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PIABA Bar Journal

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The Bar Journal of the Public Investors Arbitration Bar Association

From the Editor's Desk

by Jason Doss

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

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Fall, 2006 issue of *PIABA Bar Journal* is September 29, 2006. All submissions should adhere to the following format:

Written materials should be submitted on a disk in word or word perfect format with a printed copy.

1. One inch margins top, bottom and sides.
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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.
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President's Message

By Robert S. Banks, Jr.

Two very recent events illustrate once again just how effective PIABA can be in safeguarding investor rights, and the importance of continued vigilance.

The first occurred with the NASD's filing with the SEC of the now infamous Amendment No. 5 to the proposed rewrite of the Code of Arbitration Procedure, originally filed in 2003. Amendment 5, filed in May, 2006, included a "clarification" to proposed Rule 12504, the new dispositive motion rule. Rule 12504 states that motions to dismiss are "disfavored" and should only be granted in "extraordinary circumstances." Amendment 5 would have substantially changed the meaning of that proposed rule. It gave the following as examples of "extraordinary circumstances:" statutes of repose; accord and satisfaction; arbitration and award; and settlement and release. The effect of those examples would be to read "extraordinary circumstances" out of the rule. When they are disputed, these technical defenses involve complex issues of law and fact, and are completely inappropriate for early decision in an arbitration forum that does not permit full discovery. To make matters worse, the NASD sought SEC approval of Amendment 5 and the Code Rewrite on an accelerated basis.

PIABA quickly mounted an opposition both to the examples given in and the request for accelerated approval of Amendment 5. As a direct result of PIABA's efforts, not only was the accelerated approval request withdrawn, but NASD completely withdrew Amendment 5's "clarification" to dispositive motion practice. NASD also withdrew Rule 12504 from the SEC's consideration, and then re-filed it without the explanatory language to make clear that the examples given were not to be a part of any approved rule.

At about the same time, PIABA members learned that the NASD was sending out form letters to arbitrators in cases in which motions had been filed but not set for hearing. In those letters, the NASD was informing arbitrators that they could grant the enclosed motion *with or without a hearing*. Our members reported that those form letters were even being sent with motions to dismiss. Again, PIABA took immediate action and demanded a correction. Within a matter of hours, the form letter was discontinued. Within days, all arbitrators were advised by email that they needed to be "judicious" in granting motions to dismiss. All arbitrators were also told about the Rule 12504 rule filing, and given the link to find it. Conscientious arbitrators who read the filing will see the "disfavored" and "extraordinary circumstances" standards in the proposed rule.

Bob Banks received his BA from Reed College (1977) and his JD from the University of Wisconsin Law School (1982). He has a plaintiffs' securities law practice with an office in Portland, Oregon. He has held several bar leadership positions, and has written and spoken extensively on topics relating to securities law and arbitration. He has been a member of the PIABA Board of Directors for five years, and is currently PIABA's president. He may be contacted at rbanks@bankslawoffice.com.

Although we have allies, PIABA is the only group which cares deeply enough and is affected directly enough to take swift action on issues such as these. Without the membership standing together as one, we would not have the power to stop the injustices that we fight against.

Remember to mark your calendar and register for the 15th Annual PIABA Meeting in Tucson, Arizona to be held on October 26-28. It will be another sell-out crowd for the world's best continuing legal education program for lawyers representing customers in securities arbitrations. I look forward to seeing you there.

ProfLipner's I Love New York Law: Using New York's Pattern Jury Instructions in Arbitration

By Seth E. Lipner

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The old axiom is that arbitrators are judge and jury, but the fact is that arbitrators are neither. Arbitrators are not like judges, who are professional jurists operating in a highly-structured environment, whose every decision is subject to appellate review. And arbitrators are not like jurors; unlike jurors, arbitrators are expected to run the proceedings, rule on motions and objections to evidence, decide what laws/rules apply and how to apply them, and to determine the facts, and then decide the whole case.

In that environment, charged with these weighty tasks and given tremendous power, arbitrators must, by the end of a case, yearn for simplicity. Whether the arbitrators are trained in law or not, arbitrators would undoubtedly welcome a plain-language explanation of how to determine liability and damages. One that has minimal legal terminology. One that the lawyers on both sides can agree on.

But where can lawyers - adversaries - find such straightforward statements of how to decide?

New York's Pattern Jury Instructions (known as the "PJI") is just such a document. Developed over many years by committees of judges and distinguished scholars and practitioners, the PJI is an excellent resource for plain-English expressions of important legal issues. And even though arbitrators' function is different from that of the judges who instruct juries and the juries who execute those instructions, the language of the PJI often eloquently reduces legal principles to operational rules.[1]

The purpose of this article is to present several sections of the PJI that are useful in securities arbitrations. These instructions can be used in closing argument, or provided to arbitrators in lieu of or in addition to a brief. They are authoritative and accessible. The can help arbitrators both in the way they assess evidence and in they way they assign liability and compute damages.

The charges themselves are followed by extensive commentaries with copious citations, for those wanting to conduct deeper research. The focus in this article is the charges themselves, although certain portions of the comments are included as well.

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[1] New York's PJI is not, however, just a set of standard jury charges. It is a multi-volume book. Each charge is accompanied by a scholarly discussion of the law, with extensive references and case citations. The book is published by West, and is available on Westlaw.

Assessing Evidence

Arbitrators are almost always required to resolve testimony that is in conflict. While different human beings have different techniques for determining credibility, the PJI can provide some useful, time-honored guides.

Credibility: For example, the old Latin maxim "falsus in uno, falsus in omnibus" has been used by lawyers for eons as a tool for arguing why a witness should not be believed. The PJI provides a tight and useful definition:

> PJI 1:22. Falsus in Uno
>
> If you find that any witness has wilfully testified falsely as to any material fact, that is as to an important matter, the law permits you to disregard completely the entire testimony of that witness upon the principle that one who testifies falsely about one material fact is likely to testify falsely about everything. You are not required, however, to consider such a witness as totally "unbelievable". You may accept so much of his or her testimony as you deem true and disregard what you feel is false. By the processes which I have just described to you, as the sole judges of the facts, decide which of the witnesses you will believe, what portion of their testimony you accept and what weight you will give to it.

Missing Witness: Similarly, the so-called "missing witness charge" can be a powerful device. The PJI, appropriately, lays out all the elements of the charge, in a way arbitrators can appreciate:

> PJI 1:75. General Instruction-Evidence-Failure to Produce Witness-In General
>
> A party is not required to call any particular person as a witness. However, the failure to call a certain person as a witness may be the basis for an inference against the party not calling the witness. For example, in this case the (plaintiff, defendant) did not call AB to testify on the question of [*identify issue*]. The [plaintiff, defendant] has offered the following explanation for not calling AB [*summarize explanation*], as a witness or has offered no explanation for not calling AB).
>
> [*If explanation is offered*] If you find that this explanation is reasonable, then you should not consider the failure to call AB in evaluating the evidence. If, however, you find (the explanation is not a reasonable one, no explanation has been offered), you may, although you are not required to, conclude that the testimony of AB wouldn't not support (the plaintiff's, defendant's) position on the question of [*identify issue*] [*add if opposing party has offered evidence on the issue*]: and would not contradict the evidence offered by (the plaintiff, defendant) on this question and you may, although you are not required to, draw the strongest inference against the (the plaintiff, defendant) on that question, that opposing evidence permits.

Other Evidentiary Jury Charges: Other useful PJI charges on evidence include burden of proof (PJI 1:23; 1:64); consideration of only testimony and exhibits (PJI 1:25); weighing testimony and evidence (PJI 1:41); privilege (PJI 1:76); failure to produce documents (PJI 1:77); destroyed documents/spoliation (PJI 1:77:1); expert witnesses (PJI 1:90); and interested witnesses (PJI 1:91).

STANDARDS OF CARE/LIABILITY

Negligence: A contract is a binding agreement; fraud is lying and cheating. These are almost visceral concepts, not unlike Justice Potter Stewart's view of "pornography" - something hard to define, but identifiable once seen.

But negligence is different. Yes, it is a failure to exercise "due care"; the requirement that all actions be compared with those of the hypothetical "reasonable person" - the man as the Brits say "on the Clapham omnibus". "Reasonable care" is a concept most tort professors spend the better part of the term on, sifting through the impenetrable prose of Holmes, Cardozo and good-old Learned Hand.

Surely, some ordinary words, some easy expressions, would be useful. The PJI's charge on negligence is awesome in its simplicity.

> PJI 2:10 Common Law Standard of Care–Negligence Defined–Generally
>
> Negligence is lack of ordinary care. It is a failure to use that degree of care that a reasonably prudent person would have used under the same circumstances. Negligence may arise from doing an act that a reasonably prudent person would not have done under the same circumstances, or, on the other hand, from failing to do an act that a reasonably prudent person would have done under the same circumstances.

When more serious allegations are made, the PJI also provides useful, clear definitions:

> PJI 2:10A. Common Law Standard of Care–Gross Negligence or Wilful Misconduct
>
> In this case, you must decide whether defendant was guilty of (gross negligence, wilful misconduct). Negligence is a failure to exercise ordinary care. (Gross Negligence, wilful misconduct) is more than the failure to exercise reasonable care.
>
> ([*Use whichever of the following definitions applies*])
>
> Gross negligence means a failure to use even slight care, or conduct that is so careless as to show complete disregard for the rights and safety of others.
>
> Wilful misconduct occurs when a person intentionally acts or fails to act knowing that (his, her) conduct will probably result in injury or damage. Wilful misconduct also occurs when a person acts in so reckless a manner or fails to act in circumstances where an act is clearly required, so as to indicate disregard fo the consequence of (his, her) action or inaction.

Special Knowledge; "Malpractice": Brokers and financial advisors have, or are supposed to have, special knowledge. Though some in the industry may deny that such special knowledge exists, the arbitrators are likely to accept the assertion that brokers and advisors, like doctors, lawyers, engineers, accountants, etc. are properly held to certain professional standards[2]:

> PJI 2:15 Common Law Standard of Care–Defendant Having Special Knowledge
>
> A person who has special training and experience in a (trade, profession), when acting in the trade or profession on behalf of others who are relying on (his, her) special skills, has the duty to use the same degree of skill and care that others in the same (trade, profession) in the community would reasonably use in the same situation. (AB), the defendant in this case, has (or claimed to have) special skills in [*specify trade or profession*]. If you decide that defendant did use the same degree of skill and care that other [specify trade or profession] in the community would reasonably use in the same situation, then you must find that defendant was not negligent, no matter what resulted from defendant's conduct.

[2] *Cf. Hughes v. JP Morgan Chase*, 2004 WL 1403337 (S.D.N.Y., June 22, 2004)(applying "continuous treatment" doctrine to financial advisor.)

> On the other hand, if you decide that defendant did not use the same degree of skill and care, then you must find that defendant was negligent.[3]

Custom In the Industry: Even in the absence of a conclusion that brokers and advisors have specialized knowledge, the existence of SRO rules and brokerage-industry customs create issues for arbitrators. The PJI addresses that issue in the context of a tort claim, although it can also have other relevancy in arbitration. When the claim is negligence, however, the PJI provides the standard formula[4]:

> PJI 2:16. Common Law Standard of Care–Customary Business Practices
>
> You have heard of evidence of the general customs and practices of others who are in the same business or trade as that of defendant. This evidence is to considered by you in determining whether the conduct of defendant was reasonable under the circumstances. Defendant's conduct is not to be considered unreasonable simply because someone else may have used a better or safer practice. On the other hand, a general custom, use, or practice by those in the same business or trade may be considered some evidence of what constitutes reasonable conduct in that trade or business. You must first decide, from the evidence presented in this case, whether there is a general custom or practice in defendant's trade or business. If you find that there is a custom or practice, you may take that general custom or practice into account in considering the care used by defendant in this case. However, a general custom or practice is not the only test; what you must decide is whether, taking all the facts and circumstances into account, defendant acted with reasonable care.

Causation:

Even though causation is a question of fact, the PJI's charge is short and to the point:

> PJI 2:70 Proximate Cause - In General
>
> An Act or omission is regarded as a cause of an injury if it was a substantial factor in bringing about the injury, that is, if it had such an effect in producing the injury that reasonable people would regard it as a cause of the injury.

Fraud: The PJI, whose entire first volume covers negligence actions and defense of such actions, contains charges for other kinds of cases, but it does so on a smaller scale. There is a single charge for fraud, for example:

> PJI 3:20. INTENTIONAL TORTS--FRAUD AND DECEIT
>
> The plaintiff AB seeks to recover damages that (he, she) claims were caused by a fraud committed by the defendant CD. In order to recover for fraud, AB must prove by clear and convincing evidence that CD made a representation of fact; that the representation was false; that CD knew it was false or made the representation recklessly without regard to whether it was true or false; that CD made the representation to induce AB to rely upon it; and that AB did justifiably rely upon it, and sustained damages.

---

[3] PJI 2:36 addresses comparative fault.

[4] Note that New York follows the "some evidence" rule - failure to adhere to custom is "evidence" of negligence; in other states, the rule is sometimes tougher - that failure to adhere to industry custom creates a presumption (usually rebuttable) of negligence. Of course, it is the rule everywhere that proof of compliance with custom is not proof of due care.

AB claims that *[state AB's contentions]*. CD claims that *[state CD's contentions]*.

AB has the burden of proving, by clear and convincing evidence:

First, that CD made a representation of fact (to AB);

Second, that the representation was false;

Third, that CD knew the representation was false or made the representation recklessly without regard to whether it was true or false;

Fourth, that CD made the representation to induce AB to *[state action or omission by AB]*, and;

Fifth, that AB justifiably relied upon CD's representation in deciding to *[state action taken or omitted]*.

The first question you will be asked to decide is whether CD made the representation. If you find that CD did not make the representation, you need proceed no further on the claim of fraud. If you find that CD did make the representation, you must next decide whether the representation was true or false. If the representation was true, you need proceed no further on the claim of fraud. If the representation was false, you must next decide whether CD knew it was false or made it recklessly without regard to whether it was true or false.

If you find that CD did not know that it was false and that CD did not make it recklessly, you need proceed no further on the claim of fraud. If you find that CD did know the representation was false or acted recklessly, you must next decide whether the representation was made to induce AB to *[state action taken or omitted]*.

If you find that CD did not made the statement to induce AB to *[state action taken or omitted]*, you need proceed no further on the claim of fraud. If you find that CD did make the representation to induce AB to *[state action taken or omitted]*, you must next decide whether AB was justified in relying on the representation.

Whether the person to whom a representation is made is justified in relying upon it generally depends upon whether the fact represented is one that a reasonable person would believe and consider important in deciding whether to *[state action or omission]*. Whether a person is justified in relying on a representation also depends on whether a reasonable person would *[state action or omission]* without independent investigation. If you find that AB was not justified in relying on the representation, you need proceed no further on the claim of fraud. If you find that AB was justified in relying on the representation, you must next decide whether AB was damaged as a result of the fraud.

If you find that AB did not sustain any damage as a result of the fraud, you will find for CD on the claim of fraud. If you find that AB did sustain damage as a result of the fraud, you must next decide the actual monetary loss sustained. *[Measure of damage must reflect out of pocket rule, see Comment]*.

The charge has several notable features. First, fraud must be proven by "clear and convincing evidence."[5] Second, this is a charge for intentional fraud; New York law

[5] PJI 1:64. GENERAL INSTRUCTION--BURDEN OF PROOF--CLEAR AND CONVINCING EVIDENCE:

> The burden is on the plaintiff to prove [*here state the ultimate issue to be decided*] (e.g., fraud, malice, mistake, a gift, the contract between the plaintiff and the deceased, incompetency,

recognizes a claim for "negligent misrepresentation" only where there is a relationship of trust and confidence between the parties.[6] Depending on the facts, investor-advisor may be such a relationship.

Damages in Fraud Cases: Last, the fraud charge contains, at the end, an italicized parenthetical about the measure of damages and the so-called out-of-pocket-loss rule. The Official Comment to PJI 3:20 explains:

> Injury is an essential element of the cause of action.
> The burden is on plaintiff to prove a proper basis for damages but uncertainty of the amount of damage caused is not reason to refuse to measure damages by some practical, just means.
>
> 1. Measure of Damages
>
> The New York measure of damages in an action for fraud is indemnity for the actual pecuniary loss sustained as a direct result of the wrong (the "out-of-pocket" rule) and differs from the contract measure which accounts for lost profit (the "loss-of-bargain" rule). [citations omitted]
>
> Generally, the "out-of-pocket" rule measures pecuniary loss by the difference between the value of what plaintiff parted with and the value of what plaintiff received while the "loss-of-bargain" rule measures plaintiff's damage by the difference between what plaintiff received and what plaintiff would have received had the fraud not occurred. [citations omitted] Note, however, that in *Hotaling v A.B. Leach & Co.*, 247 NY 84, 159 NE 870, the court, while recognizing the "out-of-pocket" rule, held that unusual circumstances may require a variation of this rule, and that when the value of the bond purchased by plaintiff for investment had been affected by fraudulent representations, plaintiff's pecuniary loss is measured by the difference between what plaintiff paid and the value of the bond when redeemed two years later.
>
> Ordinarily, compensatory damages in a fraud cause of action are limited to damages for pecuniary losses [citations omitted] although a physician's

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addiction) by clear and convincing evidence. This means evidence that satisfies you that there is a high degree of probability that there was (e.g., fraud, malice, mistake, a gift, a contract between the plaintiff and the deceased, incompetency, addiction), as I (have defined, will define) it for you.

To decide for the plaintiff it is not enough to find that the preponderance of the evidence is in the plaintiff's favor. A party who must prove (his, her) case by a preponderance of the evidence only need satisfy you that the evidence supporting (his, her) case more nearly represents what actually happened than the evidence which is opposed to it. But a party who must establish (his, her) case by clear and convincing evidence must satisfy you that the evidence makes it highly probable that what (he, she) claims is what actually happened.

If, upon all the evidence, you are satisfied that there is a high probability that there was (e.g., fraud, malice, mistake, a gift, a contract between the plaintiff and the deceased, incompetency, addiction) as I (have defined, will define) it for you, you must decide for the plaintiff. If you are not satisfied that there is such a high probability, you must decide for the defendant.

[6] See *Kimmell v. Schaefer,* 89 N.Y.2d 257, 264 (1996)("liability for negligent misrepresentation has been imposed only on those persons [professionals such as lawyers, engineers, accountants, etc.] who possess unique or specialized expertise, or who are in a special position of confidence and trust with the injured party such that reliance on the negligent misrepresentation is justified."). It has been held that investment advisors and brokers giving investment advice fall into this category. See *Fraternity Fund Ltd. v. Beacon Hill Asset Management LLC*. 376 F.Supp.2d 385, 410-411 (S.D.N.Y. 2005); *Crigger v. Fahnestock & Co. Inc.*, 2003 WL 22170607 (S.D.N.Y. 2003).

