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PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

President's Column

Steven B. Caruso

As we all know, from our personal experiences in the representation of public customers in securities arbitration proceedings, there are a number of facets of our daily practices which, by conduct of commission or omission, through intentional deceit or inexcusable neglect, are simply unacceptable.

I would submit to you that a ***mandatory*** system of dispute resolution, which is owned, operated and controlled by the financial services industry, is unacceptable.

I would submit to you that a system of dispute resolution, which requires the ***mandatory*** presence of a representative of the securities industry, on every three (3) person panel of arbitrators, is unacceptable.

I would submit to you that a system of arbitration, which requires the ***mandatory*** classification of an individual as a supposedly neutral "public" arbitrator, even though that very same individual has financial and/or professional ties to the securities industry, is unacceptable.

And I would submit to you that, similar to the prior misclassification of the "death tax" as the more politically sensitive "estate tax," it is unacceptable for any of the securities dispute resolution forums to continue to refer to their customer award statistics in terms of the "customer win rate."

Simply put, when the statistics for the number of public customers who are forced into the mandatory arbitration process clearly indicate that a substantial majority of those customers, at the end of the road, receive absolutely nothing in response to their claims, then it is clearly more intellectually honest to call those statistics what they really are - the "***public customer loss rate***."

Consider, if you will, that in calendar year 2006, for public customer cases administered through the auspices of the National Association of Securities Dealers, Inc. ("NASD"), the NASD states that the "percentage of customer award cases" (otherwise known as the "customer win rate") was forty two (42%) percent. But when the labeling of this statistic is reclassified so as to reflect the majority result, the public "***customer loss percentage rate***," for cases decided by a panel of arbitrators, is actually to fifty eight (58%) percent.

Similarly, for customer cases administered through the auspices of the New York Stock Exchange, Inc. ("NYSE"), the results are even more unseemly. In calendar year 2006, for example, the ***public customer loss percentage rate***, for

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cases decided by a panel of arbitrators, increased to more than sixty three (63%) percent.

I would submit that any system of supposed "justice," where the prospects for recovery are so obviously dismal and one-sided, is not a system of justice at all.

To the contrary, I would submit that this system of alternative dispute resolution "justice" is more akin to a game of three-card monte where the sacrificial public customers are being forced to "find" the ace of spades from among a fifty two (52) card deck - and this too is unacceptable.

So until our voices are heard and the interests of public customers become a source of widespread concern, each of us must continue to advance the cause. And although, at times, the process can be labored and the injustices can be daunting, this is clearly an effort where failure cannot be an option.

In closing, I want to acknowledge and express my personal appreciation to all of the individuals who, on a daily basis, are the ones who "protect public investors" on behalf of our entire organization - my fellow directors; the chairs of our various committees; all of our members who tirelessly share their advice and guidance on our internal list-serves; and our wonderful team in Oklahoma.

Understanding the Sub-Prime Debacle

Dale Ledbetter

The financial press has been full of stories about what caused the "collapse" of the sub-prime mortgage market and who should bear the blame. It is usually the case when a financial "correction" occurs for pundits and self-appointed "experts" to focus everywhere except on Wall Street when trying to identify the real culprits. Blaming Main Street or even back-street mortgage originators for what is happening in the sub-prime market is like blaming the neighborhood drug peddler for the drug abuse epidemic in America.

This article will describe the origins and development of the sub-prime mortgage market. It will also examine the important and dominant role Wall Street underwriters have played in creating, nurturing and growing the sub-prime market, and, ultimately, their role in abusing borrowers and investors. Of course, along the way, "the street" made a bundle, and, thus far, is escaping having to answer for the incompetence, deception and outright fraud which have been perpetrated. The claimants' bar needs to rise to the challenge of representing investors who have lost hundreds of millions of dollars at the hands of clever and deceptive underwriters.

A sub-prime loan is just what the name implies: a loan made to a borrower who has poor credit or some other flaw that would disqualify him or her from getting a conforming loan (i.e., a loan which would be sold by the originator to Fannie Mae ["FNMA"] or Freddie Mac ["FHLMC"]).[1] Historically, FNMA and FHLMC provided liquidity to the conforming mortgage markets. In simple terms, loans were made and securities were issued using the loans as collateral to ensure payments of principal and interest to investors who purchased the securities. Investors would not only rely on the collateral, but also on the guarantee provided by FNMA and FHLMC, both of which function as Government Sponsored Enterprises. The originating financial institution would then, after selling its product to FNMA or FHLMC, have cash and could make another loan. The creation of this liquidity has been a driving force in the growth of the mortgage market and in the price escalation of real estate. The improvement in technology and the incessant search for sources of profit by Wall Street led to seeking other types of collateral and the growth of the asset-backed securities ("ABS") market.

Credit card debt, trailer park loans and jumbo loans (above the dollar amount for the loan to be eligible for delivery to FNMA or FHLMC) were used. Portfolios of recording artists were even used as collateral for the creative originators of

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[1] The purpose of this article is *not* to explore the detailed workings of FNMA, FHLMC or other government housing agencies or programs.

ABS products. Mortgages eventually became the primary collateral of choice. Let's look at how the sub-prime market originated and at what happened as the market blossomed and boomed.

The first ABS was issued in 1995. This is a relatively new market, and the development of that market parallels and was a huge contributing factor to a boom in real estate prices. From 1995 until 2003, loan issuance went from $1.2 billion to almost $500 billion and then, according to Thompson Financial, rose to over $850 billion in 2004. Now, well over $3½ *Trillion* in ABS have been issued, including both public and private issues. The January 2005 SEC definition of ABS stated:

> The term Asset-Backed Security is currently defined in Form S3 to mean a security that is primarily serviced by the cash flows of a discreet pool of receivables or other financial assets either fixed or revolving, that by their terms convert into cash within a finite time period plus any rights or other assets designed to assure the servicing or timely distribution of proceeds to the security holders.

The Wikipedia explanation of ABS notes that: "A significant advantage of asset-backed securities is that they bring together a pool of financial assets that otherwise could not easily be traded in their existing form." The Wikipedia statement is true and the liquidity provided by numerous ABS structures has been a boon to many market participants and investors. However, as with all too many good concepts and practices, greed on the part of some originators has overwhelmed virtue.

One banker who was selling sub-prime loans to a Wall Street underwriter tells an interesting story which illustrates the nature of the fraud and deceit being foisted onto unsuspecting investors. Our banker friend had sold millions of dollars worth of loans, most of which were not originated by his "federally insured institution." Instead, almost all the loans he sold to Wall Street were originated by "wholesale" originators who then sold their product to our banker friend. He, in turn, sold the product to Wall Street. One of his loan officers informed him that a home backed by a mortgage which had been purchased from a "wholesaler" had a "problem." He asked for details and was told that the home "had no roof." Wanting to be fair, the banker picked up the telephone and called his close friend on Wall Street and informed him that the home backing a loan which had been sold to the firm a few days earlier had a "ventilation problem." Instead of being told the loan would be sent back, the Wall Street investment banker replied: "No problem, we're trying to build this deal up as large as we can. We'll just use it as collateral, and the investors will never know the difference."

This story and very similar versions were repeated tens and scores and hundreds of times during the rapid expansion of the ABS market.

As this "we'll take anything" policy[2] on the part of Wall Street underwriters encouraged mortgage brokers at the street level to create loans out of thin air, the fraud process escalated. Lenders were made aware, sometimes indirectly and sometimes bluntly, that Wall Street would take virtually "anything" and those lenders complied. They gave Wall Street anything and everything.

One way Wall Street was able to sell mass quantities of ABS product was by selling credit enhancements which caused investors to focus less on the underlying collateral and more on the widely trumpeted credit enhancements. The Bond Market Association Publication, describing ABS securities, notes that more than 90% of issues are at AAA level and that the credit worthiness derives from sources other than the paying ability of the originator or of the underlying assets.

[2] Wall Street would often use known inferior quality as a justification for paying a lower price but would, generally, still gobble up the production.

Let's look at the typical structure of an ABS originator's deal, done using a special purpose vehicle ("SPV"). The only functional reason for the existence of the SPV is to buy the assets and then securitize them. The SPV is bankrupt proof and cannot be successfully attacked. It normally sells the collateral (loans) to a trust, which then issues the interest bearing securities. Almost all deals involve some form of credit enhancements, which boost ratings and give investors a high enough comfort level to buy the securities. This was especially true in the rising real estate market. Wall Street marketers of the product usually made passing reference to the rising value of the underlying collateral, but usually stressed the credit enhancements more than the value of the collateral.

Wall Street created various types of enhancements and consistently emphasized to their pension fund and other institutional, as well as individual, buyers that the quality of the collateral was of less importance than the value of the enhancements. Thus, what really mattered in protecting investors was the quality of the credit enhancements. Let's examine some of the credit enhancements implemented by the fertile minds on Wall Street.

In a typical deal, one type of enhancement would be over-collateralization. This meant that if the deal was to be for $200 million, it would actually contain $202 million in loans or collateral, with the "extra" $2 million segregated or set aside as the over-collateralization or "O/C" account. These loans would be used to absorb losses before any of the other collateral in the account was exposed to risk.

In addition, there would be private mortgage insurance ("PMI") which normally was issued on all loans with a loan-to-value ratio greater than 80%. A major form of credit enhancement included in many deals was loan guarantee insurance. Here, the issuer would stress that an insurance policy was set up to cover a certain percentage of loss within the portfolio. This was over and above the PMI coverage issued on individual loans. In a typical policy, coverage applied to between 5% and 10% of the total. In other words, if the coverage was for 5% of a $200 million deal, then $10 million of the loans could default and the policy would protect the security holder (investor) from any loss.

However, there were often limitations on the coverage of the loan guarantee insurance. These limitations were buried deep into a long and complicated prospectus and were seldom, if ever, drawn to the attention of buyers. For instance, the coverage would often not apply to "fraudulent" loans. This meant that if the insurer determined that a loan was "fraudulent," they would simply refuse to provide coverage for that loan, leaving the investors to bear the loss. The determination of what was fraudulent was often a unilateral decision left to the company issuing the policy. An investor could not even get criteria or any details from the insurance company as to why an individual loan was deemed "fraudulent."

In connection with the loan guarantee policies, the following information should have been provided to investors but often was not:

(a) Mortgage loan level information regarding insurance claims and insurance proceeds paid by the insurance companies for defaulted mortgage loans.
(b) Examination of claims which were rejected and reasons for rejection by the insurance company.
(c) A thorough explanation of criteria used by the insurance companies in the determination of fraud and misrepresentation as a reason to reject coverage on a defaulted loan.
(d) Examination of defaulted mortgage loans with regard to their loss and recovery experience by zip code in order to check for property appreciation.

There was another selling "feature", while not a direct credit enhancement, that was something Wall Street firms would emphasize. This added "feature" was having a "name" servicer be responsible for administering the deal (i.e., collecting principal and interest and forwarding payments which would go to investors). The servicer was also responsible for notifying late payers, collecting from stragglers, and instigating and following through on foreclosure and bankruptcy

Another important "feature" used to lure investors and to provide a high comfort level in the complex structure was to have a big name trustee, usually one of the major New York banks which accepted payments from the servicer and forwarded them to investors as well as being responsible for tabulating data which came from the servicer.

Obligations of the trustee generally included obtaining and reporting the number and amount of claims submitted under the loan guarantee policy. This was often done only partially, if at all. The trustee should always take the appropriate action to obtain the information required to be furnished to investors. Again, this was, all too often, not done.

The trustee was theoretically responsible for looking out for the interest of the investors. In fact, the trustee generated huge income from Wall Street and often put the underwriter's interests above those of the investors.

All of these enhancements and features combined to form an attractive and alluring package for investors. Rating agencies, relying on the combination of collateral enhancements and features, placed credit grade ratings on billions of dollars worth of ABS. Real estate prices went up. The defaults were minimal. Initially, all the gears meshed and everyone was happy. Then problems began to develop. Greed overpowered common sense. Wall Street let it be known that it would take virtually *any* loan. The process and system began to spiral out of control.

One of the complicating factors was that servicers were oftentimes subsidiaries or captive participants of the Wall Street issuer/underwriter. The same is often true of the originator sources. The Wall Street firm would use its mortgage company to acquire loans from "federally insured institutions" and stressed in the prospectus given to investors that the originators were "responsible parties" and that the underwriter knew the source of the loans. However, underwriters generally failed to disclose to investors that the vast majority of loans were coming from unregulated wholesalers, and that little or no due diligence was done to check the quality, or lack thereof, of the loans that went into a particular deal.

The sub-prime market exploded as mortgage originators realized Wall Street would take anything. As this article is written, well over two million homeowners are delinquent on their loans. Sub-prime loans, according to Inside Mortgage Finance, amounted to one in every 20 loans in 2001; by 2006 the number was over one in five!! Wall Street drove this explosion. It was Wall Street's voracious appetite, the yawning jaws shouting out "we'll take anything, bring it on, bring it on" that led to the fraud, abuse and the bumbling, stumbling explosion of a market that went way beyond its reasonable bounds.

Another unfortunate factor is the huge number of adjustable rate sub-prime loans that were included in many ABS deals. This fact was also generally played down in Wall Street's sales pitches, with the disclosure of the percentages of adjustable rate loans limited to the fine print. As interest rates began to rise, adjustments took place and many borrowers could not meet the higher payments. This led to greater delinquencies and ultimately to far more defaults. This process is really just beginning to impact the markets, as huge numbers of loans will adjust upward in the remainder of 2007 and throughout 2008. As defaults increase, investors will be left holding the bag with no pain falling to Wall Street. The major firms on Wall Street made the big bucks and shifted the risk to, in many cases, small, unsophisticated financial investors or even individuals.

Wall Street did more to insulate its own position by wholesaling to regional dealers many of the highest risk tranches of ABS products. Many of the regionals lacked the technical expertise to properly evaluate the securities or to explain to their buyers the results of limited and inadequate analyses. The regionals saw big spreads, and, relying on Wall Street prodding, sold the ABS product, took the big spreads and are now scrambling to explain too many of their customers how they both were hoodwinked by the big boys on Wall Street.

The regional dealers often rely on Bloomberg analytics to structure their presentations to individuals and institutional investors. Bloomberg was founded in 1981 by the current Mayor of New York City as an information services news media company. Bloomberg provides a wide range of features, including a combination of information, analytical electronic trading and communication tools. Bloomberg is an excellent global news, television, radio, internet, magazine and book publishing operation. However, the analytics Bloomberg offers in the ABS area are simply inadequate. Its stature as a publisher does not qualify Bloomberg to be the preeminent analytical source for the kinds of complex and sophisticated analyses required in analyzing ABS products.

This is because the Bloomberg analyses assume no credit losses will occur to the security being analyzed. Failure to disclose this fact would be a grossly negligent misrepresentation or omission if not fully revealed and explained to potential buyers. Instead, the state of the art analysis for this type of product is provided by Intex Solutions, Inc. According to the Intex Web site, the company is in the business of providing the most accurate, timely and comprehensive data models and related software for the structured fixed income market. In touting its ABS analytical capabilities, Intex notes that structured transactions are replete with nuances that can and do have a great impact on cash flows. Intex makes clear that even AAA rated structures with razor thin margins need careful attention and demand accurate analysis. The Intex Web site provides clear evidence that to be accurate and reliable, ABS analytics must go far beyond the minimal calculations provided by Bloomberg. Any securities dealer pushing the sale of ABS products based on Bloomberg analytics is clearly offering incomplete, inaccurate and what might be highly misleading information. Yet, literally billions of ABS products were sold by uninformed regional dealers, while Wall Street turned a blind eye to what was happening.

The next problem is likely to be in Alt-A loans. Alt-A borrowers have better credit scores than sub-prime borrowers, but usually Alt-A loans are originated with less than complete information as to net worth, employment, credit history or other areas where complete information had historically been required prior to a loan being made. This has led to the less than complimentary name of “liar loans” being applied to many Alt-A loans. There is often no income validation and “alternative” documentation is widely used for Alt-A applications. Alt-A loan originations, like sub-prime, have also exploded. Standard & Poors estimated that less than $20 billion worth were done in the fourth quarter of 2003, but more than a $100 billion were done in each of the last three quarters of 2006. This staggering explosion is a second ticking time bomb coming on the heels of the sub-prime debacle. Writers, commentators and pundits have already begun to cast blame on the unscrupulous and irresponsible originators. Time will prove that Wall Street’s heavy palm print is all over what has happened in the Alt-A market. ABS originators again put out the word that their window was open, and they invited all comers to drop off whatever Alt-A trash they could come up with. As with the sub-prime market, many Alt-A loans were acquired by Wall Street subsidiary mortgage companies directly from rogue wholesalers or indirectly from such sources who sold to "federally insured institutions" who in turn sold to the Wall Street subsidiaries.

A March 19th article in *Fortune Magazine*, written by Bethany McClain, described what fed the ABS problem: "These products exploded in popularity in recent years because investors, including pension funds and insurance companies which must mostly buy investment grade rated debt had a voracious appetite for them." That, in turn, encouraged the historic increase in sub-prime lending.

Here again, the emphasis is misplaced. Very few products are "bought" even in the so-called sophisticated world of institutional investors. In fact, the products are *SOLD*! These products are cleverly packaged and aggressively marketed by Wall Street. Direct contact with buyers was made by articulate sales people. The harder ABS product was sold and the more profit Wall Street made, the more Wall Street continued to seek out the collateral to feed the machine. The vicious cycle expanded and accelerated.

Another element in the grand scheme of the process was the role of the rating agencies. Since investors were looking to buy investment grade rated debt, getting an appropriate rating on the product was critical. Moody's net income went from $159 million in 2000 to over $700 million in 2006, in large part from fees generated in these sub-prime and Alt-A ABS deals. The rating agencies were hardly disinterested bystanders. Much like Wall Street analysts during the tech boom, the ratings agencies did not act as impartial analysts. The ratings often relied on illusory credit enhancements and persuaded investors to purchase staggering volumes of ABS product.

The problems with sub-prime loans were not restricted totally to residential loans. On March 6, 2007, Standard & Poors lowered ratings on four classes of commercial mortgage pass-through certificates from Credit Suisse First Boston Mortgage Securities Corp. This is like the tip of a large iceberg in which suspect commercial properties, just like suspect residential properties, were hastily thrown in as collateral for securitization, given that Wall Street securitizers knew they could be sold to anxious investors trained by Wall Street sales people to acquire such product.

Deterioration in the market is now rampant. Over 30 major sub-prime originators have gone out of business. More will surely follow. Foreclosures increased 100% in 2006 over the previous year. Lehman Brothers indicates that investors' losses currently exceed $18 billion. Bloomberg has offered a far more pessimistic assessment that losses are, in fact, over $75 billion.

A random sample conducted by one mortgage company indicated that 20% of loans that went into early payment default ("EPD") were damaged, unoccupied properties (i.e., the loans were fraudulent to begin wit)h. Even the slightest due diligence by the Wall Street originator would have uncovered these problems.[3]

EPD was an area in which servicers participated in a massive fraud. In most early payment default situations, the originator would be required to repurchase loans it had originated and sold to the underwriter as collateral. However, there usually was a 90 day to one year limitation on the EPDs. This meant that if a loan defaulted within the first 90 days (or whatever period was selected), the originator was required to take back the loan. Since often times the originating mortgage company was a subsidiary of the underwriter, this would have created a problem for the corporate hierarchy of the Wall Street underwriter. By having the

[3] One Wall Street originator was known to do due diligence on 5% of the loans in a deal. If 20% came back as "bad loans," those 20% would be taken out of the deal. One could and should reasonably assume a similar experience with the other 95%. However, the firm would do no more due diligence and would place all the remaining 95% into the collateral pool.

servicer advance principal and interest *beyond* the cutoff period for early payment default, it would avoid this consequence.

When the servicer advanced the money for the 90 day cutoff period, the fiction was maintained that the loan was good. When the cutoff period passed, the loan would go in default and the loss would be taken by the investor rather than having the bad loan put back to the originating mortgage company. This type of fraud on investors will no doubt amount to billions of dollars. The entire problem will be greatly exacerbated by the fall in real estate prices which is occurring throughout the country. This drop is also serving to emphasize the link between real estate price escalation and the ABS market.

State and federal regulators, and even legislators, are finally beginning to grasp the picture as far as the role Wall Street has played in the sub-prime and emerging Alt-A debacles. Barney Frank, the Massachusetts Democrat and chairman of the financial services committee of the House, said that he is considering legislation that would discourage "abusive loans" by imposing legal liability "up the chain." Frank wants to place the blame where it belongs and his actions would be to give borrowers and others greater ability to sue Wall Street firms that packaged the mortgages and sold them as ABS product. Christopher Dodd, Frank's counterpart as chairman of the Senate Banking Committee, has indicated that he wants more aggressive regulations to deal with the problem as opposed to additional legislation.

Given the lobbying history and success of Wall Street in defending its turf, it's unlikely that any significant legislation will be forthcoming. It will be up to claimants' attorneys to represent abused investors and to fight back against Wall Street. It is important that those who have suffered abuse be educated to understand that the abuse did not come as much from individual mortgage brokers and originators at the street level, but, in fact, came from the top of the pyramid: the Wall Street issuers.

Brokerage Settlement Agreements – Ethical or Unethical?

Mark A. Tepper

To settle or not to settle: that is the question.[1] Whether 'tis nobler to sign a settlement agreement which includes one or more unethical provisions or be forced to proceed to hearing.

Ethics issues frequently come up in the context of confidentiality and indemnification provisions in settlement agreements. Various state ethics committees have determined that over broad confidentiality provisions are unethical because they indirectly affect an attorney's ability to represent other clients against the same opposing party. They also agree that, generally, attorneys may not agree to be liable for indemnification to the defendant.

Recently, a customer's arbitration claim was settled with New York in-house counsel ("in-house counsel") from one of the big wire houses. In-house counsel proposed a settlement agreement with a broad confidentiality clause that required the Claimant's counsel to keep the facts of the case confidential as well as the terms of the settlement. Fortunately, the New York State Bar Association Committee on Professional Ethics had written an opinion, directly on point, which was shared with in-house counsel. He said that "reading it was an eye opening experience."

He was referring to NY Ethics Opinion 730 (2000) which is discussed below.

Confidentiality

New York's controlling rule DR2-108(B) provides: "In connection with the settlement of a controversy or suit, a lawyer shall not enter into an agreement that restricts the right of a lawyer to practice law." NY Ethics Opinion 730 (2000). This rule is intended (1) to preserve the public's access to lawyers who, because of their background and experience, "might be the best available talent to represent these individuals," (2) to prevent parties from "buying off" the opposing lawyer and (3) to prevent a conflict between a lawyer's present client and the lawyer's future ones. ABA Op. 93-371 (1993). *Id.* "This rule applies equally to a lawyer who would propose or offer such an agreement and the lawyer who would accept it." *Id.*

As New York recognized, confidentiality provisions are properly applied to the terms of the settlement. However, an ethics violation occurs when those same confidentiality provisions are applied to the underlying facts, because those facts may be needed to represent future clients against the

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[1] My apologies to William Shakespeare.

same opposing party; thus, creating a conflict of interest.

The New York opinion focused on the scope of the confidentiality provision:

> . . . confidentiality provisions that . . . prohibit the parties and their lawyers from disclosing the terms of a settlement are common and do not violate DR2-108(B). NY Ethics Opinion 730 (2000). The obligation to preserve the confidentiality of settlement terms does not effectively restrict the lawyer from representing other clients. Further, the terms of confidential settlement are client "confidences" or "secrets" within the meaning of DR4-101, which establishes the lawyer's ethical duty of confidentiality. Therefore, the lawyer may not disclose settlement terms without client consent and, conversely, the client may insist that the lawyer keep this information confidential. Since lawyers may not disclose confidential settlement terms without client consent, it is not an impermissible restriction on the right to practice law to require, as a condition of settlement, that the party's lawyer will not disclose this information.
>
> . . . however, terms of a settlement agreement may violate DR2-108(B) if their practical effect is to restrict the lawyer from undertaking future representations and if they involve conditions or restrictions on the lawyer's future practice that the lawyer's own client would not be entitled to impose. See, e.g., ABA Op. 417 (2000)(limitation contained in settlement agreement would effectively bar future representation because the lawyer's inability to use information could materially limit and adversely affect representation of future clients);

* * *

> . . . the proposed settlement term that would prohibit disclosure of "any information concerning any matters relating directly or indirectly to the settlement agreement or its terms" appears to be overbroad.
>
> These provisions would restrict the lawyer's right to practice law by requiring the lawyer to avoid representing future clients in cases where the lawyer might have occasion to use information that was not protected as a confidence or secret under DR 4-101 but nevertheless covered by the settlement terms. A settlement proposal that calls on the lawyer to agree to keep confidential, for the opposing party's benefit, information that the lawyer ordinarily has no duty to protect, creates a conflict between the present client's interests and those of the lawyer and future clients – precisely the problem at which DR 2-108(B) is aimed.

