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STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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The Bar Journal of the Public Investors Arbitration Bar Association

President's Column

Steven B. Caruso

While it has often been said that "trust" is one of the greatest virtues of a truly complete life, we have all, from time to time, witnessed the emotional exploitation and financial devastation that results when the extension of that trust has been violated or misplaced.

For whether it is in the context of a loan to a supposed personal friend that has been subsequently denied or intentionally forgotten, the retention of a financial advisor who places his own interests ahead of those of his public customer, or the submission of a dispute to an arbitrator who systemically, if not sometimes enthusiastically, denies justice to an aggrieved investor, the result is always the same - the inherent corruption of the circle of trust that is the foundation of a decent and viable society.

How these hayseed miscreants can look at themselves in the mirror each day and pretend that they are either above reproach or the pillar of purported virtuosity is beyond logical comprehension.

But as we all know, from our personal experiences in the representation of public investors in securities arbitration proceedings, we are far too often the ones who are called upon to restore the "circle of trust" into the lives of our clients through the pursuit of the recovery of their financial assets.

Our challenge is to achieve this objective through the presently constituted mandatory system of dispute resolution which is owned, operated and controlled by the financial services industry.

I am pleased to report that we are no longer approaching this challenge entirely on our own.

In fact, within the past few months, a number of United States Senators, including Patrick Leahy (D-Vt), Russell Feingold (D-Wi) and Robert Casey, Jr. (D-Pa), have publicly requested that the U.S. Securities and Exchange Commission, "in fulfillment of its statutory duty to protect individual investors, promulgate a rule that will prohibit broker-dealers from requiring investors to accept mandatory arbitration clauses" when they establish accounts with investment firms.

The stated predicate for the requests of these U.S. Senators was their recognition of the fact that the current mandatory system of arbitration for investors requires a "waiver of constitutional rights that are protected in the judicial system" because arbitration "(1) lacks the formal court-supervised discovery process often necessary to learn facts and gain

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documents; (2) does not require that arbitrators follow the rules of evidence laid out for state and federal courts; (3) imposes no obligation on arbitrators to provide factual or legal discussion of the decision in a written opinion; and (4) severely limits judicial review."

In the collective opinion of these U.S. Senators, the time has come for the U.S. Securities & Exchange Commission to "step in on behalf of individual investors and restore their ability to choose judicial process" through either "a rule banning all pre-dispute mandatory arbitration clauses" or, "if pre-dispute agreements are to be allowed, a rule requiring broker-dealers to provide their customers with a 'check the box' choice between traditional judicial process and Self-Regulatory Organization ('SRO') arbitration."

If every tidal wave does indeed begin as a small ripple, then we may very well be witnessing the first ripple that will eventually lead to the reformation of the process through which the disputes of public investors are adjudicated.

In closing, I want to acknowledge and express my personal appreciation to all of the individuals who, on behalf of our entire organization and on a daily basis, are the ones who attempt to restore "the circle of trust" to our public investor clients - 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.

Expungement Requests in Settlement Negotiations: Consequences if You Don't Just Say No

Steven B. Caruso

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On December 16, 2003, the Securities & Exchange Commission approved NASD Conduct Rule 2130 which concerns the expungement of customer dispute information from the Central Registration Depository (CRD) system.[1]

This rule, which is applicable to any customer complaint, arbitration proceeding or civil lawsuit *filed on or after April 12, 2004*, including settlements arising from any of the same, requires that an arbitration panel can only grant a request for expungement, contained in either a settlement agreement and/or a stipulated award, if the panel makes an *affirmative* finding that the subject matter of the customer dispute meets one or more of the three (3) specific standards that are set forth in NASD Conduct Rule 2130.

Standards for Expungement

NASD Conduct Rule 2130 states that, in order for an arbitration panel to grant a request for expungement that has been presented by either a broker-dealer and/or an associated person, the arbitration panel must make an affirmative finding that:

(1) the claim, allegation or information is factually impossible or clearly erroneous;

(2) the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or

(3) the claim, allegation, or information is false.

Subsequent to the approval of this rule, the NASD also issued a number of publications[2] and/or interpretations which were intended to provide arbitration panels and parties with further guidance on the applicability of these specific standards.

For example, in *Rule 2130 Frequently Asked Questions*,[3] the NASD has stated that the standard which would require that an arbitration panel be able to make an affirmative finding that "the claim, allegation or information is factually impossible or clearly erroneous," would be applicable to those circumstances when "an individual who was named in

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[1] *See*, SEC Order Granting Approval of Proposed Rule Change and Amendment No. 1, thereto, and Notice of Filing and Order Granting Accelerated Approval to Amendment No. 2, thereto, Relating to Proposed NASD Rule 2130 Concerning the Expungement of Customer Dispute Information from the Central Registration Depository System, 68 Fed. Reg. 74667 (Dec. 24, 2003).

[2] *See, e.g.*, NASD Notice to Members 04-16 (Mar. 2004).

an arbitration claim ... was not employed or associated with the member firm during the relevant time."

Similarly, for the standard which would require that an arbitration panel be able to make an affirmative finding that "the registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds," this standard would be applicable to those circumstances when "the registered person was not involved" in the alleged misconduct, *provided however*, "the dismissal of a claim, by itself, would not be a sufficient basis for ordering expungement."

And finally, for the standard which would require that an arbitration panel be able to make an affirmative finding that "the claim, allegation, or information is false," this standard would be applicable to those circumstances where the arbitration panel, after having had the opportunity to "assess the evidence in the case," decides that the claim, allegation or information is just plain false.

Expungement in the Context of Settlement

In the context of the settlement of a customer dispute (complaint, arbitration, civil lawsuit or otherwise), if, in fact, the associated person has been named as a respondent or defendant in the underlying proceeding, there will often be a point in time when the subject of expungement will be raised as a component of the settlement negotiations by opposing counsel.

More often than not, counsel for customers are being "orally" asked to consent to the expungement of the dispute, in a stipulated arbitration award, on the basis of the Rule 2130(b)(1)(C) standard which states that "the claim, allegation, or information is false."

There is a very good reason as to why this standard has become the "flavor of the month" in the context of expungement requests - it places all of the burdens and potential ramifications solely on the lap of counsel for the customer.

For aside from the fact that any expungement, except in the most narrowest of circumstances, would undermine the integrity of the entire CRD system and would also potentially mislead future investors who may inquire as to the "complaint history" of a registered representative, there are severe potential additional consequences for any attorney who agrees to the specified wording that "the claim, allegation, or information" that he or she has previously filed "is false."

• **Practical Consequences**: Since all stipulated awards are publicly available on the website of NASD Dispute Resolution, it will only be a matter of time before you are facing a dispositive motion in a *future* case where counsel for the brokerage firm and/or associated person will state to the panel that you have a "track record" of having filed claims which are admittedly "false."

It should be anticipated that the contemplated motion will perhaps even include copies of those stipulated awards which, although inadmissible, will be read (and most certainly remembered) by the members of that future arbitration panel.

• **Legal Consequences**: It is clear that any attorney who admits to having filed claims which were "false" also exposes himself or herself to severe sanctions from the bar association which could potentially lead to a disciplinary proceeding and disbarment.

For example, using the Code of Professional Responsibility of the State of New York[4] as a model for the similar provisions in almost

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[3] *See*, Rule 2130 Frequently Asked Questions, available at http://www.nasd.com/RegulatorySystems/CRD/FilingGuidance/NASDW_005224 (visited Jul. 17, 2007).

[4] See, New York Lawyer's Code of Professional Responsibility, available at http://www.law.cornell.edu/ethics/ny/ code/NY_CODE.HTM (visited Jul. 17, 2007).

every other state in the country, the submission of a false claim or allegation to an arbitration "tribunal" (whether in the context of a Statement of Claim or a Stipulated Award) could constitute an indefensible violation of the following Ethical Considerations and/or Disciplinary Rules:

> EC 7-26: The law and Disciplinary Rules prohibit the use of fraudulent, false, or perjured testimony or evidence. A lawyer who knowingly participates in introduction of such testimony or evidence is subject to discipline. A lawyer should, however, present any admissible evidence the client desires to have presented unless the lawyer knows, or from facts within the lawyer's knowledge should know, that such testimony or evidence is false, fraudulent, or perjured;
>
> DR 7-102(A): In the representation of a client, a lawyer shall not: file a suit, assert a position, conduct a defense, delay a trial, or take other action on behalf of the client when the lawyer knows or when it is obvious that such action would serve merely to harass or maliciously injure another; knowingly advance a claim or defense that is unwarranted under existing law, except that the lawyer may advance such claim or defense if it can be supported by good faith argument for an extension, modification, or reversal of existing law; conceal or knowingly fail to disclose that which the lawyer is required by law to reveal; knowingly use perjured testimony or false evidence; knowingly make a false statement of law or fact; or counsel or assist the client in conduct that the lawyer knows to be illegal or fraudulent;
>
> DR 7-102(B): A lawyer who receives information clearly establishing that: the client has, in the course of the representation, perpetrated a fraud upon a person or tribunal shall promptly call upon the client to rectify the same, and if the client refuses or is unable to do so, the lawyer shall reveal the fraud to the affected person or tribunal, except when the information is protected as a confidence or secret; and a person other than the client has perpetrated a fraud upon a tribunal shall reveal the fraud to the tribunal; or
>
> EC 8-5: Fraudulent, deceptive, or otherwise illegal conduct by a participant in a proceeding before a tribunal or legislative body is inconsistent with fair administration of justice, and it should never be participated in or condoned by lawyers. Unless constrained by the obligation to preserve the confidences and secrets of the client, a lawyer should reveal to appropriate authorities any knowledge the lawyer may have of such improper conduct.

• **Collateral Consequences**: Finally, the collateral consequence of having an admission of an attorney having filed claims which are admittedly "false" on the public record, must be considered in the context of not only applications for future bar or court admissions, but on the applications and certifications that are normally associated with the initial application for, and/or renewal of, legal malpractice insurance coverage.

Conclusion

In summary, while the ability to obtain an expeditious settlement of the claims of a client may suggest that consent to expungement is an economical means to achieve a desired result, careful consideration must be given to the potential consequences that could evolve from that "short-sighted" approach.

The solution to this issue is really quite simple - just say no.

Re-Thinking the Application of Statutes of Limitations in Arbitration

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The author[1] and several other PIABA members[2] have written on the subject of the application of statutes of limitations to arbitrations.[3] However, there has been a great deal of discussion during the past several months among the membership about this subject. Much of this discussion has been engendered by the increased filing of motions to dismiss based on the running of the statute of limitations controlling the underlying substantive claims. While the filing of these motions under the New NASD Code is presently improper,[4] the filing of such motions under the Old Code is on the increase. This increase and the subsequent concern of the PIABA members stems, at least in part, from the issuance by SICA of a new version of its “The Arbitrator’s Manual.”[5] Page 9 of the New Manual reads:

> The Uniform Code [as well as the old and new NASD versions][6] contains an eligibility provision, which states that no dispute, claim, or controversy can be submitted to arbitration if six (6) years have elapsed from the occurrence or event giving rise to the claim. This time period may be extended by court proceedings. *The*

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[1] Joseph C. Long, "Statutes of Limitations Don't Apply in Arbitration," 12 PIABA L.J. (No.1) 2 (Spr. 2005), also available on WestLaw as 1502 PLI/Corp. 309 at *311(2005); Joseph C. Long, FROM THE PROFESSOR, Dispositive Motions, 4 PIABA Quarterly (No.4) 3, 5-6 (Dec. 1997).

[2] See Charles W. Austin, "Having Their Cake and Eating It Too: Motion Practice and the Mongrelization of SRO Arbitration," available on WestLaw as 1399 PLI/Corp. 183, 192 (Dec. 2003); Kenneth R. Jones, "Applicability of Statutes of Limitations in AAA Arbitration," 5 PIABA Quarterly (No. 4) 8 (Dec. 1998); and Martin H. Aussenberg, "NASD Arbitrators Are Not Bound to Apply Statutes of Limitations," 5 PIABA Quarterly (No. 4) 10 (Dec. 1998).

[3] *See also,* Annot., “Statutes of Limitations As a Bar to Arbitration Under Agreement,” 64 ALR 3d 533 (1979) and Annot., “Which Statute of Limitations Applies to Efforts to Compel Arbitration of a Dispute,” 77 ALR 4th 1071 (1989).

[4] There is no authority under the new NASD Code Rule 12503 for the Panel to hear dispositive motions such as motions to dismiss. Section 12504 of the proposed New NASD Code covered dispositive motions. This section was withdrawn before the SEC approved the New Code. It has been resubmitted separately to the SEC, but has not been approved by the Commission.

As will be seen below, it is well-established that arbitration is strictly a creature of contract. As a result, the arbitrators only have that power or authority to do those things specifically provided for in the documents controlling the arbitration and the sovereign’s consent to allow arbitration in the first place. In the case of an NASD arbitration, the first two items are the NASD Code and the brokerage agreement between the parties. Presently, neither the Code or the brokerage contracts contain authority for the arbitrators to hear dispositive motions. Therefore, in all cases filed after April 17, 2007, the arbitrators will exceed their authority if they hear dispositive motions. The granting of such motions should lead to vacation of any dispositive pre-hearing motion to dismiss.

As to cases filed *before* April 17, 2007, it has long been debated about the authority of the arbitrators to grant such motions. There is no specific authority in the former NASD Code for the entertaining of such motions prior to trial. While there is authority that arbitrators can grant these motions, the author recently discovered an Arizona trial court decision which held that to entertain such motion without hearing was beyond the authority of NASD arbitrators. As a result, the court vacated the arbitration award. *Morgan v. Carillon Inv., Inc.*, 2005 WL 5533924 (Ariz. Super. Ct., Maricopa County, Sept 13, 2005).

> *arbitrators should also be aware that a statute of limitations may preclude the awarding of damages even though the claim is eligible for submission to arbitration.*[7]

Several other factors suggest that now is the time to revisit this issue. First, the language and arrangement in Section 12206 of the new NASD Code[8] has changed from the language used in Section 10304 of the old Code.[9] Second, the author has been made aware of the history of the clause in both the new and old Codes indicating that "This rule does not extend *applicable* statutes of limitations."

Finally, it has come to the author's attention that two relatively new state trial court decisions[10] have vacated NASD arbitration awards, dismissing a claim based upon a statute of limitation argument. Both cases appear to have reached their conclusion based upon a theory that the arbitrators exceeded their authority, a specified grounds for vacating awards under the FAA[11] and most state arbitrations acts,[12] rather than the court created grounds of “manifest disregard of the law.” In order to understand the issues

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[5] SCIA "The Arbitrator's Manual" (January 2007), currently available on the NASD Website. However, with the demise of SICA, the NASD may take down the publication. This SICA "The Arbitrator's Manual" must be distinguished from publications by the NASD. Arbitrators presently receive two NASD publications: (1) NASD Resolution Arbitrator's Reference Guide (Apr. 2007); and (2) Basic Arbitrator Training, Participant's Guide. Neither of these documents presently appears to have any reference to dispositive motions or the statutes of limitations.

[6] [Author's note] See the new NASD Code §12206(a) (2007) and old NASD Code §10304.

[7] [Emphasis added.] This exact same language appeared on page 8 of the SICA "The Arbitrator's Manual" (May 2005).

[8] The new Section 12206 reads in pertinent part:

> (a) Time Limitation of Submission of Claims
>
> No claim shall be eligible for submission to arbitration under the Code where six years have elapsed from the occurrence or event giving rise to the claim. The panel will resolve any questions regarding the eligibility of a claim under this rule.
>
> * * *
>
> (c) Effect of Rule on Time Limits For Filing in Arbitration
>
> The rule does not extend *applicable* statutes of limitations. However, where permitted by applicable law, when a claimant files a statement of claim in arbitration, any time limits for the filing in court will be tolled while NASD retains jurisdiction of the claim. [Emphasis added.]

[9] The old Code, §10304 read:

> **10304 Time Limitations Upon Submission**
>
> No dispute, claim, or controversy shall be eligible for submission in arbitration under this Code where six years have elapsed from the occurrence or event giving rise to the act or dispute, claim, or controversy. This Rule shall not extend *applicable* statutes of limitations, nor shall it apply to any case which is directed to arbitration or a court of competent jurisdiction. [Emphasis added.]

[10] *Broom v. Morgan Stanley*, Case No. 06-2-32543-5SEA (Wash. Super. Court, King County, Wash. May 11, 2007), available to members on the PIABA Website, and *Morgan v. Carillon Inv., Inc.,* 2005 WL 5533924 (Ariz. Super. Ct., Maricopa County, Sept. 15, 2005).

[11] 9 USC §10(a)(4).

[12] Unif. Arb. Act (2000), §23(a)(4).

involved in whether statutes of limitations apply in arbitrations, it is necessary to understand the nature of both statutes of limitations and arbitration. Therefore, a discussion of both is in order.

I. Statutes of Limitations

There are three different types of statutes of limitations which will be encountered in the arbitration setting. The first, and by far the most common form, of statute of limitations involves what is often called a "garden variety" statute of limitations (hereinafter "Type 1 statute of limitations.") The second type of statute of limitations (hereinafter "Type 2 statute of limitations") seen in arbitration is based upon special statutes of limitations which govern the ability to compel arbitration. Finally, the third type of statute of limitations encountered in arbitration (hereinafter "Type 3 statute of limitations") is a statute of repose.

A. Type 1 Statutes of Limitations

As noted above, by far the most common statutes of limitations found in both litigation or arbitration are what have often been referred to as "garden variety" statutes of limitations. These statutes regulate the bringing of court actions involving underlying substantive claims. The running of these statutes of limitations does not destroy the underlying remedy, merely arbitratily prohibits courts from hearing cases based upon those claims. Procedurally, these statutes of limitation must be raised as an affirmative defense and will be waived, if not so plead.

Type 1 statutes are a product of the common law of England and have a long history in both Anglo and American law. In the early common law courts of England, in the absence of special contractual provision between the parties,[13] there were no limitations on the bringing of common law actions.[14] As the name "statutes of limitations" suggests, in England limitations were based upon legislative action rather then judicial evolution. These Type 1 statutes appeared relatively early in the development of the common law, dating from the early Seventeenth Century.[15]

Type 1 statutes of limitations were the mechanism by which the English kings limited access to the law court they had created. Since the statutes were directed at the courts, and not the common law cause of action, they were considered procedural rather than substantive, in nature. As such, Type 1 statutes did not, in any way, limit or destroy the underlying common cause of action, merely limited the King's courts from entertaining suits upon such actions.

Further, Type 1 statutes were territorial, meaning that they applied only in the English common law courts created by the King. This fact is significant for two reasons. First, such statutes would not apply in the courts of other countries such as France. Most common law actions, especially those based upon torts and contracts are transatory causes of action. They do not have to be brought in the courts of the country where the cause of action arose, but may be brought in any court having jurisdiction over the parties. For example, a cause of action for tort created by the English common law could be pursued in the courts of France or Germany. Since the Type 1 statute of limitations governing the ability of the English common law courts to hear such actions were both procedural and territorial, the courts in France or Germany would apply their own statute of limitations. The same analysis also applies today to courts established by private groups, such as churches, business groups, and arbitration

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[13] *Cray v. Hartford Fire Ins. Co.*, 1 Blatchf 280, 6 F. Cas. 788 (Cir. Ct., D.Conn. 1848).

[14] *See e.g., Major League Baseball v. Morsani*, 790 So.2d 1071 (Fla. 2001); *Cray v. Hartford Fire Ins. Co.*, 1 Blatchf 280, 6 F. Cas. 788 (Cir. Ct., D.Conn. 1848), citing early English case precedent.

[15] The first general statute of limitations was the Act of 21 Jac. I (1623). *Cray v. Hartford Fire Ins. Co.*, 1 Blatchf 280, 6 F. Cas. 788 (Cir. Ct., D.Conn. 1848).

organizations, including the NASD, to the extent that the state or federal government allows these organizations to exist.[16]

The second significant reason for the limitation of Type 1 statutes of limitations to common law courts lies in a fact which most lawyers learned in law school, but did not understand. In the early days of the English common law, there were two different sets of courts, the common law courts and the Equity or Chancery courts. The English courts of equity were not created by the English Kings, but were derived from church or ecclesiastic courts. These courts were courts of conscience rather than law. As a result, they did not have to follow the common law or the King's statutes, and rendered their decisions based purely on the facts of the individual case. Again, since they were not created by the English king, they had no obligation to follow limitations imposed by Type 1 statutes of limitations, on the ability of the common law courts to hear a dispute. Thus, arose the tradition, followed today, that Type 1 statutes of limitations do not apply in courts of equity, courts of law sitting in equity, or cases involving equitable matters or remedies.

This discussion about Type 1 statutes of limitations in England has relevance both to American courts and arbitration. Another point, which most lawyers learned in law school and promptly forgot, is that English common law is the law of every American state, except possibly Louisiana. The acceptance of the English common law was not a judicial decision. At the time of statehood, most states enacted a Constitutional or statutory provision adopting the English common law as of a given date.[17] The date varies with the state, ranging from 1607, the founding of Jamestown, or July 4, 1776, to the date the state was admitted into the Union. However, as even fewer lawyers remember, this adoption covers not only the English court-made common law, but also the English *statutory* law as of that date. Therefore, most states acquired statutes of limitations at the time of statehood as part of the common law.[18] Of course, most states have long since adopted newer and more complete Type 1 statutes of limitations.

The American states have generally followed the English traditions when dealing with Type 1 "garden variety" statutes of limitations. As a result, it is well-recognized that statutes of limitations are solely the creature of legislative enactment.[19] They are procedural only,[20] and do not affect the underlying common law cause of action.[21] Also, Type 1 statutes normally don't begin to run until the last element necessary for the injured party to

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[16] Allowing the existence of arbitration courts or fora and prohibiting the states from outlawing them was the stated purpose of the Federal Arbitration Act. Many state courts prior to that time, took the position that they had a monopoly on dispute resolution. As a result, a promise to submit a dispute to a private court or arbitration was illegal and unenforceable.

[17] For example, Fla. Stat. §2.01 provides:

> The common law and statutes laws of England which are of a general and not local nature ... down to the 4th day of July 1776, are declared to be of force in the state....

[18] Interestingly, those states which use 1607 probably did not acquire any statutes of limitations as the first general statute of limitations appears to have been passed in 1623.

[19] *See e.g., Major League Baseball v. Morsani*, 790 So.2d 1071 (Fla. 2001)("[F]ixed time limits on actions are predicated on public policy and are a product of modern legislative, rather than judicial processes."); *Kansas Public Employees Retirement Sys. v. Reimer & Koger Associates, Inc.*, 262 Kan. 635, 941 P.2d 1321 (1997).(A statute of limitations is entirely subject to the will of the legislature).

[20] *See e.g., Trinity Broadcasting Corp. v. Leeco Oil Co.*, 1984 Ok 80, 692 P.2d 1364 (1985).

[21] Thus, it affects the remedy only, not the underlying right. *Trinity Broadcast Corp. v. Leeco Oil Co.*, 1985 OK 80, 692 P.2d 1364, 1366 (1984).

successfully bring such action occurs.[22] Further, such statutes are subject to various tolling doctrines[23] which further delay the commencement of the statutory period.[24] It is also well-recognized that these statutes do not apply in courts of equity,[25] or the courts of another state, unless *that* state so requires.[26] As will be seen below, Type 1 statutes of limitations clearly do not apply in private courts or arbitration proceedings, *unless the rules of these fora, so require, or the arbitration contract between the parties so commands. In either case, such decision is that of the fora, such as the NASD, or the parties, and not the state adopting the Type 1 statute of limitations.*

B. Type 2 Statutes of Limitations

Type 2 statutes of limitations do not affect substantive underlying legal claims, at least not directly.[27] Instead, Type 2 statutes of limitations are statutes of limitations which limit a party's right to enforce an existing arbitration clause.[28] While Type 2 statutes have been used in specialty areas such as disputes involving uninsured motorist coverage, malpractice, and professional fees,[29] Type 2 statutes of general application appear to be quite rare. The author's present research has revealed that only two states, New York[30] and Delaware,[31] have Type 2 statutes of limitations of general application.

As noted above, Type 1 statutes limit access to a particular sovereign's courts, but do not affect the continued validity of the underlying substantive right. Type 2 statutes do essentially the same thing for arbitration. They limit access to arbitration as an alternative dispute resolution forum, without affecting the underlying substantive right directly.[32] In this sense, they are more in the nature of a jurisdictional requirement rather

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[22] Often, in the case of common law securities fraud, that element is the occurrence of damage to the investor.

[23] I.e., the discovery rule, a fiduciary relationship, equitable estoppel, and fraudulent concealment.

[24] The better approach here is that tolling does not extend the statute of limitations, rather it prevents the statute from commencing to run, even though the statute may provide for a specific event, such as the sale of the security, as being the commencement date.

[25] *See e.g.*, *A. C. Aukerman Co. v. R. L. Chaides Constr. Co.,* 960 F.2d 1020 (9th Cir. 1992).

[26] *Wells v. Simonds Abrasive Co.*, 345 U.S. 514 (1953); Rest.2d Conflict of Laws, §143 (1971).

[27] Cf. *Constantine N. Katsoris: SICA: The First Twenty Years*, 23 Fordham Urb. L.J. 483, 493 (1996). The statute of limitations covering the underlying substantive claim may, however, indirectly impact the ability to compel arbitration in at least two instances, as discussed below. First, the parties, in their arbitration agreement, or the arbitration fora, in it rules, may provide that arbitration may not be compelled unless the demand for arbitration is made within the limitations period covering the underlying cause of action if brought in court. Second, the sovereign may pass such a limitation on compelling arbitration which incorporates the statute of limitations covering the substantive right.

[28] See generally, Annot. "Which Statute of Limitations Applies to Efforts to Compel Arbitration of A Dispute," 77 A.L.R.4th 1071 (1989).

[29] *Id.*

[30] NY CPLR §7502(b), discussed in Seth E. Lipner and Joseph C. Long, Securities Arbitration Desk Reference 62-64 (2006).

[31] 10 Del. C. § 5702(b).

[32] *Nielsen v. Barnett*, 440 Mich. 1,5, n.3, 485 N.W.2d 666, 668, n.3 (1992), quotes the arbitration panel in that case as saying:

> The arbitration agreement does not establish substantive rights and duties of the party in their dealings with each other, but rather only establishes the forum where any prospective disputes are to be resolved.

than substantive law provision. They affect the ability of a person to enforce a contractual right to arbitrate, not the substantive rights being arbitrated.

Type 2 statutes of limitations are based upon the ability of a sovereign or state to place limitations on the right to use arbitration as an alternative dispute resolution forum to the courts. Originally, the individual states, like other sovereigns, retained the right to refuse to enforce arbitration clauses altogether.[33] However, the state's right to totally ban arbitrations was curtailed by the passage of the Federal Arbitration Act, as it has been interpreted by the Supreme Court.[34] Type 2 statutes of limitation are not a total ban on the enforcement of arbitration clauses, merely a partial ban which restricts the use of the state courts after the passage of a certain time period to force arbitration.[35]

The beginning point for a discussion of Type 2 statutes of limitations is the same as that for Type 1 statutes. The common law did not recognize statutes of limitations at all, much less limitations on the right to compel arbitration. As a result, some courts have held that there is no statute of limitations to compel arbitration.[36] Other states have taken the position that refusing to arbitrate is simply a breach of a contract, and like the breach of any other contract, the contract's statute of limitations should control.[37]

However, there is a problem with applying the contract statute of limitations. Suits to compel arbitration are suits seeking specific performance of the arbitration contract, not damages for its breach. Specific performance is an equitable remedy, and, as noted above, equity is not bound by statutes of limitations.

In theory at least, Type 2 statutes of limitations would simply provide that the sovereign's court would not entertain a suit to compel arbitration after the running of a fixed period of time, say three years. The accrual point could be (1) the entering into the arbitration agreement, (2) the date of violation,[38] or (3) after the refusal to arbitrate. All of these approaches have flaws. But, clearly, none has any direct impact upon the

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[33] *See e.g., United States Asphalt Refining Co. v. Trinidad Lake Pet. Co.*, 222 F. 1006, 1012 (S.D.N.Y.1915).

[34] See generally, Edward Brunet, Toward Changing Models of Securities Arbitration, 62 Brook L. Rev. 1459, 1468-1475 (1996).

[35] Whether, within the strictures of the FAA, such partial ban is to be allowed is another question. If the parties elect to apply the *substantive arbitration law* of a state, then, under *Volt Inf. Sciences, Inc. v. Board of Trustee of Leland Stanford Junior University*, 485 U.S. 976 (1988), it would seem clear that the state's type 2 statute of limitations would apply. If the parties did not contract to adopt the *substantive arbitration law* of a state, then the state's type 2 statute of limitation may not control, just as the state's substantive arbitration law provision prohibiting award of punitive damages, does not apply. *Mastrobuono v. Shearson Lehman Hutton, Inc.,* 514 U.S. 52 (1995). Both may be impermissible limitations under the FAA.

[36] *Wagner Const. Co. v. Pacific Mech. Corp.*, 41 Cal. 4th 19, 157 P.3d 1029 (2007). However, the court will often impose a reasonable time requirement. *Id. See generally,* Annot., "Which Statute of Limitations Applies to Efforts to Compel Arbitration of a Dispute," 77 ALR 4th 1071 (1989).

[37] It is clear, however, that this statute of limitations does not begin to run until there has been a breach of the contract, which is the refusal to arbitrate. Thus, assuming a six-year contract statute of limitations, compelling arbitration would not be barred until six years *after the refusal to arbitrate, not six years after the accrual of the underlying substantive claim*.

[38] See new NASD Code Rule 12206(a). This is the famous or infamous "six-year" rule. Professor Katsoris confirms that this six-year rule was arbitrarily selected, and was based upon the records retention requirements of the SEC. *Constantine N. Katsoris: SICA: The First Twenty Years*, 23 Fordham Urb. L.J. 483, 493 (1996).

enforcement of the underlying right being arbitrated.

The two states, New York[39] and Delaware,[40] which have type 2 statutes of limitations of general application, do not use a fixed term approach, but rather tie the ability to compel arbitration indirectly to the underlying substantive claim. The New York provision reads:

> (b) Limitation of time. If, at the time that a demand for arbitration was made or a notice of intention to arbitrate was served, the claim sought to be arbitrated would have been barred by limitation of time had it been asserted in a court of the state, a party may assert the limitation as a bar to the arbitration on an application to the court as provided in section 7503 or subdivision (b) of section 7511. The failure to assert such bar by such application shall not preclude its assertion before the arbitrators, who may, in their sole discretion, apply or not apply the bar. Except as provided in subdivision (b) of section 7511, such exercise of discretion by the arbitrators shall not be subject to review by a court on an application to confirm, vacate or modify the award.[41]

As a reading of this language indicates, while it has the effect of a Type 2 statute, it uses a different approach. Understanding this approach is the key to properly applying the statute. The statute allows *a person* to do two things: (1) to seek an injunction against arbitration; and (2) to raise the issue of whether the claim is stale before the arbitrators.[42] However, the trigger for the person's ability to do *both* these acts is the running of the statute of limitations on the underlying substantive cause of action, if the substantive claim would have been barred in *a New York court*.[43] In the case of presentation to the arbitrators, the statute goes on to provide that the arbitrators[44] may apply the statute of limitations, but do not have to do so. However, *in either case*, the panel's decision is not subject to subsequent challenge in a court.[45]

C. Type 3 Statutes of Limitations

The final type of statute of limitations found in arbitration are statutes of repose. These statutes are also referred to as statutes of creation or statutes of prescription. Type 3 statutes are not a product of the English common tradition as are Type 1 statutes, but rather represent a concept borrowed from

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[39] NY CPLR §7502(b), discussed in Seth E. Lipner and Joseph C. Long, Securities Arbitration Desk Reference 62-64 (2006).

[40] 10 Del. C. § 5702(b).

[41] The Delaware provision reads virtually identically except for internal statutory reference.

[42] The New York system appears to work well when both parties are New York residents, clearly subject to New York jurisdiction, and the arbitration is to take place in New York. However, the statute would appear to be territorial in nature, normally having no application outside New York. Discussion of the extra-territorial effects of the statute, if any, is beyond the scope of this article.

[43] This language would appear to raise a choice of laws issue, if the cause of action is transitory in nature and accrues outside New York. Does the local New York statute of limitations apply, or does the statute of limitations of the state in which the action accrues. Again, this issue is beyond the scope of this article. However, in an attempt to be sure that New York law will apply, many broker-dealers provide in their customer agreements that “New York law, without regard to the New York conflict of laws rules, should govern this contract.”

[44] It is interesting that the same discretion is not given to the trial judge, if an injunction is sought. However, it is believed that such authority does not have to be given. An injunction is equitable in nature, and, as such, the trial judge has the discretion to deny the injunction.

[45] Again, there is the question of whether this provision would apply where the court entertaining the motion for affirmance, modification, or vacation was a non-New York court.

Roman law.[46] The theory here is that the sovereign gives the new action, one not known at common law, life and has chosen also to limit that life.

Thus, a type 3 statute terminates the ability of the plaintiff to make a claim based upon the underlying substantive wrong. As a result, the statute of repose is an inherent element of the right created.[47] It must be enforced within the statutory period, or both the right itself, and the remedy for its violation, are extinguished. Therefore, the Type 3 statute is substantive and not procedural. Not only will it limit the enforcement of the right in the creating sovereign's courts, but also in those of another sovereign or private fora.

Herein lies the main difference between a Type 1 and Type 3 statute. They have a substantially different affect upon the underlying substantive claim. A Type 1 statute of limitations does not destroy the underlying cause of action, it merely prevents the use of the *creating* sovereign's courts to enforce the right.[48] The right continues and can be enforced in the courts of another sovereign or private system such as an NASD arbitration.