> concealment of his or her own malpractice may give rise to a separate cause of action for fraud when it results in damages distinct from the malpractice [citations omitted] Interest is recoverable as a matter of law from date of wrong to date of verdict.
>
> Fraud by the defendant, or defendant's agent, that prevents the commencement of a timely personal injury action, opens the possibility of a suit for the damages caused by the fraud, i.e., the damages that would be recoverable for the time barred personal injury claim. [citations omitted]

This comment demonstrates that even though the pecuniary loss rule governs, there is an exception for unusual circumstances. It should not go unnoticed that the exception cited involved a case involving an investment.[7] The comment also notes that "concealment" of malpractice (in this situation, involving a physician) of fraud preventing trimely commencement of an action, may give rise to separate claim, with a separate statute of limitations for the "distinct" damages. Last, the comment also shows that interest is recoverable as a matter of law (*i.e.* it is not "discretionary.")[8]

DAMAGES

Compensatory Damages: Assessing damages is the black-hole of securities arbitration. Experienced practitioners say that they often can predict, after a hearing, which witnesses were credible, and whether liability has been established. But those same lawyers will all say that as to damages, predictions are impossible.

Perhaps the addition of some structure to the damage analysis would help. But there is, unfortunately, no magic formula, as the PJI implicitly concedes.

> PJI 2:277. Damages - General
>
> . . . .
> If you find that the plaintiff is entitled to recover from the defendant, you must render a verdict in a sum of money that will justly and fairly compensate the plaintiff for all losses resulting from the injuries (he, she) sustained.[9]

When it comes to assessing damages, we give jurors the barest instruction to an amount that will "justly and fairly compensate the plaintiff". We give the same basic instruction to arbitrators:

> . . . [A]bsent provision in the arbitration clause itself, an arbitrator is not bound by principles of substantive law or by rules of evidence. He may do justice as he sees fit, applying his own sense of law and equity to the facts as he finds them to be . . . .[10]

Punitive Damages: Arguments about whether to assess "punitive" or "exemplary" damages are always heated. Instead of submitting a brief on the legal standards, one might just refer to the PJI:

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[7] For a discussion, See Lipner, Some Old New York Damages Cases That Just Might Apply Today, 10 PIABA B.J. No.3, pp. 2-4 (2003).

[8] The comment also notes that punitive damages are not recoverable in the ordinary fraud and deceit case [citations omitted] but may be recovered when the fraud is gross, involves high moral culpability and is aimed at the general public. See also Comment at PJI 2:278 (Punitive Damages).

[9] See also PJI 2:280.2: "If your verdict is in favor of plaintiff, plaintiff will not be required to pay income taxes on the award and you must not add to or subtract from the award any amount on account of income taxes."

[10] *Silverman v. Benmor Coats*, 61 N.Y.2d 299 (1984)

PJI 2:278. DAMAGES--PUNITIVE

In addition to awarding damages to compensate the plaintiff for (his, her) injuries, you may, but you are not required to, award plaintiff punitive damages if you find that the act of the defendant that caused the injury complained of was (wanton and reckless, malicious). The purpose of punitive damages is to punish the defendant for (wanton and reckless, malicious) acts and thereby to discourage the defendant and other (people, companies) from acting in a similar way in the future.

[Use whichever of the following sentences apply:]

An act is wanton and reckless when it is done in such a way and under such circumstances as to show conscious indifference and utter disregard of its effect upon the safety and rights of others. An act is malicious when it is done deliberately with knowledge of plaintiff's rights, and with the intent to interfere with those rights. [If the jury determines that defendant's acts were wanton and reckless, or malicious, the court should proceed to charge the jury on the factors it should consider in determining the amount of punitive damages, which appear below.]

In arriving at your decision as to the amount of punitive damages you should consider the following factors:

> 1. The nature and reprehensibility of what the defendant did. That would include the character of the wrongdoing, ([state the factors that are applicable, such as:] whether the defendant's conduct demonstrated an indifference to, or a reckless disregard of, the health or safety of others, whether the plaintiff was financially vulnerable, how long the conduct went on, the defendant's awareness of what harm the conduct caused or was likely to cause, any concealment or covering up of the wrongdoing, how often the defendant had committed similar acts of this type in the past). In considering the amount of punitive damages to award, you should weigh this factor heavily.
>
> 2. The actual and potential harm created by defendant's conduct. The amount of punitive damages that you award must be both reasonable and proportionate to the actual and potential harm suffered by the plaintiff, and to the compensatory damages you awarded the plaintiff.
>
> 3. The defendant's financial condition and the impact your punitive damages award will have on the defendant.

In reporting your verdict, you will state the amount awarded by you as punitive damages.

Notable features of the charge are the standard (wanton, reckless or malicious), and that the amount of punitive damages is cast in terms of a variable test. Of course, in recent years, there have been due process limits placed on the amount of punitive damages. The official comment to the PJI says:

> Caveat: While states continue to possess considerable discretion over the imposition of punitive damages, it is now well established that there are procedural and substantive constitutional limitations on these awards.
>
> Guideposts
>
> Courts should determine the reprehensibility of a defendant's conduct by considering whether: the harm caused was physical as opposed to economic; the tortious conduct evinced an indifference to or a reckless disregard of

the health or safety of others; the target of the conduct was financially vulnerable; if the conduct involved repeated actions of a similar type or was an isolated incident; the harm was the result of intentional malice, trickery, or deceit, or mere accident [citation omitted]. The "existence of any one of these factors weighing in favor of a plaintiff may not be sufficient to sustain a punitive damages award and the absence of all of them renders any award suspect." A recidivist may be punished more severely than a first offender but, in the context of civil actions, courts must ensure that the conduct in question replicates the prior misconduct. As a general rule, a State has no "legitimate concern in imposing punitive damages to punish a defendant for unlawful acts committed outside of the State's jurisdiction." Furthermore, when relevant, a jury must be instructed that it may not use evidence of out-of-state conduct to punish a defendant for action that was lawful in the jurisdiction where it occurred. Nevertheless, "[l]awful out-of-state conduct may be probative when it demonstrates the deliberateness and culpability of the defendant's action in the State where it is tortious, but that conduct must have a nexus to the specific harm suffered by the plaintiff." Therefore, it is improper for a State court to base an award of punitive damages on dissimilar and out-of-state conduct that was independent from the acts upon which liability was premised.

Regarding the second guidepost in [the *BMW* case], the disparity between the actual or potential harm suffered by the plaintiff and the punitive damages award, the Court again declined to impose a bright-line ratio [citation omitted]. Declaring the 145 to 1 ratio in [the *State Farm* case] unconstitutional, the Court observed that "few awards exceeding a single-digit ratio between punitive and compensatory damages, to a significant degree, will satisfy due process." In *Pacific Mutual Life Insurance Company v Haslip*, 499 US 1, 111 SCt 1032, 113 LEd2d 1, the Court upheld a punitive damages award of more than four times the amount of compensatory damages, noting that this ratio might be close to the line of constitutional impropriety. Ratios greater than this may comport with due process where a particularly egregious act has resulted in only a small amount of economic damage, [citation omitted]. Conversely, "[w]hen compensatory damages are substantial, then a lesser ratio, perhaps only equal to compensatory damages, can reach the outermost limit of the due process guarantee." "In sum, courts must ensure that the measure of punishment is both reasonable and proportionate to the amount of harm to the plaintiff and to the general damages recovered." Courts must also be careful to avoid allowing components of compensatory damages awards to be duplicated in a punitive damages award. Finally, the wealth of a defendant cannot justify an otherwise unconstitutional punitive damages award.

The third guidepost in *BMW*, the disparity between the punitive damages award and the civil penalties authorized or imposed in comparable cases, allows consideration of criminal penalties that could be imposed [citation omitted] The *State Farm* Court cautioned that, when used to determine the dollar amount of a punitive damages award, a criminal penalty has less utility. Rather, the criminal penalty has a bearing on the seriousness with which a State views the wrongful action. "Great care must be taken to avoid use of the civil process to assess criminal penalties that can be imposed only after the heightened protections of a criminal trial have been observed, including, of course, its higher standards of proof." In considering civil or criminal penalties authorized or imposed in other cases, courts must ensure that the penalties relate to conduct that is

substantially similar to the defendant's.

CONCLUSION

Despite the recitation of jury charges that is provided here, it is important to remember that arbitration is not litigation, and that these expressions of the law, while important information for arbitrators, is not the solitary source of their decision. The New York Court of Appeals famous statement in *Silverman v. Benmor Coats*, part of which was quoted earlier, says:

> ". . . absent provision in the arbitration clause itself, an arbitrator is not bound by principles of substantive law or by rules of evidence. He may do justice as he sees fit, applying his own sense of law and equity to the facts as he finds them to be and making an award reflecting the spirit rather than the letter of the Agreement, even though the award exceeds the remedy requested by the parties. His award will not be vacated even though the court concludes that its interpretation of the agreement misconstrues or disregards its plain meaning or misapplies substantive rules of law, unless it is violative of a strong public policy, or is totally irrational, or exceeds a specific enumerated limitation on his power.[11]

But law remains an important guidepost. And these "official" jury instructions are useful expressions.

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[11] *Silverman v. Benmor Coats*, 61 N.Y.2d 299 (1984)

Tampering with List Selection by Enhancing the Appointment Frequency of "Chair-Qualified" Arbitrators

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In the recently-filed "Amendment 5" to its proposed rewrite of the Code of Arbitration Procedure,[1] the NASD continues previous versions' division of all "public" arbitrators[2] into two separate groups: those who meet the NASD's definition of "chair-qualified arbitrators" and those who do not.[3] But Amendment 5 amplifies the dominance of the chair-qualified arbitrators by infusing members of that favored group into the "non-chair-qualified" group for list selection purposes.[4] Thus, arbitrators from the "chair-qualified" group will serve both as panel chairs and as public non-chairs in many cases. This newest wrinkle might seem innocuous at first blush. When examined quantitatively, however, it reveals a serious and problematic consequence: the arbitrators who are in the chair-qualified group will serve far more frequently than those who are not. The impact is far from trivial, as will be proven in this article.

The irony of this is that it is contrary to at least one reasonable interpretation of the NASD's own representations to the SEC regarding what the new arbitrator selection system will achieve. At page 22 of its Amendment 5 filing, the NASD states as follows:

> "NASD believes that eliminating the ability to select an arbitrator based on expertise and implementing the random selection function of NLSS will expand use of the full arbitrator pool, **so that all arbitrators on the lists will have the same chance of being selected for any case.**" [Emphasis added.]

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[1] Unless otherwise specified, the term "Code" refers to the NASD's new Code of Arbitration Procedure as set forth in its fifth amendment to that proposed code, originally filed with the Securities and Exchange Commission as SR 2003-158.

[2] The term "public" is a commonly-used shorthand way of referring to arbitrators who meet the Code's definition of arbitrators who are not affiliated with the securities industry, *i.e*, who are not "industry arbitrators." Active controversies regarding the deep industry ties of some arbitrators who qualify as "public" under the definition, whether the definition needs further tightening, and the lack of policing which has allowed industry arbitrators to be and remain misclassified as "public" for extended periods of time are beyond the scope of this article.

[3] Thus, under the new Code, panel chairs, public non-chairs and industry arbitrators will be chosen separately by striking and ranking three separate lists instead of the current two.

[4] Proposed Rule 12400(b) states:
"NASD maintains the following roster of arbitrators:
• A roster of non-public arbitrators as defined in Rule 12100(n);
• A roster of public arbitrators as defined in Rule 12100(r); and
• A roster of arbitrators who are eligible to serve as chairperson of a panel as described in paragraph (c).
Arbitrators who are eligible to serve as chairperson will also be included in the roster of public arbitrators, but will only appear on one list in a case.

If the NASD's proposal to give chair-qualified arbitrators two bites at the apple is approved, different public arbitrators will have very different chances of being selected for any given case.

It is unclear whether the NASD has considered the quantitative problems with its proposal. What is clear, however, is that those concerns are not addressed in its rule filing. While the quantitative problems make approval of the NASD's proposal inappropriate, the NASD's failure to address them makes its request for accelerated approval doubly so.[5]

This article's conclusions about the proposed rule's quantitative impacts on list selection are not based upon speculation or arguable assumptions. They are not empirical in nature and do not await experimental confirmation. Rather, they are knowable *a priori* based solely on a straightforward application of algebra to the NASD's proposed selection rules.

If the proposed rule is approved, the SEC will have permitted the NASD to divide its public arbitrator pool into two groups and to tamper with arbitrator selection so that members of one group will sit in judgment of customer claims far more often than members of the other. Arrangements of that kind have the look of a fixed race and can be expected to erode confidence on the part an investing public that already is weary of securities industry scandals and justifiably cynical about arbitration.

It is a rare instance when the quantitative consequences of a rule filing are calculable with algebraic precision. But this is one such instance. It would be unfortunate for the investing public and an embarrassment to the SEC if the rule were to be approved on an accelerated basis, without the SEC and the public even having an opportunity to consider its clearly provable consequences.

This article is divided into two sections. The first addresses briefly the policy concerns raised by the NASD's proposed skewing of list-selection. That section begins with a brief table of sample outcomes to give a preview of the greatly increased frequency with which chair-qualified arbitrators will be appointed and the dramatically reduced frequency with which non-chair-qualified arbitrators will be appointed under the NASD's proposed rule. It then discusses non-quantitatively the potential adverse impacts on investors of a rule that makes chair-qualified arbitrators far more likely than non-chair-qualified arbitrators to sit in judgment of investors' claims.

The next section quantifies the problem. It begins with a straightforward series of numerical calculations demonstrating the skewing that would occur in a hypothetical hearing location with 40 chair-qualified public arbitrators and 40 non-chair-qualified public arbitrators. Following that series of calculations is the derivation of a parallel series of formulas describing the skewing algebraically. The formulas derived in that part will enable the reader, using any combination of pool sizes, to calculate the precise impact of the NASD's proposed rule.

1. Sample Outcomes and Policy Considerations

First, here are some sample outcomes. In this table, "tampered" refers to the arbitrators' relative odds of sitting on an arbitration panel if members of the chair-qualified group are favored with "two bites at the apple" as the NASD proposes; "untampered" refers to their odds if each group stands alone on equal footing with the other, as list selection would have been conducted under the revised code prior to Amendment 5

[5] As of this writing, the NASD is seeking accelerated approval of this aspect of Amendment 5. Therefore, readers opposed to this tampering with list selection should file their comments with the SEC quickly.

Tampering with List Selection by Enhancing the Appointment Frequency of "Chair-Qualified" Arbitrators

Number of Chair-Qualified Arbitrators "x"	Number of ***Non***-Chair-Qualified Arbitrators "y"	Chair vs. Non-Chair Relative Odds of Serving if Selection is **Untampered**	Chair vs. Non-Chair Relative Odds of Serving if Selection is **Tampered** to Boost Chairs' Odds
100	100	1 to 1	2.84 to 1
40	40	1 to 1	2.60 to 1
50	100	2 to 1	3.68 to 1
100	50	0.5 to 1	2.34 to 1

Perhaps the biggest problem with this tampering with the arbitrators' odds of serving on panels – aside from the failing of the "smell test" inherent in allowing the NASD to divide public arbitrators into two groups and then hugely favor one group over the other – is the public perception that arbitrators with substantial numbers of closed cases, all of whom will be "chair-qualified" under the revised code, are particularly lacking in independence.

To serve frequently, arbitrators must be mutually ranked – that is, they must not receive a "strike" from either party during the strike-and-rank process. Thus, as a practical matter, the arbitrators who serve most frequently will be those who have succeeded in keeping their balance of customer victories and customer losses reasonably close to the 50-50 mark; avoided awarding attorneys' fees or even interest, notwithstanding the fact that many state securities acts expressly provide for those remedies; and shunned punitive damage awards and similar remedies that would make them stand out as an obvious strike for industry defense counsel. Issuing split-the-baby awards may help those arbitrators as well. What this often means is that arbitrators can enhance their odds of being appointed by nullifying laws enacted for the protection of investors.

In short, arbitrators who want to be appointed will benefit by exhibiting a lack of the judicial independence that the Founding Fathers recognized as so clearly important when they built protection of federal judges' tenure and salaries into Article III of the U.S. Constitution. The "arbitral dependence" that comes about as a result of arbitrators' desire to serve and serve again is well known. Exacerbating the problem by inviting those most proficient in displaying a "split-the-baby" mentality to sit far more often than they otherwise would does not qualify as appropriate stewardship of American capital markets.

And that is not the only problem. Imagine how long it will take new non-chair-qualified public arbitrators to try the two cases to award (or for non-lawyers, three cases) that are required to become chair-qualified.[6]

[6] Imagining really isn't necessary. Dividing the result in "B5" (below) by the result in "B6" (also below) reveals that it can be expected to take $(x + y - 8)/y$ times as long to be appointed to any given number of cases. It will take still longer to carry the required number of cases through to award, given that only 22% of filed cases go all the way to award. As the NASD stated at page 22 of its Amendment 5 filing:

> "Last, NASD believes that the requirement that an arbitrator serve on at least three arbitrations through award to be eligible for the chair roster is an objective standard that is easily measured. **While this standard is easy to measure, it is not easy to meet. Of the arbitration cases filed in the past four years, approximately 22% went to hearing."**

As stated previously, the NASD has given no indication that it understands the quantitative implications of its rule. The difficulty it describes in becoming chair-qualified did not even account for the further lengthening of the required time described in this article. This suggests a future in which chair-qualified arbitrators are firmly entrenched, and entry into that favored group will be rare indeed.

Indeed, the dramatically reduced odds of being appointed can be expected to have a number of negative impacts on the non-chair-qualified public pool and on recruitment of new arbitrators. To name three that come quickly to mind, (1) for many new arbitrators, arbitrator training will be a distant memory by the time they finally get to serve for the first time; (2) some new arbitrators will simply lose interest and give up, irritated that they spent time and money to become arbitrators in the first place; and (3) potential arbitrators who hear from those who have experienced the problems identified in "(1)" and "(2)" may not even complete an application.

Other problems arise out of the increased frequency with which chair-qualified arbitrators will be mutually ranked and asked to serve if the NASD's proposal is approved. This inevitably will increase the frequency with which arbitrators decline appointments to panels. The already-disturbing problem of last-minute resignations can be expected to worsen as well. Either way, whether early in the case or on the eve of hearing, there will be more administrative appointments. Thus, with the new rule in place, the parties will lose some of the control over their disputes that list selection was supposed to enhance.

Those who are not convinced by the practical arguments above regarding the differences between chair-qualified and non-chair-qualified arbitrators can come to similar conclusions by taking what might be called a "black box" approach to the problem. For this purpose, forget about what it means to be "chair-qualified." Instead, suppose only that the NASD has been permitted to divide an arbitrator pool into two groups and to determine, by rule or roster, which arbitrators will be in each group. Next, you learn that the NASD seeks permission to implement a rule that will cause arbitrators in one group to decide disputes far more often than those in the other group. Faced with this stripped-down black box scenario, which of the following seems more likely: (1) that the rule favoring one group of arbitrators over the other will be absolutely neutral in its impact, or (2) that the rule somehow will work to the benefit of the NASD's member firms? Allowing the NASD's proposed change will create, at the very least, the appearance of a stacked deck.

It is not as though chair-qualified arbitrators would be disenfranchised in the absence of the NASD's latest wrinkle. There already will be one on every panel, even without the proposed rule. And that arbitrator, by serving as panel chair, will have a heightened opportunity to influence the outcome of the case. Further, the chair-qualified arbitrator will be the only arbitrator in a one-arbitrator case.[7] So the question is not whether chair-qualified arbitrators will have a voice in the outcome of arbitration proceedings. The question is whether the NASD should be permitted to adopt a rule that frequently will cause members of the chair-qualified group to have still greater influence by occupying both public seats instead of one.[8]

2. Quantifying Skewing and Deriving a Formula

This section quantifies the skewing of list selection that will be brought about by the proposed rule. To make this more approachable, Part "A" of this section works through a series of ten simple numerical calculations based on a hypothetical hearing

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[7] See Proposed rule 12403(a).