Similar agreements have also been considered by ABA Formal Opinions 00-417 and 93-371. ABA Opinion 00-417 concludes that a lawyer may not seek or agree to a settlement term prohibiting the lawyer's future use of information obtained during the representation as it violates Model Rule 5.6(b). The committee found that while this might not be a direct ban on future representation, "[a]s a practical matter, however, this proposed limitation effectively would bar the lawyer from future representations because the lawyer's inability to use certain information may materially limit his representation of the future client and, further, may adversely affect that representation."

The Florida Professional Ethics Committee has reached a similar conclusion. Fla. Opinion 27070 (2006). In that matter, the confidentiality:

> clause generally required the attorney and the claimants to keep everything confidential, regarding all negotiations, claims, and facts and circumstances of the action. . . . the confidentiality provision shall not prevent the attorney or the claimants from responding to

> subpoenas or otherwise being legally compelled to provide information, including providing information necessary for filing tax returns, responding to SEC inquiries, etc. *The clause does not make any reference to prohibiting the attorney from using information gained through this representation in later representations against the same opposing party.* Emphasis added.

The confidentiality clause that the attorney was asked to sign is governed by Rule 4-5.6(b) which states as follows: "A lawyer shall not participate in offering or making . . . an agreement in which a restriction on the lawyer's right to practice is part of the settlement of a controversy between private parties." The test for determining whether a particular agreement violates that rule is "how does a particular settlement provision affect an attorney's ability to represent another client in a matter involving the same or a related opposing party." Fla. Opinion 27070 (2006).

"Based on the above authority, [the Florida Professional Ethics Committee advised] that the confidentiality portion of the clause appears to be overbroad and therefore may restrict the inquirer's right to practice under Rule 4-5.6(b)." *Id.*

Indemnification

Often times a brokerage firm will insert an indemnification clause into the settlement agreement requiring an attorney to sign it to obtain a settlement. A typical indemnification clause may read as follows:

> Claimants and their attorneys expressly agree to indemnify and hold the brokerage firm harmless from all costs, expenses, and damages of any kind, including litigation expenses and attorney's fees, caused by any breach of the confidentiality provisions.

The proponent of such a restriction might argue that it is needed to prevent the lawyer's improper use or disclosure of information learned in the course of the representation, that the lawyer may have a duty to keep confidential. However, an attorney indemnification clause may not be justified on this ground.

The Florida Professional Ethics Committee advised an attorney that he "may not indemnify and hold harmless the opposing party caused by any breach [of the above mentioned indemnification clause] in the settlement agreement."

The Tennessee Board of Professional Responsibility determined that an attorney's signature on a release:

> should vouch only for the fact that the client releases the defendant. A requirement that a Plaintiff's attorney become a party to a release might create a conflict of interest between Plaintiff's attorney and the Plaintiff in violation of DR5-101(A). Therefore these clauses are prohibited except in cases where the Plaintiff's attorney releases a claim for attorney fees.

Tennessee Ethics Opinion 97-F-141. Additionally, the North Carolina Bar Ethics Committee has issued an opinion stating that an attorney may not accept a settlement on the behalf of a personal injury client that requires the attorney to indemnify the defendant for all outstanding medical liens. North Carolina Ethics Opinion 228 (1996). See also, Arizona Opinion 03-05.

Conclusion

After in-house counsel discussed the New York Ethics Opinion 730 with his wife (also a lawyer) she asked him: do attorneys actually signed these restrictive, unethical, confidentiality agreements?

"Sure," he replied, "they all do. No one ever objected before."

Ethics rules protect attorneys from unethical confidentiality and indemnification provisions in a settlement agreement. Don't accept the Hobson's choice to sign an unethical agreement or go to hearing. Insist on an ethical settlement agreement.

Return, Risk and Probability of Success- Why Manage Risk?

Frank A. Armstrong

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Investors focus with a laser like intensity on a single factor of investment success: rate of return. It's simple to understand and reduces the entire multidimensional problem to a single number. A good strategy, or investment manager, has a high rate of return. A bad strategy or investment manager has a low rate of return. If only life were that simple!

By focusing on rate of return and ignoring risk, investors may actually torpedo themselves. Remember back to the late 1990s, when brokers having their clients get on the gravy train of returns, only to encounter a split rail in 2000 that they hadn't bothered to discuss with their return-happy clients? High-risk strategies, even those that have high returns, may actually decrease the chance of an investor having a successful experience. Within a wide band investors may be far better served to focus on managing risk than stretching for additional return. But that takes discipline and not instant gratification.

Few investors have an intuitive feel for the impact of risk. Just mention standard deviation and most of them will his zone right out. It would be helpful if we replaced the term standard deviation with relative risk rating. It also should be required that fund managers place equal emphasis on risk rating along with rate of return and publish relevant comparative data for the appropriate indexes.

Managing risk isn't nearly as glamorous as generating returns. But, returns are elusive, while basic risk management is easily achieved.

In a previous article, I demonstrated that diversification reduces risk without compromising rate of return. An investor choosing between two strategies with equal expected returns would certainly prefer the one with a lower risk. Lower risk not only reduces the dispersion of returns, but it increases both median and average returns. High-risk strategies may produce few winners with outsized returns, but many more investors will experience substandard and unsatisfactory results.

An accumulation example

Here's a table showing the distribution of returns for at different theoretical risk levels. I assume a 10% average return, a one hundred thousand dollar beginning balance, 30 year time frame, standard deviations of 10%, 20% and 30% respectively. Feeding these assumptions into a Monte Carlo simulator shows just how important managing risk is.

Standard Deviation	Average Return	Best Case	Worst Case	Median
10%	$1,730,329	$ 7,569,806	$186,925	$1,534,396
20%	1,699,584	25,313,829	16,146	1,060,438
30%	1,641,217	65,208,720	1,171	585,919

As you can see, as risk levels increase while holding rate of return constant, results become skewed. The average returns are virtually identical. But, both the best and worst results become more extreme. A few trials yield mega results, balancing out the trials that fall under the average. Importantly, the median result decreases precipitously as risk increases. More and more trials fall below the average result. This lower median return is the "cost" of the higher risk strategy.

This finding is consistent with the widely understood concept of variance drag. Because of variance drag, average (arithmetic) returns are always above compound (geometric) returns by an amount which increases as the volatility of the portfolio increases. Only in the case of no volatility are they the same. Volatility reduces the returns that investors care about: the compound return that ends up in their pockets.

Because there are no withdrawals in my illustration, none of the portfolios crash and burn. But, when we introduce systematic withdrawals (such as a 72t election for early retirees), the probability of portfolio failure increases with the withdrawal rate. During down markets, so much capital is consumed at depressed prices to fund disbursements that the portfolio may self-liquidate.

So, it's essential that wherever there are systematic withdrawals from a portfolio, risk should be vigorously controlled. Higher risk leads to predictably higher portfolio failures. Retirees, charitable institutions, endowment funds and defined benefit pension plans must exercise prudence when managing their funds or risk portfolio blow out.

Risk is amplified with systematic withdrawals

Here's a table showing the results at various risk levels for a portfolio taking systematic withdrawals. We assume a $100,000 beginning capital, $6,000 a year withdrawal beginning year one, 30 year time horizon, and 10%, 20% and 30% standard deviation. We will call successful any portfolio with $1 remaining after 30 years.

Standard Deviation	Average Remaining Capital	Best Case	Worst Case	Median Remaining Capital	Probability of Failure
10%	$749,508	$ 4,801,855	$0	$615,244	1%
20%	759,208	18,387,065	0	318,072	21%
30%	782,699	50,637,405	0	52,577	43%

A real case postmortem

Recently I analyzed a case where a retiree, age 49, rolled over a single stock from her qualified retirement plan and failed to diversify it. For the 10 years preceding the rollover, that stock had had a standard deviation of 37.97%. Her broker estimated the future returns at 10% to 12% and commented that it was a great company. Additionally, the brokerage firm had a very high "target price" estimate over the near future. The value of the portfolio at rollover was $1,365,383, and an $80,000 annual withdrawal was agreed on from the IRA.

Poorly diversified portfolios pick up a boat load of uncompensated risk. But, in this case, the totally undiversified portfolio had even greater risk. The broker's estimate approximated the return of the S&P 500, but the risk was a large multiple of the index's risk. The difference was by definition uncompensated. The goal of any investment manager is to ruthlessly eliminate any uncompensated risk.

In this case, the entire value of the portfolio was lost. How predictable was that result? Was it a bolt from the blue, or a highly likely outcome of a totally unsuitable portfolio design?

Using Monte Carlo analysis, we can get a good indication of the range of possible outcomes for such a risky strategy. Because the retiree was so young, we believed that a minimum of 40 years was the appropriate time horizon. We accepted, for purposes of the analysis, the broker's 11% average expected return assumption for the stock.

Year	Probability of Success	Median Capital Remaining
10	86	$1,062,257
20	59	$547,294
30	48	$0
40	42	$0

It's highly unlikely that an informed investor would have opted for a strategy that offered a 58% chance of being dead broke before her projected life expectancy. Easily obtainable portfolios would reduce those dreadful possibilities to insignificance. In this case, the Monte Carlo analysis provides us with a powerful indication that the strategy is fatally flawed. It can't tell us whether any particular individual will succeed or fail, but it can point out that this strategy is much too risky and highly unlikely to meet the investor's goals.

At the time, the 10 year standard deviation of the S&P 500 Index was 16.83%. Merely buying the Index would have radically improved the probability of success. For purposes of this analysis, we estimated the expected rate of return at the same 11% the broker was using for the stock. It is within a few basis points of historical returns and simplifies the comparison.

Year	Probability of Success	Median Capital Remaining
10	100	$2,122,404
20	97	$4,079,624
30	92	$8,764,128
40	88	$19,277,076

Using readily available index funds, we can diversify globally to reduce the risk of the equity portfolio. I demonstrated this in my previous article: "How Much Diversification is Enough?"

However, it's inappropriate to have a full equity position in a retiree portfolio. Diversification between equity and high quality short term fixed income allows for further risk reduction and provides a store of value to fund withdrawals during the inevitable market declines that one would expect over a 40 year time horizon. A simple 60% global equity/40% short term bond portfolio has the following expected return and risk profile: 9.24% expected return with an 8.26% standard deviation. While it does reduce the rate of return, it dramatically reduces the risk, and improves the probability of success.

Year	Probability of Success	Median Capital Remaining
10	100	$1,964,305
20	100	$3,390,054
30	100	$6,667,003
40	99	$13,876,898

Intelligent people can disagree on the exact composition of alternative suitable portfolios. There's nothing magic about the portfolios I prepared. The key takeaway from the exercise is that *ANY* reasonably prudent diversification would have been preferable to a concentrated stock position. This train wreck did not have to happen.

The Monte Carlo simulation simply demonstrates the probability of any risky strategy to self liquidate over time if subject to withdrawals. As we saw in 2000 – 2003, a few bad years can consume so much capital that the account implodes under the pressure of continuing disbursements.

Individual company failure risk is not captured by the standard deviation of returns of the stock. It's an additional wildcard. Any company can be tomorrow's Enron or Global Crossing. It's not likely that you could spot imminent failure just from studying past returns and volatility. Fortunately, individual company failure risk can be completely diversified away in a prudent portfolio.

Summary

Diversification is the cardinal rule of investment management. It reduces risk and increases the probability of a successful outcome for the investor. Concentrated stock positions violate every principle of modern portfolio practice standards. They are neither suitable nor prudent for the vast majority of investors.

Prudent diversification reduces risk without sacrificing expected rates of return. Global diversification is the gold standard for prudence in equities. A portfolio must be tailored to the liquidity needs, risk preferences and time horizon of the client. Short term high quality bonds provide a store of value without significant market risk to meet those liquidity needs.

Over a reasonable range, reducing risk is more important than chasing returns. The appropriate portfolio is the one that offers the highest probability of success rather than the highest return regardless of the risk level. In many cases, investors may even increase their chance of a successful outcome by opting for a portfolio with lower returns and risk.

Caveat Consiliator - Let the Adviser Beware Imposing Fiduciary Duties on Fee-Based Financial Professionals

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I. Introduction

The last five years have been a very tumultuous time for individual investors. Since 2000, the following events have impacted the financial markets: (1) an economic slowdown in early 2000; (2) increased inflation and decreased consumer confidence;[2] (3) the tragic events of 9/11; (4) the fraudulent activities at Enron, Tyco, Worldcom, Global Crossing and other high-flying publicly traded companies;[3] (5) the numerous investigations into the trading abuses at many of the large mutual fund companies;[4] and, (6) a significant decline in home buying and home sales prices. Each of these events has caused individual investors to lose confidence in the securities markets.[5] In response to some of these events, Congress passed the Sarbanes-Oxley Act of 2002[6] and the Securities and Exchange Commission ("SEC") proposed or issued rules related to mutual fund disclosures.[7]

Despite the recognition of critical problems with the corporations and investment companies whose securities are offered to the public, and the subsequent regulations to enhance investor protection, regulators have done very little to change the requirements for financial professionals.[8] As a result, individual investors are also losing faith in financial

[1] Some revisions have been made from the article's original form, including discussion of the March 30, 2007 decision by the United States Court of Appeals for the District of Columbia Circuit in.

[2] *See Fed: Slowdown Not Over*, CNNMONEY, Feb. 28, 2001, *at http://money.cnn.com/2001/02/28/economy/greenspan/index.htm* (last visited Sept. 15, 2004).

[3] *See* Jake Ulich, *Year of the Scandal*, CNNMONEY, Dec. 17, 2002, *at* http: //money.cnn.com/ 2002/12/17/news/review_scandals/index.htm (last visited Sept. 15, 2004); Rebecca Thomas, *Crisis of Confidence*, SMARTMONEY, Feb. 6, 2002, *at http://www.smartmoney.com/theeconomy /index.cfm?Story=20020206* (last visited Sept. 15, 2004).

[4] *See* Christine Dugas & Elliot Blair Smith, *SEC Rule Viewed As Both 'Right Step' and Restrictive*, USA TODAY, June 24, 2004 (includes a listing of settlements reached with various mutual fund companies between Sept. 3, 2003 and June 21, 2004); *60 Minutes: Mutual Fraud; Uncovering a Late-trading Scheme of Mutual Funds* (CBS television broadcast, July 7, 2004); *Day to Day: SEC Votes On Several Proposals To Crack Down On Abuses In the Mutual Fund Industry* (National Public Radio broadcast, June 23, 2004).

[5] *See, e.g.*, *Business Center: Tom Lauricella of The Wall Street Journal and Stephen Schurr of TheStreet.com Discuss the Problems Facing Mutual Funds* (CNBC News television broadcast, Oct. 21, 2003).

[6] Sarbanes-Oxley Act of 2002, 116 Stat. 745 (codified as amended in scattered sections of 15, 18, 28 U.S.C. (2002)).

[7] *See* Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, Investment Company Act Release No. 26,418, 17 C.F.R. 239, 274 (Apr. 16, 2004); Investment Company Governance, Investment Company Act Release No. 26,520, 17 C.F.R. 270 (Sept. 7, 2004).

[8] Sarbanes-Oxley does have some provisions for "analyst conflicts of interest," relating to analysts or employees employed by a broker-dealer. *See* 15 U.S.C. § 78o-6 (2004).

professionals.[9]

Financial professionals have resorted to a variety of fraudulent practices in recent years to make up for the decline in the value of the assets they manage,[10] such as "unlicensed individuals, selling securities[,]" unauthorized transactions, unexplained fees,[11] "senior investment fraud,"[12] "mutual fund business practices,"[13] selling promissory notes,[14] and sales of high-commissioned, non-regulated products, such as equity-indexed annuities. To provide individual investors with adequate protection, additional standards must be imposed on those who most often disseminate the information to the investor—their financial professional. *A superior method to accomplish this task would be to broaden the fiduciary duties financial professionals owe their clients*. In particular, federal and state securities laws should impose fiduciary duties on financial professionals who are compensated by charging a "management fee," rather than individual commissions, and who, in conjunction with their business of serving as a broker[15] on individual transactions, provide investment advice, and other related services to their customer.

There have been a few problems in determining whether a financial professional should (or would) be held to fiduciary duties. In general, a fiduciary is:

> A person who is required to act for the benefit of another person on all matters within the scope of their relationship; one who owes to another the duties of good faith, trust, confidence, and candor; one who must exercise a high standard of care in managing another's money or property.[16]

Although this definition seems to be exactly what the average person would expect from their financial professional, the issue of whether fiduciary duties exists, and, if so, to what extent the financial professional is bound by such duties, is unclear.[17] Some ambiguity comes from the numerous designations these professionals use and the

[9] *See, e.g.*, Jeff Benjamin, *Do-it-yourself Investors? Seems They're Doing It Again; Discount Brokers See Volume Spike*, INVESTMENT NEWS, Mar. 22, 2004, at 3.

[10] *See* Helen Huntley, *Stockbroker Fraud In Investment Scam Top 10*, ST. PETERSBURG TIMES, Aug. 27, 2002, at 1E.

[11] *Securities regulators' 'Most Wanted List': the top 10 investment scams of 2002*, CONSUMER RES. MAG., Oct. 1, 2002, at 26.

[12] Press Release, North American Securities Administrators Association, State Securities Regulators Release Top 10 Scams, Schemes & Scandals: Mutual Fund Practices, Senior Investment Fraud, Variable Annuities Join 2004 List (Jan. 14, 2004), *available at* http://www.nasaa.org/nasaa/scripts/prel_display.asp?rcid=244 (last visited Sept. 15, 2004) ("Volatile stock markets, record low interest rates, rising health care costs, and increasing life expectancy, have combined to create a perfect storm for investment fraud against senior investors… [who] are being targeted with increasingly complex investment scams involving unregistered securities, promissory notes, charitable gift annuities, viatical settlements, and Ponzi schemes all promising inflated returns.") *Id*.

[13] *Id.*

[14] *Id.*

[15] "[A]ny person engaged in the business of effecting transactions in securities for the account of others." 15 U.S.C. § 78c(4)(A) (2004)

[16] BLACK'S LAW DICTIONARY (8th ed. 2004), *at http://www.westlaw.com* (last visited August 27, 2004).

[17] *See generally* Carol R. Goforth, *Stockbrokers' Duties to Their Customers*, 33 ST. LOUIS U. L.J. 407 (1989) (discussing the issue of fiduciary duty as it applies to stockbrokers).

remainder of this vagueness has come from the courts.[18]

A significant problem in determining whether a fiduciary duty exists has been related to the development of the practice of financial professionals. These professionals use a variety of terms to describe the services they provide; lack of regulation regarding generic descriptions of financial professionals has left individual investors to assume that the services offered by each are identical. The SEC, however, has created a loophole[19] in determining whether a financial professional should be held to the standard of a stock "broker", as that term is defined by the Securities Act of 1934,[20] or an "investment adviser", as defined under the Investment Advisers Act of 1940.[21] This loophole now appears to have closed.

Another significant problem in determining the application of fiduciary duties to financial professionals is that since 1987, the development of jurisprudence in securities law has stagnated because customer claims have primarily been adjudicated by arbitration panels.[22] Because these arbitration panels do not issue written opinions, there has not been much case law on the subject of the fiduciary duties of financial professionals over the past 20 years.[23] As a result, the issue of whether a financial professional has a fiduciary duty to his client has remained, for the most part, suspended.[24]

The focus of this paper is on fee-based financial professionals, hereinafter referred to as "fee-based advisers" (to distinguish their activity from the activities of "Investment Advisers", as defined in the Investment Advisers Act of 1940[25]). These financial professionals charge their customer/client a fee, generally paid quarterly or annually, based on some measurable factor.[26] Those factors include: an hourly rate; "a percentage of assets" the professional manages; a fixed rate for a package of advice; or, a percentage

[18] *See id. Compare* Farmland Indus. v. Frazier-Parrott Commodities, Inc., 871 F.2d 1402, 1411 (8th Cir. 1989) (In Missouri, fiduciary duties may arise out of a financial professional-customer relationship); *with* Lefkowitz v. Smith Barney, Harris Upham & Co., 804 F.2d 154, 155 (1st Cir. 1986) (stating that "a simple [financial professional]-customer relationship does not constitute a fiduciary relationship in Massachusetts."); *and with* Brown v. California Pension Administrators & Consultants, Inc., 52 Cal. Rptr. 2d 788, 796-97 (Cal. App. 1996) (stating that where a financial professional provided investment advice to his customer, the relationship was one of principal-agent, and therefore, fiduciary duties applied).

[19] *See* Amy Borrus, *Brokers Aren't Advisers; To Protect Investors, the SEC Must Draw a Clear Line*, BUSINESSWEEK, Aug. 30, 2004, at 55 (referring to Certain Broker-Dealers Deemed Not To Be Investment Advisers, Investment Advisers Act Release No. 1845, 64 Fed. Reg. 61,226 (proposed Nov. 10, 1999). *See also* Certain Broker-Dealers Deemed Not To Be Investment Advisers, 70 Fed. Reg. 20,424 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275) (Final Rule).

[20] *See* 15 U.S.C. § 78c(4)(A) (2004).

[21] *See* 15 U.S.C. § 80b-2(a)(11) (2004). *See also* discussion in Section II, *infra*.

[22] *See* William A. Gregory & William J. Schneider, *Securities Arbitration: A Need For Continued Reform*, 17 NOVA L. REV. 1223, 1233-35 (1993).

[23] *See* Leslie William Moore, Rodriguez de Quijas v. Shearson/American Express, Inc.*: Is Securities Arbitration Finally Above Suspicion?*, 78 KY. L.J. 839, 860 (1990) (suggesting that following the Supreme Court Decision in *Rodriguez*, some critics felt "securities case law may stagnate as more disputes are sealed through arbitration).

[24] *See* THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION § 14.15[1], at 248 (4th ed. 2002).

[25] *See* definition of "investment adviser," *infra* Part II.A.2.

of the customer/client's income.[27] The term "wrap account" has been used industry-wide to describe an account that

> significantly expands the traditional client/broker stock-picking relationship to include all a client's investment accounts under one roof. It bundles, or "wraps", all service charges for advice, execution, custody and clearing under one contract. For a set fee, a broker simply steers a client to money managers of the client's choice while continuing to service the client's other trading needs, if desired.[28]

Assets managed in wrap accounts have experienced the greatest amount of growth in the financial services industry.[29]

This paper serves three main purposes: (1) Provide a brief explanation of the current application of fiduciary duties as they pertain to financial professionals; (2) Discuss problems with the current legal framework as it applies to fee-based financial professionals; and, (3) Discuss the effects and the aftermath of the unifying and heightening the fiduciary duty imposed on fee-based financial professionals. In doing so, Section II will discuss current law as it relates to the fiduciary duty of financial professionals, including different jurisdictions' positions on what differentiates the level of fiduciary duties to which the financial professional should be held. Section III will offer an analysis of why, in many respects, the current standard falls short of offering the public the protection securities laws and SROs are designed to provide with respect to fee-based financial professionals. Section IV includes discussion of *Fin'l. Planning Assoc. v. SEC*,[30] which was recently decided by the United States Court of Appeals for the District of Columbia. Section V provides a summary of this Paper and a discussion related to the impact that the outcome that the Court of Appeals' decision in *FPA v. SEC* could have on claims in securities arbitration and litigation.

