was not a Schwab employee, the plaintiff continued to think otherwise.[12] The court stated that "[t]he execution of a limited power of attorney does not relieve Schwab of all of its responsibilities to investors."[13] The court partly denied Schwab's motion for summary judgment on the basis of Schwab's monitoring of the trading volume in its customer's accounts; genuine issues of fact existed as to whether Schwab's inaction was in reckless disregard of its duty to act.[14]

Substantial Assistance / Aiding and Abetting

Courts have also held that broker dealers may be liable to customers for the investment's adviser's fraud if they "substantially assist" the investment adviser's fraud.[15] Under securities laws, elements establishing aiding and abetting liability include "1) a violation by a primary wrongdoer, (2) knowledge by the alleged abettor, [and] 3) proof that the abettor substantially assisted in the wrongdoing."[16] For example, the court in *Rolf v. Blyth Eastman Dillon & Co.*[17] found the broker dealer an aider and abettor of the investment adviser's fraud when

> the broker dealer, although charged with supervisory authority over the adviser and aware that the adviser was purchasing "junk," actively lulled the investor by expressing confidence in the adviser without bothering to investigate whether these assurances were well-founded.[18]

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[8] *Id.* at 536.

[9] 736 F. Supp. 461 (S.D.N.Y. 1990).

[10] *See id.* at 462.

[11] *See id.*

[12] *See id.* at 462-463.

[13] *Id.* at 464.

[14] *See id.*

[15] *See, e.g., Primavera Familienstifung v. Askin,* 130 F.Supp.2d 450, *reconsidered on other grounds,* 137 F.Supp.2d 438 (S.D.N.Y. 2001).

[16] *Ruiz*, 736 F. Supp. at 464.

[17] 637 F.2d 77 (1980).

[18] *Id.* at 80-81.

However, aiding and abetting liability does not extend to "a broker-dealer who merely executes orders for 'unsuitable' securities made by an investment adviser vested with sole discretionary authority to control the account."[19] Also, aiding and abetting liability does not apply to a broker dealer's "negligent failure to inquire and disclose."[20] Inaction does not constitute "substantial assistance" unless it was designed to assist the "primary fraud" or was a "conscious and reckless" disregard of a duty to act.[21] "Substantial assistance" requires at least that the broker dealer has a "general awareness" that his role was part of an overall improper activity undertaken by the investment adviser.[22]

2. Independent Liability Theories

A. NYSE Rule 405—Due Diligence

Self-regulatory organizations, such as the NYSE, set forth general standards and guidelines which a broker dealer must abide by in dealing with its customers. NYSE Rule 405, otherwise known as the "Know Your Customer" rule, requires in pertinent part that each broker dealer

> [u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney of any account accepted or carried by such organization.

An argument can be made that Rule 405 imposes upon member firms a duty to conduct a "due diligence" inquiry of *all* persons, including investment advisers, who hold powers of attorney over their customer's accounts. Such duties could include determining whether an investment adviser is properly registered. However, research has located no reported case that carries the Rule 405 duty that far.

With respect to the application of Rule 405, the court in *Nelson v. Hench*[23] stated that such regulatory rules

> requiring broker-dealers to closely supervise their accounts and know the background of their customers must have been enacted primarily for the protection of the *dealers*. . . . [plaintiffs] cannot establish to the satisfaction of the Court that the protection of investors from unscrupulous *third party traders* was more than an incidental motive for enactment of these rules.[24]

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[19] *Id.; see also Congregation of the Passion v. Kidder Peabody & Co.,* 800 F.2d 177 (7th Cir. 1986) (Broker dealer not liable when dealt exclusively with customer's investment adviser; dealer's only contact with customer was the confirmation slips.). *But see Kaufman*, 464 F. Supp. 528 (D.C. Md. 1978) (failure of broker dealer to protect customer's assets from fraud of investment adviser who dealt directly with customer could be sufficient for aiding and abetting liability).

[20] *Katz v. Realty Equities Corp. of N.Y.*, 406 F. Supp. 802, 805 (S.D.N.Y. 1976); *see also Sullivan v. Chase Investment Servs. of Boston, Inc.*, 79 F.R.D. 246 (N.D. Cal. 1978) (failure of broker to investigate investment advisory firm and representations in promotional literature insufficient for aiding and abetting liability; need actual knowledge or reckless disregard for truth).

[21] *Ruiz*, 736 F. Supp. at 464.

