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The Madoff Mess and The Deductibility of Investment Theft Losses

A Primer on IRC Section 165(c)(2)

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Introduction

The Madoff Mess will challenge you to help your clients determine the best way to recover their losses. Where there are few, if any, viable sources of recovery, one method may be to have the government help your client with a tax refund and/or a reduction of their future tax obligations. This can be accomplished by maximizing tax benefits under Internal Revenue Code (IRC) Section 165(c)(2) the Theft Loss provision.

Background

All financial frauds start with a story that is too good to be true. Madoff and his alleged consistent rates of return are simply the latest example of that. The problem is that many frauds may leave your client with no money and no viable alternative sources of recovery.

We know that there will be no shortage of legal actions. There will be bankruptcy proceedings, class actions, and plenty of third party litigation. Lawsuits will be abundant. What may not be abundant is any money left for the Investor. Accordingly, every securities attorney practitioner should be aware that their client's best chance for recovery may be from the Theft Loss provisions of the Internal Revenue Code.

Technical Requirements

Certain investment losses may qualify for advantageous tax treatment. The "**theft loss**" provision of the Internal Revenue Code may allow for a reduction of ordinary income, a recovery of previously paid taxes and minimize future tax obligations by using IRC Section 165(c)(2).

That section has numerous technical requirements and certain "legal" determinations that may make many CPAs and attorneys reluctant to take or defend the IRS response to this type of claim. Further, most tax software does not properly handle this situation and is usually geared toward preparing the more common IRC Section 1211 deduction with its $3,000 limitation.

As a result, it may be best for most CPAs and attorneys to take such a case to an experienced tax attorney. An experienced attorney can help determine if the legal requirement of a "**theft**" has occurred. Whether a loss constitutes a "theft loss" is determined by examining the law of the state where the alleged theft occurred. *Edwards v. Bromberg*, 232 F.2d 107, 111 (5th Cir. 1956).

Specifically, the IRC does not define the word "theft" and, as a result, whether a particular loss qualifies as a "theft" is dependent upon how the state where the taxpayer lives defines that word. In addition, a taxpayer must prove there was actual fraud with the necessary element of "**scienter**" which requires criminal intent. Thus, to claim a theft loss, the taxpayer must prove that the "loss resulted from a taking of property that is illegal under the law of the state where it occurred and that the taking was done with criminal intent." Rev. Rul. 72-112, 1972-1 C.B. 60.

The investor *must* have bought the investment directly from a seller that committed fraud under a local law. This leads to a requirement of "**reliance**" that the investor relied on the fraudulent information when parting with their property. This means that the investor dealt directly with the person committing the fraud, as opposed to purchasing the stock through their broker on the open market. The courts have consistently disallowed theft loss deductions relating to a decline in the value of the stock that was attributable to corporate officers misrepresenting the financial condition of the corporation, even when the officers were indicted for securities fraud or other criminal violations. *Paine V. Commissioner*, 63 T.C. 736, 523 F.2d 1053 (5th Cir. 1975).

The IRS in Notice 2004-27, 2004-1 C.B. 782 advised taxpayers that the IRS will disallow (and may impose penalties) for theft losses claimed by taxpayers for the decline in market value of their stock caused by disclosure of accounting fraud or other illegal misconduct of the officers or directors of the corporation that committed the fraud.

If eligible, a tax attorney can help the client by using the IRC to possibly eliminate this year's tax and also by going back three years for refunds and forward for twenty years. This type of deduction can be used without triggering the Alternative Minimum Tax and is not subject to the two percent floor by IRC Section 67.

If there is no viable option for recovery, as there often aren't in financial fraud matters, then IRC Section 165 may be the best alternative for the client.

Technical Requirement and Madoff

It is clear that Mr. Madoff has been charged with "theft" and is likely to be convicted on those and/or related charges. Further it is clear that he acted with the necessary element of "scienter" or evil intent as is required by the IRS. The problem for many of Madoff victims is that there was no "reliance" as required. Remember that the reliance means that they dealt directly with Mr. Madoff or his company, Bernard L. Madoff Securities, LLC.

One potential problem will be that many of the victims came to Madoff through one of the several dozen "feeder funds." These feeder funds were intermediaries and may affect the use of the Theft Tax Loss provision because the victim was not directly in privity with Bernard L. Madoff Securities, LLC. Further review by competent counsel should be arranged to determine the viability of all such claims.

When Do You Write Off the Loss?

The timing of the Section 165 loss can at first appear black and white. A plain reading of the IRS regulation appears to limit the write off to "**the year in which the loss is sustained**". Specifically, the IRC at 26 CFR 1.165-1 (d) Year of deduction at (1) states "[a] loss shall be allowed as a deduction under section 165 (a) *only for the taxable year in which the loss is sustained*."

However, the Code Section itself states at Section 165 (a) "**there shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise**."

So what does "compensated by insurance or otherwise" mean?

The issue of insurance is a question of fact for the Bankruptcy Trustee in the Madoff Mess.

And what is meant by "otherwise"? One could interpret that to mean litigation against the principal and other possible defendants who could be liable. Any litigation has a life of its own and could go on for a substantial period of time. So the question arises, does this preclude the taxpayer from writing off his losses while participating in the ongoing litigation?

This issue is further compounded by IRC Section 6511 which acts as a statute of limitations on these claims whereby the Taxpayer must file within three years from the date that the return was required to be filed or two years from the time the tax was paid, whichever was later.

An Extraordinary Case

How do you reconcile these two positions? What is the rule for taking "theft losses"?

A recent U. S. Tax Court case was fueled by an extraordinary set of facts will that help shed light on how the U. S. Tax Court interpreted the timing of the claim.

In the case of *Johnson and Johnson* v. *The United States,* US-CL-CT, 2008 -1 USTC 50, 142 (January 24, 2008), the Court analyzed and ruled on the timing issue for 165 Theft Loss deductions.

The Johnsons sold their Detroit based television station for over $175 million in 1997. They then purchased $83.5 million of jewelry from well known Palm Beach jeweler named Jack Hasson. Late in 1997, the Johnsons discovered that the gems were worth only $5.4 million. The result was that the Johnsons lost $78,160,409 in this fraudulent scheme.

In 1998, the Johnson's took a deduction of $58 million on their federal income tax return. The Johnson's had the assistance of their accountants and lawyers in estimating that there would be an approximate $20 million recovery. Subsequently, in 2001, Hasson was convicted of fraud.

To begin the analysis, the Johnson's met the three requirements of the IRS for Section 165 – Theft Loss to apply as they had already established: (1) *Theft*, as Hasson was indicted and later convicted under Florida state law; (2) *Privity or Reliance* - the Johnson's had bought the jewels directly from Hasson so that there was privity of contract; and (3) *Scienter* – Hasson had the necessary "intent to deceive" as he knew at the time of the sale that he was deceiving and defrauding the Johnsons who had relied on him about the value of the stones he sold them.

Armed with the three needed requirements, the Johnsons filed for their theft loss in 1998. The IRS objected to the deduction and off to court they went. It was not until January of 2008, that the matter was fully resolved.

How Do You Write Off Johnson's $78 Million?

The Johnson's Position

The Plaintiffs initially sought the theft loss in 1998 with the loss carry back to 1997. The Plaintiffs tried to rely on IRC at 26 CFR 1.165-1 (d) Year of deduction at (1) says "[a] loss shall be allowed as a deduction under section 165 (a) *only for the taxable year in which the loss is sustained*."

In a revised complaint, the Plaintiffs filed for the loss in 1998 and in the alternative, for the loss deduction in 1999, 2000 and/or 2001. The Plaintiff's relied on the "year of discovery" rule for the timing of their deduction. The Plaintiffs had established their damages based upon an estimate made by their lawyers and accountant's experience using the **"reasonable prospect of recovery"** standard.

The IRS Position

The IRS argued that the Plaintiffs were not entitled to a theft loss deduction of any amount in 1998,or 2001, but instead, only in the year in which all of the claims for reimbursement were resolved. The government asserted the Plaintiffs were not entitled to a theft loss deduction until 2005, at the earliest, when the Plaintiff's last recovery efforts were concluded. The IRS used the Treas. Reg. Section 1.165-1(d)(2)(i) to support its **"reasonable certainty"** standard whereby it states that "whether or not such reimbursement will be received may be ascertained with reasonable certainty, for example, by a settlement of the claim, or by an adjudication of the claim, or by an abandonment of the claim" Treas. Reg. Section 1.165-1(d)(2)(i).

The Verdict

The Court held for both the Plaintiffs and the IRS in a split decision as follows:

The Court ruled against the Plaintiffs for a theft loss in 1998 as it stated that the Plaintiffs did nothing more than anticipate the recovery in the pending litigation against Hasson and his associates. He further stated that the Plaintiffs' reliance on the **"reasonable prospect of recovery"** standard was misplaced, as it only applies in the year a taxpayer discovers a theft loss. The Court agreed with the IRS on the use and application of the **"reasonable certainty"** standard. The judge wrote "the requirement that a taxpayer 'ascertain with reasonable certainty' means that a taxpayer must obtain a verifiable determination of the amount she will receive based on a resolution of the reimbursement claim before taking a theft loss deduction". Accordingly, the Plaintiffs were not entitled to a theft loss deduction in 1998 for any portion of their loss.

However, the Court ruled against the IRS's position that no deduction could be taken until 2005. The government had argued that Treas. Reg. Section 1.165-(d)(2) states that "no portion of the loss with respect to which reimbursement may be received is sustained … until it can be ascertained with reasonable certainty whether or not such reimbursement will be received …" However, the Court argued "[t]he government interprets the phrase 'no portion of the loss' to mean the regulation requires that a taxpayer refrain from taking any portion of a theft loss deduction until the taxpayer determines exactly how much of the entire loss the taxpayer will recover … [h]owever contrary to the government's position the Court held that 'the regulation and the examples given therefore confirm the plaintiff's contention that once a portion of the recovery was established, they were entitled to take a theft loss deduction for that "portion" that they were reasonably certain they would never recover." Accordingly, the Court held that as of 2001, the Plaintiffs had established with reasonable certainty that they had no prospect of recovering $37,216,383 of the estimated $78,160,409 loss.

Therefore, the court found that theft losses can be calculated as the loss becomes reasonably certain; and second, that those losses can be incurred over several years and not held back until the total of the loss is determined.

When Do You Write Off the Madoff Mess?

This will be the hardest decision for you and your client/investor. The year of discovery is clear, however, is there insurance? Are there viable sources of recovery? Will SIPC pay for your client's losses? We do not know the answers to these questions.

What we do know is that there will be: (1) litigation, lots of it; (2) class actions; and (3) bankruptcy proceedings. And, even with all of the above actions, there could be nothing.

If it appears that there will be nothing left, should your client just go for the theft tax loss now?

This is just one of the many issues that the victims of the Madoff Mess will have to consider. There should be an analysis of the viable options, but one viable option might be to forego the years of participation in litigation that could lead to less than what might be available now under the Theft Loss Provisions of the IRC.

Conclusion

Section 165(c)(2) – Theft Loss of the Internal Revenue Code is one of the best kept secrets of the IRS, and the attorney should apply it to any client situation that meets the requirements, especially the victims of the Madoff Mess. Further, the use of the Section of the Code with the application of the above recent Tax Court case provides a new found flexibility for the tax attorneys to help their clients recover theft losses from the only source remaining, Uncle Sam.

Financial Planning Association v. SEC: The Effects and Aftermath of the D.C. Circuit Court's Decision

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I. Introduction

Recently, there has been doubt among participants in the financial service industry, both investors and professionals alike, regarding the distinction between broker-dealers and investment advisers in relation to several of their functions in the market. The source of doubt stems from the lack of clarity as to the rules applicable to each when their functions and means of compensation begin to coincide. Specifically, there has been uncertainty about how broker-dealers should be treated when they provide fee-based accounts to their clients.

In response to this uncertainty, the Securities and Exchange Commission ("SEC") promulgated a final rule in 2005 which essentially exempted broker-dealers who deal with fee-based accounts from the regulatory requirements imposed on investment advisers who deal with similar accounts. The 2005 rule provided a competitive advantage in the market to broker-dealers and caused controversy among several financial industry groups. In 2005, the Financial Planning Association ("FPA"), a non-profit organization that exists to advance the financial planning profession[1], brought an action against the SEC challenging the validity of the 2005 rule.[2]

The D.C. Circuit Court struck down the SEC rule exempting broker-dealers from the heightened responsibilities required of investment advisors in an opinion issued on March 30, 2007. As a result of this opinion, the financial industry was left with many unanswered questions. The SEC decided not to appeal the Court's decision, and instead requested a stay in order to take the necessary action to provide the industry with some related guidance. On September 24, 2007, just one week before the expiration of the stay, the SEC issued two rules. One was an interpretative rule explaining certain provisions of the Investment Advisers Act of 1940 ("Advisers Act") in light of the changing functions of broker-dealers. The other was a temporary final rule providing guidelines for compliance with the Advisers Act when dealing with principal trades.[3]

This article will first provide a brief background into the regulation of investment advisers and broker-dealers. It will then discuss the 2005 rule set forth by the SEC, as well the

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[1] *See* "Who We Are", at http://www.fpanet.org/member/about/who/index.cfm

[2] *Financial Planning Association v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

[3] A principal trade is a type of order carried out by a broker-dealer which involves the broker-dealer buying or selling for its own account and at its own risk, as opposed to carrying out trades for the brokerage's clients.

background leading up to that rule's promulgation. The focus of this article will then turn to the D.C. Circuit Court's decision in *FPA v. SEC*, discussing the reasoning behind the Court's decision to vacate the rule, as well the effects of that decision on the financial service industry. The SEC's reaction to that decision will then be discussed, and the article will conclude with an analysis of the effects the SEC's reaction has on today's market, as well as possible future implications.

II. Regulation of the Financial Service Industry

The regulation of the financial service industry that is relevant to this article falls under the umbrella of two federal statutes. The first is the Securities Exchange Act of 1934[4] (the "1934 Act") which regulates the activities of broker-dealers.[5] The second is the Advisers Act[6] which regulates the activities of investment advisers. These two acts differ in scope both by their application to different groups of financial service professionals, and by their different set of regulations by which these professionals must abide.

The difference between a broker-dealer and an investment adviser is more than mere semantics, as the obligations and standards set out for each vary greatly. While broker-dealers are generally held only to a suitability standard, investment advisers owe a fiduciary duty to their clients.[7] This duty entails a complete loyalty to the client, where the professional must disclose his actions in writing and obtain client consent before proceeding.[8]

In today's environment of full service firms, it would seem that virtually every broker at a major brokerage house would be deemed a financial advisor and have the heightened responsibilities that go along with that title. However, under the broker-dealer exception to the Advisers Act,[9] certain professionals can avoid its provisions. It is this exception, 15 U.S.C.§ 80b-2(a)(11)(C), under which the SEC adopted 17 C.F.R. § 275.202(a)(11)-1[10] (the "2005 Rule"), which was subsequently struck down by the District of Columbia Circuit Court in *FPA v. SEC*.[11]

III. The 2005 rule: "Certain Broker Dealers Deemed Not to Be Investment Advisers"

A. Background Leading Up To The 1999 Proposition

Under the Advisers Act, brokers and dealers were excluded from the stricter requirements imposed on investment advisers if they met the criteria specified in the broker-dealer exemption.[12] This statutory exemption of broker-dealers from the Advisers Act reflects

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[4] 15 U.S.C. §78a (2002).

[5] The term "broker-dealer" is used to encompass both brokers and dealers because, for purposes of this article, their different roles are irrelevant.

[6] 15 U.S.C. §80b-2(a)(11) (2001).

[7] Black, *Brokers and Advisors – What's in a Name?,* 11 FORDHAM J. CORP. & FIN. L.31, 38 (2005).

[8] *Id.* at 39.

[9] *See* 15 USC § 80b-2(a)(11) (carving out six exemptions from the broad definition of investment adviser, including an exemption for broker-dealers which states that "(C) any broker dealer whose performance of such services is solely incidental to the conduct of his business as a broker or dealer and who receives no special compensation therefor").

[10] SEC Final Rule: *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release No.34-51523; IA2376; File No. s7-25-99, April 12, 2005, 1539 PLI/Corp 65, 75 (2006).

[11] 482 F.3d 481.

the distinction between the two forms of fees that were charged in the securities industry prior to the enactment of the Advisers Act. Generally, the type of fee charged was either a traditional commission, where professionals earned a certain amount based on each transaction completed, or a flat fee, which was typically associated with the total value of assets under the professional's supervision.[13]

The broker-dealer exception under the Advisers Act evolved from the distinction between broker-dealers and investment advisers based on the nature of the fee charged by each. As the roles played by broker-dealers and investment advisers continued to converge, each group engaged more frequently in activities typically associated with the other. Thus, fees charged by financial professionals became a key factor in determining the applicable regulatory rules. The distinction between broker-dealers and investment advisers became increasingly vague in the 1990's. The emergence of the financial planner as another financial service professional, along with the evolution of various types of accounts such as discount brokerage accounts (accounts which charge a lesser commission per transaction), and fee-based accounts (accounts which charge a fee rather than commissions, generally as a percentage of the account's value), helped distort the distinction between broker-dealers and investment advisers. The different account types led to various commissions and fee structures being charged by broker-dealers, depending on the type of account the client held. The differing fees charged led to further confusion about what compensation crossed into the realm of "special compensation", thus causing uncertainty about broker-dealer's exposure under the Advisers Act.

As a result of the uncertainty regarding the regulatory categorization of financial service providers, the SEC took several steps to distinguish among financial service professionals and the regulatory rules applying to them. As one of the SEC's first steps, it issued a Notice Of Proposed Rule Making (NOPR) in 1999 exempting a new category of broker-dealers from the requirements of the Advisers Act. The proposed rule provided an exemption to broker-dealers who received fees that constituted "special compensation" as long as: (1) the broker-dealer did not exercise investment discretion over the brokerage accounts; (2) any advice provided by the broker-dealers regarding the accounts was incidental to the brokerage services provided to those accounts; and (3) prominent disclosure was made to the client about the fact that the account was a brokerage account and not an advisory account.[14]

By proposing this rule, the SEC hoped to shift the focus away from the type of compensation received to the actual type of services provided. In a fee-based program, the fee would seemingly equate to "special compensation." However, the SEC has interpreted this fee structure as simply a different method of charging for the same services that were previously charged for on a commission-based system, rather than creating "special" fees for advisory services.[15] The SEC's interpretation has allowed broker-dealers providing investment advice to avoid the "special compensation" prong of the

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[12] 15 U.S.C. § 80b-2(a)(11) ((1) any advice that a broker-dealer gives to a client must be "solely incidental" to his business as a broker-dealer, and (2) the broker-dealer must not receive any "special compensation" for the advice given to the client).