On the other hand, in the case of a Type 3 statute of repose, the sovereign has created a new underlying substantive right or cause of action, unknown at common law. In doing so, it has elected to limit the life of that right to a specific time period. Once that time period has expired, the newly created right also expires. Further, in the case of a Type 3 statute, the right accrues at the time stated in the statute and is *not* subject to tolling. In many cases, a Type 1 statute of limitation will be joined with a Type 3 statute of repose. Further, very frequently, statutes of repose are part of the larger statute creating the new cause of action, rather than being contained in the general statute of limitations provision.

Two causes of action illustrate the point. The first cause of action is for *common law fraud*. It is obviously a common law cause of action, and normally, is governed by a provision in the general statute of limitations. Since the provision in the general statute of limitations is a Type 1 statute, it does not destroy the underlying cause of action, and the accrual of the action may be delayed by doctrines such as discovery and fraudulent concealment,[49] even if the statute itself reads in terms of a fixed time period. As a Type 1 statute, the underlying right is not affected. Therefore, it can be enforced in the courts of another state or in a private court system, such as NASD arbitration, unless that court system or the parties provide otherwise.

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[46] Marion Opala, "Prescriptio Temporis and Its Relationship to Prescriptive Easements in Anglo-American Law," 7 Tulsa L. Rev. 107 (1971).

[47] Thus, it affects the remedy only, not the underlying right. *Trinity Broadcast Corp. v. Leeco Oil Co.*, 1985 OK 80, 692 P.2d 1364, 1367 (1984).

[48] Another sovereign state or country may provide for a longer statute of limitations for this type of action and allow the plaintiff to enforce his still existing cause of action. For example, Oklahoma has a four-year statute of limitations governing breach of a written contract. New York, on the other hand, has a six-year statute of limitations for breach of a written contract. After four years from the breach, the courts in Oklahoma would be closed to an action for breach of the contract, but the cause of action has not been extinguished, merely barred from being brought in Oklahoma. The New York courts could continue to entertain such suit, however, because its statute has not run. To avoid forum shopping, many states, as a matter of community, not Constitutional obligation, have a provision that, if the state where the injury occurred has a shorter statute of limitations than does the forum state, the state of injury's statute will control.

[49] Fraud is self-concealing, and there may be, but does not have to be, a separate act of concealment.

The second example is the statute of limitations contained in Section 508(j)(2) of the new Uniform Securities Act (2002),[50] covering *securities* fraud. This Section reads:

> (j) A person may not obtain relief:
>
> * * *
>
> (2) under subsection (b) [for material misrepresentations or omissions], ... unless the action is instituted within the earlier of two years after discovery of the facts constituting the violation and five years after the violation.[51]

Under the language of this section, the two year statute of limitations is a type 1 statute, and it is subject to a built-in tolling provision. The five year provision is a statute of repose. The Uniform Act creates a cause of action for securities fraud not found at common law. The statute of limitations is contained in the larger statute creating the cause of action. And the language used makes clear that, after five years from the violation, whether or not, the fraud has been discovered, the cause of action ceases to exist.

II. Types of Arbitration

Just as there are different types of statutes of limitations, there are also different types of arbitration proceedings. Professor Edward Brunet, in a 1996 article,[52] identified two different basic arbitration models: (1) "Folklore" Arbitration; and (2) Contract Model Arbitration.[53]

A. "Folklore" Arbitration

Folklore arbitration, at least from the English perspective, is the oldest and most common form of arbitration. It became popular between merchants and the guilds during the middle ages. These groups did not like the result which would often have been reached in suits in the English common law courts. To avoid the ruling of the common law courts, these groups banded together and agreed to have their disputes decided by other members of the group, applying the customs and traditions of the group rather than the strict letter of the common law. This practice developed an alternative to the common law, known as the law merchant.

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[50] Discussed in Seth Lipner and Joseph C. Long, The 2007 Securities Arbitration Desk Reference §§14:112-14-116 (2007)(Available August 2007).

[51] Comment 14 of the Official Comments states:

> Section 509(j)(2), in contrast, generally follows the federal securities law model. An action must be brought within the earlier of two years after discovery or five years after the violation. As with federal courts construing the statute of limitations under Rule 10b-5, it is intended that the plaintiff's right to proceed is limited to two years after actual discovery "or after such discovery should have been made by the exercise of reasonable diligence" (inquiry notice), see e.g., Law v. Medco Research, Inc., 113 F.3d 781 (7th Cir. 1997), or five years after the violation.

[52] Edward Brunet, *Toward Changing Models of Securities Arbitration*, 62 Brook. L. Rev. 1459, 1461 (1996).

[53] In turn, contract model arbitration can also be, but does not have to be, either or both: (1) judicialized arbitration; or (2) Public Interest Arbitration. In judicialized arbitration, the sovereign, the parties, or the arbitration fora, imposes certain aspects of civil litigation, such as: (1) motion practice; (2) application of substantive law; (3) detailed reasoned, written, awards which require the inclusion of finding of fact and conclusions of law; and (4) a degree of substantive judicial review either by the creation of an arbitral review panel or the courts. In the case of public interest arbitration, the sovereign has given the power to control the arbitration process to a governmental agency "in the public interest" as a condition of allowing private dispute resolution. It should be obvious from the NASD Arbitration Code and, the ability of the SEC to supervise the SRO's, whether or not exercised, that securities arbitration today is not folklore arbitration, but a form of contract arbitration.

Folklore arbitration is what most lawyers, lay persons, arbitration fora, such as the NASD, and even the arbitrators themselves think of when defining arbitration today. As identified by Professor Brunet, the following are the most common attributes associated with folklore arbitration. First and foremost, folklore arbitration is characterized as a cheap, informal, totally private, process, resulting in a speedy resolution. To accomplish this goal of speedy resolution, the rules of evidence applied by courts have no application; there is virtually no discovery; and awards are made without written decision.

Further, there are two other attributes which are very important to the present discussion. First, awards are of an equitable nature, which frequently ignore the prevailing law in favor of what the arbitrators believe is “equitable and just.” And, second, the awards are final with no appeal to the courts. As a result of these last two attributions, in folklore arbitration, arbitrators are free to use whatever norms they want when deciding disputes, and the courts will refuse to review their decisions when they are at odds with the law.[54] Based upon these popular beliefs as to the attributes of folklore arbitration, Professor Brunet concludes that:

> In the folklore type of arbitration, the parties to an arbitration clause are opting out of the court system and seeking a "final" result from the arbitrators.[55]

In reality then, in folklore arbitration, the parties who consent to arbitration give up all legal rights and effectively opt out of the legal system.[56]

Concluding that securities arbitration under both the NYSE and NASD is perceived as being folklore arbitration, Professor Brunet said that:

> [S]ecurities arbitration remains lawless. The arbitrator need not apply the substantive legal principles. ... While securities arbitration surely operates in the "shadow of the law," it is clear that the arbitrators need not apply the law.[57]

Both the securities industry itself and securities Self-Regulatory Organizations appear to concur with Professor Brunet’s perception that arbitration before the NYSE and NASD amounts to folklore arbitration, with its free-wheeling view that arbitrators are not limited by law, but are to make "fair and just" awards.

In his testimony before Congress, the President of the then Securities Industry Association assured Congress that the SRO arbitration process is "fair to customers" because it is purely an equitable proceeding, and allows customers to avoid technical litigation roadblocks--citing statutes of limitations as one such "technical procedural" obstacle which arbitration dispenses with. He said:

> Aggrieved customers get what so many say is what they really want: their “day in court.” [C]laimants in arbitration are not held to technical pleading standards... [T]he hearings themselves ... are designed to be flexible and allow the arbitrators to reach the most equitable conclusion. The more streamlined process of arbitration, as compared with the many procedural ... obstacles that must be overcome by a plaintiff in a court case, means that nearly every case brought in arbitration ... goes to a full merits hearing....

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[54] *Id.* at 1470.

[55] *Id.*

[56] *Id.*

[57] *Id.*

> This is in sharp contrast to court proceedings, where a significant percentage of claims are dismissed on pre-hearing motions to dismiss or for summary judgment. Many of these dismissals are on what may be described as technical, or procedural, grounds. This includes dismissals for pleading failures, jurisdiction deficiencies, *and statutes of limitations bars....*
>
> [M]any claims that would otherwise have been dismissed in court on legal grounds are nonetheless presented on the merits to arbitrators, allowing the claimants an opportunity...to persuade arbitrators that fairness and equity dictate that relief should be granted, *even if the technical aspects of the law may not be on their side.* [58]

A similar view was expressed at the same hearing by Karen Kupersmith, the then Director of Arbitration for the New York Stock Exchange, who said:

> Arbitration is based on principles of equity--doing what is most fair and just in light of the facts and circumstances of the particular case. Public investors receive a direct benefit from these equitable principles. Should a panel of arbitrators find that facts of a particular case merit an award because it is equitable, an award can be made without the need to cite any precedents or other justification.

The newly appointed director of arbitration for the merged NYSE and NASD, Linda Feinberg, has also taken the position that legal technicalities, like the statute of limitations, has no place in arbitration:

> [T]he strict rules of evidence do not apply. ... In arbitration, an SRO, an NASD arbitration, unlike in court, you get an equitable result. *You do not have to have a claim that is cognizable under state or federal law. It can be cognizable under NASD rules. So, for example, there is only one cause of action under federal securities laws, that's 10b, very limited, has a very short statute of limitations. The rules that are applied by arbitrators looking for equitable relief are much broader than if they had to strictly follow the law.*[59]

Likewise, the courts have long held that a defendant can not claim some benefits of folklore arbitration, while also demanding the benefits of a legal proceeding. In the 1950's, the court, in *Commercial Solvents Corp. v. Louisiana Liquid Fertilizer Co.*,[60] rejected an attempt by an arbitration defendant to have its cake and eat it too. The court said:

> By voluntarily becoming a party to a contract in which arbitration was the agreed mode for settling disputes thereunder respondent chose to avail itself of procedures peculiar to the arbitral process rather than those used in judicial determinations.... Arbitration may well have advantages but where the converse results a party having chosen to arbitrate cannot then vacillate and successfully urge a preference for a unique combination of litigation and arbitration.[61]

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[58] This testimony is available at: http://financialservices.house.gov/media/pdf/031705ml.

[59] Remarks of Linda Feinberg, President, NASD Dispute Resolution, Executive Vice President and Chief Hearing Officer of Regulatory Policy and Oversight, at First NASAA Listen's Forum on Arbitration, National Press Club, Washington, D.C., Tuesday, July 20, 2004.

[60] 20 F.R.D. 359 (S.D.N.Y. 1957).

[61] *See also Mitchell v. Prudential Property & Cas. Ins. Co.*, 346 Pa. Super. 327, 499 A.2d 632 (1985)("It is well settled that arbitration proceedings are informal adversarial hearings in which the *arbitrators are not governed by technical rules employed in court proceedings."*)(Emphasis added); *Champ v. Siegel Trading Co., Inc.,* 55 F.3d 269 (7th Cir. 1995)("When contracting parties stipulate that disputes will be submitted to arbitration, they relinquish the right to certain procedural niceties which are normally associated with a formal trial").

In summary, if Professor Brunet, the securities industry, and the SRO's are correct that securities arbitration is, in fact, today,[62] folklore arbitration, then, law, including statutes of limitations, have no place in arbitration proceedings.

But are the securities and the SRO's correct that NASD arbitration is intended to be folklore arbitration?

B. Contract Model Arbitration

Contract arbitration is exactly what the name suggests-arbitration governed solely by terms of the contract between the parties. Of course, *all arbitration* is by consent. It is an oxymoron to talk about mandatory arbitration. The difference between "folklore" arbitration and contract model arbitration is that folklore arbitration carries with it the "customs and practices" of the industry sponsoring the arbitration. Conversely, in contract arbitration, there is nothing but arbitration contract. The power of the arbitrator flows from that contract and only that contract. If the power to do a particular thing or consider a particular issue is not found in the arbitration contract, the arbitrator simply has no power to act.

In this respect, arbitration differs substantially from a court proceeding. A court, because of its creation by the sovereign and past court history, has certain powers which are implied from the fact that it is a court. There is no such thing as implied powers of an arbitrator in contract arbitration.

As the Supreme Court said in *Alexander v. Gardner-Denver Co.*:

> As the proctor of the bargain, the arbitrator's task is to effectuate the intent of the parties. His source of authority is the collective-bargaining agreement....[63]

It then quoted the late Dean Shulman with approval,[64] who stated:

> A proper conception of the arbitrator's function is basic. He is not a public tribunal imposed upon the parties by superior authority which the parties are obliged to accept. He has no general charter to administer justice for a community which transcends the parties. He is rather part of a system of self-government created by and confined to the parties. He serves their pleasure only to administer the rule of law established by their [arbitration] agreement.[65]

Finally, the Court quoted from its earlier opinion in *United Steelworkers of America v. Enterprise Wheel & Car. Corp.*:[66]

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[62] Professor Brunet and the present author do not accept this view of securities arbitration under the NASD Rules. Both agree that the Supreme Court has indicated in *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220, 232 (1987) and *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20,32 n.4, that in arbitrations dealing with statutory causes of action, arbitrators *must* follow the law. Brunet, supra, at 1473-1474. Rejection of the position that securities arbitration, today, is folklore arbitration, does not mean, however, that statutes of limitations are applicable in arbitration because of the Supreme Court mandate to follow the law.

Under the Supreme Court mandate, a particular statute would be applicable in arbitration, if its language indicated that it was to apply to arbitrations, i.e. type 2 statutes of limitations, or did not preclude its application. As will be seen below, most type 1 statutes of limitation, by their own language, apply only to “actions.” "Actions" have traditionally been defined only to include certain types of cases brought in court. Arbitrations are not "court actions or suits."

[63] 415 U.S. 36, 53, 94 S.Ct. 1011, 1022 (1974)[Footnote omitted.]

[64] *Id.* at n. 16.

[65] *Shulman, Reason, Contract, and Law in Labor Relations*, 68 Harv.L.Rev. 999, 1016 (1955).

[66] 363 U.S. 593, 80 S.Ct. 1358 (1960).

> [A]n arbitrator is confined to interpretation and application of the collective bargaining agreement; he does not sit to dispense his own brand of industrial justice. He may of course look for guidance from many sources, yet his award is legitimate only so long as it draws its essence from the [arbitration] agreement. When the arbitrator's words manifest an infidelity to this obligation, the courts have no choice but to refuse enforcement of the award.

Professor Brunet makes a compelling case for the argument that NASD arbitration is not folklore arbitration as many have supposed or assumed. Rather, NASD arbitration contract arbitration, with strong elements of judicialized arbitration and public interests arbitration pored into the mix. These latter items, however, *are added solely as a part of the contract to arbitrate.*

NASD arbitration is the result of a four-party contract. Obviously, the first two parties to this four-party agreement are the investor and the broker-dealer. The investor, under pressure from the broker-dealer and having no real alternative, accepts the broker-dealer's demand that disputes be settled by arbitration. While this contract could establish detailed rules concerning what the arbitrator must do and what powers he possesses, normally, the investor-broker-dealer agreement does not establish any of the terms and conditions of the arbitration other than stating that the arbitration will be conducted under the rules of the NASD.

Thus, the NASD becomes a party to the contract by the incorporation by reference of the NASD Code of Arbitration. The NASD Code either has or is claimed to have judicialized some aspects of arbitration. Certainly, the discovery code is a judicialization as is the New Code's limited recognition of motion practice.[67]

As seen from the statements quoted above, the securities industry and the SRO's do not believe that the NASD Code requires arbitrators to apply the letter of the law. Curiously, however, they appear to believe that arbitrators must apply the law when dealing with statutes of limitations issues. On the surface, these positions are clearly inconsistent. The law does not control arbitrators' discretion in reaching their decision, except in the limited area of the statute of limitations. Such position smacks of trying to have one's cake and eat it too.[68] The claimed justification for the inconsistency, however, is the old "six-year" rule.[69] Whether the language of the "six year" rule actually supports this claim will be examined in a moment.

The final party or parties to the NASD arbitration agreement are the state and federal governments. As the controlling sovereigns, remember they possess the power to impose restrictions on the ability to use private arbitration as a dispute resolution fora. If the state or federal governments elect to impose conditions, and if these pre-conditions are not met, then the use of arbitration by agreement becomes contrary to public policy.

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[67] NASD Code of Arbitration §§ 12503, 12509 (2007). However, again, note that the proposed § 12504 covering dispositive motions was not adopted. Therefore, presently under the Contract Model of Arbitration, *arbitrators do not have the authority to entertain such motions.*

[68] *Commercial Solvents Corp. v. Louisiana Liquid Fertilizer Co.*, 20 F.R.D. 359 (S.D.N.Y. 1957), quoted above.

[69] Presently found in § 12206(a) of the New NASD Code.

Bowles v. Stifel, Nicolaus & Co., Inc.,[70] the Tenth Circuit summarized the public policy exception to enforcement of an arbitration award as:

> A judicially-created doctrine, the public policy exception provides an additional basis for reversing an arbitration award where the terms of the arbitration contract, either expressly or as interpreted by the arbitrators, violate public policy....

The Supreme Court, in *United Paperworkers Int'l Union v. Misco, Inc.*, explained the rationale behind the public policy exception:

> [The doctrine of non-enforcement of an arbitration agreement as violative of public policy] is further justified by the observation that the public's interest in confining the scope of private agreements to which it is not a party will go unrepresented unless the judiciary takes account of those interests when it considers whether to enforce such agreements.[71]

When the arbitration agreement or its execution by the arbitrators contravenes public policy, the arbitration agreement or the award should be treated as *void ab initio*.

The obvious question becomes, under the FAA, is there a mandate for the arbitrators to follow the law? Both the author and Professor Brunet[72] think so. Our position is supported by Supreme Court holdings.

The idea that the courts have an obligation to require arbitrators to follow the securities law first appears in the now overruled *Wilko v. Swan*,[73] rejecting arbitration of securities cases. In *Wilko*, the majority stated:

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[70] 22 F.3d 1010, 1012, n. 1 (10th Cir. 1994). The *Bowles* case is of especial interest to investors in NASD arbitration because it held that the disclosure by the investor's attorney of previous offers of settlement made by the broker-dealer, while improper in court proceedings because of the rules of evidence, was *not* improper in arbitration, or against public policy, because the rules of evidence did not apply.

[71] *United Paperworkers Int'l. v. Misco*, 484 U.S. 29, 42, 108 S.Ct. 364, 373 (1987), citing, *Twin City Pipe Line Co. v. Harding Glass Co.*, 283 U.S. 353, 51 S.Ct. 476 (1931), and *McMullen v. Hoffman*, 174 U.S. 649, 19 S.Ct. 839 (1899).

Julius Cohen, the chief proponent of the FAA would agree. In a law review article written shortly after the adoption of the FAA in 1925, stated:

> [Folklore Arbitration] is not the proper method for deciding points of law of major importance, involving constitutional questions or policy in the application of statutes. Speaking generally, it is a proper remedy for the determination of those classes of disputes which arise day to day in common experience of disputants and the individuals to whom the dispute is to be referred.

Julius H. Cohen & Kenneth Dayton, *The New Federal Arbitration Law*, 12 Va. L. Rev. 265, 281 (1926).

Cohen's last point is used by the NASD to justify the requirement that one of the three panel members be from the securities industry. This NASD position, again, indicates that the NASD thinks that industry customs and procedures, which will be known to the industry member, are far more important in deciding the arbitration than rules of law, which the industry member has no special knowledge about.

[72] Brunet at 1474. However, Professor Brunet realizes that the lower courts have, generally, ignored the administration of the Supreme Court that under the FAA the court must protect the statutory rights of the parties. Instead, they continue to follow the "myth of folklore arbitration" decreeing "minimal or no judicial review or protection of statutory rights."

[73] 346 U.S. 427, 74 S.Ct. 182 (1953), *overruled by Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987).

> We agree that in so far as the award in arbitration may be affected by legal requirements, statutes or common law, rather than by considerations of fairness, the provisions of the Securities Act control.[74] This is true even though this proposed agreement has no requirement that the arbitrators follow the law.[75]

Even the dissenters, arguing that securities cases should be subject to arbitration, acknowledge, that if arbitration were allowed, there has to be an implied means for the courts to force the arbitrators to comply with the law. Justice Frankfurter said:

> Arbitrators may not disregard the law. Specifically they are, as Chief Judge Swan pointed out, "bound to decide in accordance with the provisions of section 12(2) [of the Securities Act of 1933]." On this we are all agreed. It is suggested, however, that there is no effective way of assuring obedience by the arbitrators to the governing law. But since their failure to observe this law "would * * * constitute grounds for vacating the award pursuant to section 10 of the Federal Arbitration Act." 201 F.2d 439, 445, appropriate means for judicial scrutiny must be implied, in the form of some record or opinion, however informal, whereby such compliance will appear, or want of it will upset the award.[76]

In *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*,[77] the Court confirmed Its earlier position that, at least in statutory claims, the arbitrators must follow the law, by saying:

> By agreeing to arbitrate a statutory claim, a party does not forgo the substantive rights afforded by the statute; it only submits to their resolution in an arbitral, rather than a judicial, forum.[78]

The issue before the Court in *Mitsubishi* was the enforceability of the arbitration clause itself, not what would happen if the arbitrators were to deny Soler the protection of the American anti-trust laws. If that event occurred, the Court said: "[W]e would have little hesitation in condemning the agreement as against public policy."[79]

Even in *Shearson/American Express, Inc. v. McMahon*, while overruling *Wilko* as to the arbitratibility of statutory claims, the Court recognized the admonition of *Mitsubishi* that, if in the arbitration process, the arbitrators did not follow the law, the courts should overturn the award. It said:

> [W]e have indicated that there is no reason to *assume at the outset that arbitrators will not follow the law; although judicial scrutiny of arbitration awards necessarily is limited, such review is sufficient to ensure that arbitrators comply with the requirements of the statute.* [Emphasis Added.][80]

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[74] [Footnote in the original] See Sturges, Commercial Arbitration and Awards, 500.

[75] 346 U.S. at 433, 74 S.Ct. at 186.

[76] *Id.* at 440, 74 S.Ct. at 189 (Frankfurter, J., dissenting.)

[77] 473 U.S. 614, 105 S.Ct. 3346 (1985).

[78] 473 U.S. at 628, 105 S.Ct. at 3354, subsequently *quoted with approval* in *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26, 111 S.Ct. 1647, 1652 (1991).

[79] *Id.* at 637, n. 19, 105 S.Ct. at 3359, n. 19. [Emphasis added.]

[80] 482 U.S. 220, 232, 107 S.Ct. 2332, 2341 (1987), subsequently *quoted with approval* in *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 32, n. 4, 111 S.Ct. 1647, 1655, n. 4 (1991).

III. Do Statutes of Limitations Apply in NASD Arbitration?

With this background as to the various types of statutes of limitations and arbitration models, it is possible to address the central theme of this article, do statutes of limitations apply in NASD arbitration? The answer to this question lies in which type of statute of limitations is involved and, to a lesser degree, what arbitration model applies to NASD arbitrations.

A. Statutes of Limitations In Folklore Arbitrations

The author submits that, generally, statutes of limitations have no place in folklore arbitration. Therefore, statutes of limitations would have no place in NASD arbitrations, if the industry and SROs are correct that NASD arbitration is folklore arbitration.

1. Type 1 Statutes of Limitations (Garden Variety Statutes)

From the above discussion of the nature of folklore arbitration, it should be clear that Type 1 statutes of limitations have no place in such arbitrations for two reasons. First, as Professor Brunet concludes, folklore arbitrations operate outside the law and are truly alternative dispute resolution systems. The parties have no legal rights or protection under statutes and common law. Decisions are made on what the arbitrators believe to be fair and just, based upon the customs and traditions of the industry involved.[81]

Second, consistent with the first reason, arbitration has always been considered equitable in nature. As outlined above, equity courts have traditionally not considered themselves bound by statutes of limitations as the law courts are.

2. Type 2 Statutes of Limitations (Statutes Limiting Access to Arbitration)

The analysis of Type 2 statutes of limitations in folklore arbitration is a more complicated issue. On a basic level, since arbitrators do not have to follow the law in folklore arbitration, the answer would appear to be that Type 2 statutes of limitations, again, have no place in this type of arbitration.

However, this conclusion may be an oversimplification. Remember that Type 2 statutes of limitations primarily prevent one from enforcing his right to arbitration after the other party has refused. While some courts have held that there is no time limit upon the right to enforce the right to arbitrate, the majority appears to hold that the ability to seek enforcement of this right should be limited.[82] As noted above, there are only two

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[81] There is an important corollary to this conclusion which the industry refuses to recognize, but which the Code and the NASD staff do recognize. In folklore arbitrations, there are no causes of action based on such legal theories as tort, breach of fiduciary duty, or violation of the securities act. There are only facts and a claim for recovery. The normative standard for decision is what the arbitrators decide it is, based on the facts, industry customs and traditions, and their own sense of justice, right, and fair play. Truly, the wild west which Professor Brunet thinks securities arbitration is presently.

As a result, Section 12302 of the New NASD Code carries forward the idea that the initial claim need only provide: "A statement of claim specifying the relevant facts and remedies requested." This language does not require the identification of any legal theories and should prohibit the making of motions for more definite statement or a Rule 12(b)(1) type-motion for failure to plead a cause of action upon which recovery can be granted.

Further, the broker-dealers have long claimed that a violation of an NASD rule is not actionable in arbitration. Linda Feinberg, in her statement quoted earlier, however, disagrees.

[82] *See generally,* Annot., "Which Statute of Limitations Applies to Efforts to Compel Arbitration of a Dispute," 77 ALR 4th 1071 (1989); *Wagner Constr. Co. v. Pacific Mech. Corp.*, 41 Cal. 4th 19, 157 P.3d 1029 (2007)(where no time provided by statute or agreement within a reasonable time).

states, New York[83] and Delaware,[84] with statutes of limitations dealing with the right to compel arbitration. In absence of a specific statute, most courts have turned to the general contract statute of limitations. They argue that the refusal to arbitrate is a simple breach of the arbitration contract. Therefore, the general contract statute of limitations gives the non-breaching party so many years, often six, to bring suit for specific performance of the arbitration agreement. However, the period on starts to run with the refusal to arbitrate.

This variety of Type 2 statute of limitations has no impact upon arbitration because it operates *before the arbitration begins.* If the person seeking arbitration files a motion to compel *before* a Type 2 statute has run, a court will grant an order compelling arbitration. Then, the arbitration then will proceed normally. The Type 2 statute has no impact on the arbitration and will not be considered by the arbitrators. If, on the other hand, the party seeking arbitration brings his action to compel *after* the Type 2 statute has run, the court will *simply* refuse the order to compel. In such case, no arbitration takes place.

The New York[85] and Delaware[86] Type 2 statutes modify the above analysis in three ways. First, rather than allowing an action to be brought within so many years from the date of refusal to arbitrate, these statutes incorporate the Type 1 statute of limitations for the underlying substantive action as the measure of the length of the enforcement period. As a result, the enforcement period will vary according to the type of underlying substantive action.[87] Further, the statute begins to run when the underlying cause of action becomes viable rather than on the date of a refusal to arbitrate.

The New York and Delaware statutes also add another twist. The normal Type 2 statute is offensive only. The plaintiff is seeking to compel arbitration. The New York and Delaware statutes allow the refusing party to use the statute defensively. Once the statutory time period has run, the defendant can go into court and seek an injunction against the filing or continuation of an arbitration action.

The first two modifications do not impact folklore arbitration because they do not require or compel any action by the arbitrators, nor does it have any impact upon them. All action is taken by the judge outside the arbitration setting. Further, the injunction is issued *against the person seeking to force arbitration*, not the arbitrators themselves.[88] Thus, if the arbitration is filed or continued, the arbitrators have not violated the injunction and can proceed with the arbitration. On the other hand, the moving party in the arbitration will have to face the wrath of the judge for violating his order.

The third New York and Delaware modification may have an impact upon the arbitration itself. These statutes allow the refusing party to raise the issue of the bar in the arbitration itself. Under this provision, the arbitrators make the decision whether to bar further proceedings or to continue with the

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[83] NY CPLR, §7502(b).

[84] 10 Del. C., §5702(b).

[85] NY CPLR, §7502(b).

[86] 10 Del. C., §5702(b).

[87] Traditionally, torts, breach of fiduciary duty and fraud have a shorter statutes of limitations than do contract actions.

[88] This approach is partly dictated by the limitations of the judge's in personam jurisdiction. To issue a valid injunction, the judge would have to have in personam jurisdiction over the party seeking arbitration. Having this jurisdiction, he can then punish for the violation of injunction. He may or may not have personal jurisdiction over the arbitrators.

arbitration. However, the draftsmen of the New York and Delaware provisions were aware that, in folklore arbitrations, the arbitrators did not have to follow the dictates of the statute. To accommodate to this reality, the draftsmen made it discretionary with the arbitrators whether to bar or proceed. Further, the arbitrators' decision on this point is made non-reviewable by the New York courts.[89]

3. Type 3 Statutes of Limitations (Statutes of Repose)

If the premise is accepted that in folklore arbitrations the arbitrators have no obligation to follow the law or to require the pleading of causes of action, then it should be apparent that statutes of repose have no place in folklore arbitrations. In folklore arbitrations, the arbitrators should allow recovery for conduct which would have been barred had a suit been filed in court. The conduct is improper whether or not prohibited by statute. While the statute of repose, governing the life of the statutory action will destroy the statutory cause of action, it does not change the fact that the conduct is improper. If the conduct is improper under the customs, practices, or rules of the industry in which the arbitration takes place, arbitrators still have the power to make an award for such conduct. As outlined above, the original reason for arbitration in medieval England among the merchants and guilds, the basis for folklore arbitration, was to avoid a result which would have been reached in the law courts. They believed that such result was inequitable and unjust. Therefore, they wanted to establish a private dispute resolution system which was not tied to the common law.

The following example illustrates the point. A registered representative sells securities away from his broker-dealer. The conduct, however, is not discovered until after five years from the sale of the securities, which, in this example, is the date of violation. This conduct would normally be actionable under Section 509(b) of the new Uniform Securities Act.[90] However, Section 509(j)(2)[91] imposes a five year statute of repose on the cause of action created by Section 509(b). In the above example, the wrongful conduct was not discovered until after five years from the sale. Therefore, no cause of action for the violation may be brought in court.

However, in arbitration, for the conduct to be actionable, it does not have to be a violation of any statutory provision. It need only be a violation of the customs, practices, or rules of the industry. NASD Rule 3040 specifically prohibits "selling away." There is no statute of repose on a violation of Rule 3040.

Therefore, assuming that the arbitrators can not base their award on Section 509(b) of the Uniform Act,[92] the arbitrators may still make an award based upon Rule 3040.

B. Statutes of Limitation in Contract Model Arbitrations

If Professor Brunet and the author are correct that NASD arbitration is not folklore arbitration, but rather contract model arbitration, then the only differences between the application of the various types of statutes of limitation from that discussed above for folklore arbitration are changes imposed by the individual parties, the NASD, or the state and federal governments. As will be seen below, the NASD, as well as the federal government, have imposed restrictions which make a substantial difference in the application of statutes of limitations, or the NASD's private equivalent, in arbitration.

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[89] Quare are the courts of another state, say New Jersey, bound by this non-reviewability provision?

[90] Uniform Securities Act (2002), §509(b).

[91] *Id.* §509(j)(2).

[92] A point that the author is not willing to concede.

1. Type 1 Statutes of Limitations (Garden Variety Statutes)

As seen above, one of the restrictions that the Supreme Court has to impose on securities arbitration as a condition to enforcing arbitration contracts involving securities is *that the arbitrators must follow the law.* This requirement has two potential impacts upon Type 1 statutes of limitations in NASD arbitrations. First, it means that arbitrators must only consider legally identifiable causes of action. For example, the courts have generally held that a violation of an NASD rule is not actionable.[93] Under the mandate that the arbitrators must follow the law, such violation *would also not be actionable* in arbitration, either. Second, statutes of limitations governing underlying substantive causes of action would apply equally in court and in arbitration, the same way that elements of a substantive offense should.

From these two points, it would be natural to *assume* that Type 1 "garden variety" statutes of limitations, while having no application in folklore arbitration, *do apply* in contract model arbitration. As a result, these Type 1 statutes are a valid limitation on the ability to enforce the underlying substantive claims both in court and in arbitration. Many people have made this assumption; *however, they are wrong. The case law makes crystal clear that Type 1 statutes of limitations are not applicable in arbitrations.*[94]

The author's research has found no cases applying Type 1 statutes of limitations to arbitrations.[95] Therefore, the universal rule is not to recognize Type 1 statutes of limitations in arbitration. The position is so well-established that two lower courts have specifically held that arbitrators violated public policy and were in manifest disregard of the law when they applied statutes of limitations in arbitrations.[96]

The basis for this universal rule is two fold. First, as noted above, arbitration has always been considered to be an equitable proceeding. Courts of equity have never considered themselves bound to apply statutes of limitations as the law courts are.

The second reason for not applying statutes of limitations explains the apparent inconsistency between the obligation to follow the law, but not applying statutes of limitations. The arbitrator's obligation is only to follow the law, including statutes of limitations *as written.* Therefore, it must be established whether the Type 1 statute of limitations *as written* apply to both court actions and *arbitrations. The language of most garden variety statutes of limitations speaks in terms of the statute applying only to "actions," "civil actions," or "suits."* The language of most modern pleading codes make clear that arbitrations are not "actions," "civil actions," or "suits." The older case law reached the same conclusion by narrowly defining "civil actions" and treating other court actions,[97] and sometime arbitrations,[98] as

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[93] *See e.g., In re Verifone Sec. Lit.*, 11 F.3d 865, 870 (9th Cir. 1990); *Craighead v. E. F. Hutton & Co., Inc.,* 895 F.2d 485, 493 (6th Cir. 1990); *Brady v. Calgon Sec. (USA)*, 406 F.Supp.2d 307 (S.D.N.Y. 2005).

[94] See Annot., "Statutes of Limitations As a Bar to Arbitration Under Agreement," 94 A.L.R.3d 533 (1979).