[8] If there are x chair-qualified arbitrators and y non-chair-qualified arbitrators in a hearing location, chair-qualified arbitrators will occupy both public seats on three-arbitrator panels $(x - 8)/(x + y - 8)$ of the time. For example, if $x = y = 50$ (so that there are 50 chair-qualified arbitrators and 50 non-chair-qualified arbitrators), chair-qualified arbitrators can be expected to occupy both public seats on 42/92, or approximately 46%, of three-arbitrator panels.

location with 40 chair-qualified public arbitrators and 40 non-chair-qualified public arbitrators. The benefit of beginning the quantitative discussion with actual numbers instead of the variables "x" and "y" is that doing so will make it easier to see what is happening to the quantities involved and may help to impart a more intuitive feel for the size of the problem.

Part "B" of this section then will generalize the analysis, replacing each numerical calculation with an algebraic formula. Using the resulting formulas, anyone with knowledge of the number of arbitrators in the chair-qualified pool and the non-chair-qualified pool will be able to determine the precise consequences of the tampering for which the NASD is seeking accelerated approval.

The derivation of formulas in Part "B" is not the product of complicated mathematics. It should be accessible to anyone who has had a year of algebra. While the expressions may look daunting at first, you will see that, when boiled down, the resulting formulas are simple and elegant. To make this more approachable, the article shows each step in the calculations and derivations and, in addition, provides plain-English explanations where they will be helpful.

Readers who are good at algebra will find all of this quite easy. It is my hope that those whose algebra skills are a bit rusty will find them less rusty after working through Part "B." The key to reading Part A and especially Part B (or any other mathematical discussion, for that matter) is to read them slowly and to think about each step until you are sure you understand why it is correct (or can show why it is in error). The plain-English explanations accompanying each mathematical statement may prove helpful in this regard.

While probability concepts also figure in this analysis, the knowledge of probability theory required for an understanding of the quantitative discussion below is minimal. That may seem surprising at first, given that arbitrators will be selected at random[9], rather than by "rotation," under the revised code of arbitration procedure.[10 11 12]

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[9] See Rule 12400(a):

> **"12400. Neutral List Selection System and Arbitrator Rosters**
> **(a) Neutral List Selection System**
> The Neutral List Selection System is a computer system that generates, on a random basis, lists of arbitrators from NASD's rosters of arbitrators for the selected hearing location for each proceeding. The parties will select their panel through a process of striking and ranking the arbitrators on lists generated by the Neutral List Selection System."

[10] The current "rotational" system is not a rotation at all. Rather, it employs an algorithm that attempts to match what a true rotation would do. It does this without complete success. For more about this, see Bernstein, Scot, "Understanding NLSS or How I Learned To Stop Worrying and Love List Selection," *PIABA Ninth Annual Meeting*, October 2000.

A number of public comments filed in response to prior amendments to the revised code of arbitration procedure called for annual audits of the NASD's new "random" system for generating lists of arbitrators for striking and ranking purposes. The comments sought to inject a bit of transparency into the arbitrator selection process. Here is the relevant text from the NASD's Amendment 5 filing, at page 20:

> **"Neutral List Selection System and Arbitrator Rosters (Rule 12400(a))**
>
> Nineteen commenters suggest that NASD hire a neutral third party, not connected to NASD or the securities industry, to conduct an annual audit of the Neutral List Selection System (NLSS), and make the results of the audit publicly available on NASD's Web site.

> NASD is committed to ensuring that the NLSS operates as described in the Customer Code. Thus, NASD plans to hire an independent auditor to conduct an initial audit of the system and will make public the results of the audit. Thereafter, NASD will conduct an audit on an as needed basis."

See NASD Amendment Number 5 to SR-NASD-2003-158, May 4, 2006, page 20 (footnote omitted).

Apparently, the NASD thinks that having a one-time independent audit at the inception of a system that will select arbitrators for thousands of disputes each year for many years is sufficient because it will conduct further audits on its own (it doesn't say whether those results will be made public) whenever it wants (what else could "as needed" mean, given that the NASD gets to decide when an audit is "needed"?).

[11] As long as we're discussing other problems with the NASD's proposal, here's another: ties during the process of consolidating rankings will be handled in a less desirable manner under the proposed rule. The proposed approach is described in footnote 63 to the NASD's Amendment 5 filing, at page 23:

> "63 The system will select randomly one name at a time for each list (i.e., chair, public, non-public), and list the names in the order in which they were selected. The first arbitrator selected would be Arbitrator #1; the second would be Arbitrator #2, etc. After the parties have made their selections and the lists have been consolidated, in the unlikely event of a tie among arbitrators, the system will break the tie based on the order in which the arbitrators were placed on the list. So, for example, if Arbitrators 3 and 5 are "tied" after the public lists are consolidated, the system will select Arbitrator 3 for the public non-chair position, because the system selected him or her before Arbitrator 5."

Previously, ties were broken based on the lowest difference between the parties' rankings. For example, if your #1-ranked arbitrator were my #3-ranked arbitrator, and if your #2-ranked arbitrator were my #2-ranked arbitrator, both arbitrators would tie for top-ranked with the same sum: 4. But two minus two is less than three minus one, so the arbitrator ranked as both parties' second choice would be chosen. The greater fairness inherent in using the lowest difference as the tie-breaker is self-evident. The NASD's proposal, while it may make things administratively easier for the NASD, comes at some cost in terms of fairness. The NASD's "order of selection" approach should be used only when two arbitrators are tied in both sums and differences.

[12] Other list-selection problems arise in connection with "strikeouts" – situations in which the joint selection process leaves no one standing. While the limited strikes in the proposed rule will make strikeouts less common, they still will occur. An example would be the situation in which the lone mutually-ranked arbitrator could not or would not agree to serve. Proposed rule 12406(c) will handle strikeouts as follows:

> **"12406. Appointment of Arbitrators; Discretion to Appoint Arbitrators Not on List**. . .
>
> (c) If the number of arbitrators available to serve from the combined list(s) is not sufficient to fill an initial panel, the Director will appoint one or more arbitrators of the required classification to complete the panel from names generated randomly by the Neutral List Selection System. If the Director must appoint a non-public arbitrator, the Director may not appoint a non-public arbitrator as defined in Rule 12100 (p)(2) or (3), unless the parties agree otherwise. The Director will provide the parties information about the arbitrators as provided in Rule 12403 and the parties will have the right to challenge the arbitrators as provided in Rule 12410."

The first sentence of this text could be interpreted to give the Director the right to pull a number of randomly-selected names from the system and to make the choice from among them to fill the vacancy. That would be unfair to investors, who should not have to vest discretion to choose arbitrators in an organization that is, after all, a membership association of the investors' opponents. A better and fairer approach, one that would enhance rather than detract from the parties' control over their dispute, would be to fill all vacant seats (whether they occur by strikeout, by later resignation of an arbitrator, or by any other means) in the following order of preference: (1) If there are arbitrators in the same classification who were mutually ranked by the parties (*i.e.*, not stricken by either party), then the highest ranked among those arbitrators shall be appointed to fill the vacancy; (2) if there is no mutually-ranked arbitrator in the appropriate classification to fill the vacancy, then the next randomly-selected arbitrator in that classification shall be appointed to fill the vacancy.

Nonetheless, the only probability concepts needed for an understanding of this paper are those which many readers probably understand intuitively:

1. If you are in a group of ten people out of which one person will be picked at random, you have a 10% chance – or equivalently, a probability of 1/10 – of being picked.

2. The sum of the probabilities of all possible outcomes, taken together, must equal 1.0 or, equivalently, 100%. For example, if you will either be late or not be late and there is no other possibility, and if you have a 30% chance of being late, then you must have a 70% chance of not being late.

3. The probability of a sequence of independent events occurring is the product of the probabilities of the individual events. For example, if the probability of "heads" is ½, the probability of tossing "heads" three times in three tosses is ½ x ½ x ½, or one in eight. Indeed, each of the eight possible sequences that can occur in three tosses of a coin has this same probability; and, consistent with item 2 above, 8 x 1/8 = 1.

The calculations and the derivations of formulas below assume application of the NASD's proposed rules that (1) a list of 8 potential chairs will be drawn randomly from the chair-qualified pool; (2) all ***other*** arbitrators in the chair-qualified pool will be combined with the arbitrators in the non-chair-qualified pool and a list of 8 potential non-chair public arbitrators will be drawn randomly from that combined pool; and (3) the parties then will proceed with striking and ranking. The illustrative numerical calculations in Part "A" assume, in addition, that there are exactly 40 chair-qualified arbitrators and exactly 40 non-chair-qualified arbitrators.

That's it. The calculations and formula derivations below are not based on assumptions that are controversial or the subject of argument. Rather, they are knowable *a priori*, the result of a straightforward application of algebra to the NASD's proposed rule.

A. Calculations Assuming 40 Arbitrators in Each Pool

For purposes of these calculations,

Let $P_{\text{described event}}$ = probability of that event.

A1. Average Probability[13] of Chair-Qualified Arbitrator Serving as Chair:

$$P_{\text{chair-qualified arbitrator serving as chair}} = \frac{8}{40} \cdot \frac{1}{8} = \frac{1}{40} = \frac{9}{360}$$

In plain English, a chair-qualified arbitrator in a pool of 40 has, on average, 8 chances in 40 of being placed on a chair strike-and-rank list and 1 chance in 8 of being selected as chair. A chair-qualified arbitrator's chances of serving as chair are, of course, independent of and unaffected by any tampering with the selection of the non-chair. And a chair-qualified arbitrator's chances of serving in any capacity in the absence of tampering are equal to that individual's chances of serving as chair because, without tampering, chair is the only available position. I have provided the conversion of 1/40 to 9/360 for reasons that will become apparent in A3, below.

A2. Average Probability of Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Untampered:

$P_{\text{chair-qualified arbitrator serving as non-chair if selection untampered}} = 0$

This is simply a mathematical way of expressing the idea that, absent the tampering inherent in the NASD's proposed rule, a chair-qualified arbitrator would have no chance of serving as a public non-chair.

A3. Average Probability of Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Tampered to Boost Chairs' Odds:

$$P_{\text{chair-qualified arbitrator serving as non-chair if selection tampered}} = \frac{32}{40} \cdot \frac{8}{72} \cdot \frac{1}{8} = \frac{1}{90} = \frac{4}{360}$$

A chair-qualified arbitrator in a pool of 40 has, on average, 32 chances in 40 of ***not*** being placed on a chair strike-and-rank list and instead being added into the 40-arbitrator non-chair roster to create a 72-arbitrator combined roster; eight chances in 72 of being placed on a non-chair strike-and-rank list; and 1 chance in 8 of being selected as the non-chair public arbitrator. The reason for expressing the results in 360ths is now clear: that figure serves as a common denominator that will make it possible to add the results of A1 and A3.

One further comment is in order here, because it will be useful in A4 and A7, below: this probability of a chair-qualified arbitrator serving in an additional capacity (*i.e.*, as a public non-chair) represents the *increase* in the chair-qualified arbitrator's probability of serving in *any* capacity.

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[13] "Different arbitrators will be differently ranked. Thus, their individual probabilities of serving cannot be determined. But, in a group of eight arbitrators of which one must serve as chair, the ***average*** probability of serving for the eight arbitrators is 1/8. Similarly, when the groups of chair-qualified and non-chair-qualified arbitrators are mixed for public non-chair selection purposes as the NASD has proposed, we cannot say whether there is any difference between an average chair-qualified arbitrator's and an average non-chair-qualified arbitrator's probabilities of being mutually ranked and selected as the public non-chair. The calculations and derivations in this article assume that arbitrators from the two groups, once their names are included on a public non-chair strike-and-rank list, have the same average probability of being selected.

A4. Average Probability of Chair-Qualified Arbitrator Serving In Any Capacity if Selection Tampered to Boost Chairs' Odds (see A1 and A3):

$$P_{\text{chair-qualified arbitrator serving on panel in any capacity if selection tampered}} = \frac{9}{360} + \frac{4}{360} = \frac{13}{360}$$

This is just the sum of A1 and A3 – the average probabilities of serving as the chair and as the public non-chair, respectively.

A5. Average Probability of *Non*-Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Untampered:

$$P_{\text{non-chair-qualified arbitrator serving as non-chair if selection untampered}} = \frac{8}{40} \cdot \frac{1}{8} = \frac{1}{40} = \frac{9}{360}$$

A non-chair-qualified arbitrator in a pool of 40 has, on average, 8 chances in 40 of being placed on a non-chair strike-and-rank list and 1 chance in 8 of being selected as non-chair – the same as a chair-qualified arbitrator's chances of being selected as chair out of a 40-arbitrator chair-qualified roster. Note that a non-chair-qualified arbitrator's chances of serving in any capacity are equal to that individual's chances of serving as public non-chair because non-chair is the only position available to non-chair-qualified arbitrators.

A6. Average Probability of *Non*-Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Tampered to Boost Chairs' Odds:

$$P_{\text{non-chair-qualified arbitrator serving as non-chair if selection tampered}} = \frac{8}{72} \cdot \frac{1}{8} = \frac{1}{72} = \frac{5}{360}$$

A non-chair-qualified arbitrator in a combined pool of 72 has, on average, 8 chances in 72 of being placed on a non-chair strike-and-rank list and 1 chance in 8 of being selected as non-chair – a 44% reduction in the non-chair-qualified arbitrator's likelihood of being appointed.

Note that the non-chair's chances of serving are now 5/360, a decrease of 4/360 from the untampered figure of 9/360 shown in A5. As must be the case, this 4/360 reduction is equivalent to a chair-qualified arbitrator's chances of serving as a public non-chair if the system is tampered. In other words, the tampering has the effect of *transferring* a 4-in-360 chance of serving as a public-non-chair from the non-chair-qualified arbitrators to the chair-qualified arbitrators.

A7. Average Percentage Increase in Probability of Chair-Qualified Arbitrator Serving In Any Capacity as a Result of Tampering (see A1 through A4):

Average Percentage Increase = $\frac{4}{360} \div \frac{9}{360} = 44\%$

This is A3 divided by A1 or, equivalently, (A4 minus A1) divided by A1.

A8. Average Percentage Decrease in Probability of *Non*-Chair-Qualified Arbitrator Serving as a Result of Tampering (see A5 and A6):

Average Percentage Decrease = $\frac{4}{360} \div \frac{9}{360} = 44\%$

This is (A5 minus A6) divided by A5. Note that the non-chair-qualified arbitrator's 44% decrease equals the chair-qualified arbitrator's 44% increase (see A7).

A9. Ratio *Without* Tampering of
- Average Chair-Qualified Arbitrator's Probability of Serving in Any Capacity
to
- Average *Non*-Chair Qualified Arbitrator's Probability of Serving in Any Capacity
(*i.e.*, A1 divided by A5)

Ratio = $\frac{9}{360} \div \frac{9}{360} = 1.0$

Thus, when they come from pools of equal size, the chair-qualified arbitrator has no advantage over the non-chair-qualified arbitrator in the absence of tampering.

A10. Ratio *With* Tampering of
- Average Chair-Qualified Arbitrator's Probability of Serving in Any Capacity
to
- Average *Non*-Chair Qualified Arbitrator's Probability of Serving in Any Capacity
(*i.e.*, A4 divided by A6)

Ratio = $\frac{13}{360} \div \frac{5}{360} = 2.6$

> **(*Thus, chair-qualified arbitrators have gone from being on equal footing with non-chair-qualified arbitrators (based on equal pool size) to being selected, on average, 2.6 times as often.*)**

Let me expand a bit on this last calculation. To make probabilities more approachable and intuitive, it sometimes helps to replace them with something more concrete. Suppose you and I each have ten dollars. We both have the same amount of money. Next, suppose I get an extra five dollars. Now I have one and a half times as much money as you have, right? Well, it depends. If I got that extra five dollars from some third-party source, the answer is "yes." But if I got the five dollars by taking it from you, I now have three times as much money as you have.

The probability situation is much the same. To simply the example, if I am one of ten chair-qualified arbitrators and you are one of ten non-chair-qualified arbitrators, each of us has an equal one-in-ten chance of serving on any given panel. But if all ten of the chair-qualified arbitrators suddenly are injected into the non-chair-qualified arbitrators' selection process, I now have not only my one chance in ten of being selected as chair, but an additional chance in twenty of being selected as a public non-chair. So now I have three chances in twenty of being selected. You, in contrast, now have only one chance in twenty of serving, down from your previous one in ten. And I now have three times the chance to serve that you have.

B. Deriving a General Formula

Arbitrator pool sizes vary from one hearing location to the next. Thus, this section will derive a general formula for the skewing described in this article. A formula will be developed corresponding to each calculation in A1 through A10 above. To use the formulas, the reader will need to know the sizes of the chair-qualified and non-chair-qualified pools at the hearing location in question – nothing more. For these purposes,

Let x = number of arbitrators in chair-qualified pool
Let y = number of arbitrators in non-chair-qualified pool
Let $P_{\text{described event}}$ = probability of that event

B1. Average Probability of Chair-Qualified Arbitrator Serving as Chair:

$$P_{\text{chair-qualified arbitrator serving as chair}} = \frac{8}{x} \cdot \frac{1}{8} = \frac{1}{x}$$

In plain English, a chair-qualified arbitrator in a pool of x arbitrators has, on average, 8 chances in x of being placed on a chair strike-and-rank list and 1 chance in 8 of being selected as chair. A chair-qualified arbitrator's chances of serving as chair are, of course, independent of and unaffected by any tampering with the selection of the non-chair. And the chair-qualified arbitrator's chances of serving in any capacity in the absence of tampering are equal to that individual's chances of serving as chair because, without tampering, chair is the only available position.

B2. Average Probability of Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Untampered:

$$P_{\text{chair-qualified arbitrator serving as non-chair if selection untampered}} = 0$$

As in A2, absent the tampering inherent in the NASD's proposed rule, a chair-qualified arbitrator would have no chance of serving as a public non-chair.

B3. Average Probability of Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Tampered to Boost Chairs' Odds:

$$P_{\text{chair-qualified arbitrator serving as non-chair if selection tampered}} = \frac{x-8}{x} \cdot \frac{8}{x+y-8} \cdot \frac{1}{8} = \frac{x-8}{x(x+y-8)}$$

A chair-qualified arbitrator in a pool of x has, on average, (x – 8) chances in x of ***not*** being placed on a chair strike-and-rank list and instead being added into the y-arbitrator non-chair roster to create an (x+y-8)-arbitrator combined roster; 8 chances in (x+y-8) of being placed on a non-chair strike-and-rank list; and 1 chance in 8 of being selected as the non-chair public arbitrator.

Just as in A3, this probability of a chair-qualified arbitrator serving in an additional capacity (*i.e.*, as a public non-chair) represents the *increase* in the chair-qualified arbitrator's probability of serving in any capacity.