[13] *See* 11 Fed. Reg. 10,966 (Sept. 27, 1946).

[14] Proposed Rule 15 C.F.R 275.202 (a)(11)-1, Release No. 34-42099; IA-1845; File No. S7-25-99, (1999).

[15] SEC Final Rule: *Certain Broker-Dealers Deemed Not To Be Investment Advisers*, Release No.34-51523; IA2376; File No. s7-25-99, April 12, 2005, 1539 PLI/Corp 65, 75 (2006).

broker-dealer exception in the Advisers Act.

Contrary to the norms of statutory construction, which dictate that all words in a given statute are to be treated as if they have meaning,[16] the proposed rule effectively rendered the term "special compensation" within the broker-dealer exception of the Advisers Act meaningless. The idea that a broker-dealer can avoid the Advisers Act regardless of the type of compensation received seemed to be an improper reading of the statute.[17]

B. The 2005 Rule

In 2005, a rule was adopted by the SEC which exempted from the Investment Advisers Act broker-dealers receiving special compensation[18] (the "2005 Rule")[19]. Compared to the proposed rule, the 2005 Rule expanded the disclosure statement requirements and further clarified when investment advice from a broker-dealer is solely incidental to his or her business as a broker or a dealer.[20] The 2005 Rule essentially expanded the exemption of broker-dealers from the stricter requirements of the Advisers Act.

The broker-dealers exempted under the 2005 Rule were those "whose delivery of advice is wholly incidental to their brokerage services, yet who collect a specific type of non-commission compensation. Such broker-dealers levy either a fixed fee or a fee based on the total assets in a customer's account".[21] In turn, they afford their consumers a traditional brokerage services package encompassing investment advice, execution, arrangement for delivery and payment, and custodial and recordkeeping services.[22] Thus, clients can receive "fee based programs, also known as wrap accounts, in which [they] pay an annual fee for an unlimited number of transactions and can obtain basic advice from brokers on whether to buy, hold, or sell a stock."[23] Under the 2005 Rule, a broker-dealer must still register as an investment adviser if it charges a separate fee or offers separate contracts for advisory services, holds itself out as a financial planner, or offers discretionary accounts. With such a broad rule in place, essentially all major Wall Street brokers are excluded from liability under the Advisers Act when offering fee-based programs, despite the fact that many customers believe such fee-based accounts provide additional protection.[24]

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

[17] Edwards, Samuel Benton: *Pay Me But Don't Blame Me: The Merrill Rule*, 1615 PLI/Corp 557, (August 8, 2007).

[18] "Certain Broker-Dealers Deemed Not to Be Investment Advisers," 70 Fed. Reg. 20,424 (Apr. 19, 2005).

[19] 17 C.F.R. § 275.202(a)(11)-1.

[20] *Id.*

[21] *Id.*

[22] George Steven Swan, *The Law And Economics of Interprofessional Frontier Skirmishing*: *Financial Planning Association v. Securities and Exchange Commission*, 16 U. MIAMI BUS. L. REV. 75 (Winter 2007), (citing *Fin Planning Ass'n*, 482 F.3d at 494) (Garland, J. dissenting.)(citing "Certain Broker-Dealers Deemed Not to Be Investment Advisers" 70 Fed. Reg. 20,424 (Apr. 19, 2005).

[23] Jane J. Kim & Eleanor Laise, *SEC Decision Forces Investors to Make Choice: Limit on Fee Based Programs Could Spark Shifts to Pricier Accounts*, WALL ST. J. May 17, 2007, at D4.

[24] Edwards, *Pay Me But Don't Blame Me: The Merrill Rule*, 1615 PLI/Corp 557, at 5 (August 8, 2007).

IV. The DC Circuit Strikes Down the 2005 Rule

A. Problems With The 2005 Rule

The 2005 Rule set forth by the SEC was riddled with controversy. Several aspects of the rule caused disputes within the financial services industry, and the SEC's promulgation of the Rule (as well as the 2005 Rule's effects) were the source of debate among various agencies soon after it was passed. Two key problems with the 2005 Rule are briefly discussed below.

First, the 2005 Rule contradicts the plain meaning of the Advisers Act. The exemption provided in the Advisers Act only excludes brokers whose advice is "solely incidental" to their services and for which they do not receive any "special compensation."[25] By enacting the 2005 Rule, the SEC essentially created new definitions for the terms "special compensation" and "solely incidental." The 2005 Rule, like the rule proposed in 1999, effectively rendered the "special compensation" prong of the Advisers Act's exception meaningless by establishing that a broker-dealer is not an investment adviser based on the type of compensation received. The rule also added ambiguity to the meaning of "solely incidental" by interpreting it to mean any services "in connection with and reasonably related to" brokerage services,[26] but without providing specific examples of what constitutes "solely incidental" advice.

Second, the 2005 Rule added to the confusion for clients regarding the responsibility that is owed them by the financial professionals they trust. Specifically, the 2005 Rule limited the exposure of certain broker-dealers to the regulations set forth by the Advisers Act. In effect, the 2005 Rule made unclear what protections established by Congress under the Advisers Act are available for investors with regard to financial professionals who offer advice to those investors. By granting broker-dealers power to offer advice to their clients without exposure to the Advisers Act, the rule further blurs the already unclear distinction between brokers, advisers and financial planners.

B. FPA v. SEC - The 2007 Decision

In 2005, the FPA brought suit against the SEC in the Circuit Court for the District of Columbia, challenging the 2005 Rule on the grounds that the SEC exceeded its power by adopting the 2005 Rule and exempting a category of broker-dealers from the requirements of the Advisers Act beyond those specifically exempted by Congress.[27] The FPA argued that because broker-dealers were already covered by specific legislation, the SEC could not use its authority to establish new, broader Advisor Act exemptions for broker-dealers. This new broader exemption caused concerns for the FPA, such as losing significant business because of the broker-dealers' ability to perform all of the functions of a financial planner without having to succumb to the same obligations. Specifically, the FPA's concern was that the exemption created by the 2005 Rule allowed for certain services to be provided by brokerages while only meeting the suitability standard rather than the higher fiduciary standard imposed on investment advisers for similar services. Additionally, the FPA was worried about the impact that the new SEC rule would have on investors regarding the increasingly difficult task of distinguishing among financial service professionals and their respective roles and obligations.[28]

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[25] *Id.*

[26] 70 Fed. Reg. 20,424, at 20,436 (April 19, 2005).

[27] *Financial Planning Ass'n v. SEC*, 482 F.3d 481 (D.C. Cir. 2007).

[28] Dan Moisand, *A Stand On Standards*, WEALTH MANAGER, July/August 2006, at 12, 13.

In a split decision in March 2007, the D.C. Circuit Court agreed with the FPA. In an opinion by Circuit Judge Rogers, the Court vacated the 2005 Rule.[29] First, the Court offered a brief history and analysis of the Advisers Act. Second, it analyzed whether the FPA had standing to assert its claim against the SEC.[30] Third, the Court addressed the question of whether the SEC exceeded its authority by adopting the 2005 Rule, a question the Court answered affirmatively.[31] Only the first and third parts of the Court's opinion are relevant to this paper, and only those parts will be discussed below.

The Court began its opinion by briefly discussing the history of the Advisers Act. The Court stated that the

> IAA arose from a consensus between industry and the SEC "that investment advisers could not completely perform their basic function – furnishing to clients on a personal basis competent, unbiased, and continuous advice regarding the sound management of their investments – unless all conflicts of interest between the investment counsel and the client were removed."[32]

The court then listed both the relevant requirements the Advisers Act imposed on investment advisers, as well as the groups that were excluded from those requirements.

After determining that the FPA had proper standing to bring this action against the SEC, the Court then addressed the question of whether the SEC had exceeded its authority by adopting the 2005 Rule.[33] The FPA contended that "when Congress enacted the IAA, Congress identified in subsection (C) the group of broker-dealers it intended to exempt, and that subsection (F) was only intended to allow the SEC to exempt new groups from the IAA, not to expand the groups that Congress specifically addressed."[34]

To determine whether the SEC exceeded its authority pursuant to 15 U.S.C. § 80b-2(a)(11)(F), the court then conducted the two-step analysis set forth in *Chevron, USA, Inc. v. Natural Res. Def. Counsel, Inc.*[35] The Court analyzed Section 202(a)(11) of the Advisers Act, considering the text, structure, overall statutory scheme, and the problem Congress sought to solve, in order to determine whether that statute was ambiguous.[36] After a thorough analysis of the statute and all relevant factors, the court concluded that "all four elements [of statutory construction] demonstrate that the SEC has exceeded its authority in promulgating the rule under §202(a)(11)(F) because Congress has addressed the precise issue at hand."[37]

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[29] *Financial Planning Ass'n v. SEC*, 482 F.3d at 483.

[30] *See Id.* at 486 (determining the FPA met the well established standard for representational standing , as well as an injury in fact based on the increased competition that was allowed against them by the SEC rule, which allowed broker-dealers to compete for clients seeking financial advice while not having to comply with the obligations set forth by the Advisers Act)..

[31] *Id.*

[32] *Id.* at 483, (*citing SEC v. Capital Gains Research Bureau, Inc.,* 375 U.S. 180, 187 (1963)).

[33] *Id.* at 486.

[34] *Id.* at 487.

[35] 467 U.S. 837, 842–43 (1984) (stating that under step one, "if the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress." Under step two, "if the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute.")

[36] *Financial Planning Ass'n v. SEC*, 482 F.3d at 487.

The Court concluded that the SEC, in adopting the 2005 Rule, went beyond the power granted to it by Congress.[38] The court declared that "as indicated by the structure of § 202(a)(11) and the problems that Congress addressed in the IAA, as well as the other indicators of Congress' intent, under *Chevron* step one the text of subsections (C) and (F) is unambiguous, and that, therefore, the SEC has exceed its authority in promulgating the final rule."[39] Because the rule did not contain a severability clause, the entire 2005 Rule was vacated by the Court.[40]

V. The SEC's Reaction to the FPA v. SEC Decision

The D.C. Circuit Court handed down its decision in *FPA v. SEC* on March 30, 2007. Shortly thereafter, on May 14, the SEC declared that it would not appeal that decision, and instead it requested that the court delay implementing the decision until September 2007, so brokerage firms and investors could figure out what to do with the fee-based accounts in controversy.[41] On June 27, 2007, the court granted the Commission's motion and stayed the issuance of its mandate until October 1, 2007.

The D.C. Circuit Court's decision in *FPA v. SEC* significantly affected the financial services industry. Under the 2005 Rule, fee-based brokerage accounts were not considered advisory accounts, and thus were not subject to the Advisers Act. The Court's decision had an important impact on both the customers and the professionals involved with these accounts. As a result of the *FPA v. SEC* decision, fee-based brokerage customers were forced to decide whether their accounts would be converted to fee-based accounts subject to the Advisers Act, or to commission based brokerage accounts. On the other hand, broker-dealers would need to register as investment advisers (if they had not done so already), act as fiduciaries with respect to those clients, disclose all potential material conflicts of interest, and otherwise fully comply with the Advisers Act, including the Act's restrictions on principal trading.

The Court's decision in vacating the 2005 Rule also left the industry wondering about what the proper interpretations were of certain key terms used in the statute. For example, the circumstances were unclear as to when a broker-dealer offers advice that is "solely incidental" to the conduct of its business as a broker-dealer. There was also doubt surrounding the issue of whether certain fee structures constitute "special

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[37] *See Id.* at 487– 92. The court indicated that the legislative intent behind the Advisers Act does not support the rule promulgated by the SEC. The court based its determination on the fact that broker-dealers were already included under one of the exceptions in the statute, and the plain language of the statute provided for the exemption of "such other persons not within the intent of this paragraph, as the Commission may designate by rules and regulations or order." *Id.* at 488. Since broker-dealers were already included, they do not fit into the category of "other persons," the court determined. *Id.* The court referenced committee reports which evidenced Congress' intent when drafting the statute for subsection (C) to apply as written ("the term 'investment adviser' is so defined as specifically to exclude … brokers (insofar as their advice is merely incidental to brokerage transactions for which they receive only brokerage commissions)." S. Rep. No. 76-1775). The SEC, the court stated, "has promulgated a final rule that is in direct conflict with both the statutory text and the Committee Reports." *Id*.

[38] *Id.*

[39] *Id.* at 492.

[40] *Id.* at 493 (acknowledging that "[t]he final rule does not contain a severability clause; nor does the SEC suggest it is severable.").

[41] Kim & Laise, *supra* n. 43, at D1.

compensation" within the meaning of the statute.

The *FPA v. SEC* decision prompted the SEC to take several steps. First, in order to facilitate investors with making an informed decision about the future of fee-based brokerage accounts, as well as to allow them to have access to securities held in the principal accounts of certain advisory firms while remaining protected from conflicts of interest, the SEC adopted an interim final temporary rule, Rule 206 (3) – 3T: Temporary Rule Regarding Principal Trades With Certain Advisory Clients ("Temporary Rule").[42] The Temporary Rule will remain in effect until December 31, 2009. The SEC also issued a proposed interpretative rule and release ("Interpretative Rule") which was designed to replace the 2005 Rule by reinstating several interpretative provisions of the 2005 Rule, along with adding several provisions which were newly revised.

A. Rule 206(3)-3T: "Temporary Rule Regarding Principal Trades With Certain Advisory Clients."

By exposing broker-dealers to the disclosure and consent requirements of the Advisers Act, section 206(3) posed a significant practical impediment to broker-dealers desiring to continue to meet the needs of customers who depend both on access to principal transactions with their brokerage firms and on the protections associated with a fee-based compensation structure.[43] Section 206 (3) of the Advisers Act states that it is unlawful "for any investment adviser…directly or indirectly...acting as principal for his own account, knowingly to sell any security to or purchase any security from a client…, without disclosing to such client in writing before the completion of such transaction the capacity in which he is acting and obtaining the consent of the client to such transaction."[44] Accordingly, the adviser must satisfy these disclosure and consent requirements for every transaction, prior to the settlement of that transaction.[45] In order to deal with the impediments to broker-dealers and customers caused by the exposure of broker dealers to Section 206(3) of the Advisers Act as a result of the *FPA v. SEC* decision, the SEC set forth Rule 206(3)-3T, the Temporary Rule.

The Temporary Rule provides an alternative method for advisers who are also registered as broker-dealers to comply with Section 206(3) of the Act. Specifically, the Temporary Rule allows an investment adviser, with respect to a non-discretionary advisory account, to comply with section 206(3) of the Advisers Act by, "among other things:

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[42] 17 CFR § 275.206(3)-3T Temporary Rule for Principal Trades With Certain Advisory Clients.

[43] TEMPORARY RULE REGARDING PRINCIPAL TRADES WITH CERTAIN ADVISORY CLIENTS, Securities and Exchange Commission Release No. IA-2653, File No. S7-23-07, released Sept. 24, 2007 (hereinafter referred to as "Temporary Rule Release"). "[F]or example, the combination of rapid electronic trading systems and the limited availability of many of the securities traded in principal markets means that an adviser may be unable to provide written disclosure and obtain consent in sufficient time to obtain such securities at the best price or, in some cases, at all." *Id.* at 3, citing Letter, with Exhibit, from Ira D. Hammerman, Senior Managing Director and General Counsel, Securities Industry and Financial Markets Association, to Robert E. Plaze, Associate Director, Division of Investment Management, U.S. Securities and Exchange Commission, and Catherine McGuire, Chief Counsel, Division of Market Regulation, U.S. Securities and Exchange Commission, dated June 27, 2007 ("SIFMA Letter").

[44] 15 U.S.C. 80b-6(3).

[45] *See* Commission Interpretation of Section 206(3) of the Investment Advisers Act of 1940, Investment Advisers Act Release No. 1732 (July 17, 1998).

(i) providing written prospective disclosure regarding the conflicts arising from principal trades;
(ii) obtaining written, revocable consent from the client prospectively authorizing the adviser to enter into principal transactions;
(iii) making certain disclosures, either orally or in writing, and obtaining the client's consent before each principal transaction;
(iv) sending to the client confirmation statements disclosing the capacity in which the adviser has acted and disclosing that the adviser informed the client that it may act in a principal capacity and that the client authorized the transaction; and
(v) delivering to the client an annual report itemizing the principal transactions.

The rule only applies to investment advisers who are also registered as a broker-dealer under Section 15 of the 1934 Act and only applies to those accounts that are brokerage accounts subject to the 1934 Act, the rules thereunder, and the rules of the applicable SRO.[46]

It is the SEC's position that the Temporary Rule both adheres to the court's opinion in *FPA v. SEC*, and is consistent with the Congressional intent with respect to the Advisers Act. The SEC claims that the rule retains transaction by transaction disclosure and consent, as well as adds additional investor protection by requiring an adviser to: "i) disclose in writing, at the outset of the relationship with the client, existing and potential conflicts of interest; ii) obtain prospective written consent in response to the initial disclosure; iii) acknowledge explicitly in each disclosure the right of the client to revoke that prospective consent; iv) obtain oral or written consent prior to each transaction; v) send to the client, at or before completion of the transaction, a written trade confirmation relating to the principal transaction and the client's consent; and vi) send to the client an annual statement listing and describing each principal transaction."[47]

The SEC's response to the *FPA v. SEC* decision by introducing the Temporary Rule is commendable. The rule was set forth under a time constraint due to the availability of only a 120 day stay of the court's decision, and it evidenced an attempt by the SEC to square its regulation with the intent of Congress (as demonstrated by the Advisers Act) and the general needs of the securities market. It seems to err on the side of protecting the investor, while permitting industry professionals to provide their services without insurmountable hurdles.

However, certain problems surrounding the Temporary Rule still exist, and in light of today's evolving market, will need to be addressed by future actions of the regulatory agencies. Some of these problems tend to mirror issues that are currently at the focus of discussion among industry leaders. Others are more specific to the promulgation of the Temporary Rule. The main areas of concern are discussed below.

1. *Disclosure*: The requirement for complete disclosure at the beginning of the client relationship is aimed to inform the client of possible conflicts of interest, risks, and other possible hazards the account may encounter. While informing and protecting the investor is indeed a desirable goal, it may not necessarily be reached by implementing the means that the Temporary Rule suggests. Specifically, research shows that even if there is a mandate which requires a conspicuous disclosure statement, that disclosure statement may not be effective in protecting an investor. This concern is shared by many practitioners in the field. Particularly, the FPA has expressed its

[46] Temporary Rule Release, at 8.