II. When Does a Fiduciary Duty Exist?

The concept of fiduciary duty originated in trust law.[31] Fiduciary duty is "an equitable concept that has been applied by courts across separate and discrete areas of the law,"[32] generally in which there is some form of principal-agent relationship.[33] Typically, for a fiduciary relationship to exist, specific factors need to be present that cause the subservient party to rely on the dominant

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[26] *See* National Ass'n of Personal Financial Advisors, *Why Select a Fee-Only Financial Advisor?*, *at http://www.napfa.org/ConsumerServices/whyfee.htm* (last visited September 3, 2004).

[27] *See id.*

[28] Jessica Sommar, *Wrap Accounts: Is the Fox In With the Hens?*, INVESTMENT DEALERS DIG., Mar. 2, 1992, at 18.

[29] *See* Gregg Wirth, *It's the Advice, Stupid*, REGISTERED REPRESENTATIVE, July 1, 2004, at 7; *Wraps Boom: A Product or Process?*, ON WALL STREET, May 1, 2002, *available at http://www.onwallstreet.com/detail.cfm?page=/pubs/ows/20020501007.html* (last visited Sept. 3, 2004); John Churchill, *Huge Growth in Fee-Based Brokerage*, REGISTERED REPRESENTATIVE, Mar. 12, 2004, *available at http://registeredrep.com/news/finance_huge_growth_feebased/index.html* (last visited Sept. 3, 2004).

[30] No. 04-1242 (consol. with No. 05-1145), 2007 U.S. App. LEXIS 7356 (D.C. Cir. 2007) (hereinafter "*FPA v. SEC*").

[31] Victor Brudney, *Contract and Fiduciary Duty in Corporate Law*, 38 B.C. L. REV. 595 (1997).

[32] Cheryl Goss Weiss, *A Review of the Historic Foundations of Broker-Dealer Liability for Breach of Fiduciary Duty*, 23 Iowa J. Corp. L. 65, 67 (1997).

[33] Brudney, *supra* note 55, at 595.

party – the fiduciary.[34] Those elements have been defined as:

> (1) as between the parties, one must be subservient to the dominant mind and will of the other as a result of age, state of health, illiteracy, mental disability, or ignorance; (2) things of value such as land, monies, a business, or other things of value which are the property of the subservient person must be possessed or managed by the dominant party; (3) there must be a surrender of independence by the subservient party to the dominant party; (4) there must be an automatic or habitual manipulation of the actions of the subservient party by the dominant party; and (5) there must be a showing that the subservient party places a trust and confidence in the dominant party.[35]

Courts have also found fiduciary relationships in situations where one or more of the elements are lacking.[36] For example, "[a] fiduciary relationship may arise as a matter of law by virtue of the parties' relationship, e.g., attorney-client, or it may arise as a result of the special circumstances of the parties' relationship where one places trust in another so that the latter gains superiority and influence over the former."[37] Accordingly, a fiduciary relationship has been found to exist for physicians,[38] attorneys,[39] insurance brokers,[40] and in other agency-principal relationships.[41] The foundation for fiduciary duty as it applies to "stockbrokers"[42] has been discussed at length by numerous authors.[43] Whether a financial professional is held to a fiduciary duty often varies by jurisdiction, as well as other factors.[44] A financial professional may be liable to his customer under a theory of breach of fiduciary duty;[45] however, whereas securities laws are written, enforceable legislation, the theory of fiduciary duty is largely a matter of judicial construction and interpretation.[46]

Since the enactment of the various securities regulations, a variety of terms has evolved to describe financial professionals.[47] Whether a financial professional is called a "broker", a

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[34] *See* Chmieleski v. City Prods. Corp., 660 S.W.2d 275, 294 (Mo. Ct. App. 1983)

[35] *Id*.

[36] A.G. Edwards & Sons, Inc. v. Drew, 978 S.W.2d 386, 394 (Mo. Ct. App. 1998).

[37] State Sec. Ins. Co. v. Frank B. Hall & Co., 630 N.E.2d 940, 945 (Ill. Ct. App. 1994) (citations omitted).

[38] *E.g.*, Brandt v. Med. Def. Assocs., 856 S.W.2d 667 (Mo. 1993) ("The legislature has implicitly recognized the existence of a physician's fiduciary duty of confidentiality."). *Id*. (citations omitted).

[39] *E.g.*, Shaffer v. Terrydale Mgmt. Corp., 648 S.W.2d 595, 605 (Mo. Ct. App. 1983).

[40] *E.g.*, *A.G. Edwards*, 978 S.W.2d at 395; Faulkner v. Gilmore, 621 N.E.2d 908, 911 (Ill. Ct. App. 1993) (citations omitted).

[41] *E.g.*, Preferred Physicians Mut. Mgmt. Group v. Preferred Physicians Mut. Risk Retention, 918 S.W.2d 805 (Mo. Ct. App. 1996).

[42] Distinguishing "stockbrokers" from "investment advisers." *See* discussion *infra* Parts II.A.1, II.A.2.

[43] For a thorough discussion of the development of the duty owed by a stockbroker to his client, see, for example, Weiss, *supra* note 56. *See also* Goforth, *supra* note 16; Ramirez, *supra* note 29.

[44] *See* Ramirez, *supra* note 29, at 550-51.

[45] Goforth, *supra* note 16, at 409, 412.

[46] *See id.* at 409-10.

[47] *See Generally* Lewis Braham, *Which Adviser Knows the Way?*, BUSINESSWEEK, Nov. 25, 2002, at 146 ("Almost anyone can claim to be a financial planner or investment adviser. There are a myriad of credentials an adviser can appropriate, some familiar and others obscure.").

"stockbroker", a "financial advisor", a "financial planner", or any of the other often-used titles, many of these professionals often perform the same tasks for their clients.[48] In fact, the designation one of these professionals uses is often a matter of personal preference.[49] While there are numerous designations that are restricted based on certification or licensing,[50] a financial professional can often provide financial planning services by successfully completing only two securities licensing examinations offered by the National Association of Securities Dealers ("NASD").[51]

A. Types of Financial Professionals

1. "Stockbrokers"

The Securities and Exchange Act of 1934 uses the term "broker" or "stockbroker" to define financial professionals who engage "in the business of effecting transactions in securities for the account of others."[52] However, the financial services industry has evolved since 1934, and now, in addition to stockbrokers, financial professionals are designated with various titles and perform different services.[53] While financial professionals provide varied services depending on the specific securities licenses they possess, the majority provide some form of *investment related advice*.[54] This advice can come in the form of specific investment recommendations, asset allocation proposals, investment related tax advice, or comprehensive financial plans.[55] This advice is often used as a marketing tool, designed to promote the financial professional's services and/or knowledge of related issues.[56] In other situations, it is provided as a component of an over-arching agreement between the financial professional (and his or her broker/dealer) and the customer, as part of the implementation of a comprehensive plan.[57]

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[48] *See Lawsuit Seeks To Define Who Is 'Financial Adviser,'* ROANOKE TIMES, July 24, 2004, *available at http://www.roanoke.com/roatimes/news/story169990.html* (last visited Sept. 3, 2004).

[49] *See id.*

[50] For example, in order to call themselves a Certified Financial Planner ("CFP"), a financial professional must satisfy "education, examination, experience and ethics requirements" of the Certified Financial Planner Board of Standards, Inc. *See* Certified Financial Planner Board of Standards, Inc., *Financial Services Credentials*, *at http://www.cfp.net/learn/knowledge base.asp?id=15* (last visited Aug. 27, 2004). There are additional numerous other financial services credentials, such as a Chartered Financial Analyst ("CFA"), Chartered Financial Consultant ("ChFC"), or Personal Financial Specialist ("PFS"). *See id*.

[51] For example, in most states, a financial professional may serve as a registered representative after successfully completing the NASD Series 63 Examination and the NASD Series 6 Examination. *See* NASD, Inc., *NASD Registration and Examination Requirements*, *at http://www.nasdr.com/5200_explan.asp* (last visited Aug. 27, 2004).

[52] 15 U.S.C. § 78c(4)(A) (2004).

[53] *See* Christine Dugas, *What to Look for When Picking a Financial Planner*, NEWSDAY, Nov. 21, 1993, at 113.

[54] *See, e.g.*, Mitch Zacks, *Likelihood of Recovery Should Spur Stock Buying*, CHICAGO SUN-TIMES, July 27, 2003, at 48.

[55] *See* SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011-12 (Mar. 16, 1988)

[56] *See* Anuradha Raghunathan, *Money Advisers Await Wave of Empty-Nesters*, CHATTANOOGA TIMES FREE PRESS, Nov. 5, 2003, at C1.

[57] *See* Investment Advisers Act Release No. 1845, 64 Fed. Reg. at 61,228.

As stated above, a "broker" is a financial professional who engages "in the business of effecting transactions in securities for the account of others."[58] Stockbrokers (and presumptively, financial professionals in general) have a fiduciary, confidential relationship with their customers,[59] which is "as exacting as those imposed upon a trustee, and include the duty of keeping the customer fully informed of all facts pertinent to the transaction."[60] The financial professional's duty "includes at least these obligations: to manage the account as dictated by the customer's needs and objectives, to inform of risks in particular investments, to refrain from self-dealing, to follow order instructions, to disclose any self-interest, to stay abreast of market changes, and to explain strategies."[61] In addition, at the time the Securities and Exchange Act of 1934 was enacted, Congress "assumed that an ordinary stockbroker owed fiduciary duties to clients with respect to the giving of investment advice. This concept of fiduciary duty was general and wide-ranging."[62] Unfortunately, the obligation to manage the account as dictated by the customer's needs and objectives often conflicts with the obligation to follow order instructions.[63] It is this conflict that will be discussed throughout this article, and will serve as a primary point of tension in the discussion of the relationship between a financial professional and his or her customer. In many states, for example, it has not yet been determined "whether fiduciary duties between a broker and a customer can exist independent of any principal-agent relationship . . . [and the] cases that have discussed the subject have in general . . . suggest[ed] that a stockbroker-customer relationship is ordinarily that of principal and agent and that fiduciary duties may arise out of it."[64]

2. "Investment Advisers"

The Investment Advisers Act of 1940 introduced the term "investment adviser" to define "any person who, for compensation, engages in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing, or selling securities, or who, for compensation and as part of a regular business, issues or promulgates analyses or reports concerning securities."[65] Investment advisers, however, "do not buy or sell securities or execute trades as a part of that business,"[66] and the definition does not include "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 therefor."[67] In addition, financial professionals "who may render generalized advice as to how people should manage their money, including their investment activities but do not render advice on individual securities" are excluded from the definition of "investment adviser."[68] As a

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[58] 15 U.S.C. § 78c(4)(A) (2004).

[59] Leuzinger v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 396 S.W.2d 570, 575 (Mo. 1965).

[60] *Id.* at 575-76 (citing Feltz v. Pavlik, 257 S.W.2d 214 (Mo. Ct. App. 1953)).

[61] *See, e.g.*, Missouri *ex rel.* PaineWebber, Inc. v. Voorhees, 891 S.W.2d 126, 130 (Mo. 1995).

[62] Ramirez, *supra* note 29, at 551 (citations omitted).

[63] *See* NORMAN S. POSER, BROKER-DEALER LAW & REGULATION § 16.01 (2d ed. 2001).

[64] Farmland Indus. v. Frazier-Parrott Commodities, Inc., 871 F.2d 1402, 1410-11 (8th Cir. 1988).

[65] 15 U.S.C. § 80b-2(a)(11) (2004).

[66] JAMES D. COX ET AL., SECURITIES REGULATION: CASES AND MATERIALS 1173 (3rd ed. 2001).

[67] 15 U.S.C. § 80b-2(a)(11)(C) (2004).

[68] THOMAS LEE HAZEN & DAVID L. RATNER, BROKER DEALER REGULATION: CASES AND MATERIALS 584 (2003).

result, a broker can often provide advice related to securities transactions as long as he is not paid specifically for the advice, thereby escaping registration as an investment adviser under the 1940 Act.[69]

For a financial professional to qualify as an investment adviser, he must generally satisfy two conditions: (1) he must be "in the business of advising others;" and (2) he must be compensated for his advice.[70] The question of whether a professional is "in the business" has generated some interesting case law;[71] however, this article is only focusing on those professionals who are assumed to meet the "in the business" test – by the fact that they are affiliated with a brokerage-type service and that is the only business they conduct. The question of compensation is equally complex. To qualify as an "investment adviser" under the 1940 Act, the individual must be paid for the action of offering advice. In addition, an investment adviser does not engage in placing the transactions; rather, his sole purpose is to provide financial advice. For example, a person who meets with an individual, then gathers relevant personal and financial information, creates a report that illustrates a proposed financial plan, presents the plan to the individual, and is paid by the individual for the plan and does nothing more obviously meets the statutory definition of "investment adviser". The issue of compensation is often blurred, however, when a financial professional engages in providing his client with advice *and* directly manages the assets involved. The varied ways in which financial professionals are compensated also cloud this issue.

Investment advisers are fiduciaries[72] who are required to adopt a code of ethics.[73] The legislative history behind the Investment Advisers Act and the general nature of the investment adviser-client relationship support such a fiduciary duty.[74] An investment adviser "should continuously occupy an impartial and disinterested position, as free as humanly possible from the *subtle* influence of prejudice, *conscious or unconscious*."[75] Therefore, "he should scrupulously avoid any affiliation, or any act, which subjects his position to challenge in this respect."[76] The SEC has stated "that although the investment adviser's fiduciary duty is not specifically delineated in the Act, the concept of fiduciary duty is indirectly incorporated into the Act through the various prohibitions and disclosure requirements."[77] For example, the SEC requires investment advisers to disclose detailed information regarding the individual

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69 *See* Louis Loss & Joel Seligman, FUNDAMENTALS OF SECURITIES REGULATION, at §8-C-2(b)(iv) (3d ed. 2004).

70 *See* 15 U.S.C. § 80b-2(a)(11) (2004).

71 *Compare* Abrahamson v. Fleschner, 568 F.2d 862 (2d Cir. 1977) (general partner in a limited partnership that was formed to invest in securities and whose compensation was based on the performance of the securities is an investment adviser), *with* Zinn v. Parrish, 644 F.2d 360 (7th Cir. 1981) (sports agent who occasionally passed securities recommendations from others to his client not an investment adviser).

72 SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 191-92 (1963).

73 *See* Investment Adviser Codes of Ethics, Investment Advisers Act Release No. 2256, 69 Fed. Reg. 41,696 (July 9, 2004).

74 Lowe v. SEC, 472 U.S. 181, 210 (1985).

75 *Capital Gains*, 375 U.S. at 188 (emphasis in original).

76 *Capital Gains*, 375 U.S. at 188 (emphasis in original).

77 Susan K. Foster, Note, *Financial Planning: Is It Time For a Self-Regulatory Organization?*, 53 BROOK. L. REV. 143, 168 (1987).

investment adviser, and his practice by completing and amending Form ADV,[78] and requires investment advisers to provide similar disclosures to their clients in the form of a brochure.[79] This brochure discloses "information about [the adviser's] business practices, fees and any conflicts of interest [(s)he] may have with [his or her] *clients*."[80]

Additionally, if the adviser offers a fee-based (wrap) account, he or she must provide a separate brochure that discloses information about the wrap program,[81] such as the adviser's name, business address, telephone number, date of the brochure,[82] a table of contents,[83] a description of the "services, including the types of portfolio management services, provided under each program,"[84] disclosure of any additional fees the customer might have to pay,[85] and a disclosure that "the *person* recommending the *wrap fee program* to the *client* receives compensation as a result of the *client's* participation in the program."[86] In addition, the brochure must disclose client-related information that will be relayed to the portfolio managers,[87] as well as the process by which the adviser selects the portfolio managers.[88] The NASD also mandates that the determination of whether a financial professional may use a fee-based arrangement with its customer must be appropriate and adequately supervised,[89] under its "Standards of Commercial Honor and Principles of Trade."[90] All of these requirements focus on the issue of full disclosure to the client, and illustrate the fiduciary nature of the relationship.

3. "Financial Planners"

Over the past 20 years, the term "financial planner" has become main stream in the financial services industry. Many financial professionals complete a rigorous training and certification process to be designated as a Certified Financial Planner.[91] The SEC has

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[78] *See* Form ADV, Uniform Application for Investment Adviser Registration, *available at http://www.sec.gov/pdf/propadv.pdf* (last visited Sept. 3, 2004) (hereinafter Form ADV).

[79] *See* Written Disclosure Statements, 17 C.F.R. § 275.204-3 (2004).

[80] Form ADV: General Instructions, at 2, *available at http://www.sec.gov/pdf/propadv.pdf* (last visited Sept. 3, 2004).

[81] Written Disclosure Statements, 17 C.F.R. §275.204-3(f) (2004).

[82] Form ADV, Part 2A Appendix 1, at Item 1, p. 82, *available at http://www.sec.gov/pdf/propadv.pdf* (last visited Sept. 3, 2004).

[83] *Id*. at Item 3, p. 82.

[84] *Id.* at Item 4(A), p. 82.

[85] *Id.* at Item 4(C), p. 82.

[86] *Id.* at Item 4(D), p. 83 (emphasis in original).

[87] Form ADV, Part 2A Appendix 1,at Item 7, p. 83, *available at http://www.sec.gov/pdf/propadv.pdf* (last visited Sept. 3, 2004).

[88] *Id.* at Item 6, p. 83.

[89] *See* National Association of Securities Dealers, Action Required: Fee-Based Compensation; NASD Reminds Members That Fee-Based Compensation Programs Must Be Appropriate, NASD Notice to Members 03-68, at 2-3 (Nov. 2003), *available at* http: //www.nasdr.com/pdf-text/0368ntm.pdf (last visited Sept. 15, 2004).

[90] NAT'L ASS'N OF SECS. DEALERS R. 2110.

[91] *See* Certified Financial Planner Board of Standards, Inc., *Guide to CFP Certification*, *at http://www.cfp.net/become/certification.asp* (last visited September 1, 2004).

referred to a "financial planner" as a professional who typically provides "a variety of services, principally advisory in nature, to individuals or families regarding the management of their financial resources based upon an analysis of individual client needs."[92] The SEC has stated that the typical "financial planner" is not involved in the direct management of his client's money; rather, he is a consultant whose "primary service is to prepare a financial plan for the client, and to offer advice as to the purchase or sale of specific financial products appropriate to the implementation of the plan."[93] If a financial planner offers advice related to any type of security, he must register with the SEC under the Investment Advisers Act of 1940.[94] A variety of financial professionals who perform a variety of services use the label "financial planner."[95] The SEC distinguished financial planners from other financial professionals as those who "usually do[] not manage client assets;"[96] however, they acknowledge that the term "financial planner" is not always applied to individuals performing the same services.[97]

B. Conditions in Determining the Existence of Fiduciary Duties

1. Types of Services Provided

Financial professionals "may be divided roughly into three groups depending on the principal type of service they provide to clients."[98] They include "discretionary money managers, non-discretionary money managers and financial planners;" some may provide overlapping services.[99] Most courts have found that "[i]n general, the relationship between a stockbroker and a customer is a fiduciary one."[100] Nevertheless, "the mere existence of a broker-customer or investment adviser-customer relationship may not be proof of the fiduciary character of the relationship."[101] While most courts find a broker/financial professional has a general fiduciary duty in each individual transaction – to make sure that the transaction is executed in the customer's best interest[102] - the legal basis for imposing a fiduciary duty on a financial professional has often turned on whether the professional has discretion to trade in the account.[103]

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[92] Louis Loss & Joel Seligman, FUNDAMENTALS OF SECURITIES REGULATION 885 (5th ed. 2004) (citing Investment Adviser Act Release No. 1092, 39 SEC Dock. 494, 495-98 (1987)).

[93] *See* SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011 (Mar. 16, 1988).

[94] 15 U.S.C. §§ 80b-2(a)(11), 80b-3 (2004).

[95] Carolyn Mora, *Avoid Errors That Could Smash Your Financial Plan*, EL PASO TIMES, May 17, 2004, at 1F.

[96] SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011 (Mar. 16, 1988).

[97] SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,012 (Mar. 16, 1988).

[98] SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011 (Mar. 16, 1988).

[99] SEC Staff Study, Financial Planners, [1997-1998 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 84,220, at 89,011 (Mar. 16, 1988).

[100] 12 AM. JUR. 2D *Brokers* § 149 (2004) (citations omitted).

[101] *Id.*

[102] *See, e.g.*, De Kwiatkowski v. Bear, Stearns & Co., 306 F.3d 1293, 1302-03 (2d Cir. 2002).

[103] *See* French v. First Union Secs., Inc., 209 F. Supp. 2d 818, 825 (M.D. Tenn. 2002).

a. Discretionary Accounts

Discretionary accounts are those "in which the broker determines which investments to make and carries out such transactions without prior authorization" from his customer.[104] A financial professional has actual authority to handle the affairs of the client in relation to the discretionary account. Discretionary authority over an account is usually established by checking a box on the customer's account agreement; such authority can be created through other forms of agreement[105] or modified by contract.[106] It has generally been held that financial professionals are subject to fiduciary duties when they oversee a discretionary account.[107] As a result of the fiduciary duty owed by the financial professional in a discretionary account, he (or she):

> must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history; (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests; (3) keep his customer informed as to each completed transaction; and (5) [sic] explain forthrightly the practical impact and potential risks of the course of dealing in which the [financial professional] is engaged.[108]

Courts have generally imposed a fiduciary duty with respect to discretionary accounts based on the level of influence the financial professional has over the customer, and the fact that the customer has deposited money or securities with the broker.[109]

b. Nondiscretionary Accounts

A nondiscretionary account is just the opposite of a discretionary account – the financial professional must get permission from the customer before he or she can conduct any activity whatsoever within the account.[110] In most cases, a nondiscretionary account is created by leaving a box unchecked on an account agreement.

The courts have been inconsistent in determining whether a fiduciary duty exists within non-discretionary accounts. Generally, courts *do not* impose a fiduciary duty on a financial professional who oversees a nondiscretionary account because he lacks control over the investment decisions.[111] Furthermore, a broker has no ongoing duty to keep a nondiscretionary customer updated as to "financial information which may affect his customer's portfolio or to inform his customer of developments which could influence his investments."[112] It has also been stated that the relationship between a financial professional and his customer in a non-

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[104] Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cheng, 901 F.2d 1124, 1128 (D.C. Cir. 1990).

[105] *See*12 AM. JUR. 2D *Brokers* § 43 (2004)

[106] *See* 12 AM. JUR. 2D *Brokers* § 47 (2004); Chipser v. Kohlmeyer & Co., 600 F.2d 1061, 1066 (5th Cir. 1979).

[107] Vogel v. A.G. Edwards & Sons, Inc., 801 S.W.2d 746, 752 (Mo. Ct. App. 1990).

[108] *Leib*, 461 F. Supp. at 953 (citations omitted).

[109] "A broker . . . is bound to keep accurate records and to account to his or her principal for all funds belonging to the latter." 12 AM. JUR. 2D *Brokers* § 113 (2004).

[110] Merrill Lynch, Pierce, Fenner & Smith v. Perelle, 514 A.2d 552, 561 (Pa. Super. Ct. 1986).

[111] *See* Int'l Order of Foresters v. Donaldson, Lufkin & Jenrette, 157 F.3d 933, 940-41 (2d Cir. 1998).

[112] Robinson v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 337 F. Supp. 107, 112 (N.D. Ala. 1971).

discretionary account is "that of a limited agent",[113] in which "a far more limited range of duties" are owed by the financial professional to his customer.[114] Even if a nondiscretionary customer pays an ongoing management fee to the broker, the broker may not necessarily owe a fiduciary duty to the client.

Courts have held that a financial professional owes fiduciary duties to his customer when the account is technically a non-discretionary account, if they take 'control" of the customer's account.[115] This rationale is logical because the financial professional should reasonably be held liable for his actions if he has assumed control over the account. In truth, if a financial professional has assumed control over his customer's account, she is acting as if there is an implied discretionary agreement because she is acting without the approval of the customer.[116] The courts have devised a number of "tests" to determine whether the financial professional has assumed control over his customer's account.[117]

2. Other Tests

In addition to determining whether a financial professional owes his customer a fiduciary duty based on whether the account was discretionary or nondiscretionary, there have been a variety of tests that have been isolated to impose a fiduciary duty on financial professionals.[118] Most of these tests strike at a similar point of the relationship between a financial professional and his

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[113] David M. Minnick, *Breach of Fiduciary Duty in Securities Arbitration*, 53 J. MO. BAR. 210, 210 (July/Aug. 1997).