[95] The brokerage houses often cite *Shearson Lehman Hutton, Inc. v. Wagoner,* 944 F.2d 114 (2d Cir. 1991) and *Davis v. Skarnulis*, 827 F.Supp. 1305, 1308 (E.D. Mich. 1993), as supporting their claim that the statute of limitations limiting the underlying substantive claim apply in arbitration. Both cases, however, do not address the application issue, but rather who is to make the decision concerning applicability.

[96] *Broom v. Morgan Stanley*, Case No. 06-2-32543-5SEA (Wash. Super. Ct. King County, May 11, 2007) and *Morgan v. Carillon Inv. Co.*, 2005 WL 5533924 (Ariz. Super. Ct., Maricopa County, Sept. 15, 2005).

special proceedings.

The Oklahoma statutes illustrate the current statutory approach. The Oklahoma statute of limitations starts off by saying: "A *civil action* ... can only be brought within the following periods, after the *cause of action* shall have accrued, and not afterwards...."[99] Then the Oklahoma Pleading Code reads: “There shall only be one form of action to be known as ‘civil action.’”[100] Finally, the Pleading Code reads: "A civil action is commenced by filing a petition with the court."[101] An arbitration does not come within the terms of the general Oklahoma statute of limitations because it is not filed in a court and, therefore, is not a civil action.

The older approach was to define a "civil action" action in such a way that an arbitration would not be included.[102] For example, in *Thorgaard Plumbing & Heating Co. v. King County*, the court defined an "action" as follows:

> An *action* is a prosecution *in a court* for the enforcement or protection of private rights and the redress of private wrongs.[103]

Then, all other court,[104] and private proceedings such as arbitrations, were treated as "special actions or proceedings" to which the general statutes of limitations did not apply.[105]

Whichever approach is used, the result is the same. Arbitrations simply are *not* civil actions. Therefore, since the plain language of most general statutes of limitation apply only to civil actions, these statutes of limitations *do not apply.* The following cases illustrate the point.

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[97] *See e.g., Hunt v. State*, 17 Ohio C. D. 16, 1904 WL 576 (Ohio Cir. Ct. Dec. 10, 1904).

[98] *Id.*

[99] 12 Okla. Stat. (2001), §95. [Emphasis Added.]

[100] 12 Okla. Stat. (2001), §2002.

[101] 12 Okla. Stat. (2001), §2003.

[102] Likewise, in contexts other than the statute of limitations, the United States Supreme Court has held that arbitrations are not “actions.” *See McDonald v. City of West Branch, Mich.,* 466 U.S. 284 (1984); *Kremer v. Chem. Const. Corp.*, 456 U.S. 461, 466 (1982).

[103] 71 Wash.2d 126, 426 P.2d 828 (1967). [Citations Omitted.]

[104] *See e.g., Oklahoma City v. Wells*, 185 Okla. 369, 91 P.2d 1077 (1939); *Foley v. Kennedy*, 110 Nev. 1295, 885 P.2d 583 (1994).

In *Schmaling v. Johnston*, 54 Nev. 293, 301, 13 P.2d 1111, 1113 (1932), *aff’d on reh’ing*, 55 Nev. 164, 27 P.2d 1059 (1934), the Nevada court defined a “special proceeding” as:

> [A]ny proceeding in a court which was not under common law and equity practice, either an action at law or a suit in chancery, is a special proceeding.

Quoted with approval in *Foley, supra*. This definition of special proceeding was taken from the California case of *In re Central Irrigation Dist.*, 117 Cal. 382, 49 P. 354, 356 (1897).

In *Salawy v. Ocean Towers Housing Corp.*, 121 Cal.App.4th 664, 17 Cal.Rptr.3d 427 (2004), the Court said:

> The broad definition of action covers the following: 91) suits at law or in equity; (2) certain adversary proceedings that take place during a probate proceeding; (3) actions for declaratory relief; and (4) actions for dissolution of marriage.

[105] *Id.*

In *City of Auburn v. King County*,[106] the Washington Supreme Court summarily rejected the application of statutes of limitations to arbitration, declaring simply:

> "The trial court correctly concluded that *the statute of limitations by its language does not apply to arbitration*. See RCW 4.16.130."[107]

Earlier, this same court had explained in some detail the reasoning for its conclusion:

> An *action* is a prosecution *in a court* for the enforcement or protection of private rights and the redress of private wrongs. ... [B]y using the word "action" in the foregoing section the legislature had a *lawsuit* in mind....
>
> An arbitration proceeding is not had in a court of justice. It is not founded on the filing of a claim or complaint as they are generally understood. The very purpose of arbitration is to *avoid* the courts insofar as the resolution of the dispute is concerned....
>
> While arbitration is similar to a judicial inquiry in that witnesses are called and evidence is considered, the standards of judicial conduct and efficiency to which a panel of arbitrators will be held are markedly different from those resting by law and tradition upon judicial officers. [Citation omitted] The proceeding is in a forum selected by the parties in lieu of a court of justice. The object is to *avoid*, what some feel to be, the formalities, the delay, the expense and vexation of ordinary litigation.[108]

In *Skidmore, Owings & Merrill v. Connecticut Gen. Life Ins. Co.*, the court reached a similar conclusion:

> Arbitration is not a common-law action, and the institution of arbitration proceedings is not the bringing of an action under any of our statutes of limitations. "Arbitration is an arrangement for taking and abiding by the judgment of selected persons in some disputed matter, instead of carrying it to the established tribunals of justice; and it is intended to avoid the formalities, the delay, the expense and vexation of ordinary litigation. When the submission is made a rule of court, the arbitrators are not officers of the court, but are the appointees of the parties, as in cases where there is no rule of court."[109]

Finally, in *NCR Corp. v. CBS Liquor Control, Inc.*,[110] the court also accepted this reasoning:

> Before the arbitrators NCR established that any cause of action by Acme had for unfair competition had accrued by and was known to Acme by 1984. Thus NCR was able to make a forceful argument that these claims were barred by a number of potentially

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[106] 114 Wash.2d 447, 788 P.2d 524 (1990).

[107] Emphasis Added. RCW 4.16.130, cited by the Courts, reads, "An action for relief not hereinbefore provided for, shall be commenced within two years after the cause of action shall have accrued."

[108] *Thorgaard Plumbing & Heating Co. v. King County*, 71 Wash.2d 126, 130-132, 426 P.2d 828 (1967). [Citation and footnotes omitted, but emphasis in the original).

See also Carpenter v. Pomerantz, 634 N.E.2d 587, 589-590 (Mass. App. 1994)("As used in statutes of limitation, the word 'action' has been consistently construed to pertain to court proceedings), citing many cases; *Lewiston Firefighter Assoc. v. City of Lewiston*, 354 A.2d 154, 167 (Me. 1976)("Arbitration is not an action at law and statute [of limitations][is not, therefore, an automatic bar to the Firefighters' recovery.")

[109] 25 Conn. Supp. 76, 84, 197 A.2d 83, 87 (Conn. Super. 1963), cited with approval in *Dayco Corp. v. Fred T. Roberts & Co.*, 192 Conn. 497, 472 A.2d 780 (1984).

> applicable provisions of the New York Civil Practice statute.... However, effect of a statute of limitations is to bar an action at law, not arbitration. See Annotation, "Statute of Limitations as Bar To Arbitration Under Agreement," 94 A.L.R.3d 533, §2 (1997). Had these claims remained pending in the New York Supreme Court, NCR would have had an excellent motion to dismiss the counterclaims as barred by statute. It chose instead to demand the claims be arbitrated.

Likewise, in *Vaubel Farms, Inc. v. Shelby Farmers Mut.*,[111] the court did a similar analysis with the term "suit" and held:

> [W]e hereby adopt the following definition [of "suit"]: "any proceeding by a party or parties against another in a court of law." .... Arbitration, on the other hand, is an adjudicative process carried out outside the established tribunals of justice. We therefore conclude that "suit" refers specifically to established and traditional judicial proceedings, while "arbitration" involves the resolution of disputes by non-traditional means. Because "suit" does not include "arbitration," North Star cannot claim that the two-year limit for suits bars arbitration.[112]

The above outlined overwhelming weight of authority against applying Type 1 statutes of limitations to arbitration has recently led two trial courts in *Broom v. Morgan Stanley*[113] and *Morgan v. Carillon Inv., Inc.*,[114] to vacate NASD arbitrations where the arbitrators applied statutes of limitations in arbitration. In *Broom*, the court vacated the award, holding:

> The Panel incorrectly concluded that plaintiffs' claims were barred by the statute of limitations; however, in Washington, statutes of limitations do not bar a claimant from pursuing a claim submitted to arbitration.

Similarly, in *Morgan*, the court vacated the award and returned the case to a new panel, saying:

> The court determines that statutes of limitations do not apply in arbitration proceedings unless the contract requiring arbitration or the documents comprising the rules of arbitration refer to the application of statutes of limitations. Statutes of limitations apply to actions brought in court. Arbitration agreed to by contract is not an action brought in court. Therefore the basis for the dismissal of Plaintiffs claim in arbitration was not proper.

As the *Morgan* case indicates, the parties may themselves, to the extent that it does not violate public policy, include in their contract a provision which incorporates the Type 1 statute of limitations governing the underlying substantive cause of action.[115] In contract model arbitration, the industry in which the arbitration takes place or the arbitration fora

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[110] 874 F.Supp. 168, 172 (S.D. Ohio 1993).

[111] 679 N.W.2d 407 (Minn. App. 2004).

[112] Citations omitted. Citing the earlier case of *Har-Mar, Inc. v. Thorsen & Thorshov, Inc.*, 300 Minn. 149, 218 N.W.2d 751 (1974). *See also Thompson v. Miller*, 112 Cal.App.4th 327, 4 Cal.Rptr.3d 905 (2003).

[113] Case No. 06-2-32543-5SEA (Wash. Super. Court, King County, Wash. May 11, 2007), a copy of which is in the possession of the author.

[114] 2005 WL 5533924 (Ariz. Super. Ct., Maricopa County, Sept. 15, 2005).

[115] This practice is more commonly done in the case of a Type 2 statute of limitations, limiting the ability to bring an arbitration. As will be seen below, often a Type 2 statute of limitations will incorporate a Type 1 statute to establish the time period in which arbitration can be sought or compelled.

may also adopt a provision making Type 1 statutes of limitations applicable to their arbitrations. The broker-dealers often claim that the NASD has done this in Section 10304 of the old NASD Code of Arbitration and Section 12206(c) of the new Code.

The NASD *has not done so.* Section 10304 and Section 12206(a) establish a private contractual provision, similar to a Type 2 statute of limitations, limiting those claims eligible for arbitration under the NASD Code--the famous "six-year" rule. Then, Section 12206(c) states: "The rule does not extend applicable statutes of limitations."[116] However, a simple reading of the language of the two sections indicates that they *do not incorporate Type 1 statutes of limitation* into NASD arbitrations. Thus, while the NASD has the power to incorporate Type 1 statutes of limitations into its arbitrations, neither Section 1034 of the old Code nor Sections 12206(a)-(c) of the new Code does so.

2. Type 2 Statutes of Limitations (Statutes Limiting Access to Arbitration)

As was seen above, most states do not have a specific statute of limitations dealing with the ability to compel arbitration. In these states, the right to compel arbitration is either open-ended or the contract statute of limitations is used. However, in the latter case, the statute does not begin to run until a party refuses to arbitration on the theory that the refusal is the breach of the agreement to arbitrate. Since the contract statute of limitations is usually quite long, four to six years, the party seeking arbitration often will have a very long period from the date of violation in which to bring his action to compel arbitration.

In order to avoid this long period of uncertainty, as noted above, two states, New York[117] and Delaware[118] have special statutes of limitations dealing with the ability to compel arbitration. Rather than using the contract statute of limitations, these provisions incorporate the Type 1 statute controlling the underlying substantive action as the measure of eligibility. They also start the period from the date of the accrual of the underlying cause of action, rather than the date when the agreement to arbitrate is breached. Further, these statutes give the party refusing arbitration two options: (1) he can seek an injunction against arbitration; or (2) he can raise the issue with the arbitrators. In the latter case, the arbitrators are free to accept or reject the limitation on eligibility, and their decision is non-reviewable by the courts.

Where either the contract statute of limitations or the special eligibility statute is used, in contrast to the case of folklore arbitration discussed above, *these statutes will have application* in contract model arbitration. They are conditions imposed by the sovereign on the right to arbitrate. If these conditions are not met, then the agreement to arbitrate is void as against public policy, and no arbitration can take place.

As with other types of statutes of limitations, under contract model arbitration, the parties, the industry, and arbitration fora have the power by private agreement to impose eligibility requirements for access to arbitration. The NASD, of course, has exercised this power by adopting the "six-year" rule found in the first sentence of Section 10304 of the Old Code of Arbitration and Section 12206(a) of the new Code.[119] Other arbitration fora such as the AAA, have elected not to adopt private eligibility restrictions on access to their arbitration fora.

Section 11206(a) now reads:

> (a) Time Limitation on Submissions of Claims

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[116] Section 10304 reads: “This Rule shall not extend applicable statutes of limitations . . . .”

[117] N.Y., CPLR §7502(b).

[118] 10 Del. C., §5702(b).

> No claim shall be eligible for submission to arbitration under the [NASD Code of Arbitration for Customer Disputes] where six years have elapsed from the occurrence or event giving rise to the claim. The panel will resolve any questions regarding the eligibility under this rule.

Several points need to be made concerning this rule. First, *it is not a statute of limitations.* It is a jurisdictional requirement imposed by private agreement.[120] Nor is it a statute of repose. This latter point is made clear in the new Code by the inclusion of Section 12206(b) which reads:

> (b) Dismissal under Rule
>
> Dismissal of a claim under this rule, does not prohibit a party from pursuing the claim in court. By filing a motion to dismiss under this rule, the moving party agrees that if the panel dismisses a claim under this rule, the non-moving party may withdraw any remaining related claims without prejudice and may pursue all of the claims in court.[121]

Nor does this restriction apply to any alternative arbitration fora because it is imposed by the NASD by private agreement. But most important of all, it does not say anything about incorporating Type 1 statutes of limitations in NASD arbitrations.

The broker-dealers who seek support for their claim that Type 1 statutes of limitations apply in arbitration look instead to Section 12206(c) of the New Code, which reads:

> (c) Effect of Rule on Time Limits for Filing Claim in Court
>
> *This rule does not extend applicable statutes of limitations.* However, where permitted by applicable law, when a claimant files a statement of claim in arbitration, any time limits for the filing of the claim in court will be tolled while NASD retains jurisdiction of the claim.[122]

If the italicized language is taken out of context and without reference to other provisions of section, tortured logic might find some support for the broker-dealers' position. Their argument has to be: Why would this language be included in Section 12206, if it wasn't to indicate that Type 1 statutes of limitations were to be applied in NASD arbitrations?

But this reasoning ignores the language used. There is nothing in the italicized language indicating any incorporation of Type 1 statutes of limitations. The broker-dealers' reasoning also ignores the general setting in which the language is found. Section 12206 is titled "Time Limits." The general rule is stated in Section 12206(a) which is the six-year eligibility rule. Sections 12206(b)-(d) merely explain the ramifications of the six-year rule. Subsection (b) makes clear that Section 12206 is not a Type 3 statute of limitations, a statute of repose. Subsection (c) then indicates that the six-year rule does not impact *applicable* statutes of limitations, be they Type 1, 2, or 3 statutes of limitations. However, it does not attempt to explain *when* a statute of limitations *might be applicable.*

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[119] *Davis v. Skarnulis,* 807 F.Supp. 1305 (E.D. Mich. 1990).

[120] *Id.*

[121] Note that the use of the language "in court" means that there no longer is any obligation to arbitrate. Thus, the broker-dealer can not force the investor into another arbitration fora or before an arbitrator appointed by the court.

[122] Emphasis added. The second sentence of old Code Section 10304 simply read: "This Rule shall not extend applicable statutes of limitations . . . ."

The last Subsection, Subsection (d), merely states in a precatory way,[123] that, local law permitting,[124] it is the intent of the NASD that statutes of limitations applying to court actions should be tolled while the case is before the NASD.

Finally, when Subsection 12206(c) is read as a whole in context with its title, it is clear that the subsection is not intended to incorporate Type 1 statutes of limitations into NASD arbitrations. To begin with, the title of subsection (c) indicates that the subsection has nothing to do with the applicability of statutes of limitations in arbitration. The title reads: "Effect of Rule on Time Limits for Filing Claim in Court." Secondly, the operative language of the first sentence merely indicates that Section 12206 does not extend *applicable* statutes of limitations. Again, no language suggesting any incorporation into arbitration of Type 1 statutes of limitations. What it does do is tell the courts that Section 12206 does not constitute a waiver of the application of statutes of limitations in *court.* Likewise, the operative language of the second sentence is directed toward tolling the statutes of limitations for *court* filing.

The only ambiguity in Subsection (c) is what constitutes an "applicable" statute of limitations. As noted above, the Code does not define the term. Frequently, claims presented to courts will be beyond the Type 1 statute of limitations governing the substantive cause of action.

For example, the original Uniform Act in Section 410(a)(1)[125] created a cause of action for non-registration of the securities or the securities professional. Section 410(e), however, places a two-year statute of limitations on this action, running from the date of sale. Normally, if an action is brought in the third year, a court would dismiss it as barred. However, it is clear that the parties could agree to toll this two-year period. Section 12206(a) provides a six-year period of *eligibility* for such claims to be arbitrated. Without Subsection (c), it could be argued that the parties had agreed to waive the two-year statute until the end of the six-year period in Section 12206(a). Section 12206(c) makes clear that no waiver of the two-year statute in Section 410(e). Thus, the *court* should still dismiss the claim after two years, as Section 12206 was not intended to, and does not impact the court's consideration of the claim.

Similar situations can come up in the case of the New York and Delaware Type 2 statute of limitations. These statutes, as outlined above, allow the party against whom arbitration is sought to seek an injunction against arbitration if the statute of limitations has run on the underlying substantive claim. Delaware (but not New York) has the original Uniform Act, with its two years statute of limitation for non-registration. Thus, in Delaware, if the investor sought to force the brokerage house to arbitrate after two years from the offer or sale of a security, the broker-dealer can get an injunction against the bringing of an NASD arbitration, even though

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[123] The language is merely precatory because the NASD, as a private organization, obviously can not override a state law provision to the contrary. The NASD, however, could have made the tolling binding of the parties before it. The parties can enter into an enforceable agreement to toll the statute of limitations. The NASD could have made such an agreement mandatory as a condition of filing an NASD arbitration. It followed this pattern in subsection (b) dealing with the dismissal of a claim. Why it elected not to do so here is unexplained.

[124] A note to the wise. Counsel need to check the local law on this point because the law varies as to whether tolling takes place. To avoid any problem, the safe thing to do is to file suit before the running of the statute and ask the court to suspend further action on the case until the arbitration is completed. See NASD Code 12209 about the filing of legal proceedings. The language of that Section would not seem to prohibit the practice of filing suit to prevent the running of the statute of limitations.

[125] Unif. Sec. Act (1956), §410(a)(1).

the NASD, without the injunction would entertain[126] the claim for another four years.

The same type of issue can arise in connection with a Type 3 statute of limitations where the statute establishes a statute of repose. Section 509(j)(2) of the new Uniform Act imposes a five-year statute of repose on material omissions and misrepresentations. After 5 years, the court will consider the claim barred as Subsection 12206(c) makes clear that the five-year period is not extended to six years by Subsection 12206(a).

The above analysis is consistent with the limited history of the six year rule. Most of this history is drawn from the writings of Professor Constantine N. Katsoris. Professor Katsoris was a founding member of The Securities Industry Conference on Arbitration ("SICA") in 1977. Professor Katsoris has, on several occasions, pointed out that the language of the first sentence of Section 12206(c) was originally written in the late 1970's and early 1980's *before* the decision in *Shearson/American Express, Inc. v McMahon*,[127] allowing mandatory arbitration in securities actions.[128] Therefore, at the time of adoption, claimant has his choice whether to go to court or to arbitration.[129] He also has stated that the first sentence of Section 12206(c) had nothing to do with arbitrations under the NASD rules, but was merely a statement to the courts that Section 12206 did not extend any applicable statutes of limitation. In Professor Katsoris' words:

> It was never the intent of SICA to invalidate claims by this rule, but merely to articulate that claims over six years old could not be submitted to an SRO forum for arbitration.[130]

3. Type 3 Statutes of Limitations (Statutes of Repose)

The treatment of Type 3 statutes of limitations, statutes of repose, under the contract model of arbitration will be very similar to that of Type 1 discussed above. Since NASD arbitrators in contract model arbitrations are required to follow the law, at first glance, statutes of repose would seem to apply. However, the language of most statutes of repose, like their garden-variety cousins, Type 1 statutes of limitations, refers to “actions,” “causes of action,” or “suits.” As a result, since arbitrations are not any of these things, the arbitrators have no obligation to apply statutes of repose. In fact, under that rationale of *Broom v. Morgan Stanley*[131] and *Morgan v. Carillon Inv., Inc.,*[132] it should also be a violation of public policy and manifest disregard of the law for arbitrators to apply statutes of repose in an NASD arbitration. This is not to say that Type 3 statutes of limitations, like Type 1 statutes, *could not be made to apply in NASD arbitrations.* It means only that neither the states nor the federal government nor the NASD has chosen to give arbitrators the power to apply them. Absent the granting of such authority, arbitrators in contract model arbitration, as in folklore arbitration, exceed

[126] But not necessarily allow the claim to go to judgment as explained below.

[127] 482 U.S. 220, 107 S.Ct. 2332 (1987).

[128] Constantine N. Katsoris, The Betrayal of McMahon, 24 Fordham Urb. L.J. 211, 225, n. 22 (1997).

[129] *Id.*

[130] Constantine N. Katsoris, SICA: The First Twenty Years, 23 Fordham Urb. L.J. 483, 493 (1996). *See also* Constantine N. Katsoris, The Betrayal of McMchon, 24 Fordham Urb. L.J. 211, 225, n. 22 (1997), quoted and discussed in Seth E. Lipner & Joseph C. Long, Securities Arbitration Desk Reference 113, n. 4 (2006).

[131] Case No. 06-2-32543-5SEA (Wash. Super. Court, King County, Wash. May 11, 2007), a copy of which is in the possession of the author.

[132] 2005 WL 5533924 (Ariz. Super. Ct., Maricopa County, Sept. 15, 2005).

their power, if they apply statutes of repose.

CONCLUSION

The discussion has come full circle back to the statement in the new version of the Arbitrator's Manual. This statement that an arbitrator "should also be aware that a statute of limitations may preclude the awarding of damages even though the claim is eligible for submission to arbitration" is technically true, but grossly misleading. In securities terms, it is a material misrepresentation in the form of a half truth. It leaves the impression that the bar of a statute of limitations is a rather common occurrence, when, in fact, as the above discussion indicates, such bar would be very rare indeed. None of the three types of statutes of limitations discussed above apply in folklore arbitration. Yet the brokerage community and the self-regulatory organizations characterize NASD arbitration as being folklore arbitration. Even Professor Brunet recognizes that present NASD arbitration, in practice, is folklore arbitration, resembling "frontier justice" where anything goes.

Even if NASD arbitration is supposed to be contract model arbitration where arbitrators are bound to follow the law as the author and Professor Brunet believe, Type 1 and 3 statutes of limitations have no application. By their own language, these statutes apply only to “actions,” “civil actions,” or “suits,” which arbitrations are clearly not. Only under the Type 2 statutes of limitations found in New York and Delaware, which allow the arbitrators to decide whether an arbitration is barred based upon the Type 1 substantive statute governing, will the arbitrators ever be faced with a situation described by the statement from the Arbitration Manual. Such situation will be faced so rarely, it does not deserve special mention.

It is doubtful that the authors of the Manual statement had the New York or Delaware exception in mind when they wrote the statement. Therefore, it is a grossly inaccurate statement and highly misleading. If such statement had been made in connection with the offer or sale of a security, the person making it would be civilly liable under the securities acts.

Closed-end Fund IPOs

Edward S. O'Neal, PhD

Investment companies in the United States are typically organized as either open-end mutual funds (commonly truncated to "mutual funds") or as closed-end funds.[1] The difference in the two organizational structures is the way investors purchase and redeem shares. Most investment companies are mutual funds.[2] Investors transact directly with the mutual fund distributor, purchasing new shares or redeeming old shares. The number of shares outstanding is dynamic or "open-ended." In contrast, the number of shares of a closed-end fund is static. The investment company does not continually issue or redeem shares. Instead, investors trade shares of closed-end funds on an Exchange just as they would stocks of other types of companies. Once the shares of the closed-end fund are initially brought to market, the offering of new shares is "closed."[3]

Closed-end funds have a Net Asset Value (NAV) just like a mutual fund. However, transactions on the Exchange for closed-end funds occur at the prevailing price of the fund shares, not at the NAV. This price, determined by supply and demand for fund shares, is typically lower than the NAV, and in such circumstances the fund is said to trade at a "discount." At the Initial Public Offering (IPO), the price of closed-end fund shares is set equal to the NAV plus a sales commission of 4% to 5%. Investors who purchase closed-end fund shares at the IPO almost invariably see the price decline relative to the NAV by as much as 5%. This predictable relative price decline, along with the initial sales commission, could be avoided by waiting to purchase fund shares until after the IPO. Advice given to investors to purchase closed-end fund shares at the IPO is suspect. Closed-end fund IPOs appear to be aggressively marketed to retail investors even in the face of predictable inferior performance. This paper discusses the empirical evidence on closed-end fund IPOs in an attempt to educate investors and their counsel.

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I. Discounts on Closed-end Funds

A closed-end mutual fund is a form of investment company. Like its cousin the mutual fund, a closed-end fund is a portfolio of securities. By purchasing shares of the closed-end fund, investors obtain a fractional ownership of the

[1] Exchange Traded Funds and Unit Investment Trusts are also types of investment companies, but are not treated in this paper.

[2] As of year-end 2006, $10.4 trillion was invested in open-end mutual funds versus $298 billion in closed-end funds.

[3] Closed-end funds may have subsequent seasoned offerings of shares, but such offerings are discrete events.

underlying securities portfolio. The closed-end fund has an investment manager just, who, just like a mutual fund, actively manages the portfolio in return for a management fee.

The major distinction between an open-end mutual fund and a closed-end fund is how ownership is transferred. With mutual funds, the fund distributor stands ready to redeem and sell shares of the fund to investors.[4] These redemptions and sales occur at the fund's NAV. The NAV is determined by adding the value of all investments held by the fund and dividing that total value by the number of mutual fund shares outstanding. The NAV for a closed-end fund is calculated in the same way. However, closed-end funds do not redeem or sell additional shares on an ongoing basis. The number of shares in such funds is static. Investors who wish to hold closed-end funds must purchase them on an Exchange just like a stock. The price of closed-end fund shares is, therefore, determined by demand and supply in the market.

One of the most persistent anomalies in modern capital markets has been coined the "closed-end fund puzzle." The puzzle has two parts in which we are interested. The first has a number of explanations:

1. The first is the tendency for the price of closed-end funds in the market to be different from their NAV. Because all of the assets of a closed-end fund are marketable securities that are easily valued, an efficient market should price the closed-end fund shares almost identically to the value of the underlying investments. In reality, most closed-end funds sell at a discount to NAV. The magnitude of the difference between price and NAV for a closed-end fund fluctuates over time and the fund can sell at a premium to NAV. However, in most circumstances, the fund will sell at a discount to NAV.

   Numerous potential explanations for the divergence between price and NAV for closed-end funds have been offered by academic researchers. These explanations fall into one of two camps. The first holds that there are rational explanations for the phenomenon. The second suggests that irrational investor sentiment leads to the existence of discounts in closed-end funds.

   Among the rational explanations for *closed-end fund discounts* is that the expenses charged by the manager actually reduce the value of the fund relative to the underlying holdings. If you, instead, bought all the underlying securities in the same proportions as the fund, you would have a basket of securities that would be priced at the NAV. Holding that same basket within the closed-end fund is less valuable because you must pay the manager each year. Therefore, the basket within the fund is worth something less than the basket outside of the fund.

2. A second explanation for the discount is that by holding the basket within the closed-end fund rather than outside of it, the investor sacrifices the ability to efficiently manage taxes. Therefore, all other things being equal, the value of the holdings *in the fund* is less than the value of the holdings *outside of the fund*.

3. A third explanation is that a closed-end fund is a reasonable organizational form because it allows investors the ability to hold illiquid securities without incurring transactions costs. This explanation suggests that discounts (and premiums) on closed-end funds fluctuate over time

[4] If a fund is closed to new investment, the distributor will still redeem shares, but will not sell additional shares.

with the liquidity of fund holdings.

The most common *irrational explanation* for closed-end fund discounts is investor sentiment. Investors in closed-end funds bear two types of risk: (1) the risk of the underlying securities, and (2) that investor sentiment will change, affecting the demand for closed-end funds and potentially pushing the NAV and price of the fund further apart. The discount (being able to buy the fund more cheaply) compensates investors for this additional investor sentiment risk.

None of these explanations has been proven empirically and the reason for closed-end fund discounts may be a combination of the above factors. Empirical papers that examine these factors typically find some statistical regularities that are consistent with the offered explanations and some regularities that are inconsistent with the explanations. Further academic research may ultimately provide a more concrete answer for why closed-end fund prices diverge from the underlying asset value. Until then, it remains an unresolved issue.

II. Part Two of the Puzzle: Closed-end Fund IPOs

The second part of the closed-end fund puzzle is the behavior of closed-end fund prices after the Initial Public Offering (IPO). This part of the puzzle was thoroughly investigated by Hanley, Lee and Seguin (1996) ten years ago. They wrote:

> "[Information asymmetry] models do not explain the motivation of those who purchase funds that are expected to decline in price. With the typical fund losing 8% of its value over the first 100 trading days, rational investors should wait several months before buying into these securities. Anticipating such behavior, prospective issuers and underwriters would have no incentive to bring these offerings to market. Consequently, in a rational expectations equilibrium, these funds should not get started at all."[5]

The authors attribute the existence of closed-end funds in the face of such poor post-IPO behavior to marketing tactics of brokerage firms and the informational disadvantage of small investors. That is, small investors are being duped by brokerage firms into overpaying in the offerings of closed-end mutual funds.

Material features of closed-end fund IPOs lend credence to the idea that *investors may be uninformed about the prospects of these IPOs and that brokerage firm behavior obscures the workings of the process to the detriment of small investors.* Lead underwriters stabilize the price of closed-end fund IPOs by standing ready to buy shares that are flipped (sold) shortly after issue. This stabilization may last as long as 29 days after the IPO. This stabilization may retard the deterioration in the price that occurs because the underwriting fee ensures that the NAV of the fund will be below the offering price from day one.[6]

Much of the early trading in fund shares is attributable to large investors who are flipping fund shares. During this period, closed-end fund prices change very little, indicating that brokerage firms are supporting prices and buying shares from flippers. After this initial period of flipping, the vast majority of trades are small, indicating that the investors who hang around for the subsequent downward price trend are predominantly small investors.

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[5] From "The Marketing of Closed-end Fund IPOs: Evidence from Transactions Data," 1996, by Hanley, Lee and Seguin, *Journal of Financial Intermediation* 5, 127-159. Quote from page 128.

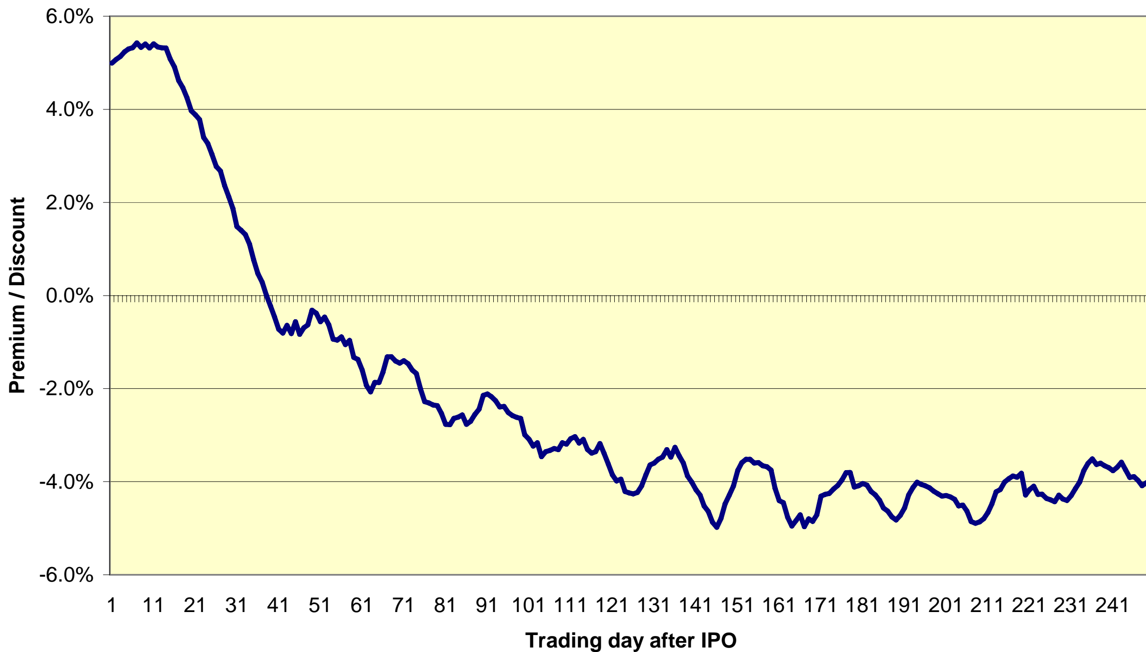
[6] The price of the closed-end fund IPO has the underwriting fee embedded. For example, if a fund has a 5% underwriting fee and the price of fund shares is $20 at the IPO, only $19 goes into the fund, with the remaining 5% going to the underwriters. Therefore only $19 is invested in fund assets and the NAV at that point is $19.