[47] *Id.* at 15.

doubts as to whether an initial disclosure will be effective in protecting clients, and suggested a requirement that the disclosure be made in a separate document provided to the client, rather than as part of another document, such as a new account form.[48]

The SEC selected the Rand Corporation to conduct factual research and analysis for a major study comparing how the different regulatory systems that apply to broker-dealers and investment advisers affect investors.[49] The findings of the Rand study tend to reinforce the concern the FPA has expressed regarding disclosure. According to the study, where representatives from industry groups, regulatory agencies, and academia were interviewed, a majority felt that disclosures do not help to inform or protect the investor. This is due particularly to the fact that they are generally difficult to understand and few investors actually read them.[50] The fact that clients do not take the time to read the disclosures is a likely contributing factor to the more general problem, the lack of understanding by the clients of the different roles played by investment advisers and broker-dealers. It naturally follows that these clients do not understand the different regulations and requirements to which each group is subject, and therefore are not aware of the protections available to them. The Investment Adviser Association shared this concern for a client's lack of ability to distinguish between various financial professionals, and expressed such a concern as a result of the Temporary Rule.[51] There is, however, evidence indicating a trend within the industry toward increasing and improving disclosure toward clients.[52]

2. *Consent for each transaction*: The section of the Temporary Rule that requires that the client give consent, either orally or in writing, prior to the execution of each transaction may be problematic in several aspects. Although the idea behind it, to keep clients informed and in control of their accounts, is meant to protect and benefit the client, the practical compliance with that aspect of the rule may lead to contrary results. Several problems arise. First, the consent requirement is difficult to adequately monitor, document, and prove. This leaves open the possibility for self-dealing and abuse by professionals who

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[48] *See* Letter from Daniel J. Barry, Director of Government Relations, Financial Planning Association, to Nancy M. Morris, Securities and Exchange Commission, dated November 30, 2007, via electronic mail, find at http://www.sec.gov/comments/s7-23-07/s72307-17.pdf ("FPA Letter"). "We are concerned that under the temporary rule the written notice and consent will merely be included as part of a new account or other document. Though it may be "conspicuous" its purpose may be undercut by including it as part of another document. Further, if the notice and consent are part of a new account document, we are very concerned that the consent will effectively become a condition of opening an advisory account. This result would clearly be contrary to the purpose of the Advisers Act and the temporary rule which contemplates a knowing consent to principal trading. We urge the Commission to require that the notice and consent be contained in a separately delivered and executed document." *Id.*

[49] LRN-RAND Center for Corporate Ethics, Law, and Governance, *Investor and Industry Perspectives in Investment Advisers and Broker-Dealers* (Mar. 2008)

[50] *Id.* at 20, 77.

[51] Letter from Valerie Baruch, Assistant General Counsel, Investment Adviser Association, to Nancy Morris, Secretary, Securities and Exchange Commission, dated Nov. 30, 2007. Find at http://www.sec.gov/comments/s7-23-07/s72307-15.pdf. "[W]e recommend that the Commission actively provide notice and information to investors about the differences between broker-dealers and investment advisers, and the laws and activities governing each." *Id.*

[52] LRN-RAND Center for Corporate Ethics, Law, and Governance, *Investor and Industry Perspectives in Investment Advisers and Broker-Dealers* (Mar. 2008) at 56.

realize these problems, and may render the consent requirement merely words on a page. The consent may also be required in writing, which would deal with the aforementioned problems, but obtaining written consent on a per transaction basis would lead to a host of new problems. These problems include timeliness, efficiency, and increased costs. Second, the consent requirement may keep the financial professionals from making the most beneficial transactions for their clients. For example, during the time that elapses while consent is obtained the price of the particular securities may change.[53] One suggestion is to allow the client to waive the per transaction consent requirement, given that certain conditions are met.[54]

There is an opposing wave of opinion which agrees with and supports the per transaction requirement of the Temporary Rule. Subscribers to this view feel that the requirement resembles the intent of original Section 206(3), and provides necessary protection to investors. However, none of the problems discussed above, which are closely tied to the new requirement, have been addressed by these per transaction requirement's supporters.[55]

3. *Limitation to Dual Registrants*: Another source of controversy is that the rule offers relief only to dual registrants (financial service professionals that are registered both as broker-dealers and investment advisers–and are thus subject to both sets of regulations). Numerous agency representatives have expressed their concern and dissatisfaction with this requirement under the Temporary Rule.[56] There are several problems that may arise as a result of requiring dual registration. The rules which apply to broker-dealers and investment advisers vary with respect to certain requirements and tend to be inconsistent. Application of inconsistent rules to the same entity or individual is not an easy task. Rather than requiring dual registration, the SEC should strive to harmonize the rules applicable to these two groups of professionals, especially because their functions in today's market tend to overlap and they are not being distinguished by investors.[57] The Rand study shows that an overwhelming majority agrees that if the types of services offered by broker-dealers

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[53] *See* Letter from Keith F. Higgins Chair, Committee on Federal Regulation of Securities, American Bar Association, Section of Business Law to Nancy Morris, Secretary, Securities and Exchange Commission, dated Apr. 18, 2008("ABA Letter"). Find at http://www.sec.gov/comments/s7-23-07/s72307-20.pdf. "[W]e believe the oral trade-by-trade reminder serves no significant investor protection objective not already provided by the pre-trade written consent requirement before an adviser can engage in principal trades (together with the post-trade confirm reminder and the annual summary of principal trading activity). The trade-by-trade oral reminder is difficult to supervise and, more importantly, may harm customers by delaying trade executions in fast-moving markets." *See also* Letter from Nora M. Jordan, Yukako Kawata, Leor Landa, Danforth Townley, John G. Crowley, Davis Polk & Wardwell to Nancy Morris, Secretary, Securities and Exchange Commission, dated Dec 4, 2007. Find at http://www.sec.gov/comments/s7-23-07/s72307-19.pdf.

[54] *See Id.*

[55] *See* Letter from Mercer Bullard, Founder and President, Fund Democracy, Barbara Roper, Director of Investor Protection, Consumer Federation of America, to Nancy Morris, Secretary, Securities and Exchange Commission, dated Apr. 18, 2008. Find at http://www.sec.gov/comments/s7-23-07/s72307-18.pdf; *see also* FPA letter, n. 70 *supra*.

[56] *See* FPA Letter n. 70 *supra*; *see also* Letter from Ira D. Hammerman, Senior Managing Director and General Counsel, SIFMA, to Nancy Morris, Secretary, Securities and Exchange Commission, dated Nov. 30, 2007. Find at http://www.sec.gov/comments/s7-23-07/s72307-16.pdf ; ABA Letter.

[57] LRN-RAND Center for Corporate Ethics, Law, and Governance, *Investor and Industry Perspectives in Investment Advisers and Broker-Dealers* (Mar. 2008).

and investment advisors are essentially the same, the same regulations should apply.[58] There is little value to two separate regulatory schemes which apply to two groups that serve nearly identical functions. There is also evidence which indicates that even though they are not the majority group, dual registrants are more likely to be involved in some type of enforcement action.[59] This may possibly be due to the fact that they are subject to two, sometimes inconsistent, sets of regulations.

B. SEC Proposes the "Interpretative Rule Under the Advisers Act Affecting Broker-Dealers"

The court's decision in *FPA v. SEC* led to another result, the SEC's proposal of the Interpretative Rule.[60] The Interpretative Rule shed light on several sources of uncertainty within the industry caused by the *FPA v. SEC* decision. First, the Interpretative Rule clarified that a broker-dealer that exercises investment discretion with respect to an account or charges a separate fee, or separately contracts for advisory services, is indeed providing investment advice that is not "solely incidental" to its broker-dealer business. Second, a broker would not be receiving "special compensation" solely because it charges different rates for full service brokerage accounts as opposed to discount brokerage accounts. Third, a registered broker-dealer is an investment advisor only with regard to accounts for which it provides services that subject it to the Advisers Act.[61]

The SEC, in discussing the Interpretative Rule, noted that the re-proposal was identifying situations in which broker-dealer advice would not be considered solely incidental to its business as a broker-dealer. Under the newly proposed rule, a "separate contract specifically providing for the provision of investment advisory services" would demonstrate recognition that the advisory services are provided independent of the brokerage services and accordingly

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[58] *Id.* at 55.

[59] *Id.* at 61.

[60] 17 CFR § 275.202(a)(11)-1 Certain Broker Dealers. The Interpretative Rule reads as follows:

§ 275.202(a)(11)-1 Certain broker-dealers.

(a) *Solely incidental*. A broker or dealer provides advice that is not solely incidental to the conduct of its business as a broker or dealer within the meaning of section 202(a)(11)(C) of the Advisers Act (15 U.S.C. 80b-2(a)(11)(C)) if the broker or dealer:

(1) Charges a separate fee, or separately contracts, for advisory services; or

(2) Exercises investment discretion (as that term is defined in section 3(a)(35) of the Securities Exchange Act of 1934 ("Exchange Act") (15 U.S.C. 78c(a)(35)), except investment discretion granted by a customer on a temporary or limited basis, over such account.

(b) *Special compensation*. A broker or dealer registered pursuant to section 15 of the Exchange Act (15 U.S.C. 78o) does not receive special compensation within the meaning of section 202(a)(11)(C) of the Advisers Act solely because the broker or dealer charges a commission, mark-up, mark-down, or similar fee for brokerage services that is greater than or less than one it charges another customer.

(c) *Special rule*. A broker or dealer registered with the Commission under Section 15 of the Exchange Act is an investment adviser solely with respect to those accounts for which it provides services or receives compensation that subject the broker-dealer to the Advisers Act.

[61] INTERPRETIVE RULE UNDER THE ADVISERS ACT AFFECTING BROKER-DEALERS, Rel. No. IA-2652 (Sept. 24, 2007) ("Interpretative Rule Release").

could not be considered "solely incidental to the brokerage services."[62] In addition, when a broker charges a separate fee for investment advice, it clearly is providing advisory services and is subject to the Advisers Act.[63] Furthermore, under the Interpretative Rule, brokers would be subject to the Advisers Act for any accounts over which they exercise investment discretion, unless the discretion is granted on a temporary or limited basis.[64] The SEC justified its position on discretionary accounts with the observation that, in such situations, brokers are the source of the advice given and they also have decision making authority. According to the SEC, this relationship warrants the protection of the Advisers Act because of the "special trust and confidence inherent in such a relationship."[65] The Commission indicated that it believed this provision would provide a "workable, bright-line test for the availability of the section 02(a)(11)(C) exception."[66]

The SEC also eliminated from the Interpretative Rule the provision of the 2005 Rule that held that the services of a broker, who holds himself out as a financial planner or who provides financial planning services, would not be viewed as incidental to providing brokerage services. The SEC did not re-propose this aspect of the rule because financial services firms had indicated that they found it difficult to apply.[67]

The Interpretative Rule left untouched the portion of the 2005 Rule that allowed discount brokers to charge different commission or mark-up/mark-down rates, depending upon whether the account is treated as a full service or a discount account, without the broker considered to have received "special compensation."[68] The SEC reiterated that it was awaiting the results of the Rand study in order to determine how to regulate the different systems brokers utilize to provide financial services to customers.[69] The SEC concluded that because the D. C. Circuit did not question the Commission's interpretative position regarding differential fee accounts, those interpretations remain in effect. The SEC reasoned that because the Interpretative Rule is substantially identical to those interpretative positions, the adoption of the proposed rule would not require a change for broker or adviser conduct.[70]

There is some concern about this fee provision, and the effect it may have on how various fee structures expose broker-dealers to Adviser Act requirements. As indicated in a letter to the SEC on behalf of the FPA, broker-dealers are devising alternative pricing mechanisms in order to structure commission fees charged in a way that allow them to evade requirements set forth by the Advisers Act.[71] The brokers are still providing investment advice in connection with certain transactions, but are avoiding

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[62] Interpretative Rule Release at 3.

[63] *Id.* at 2.

[64] *Id.* at 4.

[65] *Id.* at 2.

[66] *Id.* at 2.

[67] *Id.* at 5.

[68] *Id.* at 2.

[69] *Id.* at 2.

[70] *Id.* at 7.

[71] Letter from Merril Hirsch, Ross Dixon & Bell, LLP, to Nancy Morris, Secretary, Securities and Exchange Commission, dated February 12, 2008. Find at http://www.sec.gov/comments/s7-22-07/s72207-13.pdf.

greater exposure because they are only charging commission on those transactions. Given this approach by broker-dealers, the rule misses the mark in providing the greater protection of the Advisers Act to investors.

VI. Conclusion

As a result of the recent developments in the financial service industry, the SEC proposed and promulgated several rules meant to add clarity to the evolving market. As good of an effort as these rules may have been in providing guidance through today's turbulent waters, they are unfortunately not enough to sufficiently address the problems faced by both the investors and the professionals of today.

The current trend seems to be toward an amalgamation of the regulatory systems controlling broker-dealers and investment advisers who serve the same or very similar functions. The blurring of the line between the two is increasingly prevalent. This is evidenced by the overlapping functions that the two groups serve, the similar services they provide to investors, and by the simple actuality that investors are not able to distinguish between them. Due to the inability to make this distinction, investors are not aware of the different regulations each group is subject to, nor are they aware of the different levels of protection that dealing with each group may offer.

Given the current state, the SEC should make efforts to harmonize the industry through a merge of the functions of the different groups of professionals. The most conducive vehicle to accomplishing this desired result would be a gradual unification of the regulations to which the groups are subject. By achieving this goal, the SEC can embrace the financial marketplace of today and leave behind the nearly outdated distinctions on which the Securities and Exchange Act of 1934 and the Investment Advisers Act of 1940 were based.

NASD Rule 2821: New Regulation of Deferred Variable Annuities

Brian R. Decker

Brian R. Decker recently received his law degree from the Benjamin N. Cardozo School of Law where he was a part of the Moot Court Honor Society. Mr. Decker was also Student Legal Counsel at the Securities Arbitration Clinic under Director and Professor Elizabeth Goldman. Mr. Decker's article was submitted to PIABA as part of the inaugural PIABA Student Writing Competition.

I. Introduction

An all out war is being waged between the insurance and securities industries for the management of $17.6 trillion in U.S. retirement assets, constituting nearly 40 percent of all U.S. household financial assets.[1] The insurance industry's product of choice has been the deferred variable annuity ("DVA"). Critics have maintained that DVAs offer inferior tax benefits compared to IRAs and 401(k)s,[2] and relatively less investment growth because of high fees[3] for rarely utilized and overpriced insurance features.[4] These structural deficiencies along with complex contract features[5] suggest that the typical DVA would capture very little market share in retirement assets when competing against other superior retirement vehicles. Just the opposite has occurred as total sales of DVAs have skyrocketed over the past 20 years from a meager $11.8 billion in 1988 to $182.2 billion last year.[6] Over $1.4 trillion in retirement assets are currently managed within DVAs.[7]

There is widespread condemnation of the DVA industry by the media[8] and regulators.[9] Many baby boomers and seniors have complained that they were sold wholly unsuitable DVAs that yielded greater remuneration to the insurance company

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[1] INV. CO. INST., 2008 INVESTMENT COMPANY FACT BOOK 89 (48th ed. 2008).

[2] *See* SEC, Investor Tips: Variable Annuities (Aug. 1, 2007), http://www.sec.gov/investor/pubs/varannty.htm. Most investors should "make the maximum allowable contributions to IRAs and 401(k) plans before investing in a variable annuity." *Id.*

[3] *See generally* SEC & NASD, JOINT SEC/NASD REPORT ON EXAMINATION FINDINGS REGARDING BROKER-DEALER SALES OF VARIABLE INSURANCE PRODUCTS, at 6 (2004). Surrender charges normally start at about 6-8% and last for a period of seven to nine years. *Id,* at 6. The annual expense charge is 2.3% for the average variable annuity compared to 1.44% for the average mutual fund. *Id.*

[4] A renowned study by Moshe Milevsky and Steven E. Posner, *The Titanic Option: Valuation of the Guaranteed Minimum Death Benefit in Variable Annuities and Mutual Funds*, 68 J. OF RISK AND INS. 91 (2001), concluded that the value of the standard death benefit was five to ten times less than the price of the mortality and expense (M&E) charge.

[5] JOINT REPORT, *supra* note 3, at 5. DVAs "may offer various types of death benefits, rebalancing features, dollar cost averaging options, assorted payout structures, and optional riders such as a guaranteed minimum income benefit, estate protection enhancements, or long-term care insurance, in addition to a range of choices among investment options." *Id.*

[6] NAT'L ASS'N OF VARIABLE ANNUITIES ("NAVA"), ANNUITY FACT BOOK 89 (2008).

[7] Press Release, NAVA, NAVA Reports Second Quarter Variable Annuity Industry Data (Sept. 23, 2008).

[8] *See* Carolyn T. Greer, *The Great Annuity Rip-off*, FORBES (Feb. 9, 1998) (The sale of DVAs inside individual retirement accounts is "one of the biggest disgraces in the entire securities industry."); Smartmoney.com, What's Wrong With Variable Annuities?, http://www.smartmoney.com/personal-finance/retirement/whats-wrong-with-variable-annuities-9512/ (last visited Oct. 1, 2008) ("VARIABLE ANNUITIES are sold more aggressively than fake Gucci handbags on the streets of New York City."); *Dateline NBC: Tricks of the Trade*, (NBC television broadcast Apr. 13, 2008) (A Dateline hidden camera investigation sees what insurance agents say – and what they don't – when they think they are alone with a senior).

and its sales agents, but were not in the customers' best interests.[10]

Perhaps due to this political pressure, the SEC and the NASD/FINRA linked regulation of DVAs to the broader mandate of protecting senior investors, which former SEC Chairman Christopher Cox called "one of the most important issues of our time."[11] This political pressure undoubtedly was the catalyst causing the securities industry to promulgate NASD Rule 2821, which is designed to regulate broker-dealers' responsibilities for DVA transactions and curb sales practice abuses.

Since it was first proposed four years ago, NASD Rule 2821 has been a work in progress. Consumer advocates argue that the insurance industry has been successful in watering down NASD Rule 2821 during the multiple comment periods.[12] For example, the SEC and the NASD/FINRA received over 3,000 comments on NASD Rule 2821, consisting primarily of criticism from the insurance industry alone.[13] In response to these comments, the NASD filed four approved amendments to Rule 2821, limiting the scope of the rule and deleting many of its original requirements.[14] On September 7, 2007, NASD Rule 2821 was approved by the Securities and Exchange Commission (SEC).[15] As discussed below, however, enforcement of certain portions of the rule (i.e. NASD Rule 2821(c) (principal review and approval) and NASD 2821(d) (supervisory procedures)) has been suspended indefinitely. Another important issue regarding enforcement of the rule is that due to the merger of the NASD and NYSE, FINRA has not completed consolidating its own set of rules, which includes FINRA Rule 2821. As a result, the current rule is found in NASD 2821 and it does not contain subsections (c)

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[9] *See* JOINT REPORT, *supra* note 3, at 2 ("High commissions…help drive sales of these products."); NORTH AMERICAN SECURITIES ADMINISTRATORS ASSOCIATION, TOP 13 INVESTMENT SCAMS (2006) (listing DVA sales practices as #1 scam); CAL. DEP'T. OF CORP., NEWS RELEASE NO. 05-03, CALIFORNIA ISSUES "DIRTY DOZEN" INVESTMENT SCAMS FOR 2005 (2005) (listing DVA sales as "#2" scam); ALA. SEC. COMM., IRS AND ALABAMA SECURITIES COMMISSION WARN OF TOP 10 SCAMS (2008) (Variable annuities listed as #3 scam); MO. SEC. DIV., TOP TEN THREATS FOR MISSOURI INVESTORS (2008) (Equity-indexed and variable annuities ranked as #6 threat).