[114] *Id.* at 211. The duties "have been enumerated as follows:

> (1) the duty to recommend a stock only after studying it sufficiently to become informed as to its nature, price and financial prognosis . . .;
> (2) the duty to carry out the customer's orders promptly in a manner best suited to serve the customer's interests . . .;
> (3) the duty to inform the customer of the risks involved in purchasing or selling a particular security . . .;
> (4) the duty to refrain from self-dealing or refusing to disclose any personal interest the broker may have in a particular recommended security . . .;
> (5) the duty not to misrepresent any fact material to the transaction . . .;
> (6) the duty to transact business only after receiving prior authorization from the

customer . . . ." *Id.* (citing Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 953 (E.D. Mich. 1978), *aff'd,* 647 F.2d 165 (6th Cir. 1981)).

[115] Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F. Supp. 951, 954 (E.D. Mich. 1978)

[116] *See* Paine, Webber, Jackson & Curtis, Inc. v. Adams, 718 P.2d 508, 516 (Colo. 1986) (en banc) (citing *Leib*, 461 F. Supp. at 954).

[117] *See Adams*, 718 P.2d at 516-17. These tests include:

> (1) the broker's past activities as investment advisor; (2) the extent to which the customer followed the broker's advice; (3) the extent to which the broker trades without the customer's prior approval; (4) the frequency of communication between the broker and customer; (5) the investment sophistication of the customer; and (6) the degree of trust and confidence reposed in the broker.

Goforth, *supra* note 16, at 428-29.

[118] *See* Goforth, *supra* note 16, at 417-31. Goforth sets out six "tests" that courts had used to decide to impose a fiduciary duty on brokers. *Id.* These "tests" are: (1) a per se determination that a broker is a fiduciary; (2) a broker is an agent for his principal (customer); therefore, he has a fiduciary duty; (3) if the broker has discretionary authority over the account; (4) the customer places "trust and confidence" in the broker; (5) the broker exercises "control" over the account; and (6) there is a "special agreement" between the customer and the broker. *Id*.

customer – the customer trusts and places confidence in the financial professional to act in the customer's best interests – the essence of a fiduciary duty. The remaining tests focus on control over the account. It has been urged by at least one commentator that an arbitration panel "should focus first on ascertaining the nature of the relationship . . . to determine: (1) whether the account is discretionary or non-discretionary; (2) whether or not the claim is based upon specific recommendations made by the broker; (3) whether there is a mixture of recommendations made, some of which are not followed; and (4) whether there are mere execution services provided by the broker to follow the directives received from the investor."[119]

a. Nature of the Relationship Between the Financial Professional and the Customer

Courts have held financial professionals to a fiduciary duty to their customers based on the general nature of their relationship with the customer.[120] These cases have found a fiduciary duty to exist because of the financial professional's position as an agent of his customer,[121] a "special trust and confidence" placed on the financial professional by the customer,[122] or because of a special agreement, more than a standard brokerage agreement, between the financial professional and the customer.[123] Other courts have looked at the activity of the financial professional to determine whether a fiduciary duty was breached.

b. Violation of SRO Rules

There is a significant amount of overlap between a claim for breach of fiduciary duty and a violation of SRO rules. For example, the NASD requires that a financial professional "make reasonable efforts to obtain information concerning: (1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[124] Some courts have factored a violation of NASD or stock exchange rules into a determination of liability for excessive trading[125] or standard of care,[126] both of which are considered breaches of fiduciary duty. A violation of NASD rules, by itself, however, does not create a private cause of action.[127] Therefore, investors must look to the law to provide such a right.

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[119] Minnick, *supra* note 133, at 210.

[120] *See, e.g.*, Clayton Brokerage Co. v. Commodity Futures Trading Comm'n, 794 F.2d 573, 582 (11th Cir. 1986).

[121] *See, e.g.*, Roth v. Roth, 571 S.W.2d 659, 668 (Mo. Ct. App. 1978).

[122] *See, e.g.*, Stevens v. Abbott, Proctor and Paine, 288 F. Supp. 836, 846 (E.D. Va. 1968).

[123] *See, e.g.*, McGinn v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 736 F.2d 1254 (8th Cir. 1984).

[124] NASD Conduct Rule 2310.

[125] *See e.g.*, Miley v. Oppenheimer & Co., Inc., 637 F.2d 318, 333 (5th Cir. 1981).

[126] *See e.g.*, United States v. Bloom, 450 F. Supp. 323 (E.D. Pa. 1978).

[127] Reed v. Bear, Stearns & Co., 698 F. Supp. 835 (D. Kan. 1988); *see also* Touche Ross & Co. v. Redington, 442 U.S. 560 (1979) (denied private claims under securities acts where the statutory language was silent on whether a private cause of action existed because to imply "a private right of action on the basis of congressional silence is a hazardous enterprise, at best."). *Touche Ross*, 442 U.S. at 571.

c. Representation to the Public as a Professional

Under the "shingle theory," an individual who holds himself out to the public as a financial professional makes a representation that he "will conduct business in an equitable and professional manner."[128] In so doing, if he "solicits another to trust him in matters in which he represents himself to be expert as well as trustworthy and the other is not expert and accepts the offer and reposes complete trust in him, a fiduciary relation is established."[129]

3. Conflicting Views Related to Fiduciary Duties as Applied to Financial Professionals

Despite the case law supporting a fiduciary duty on financial professionals, there is an equal amount of support for the argument that a fiduciary duty does not exist.[130] In some jurisdictions, the question of whether a fiduciary duty applies is unsettled.[131] Most courts have determined that a case-by-case analysis must be done prior to any determination of fiduciary duty.[132] In general, however, the standard of fiduciary duty applied to securities brokers is far short of what Congress intended.[133]

To make matters worse, in November 1999, the SEC proposed a rule entitled "Certain Broker-Dealers Deemed Not To Be Investment Advisers,"[134] that ultimately created an exception to the Advisers Act. The rule provides that a financial professional is exempted from the definition of an "investment adviser," and the corresponding fiduciary duties, as long as (s)he (1) provided advice on a non-discretionary account, (2) provided advice "solely incidental to the brokerage services;" and (3) the financial professional "discloses to its customers that their accounts are brokerage accounts,"[135] This exception has formed the basis on which many financial professionals have provided quasi-fiduciary services for their clients without incurring the express duties related to a traditional fiduciary relationship[136] by presenting financial professionals with an opportunity to provide investment related advice for a fee, as opposed to charging commissions on individual transactions, without registering under the Investment Advisers Act.[137]

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[128] HAZEN, *supra* note 44, § 14.15[3], at 257.

[129] Burdett v. Miller, 957 F.2d 1375, 1381 (7th Cir. 1992).

[130] *See e.g.*, Minnick, *supra* note 133, at 210-11.

[131] *Compare* Perl v. Smith Barney Inc., 646 N.Y.S.2d 678 (N.Y. 1996) (no fiduciary duty under New York law in ordinary broker-client relationship), *with* Jaksich v. Thomson McKinnon Secs., Inc., 582 F. Supp.485, 502 (S.D.N.Y. 1984) ("Under New York law, brokers maintain fiduciary duties to their customers, and the relationship between the two parties is one of principal and agent.").

[132] *See* Minnick, *supra* note 133, at 211.

[133] Ramirez, *supra* note 29, at 552.

[134] 70 Fed. Reg. 20,424 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275) (Final Rule); Investment Advisers Act Release No. 1845, 64 Fed. Reg. at 61,226 (Proposed Rule).

[135] *Id*. at 61,227.

[136] *See* Investment Advisers Act Release No. 1845, 64 Fed. Reg. At 61,226. Discussion of this proposed rule was reopened August 18, 2004, and closed September 22, 2004. *See also* Investment Advisers Act Release No. 2278, 69 Fed. Reg. at 51,620 (Aug. 20, 2004).

[137] Borrus, *supra* note 18, at 55.

Rather than recognize fee-based advisory services for what they really are, the SEC rule referred to such advice as merely "re-pricing" of a broker's services."[138] Furthermore, during the period before and after "the Commission takes final action on the proposed rule, the Division of Investment Management will not recommend, based on the form of compensation received, that the Commission take any action against a broker-dealer for failure to treat any account over which the broker-dealer does not exercise investment discretion as subject to the [Advisers] Act."[139]

The rule has drawn some criticism,[140] including a petition for judicial review by the Financial Planning Association ("FPA").[141] Before the final rule was passed, the Financial Planning Association, which consists of practicing financial professionals, urged the SEC to immediately abandon[142] or amend the proposed rule[143] because it is of the opinion that:

> the Rule is detrimental to consumer protection by allowing broker-dealers to avoid the blanket fiduciary protections of the Investment Advisers Act of 1940 . . . [and b]y eliminating "special compensation" as a critical element in the contractual relationship, the Rule permits stockbrokers to misrepresent their fundamental sales role as one of a fiduciary adviser receiving a fee for advice. Further, it places financial planners[144] at a competitive disadvantage by allowing brokers to market similar programs under less rigorous regulatory standards for disclosure and advertising.[145, 146]

In April 2006, the SEC unanimously approved and adopted the final rule that created this exemption.[147] Most securities brokerage firms are registered

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[138] Investment Advisers Act Release No. 1845, 64 Fed. Reg. At 61,226.

[139] *Id.*

[140] *See* Securities and Exchange Comm'n, *Comments on Proposed Rule: Certain Broker-Dealers Deemed Not To Be Investment Advisers*, *at* http ://www.sec.gov/rules/proposed/s72599.shtml (last visited Sept. 15, 2004).

[141] Fin. Planning Ass'n v. SEC, No. 04-1242 (D.C. Cir. Filed July 20, 2004).

[142] Letter from Duane R. Thompson, Group Director, Advocacy, The Financial Planning Association, to Jonathan G. Katz, Secretary, Securities and Exchange Commission 2 (June 21, 2004), *available at* http: //www.sec.gov/rules/proposed/s72599/fpa062104.pdf (last visited Sept. 15, 2004). The Financial Planning Association has provided the SEC with five reasons on which they base their request for immediate withdrawal of the Rule. Those five reasons are "Non-Compliance with Administrative Procedures Act . . . . Failure to Provide Clear Regulatory Guidance . . . . Misinterpretation and Misapplication of Discretionary Exemption Authority . . . . Absence of Rule Enforcement . . . . Inconsistent Application of Disclosure Standards to Brokerage Transactions." *Id*. at 2-3.

[143] *Id*. at 6-7.

[144] The Financial Planning Association's use of the term "financial planner" is the equivalent to the "fee-based adviser" discussed herein.

[145] *Id*. at 2.

[146] The members of the Financial Planning Association are governed by the organization's bylaws and code of ethics. To access these materials, see The Financial Planning Association Bylaws, *at http://www.fpanet.org/member/about/principles/ByLaws.cfm* (last visited Sept. 15, 2004), and Code of Ethics, *at http://www.fpanet.org/member/about/principles/ethics.cfm* (last visited Sept. 15, 2004).

[147] Certain Broker-Dealers Deemed Not To Be Investment Advisers, 70 Fed. Reg. 20,424 (Apr. 19, 2005) (to be codified at 17 C.F.R. pt. 275).

with the SEC as both a broker-dealer and an investment adviser.[148] Therefore, the rule essentially extends the registration of the broker-dealer to the individual financial professional, without requiring that individual to register, and be subject to the heightened scrutiny of an Investment Adviser. The SEC stated their preference for a fee-based engagement because it would contribute to a reduction in conflicts between the financial professional and the customer by reducing the incentive to churn[149] the account would be virtually eliminated.[150] The FPA continued its opposition to the final rule, and, later that month, filed a petition in the United States Court of Appeals for the District of Columbia challenging the final rule.[151] In March 2007, the court of appeals vacated the final rule.

III. Why Should There Be a Fiduciary Duty?

A. The Existing Framework Did Not Provide Adequate Protection

Existing case law and scholarly writing generally focus on whether there is a fiduciary duty imposed on professionals who hold themselves out as stockbrokers, as well as the factors used to determine that such a duty exists. This seems to be due to the general term used to describe a financial professional—a "stockbroker". In many situations, the application of a fiduciary duty is inconsistent, leaving individual investors at risk. The issue of breach of fiduciary duty is important in financial professional-customer issues because the largest number of cases heard in NASD arbitrations involve a claim of breach of fiduciary duty.[152] The following chart reveals the total number of arbitration cases filed at the NASD arbitration from 2004 through 2004, the number of cases in which a breach of fiduciary duty was alleged and the percentage of the total cases filed in which breach of fiduciary duty was alleged: .
This chart clearly demonstrates that not only has the *number* of cases in which breach of fiduciary duty is alleged increased, but also that the *percentage* of cases in which breach

Year	**Total Cases Filed**	**Breach of Fiduciary Duty Cases**	**Percentage**
2000	5,558	2,489	45%
2001	6,915	3,485	50%
2002	7,704	4,236	55%
2003	8,945	5,565	62%
2004	8,201	5,426	66%
2005	6,074	3,514	58%
2006	4,614	2,621	57%

[148] *Id.*

[149] Churning is a term used to describe the activity of a financial professional "from using control over a customer's account to generate excessive trading activity, in view of the customer's financial resources, objectives, and needs, in order to maximize commissions." Steven A. Ramirez, *The Professional Obligations of Securities Brokers Under Federal Law: An Antidote For Bubbles?*, 70 U. CIN. L. REV. 527, 545 (2002) (citations omitted).

[150] Investment Advisers Act Release No. 1845, 64 Fed. Reg. at 61,228.

[151] *See* Fin'l Planning Assoc., *Legal Challenge to SEC's Broker-Dealer Rule*, *at http://www.fpanet.org/member/govt_relation/lawsuit-against-sec-broker-dealer-rule.cfm#factsheet* (last visited Apr. 11, 2007). The FPA also filed a motion to consolidate Case No. 04-1242 (*see* fn. 35, *supra*).

[152] *See* NASD, Inc., *Dispute Resolution Statistics*, July 19, 2004, *at http://www.nasdadr.com/statistics.asp* (last visited August 28, 2004). From 2000 through 2004, the greatest number of cases involved claims of breach of fiduciary duty. *Id*.

of fiduciary duty is alleged has increased each year. It is apparent from these statistics that customers are feeling betrayed at an ever-increasing rate by their financial professionals.

This presents two questions:

> (1) Are customers merely "piggybacking" breach of fiduciary duty claims onto other claims brought to arbitration?
> (2) Are financial professionals violating their customers' trust in greater numbers?

While it could certainly be argued that breach of fiduciary duty claims are being added as a matter of course, NASD arbitration award statistics do not suggest that adding such a claim has improved a claimant's chances of winning his case. Although the percentage of cases alleging breach of fiduciary duty climbed from 45% in 2000 to 66% in 2004, the percentage of cases in which damages were *awarded* to claimants did not increase over that period. In fact, the percentage of cases in which an arbitration panel awarded damages to claimants declined.[153]

The increasing number of "breach of fiduciary duty cases" does, however, suggest customers feel that their trust is being increasingly more violated by their financial professional.

B. The Subservient Customer

There are two types of financial professional-customer relationships to differentiate.

1. The first is a purely **transaction-based relationship** in which the customer engages the broker to place an order to buy or sell a security. In this relationship, the customer has the idea for the purchase and maintains possession of his assets at all times. In this situation, it would be unreasonable to hold the financial professional to a fiduciary duty outside the duty owed for each transaction – the customer assumes all responsibility for his investment.
2. The second type of relationship is the more common type, which will be referred to as the **adviser-customer relationship.** In this relationship, the financial professional may provide his customer with recommendations, investment strategies and/or general financial advice, in addition to any other type of advice related to the customer's financial situation. *It is for this situation that a per se rule imposing a fiduciary duty on the financial professional is required.* When a financial professional makes recommendations of any sort, he is acting in the capacity of an investment adviser. In addition, the customer generally relies on the advice offered by the financial professional as he or she would rely on advice provided to them by an attorney, doctor, or other professional. This puts the customer in a subservient position to the "dominant" financial professional. Although the Investment Advisers Act provides an exception to the definition of "investment adviser" for a broker who provides

[153] The annual percentage of all arbitration cases decided in favor of claimant from 2000 through June 2004, are as follows:

2000 – 53%
2001 – 53%
2002 – 55%
2003 – 54%
2004 – 53%
2005 – 43%
2006 – 42%

Id.

advice incidental to his brokerage business, the type of advice that financial professionals tend to provide is far from "incidental."

C. Customer's Reliance on the Advice Provided by the Financial Professional

When a customer agrees to work with a financial professional, he or she places a great deal of trust in that person to do what is right. In the course of their relationship, the customer places a great deal of reliance on the advice of the professional. The elements for a claim of breach of fiduciary duty generally include:

"(1) the existence of a fiduciary relationship between the parties;
(2) a breach of that fiduciary duty;
(3) causation; and
(4) harm.

A fiduciary is a person having a duty to act primarily for the benefit of another in matters connected with his undertaking."[154]

The reliance and trust a customer places with a fee-based financial professional is demonstrated primarily in four ways.

1. By engaging in business as an investment professional, that person conveys that he has superior knowledge, skill, and expertise in financial matters.
2. A fee-based advisor disseminates and conveys recommendations to the customer prior to engaging in any transactions.
3. The customer generally relinquishes control, if not expressly, then implicitly. The customer, even in a nondiscretionary account, gives the financial professional control over their financial position by revealing the intimate details of their personal and financial lives. The NASD requires that, prior to engaging in a trade of any non-money market security, a financial professional must gather certain information from any individual customer to make sure that the transaction is appropriate for the customer.[155] The information a financial professional must obtain includes: "(1) the customer's financial status; (2) the customer's tax status; (3) the customer's investment objectives; and (4) such other information used or considered to be reasonable by such member or registered representative in making recommendations to the customer."[156]
4. The customer pays the financial professional for his (or her) services. Payment for services is a crucial component in establishing a fiduciary duty because it is the customer providing consideration to the financial professional for the services provided.

D. The Manner of Compensation the Financial Professional Receives Has An Affect on Whether Fiduciary Duties Should Exist

Other than charging a fee to create a financial plan, there are generally two different ways a financial professional is compensated.

1. The first manner of compensation is through a commission that is paid either as a percentage of the investment transaction or at a fixed rate, which is often scaled based on the total amount of the transaction.
2. The second manner of compensation is through a management fee charged as a percentage of assets that the financial professional "manages." Compensation through

[154] *See, e.g.*, Dairy Farmers of A., Inc. v. Traveler's Ins. Co., 292 F.3d 567, 572 (8th Cir. 2002).

[155] NASD RULE 2310(a), (b) (2004).

[156] NASD RULE 2310(b) (1)-(4) (2004).

the charging of a management fee (alternatively referred to as a "wrap fee") has become increasingly popular in the financial services industry.[157] This manner of compensation is favorable to the financial professional because it allows him or her to establish a more constant stream of income, as the fees are deducted from the customer's account on a monthly, quarterly, semi-annual, or annual basis, and paid to the financial professional accordingly. Financial professionals also feel they can spend more time providing service to their customers and less time having to make sales.[158] Furthermore, by charging a management fee rather than a commission, the financial professional is able to "consolidate multiple types of investments into a single location", which makes "planning and ongoing investment management much easier."[159] Fee-based financial management is also viewed by many financial professionals as a viable alternative to paying commissions on individual transactions.[160]

Financial professionals often fail to deliver the level of service their customers' desire.[161] Despite the benefits to financial professionals, customers do not always receive the benefits for which they pay, and are often left with unfulfilled expectations. In addition, by charging a fee based on the amount of assets under "management", the financial professional conveys that his or her interests are aligned with the customers. However, this is not always the case because a 50% loss in the value of an account under management translates into a pay cut of 50% to the financial professional; such a loss is far more significant to the customer.

Because the SEC viewed paying a management fee as a reasonable alternative to paying commissions on individual transactions, that fact alone did not necessarily bind the financial professional to a continuous fiduciary obligation. However, *the customer* typically views the payment of ongoing management fees as a payment for more than facilitation of the transactions within the account. The manner in which the financial professional is compensated distinguishes not only the service he or she provides, but his customers' expectations; the manner of compensation should be an equally determinative factor in determining the fiduciary duty owed by a financial adviser to his customer.

In purely transactional relationships – to use a loose interpretation of the rule – the current duties owed are adequate. It would be unreasonable to hold a transactional broker accountable for decisions made on the account because the transactional broker is just that – transactional – and his or her responsibility to the customer logically exists

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[157] *See* John Churchill, *Huge Growth in Fee-Based Brokerage*, REGISTERED REP., Mar. 12, 2004, *available at http://registeredrep.com/news/finance_huge_growth_feebased/index.html* (last visited Aug. 27, 2004).

[158] *See* Kevin McKinley, *Fee-ling Good*, REGISTERED REP., June 1, 2004, *available at http://registeredrep.com/mag/finance_feeling_good/index.html* (last visited Aug. 27, 2004).

[159] *Id*.

[160] *See e.g.*, Dan Jamieson & Rick Weinberg, *Fees Versus Commissions*, REGISTERED REP., Mar. 9, 2001,*available at http://registeredrep.com/news/finance_fees_versus_commissions/index.html* (last visited Aug. 27, 2004).

[161] This statement is supported, in general, by the number of NASD arbitration cases filed annually by customers against fee-based planners. *See e.g.*, *In re* Arcement v. Merrill, Lynch, Pierce, Fenner & Smith, 2004 NASD Arb. LEXIS 1423 (June 22, 2004).

only during that specific transaction, and the form of payment is based entirely on each specific transaction; the duty would logically begin when the agreement was entered (at the time the order was taken), and it would end when the agreement was fulfilled (when the order was executed). During that period of time, the broker has the duty to put the customer's interest ahead of all others, not to engage in self-dealing, to fully disclose all material facts related to the transaction (including any potential risk to which the customer might be exposed) and to execute the transaction in a timely manner. However, in the situation in which the customer pays a financial professional for ongoing "management" of his investments, heightened fiduciary duties must apply.

It is important to keep in mind that the Advisers Act was drafted in the wake of the Great Depression and that Congress had a strong interest in *regulating* financial market conduct. Prior to 1999, fee-based account management constituted a relatively small segment of the market. However, from 1999 (when the SEC proposed the rule) through the third quarter of 2003, there was a huge growth in fee-based brokerage accounts, as managed account assets increased by 19%.[162] However, the *transfer* of assets to fee-based accounts was actually *much larger*, because during this period the Standard and Poor's 500 Index dropped by more than 30%.[163] Even the significantly more conservative Dow Jones Industrial Average declined by more than 19% over the same period.[164] Perhaps the fact that the growth in fee-based business coincided with the 2000 – 2002 bear market is merely a coincidence. Perhaps it is not. It is interesting to note that one customer-specific concern raised by the FPA included the fact that under the final rule, a broker-dealer could permit a broker to provide fee-based advice without having to identify conflicts of interest.[165] In light of the investment banking and mutual fund scandals that investors brought to the attention of regulators in the period soon following the SEC's proposal of *Certain Broker-Dealers*, perhaps more disclosure *is* better for everyone.

Broker-dealers continue to report growth in fee-based business. According to Cerulli Associates, Inc., fee-based brokerage account assets increased by more than 37% from September 30, 2003 through December 31, 2006.[166] However, these statistics are a bit misleading because during this same period, the Dow Jones Industrial Average increased by approximately 34%[167] and the Standard & Poors 500 Index increased by more than 40%.[168] Perhaps the negative criticism of relaxed regulation over these accounts made it to the ears of the investing public, after all.

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[162] *See e.g.*, Churchill, *supra* note 30.

[163] The S&P 500 Index closed at 1,469.25 on Dec. 31, 1999 and at 995.97 on Sept. 30, 2003.

[164] The DJIA closed at 11,497.12 on Dec. 31, 1999 and at 9,275.06 on Sept. 30, 2003.

[165] *Id.* at 14.