[22] *Investors Research Corp. v. SEC*, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied*, 449 U.S. 919, 101 S. Ct. 317 (1980); *accord Congregation of the Passion.,* 800 F.2d at 183-84.

[23] 428 F. Supp. 411 (D. Minn. 1977).

Not all courts accept that a private right of action exists for a violation of Rule 405, although many courts have held that Rule 405 establishes a standard of care, violation of which may support a negligence claim.[25]

Where courts have accepted that a broker dealer may be liable solely for violation of NYSE Rule 405, a private right of action may exist only upon proof "by a preponderance of the evidence that the actions of [the broker dealer] constituted violations of the applicable rules 'tantamount to fraud.'"[26] An investor must prove that the broker dealer acted with "intent to defraud or with willful and reckless disregard for the truth or falsity of their representations or of whether their actions constitute a fraud."[27] "The 'tantamount to fraud' standard makes the determination concerning the private right of action depend upon individual conduct rather than upon the nature of the rule in question."[28] If the broker dealer was actually aware of the potential shortcomings, irregularities or suspicious circumstances of the customer's agent's transactions, but recklessly disregarded them, the customer could recover, under Rule 405, damages sustained as a result of the broker dealer's recklessness.[29]

B. Monitoring of Accounts

In assessing the duty owed to the customer, courts consider the "degree of control" the broker dealer exercises over the customer's account.[30] "[I]t is the ability to control transactions in the customer's account that gives rise to the need to provide those protections to the customer that inhere in recognition of fiduciary duties in the broker."[31]

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[24] *Id* at 419 (emphasis added). Also, the NASD's "Suitability Rule" provides that "[i]n *recommending* to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs." Art. III, § 2, NASD Rules of Fair Practice, NASD Manual (CCH) § 2152 (emphasis added). Arguably, under the Suitability Rule, a broker dealer cannot be held responsible for the "unscrupulous" actions of the customer's investment adviser when the broker dealer makes no recommendations, simply executing unsolicited trades.

[25] *See Miley v. Oppenheimer & Co. Inc.*, 637 F.2d 318, 333, *reh'g denied*, 642 F.2d 1210 (5th Cir. 1981) (NYSE rules are "excellent tools" to assess "the reasonableness or excessiveness of a broker's handling of an investor's account.).

[26] *Rolf v. Blyth Eastman Dillon & Co.*, 424 F. Supp. 1021, 1041 (S.D.N.Y. 1977), *aff'd*, 570 F.2d 38 (2d. Cir. 1978), *cert. denied*, 439 U.S. 1039, 99 S. Ct. 642 (1978), *amended* 637 F.2d 77 (1980); *accord Smith v. Smith, Barney, Harris, Upham & Co.*, 505 F. Supp. 1380 (W.D. Mo. 1981); *Faturik v. Woodmere Securities, Inc.*, 442 F. Supp. 943 (S.D.N.Y. 1977).

[27] *Rolf*, 424 F. Supp. at 1041.

[28] *Nelson*, 428 F. Supp. at 419.

[29] *See Wolfson v. Baker*, 444 F. Supp. 1124 (M.D. Fla. 1978), *aff'd*, 623 F.2d 1074 (5th Cir. 1980), *cert. denied*, 450 U.S. 966, 101 S. Ct. 1483 (1981).

[30] *See Paine, Webber, Jackson & Curtis, Inc. v. Adams,* 718 P.2d 508, 515 (Colo. 1986).

[31] *Id.* at 518; *accord Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 906 F.2d 1206 (8th Cir. 1990). Courts decline to align fiduciary duties owed by the broker dealer to the customer based on a discretionary vs. nondiscretionary account basis. *See id.*

When a customer reposes trust and confidence in the broker dealer to make all the investment decisions, and the broker dealer exercises control over the account, the broker dealer has a continuing duty to carefully monitor the account.[32] Monitoring the account includes a duty to investigate any "red flags and suggestions of irregularities" which "demand inquiry as well as adequate follow-up and review."[33] Even the execution of a trading authorization for another does not relieve the broker dealer from its duty to supervise the customer's accounts and exercise due diligence.[34] For example, in *Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, [35] the court refused to excuse Merrill Lynch from liability from churning when the customer, an elderly woman, failed to report at least 106 unauthorized trades. The court noted that Merrill Lynch should have implemented a procedure or review process which would have effectively detected churning.[36]

In nondiscretionary accounts where the customer retains control over the account and has full responsibility for the trading decisions, the broker dealer's duties have been said to end upon completion of each transaction and do not typically include a duty to monitor the account or "offer unsolicited information, advice, or warnings concerning the customer's investments."[37] Upon the faithful execution of each trade order by the broker dealer, the customer "has no legal claim on the broker's ongoing attention."[38] If the broker dealer monitors the account in accordance with its procedures anyway and, for example, sends "happy" letters or otherwise communicates directly with the customer, an argument can be asserted that the broker dealer assumed a duty to monitor that it did not otherwise have; the broker dealer could be responsible for failing to comply with the duties it voluntarily assumed.