[10] *See* FINRA Regulatory Notice 07-53 (Nov. 2007) (SEC Approves New NASD Rule 2821 Governing Deferred Variable Annuity Transactions). An elderly customer might lack the actuarial expectations necessary for a DVA to yield its benefit of income tax deferral versus costs, and his or her tax bracket might render such benefits negative. *Id.*

[11] *Advising Seniors About Their Money: Who Is Qualified – And Who Is Not?: Hearing Before the S. Spec. Comm. on Aging*, 110th Congress 21 (2007) (testimony of Chairman Christopher Cox, SEC). Chairman Cox also described difficulties faced when helping his dying mother who was "pestered by a seemingly endless barrage of annuity schemes…The products these brokers were pushing weren't just unsuitable, but affirmatively harmful to anyone in my parents' circumstances. The annuity products they purchased locked up their modest savings with huge penalties." *Iid*, at 22.

[12] FINRA Manual, NASD Rule 2821 (effective May 5, 2008) (Members' Responsibilities Regarding Deferred Variable Annuities); *with* NASD Notice to Members 04-45 attachment a (June 2004) (Proposed Rule Governing the Purchase, Sale, or Exchange of Deferred Variable Annuities).

[13] SEC, NASD Rulemaking Comments: SR-NASD-2004-183, http://www.sec.gov/rules/sro/nasd/nasd2004183.shtml (last visited on Oct. 1, 2008).

[14] Amendment No. 1 to Rule 2821, Exchange Act Release No. 52046A, 70 Fed. Reg. 42126 (July 21, 2005) (SR-NASD-2004-183); Amendment No. 2 to Rule 2821, Exchange Act Release No. 54023, 71 Fed. Reg. 36840 (June 28, 2006) (SR-NASD-2004-183); *and* Order Approving Rule 2821, Exchange Act Release No. 56375, 72 Fed. Reg. 52403 (Sept. 13, 2007) (SR-NASD-2004-183) (also approving amendment numbers 3 and 4).

[15] Order Approving Rule 2821, 72 Fed. Reg. 52403, *supra* note 14.

and (d) described above. According to FINRA's website, however, FINRA Rule 2821 proposed in SR-FINRA-2008-015, which includes subsections (c) and (d), has been approved by the Securities and Exchange Commission, but the effective date has not yet been determined.

This article will discuss and critique some of the key aspects of NASD and FINRA's Rule 2821.[16] The article will also provide several case studies conducted by the author that illustrate some of the flaws inherent in the rule.

II. Investor Protection Provisions of Rule 2821

All brokers and broker-dealers who sell DVAs issued *on or after* May 5, 2008 must comply with a variety of provisions designed to protect investors. Under Rule 2821(b), a registered representative who recommends the purchase or exchange of a DVA must provide point-of-sale disclosures,[17] meet heightened "know your customer" obligations,[18] and make a heightened suitability determination.[19] Compliance with these provisions must be documented and signed by the representative.[20] For example, the registered representative must have a "reasonable basis to believe" the customer was informed of the features of DVAs in general, such as the surrender period and charge, early withdrawal tax penalty, M&E charges, sub-account fees, charges for and features of riders, the insurance and investment components of DVAs, and market risk.[21] Mere delivery of the prospectus is insufficient.[22] These new provisions make it harder for representatives to sell DVAs in comparison to other securities products, such as mutual funds and will force registered representatives to learn more than just the selling points of the products.

An even more dramatic reform of DVA sales practices is the requirement of pre-transmittal principal approval in Rule 2821(c). Perhaps because of pressure from the insurance industry, enforcement of this subsection has been suspended indefinitely. If enforced, however, it could greatly improve the sales process of DVAs and better protect investors. The rationale behind this provision is that the suitability determination by the representative is tainted by his or her pecuniary interest in earning a sales commission. Therefore, a registered principal must reevaluate the suitability of the recommended transaction prior to transmitting the customer's application to the insurer.[23] The principal has seven business days to determine whether to approve or reject the DVA transaction, and

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[16] For simplicity, the remainder of this article will refer to NASD/FINRA Rule 2821 as simply Rule 2821.

[17] Notice 07-53, *supra* note 10. The representative's understanding of these features is an important component of suitability. *Id.*

[18] Rule 2821(b)(2), *supra* note 12. The representative must use "reasonable efforts to obtain" a dozen enumerated items of customer information, including the customer's "intended use of the deferred variable annuity." *Id.* Representatives must also comply with their general "know your customer" obligations. FINRA Manual, NASD Rule 2310 (effective Aug. 20, 1996).

[19] Rule 2821(b)(1)(A)(ii)-(iii), *supra* note 12. The representative must have a "reasonable basis to believe" that the customer would benefit from certain features of DVAs, that this particular DVA along with the riders and initial subaccount allocation as a whole is suitable, and for exchanges, that the transaction as a whole is suitable. *Id.*

[20] Rule 2821(b), *supra* note 12.

[21] Rule 2821(b)(1)(A)(i), *supra* note 12.

[22] Notice 07-53, *supra* note 10.

[23] Rule 2821(a)(3), *supra* note 12. "Registered principal" includes any person registered under Series 9, 10, 24, or 25. *Id.*

must make an independent determination as to its suitability.[24] Moreover, *all* purchases or exchanges of DVAs must be approved by a principal, even when the customer application is unsolicited.

Two new requirements are also placed on broker-dealers. First, broker-dealers must document training programs for brokers and registered principals to ensure that their employees "understand the material features" of DVAs, pursuant to Rule 2821(e).[25] Like subsection (b), this new training requirement is currently in effect. It will be invaluable to securities attorneys representing investors because it undoubtedly will serve as excellent cross-examination material at arbitration hearings. Finally, Rule 2821(d), which is not currently in effect, requires broker-dealers to supervise the amount of DVA exchanges effectuated by each broker, and "to implement corrective measures to address inappropriate exchanges" – i.e. churning.[26]

III. Problems With Rule 2821

One of the major shortcomings of Rule 2821 is that recommendations to surrender or liquidate a DVA are not within the scope of the rule. The original version of Rule 2821 applied to "the purchase, sale or exchange" of a DVA, and required a broker, prior to effectuating any replacement of a DVA, to provide the customer with written information concerning "the possibility, if any, of modifying or adjusting the existing contract to meet the customer's objectives rather than…replacing the contract."[27] The scope of Rule 2821 has been subsequently limited to "the purchase or exchange" of a DVA.[28] This limitation is significant because persistency studies have repeatedly shown that very few investors ever annuitize DVAs. For example, according to LIMRA International, a pro-insurance industry organization, only 0.1% of all DVAs are ever annuitized.[29] This shocking statistic indicates the vast majority of DVA policyholders make significant withdrawals from DVAs during the deferral period or surrender them altogether without ever annuitizing them. As a result, Rule 2821 provides no protection for investors who fall victim to scams or bad advice after the initial sale of the DVA. This is a problem that Rule 2821 unfortunately does not address. After all, in August 2008 alone, two unrelated disciplinary actions were taken against FINRA members for their misconduct in customer withdrawals from DVAs.[30] In addition, a 2004 Joint SEC/NASD study of DVAs, which prompted Rule 2821, revealed many problematic practices concerning recommended withdrawals from DVAs.[31]

There are a myriad of ways in which DVA policyholders can be harmed after the initial sale. Over the past year, I have prosecuted numerous investor claims against broker-

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[24] Rule 2821(c), *supra* note 12.

[25] Rule 2821(e), *supra* note 12.

[26] Rule 2821(d), *supra* note 12.

[27] NTM 04-45, *supra* note 6.

[28] Order Approving Rule 2821, 72 Fed. Reg. 52403, *supra* note 14.

[29] MATTHEW DRINKWATER, LIMRA INT'L INC., DEFERRED ANNUITY PERSISTENCY (2006).

[30] Thomas Charles Helbig, FINRA Case #2006005528601 (August 2008) (misusing $10,000 distribution from customer's annuity); David Michael Rozzano, FINRA Case #2027455 (August 2008) (misappropriating over $170,000 from customers by persuading them to withdraw funds from their existing DVAs).

[31] JOINT REPORT, *supra* note 3. "Registered representatives gave unfounded, false or misleading justifications for switches or replacements. Registered representatives misrepresented or failed to inform clients of sales charges associated with switches or replacements….Guidance was not provided to registered representatives regarding the factors to consider in determining the suitability of variable products." *Id*, at 9-10.

dealers and other financial institutions in cases referred by FINRA to the Benjamin N. Cardozo School of Law's Securities Arbitration Clinic. Three of these cases involved DVA transactions, none of which would be regulated by Rule 2821. A discussion of these three cases will illustrate the problems with the limitations of Rule 2821.

CASE STUDY #1

Registered Representative ("RR") incorrectly advised Customer, a 57-year-old teacher, that she could withdraw up to $100,000 from her non-qualified DVA without incurring any tax consequences. Customer later discovered that the entire distributed amount was taxable, and subject to the 10% early withdrawal penalty.[32]

The RR's lack of knowledge as to the tax treatment of distributions from this DVA proved to be very costly to the Customer. Partial withdrawals from non-qualified DVAs purchased prior to August 14, 1982 are taxed on a FIFO basis,[33] while partial withdrawals from non-qualified DVAs purchased after August 13, 1982 are taxed on a LIFO basis.[34] If the $100,000 distribution from the DVA were taxed pursuant to the FIFO rule, then the RR would have been correct that this transaction would not cause the Customer to owe any taxes.[35] Since the DVA was purchased after 1983, the $100,000 withdrawal at issue was subject to the LIFO rule, generating an income tax liability exceeding $50,000.

Rule 2821 should be amended so that it applies to all recommend withdrawals from DVAs, because Rule 2310 does not adequately regulate such transactions. FINRA has previously interpreted Rule 2310 as requiring any associated person who recommends the sale of a DVA, regardless of the use of the proceeds, to consider "significant tax consequences, surrender charges and loss of death or other benefits."[36] However, FINRA has already observed that its rule interpretations have not adequately protected customers from unscrupulous DVA salespersons.[37]

In approving Rule 2821, the SEC determined that "the complexity of deferred variable annuities warrant more targeted regulation."[38] While "inappropriate exchanges"[39] are

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[32] Notice 07-53, *supra* note 10.

[33] *See Pension and Annuity Income*, I.R.S. Pub. 575, at 4-5 (2007) (Tax on Early Distributions). The FIFO (first in, first out) rule treats partial withdrawals as coming first from the cost basis (i.e. total premiums paid), and then from any gains. RANDE SPIEGELMAN, SCHWAB CENTER FOR FINANCIAL RESEARCH, DOES YOUR VARIABLE ANNUITY COST TOO MUCH? (2008), http://www.schwab.com/public/schwab/research_strategies/market_insight/retirement_strategies/planning/does_your_variable_annuity_cost_too_much.html.

[34] *See* Pub. 575, *supra* note 33, at 4-5. The LIFO (last in, first out) rule treats partial withdrawals as coming first from earnings, not principal and will be fully taxed as ordinary income up to the point where the amount of principal is reached. *See* SPIEGELMAN, *supra* note 33.

[35] Pub. 575, *supra* note 33, at 30. The 10% early withdrawal penalty would not affect the transaction since this penalty is only levied on an early distribution of the gains, not of the principal. *Id.*

[36] Amendment No. 1, 70 Fed. Reg. 42126, 42127, *supra* note 14; *see also* NASD Regulatory & Compliance Alert, Reminder – Suitability of Variable Annuity Sales (2002) ("The suitability rule applies to any recommendation to sell a variable annuity regardless of the use of the proceeds.")

[37] *Id.* "NASD issued *Notices to Members* that provided guidelines and reminders about members' suitability obligations regarding variable annuities. NASD also issued *Investor Alerts* and *Member Alerts*, strengthened its examination program and brought a number of significant enforcement actions concerning variable annuities Despite these efforts, problematic sales practices continued." *Id,* at 42127.

[38] Order Approving Rule 2821, 72 Fed. Reg. 52403, 52412, *supra* note 14.

worrisome, inappropriate withdrawals are even more problematic and complex given the potential tax consequences and penalties, and the difficulty in comparing DVAs to different types of investment products, such as mutual funds. Since a DVA is generally considered a "long-term investment for retirement,"[40] allowing untrained and unsupervised brokers to disturb customers' established retirement plans will invariably lead to undesirable consequences.

CASE STUDY #2

Customer is a 72-year-old widow, who lives alone in subsidized housing for low-income families and individuals located in New York City. While traveling to Las Vegas to purchase a house, a real estate agent introduced Customer to RR, a financial advisor employed by a Broker-Dealer ("BD"). At the initial meeting, the Customer transferred her deferred variable annuity ("DVA"), valued at approximately $500,000, to an account at the BD. The RR recommended that the Customer exchange a portion of the DVA for an immediate fixed annuity ("IFA"), a "preferred" annuity for which the RR received enhanced compensation through revenue sharing agreements. The Customer informed the RR that she did not want to purchase a fixed annuity because her social security payments provided her with sufficient income, and that any income payments from a fixed annuity would cause her to lose her subsidized housing. Because of the trust relationship with the RR filled out the application anyway and got the Customer to sign it.

Rule 2821 does not place any obligations on members recommending an exchange of a DVA to a fixed annuity. The result is that a hardworking senior had her lifelong dream of owning a home destroyed, and now faces possible eviction from her apartment without any meaningful oversight by a registered principal. Rule 2821 guarantees that seniors such as this Customer will have no protection against transactions that leave them fully exposed to inflationary risk and rising health care costs, and that deprive them of the right to bequeath an inheritance to their heirs.

Rule 2821 creates a perverse framework in which an exchange of a DVA for another DVA is subject to heightened suitability requirements and principal review, but where an exchange of a DVA for an equity-indexed annuity, a fixed annuity, or an immediate variable annuity escapes the burdens of compliance with Rule 2821. Thus, Rule 2821 might lead to the unintended consequence of customers being steered into annuity products that are outside the scope of Rule 2821 yet even less suitable than DVAs. Recent annuity industry estimates show that DVA sales have decreased, while deferred fixed annuity sales have increased.[41] However, no studies have yet been conducted to determine whether this shift is the result of Rule 2821, overall market conditions, or other factors.

CASE STUDY #3

Customer, an 86 year old grandmother and self-described "depression-era baby," owned two DVAs at an Insurer: (1) a non-qualified deferred variable annuity ("DVA"); and (2) a qualified deferred variable annuity ("QDVA"). When the RR, an employee of a Bank, called the Insurer to arrange a partial withdrawal from the DVA, he was mistakenly supplied the account number for QDVA. Upon receiving the confirmation of transaction, the Customer realized that the distribution had

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[39] Rule 2821(d), *supra* note 12.

[40] NASD Notice to Members 99-35 (May 1999) (The NASD Reminds Members Of Their Responsibilities Regarding The Sales Of Variable Annuities).

[41] Press Release, LIMRA International, Individual Annuity Sales Grow in Second Quarter of 2008 (Sept. 3, 2008) (reporting that DVA sales fell 6%, while deferred fixed annuity sales increased by 46% in 2008 year-to-date compared to 2007 year-to-date).

been made from the wrong annuity. The Bank voided and returned the check to the Insurer, requested that the distributed amount be reinstated into the QDVA, and provided a letter of indemnification to the Insurer. Without explanation, the Insurer reneged on its offer to correct the error, and mailed a replacement check to the Bank. Within the 60-day rollover period prescribed by *§ 408(d)(3) of the Internal Revenue Code*,[42] the Customer attempted to redeposit the erroneously distributed funds into QDVA, but was precluded from doing so by the Insurer, who incorrectly advised the Customer that she was too old to rollover the distribution into another individual retirement account ("IRA").

The above-scenario has the potential to be a systemic issue. While the merits of purchasing a tax-deferred product inside a tax-deferred account are questionable,[43] the fact is that a lot of DVAs are held within qualified retirement savings plans, such as an IRA, 401(k), 403(b), or 457.[44] This Customer, like many of today's qualified DVA owners, built a substantial nest egg through decades of contributions to her employer-sponsored plan, not through any sophisticated investment dealings. As a result, persons holding these investments rely heavily on their brokers for retirement planning advice. Mistakes can be made by financial advisors in the process of rolling over customer funds from a qualified DVA to a new IRA. FINRA has observed that the complexity of DVAs can cause confusion for persons associated with members.[45] The fact that many customers have more than one DVA only heightens the risk of financial advisors committing mistakes.[46]

IV. Conclusion

Regulation of deferred variable annuities remains a work in progress. While Rule 2821 does take steps in the right direction, the investing public would benefit most from broadening the scope of Rule 2821 to include recommendations to sell or liquidate a deferred variable annuity. While one can certainly appreciate FINRA's frustration over spending the past four years debating every little nuance of the rule, a sound regulatory framework is vital to ensuring that deferred variable annuities play a positive role in Americans' retirement plans.

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[42] I.R.C. § 408(d)(3) (2007) (providing that a distribution from an individual retirement annuity does not need to be included in gross income, if the amount received is paid into another individual retirement annuity or eligible retirement plan within 60 days).

[43] NASD Investor Alert, Variable Annuities: Beyond the Hard Sell (May 27, 2003). "Since IRAs are already tax-advantaged, a variable annuity will provide no additional tax savings. It will, however, increase the expense of the IRA, while generating fees and commissions for the broker or salesperson." *Id.*

[44] *See* Warren S. Hersh, *Qualified Annuity Sales Go Mainstream*, NATIONAL UNDERWRITER: LIFE & HEALTH, Jan. 21 2008, at 28 (noting that over 60% of all DVA sales are qualified).

[45] JOINT REPORT, *supra* note 3, at 8.

[46] Jon A. Jacobson and Bradford D. Kaufman, *Respect Your Elders: A Survey Of The Rules And Laws That Apply To Claims Brought By Senior Investors*, *in* PRACTICING LAW INSTITUTE, SECURITIES ARBITRATION 2008: EVOLVING AND IMPROVING 265 (2008) (The average 65-year-old person, who is the head of household, owns seven financial products). In the three case studies, Customers owned 4, 3 and 2 DVAs respectively.