[166] *See* Churchill, *supra* note 30 (according to Cerulli Associates, "[t]otal assets in fee-based brokerage accounts reached $201.5 billion through the end of third-quarter 2003."); Dan Jamieson, *Wall Street grapples with defeat of rule, uncertain of its effects*, INVESTMENT NEWS, Apr. 9, 2007, *available at http://www.investmentnews.com/apps/pbcs.dll/article?AID=/20070409/FREE/70409001/1009/INIssueAlert01* (last visited Apr. 12, 2007) ("At year end [2006], $277 billion resided in nearly 1 million fee-based brokerage accounts, according to research firm Cerulli Associates.")

[167] The DJIA closed at 9,275.06 on Sept. 30, 2003 and at 12,463.15 on Dec. 31, 2006.

[168] The S&P 500 closed at 995.97 on Sept. 30, 2003 and at 1,418.30 on Dec. 31, 2006.

IV. *Financial Planning Association v. Securities and Exchange Commission*

On March 30, 2007, the United States Court of Appeals for the District of Columbia Circuit issued an opinion[169] that has the potential to significantly impact the fee-based advisory business. In *FPA v. SEC*, the court invalidated the "Merrill Lynch Rule," finding that "the SEC has exceeded its authority in promulgating the final rule."[170] The court was very critical of the arguments raised by the SEC in support of the Rule, finding that the SEC failed "to respect the unambiguous textual limitations" of the Investment Advisers Act[171] and that its arguments contradicted "the SEC's own actions for the last 65 years."[172] The SEC has until May 21, 2007, to seek rehearing from the court of appeals.

While arguing the SEC abused its authority in passing the Rule, the focus of the argument in the FPA's brief was consumer (customer) protection. In fact, the second point raised in the brief was the fact that the Advisers Act imposes fiduciary duties on Investment Advisers, and that these fiduciary duties were necessary to protect the public.[173] In addition, the Consumer Federation of America, Private Investors Arbitration Bar Association, Fund Democracy, and the North American Securities Administrators Association (NASAA) each filed Amicus briefs on behalf of the FPA. Each of these entities focuses on serving the interests of public investors and consumers.

Perhaps most concerning about the *FPA v. SEC* case is the timing of the SEC's actions related to the proposed and final rule. The FPA's brief highlighted the history of the SEC's approach with respect to the Adviser Act's broker-dealer exemption. Specifically, the FPA noted that since the inception of the Advisers Act to 1999, the SEC had implemented the Broker-Dealer exemption explicitly.[174] In the very document that created the initial proposed rule, the SEC continued to observe that broker-dealers were shifting to "advice plus execution"

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[169] No. 04-1242 (consol. with No. 05-1145), 2007 U.S. App. LEXIS 7356 (D.C. Cir. Mar. 30, 2007).

[170] *FPA*, 2007 U.S. App. LEXIS 7356, at *30.

[171] *FPA*, 2007 U.S. App. LEXIS 7356, at *25.

[172] *FPA*, 2007 U.S. App. LEXIS 7356, at *27.

[173] Brief for Petitioner at 5-6, *FPA*, No. 04-1242 (consol. with No. 05-1145), 2007 U.S. App. LEXIS 7356.

[174] *Id*. at 9-11. The following examples were highlighted in the FPA's brief:

In 1940, the SEC's General Counsel stated that the portion of 15 U.S.C. § 80b-2(a)(11)(C)

> Which refers to 'special compensation' amounts to an equally clear recognition that a broker or dealer who is specially compensated for the rendition of advice should be considered an investment adviser and not be excluded from the purview of the Act merely because he is also engaged in effecting market transactions in securities.

1940 SEC LEXIS 1466 (1940).

In 1978, the SEC stated that where a broker has two-tiered pricing, a lower charge for traditional brokerage services (no advice) and a higher charge that included providing investment advice, the higher priced services would be regarded as "special compensation for investment advice." Furthermore, if a full service broker-dealer offered a "discount" or "execution only" service, the broker-dealer would not qualify for the exception with respect to all customers who elected not to participate in the "discount" or "execution only" services. 43 Fed. Reg. 19,224 (May 4, 1978).

In 1985 and in 1994, the SEC stated that broker-dealers who imposed additional charges for investment advices would not be exempted from the responsibilities imposed by the Advisers Act. Am. Capital Fin. Servs., Inc., 1985 SEC No-Act. LEXIS 2209, at *5 (Apr. 29, 1985); Townsend & Assocs., Inc., 1994 SEC No-Act. LEXIS 739, at *3 (Sept. 21, 1994).

services.[175] However, rather than require broker dealers who provided these services to comply with the Advisers Act, the SEC sought to change the rules altogether by proposing *Certain Broker-Dealers Deemed Not To Be Investment Advisers*. Rather than put protections in place for the investing public and uphold the integrity of the financial markets, as it is supposed to do, the SEC sided with the broker-dealers and sought to relax Congressionally-implemented regulations. In fact, the FPA highlighted the SEC's statement that although "the Advisers Act was written in such a way that it covers fee-based programs . . . we do not believe that it would be consistent with Congress' intent to apply the Act to cover broker-dealers providing investment advice as part of the package of brokerage services they provide under fee-based brokerage programs."[176] As the FPA noted, while the exception under the Advisers Act applied to situations where "advice is incidental to brokerage services," the SEC attempted to exempt situations where the brokerage services are incidental to the advice.[177]

V. Conclusion

The explosion of fee-based financial planning has impacted the financial services industry. For a variety of reasons, fee-based advisers need to be held to higher standards in how they go about managing their customers' accounts. In an era of enhanced disclosure of public information, financial professionals hold the key to whether the public actually has the opportunity to acquire the publicly-disclosed information, and fee-based advisers convey to their customers that their advice is based on an expert's opinion and is specifically tailored to the individual customer. In general, an individual investor does not have the expertise, training or resources that financial professionals have, and fully entrust their financial affairs to their financial professional. By charging a management fee, the fee-based adviser gives the customer the impression that he is performing a continuous duty, and it is justifiable to hold the fee-based adviser to *per se* fiduciary duties with respect to the customer.

As a result of the decision in *FPA v. SEC*, Wall Street is now forced to come to grips with the fact that fee-based advisors are bound by the fiduciary duties set forth in the Advisers Act. However, the benefits for claimants in arbitration are largely unclear. Because the Advisers Act does not provide for an explicit private right of action for damages, and because the United States Supreme Court declined to imply such a right,[178] any such benefits will have to come more from arbitration panels awarding damages under common law breach of fiduciary duty claims for violations of the duties set forth in the Advisers Act.[179]

In 1987, the SEC stated:

> "[a] person relying on an exclusion from the definition of investment adviser must meet *all* of the requirements of the exclusion . . . [T]he exclusion for broker dealers contained in Section 202(a)(11)(C) would not be available to a broker or dealer . . . if the person receives any special compensation for providing investment advisory services."

Investment Advisers Act Release No. IA-1092, 1987 SEC LEXIS 3487, *17-*18 (Oct. 8, 1987).

[175] *Id.* at 11-13.

[176] *Id.*at 16.

[177] *Id.*

[178] Transamerica Mortgage Advisors, Inc. v. Lewis, 444 U.S. 11 (1979) ("TAMA"). However, the Act does provide a private cause of action for rescission of an investment advisory contract. *Id*.

Because the Advisers Act speaks more in terms of "prohibited transactions" and other prohibitions, its explicit provisions are more in the form of antifraud regulation than the imposition of "fiduciary duties". It is from the substance of the Act's provisions and the legislative history that the Supreme Court has found Congress recognized an investment adviser as a fiduciary.[180] Because the Court has reinforced that investment advisers are, in fact, fiduciaries, and because the fiduciary status is based on trust, a breach of duty by an investment adviser should generally satisfy a common law breach of fiduciary duty claim.

While an imposition of a higher fiduciary duty might seem to only benefit the customer, this is not the case. By having a legal standard for whether a fiduciary duty exists, and if so, to what extent, the law would provide fee-based advisers with firm guidelines as to how they operate their advisory practice. A higher standard of care will only improve the industry as a whole, and, as a result, more individuals will feel confident in placing their trust with fee-based advisers and financial professionals in general.

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[179] In TAMA, the Supreme Court stated "we hold that there exists a limited private remedy under the Investment Advisers Act of 1940 to void an investment advisers contract, but that the Act confers no other private causes of action, legal or equitable." 444 U.S. at 24. However, TAMA concerned whether the antifraud provisions of the Advisers Act conferred a private right of action, similar to the private right of action under the Securities and Exchange Act of 1934. What was not before the Court, and that the Court did not address, was whether a breach of the fiduciary duties imposed by the Act can constitute the basis for a common law claim of breach of fiduciary duty.

[180] SEC v. Capital Gains Research Bureau, Inc., 375 U.S. at 194. *See also* TAMA, 444 U.S. at 17 ("[i]ndeed, the Act's legislative history leaves no doubt that Congress intended to impose enforceable fiduciary obligations.") *Id.*

Forum Shopping: What forums are available to investors who pursue claims against their brokers and which best protects their rights?

By Mark K. Davis, J.D.*

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The financial market is a volatile and dynamic environment, which can punish those who fail to adapt. Investor wealth can evaporate in a matter of days, hours and even minutes. These losses are often due to broker malfeasance. In such cases, aggrieved investors must decide whether to seek a jury trial or to pursue arbitration before the NASD.[1] The differences between the jury system and the arbitration process will impact an investor's ability to recover any losses. In 1987, the U.S. Supreme Court held that arbitration panels are competent to handle the complexities of securities disputes while adequately protecting the rights of investors.[2] *But do securities arbitrations support this holding? Or are juries better suited to handle securities disputes?* This article addresses these questions by conducting a five part inquiry into: (1) the precedent for pre-dispute arbitration clauses, (2) whether investors can avoid arbitration, (3) results reached by arbitration panels, (4) results reached by juries, and (5) procedural issues in arbitration. This inquiry supports the conclusion that while both arbitrators and juries are competent to handle securities disputes *the jury system better protects the rights of investors*.

I. Pre-Dispute Arbitration Clauses

Brokerage firms require customers to sign an agreement which sets forth the various duties and obligations of the parties. These agreements invariably contain pre-dispute arbitration clauses that compel arbitration in the event of a dispute.

Initially, these clauses were not enforced. The U.S. Supreme Court held that a pre-dispute agreement to arbitrate a claim under the Securities Act of 1933 was not enforceable in spite of the Federal Arbitration Act ("FAA") because it violated public policy.[3] The *Wilko* court refused to compel arbitration because the clause violated both sections 14 and 22 of the 1933 Act, which place jurisdiction in state and federal courts and prohibit waivers of the statute.[4] The court saw securities arbitrations as more complicated than traditional commercial arbitrations. Securities disputes involve difficult questions of fact and law including, *inter alia*, intent and knowledge. The

[1] The NASD-DR was the forum for 89.75% of all securities arbitrations. Michael Perino, Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirement in NASD and NYSE Securities Arbitrations pg. 10, n.24 (November 4, 2002). Data compiled by SICA in 2000 and 2001.

[2] *Shearson American Express v. McMahon*, 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987).

[3] *Wilko v. Swan,* 346 U.S. 427, 74 S.Ct. 182, 98 L.Ed. 168, (1953)

[4] *Id.* at 429.

court did not place credence in the ability of arbitrators to adequately determine such complicated questions.[5] *Wilko* refused to enforce pre-dispute arbitration clauses in investor-broker contexts.

Wilko remained the law regarding the validity of arbitration clauses until 1987, when it was expressed overruled by *Shearson American Express v. McMahon*.[6] *Shearson* enforced a pre-dispute arbitration clause almost identical to the one invalidated in *Wilko*. The *Shearson* court found that non-waiver provisions of the 1933 Act apply only to substantive rights and not procedural rights.[7] The *Shearson* court was convinced that the Securities and Exchange Commission ("SEC") could ensure that NASD arbitrations were adequate to protect investors' rights.[8] The court wanted to promote the arbitration process and held NASD arbitrations mandatory for investor disputes with brokerage firms.[9] This holding was reaffirmed two years later and remains the controlling authority.[10]

II. Can Investors Avoid Arbitration?

The NASD Code of Arbitration Procedure compels arbitration in almost all disputes involving an investor and their broker.[11] NASD Rule 10301(a) requires arbitration in "any dispute, claim, or controversy between a customer and a member and/or associated person arising in connection with the business of such member."[12] A dispute must be arbitrated if (1) it involves a customer and a broker and (2) it arises from the normal activities of the broker.[13] A court must compel arbitration in disputes between a customer and a broker when an investment transaction or relationship is involved.

However, there are three recognized exceptions that allow investors to avoid arbitration, including: (1) the absence of a signed contract, (2) contracts induced by fraud and (3) disputes brought as class action suits[14].

A. Unsigned Agreement

Pre-dispute arbitration clauses arise from the formation of a contractual relationship between parties. If parties fail to execute a contract, including a pre-dispute arbitration clause, such a provision is unenforceable against both parties. This result was made explicit by the U.S. Supreme Court, which stated that "arbitration is a matter of contract and a party cannot be required to submit to arbitration any dispute which he had not agreed so to submit." *AT&T Technologies, Inc. v. Communications Workers of America*.[15]

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[5] *Id*. at 436.

[6] *Shearson American Express v. McMahon*, 482 U.S. 220, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987).

[7] *Id.*

[8] *Id*. 221.

[9] *Id*. at 221.

[10] *Rodriguez de Quijas v. Shearson/Am. Express Inc.*, 490 U.S. 477, 109 S.Ct. 1917, 104 L.Ed.2d 526, (1989).

[11] In April 2007, the new Customer Code became effective after SEC approval in January 2007. Since this article was written prior to the effective date of the new Code, prior Code provisions are cited. To review the new Customer Code, go to www.nasdadr.com

[12] NASD Code of Arbitration Rule 10301(a); available at http://nasd.complinet.com/nasd/display/display.html?rbid=1189&record_id=1159001049&highlight=code+of+arbitration+procedure

[13] *Vextax Securities Corp. v. McWood*, 280 F.3d 1078, 1081 (2002)

[14] The new Customer Code adds derivative actions to this list of exclusions.

The *AT&T* court explained this rationale:

> This axiom recognizes the fact that ***arbitrators derive their authority to resolve disputes only because the parties have agreed in advance*** to submit such grievances to arbitration. (emphasis added) [16]

The law unequivocally states that investors cannot be compelled to arbitrate a dispute if a contract containing a pre-dispute arbitration agreement was never signed.[17]

Moreover, it is for a court to decide whether the parties actually agreed to arbitrate their disputes. The *AT&T* court reversed a seventh circuit decision ordering the parties to arbitrate the "arbitrability question." The *AT&T* court held that it is for the court to determine whether the parties intended to arbitrate grievances.[18] If the question arises whether an investor signed a contract requiring arbitration the issue will be determined by a court. If the court decides that the contract was never signed then an investor may pursue a claim in court. Conversely, if a court determines that an investor did sign a contract then a court must compel arbitration.

Courts have created an exception to this rule when investors seek to enforce arbitration clauses against brokers. The Second Circuit Court of Appeals compelled arbitration at the request of customers despite the fact that none of the customers had a written contract with the brokerage firm.[19] The court relied upon previous Second Circuit rulings, stating that "Rule 10301 does not require an investor to be a direct customer"[20], but that:

> Under the NASD Code, when the investor deals with an agent or representative, the investor deals with the member, and on that basis the investor is entitled to have resolved in arbitration any dispute that arise out of that relationship.[21]

The Second Circuit compelled arbitration because the investors had numerous interactions with a broker who was employed by an NASD member. Enforcing arbitration against the NASD member was not prejudicial, said the court, because arbitration is standard practice in the securities industry and can be anticipated and prepared for by NASD members. The Second Circuit presents an interesting legal wrinkle that supports giving investors a choice of forum when pursuing claims against their brokers.

B. Fraud In The Inducment

Another avenue for investors seeking to avoid arbitration is to argue that their contract was induced by fraud and that, but for the broker's fraudulent actions, i.e., forgery, misrepresentations, etc., there would be no contract and no arbitration agreement. Courts analyze these claims in two ways. The predominant view, known as the "separability doctrine," considers an arbitration clause "separate" from other contractual provisions. The minority view, known as the "void-able contract" doctrine, holds that void contracts

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[15] *AT&T Technologies, Inc. v. Communications Workers of America*, 475 U.S. 643, 648-649, 106 S.Ct. 1415, 89 L.Ed.2d 648, (1986)

[16] *Id.* at 649, citing, *Gateway Coal Co. v. Mine Workers,* 414 U.S. 368, 374 (1974).

[17] Although an exception exists for margin agreements that contain arbitration clauses. If those agreements are not signed but the customer, nevertheless, derives the benefits of margin trading, courts will enforce the margin agreement that contains an arbitration clause.

[18] *Id.* at 651

[19] *Vextax Securities Corp. v. McWood*, 280 F.3d 1078, 1081 (6th Cir. 2002).

[20] *John Hancock Life Insurance Co., v. Wilson*, 254 F.3d 48 (2nd Cir. 2001)

[21] *Oppenheimer & Co. Inc. v. Neidhardt*, 56 F.3d 352 (2nd Cir. 1995).

were never contracts at all. These two doctrines create significant issues for investors seeking to avoid arbitration.

i. Federal Separability Doctrine

The "seperability doctrine" was first articulated in *Robert Lawrence Company v. Devonshire Fabrics, Inc.* The court held that:

> [S]ince the arbitration clause was separable from the other provisions of the contract, the issue of the misrepresentation which induced the execution of the contract could be determined by the arbitrator, as long as the arbitration clause itself was not distinctly induced by fraud. [22]

This meant that a claim of fraud in the inducement regarding the entire contract would be determined by the arbitrator(s). By negative inference the *Devonshire* court held that if the claim of fraud in the inducement was directed towards the arbitration clause the issue would be for a court to decide.

Seven years after *Devonshire*, the Supreme Court reaffirmed the separability doctrine, broadened its scope, and clarified its effect. In *Prima Paint Corp., v. Flood & Conklin Mfg. Co.*,[23] the court held that:

> Arbitration clauses as a matter of federal law are '*separable*' from the contracts in which they are embedded, and where no claim is made that fraud was directed to the arbitration clause itself, a broad arbitration clause will be held to encompass arbitration of the claim that the contract itself was induced by fraud.[24]

The court broadened the separability doctrine by expressly allowing a broad arbitration clause to be effective even if the contract itself was fraudulently induced. *Prima Paint* relied heavily upon the Federal Arbitration Act ("FAA") for the authority to clarify the effect of the separability doctrine. FAA § 4 provides this authority as reaffirmed in *Prima Paint*. FAA § 4 provides:

> A federal court is instructed to order arbitration to proceed once it is satisfied that 'the making of the agreement for arbitration or the failure to comply [with the arbitration agreement] is not an issue.' However, "if the making of the arbitration agreement or the failure, neglect, or refusal to perform the same be in issue, the court shall proceed summarily to trial.[25]

As a result, the separability doctrine now clearly stands for two core propositions: (1) if the alleged fraud relates to the arbitration clause itself the court should adjudicate the fraud claim, but (2) if the alleged fraud relates to the entire agreement, the FAA requires that the fraud claim be decided by an arbitrator.[26]

The results of *Prima Paint* and FAA § 4 are now clear. If a party claims that the *entire contract* was fraudulently induced, a court must order arbitration if it is satisfied that the making of the arbitration agreement is not at issue. All issues, including the fraud claim, will then be settled at arbitration. However, if the court finds the formation of the *arbitration agreement* to be at issue then the court will proceed to trial.

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[22] *Robert Lawrence Company v. Devonshire Fabrics, Inc.,* 271 F.2d 402, 38 Lab. Cas. (CCH) ¶; 65893 (2nd Cir. 1959), cert. granted, 362 U.S. 909, 80 S.Ct. 682, 4 L.ed 2d 618 (1960)

[23] *Prima Paint Corp., v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 87 S.Ct. 1801, 18 L.Ed. 2d 1270 (1967)

[24] *Id*. at 342.

[25] 9 U.S.C. § 4.

[26] *Prima Paint Corp., v. Flood & Conklin Mfg. Co.*, 388 U.S. 395, 404 87 S.Ct. 1801, 18 L.Ed. 2d 1270 (1967)

The result is the same in securities cases. *Shearson* held that the analysis under section 4 of the FAA "does not change when applied to securities fraud claims."[27] An investor who is seeking to avoid arbitration must convince a court that an issue exists in the "making of the arbitration agreement,"[28] because a court will only void an arbitration agreement "for some error in its making."[29]

Therefore, in order to proceed in court, an investor must prove that some fraudulent conduct took place, such as forgery, misrepresentation, unconscionability, or lack of consideration.[30] If an investor can make such a showing FAA § 4 will mandate that a court decide the fraud issue at trial along with the rest of the dispute.

In the event that an investor can only challenge the validity of the contract as a whole, the issue will be arbitrated along with the entirety of the investor's claim. This result was reached by the Sixth Circuit in a securities dispute.[31] Authorities on the subject also support this view.[32] While the separability doctrine has been challenged, a number of state courts have upheld the validity of the doctrine.[33] Most federal circuits agree.[34]

ii. Void-able Contract Doctrine

Not all federal circuits agree with *Prima Paint* and its progeny. A number of circuits have taken an entirely different approach.[35] These courts apply a voidable contract distinction and hold that a void contract was never a contract at all.[36] This void-able contract doctrine asserts that a valid arbitration agreement cannot arise out of a broader contract if no broader contract ever existed. If

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27 *Shearson American Express v. McMahon*, 482 U.S. 220, 223, 107 S.Ct. 2332, 96 L.Ed.2d 185 (1987)

28 9 U.S.C. § 4.

29 *Fazio v. Lehman Brothers, Inc. et al*., 340 F.3d 386, 393, 2003 Fed.App. 0284P (6th Cir. 2003)

30 *Doctor's Assoc., Inc. v. Casarotto*, 517 U.S. 681, 687, 116 S.Ct. 1652, 134 L.Ed.2d 902 (1996). (An arbitration agreement may be invalidated for the same reasons for which any contract may be invalidated, including forgery, unconscionability, and lack of consideration).

31 *Fazio v. Lehman Brothers, Inc. et al*, 340 F.3d 386, 393, 2003 Fed.App. 0284P (6th Cir. 2003). (Even if there was fraudulent inducement to sign the contract as a whole, by the terms of FAA §§ 3 and 4, the arbitration clause is severable).

32 Thomas H. Oehmke on Commercial Arbitration, CMLARB § 24:2 (2006).

33 *Larsen v. Opie*, 237 Mont. 108, 771 P.2d 977 (1989). (fraud in the inducement of a securities contract, applied the USAA, and thus followed the federal separability doctrine); *Anderson v. Ashby*, 2003 WL 21125998 (Ala. 2003), cert. denied, 124 S.Ct. 1506, 158 L.ed 2d 153 (U.S. 2004). (when a claim of fraud in the inducement is directed toward the entire contract the issue is subject to arbitration); *Johnson Mobile Homes of Alabama, Inc., v. Hathcock*, 2003 WL 380498 (Ala. 2003). (if a claim of fraud in the inducement of the arbitration clause itself, an issue which goes to the making of the agreement to arbitrate, the court may decide it).

34 *Peoples Sec. Life Ins. Co. v. Monumental Life Ins. Co*., 867 F.2d 809, 812 (4th Cir. 1989); *Buckeye Check Cashing, Inc. v. Cardegna*, 126 S.Ct. 1204, 163 L.Ed.2d 1038, (2006); *Large v. Conseco Finance Servicing Corp.*, 292 F.3d 49 (1st Cir. 2002); *Banc One Acceptance Corp. v. Hill*, 367 F.3d 426 (5th Cir. 2004); *Masco Corp. v. Zurich American Ins. Co*., 382 F.3d 624 (6th Cir. 2004); *Commonwealth Edison Co. v. Gulf Oil Corp.*, 541 F.2d 1263 (7th Cir. 1976).