B4. Average Probability of Chair-Qualified Arbitrator Serving In Any Capacity if Selection Tampered to Boost Chairs' Odds (see B1 and B3):

$P_{\text{chair-qualified arbitrator serving on panel in any capacity if selection tampered}} =$

$$\frac{1}{x}+\frac{x-8}{x(x+y-8)}=\frac{(x+y-8)}{x(x+y-8)}+\frac{x-8}{x(x+y-8)}=\frac{2x+y-16}{x(x+y-8)}$$

This is just the sum of B1 and B3 – the average probabilities of serving as the chair and as the public non-chair, respectively.

B5. Average Probability of *Non*-Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Untampered:

$P_{\text{non-chair-qualified arbitrator serving as non-chair if selection untampered}} = \frac{8}{y}\cdot\frac{1}{8}=\frac{1}{y}$

A non-chair-qualified arbitrator in a pool of y has, on average, 8 chances in y of being placed on a non-chair strike-and-rank list and 1 chance in 8 of being selected as non-chair. In the special case where x = y (in other words, where the pools are of equal size) chair-qualified arbitrators and non-chair-qualified arbitrators have, on average, equal chances of being selected as long as the system is untampered.

B6. Average Probability of *Non*-Chair-Qualified Arbitrator Serving as Public Non-Chair if Selection Tampered to Boost Chairs' Odds:

$P_{\text{non-chair-qualified arbitrator serving as non-chair if selection tampered}} = \frac{8}{(x+y-8)}\cdot\frac{1}{8}=\frac{1}{(x+y-8)}$

A non-chair-qualified arbitrator in a combined pool of (x+y-8) has, on average, 8 chances in (x+y-8) of being placed on a non-chair strike-and-rank list and 1 chance in 8 of being selected as non-chair. This is a substantial reduction from the previous 1/y chance that the average non-chair-qualified arbitrator would have of being appointed in the absence of an infusion of chair-qualified arbitrators into the non-chair pool. This is the general case of the calculated numerical reduction seen in A6.

B7. Average Increase in Probability of Chair-Qualified Arbitrator Serving In Any Capacity as a Result of Tampering (see B1 through B4):

Increase = $\frac{x-8}{x(x+y-8)}$

This is simply the chair-qualified arbitrator's added probability of serving as a non-chair. It therefore is equivalent to B3.

Relative Increase = $\frac{x-8}{x(x+y-8)} \div \frac{1}{x} = \frac{x(x-8)}{x(x+y-8)} = \frac{(x-8)}{(x+y-8)}$

This is the chair-qualified arbitrator's added probability of serving divided by the chair-qualified arbitrator's initial probability of serving if the system were untampered – *i.e.*, B3 divided by B1. To express it as a percentage, multiply by 100. This is the general version of the numerical result reached in A7.

B8. Average Decrease in Probability of Non-Chair-Qualified Arbitrator Serving as a Result of Tampering (see B5 and B6):

Decrease = $\frac{1}{y} - \frac{1}{(x+y-8)} = \frac{(x+y-8)}{y(x+y-8)} - \frac{y}{y(x+y-8)} = \frac{(x-8)}{y(x+y-8)}$

This is simply the non-chair-qualified arbitrator's reduction in probability of serving as a non-chair – *i.e.*, B5 minus B6.

Relative Decrease = $\frac{(x-8)}{y(x+y-8)} \div \frac{1}{y} = \frac{(x-8)}{y(x+y-8)} \cdot \frac{y}{1} = \frac{(x-8)}{(x+y-8)}$

This is the reduction in a non-chair's probability of serving divided by the initial probability of serving in an untampered system – *i.e.*, (B5 minus B6) divided by B5. To express it as a percentage decline, multiply by 100. Note that the non-chair-qualified arbitrator's relative decrease equals the chair-qualified arbitrator's relative increase (see B7).

B9. Ratio *Without* Tampering of
- Average Chair-Qualified Arbitrator's Probability of Serving in Any Capacity
to
- Average Non-Chair Qualified Arbitrator's Probability of Serving in Any Capacity (see B1 and B5)

Ratio = $\frac{1}{x} \div \frac{1}{y} = \frac{1}{x} \cdot \frac{y}{1} = \frac{y}{x}$

Thus, in the absence of tampering, the chair-qualified arbitrators and non-chair-qualified arbitrators have chances of serving that vary inversely with the sizes of their respective pools. In the special case where they come from pools of equal size, they have equal chances of serving.

B10. Ratio *With* Tampering of
- Average Chair-Qualified Arbitrator's Probability of Serving in Any Capacity
to
- Average Non-Chair Qualified Arbitrator's Probability of Serving in Any Capacity
(see B4 and B6)

Ratio = $\frac{2x+y-16}{x(x+y-8)} \div \frac{1}{(x+y-8)} =$

$$\frac{2x+y-16}{x(x+y-8)} \cdot \frac{(x+y-8)}{1} = \frac{2x+y-16}{x} = \frac{2x}{x} + \frac{y}{x} - \frac{16}{x} = 2 + \frac{y}{x} - \frac{16}{x} = \frac{y}{x} + 2 - \frac{16}{x}$$

This final expression - $\frac{y}{x} + 2 - \frac{16}{x}$ - is particularly helpful to understanding all of this because it shows that the ***increase*** over the untampered odds (which were y/x, as shown in B9) ***always*** will be equal to $2 - \frac{16}{x}$. This simple formula can be applied to any combination of pool sizes to determine the precise effect of the NASD's proposed skewing.

Thus, for example, in a situation where the chair-qualified arbitrators and the non-chair-qualified arbitrators have an equal chance of serving in an untampered system (that is, where the pools are of equal size and y/x therefore is equal to 1) and the pool size is 80, the chair-qualified arbitrators benefiting from the NASD's proposed rule will have **2.8 times** the chance of serving that the non-chair-qualified arbitrators will have – that is, 1 + 2 – 16/80 = 3 – 0.2 = 2.8.

To take an example from the table that appeared early in this article, suppose there are 50 chair-qualified arbitrators and 100 non-chair-qualified arbitrators. In an untampered system, the chair-qualified arbitrators would be twice as likely to serve as the non-chair-

qualified arbitrators, because there are half as many of them. But with the NASD's proposed tampering, the chair-qualified arbitrators will have **3.68 times** the likelihood of serving that the non-chair-qualified arbitrators will have – that is, 2 + 2 – 16/50 = 4 – 0.32 = 3.68.

Conclusion

The NASD's proposed inclusion of chair-qualified arbitrators in the non-chair-qualified arbitrators' pool for public non-chair list selection purposes may look innocuous at first blush. But it is far from innocuous when its real effects are quantified. The devil is in the details. One can only hope that the SEC will display an understanding of the mathematics of list selection by denying the NASD's request.

"Pay Me, But Don't Blame Me": The Merrill Rule

By Samuel Edwards

I. Introduction

As practitioners in the securities arbitration arena, we are often faced with difficult law, difficult facts and difficult panels. These "difficulties" (to use a euphemism) often place nice, trusting people in the unenviable position of losing much of their retirement savings and offer little chance of recovering their losses. Although the law regulating securities is supposed to protect those who cannot protect themselves, what little law that continues to develop in this area seems to only erode those protections. The Merrill Rule, espoused by the SEC, is just another in the line of example of how the entire securities industry, including the regulatory bodies charged with policing the securities industry, continue to work against the public investor.

The impact of this rule could be enormous for those of us who often arbitrate suitability cases based on principles of asset allocation, continuing obligations of the broker and his firm, and failures to disclose certain facts. If broadly applied, the Merrill Rule could be interpreted to mean that brokers at major wirehouses, despite representing to their customers that they are "Financial Advisors" or "Financial Consultants", have little more responsibility than discount brokerage firms. Moreover, because of these loose interpretations of legal responsibility, the major Wall Street firms will be able to continue to charge a large premium for their "services", but be almost completely immune from any responsibility when those high commission "services" are negligently used. Ultimately, the Merrill Rule could allow the major firms the legal authority to finally argue what they truly want: a "pay me, don't blame me" policy that is completely antithetical to the principles of securities regulation and investor protection.

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II. Background for Securities Regulation

Under Federal Law, there are two sets of statutes in place for regulating financial service professionals. The Securities Exchange Act of 1934 controls the activities of broker-dealers while the Investment Advisers Act of 1940 regulates investment advisers.[1] It is important to distinguish the two from each other in order to understand their functions, the requirements they lay out as obligations to the client as well as how they are affected by the Merrill Rule.[2]

[1] Securities Exchange Act of 1934 15 U.S.C. § 78a (2002); Investment Advisers Act of 1940 15 U.S.C. § 80b-2(a)(11) (2001).

A. The '34 Act

The United States Congress passed the Securities Exchange Act in 1934 in response to the "Great Depression" and loss of confidence in the financial markets.[3] The Securities Exchange Act defines a broker as a person "engaged in the business of effecting transactions in securities for the account of others."[4] Conversely, a dealer is defined as a person "engaged in the business of buying and selling securities for [its] own account."[5] "Brokerage services" have been interpreted by the SEC to encompass:

> "services provided throughout the execution of a securities transaction, including providing research and advice prior to a decision to buy or sell, implementing that decision on the most advantageous terms and executing the transaction, arranging for delivery of securities by the seller and payment by the buyer, maintaining custody of customer funds and securities and providing recordkeeping services."[6]

Only a broker-dealer may perform these tasks of executing securities transactions for clients.

Broker-dealers are held to a suitability standard.[7] That is, any recommendation must be "suitable" for the client based on their objectives and current financial situation.[8] Unlike a fiduciary, they are not required to obtain the customer's informed consent before engaging in self-dealing transactions.[9] Broker-dealers are, however, susceptible to claims for fraud and negligence if they pass false or deceptive information along to a customer.[10]

B. The '40 Act

The Advisers Act was enacted in 1940 with the purpose of protecting investors and the general public from receiving poor securities advice.[11] The Advisers Act provided regulation in a highly unregulated securities market after the Commission submitted the "Investment Council Report" to Congress.[12] The Report recognized two main problems

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[2] A third type of financial professional, financial planners, are most commonly treated as investment advisors for regulatory purposes. Barbara Black, *Brokers and Advisers – What's In A Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 39 (2005). As the SEC explains, financial planning involves "assisting clients in identifying long-term economic goals, analyzing their current financial situation, and preparing a comprehensive financial program to achieve those goals." Id.

[3] Securities Exchange Act of 1934 15 U.S.C. § 78a (2002).

[4] Barbara Black, *Brokers and Advisers – What's In A Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 36 (2005).

[5] Id.

[6] Id.

[7] Id.

[8] Id.

[9] Id.

[10] Id.

[11] *See* Johnston v. CIGNA Corp., 916 P.2d 643, 646 (Colo. Ct. App. 1996) (stating the purpose of the Investment Advisers Act of 1940).

among investment advisers: "(a) the problem of distinguishing between bona fide investment counselors and 'tipster' organizations; and (b) those problems involving the organization and operation of investment counsel institutions."[13] The Advisers Act helped resolve these problems and sought to distinguish certain professionals from investment advisers.

As background, up until the end of World War I, customers paid fixed commissions for investment advice.[14] Later, in 1920, investment advice was offered for a separate and specific fee.[15] As a result, it was easy to differentiate broker-dealers from those who received "special compensation." However, in today's environment, the line between brokers and financial advisors has been blurred.

> The Advisers Act defines "investment adviser" as:
> "[A]ny 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 regulator business, issues or promulgates analyses or reports concerning securities…"[16]

This appears to include a variety of professionals, from those who publish stock tips online to those who manage complex investment portfolios.[17] In *SEC v. Capital Gains Research Bureau*, the Supreme Court stated that an investment adviser's function is "furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments."[18] The difference between a "broker" and an "adviser" is more than mere semantics as the obligations and standards of each vary greatly. While broker-dealers are only held to a suitability standard, investment advisers owe a fiduciary duty to their clients.[19] This is a duty of complete loyalty where the professional must disclose his actions in writing and obtain client consent before proceeding.[20]

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[12] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 87 (2006) (citing INVESTMENT COUNSEL REPORT, supra note 38, at 1).

[13] Id. at 88 (citing INVESTMENT COUNSEL REPORT, supra note 38, at 27).

[14] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 83 (2006).

[15] Id.

[16] Investment Advisers Act of 1940 15 U.S.C. § 80b-2(a)(11) (2001).

[17] Barbara Black, *Brokers and Advisers – What's In A Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 38 (2005).

[18] *See,* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 187 (1963).

[19] Barbara Black, *Brokers and Advisers – What's In A Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 38 (2005).

[20] Id. at 39.

In today's environment of "full service" firms, it would seem that virtually every broker at a major wirehouse would be deemed a financial advisor and have those heightened responsibilities. However, Section 80b-2(a)(11) of the Advisors Act provides exceptions under which these professionals can avoid its provisions.[21] The Broker-Dealer Exception provides that "any broker or dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefore…" is exempt from the Advisors Act.[22] It is this exemption that the Merrill Rule discusses and it clearly favors Wall Street and its continual attempts to receive high commissions with no responsibility.

III. The Merrill Rule

The Merrill Rule was created to determine when a broker-dealer's activities are subject to the Advisers Act.[23] The rule was developed in response to the increased use of fee-based wrap accounts. Fee-based brokerage programs provide brokerage services packages for an asset-based fee or a fixed-fee.[24] Packages normally include investment advice. The benefit of fee-based programs is that they discourage churning of accounts.[25] Churning is a problem in commission-based compensation because broker-dealers are tempted to sell packages that will provide them with the greatest commission rather than acting in what is necessarily the customer's best interests. Contrarily, the fee-based programs often result in an increase in "reverse churning." Broker-dealers under this program no longer have greater commissions as motivation to act so it is common that they remain idle when account activity would actually be more proper.

This trend towards the use of "wrap accounts" gained significant momentum when Merrill Lynch announced its new Unlimited Advantage program in 1999 — a change to traditional brokerage programs because it was to charge an asset-based fee in lieu of a commission. The program was necessary because other brokerage firms were offering services for under $10 per each trade, and the public was no longer as willing to pay Merrill's hefty commissions.[26] Although many were happy that customer and broker interests would be more appropriately aligned due to a decrease in churning, Merrill Lynch soon realized that its new program would subject it to the Advisers Act. Merrill was obviously selling advice when it advertised that a "'Financial Consultant' will 'help you develop investment strategies,' including 'retirement planning, saving for college, estate preservation and liability-management

[21] Investment Advisers Act of 1940 15 U.S.C. § 80b-2(a)(11) (2001).

[22] 15 U.S.C. §80b-2(a)(11)(C) (2001).

[23] Final Rule Release: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Exchange Act Release No. 51,523, Investment Advisers Act, Release No. 2376, 70 Fed. Reg. 20,424 (April 19, 2005).

[24] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 73 (2006).

[25] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 75 (2006).

[26] *See* Mercer Bullard, *Proposed SEC Rule on Brokers Makes No Sense*, (May 15, 2001), *at* http://www.thestreet.com/funds/mercerbullard/1429187.html.

strategies.'"[27] In an attempt to increase the usage of these programs, then SEC Chairman Arthur Levitt proposed to exempt broker-dealer advisory services from the Advisers Act regulation. Thus, the new Rule 202(a)(11)-1 has been dubbed the "Merrill Rule."[28]

A. The Original SEC Merrill Rule

The SEC first proposed the Merrill Rule on November 4, 1999 under the name "Certain Broker-Dealers Deemed Not To Be Investment Advisors."[29] Under this new rule, those broker-dealers who are not excepted from the Advisers Act must register under the Act and treat their clients with advisory accounts as advisory clients rather than regular brokerage customers.[30]

Under this initial proposal, the Rule provided that broker-dealers are not considered investment advisers under the Advisers Act regardless of any compensation received as long as 1) the advice given is not discretionary; 2) the advice given is solely incidental to the brokerage services provided; and 3) the broker-dealer discloses to his customers that their accounts are brokerage rather than advisory accounts.[31] By constructing the rule this way, the SEC was hoping to shift the focus away from the type of compensation received to the actual type of services provided.[32] In a fee-based program, one would think that the fee would equate to "special compensation." However, the SEC has interpreted this model as having simply re-priced the older programs rather than creating special fees for advisory services.[33] This interpretation allows broker-dealers who are in fact providing investment advice to avoid the "special compensation" prong of the Broker-Dealer Exception.

Regardless of the SEC's intentions, this reading essentially rendered the meaning of "special compensation" within the Broker-Dealer Exception completely meaningless. Normal rules of statutory construction dictate that all words in a given statute are to be treated as if they have meaning.[34] Thus, the idea that a broker-dealer can avoid the Advisers Act regardless of the type of compensation seemed to many to be an improper reading of the statute.

Immediately after its proposal in 1999, the Merrill Rule became the source of significant

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[27] Id.

[28] Id.

[29] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 72 (2006).

[30] Id. at 73.

[31] 17 C.F.R. § 275.202(a)(11)-1, *published* 70 Fed. Reg. 20,424 (April 19, 2005).

[32] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 75 (2006).

[33] Id. (explaining that although brokerage services have changed over time, the basic structure has remained the same).

[34] *See*, U.S. v. Ven-Fuel Inc., 758 F.2d 741, 751-52 (1st Cir. 1985) (explaining that "all words and provisions of statutes are intended to have meaning… and no construction should be adopted which would render statutory words or phrases meaningless…").

controversy. In fact, after the first proposal, the Commission received more than 1,700 comment letters.[35] Not surprisingly, a strong majority of broker-dealers supported the Rule under the guise that the new fee-based brokerage programs better consider customer interests.[36] Moreover, broker-dealers believed that the Rule encouraged development of these new programs because the industry would not be susceptible to the more stringent rules of the Advisers Act.[37] In opposition, financial planners, investment advisors, and those groups who represent investors were against the Rule because it decreases the level of investor protection.[38] The SEC allowed different parties to comment on the proposal for an additional month in August 2004 in order to accommodate late letters, and then considered them for approximately three months.[39]

B. The Revised Merrill Rule

After reviewing the many comment letters, the SEC revised the Rule and submitted a reproposal in January 2005.[40] The reproposed rule included a few notable changes. For example, under the reproposal, the Merrill Rule now includes greater disclosure requirements in response to commenters' concerns about investor confusion on the differences between broker-dealers and investment advisers.[41] In addition, the Merrill Rule now requires that "all advertisements for, and all agreements, contracts, applications and other forms governing the operation of, a fee-based brokerage account contain a prominent statement that the account is a brokerage account and not an advisory account."[42] The disclosure must also include an explanation of the customer's rights and the firm's duties to the customer, including the appropriate standard of obligation.[43] The following statement must be displayed clearly on all client documents:

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[35] Due to the receipt of almost all of the letters after the comment period had ended, the comment period was extended. Id. at 76 (citing Investment Advisers Act Release No. 2278 (Aug. 18, 2004).

[36] Id. (citing Comment Letter of Merrill, Lynch, Pierce, Fenner & Smith Incorporated (Sept. 22, 2004); Comment Letter of Raymond James Financial, Inc. (Sept. 21, 2004); Comment Letter of Northwestern Mutual Investment Services, LLC (Sept. 22, 2004); Comment Letter of Smith Barney Citigroup (Jan. 14, 2000) for supporting the Rule); (citing Comment Letter of Citigroup Global Markets Inc. (Sept. 22, 2004); Comment Letter of Charles Schwab & Co. (Sept. 22, 2004); Comment Letter of Securities Industry Association (Aug. 5, 2004) for their belief that customers and brokers would have similar interests).