Dura's Effect on Securities Class Actions

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Introduction

Dura Pharmaceuticals, Inc. v. Broudo was expected to be the "most important securities case in a decade."[2] It was to be the seminal case in which the Supreme Court would define, clearly, the operative principles of "loss causation."[3] The decision was highly anticipated in part because loss causation was one of the most heavily litigated issues in securities actions, resulting in a split among the circuits.[4] To establish loss causation, plaintiffs must prove that their injury is directly attributable both to the wrongful conduct and to the form and manner in which the challenged transaction occurred.[5] Loss causation provides the necessary connection between the challenged conduct and plaintiffs' pecuniary loss.[6]

During the months preceding the April 2005 decision, many potential litigants and corporate defendants postponed related procedures in anticipation of the Court's verdict.[7] For example, NERA, an economic consulting firm, suggested that the nationwide decline in federal filings in the first half of 2005 was due to a sharp drop in Ninth Circuit filings, likely caused by plaintiffs choosing to delay certain filings until after the *Dura* decision determined pleading standards for loss

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[1] The author would like to thank Associate Professor Peter B. Oh for his comments, suggestions, and guidance as well as Cornerstone Research for providing the data used in the study.

[2] Patti Waldmeir, *Supreme Court to Rule on 'Most Important Securities Case in a Decade,'* FIN. TIMES, Jan. 10, 2005, at 5.

[3] John C. Coffee, Jr., *Loss Causation After* 'Dura'*: Something for Everyone*, 231 N.Y.L.J. 5 (2005)

[4] Richard A. Spehr & Joseph DeSimone, *The Battleground After* 'Dura' *Decision; Differences Remain over Implementing Standard for Pleading Loss Causation*, N.Y.L.J., Aug. 22, 2005, at S6. *Compare* Emergent Capital Inv. Mgmt, LLC v. Stonepath Group, Inc. 343 F.3d 189, 198 (2nd Cir. 2003) ("[I]nflation of purchase price alone cannot satisfy loss causation") *and* Semerenko v. Cendant Corp., 223 F.3d 165, 184-85 (3d Cir. 2000) ("Where the value of the security does not actually decline as a result of an alleged misrepresentation, it cannot be said that there is in fact an economic loss attributable to that misrepresentation.") *and* Bastian v. Petren Res. Corp., 892 F.2d 680, 683 (7th Cir. 1990) ("Rule 10b-5 has been interpreted to authorize the creation of a federal common law of securities fraud, and common law fraud is not actionable without proof of harm. No reason is given why Rule 10b-5 should be an exception to this principle.") *and* Robbins v. Koger Properties, Inc., 116 F.3d 1441, 1448 (11th Cir. 1997) ("Our decisions explicitly require proof of a causal connection between the misrepresentation and the investment's subsequent decline in value.") *with* Gebhardt v. ConAgra Foods, Inc., 335 F.3d 824, 832 (8th Cir. 2003) ("[P]laintiffs were harmed when they paid more for the stock than it was worth. This is a sufficient allegation.") *and* Broudo v. Dura Pharm., Inc., 339 F.3d 933, 938 (9th Cir. 2003) ("[I]n a fraud-on-the-market case, plaintiffs establish loss causation if they have shown that the price *on the date of purchase* was inflated because of the misrepresentation) (emphasis in original), *rev'd*, 544 U.S. 336 (2005).

[5] THOMAS L. HAZEN, THE LAW OF SECURITIES REGULATION § 12.11, at 507 (5th ed. 2005).

[6] *Id.*

[7] *See* Christopher J. Dutton, Note, *Dura Pharmaceuticals, Inc. v. Broudo: Extracting Teeth from Securities Regulation*, 33 N. KY. U. L. REV. 153, 179 (2006).

causation.[8]

Commentators debated vigorously about how the Court should rule.[9] Ultimately, Justice Breyer delivered a minimalist text with a narrow holding that an investor may not establish loss causation by merely alleging that a defendant's misrepresentations caused the artificial inflation of the price of a security.[10] The pleadings must also provide the defendant with "some indication of the loss and the causal connection the plaintiff has in mind."[11] *Dura* thus requires a plaintiff to show *ex post* losses in the form of a market decline, as opposed to *ex ante* losses in the form of price inflation at the time of purchase.[12] The decision does not impose a higher pleading standard on loss causation than that mandated by Federal Rule of Civil Procedure Rule 8(a)(2).[13] However, plaintiffs must abide by a "marginally stricter loss causation approach" that requires articulation of the theory of their loss at the complaint stage.[14] This heightened pleading requirement "enables courts to separate out the cases that ought to enter discovery, thereby minimizing the risk that defendants will have to settle flimsy claims."[15]

Some commentators have described the *Dura* decision as an imposition of a "Herculean requirement"[16] for loss causation that will favor corporate defendants in a myriad of ways including reducing the damages claimed by plaintiffs, the risk posed by securities actions, and the settlement value of these actions.[17] Others have argued that, in failing to address loss causation in

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[8] Elaine Buckberg, Todd Foster & Ronald I. Miller, *Recent Trends in Shareholder Litigation: Are WorldCom and Enron the New Standard?*, NERA Economic Consulting, 2005, at 2.

[9] *See, e.g.,* Merritt B. Fox, *Demystifying Causation in Fraud-on-the-Market Actions*, 60 BUS. LAW. 507, 519-31 (2005) (concurring with the Ninth Circuit's decision merely requiring plaintiffs to plead price inflation at the time of purchase. While admitting that the literal language of traditional loss causation is phrased in terms of *ex post* loss, a less strict, *ex ante*, standard would block fewer meritorious suits.); John C. Coffee, Jr., *Causation by Presumption? Why the Supreme Court Should Reject Phantom Losses and Reverse* Broudo, 60 BUS. LAW. 533, 535-47 (2005) (arguing for a literal *ex post* approach. The Court should adopt a heightened standard requiring market corroboration in the form of a subsequent stock market decline. To allow otherwise would force corporate defendants to act as insurers compensating shareholders for losses during a class period tenuously tied to any alleged misrepresentation.)

[10] Dura Pharm., Inc. v. Broudo, 544 U.S. 336, 342-46 (2005).

[11] *Id.* at 347.

[12] James C. Spindler, *Why Shareholders Want Their CEOs to Lie More After* Dura Pharmaceuticals, 95 GEO. L.J. 653, 653 (2007) (arguing that the *Dura* rule fails to adequately internalize the costs of fraud making it a profitable strategy.).

[13] *Dura*, 544 U.S. at 346 (conceding that "the Federal Rules of Civil Procedure require only 'a short and plain statement of the claim showing that the pleader is entitled to relief.'"). *See also* Spehr & DeSimone, *supra* note 3 (noting that the Court did not expressly decide the issue as to whether Rule 8 or 9(b) applied. Rather it assumed, arguably, that the less restrictive notice pleading standard of Rule 8 applied, and dismissed the complaint under the more liberal standard).

[14] Ann Morales Olazabal, *Loss Causation in Fraud-on-the-Market Cases Post*-Dura Pharmaceuticals, 3 BERKELEY BUS. L. J. 337, 381 (2006).

[15] Larry E. Ribstein, *Fraud on a Noisy Market*, 10 LEWIS & CLARK L. REV. 137, 154 (2006).

[16] Devin F. Ryan, Comment, *Yet Another Bough on the "Judicial Oak": The Second Circuit Clarifies Inquiry Notice and its Loss Causation Requirement Under the PSLRA in* Lentell v. Merrill Lynch & Co. 79 ST. JOHN'S L. REV. 485, 500 (2005).

private securities fraud litigation, portions of the Court's reasoning are confused or simply wrong.[18] Another has ridiculed the decision as inconsistent, incoherent, incomplete, and, ultimately, inconsequential.[19]

This study examines which, if any, of these commentators were right: Has *Dura* reduced the amount of frivolous litigation or is it instead inconsequential? Part I provides a brief history of the concept of loss causation within the framework of private securities fraud actions under SEC Rule 10b-5. Part II introduces *Dura's* factual background, procedural history, and analyzes the Court's holding. Part III reviews commentary from both plaintiffs' and defense bar. Part IV defines this study's hypotheses and examines the theory behind these suppositions. Part V explains the data sources and sample selection process. Part VI sets forth summary statistics supporting the claim that the *Dura* decision has had a statistically significant impact on the frequency of federal securities class action filings and may have reduced the number of frivolous settlements. Part VII concludes the study. Ultimately, this analysis demonstrates that *Dura* has had a significant impact, but not necessarily in the ways predicted by commentators.[20]

I. A BRIEF HISTORY OF LOSS CAUSATION

Private securities fraud actions are based upon federal securities statutes and their implementing regulations.[21] Section 10(b) of the Securities Exchange Act of 1934 makes it unlawful to "use or employ, in connection with the purchase or sale of any security . . ., any manipulative or deceptive device or contrivance in contravention of" the rules and regulations of the Securities and Exchange Commission.[22] SEC Rule 10b-5 forbids, *inter alia*, "any untrue statement of a material fact" or the omission of "a material fact necessary in order to make the statements made . . . not misleading."[23] Courts have implied from Rule 10b-5 a private right of action[24] and Congress has imposed statutory requirements on that private action. [25]

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[17] *See* Jacob M. Kantrow, Note, *Dura Pharmaceuticals, Inc. v. Broudo: Not really a Loss Causation Case*, 67 LA. L. REV. 257, 275 (2006) (citing Jonathan C. Dickey, Robert F. Serio & Wayne W. Smith, *Supreme Court Reverses ninth Circuit's Loss Causation Standard,* 19 No.5 INSIGHTS 20, 21 (2005)); s*ee also, e.g.,* Jerod Neas, Note, Dura *Duress: The Supreme Court Mandates a More Rigorous Pleading and Proof Requirement for Loss Causation under Rule 10b-5 Class Actions*, 78 U. COLO. L. REV. 347, 366 (2007) (writing that the *Dura* holding which requires "a particular showing of loss causation at the pleading stage. . . imposed a much greater obstacle for plaintiffs in Rule 10b-5 actions.").

[18] Merritt B. Fox, *Understanding* Dura, 60 BUS. LAW. 1547,1567-69 (2005) (noting that the Court's reasons for reaching this conclusion "appear to be rather confused" and that their explanation of the situation where the purchaser does not sell until after the truth has come out was "simply wrong"); Spindler, *supra* note 11, at 666 (explaining that "the Court's reasoning is confused").

[19] Michael J. Kaufman, *At a Loss: Congress, the Supreme Court and Causation under the Federal Securities Laws*, 60 N.Y.U. J.L. & BUS. 1, 1 (2005) (asserting that the "Court's decision is inconsistent with the federal securities laws, incoherent in its reliance upon an amoebic notion of 'economic loss,' incomplete in its failure to address pressing causation questions and, ultimately, inconsequential.").

[20] *E.g., id.* (arguing that the "Court's decision is. . . , ultimately, inconsequential.").

[21] *Dura*, 544 U.S. at 341.

[22] 15 U.S.C. § 78j(b) (2008).

[23] 17 C.F.R. § 240.10b-5 (2008).

[24] *See, e.g.,* Blue Chip Stamps v. Manor Drug Stores 421 U.S. 723, 730 (1975) (noting that "that there was an implied private right of action under" Rule 10b-5).

[25] *E.g.*, 15 U.S.C. § 78u-4(b)(4) (2008).

Causation in securities cases has two elements: "transaction causation" and "loss causation."[26] Transaction causation requires a plaintiff to prove that he would not have purchased "but for" the misstatement.[27] Loss causation connects a defendant's fraud with a specific loss, functioning as a proximate cause requirement, designed to protect defendants from market fluctuations unrelated to their challenged conduct.[28] Establishing "loss causation" has long been a part of the common law.[29] Courts created the loss causation element as a means of restricting liability by requiring "something more" than just transaction causation.[30] If a mere showing of inducement based on a misstatement or omission was sufficient, the plaintiff would be automatically protected against any risk that could later depress the stock price below the purchase price, including risks wholly unrelated to the misstatement.[31] Permitting allegations of mere price inflation thus would convert Rule 10b-5 into a scheme of investors' insurance.[32]

The Private Securities Litigation Reform Act of 1995 ("PSLRA") expressly codified loss causation. Specifically, the PSLRA made loss causation an element of a private suit for securities fraud.[33] According to Judge Posner of the Seventh Circuit, "what securities lawyers call 'loss causation' is the standard common law fraud rule . . . merely borrowed for use in federal securities cases."[34] In securities cases "loss causation" generally refers to the "loss produced by a discrepancy between the actual market value of a stock and what the value would have been had there been no misrepresentation."[35] Prior to *Dura*, the Supreme Court had never discussed the concept, which had been heavily debated by the lower courts.[36]

II. *DURA PHARMACEUTICALS, INC. V. BROUDO*

A. BACKGROUND AND PROCEDURAL HISTORY

On January 27, 1999, a class of plaintiffs commenced suit against Dura Pharmaceuticals, Inc. ("Dura").[37] The plaintiff class was comprised of investors who had purchased securities of Dura between April

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[26] HAZEN, *supra* note 4, § 12.11, at 506.

[27] *See, e.g.,* Huddleston v. Herman & MacLean, 640 F.2d 534, 549 n.24 (5th Cir. 1981) ("'transaction causation' is used to describe the requirement that the defendant's fraud must precipitate the investment decision.").

[28] *See, e.g.,* Dura, 544 U.S. at 342; Ribstein, *supra* note 14, at 150 ("plaintiff must show that defendant's fraud caused. . . her specific loss – that is, . . . loss causation").

[29] *See* Pasley v. Freeman, 3 T.R. 51, 65, 100 Eng. Rep. 450, 457 (1789) ("[If] no injury is occasioned by the lie, it is not actionable. . . attended with a damage, it then becomes the subject of an action."). *See also* Dura, 544 U.S. at 344 (highlighting several cases and treatises regarding the common law requirement of loss causation).

[30] Fox, *supra* note 8, at 515.

[31] *Id.*

[32] *Dura*, 544 U.S. at 345.

[33] 15 U.S.C. § 78u-4(b)(4) (2008) ("In any private action arising under this chapter, the plaintiff shall have the burden of proving that the act or omission of the defendant alleged to violate this chapter caused the loss for which the plaintiff seeks to recover damages.")

[34] Bastian v. Petren Res. Corp., 892 F.2d 680, 683 (7th Cir. 1990).

[35] Isquith v. Caremark Int'l, Inc., 136 F.3d 531, 535 (7th Cir. 1998).

[36] Fox, *supra* note 8, at 515; *see also supra* note 3.

[37] Complaint for Violation of the Securities Exchange Act of 1934, Broudo v. Dura Pharm., Inc., 1999 WL 34771282 (S.D.Cal. Jan. 27, 1999) (No. 99 Civ. 0151).

15, 1997 and February 24, 1998.[38] The complaint alleged that Dura falsely claimed that it expected its drug sales would prove profitable and that the FDA would soon approve a new asthmatic spray device.[39] On February 24, 1998, Dura announced that its earnings would be lower than expected due in part to slow drug sales.[40] The Company's shares declined in value by 47% the following day.[41] Plaintiffs filed several class actions, which were consolidated, alleging violations of §§ 10(b) and 20(a) of the Securities Exchange Act and Rule 10b-5.[42] The complaint claimed, with respect to the spray device statements, that the plaintiffs had relied "on the integrity of the market" and "paid artificially inflated prices for Dura securities" that resulted in damages.[43] The District Court for the Southern District of California dismissed the complaint on the basis that the allegations of loss causation were inadequate.[44]

The Court of Appeals for the Ninth Circuit reversed, holding that loss causation could be satisfied by allegations that defendants' misrepresentations or omissions caused the investor to purchase securities at an artificially inflated price.[45] The Ninth Circuit recognized that its ruling conflicted with the position held by the Third and Eleventh Circuits that required demonstration of a corrective disclosure followed by a subsequent stock price decline.[46]

B. THE SUPREME COURT'S HOLDING

To resolve the circuit split, the Supreme Court granted *certiorari*.[47] In a unanimous opinion written by Justice Breyer, the Supreme Court reversed the Ninth Circuit's judgment.[48] According to the Court, mere allegation and proof of an inflated purchase price "will not itself constitute or proximately cause the relevant economic loss" in fraud-on-the-market cases.[49] Rather, at the time of purchase "the plaintiff has suffered no loss" since "the inflated purchase payment is offset by ownership of a share that *at that instant* possesses equivalent value."[50] "Moreover, the logical link between the inflated share purchase price and any later economic loss is

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[38] Broudo v. Dura Pharm., Inc., 339 F.3d 933, 935 (9th Cir. 2003), *rev'd*, 544 U.S. 336 (2005).

[39] *Id.*

[40] *Broudo*, 339 F.3d at 936.

[41] *Id.*

[42] *Id.*

[43] *Dura*, 544 U.S. at 340.

[44] *Id*.

[45] *Broudo*, 339 F.3d at 938 (holding that loss causation "merely requires pleading that the price at the time of purchase was overstated and sufficient identification of the cause.").

[46] *Id.* (noting that "other circuits are less favorable to plaintiffs and do require demonstration of a corrective disclosure followed by a stock price drop to be alleged in the complaint"). *See Robbins*, 116 F.3d at 1448 (loss causation required plaintiffs to give "proof of a causal connection between the misrepresentation and the investment's subsequent decline in value"); *Semerenko*, 223 F.3d at 184-85 ("where the claimed loss involves the purchase of a security due to an alleged misrepresentation, there is a sufficient causal nexus between the loss and the alleged misrepresentation to satisfy the loss causation requirement," provided "that the artificial inflation was actually 'lost' due to the alleged fraud").

[47] *Dura*, 544 U.S. at 340.

[48] *Id.* at 348.

[49] *Id.* at 342.