In general, institutional investors hold a far smaller fraction of closed-end funds in the periods after the IPO than traditional industrial IPOs.

III. Recent Closed-end Fund IPO Activity

Over the 30-month period from January 2005 through June 2007, there were approximately 88 closed-end fund IPOs which in aggregate raised of $49 billion.[7] The average underwriting fee on these issues was 4.99%, which translates into $2.45 billion in underwriting fees generated from the issuance of closed-end fund IPOs over that period.[8] Figure 1 shows the evolution of the discount/premium price of closed-end fund shares in the first 250 trading days post-IPO.

Figure 1: Evolution of Closed End Fund Premia and Discounts: First 250 Trading Days



The characteristics of the graph are entirely consistent with previous studies of closed-end funds. The stabilization of immediate post-IPO prices is indicated by the fact that the price, relative to the NAV, remains very stable over the first 15 trading days. The offering price is significantly above the NAV because of the selling concession paid to brokerage firms and brokers. Over the next 30 days, the price of the issue relative to the NAV drops almost monotonically. A more gradual and erratic decay in price to NAV occurs over from approximately day 45 through day 127. At day 127, the average

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[7] This sample of closed-end fund IPOs was drawn from the website of the Closed-end Fund Association of America (CEFA). The website is: closed-endfunds.com. Information on prices and net asset values are collected from Bloomberg.

[8] 4.99% is the average difference between the NAV and the price of the closed-end funds at the end of the first trading day.

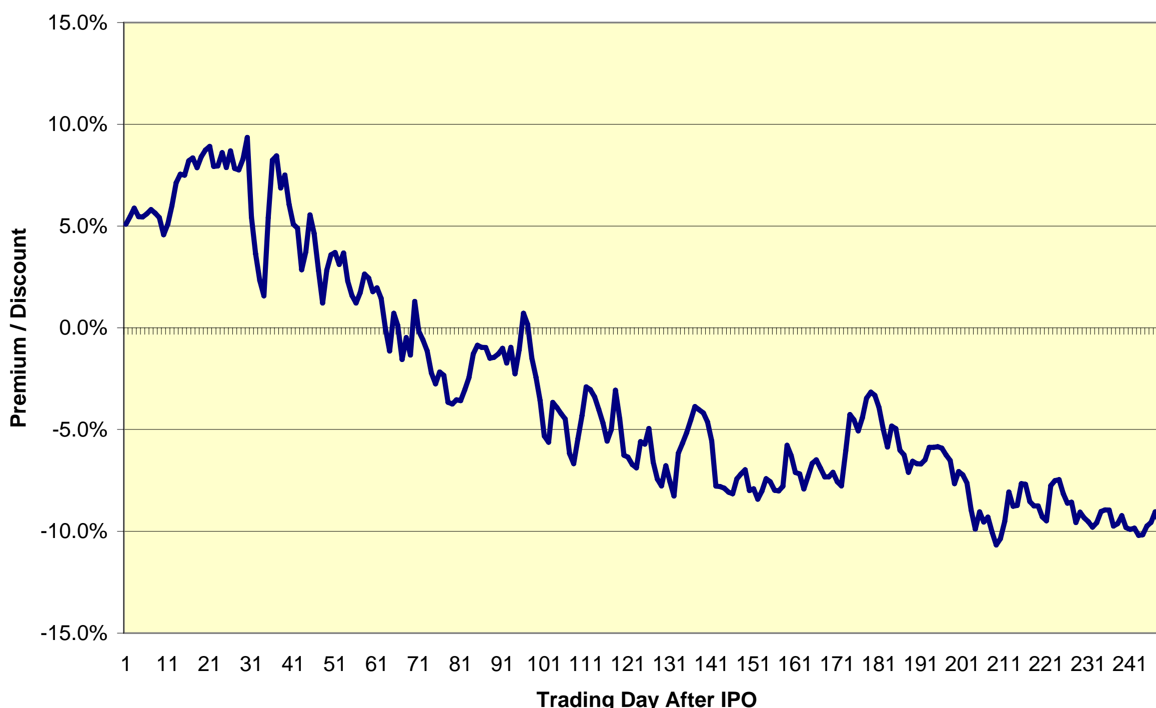
discount in our sample of closed-end funds is -4.2%. Therefore, over the first six months of trading, the price of the average closed-end fund in our sample declines by 9% relative to the NAV, or over $4.5 billion. The $4.5 billion in losses suffered by investors who purchased at or shortly after closed-end fund IPOs are predictable and explain why primarily small retail investors hold shares purchased during the stabilization period. Retail investors purchasing closed-end fund IPOs appear to be misinformed by their brokers about the prospects for such investments.

IV. The Clough Global Opportunities Fund – A Case Study

The Clough Global Opportunities Fund IPO occurred on April 25, 2006 at $20 per share. 47.5 million shares were offered at the $20 initial offering price, which included a sales load of 4.5% ($.90 per share) and additional offering expenses paid by the fund of 0.2% ($.04 per share). After the deduction of the sales load and the offering expenses, $19.06 per share was actually paid into the fund. Therefore, an investor at the IPO paid $20 per share, but the immediate underlying NAV of the fund was $19.06. While the total offering price was $950 million, the net proceeds to the fund were $905.350 million. The remaining $44.650 million were a combination of the sales load and the additional offering expenses.[9]

Figure 2 shows the evolution of the discount of Clough Global Opportunities Fund shares in the 250 trading days after the IPO. The fund started trading at a 5% premium. The premium increased in the immediate aftermarket to as high as 9.3% on the 30th trading day. From there, the premium began to decrease significantly. At day 120, the discount was -6.3%. The discount continued to widen over the subsequent 6 months to -10.4% by the 250th trading day. By June 30, 2007, the discount to NAV was -10.8%.

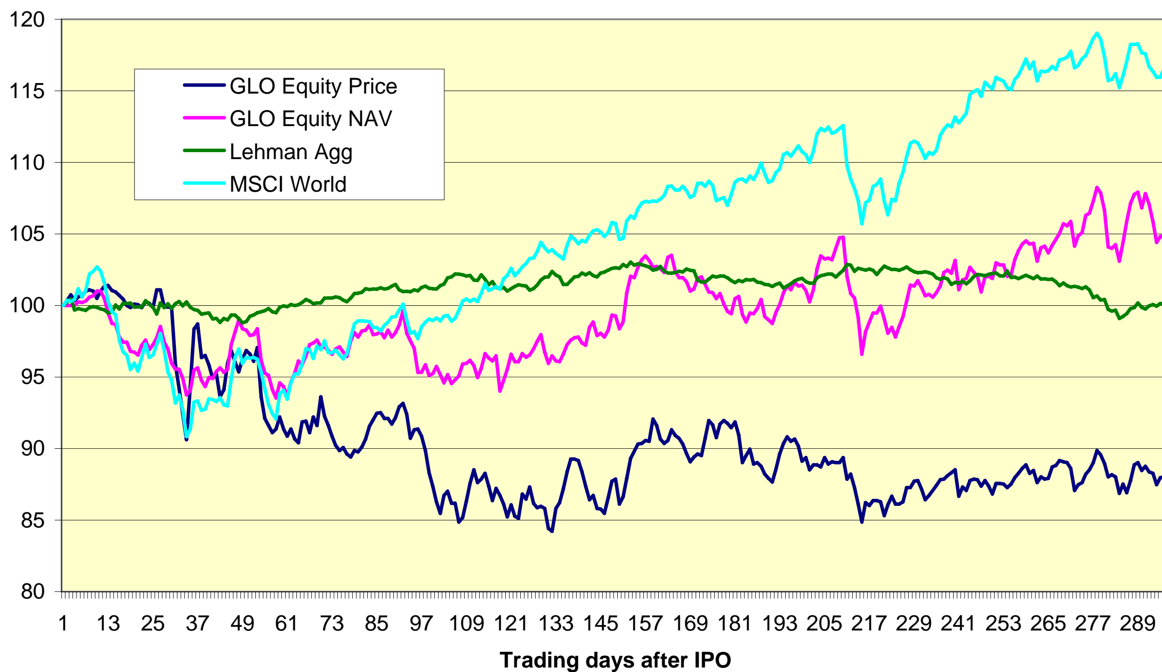
Figure 2: Evolution of Discount on Clough Global Opportunities Fund



Over this period, the price of the fund declined from $20 to approximately $18 per share. The objective of the fund as stated in the prospectus is total return. The fund invests in stocks and fixed income instruments of both US and foreign issuers. Figure 3 shows the performance of the Clough Global Opportunities Fund, the change in the Net Asset Value of the fund and two indexes: the MSCI World Index and the Lehman Aggregate Bond Index.

By June 30, 2007, the price of fund shares had dropped by 10.8%. Over that same period, the NAV of the fund actually rose by 5%.[10] The Lehman Aggregate Bond Index was almost flat over this period, rising just 0.2%. The MSCI World index rose by 17%. It is intuitive that the performance of the underlying assets in the fund, tracked by the NAV of the fund, would be somewhere in between the global stock market index and the broad-based US bond market index, since those asset classes are likely to be strongly represented in this portfolio according to the prospectus. The deterioration in the price of the closed-end fund came even as the value of the underlying securities rose. This price behavior of the fund relative to the underlying assets is characteristic of closed-end funds in general.

Figure 3: Performance of Clough Global Opportunity Fund Shares vs. NAV, Lehman Aggregate Bond Index and MSCI World Index



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[9] Offering details are gathered from the prospectus available at http://www.sec.gov/Archives/edgar/data/1350869/000104746906005576/a2168239zn-2a.htm

[10] It may seem strange that the discount to NAV at June 30, 2007 is -10.8%, but that the fund price dropped by 10.8% while fund NAV actually rose by 5%. This would suggest that the discount would be closer to 15% than to 10%. However, recall that due to the sales load, the price of the fund started out at a 5% premium to NAV.

IV. Conclusion

The price behavior of the Clough Global Opportunities closed-end fund is not unique. In fact, it is the rule rather than the exception. It has been well-documented for at least the past 10 years that *closed-end funds are brought to the market at a premium to NAV and that this premium erodes over the ensuing 6 to 12 months.* Investors at the IPO, if they were informed of this regularity of closed-end fund price behavior, would not purchase closed-end funds at the IPO since *they will lose nearly 10% in the first six months* compared to a seasoned closed-end fund or an open-end fund holding similar securities. Rather, if they were inclined to hold a portfolio of the underlying assets of the fund, *investors should wait* until the highly predictable erosion of fund price relative to NAV before purchasing shares.

Those who invested in the Clough Global Opportunities fund IPO lost nearly $90 million as a result of buying shares at the IPO. Investors in the 88 IPOs between January 2005 and June 2007 lost over $4.5 billion. It is not the underlying portfolio that caused the losses, but: (1) the structure of the closed-end fund product and (2) the high selling concession that accompanies the purchase of the fund at the IPO. Informed investors could avoid the selling concession and the erosion to discount of fund shares by waiting until the fund has seasoned. [11]

[11] Investors who purchase after the IPO would pay commissions on par with what they pay to purchase any stock from their brokerage firm.

A CMO Primer: The Law of Conservation of Structured Securities Risk

Craig McCann, Ph.D., CFA

The collapse of Brookstreet Securities and the bailout of two Bear Stearns hedge funds on the brink of collapse have focused attention on collateralized mortgage obligations ("CMOs").[1] The collapse of the subprime lending market, lax loan underwriting standards and misleading credit ratings have combined to cause dramatic investor losses in 2007. These recent CMO losses closely parallel earlier CMO losses. In 1994, a significant increase in interest rates and misleading interest rate risk disclosure caused many bond mutual funds to fall in value far more than expected. These funds had invested heavily in CMOs, for which the funds' simplistic interest rate risk disclosure was misleading. Today's CMO losses resulted from the relatively recent introduction of CMOs with substantial credit risk and the inadequate or misleading way in which that credit risk was disclosed. This article provides a selective history and a brief description of CMOs in an effort to enable practitioners to evaluate the merits of a potential CMO case.

Introduction

Prior to the 1980s, homeowners applied to their local savings and loan, bank or mortgage company for a loan to purchase or refinance a home. The lending institution would assess the terms of the loan, the borrower's creditworthiness and the value of collateral. If the institution extended a loan, the homeowner would make monthly principal and interest payments through a "servicer" which could be a department of the lender or an independent company that specialized in bookkeeping for mortgages. If the homeowner was late, the servicer would pester him and if the borrower ultimately defaulted the lender would foreclose.

There was accountability in this framework. If a borrower defaulted, the lending institution's shareholders suffered. Shareholders could hold bank managers and lending officers accountable for mismanagement and had good incentives to do so. As a result of so-called *innovations* in mortgage financing and securitization, accountability has been diffused and dramatically reduced. Potential liability for the sale of these products to investors has not lessened, however.

Agency Mortgage Pass-Through Securities

In the 1980s, Fannie Mae and Freddie Mac – private companies sponsored by the Federal government – bought qualified mortgage loans from lenders and used the mortgages as collateral to issue pro-rata interests in pools of

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[1] "Brookstreet to Liquidate Positions After Margin Call From Fidelity Unit" *The Wall Street Journal*, June 22, 2007; "$3.2 Billion Move by bear Stearns to Rescue Fund", *The New York Times*, June 23, 2007.

mortgages. An investor in these newly issued "agency" mortgage pass-through securities or mortgage backed securities ("MBS") received a pro-rate share of the periodic interest and principal payments made by borrowers on an underlying pool of mortgages, after the payment of a servicing charge.

Agency pass-through securities made investing in mortgages much more attractive to investors by eliminating credit risk. Investors received timely interest and principal payments whether or not borrowers made their monthly payments in a timely fashion.[2] Agency pass-though securities thus *expanded* the available mortgage funding, *lowered* mortgage interest rates and *increased* home ownership.

Prepayment Risk

Despite being free of credit risk, agency pass-through securities had significant interest rate risk. Pass-through securities' interest risk is similar to the interest risk in ordinary bonds but is amplified by borrowers' ability to prepay their mortgages.[3] On average, mortgages are paid off well before their stated maturity. For example, 30-year mortgages are paid off on average after only 16 or 18 years at typical prepayment rates.

When interest rates fall, homeowners refinance, paying off their mortgages either: (a) to take advantage of the lower interest rates available compared to when the mortgages were first taken out or (b) to move up since monthly payments on the next size/quality home up is now more affordable. These accelerated prepayments harm investors because the investor must reinvest principal, received earlier than expected, at lower currently available re-investment rates. On the other hand, when interest rates rise, mortgage prepayments come in slower than initially expected. These reduced prepayments harm investors because the investor is not able to reinvest as much principal at the new, higher, current interest rates as had been anticipated before interest rates rose.

The fraction of a pool of mortgages which will prepay in any period – known as *the prepayment speed* – can be estimated as a function of characteristics of the mortgages in the pool such as the average age and average coupon rate of the mortgages. Prepayment speeds are usually quoted as a percent of the Public Securities Association ("PSA") standard assumptions. Changes in interest rates are the primary determinants of changes in prepayment speeds.

Figure 1 illustrates the impact of prepayment speeds equal to 100%, 200% and 300% of PSA on the annual payments of principal and interest from a $300 million pool of 30-year mortgages.[4]

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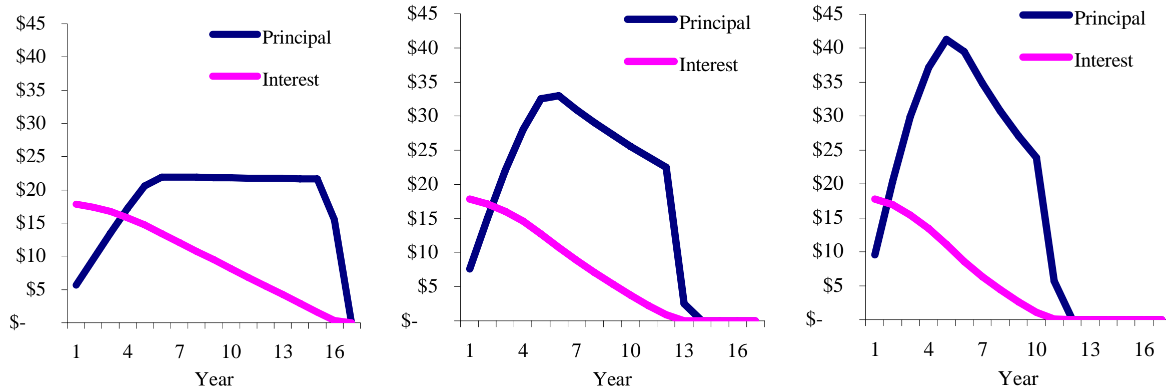
[2] Fannie Mae and Freddie Mac guaranteed timely payment of principal and interest on their pass-through securities. Ginnie Mae – a Federal government agency – guarantees timely principal and interest payments on privately issued pass-through securities backed by FHA and VA loans.

[3] The price of a fixed coupon bond increases when interest rates fall because bondholders continue to receive the fixed coupon rate which is now above market. Unless the bond is callable, a corporate issuer would have to pay investors more than par to redeem bonds and stop paying the above market coupon rate.

[4] Prepayment speeds are quoted as a percent of the Public Securities Association ("PSA") base assumption. The PSA base assumes that monthly prepayments increase linearly from 0% to 6% over the first 60 months and then remains at 6% per month until the mortgages are assumed to be paid off.

Figure 1
Annual Principal and Interest Payments by Prepayment Speed

100% PSA 200%PSA 300% PSA



The impact of changes in interest rates and resulting changes in prepayment speeds on the value of a mortgage pass-through security can be readily estimated. The cash flows from a pool of mortgages can be forecasted for a given prepayment speed assumption and then discounted at a credit spread above the Treasury yield curve that equates the present value of the cash flows to the market price of the security. Changes in prepayment speed and yield curve assumptions generate alternative discounted cash flow values, allowing the analyst to evaluate the sensitivity of the mortgage pass-through security to interest rates and prepayment speeds.

Collateralized Mortgage Obligations Circa 1994

Pass-through securities were not attractive to some investors because they had more risk – especially prepayment risk - than non-callable coupon bonds. Financial engineers knew that the cash flows coming out of a pool of mortgages didn't have to be paid out in the strictly pro rata fashion of pass-through securities. As long as every dollar of principal and interest paid on the mortgages after servicing costs – but not a dollar more – was allocated to a security holder, each pool of mortgages, however homogenous, could support a wide variety of complex structured securities.[5]

The customized classes of CMOs have been referred to as *tranches* after the French word for "slice". Tranches in early CMO deals were typically sequential-pay securities. That is, principal payments would be applied to tranches sequentially with lower priority tranches to receive principal payments only after higher priority tranches' principal balances are paid off.

Redistributing Risk

Planned amortization classes ("PACs") were designed to have stable maturities and cash flows over a broad range of prepayment speeds. Principal and interest payments on the underlying mortgages were allocated to meeting the principal amortization schedules and interest obligations of the PACs. Any principal payments in excess of what was required for the PACs would be allocated to the "support" tranches. PACs could therefore be designed to look exactly like a Treasury security with fixed cash flows and no credit risk.

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[5] Financial marketers knew that if they could structure securities so that unsophisticated investors would buy the securities with high concentrations of interest rate and prepayment risk, the low risk securities would sell themselves.

Since all classes in a deal collectively had the prepayment risk of the underlying pool of mortgages and the PACs had little or no prepayment risk, the remaining securities bore a concentrated amount of prepayment risk. The more protected the PACs in a CMO deal were from prepayment risk and the bigger these PAC classes were, the more concentrated the prepayment risk borne by the support classes.

CMO classes were also created to redistribute interest rate risk. Floating rate CMOs ("floaters") are CMOs whose coupon rates fluctuate up and down with a specific indicative interest rate – typically LIBOR. Floating rate notes were attractive to buyers because they had virtually no interest rate risk. The coupon rates paid on the underlying mortgages were almost always fixed, so if there was a floating rate class, there invariably had to be a roughly equivalent size class whose coupon rates moved up and down in the opposite direction as interest rates. Since floating rate bonds have no interest rate risk, the offsetting "inverse floaters" had roughly twice the risk of a fixed rate bond.

Issuers could issue much larger floating rate classes if they added leverage to the inverse floaters, making their coupons change by a multiple as high as six or eight times the change in the reference interest rate. For example, $20 million in inverse floating notes could offset $100 million in floating rate notes if the inverse floater had a coupon that adjusted five times the change in the reference interest rate. These leveraged inverse floaters had as much as ten times the interest rate risk as an ordinary bond with the same stated maturity and duration[6] and were the source of much of the CMO losses in 1994.

Issuers also created classes of securities that only received payments of interest ("IO strips") or received only payments of principal ("PO strips") on the underlying mortgages. These IO and PO strips had highly unstable market values and were therefore extremely risky. If interest rates fell after an investor purchased an IO strip, the underlying mortgage loans would pay off more rapidly than expected and the IO strip would stop making payments earlier than had been anticipated. While IO investors lost when interest rates fell, PO investors gained since they would receive their cash flows from principal payments earlier than expected. If interest rates increased, IO investors gained and PO investors lost as the mortgages returned principal to PO investors more slowly and continued to make interest payments longer than expected.

The Law of Conservation of Mass Applies to Structured Securities

Mortgages have interest rate risk, prepayment risk and credit risk because of the behavior of borrowers and the features of the mortgages. A pool of mortgages has the average interest rate risk, prepayment risk and credit risk of the individual mortgages in the pool just as surely as it has their average coupon rate and average maturity. If investors purchase 1/100th interests in a pool of mortgages, the owner of each interest bears the same interest rate risk, prepayment risk and credit risk as the owners of the other interests and collectively they own all the risks of the entire portfolio. This principle is so fundamental to understanding mortgage-backed securities that I think it warrants being called *The Law of Conservation of Structured Securities Risk*. When issuers created CMO classes that had less than a pro rata amount of interest rate or prepayment risk, they had

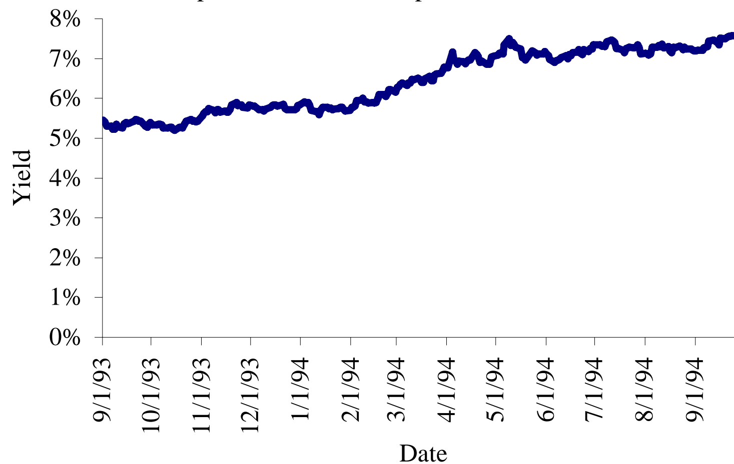
[6] Duration is a measure of interest rate risk. Roughly speaking a bond's price will move in the opposite direction as changes in interest rates in proportion to the bond's duration. For example, if the yield on a bond with a duration of 6 increases 0.5%, say from 6.0% to 6.5%, the bond's price will fall 3% (i.e. 6 * 0.5% = 3%). Duration and related concepts are explained in the Appendix.

to include in the same deals classes with more interest rate risk or prepayment risk than average in the underlying mortgages.

The Reckoning

Interest rates rose repeatedly in late 1993 and early 1994. The average yield on ten year Treasury securities increased almost 1.5% from 5.62% during the fourth quarter of 1993 to 6.08% during the first quarter of 2004 and to 7.08% during the second quarter of 2004. *See* Figure 2.

Figure 2
Yields on 10-Year Constant Maturity Treasuries
September 1, 1993 – September 30, 1994



Piper Jaffray's Institutional Government Income Fund ("PJIGX") and Fundamental Portfolio Advisors' ("FPA") Fundamental U.S. Government Strategic Income Fund are two prominent examples of bond mutual funds whose net asset values dropped significantly more in response to increases in interest rates than they should have given the funds' risk disclosures. This roughly 150 basis point[7] increase in interest rates in 1994 could be expected to cause bonds and bond mutual funds to drop in value with longer maturity bonds falling more than shorter maturity bonds. Intermediate term bond funds like the Piper Jaffray and FPA funds should have lost about 5% of their value as a result of the increase in interest rates illustrated in Figure 2.

Piper Jaffray marketed its Institutional Government Income Fund ("PJIGX") to investors who wanted to invest in short and intermediate term fixed-income securities issued by the U.S. government and government agencies.[8] Over time, Piper Jaffray significantly deviated from its stated investment policy, investing substantially all its portfolio in CMOs by 1993 and leveraging up this portfolio with repurchase agreements.[9] The securities PJIGX loaded up on were extraordinarily risky leveraged inverse floaters. These inverse floaters were

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[7] 100 basis points = 1%.

[8] In the Matter of Piper Capital Management, Inc., Marijo A. Goldstein, Robert H. Nelson, Amy K. Johnson, and Molly Destro, Securities Act of 1933 Release No. 8276, August 26, 2003 available at http://www.sec.gov/litigation/opinions/33-8276.htm.

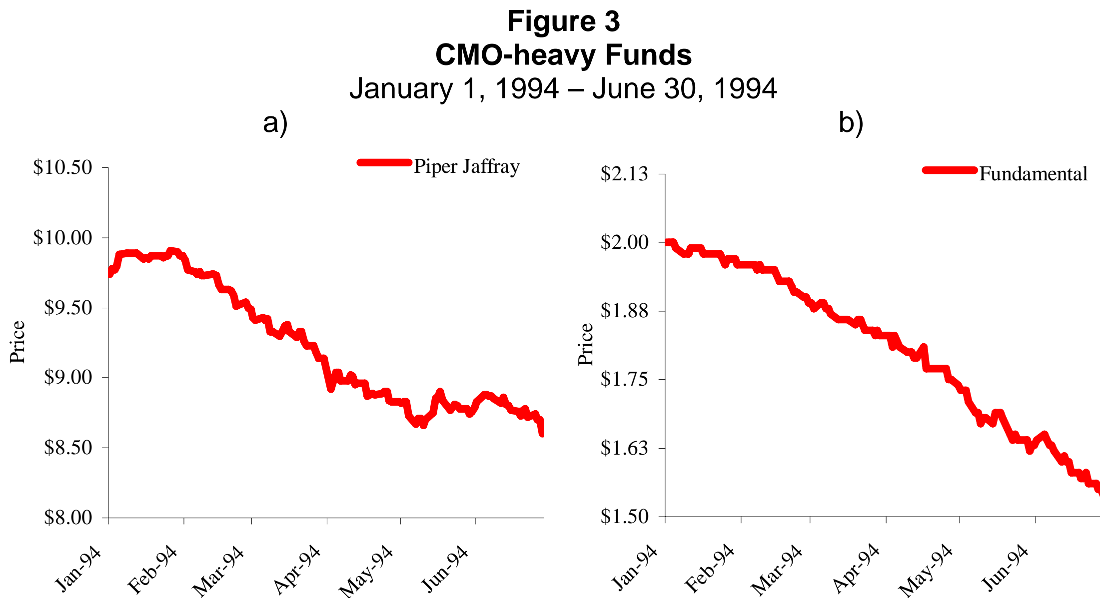
[9] Hedge fund Askin Capital Management imploded in 1994 because it made a leveraged bet on these highly interest-rate sensitive mortgage-backed securities. See "Investment Funds Are Liquidated", *The New York Times*, April 1, 1994.

especially poorly described by the fund characteristics Piper Jaffray reported to investors. As interest rates rose in 1994, PJIGX's net asset value plummeted well beyond what a true portfolio of short and intermediate term government bonds would have declined.[10]

FPA sold its Fundamental U.S. Government Strategic Income Fund as a safe investment for conservative investors wishing to invest in high quality, short and intermediate term government securities.[11] FPA claimed to limit the volatility of the fund's NAV due to interest rate fluctuations by maintaining a duration of three years. This is roughly the interest rate risk of a portfolio of five year Treasury securities. The fund languished in the bottom half of its Lipper and Morningstar peer groups during its first year in existence, so its assets under management grew slowly.

Knowing the only way to attract significant investor cash was to vault into the top tier of its peer group, FPA copied Piper Jaffray's strategy and started buying significant amounts of inverse floaters in May 1993. Despite the significant increase in interest rate risk that the inverse floaters brought with them, the fund falsely continued to tout its low-risk investment strategy. By year end 1993, the fund was outperforming its peer group and attracting a significant number of new investors. When interest rates rose in late 1993 and early 1994, the fund's undisclosed risks resulted in dramatically lower NAVs than should have occurred given its claimed sensitivity to interest rates. *See* Figure 3.

Figure 3
CMO-heavy Funds
January 1, 1994 – June 30, 1994



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[10] PJIGX's NAV fell in part because of the undisclosed interest rate risk in its portfolio and in part because of undisclosed liquidity risk. CMOs are not thickly traded and prices are approximations at best of what could be realized. Some of the prices Piper used to report its NAV had become stale in March 1993. The crisis at PJIGX became apparent with the coincidental failure of Askin Capital management when fresh prices turned out to be much lower than Piper had been reporting.

[11] In the Matter of Fundamental Portfolio Advisors, Inc., Lance M. Brofman, and Fundamental Service Corporation, Securities Act of 1933 Release No. 8251, July 15, 2003 available at www.sec.gov/litigation/opinions/33-8251.htm.

Private Label CMOs

The CMOs featured in this brief history so far were all agency CMOs. That is, they had interest rate and prepayment rate risk from the underlying pool of mortgages but no credit risk. *Recent CMO losses have occurred because of the development of "private label" CMOs which have significant credit risk.* Pass-through securities have many of the same features as agency securities but don't benefit from the agency securities' expressed or implied US Treasury guarantees. This credit risk, like the interest rate and prepayment risk in the 1994 CMOs, has not been adequately disclosed by the metrics used in CMO prospectuses.

CMOs are in the news today largely because of the spectacular failure of the subprime lending industry. Underwriters such as CSFB and subprime lenders such as Oakwood Mortgage Investors significantly expanded the borrowing of poor credit quality borrowers by bundling subprime mortgages into pools, carving the pools up into many smaller securities, obtaining investment grade ratings from Moody's and S&P, and then selling the securities as low risk. This was followed by a fall in housing prices and mortgage defaults.

OMI Trust 2001-E B-1

The $171,660,148 OMI Trust 2001-E [12] deal sold by Oakwood Mortgage Investors in November 2001 is a great illustration of the complex structure and targeted abuse in the private label CMO market. These securities were not worth $172 million when issued and the losses suffered by the lowest priority tranches were completely predictable. Figure 4 lists the securities offered to the public in the deal.

Figure 4
OMI 2001-E
Senior/Subordinated Pass-Through Certificates
Oakwood Mortgage Investors, Inc.

Class	Principal Amount	Offering Market Value	Coupon	Original WAL	Moody's	S&P
A-1	$39,400,000	$39,380,064	LIBOR + 0.30%	1.02	Aaa	AAA
A-2	$34,300,000	$34,291,932	5.05%	3.01	Aaa	AAA
A-3	$10,500,000	$10,498,668	5.69%	4.60	Aaa	AAA
A-4	$36,287,000	$36,274,186	6.81%	10.49	Aaa	AAA
A-IO	$57,400,000[13]	$16,346,348	6.00%	5.08	Aaa	AAA
M-1	$16,352,000	$12,905,547	7.56%	9.81	Aa3	AA
M-2	$12,909,000	$13,881,426	8.76%	9.81	A3	A
B-1	$9,467,000	$8,081,978	7.50%	9.74	Baa3	BBB
Total	$159,215,000	$171,660,148				

The B-1 tranche in this deal and other similar lowly ranked tranches from other deals were sold to elderly investors in southern California as safe substitutes for bank CDs. These investors were falsely told that the CMOs would provide high yields and that their principal was safe.[14]

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[12] http://www.sec.gov/Archives/edgar/data/929541/000095010901505486/d424b5.htm

[13] The A-IO strip had a $57.4 million notional principal amount which is not included in the total at the bottom of the column. The notional principal is the amount against which the inerest rate is applied to yield the interest payment due on the IO strip.

[14] ; "Mortgage Bets Trip Up Main Street Investors – And a Group of Nuns" *The Wall Street Journal*, July 14, 2007.

The assets in the OMI 2001-E Trust were predominantly subprime mortgages on manufactured homes. Many of the mortgages were on homes that had been previously repossessed; most were on the homes, but not on the land beneath them. Many of the loans were already delinquent or likely to become delinquent. They had an average remaining stated maturity of 26 or 27 years and carried an average mortgage interest rate around 10.5%. The home borrowers whose mortgage notes backed these CMOs were among the worst credit risks in the market place.

The prospectus describes the collateral as:

- manufactured housing installment sales contracts secured by interests in manufactured homes and, in some cases, by liens on the real estate on which the manufactured homes are located,
- mortgage loans secured by first liens on the real estate on which manufactured homes are permanently affixed, and
- cash in the pre-funding account.[15]

And among the risk factors listed in the prospectus were:

- **You May Experience A Loss On Your Investment If Losses And Delinquencies On Assets In The Trust Are High**
  Manufactured housing usually depreciates in value. Over time, the market values of the manufactured homes could be less than the amount of the loans they secure. This may cause delinquencies and may increase the amount of loss following default. In this event, your trust may not be able to recover the full amount owed, which may result in a loss on your certificates. ...
- **Losses Will Affect Subordinated Certificates Before Affecting More Senior Certificates**
  The class M-1, M-2 and class B-1 certificates are subordinated to the class A certificates. Losses in excess of the credit support provided by the class B-2, class X, and class R certificates will be experienced first by the class B-1 certificates, second by the class M-2 certificates, and next by the class M-1 certificates. ...[16]

As discussed above, the average credit quality of the securities backed by a pool of mortgages will have the same or lower than the average credit quality of the underlying mortgages unless the issuer has purchased meaningful credit insurance or has over-collateralized the securities. There was no credit insurance or over-collateralization in OMI 2001-E, despite the prospectus's claimed over-collateralization. The trust's assets totaled $172,159,171 or about 8% more than the eight securities' $159,215,000 principal listed in Figure 4. These eight securities were sold to the public at or shortly after the offering for $171,660,148. In addition to these eight securities, the collateral supported payments to the B-2, R and X classes not offered to the public and the servicer, Oakwood Acceptance, expected to take approximately 5% of the present value of any cash flows as a result of its 1% annual servicing charge. Thus there was no over-collateralization in this deal.