[37] Id.

[38] Id. at 77 (citing Comment Letter of American Institute of Certified Public Accountants (Sept. 22, 2004).

[39] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 72 n.15 (2006).

[40] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 78 (2006).

[41] Id.

[42] 17 C.F.R. § 275.202(a)(11)-1, *published* 70 Fed. Reg. 20,424 (April 19, 2005).

[43] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 79 (2006).

> "Your account is a brokerage account and not an advisory account. Our interests may not always be the same as yours. Please ask us questions to make sure you understand your rights and our obligations to you, including the extent of our obligations to disclose conflicts of interest and to act in your best interest. We are paid by both you and, sometimes, by people who compensate us based on what you buy. Therefore, our profits, and our salespersons' compensation, may vary by product and over time."[44]

Furthermore, broker-dealers are now required to make available a person within their firm to answer any customer questions on the above issues.[45]

The reproposed rule also attempted to appease commenters who worried about when, specifically, advisory services are not "solely incidental to" brokerage services.[46] The SEC responded by stating that investment advice is "solely incidental to" brokerage services when the advice is reasonably related to the regular brokerage services (which, of course, provided no real guidance).[47] The Commission also interpreted that financial planning services are not necessarily "solely incidental to" brokerage services.[48] Finally, the Commission mandated that when a broker-dealer exercises investment discretion over a client's account, he is no longer providing advice that is "solely incidental to" the business of brokerage under the Advisers Act.[49]

In one of the worst parts of the reproposal, the Commission chose not to include holding out limitations in the new Merrill Rule beyond those for financial planners. In relation to financial planning, the reproposed Merrill Rule states that a broker-dealer's advice is not solely incidental to brokerage services if it provides some type of financial plan or services "and: (i) holds itself out generally to the public as a financial planner or as providing financial planning services; or (ii) delivers to its customer a financial plan; or (iii) represents to the customer that the advice is provided as part of a financial plan or financial planning services."[50] In sum, if a broker-dealer advertises financial planning services, he must register under the Advisers Act.

Surprisingly, other than the above restriction, there are no other restrictions on how a broker holds himself out to the public. A broker may creatively title himself any way he chooses without facing liability under the

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[44] 17 C.F.R. § 275.202(a)(11)-1, *published* 70 Fed. Reg. 20,424 (April 19, 2005). The SEC states that the disclosure should be "included, at a minimum, on the front page of each document or agreement in a manner clearly intended to draw attention to it." *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 110 n.123 (2006).

[45] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 79 (2006).

[46] Id.

[47] Id.

[48] Id.

[49] 17 C.F.R. § 275.202(b)(3), *published* 70 Fed. Reg. 20,424 (April 19, 2005).

[50] Id.

Advisers Act.[51] Even the illusory terms "financial advisor" and "financial consultant" are allowed under the new Rule. The Commission came to this conclusion based on the fact that professionals in other related industries such as banks and insurance companies typically utilize such "generic" terms to describe a wide variety of different services. The SEC has determined that requiring broker-dealers to notify advisory clients of the stricter legal obligations is sufficient to protect investors.

Ultimately, according to the SEC's Merrill Rule, broker-dealers will not be subject to the Advisers Act when investment advice given is "solely incidental to" the brokerage services provided by the broker-dealer regardless of whether special compensation is received.[52] According to the SEC, a broker-dealer's advice is not "solely incidental" if he: 1) charges a separate fee for advisory services; 2) holds himself out to the public as a financial planner or as providing financial planning services; or 3) exercises investment discretion over a customer's account.[53] Such a broad interpretation essentially excludes all major Wall Street brokers from any liability under the Advisors Act. Moreover, it clearly excludes the typical fee-based account, despite the fact that many customers believe this fee-based account is beneficial to them and provides more protection.

C. SEC's Conclusions

The SEC drew several conclusions in support of the Merrill Rule. First of all, the Commission believes that the Advisers Act was created in order to avoid duplicative regulation of broker-dealers.[54] Under this belief, broker-dealers were already regulated by the Exchange Act; thus, Congress must not have intended to further restrain their activities under the Advisers Act which regulates a separate type of professional.

The SEC has also interpreted the Advisers Act to distinguish between broker-dealers who included advice in their brokerage services packages and those who charged a separate fee, usually through a special advisory department, for investment advice.[55] According to the Commission, the Advisers Act was only meant to regulate broker-dealers when they were charging a separate fee for investment advice.[56]

Lastly, the SEC believes that the Rule resulted in "an exception to the definition of investment adviser for broker-dealers only in circumstances in which the Commission believes that Congress did not intend to apply the Advisers Act, and clarifies certain

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[51] Id. at 124; *See also* Kevin Keogh, Gregory Gnall & Claudette R. Druehl, *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, 24 NO. 6 BANKING & FIN. SERVICES POL'Y REP. 1, 3 (2005) (describing how broker-dealers may hold themselves out under the Merrill Rule).

[52] 17 C.F.R. § 275.202(a)(11)-1, *published* 70 Fed. Reg. 20,424 (April 19, 2005).

[53] Id.

[54] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 91 (2006); *See also* 15 U.S.C. § 78a (regulating broker-dealers); 15 U.S.C. § 80b-2(a)(11)(C) (defining when a broker-dealer is subject to the Investment Advisers Act of 1940).

[55] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 92 (2006); *See also* 15 U.S.C. § 80b-2(a)(11)(C) (including broker-dealers who receive special compensation for advice under the Act).

[56] Id.

circumstances in which we believe the Advisers Act is intended to apply."[57] Thus, the Commission interpreted Congressional intent and created a Rule based on its own theories rather than following the plain-meaning of the statute.

IV. Problems with the Merrill Rule

The Merrill Rule is a source of great debate because, on its face, it appears to conflict with the Advisers Act. Moreover, the Merrill Rule dilutes consumer protection and creates industry confusion. The Merrill Rule also holds professionals who do the same job to different standards. Further, the Merrill Rule's disclosure requirements do not adequately inform customers of their rights. Finally, the Merrill Rule can be expected to harm the emergent financial planning industry in the long-term. In fact, the financial planning industry has taken this issue so seriously that the Financial Planning Association filed a lawsuit against the SEC on April 28, 2005 in the U.S. Court of Appeals, D.C. Circuit in order to challenge the Rule.[58] This suit is sure to be just one of many in the coming years, and it is time to begin formulating arguments for the inevitable conflicts that the Merrill Rule will cause.

A. The Merrill Rule Decreases Investor Protection

The Advisers Act was created with the goal and purpose of better protecting investors.[59] The Merrill Rule seeks to destroy some of the protections that Congress saw as essential in the securities industry. For example, a broker-dealer registered under the Advisers Act is held to a fiduciary standard.[60] An investment adviser has a duty to continuously monitor and provide advice for a customer's account.[61] As a result, remaining idle when account activity is more appropriate is a violation of that duty. Rather than follow these prudent investment policies, the Merrill Rule allows broker-dealers who are acting in the same advice-giving capacity to maintain the lower standard of suitability. This duty is not ongoing, as it simply lasts the length of a single transaction. As a result, investors do not receive the same level of protection under the Merrill Rule that they receive under the Advisers Act.

Moreover, the Merrill Rule increases the level of investor confusion in the marketplace. Even with the definitions included above, it should be no surprise that investors are perplexed by the differences between a broker-dealer, investment adviser and financial planner. Instead of making this distinction clear, the Merrill Rule further muddles the three by granting the same advice-giving powers to all three categories.

B. The Rule Contradicts the Plain-Meaning of the Advisers Act

In the Broker-Dealer Exception laid out in the Advisers Act, there is a very clear two-prong test that determines whether a broker-dealer is exempted from the Act.[62] The SEC has

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[57] Id. at 104.

[58] Heather Almand, *FPA Files New Lawsuit Against SEC*, NEWS RELEASE (The Financial Planning Association), April 28, 2005, at 30.

[59] *See* Johnston v. CIGNA Corp., 916 P.2d 643, 646 (Colo. Ct. App. 1996).

[60] Barbara Black, *Brokers and Advisers – What's In A Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 36 (2005).

[61] *See* SEC v. Capital Gains Research Bureau, 375 U.S. 180, 187 (1963).

[62] 15 U.S.C. § 80b-2(a)(11)(C) (2001).

essentially created new definitions for the terms "special compensation" and "solely incidental." Although the Advisers Act clearly states that a broker-dealer who receives special compensation for advice is required to register, the Commission has ignored the statutory language and determined that a broker-dealer is not to be considered an investment adviser simply because he receives some type of compensation.[63] Therefore, the Rule leaves one prong of the Broker-Dealer Exception completely meaningless.

Further, the Commission has interpreted "solely incidental" to mean any advisory services that are "in connection with and reasonably related to" the brokerage services.[64] This definition of "solely incidental" effectively allows every broker on Wall Street to avoid the restrictions of the Advisers Act. Also, it adds to market confusion because the SEC has failed to give any specific examples of what constitutes solely incidental advice. The bright-line two prong test has been abandoned by the SEC's own interpretation of the statute.

C. The Rule's Disclosure Requirements Are Insufficient to Fully Inform Customers

Although it is commendable that the SEC has attempted to increase investor awareness on the issue of the duties owed by financial service professionals, unsophisticated investors will not be informed as fully as they need to be in order to best protect themselves under the Merrill Rule. One problem is that customers may not realize that they are expected to understand that a broker-dealer may not be acting in their best interests. Many financial professionals portray themselves as fortifying trusting relationships with their clients; however, many times the broker and customer have separate and distinct goals which do not align with one another. Moreover, the statement printed on customer documents is easily overlooked as just one more fine-print, boiler-plate statement.

In addition, it is ridiculous to have someone within the firm serve as an "impartial" agent to whom customer questions are addressed. The person in the company designated to educate clients on the firm's legal obligations and the clients' risks and rights may have the same interest in the deal as the stockbroker. In fact, the designated person may also have their own departmental quotas to meet which, by definition, acts in opposition to the customer.

D. It Is Necessary For "Holding Out" Rules to Be More Specific

Confusion in the marketplace is also high because brokerage firms are able to creatively "hold themselves out" as touted financial advisers and consultants. This creates a false trust between clients and brokers because customers are unaware that the "financial advisor" is actually a broker-dealer that is held to a suitability standard, with no real fiduciary obligation to protect the customer's interests.[65] The current Merrill Rule prohibits brokerage firms from using "financial planning" when getting their name out to the public, but this leaves room for a myriad of other confusing terms to circumvent this ban.[66]

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[63] 17 C.F.R. § 275.202(a)(11)-1, *published* 70 Fed. Reg. 20,424 (April 19, 2005).

[64] 70 Fed. Reg. at 20,436.

[65] Barbara Black, *Brokers and Advisers – What's In A Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 36 (2005).

[66] *SEC Final Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers, Release No. 34-51523; IA-2376; File No. S7-25-99, April 12, 2005*, 1539 PLI/Corp 65, 123 (2006).

E. The Financial Planning Industry Will Suffer As a Result of The Rule

The financial planning industry is relatively new and growing rapidly. Although it has no specific statutory regulation, it is most often governed by the Advisers Act.[67] Thus, financial planners are held to the same fiduciary duties as investment advisers.[68] The Merrill Rule harms the growth of the industry by allowing broker-dealers to compete directly with financial planners while avoiding the stringent liability that financial planners face in their daily activities. This places an undue burden on financial planners who have to overcome obstacles that broker-dealers do not encounter in order to accomplish the same goal — providing competent personal advice to customers. Furthermore, encumbering financial planners in this way devalues the high integrity and ethics of their business practices. Finally, the Rule once again adds to the public's confusion over the differences between stockbrokers and financial planners, thereby harming an innovative industry during the height of its growth.

V. How to Deal with the Merrill Rule in Your Arbitrations

Whether we like it or not, the Merrill Rule is a part of the reality of securities arbitration. PIABA members will soon be hearing in many arbitrations how this involves a "mere broker" and therefore he/she had no obligation or duty to the client. As a result, we must learn to effectively refute these arguments if we are to better protect investors. Below are some ideas from this author for dealing with the Merrill Rule and the argument that the case involves a "mere broker."

A. Read the Contract

Despite legions of $800 an hour counsel reviewing their agreements, many of the brokerage industry contracts contain language representing that the broker and the firm will be watching out for the client or will be reviewing the account. This is especially true with the recommendation of outside money managers. In such cases, the contract between the firm and the customer often contains language that the firm will "monitor" the manager and provide "other financial services." Let's find such an agreement. Of course, the purpose behind this language is to justify the enormous fees the firm is charging for "carrying" the account. However, members can use that language to demonstrate that the firm has made a clear representation that it will be acting as a "financial planner" and therefore should be held to that standard.

B. Oral Representations

While a written contract is obviously preferable, in its absence, the words of a broker can be used to defeat arguments of their limited responsibilities. Brokers are notorious for making statements against their own interest and obligating themselves to heightened duties. It is important to obtain this information from your client at the beginning and to plead it in your statement of claim. First, it simply adds more credibility to your client's testimony if the statements were included from the very beginning. In addition, considering the rampant use of motions to dismiss in today's securities arbitrations, such language could be vital to defeating a motion to dismiss on the grounds that a claim has not been stated.

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[67] Barbara Black, *Brokers and Advisers – What's In A Name?*, 11 FORDHAM J. CORP. & FIN. L. 31, 39 (2005) (citing Investment Advisers Act Release No. 1092 (Oct. 8, 1987)).

[68] 15 U.S.C. § 80b-2(a)(11).

C. Check the Fee Structure

In addition to the above, the fee structure of many brokerage firms can be used to argue that the firm is receiving "special compensation" for its investment advice. For example, in many managed account agreements, the firms charge the client up to 3% of the assets under management. If you investigate what the manager is being paid, usually 50 basis points or less, you may find that the firm is charging from 2% to 3% to carry the account. If the normal wrap fee for such an account would only be 1%, there is 1% to 2% which is not accounted for in the fee structure. It could certainly be argued that this can only be termed "special compensation" for investment advice. Alternatively, it would have to be a violation of the "fair dealing" requirement of NASD Rule IM-2310-2, as the firm is clearly charging without providing any service.

D. Rely on State Law

Many members have long refused to plead federal securities violations in their statements of claim because of the long list of bad law in that area. This is just another good reason to avoid federal claims. Rather than relying on any federal law, it may be advisable to rely exclusively on state remedies. However, if you are going to do so, it is vitally important that it is made clear to the Panel. Otherwise, the Panel will become easily confused and simply look at this bad law as an excuse to let the firm "off the hook." Moreover, if you live in a state without good securities laws, such as New York, this may not be a viable option.

VI. Conclusion

While the Merrill Rule attempts to clarify when a broker-dealer's actions are subject to the Advisers Act, it ultimately causes more confusion than it resolves. This is especially tragic in a time when more and more consumers are looking toward financial services professionals to play a large role in planning their futures. Ultimately, it is clear that the Merrill Rule was established as a part of the continual erosion of investor protection under federal law.

While this ruling, as long as it stands, could create some problems for our membership, most attorneys should be able to find ways to avoid its application using firm contracts, the broker's statements, and state law.

The Unauthorized Practice of Law in Securities Arbitrations: The Times They are a Changin'

By Carl J. Carlson

Virtually all states bar an attorney who is not licensed in that state from practicing law in the state. But many securities arbitration attorneys don't seem to think that "unlicensed practice of law" rules apply to NASD or NYSE arbitrations. This is a mistake. While it is true that the NASD and NYSE don't care if attorneys are licensed in the state in which an arbitration hearing is conducted[1], it is the states that regulate the practice of law, and some of the states clearly *do* care.

Engaging in the unlicensed practice of law ("UPL") in a securities arbitration can be a disaster: it can subject the attorney to discipline, put the client's award at risk, or (more likely) cost the attorney his or her fee. Generally it is not hard for an out-of-state attorney to comply with a state's UPL rules. Counsel just need to check the state's rules in advance of conducting the hearing, and taking the steps necessary to obtain authority to represent a party in the proceeding.

I. General Discussion

A. The NASD Recognizes that State UPL Rules Apply to Securities Arbitrations.

In 2005, the NASD proposed an amendment to Code of Arbitration Procedure Rule 10316 ("Representation in Arbitration") which makes clear that, as far as the NASD is concerned, an attorney licensed in any state can appear in any NASD arbitration. The NASD's proposed new language is underlined below, and deleted language is bracketed:

> (b) Representation by an Attorney**.** *At any stage of the arbitration proceeding held in a United States hearing location,* [A]all parties shall have the right to [representation by counsel at any stage of the proceedings.] *be represented by an attorney at law admitted to practice before the Supreme Court of the United States or the highest court of any state of the United States, [or] the District of Columbia. . . .*

But at the same time, the NASD recognized that regulating the practice of law is a state function, and that state UPL laws may apply, with the following new subsection:

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[1] NASD Code of Arbitration Procedure Rule 10316 and NYSE Arbitration Rule 614 both provide simply: "All parties shall have the right to representation by counsel at any stage of the proceedings". Neither set of rules requires that attorneys be licensed in the state in which the matter is pending, and neither provides a *pro hac vice* procedure to obtain permission to appear.

> *(c) Qualifications of Representative. Issues regarding the qualifications of a person to represent a party in arbitration are governed by applicable law and may be determined by an appropriate court or other regulatory agency.*

The NASD's "Statement of Purpose" accompanying the proposed amendments begins by observing that the unlicensed practice of law has "recently" become an issue in arbitrations generally:

> [I]t is common for an attorney licensed to practice law in one state to represent a client in an arbitration proceeding in another state . . . . Although this practice is common, it can be a violation of state unauthorized practice of law provisions. Until recently, most states had taken no action against this practice. However, recent case law developments suggest that states are reconsidering this position. For example, two state court rulings have found that an out-of-state attorney providing representation in an arbitration . . . is . . . a violation of the state's unauthorized practice of law statute.[2]

The NASD clearly thinks just being licensed anywhere is good enough to handle cases in arbitration under any state's laws:

> The proposed rule change is not intended to prevent a state from deciding that an out-of-state attorney may have violated a state's unauthorized practice of law provision by representing a party in an NASD arbitration. It is intended, however, to reflect current practice in the forum, which, based on experience, shows that the level of knowledge, training and skill of an attorney affects the outcome of an arbitration hearing, not the jurisdiction from which the attorney received his license to practice.

B. UPL in Arbitrations Generally.

"The practice of law" is generally defined (by statute, court rule, or case law) to include more than representing a party in court. Those definitions are generally broad enough to cover representing a party in an arbitration proceeding, and most, but not all, courts hold that appearing in an arbitration constitutes the practice of law.[3]

C. UPL in Securities Arbitrations.

More to the point, those courts which have considered the issue have held that representing a party in an NASD arbitration proceeding constitutes the practice of law, and that the forum state's unauthorized practice of law rules controlled. *The Florida Bar v. Rapoport, supra; Disciplinary Counsel v. Alexicole, Inc., supra. See also, Florida Bar re Advisory Opinion on Nonlawyer Representation in Securities Arbitration*, 696 So.2d 1178 (Fla. 1997) (NASD proceedings are subject to state's regulation of practice of law).

In *Rapoport* and *Alexicole,* the Florida and Ohio Supreme courts, respectively, each held that representing a party in an NASD arbitration without being licensed to practice law in the forum state constituted the unauthorized practice of law.