[50] *Id.* (emphasis in original).

not invariably strong . . . if, say, the purchaser sells the shares quickly before the relevant truth begins to leak out, the misrepresentation will not have led to any loss."[51] A plaintiff must demonstrate that the alleged misrepresentation actually did "*cause* a loss."[52] To hold otherwise "would permit a plaintiff 'with a largely groundless claim . . . representing an *in terrorem* increment of the settlement value'" to transform a private securities action into a partial downside insurance policy.[53]

The actual loss requirement for private securities fraud actions is based on an analogy to the common-law tort actions for deceit and misrepresentation.[54] The Restatement (Second) of Torts refers to the loss sustained by a purchaser as occurring when the facts surrounding a misrepresentation become known and the share value depreciates.[55] The Court noted that the Second, Third, Seventh, and Eleventh Circuits all require something more than "the Ninth Circuit's 'inflated purchase price' approach to proving causation and loss."[56] The PSLRA imposes on plaintiffs the burden of proving that the defendant's misrepresentations caused the loss for which the plaintiff seeks to recover.[57] Having held that "plaintiffs need to *prove* causation and economic loss," the Court determined that the plaintiffs' "complaint here failed adequately to *allege* these requirements."[58] However, the Court stressed that the pleading requirements "should not prove burdensome for a plaintiff who has suffered an economic loss."[59] Plaintiffs, they said, need only "provide a defendant with some indication of the loss and the causal connection that the plaintiff has in mind."[60]

III. REACTION TO *DURA'S* HOLDING

Although *Dura* was expected to clarify the confused state of loss causation jurisprudence, the Supreme Court declined to articulate a clear loss causation standard.[61] Critics of the opinion contend that the Court's rationale appears confused and, at times, simply wrong.[62] Representatives of both the plaintiffs' and defendants' bar claimed victory in *Dura*.[63] Patrick Couglin, the plaintiffs' attorney, stated that despite the adverse

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[51] *Id.*

[52] *Id.* at 343 (emphasis in original).

[53] *Id.* at 347-48.

[54] *Id.* at 341, 343-44 (noting that "the common law has long insisted that a plaintiff in such a case show. . . that he suffered actual economic loss.")

[55] *Id.* at 344 (citing RESTATEMENT (SECOND) OF TORTS § 548A, cmt. b (1977)).

[56] *Id.* at 344.

[57] *Id.* at 345-46.

[58] *Id.* at 346 (emphasis in original).

[59] *Id.* at 347.

[60] *Id.*

[61] *See, e.g.,* In re Initial Pub. Offering Sec. Litig., 2005 WL 1529659, at *1 (S.D.N.Y. June 28, 2005) ("*Dura* did not establish what *would* be a sufficient loss causation pleading standard; it merely established what was *not*") (emphasis in original); Olazabal, *supra* note 13, at 341.

[62] *See, e.g.,* Fox, *supra* note 17, at 1567-69 (2005) (noting that the Court's reasons for reaching this conclusion "appear to be rather confused" and that their explanation of the situation where the purchaser does not sell until after the truth has come out was "simply wrong"); Spindler, *supra* note 11, at 666 (explaining that "the Court's reasoning is confused …").

[63] *See* Fox, *supra* note 8, at 507. *See also* Spehr & DeSimone, *supra* note 3, at S6 ("the Dura decision appeared to be a significant victory for the defense bar").

outcome, the Court's ruling was not hostile to investors.[64] On the contrary, the Court had adopted sensible rules for pleading and proving loss causation that would be less burdensome for plaintiffs.[65] At the same time, defense lawyers greeted the decision as one that "closes the door to what could have been a flood of speculative new lawsuits for recovery of stock losses unrelated to the defendant's alleged fraud."[66]

Defendants quickly seized on *Dura,* filing motions to dismiss prominently featuring arguments that the complaint fails to adequately allege loss causation.[67] As a practical matter, since claims unaccompanied by a market decline are readily dismissible, *Dura's ex post* measure may reduce the number of frivolous lawsuit filings, thereby easing administrative burdens.[68] A limited study of cases by Spindler in the fifteen months immediately after *Dura* found that an absolute price decline following disclosure of the truth was alleged in all cases which satisfied the duty to plead loss causation.[69] Where the loss causation requirement was not satisfied, plaintiffs alleged mere price inflation or failed to link an absolute decline to the corrective disclosure.[70]

Arguably, *Dura* has something for both sides of the bar.[71] *Dura* does seem to favor plaintiffs in its suggestion that price inflation can be recovered when the stock fails to rise and in its relaxed pleading standard for proximate causation.[72] On the other hand, the real significance of *Dura* is that defendants can now scale back the class at the outset of litigation, thereby improving their position in settlement negotiations.[73] Prior to *Dura,* individuals who purchased and sold shares for a loss during the class period, but prior to any corrective disclosure could be litigated as part of the damages determination.[74] *Dura*

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[64] Patrick J. Coughlin, Eric Alan Isaacson & Joseph D. Daley, *What's Brewing in Dura v. Broudo? The Plaintiffs' Attorneys Review the Supreme Court's Opinion and its Import for Securities-Fraud Litigation*, 37 LOY. U. CHI. L.J. 1, 1-2 (2005).

[65] *Id.* at 2.

[66] Latham & Watkins, *Supreme Court in Dura Pharmaceuticals Unanimously Endorses "Loss Causation" Requirement in Fraud-on-the-Market Cases*, Client Alert No. 455, April 28, 2005, at 1 *available at* http://www.lw.com/upload/pubContent/_pdf/pub1258_1.pdf.

[67] Richard A. Rosen, *Pleading and Proving "Loss Causation" after* Dura Pharmaceuticals*: What's Happening in the Lower Courts?*, 37 SEC. REG. & L. REP. No. 48, at 1 (Dec. 12, 2005) (observing "[a]rguments that a complaint fails to allege loss causation now feature prominently in motions to dismiss."). *See, e.g.,* Garber v. Legg Mason, Inc., 2008 WL 697638, at *15 (S.D.N.Y. March 17, 2008) (failure to plead loss causation as an independent basis for dismissing plaintiffs' claims); Lopes v. Vieira, 2008 WL 706860, at *45 (E.D.Cal. March 13, 2008) ("Our holding about plaintiffs' need to *prove* proximate causation and economic loss leads us also to conclude that the plaintiffs' complaint here failed to adequately *allege* these requirements.") (emphasis in original); 60223 Trust v. Goldman, Sachs & Co., 2007 WL 4326730, at *1 (S.D.N.Y. December 4, 2007) (granting motion to dismiss on the ground that the complaint fails to adequately plead loss causation).

[68] Spindler, *supra* note 11, at 665.

[69] *Id.* at 671.

[70] *Id.* at 672-73.

[71] Coffee, *supra* note 2 ("Dura Pharmaceuticals is a decision that has something for everyone").

[72] *Id.* (mentioning the Court's dictum in which they do not consider the case where a share's higher price is lower than it would otherwise have been creates the danger of "phantom losses").

[73] John C. Coffee, Jr., *Litigation: New Doctrine Spawns New Tactics,* 235 N.Y.L.J. 1 (2006).

[74] *Id.*

explicitly disallows liability to be premised upon any stock price decline in advance of a defendant's corrective announcement.[75] Smaller potential damages estimates translate into less leverage during settlement negotiations.

IV. HYPOTHESES

A. FILINGS

In theory, class actions ameliorate the collective action problem confronting shareholders.[76] Rather than pursuing individual actions, which can be prohibitively expensive, the class members can jointly pursue a single action.[77] Pressure from both plaintiffs and defendants to settle has caused some commentators to argue that plaintiffs' attorneys have a strong incentive to file frivolous lawsuits,[78] even when the expected value of litigation is negative.[79] The large market capitalizations of many firms combined with high trading volumes can lead to potentially high damage awards and provide further incentive to plaintiffs' counsel to pursue numerous class actions.[80] Frivolous suits, often referred to as "strike suits," are defined by the Court as an action that is brought "not to redress real [corporate] wrongs, but to realize upon their nuisance value" through settlement.[81] As noted in *Dura*, these largely groundless claims represent no more than an "*in terrorem* increment of the settlement value"[82] in which the plaintiffs have no expectation of finding any evidence of fraud or culpability on the part of defendants.[83]

With respect to class action filings, this study posits that plaintiffs' attorneys have narrowed their post-*Dura* focus to cases with market corroboration in the form of a price decline subsequent to a corrective disclosure. Since this is a subset of all potential cases, it is likely that the number of frivolous filings, and thus the total number of class action filings, has declined following the *Dura* decision. These anticipated declines are most likely to occur in jurisdictions, like the Ninth Circuit, that previously permitted a relaxed pleading standard for loss causation. But while *Dura*'s standard is suited to reduce the impact of frivolous litigation, the decision may have also chilled meritorious litigation,[84] as the new loss causation requirement raises the expected costs of litigation while diminishing the probability of success, thereby diminishing the number of cases in which the expected return will justify filing suit.[85] However, since the stricter pleading requirements would reduce the amount of preparation later needed at trial, the *Dura* rule does not necessarily change the total cost of litigation

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[75] *See, e.g.,* Rosen, *supra* note 67, at 2 ("a plaintiff must plead and prove that "the truth became known" *before* the stock price drop from which the plaintiff claims a loss.").

[76] Steven J. Choi, *The Evidence on Securities Class Actions*, 57 VAND. L. REV. 1465, 1466 (2004).

[77] *Id.*

[78] *Id.*

[79] *See* Lucian A. Bebchuk, *Suing Solely to Extract a Settlement Offer*, 17 J. LEGAL STUD. 437, 437 (1988) (noting that "the negative expected value of litigation might not deter the plaintiff from suing"); Avery Katz, *The Effect of Frivolous Lawsuits on the Settlement of Litigation*, 10 INT'L REV. L. & ECON. 3, 25 (1990) (concluding that "[b]ecause the defendant does not know whether a given lawsuit is frivolous or genuine, he may choose a strategy that leads to the settlement of frivolous claims").

[80] Choi, *supra* note 76, at 1467.

[81] Cohen v. Beneficial Indus. Loan Corp., 337 U.S. 541, 548 (1949).

[82] *Dura*, 544 U.S. at 347

[83] Choi, *supra* note 76, at 1466.

[84] *Id.* at 1472.

for genuine plaintiffs.[86]

B. SETTLEMENTS

Private securities class actions produce strong incentives for both sides to avoid trial.[87] Cases that survive pretrial dismissal tend to be settled.[88] In other words, plaintiffs need only survive a motion to dismiss to gain financial reward.[89] Accordingly, there is a very real incentive for plaintiffs to file strike suits. This study tests whether the *Dura* decision caused a drop in the number of frivolous settlements. More specifically, there should be fewer cases settling quickly for small amounts. This hypothesis would result in an increase in the average and median settlements post-*Dura*, a reduction in the number of smaller settlements, and a decline in the number of cases settling relatively quickly.

V. SAMPLE SELECTION

The federal filings data in this study come from the Stanford Law School *Securities Class Action Clearinghouse* ("Clearinghouse") in cooperation with Cornerstone Research.[90] The Clearinghouse maintains an Index of Filings of named issuers in federal class action securities fraud lawsuits since the passage of the PSLRA.[91] This study examines the 4-year period[92] surrounding the April 2005 *Dura* decision. There were 119 "classic" federal securities class actions[93] filed from April 20, 2003 through the end of 2003, 215 filed in 2004, 178 in 2005, 116 in 2006, and 39 filed in 2007 through April 19, 2007. Thus, the initial filing sample for the 4-year period surrounding the *Dura* decision (2 years before, 2 years after) contains 667 filings for federal securities class actions.

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[85] *Id.* (noting that this is especially true for companies that have small market capitalizations). The stricter pleading requirement forces plaintiffs to engage in a higher degree of preparation before filing suit. For example, in cases where price falls prematurely, after the false statement but prior to any corrective statement made by the company, plaintiffs' counsel will have to employ more careful pleading. Another example requiring more care and preparation before filing would occur where the market does not react, or reacts modestly after the corrective announcement, followed later by a larger price decline. Dura thus arguably raises the cost of bringing frivolous claims relative to valid ones and may raise the average merit of cases brought. *See, e.g.,* Katz, *supra* note 79, at 16; Coffee, *supra* note 73, at 1.

[86] *See* Katz, *supra* note 79, at 16.

[87] Janet Cooper Alexander, *Do the Merits Matter? A Study of Settlement in Securities Class Actions*, 43 STAN. L. REV. 497, 528 (1991) (noting that substantive and procedural rules, relationships among the parties, the lawyers on both sides, and the insurance carriers all encourage settlement of 10b-5 actions).

[88] Coffee, *supra* note 8, at 540.

[89] *See, e.g.,* Elliot J. Weiss & John S. Beckerman, *Let the Money Do the Monitoring: How Institutional Investor Can Reduce Agency Costs in Securities Class Actions*, 104 YALE L.J. 2053, 2064 (1995) ("If a class action survives motions to dismiss and motions for summary judgment, though, it is practically certain to result in a fee award to the attorneys for the plaintiff class.")

[90] The Stanford Law School Securities Class Action Clearinghouse in cooperation with Cornerstone Research, http://securities.stanford.edu/ (last visited February 4, 2008). The Stanford Law School Class Action Clearinghouse, in cooperation with Cornerstone Research, tracks the content of the first-identified class action complaints in addition to the level of filing activity. The information is publicly available.

[91] *See* http://securities.stanford.edu/.

[92] Data is limited to a two-year period before and after the decision due to restrictions on the settlement data requested from Cornerstone Research by the author. At the time of the request, settlements data was only available through April 2007. To maintain consistency with the filings data, it too is limited to 2 years before, and after the decision.

The settlements data come from a proprietary database prepared by Cornerstone Research, a consulting firm that provides economic and financial analysis in commercial litigation and regulatory proceedings.[94] Institutional Shareholder Services' *Securities Class Action Services* ("SCAS") originally identified the sample of cases prepared by Cornerstone Research.[95] Cornerstone has limited the larger set of cases identified by SCAS to cases alleging fraudulent inflation in the price of a corporation's common stock (i.e., excluding cases filed by bondholders, preferred stockholders, etc.).[96] In addition, their database is limited to cases alleging Rule 10b-5, Section 11 and/or Section 12(a)(2) claims brought by purchasers of common stock.[97] Cornerstone assigns settlements to a particular year based upon the settlement hearing date.[98] Cornerstone tracks and gathers a multitude of qualitative and quantitative variables using data from a myriad of sources.[99] This paper focuses upon the magnitude and frequency of settlements surrounding the *Dura* decision using three variables: class action filing date, settlement hearing date, and settlement amount.

The settlement data set includes only cases alleging Rule 10b-5 claims brought by purchasers of a corporation's common stock. This ensures homogeneity because *Dura* was a Rule 10b-5 case with a narrow holding covering only claims brought by purchasers of securities pursuing private fraud-on-the-market claims under the PSLRA.[100] Limiting Cornerstone's settlements database to cases alleging Rule 10b-5 claims yields 398 cases with settlement hearing dates ranging from April 20, 2003 through April 19, 2007.[101]

VI. Summary Statistics and Empirical Results

A. Filings

During the two years before *Dura*, 400 classic securities class actions were filed. During the two years following *Dura*, 267 classic securities class actions were filed, a decline of 33% from the corresponding period. As demonstrated in Figure 1 there were 224 filings in the year preceding *Dura*, and just 149 filings the year after the decision. Generally, aggregate 6-month filing rates exhibited an upward trend from April 2003 through late 2004 before declining slightly prior to the *Dura* decision and continuing to trend downward over the next two years. The decline prior to the decision may be explained by the progression of the *Dura* case, since

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[93] "Classic," as defined by the Clearinghouse, excludes "IPO Allocation," "Analyst," and "Mutual Fund" filings.

[94] Cornerstone Research, http://www.cornerstone.com/ (last visited February 4, 2008).

[95] Laura E. Simmons & Ellen M. Ryan, *Securities Class Action Settlements 2006 Review and Analysis*, Cornerstone Research, 2007, at 19.

[96] *Id.*

[97] *Id.*

[98] *Id.* at 1 ("For partial settlements, the settlement hearing date is the date the first settlement was approved unless the subsequent partial settlements are in excess of 50% of the then current settlement fund total.").

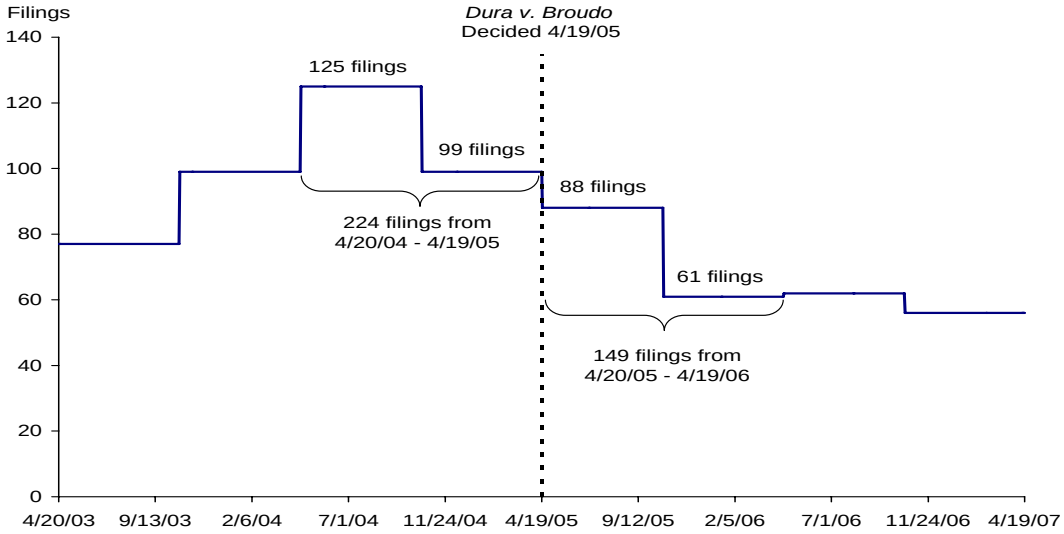
[99] *Id.* at 19 ("In addition to the SCAS, data sources include Factiva, Bloomberg, the Center for Research in Security Prices at the University of Chicago, Standard & Poor's Compustat, court filings and dockets, SEC registrant filings, SEC litigation releases and administrative proceedings, LEXIS-NEXIS, and the public press.").

[100] *See, e.g.,* Kaufman, *supra* note 18, at 42.

[101] The Enron and WorldCom settlements were excluded from the analysis as they are the two largest settlements in history and would heavily skew the settlement averages presented here.

the Supreme Court granted the petition for writ of *certiorari* on June 28, 2004.[102]

FIGURE 1
SECURITIES CLASS ACTION FILINGS
TOTAL FILINGS AGGREGATED EVERY 6 MONTHS



Federal filings data belie the claim that *Dura*'s loss causation standard would be easily satisfied and thus prove inconsequential.[103] Using the same Clearinghouse data incorporated in Figure 1, Table 1 explores the number of class action filings two years, one year, and six months before and after *Dura*. For each of the respective periods, the number of federal filings declined.

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[102] Broudo v. Dura Pharm., Inc., 339 F.3d 933 (9th Cir. 2003), *cert granted*, 542 U.S. 936 (June 28, 2004) (No. 03-932).

[103] *See* Kaufman, *supra* note 18, at 5-6 (stating that "[e]ven in those cases in which *Dura* does apply, the Court's new loss causation standard will prove to be inconsequential because that standard can be easily satisfied").