Without credit insurance or over-collateralization, the average credit quality of the tranches had to equal the subprime borrowers' credit quality. Yet, 76% of the tranches by market value were rated Aaa/AAA, 10% were rated Aa3/AA, 8% A3/A and the remaining 6% were rated Baa3/BBB

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[15] Page S-2.

[16] Page S-5.

by Moody's and S&P. Thus, Oakwood took $172 million worth of subprime paper backed by installment sales contracts on mobile homes, subtracted value and sold $172 million of "investment grade" securities.

The B-1 tranche was the riskiest of the securities offered to the public in this deal. The classes received principal sequentially with each class receiving principal payments only after all the higher ranked classes were paid off. The B-1 class would therefore not receive any principal payments until A-1, A-2, A-3, A-4, M-1, and M-2 were completely paid off. In addition to concentrating the interest rate risk on the B-1 class, this sequencing meant that B-1 provided credit support for all the higher ranked classes. Thus, the B-1 securities had much more credit risk than the subprime mortgages, which already had a high probability of default.

Not All Investors Are Equal

Not all investors who are sold CMO tranches – even in a deal like OMI 2001-E – are being taken advantage of. In fact, these deals were structured so that sophisticated investors received significantly higher risk-adjusted expected returns than they could find elsewhere. Unfortunately, these higher risk-adjusted returns to sophisticated investors were a wealth transfer from unsophisticated investors who bought the lower tranches like the B-1 tranche in our example.

Figure 5 lists the average yields to maturity on corporate bonds of different credit qualities and maturities when OMI 2001-E was issued on November 30, 2001. At 100% MHP[17], investors who bought the A-2 tranche would have their principal substantially paid off after four or five years. They received a 5.05% coupon, roughly 50 basis points more than they would have received on a four year or five year AAA corporate bond. Investors who bought the A-3 tranche likewise got approximately 50 basis points more than a AAA corporate bond with comparable cash flow timing.

Figure 5
Corporate Bond Yields
November 30, 2001

	1 Year	3 Year	5 Year	10 Year	20 Year	30 Year
AAA	2.54%	3.92%	4.78%	5.66%	6.26%	6.20%
AA	2.88%	4.50%	5.27%	6.14%	6.76%	6.69%
A	3.14%	4.83%	5.57%	6.46%	7.07%	7.01%
BBB	3.79%	5.40%	6.11%	7.06%	7.89%	7.77%
BB	6.24%	7.58%	8.20%	8.92%	9.66%	9.59%
B	7.83%	9.33%	10.11%	11.00%	11.64%	11.67%

Investors who bought the top-tier tranches received higher returns than they could earn on AAA corporate bonds and were shielded from the interest rate risk, prepayment risk and credit risk by investors who bought the B-1 tranches. The B-1 tranche was not expected to be substantially paid off until after about ten years. B-rated, ten-year corporate bonds were paying 11% on November 30, 2001. B-1 tranche investors on the other hand were exposed to far greater risks than investors in B-rated corporate bonds and

[17] MHP is the base prepayment speed assumption for manufactured housing. It equals 3.7% per annum of the outstanding principal in the first month, increasing 0.1% per month for 24 months and then constant at 6.0% per annum until the mortgages are paid off. Base MHP therefore assumes more rapid pay down of principal than base PSA.

were given a coupon of 7.5%. OMI 2001-E and many other CMO deals transferred wealth from unsophisticated investors to investment banks, mortgage lenders, ratings agencies and sophisticated investors.

Conclusion

Current CMO losses have been attributed almost exclusively to the credit losses in subprime mortgages as a result of the simultaneous increase in interest rates and slowing of home price appreciation. This attribution is too superficial and too convenient.

The 1994 CMO losses illustrated how CMOs with substantial interest rate risk can be misrepresented to have little interest rate risk and sold to unsophisticated investors. The ability of investment banks and mortgage lenders with the help of ratings agencies to sell high risk securities to unsophisticated investors allowed them to put together deals that were attractive to sophisticated investors.[18] OMI 2001-E and many other CMO deals transferred wealth from unsophisticated investors to sophisticated investors, investment banks, mortgage lenders and ratings agencies.

Appendix

Duration

Piper Jaffray and FPA got into trouble in part because they misled investors about the interest rate risk in their CMO-laden portfolios. These advisors reported a measure of interest rate risk – duration – which is adequate for simple coupon bonds but which was wholly inadequate for CMOs. Of course, the funds' intentional understatement of risk made their returns in the early 1990s look extraordinary on a risk adjusted basis and caused investors to pour hundreds of millions of dollar into these hot funds.

Duration is equal to the weighted average time until the bondholder receives the remaining coupon interest and principal payments. Duration is measured in years like maturity but is less than maturity unless the bond is a zero coupon bond in which case the duration is equal to the maturity.

$$Duration = \sum_{i=0}^{T} w_i \times i = \sum_{i=0}^{T} \left(\frac{\frac{CF_i}{(1+ytm)^i}}{P_t} \right) \times i = \sum_{i=0}^{T} \left(\frac{\frac{CF_i}{(1+ytm)^i}}{\sum_{i=0}^{T} \frac{CF_i}{(1+ytm)^i}} \right) \times i$$

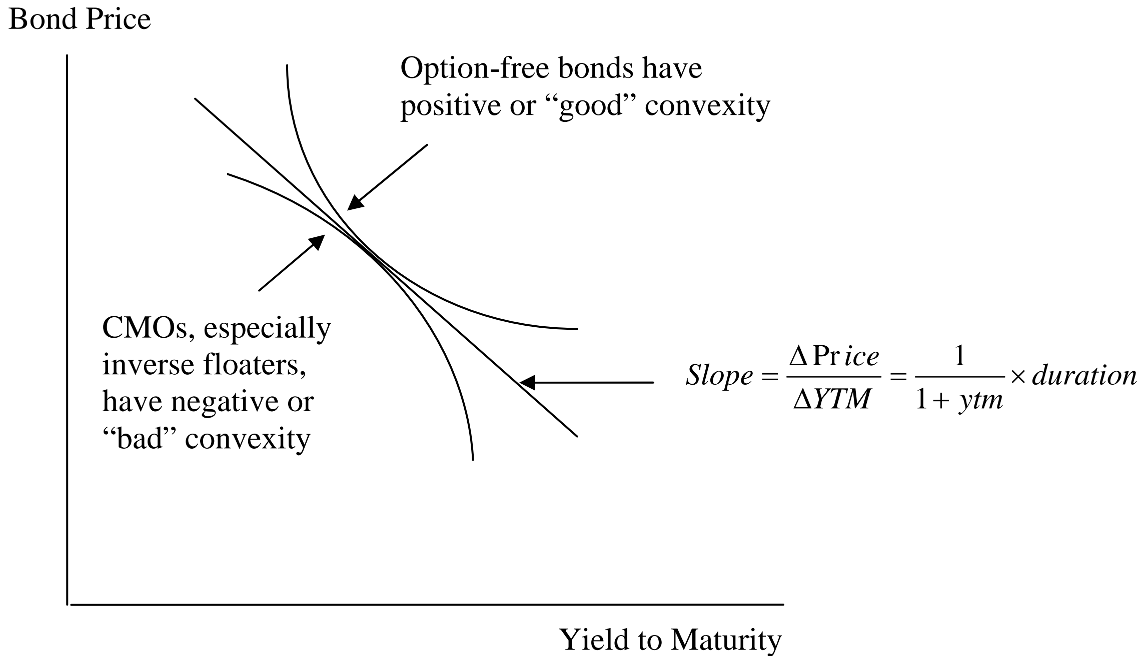
For small changes in yields:

$$\frac{\Delta Price_t}{Price_t} = -\Delta Yield_t \times (\frac{1}{1+ytm}) \times Duration_t$$

Duration is useful because the percentage change in a simple bond or bond fund's price is equal to the change in the bond's yield multiplied by the bond or bond fund's *modified* duration. Modified duration is equal to duration divided by one plus the yield to maturity and is equal to the slope of a line tangent to the bond price – yield relationship in Figure 6.

[18] 44% of Moody's 2006 revenues came from providing credit ratings to CMOs and CDOs – significantly more revenue than it received from rating the credit of companies. "The Ratings Charade" *Bloomberg Markets* July 2007. Ratings agencies, Moody's in particular, may yet be the big loser in the current CMO crisis. "Moody's Faces the Storm" *The Wall Street Journal*, July 10, 2007.

Figure 6
Duration Doesn't Capture Interest Rate Risk in CMOs



Convexity

Duration or modified duration only works for predicting bond price changes for small changes in yields to maturity. This is because the change in a bond's price for each basis point change in yield to maturity is not constant. Bond prices drop by smaller increments for successive increases in yields to maturity and increase by greater increments for successive decreases in yields to maturity. For example, an increase in the yield to maturity from 8% to 8.5% on an 8% 10-year coupon bond causes the bond's price to drop $53.98 but the same 0.5% increase from 9% to 9.5% causes the bond price to drop only $44.95. This feature is called convexity and is highly valued by investors since the greater a bond's convexity the more it's price will increase for any given decrease in interest rates and the less it will fall for any given increase in interest rates.

While option-free bonds have positive or "good" convexity, some CMOs – especially inverse floaters - have negative convexity. That is, their values drop more rapidly, not less rapidly with successive increases in interest rates and increase more slowly, not more rapidly with decreases in interest rates.

Effective Duration

Effective duration incorporates the convexity of a CMO resulting from changes in prepayment speeds into the risk measure by simulating the value of a bond at higher and at lower assumed yields to maturity and consequently changing prepayment speeds. The difference in bond prices resulting from analyzing both changes in interest rates and prepayment speeds is a more accurate measure of risk for CMOs than simple duration.

The Rules are Not Discounted for the Discounter

Mark A. Tepper, Esq.

Discount firms frequently argue that they are merely "order takers" and have no supervisory responsibilities to their customer accounts. Interestingly, there is a long history of legal authorities that consistently say the opposite. The NYSE Director of Rules and Interpretations discredited the discounter's argument when he wrote that ". . . [e]xchange rules do not make a distinction between 'discount' firms and firms that conduct business on other than a discount basis."[1]

That NYSE interpretive letter was published in the Wall Street Journal under the headline: *Discounters Must Watch out for Customers, Big Board Says.*[2] Eight months later, the NYSE elaborated on its position: "[a]ccordingly, the Exchange rules have always applied with equal force and effect to all Exchange member organizations, regardless of whether they choose to discount commissions."[3]

Charging less commission does not entitle a discount broker to disregard its supervisory obligations under the law – "the rules are not discounted for the discounter."[4]

All Brokers Must Supervise their Customer Accounts

Arbitration claims against discount brokers are often prejudiced by a misunderstanding of the law. SRO rules require on-line and discount brokers to supervise their customer accounts as well as monitor their transactions with respect to suitability even though they make no recommendation. This concept is difficult for some arbitrators to understand. It shouldn't be.

Supervision is the watchword of the brokerage industry. The supervisory duty is bound up in such basic concepts as "know your customer." Discount brokers are obligated to supervise customer accounts, regardless of how the account orders are received and transmitted, even if the broker makes no recommendation.

Discount brokers frequently argue that since they made no recommendation, they have no supervisory obligation. However, this defense is inconsistent with NYSE Rule 405 and the applicable NYSE Information Memo regarding the electronic transmission of orders without a broker

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[1] December 22, 1989 letter from NYSE Director Rule and Interpretive Standards. Exhibit 1.

[2] July 19, 1991 Wall Street Journal: *Discounters Must Watch Out for Customers, Big Board Says*, p. C-1 Exhibit 2.

[3] March 31, 1992 letter from NYSE Senior Special Counsel, Member Firm Regulation. Exhibit 3.

[4] Comment by J. Boyd Page, July 19, 1991 Wall Street Journal: *Discounters Must Watch Out for Customers, Big Board Says*, p. C-14. Exhibit 2.

recommendation. Referring to Rule 405, the NYSE plainly stated that "[t]he Rule's [405] requirements are imposed on every customer order, regardless of the method or system used for their receipt and transmission, including those routed via electronic trading systems."[5]

It makes no difference whether the broker made a recommendation or not, since how the order was received does not affect supervisory obligations. As electronic brokers must supervise their customer accounts, discount brokers must do the same.

Certain types of accounts and orders raise red flags which discount brokers cannot ignore by erroneously calling themselves "order takers." Every broker-dealer must follow the law and industry rules which includes supervisory responsibilities for every order carried by the organization. NYSE Rule 405.

Discount Brokers Cannot Contract Out of their Duty to Supervise

Some brokers attempt to have clients execute disclaimers or indemnity agreements that would limit the discount broker's liability for failure to supervise. Disclaimers or indemnity agreements are not an obstacle to recovery from a discount broker because Federal and most State laws prohibit brokers from contracting out of their obligations under the securities laws. Any such provision is null and void.
For example:

> Federal law – 15 USC §78cc(a) ("Any condition, stipulation, or provision binding any person to waive compliance with any provision of this chapter or of any rule or regulation thereunder, or of any rule of an exchange required thereby shall be void."); and
>
> Florida Law[6] – Fl. Adm. Code § 69W-600.012 (2) ("A dealer shall not enter into any contract with a customer if the contract contains any condition, stipulation or provision binding the customer to waive any rights under Chapter 517, F.S. [the Florida Investor Protection Act], or any rule or order thereunder. Any such condition, stipulation or provision is void.").

NYSE Rule 405 requires a discount broker to diligently supervise the establishment and trading of a customer's account. The discount broker must "[u]se due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization." NYSE Rule 405 (1).

A discount broker must "[s]upervise diligently all accounts handled by registered representatives of the organization." NYSE Rule 405 (2). "The member, general partner, officer or designated person approving the opening of the account shall, prior to giving his approval, be personally informed as to the essential facts relative to the customer and to the nature of the proposed account and shall indicate his approval in writing on a document which is a part of the permanent records of his office or organization." NYSE Rule 405 (3).

Similarly, NASD Rule 3010 requires all member organizations to "establish, maintain and enforce written procedures . . . that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules." NASD Rule 3010.

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[5] NYSE Information Memo 02-48, November 7, 2002, *Electronic Transmission of Orders*, p. 3, section "Due Diligence Obligations," Exhibit 4.

[6] Most states have a similar provision in their securities laws.

What Does the Duty to Supervise Mean to a Discount Broker?

Red flags are indications of irregularities. *Quest Capital Strategies*, Release no. ID141, 69 SEC 1317 (1999). In *Quest*, the SEC has made it clear that when there are red flags in a customer account, broker-dealers have specific duties to their customers:

> **Supervisors have an obligation to respond vigorously and with the utmost vigilance to indications of irregularity. A supervisor cannot ignore or disregard 'red flags' and must 'act decisively to detect and prevent' improper activity. Indications of wrongdoing demand inquiry as well as adequate follow-up and review.** (Citations omitted).

Thus, a discount broker may not establish an unsuitable account or ignore unsuitable transactions in a customer's account. For example, an elderly person who relies on income, and has a conservative trading history is not suitable for a speculative margin account. If a customer or her agent tried to establish such an account, it should not be opened.

Similarly, a pattern of unsuitable transactions in a customer's account may not be ignored. Unsuitable accounts and unsuitable transactions are the most basic red flags. Discount brokers are not dime stores. It is their legal duty to refuse unsuitable business.

The Duty to Supervise an Advised Account

The same supervisory concept that binds discount brokers to reject unsuitable accounts and transactions holds true for third party traders.
When a customer signs a power of attorney or trading authorization in favor of a third party, an advised account is created. But an advised account does not suspend the broker's supervisory obligations to that customer.

The law is well settled that the presence of an investment adviser does not relieve a broker of his fiduciary and regulatory obligations, even when the Adviser is deemed to be acting as the customer's agent. *Rolf v. Blyth Eastman Dillon & Co.*, 570 F.2d 38, 45 (2nd Cir. 1978). The *Rolf* Court specifically rejected the broker's argument that an investor who signs a broad authorization giving an adviser full trading authority relieved a broker of its responsibilities to an advised account:

> **We reject Stott's argument that the trading authorization given to Yamada [investment advisor] relieves Stott of any duty to Rolf and thus of any liability. Stott was still Rolf's broker, though not his investment advisor, and owed Rolf a duty of loyalty normally expected of brokers.** *Id.*

Similarly, an American Stock Exchange Disciplinary Panel censured, barred and fined a branch office manager, when, among other things, he "failed to take meaningful and effective steps to prevent ... unsuitable options transactions from occurring [in an advised account] ...." *In the Matter of Richard DeCastro*, 1998 WL 295513 (AMEX). The AMEX Panel ruled:

> **The Panel believes that the existence of a third party power of attorney does not relieve a member organization or its supervisory personnel of their obligations under the Exchange's rules to supervise the accounts of their customers.** *DeCastro, supra.* at *7.

The Exchange specifically rejected the broker's argument that the branch office manager had no duty to supervise an advised account. *Id.*

Finally, a broker may not turn a blind eye to unsuitable transactions. In *In Re Merrill*

Lynch, 1982 WL 522831 (S.E.C. Release No. 19070), the Commission found that " . . . continued execution of the adviser's orders where a broker-dealer has knowledge of improprieties in an investment adviser's handling of accounts may subject the broker-dealer to liability for aiding and abetting a violation of the federal securities laws if the adviser is in fact a primary violator of some provision of those laws.. . . ." *Id.*
Clearly, a discount broker's duty to supervise its customer accounts applies even when the customer has an advisor.

Supervision is the Word

When faced with unsuitable accounts, discount brokers should refuse the business. Just like a restaurant insists on shirts and shoes, a broker has legal standards it cannot ignore. No suitability – No trade. No suitability – No account. Discount brokers are not free to take every account and every trade offered them. They must evaluate each trade and account and, if appropriate, refuse the business.

In closing, supervision of an account and its trading is protection guaranteed to brokerage customers. This is true whether the customer is dealing with a discount broker or a third party adviser. The customer is entitled to the protection afforded by Federal and State securities laws, no matter how much commissions they pay or who is trading their account. Brokers are bound by the law and cannot contract out of their responsibilities.

Corporate and Municipal Bonds

Michael S. Piwowar, PhD

I. Introduction

Corporate and municipal bonds are substantially more expensive for retail investors to trade than similar-sized trades in common stocks. Trading costs including explicit commissions, mark-ups and mark-downs are significantly higher for retail-sized (small) bond trades than for institutional-sized (large) bond trades. Financial economists who study bond markets have widely attributed these two facts to the lack of reliable data on trade prices in the bond market as compared to the abundance of publicly available information on stock trades. The extent of information available on trade prices in a market is referred to as price "transparency" and bond markets have been notoriously opaque.

In this article, I will summarize key findings in the academic finance literature on bond market trading costs, including research on the effects of adding price transparency to the bond markets, and explain how bond trading costs can be hidden in realistic examples using simple numerical examples. **THIS IS WHERE YOU WRITE A SENTENCE ON IMPLEMENTING WHAT THEY WILL READ TO THEIR PRACTICES.** Economic experts can help investors, and attorneys working on their behalf, uncover some of the hidden costs of trading bonds.

The lack of transparency in the bond markets has allowed market professionals - including sophisticated investors, brokers and dealers - to stealthily obtain expropriate vast sums of money from unsophisticated investors *and* taxpayers. The SEC's global settlement of the yield-burning cases in 2000 and their more recent cease-and-desist order against the City of San Diego for committing securities fraud in the sale of its municipal bond offerings in 2002 and 2003[1] are just two examples of the wide range of fraud that is possible in these opaque markets.

Recent regulatory initiatives have increased the price transparency in the secondary bond markets. Price and quantity information on the most recent bond trade is now available on a near real-time basis – for those who know where to find it. Sophisticated investors are now able to find the prices at which bonds are bought and sold, allowing them to make better decisions. Indeed, the empirical evidence suggests that *overall bond trading costs have fallen as a*

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[1] See the April 6, 2000 Press Release "SEC Settles with Ten Brokerage Firms as Part of Global Resolution of Yield Burning Claims: Total Recovery to Date Exceeds $172 million" http://www.sec.gov/news/press/2000-45.txt and the November 14, 2006 Press Release "SEC Sanctions the City Of San Diego for Fraudulent Municipal Bond Offerings and Orders the City to Retain an Independent Consultant" http://www.sec.gov/news/press/2006/2006-191.htm.

result of the increased price transparency. However, while institutional investors and sophisticated investors have seen their bond trading costs fall, trading costs for retail investors remain high for one simple reason: the true costs of trading bonds are often hidden by minimal compliance with regulatory disclosure requirements or by outright fraud.

Mark-ups on principal (including riskless principal) transactions do not need to be disclosed on customer confirmations. As a result, investors may mistakenly conclude that do not incur *any* trading costs when they don't see an explicit commission, mark-up or markdown reported on the trade confirmation. In addition, high-cost bond trades may be broken up into series of several transactions that deceptively seem to involve little or no commissions or mark-ups. In fact, investors may have been unknowingly exposed to unfair prices and/or "daisy chains" that involve their broker or investment advisor favoring another customer or intermediary over them.

II. Bonds Are Expensive For Retail Investors to Trade

Empirical studies of bond markets have only recently attracted the attention of academic researchers because, until recently, in contrast to equity markets, comprehensive data on bond market transactions were almost impossible to obtain. Several recently published studies in major academic finance journals document that corporate and municipal bonds are much more expensive for retail investors to trade than common stocks. This same dearth of reliable market data has allowed abusive practices to persist in the bond markets.

Regulatory initiatives now require central reporting and public dissemination of all U.S. corporate and municipal bond transactions, thereby providing market-wide, comprehensive access to data. The SEC oversees the corporate and municipal bond markets, which are also subject to oversight by the SROs (which, themselves, are subject to oversight by the SEC).

An overview of SRO regulation of the bond market looks like this:

- The NYSE is responsible for developing and enforcing rules on the small amount of corporate bond trading that occurs on its Automated Bond System.[2]
- NASD is responsible for operating the reporting and dissemination facility for over-the-counter (OTC) corporate bond trades, known as the Transaction Reporting and Compliance Engine (TRACE). NASD is responsible for developing and enforcing the rules for the trading that occurs on TRACE.[3]
- The MSRB is responsible for operating the reporting and dissemination facility for OTC municipal bond trades, known as the Real-Time Transaction Reporting System (RTRS). The MSRB is responsible for developing its rules, but the responsibility for enforcing its own rules is delegated to NASD.

Table 1 (at the end of this article) lists the transaction reporting facilities for the municipal and corporate bond markets and summarizes the information that is disseminated to the public.

[2] The NYSE has filed a rule proposal with the SEC to replace its Automated Bond System (ABS) with a new trading technology system named "NYSE Bonds." This article was written during the comment period for the rule proposal.

[3] On November 28, 2006, NASD and NYSE announced plans to consolidate their member regulation operations into a new SRO. Subject to SEC approval, the new SRO is expected to begin operations in second quarter 2007.

My own research conducted while I was at the SEC[4] was enabled by the data provided by the enhanced regulatory reporting requirements and resulted in co-authoring two articles published in the *Journal of Finance.* The first - “Secondary Trading Costs in the Municipal Bond Market” (joint with Lawrence Harris) - was published in June 2006. In our November 1999 - October 2000 sample period, we found that the average effective spread of a representative retail-sized *municipal bond trade* ($20,000) was almost 2% of the price. To put this number in perspective, we pointed out that this is the equivalent of almost four months of the total annual return for a bond with a 6% yield to maturity. In comparison to a similar-sized equity trade of 500 shares of a $40 stock ($20,000), we stated that this would be equivalent to an effective spread of 80 cents per share.

Observed effective spreads in equity markets for retail-size trades are rarely that high, even for the most illiquid stocks. Thus, *municipal bond trades are substantially more expensive than similar-sized equity trades.*

The second study - “Corporate Bond Market Trading costs and Transparency” (joint with Amy Edwards and Lawrence Harris) - was published in the June 2007 issue. In this study, we found that the average effective spread of a representative retail-sized trade ($20,000) in a *corporate bond trade* in 2003 was 1.24% of the price, making it the equivalent of over two months of the total annual return for a bond with a 6% yield to maturity. This is equivalent to almost 52 cents per share on a similar-sized equity trade of a $40 stock.

Our corporate bond study also examined the impact of publicly disseminating information about trade prices on trading costs. Results from a multitude of tests suggested that transparency decreases customer trading costs by roughly five basis points. Our data showed that in 2003, public investors traded approximately $2 trillion in bond issues for which prices were not published on a contemporaneously with the trades. These results suggested that investors could have saved approximately $1 billion that year if the transaction prices of all bonds had been transparent and reported. In the corporate bond study, we carefully explained why this is a conservative (lower bound) estimate on the full cost savings of transparency. Nevertheless, the $1 billion figure from our paper has been widely reported in the press, and has almost taken on a life of its own.[5]

Both studies developed new econometric methods to estimate average trading costs over time. We measured bond trading costs as round-trip “effective spreads,” a measure designed to capture commissions, mark-ups and markdowns. Our methods allowed us to estimate trading costs as a function of trade size. We found that average estimated trading costs decrease significantly with trade size. In other words, *retail investors generally pay substantially more to trade a bond than institutional investors.*

Our research found that trading costs increase with: (a) credit risk, (b) time since

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[4] I was a senior financial economist in the SEC’s Office of Economic Analysis where, among other duties, I contributed economic analysis to several SEC investigations involving alleged violations of securities laws by broker-dealers and individuals.

[5] See, for example, “Bond Traders May Save $1 Billion If Pricing Data Improves, SEC Says,” Amy Strahan Butler, Bloomberg, 9/29/2004. Also, “Spanning the Transparency Divide FSA Points Out Differences Between European and UK Markets Amid Pressure to Make Bond Trading More Transparent,” Gillian Tett, Financial Times, 9/6/2005 begins “When the London Business School held a conference on credit markets earlier this year, Michael Piwowar, a senior official at the US Securities and Exchange Commission, produced an eye-popping statistic. After analysing recent moves that the US has taken to introduce more price transparency in corporate bond markets, Mr. Piwowar argued that US investors could save themselves $1 billion a year in trading costs if all the prices of bond trades were displayed promptly after deals had been struck.”

issuance and (c) time to maturity. Lower rated bonds (i.e., bonds with higher credit risk) are more expensive to trade than higher rated bonds. Throughout the life of a bond, its trading costs are lowest when it has just been issued and when it is about to mature.

Our municipal bond study also found that trading costs increase with complexity features that complicate valuation analyses for investors. The bond complexity features that we examined included: call provisions, put provisions, sinking funds, special redemption or extraordinary call provisions, nonstandard interest payment frequency or accrual basis and credit enhancements (such as bond insurance). We found that municipal bond investors incur higher trading costs when trading complex bonds than when trading otherwise similar simple bonds. Not surprisingly, our evidence suggests that retail investors appear to be more adversely affected by bond complexity than institutional investors. As a result, they must rely more on their brokers to explain the product than they would for equities.

In summary, several empirical regularities are apparent from the emerging academic finance literature on bond trading costs:

- Trading costs for retail-size (small) bond trades are much higher than for institutional-size (large) bond trade and bond trading costs are substantially higher than similar-sized equity trades.
- The introduction of price transparency has benefited investors in the form of lower overall trading costs.
- However, bond trading costs for the average retail investor remain high because these costs are often still hidden from the investing public, as I will now discuss.

III. Bonds Trading Costs Are Often Hidden

By using simple numerical examples, I will now explain how bond trading costs are often hidden from the average investor.. When a customer wants to trade a bond, he/she must do so through an "intermediary"- any organization (or individual representing an organization) that trades bonds with customers, or on behalf of customers.[6] Bond intermediaries include brokers, dealers, broker-dealers, banks, buy-side institutions (e.g., mutual funds, hedge funds) and investment advisers.[7]

When an intermediary trades through its proprietary trading account, we typically say that the intermediary is acting as a "dealer." An intermediary acting as a dealer of bonds and/or equities is exposed to the risk that securities held in inventory will decline in price. Bond market regulators require that bond dealers trading through their proprietary trading accounts must report these trades as "principal" trades.

In contrast, when an intermediary simply arranges trades on behalf of customers, we typically say that the intermediary is acting as an "agent" or a "broker" and is not exposed to any price risk. Bond market regulators allow firms to choose whether they consider these economically riskless trades as "agency" trades or "riskless principal" trades in their internal accounting and reporting decisions.[8]

A round-trip "transaction chain" involves an intermediary buying a particular bond and then selling it. Counterparties in a transaction chain may include customers on both sides, or a customer on one side and an intermediary on the other. "Trading profits"

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[6] The bond markets include dealers such as "brokers' brokers" that only trade with other dealers.

[7] There are currently no market-makers in the U.S. corporate and municipal bond markets.

[8] Although bond intermediaries are theoretically exposed to counterparty risk, regulatory safeguards and industry practices have virtually eliminated this risk from bond transactions.

are earned by an intermediary involved in a transaction chain. For example, if a dealer[9] buys a bond at $100 and then sells it at $101, the dealer makes a trading profit of $1 or 1%.

Trading profits earned by the dealer involved in a transaction chain are equivalent to the "trading costs" paid by the customers. In this particular example, without additional information, it is impossible to determine how the trading costs are split between the two customers. It is possible that the buyer incurred $1 in trading costs, while the seller incurred none, or that the buyer incurred no trading costs while the seller incurred $1. It is also possible that each customer incurred some fraction of the total trading cost. In Section II B of this article, I will show you how it's possible that the trading costs paid by one of the customers in this transaction chain may actually exceed $1 (with the dealer earning $1 and the other customer essentially earning a "kickback" or rebate).

A. Excessive Commissions, Mark-ups and/or Markdowns

Until this point, I have referred to the trading costs incurred by customers without distinguishing between "commissions" and "mark-ups/markdowns." Bond dealers are entitled to earn a commission on a trade done on an agency basis. They are entitled to earn a mark-up (when the dealer is selling) or a markdown (when the dealer is buying) on a trade done on a principal basis.

A bond dealer's decision to report a riskless trade as an agency trade or a riskless principal trade depends on a number of factors, including: net capital rules, arrangements between clearing brokers and their correspondents and soft-dollar arrangements. Three points related to this decision are relevant to the identification and measurement of bond trading costs.

1. First, trade reporting rules don't provide a mechanism for bond dealers to report or identify a principal transaction as a riskless principal transaction. As a result, economists (including regulatory economists) must use patterns in the data to "connect the dots" and identify transaction chains that are likely to involve riskless principal trades.
2. Second, an intermediary's reporting decision for brokered trades affects how transparent these trading costs are to its customers. Commissions on agency transaction need to be disclosed on customer confirmations. Mark-ups (and markdowns) on principal transactions, including riskless principal transactions, do not. Customers who pay hidden mark-ups and markdowns, instead of explicitly disclosed commissions, may mistakenly conclude that they are not incurring *any* trading costs. They would be wrong.
3. Finally, firms may change how they report these trades over time. If a firm switches from an agency reporting model to a riskless principal reporting model, customers may mistakenly conclude that they are no long incurring any costs for trading bonds because a commission no longer appears on their trade confirmations.

For example, suppose all of the transaction chains involve agency trades, so that the dealers are not exposed to any price risk and that a very liquid bond is being traded at $100 "bid" and $101 "ask", establishing a "prevailing market price" of $100-$101. In the absence of transparent trades and/or quotes, unscrupulous dealers can pay sellers less than $100 – say $98 - and/or charge buyers more than $101 – say $103.

The total trading profits for each dealer involves some combination of a commission/markdown to the customer selling the bond and a commission/mark-up to the customer buying the bond. If the prevailing price of the bond is $100, then $2 in trading costs are incurred by the customer selling the bond for $98 ($100-$98) and $3 in

[9] To simplify the exposition, I refer to intermediaries as dealers and counterparties as customers from this point forward.

trading costs are incurred by the customer buying the bond for $103 ($103-$100). If the dealer reports these transactions on an agency basis, it would be required to disclose the commissions on each customer's trade confirmation.

If, however, the dealer reports its transactions on a riskless principal basis, it would not be required to disclose the markdown or the mark-up to either customer. In this case, the dealer's customers may mistakenly conclude that they are not incurring any costs for trading this bond while, in fact, they are incurring the highest trading costs in the market. The lack of transparency allows dealers to stealthily obtain a great deal of investable wealth from unsophisticated investors.

B. Unfair or Unreasonable Prices

Deceptively low trading costs can mask unfair or unreasonable prices. Assume as in our prior example, that the dealers are not exposed to any price risk - that all dealers report the trades on an agency basis - so that the commissions are fully disclosed on all customer confirmations, and that the prevailing market price is $100-$101.

A dealer may buy a particular bond from one customer at $102 and sell it to another customer at $103. Around the same time, a different dealer may pay a customer $98 for the same bond and then sell it to a different customer at $99.

Each dealer earns trading profits of $1 (A: $103-$102, B: $99-$98). At first glance, these trading profits don't appear to be excessive. However the transaction prices of dealers are puzzling. Why did one dealer buy the bond at $98 and another dealer sell the bond at $103 (a difference of $5, more than 5%) while the rest of the market is buying the bond at $100 and selling it at $101?