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[2] Citing *Birbrower, Montalbano, Condo & Frank v. Superior Court*, 17 Cal.4th 119, 70 Cal.Rptr.2d 304, 949 P.2d 1 (Cal. 1998), and *Florida Bar v. Rapoport*, 845 So. 2d 874 (Fla. 2003).

[3] *Superadio Ltd. Partnership v. Winstar Radio Productions*, LLC, 844 N.E.2d 246 (Mass., 2006); *Disciplinary Counsel v. Alexicole, Inc.*, 105 Ohio St.3d 52, 822 N.E.2d 348 (Ohio, 2004); *The Florida Bar v. Rapoport*, 845 So.2d 874 (Fla. 2003); *In re Creasy*, 12 P.3d 214 (Ariz. 2000); *Birbrower, Montalbano, Condo & Frank v. Superior Court*, 17 Cal.4th 119, 70 Cal.Rptr.2d 304, 949 P.2d 1 ((Cal. 1998). *Contra*, *Colmar, Ltd. v. Fremantlemedia North America*, Inc., 801 N.E.2d 1017 (Ill.App. 2003); *Williamson v. John D. Quinn Const. Corp.*, 537 F.Supp. 613 (S.D.N.Y. 1982).

In *Florida Bar re Advisory Opinion*, which dealt with a *nonlawyer's* appearance for a party, Florida's Supreme Court in 1997 adopted a Bar Association Standing Committee on the Unlicensed Practice of Law advisory opinion with a thorough explication of the rationale for applying UPL rules to attorneys appearing in NASD arbitrations:

> [S]ecurities arbitration is conducted before self-regulatory organizations (SROs), which are private bodies and not federal offices or agencies. . . .
>
> [T]he rules governing the SROs do not expressly prohibit nonlawyer representation, and . . . the Arbitrator's Manual . . . indicates that parties in securities arbitration "may choose to . . . be represented by a person who is not an attorney, such as a business associate, friend, or relative." Nevertheless, the Committee maintains first that neither the rules provision, nor the Manual, constitutes federal legislation preempting this Court's regulatory authority, and, second, that these very general, permissive guidelines do not condone the nonlawyer representation for compensation at issue here. . . .
>
> We conclude that compensated nonlawyer representatives in securities arbitration are engaged in the unauthorized practice of law and pose a sufficient threat of harm to the public to justify our protection.

Subsequently, in 2003, the Florida Supreme Court in *Florida Bar v. Rapoport*, *supra,* applied the same rule to an out-of-state *attorney* who had represented parties in NASD arbitrations, holding that (1) the attorney engaged in the practice of law by giving legal advice and consultation to clients, drafting, signing, and filing securities arbitration claims, and representing clients in NASD arbitrations; (2) no federal or state law authorized the unlicensed attorney to provide legal services in NASD arbitration matters; and (3) Florida has the authority to prohibit UPL to protect the public.

In *Alexicole*, the Ohio Supreme Court held that representing a party in an NASD arbitration hearing constituted the practice of law in Ohio. One respondent in that case, Bandali Dahdah, admitted that he regularly prepared statements of claims in NASD arbitration claims, conducted discovery, participated in prehearing conferences, negotiated settlements, and participated in mediation and arbitration hearings. Upholding a decision by the Ohio Board of Commissioners on the Unauthorized Practice of Law that Dahdah had engaged in UPL and enjoining him from continuing to do so, the Ohio Supreme Court held:

> We concur in the board's findings and recommendation. . . . The unauthorized practice of law consists of rendering legal services, including representation on another's behalf during discovery, settlement negotiations, and pretrial conferences to resolve claims of legal liability, by any person not admitted to practice in Ohio.

Disciplinary Counsel v. Alexicole, Inc., *supra,* 822 N.E. at 349.

D. Nothing "Federal" Preempts State Regulation of Attorneys Appearing in NASD or NYSE Arbitrations

States cannot regulate or restrict the ability of federal courts and agencies to control who practices before them. *Benninghoff v. Superior Court*[4]; *Sperry v. State of Florida*[5] (federal regulations allowing nonlawyers to prosecute

[4] 136 Cal.App.4th 61, 38 Cal.Rptr.3d 759 (2006).

[5] 373 U.S. 379, 385, 83 S.Ct. 1322, 10 L.Ed.2d 428 (1963).

patents preempted state UPL laws; a state "may not deny to those failing to meet its own qualifications the right to perform the functions within the scope of the federal authority").

While the SROs are heavily regulated by the SEC, they are still private bodies and do not qualify as government agencies. *Florida Bar re Advisory Opinion, supra.*

No preemption by the NASD's rules. Federal preemption occurs where (1) it is impossible for a private party to comply with both state and federal law, or (2) a state law "stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress."[6] As noted above, the NASD agrees that states have the power to regulate attorneys in NASD arbitrations and that no conflict is created in doing so:

> The attorney's qualifications to participate . . . in a jurisdiction in which they are not licensed would be subject to the applicable law of that jurisdiction. NASD believes the proposed rule change would . . . [avoid] encroaching on the states' rights to determine what activities violate the states' unauthorized practice of law provisions.

No FAA preemption. Both *Florida Bar re Advisory Opinion* and *Birbrower* also held that the FAA does not preempt state regulation of attorneys appearing in FAA-governed arbitrations: "[T]he parties . . . have not shown that California law in any way conflicts with the FAA. Moreover . . . the FAA does not contain an express preemptive provision, nor does it 'reflect a congressional intent to occupy the entire field of arbitration' [citation]". *Birbrower, supra,* 949 P.2d at 9.

II. What's the Harm In a Little UPL Among Friends?

Potential Loss of Attorney's Fees. It is a general, but not absolute, rule that an attorney is barred from recovering compensation for services rendered in another state where the attorney was not admitted to the bar. *See Annot.*, "Right of Attorney Admitted in One State to Recover Compensation for Services Rendered in Another State Where He Was Not Admitted to the Bar" (1967) 11 A.L.R.3d 907; *Birbrower, Montalbano, Condo & Frank v. Superior Court*, *supra*; *Perlah v. S.E.I. Corp.*, 612 A.2d 806 (Conn.App., 1992).

A related risk is that a client might object to enforcement of a fee agreement, on the ground that agreeing to engage in UPL constitutes a contract to engage in criminal conduct, or violates a state's public policy. Courts generally will not enforce an illegal contract, but will leave the parties where it finds them. Courts have applied this rule to deny payment under attorney's fee agreements that involved the unlicensed practice of law. *Montgomery v. Utilities Ins. Co.*, (courts "will not enforce or aid in the enforcement of a contract made for the illegal practice of law")[7]; *Curry v. Dahlberg,* (court refused to enforce contract by layman to recover compensation under a contract which the court determined called for the layman to engage in unauthorized practice of law)[8]; s*ee also, Irwin v. Young* (held, contract was for accounting services, not the practice of law; majority assumed, and dissent argued, that if contract was for legal services it would have been void as illegal)[9]; *McRae v. Sawyer* (holding that, like other licensed professions,

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[6] *Crosby v. Nat'l Foreign Trade Council*, 530 U.S. 363, 372, 120 S.Ct. 2288, 147 L.Ed.2d 352 (2000).

[7] 117 S.W.2d 486, 491 (Tex.Civ.App.—Beaumont, 1938), *rev'd on other grounds*, 134 Tex. 640, 138 S.W.2d 1062 (1940).

[8] 341 Mo. 897, 110 S.W.2d 742 (1937).

[9] 212 Ga. 1, 90 S.E.2d 22 (1955).

an unlicensed attorney is "estopped" from enforcing a contract to render services)[10].

Legal Actions by One Not Licensed, Including Judgments, May be Void. Many courts—but again, not all—apply the rule that legal proceedings conducted by an unlicensed individual are void. *Ford Motor Credit Co. v. Sperry* (well settled that "effect of a person's unauthorized practice on behalf of a party is to require dismissal of the cause or to treat the particular actions taken by the representative as a nullity")[11]; *Jadair Inc. v. U.S. Fire Ins. Co.* (nonlawyer corporate employee's signing notice of appeal constituted unlicensed practice of law; notice of appeal failed to give appellate court jurisdiction; appeal voided)[12]; *Osei-Afriyie by Osei-Afriyie v. Medical College of Pennsylvania* (jury verdict for defendant in medical malpractice case vacated, where plaintiffs had been represented at trial by their non-lawyer father)[13]; *Alexander v. Robertson*[14]; *Williams v. Global Const. Co., Ltd.*[15]

Massachusetts, however, recently declined to apply the rule in two cases decided on the same day. *Superadio Ltd. Partnership v. Winstar Radio Productions, LLC* ("[E]ven assuming that the representation might constitute the unauthorized practice of law, the conduct would not provide a basis to vacate the award, where arbitration awards could be vacated only for "fraud, corruption, or other undue means")[16], and *Mscisz v. Kashner Davidson Securities Corp.* (same; case involved NASD arbitration proceeding).[17]

III. How To Avoid Committing UPL

California. Following *Birbrower*, California amended its Civil Procedure Code to create a procedure for an out-of-state attorney to obtain permission to appear in an arbitration within the state. The NASD now provides instructions for doing so, and a "Non-California Attorney Certification Form", both of which are available on the NASD's web site.

Florida. Effective January 1, 2006, Florida adopted a modified form of ABA Model Rule 5.5 (multijurisdictional practice), which allows non-Florida attorneys to represent clients in arbitrations on *a temporary basis* in Florida if:

- the attorney associates with a Florida attorney who "actively and materially participates in the case;" and
- the services arise out of or are reasonably related to the lawyer's practice in a jurisdiction in which the lawyer is admitted to practice.

Florida omitted from its version of the rule, Model Rule subsection 5.5(d), which allows in-house counsel to appear in arbitrations in states where they are not licensed. While in-house counsel will generally be able to participate in securities arbitrations under Florida's general provisions, they will be

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[11] 214 Ill.2d 371, 827 N.E.2d 422 (Ill., 2005).

[12] 209 Wis.2d 187, 562 N.W.2d 401 (Wis., 1997).

[13] 937 F.2d 876 (3rd Cir. 1991).

[14] 882 F.2d 421 (9th Cir. 1989; applying California law)

[15] 26 Ohio App.3d 119, 498 N.E.2d 500 (1985).

[16] 844 N.E.2d 246 (Mass., 2006).

[17] 844 N.E.2d 614 (Mass., 2006).

subject to the "3 cases per year" limitation discussed below.

To complement its new multi-jurisdictional practice of law rule, Florida adopted Bar Rule 1-3.11, defining when an out-of-state attorney may appear at Florida arbitrations and prescribing procedures for being authorized to do so. Under the Rule, out-of-state attorneys cannot file more than 3 demands for arbitration, or responses to demands for arbitration, in a 365 day period. The attorney must serve on the State Bar Association and on opposing counsel a "Verified Statement Pursuant to Rule 1-3.11 Regulating the Florida Bar", a copy of which is available on the Bar Association's website, and pay a $250 fee.

Under ABA Model Rule 5.5. In those states that have adopted the ABA's Model Rule 5.5 on multi-jurisdictional practice, attorneys are authorized to represent clients in securities arbitrations within the state "on a temporary basis", so long as (1) the attorney is, or reasonably expects to be, authorized "by law or order" to appear in such proceeding; or (2) the attorney's services "arise out of or are reasonably related to the lawyer's practice" in his or her home jurisdiction.

On a temporary basis. Attorneys whose website describes their securities arbitration practice as "national" or "nationwide", or who continuously solicit clients in a particular state, may be at risk of violating the Model Rule. See Official Comment 14 to the Model Rule for some vague guidance on what "temporary" might mean.

Related to the lawyer's practice in the state in which he is licensed. The ABA's Official Comment 14 on Model Rule 5.5's requirement that an attorney's representation be "related" to his or her practice in the state of licensing, explains helpfully that such relation can arise "out of a variety of factors". (The Official Comment does go on to give some examples, however, which might provide some guidance.)

***Caution**.* If a state has adopted Model Rule 5.5, the attorney must check the state's bar association and court rules to determine if there are further procedures, like in Florida, that the attorney must comply with in order to represent a client in that state. For example, in Arizona, which recently adopted Model Rule 5.5, out-of-state attorneys engaging in arbitration proceedings must inform their clients that they are not admitted to practice in Arizona, and "must obtain the client's informed consent to such representation." Ariz. R. Prof. C. 5.5(e).

Other States. Generally it will be possible to represent clients in out-of-state securities arbitrations without violating the state's UPL rules. The key is simply to inquire into the state's particular rules in the first place.

Arguments and Authorities Supporting the Viability of Holder Claims

By Samuel T. Brannan

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Introduction

"Holder" claims are simply claims of fraudulent misrepresentation and suppression which base the element of reliance on a claimant's fraudulently induced ***forbearance*** or ***inaction***. Formally recognized by the New York courts in 1927 in the seminal decision of *Continental Ins. Co. v. Mercandante*, 222 A.D. 181, 187, 225 N.Y.S. 488 (N.Y. 1st Dept. 1927), the general principle underlying a "holder" claim is a party's fraudulently induced decision to retain and not sell a security.

While counsel for SRO member firms often attempt to cast "holder claims" as having no legal basis, they have been recognized for more than a century. Further, in recent years, a growing number of states have expressly recognized "holder" liability in their common law. This long and growing acceptance of this type of fraud claim belies the assertion made by some respondents' counsel that holder claims are impermissible as a matter of law in most jurisdictions.

A. Holder Claims Are Permitted Under New York Law, Law That Often Applies Under The Parties' Contract.

The account opening agreements often contain a New York choice of law clause. In such cases, we have argued that the issue of the validity of a holder claim must be decided in accordance with New York law.[1] The courts of New York have clearly and repeatedly approved holder claims.

The court in *Mercandante* applied general principles of common law fraud to allow a claim by an investor who was fraudulently induced to retain securities and suffered loss as a result:

> [The Plaintiff's] intention and practice was at all times to buy and retain only bonds which were investments, as distinguished from speculations, and which could be safely retained to maturity; that this was at all times known to the defendants; … that with this knowledge the defendants, for their own gain and to enable them to market similar bonds held by them, made at various times ***essentially false representations as to the earnings and solvency of the obligor; that these representations were made with the intention that the***

[1] In the context of a dispositive motion, we would argue that, even if a question of law regarding the viability of holder claims is properly before this Panel (and it would not be because we contend that such motions are not permitted in NASD arbitration), it must be decided in accordance with New York law.

> ***plaintiff should rely on them in retaining and not selling their bonds***; that at the time these representations were made the bonds could have been sold for a substantial price; that ***in reliance upon these misrepresentations the plaintiffs held their bonds***....

222 A.D. at 181 (emphasis added). In recognizing this cause of action, the court in *Mercandante* simply applied the general common law rule that reliance may consist not only of acting but also of refraining from action based upon the defendant's fraud.

In concluding that holders of securities "cannot be denied redress because their conduct was inaction rather than action," because "the purpose of the law is, wherever possible to afford a remedy to defeat fraud," the court in *Mercandante* observed:

> The defendants intended that their misrepresentations should cause the plaintiffs to keep their bonds, desist from further inquiry and remain passive. The motive for their conduct was their own gain. The law should not countenance a standard of business morality which would permit vendors of securities to promote a market by publication of false representations and escape the consequence thereof by the contention that the owners of these securities might well have retained them even though the false representations had not been made. 222 A.D. at 186.

Nearly two decades after the *Mercandante* decision, the court in *Hiliel v. Motor Haulage Co.*, 140 N.Y.S.2d 51, 54 (Sup. Ct. Kings County 1955), held that holder claims are viable where concealment of material facts induced inaction where action would have otherwise been taken.

Recently, Citigroup Global Markets, Inc. and its counsel lost a motion to dismiss a WorldCom holder claim in a New York court action. *See* Order of the Supreme Court of the State of New York, County of New York, in the case of *Babcock v. Citigroup, Inc. et al.*, Index No. 602965/04 (HEF), dated December 27, 2005 ("Babcock Order"), p. 3. In the *Babcock* case, the court held:

> Defendants also seek dismissal of all claims to the extent that they are connected not with plaintiff's purchases of WorldCom stock, but with his retention of it. However, the First Department upheld the viability of 'holder' claims in a 1927 decision that is still binding precedent for this court. *Babcock Order* at 3 (citing *Mercandante, supra*).

Federal courts sitting in New York attest to the continuing viability of securities holder claims under New York law. *See In re WorldCom, Inc. Securities Litigation*, 382 F. Supp.2d 549, 559 (S.D.N.Y. 2005), in which Judge Denise Cote acknowledged: "New York recognizes a claim [of] fraud where investors were induced to retain securities in reliance on a defendant's misrepresentations."

The United States Court of Appeals for the Second Circuit, in *Marbury Management, Inc. v. Kohn*, 629 F.2d 705 (2d Cir. 1980), upheld a judgment awarding damages to an investor for losses attributable to his retention of securities in reliance upon false representations made by his broker. "'Fraud which induces non-action where action would otherwise have been taken is as culpable as fraud which induces action which would otherwise have been withheld.'" *Id.* at 708 (quoting *Hadden v. Consolidated Edison Co.*, 382 N.E.2d 1136 (N.Y. 1978)).[2]

Respondents' counsel have argued that, even in the jurisdictions that have approved holder claims, claimants failed to meet heightened pleading requirements. However, there are no stringent pleading requirements for a holder claim under New York law.[3] The decision in *Small v. Fritz*, 65 P.2d 1255 (Cal. 2003), cited by respondents for the proposition that, in alleging a holder claim, a plaintiff must allege actions that would

indicate actual reliance on the misrepresentations, is inapplicable at least where the holder claim is governed by New York law.[4]

Given the viability of holder claims under New York law, if an arbitration panel were to decide that holder claims are not permitted, that would arguably constitute a "manifest disregard" of the law, a ground for vacatur of an award. *Wien & Malkin LLP v. Helmsley-Spear, Inc.*, 6 N.Y.3d 471 (Feb. 21, 2006); *Matter of Engle (Refco, Inc.)*, 746 N.Y.S.2d 826 (Sup. Ct. N.Y. Co. 2002).

B. The Emerging Consensus Of The Law In States That Have Considered Them, And The Position Of The Restatement Second Of Torts, Is That "Holder Claims" Are Permitted.

1. The State Courts That Have Ruled On "Holder Claims" Permit Them.

Since its first recognition over 100 years ago, holder liability has become a settled principle of liability in those state jurisdictions encompassing the heart of the country's financial services industry. Since the 1890s, courts in New York, Massachusetts[5], New Jersey[6], California[7] and Illinois[8] have recognized common law liability based on the fraudulently induced retention of securities.

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[2] *See also Primavera Familienstifung v. Askin*, 130 F. Supp.2d 450, 493-95 (S.D.N.Y. 2001), ("investors may bring a claim based on inducement to make and/or retain their investments"); *ABF Capital Management v. Askin Capital Management, L.P.*, 957 F. Supp. 1308, 1325 (S.D.N.Y. 1997) (recognizing "the settled principle that the common law provides a remedy for misrepresentations that induce retention of securities"); *Alvin S. Schwartz, M.D., P.A. v. O'Grady*, 1990 WL 156274 at *14 (S.D.N.Y. Oct. 12, 1990) ("it is sufficient that the misrepresentation induce plaintiff to purchase or retain his investment"); *Metropolitan Life Ins. Co. v. RJR Nabisco, Inc.*, 716 F. Supp. 1504, 1525 (S.D.N.Y. 1989) ("disclosure-related common law fraud claims are not restricted to purchases and sales").