TABLE 1[104]
SECURITIES CLASS ACTION FILINGS
PRE- AND POST-*DURA*

Time Period	Filings	Decline from Corresponding Period
t - 2 years	400	
t - 1 year	224	
t - 0.5 year	99	
t+ 0.5 year	88	-11%
t + 1 year	149	-33% *
t + 2 years	267	-33% ***

Table 1 indicates that *Dura* had a statistically significant impact on the overall number of class actions filed, reducing filings by a third for the one and two year time frames.[105] Figure 1 and Table 1 collectively indicate that *Dura* has caused a reduction in the number of securities class actions filed by plaintiffs' attorneys. These results support the hypothesis that plaintiffs' attorneys have shifted focus post-*Dura*, avoiding more ambiguous instances of fraud.[106] It is likely that the *Dura* rule has chilled the filing of cases lacking market corroboration in the form of a price decline, because such cases would face a higher risk of dismissal pursuant to the enhanced pleading requirements mandated by the Supreme Court.[107]

The bulk of the cases analyzed were filed in just two judicial circuits, the Ninth and the Second. Table 2 shows the severe decline in Ninth Circuit filings immediately following *Dura*.

TABLE 2
SECURITIES CLASS ACTION FILINGS
PRE- AND POST-*DURA*
NINTH CIRCUIT

Time Period	Filings	Decline from Corresponding Period
t - 2 years	114	
t - 1 year	77	
t - 0.5 year	34	
t + 0.5 year	9	-74% *
t + 1 year	19	-75% ** ††
t + 2 years	56	-51% ** †††

[104] Where t = 4/19/2005, the date of the Supreme Court's decision in *Dura Pharmaceuticals, Inc. v. Broudo*. The decline column compares the 6 months before with the 6 months after the decision, one year before with one year after, and two years before with two years after the decision.

[105] To test whether the average monthly filings during the pre- and post-*Dura* periods are statistically similar I set up the hypothesis that the mean score is identical for the two populations, in other words that the difference between the average number of monthly filings before and after the decision is equal to zero. Two-tailed, two-sample with equal variance *t*-tests comparing means of monthly filing data between the pre- and post-*Dura* time frames proved significant at $p < 0.05$ (*) and $p < 0.001$ (***) for the one and two year time frames, respectively. *p*-value, or probability value, is a number that reflects the likelihood that statistical results have occurred by chance. Results with *p*-values equal to or less than .05 (*), .01(**) or .001(***) are labeled as statistically significant. *See generally* DUNCAN CRAMER, BASIC STATISTICS FOR SOCIAL RESEARCH 180-89 (1997).

[106] *See supra* Part IV.

[107] *See* Choi, *supra* note 76, at 1496.

In the Ninth Circuit, 114 securities class actions were filed in the two years before *Dura*. In the two years after the *Dura* decision, only 56 class actions were filed in that Circuit, a decline of more than 50% from the earlier time period. Strikingly, in the six months prior to *Dura*, there were 34 securities class action filings in the Ninth Circuit. In the six months following the Court's holding, which overturned the Ninth Circuit's relaxed pleading requirement, the number of filings dropped by 74%, to just 9. Comparisons of the monthly filings rate during the pre- and post-*Dura* time periods shows that the six month, one year, and two year declines in the number of filings were all statistically significant.[108]

Generally, the number of federal filings has decreased in most circuits in the two years following the decision.[109] However, the Second Circuit, which applied strict pleading standards even before the *Dura* decision,[110] did not see declines as severe as those in the Ninth Circuit. In the Second Circuit, 88 securities class actions were filed in the two years before *Dura*. In the two years following the decision 65 class actions were filed, a statistically insignificant decline of 26% from the corresponding time period. Indeed, statistical tests establish that none of the declines for the Second Circuit was statistically significant in comparing the difference in means or variance of monthly filings data over the six month, one year, and two year periods.

B. SETTLEMENTS

As displayed in Table 3, settlements data for the 4-year time period surrounding the *Dura* decision shows that the fraction of cases settling within 3 years of the original filing date decreased by 14% post-*Dura*.[111]

TABLE 3
SECURITIES CLASS ACTIONS SETTLED WITHIN 4 YEARS OF FILING FOR THE TWO YEARS PRE- AND POST-*DURA*

Time from Filing to Settlement	% of Total Cases Settled Pre-*Dura*	% of Total Cases Settled Post-*Dura*	Difference
Within 3 Years	50%	43%	-14%
Within 4 Years	69%	65%	-6%

[108] Two-tailed, t-tests for two samples with unequal variance were significant at $p < 0.05$ ("*"), $p < 0.01$ ("**") , and $p < 0.01$ ("**") for the six month, one year, and two year time frames, respectively. In addition, F tests, used to return the one-tailed probability that the variances in monthly filings data are not significantly different, find that the variance in the number of monthly filings in the pre- and post-*Dura* time periods are significantly different at $p < 0.01$ ("††"), and $p < 0.001$ ("†††") for the one year and two year time frames, respectively. *See generally* DUNCAN CRAMER, ADVANCED QUANTITATIVE DATA ANALYSIS 146-50 (2003).

[109] Exceptions for the two-year time frame include the Fourth, Eighth, Tenth, and DC Circuits, all of which represent a small proportion of total filing activity.

[110] *E.g., Emergent*, 343 F.3d at 198 ("[I]nflation of purchase price alone cannot satisfy loss causation").

[111] Cases settling within four years of the filing date dropped by 6%.

If defendants are settling frivolous lawsuits to avoid the high cost of defending such actions, those settlements should occur relatively soon after the filing of a suit.[112] This data provides some support that the *Dura* decision may have suppressed the filing of frivolous litigation, thus advancing the Court's explicit concern with strike suits.

The average settlement for the 2-year pre-*Dura* period was $29.13 million. The average settlement for the same period post-*Dura* was $64.52 million, a statistically significant increase.[113] In addition, the median settlement amount increased from $6.33 million to $7.00 million. The higher average and median settlements post-*Dura* may be the result of a decline in frivolous or negative expected value suits, which have been shown to reduce the settlement value of meritorious positive expected value suits and consequently increases the proportion of those suits that go to trial.[114]

Lastly, Table 4 demonstrates the number of settlements occurring in the lower dollar amounts, $10 million dollars and less. Remarkably, each settlement category was reduced in comparisons of the 2 years before and after the Court's decision.

TABLE 4

SECURITIES CLASS ACTION SETTLEMENTS BY SETTLEMENT AMOUNT

PRE- AND POST-*DURA*

Less than or Equal to Settlement Amount	% of Total Cases 2 Years before *Dura*	% of Total Cases 2 Years after *Dura*	Difference
$1,000,000	9%	7%	-28%
$5,000,000	42%	41%	-3%
$10,000,000	66%	60%	-9%

Thus, *Dura* appears to have reduced the filing of strike suits by providing a mechanism for weeding out such cases at the pleading stage. The settlement data support the hypothesis that *Dura* has also likely reduced the number of frivolous lawsuits resulting in a reduction in the number of quick settlements, an increase in the average and median settlements, and fewer settlements under $10 million.

VII. CONCLUSION

Filing and settlement data for securities class actions indicate that *Dura* was anything but inconsequential.[115] Rather, empirical evidence demonstrates that the decision has had a statistically significant impact on both ends of the securities litigation process. Post-*Dura* the number of class action filings has declined, the average settlement amount has increased, and the number of lower and relatively quick settlements has declined. As an indirect measure or proxy for strike suits, these results collectively indicate that the

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[112] *See* Choi, *supra* note 76, at 1496-97.

[113] Two-tailed, *t*-tests for the two samples with unequal variance were significant at $p < 0.05$ ("*") for the two-year period. In addition, an F test finds that the variance in the settlement amounts for the 2 years pre- and post-*Dura* are significantly different at $p < 0.001$ ("†††").

[114] Bebchuk, *supra* note 79, at 441.

[115] *Contra* Kaufman, *supra* note 18, at 1.

decision has reduced the amount of frivolous securities litigation.

Like the PSLRA before it, *Dura* sought to reduce abusive litigation and coercive settlements,[116] and this study indicates that the decision seems to be having the desired effect. No longer can plaintiffs extract settlements merely by alleging that a defendant's misrepresentations caused the price of a security to be artificially inflated, as cases are subject to quick dismissal unless the pleading includes allegations of a market decline following a corrective disclosure. While findings reveal conclusively that the number of federal securities class actions has declined post-*Dura*, the possibility exists that the decision may also have chilled some meritorious litigation.[117] As a result, what seemed to be simply a "Pyrrhic Defeat" for plaintiffs, may have in fact been more real and less symbolic than initially anticipated.[118]

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[116] *See Dura*, 544 U.S. at 347; SEC. LITIG. REFORM CONF. REP., H.R. CONF. REP. No. 104-369, at 2, 23 (1995)

[117] *Cf.* Choi, *supra* note 76, at 1472 (discussing how the PSLRA may have reduced the impact of frivolous litigation while possibly also acting to chill meritorious litigation).

[118] *But see* Coffee, *supra* note 73, at 1 (noting that *Dura* "initially seemed only a Pyrrhic Defeat for plaintiffs … more symbolic than real and has little cost to the losing side").

Recent Arbitration Awards

Jason M. Kueser

David Franck v. Ameriprise Financial Services, Inc.;
FINRA Case No. 07-00117

After working 30 years with his company, Mr. Franck was forced into early retirement. Mr. Franck's Ameriprise broker recommended he take retirement plan distributions under IRC § 72(t). The funds were invested primarily in proprietary AXP mutual funds. During the period at issue, Claimant's withdrawals exceeded the scheduled withdrawals and because of losses in some of the mutual funds, the account value plummeted to a fraction of the original amount. Claimant asserted the following causes of action: breach of fiduciary duty; breach of contract; unsuitability; failure to diversify; failure to supervise; violation of NASD Rules of Fair Practice; violation of Idaho Uniform Securities Act; violation of Idaho Consumer Protection Act, Idaho Code § 48-603(17) and 48-608; intentional and negligent misrepresentation; unjust enrichment; and breach of good faith and fair dealing.

Respondent raised various affirmative defenses.

Award**:** $171,307 in compensatory damages; $16,090 in costs; and $77,088 in attorneys' fees, pursuant to Id. Code § 30-14-509.

Claimant's Counsel: Debra Hayes, Esq. and Charles C. Hunter, Esq., Woska & Hayes, LLP.

Respondent's Counsel**:** Thomas P. Swigert, Esq. and Gretchen A. Agee, Esq., Dorsey & Whitney, LLP.

Claimant's Expert: Jeffrey Schaff.

Arbitrators: James G. Harlan (Chairperson); Dale G. Higer (Public); and Gary L. Vezina (Non-public).

This case is significant for several reasons. First, Claimant was able to survive Respondent's multiple attempts to bar the case for statutes of limitation violations. Second, the Panel rejected Respondent's argument that excessive withdrawals caused the losses. Third, the Panel awarded Claimant the full net-out-of-pocket damages, costs, and attorney's fees.

***Ronald W. May & Kathryn R. Chapman v. Linsco/Private Ledger Corp. & Michael H. McClellan*;**
FINRA Case No. 07-02717

In 1990, Claimant Ronald May ,11, and his sister Kathryn ,14, were orphaned. At the time of their mother's death, the two young children were left an estate consisting of

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approximately $730,000. Prior to their deaths, Claimants' parents had appointed their long-time friend and broker, Respondent McClellan, as the trustee of the two family trusts, as well as the broker of record for both trusts. At the time, McClellan was a registered representative of LPL. Almost immediately after the death of Claimants' mother, McClellan began to systematically steal from the trust funds for his personal use. By 2006, McClellan had spent all of the assets that had been left for the children. Over the years, McClellan sent to Claimants' guardians fabricated monthly statements that showed the account value increasing.

McClellan joined LPL as an independent contractor in 1983 (prior to the merger of Linsco and Private Ledger in 1999). He also became an Office of Supervisory Jurisdiction. At the time he joined LPL, he already had a number of serious, reportable events on his CRD, including an NASD regulatory action involving improper, outside securities transactions. His U-5 also disclosed his prior firm had terminated him for commingling client funds with personal funds.
In April 2007, Ronald May obtained the age of majority and became entitled to a distribution of his share of the trust funds. Claimant had contracted to purchase a house and requested his distribution. At that time, McClellan met with Claimants and admitted he had stolen all of their funds and the statements he had sent them were phony and fraudulent.

The entire case proceeded on the theory that LPL had failed to adequately supervise McClellan by allowing him to act as a fiduciary and broker on the May family trust accounts in violation of LPL's own compliance manual and internal rules and regulations. The evidence at the hearings showed that, despite his prior reported events, particularly his termination from another firm for commingling client funds with his own, LPL never placed McClellan on any heightened supervision.

Claimants asserted the following causes of action: violation of state and federal securities laws, as well as SEC Rules; common law fraud; breach of fiduciary duty; negligent misrepresentation; violation of NASD and NYSE Rules of Practice; failure to supervise; breach of contract; negligence; and unauthorized trading. Specifically, Claimants argued that LPL was liable under an agency theory pursuant to *Hollinger* v*. Titan Capital Corp.*, 914 F.2d 1564, 1575-1578 (9th Cir. 1990) (holding that broker-dealers may be vicariously liable for the wrongful conduct of their registered representatives, under the principles of respondeat superior, so long as the wrongful conduct was committed in the course and scope of the firm's agency relationship with the representative).

Respondents raised various affirmative defenses and, in addition, LPL relied on *Asplund* v. *Selected Investments in Financial Equities, Inc*.("SIFE"), 86 Cal.App.4th 26 (Cal. App. 1st Dist. 2000), which held that a broker dealer was not liable for the intentional misconduct of its broker, who was an independent contractor. In addition, Respondent's expert testified that (1) LPL had no duty to supervise the broker's activities as a trustee for the family trust, since those activities were considered outside business activities and not securities transactions, and (2) LPL had no duty to detect and prevent the broker's misappropriation of cash deposits, which the broker stole by funneling money through mutual fund accounts which he opened directly at various mutual funds instead of through LPL's clearing agent.

Award: $1,300,000 in compensatory damages, plus $500,000 in punitive damages and all hearing session fees.

Claimant's Counsel**:** Erwin J. Shustak, Esq. and Thomas C. Frost, Esq., Shustak & Partners, P.C.

Respondent's Counsel**:** Linsco/Private Ledger Corp. was represented by Michael L. Kirby, Esq., Kirby Noonan Lance & Hoge LLP. Michael H. McClellan appeared *pro se*.

Claimant's Expert: Tom Mason (supervision and damages).

Respondent's Expert: Irving Einhorn (supervision and securities laws) and Patrick Kennedy (damages).

Arbitrators: Joel Estes (Chairperson), Great Glavis (Public), and Steven Fox (Non-Public).

This case is significant as it resulted in the Panel assessing liability against the broker-dealer for the actions of its representative as trustee of Claimants' trust. The Panel awarded Claimants $1.3 million in compensatory damages against the broker and LPL jointly and severally, as well as $500,000 in additional punitive damages against the broker individually. Claimants' out-of-pocket losses totaled only $400,000. Additionally, even though the broker's misconduct occurred over a twenty year period, the Panel awarded damages based on a well-managed portfolio over this long period of time.

Judith L. Chiosso Glass v. Stanley C. Brooks, Kyle R. Christensen, Janet L. Ross, William Betta, Jr., Russell M. Kautz, National Financial Services, LLC, and Brookstreet Securities Corp.;
FINRA Case No. 07-02276

Claimant's claims relate to investments in collateralized mortgage obligations ("CMO") on margin, largely concentrated in a toxic mess of inverse floater CMOs. Some of these CMOs were privately labeled and others were government backed. The particular tranches sold to Claimant were highly susceptible to movements in interest rates. In addition, the CMOs were difficult to value. The turnover in Claimant's accounts was 12.5 times and the cost to equity ratio was approximately 95%. Prior to the hearing, Claimant settled her claims against the clearing firm (National Financial Services), as well as her claims against William Betta, Jr., Janet L. Ross, and Kyle R. Christensen.

Claimant asserted the following causes of action: breach of fiduciary duty; fraud and misrepresentations; negligence; violation of Oregon securities laws; violation of Federal securities laws; and breach of Implied Warranty of Good Faith and Fair Dealing. Respondents raised various affirmative defenses. In addition, Respondent National Financial Services raised the following counter-claims: (1) Breach of contract; and (2) money had and received.

Award: The Panel ordered Brookstreet Securities Corp. to pay Claimant $400,000 in compensatory damages; ordered Russell M. Kautz to pay Claimant $200,000 in compensatory damages; (but ordered Claimant to return all existing CMO related long positions that were purchased through Brookstreet from the time the accounts were opened to the date of the award to the account of Russell M. Katz); and ordered Respondents to pay all hearing session fees, totaling $6,000.

Claimant's Counsel: David Liebrader; The Law Offices of David Liebrader, APC.

Respondent's Counsel: H. Thomas Fehn, Esq., Fields, Fehn & Sherwin.

Claimant's Expert: Larry Weiner (CMOs, structured products, mortgage backed securities).

Arbitrators: Robert E.L. Bonaparte (Chairperson), Daniel B. MacLeod (Public), and Gary F. Purpura (Non-Public).

This case is significant as it is believed to be one of the first post-collapse CMO-related awards against Brookstreet. In addition, the award represented more than 100% of the net-out-of-pocket losses. The Panel also ordered a hybrid and discretionary form of rescission by ordering Claimant to return

some worthless "odd lot" CMOs to the broker in exchange for his payment of damages.

Lily Azmoun v. Scott & Stringfellow, Inc. and Ronald Salyer;
FINRA Case No. 08-0144

Claimant, a recently divorced Virginia resident, was sold $100,000 of private placement stock by the Respondent firm's representative. Claimant alleged that the broker made multiple misrepresentations and omissions in selling the stock as safe, liquid, and short-term. At the hearing, the representative's manager stated that he had properly supervised the representative, but conceded that he was not aware of the representative's prior regulatory history. After the Claimant brought the sale of the private placement stock to the firm's attention, the firm took the position that it was not responsible for the sale. Respondents failed to help Claimant sell the stock, despite the fact that much of the original investment could have been recouped at the time. The stock price ultimately fell to almost zero. Claimant asserted the following defenses: violations of the Virginia Securities Act; federal securities fraud; common law fraud; breach of fiduciary duty; negligence; and breach of contract.

Claimant requested the Panel order rescission of the $100,000 investment, plus interest and attorneys' fees. Claimant argued at the hearing that the firm was jointly liable as a control person under the Virginia Securities Act, and under the theory of respondeat superior for the tort claims.