There are basically two possible answers to this question:

1. One possibility is that the dealers are just bad at pricing bonds (i.e., they don't have an accurate view of the prevailing market price of the bond). This possibility might have been plausible in the past, before last sale information became available on a real-time basis. However, now that this data is publicly disseminated, they can access the data directly themselves or use one of the many third-party pricing services to accurately determine the prevailing market price.
2. The more likely possibility is that the dealers are as good as (or better than) the other dealers at pricing bonds, but that they are favoring one customer over another.[10]

Here's how it works in a profit-sharing arrangement: Suppose that a dealer has an unsophisticated customer who is willing to pay $103 for the bond and the dealer knows that the prevailing market price is $100-$101. The dealer may have an arrangement with another customer or dealer to share in trading profits. In this case, the total trading profits are $3. The $3 represents the difference between the price at which the buying customer paid for the bond - $103 - and the prevailing market price - $100. The dealer shows a trading profit of $1. *Who earns the other $2?* The customer who sold the bond at $102. The $2 trading profit to this customer represents the difference between the price at which it was able to sell the bond - $102 - through this particular dealer and the price it would have been able to sell the bond through one of the other dealers offering a reasonable price - $100.

C. Daisy Chains

Daisy chains involve dealers splitting up a single transaction chain into multiple transaction changes - often involving other dealers (or customers) - for all kinds of nefarious purposes. Unscrupulous bond

[10] This point is developed more fully in Craig McCann's "Detecting Personal Trading Abuses" working paper, 2003, available at www.slcg.com.

dealers may want to split up trading profits to avoid regulatory or legal scrutiny. They may want to hide the true trading costs paid by their customers. Some dealers may even pre-arrange daisy chains to illegally manipulate the prevailing market price of the bond. Daisy chains in the bond markets are not theory; they are reality.[11]

Figure 1 shows an example of a simple daisy chain scenario. Suppose that Dealer A has an unsophisticated customer who can be induced to sell a particular bond and another customer who can be induced to buy it. Also suppose that the bond involved in this particular example rarely trades. Without any recent last sale information, the prevailing market price of $100-$101 is difficult for both customers to determine. The lack of liquidity in this particular bond might justify a mark-up of up to, say 2%, so a transaction chain involving prices of $100 and $102 would not be considered unfair or unreasonable.

But, instead of arranging a single transaction chain between these two customers, let us suppose that Dealer A engages in a daisy chain with Dealer B. In this example, Dealer A buys the bond at $98 from the first customer and sells it to Dealer B for $100. Dealer B then turns around and sells it back to Dealer A for $101. Dealer A then sells it to its second customer for $103.

Further, suppose that Dealer A decides to report all of its transactions on an agency basis. As a result, it will have to separately disclose commissions on the customer confirmations. The first customer's confirmation would show that it sold a bond for $100 and was charged a commission of $2, receiving a net price of $98. The second customer's confirmation would show that it bought the bond at $101 and was charged a commission of $2, paying a net price of $103. Neither customer saw the other's confirmation, and if they don't take the time and effort to look at the TRACE data (or they don't even know that it exists), neither customer will have enough information to make a complaint. And they rarely do. But you could, on their behalf.

IV. Economic Analysis of Publicly Available Data Can Help Uncover Some of the Hidden Costs

These examples show how bond trading costs can still be hidden even after the introduction of price transparency. Moreover, anecdotal evidence suggests that most investors don't even know that comprehensive real-time and historical corporate and municipal bond pricing data is available. That's the bad news.

The good news is that economic experts know that the data exists, and we have developed methods to look for patterns in the data to uncover some of the hidden costs of trading bonds. Careful economic analysis can give investors valuable information about their true costs of trading bonds. Here are just a few examples.

1. Economic experts can search for transaction chains that are likely to involve economically riskless (agency or riskless principal) transactions by looking for two transactions that are reported at the same time (or very close in time) involving the same quantities of the same bond. The MSRB provides additional useful information for municipal bonds by disseminating fields indicating whether the trade was a buy or a sell and whether the transaction involved a customer or another dealer. Unfortunately, TRACE does not currently disseminate these additional data fields for corporate

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[11] See, for example, "Remarks Before the TBMA Legal and Compliance Conference" by SEC Commissioner Annette, New York, NY, Feb 7, 2006, http://www.sec.gov/news/speech/spch020706aln.htm.

bonds,[12] but the price, size and time data fields provide meaningful information nonetheless. Multiple transaction chains occurring close in time might be suggestive of daisy chains.

2. Prevailing market prices for active bonds, i.e., bonds that trade fairly regularly, can easily be determined from their transaction data. Prevailing market prices for inactive bonds can be estimated by using data on “similar” bonds. Municipal bonds, in general, do not trade very often. They are often issued in serial offerings which can involve 20 or more separate securities with different maturities. If a particular municipal bond does not trade very often, the pricing information of bonds in the same offering, with slight different maturities may be useful. For example, suppose an economic expert would like to know the prevailing market price of a five year municipal bond that hasn’t traded in the past several weeks. The economist could look to recent prices in the four year bond and/or the six year bond (and/or other maturities) in the same offering and interpolate an estimate of the price of the five year bond. Similarly, for corporate bonds, trade prices in bonds of other issuers in the same industry with similar credit rating, similar maturity, similar features, etc. may provide useful pricing information.

Armed with accurate estimates of prevailing market prices, economists can begin to look for patterns that are suggestive of trades involving unfair or unreasonable prices. Economic experts can provide useful estimates of various dimensions of the liquidity of a particular bond, such as trading costs, trading activity, price volatility, etc.

V. Summary and Conclusions

Corporate and municipal bonds are expensive for retail investors to trade. Recent regulatory initiatives have increased price transparency in both markets, providing useful last sale information that is publicly disseminated to the market. Empirical evidence suggests that the increase price transparency has yielded lower overall bond trading costs. However, although bond prices are now transparent to all investors, the costs of trading bonds are still hidden to many of them.

Strategic behavior by bond market professionals can make it very difficult for the average investor to recognize the true costs of trading bonds. Investors may be unknowingly exposed to situations involving egregious commissions or mark-ups/markdowns, unfair or unreasonable prices, or daisy chains.

Economic experts can help investors uncover some of the hidden costs of trading bonds. Careful analysis of transaction data provided by the TRACE and MSRB (RTRS) systems can provide useful information about the true costs of trading corporate and municipal bonds for investors.

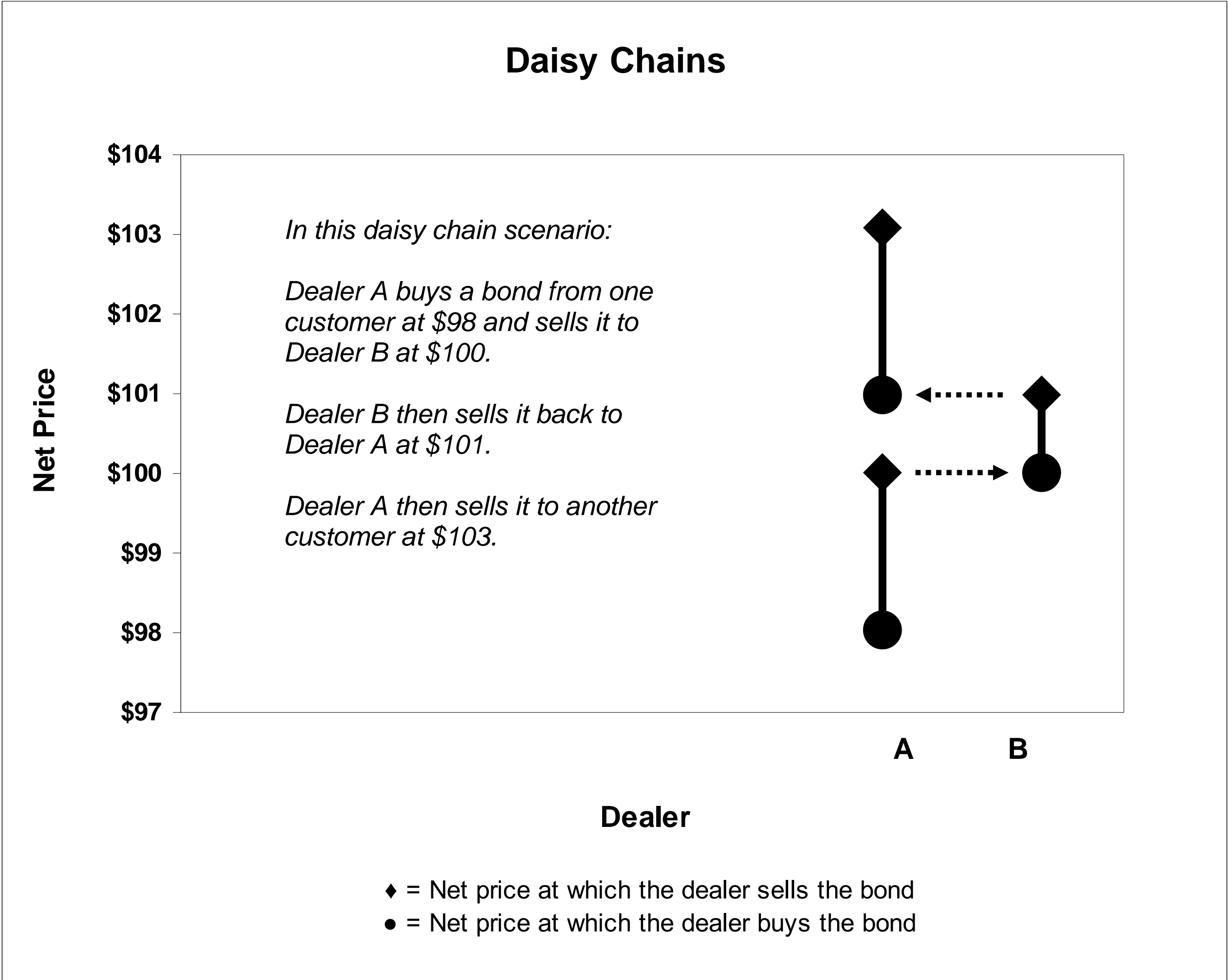
[12] NASD Notice to Member 06-32, June 2006, requested comment on providing these (and other) fields on a historical basis. At the time this article was written, NASD had still not formally responded to the comment request.

Table 1: Summary of Publicly Available Information on Bond Market Transactions

	Municipals	Corporates		
	OTC	OTC	Exchange	
Name of transaction reporting and dissemination facility/platform	MSRB (RTRS)	TRACE	ABS	NYSE Bonds
Securities included	Municipal securities	TRACE-eligible securities	ABS-Listed Bonds	Subject to SEC approval
Notable securities excluded	Municipal fund securities (529 college savings plans and local government investment pools)	Rule 144a securities [b], sovereign debt, development bank debt, debt issued by government-sponsored entities (GSEs), mortgage-backed securities (MBSs), asset-backed securities (ABSs), collateralized mortgage obligations (CMOs), and money market instruments		
Earliest date historical data is publicly available in electronic format and easily obtained	January 24, 1995 for interdealer trades, August 25, 1998 for customer trades [a]	July 1, 2002 [c]	February 7, 2002	TBD
Types of trades reported and disseminated	Customer and Interdealer	Customer and Interdealer	Customer	Customer
Are customer/interdealer trade identifiers disseminated?	Yes	No	N/A	N/A
Are buy/sell trade identifiers disseminated?	Yes	No	N/A	N/A
Do principal trades include identifiers for "riskless principal" trades?	No	No	N/A	N/A
Do disseminated prices include mark-ups/markdowns on principal trades?	Yes	Yes	N/A	N/A
Do disseminated prices include commissions on agency trades?	Yes	Yes	No	No
Are actual trade sizes disseminated?	Capped for large sizes [d]	Capped for large sizes [d]	Yes	Yes
Are broker-dealer or customer identities disseminated?	No	No	No	No
Is descriptive data (e.g., ratings, call dates, etc.) available?	Yes	Yes	Yes	Yes

[a] The MSRB historical data is not limited to "frequently traded" issues that had been disseminated on a one-day lag basis.
[b] Transactions in Rule 144a securities are reported, but not disseminated.
[c] Currently, the TRACE historical data product does NOT include transactions in bonds that were reported, but not disseminated before it was phased-in.
[d] If the reported amount of an investment grade security is greater than $5 million, a large volume trade dissemination cap identifier of "5MM+" is disseminated instead of the actual quantity. If the reported amount of an non-investment grade security is greater than $1 million, a large volume trade dissemination cap identifier of "1MM+" is disseminated instead of the actual quantity.

Figure 1: Daisy Chains



Recent Arbitration Awards

Samuel Edwards, Esq.

Edwin "Bob" Bearb v. Merrill Lynch, Pierce, Fenner & Smith, Inc.
NASD Case No. 06-01360

Claimant brought an action against Respondent related to Claimant's accounts with Merrill Lynch, and the failure of Respondent to properly allocate the assets in a manner consistent with the objectives of the account.

Claimant asserted the following causes of action: breach of fiduciary duty; breach of contract, breach of warranties, promissory estoppel, violation of the Texas Deceptive Trade Practices-Consumer Protection Act, violation of Texas Securities Act, negligence and failure to supervise.

Claimant requested market adjusted damages, statutory and/or punitive damages, interest, costs, attorney's fees, and all other relief 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 $578,112.00, plus interest at 6% from the date of filing the claim until the date of payment of the Award, attorney's fees of $231,245.00, and costs of $26,500.00, for a total award of $835,857.00.

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

Claimant's Expert: Jerrod Summers for both damages and suitability

Respondent's Counsel: Linda Broocks, Esq., and Judith A. Meyer, Esq., Ogden, Gibson, Broocks & Longoria, LLP, Houston, TX.

Respondent's Experts: Christopher C. Williams, Manager, Bates Private Capital & Dr. Roger Marting, Supervision and Suitability

Arbitrators: Stacey L. Barnes (Chair), William R. Jonson (Public) and Maurice J. Fallas (Industry)

Mr. Fallas (the Industry arbitrator) dissented in the award stating: "Claimant was partially responsible for the losses incurred. Claimant failed to mitigate his damages. I concur, in part, regarding negligence, failure to supervise, and lack of internal controls. I dissent, in part, regarding breach of

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contract, intentional acts, and the amount of damages awarded."

This case is significant because it resulted in market adjusted damages based largely on Merrill Lynch's own recommended asset allocation model for each of the accounts. The Claimant was a long-time Merrill Lynch customer and Merrill Lynch argued there were no or limited "net out-of-pocket" losses during the life of the accounts. Further, the award is significant because the Panel awarded the Claimant attorney's fees in the amount of the full value of the contingency fee contract. Lastly, the award is significant because it was the result of two public arbitrators ignoring the industry arbitrator and, instead, awarding full compensatory damages.

Angelos and Robin Skulas, West Virginia Emergency Medical Systems, Inc., Emergency Med Systems Ltd., v. Merrill Lynch, Pierce, Fenner & Smith, Inc., Jeffery Shover
NASD Case No. 06-02967

Claimants brought an action against Respondents related to Claimants' accounts with Merrill Lynch, and the actions of the Respondents in regards to margin use, the Claimants' co-signing of a loan to another customer, and the failure of the Respondents to properly allocate the assets in a manner consistent with the objectives of the account. Notably, the primary Claimant was disabled and was unable to further work and claimed to be seeking safe investments with a fixed return while the broker invested all of the money into equities.

Claimant asserted the following causes of action: breach of industry rules (including but not limited to NYSE's "Know your customer" standard, Rule 405, and NASD's customer suitability standard, Rule 2310), breach of contract, breach of fiduciary duty, common law fraud, negligence, negligent hiring, negligent retention, and negligent supervision of employees.

Claimants requested market adjusted damages, recession, punitive damages, interest, costs, and all other relief which may be granted by the Panel.

Respondent denied the allegations made in the statement of claim, requested that the action be dismissed and removed from the NASD Central Registration Depository records of Respondent Shover, and asserted various affirmative defenses.

The panel awarded Claimants compensatory damages of $120,000.00 ($90,000 against Merrill Lynch, $30,000 against Jeffery Shover), punitive damages of $120,000.00 ($90,000 against Merrill Lynch, $30,000 against Jeffery Shover), costs of $19,050.00, for a total award of $259,050.00.

Claimants' Counsel: Scott L. Silver, Esq. and Randall C. Place, Esq., Blum & Silver, LLP, Coral Springs, Fl.

Respondents' Counsel: Keith Olin, Esq., and Seth V. Alhadeff, Esq., Bressler, Amery & Ross, P.C., Miramar, Fl.

Arbitrators: Joseph Leonard (Chair), Martin P. Bergman (Public), Michael S. Kozlow (Industry)

The case is significant largely because the Panel awarded punitive damages against both the broker and brokerage firm independently. According to the reasoned award, the punitive damages stem from the representations of the broker concerning his status as a financial planner to the Claimants, to which the Panel found that he demonstrated "no understanding of the financial planning process." In conjunction with the lack of financial planning skills, the Panel found that Merrill Lynch allowed the broker to mislead the Claimants regarding his capabilities. Accordingly, the Panel found that Merrill Lynch's supervision of the broker was inadequate or non-existent. Finally, the case is significant because the Respondents were cited for having not properly informed the Claimants regarding their involvement

and risk in co-signing a loan to another Merrill Lynch client who the Claimants did not know. The Panel found that Merrill Lynch was liable on the claims of failure to supervise, breach of contract, breach of fiduciary duty, and negligence. Additionally, the panel found that the broker was liable for breach of fiduciary duty, breach of contract, negligence, and violating NYSE Rule 405. These activities were found to amount to intentional misconduct and gross negligence which gave the basis for the relatively large punitive damages awarded.

John and Janette Czech Revocable Trust v. Rosenthal Collins Securities, LLC, Rosenthal Global Securities, LLC, Dean William Urick and Kevin Luetje
NASD Case No. 05-00294

Claimant sought damages relating to an investment in a bogus hedge fund owned and marketed by Dean Urick and Kevin Luetje while employed by Rosenthal Collins Securities, LLC.

Claimant asserted the following causes of action: 1) fraudulent transfer of property in violation of the federal bankruptcy laws; 2) failure to maintain brokerage house books and records while serving as control person for various companies; and, 3) failure to disclose brokerage accounts. The causes of action relate to the alleged transfer of securities, including shares of stock in Proactive Computer Services and Intelligent Motor Cars Group, and properties to various entities and persons.

Claimant requested compensatory damages of $339,020.00, statutory interest from date of purchase, rescission, punitive damages, costs, and all just and proper relief.

Respondents Urick and Luetje failed to file an answer in the matter, and Claimant opted to proceed against them pursuant to Rule 10314(e).

The Panel awarded Claimant compensatory damages of $291,520.00.

Claimant's Counsel: Scott Silver, Esq., Blum & Silver, LLP, Coral Springs, Florida.

Respondent's Counsel: Jeffrey Schulman, Esq., Wolin & Rosen, Ltd., Chicago, Illinois for Rosenthal Collins Securities, LLC, and Rosenthal Global Securities, LLC. Respondents Urick and Luetje did not make an appearance in the arbitration.

Arbitrators: Richard S. Zaifert, Esq.

This case is significant because the Chairman agreed to hear the case under the NASD's new default proceedings and awarded damages on an expedited basis without requiring a full evidentiary hearing in front of the Panel.

Jordan Weinerman v. Morgan Stanley DW, Inc. d/b/a Morgan Stanley
NASD Case No. 05-02371

The Claimant, a retiree WWII vet, brought an action against Respondent related to the purchase of technology focused funds, growth stock mutual funds and proprietary funds including "B" shares. Specifically, Claimant, who had been a Morgan Stanley/Dean Witter client since the early 1980s, was assigned a new broker in November 1999. That broker almost immediately repositioned Claimants account, largely on an unauthorized basis, and purchased many proprietary and aggressive growth securities.

Claimants asserted the following causes of action: breach of fiduciary duty; negligence; and negligent supervision.

Claimant requested compensatory damages, punitive damages, interest, attorney's fees, costs, and any other relief deemed just. The net out-of-pocket losses were roughly $372,000, but Claimant's attorney offered several alternative damages theories, including claims just for the unauthorized trading and well-managed damages.

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

The Panel awarded Claimant compensatory damages of $600,000.00 and punitive damages of $250,000.00.

Claimant's Counsel: Jeffrey R. Sonn, Esq., Sonn & Erez, Fort Lauderdale, FL.

Claimant's Experts: Jim Gertz (supervision) and Larry Dugan (damages).

Respondent's Counsel: Todd A. Zuckerbrod, Esq., Greenberg Traurig, West Palm Beach, FL.

Respondent's Expert: Harold Corrigan

Arbitrators: Richard K. Wilson, Esq. (Chair), Perry Phillips (Public) and Bernard Hornick (Industry)

The Case is significant because the arbitrators awarded significantly more than the net out-of-pocket losses. It appears that the arbitrators awarded Claimant well-managed damages presented at the final hearing which sought to put Claimant in the position he would have been in had Morgan Stanley allocated the vast majority of Claimant's account in fixed income investments and equities commensurate with his needs, risk tolerance and age. This case is also significant because the Panel awarded $250,000 in punitive damages and gave explicit findings to support is award of punitive damages.

Peter S. Weinreb v. J.P. Morgan Securities, Inc. and Gary V. Garabedian
NASD Case No. 06-01019

The Claimant brought an action against Respondents related to uncovered options, specifically uncovered puts in the following companies: Infospace, JDS Uniphase, LSI Logic, Corvis, Atmel, E*Trade, and MRV Communications.

Claimant asserted the following causes of action: breach of contract, breach of implied covenant of good faith and fair dealing, breach of fiduciary duty, unsuitability, fraud, deceit and omission of material fact, misrepresentation, negligence, violation of federal and state securities laws, violation of NASD rules, and failure to supervise.

Claimant requested compensatory damages, disgorgement of commissions, loss of investment opportunity, interest, punitive damages, costs, and attorney's fees.

Respondents denied the allegations made in the Statement of Claim.

The Panel awarded Claimant compensatory damages of $175,825.00.

Claimant's Counsel: Jonathan W. Evans, Esq., Jonathan W. Evans Associates, Studio City, CA.

Respondents' Counsel: Robert J. Stumpf, Jr., Esq., Sheppard Mullin Richter & Hampton, LLP, San Francisco, CA.

Arbitrators: Thomas L. Flattery, Esq. (Chair), Arthur F. Brueggeman (Public) and Kenneth I. Rosenblum (Industry)

Celeste Pisano and Helene P. Ermocida v. MetLife Securities Inc., Metropolitan Life Insurance Company and William Stinger
NASD Case No. 06-00227

The Claimants brought an action against Respondents related to the purchase of various mutual funds including Janus Mid-Cap Growth and State Street Investment Trust. The Claimants further alleged that Respondents failed to allocate the assets in a manner consistent with the objectives of the account.

Claimants asserted the following causes of action: negligence, breach of fiduciary duty, breach of contract, breach of NASD's rules including suitability, and failure to supervise.

Claimant requested unspecified compensatory damages, out-of-pocket losses, disgorgement of commissions and margin interest, insurance premiums, costs and fees, attorney's fees, punitive damages and any other remedy available 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 compensatory damages of $105,000.00.

Claimant's Counsel: Richard DeVita, Esq., DeVita & Associates, Hoboken, NJ.

Respondent's Counsel: B. John Pendleton, Esq., McCarter & English, Newark, NJ.

Arbitrators: Michael P. Marryshow, Esq. (Chair), David B. Harwi (Public) and Jack H. McNairy (Industry)

Jerome Schutzer v. Kevin John Lent
NASD Case No. 06-03476

The Claimant brought an action against the Respondent related to the Claimant's investment in mutual funds and a variable annuity. The claim further involved the Respondent's use of margin and misappropriation of funds from Claimant's Cash Management Account.

The Claimant asserted the following causes of action: breach of contract; negligence, negligent supervision; breach of fiduciary duty; theft; conversion; unjust enrichment; *respondeat superior*; common law and statutory fraud; and securities fraud under Chapters 501 and 517 of Florida Statutes.

Claimant requested compensatory damages of $1,126, 151.00.

The Claimant's claims against Respondents Merrill Lynch Pierce Fenner & Smith, Inc. and Kevin John Lent were initially arbitrated in NASD Case 05-06282. Claimant chose to proceed against Respondent Lent pursuant to Rule 10314(e) of the NASD Code of Arbitration Procedure. The claims against Respondent were bifurcated when Respondent failed to file an answer.

The Arbitrator awarded Claimant all requested compensatory damages of $1,126,151.00 and attorney's fees to be determined by a court.

Claimant's Counsel: Robert L. Herskovits, Esq., Gusrae, Kaplan, Bruno & Nusbaum, PLLC, New York, New York.

Respondent's Counsel: Respondent did not enter an appearance in the arbitration.

Arbitrator: Robert K. Ruskin, Esq.

The Case is significant because it resulted in a default judgment over $1,000,000.00. Additionally, the Arbitrator awarded the Claimant attorney's fees as the "prevailing party." This case was bifurcated from the case against the brokerage firm, resulting in a liability judgment that the attorney could later use against Merrill Lynch (an interesting and potentially very wise way to handle a case in which the broker is named, but is no longer in the business and will not be involved in the case).

Ronald Kelley v. Ameriprise Financial Services
NASD Case No. 06-01728

The Claimant brought an action against the Respondent related to the purchase of a Joint Life Annuity, and the failure of the Respondent to recommend a suitable investment vehicle. Claimant asserted that the investments were unsuitable and resulted in excessive fees, unexpected taxes, and loss of economic opportunities.

Claimant asserted the following causes of action: breach of fiduciary duty; misrepresentation; omission of facts; and negligence.

Claimant did not specify the amount of relief requested.

Respondent denied the allegation made in the Statement of Claim and asserted numerous affirmative defenses.

The Panel awarded Claimant $385,000.00 in compensatory damages and $250.00 as reimbursement for Claimant's filing fee. Claimant was then ordered to return the annuity to Respondent.

Claimant's Counsel: Michael L. Einterz, Esq., Einterz & Einterz, Indianapolis Indiana.

Respondent's Counsel: Thomas Swigert, Esq., Dorsey & Whitney, LLP, Minneapolis, Minnesota.

Arbitrators: Richard Potter (Chair), Stephen L. Flint, Jr., Esq. (Public) and Jeffrey Richard Chiappetta (Industry).

This award is significant because it appears to have resulted in recessionary damages being awarded to the Claimant, allowing the Claimant to obtain all their invested money and get rid of the improper product.

Robert and Arlette Kramer v. Raymond James Financial Services, Inc. and Joe R. Woods, II
NASD Case No. 06-00236

The Claimants brought an action against Respondents related to the handling of their accounts, and the failure of Respondents to allocate the assets in a manner consistent with the objectives of the accounts. Specifically, Claimants dispute involved investments made into various technology stocks.

Claimant asserted the following causes of action: breach of fiduciary duty; negligence; breach of contract; and unfair business practices.

Claimants requested market adjusted damages, interest, disgorgement of all commissions and fees paid to Respondents, attorney's fees, which Claimant stated to exceed $200,000, and all just and proper relief which may be granted by the Panel.

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

The Panel awarded Claimant market adjusted damages of $200,000.00 and $25,000.00 in disgorged commissions. In addition, the Panel assessed all of the forum fees ($11,700) against Respondent and ordered that Claimant be refunded his previous payments.

Claimant's Counsel: Matthew R. Miller, Esq., Dreher Law Firm, San Diego, CA.

Respondent's Counsel: Joseph L. Larrinaga, Raymond James Financial Services, Inc., St. Petersburg, FL.

Arbitrators: E. Milton Frosburg, Esq. (Chair), James Aoron Skidmore, II, Esq. (Public) and Richard G. Link (Industry).

The case is significant because it resulted in an award of market adjusted damages to the Claimant. Further, the Award is significant because it included an award of disgorged commissions and investment fees to the Claimant.

Cases & Materials

Timothy A. Canning

Following are summaries of recent cases that may be of interest, from state and federal courts involving arbitration and/or securities, arranged generally by topic.

Before The Arbitration

Challenging Arbitration Agreement: Duress Is For Arbitrator

In Re RLS Legal Solutions, LLC
(Tex. 4/20/07) 221 S.W.3d 629, 50 Tex. Sup. Ct. J. 641

Texas Supreme Court compelled arbitration of an employment dispute pursuant to an employment agreement, where the plaintiff / former employee did not produce evidence that she was under duress to agree specifically to an arbitration provision, even though she had produced evidence of duress to agree to employment agreement as a whole.

While plaintiff was employed by the employer, the employer required her to sign a new employment agreement, which contained an arbitration clause. Plaintiff objected to signing the new employment agreement, but ultimately signed it, telling her employer that she was during so under duress.

In opposing the employer's motion to compel arbitration, the employee testified that she was told that the employer would no longer "direct deposit" her paychecks unless she signed the arbitration agreement. The employee also testified that she objected to other provisions of the employment agreement.

Applying the federal arbitration act, the court held that the issue of duress as to the entire employment agreement was a matter for the arbitrator to decide. Unless the arbitration provision alone was singled out from the other provisions, the claim of duress goes to the agreement generally and must be decided in arbitration.

Challenging Arbitration Agreement: Formation Is For Court

Sanford v. Memberworks, Inc. (9th Cir. 4/16/07) 483 F.3d 956

In this consumer action for unfair trade practices against a telemarketer, the Ninth Circuit holds that issues regarding the *validity* or *enforcement* of a putative contract which includes an arbitration clause should be referred to an arbitrator, but challenges to the *existence* of a contract as a whole – i.e.,

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formation issues -- must be determined by the court prior to ordering arbitration.

In this case, the consumer disputed whether she had ever entered into an agreement to enroll in the defendants' cosmetics program. According to MemberWorks records, Sanford was enrolled in the program and was sent a membership kit with an agreement containing an arbitration clause. The consumer, however, had no recollection of having been read a script, agreeing to the trial membership, or receiving a membership kit. The defendant relied on the arbitration clause in the membership kit in moving to compel the consumer to arbitrate.

The district court ruled that the contract formation issues surrounding the membership kit were for the arbitrator to decide, relying on Prima Paint Corp. v. Flood & Conklin Mfg. Co., 388 U.S. 395, 87 S.Ct. 1801, 18 L.Ed.2d 1270 (1967). In reversing the district court's decision, the court stated that Ninth Circuit precedent limited *Prima Paint* to challenges seeking to *avoid* or *rescind* a contract – not to challenges going to the very existence of a contract that a party claims never to have agreed to.

Scope/Arbitrability: Successor Liability

World Group Securities, Inc. v. Bradley (D. Nev. 5/21/07) 2007 WL 1489813

Defendant customers had filed an arbitration claim against World Group Securities, arising out of transactions that occurred while their accounts were at WMA Securities (whose assets were subsequently purchased by World Group Securities). Defendant customers also alleged misconduct that occurred while they were customers of World Group Securities.

World Group filed this action to enjoin the arbitration from proceeding against it as to the transactions that occurred at WMA Securities.

Plaintiff World Group requested that the Court stay the arbitration on the possibility that the arbitrator could improperly entertain, determine, or enter an award predicated on successor liability. World Group contended that the arbitrator may not follow the law in resolving that issue. The court characterized such a scenario as purely speculative and far from a certainty. However even assuming, *arguendo,* that the arbitrator does address the matter of successor liability of Plaintiff, the NASD rules governing the scope of arbitration are sufficiently broad to permit the arbitrators to rule on that question.

It is undisputed that Defendants are customers of Plaintiff, an NASD-member. It is also undisputed that Defendants have requested arbitration of claims allegedly arising in connection with the business activities of Plaintiff. The provision for arbitration covers "any dispute" between a customer and a member arising in connection with the business of such member.

Plaintiff World Group argued that, under the facts of this case, there can be no successor liability. Were the claim of successor liability the only dispute subject to arbitration, this Court stated it would arguably have a duty to decide that issue preliminarily.

However, that was not the only arbitrable issue. Plaintiff World Group conceded that the customers stated an arbitrable claim against it for the period during which they were World Group's customers. Accordingly, there is a basis for arbitration independent of the putative successor liability claim. Once the court has determined that any matter is subject to arbitration, the strong federal policy in favor of arbitration requires that the matter be sent to arbitration without further interference from the court.

The court declines Plaintiff's request to separately and summarily adjudicate the issue of successor liability during the pendency of arbitration.

Scope/Arbitrability: New York SOL is for arbitrator, not courts, to decide.

Goldman, Sachs & Co. v. Griffin (S.D.N.Y. 5/16/07) 2007 WL 1467430

In response to an NASD arbitration claim filed by a public customer (respondent Griffin), Goldman Sachs (petitioner) sought a court ruling, under New York law, to stay the arbitration permanently because all of Griffin's claims were barred by New York statute of limitations. The court held that this was an issue for the arbitrators to decide.

The court first ruled that the Federal Arbitration Act applied to this case, even though the arbitration agreement itself provided that New York law was to govern the agreement and its enforcement.

The court then ruled that under the FAA and the governing case law, the issue of whether respondent's claims are barred by any New York statute of limitation is for the arbitrator to decide, not the court. The court relied primarily on *Howsam v. Dean Witter Reynolds, Inc.,* 537 U.S. 79 (2002), *Painewebber v. Bybyk,* 81 F.3d 1193, 1198 (2d Cir. 1996), and *Shearson Lehman Hutton, Inc. v. Wagoner,* 944 F.2d 114 (2d Cir. 1991). The court did not acknowledge or discuss any distinction between the NASD's "six year" eligibility rule and state statutes of limitation.

Scope of Arbitration Agreement: Includes Torts

Efund Capital Partners v. Pless (Cal.App. 5/21/07) 59 Cal.Rptr.3d 340

Plaintiff Efund Capital sued a company for securities fraud, on its own behalf, and derivatively on behalf of nominal defendant RAP Technologies, Inc., doing business as Loan Vibe (RAP Technologies). Plaintiff is "a private equity firm" that finances and restructures companies.

The parties executed an agreement which also included an arbitration clause. The arbitration clause specifically provided, "The interpretation and enforcement of this Agreement shall be governed by California Law as applied to residents of the State of California relating to contracts exercised in and to be performed solely within the State of California."