35 *Sandvik AB v. Advent Intern. Corp.*, 220 F.3d 99 (3rd Cir. 2000); *Sphere Drake Ins. Ltd. V. Clarendon Nat. Ins. Co.*, 263 F.3d 26 (2nd Cir. 2001); *Three Valleys Mun. Water Dist. V. E.F. Hutton & Co., Inc.*, 925 F.2d 1136, 1140 (9th Cir. 1991); *Chastain v. Robinson-Humphrey Co., Inc.*, 957 F.2d 851 (11th Cir. 1992).

36 *Id.*

there is no contract then the arbitrator has no authority to adjudicate a dispute between parties. This leaves the determination of whether the contract is void *ad initio* to a court.

The ninth circuit has applied the void-able contract doctrine. For example, in *Three Valleys,* the Ninth Circuit held that:

> A party who contests the making of a contract containing an arbitration provision cannot be compelled to arbitrate the threshold issue of the existence of an agreement to arbitrate. Only a court can make that decision [37]

The *Three Valleys* court held that contracts that are void *ab initio* cannot be used to compel a party to arbitrate. This argument concurs with the holding reached by the *AT&T* court: that arbitrators have no authority to arbitrate disputes without advance agreement by parties to submit their grievances to arbitration.[38] Under the voidable contract doctrine, an investor can argue that because the contract was induced by fraud, it was never valid. Ergo, the arbitrators have no authority to settle a dispute between the parties because they never agreed to arbitrate their disputes. If a court agrees, an investor can proceed in court.

Investors should be wary when utilizing the voidable contract doctrine. While the doctrine has been successfully argued before a number of circuit courts, it remains the minority view in most federal circuits and state courts. The doctrine is premised upon a challenge to the validity of the entire contract on the basis of fraudulent inducement. This same argument would land an investor in arbitration if decided by a court that has adopted the separability doctrine. The separability doctrine mandates that challenges to entire contracts be decided in arbitration. Thus, if an investor is seeking to avoid arbitration, it is important to determine whether the void-able contract or the separability doctrine will apply.

C. Exclusion Of Class Action Lawsuits

The most straightforward method to avoid arbitration is for an investor to bring a claim as part of a class action suit. Class action claims are expressly excluded by the NASD rules from submission to arbitration.[39] This exclusion is contained in NASD Code of Arbitration Rule 10301(d), which states: "a claim submitted as a class action shall not be eligible for arbitration under this Code at the Association."[40]

The Code of Arbitration prohibits an NASD member or associated person from enforcing a pre-dispute arbitration clause against an investor who brings his claim as part of class action. However, there are a number of limited exceptions to this rule. NASD members can seek to compel arbitration if an investor's claim does not qualify as a class action lawsuit. This can happen if the class to which the investor is claiming membership is decertified or if class action status is denied. [41] This can also occur if the claimant is excluded from the class for some other reason or if the claimant elects not to participate in the class (Rule 10301(d)(3)).[42]

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[37] *Three Valleys Mun. Water Dist. V. E.F. Hutton & Co., Inc.*, 925 F.2d 1136, 1140 (9th Cir. 1991)

[38] *AT&T Technologies, Inc. v. Communications Workers of America.*, 475 U.S. 643, 649, 106 S.Ct. 1415, 89 L.Ed.2d 648, (1986).

[39] NASD Code of Arbitration Rule 10301(d); available at: www.nasd.com/Arbitration Mediation/.htm. As noted above, under the new Customer Code, this exclusion extends to derivative actions as well.

[40] NASD Code of Arbitration Rule 10301(d)(1); available at: www.nasd.com/Arbitration Mediation/.htm.

[41] NASD Code of Arbitration Rule 10301(d)(3); available at: www.nasd.com/Arbitration Mediation/.htm

[42] NASD Code of Arbitration Rule 10301(d)(3); available at: www.nasd.com/Arbitration Mediation/.htm

Outside of these limited exceptions provided by the NASD rules, an NASD member seeking to compel arbitration of a class action will be unsuccessful.

III. NASD Arbitration Awards

The enforcement of pre-dispute arbitration agreements has not resulted in investors losing uniformly at arbitration. Since *Shearson*, investors have enjoyed limited success against brokers at NASD arbitration hearings. Two notable arbitration awards, *Lopez v. Merrill Lynch* and *Barkan v. Lehman Brothers*, provide good examples of investors prevailing at arbitration.

A. Lopez v. Merrill Lynch et al.

In 2004, a Texas arbitration panel entered an arbitration award against Merrill Lynch for over $5 million. This included an award of punitive damages. The claimants only pled damages in the amount of $3 million.[43] The compensatory damages awarded were also significant because they represented three times the amount of claimants' actual out-of-pocket damages.

The facts in *Lopez* show that the four claimants alleged that Merrill Lynch had advised them to exercise their employee stock options and to then hold them without diversifying their portfolio. Moreover, Merrill Lynch had advised claimants to utilize margin debt to exercise their options. This extremely aggressive strategy placed claimants' investments in a highly volatile and risky position. When the market for the underlying stock declined, the claimants were left unprotected and, since their investments were concentrated in only one stock, their portfolios became worthless.

The award was notable because the claimants were able to win at arbitration in an exercise and hold case. Such cases are very difficult to prove. It is easy for arbitrators to place the blame upon the investors in such cases because they often view investors as inherently greedy. Merrill Lynch bolstered this perspective in the *Lopez* case by arguing that the claimants were strongly tied to their stock because they worked for the underlying company that granted them the stock options.[44] Merrill argued that the claimants believed in the strength of the company, as well as its stock, and were vehemently opposed to selling any shares of their stock.[45]

However, claimants were able to convince the arbitrators that Merrill Lynch acted negligently in failing to diversify their portfolios and in recommending the use of margin loans. Claimants relied upon several NASD Rules, including the "Suitablitity Rule" (NASD Code of Arbitration Rule 2310), which mandates that brokers and NASD member conduct a thorough analysis of their client's financial circumstances, investments goals and risk tolerance before making a recommendation or solicitation to their customers. All advice given to clients must take into consideration these factors. Claimants were successful at arbitration because they convinced the arbitrators that Merrill Lynch failed to take into account their financial circumstances when advising an exercise and hold strategy. Therefore, Merrill Lynch's advice was unsuitable and its actions were found to be negligent.

The *Lopez* arbitration award is a strong confirmation of the *Shearsonv. McMahon* holding, namely arbitrators can deal with complicated evidentiary and legal issues and reach an equitable result while still protecting the rights of the investor.

B. Barkan v. Lehman Brothers et al.

The *Lopez* decision was a great result for

[43] *In the matter of the Arbitration between Carla J. Lopez et al. v. Merrill Lynch et al.*, NASD Case No. 02-04422. This information is available at: www.nasd.com/ArbitrationMediation/.htm

[44] *Id.*

[45] *Id.*

investors who submitted their claim through the NASD dispute resolution process. The argument posited in *Shearson* that arbitrators can competently handle securities disputes is also supported by the arbitration award in *Barkan v. Lehman Bros et al*.[46]

In *Barkan*, the claimants alleged that the broker failed to diversify their concentrated holdings. Claimants argued that Lehman Brothers had a duty to ensure that they received suitable advice from their broker. The arbitration panel agreed and found in favor of the claimants even though it found that the broker himself had not acted negligently. The panel placed liability upon the brokerage firm for failing to supervise its employee. This liability was based upon the presumption that brokerage firms have a responsibility to monitor the actions of their employees. If a brokerage firm finds that its employees are not meeting their client obligations, it has a duty to take action. Here the arbitrators found Lehman Brothers failed to (1) supervise the actions of its employee, and (2) to take corrective action to remedy the failures of its employee.

In upholding the arbitration award, the district court addressed the issue of *respondeat superior*, and held that, "an arbitration panel may hold a brokerage house liable for negligence while absolving the particular broker from liability."[47] The court agreed with the arbitration panel and rendered judgment confirming the award.

Barkan stands alongside *Lopez* in validating the central holding of *Shearson*. These two arbitration awards evince that NASD arbitrations can handle the complex legal and factual arguments in securities disputes.

IV. Jury Verdicts In Securities Cases

Barkan and *Lopez* make a strong argument for the ability of arbitration panels to effectively adjudicate securities disputes. But how do these arbitration awards compare to jury verdicts rendered in similar securities cases? Moreover, how do class action verdicts in securities cases affect this comparison? A review of two prominent individual lawsuits and two class action lawsuits provide a solid ground for measuring the results of jury verdicts to those decided by arbitration panels and to the conclusion I reach in this article.

A. Millan v. Morgan Stanley Dean Witter et al.

The first jury verdict represents a nightmare result for a highly sympathetic investor. *Millan v. Dean Witter Reynolds, Inc*.[48] The *Millan* case involved perhaps one of the most egregious examples of broker misconduct in a reported decision in recent memory. The claimant, Mrs. Millan, held her investment accounts with Morgan Stanley and its broker Miguel, who was her son. Miguel systematically looted his mother's accounts and ultimately stole almost $300,000 from her.[49]

Miguel opened an additional account in his mother's name by forging her signature and then wrote checks to cash and to himself from the fraudulent account. Miguel liberally used this account to purchase numerous luxury goods for himself and made efforts to cover his tracks, including lying to his mother about the account activity.[50]

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[46] *Barkan v. Lehman Bros et al*, No., 04-CIV-07431 (S.D.N.Y. 2003)

[47] *Id*.

[48] 90 S.W. 3d 760 (Tex.App.-San Antonio 2002)

[49] *Millan v. Dean Witter Reynolds, Inc.*, 90 S.W. 3d 760, 763 (Tex.App.-San Antonio 2002).

[50] *Id*.

Despite these facts, a jury found Millan to be comparatively negligent for 85% of her damages and awarded her only $12,000.[51] This verdict was based upon evidence showing that Millan knew of irregularities in her account statements as early as July 7, 1993. The evidence also showed that she suddenly received check-writing privileges in her account without any request or paperwork on her part. Furthermore, Mrs. Millan did not receive a statement for June 1994 and only received some of her statements after this date. She failed to make any inquiries or objections to these issues. Based upon this evidence, the jury found that Millan should have discovered the fraud against her in July 1994 and barred all of her claims except negligence.[52] Mrs. Millan's comparative negligence then reduced her damages to approximately $12,000.

The Court of Appeals of Texas, San Antonio, held that this evidence supported the jury's findings that Millan should have known something was amiss by July 1994 and that she bore 85% of the responsibility. Ultimately, Millan's failure to "discover" the fraud barred her claims for breach of fiduciary duty, conversion, and gross negligence under the Texas two year SOL.[53]

The result was disastrous for Mrs. Millan. She received a recovery of approximately four cents for every dollar lost. Was this a just result or did the jury system fail to provide an adequate remedy to an investor whose life savings were looted by her own son? The answer would appear to be the latter, especially when considered in light of *Barkan v. Lehman Bros., supra*. As noted above, the *Barkan* court held that a brokerage firm could be liable for failing to supervise an employee. However, the appellate court in *Millan* held that Morgan Stanley could not be held vicariously liable for its broker's acts because they were beyond the scope of his employment. On its face, it seems that the jury system failed Mrs. Millan.

However, *Barkan* and *Millan* are distinguishable. In *Barkan*, Lehman Brothers was held liable because it *failed to take any action at all*. The court made it clear that the brokerage firm had an affirmative duty to take action when it saw that its employee was not performing his duties. Unlike *Millan*, the broker's actions in *Barkan* were not criminal, only negligent. Conversely, the broker in *Millan* was acting outside the scope of his employment. The law does not hold brokerage firms liable for such conduct.

The *Millan* ruling is legally sound according to Texas law. The jury cannot be blamed for the result. It performed its function by finding the facts and applying them to the law. Whether or not Mrs. Millan prevailed at trial is not dispositive. Rather, as both *Shearson* and *Wilko* made clear, the central issue is whether the rights of the investor were adequately protected. That the appellate court affirmed the jury verdict is strong evidence that the Millan jury fairly and adequately protected her rights as a litigant.

B. DeKwiatkowski v. Bear Sterns et al.

Another case that reached an equally disastrous result is *de Kwiatkowski v. Bear, Stearns & Co., Inc*.[54] This seminal case involved individual investments made on an institutional level. Mr. deKwiatkowski invested in currency futures through the Chicago Mercantile Exchange with the help of Bear Sterns. During the years 1994-1995, he went from netting $200 million in a few weeks, to suffering single day losses of $112 million, $98 million, and $70 million.[55] His investment

[51] *Id.*

[52] *Id.*

[53] Tex. Civ. Rem. & prac. Code Ann sec 16.003(a).

[54] *de Kwiatkowski v. Bear, Stearns & Co., Inc*, 306 F.3d 1293 (2nd Cir. 2002)

[55] *de Kwiatkowski v. Bear, Stearns & Co., Inc.*, 306 F.3d 1293, 1296 (2nd Cir. 2002).

strategy was based upon a strong belief that the U.S. dollar was undervalued.

The evidence showed that plaintiff's broker did several things to reinforce this strategy during late 2004, including telling him that "this is the time to buy the dollar," and that "this time the dollar will do what [Kwiatkowski] always believed it would."[56] In November 2004, the broker gave plaintiff a report from Bears Sterns' top economist, Wayne Angell, entitled "Dollar Investment Opportunity," which expressed the view that the dollar was undervalued.[57]

Notably, plaintiff never received a copy of a different report from Bear Sterns that downgraded the dollar's outlook to "negative," based upon the Mexican economic crisis and the increasing strength of the German mark and Swiss franc, two currencies in which the customer held short positions.[58] The dollar did indeed weaken and by March 1995 he was losing millions every day. Despite liquidating his holdings, the customer suffered losses totaling over $100 million.

Plaintiff proceeded to trial on a negligence claim. Even though his accounts with Bear Sterns were non-discretionary (meaning all transactions must be approved by the investor beforehand), the jury was instructed that defendants owed plaintiff "a duty to use the same degree of skill and care that other brokers would reasonably use under the same circumstances."[59] With this instruction, and on the above facts, the jury found in favor of plaintiff on his negligence claim and awarded him $111.5 million in damages. That victor was short-lived.

On appeal, the Second Circuit overturned the verdict. No flaw was found in the jury's verdict itself. Rather, the Second Circuit changed the law of negligence as it applies to non-discretionary accounts. The appellate court held that in a "nondiscretionary account, the broker's failure to offer information and advice between transactions cannot constitute negligence." *Id*. at 1306. The Second Circuit disagreed that special circumstances imposed additional burdens upon the brokers and reversed for a dismissal of the complaint.

While Mr. deKwiatkowski may have ultimately lost his case,[60] it is inappropriate to conclude that the jury was incapable of handling such a complicated case. Just like the jury in *Millan,* the jury in *deKwiatkowski* performed its function. It found the facts and applied them to the law. That the Second Circuit would eventually change the law of negligence regarding non-discretionary accounts was beyond the scope of the jury's function. Both *Millan* and *deKwiatkowski* show that when tasked to handle complicated securities disputes, juries are exceptionally well suited at discerning the most relevant facts and applying them to the law. It was this ability that convinced the *Wilko* court to refrain from mandating the enforcement of pre-dispute arbitration clauses.

C. Class Action Verdicts: Real Estate & Viratek

Verdicts reached in class action trials also support the ability of juries to adjudicate securities disputes[61]. Class actions present juries with challenging intellectual facts, legal concepts and numerous issues. These cases test a jury's ability to sift through complex information, apply it to complicated areas of law, and to render a reasonable verdict.

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[56] *Id*., at 1298.

[57] *Id*., at 1299.

[58] *Id*., at 1300.

[59] *Id*., at 1301.

[60] And ultimately died at the race track, where he loved to spend his time.

[61] Although it is the rare class action in which the investor fairs better than his attorney.

Several recent class action juries have awarded damages in favor of investors on an astronomical level.

One of the most notable class action "home runs" for investors came from *In re Real Estate Associates Ltd. Partnership Litigation*.[62] The investors' cause of action was based upon the defendant issuing misleading proxy solicitations that induced many investors to invest capital in exchange for shares that quickly became worthless. After a five week trial, the jury found for the plaintiffs and awarded $185,095,112 in damages ($92,550,056 in compensatory damages; $92,545,056 in punitive damages).

The second class action that rendered a large verdict was also brought on a cause of action alleging misstatements in relation to securities, *In re ICN/Viratek Securities Litigation*.[63] The jury in *Viratek* found that a pharmaceutical company had issued misleading statements about one of its drugs. Furthermore, the jury found that based upon this misleading information, many investors bought its stock and subsequently watched their money disappear. The jury came to a partial verdict that led to a settlement of $14.5 million.

By no means do class action lawsuits always result in jury verdicts for investors. In fact, over the past 10 years, numerous large class action suits that were tried before juries resulted in defense verdicts.[64] Regardless, *Real Estate* and *Viratek* show that investors can win large jury verdicts in class action securities trials. More importantly, these two cases illustrate that juries are more than competent to fairly adjudicate large scale securities disputes.

V. Procedural Issues In Arbitration

NASD arbitrations present a host of procedural and systematic difficulties for investors. Perhaps the most problematic issues posed by the NASD arbitration process include the rule prohibiting the use of interrogatories, the policy strongly discouraging the use of depositions, and the potential for bias in arbitrators. It is important to address these issues as they can present significant hurdles for investors seeking an equitable determination of their disputes.

A. Interrogatories Are Prohibited In Arbitration

The NASD does not allow testimonial interrogatories, although it does ;permit the propounding of Information Requests without requiring explanations or anticipated testimony. *See*, NASD Notice to members 99-90 ("NTM 99-90"), Ex. 1, Item V, pg. 691.[65] NTM 99-90 specifically prohibits standard interrogatories as utilized in state and federal courts. [66] This limitation supposedly prevents parties from propounding overly burdensome interrogatories upon each other and unnecessarily increasing the length of discovery. The NASD believes that this prohibition serves to expedite the discovery process.

Instead, NASD arbitration allows for parties to use information requests.[67] Information requests are limited to the identification of

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[62] 223 F.Supp.2d 1109 (C.D.Cal. 2002).

[63] 1996 WL 164732, 1 (S.D.N.Y. 1996).

[64] *In Re Clarent Corporation Securities*, 01-CV-3361, (N.D.Cal. 2005); *Miller v. Thane Intern., Inc.*, 372 F.Supp.2d 1198 (C.D.Cal. 2005); *Lazar v. James*, No. 94-CV-12177-PBS (D. Mass. 1998). *In re Biogen Sec. Litig.*, 179 F.R.D. 25 (D. Mass. 1997); *Howard v. Hui*, 2001 WL 1159780, 1 (N.D.Cal. 2001).

[65] Available at: http://www.nasd.com/RulesRegulation/NoticestoMembers/1999Noticesto Members/NASDW_004057

[66] *Id*. Available at: http://www.nasd.com/RulesRegulation/NoticestoMembers/1999Noticesto Members/NASDW_004057

individuals, entities, and time periods related to the dispute.[68] This definition as provided by NTM 99-90 is narrow in scope and eviscerates the efficacy of the interrogatory as a discovery tool. By limiting parties to the use of information requests the NASD severely curtails the ability of investors to obtain information this is both relevant and material to their disputes.

B. Depositions Are Strongly Discouraged In Arbitration

Depositions are rarely allowed in arbitration. While not prohibited, depositions are nonetheless strongly discouraged in arbitration. *See*, NASD Notice to members 99-90 ("NTM 99-90"), Ex. 1, Item V, pg. 691.[69] Parties may only conduct depositions in four limited circumstances, including: (1) to preserve the testimony of ill or dying witnesses, (2) to accommodate essential witnesses who are unable or unwilling to travel long distances or may not otherwise be able to participate in an arbitration hearing, (3) to expedite large or complex cases, and (4) to address unusual situations where the arbitrators determine the circumstances warrant departure from the general rule against depositions.[70] These exceptions infer that depositions will only be allowed if the witness cannot attend the arbitration hearing and presume that arbitrator(s) shall use their discretion in determining whether to allow a deposition(s).

The inability to depose witnesses can present major difficulties at arbitration. An investor must present evidence proving broker misconduct. Without the ability to take depositions, an investor cannot predict or control the testimony of defense witnesses. Unlike trials, where depositions are commonly used to impeach witnesses, investors at arbitration cannot contradict witness testimony with inconsistent statements from a deposition. Without this device it is conceivable that an unscrupulous defendant could alter the defense testimony based upon the evidence and testimony presented by an investor. Even if such egregious conduct does not occur investors are nonetheless deprived of an important and useful litigation tool.

C. Potential For Arbitrator Bias

In disputes exceeding $50,000, the NASD currently requires three arbitrators be appointed to a panel. One of the arbitrators on the panel must be an "industry arbitrator." The industry arbitrator usually works in the securities industry and is highly experienced in securities terminology and practice. The purpose of an industry arbitrator is to provide the arbitration panel with expert knowledge. However, the industry arbitrator appears to present a potential conflict of interest not present in jury trials. In a jury trial, counsel work hard during voir dire to ensure that potential jurors do not have ties to the parties or issues in dispute to avoid the potential for bias on the jury. For example, a plaintiff suing their insurance company would not want an employee of the insurance company on their jury. Yet this can occur in arbitration. This opens up the issue of whether industry arbitrators create a biased NASD arbitration system.

Michael A. Perino argues that the system is not biased. Mr. Perino submitted a report to the Securities and Exchange Commission ("SEC") finding that NASD arbitrations are not

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[67] NASD Uniform Code of Arbitration Rule 10321(b)

[68] See NTM 99-90 Ex. 1, Item V, pg. 691. Available at: http://www.nasd.com/RulesRegulation/NoticestoMembers/1999NoticestoMembers/NASDW_004057

[69] *Id*. Available at: http://www.nasd.com/RulesRegulation/NoticestoMembers/1999NoticestoMembers/NASDW_004057

[70] Available at: http://www.nasd.com/RulesRegulation/NoticestoMembers/1999NoticestoMembers/NASDW_004057

biased.[71] Mr. Perino's report focused on two propositions to support his finding. Similar to the opinion in *Shearson*, Mr. Perino believes that SEC oversight provides a substantial check against any bias in SRO ("self regulatory organization") arbitration. [72] He also argues that the SRO system itself has "A rationale self-interest in proving a fair dispute resolution system."[73] Mr. Perino theorizes that systematic unfairness would increase costs of arbitration as more parties would appeal and overturn arbitration awards. This would defeat the efficiency goal arbitration. Thus, the system has a rationale self-interest to avoid such a result.

Mr. Perino provides several other basis to support his finding. First, he states that the limited grounds for courts to overturn arbitration awards results in greater finality than litigation which benefits the public.[74] Mr. Perino also argues that investors benefit from the fact that arbitrators are not bound by precise legal standards which allows arbitrators to be more flexible in reaching decisions. Finally, Mr. Perino points to the formation of various organizations that serve to encourage change and improvements in the arbitration system thereby keeping it fair and impartial. These organizations include: SICA,[75] NAMC,[76] and PIABA.[77]

However, for the most part, Mr. Perino's report is a regurgitation of the pro- arbitration argument made in *Shearson*. His report makes unfounded conclusions that are factually unsupported. The data Mr. Perino does provide to support his findings is woefully incomplete. For example, Mr. Perino places emphasis on a study conducted by Gary Tidwell[78] regarding perceived fairness of SRO arbitration.[79] Mr. Tidwell obtained evaluations from participants of arbitrations during 1997 through 1999 and found that 93.49% of parties agreed or strongly agreed that their cases were handled fairly and without bias.[80] A follow up study in 2001 found similar results.[81] Only an estimated 10-20% of arbitration participants during these time periods completed the surveys. This means at least 80% of the participants did not provide any input on perceived fairness. Regardless, Mr. Perino relies upon this study as evidence that NASD arbitrations are fair.

Mr. Perino also argues that various organizations serve to balance the arbitration process and maintain its impartiality. Yet, PIABA, one of the organizations Mr. Perino mentions in his report, has actively lobbied

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[71] Report to the Securities and Exchange Commission Regarding Arbitrator Conflict Disclosure Requirements in NASD and NYSE Securities Arbitrations, Michael A. Perino, November 4, 2002. Available at: www.sec.gov.

[72] *Id.* At page 9.

[73] *Id.* At page 9.