Where the broker dealer's sole role and function has been to execute trade orders, the courts have typically refused to require the broker dealer to monitor the investment adviser's misconduct. For example, the North Carolina Court of Appeals in *Sterner v. Penn*[39] recently rejected the investor's claims, including negligence and constructive fraud, against Ameritrade, Inc. and other broker dealers. There, the investor entrusted her money to an "investment adviser" who opened accounts with the brokerage firms

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[32] *See Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 460-61 (9th Cir. 1986) (duty to advise of risk of margin call). NYSE Rule 405 also provides that broker dealers must diligently supervise all accounts and specifically approve the opening of an account either prior to or promptly after the completion of a transaction.

[33] *Graham v. SEC*, 222 F.3d 994, 1006 (D.C. Cir. 2000) (citations omitted) (SEC upheld securities violation where broker dealer was aware of customer's financial difficulties, customer's suspicious and irrational trading, and customer's attempt to circumvent account restrictions.).

[34] *See Rolf*, 424 F. Supp. 1021 (S.D.N.Y. 1977).

[35] 906 F.2d 1206 (8th Cir. 1990).

[36] *See id.* at 1214 n.10.

[37] *De Kwiatkowski v. Bear, Stearns & Co., Inc.,* 306 F.3d 1293, 1302 (2d Cir. 2002).

[38] *Id.*

[39] 159 N.C. App. 626, 583 S.E.2d 670 (2003).

and traded the funds, losing the investor's money.[40] The investor asserted that the brokerage firms negligently allowed an unlicensed broker to transfer her funds from her account to the brokerage accounts and failed to supervise the manner in which the broker invested the funds.[41] Dismissing plaintiff's negligence claims, the court held that the broker dealers had no legal duty to "supervise" or "monitor" the adviser's activities.[42] Further, the court held that the brokerage firms did not breach the fiduciary duties arguably owed to plaintiff when all the brokerage firm did was accept orders and earn commissions.[43]

Conclusion

Although each case turns on the facts, a broker dealer will most likely be responsible to the customer for the misconduct of the customer's investment adviser when it employed or recommended the investment adviser, or when its actions substantially assisted the adviser's fraud or were tantamount to fraud. The bottom line is that the broker dealer must be significantly involved in the transactions beyond mere execution of orders to be responsible for the investment adviser's misconduct.

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[40] *See id.* at 628, 583 S.E.2d at 672.

[41] *See id.* at 628, 583 S.E.2d at 672-73.

[42] *See id.* at 629-31, 583 S.E.2d at 673-74, *citing Cumis Ins. Society v. E. F. Hutton & Co.,* 457 F. Supp. 1380 (S.D.N.Y. 1978).

[43] *See id.* at 632, 583 S.E.2d at 674; *see also Congregation of the Passion*, 800 F.2d at 182-83 (Broker dealer had no duty to inform the customer that its investment adviser was engaged in risky transactions when it simply executed orders.). In North Carolina, as elsewhere, damages may be awarded for breach of fiduciary duty where there is (1) a relation of trust and confidence; *and* (2) the defendant takes advantage of that relation to the harm of plaintiff *and to the benefit of defendant. See State ex rel. Long v. Petree Stockton, L.L.P.,* 129 N.C. App. 432, 445, 499 S.E.2d 790, 798 (1988).

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Upcoming Events:

PIABA Board of Directors Meeting, July 16-17, 2005, The Broadmoor, Colorado Springs, CO.

7th *Annual Securities Law Update*, September 28, 2005. La Costa Resort and Spa. Carlsbad, California.

PIABA 14th Annual Meeting September 29 -October 1, 2005. La Costa Resort and Spa. Carlsbad, California.

PIABA Board of Directors Meeting, October 2, 2005. La Costa Resort and Spa. Carlsbad, California.

PIABA Board of Directors Meeting, March 4-5, 2006, Location to be announced

California Mid-Year Meeting, March 18, 2006, Location to be announced

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