The court initially held that this language was sufficient to avoid application of the limited preemptive aspects of the United States Arbitration Act, title 9 United States Code section 1 et seq.

However, the court held that the language *"[a]ny* dispute or other disagreement" extends beyond contract claims to encompass tort causes of action having their roots in the contractual relationship between the parties.

Scope of Arbitration Agreement: Does Not Include Torts

Aiken v. World Finance Corp. of South Carolina (S.C. 4/23/07) --- S.E.2d ----, 2007 WL 1223615

The scope of an arbitration agreement does not include outrageous torts that are unanticipated and unforeseeable by a reasonable consumer in the context of normal business dealings, where the outrageous torts, are legally distinct from the contractual relationship between the parties, even if the tortuous conduct is factually related to the performance of the contract.

Richard Aiken ("Aiken") filed a law suit against World Finance Corporation of South Carolina and World Acceptance Corporation (collectively, "World Finance") alleging various torts arising from the misuse and theft of Aiken's personal financial information by employees of World Finance.

In denying World Finance's motion to compel arbitration, the court found that the theft of Aiken's personal information by World Finance employees to be outrageous conduct that Aiken could not possibly have foreseen when he agreed to do business with World

Finance. Consequently, in signing the agreement to arbitrate, Aiken could not possibly have been agreeing to provide an alternative forum for settling claims arising from this wholly unexpected tortious conduct.

Scope of Arbitration Agreement: Brokerage Account Agreement

Citicorp Investment Services, Inc. v. Medanic (Fla.App. 5/30/07) --- So.2d ----, 2007 WL 1542025
~ and ~
Medanic v. Citicorp Inv. Services (Fla. App. 4/18/07) 954 So.2d 1210

Citicorp Investment Services, Inc. ("CIS") and broker Luis Prieto appealed an order denying their motion to stay this action pending arbitration pursuant to an arbitration clause contained in plaintiffs/appellees Medanic client agreement.

CIS is a securities broker-dealer and a member of the NASD. Luis Prieto is a former financial executive at CIS, whose responsibilities included recommending financial investments for CIS clients and conducting transactions with respect thereto on the clients' behalf. Appellees had individual accounts at CIS with Prieto as their financial advisor at all times relevant to this appeal.

CIS, citing to virtually identical arbitration clauses in the client agreements signed by both plaintiffs, moved to stay the underlying action pending arbitration. The motion was denied because the sale of the fixed annuity purchased through the clients' CIS account and the subsequent purchase of the variable annuity did not constitute transactions within the meaning of the arbitration clause.

The appellate court, however, disagreed. In light of the client's express grant of broad authority to CIS and Prieto to "to use [her] brokerage account to process orders to purchase fixed or variable annuities," the sale of the Sun Life fixed annuity initially purchased through Vilma's CIS account to purchase a Sun Life variable annuity (again purchased through that same CIS account) was a transaction that fell within the scope of the parties' arbitration clause irrespective of the account in which these annuities were held.

The court distinguished *Citigroup, Inc. v Amodio* (Fla. App. 2005) 894 So.2d 296, in which a Florida appellate court considered an identical arbitration provision and held that the plaintiff's fraud, misrepresentation, and violation of Florida Blue Sky law claims did not fall within the scope of the parties' arbitration agreement The *Amodio* court held that the plaintiff's claims were not subject to arbitration because the claims arose directly from the analyst's advice on whether to sell his WorldCom stock shares and not from "an order or transaction" within the meaning of the arbitration provision.

Unlike *Amodio,* the dispute in this case arose from an "order or transaction" under the plain language of the arbitration provision. By its plain language, the arbitration provision at issue applies to "all controversies which may arise concerning [1] any order or transaction, or [2] the construction, performance, or breach of th[e] Agreement." It is undisputed that the client deposited funds into an account at CIS and, thereafter, purchased a SunLife annuity with those funds. It is also undisputed that the client is challenging the suitability of this particular transaction. While in *Amodio* the plaintiff's claim arose directly from the analysts' advice, here, the client's claims arose directly from the purchase of an investment product. The court held that the arbitration provision applied to the client's claims here.

Scope of Arbitration Agreement: Includes Other Contracts

Norwood Promotional Products, Inc. v. Roller (Ind.App. 6/5/07) -- N.E.2d ----, 2007 WL 1599193

An employee brought an action under state blue sky laws against his employer, arising

out of a Stock Plan and Stock Award Agreement. The employee and employer also had entered into an employment agreement, which contained an arbitration clause; there was no arbitration clause in the Stock Plan or Stock Award Agreement.

The employer moved to compel arbitration of the employee's claims, which the court denied. The arbitration clause in the Employment Agreement read, "Any dispute between the parties *under this Agreement* shall be resolved ... through arbitration". (emphasis added). The arbitration clause is unambiguous in its meaning. When we interpret an unambiguous contract, we give effect to the parties' intention as expressed in the four corners of the instrument, and clear, plain, and unambiguous terms are conclusive of that intent. The word "this" is a singular pronoun that modifies a single agreement. Here, the use of the word "this" means *this*-not that or those. The employer's unambiguous language evidences its intention that the arbitration clause should apply only to the Employment Agreement.

Had the employer intended the arbitration clause to apply to the Stock Plan and the Stock Award Agreement, the court observed that the employer could have inserted these documents into the Employment Agreement or *expressly* incorporated said documents by reference. Here, there was neither an express wholesale incorporation of the Stock Award Agreement and Stock Plan into the Employment Agreement by reference, nor any language that indicates any such intent.

The court found that the arbitration clause must be narrowly construed to refer to the Employment Agreement alone, and affirmed the denial of the employer's motion to compel arbitration.

Who Can Enforce Arbitration Obligation: Parent Corporation of Broker-Dealer

Alfano v. BDO Seidman, LLP (N.J. Super. A.D. 6/15/07) --- A.2d ----, 2007 WL 1712614

Plaintiff brought this action for fraud against his accountants, their attorneys, investment advisors, and a bank (Duetchse Bank), arising out of plaintiff's investment in a failed tax shelter. The bank moved to compel arbitration, relying on an arbitration agreement between the plaintiff and an indirect subsidiary of the bank (Deutsche Bank Securities, Inc. ("DBSI")). DBSI was an NASD member. The underlying securities transactions which formed the basis of the tax shelter were handled by DBSI. DBSI was not named as a defendant.

Plaintiff alleged that in 1998, he was solicited by his accountants, BDO Seidman, LLP (accountants), to participate in a tax strategy to shelter a $150 million capital gain he realized from the sale of his business. The plan, known as an off-shore portfolio investment strategy (OPIS), was effectuated through investment advisor defendants Presidio Advisors, LLC, and Presidio Growth, LLC (collectively, Presidio). OPIS required the plaintiff to enter into a series of transactions to borrow funds from DB and then buy stock and options in DB, individually and through a Cayman Islands limited partnership, for which he would realize more than a $100 million loss to offset the gain realized from the sale of his business. Plaintiff asserted that he was told the investment was unique to his needs and afforded him the necessary tax avoidance to shelter his gain.

The accountants introduced the plaintiff to attorney R.J. Ruble of Sidley Austin Brown & Wood, LLP, formerly Brown & Wood (attorneys), who provided legal assistance and a tax opinion letter to the plaintiff, which he suggests represented that OPIS fully complied with federal tax laws.

The Internal Revenue Service, after auditing the plaintiff, ascertained that the tax shelter was "abusive," and disallowed most of the claimed costs and losses, requiring Alfano to pay capital gains taxes, interest and penalties. Plaintiff then brought this suit.

In ordering the dispute to arbitration, the court first concluded that there was an agency relationship between DB and DBSI. The underlying tax shelter strategy could not have been accomplished except for the participation of DBSI; the plaintiff had to rely on the DBSI transactions to assert his claim against DB. The court stated that the plaintiff should not be permitted to avoid the practical consequences of his agreement to arbitrate by not naming DBSI as a defendant, yet implicate DBSI's actions to establish his claim.

Next, the court concluded that even if the NASD forum was unavailable to resolve the dispute between plaintiff and non-NASD member DB, that fact would not defeat the application of the arbitration clause (the DBSI arbitration agreement specified the NASD as the arbitration forum, and DB was not a member of the NASD). The court also concluded that the FAA applied to the agreement.

The court then addressed the scope of the arbitration clause, concluding that it was worded broadly enough to encompass plaintiff's tort and contract claims against DB, in light of the strong judicial presumption favoring arbitration.

Who Can Enforce Arbitration Agreements: U-4 Form

Filloramo v. NewAlliance Investments, Inc.
(D.Conn. 4/23/07) 2007 WL 1206736

A broker-dealer can rely on a U-4 form to compel an associated person to arbitrate at the NASD, held the court in this action by an associated person against his former employer for damages under the Americans with Disabilities Act ("ADA"). The plaintiff, associated person Charles Filloramo, alleges that his former employer, broker-dealer NewAlliance Investments, Inc. ("NewAlliance"), discriminated against him because he is disabled.

The broker-dealer moved to compel arbitration of plaintiff's claims. Plaintiff opposed on the grounds that there was no written arbitration agreement between the parties.

In ordering arbitration, the court held that it was immaterial that there was not contract between the parties, because the plaintiff signed his U-4 application for NASD registration which explicitly names NewAlliance as Filloramo's firm, and further states that Filloramo "agree[s] to arbitrate any dispute, claim or controversy that may arise between [him] and [his] firm...."

The court concluded that, as a third-party beneficiary to Filloramo's agreement with the NASD, NewAlliance is entitled to enforce the arbitration provisions of that agreement. Because Filloramo did not argue otherwise, the court also presumed that the ADA claims were within the scope of that agreement, and that Congress did not intend ADA claims to be non-arbitrable.

NASD Membership Sufficient For Agreement to Arbitrate

In re Continental Broker-Dealer Corp.
(Bkrtcy E.D.N.Y. 5/9/07) --- B.R. ----, 2007 WL 1385605; 2007 WL 1412430

Bankruptcy trustee for a bankrupt broker-dealer sought to recover a $300,000 advance paid to a sales representative, on ground that the sales representative had not completed five years of employment (required in order to earn the advance). The trustee also pursued GunAllen, another brokerage firm, on a claim of "raiding" the broker-dealer for employees and customers. The sales representative and GunAllen moved to compel arbitration, which the trustee opposed, on the grounds that there was no arbitration agreement between the parties.

The court ordered the matter to arbitration, finding that the broker-dealer and the sales representative had independent obligations to arbitrate certain disputes, such as this one,

under the NASD's Code of Arbitration Procedure. Given the language of the NASD Code of Arbitration Procedures, the Court finds that Rule 10201 mandates that the broker dealer as a former member and the sale representative as an associated person of a member must arbitrate their dispute before the NASD. Even though these agreements were not between the broker dealer and the sales representative, these were separate agreements that each party entered into directly with the NASD, long before the Agreement herein was undertaken. The court applied the same analysis to order arbitration between the broker-dealer and GunAllen.

Plaintiff Trustee argued that the broker-dealer is a former member of the NASD and no longer subject to the NASD Code, and hence no longer obligated to arbitrate. The Trustee urged the Court to consider the Affidavit of Michele D. Collins ("Collins"), Associate Director of Case Administration at NASD, as support for his position that a former member cannot be compelled to arbitrate. The Court refused to consider it, on grounds it was unnecessary parole evidence and that Collins was not a drafter of the rule and hence could not speak to intent behind the NASD code.

The Court held that the broker-dealer's status as an NASD member, for the purpose of determining the applicability of the NASD's Code, should be determined at the time of the events leading to the dispute or claim or when the dispute or claim arose.

Finally, the Court rejects the trustee's argument that sales representative waived the right to arbitrate by submitting an Answer in the adversary proceeding and participating in discovery without asserting a right to arbitration. The Court concluded that the adversary proceeding had not so substantially proceeded as to prejudice any party were the Court to order that the parties arbitrate.

Class Actions: Exclusion in order to Arbitrate

Bowman v. UBS Financial Services, Inc.
(N.D. Cal. 5/17/07) 2007 WL 1456037

Two former employees of UBS sought to be excluded from a wage and hour class action against UBS. The two former employees had commenced an NASD arbitration, which UBS moved to enjoin on the grounds that the employees' claims were encompassed within the class action.

The court rejected the employees' attempt to be excluded from the class action, because the class action notice clearly notified them that any and all wage and hour claims against UBS during the class period would be released, with no exception for claims asserted in separate litigation. The employees admitted that they received the notice, and that they knew of the opt out deadline, but failed to opt out of the class action. The employees also requested a "retroactive extension" of the opt out deadline, which the court also denied, because the employees failed to show excusable neglect or good cause.

The court enjoined the arbitration brought by the employees but only to the extent their claims arose during the class period.

The court also ruled that UBS was entitled to recover its attorneys' fees and costs from these two employees, because class action settlement agreement entitled the prevailing party in any action to enforce the settlement agreement to recover reasonable attorneys' fees.

Class Actions: NASD Rules on Eligibility

Clark v. First Union Securities, Inc.
(Cal.App. 5/9/07) 2007 WL 1346188

Defendant Wachovia obtained a trial court ruling that the putative class and class action causes of action brought by plaintiffs Clark and Pool were to be resolved in NASD

arbitration. Wachovia then obtained a ruling from the NASD arbitrators that these causes of action were not eligible for arbitration. Following that decision, the trial court, on its own motion, reconsidered its first ruling, and issued an order holding that the putative class and class causes of action were to be heard in the trial court.

In affirming the trial court's second ruling, the court characterized Wachovia's motion to dismiss the arbitration as asking the arbitrators if they could hear the class action claims. The arbitrators answered "no," by holding (as Clark had urged) that the claims were "ineligible" for arbitration. Unlike other dismissals, the arbitrators' decision did not dispose of the claims nor foreclose the trial court from considering them. Rather, the arbitrators concluded only that they were not "eligible" for arbitration.

The fact that the arbitrators did not remand the class action claims to the trial court did not alter the Court's conclusion. The arbitrators decided that they did not have the authority under the NASD Code to consider the issues. Thus, the trial court was free, on its own motion, to consider if it had such power.

The court compared the general rule of NASD Rule 10324 (arbitrators are empowered to interpret the applicability of the Code's provisions) with the specific rule applicable to class claims (NASD Rule 10301(d)), which permits either the court *or* the arbitrators to decide if claims are "encompassed by a putative or certified class action...." Thus, according to the court, the trial court had the authority to make the arbitrability decision.

The court also rejected Wachovia's argument that Rule 10301(d) is the "functional equivalent" of a class action waiver, because a "clear reading" of rule 10301(d) acknowledges that class claims not eligible for arbitration can be brought in court.

During The Arbitration

Severance Is For The Arbitrators

Twist v. Arbusto (S.D. Ind. 6/8/07) 2007 WL 1686950

A group of investors asserted similar claims against company. The company obtained order compelling all the investors to arbitrate their claims. The group of investors then initiated one arbitration proceeding at the AAA, an arbitrator was appointed and hearing dates set. The company then moved in the arbitration to sever each investor's claim, so that each claim would be arbitrated in a separate proceeding. The company did not object to arbitrator's authority to rule on its motion to sever. The arbitrator denied motion.

The company then moved the court to order separate arbitrations, based on language in the arbitration agreement. In denying the motion, the court held: (1) the company waived the issue by submitting it to the arbitrator to decide without taking any steps to preserve objections to arbitrator's authority to decide severability; and (2) as arbitration agreement did not expressly prohibit joinder of all the investors claims, it was in the arbitrator's authority to rule on the question of severance. Even if the company had preserved an objection, it would not be able to overcome the presumption in this circuit in favor of letting the arbitrator decide the issue.

Consolidation is for Arbitrators

Certain Underwriters at Lloyd's London v. Westchester Fire Ins. Co. (3rd Cir. (N.J.) 6/12/07) --- F.3d ----, 2007 WL 1673876

Whether coverage disputes under essentially identical insurance contracts should be arbitrated separately on a contract-by-contract basis or collectively in a consolidated arbitration is a question for the arbitrators to decide, and not the court.

In light of the parties' agreement to arbitrate their disputes, contractual silence as to the consolidation issue, and the longstanding federal policy favoring arbitration, the court could not see any reason why this procedural issue should not be resolved in arbitration. As the court framed it, the question was "not whether the parties wanted a judge or an arbitrator to decide *whether they agreed to arbitrate a matter,*" but rather "what *kind of arbitration proceeding* the parties agreed to." The parties do not dispute that they agreed to arbitrate the underlying substantive issues. Instead, they disagree only as to whether their dispute should be resolved in individualized or consolidated proceedings as a matter of procedure.

Representing Parties in Arbitration: Malpractice

Cecala v. Newman (D. Ariz. 5/2/07) 2007 WL 1297241

A client filed suit against an attorney who represented her in an employment arbitration at the NASD. The court held that the client failed to prove "but for" causation, as required for malpractice.

The client raised a number of grounds for asserting malpractice liability (by way of an expert's testimony). The client's expert stated that the result in the underlying arbitration would have been different if the attorney had been admitted to practice law in North Carolina, or prepared more assiduously for trial, or volunteered legal advice that his client did not seek, or filed a charge of discrimination with the Charlotte division of the EEOC, or challenged the enforceability of the arbitration agreement in a judicial forum, or exercised greater care in the selection of the arbitrators, or obtained some unspecified documentary evidence from NationsBank by pursuing a more aggressive discovery strategy, or abstained from sexual intercourse with his client, or adopted a more cohesive trial strategy, or returned the client's file after he was discharged by her and before the arbitration concluded.

However, according to the court, the expert did not substantiate any of those claims with any facts or reasoned analysis. The expert did not discuss any missing evidence or say how it would have changed the client's fate.

The court recognized numerous legal, factual, and credibility problems that plagued the client's arbitration claims.

The attorney's rude behavior to the arbitrators would not support a conclusion that the client would have prevailed at the arbitration hearing if not for the attorney's behavior. The attorney was accused of long and repetitive questioning of witnesses on matters of which the witnesses claimed no knowledge, or matters consistent with Mr. Newman's pleadings, or matters which the panel had ruled were objectionable for one reason or another. When the panel objected to the attorney's line of questioning, he became rude, sarcastic and insulting to the panel members, which in turn drew stern admonishments from the tribunal. According to the client's expert, the attorney's display of "contempt" toward the fact finders who held his client's legal fate led the expert to conclude that the attorney's behavior "probably destroyed" Cecala's case and extinguished any chance of recovery.

According to the court, however, those facts would not permit a reasonable jury to conclude that client otherwise should have won and that the arbitrators put aside law and evidence to punish her for her lawyer's tactlessness.

The client's expert's related averment that the attorney "departed from the standard of care in failing to investigate, evaluate and exercise professional judgment as to the selection of the arbitrators who served on the arbitration panel" must also be rejected. This conclusion is inherently speculative and contrary to public policy. Moreover, even if an inference of injury were permissible on this ground, the expert advanced no rationale for gainsaying the attorney's choice of arbitrators.

The expert further contended that the attorney's decision to proceed directly to arbitration itself caused the client to lose her claim, because the "waiver of any opportunity of litigation" had "serious repercussions" because it resulted "in some loss in the rights of discovery" and also led to "the loss of a trial by jury." This too is insufficient for a jury to find causation and insufficient as a matter of law for legal malpractice.

The expert finally contends that client would have won if she had not been forced to discharge lawyer Newman prior to the conclusion of the arbitration. According to the expert, the termination of the attorney-client relationship prejudiced the merits of the client's case in three ways. First, the client was forced to represent herself during the October 1999 hearing dates. Although she presented evidence, the client was "no match" for the Bank's lawyer. Second, the client's pro se representation was hamstrung by the attorney's refusal to return the client file until 2000. Third, the client was "unable to provide a closing argument or brief to the arbitration panel." As a result, "the evidence in the record which could have provided a basis for a strong response to the bank's brief" went undiscovered. The expert concluded, without more, "The failure to present a closing argument or brief insured the loss of Ms. Cecala's claims." (Id. Ex. 16 at 10.)

However, the expert identified no evidence that, if located and presented to the arbitrators at the close of the hearing, would have changed the outcome of the arbitration. The lack of substantiation is fatal to the client's claim. A fair-minded jury could not conclude that a reasonable arbitrator would have disregarded the substantive flaws in Cecala's case in favor of unidentified but supposedly dispositive evidence after 18 full days of litigation.

The attorney's failure to call one witness could not have caused the loss. The omitted evidence was almost entirely self-serving hearsay- a recitation of the client's statements that one supervisor tried to manipulate her into a sexual relationship, and that another NationsBank executive, made unwelcome sexual advances toward her.

The client also contends that the attorney's "self-serving, manipulative and predatory" sexual relationship caused her to lose her otherwise meritorious Title VII claims because it "interfered" with and "adversely affected" the attorney's representation. But the client provided no factual support for this claim

The client finally contends that the attorney's failure to bring a claim for retaliation against NationsBank deprived her of an opportunity to recover damages against NationsBank under Title VII. Even if the attorney was negligent in failing to urge Title VII retaliation, the client failed to show that attorney's omission caused her to sustain much more than nominal damages, which it could not have been negligent to fail to pursue at a cost in attorney's fees that would dwarf any recovery.

The court has located no authority for the proposition that an attorney may be liable in negligence for failing to assert a theoretically viable claim that would cost far more to prosecute than it would yield.

The court granted summary judgment in the attorney's favor.

Arbitrator Disclosure & Bias: Frequent Users

Hayden v. Robertson Stephens, Inc. (Cal.App. 4/27/07) 150 Cal. App.4th 360, 58 Cal.Rptr.3d 333

In this case, the court interprets state arbitration act regarding what disclosures arbitrators must make.

The underlying facts were that a brokerage firm lent money to a client. The loan was secured by the client's shares in a technology company the client founded. When the

market value of the corporate shares fell, the client pledged real property as additional security. The client defaulted on the loan, owing more than $25 million. The client sued the brokerage firm for alleged breach of fiduciary duty in giving financial advice, and the brokerage firm cross-complained to collect on the loan.

The parties agreed to arbitrate their dispute at JAMS, and the arbitrator ruled in favor of the brokerage firm. The trial court confirmed the arbitration award over the client's objection that the award should have been vacated because the arbitrator refused to disclose all present and prospective relationships with Bank of America. The Bank of America had purchased the defendant brokerage firm after the arbitrator had issued an "interim award" in favor of the brokerage firm.

The court held that Bank of America Corp. or Bank of America, N.A. was not a party to the proceeding for arbitral disclosure purposes, under state law. The arbitrator, in his interim award, had resolved all liability issues adverse to Hayden before Bank of America Corp. acquired a party to the arbitration. No one can reasonably entertain a concern that the arbitrator's decision was motivated by partiality for Bank of America Corp. or its subsidiary. Accordingly, the arbitrator was not required to disclose past, present, or prospective employment relationships with either banking entity, and no ground exists for vacating the award for failure to disclose. (§ 1286.2, subd. (a)(6).). The court also held that the mere fact that the client also had loans with Bank of America were not relevant, as those loans were not the subject of the arbitration.

Plaintiff also argued that there was a substantial doubt about the JAMS arbitrator's impartiality because Bank of America, N.A. is a frequent client of JAMS in consumer litigation. The court did not address this argument directly, but instead summarily rejected this contention, simply stating that, "Bank of America, N.A.'s retention of JAMS for arbitration services provides no evidence of bias. The bank was not a party to the arbitration or otherwise involved in the arbitrated dispute. In any event, there is no evidence that arbitrator bias played any role in the award."

The court affirmed the superior court's order denying the investor's petition to vacate the arbitration award.

After The Arbitration: Challenging/Confirming Awards

Jurisdiction

Fox v. Faust (3rd Cir. (Pa) 5/18/07) 2007 WL 1454291

Thomas Fox, a securities broker, moved to vacate an NASD arbitration award entered in favor of his former customers, the Fausts, arising out of violations of the Securities Exchange Act of 1934 and state consumer protection laws.

The District Court confirmed the arbitration award, and Fox appealed. The court of appeals vacated the district court's confirmation, on the grounds that the court lacked subject matter jurisdiction.

In support of his suit for vacatur, Fox alleged only violations of the Federal Arbitration Act, which the court held to be insufficient to establish federal question jurisdiction. Fox further contended that his action to vacate the award arises under federal law because some of the Fausts' claims in the underlying arbitration arose under the Securities Exchange Act of 1934. He contended that because the Fausts could have sued him in federal court if they had not been compelled to arbitrate their claims, the District Court had jurisdiction over Fox's action to vacate an award based on these claims.

The court rejected those contentions, holding that a suit to vacate an arbitration award under § 10 of the FAA does not raise a federal question merely because the underlying arbitration involves a federal

question.

Manifest Disregard – Amount of Award
Public Policy
Arbitrary and Capricious

Fromm v. ING Funds Distributor, LLC
(S.D.N.Y. 5/24/07) --- F.Supp.2d ----, 2007 WL 1540968

Plaintiff Fromm sought to vacate an arbitration award in which he was awarded $42,500 from his former employer. Fromm-a financial services professional-was employed by ING as a wholesaler of mutual funds until his termination on June 8, 2004. Fromm alleges that he was fired in retaliation for questioning certain of ING's business practices that he believed were in violation of law and NASD rules. On July 5, 2005, Fromm filed a claim for arbitration under the auspices of the NASD, alleging: (1) violation of the whistle-blower protections in the Sarbanes-Oxley Act of 2002; (2) defamation, libel and slander; (3) failure to pay wages in violation of state law; (4) breach of contract; (5) unjust enrichment; (6) quantum meruit; and (7) conversion.

After ten days of hearings, in which Fromm was represented by an attorney, the arbitration panel dismissed Fromm's claims against the individual defendants and, in an award dated December 5, 2006, ordered ING to pay Fromm $42,500 in compensatory damages. All other relief was denied. Fromm then filed this petition to modify or correct the NASD arbitration award.

Fromm maintains that the arbitration panel's award was in manifest disregard of the law because it did not afford him all the relief to which he believes he was entitled.

In rejecting Fromm's claim, the court ruled that Fromm's position rested upon a faulty premise: namely, that he prevailed in all of his claims.

The arbitration award does not state which of Fromm's claims were granted and which were denied. What was clear from the award, however, was that the panel believed petitioner prevailed on at least one of his claims and awarded him compensatory damages in an amount that the panel considered appropriate under the circumstances.

Fromm could not satisfy either prong of the "manifest disregard" standard. First, he could not show that the panel knew of a "governing legal principle" which it ignored or refused to apply, because the award does not indicate which of petitioner's claims was granted. Similarly, Fromm cannot show that any legal principle allegedly disregarded by the panel was "well defined, explicit, and clearly applicable to the case," because the panel did not set forth what law governed its decision to award petitioner $42,500, nor was it required to do so. Therefore, petitioner's contention that the arbitration panel's award was in manifest disregard of the law was rejected.

Even if an "arbitrary and capricious" standard applied in this action, the court held that it would not provide grounds for disturbing the arbitration panel's award. At the arbitration hearing, ING offered the testimony of Renee Marino-a purported "expert on economic loss"-to rebut Fromm's damages calculation. Marino testified that based on her analysis, Fromm's damages ranged from a low of $0 to a high of $85,000. The panel's award of $42,500 falls precisely at the mid-point of Marino's range, and her testimony may have been the basis for the panel's decision. It is not necessary to determine whether the panel actually did credit Marino's testimony, because the mere fact that the award falls within the range shows the existence of "a ground for the arbitrator's decision [that] can be inferred from the facts of the case."

The court also rejected a "public policy" argument advanced by Fromm. Fromm contended that the panel's award of $42,500 violates public policy because it falls short of the full measure of damages to which he claims to be entitled under federal and state

law. This type of legal error, according to the court, does not constitute a violation of public policy warranting the modification of an arbitration award.

Harmless Error
NASD Rules are Not Law (Motion to Dismiss)
Denial of Postponement Request
Unlicensed Counsel

Cartwright v. Roxbury Capital Management, LLC (M.D. Fla. 5/3/07) 2007 WL 1303033

Plaintiff's NASD arbitration claim against Roxbury was dismissed by the arbitrators in response to a motion to dismiss filed by Roxbury Capital Management. Roxbury contended that the NASD did not have jurisdiction over it; the arbitrators agreed. Plaintiff sought to vacate the award, asserting various theories.

The Court initially found that the unavoidable result of vacatur would simply be another dismissal by the NASD arbitrators of the Plaintiff's claim against Roxbury. Accordingly, any error by the Panel in reaching its decision was harmless. No interpretation of the facts in this case would provide the NASD with jurisdiction over Roxbury in an arbitration proceeding. Indeed, it is undisputed that Roxbury is not a member of the NASD and never submitted to the jurisdiction of the NASD. To the contrary, the agreement between Roxbury and the Plaintiff provided for arbitration before the American Arbitration Association. Even if, as alleged by the Plaintiff, the arbitration provision in his contract with Roxbury was hopelessly ambiguous, such a finding would not subject Roxbury to arbitration before the NASD.

The court then turned to the arguments plaintiff advanced in support of vacatur. First, the court found that the NASD's violation of its procedural rules, without more, does not support the allegation that the Panel acted "contrary to law" because those rules are not law. Moreover, the Plaintiff's abbreviated argument that the Panel "exceeded their powers" by issuing a decision on the motion to dismiss without having made a verbatim recording of the hearing on that motion is wholly without legal support, and the Plaintiff provides no explanation as to how the absence of that recording has harmed him.

The arbitrators' refusal to postpone the hearing on the motion to dismiss, so that plaintiff could present testimony from a witness who was unavailable at that time, did not afford grounds for vacatur. First, the Plaintiff did not, and still has not, indicated what testimony the witness would give that would be material to the issue before the Panel, *i.e.* whether the NASD had jurisdiction over Roxbury. Second, if the Plaintiff really believed that the witness' testimony was material, the Plaintiff had ample opportunity to have obtained that testimony, whether by affidavit, deposition, or otherwise. Third, the Panel may have decided that the proceeding, already pending for almost a year, had been protracted so long as to violate the policy of expeditious handling of such disputes. Indeed the Panel stated that: "In order to expedite this case, the panel determined to consider the Motion based upon the written pleadings and oral argument."

Plaintiff then argued that since Roxbury's counsel did not comply with the Florida rules on out-of-state counsel appearing in arbitration, the Court should vacate the Panel's Order The court rejected this contention, stating that no matter how the Plaintiff couches his argument (whether "undue means," "against public policy," or "manifest disregard of the law"), he provided the court with no legal authority for his proposition that the violation of a bar rule provides ground for the vacatur of an arbitration award, especially, as here, where there is no nexus between the purported violation and the grounds upon which the arbitration award was entered.

Moreover, the Plaintiff suffered no prejudice by the Panel's decision to allow Roxbury's counsel to proceed with the hearing on the

motion to dismiss, as there is no evidence that a delay to allow Roxbury's counsel to comply with the rule would have affected the Panel's decision. To the extent that Roxbury's counsel violated the Rules Regulating the Florida Bar, the remedy for such a violation is an action against those attorneys by the Bar, and not the vacatur of the Panel's Order by this Court.

Order Compelling Arbitration Void

Rossco Holdings Inc. v. Bank of America (Cal.App. 4/19/07) --- Cal.Rptr.3d ----, 2007 WL 1152977

During the course of litigation, one party moved to compel arbitration, which the trial court judge granted. After arbitration, the parties filed cross-petitions to vacate and confirm the arbitration award.

At this point, the judge disqualified himself, due to previous conversations he had with dispute resolution providers regarding possible employment. These conversations had occurred prior to the judge's initial ruling on the motion to compel arbitration. The case was then transferred to a second judge. The unsuccessful party at the arbitration moved to vacate the trial court's earlier ruling compelling arbitration, based on the first judge's apparent disqualification to issue that order. The second judge granted the motion based on the first judge’s disqualification, and issued an order vacating not only the order compelling arbitration, but the arbitration award itself. The party successful at the arbitration appealed.

The appellate court held that the trial court should determine whether arbitration should be compelled without regard to the first judge’s disqualification. *If* the parties were required to arbitrate their dispute, they were required to do so because of an arbitration clause that existed *independently* of the first judge’s order. *If* that arbitration clause governs the parties' dispute, then the matter should have been arbitrated *regardless of* the first judge’s order. And if the arbitration was not otherwise tainted by the disqualification of the first judge, then the award should not be vacated.

When the *only* act of the disqualified judge was to send the parties to an alternative process in which the disqualified judge had no input whatsoever, the result of the alternative process should not be vacated solely by virtue of the judge's disqualification.

The court remanded the case to the second judge, to hear and decide anew the original motion to compel, without any consideration of or regard for the first judge’s ruling. If the second judge grants the motion to compel, then the second judge should proceed to hear and decide the pending cross-petitions to confirm and vacate the arbitration award.

Postponement of Hearing

Beckman v. H&R Block Financial Advisors, Inc. (D.Minn. 5/1/07) 2007 WL 1288011

In this employment case, a registered representative (Beckman) challenged an arbitration award on the grounds that the arbitrators refused to grant a reasonable request for postponement. The arbitrators found against Beckman and in favor of his former employer, H&R Block.

When Beckman was hired by H & R Block, he signed a promissory note for $80,000. Nearly two years later, H & R terminated Beckman for failing to keep his Form U-4 current, as required under National Association of Securities Dealers, Inc. (“NASD”) Rules. Under the terms of the promissory note, the outstanding portion of Beckman's loan became immediately due and payable at the time of termination and began to accrue interest.

H& R Block filed an arbitration proceeding against the registered rep in August, 2005. The hearing was original set for May, 2006, which was cancelled and rescheduled for August 2, 2006. On July 21, Beckman

requested that the NASD postpone the arbitration hearing, asserting that he had not received notice of the new arbitration hearing date. Beckman also filed a motion for leave to amend its answer and assert a counterclaim.