[74] *Id.* At page 7. (Arbitrators may not completely ignore the law; most courts hold that they may overturn SRO arbitration awards based on 'manifest disregard of the law.') See, e.g., *Halligan v. Piper Jaffray, Inc.*, 148 F.3d 197 (2nd Cir. 1998); *Montes v. Shearson Lehman Brothers, Inc.*, 128 F.3d 1456 (11th Cir. 1997); see also *First Options of Chicago, Inc., v. Kaplan*, 514 U.S. 938, 942 (1995)

[75] SICA is a co-operative venture including representatives from SRO, the Security Industry Association, and members of the public.

[76] National Arbitration and Mediation Committee.

[77] Public Investors Arbitration Bar Association.

[78] Mr. Tidwell is the current Director of Neutral Training and Development for NASD Regulation.

[79] *Id.* at page 34.

[80] *Id.* at page 34.

[81] *Id.* at page 35.

congress to reform the NASD arbitration process because it is biased against investors. PIABA, in its statement to the 109th Congressional Subcommittee on Financial Services, specifically argued that "the industry arbitrator presents an appearance of bias and impropriety to the investing public."[82]

PIABA's congressional statement presented the concern that it is unfair to allow arbitrators to hear claims from investors when the arbitrator's employer might be profiting from the very same acts which injured the investor. Such situations present an unavoidable conflict and would not be allowed in the courtroom. Why should it be allowed in an arbitration hearing? PIABA contends that it should not. PIABA argues that eliminating the requirement of an industry arbitrator would "be the number one way to improve mandatory arbitration in customer cases."[83]

It is not contended that industry arbitrators are biased against investors. Most industry arbitrators serve a valid function on arbitration panels. The problem lies in the potential for bias against the investing public. It is foreseeable that an industry arbitrator could be biased. In such a circumstance, an investor will be prejudiced because the standard or review is extremely limited. Moreover, as Mr. Perino points out in his report, arbitrators are not required to follow the law in an exacting manner. Therefore, an investor who empanels a biased arbitrator who is not required to follow the law may end up with no recovery and almost no opportunity to overturn the arbitrators' award. Such an occurrence may not be probable, but it is definitely possible, and it is this possibility that must be removed before the arbitration process can claim to adequately protect the rights of investors.

VI. Conclusion

Shearson effectively rendered arbitration mandatory in all disputes between investors and brokers. The U.S. Supreme Court was satisfied that SEC oversight would enable SRO arbitration to adequately protect investor rights while adjudicating securities disputes in an efficient manner. As a result, most investors are forced to arbitrate their disputes. The law does allow certain investors to pursue their claims in court. However, the three exceptions to arbitration are dependant upon the facts of each case. To avoid arbitration, an investor must show that, (1) a contract was never executed, (2) the contract was fraudulently induced, or (3) the claim is included in a class action suit. If an investor cannot prove that one of these exceptions applies then a court will compel arbitration.

Pro-investor results in NASD arbitration do occur. *Lopez* and *Barkan* provide strong evidence that investors can win at arbitration. Meanwhile, jury verdicts can appear inequitable, as evidenced by the *Millan* decision, while other verdicts are overturned, as was *deKwiatkowski*. But arbitration awards like *Lopez* and *Barkan* are the exception to the rule. Recent NASD statistics show that investors are more likely than not to lose at arbitration. For example, in 2005, 57% of investor disputes before the NASD resulted in dismissals.[84] However, the *Wilko* and *Shearson* holdings did not emphasize victory as essential to a fair process. Instead, the stated benchmark was whether investor rights are adequately protected.

While it is uncertain whether arbitrations or jury trials adequately meet this benchmark, it

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[82] United States House of Representatives: Committee on Financial Services, Subcommittee on Capital Markets, Insurance and Government Sponsored Enterprises 109th Congress – First Session; "*Statement of the Public Investors Arbitration Bar Association in Connection with the Subcommittee's review of the Securities Arbitration System.*" Page 3.

[83] *Id*. at page 4.

[84] NASD – Arbitration & Mediation – Dispute Resolution Statistics; www.nasd.com/ArbitrationMediation/NASDDisputeResolution/Statistics/index.htm

is clear to me that the jury system comes closer. NASD procedural limitations on interrogatories and depositions take away important discovery tools that an investor could otherwise use to obtain and present evidence. Moreover, the requirement of an industry arbitrator presents the strong possibility of bias in the NASD arbitration regime. The danger inherent in arbitrator bias is compounded by the limited standard of review for arbitration awards and the flexibility allowed to arbitrators when applying the law.

Both NASD arbitration and the jury system are capable to handle securities disputes in a competent manner. But when compared to the jury system, the NASD arbitration process has the potential to severely prejudice investor rights. Only the jury system affords investors a full complement of litigation tools as well as an adjudicatory body free from selection requirements and the potential for bias.

Recent Arbitration Awards

Samuel Edwards, Esq.

Betsy Engel v. Bank of America Investment Services, Inc.,
NASD Case No. 05-4314

The Claimant brought an action against Respondent related to the purchase of "B" shares of Putnam mutual funds, and the failure of the Respondents to allocate the assets in a manner consistent with the objectives of the account.

Claimant asserted the following causes of action: breach of contract and warranties/unsuitability; promissory estoppel; violation of state securities statutes; intentional and negligent misrepresentations of material fact; unjust enrichment; breach of fiduciary duty; breach of the covenant of good faith and fair dealing; and, negligence.

Claimant's net out-of-pocket loss was $93,723. Claimant requested market adjusted damages, statutory and/or punitive damages, interest, costs, attorneys' fees, and all other relief available to Claimant which may be granted by the Panel.

Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

The Panel awarded Claimant market adjusted damages of $110,000.00, plus interest at 6% from the date of the filing of the claim until the date of payment of the Award, attorney's fees of $44,000.00, and costs of $13,750.00, for a total Award of $176,429.

Claimant's Counsel: Robert A. Kantas, Esq., Shepherd, Smith & Edwards, LLP, Houston, TX.

Claimant's Expert: Jerrod R. Summers

Respondent's Counsel: Daniel J. Donovan, Esq., Donovan & Rainie, LLC, Baltimore, MD.

The case is significant because it resulted in an Award of market adjusted damages to the Claimant. In addition, the Award is significant because it included an award of interest, attorney's fees and costs in accordance with applicable law, resulting in the Panel essentially awarding Claimant all of the damages she sought.

Samuel B. Edwards is a partner with the law firm of Shepherd Smith & Edwards LLP in Houston, Texas and has been a member of PIABA since 2002. Mr. Edwards may be reached at 713.227.2400 or by email at sedwards@sselaw.com.

John W. Hartsell v. Edward D. Jones & Co., NASD Case No. 05-06306

Claimant brought an action against Respondent related to the recommendation that he take early retirement and a lump sum payment from his company's pension plan. Claimant then alleged that Respondent purchased of unsuitable mutual funds, annuities, and other unspecified securities in Claimants' accounts. The claims specifically involved Respondents' failure to allocate the assets in a manner consistent with the stated objectives of the accounts and consistent with Respondent's recommended asset allocation models.

Claimants asserted the following causes of action: breach of contract and warranties; promissory estoppel; violation of state securities statutes, intentional and negligent misrepresentation, and breach of fiduciary duty.

Claimant had net out-of-pocket losses of roughly $95,000.

In addition, all Claimants requested market adjusted damages, statutory and/or punitive damages, interest, costs, rescission, attorneys' fees, and all other relief available to Claimant which may be granted by the Panel.

Lastly, the Claimant asked that the Panel award him damages based on a benefit of the bargain theory. Specifically, Claimant alleged that he was entitled to as damages the cost of purchasing an immediate annuity that would guarantee the income which the broker promised.

The case was originally filed as a joint case with seven other Claimants. Respondent filed a motion to sever which the Panel ultimately granted, which left Claimant Hartsell on his own in the case.

The Panel awarded Claimant John Hartsell $300,000 in compensatory damages (essentially the cost to purchase an annuity with the full replacement income).

The Panel also awarded Claimant $120,000 in attorney's fess pursuant to Michigan statute and common law (which represented the full 40% contingency contract).

The Panel also awarded Claimant $15,000 in interest.

Claimants' Counsel: Samuel B. Edwards, Esq., Shepherd, Smith & Edwards, LLP, Houston, Texas.

Claimants' Expert: Jerrod R. Summers

Respondents' Counsel: Dennis K. Egan, Butzel Long, Bloomfield Hills, Michigan.

The Case is significant because it resulted in an Award of benefit of the bargain damages for a retiree who gave up a guaranteed pension at a broker's recommendation for the opportunity to make a higher income. In addition, the case is significant because the Panel awarded the client full attorney's fees under the contingency contract as well as interest, which made sure the Claimant was actually "made whole" after the arbitration. Lastly, the case is significant because it shows that even a small, sub-hundred thousand case can result in large losses to a brokerage firm, which should encourage more fair settlements.

Byoung Im v. JPR Capital Corp., Paul Umansky, Hong Joon Chun, NASD Case No. 04-06685

Claimant transferred $680,000 to JPR Capital and their broker, Mr. Chun. Chun engaged in day-trading in the account without the authorization of Claimant. Chun manufactured account statements and faxed them to Claimant from his apartment in New York, and told Claimant to ignore the firm account statements. Chun engaged in options trading over the course of four months, reaping commissions of over $80,000. When Claimant requested a withdrawal of $500,000 for real estate investment, Chun sent a check for $50,000, as the remainder of the account had been depleted by way of losses. Chun drafted a confession letter to Claimant and offered to pay back the losses over time.

After the claim was filed, Chun voluntarily left JPR Capital, and upon information and belief, left the United States for South Korea. Before the award was entered, Chun was barred from the securities industry for failing to respond to a request to be interviewed by NASD regarding the facts outlined in the claim.

Claimant asserted the following causes of action: negligence, fraud, violation of Texas Securities Act and Texas Deceptive Trade Practices Act.

Claimant requested full compensatory damages of $630,000, consequential damages and interest. Additionally, Claimant requested a finding of fraud and violation of the Texas Securities Act for Mr. Chun.

The Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses, including ratification, waiver, estoppel, contributory negligence, assumption of risk, unclean hands.

The Panel awarded Claimant $630,000 in compensatory damages; attorney fees and case expenses, 8.25% interest from the time account was closed in May 2004 until award is paid

Claimants' Counsel: Jeffrey S. Kruske, Overland Park, KS

Claimants' Expert: None

Respondents' Counsel: Hayward Pressman, Pressman & Trien;
Michael Schwartzberg, Winget, Spadafora & Schwartzberg

Respondent's Expert: None.

The case is significant because it resulted in an Award of full damages. After settling with JPR Capital and Paul Umansky, both parties consented to Claimant pursuing the case at hearing against Chun. After confirming that Chun was no longer represented, but had been served with the claim and had notice of the hearing, the Panel allowed Claimant to present his case in chief by way of pre-hearing briefs and affidavits over the telephone.

At Claimant's request, the Panel awarded all damages requested in the statement of claim, including costs, attorney fees, and interest, without any offset for the settlement from JPR Capital.

The award is also significant because the Panel made a specific finding that Mr. Chun committed fraud and violated the Texas Securities Act, which would prevent him from entering the United States in the future to file for bankruptcy.

Barbara Karp, Edwin Rosenberger and Thomas Johnson v. Edward Jones & Co. L.P. d/b/a Edward Jones and Thomas Frank Belvin,
NASD Case No. 05-03983

Claimants brought an action against Respondents related to the purchase of unsuitable mutual funds, annuities, and other unspecified securities in Claimants' accounts. Case involved Respondents' failure to allocate the assets in a manner consistent with the stated objectives of the accounts.

Claimants asserted the following causes of action: breach of contract and warranties; promissory estoppel; violation of the Virginia State Securities Act; intentional and negligent misrepresentations of material fact; unjust enrichment; breach of fiduciary duty; breach of the covenant of good faith and fair dealing; and, negligent supervision.

Claimant Barbara Karp's net out-of- pocket loss was $135,358.

Claimant Thomas Johnson's net out-of-pocket loss was $60,083.

Claimant Edwin Rosenberger had an out-of-pocket *gain* in the amount of $4,184.

In addition, all Claimants requested market adjusted damages, statutory and/or punitive damages, interest, costs, rescission, attorneys' fees, and all other relief available to Claimant which may be granted by the Panel.

The Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

The Panel awarded Claimant Karp market adjusted damages of $165,000.00, attorneys' fees of $49,500.00, and costs of $10,700.00, for a total award of $225,200.

The Panel awarded Claimant Johnson market adjusted damages of $75,000.00, attorneys' fees of $22,500.00, and costs of $8,700.00, for a total award of $106,200.

The Panel awarded Claimant Rosenberger market adjusted damages of $100,000.00, attorneys' fees of $30,000.00, and costs of $8,700.00, for a total award of $138,700.

Claimants' Counsel: Robert A. Kantas, Esq., Shepherd, Smith & Edwards, LLP, Houston, TX.

Claimants' Expert: Jerrod R. Summers

Respondents' Counsel: Wendy S. Menghini, Esq., Greensfelder, Hemker & Gale, P.C., St. Louis, MO.

The case is significant because it resulted in an Award of market adjusted damages based largely on Edward Jones' own recommended asset allocation models listed on each account statement. In addition, the Award is significant because it included an award of attorney's fees and costs, resulting in the Claimants being almost fully compensated for their losses.

Sherrilyn S. Lawrence, Alfred E. Moore, Paul F. Limandri, Lee A. Hammond, Hilton Henderson v. Edward D. Jones & Co. L.P. and Thomas Frank Belvin,
NASD Case No. 05-04943

Claimants brought an action against Respondents related to the purchase of unsuitable mutual funds, annuities, and other securities purchased in Claimants' accounts. Case involved Respondents' failure to allocate the assets in a manner consistent with the stated objectives of the accounts. Claimants asserted the following causes of action: breach of contract and warranties; promissory estoppel; violation of Virginia Securities Act; intentional and negligent mis-representations of material fact; unsuitable recommendations; unjust enrichment; breach of fiduciary duty; breach of the duty of good faith and fair dealing; and, negligent supervision.

Claimant Sherrilyn S. Lawrence's net out-of-pocket loss was $97,064.

Claimant Alfred E. Moore's net out-of- pocket loss was $56,699.

Claimant Paul F. Limandri's net out-of- pocket loss was $55,313.

Claimant Lee A. Hammond's net out-of-pocket loss was $14,611.

Claimant Hilton Henderson's net out-of-pocket loss was $21,652.

In addition, all Claimants requested market adjusted damages, statutory damages, punitive damages, pre- and post-award interest, costs, attorneys' fees, and any and all other relief available to Claimant which may be granted by the Panel.

The Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

The Panel awarded Claimant Sherrilyn S. Lawrence market adjusted damages of

$135,985.00, plus interest at 6% from the date of the filing of the claim until the date of payment of the Award, and costs of $9,981.00 for a total Award of $156,562.

The Panel awarded Claimant Alfred E. Moore market adjusted damages of $47,723.00, plus interest at 6% from the date of the filing of the claim until the date of payment of the Award, and costs of $10,981.00 for a total Award of $62,422. (Note: Due to the time frame involved, the market adjusted calculation for Claimant Moore resulted in a net decrease to his damages model.)

The Panel awarded Claimant Paul F. Limandri market adjusted damages of $102,933.00, plus interest at 6% from the date of the filing of the claim until the date of payment of the Award, and costs of $11,481.00 for a total Award of $122,434.

The Panel awarded Claimant Lee A. Hammond market adjusted damages of $85,457.00, plus interest at 6% from the date of the filing of the claim until the date of payment of the Award, and costs of $10,981.00 for a total Award of $103,097.

The Panel awarded Claimant Hilton Henderson market adjusted damages of $68,261.00, plus interest at 6% from the date of the filing of the claim until the date of payment of the Award, and costs of $11,231.00 for a total Award of $84,811.

Claimants' Counsel: Robert A. Kantas, Esq., Shepherd, Smith & Edwards, L.L.P., Houston, TX.

Claimants' Expert: Jerrod R. Summers

Respondents' Counsel: Wendy S. Menghini, Esq., Greensfelder, Hemker& Gale, P.C., St. Louis, MO.

The case is significant because it resulted in an Award of market adjusted damages based largely Jones' own recommended asset allocation models listed on each account statement. In addition, the Award is significant because it included an assessment of interest and costs for each of the Claimants.

Albert Sousa, Jr. v. David C. Lubelt and U.S. Bancorp Investments, Inc.,
NASD Case No. 06-00583

Claimant brought an action against Respondents related to the purchase of a "Universal Lease" sold by Resorts Holdings International, a time share company based in Cancun, Mexico. The client did not have an account with U.S. Bancorp Investments, but he did his banking business with U.S. Bank. The teller at the bank referred the Claimant to a registered represented of the securities side who then sold unregistered securities to Claimant.

Claimants asserted the following causes of action: breach of fiduciary duty, fraud, misrepresentation, negligence, violation of Nevada securities laws, violation of Nevada Revised Statues Section 598.092 (deceptive trade practices), breach of contract, and control person liability.

Claimant requested rescission, accumulated rental income, consequential damages, opportunity lost, disgorgement, punitive damages and interest.

The Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

The Panel awarded Claimant $310,000 in compensatory damages, which represented the amount of Claimant's initial investment in the universal lease.

The Panel also awarded $102,300 in attorney's fees, pursuant to the Nevada Deceptive Trade Practices Act and interest of $19,750.

Claimants' Counsel: David Liebrader, Esq., Law Offices of David Liebrader, Las Vegas, NV.

Claimants' Expert: Joseph Long
Respondents' Counsel: Terry J. Thomas, Esq., Bowers, Thomas & Associates, Reno, NV.
James K. Langdon, Esq., John Rock, Esq., Dorsey & Whitney LLP, Minneapolis, MN.

The case is significant because it resulted in an Award of full rescissionary damages. In addition, the case is significant because the Panel determined that the investment was a security under Nevada law and the firm was liable for the outside business activities of their broker even when the client did not have an account with the firm. Lastly, the case is significant because the Panel decided that a contingency fee fits the definition of "reasonable attorney's fees" under Nevada law.

Gary A. Wassel Trustee U/A DTD 02/03/1995 by Gary A. Wassel and Gary A. Wassel IRRA v. Merrill Lynch, Pierce, Fenner & Smith, Inc. and Frederick C. Wong,
NASD Case No. 05-05179

Claimant brought an action against Respondents related to investments in a highly speculative investment "strategy" featuring uncovered or "naked" options, speculative and volatile internet and technology stocks, and heavy margin leverage.

Claimants asserted the following causes of action: unsuitability; breach of fiduciary duty; misrepresentation and omission; churning; mismarking of order tickets; excessive commissions, mark-ups, mark-downs and spreads; negligence; gross negligence; respondeat superior; controlling person liability; failure to supervise; and unjust enrichment.

The Respondents denied the allegations made in the Statement of Claim and asserted various affirmative defenses including: failure to state a claim upon which relief can be granted; Respondents acted properly, in good faith, and in a commercially responsible manner with respect to Wassel's accounts; applicable statutes of limitation; doctrine of laches; all transactions were conducted within the applicable NASD, NYSE, and SEC rules and regulations; doctrine of waiver; doctrine of estoppel; doctrine of unclean hands; ratification; assumption of risk; contributory negligence; failure to plead fraud and misrepresentation claims with required specificity; failure to mitigate; and unconstitutionality of punitive and exemplary damage claims.
The Panel awarded Claimant compensatory damages in the amount of $550,000, plus interest at the rate of 5% per annum from December 1, 2002 until the date of payment of the Award.

Claimants' Counsel: Margery S. Bronster and Rex Y. Fujichaku
Bronster, Crabtree & Hoshibata, Honolulu, Hawaii

Claimants' Expert: Edward B. Horwitz

Respondents' Counsel: Jeffrey S. Portnoy and Theodore D.C. Young Cades Schutte, Honolulu, Hawaii

Respondents' Experts: Shel Ekdahl, Bates Capital
Paul A. Yenofsky

Arbitrators: Brian Crawford, Esq. – Chairperson, Public arbitrator
Timothy J. Kroll, M.S. – Public arbitrator
Theodore G. Ray – Non-public arbitrator

The case is significant because it resulted in a large award against a major wirehouse, something that has become increasingly difficult.

Cases & Materials

Timothy A. Canning

Timothy A. Canning, Arcata, California, is a PIABA member and active on PIABA's Amicus Committee. His practice is devoted primarily to representing parties in securities and investment–related disputes, in court and in arbitration. He is also an arbitrator for the NASD and NYSE, and is on the neutrals roster for the Marin County, California Superior Court.

Following are summaries of recent cases that may be of interest, from state and federal courts (as well as relevant SEC notices published in the Federal Register) involving arbitration and/or securities, arranged generally by topic.

BEFORE THE ARBITRATION
COMPELLING/RESISTING ARBITRATION

Challenging Arbitration Agreements

***Crawford v. Great American Cash Advance**, Inc.* (Ga. App. 3/29/07) __ S.E.2d __, 2007 WL 925906

Court rejects consumer's attempt to avoid a contractual arbitration clause with "cash advance" company. Court holds that 1) mutuality of remedy is not required in arbitration clauses; 2) the mere possibility that the consumer could be saddled with prohibitive costs of arbitration is too speculative to invalidate arbitration clause; 3) there was no evidence or legal authority to support consumer's contention that the clause was unconscionable because consumers cannot reasonably be expected to investigate and understand AAA arbitration rules; and 4) issue of illegality of the entire contract was a question for the arbitrator to decide

Failure of Forum in Arbitration Agreement

Inter@Ctivate, Inc. v. Cubic Transporta-tion Systems, Inc., (Cal. App. 1/25/2007) 2007 WL 178429

An arbitration clause between the parties provided for arbitration before the "ABA" under its commercial arbitration rules. After a dispute arose, one party moved to compel arbitration, which the lower court denied. The court of appeal reversed. It was undisputed that the "ABA" does not have commercial arbitration rules and does not conduct arbitrations; the attorney who drafted the agreement testified that designating the ABA was a mistake, instead, it should have read, "AAA."

The court first held that it could not change the arbitration agreement. Because there was no evidence of the mutual intention of the parties, the court could not strike out the term "American Bar Association (ABA)" and replace it with "American Arbitration Association (AAA)." The court then held that because the parties' chosen method for selecting arbitrators had failed, the lower court should have appointed an arbitrator under California's Arbitration Act or under the Federal Arbitration Act. The parties' designation of the

"ABA" as a forum for resolving disputes was not an integral part of the arbitration agreement.

Scope of Arbitration Agreements

Rogers-Dabbs Chevrolet-Hummer, Inc. v. Blakeney**,** (Miss. 2/22/2007) 950 So.2d 170

Car purchaser brought an action for civil fraud against a car dealership. The Mississippi Supreme Court reversed a lower court's to compel arbitration of some of the claim, holding that the purchaser did not agree to arbitrate claims arising from alleged actions of dealership that he was unaware of when executing arbitration agreement. The court addressed the "second prong" of determining whether a motion to compel arbitration should be granted, i.e., whether the parties' dispute is within the scope of the arbitration agreement. (The first prong being whether there was a binding arbitration agreement between the parties). The court held that the dispute between the parties involved a claim of civil fraud totally outside the formation of the purchase agreement. While the purchaser no doubt agreed to arbitrate claims that originated from the sale of the vehicle or that were related to the sale of the vehicle, no reasonable person would agree to submit to arbitration any claims concerning (1) a vehicle to which he would never receive a title; (2) a scheme of using his name to forge vehicle titles and bills of sale to sell stolen vehicles; and (3) the commission of civil fraud against him by misappropriating his title to the vehicle he purchased and forging his name on fake titles and bills of sale on various stolen vehicles. The court held that these were all actions of which the purchaser was presumably totally unaware at the time of the execution of the arbitration agreement, and hence were not within the scope of the arbitration agreement.

Who Can Enforce Arbitration Obligation

Marciano v. MONY Life Ins.*,* (E.D. Pa. 1/22/2007) 470 F.Supp.2d 518

Former employees sued MONY Life Insurance Company (MONY Life) and affiliated companies for actions that precipitated Plaintiffs' departure from the MONY organization. MONY Life moved to compel arbitration under the National Association of Securities Dealers (NASD) Code of Arbitration. MONY Life, however, is not a member of the NASD. The arbitration agreement at issue is between Plaintiffs and the NASD, and the agreement expressly obligates Plaintiffs to arbitrate with a MONY Life subsidiary.