[3] Even if there were such pleading requirements, they would not apply in a NASD arbitration proceeding. The NASD Code requires only that "[t]he statement of claim shall specify the relevant facts and the remedies sought." (NASD Code of Arbitration Procedure, Rule 10314(a)). The NASD has confirmed that it is not necessary to plead specific facts or evidence to be presented at the final hearing:

> NASD does not consider a Statement of Claim to be deficient if it meets the minimum requirements of a properly signed Uniform Submission Agreement that names the respondents as shown on the Statement of Claim, proper fees, and sufficient copies of the Statement of Claim. ... *Accordingly, the Statement of Claim may not contain details on the evidence to be presented at the hearing.* (*See* NASD Notice to Members 02-59 at 2, effective October 14, 2002, emphasis added).

[4] Even in *Small*, the court stated: "In a holder's action a plaintiff must allege specific reliance on the defendants' representations: for example, that if the plaintiff had read a truthful account of the corporation's financial status the plaintiff would have sold the stock, how many shares the plaintiff would have sold, and when the sale would have taken place." That requirement is met in an analyst fraud case where the facts are that claimants would have sold all of their shares of a certain stock on the date they received a truthful opinion on the stock from the analyst.

[5] *David v. Belmont*, 197 N.E. 83 (Mass. 1935); *Fottler v. Mosely*, 60 N.E. 788 (Mass. 1901); *Reisman v. KPMG Peat Marwick LLP*, 787 N.E.2d 1060, 1068-70 (Mass.App.Ct. 2003) (recognized holder's claim under Massachusetts law).

2. The Restatement Second Of Torts Expressly Contemplates Forbearance Claims Presented As Common Law Fraud Claims.

The Restatement of Torts Second is published by the American Law Institute and a distinguished group of reporters and advisors. The original reporter was the late Dean William L. Prosser, widely regarded as one of the most respected and influential experts on the law of torts. "For more than [70] years the Restatement has been a vital force in shaping the law of torts, as it has developed in the courts and has been taught to [many generations] in the schools." Restatement Second of Torts, Introduction, p. VII (1965).

Under common law fraud, actionable reliance can take the form of refraining from action or forbearance. Thus, the Restatement Second of Torts § 525 states: "One who fraudulently makes a misrepresentation … for the purpose of inducing another to act *or to refrain from action* in reliance upon it, is subject to liability…." (emphasis supplied). Dan Dobbs, *The Law of Torts* 1358 (2000), makes the same point: "To rely, the plaintiff must choose her conduct because of the representation, either acting *or refraining from action* because or partly because of the representation." (emphasis supplied).

C. Holder Claims Are Contemplated By Industry Rules.

As a result of the account opening agreements, member firms and associated persons are typically subject to NYSE Rules and as such are obligated to provide services in conformity with those Rules. In such cases, they are contractually obligated to abide by NYSE Rule 472. Under NYSE Rule 472, advice or statements reasonably expected to cause a customer to hold a security are considered a recommendation under that rule.

> For purposes of these standards, the term 'recommendation' includes any advice, suggestion or other statement, written or oral, that is intended, or can reasonably be expected, to influence a customer to purchase, sell or ***hold*** a security. (emphasis added) NYSE Interpretation Handbook Rule 472/09.

The rules of the self-regulatory organizations such as the NYSE and NASD "…set out general standards of industry conduct" and are evidence of the standard of care by which brokers must abide in dealing with their clients. *In re E.F. Hutton & Co. Inc.*, Exchange Act Release No. 25,887 [1988-89 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,303 (July 6, 1988). *Accord, Miley v. Oppenheimer & Co., Inc.*, 637 F. 2d 318, 333 (5th Cir. 1981) (industry rules are "excellent tools against which to assess in part the reasonableness or excessiveness of a broker's handling of an investor's account"); *Lange v. H. Hentz & Co.*, 418 F. Supp. 1376, 1383-84 (N.D. Tex. 1976) (violations of industry rules and practices give rise to common law claim for negligence); *Mihara v. Dean Witter & Co., Inc.*, 619 F. 2d. 814, 824 (9th Cir. 1980).

Thus a violation of Rule 472, which expressly prohibits misrepresentations of analysts to buy, sell or ***hold*** a security, a breach of a

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[6] *Duffy v. Smith*, 32 A. 371 (N.J. 1895); *Gutman v. Howard Sav. Bank*, 748 F. Supp. 254 (D.N.J. 1990) (applying both New York and New Jersey law).

[7] *Small v. Fritz Cos., Inc.*, 65 P.3d at 1258 (Cal. 2003) ("California recognizes a cause of action for a stockholder induced by fraud or negligent misrepresentation to refrain from selling stock").

[8] *Gordon v. Buntrock*, Case No. 99 CH 18378 (Circuit Court of Cook County, Illinois, County Department, Chancery Division, July 19, 2004) ("There can be no legitimate argument with the proposition that an investor who holds a security in reliance on false statements concerning the company's financial status can maintain a claim for fraud").

broker-dealer's duty that is actionable.

D. The Cases We Have Seen Cited By Defense Counsel Are Either Inapplicable Or Supportive Of Holder Claims.

In the arbitrations in which we have been involved, respondents have not pointed to a single state court that made a ruling disallowing holder claims.[9] Instead, they pointed to federal district decisions that ***predicted*** state courts would disallow holder claims under the laws of those states when, in fact, those state courts have ***not*** disallowed holder claims. Two of the district court cases involved the same New York district court judge (Denise Cote) "predicting" how state appellate courts in Georgia and Texas would decide holder claims under the laws of those states, ***if*** such a case ever came before them – which it has not. Federal courts cannot make state law.[10]

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975), is a case that often cited by respondents as an anti-holder decision. However, that decision is merely limited standing ***in SEC Rule 10b-5 cases*** to those who purchase or sell a security in connection with the alleged fraud. *Blue Chip Stamps* actually ***supports*** the position that holder claims presented as common law fraud or deceit claims are well established in law:

> And it has long been established in the ***ordinary case of deceit*** that a misrepresentation which leads to ***a refusal to purchase or to sell*** is actionable in just the same way as a misrepresentation which leads to the consummation of a purchase or sale. *Id.* at 744 (emphasis added.)

Conclusion

Securities holder claims are well supported by case law in jurisdictions that comprise the heart of the financial services industry. The Restatement Second of Torts expressly contemplates retention claims brought as common law fraud claims. The state most strongly identified with the financial services industry, and whose laws are most often chosen by member firms in their account opening documents – New York – is also the jurisdiction with the greatest number of decisions affirming securities holder claims.

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[9] One case, *Manzo v. Rite Aid Corp.*, 2002 WL 31926606 (Del. Ch. Dec. 19, 2002), an unpublished decision of the Delaware Court of Chancery, was wrongly cited by one respondent as disallowing holder claims. It did no such thing. In that case, the class action claims for common law fraud were dismissed because Delaware does not allow common law fraud claims to be maintained as a class action. The court also dismissed the individual common law fraud claims "without prejudice because the amended complaint fails to adequately allege reliance and damages." The court did not disallow (or even address) holder claims.

[10] *E.g., Harter v. Vernon,* 101 F.3d 334, 342 (4th Cir. 1996) (federal holdings on questions of state law do not bind state courts*); Diginet, Inc. v. Western Unon ATS, Inc.,* 958 F.2d 1388, 1395 *(7th Cir. 1992); Beavers v. Northrop Worldwide Aircraft Services, Inc.*, 821 S.W.2d 669, 674 (Tex. App. 1992).

The Challenges of Hedge Fund Regulation After the Pequot Investigation and Goldstein v. SEC

By James A. Nofi

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Hedge Funds are the investment product of the early 21st Century. Hedge Fund managers are the new Masters of the Universe. They have captured the popular imagination; their growth has been phenomenal. According to the New York Times, almost 9,000 hedge funds exist with total investment assets of $1.2 trillion.

With this popularity has come increased pressure to regulate these secretive entities. It is difficult to read the daily business or financial press without seeing some story about hedge funds and their growing clout and effect on the financial markets. Stories about hedge funds abound on business networks like CNBC and Bloomberg.

The dangers of unregulated hedge funds are not limited just to the well-to-do. More and more pension funds, university endowments, charitable organizations, and foundations are investing a significant portion of their money in hedge funds. Additionally, broker firms are packaging hedge funds into funds-of hedge funds and marketing them to more Main Street clients. Hedge funds themselves are reported to account for approximately 30% of all daily trading on U.S. stock exchanges.

The SEC's interest in regulating hedge funds began with the failure of Long Term Capital Management in 1998 and continues with the saga of International Management in Atlanta.[1] When the definitive history of the Hedge Fund Era – and attempts to regulate them – is written, the date of Friday June 23, 2006, will surely merit at least a footnote, if not more.

That morning, readers of the New York Times were greeted with a story about an SEC investigation of Pequot Capital Management ("Pequot"), one of the oldest and largest hedge funds managers.[2] According to the story, the SEC was investigating Pequot for possible trading on material non-public information. Stock exchange officials had referred 18 matters of suspicious trading to the SEC for further investigation. In just one of those instances in July 2001, Pequot is reported to have made $18 million by investing in

[1] International Management made the front page of the Wall Street Journal on March 9, 2006 when it was reported that the SEC had sued the hedge fund and its adviser for fraud. International Management had between $115 and $185 million in assets and counted several NFL football players among its investors. The court appointed receiver, however, could only locate approximately $150,000. Wall Street Journal, March 9, 2006, http://online.wdj.com/article_print/SB114187433315493405.html viewed on July 30, 2006.

[2] New York Times, June 23, 2006, http://nytimes/2006/06/23/business/23fund/html?ei=5094…a51076bca7&hp=&ex=1151121600&partner=homepage&pagewanted+print viewed on June 23, 2006 (hereinafter "NY Times").

companies shortly before the announcement of a major corporate merger. Pequot reportedly bought $44 million in Heller Financial before the public announcement of its takeover by General Electric Capital Corporation in a $5.25 billion buyout. Heller's share price rose 50% after the announcement. Pequot is also reported to have shorted $36 million in GE stock before the merger announcement.

What made this story memorable was that the SEC was publicly accused of firing the attorney who was leading the investigation into possible trading by the hedge fund while in possession of material non-public information because he wished to take the investigative testimony of the chairman of a major broker-dealer regarding his tenure as chairman of yet another major broker-dealer.

Gary Aguirre ("Aguirre"), the former SEC attorney, sent an 18-page whistleblower letter to Senator Chuck Hagel, the Republican chairman, and Christopher Dodd, the ranking Democratic member, of the Senate Subcommittee on Securities and Investment in which he complained that he had been fired after SEC officials had turned down his request to take the investigative testimony of John Mack ("Mack"). Mack is currently the chairman of Morgan Stanley, is the former chairman of Credit Suisse First Boston, and briefly served as chairman of Pequot. He is also a financial contributor to the Bush administration.

SEC officials refused to permit Aguirre to issue a subpoena to Mack on the ostensible grounds that he had not made a strong enough case for taking Mack's deposition. In his whistleblower letter, Aguirre wrote that his supervisor told him that it would be difficult to receive authorization to subpoena Mack because of his "powerful political connections."[3]

Aguirre continued to press the issue with his supervisors and on up the SEC's chain of command. Aguirre was fired on September 1, 2005, while he was on vacation.[4]

Before this controversy erupted, however, the SEC considered Aguirre a model employee. His immediate supervisor wrote in his June 2005 performance evaluation of Aguirre that:

> "Gary has an unmatched dedication to this case (often working well beyond normal work hours) and his efforts have uncovered evidence of potential insider trading and possible manipulative trading by the fund and its principals. He has been able to overcome a number of obstacles opposing counsel put in his path on the investigation. Gary worked closely with the Office of Compliance Inspection and Examinations to develop the case and worked with several self-regulatory organizations to develop a number of potential leads. He has gone the extra mile and then some."[5]

On August 21, 2005, Aguirre received a rare two-step merit pay increase based on his handling of the hedge fund investigation.[6] Less than two weeks later, he was fired. According to the Times story, Michael Clampitt, the head of the SEC's union, said that he knew of no one who got a pay increase – particularity a significant one – and was then fired with no written warnings.[7]

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[3] Letter dated May 30, 2006 from Gary J. Aguirre to Sens. Hagel and Dodd, p. 10 ("Aguirre Letter").

[4] *Id.* at 11.

[5] *Id.*

[6] *Id.*

On Friday, July 21, 2006, the SEC announced that its staff would question Mack regarding the possibility that he could have tipped Pequot off to certain merger deals.

While the public and the markets were still digesting and reacting to the news about the Pequot investigation, the Court of Appeals for the District of Columbia Circuit struck down the SEC's rules on hedge fund adviser registration in Goldstein *v. SEC*, No. 04-1434.[8]

In a well-reasoned opinion, Circuit Judge Randolph gave a primer on hedge funds, their particular characteristics, and the background on the SEC's attempt to regulate hedge funds by changing the definition of the term "client" as it appears in the Investment Advisers Act.[9] Ultimately, the Court held that the SEC's definition of "client" was not reasonable in this context.

Judge Randolph set forth many of the reasons for the difficulty in regulating hedge funds. The first – and most obvious – reason is that hedge funds are not easily defined. This lack of a generally accepted definition makes it difficult to draft a rule or regulation that would cover the great variety of hedge funds without being so general and vague that it would be subject to attack on those grounds.

The Court noted that nowhere is the term "hedge fund" defined in any of the federal laws and that industry participants are unable to agree on a single definition. For example, government and industry publications contain at least 14 different definitions of a hedge fund. The catchall definition cited by the Court is that a hedge fund is "any pooled investment vehicle that is privately organized, administered by professional investment managers, and not widely available to the public."[10]

In its definitional search, the Court then attempted to define hedge funds by discussing what they were not.

Hedge funds are not investment companies under the Investment Company Act of 1940 ("the 1940 Act").[11] Although, at first glance, hedge funds would seem to be investment companies as defined, they are exempt from coverage under the 1940 Act because they either (i) have 100 or fewer beneficial owners, (ii) do not offer their securities to the public, or (iii) their investors are all "qualified" high net worth individuals or institutions. Unlike mutual funds, such entities have never been understood to offer the same possible dangers to investors as mutual funds, which are available to the public at large.[12]

In their operations, hedge funds are almost the exact opposite of mutual funds. Mutual funds must register with the SEC and disclose their investment positions and financial conditions. For all practical purposes, they must have at least one public director on their Board of Directors. Mutual funds are unable to trade on margin or engage in short sales and need shareholder approval to take on significant debt or to invest in certain types of assets such as real estate or commodities.[13]

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[7] NY Times at 6.

[8] 451 F.3d 873 (D.C. Cir. 2006).

[9] 15 U.S.C. § 80b-1 *et seq.*

[10] *Id.* at 875 (citations omitted).

[11] 15 U.S.C. § 80a-1 *et seq.*

[12] *Goldstein* at 875.

[13] *Id.*

In contrast, hedge funds often take long and short positions in stocks and bonds to reduce risk. They trade in all sorts of assets, from stocks, bonds, and currencies to derivatives and even non-financial assets.[14]

The management structure of hedge funds is also drastically different than that of mutual funds. Mutual funds must comply with detailed requirements for their independent boards of directors and require shareholder approval of certain actions and transactions. In contrast, domestic hedge funds are usually structured as limited partnerships. Such limited partnerships achieve the maximum separation possible of ownership from management. In most hedge funds, the general partner manages the fund for a fixed fee and a performance fee, *i.e.*, a percentage of the gross profits from the fund.[15] Such performance fees can be as high as 20%.

Hedge fund advisers, while they fulfill all the definitions of investment advisers under the Investment Advisers Act, are generally exempt from registration under the "private advisor exemption" in § 203(b)(3) of the Advisers Act. That section exempts from registration "any advisor who during the course of the preceding twelve months had had fewer than fifteen clients and who neither hold himself out generally to the public as an investment advisor nor acts as an investment to any investment company registered" under the 1940 Act. Traditionally, the SEC had interpreted this provision to refer to the partnership or the entity itself as the adviser's client.[16] The Court noted that even the largest hedge fund managers usually ran fewer than fifteen hedge funds.[17] For all practical purposes, hedge fund managers were thus exempt from registration as investment advisers.

After the near collapse of Long Term Capital Management, a hedge fund that had more than $125 billion in assets under management at its peak, the SEC renewed its push for greater regulation of hedge funds.[18] After reviewing reports from both a joint working group of the major federal financial regulators and an SEC staff report, the SEC issued rules in December 2004.[19] The Hedge Fund Rules were issued over the dissent of two of the five SEC commissioners.

Among the Hedge Fund Rules was an amendment to Rule 203(b)(3)-1 to define a private fund as an investment company that (a) is exempt from registration under the Investment Company Act by virtue of having fewer than one hundred investors or only qualified investors, (b) permits its investors to redeem their interest within two years of investing, and (c) markets itself on the basis of the "skills, ability or expertise" of the investment adviser.[20] The rule then specifies that, for the purposes of the private adviser exemption, the shareholders, limited partners, members or beneficiaries of the fund are to be counted as "clients."[21]

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[14] *Id.* at 876.

[15] *Id.*

[16] *Goldstein* at 876.

[17] *Id.*

[18] *Id.* at 877.

[19] *See* Registration Under the Advisers Act of Certain Fund Advisers, 69 Fed. Reg. 72,054 (Dec. 10, 2004) (codified at 17 C.F.R. pts 275, 279) ("the Hedge Fund Rules.")

[20] *Goldstein* at 877.

[21] *Id.*

This had the effect of requiring most hedge fund advisers to register and thus subject themselves to SEC inspection. Additionally, a registered investment adviser cannot charge a performance fee unless the clients have a net worth of $1.5 million or more or at least $750,000 under management with the adviser.[22]

The Court noted that the Advisers Act does not define the term "client" and rejected the SEC's argument that this lack of a definition renders the statute "ambiguous as to a method for counting clients."[23]

> "There is no such rule of law. The lack of a statutory definition of a word does not necessarily render the meaning of a word ambiguous, just as the presence of a definition does not necessarily make the meaning clear. A definition only pushes the problem back to the meaning of the defining terms. *See Alarm Indus. Commc'ns Comm. v. FCC*, 131 F.3d 1066, 1068-70 (D.C. Cir. 1997); *Doris Day Animal League v. Veneman*, 315 F.3d 297, 298-99 (D.C. Cir. 2003)."[24]

In discussing the interpretation of a term susceptible to more than one meaning, the Court held that just because Congress employed such a term, it does not follow that an agency has the latitude to choose any one of such meanings. Such a term must always be read in context.

The Court noted that, in a 1970 amendment to §203 of the Advisers Act, Congress appeared to suggest that investment company entities and not the shareholders were the advisers' clients. Congress had eliminated a separate exemption from registration for advisers who advise only investment companies and explicitly made the 15-customer exemption unavailable to such advisers.[25] Such a prohibition would have been unnecessary if the individual shareholders of the investment companies were to be counted as "clients."