On July 28, 2006, the Panel denied Beckman's motion and request to postpone. The hearing went forward on August 2, 2006, and lasted one day. At the close of the hearing, each party agreed that it had received a "full and fair opportunity to be heard." Six days later, on August 8, the Panel issued its unanimous decision, finding Beckman liable to H & R for the remaining amount of the loan principal, interest and arbitration costs. The Panel also denied with prejudice "all other claims and requests for relief by any party hereto."

Beckman then petitioned the court pursuant to 9 U.S.C. § 10 to vacate the award, arguing that the Panel unreasonably denied his request to postpone the arbitration hearing. H & R counter-petitioned to confirm the award.

Beckman's counsel argues that she did not receive notice of the rescheduled arbitration date due to the failure of her former law firm to forward the relevant NASD and H & R Block correspondence to her. However, the court found it unreasonable for Beckman's counsel to take no action during the nearly four months she went without contact from the NASD or H & R. Further, Beckman received notice of respondent's statement of claim on August 9, 2005, and the original arbitration was scheduled to occur on May 9, 2006. Petitioner had ample time to prepare for the hearing. Moreover, two days before requesting the postponement, Beckman's counsel asserted to H & R Block that Beckman was committed to going forward with the August 2 hearing.

For these reasons, the court concluded that the arbitrators had a reasonable basis for denying Beckman's request to postpone the arbitration hearing.

Postponement of Hearing
Refusal to Allow Amendment

*SWAB Financial v. E*Trade Securities* (Cal.App. 5/17/07) 150 Cal.App.4th 1181, 58 Cal.Rptr.3d 904

An NASD arbitrators' refusal to allow an amendment to a statement of claim is not grounds for vacating an arbitration, under California state law. Further, to vacate an arbitration award on the grounds that a postponement request was denied, the party challenging the award must show that the arbitrator abused his or her discretion by refusing to postpone the hearing upon sufficient cause being shown; and then must show that the moving party suffered substantial prejudice as a result of the arbitrator's abuse of discretion.

In this case, the trial court found that the plaintiff's rights were substantially prejudiced by the National Association of Securities Dealers arbitrators' failure to postpone the arbitration hearing upon sufficient cause being shown, and also found that the arbitrators' failure to permit plaintiff to amend its statement of claim was also grounds for vacatur. The court of appeals reversed.

If you like reading about tactical uses of arbitration and civil litigation procedures, this is a good case to read. To briefly recap the central underlying procedural facts: After initially filing an arbitration claim, plaintiff then commenced a series of court cases against defendant (and one case against the NASD); in each case, plaintiff was ordered to arbitrate the claims. Three years after filing the arbitration and after one prior postponement of the arbitration hearing, the NASD arbitrators refused to permit plaintiff to amend its statement of claim (the request was made within one month of the reset hearing date), and also denied plaintiff's request for a continuance. After plaintiff failed to appear at the arbitration hearing, the panel entered an award in defendants' favor. Plaintiff then sought to vacate the award, which the trial court granted.

The court of appeals reversed, holding that when an arbitrator exercises discretion in denying a continuance request, there are two issues to be resolved in vacatur proceedings. First, the trial court must determine whether the arbitrator abused his or her discretion by refusing to postpone the hearing upon sufficient cause being shown. Second, if there was an abuse of discretion, the trial court must determine whether the moving party suffered substantial prejudice as a result.

The court concluded that there was no abuse of discretion in denying the postponement. Plaintiff's continuance request came: more than three years after it first initiated the arbitration; more than one year beyond the original arbitration date; after plaintiff had already once refused to appear at the arbitration hearing; and after plaintiff had twice brought legal actions against defendant, *SWAB I* and *SWAB III,* and twice been ordered to arbitrate the dispute. Plaintiff did not seek to amend its uniform submission agreement in arbitration until August 12, 2005. Moreover, plaintiff offered no excuse for failing to earlier assert its Business and Professions Code section 17200 claims which arose out of the same facts. Under these circumstances, the arbitrators could reasonably conclude there was no good cause to further delay the arbitration.

As to the arbitrators' refusal to permit plaintiff to amend its statement of claim, the trial court had no authority to *order* the arbitrators to allow amendment of the claims in the pending arbitration. The parties elected to follow and be governed by the National Association of Securities Dealers Code of Arbitration Procedure. The parties agreed, "[A]rbitration shall be conducted in accordance with the rules then in effect of the National Association of Securities Dealers, Inc." That agreement was an "integral part" of their arbitration contract. Rule 10328(c) states that once a panel of arbitrators has been appointed, a new or different pleading can be filed only with their consent. Rule 10328(c). Whether to allow plaintiff to amend its claims in the pending arbitration to include Business and Professions Code section 17200 allegations was for the arbitrators and not the trial court to decide.

The trial court also had no discretion to vacate the arbitration award based on the arbitrators' disallowance of an amendment. Judicial review of arbitration awards is limited exclusively to the statutory grounds for vacating or correcting the award. That the arbitrators refused to allow an amendment to introduce new claims into a pending arbitration is not one of the statutory grounds for a trial court's vacation of an arbitration award.

Relief Awarded Beyond Scope of Request

Alaia v. Merrill Lynch, Pierce, Fenner & Smith Inc. (Pa.Super. 6/11/07) --- A.2d ----, 2007 WL 1687279

Where arbitrators awarded relief in particular counts where that relief was not requested by the plaintiff, the arbitrators' award should be vacated, under Pennsylvania state law standards for vacatur.

In this case, the plaintiffs sought different relief from different parties in different counts; the arbitrators, however, awarded relief not in accordance with what was requested. In count I, for example, plaintiffs sought breach of contract damages against Merrill Lynch only; however, the arbitrators expressly but inexplicably, awarded damages under this count against both Merrill Lynch and Cully, jointly and severally. In contrast, with respect to the Count II negligence claim, which the plaintiffs asserted against both Merrill Lynch and Jack Cully, as Merrill Lynch's Agent (its sales representative), the arbitrators rendered an award against Cully only in the amount of $140,000.00.

Such a procedural irregularity involved a flagrant abuse of the arbitration process and displayed a palpable indifference on the part of the arbitrators to the justice of the result, since the arbitrators altered the plaintiffs'

claim by entering an award against a party (Cully) from whom claimants had sought no relief (Count I), while, at the same time, failing to enter an award against a party (Merrill Lynch) from whom claimants had requested relief for negligent conduct based upon the doctrine of respondent superior (Count II).

Thus, according to the court, this procedural irregularity in the arbitration process itself warranted the judicial intervention of the lower court to rectify an unjust, inequitable and unconscionable award.

Award Procured by Fraud

Citigroup Global Markets, Inc. v. Masek (Ohio App. 5/11/07) 2007 WL 1395360

An arbitration award will not be vacated on the grounds it was procured by fraud by way of false testimony, where the party asserting false testimony was in possession of evidence of the falsehoods at the time of the arbitration hearing but failed to use that evidence to impeach the witness.

After an arbitration hearing, the arbitrators found in favor of the brokerage firm and against the investor. The investor sought to set aside the award, on the grounds that the award was procured by fraud. The alleged fraud was that telephone records demonstrated that the broker's last telephone contact with the investor was on March 18, 2000. However, the broker testified at the arbitration hearing that he was in "daily" contact with the investor up to and including April 10, 2000, the day the market collapsed and the investments went sour. The investor conceded that had there been "daily" contact up to and including April 10, 2000, then the broker and Citigroup would be absolved of all responsibility for his investment losses. The investor contends, however, that there was not "daily" contact, as the telephone records reflect, and therefore the broker committed fraud in his testimony at the NASD hearing.

The court affirmed the trial court's denial of the petition to vacate. The court noted that Masek furnished no verbatim excerpt from the hearing or affidavit of a witness to the arbitration hearing that shows that telephone records were used to cross-examine Marroulis concerning his testimony. The brokerage firm argued that the investor was in possession of the phone records well in advance of the arbitration hearing, that he did not use such records to cross-examine the broker at the arbitration hearing, and that he offered them for the first time in support of his motion to vacate in the trial court

The court also held, without discussion, that the state law one-year time period to confirm an award was not an absolute time period, whereas the time to petition to vacate is an absolute bar.

Expungement

Sage, Rutty & Co., Inc. v. Salzberg (N.Y. Sup. Ct., Erie Cty., 5/30/07) No. 2007-01942.

Brokerage firm sought to confirm a stipulated award between a customer and the firm. The stipulated award recommended expungement of the underlying NASD arbitration proceeding from the CRD records of the broker. The customer challenged confirmation and requested vacatur of the stipulated award, on the grounds that she entered the settlement agreement and stipulated award under duress from her then-current attorney. The New York attorney general also intervened, opposing confirmation of the expungement portion of the award.

After describing the purposes behind NASD rule 2130 (expungement), the court described a conflict between that rule – which promotes a type of judicial review of arbitration awards – and New York state law on vacating arbitration awards. The court concluded that stipulated awards should be disturbed only if there is something uniquely troubling about the dispute.

The court was troubled about the stipulated award for expungement. The court found that

the arbitrators' decision on expungement was irrational because it was made without any evidentiary support. There was no hearing, no written settlement agreement, and no other documents, upon which the court could rely in order to fulfill what the court believed was its responsibility under NASD rule 2130, in reviewing expungement awards.

The court also expressed concern that brokers will entice aggrieved investors to settle factually accurate claims if they agree to a stipulated award recommending expungement. According to the court, this promotes private interests at the expense of the state's interest, as well as at the expense of the interests of potential investors and the public generally.

The court ordered a rehearing by the arbitrators: "The Arbitrators are directed to clarify the facts and circumstances which led them to conclude [as they did in the Award] that 'the claim, allegation, or information is factually impossible or clearly erroneous.'"

The court rejected the customer's claim of duress, however, finding that she had over one month from the date of the alleged duress to the date she signed the stipulated award, and there was no evidence that she did so against her free will.

Procedural Issues: Stay of Remand to Arbitration

Strobel v. Morgan Stanley Dean Witter
(S.D. Cal. 4/24/07) 2007 WL 1238709

In a previous decision, the Court remanded an NASD arbitration award back to the arbitrators, for clarification of the panel's damage award. The arbitrators had originally found in favor of plaintiff / investor, but awarded a very low amount in damages. See *Strobel v. Morgan Stanley Dean Witter* (S.D. Cal. 4/10/07) 2007 WL 1053454
In this opinion, the court denies Morgan Stanley's motion to stay the court's remand order, pending appellate review of its order.

Morgan Stanley argued that it would be deprived of the benefit of its arbitration agreement should the Court deny them a stay. According to the court, this argument seems to imply that the arbitration agreement Morgan Stanley entered into with the investor was intended to be beyond the reach of the Court's review powers under the Federal Arbitration Act, 9 U.S.C. § 9, *et seq.* ("FAA"). The other inference to be drawn from this argument is that any time a district court uses the limited review power granted to it by Congress under the FAA, it is denying the parties the benefit of their arbitration agreement. Surely Congress would not go to the effort of passing legislation it intended to be completely toothless.

The court also rejected Morgan Stanley's argument that should the panel issue a new damages award the Ninth Circuit would be unable to reverse the district court and find that the original award should have been confirmed.

The court then observed that the public interest, which Respondents define as preserving the finality of arbitration proceedings, does not weigh strongly here one way or the other. The public has an equally strong interest in arbitration awards not being rendered in manifest disregard of the law.

The court found that the crucial factor was the potential harm to Petitioner/investor from the granting of a stay. As the Court noted in its April 11 Order, Petitioner/investor is 86 years old, and has already been prejudiced by the delay. In this case, the only real harm that can be made out to Morgan Stanley would be the payment of damages to the petitioner, in an amount which given Morgan Stanley's size and worth, is barely a drop in the proverbial bucket. This does not qualify as irreparable injury because Morgan Stanley can be made whole again by the return of those same money damages. Where there is an adequate remedy at law, i.e. money damages,

equitable relief in the form of a stay pending appeal is not appropriate.

Time Limit To Challenge Award Where No Agreement to Arbitrate

Danner v. MBNA America Bank, N.A. (Ark. 4/26/07) --- S.W.3d ----, 2007 WL 1219747

The Arkansas Supreme Court held that a consumer in a debt collection case can raise the argument that she is not bound by an arbitration clause for the first time in opposing a petition to confirm an arbitration award, because the FAA's 90-time limit for seeking to vacate an award does not apply unless there is a written agreement to arbitrate.

After obtaining an award against the alleged debtor, MBNA waited until the 90 days for vacatur had just passed before filing its petition to confirm. The consumer opposed confirmation, alleging that she had never entered into an arbitration agreement with MBNA, that she did not participate in the arbitration, and that she had never waived her due-process rights with respect to any disputes related to any business or other relationship that may have existed between the parties. MBNA argued that she was time-barred from making this argument, and the trial court agreed and confirmed the award.

Following the reasoning of *MCI Telecom v. Exalon Industries, Inc.* (1st Cir. 1998) 138 F.3d 426, and applying the FAA (rather than state arbitration law), the Supreme Court held that "the time limit imposed by 9 U.S.C. § 12 is not triggered unless there is a written agreement to arbitrate." Because the trial court had granted summary judgment to MBNA on timeliness grounds, the case was remanded for determination of whether there was an enforceable agreement to arbitrate.

"[A]s a general matter, section 12, as well as section 2 and the other enforcement provisions of the FAA, do not come into play unless there is a written agreement to arbitrate. Thus, if there is no such agreement, the actions of the arbitrator have no legal validity. It follows that one is not required to mount a collateral challenge to such an ineffectual action, for if the agreement to arbitrate does not exist, there is no obligation to arbitrate -- and a noncontracting person's failure to appear at the arbitration hearing does not create such an obligation. . . .

[T]he time limits provided by section 12 for the vacation . . . of an award do not prevent a party who did not participate in an arbitration proceeding from challenging the validity of the award at the time of its enforcement on the basis that no written agreement to arbitrate existed between the parties. . . ."

Substantive Issues

Statute of Limitations – Federal Securities Act

Betz v. Trainer Wortham & Co., Inc. (9th Cir. (Cal.) 5/11/07) --- F.3d ----, 2007 WL 1377613

A declining account balance, in and of itself, would not necessarily have spurred a reasonable investor to further inquire whether he or she had been defrauded, according to the Ninth Circuit in this rule 10(b)(5) fraud case.

Summary judgment against plaintiff investor for securities fraud under section 10(b) was reversed, on the grounds that there were genuine issues of fact as to whether the investor had actual or inquiry notice of her claims more than two years before she filed her action. A reasonable fact-finder could conclude that the investor did not discover that the defendants intentionally misled her into believing that she could withdraw $15,000 per month without depleting her principal until June 2002, when she was told that Trainer Wortham was “not going to do anything” to fix her account.

In reaching that conclusion, the court resolved an open question in the Ninth Circuit as to whether inquiry notice can start the statute of limitations running under federal

securities law. The court adopted the "inquiry-plus-reasonable-diligence" test used by the Tenth Circuit. Under that standard, to determine when the statute of limitations begins running, the court first determines when the plaintiff had inquiry notice of the facts giving rise to his or her securities fraud claim. A plaintiff is on inquiry notice when there exists sufficient suspicion of fraud to cause a reasonable investor to investigate the matter further. Inquiry notice should not be construed so broadly that the particular plaintiff cannot bring his or her suit within the limitations period. The facts constituting inquiry notice "must be sufficiently probative of fraud-sufficiently advanced beyond the stage of a mere suspicion ... to incite the victim to investigate."

A statement by defendants that there was a "serious problem" with the investor's portfolio did nothing more than indicate to the investor that the defendants had not been able to make good on their promise of at least $15,000 per month in interest income. Because such a statement provided no evidence that the defendants had intentionally or deliberately and recklessly misled the investor, a rational jury could conclude that, upon hearing such a statement, a reasonable investor would not have initiated further inquiry into the existence of fraud.

Even if a reasonable investor would have initiated inquiry into the possibility of fraud, the assurances Betz received from the defendants tolled the statute of limitations on her securities fraud claim. When a defendant reassures a plaintiff that the defendant has not deceived the plaintiff and encourages the plaintiff to defer legal action, and the result is that the plaintiff postpones filing suit, we should be reluctant to grant summary judgment in favor of the defendant on statute of limitations grounds.

This holds especially true when the plaintiff is a naive investor, who enlists investment professionals and relies on those professionals' expertise. The case is entirely different for a sophisticated investor who would not normally be entitled to any equitable tolling of the limitations period.

The investor questioned the defendants about her account and the defendants assured her that they would take care of any problems and asked her not to file suit. When a plaintiff questions a defendant about possible fraud and receives reassurances from the defendant, whether the statute of limitations began running is a question for the Trier of fact.

The court stated, in a footnote: No person with any degree of investment and financial sophistication could have believed that it was possible to receive $15,000 per month, or $180,000 per year, on a portfolio with capital value of $2.2 million, without some significant degree of market risk. Sophisticated investors know that a return exceeding 8% per year cannot be gained without a substantial risk, and the safest investments, in government notes, would likely return not more than half of that rate. When the facts are determined by trial, the investor's factual premises might be rejected, but in this case coming before us after a grant of summary judgment, we must accept as true the investor's testimony that she was told she could gain this level of monthly income with defendants managing her investments and without risking the capital she had gained on the sale of her house.

Statute of Limitations: Conflicts of Law, Discovery

Seghers v. Morgan Stanley DW, Inc. (S.D.N.Y., 5/10/2007) 2007 WL 1404434

Plaintiff Conrad P. Seghers, founder and senior manager of hedge funds for Integral Investment Management, L.P. ("Integral"), brought this action in New York district court against defendant Morgan Stanley DW, Inc., alleging fraud and other tortious conduct arising out of a failed investment brokerage relationship. As plaintiff was a Texas resident and his claim accrued in Texas, the Court

decided that it must compare the New York and Texas limitations rules.

New York's borrowing statute provides that, when a plaintiff is a non-resident of New York, the applicable statute of limitations is the shorter of New York's limitations period or the limitations period of the state in which the non-resident's claims accrued

New York law provides that fraud claims must be brought within the “greater of six years from the date the cause of action accrued or two years from the time” of discovery of the fraud. However, under Texas law, plaintiffs have four years from the date of the fraud or the discovery of the fraud to bring an action. Thus, Texas provides the shorter of the limitations periods, and the claim must be dismissed if it is barred by the Texas limitations provision.

The court ruled that plaintiff had sufficient knowledge of his injury to cause him to begin investigating its cause as of August 1, 2001, as a letter from plaintiff reveals that plaintiff had actually begun that investigation. Plaintiff's claim that he did not learn about the specific details of the fraud until 2004 is irrelevant to the limitations analysis, just as it is of no moment that plaintiff did not know the “full extent” of his injury until that time. All that is necessary for the limitations period to commence is knowledge of the “general cause” of the injury, in this case, defendant's mismanagement of plaintiff's accounts.

Plaintiff could not allege that he could not have discovered the activity or that such activity was “inherently unknowable.” To the contrary, the complaint reveals that plaintiff had actual knowledge of the fraudulent activity; indeed, it was this very knowledge that caused plaintiff to terminate his relationship with defendant in July 2001.

Accordingly, the court concluded, plaintiff's fraud claim accrued no later than August 1, 2001, and expired, at the latest, on August 1, 2005. Because plaintiff did not commence this action until June 15, 2006, more than four years after his fraud claim accrued, the fraud claim was held to be time-barred.

Statute of Limitations: Discovery

Alexander v. Cadaret, Grant & Co., Inc.
(Wash.App., 4/9/07) 137 Wash.App. 1059, 2007 WL 1041380

Investors in a private placement exercising reasonable care should have discovered a ponzi-scheme fraud upon their receipt of letters from the private placement manager, where the letters were intended to assuage investors' fears but which were replete with vague promises and explanations, and mysterious references to government compliance agencies and unnamed foreign banks, and where one such letter explained that private placement would no longer take additional investments *so the government could not accuse the company of running a Ponzi scheme.* Because the state securities fraud action was filed more than 3 years after those letters were received, the court held the investors' action was time-barred.

The court rejected plaintiffs' arguments that plaintiff investors could not have reasonably discovered the Ponzi scheme fraud until a newspaper article appeared, describing a raid by the SEC on the offices of the private placement (the action was filed within 3 years of the date of that article.)

The court also rejected plaintiffs' argument that the state securities law's purpose of protecting investors required application of a subjective standard as to discovery of the fraud, such that a cause of action does not accrue until the relevant facts are public knowledge, *and* the plaintiff understands the legal significance of those facts.

Instead, the court stated that a cause of action for a state securities act violation accrues when the plaintiff knows or should know the relevant facts of the fraud, whether or not the plaintiff also knows that these facts are enough to establish a legal cause of action. The plaintiff must exercise due

diligence in discovering the basis for a cause of action, and the plaintiffs' actions are judged against those of a reasonable investor.

According to the court, plaintiffs had been receiving regularly monthly payments which suddenly stopped, and then began receiving letter after letter explaining that payments were not forthcoming because of governmental investigations. The court contrasted this situation to one in which plaintiffs had been receiving promised monthly payments, which could lull investors into inaction. In the present case, however, rather than lulling the plaintiff investors to inaction, the letters and the cessation of monthly payments should have spurred the plaintiffs to investigate. Since the last letter was sent more than 3 years prior to commencement of the suit, the claim was barred by the statute of limitations.

Definition of Securities: Promissory Notes Are Securities

Highland Capital Management LP v. Schneider (N.Y. 4/3/07) 8 N.Y.3d 406, 866 N.E.2d 1020

A New York court concluded that because certain promissory notes were securities under the Uniform Commercial Code, the statute of frauds did not apply to an agreement to sell those promissory noted.

In the underlying case, plaintiff alleged that defendants breached an oral agreement to sell the notes to the plaintiff. Defendants denied having entered into such an agreement, and further contended that such an oral agreement would have been unenforceable since it fell within the statute of frauds.

In concluding that the notes were securities, the court held that the notes were obligations represented by a security certificate in bearer or registered form. The promissory notes definitively embodied and evidenced the underlying intangible obligation of the maker to the defendant, and specified who was entitled to the security.

The court further concluded that the notes could have been registered, even if they were not actually registered, and therefore were a "security certificate in registered form". The notes could have been registered by the maker, as the maker would have to have recorded any transfer of the notes in order to protect itself and the senior debt holders. The court concluded that the notes therefore satisfied the transferability test in UCC 8-102(a)(15)(i): they were obligations represented by a security certificate in registered form.

The notes also satisfied the divisibility test in section 8-102(a)(15)(ii). "[M]inimum compliance with this formality requires that there be at least two instruments in a specified class or series, or that the single instrument be divisible into at least one additional instrument

Finally, the notes fulfilled the functional test in section 8-102(a) (15)(iii)(A) because these obligations "[were], or [were] of a type, dealt in or traded on securities exchanges or securities markets." Treating these notes as article 8 securities comports with a central goal of the Uniform Commercial Code, which is to create a framework for commercial activity that reflects and fosters developing custom and usage. Or as one commentator remarked with specific reference to article 8: "[T]he definition [of securities] will change as 'securities' trading practices evolve to include or exclude new property interests. It is believed that the definition will cover anything which securities markets, including not only the organized exchanges but as well the 'over-the-counter' markets, are likely to regard as suitable for trading"

Since the notes qualified as securities under section 8-102(a)(15), the statute of frauds did not apply to an agreement to transfer the notes.

Definition Of Security: Promissory Note Misrepresentations: What Constitutes

State v. McGuire (Wis.App. 5/2/07) 2007 WL 1266895

A seller of promissory notes (ostensibly to fund the seller's NASCAR racing endeavors) was convicted of securities fraud under Wisconsin's blue sky law, on the grounds that the seller's failure to disclose a prior felony conviction and a bankruptcy to the buyer were actionable misrepresentations.

On appeal, the seller argued that the notes were not securities. The Wisconsin appellate court weighed the following four factors to determine whether or not the note fell within or closely resembles a "family" of instruments deemed not to be securities, which in turn would rebut the presumption that the note was a security.

1) the seller's motivation was to raise money for his NASCAR venture and the buyer's motive was to make a profit, which weighs against a family resemblance to a non-security.

2) the narrow "plan of distribution" of the note weighs in favor of a "non-security", as the note was sold to only one person;

3) the seller convinced the investor that since NASCAR was "up and coming," his venture had a promising future and she would realize a return significantly better than likely could have been achieved at a local bank. A reasonable investor would have considered the transaction with its higher-than-commercial interest rate to be an investment.

4) the state's Deceptive Trade Practices Act (DTPA) did not provide a regulatory scheme sufficient to protect investors, because it prohibits only affirmative assertions, not a failure to disclose, whereas omitting information supports a claim under the state's blue sky laws. Relying on the DTPA would not offer sufficient risk protection because it provides no remedy for omissions of material facts.

After holding that the note was a security, the court then held that the following were s were material facts which would influence a reasonable investor's investing decision: seller's failure to inform the investor of his undischarged bankruptcy, the terms and conditions of which significantly limited the seller's ability to incur debt; the seller's failure to disclose his felony conviction and prison time for theft by conversion; and the seller's affirmative statements that this was a good, safe investment.

Commodities: CFTC Jurisdiction

U.S. Commodity Futures Trading Com'n v. Reed (D.Colo. 3/27/07) 481 F.Supp.2d 1190

The CFTC has broad authority to regulate price manipulation of any commodity in interstate commerce, according to this Colorado court.

In this case, the CFTC alleged that defendants (1) knowingly delivered false or misleading or knowingly inaccurate information concerning natural gas transactions to industry reporting firm that calculated and reported the index price of natural gas, and (2) attempted manipulation of natural gas price indices. The natural gas transactions involve actual physical delivery of natural gas, and not futures or option contracts. The CFTC's complaint does not allege that any of the Defendants were natural gas futures traders or that they entered into any futures or options contracts or made any statements about futures or options contracts.

In denying defendants' motion to dismiss, the court rejected defendant's argument that the CFTC did not have jurisdiction over the alleged misconduct. The court also rejected the defendant's argument that the CFTC's jurisdiction over cash markets was limited only to where a nexus was shown between

the alleged price manipulation in a cash market and a futures market.

Instead, the Commodity Exchange Act (7 U.S.C. § 13(a)) grants the CFTC jurisdiction over both futures contracts *and* over certain conduct involving or affecting cash markets. The CFTC has exclusive jurisdiction to regulate transactions involving the futures market, the CEA does not limit the CFTC's broad authority to regulate price manipulation of *any* commodity in interstate commerce.

Further, the CFTC alleged that if Defendant Reed's attempted manipulation of the natural gas price indices had occurred it "could have affected the price of natural gas futures and options contracts traded on the NYMEX." Moreover, nothing in the plain language of the Commodity Exchange Act limits that section to "contracts of sale of a commodity for future delivery."

The court also held that the illegal activity alleged in the Complaint-false reporting of market information concerning natural gas and attempted manipulation of natural gas price indices -- does not implicate an "agreement, contract or transaction" and hence is not exempt under 7 U.S.C. §§2(g) and 2(h).

The court further found that the CEA defines the prohibited conduct with "sufficient definiteness that ordinary people can understand what conduct is prohibited," and, therefore, the statute is not unconstitutionally vague. The court further found that fraud was sufficiently pled by the CFTC under FRCP 9(b), but without deciding whether that rule applies to CFTC actions alleging price manipulation.

Actions Involving The SRO's

NASD Dispute Resolution, Inc. v. Judicial Council of California (9th Cir. 5/30/07) --- F.3d ----, 2007 WL 1544589

In what may well be the last chapter in the dispute over whether California's enhanced disclosure requirements for arbitrators apply to SRO arbitration, the court of appeal vacated the district court judgment in this action between the SROs and California's Judicial Council.

In 2001, the California legislature passed a law ordering the Judicial Council of California, the rule-making arm of the California court system, to create ethical standards for commercial arbitrators. The Council responded by enacting comprehensive standards including requirements for conflict-of-interest checks, disclosures to arbitrating parties, and penalties for unrevealed conflicts.

NASD and NYSE objected to the California standards. Those organizations argued that they have operated their own securities arbitration services for decades under federal auspices. They have their own standards and procedures, which are not entirely consistent with the California standards. They feared the California standards would make NASD or NYSE arbitration in California more expensive, because of the added requirements, and less reliable, because an arbitrator's decision could be vacated if the arbitrator failed to comply with the California standards. Thus, the NASD and NYSE sued the Council and its individual members in federal court, seeking a declaratory judgment that (1) federal securities law preempted the California standards, (2) the California standards could not constitutionally be applied to the stock exchanges' arbitration programs, and (3) under state law the California standards did not cover NASD or NYSE arbitrations.

The district court dismissed the NASD's suit on the grounds that the California Judicial Council was immune from suit under the Eleventh Amendment to the U.S. Constitution. The NASD and NYSE appealed that decision.

While the NASD's appeal was pending, both the Ninth Circuit and the California Supreme Court ruled that the NASD Code of Arbitration

Procedure preempted contrary state law on arbitrator disclosure standards. *Credit Suisse First Boston Corp. v. Grunwald,* 400 F.3d 1119, 1126-36 (9th Cir. 2005); *Jevne v. Superior Court,* 35 Cal.4th 935, 28 Cal.Rptr.3d 685, 111 P.3d 954 (Cal. 2005).

Both parties agreed that the decisions in *Grunwald* and *Jevne* rendered the NASD's appeal moot. The dismissal did not reach the merits of the arguments put forth by NASD and NYSE but was instead based on the conclusion that the Eleventh Amendment barred suit in federal court against the Judicial Council and its individual members

The court acknowledged that vacating a lower court's opinion based on mootness is not always appropriate, such as in the case of settlements while an appeal is pending. However, the court observed that regardless of whether it vacated the district court's judgment or not, the opinion of the district court "will not be ripped from Federal Supplement 2d." The opinion would still be available and will still be citable for its persuasive weight – which the court believed would not be too persuasive outside of future litigation involving the same parties and their privies, because a district court opinion does not have binding precedential effect

Breach of Contract to Provide Services Against Brokerage Firm

Green v. Ameritrade, Inc. (Neb. App. 6/5/07) 2007 WL 1599708

Plaintiff Green brought a breach of contract action against Ameritrade, Inc., and Ameritrade Holding Corporation (collectively Ameritrade) in the district court for Douglas County, alleging that Ameritrade failed to provide "real time" quotes for stocks and options on its Internet Web site as agreed to in the contract. Green alleged that Ameritrade failed to provide "real time" last sales information with respect to stock and option quotes as it was contractually required to provide. He alleged that his contract with Ameritrade for the "real time" service did not differentiate between real time information for stocks and options and that subscribing to the service provided last sales information for both.

Green alleged that Ameritrade does not purchase or obtain information from all exchanges or market makers and thus, that Ameritrade is not providing "true" real time, last sales information, but, rather, that the information it provides to its subscribers with respect to stocks and options is inaccurate and delayed. Green's second amended complaint did not identify any instance in which he lost money as a result of the allegedly inaccurate market information supplied by Ameritrade, and he sought only a refund on his subscription fee.

Ameritrade first argued that it delivered the stock and option information that it contractually promised to provide. Specifically, Ameritrade claimed that the contract did not promise to provide real time option quote information, but, rather, the contract promised to provide market data from certain identified stock reporting networks. Ameritrade argued that it provided the information required by the contract.

In regard to this argument by Ameritrade, Green did not present any evidence to show that he ever received inaccurate or delayed stock information. His evidence alleges only specific instances of inaccurate or delayed information in regard to options._Ameritrade also argued that even if it had a duty to provide real time option quote information, it could not be liable, because a provision in the CMO Agreement precludes "Information Providers" from being held liable for inaccurate or delayed information and Ameritrade meets the definition of "Information Provider."

In affirming summary judgment in favor of Ameritrade, the court held that even if the Trading Account Handbook was part of the contract, it does not promise to provide real time quotes for options. Further, the words "Real Time Quotes" on Ameritrade's Web site

do not constitute a contractual obligation. The court concluded that Ameritrade provided the information that it promised in the contract.

PSLRA
Unsuitability Under 10(b)(5)

Robert N. Clemens Trust v. Morgan Stanley DW, Inc. (6th Cir. (Tenn.) 5/2/07) 485 F.3d 840

Plaintiffs brought this class-action suit on behalf of individuals and entities who, at the recommendation of a Morgan Stanley broker, purchased $50,000 or more of Class B shares in one or more of Morgan Stanley's mutual funds. The district court granted MSDW's motion to dismiss, on the grounds that plaintiffs failed to state a cause of action under the heightened pleading requirement for rule 10(b)(5) claims, under the PSLRA.

In affirming, the appeals court observed that plaintiffs' claim was based on unsuitability, namely, that Morgan Stanley, by recommending Class B shares, knowingly sold Plaintiffs unsuitable securities. A suitability claim is a type of section 10(b) fraud claim. A determination as to the suitability of an investment is made after considering the investor's investment objectives and needs because an investment is unsuitable for an investor if what the broker recommends contradicts the investment goals communicated to the broker by the investor.

Plaintiffs here, however, could not have pleaded the individualized investment objectives of each investor, as Morgan Stanley insisted they must, because doing so would likely have defeated class certification. To satisfy the pleading requirements of the PSLRA and still be able to pursue their claims as a class, Plaintiffs should have pleaded facts demonstrating that Morgan Stanley engaged in a *scheme to defraud* its investors.

Plaintiffs' complaint must allege facts indicating that Morgan Stanley was steering all investors or a predetermined number of investors into investments in Class B shares, regardless of each investor's personal investment goals or what each investor told their broker. If Morgan Stanley were engaged in such a fraudulent scheme, its brokers would recommend Class B shares to all investors despite each investor's specific needs. Plaintiffs, however, did not alleged sufficient facts indicating that Morgan Stanley was encouraging its brokers to recommend Class B shares to investors regardless of their investment objectives.

Plaintiffs' allegation that Morgan Stanley's brokers recommended Class B shares for investors with investments of $50,000 or greater because of the lucrative compensation structure was not sufficient to establish the existence of a fraudulent scheme because it amounts to no more than pleading a motive and opportunity for Morgan Stanley to commit securities fraud. Such allegations alone are insufficient under PSLRA.