The court held that:
(1) The parent corporation did not qualify as an associated person who could compel arbitration under NASD Code by virtue of its subsidiary's status as member
(2) the parent was sufficiently immersed in dispute to qualify as "certain other" for purposes of NASD Code, but the parent could not compel arbitration under NASD Code by virtue of its status as a "certain other;" but

(3) the parent as "certain other" could compel arbitration under Form U-4, which compels signatories to arbitrate disputes arising between signatory and any other person.

FAA Preempts Contrary State Law re Arbitration Agreement

Shepard v. Edward Mackay Enterprises, Inc.*,* (Cal. App. 3/22/07) __ Cal.Rptr.3d __, 2007 WL 853456.

Real property purchaser brought construction defect action against developer and other defendants alleging negligent installation of plumbing system. The trial court denied defendants' motion to compel arbitration, based on a California statute which permits a purchaser to pursue a construction defect action in court even though there is an arbitration provision in the real estate purchase agreement. The court of appeal reversed, holding that the Federal Arbitration Act (FAA) preempted the state statute.

The underlying dispute involved activity having substantial relation to interstate commerce under FAA, since construction involved receipt and use of building materials that were manufactured or produced outside California. The court broadly framed the standard for whether the FAA applies: if the contract evidences a transaction involving interstate commerce, then the FAA applies. (The court rejected a narrower standard, that the FAA applies only where the dispute itself arises from the particular part of the transaction involving interstate commerce).

Giuliano v. Inland Empire Personnel, Inc., (Cal. App. 3/26/2007) __ Cal.Rptr.3d __, 2007 WL 891315

In a non-securities case, the court held that an arbitration clause in an employment agreement was enforceable under the FAA, which preempted California state law on validity of arbitration clauses in employment agreement. The court first held that the employment agreement involved activity that affected interstate commerce, because the employer was engaged in "business throughout Arizona and California;" the employee had "attend[ed] meetings, site visits and grand opening ribbon cuttings" in other states; and the employee had negotiated on the employer's behalf "multi-million dollar loan agreements" with a bank that was headquartered in another state.

Because the employee's claim only involved a "garden variety" breach of contract claim for a multimillion dollar bonus and severance payment, the requirements under state law for compelling arbitration of an employee's state law fair employment act claims or fundamental public policy claims did not apply, and the procedural requirements of *Armendariz v. Foundation Health Psychcare Services, Inc.* (2000) 24 Cal.4th 83 also did not apply. The employee's "wage" claim did not implicate unwaivable statutory claims for federally mandated overtime and minimum wage payments, in light of the large dollar amount of the bonus and severance pay claim. The lower court's denial of motion to compel arbitration was reversed.

Scope of Order Compelling Arbitration

Walzer v. Muriel, Siebert & Co., Inc., 2007 WL 990265 (3rd Cir. (N.J.) Apr 04, 2007)

A pro se investor's action against brokerage firm in U.S. District Court was not entirely barred by order from a New York state court compelling arbitration. Investor had originally filed a civil action in New York State Court. When the New York State court compelled arbitration, the investor filed an action against the brokerage firm in federal district court in New Jersey. Brokerage firm then moved to dismiss the district court case on the grounds that the New York State Court order compelling arbitration barred the investor from pursuing his claims in federal district court.

On appeal, the court affirmed dismissal as to investor's non-federal claims, but reversed as to the investor's federal claims. The state court order compelling the investor to arbitrate could not have included the investor's Securities Exchange Act claims, because Exchange Act claims can only be brought in federal court. (It appears that the brokerage firm moved only to dismiss the federal District Court action, and had not moved to compel arbitration in the District Court.)

Waiver of right to compel arbitration

Gordon v. Dadante, (N.D. Ohio 3/29/2007) 2007 WL 949657

H & R Block Financial Advisors, Inc.'s ("HRBFA") was one of several brokerage firms that held accounts for a Fund. Certain investors filed a complaint by against the Fund, alleging that the Fund was a Ponzi scheme replete with misrepresentations, false account statements, manipulated accounts, and improper self-dealing. The investors requested, *inter alia,* that the Court freeze the assets of the Fund, and appoint a receiver over the remaining assets the Fund, including those held at HRBFA.

HRBFA participated in the litigation to protect its rights regarding a margin debt in some of the Fund's accounts that it held. HRBFA then filed an arbitration claim with the NASD, and sought to stay the litigation. The court denied HRBFA's motion, finding that HRBFA had waived its right to arbitrate its dispute over the validity of the margin debt, because it had been so active in the litigation.

Howard v. Morgan Stanley*,* (S.D. Ill. April 11, 2007) 2007 WL 1100615

Former employee filed suit in Illinois state court for wrongful termination. Morgan Stanley removed to federal court and moved to compel arbitration pursuant to U-4 form. Court granted motion and stayed the litigation, rejecting plaintiff's argument that Morgan Stanley waived its right to compel arbitration by failing to initiate arbitration after learning of the dispute. Court held that waiver of the right to compel arbitration is based on conduct in litigation, not on conduct prior to litigation. Court also rejected argument that the arbitration provision in the U-4 agreement was a contract of adhesion, even if the U-4 form was a "take or leave it" proposition. The court also rejected plaintiff's claim that SRO arbitration was unfair or otherwise violated due process, relying on *Koveleskie v. SBC Capital Markets, Inc.,* 167 F.3d 361, 365-66 (7th Cir.1999),

DURING THE ARBITRATION

Location of Arbitration Hearing

Conestoga Title Ins. Co. v. Acoustic Home*,*
(S.D. Ind. 4/5/2007) 2007 WL 1058228

Plaintiff challenged AAA's arbitrator's interlocutory decision to hold arbitration hearing in Los Angeles, CA. and requested that the court order that the hearing be held in Indiana. (Acoustic Home's principal place of business was Los Angeles, and it had initiated the arbitration). The court denied the motion, holding that there was no manifest disregard of the law (which in the 7th Circuit requires a showing that the arbitrators required the parties to violate a law), and that the court could not review whether the decision was "logical." Instead, the court could only review whether the arbitrator had interpreted the contract. As the AAA arbitrator had reviewed the contract, had interpreted its terms and had applied its rationale to the present dispute, the court concluded that it could not review the AAA's venue decision further.

Notice of Arbitration Hearing/Due Process

Ying Chun Tan v. Hung Pin Lee*,* (Tex. App. 2/27/2007) 2007 WL 582084

A former customer commenced an NASD arbitration against broker Tan and others for securities fraud. After an award against broker Tan, Tan sought to vacate the award on several grounds. On appeal from the lower court's confirming the arbitration award, Tan contends that the arbitration award should be vacated because she did not receive notice of the hearing date as required by the Texas Arbitration Act (TAA) and the NASD Code of Arbitration Procedure. She further argued that the lack of notice violated her due process rights under the 14th Amendment to the United States Constitution.

The appellate court held that the Texas Arbitration Act provisions on notice of hearing did not apply, as the arbitration agreement (i.e., the NASD Code) contained its own provisions on notice of hearing. The record also contained two letters from the NASD to Tan informing her of the hearing dates and a third letter from NASD explaining that a hearing notification letter was mailed to Tan and was not returned as undelivered. Tan contended that she had moved and left a forwarding address, but there was no evidence that she notified the NASD of her new address. In the award, the arbitrators found that Tan "received due notice of the hearing." *Actual receipt of* notice of an arbitration hearing is not required; instead, proof of mailing by regular mail is sufficient to demonstrate that due notice was given when the arbitration rules permit such service, even in light of a party's denial that notice was received.

Representing Parties in Arbitration

SR-NASD-2006-109, 72 Fed. Reg. 18703 (April 13, 2007)

The NASD has proposed a rule which would: 1) acknowledge that a party can be represented in arbitration by an attorney licensed anywhere in the US; 2) permit non-attorneys to represent parties in arbitration unless prohibited by state law, and as long as the non-attorney has not been suspended from the securities industry or a state bar; and 3) state that arbitrators are not empowered to rule on issues of representation. In its justification for the rule, the NASD states that it does not intend to preempt state law on multi-jurisdictional practice or on non-attorney representation.

Arbitrator Training
Forum Fees

Yu Galan v. Morgan Stanley DW, Inc., (9th Cir. 3/27/2007) 2007 WL 900995

In a very brief, unpublished decision, the Ninth Circuit rejected a challenge to an NASD arbitration award by a losing claimant. The challenge was based in part on allegations that the sections of the NASD's Arbitrator Training Manual (1996) regarding allocation of forum fees between the parties contradicted SEC rules on that same subject. Claimant initially named NASD and MSDW as respondents in an action to vacate an arbitration award; the court briefly observed that the NASD had standing to pursue a motion to confirm the award in conjunction with MSDW.

Arbitrator Disclosure
Challenges to Arbitrator/Removal

Vigorito v. UBS Painewebber, Inc., (D. Conn. 3/13/07) __ F.Supp.2d __, 2007 WL 756320

The court denied a public customer's petition to vacate an adverse NYSE award. The public customer asserted that one arbitrator failed to make an adequate disclosure of a conflict of interest and should have resigned from the panel. After being sworn in as an arbitrator on the first day of the hearing, the industry arbitrator disclosed that his adult son worked as a "lower level" employee at respondent brokerage firm's office in California. Claimants' attorney did not challenge the arbitrator when the disclosure was made, or at anytime during the arbitration hearing. (Though the court also noted that the public customer's attorney did not answer the arbitrator's question as to whether or not the parties were provided a fair hearing, apparently the court did not give that any weight. The court noted that the claimants themselves had "nodded affirmatively.")

The court held that the arbitrator's tardy disclosure, while somewhat inaccurate, had not been shown to have been materially incomplete, such as to warrant vacating the award. "Materially incomplete" apparently requires a showing that if all the information had actually been disclosed, then the public customer's attorney would have objected to that arbitrator. The court found that the actual disclosure was not materially defective, and there was no evidence that the arbitrator or his son had any financial interest in the arbitration itself.

SR-NYSE-2004-56 (approved 4/6/07, published 4/12/07)

NYSE's proposed amendment to rule 611 regarding the Director's authority to remove an arbitrator was approved by the SEC. Prior to approval of this rule, once an arbitrator had taken the Oath of Arbitrators for a particular case, NYSE rules did not provide for the Director of Arbitration to remove an arbitrator from serving on that case. Rather, NYSE Rule 610 permits the Director of Arbitration to remove an arbitrator prior to, but not after, the commencement of the hearing. The need to remove a sitting arbitrator could arise if, for example, an item that should have been disclosed by the arbitrator pursuant to Exchange rules had not been disclosed, or a conflict arises after commencement of the hearing. Historically, when this situation has arisen, the remedy has been for the arbitrator to recuse himself or herself. Nevertheless, the Exchange proposed to amend its rules, indicating that it would be prudent to give the Director of Arbitration the authority to remove an arbitrator in the event a conflict comes to the attention of the parties or the Exchange that for any reason was not appropriately disclosed pursuant to NYSE rules and was unknown to the parties, or if a conflict arises after the commencement of the hearing.

AFTER THE ARBITRATION CHALLENGING/CONFIRMING ARBITRATION AWARDS

Failure to Hear Evidence
Inadequate Damages

Lessin v. Merrill Lynch, Pierce, Fenner & Smith, Inc., (D.C. Cir. 3/16/2007) __ F.3d __, 2007 WL 776864

Where the proposed testimony of a claimant's expert witness was immaterial, NASD arbitrators' refusal to hear that expert witness testify as to genuineness of respondent broker's notes did not deprive claimant of a fundamentally fair hearing.

Claimant also challenged award on the grounds that the panel had awarded him only one-half of one percent of his documented damages. The court rejected this argument, stating that it was premised on the flawed notion that claimant's out-of-pocket losses at Merrill Lynch are proof of the measure of his compensable damages. Instead, the record supported the inference that the panel concluded that the claimant "risked losses to his account, and his account suffered losses as a result." The court considered that the amount awarded by the arbitrators could have represented the $500 non-refundable arbitration filing fee and $32,475 for management fees he paid to Merrill Lynch, noting that the panel found that Merrill Lynch had failed to supervise the broker properly.

Claimant also argued that the arbitrators failed to adjudicate his claims against the individual broker. The court considered that argument to be frivolous, because the arbitrators in the award specifically denied "any relief not specifically addressed."

The court affirmed the district court's denial of claimant's motion to vacate an arbitration award.

Manifest Disregard
Churning/High Rate of Turnover
Fraud/Perjured Testimony

Mitchell v. Ainbinder, (6th Cir. 1/24/07) 2007 WL 177896, 2007 Fed.App. 0058N

A public customer's arguments that an NASD panel manifestly disregarded the law were rejected by a district court and affirmed on appeal. The court stated that though the high rate of turnover in the customer's account might be enough to support a churning claim, the high rate of turnover does not require a finding of excessive trading in every instance. The court stated that the brokerage firm had presented plausible arguments for the denial of public customer's suitability claim. According to the court, the arbitration panel was presented with evidence suggesting that the public customer was an aggressive trader who preferred high risk investments.

Claimant also sought to set aside the award based on perjured testimony. The court held that to set aside an arbitration award under the FAA because of perjured testimony, the perjured testimony must be proven by clear and convincing evidence, and the evidence must show a willful intent to give false testimony. According to the court, fraud under the FAA must be established by clear and convincing evidence. Both perjury and fraud require proof of some sort of willful intent to give false testimony. Therefore, plaintiff would be required to prove, by clear and convincing evidence, that the witness intended to provide false testimony, in order to have the arbitration award set aside. The court held that there was no such evidence.

Inadequate Damages
Inconsistent Award

***Vigorito v. UBS PaineWebber**,* (D. Conn. 2007) __ F.Supp.2d __, 2007 WL 756320

After an NYSE arbitration hearing, the public customer claimants were awarded their "litigation costs" in the amount of $32,983. The forum fees were also assessed to the broker dealer, but claimants' substantive claims were dismissed. Claimants sought vacatur, asserting that because the arbitrators awarded them their litigation costs, the panel must have made a finding that the claimants were the prevailing party, and thus there was a "fundamental disconnect within the award itself," constituting "one of the recognized grounds for invoking the doctrine of manifest disregard of law." The court declined to vacate the award under a "manifest disregard" theory. Even though plaintiffs contend that established practice is to award costs and fees to the prevailing party, they pointed to no applicable law or legal principle disregarded by the arbitrators in exercising their discretion-other than the default "American rule" that each party bears its own costs in litigation, which does not constitute established law warranting vacatur.

SUBSTANTIVE ISSUES

Broker Regulations

***Financial Planning Association v. S.E.C**.,* (D.C. Cir. 3/30/07) __ F.3d __, 2007 WL 935733, Fed. Sec. L. Rep. P 94,185

Court of Appeals for District of Columbia vacated an SEC rule which exempted broker-dealers from complying with the Investment Advisors Act. The Financial Planning Association challenged the SEC rule on the grounds that the SEC exceeded its authority. In agreeing with the FPA, the court first found that the FPA had standing to bring the challenge. The court then held that the SEC rule provided a broader exemption to the requirements of the IAA for broker-dealers than as provided by Congress, and concluded that the SEC exceeded its authority in adopting the Merrill Lynch rule.

Clearing Firm Liability

Kostoff v. Fleet Securities, Inc.**,** (M.D. Fla. 4/5/2007) 2007 WL 1064217

Court confirmed an NASD arbitration award against a clearing firm, rejecting the clearing firm's contention that: (1) the panel's decision was arbitrary and capricious (requiring proof that there was no grounds for the arbitrators' decision), and (2) the panel manifestly disregarded the law, by (a) imposing a duty to supervise an introducing broker, by (b) awarding punitive damages, and by (c) awarding attorneys' fees.

The court held that while it is true that clearing firms that perform typical ministerial functions are generally not liable for the wrongful acts of the introducing broker, an exception to this rule has been applied where the clearing firm acts outside of its traditional role and participates in the wrongful conduct. The court observed that the panel found that clearing firm was aware of the malfunctioning of the introducing broker-dealer, and that an agent of the clearing firm purposefully brought one broker-dealer together with another, so as to enable the first offending broker-dealer to change its name and continue to defraud the claimant. According to the Panel, the clearing firm was "the major factor in allowing the fleecing of [Kostoff's] brokerage account."

These findings by the panel were consistent with the Panel's conclusion that the clearing firm stepped outside the ministerial duties as outlined in its Clearing Agreements and instead participated in the alleged wrongdoing, thereby stripping itself of the protections normally afforded clearing firms. Based on the evidence presented, the panel could have reasonably inferred or concluded that the clearing firm supervisor knew of the introducing broker's regulatory problems because of his relationship with the introducing broker's principals, and the introducing broker's contractual duty to report violations to the clearing firm. The Panel's finding that clearing firm participated in the fraud supports its conclusion that the clearing firm stepped outside its role as clearing firm and alone provides a justification for imposing liability

As to the challenge to the award of punitive damages, the court stated that the clearing firm must establish that the Panel was conscious of the law regarding punitive damages and deliberately ignored it. The Court could not conclude that there was no evidentiary basis for the Panel's award of punitive damages or that the Panel acted in manifest disregard of the law, even if this Court would have resolved the issues differently.

As to attorneys' fees, though there was no express pre-dispute contract providing for attorneys' fees, the court held that the panel had authority to award fees. Kostoff sought attorneys' fees in her Statement of Claim and signed the Uniform Submission Agreement thereby agreeing to submit her claims and all related counterclaims to arbitration. At the arbitration, Kostoff's counsel asked the Panel to award Kostoff attorneys' fees. The clearing firm requested that its attorneys' fees be assessed against Kostoff's counsel personally. The parties' actions in this regard amount to an agreement to waive the right to submit the issue of attorneys' fees to a court.

Private Right of Action / Investment Company Act.

Bellikoff v. Eaton Vance Corp., (2nd Cir. 3/15/2007) __ F.3d __, 2007 WL 766209

Shareholders of mutual funds brought class action against trustees and investment advisors, alleging violations of Investment Company Act and other laws. In affirming the district court's granting of investment advisors motion to dismiss, the court held that (1) there was no private right of action under ICA sections prohibiting misrepresentation in registration statement, prohibiting personal misconduct-based breach of fiduciary duty, and creating control person liability; (2) compensation-based breach of fiduciary duty claim could not be asserted against defendants who did not receive the fees and commissions in question; and (3) to recover fees from the recipients, the fees must be excessive, not just "improper," and the fees must also be so disproportionately large that they bore no relationship to the services rendered.

Plaintiffs alleged that the defendants (fund managers, marketers and distributors) siphoned funds from Eaton Vance mutual funds to pay kickbacks to brokers who agreed to promote the sale of fund shares. Plaintiffs further alleged that the expansion in fund assets-resulting from increased broker enthusiasm generated by the alleged kickbacks-increased the advisory fees paid to the Investment Advisor and Distributor Defendants, while providing no benefits to the funds or the fund investors. Finally, the plaintiffs argued that the advisory fees were disproportionate to the value of services provided and were outside the bounds of what would have been negotiated at arm's length.

Plaintiffs' claims rested upon the notion that the benefits of certain "economies of scale" were not passed along to shareholders. Specifically, the defendants orchestrated arguably improper "shelf-space" payment schemes with brokers such as Morgan

Stanley, Salomon Smith Barney, and Wachovia. The plaintiffs contend that these arrangements included: (1) cash payments to brokers in return for the brokers' agreement to promote sales of fund shares; (2) directing fund portfolio brokerage to brokers in return for agreements by the brokers to promote the funds (a practice known as “directed brokerage”); and (3) excessive commission arrangements with brokers.

The engine driving this misbehavior was the fees paid to the Investment Advisor and Distributor Defendants, which were calculated as a percentage of assets under management. Thus, as more investors were drawn to the funds through these arguably nefarious business practices, the fees paid to various defendants mushroomed.

Purchase or Sale of Security
Fraud or Deceit – Acts Constituting

Kinney v. Cook*,* (Wash. 3/22/07) __ P.3d __, 2007 WL 851854

Plaintiffs brought securities fraud claim under Securities Act of Washington, alleging that after a judgment had rescinded their sale of stock to defendant and had ordered the reinstatement of the promissory note evidencing the loan which defendant had made to plaintiffs to finance their original purchase of the stock, defendant did not disclose to plaintiffs that defendant had burdened the corporation with multimillion dollar debt.

Washington Supreme Court held: (1) Stock purchasers' allegation that seller failed to inform them that seller had burdened corporation with multimillion dollar debt was sufficient to allege a fraudulent or deceitful act, but (2) the facts alleged by plaintiffs did not constitute a purchase or sale of securities, an essential element for stating a securities fraud claim under Securities Act of Washington.

Definition of Security
Materially Misleading

S.E.C. v Merchant Capital*,* (11th Cir. 4/4/07) __ F.3d __, 2007 WL 983082

Securities and Exchange Commission (SEC) brought enforcement action against managing general partner of twenty-eight registered limited liability partnerships (RLLPs), and its principals, alleging violations of the registration and antifraud provisions of the federal securities laws. The SEC appealed a United States District Court judgment for the defendants, and the 11th Circuit reversed.

The 11th Circuit held that the RLLPs were investment contracts, because the partners had the powers of limited partners, since they had no ability to remove the managing general partner, and the purported authority to approve purchases was illusory. The RLLPs were completely inexperienced in the debt purchasing industry. Finally, even if they could have removed the managing general partner (which they could not), they had no realistic alternative because their debt pools were in fractional form with a company whose only contractual relationship was with the managing general partner.

The court then held that there were 3 material misrepresentations:
(1) the managing general partner’s omission of the performance history of the existing RLLPs was materially misleading, and not cured by the general cautionary language in the risk disclosure; (2) one of the owners of the managing general partner had previously filed for bankruptcy, which was not disclosed, and the court held that a reasonable investor would have been interested in the previous personal bankruptcy, and that it was thus materially misleading to omit the information; and (3) the existence of a state cease and desist order against identical instruments is clearly relevant to a reasonable investor, who is naturally interested in whether management is following the law in marketing the securities.

Fiduciary Obligations under ERISA

***Ellis v. Rycenga Homes, Inc**.,* (W.D. Mich. 3/15/07.) Slip Copy, 2007 WL 837224

Successor trustee of a profit-sharing plan brought civil action against prior trustee and purported co-trustee, Edward Jones, pursuant to the Employment Retirement Income Security Act of 1974 (ERISA), 29 U.S.C. § 1001-1461. The plan was established by Rycenga Homes, Inc. for the benefit of its employees. Plaintiff's claims, brought on behalf of the plan and its participants, arise from improper loans made from plan assets to Rycenga Homes, under the direction of Ronald J. Retsema, the former trustee of the plan. All parties agree that the loans were prohibited transactions under section 406(a)(1) of ERISA, 29 U.S.C. § 1106(a)(1). Default judgments were entered against Rycenga Homes, Inc. and Retsema.

The only remaining defendant is Edward D. Jones & Co., L.P. (Edward Jones), a securities broker who maintained accounts for the plan from 1984 through 2004. Plaintiff contends that Edward Jones was a fiduciary and is liable for Retsema's wrongdoing under the provisions of ERISA governing fiduciary liability.

The court rejected Edward Jones' argument that a finding of discretionary control or responsibility is necessary for any finding of fiduciary status under ERISA. An ERISA fiduciary status includes stockbrokers who (1) actually have discretionary authority with regard to buying and selling securities, or (2) render investment advice pursuant to a mutual agreement that the stockbroker's advice will serve as a primary basis for investment decisions and that the broker will render "individualized investment advice."

The court rejected plaintiff's theory that Edward Jones was an active participant, which was based almost completely on a depository's routine processing of checks in circumstances that were, at most, arguably suspicious. However, the Court found there were disputed material facts as to whether Edward Jones had actual knowledge of breach by the co-trustee; whether Edward Jones complied with the prudent person standard; and on the theory that a prudent exercise of Edward Jones' role as investment advisor should have put it on inquiry notice and whether further losses could have been averted had Edward Jones acted when it had such notice.