While the Advisers Act does not define "client," the Court noted that the definition of investment adviser does provide support for the view that Congress did not intend for shareholders, limited partners, members or beneficiaries of a hedge fund to be counted as clients. The Advisers Act defines 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."[26]

An investor in a hedge fund may benefit from an adviser's advice but he does not receive the advice *directly* from the adviser. Once the investor buys into the hedge fund, he becomes passive. If the adviser to the fund is not an investment adviser to each individual investor, then each investor cannot, buy definition, be a client of the adviser.[27]

This was the SEC's view until it reversed direction in the Hedge Fund Rules. In 1997, the SEC explained that:

[22] 15 U.S.C. § 80b-5, *Goldstein* at 877, n. 3.

[23] *Id.* at 878.

[24] *Id.*

[25] *Id.* at 879 (citation omitted).

[26] *Id.* (emphasis in original), citing 15 U.S.C. §80b-2(11).

[27] *Id.* at 880.

> "A client of an investment adviser typically is provided with individualized advice that is based on the client's financial situation and investment objectives. In contrast, the investment adviser of an investment company need not consider the individual needs of the company's shareholders when making investment decisions, and thus has no obligation to ensure that each security purchased for the company's portfolio is an appropriate investment for each shareholder."[28]

Likewise, in 1985, the SEC promulgated a rule that the "client" for purposes of the 15-client registration exemption for an investment company set up as a limited partnership is the limited partnership and not the individual partners. Under the Safe Harbor Rule, when "an adviser to an investment pool manages the assets of the pool on the basis of the investment objectives of the participants as a group, it appears appropriate to view the pool – rather than each participant – as a client of the adviser."[29]

In *Lowe v. SEC*,[30] the Supreme Court held that publishers of certain financial newsletters were not "investment advisers." That Court held that the existence of an advisory relationship depended on the character of the advice rendered. Investment advisers provided "personalized advice attuned to a client's concerns,"[31] and" fiduciary, person-to-person relationships" were "characteristic" of the "investment adviser-client relationship."[32] As the *Goldstein* Court noted, "[t]his type of direct relationship exists between the adviser and the fund but not between the adviser and the investors in the fund. The fund is concerned with the fund's performance, not with each investor's financial performance."[33]

In holding that the SEC's definition of "client" under the Hedge Fund Rules was "outside the bounds of reasonableness"[34] and "came close to violating the plain language of the statute,"[35] the *Goldstein* Court focused on the existence of fiduciary duties owed by the adviser to the fund and not to the fund's investors.

> "The Commission recognizes more generally that the duty of loyalty 'requires advisers to manage their clients' portfolios in the best interests of clients,' and imposes obligations to 'fully disclose any material conflict the adviser has with its clients, to seek best execution for client transactions, and to have a reasonable basis for client recommendations.' [Hedge Fund Rule, 69 Fed. Reg.] at 72,054.

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[28] Status of Investment Advisory Programs Under the Investment Company Act of 1940, 62 Fed. Reg. 15,098, 15,102 (Mar. 31, 1997) cited in *Goldstein* at 880.

[29] Definition of "Client" of Investment Adviser for Certain Purposes Relating to Limited Partnerships, 50 Fed. Reg. 8740, 8741 (Mar. 5, 1985) cited in *Goldstein* at 880.

[30] 472 U.S. 181 (1985)

[31] *Id.* at 208.

[32] *Id.* at 210.

[33] *Goldstein* at 880.

[34] *Id.* at 881.

[35] *Id.*

> If the investors are owed a fiduciary duty and the entity is also owed a fiduciary duty, then the adviser will inevitably face conflicts of interest. Consider an investment adviser to a hedge fund that is about to go bankrupt. His advice to the fund will likely include any and all measures to remain solvent. His advice to an investor in the fund, however, would likely be to sell. For the same reason, we do not ordinarily deem the shareholders in a corporation, the 'clients' of the corporation's lawyers or accountants. . . . While the shareholders may benefit from the professionals' counsel indirectly, their individual interests easily can be drawn into conflict with the interests of the entity."[36]

The Court found none of the SEC's arguments persuasive and failed to justify this departure from its previous interpretations of §203(b)(3). The Court rejected the SEC's attempt in the Hedge Fund Rules to carve out an exception from the "safe harbor" for general partners of limited partnerships solely for investment entities that have fewer than 100 but more than 14 investors. "The Commission does not justify this exception by reference to any change in the nature of the investment adviser-client relationships since the safe harbor was adopted. Absent such a justification, its choice appears completely arbitrary."[37]

The future of the SEC's regulation of hedge funds is completely up in the air after the *Goldstein* decision. Some commentators have predicted a massive rush to de-register by hedge fund advisers. Others have predicted that many, if not most, of the advisers who registered because of the Hedge Fund Rule will remain registered, if only to present such registrations as a kind of "Good Housekeeping Seal of Approval."

Chairman Christopher Cox of the SEC had testified before the Senate Banking Committee that the agency needs to move quickly to fill the "hole" left by the *Goldstein* decision. According to news reports of that testimony, Cox will recommend that the SEC write a new anti-fraud rule that would ensure hedge fund advisers have a fiduciary duty to investors in their funds.

To this observer, Cox's plan would seem to be an impossible task under the *Goldstein* analysis. Even if such a rule could be crafted that would comply with *Goldstein*, the SEC, to date, has not demonstrated the willingness to regulate hedge funds with the tools it does have at its disposal, as suggested by the Pequot affair. Such new rules could end up being part of a regulatory scheme that is nothing more than a show for public consumption.

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[36] *Id.* (citation omitted).

[37] *Id.* at 885.

Recent Arbitration Awards

By Jena Borden and
Carl J. Carlson

Daniel Barnathan v. Neal Bohlman and Saxony Securities, Inc.
NASD No. 05-01066

Overview. This case was a not-so-unusual pyrrhic victory for the Claimant: after 14 hearing sessions, stretched over 4 months, the arbitrators awarded $293,013 (+ interest) against the probably-insolvent defaulting registered rep, while holding the employer liable for much smaller amounts ($66,300 severally, and $9,085 jointly and severally with the rep), and requiring the Claimant to pay ½ of the $20,300 forum fees. The facts underlying this claim are, as usual, not explained in the award.

Claims and Defenses. Claimant Barnathan demanded $500,000 compensatory and $500,000 punitive damages, and specific performance (an unusual request), alleging everything including the kitchen sink: breach of contract, breach of fiduciary duty, violation of state and federal anti-fraud securities laws, failure to supervise, fraud, and negligence.

Saxony Securities denied all of the claims and alleged "various affirmative defenses", which the arbitrators apparently did not consider significant enough to list in detail. The registered rep did not appear.

Award and Significance. The panel entered the award in favor the Claimant, described above. It is significant that:

1. The panel allocated its award among the registered rep and the broker dealer, with most awarded solely against the registered rep.

2. Even though the registered rep defaulted and the Claimant prevailed on at least some of his claims against all parties, the panel did not award the Claimant any attorneys' fees—despite the fact that the $75K award against the presumably solvent broker-dealer won't come close to covering those actual fees.

3. The substantial hearing session fees, totaling $20,300—were *split* between the Claimant and the broker-dealer—further making this a hollow victory for the Claimant who apparently was genuinely damaged. (One might well ask why none were allocated to the defaulting registered rep?)

4. No punitives were awarded, as is almost universally the case.

Jena L. Borden is an attorney with the law firm of SimmonsCooper, LLC in East Alton, Illinois. Ms. Borden is a 2000 graduate of the University of Texas School of Law in Austin, Texas. Currently, her practice is devoted exclusively to representing investors in disputes with the securities industry. She is a member of the Missouri and Illinois bars. She can be reached at (800) 479-9533 or jborden@simmonscooper.com.

Carl J. Carlson is a 1976 graduate of Stanford Law School, and has practiced commercial litigation in Seattle for 30 years. He established his own firm, Carlson & Dennett, P.S. in 1995, after many years with a mid-sized firm. His practice emphasizes investor litigation and trust and estate litigation. Mr. Carlson recently completed a three year term on the Washington State Bar Association Board of Governors, and prior to that served on the King County Bar Association Board of Trustees. He can be reached at 206-621-1111, or via e-mail at carl@carlsonlaw.com.

Claimants' counsel: Scott L. Warfman, Law Offices of Scott L. Warfman

Respondent Bohlmans' counsel: none

Respondent Saxony Securities' counsel: Brian J. Neville, Law Office of Brian J. Neville

Hearing location: New York

Arbitrators: Thomas Crawford (chair), Keith Roberts, John B. Ryan (industry)

Doyle Bouse, et. al v. Wedbush Morgan Securities Inc. v. (third party claim) Michael P. Farah
NASD No. 05-01410

Overview: PIABA's own Phil Aidikoff and Ryan Bakhtiari obtained what can only be viewed as a quasi-class action award in the aggregate amount of over $2.7 million damages, plus $1,086,000 attorneys fees, on behalf of 23 separate claimants in a single proceeding arising out of Wedbush Morgan's sales of Collateralized Mortgage Obligations. The hearing took 19 hearing sessions, over two weeks. Claimants named only the firm, Wedbush Morgan, as a Respondent.

Claims and Defenses. Claimants claims "involved the solicitation and recommendation to purchase Collateralized Mortgage Obligations". Claimants alleged most of the usual suspects: breach of fiduciary duty, constructive fraud, fraud, intentional and negligent misrepresentation, failure to supervise and control, and violation of state and federal securities laws, NASD Rules of Fair Practice, and NYSE Rules. Claimants demanded an *understated* "not less than $1,000,000", plus punitives, interest, and attorneys' fees.

Wedbush Morgan denied the allegations, and asserted "various affirmative defenses." Wedbush, in turn, obtained permission from the panel to file a third party claim against the registered rep involved, alleging claims for indemnification, tortious interference with contractual relations, negligent and intentional misrepresentation, and breach of contract.

Award and Significance. The panel entered an award in favor of every one of the Claimants, in specific individual amounts ranging from $15,851 to $360,000, for a total compensatory damages award of over $2.7 million, plus attorneys fees of $1,086,266 "pursuant to the Client Account Agreements, California statutory law, and federal case law."

While Wedbush Morgan obtained the panel's permission to, and did, file a third-party claim against the registered rep, the panel allowed Wedbush Morgan to later dismiss its claims without prejudice—over the rep's objections—at the commencement of the hearing, and referred Wedbush Morgan claims against the broker to the parties' "judicial remedies".

It is significant that:

1. Claimants did not name the individual registered rep, and obtained an award against only the broker dealer involved.

2. The Panel awarded a very substantial sum for attorneys' fees, apparently relying on legal arguments about "California case law, and federal case law"—suggesting that it's not hopeless to argue case law to a panel.

3. Claimants' counsel figured out how to effectively summarize, and individually present, the monetary damages incurred by a large number of claimants.

Claimants' counsel: Philip M. Aidikoff, Ryan K. Bakhtiari, Aidikoff, Uhl & Bakhtiari

Respondent Wedbush Morgan Securities' counsel: Jerry S. Phillips, Loeb & Loeb, LLP

Third-party Respondent's counsel: David Harrison, Spivak & Harrison, LLP

Hearing location: Los Angeles

Arbitrators: Douglas J. Rovens (Chair), CathyLyn Rossi, Karen A. Lockwood (industry).

Rita B. Miller, Individually and as Trustee of the Rita B. Miller Trust v. Edward D. Jones & Co. and Daniel Holohan
NASD No. 04-07648

Overview. This case involved a Edward D. Jones' conduct in recommending to clients products sold by companies with which the broker dealer had undisclosed financial relationships. The panel awarded the claimant nearly all of the Claimant's substantial demand for compensatory damages, but required the Claimant to bear her own attorneys' fees.

Claims and Defenses. Miller alleged that Holohan and Edward J. Jones, motivated by their own self interest over the client's best interests, (1) recommended investments in Unit Investment Trusts, mutual funds, and insurance products (presumably annuities), in which Edward Jones had revenue sharing agreements; (2) did not disclose those conflicting financial relationships to Miller; and (3) did not provide to Miller the break point savings to which she was entitled. Miller demanded rescission of the transactions or, in the alternative, damages estimated at $500,000.

Respondents alleged that Miller's account was worth over $1,000,000, and she had been invested primarily in "growth and aggressive" stocks at a prior discount broker dealer, ergo she was "a wealthy and intelligent investor", experienced in choosing her own investments. The registered rep had simply recommended "more managed investments, such as mutual funds, [and] annuities", and less aggressive investments.

Award and Significance. The panel awarded Miller virtually her entire damage claim, $457,914, jointly and severally against the firm and the registered representative. The panel further ordered the registered rep and the firm to pay the entire forum fee assessment ($10,575), but did not award Miller any attorneys' fees.

It is significant that:

1. This claim focused on undisclosed conflicts of interest in a firm's recommendations to a client. Awards in favor of individual customers based on conflicts of interest are relatively rare.

2. Despite the Claimant scoring a clear and convincing "win" on the merits of her claims, she had to absorb her own attorneys' fees.

3. The Respondents' efforts to avoid responsibility by pointing to the investor's relative wealth and investment experience did not succeed, with this panel.

Claimants' counsel: Peter B. Shaeffer

Respondents' counsel: Lisa A. Nielsen, Lizabeth M. Conran, Greensfelder, Hemker & Gale, P.C.

Hearing location: Chicago

Arbitrators: John Fennig (chair), Donald M. Thompson, Georgia K. Fountoulakis (industry)

Shelly Waln v. Citigroup Global Markets, Inc., as successor to Salomon Smith Barney, William T. Lent and Michael Lent v. Merrill Lynch Pierce Fenner & Smith, Inc, Peter Bacanovic and Jake Bartlett
NASD Case No. 04-02050
New York, New York

Claimant asserted several causes of action relating to Martha Stewart Living Omnimedia Employee Stock Options. They were: breach of fiduciary duty, unsuitability, breach of contract, negligence, misrepresentation, breach of the covenant of good faith and fair dealing, breach of warranty, and respondeat superior.

Respondents Citigroup, W. Lent and M. Lent asserted contribution in their third-party claim against Merrill Lynch, Bartlett, and Bacanovic.

Claimant requested unspecified compensatory damages, attorneys' fees, costs and expenses of the arbitration and prejudgment interest.

1. After a telephonic hearing on July 6, 2005, the Panel denied Baconovic's Motion to Dismiss and Claimant Citigroup's cross motion for indemnification against Third-party Respondents, Merrill Lynch, Bartlett and Bacanovic.

2. On October 25, 2005, Respondents withdrew their claims against Third-party Respondents.

3. On June 1, 2006, the Panel found Respondents Citigroup, W. Lent and M. Lent jointly and severally liable to Claimant and were ordered to pay compensatory damages in the amount of $874,631.00 plus interest at the rate of nine percent per annum from March 31, 2001 until the award was paid.

Counsel for Claimant: Paul A. Goldberger, Esq., Goldberger & Dubin, P.C., New York, New York and J. Jeffrey Weisenfeld, Esq., New York, New York.

Counsel for Respondents Citigroup Global Markets, Inc, William T. Lent and Michael Lent: Jonathon C. Thau, Esq., Luboja & Thau, New York, NY. Previously represented by Ellen Slipp, Esq., Citigroup Global Markets, Inc, New York, NY. Previously represented by Andrew W. Sidman, Esq., Butler Fitzgerald & Potter, P.C., New York, NY.

Counsel for Third-party Respondents Merrill Lynch Pierce Fenner & Smith, Inc. and Jake Bartlett: Brenda F. Szydlo, Esq., Sidley Austin Brown & Wood, LLP, New York, NY.

Counsel for Third-party Respondent Peter Bacanovic: J. Todd Hahn, Esq. Goodwin & Procter LLP, New York, NY.

Edward Barone, Alan Billings, et. al v. Carlin Equities Corporation and Generic Trading of Philadelphia, LLC
NASD Case No. 05-00737
Albany, New York

Thirty-three Claimants asserted the following causes of action relating to investments in patrollers Capital Fund I and Patrollers Capital Fund II: vicarious liability, respondeat superior, intentional tort, negligent hiring, negligent supervision and negligent retention.

Claimants requested compensatory damages in an amount in excess of $4,700,000.00 plus pre-judgment and post-judgment interest, costs, expenses, expert witness fees, attorneys' fees, punitive damages, and such other relief as the Arbitrators deem appropriate.

Respondents requested dismissal of the Statement of Claim in its entirety, costs, and attorneys' fees.

1. On May 31, 2206, The panel found Respondents jointly and severally liable to Claimants for compensatory damages in the amount of $3,000,000, plus interest at the rate of 4% per annum beginning from January 1, 2002 until the Award is paid.

2. Each party was ordered to bear its own attorneys' fees.

3. Any further relief, including punitive damages was denied.

Counsel for Claimant: Kevin P. Conway, Esq., Conway & Conway, New York, NY and Jennifer A. Pogorelec, Esq., formerly of Conway & Conway, New York, NY.

Counsel for Respondents: Michael L. Sullivan, Esq., Coughlin Duff, LLP, Morristown, NJ and Lewis D. Lowenfels, Esq., Tolins & Lowenfels, New York, NY.

Harvey Novack and Manuel Palan v. Morgan Stanley DW, Inc.
NASD Case No. 05-04144
St. Louis, MO

Claimants asserted the following causes of action: breach of employment contract, failure to pay compensation and commissions, negligence and breach of fiduciary duty.

Claimants contended that Morgan Stanley breached promises it made to Claimants and made intentional and/or negligent misrepresentations and omissions to induce Claimants to transfer their business to Morgan Stanley from Stifel Nicolaus & Co., Inc. Because of this move, Claimants lost substantial amounts in compensation, stock options, stock, deferred compensation and pension benefits that they had accrued at Stifel Nicolaus. Claimants further asserted that because Morgan Stanley breached its promises and falsely or negligently represented to Claimants that they could transfer and conduct all of their business as they had done at Stifel Nicolaus, Claimants lost considerable revenue and incurred expenses that Morgan Stanley promised it would cover.

Morgan Stanley denied the allegations and asserted affirmative defenses of statute of limitations, equitable estoppel and acquiescence, waiver, laches and accord and satisfaction and ratification.

Claimants requested $3,900,000.00 in compensatory damages.

Morgan Stanley requested that the claims be dismissed.

1. The Panel found Respondent Morgan Stanley DW, Inc., liable and ordered them to pay Claimants $296,000.00 as compensatory damages to be divided between them as they decided.

2. The parties were to bear their own costs, including attorneys' fees.

3. All other relief, including punitive damages, was denied.

Counsel for Claimant: Anthony S. Bruning, Esq. of Leritz, Plunkert & Bruning, P.C., St. Louis, MO.

Counsel for Respondent: Salvador M. Hernandez, Esq. of Bowen, Riley Warnock & Jacobson, PLC, Nashville, TN.

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Upcoming Events:

PIABA 8th Annual Securities Law Seminar. October 25, 2006. Westin La Paloma. Tucson, Arizona.

PIABA 15th Annual Meeting, October 26 - 28, 2006. Westin La Paloma. Tucson, Arizona.

PIABA Annual Business Meeting and Election of Directors. October 26, 2006. Westin La Paloma. Tucson, Arizona.

PIABA 16th Annual Meeting, Ritz Carlton Hotel Reservations. Opens December 1, 2006.

PIABA Board of Directors Meeting, March 10-11, 2007. To Be Announced.

PIABA Board of Directors Meeting, July 14-15, 2007. To Be Announced.

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

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