The Respondent firm asserted the following defenses: it was not legally liable in this "selling away" private securities sale situation; it had not authorized the sale by its broker; it was unaware of the sale; the security was not held in the Claimant's account at the firm; it had properly supervised its broker; the claim was barred by a release.

Award: Respondents were held jointly and severally liable to Claimant and the Panel awarded full damages under the Virginia Securities Act, including rescission of the $100,000.00 sale, 6% interest from the date of sale, and all arbitration costs. In addition, the Panel ordered Respondents to pay Claimant's attorneys' fees, which were valued at 1/3 of the $100,000 plus interest.

Claimant's Counsel: W. Scott Greco, Greco & Greco, P.C.

Respondent's Counsel: Douglas M. Palais, Esq., Leclair Ryan.

Claimant's Expert: Robert Lowry, RL Consulting (Leesburg, VA).

Arbitrators: Christopher McMurray (Chairperson), Dolores Marie Coutts (Public), and Wilson Thompson (Non-Public).

This case is significant as it resulted in the Panel awarding full damages under the Virginia Securities Act, including attorneys' fees. This is especially significant in light of the fact that the Respondent firm took the position that it had no responsibility as this was a "selling away" situation, and refused to make any settlement offers. In addition, the case is significant as the Panel ordered Respondents to pay attorneys' fees that were equal to 1/3 of the damage award, which included statutory interest from the date of sale.

***Carlton Stephenson v. Wachovia Securities, LLC*;**
FINRA Case No. 2007-016725 (transferred from NYSE)

Mr. Stephenson was employed by a Proctor & Gamble subsidiary as a forklift operator. The company was sold and he was given early retirement. Claimant transferred his retirement funds of more than $300,000 to Respondent and asked that they be invested in something with "low risk." The broker invested Mr. Stephenson's funds in Putnam mutual funds and recommended that he begin retirement plan distributions under IRC § 72(t). Within a couple of years, all of

Claimant's retirement assets were gone. During testimony, it became obvious that Claimant was "functionally" illiterate. Claimant contended the money was lost due to the poor performance of the funds. Wachovia claimed the Claimant's excessive withdrawals were the cause of the demise of the account.

Claimant asserted the following causes of action: violation of SRO rules; negligence; misrepresentation; unsuitable investment recommendations; violations of Sec. 10(b) and Rule 10(b) (5) of the Securities Exchange Act; control person liability; breach of fiduciary duty; breach of contract; failure to diversify; failure to supervise; and violation of the North Carolina Securities Act.

Respondent raised various affirmative defenses.

Award: The Panel awarded Claimant $108,000 in compensatory damages (representing $94,000 for lost principal and $14,000 for lost interest), $36,000 in attorney's fees, NYSE forum fees of $5,500, and costs of $1,950.

Claimant's Counsel: Milton H. Fried.

Respondent's Counsel: Andrew R. Park.

Claimant's Expert: Ron Heakins.

Respondent's Expert: Jay Rosen and Clint Eddington.

Arbitrators: Francis M. Hall, John Adam Kerns, Jr., and Stephan P. Carrier.

What makes the Case significant?: The Panel awarded Claimant damages equal to all losses in the Putnam Funds, plus interest and attorneys' fees. The amount of damages awarded also exceeded the amount of damages claimed and included lost interest as well as lost principal.

Cases & Materials

Timothy A. Canning

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

Before the Arbitration: Compelling/Resisting Arbitration

Enforcing Arbitration Agreements: Fraudulent Modification / Electronic Signature

Mead v. Moloney Securities Co., Inc.
(Mo. App. E.D. 12/9/2008) --- S.W.3d ----, 2008 WL 5263996

Electronic signatures are sufficient to bind a registered representative to the arbitration clause in a U-4 form; and an arbitrator's failure to disclose his affiliation with a FINRA member firm which was not involved in the underlying events or occurrences and which had no financial interest in any of the parties, did not constitute "evident partiality".

In this matter, the Meads were former stockbrokers with Moloney Securities. In 2003, a number of the Meads' clients filed a NASD claim against the Meads and Moloney Securities and others ("the client claims"). Moloney Securities settled the client claims and sought payment of its attorneys' fees and costs from the Meads. When the Meads refused to pay, Moloney Securities filed with FINRA a breach of contract action against the Meads seeking payment of its attorneys' fees and costs incurred in connection with the client claims.

FINRA Dispute Resolution arbitrated Moloney Securities' claim against the Meads. The arbitrator found the Meads jointly and severally liable for compensatory damages consisting of attorneys' fees and costs incurred in connection with the client claims. The arbitrator also ordered each party to bear its own costs and expenses, and specifically denied attorneys' fees in connection with the arbitration.

The trial court denied the Meads' motion to vacate the award, and the Meads appealed.

In seeking to vacate the arbitration award, the Meads contended that they were not bound to arbitrate, despite the arbitration provision contained in their U-4 forms. Moloney Securities had noted on Ms. Mead's U-4 form that the date provided by Ms. Mead on the form was the date on which she signed the application (as opposed to the later date on which Moloney Securities submitted the application for processing). The Meads contended that this notation

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constituted a fraudulent modification of the U-4 form, and was in violation of FINRA's internal rules relating to the U-4 Form. The court rejected that challenge because, in the absence of fraud or other wrongdoing, a party who signs or accepts a written contract is presumed to know its contents and to assent to them, and the notation by the firm did not constitute fraud.

The Meads also contended that they were not bound by the U-4 arbitration provision because they did not physically sign the form. The court held that their electronic signatures on the U-4 forms were sufficient to bind them to the arbitration clause. Federal law recognizes and gives effect to electronic signatures, 15 U.S.C. § 7001(a)(2) (2008), and the U-4 Form itself defines "signature" to include "a manual signature or an electronically transmitted equivalent." An electronic signature is not invalid for purposes of forming a binding and enforceable arbitration agreement.

The court also rejected the Meads' challenge to the award on the grounds of evident partiality of the arbitrator. Prior to arbitration, the arbitrator disclosed to the parties only that he was a registered representative employed by Royal Alliance Associates, Inc. The arbitrator neglected to disclose that (1) Royal Alliance was a subsidiary of AIG Group, Inc., and (2) the arbitrator was also a registered principal and controlling person of Financial Legacy Associates, Inc.

The court concluded that the Meads did not demonstrate how either of these relationships created "evident partiality." The Meads did not demonstrate that any one of these three entities had any type of relationship with Moloney Securities, or that the arbitrator had any financial interest relating to Moloney Securities.

The court affirmed the trial court's decision denying the motion to vacate the award.

Arbitration Agreements: Substantive Unconscionability & Fiduciary Relationship

Brown v. Wells Fargo Bank, NA
(Cal. App. 11/25/2008) 168 Cal.App.4th 938, 85 Cal.Rptr.3d 817

NASD arbitration procedures applicable to disputes between brokers and their customers are not substantively unconscionable; but if a fiduciary duty already exists between the brokers and their clients, the brokers may have a duty to make certain that the clients understand the arbitration clause, otherwise the arbitration clause may not be enforceable.

In this case, the trial court had denied Wells Fargo's motion to compel arbitration of claims asserted by its former clients, on the grounds that the arbitration clause was procedurally unconscionable. The appellate court concluded that the agreement, which provided for arbitration to be conducted by the National Association of Securities Dealers, Inc. (NASD), was not, as a matter of law, substantively unconscionable. In light of this finding, the court did not address whether the arbitration provision in the Agreement was procedurally unconscionable.

Substantive unconscionability addresses the fairness of the term in dispute. Substantive unconscionability "traditionally involves contract terms that are so one-sided as to 'shock the conscience,' or that impose harsh or oppressive terms."

The trial court stated that it was concerned with certain aspects of the arbitration provision, namely that the arbitrators' award is not required to include any factual findings or legal reasoning and that the parties' right to appeal is strictly limited. The appellate court disagreed.

An award issued under the NASD Code must contain, inter alia, a summary of the issues, a statement of the issues resolved, and a statement of the damages or other relief

awarded. (NASD Code, rule 12904(e)) An award, however, need not include factual findings or legal reasoning.

But this does not, as plaintiffs contended, favor one side, and thus does not make the NASD Code substantively unconscionable. The court noted that under the California Arbitration Act, an arbitration award cannot be vacated on the grounds that an arbitrator made an error in law or that there was insufficient evidence to support the arbitrator's findings of fact.

Likewise, the limited ability of the parties to appeal an award does not necessarily make the arbitration provision one-sided. A limitation on appeals is consistent with the California public policy of encouraging expeditious, binding, and final resolutions of disputes through arbitration.

Plaintiffs argued that NASD arbitration is substantively unconscionable because under the NASD Code, a minority of arbitrators may be affiliated with the securities industry. This will result, plaintiffs contend, in a lack of impartiality of some NASD arbitrators and an unfair bias in defendants' favor.

The NASD Code provides that a majority of the arbitration panel must be comprised of people not from the securities industry. (NASD Code, rule 12402) The parties have a right to strike and rank arbitrators from a list of potential arbitrators produced by NASD. (NASD Code, rules 12403-12405) Arbitrators are required to disclose conflicts of interest arising from direct or indirect financial or personal interest in the outcome of the arbitration and other circumstances affecting their impartiality. (NASD Code, rule 12408) The Director of NASD Dispute Resolution may remove an arbitrator for conflict of interest or bias, either upon request of a party or on the Director's own initiative. (NASD Code, rule 12410(a))

The court concluded that these provisions on arbitrator selection and qualification were not so one-sided as to shock to conscience.

Finally, plaintiffs argued that the "discouragement of depositions" in NASD arbitration makes NASD arbitration substantively unconscionable. Under the NASD Code, depositions are generally only allowed to preserve testimony, to accommodate essential witnesses who are unable or unwilling to travel long distances for a hearing, or if other exceptional circumstances exist. Such limitations on depositions, however, do not make NASD arbitration substantively unconscionable. Under the California Arbitration Act, these same restrictions apply to all non-personal injury arbitrations, unless the parties agree otherwise.

In sum, the arbitration clause the clients signed was not substantively unconscionable. As such, the court concluded that the trial court's finding of procedural unconscionability was irrelevant to the determination of the motion to compel arbitration. Without substantive unconscionability, procedural unconscionability is an insufficient basis on which to deny a motion to compel arbitration.

The clients then argued that because Wells Fargo had established a fiduciary relationship with them, Wells Fargo's failure to draw their attention to the arbitration clause at the time of execution constituted constructive fraud.

When the parties are in a fiduciary relationship, the same degree of diligence is not required of the non-fiduciary party. If the defendant is in a fiduciary relationship with the plaintiff which requires the defendant to explain the terms of a contract between them, the plaintiff's failure to read the contract would be reasonable. In such a situation, the defendant fiduciary's failure to perform its duty would constitute constructive fraud, the plaintiff's failure to read the contract would be justifiable, and constructive fraud in the execution would be established.

The court concluded that there was sufficient evidence to support the trial court's finding of a fiduciary relationship between the parties. Wells Fargo's fiduciary duty to these

particular clients encompassed a duty not to treat the execution of the Agreement as an arm's-length transaction, but to instead explain the material terms of the Agreement to them.

The court was not persuaded by the testimony of John Maine, Wells Fargo's securities industry expert. Maine stated that it would be contrary to accepted industry practice for a stock broker to read an agreement aloud or explain it to a prospective customer; he also asserted that it would be a mistake to require these non-attorneys to interpret contracts for prospective customers.

The court stated that it was not requiring stock brokers to generally read or explain their initial agreements to prospective customers. However, when the facts establish that an investment professional has previously voluntarily induced a vulnerable individual to repose trust and confidence in the professional, that professional has a fiduciary duty toward that individual, and may be required by that duty to fully disclose, in a manner the individual understands, the material terms of a contract between them.

Compelling Arbitration: Judicial Admission

Smith Barney v. Burrow
(E.D. Cal. 9/26/2008) 2008 WL 4426805

A judicial admission of being bound to arbitrate is a sufficient basis on which to compel arbitration.

In this employment dispute between Smith Barney, its former employees, and their new company (which was an RIA, not a FINRA member), Smith Barney sought injunctive relief from the court, and at the same time filed a FINRA arbitration claim for damages against the former employees and the new company. After obtaining injunctive relief in court, Smith Barney requested the court to stay the judicial action as to the employees and the new company.

The former employees stipulated to stay the action and arbitrate, but the new company opposed the application for a stay and to compel arbitration. The new company pointed out that it was not a FINRA member and that there was no arbitration agreement between the new company and Smith Barney. The new company requested that Smith Barney's court action against it not be stayed.

The court rejected the new company's argument. When the new company filed its original answer in the civil action, it filed its answer jointly with the former employees. In that answer, the "answering defendants" stated that the dispute was subject to arbitration. The court concluded this was a sufficient judicial admission by the new company that it was subject to an arbitration agreement, and granted Smith Barney's request to stay the action.

Arbitration Required under FINRA rules: Arbitrability

Citigroup Global Markets Inc. v. VCG Special Opportunities Master Fund
(S.D.N.Y. 11/12/2008) 2008 WL 4891229

In the absence of an arbitration agreement, a brokerage firm could not be compelled to arbitrate a dispute involving transactions that were not securities and where the other party was not a customer of the firm for the purposes of that transaction.

In this action, FINRA member firm CGMI obtained a preliminary injunction halting FINRA arbitration until the court could decide whether the claimant was a customer of the member firm, and whether the dispute involved the securities business of the member firm.

VCG had initiated FINRA arbitration against CGMI, its prime broker. The claims alleged in the arbitration relate to a larger dispute that VCG brought against CGMI's affiliate, Citibank, N.A. ("Citibank"), concerning a credit default swap ("CDS") transaction

between those parties. CGMI sought to enjoin the arbitration proceeding on the grounds that FINRA Rule 12200 did not obligate it to arbitrate VCG's claims.

The court first rejected VCG's contention that arbitrability under rule 12200 was for the arbitrators to decide. The mere fact that CGMI is a member of FINRA was insufficient evidence to show that the parties clearly and unmistakably agreed to submit the question of arbitrability to the arbitrators.

Turning to the arbitrability issue, CGMI conceded that it had a customer relationship with VCG in connection with CGMI's business activities as a broker-dealer. However, CGMI contended that VCG was not its "customer" with regard to the "swap" transaction at issue in the arbitration, and/or that the current dispute did not arise in connection with its business activities governed by FINRA.

The court first concluded that there was enough evidence to raise serious questions whether VCG qualifies as a "customer" of CMGI in the swap transaction, as relevant for Rule 12200. In particular, the documentary evidence confirmed that the relevant CDS or "swap" contract was between Citibank and VCG, to which CMGI was not a party.

With regard to CGMI's contention that the dispute did not arise in connection with its business activities as a broker-dealer, the court likewise concluded that CGMI raised sufficiently serious questions. CGMI primarily argued that the VCG dispute did not meet the requirements of Rule 12200 because a CDS transaction is not a security and, under the definition set forth in the Securities Exchange Act of 1934, a "broker" must be a "person engaged in the business of effecting transactions in securities for the account of others."

Cases cited by VCG dealt in large part with individual brokers' fraudulent conveyances or investments, where there is a strong policy argument favoring arbitration, particularly with respect to a financial firm's incentive to supervise its agents and representatives in providing investment advice regarding all financial products.

In light of the undefined scope of Rule 12200 and the unique set of facts before the Court, the Court concluded that CGMI presented legal and factual issues that make its assertions a fair ground for litigation. Given that a preliminary injunction would simply maintain the status quo until the Court decided the underlying issues, the balance of hardships also tipped decidedly in CGMI's favor.

VCG will eventually be able to pursue its claim in arbitration should the Court decide that CGMI is a proper respondent in the arbitration. Conversely, if the Court were to deny the preliminary injunction motion, CGMI would be forced to expend time and resources to defend itself in an arbitration to which it may ultimately be determined not to have been a proper party, and any award would be unenforceable.

Arbitration Required under FINRA rules: Customer & Successor-In-Interest

Royal Alliance Associates, Inc. v. Branch Ave. Plaza, L.P.
(E.D. Va. 11/20/2008) --- F.Supp.2d ----, 2008 WL 4974824

A brokerage firm which bought substantially all of another firm's assets could not be compelled to arbitrate by a securities customer of the first firm, as the securities customer was not a customer of the acquiring firm, and the acquiring firm was not a successor-in-interest to the first firm.

This declaratory judgment action arises from a dispute between the defendant, Branch Avenue Plaza, L.P. ("Branch Avenue"), and non-party United Securities Alliance, Inc. ("United Securities"), a financial services firm and former member of the Financial Industry Regulatory Authority ("FINRA"), over an investment that Branch Avenue alleges was induced through fraudulent representations.

Two years after Branch Avenue made the investment at issue, plaintiff Royal Alliance Associates, Inc. ("Royal Alliance") purchased most of United Securities' assets under an agreement that did not include the purchase of United Securities' liabilities. Branch Avenue initiated an arbitration proceeding under the FINRA rules against both United Securities and Royal Alliance, claiming $3.9 million in damages.

On December 29, 2006, United Securities entered into a Rights and Information Transfer Agreement ("Transfer Agreement") with the plaintiff, Royal Alliance. Under the Transfer Agreement, Royal Alliance purchased United Securities' entire retail broker-dealer operation, which constituted substantially all of the assets of United Securities.

Under the Transfer Agreement, Royal Alliance expressly did not agree to pay any of United Securities' liabilities "of any nature whatsoever," including any actions "arising out of, associated with, or relating to, any facts or circumstances regarding any of [United Securities'] customer accounts prior to the Closing Date."

Because Royal Alliance and Branch Avenue never entered into an arbitration agreement, any requirement that Royal Alliance submit to arbitration stems from the governing rules of FINRA-either because of Royal Alliance's own membership in FINRA or because of its alleged status as successor-in-interest to United Securities, which was a FINRA member at the time of its dealings with Branch Avenue.

The court first concluded that this question of arbitrability was for the court to decide, not the arbitrators. Under FINRA Rule 12413, a FINRA arbitration panel "has the authority to interpret and determine the applicability of all provisions under the Code," and "such interpretations are final and binding upon the parties." (FINRA Rule 12413) Branch Avenue asserted that this language "clearly and unmistakably" provides that questions of arbitrability must be decided by the FINRA arbitrators.

The court, however, concluded that Rule 12413 is a general provision providing arbitrators with the power to interpret their own rules. It does not address issues of arbitrability at all, let alone do so "clearly and unmistakably."

The court then turned to the question as to whether Branch was a customer of Royal Alliance. At issue between the parties is whether Branch Avenue qualifies as a "customer" who can require Royal Alliance to submit to arbitration. The FINRA rules do not precisely define who a "customer" is, other than providing that a customer "shall not include a broker or a dealer." (FINRA Rule 12100(i)) As a result, "[t]he key issue of who is a 'customer' [under FINRA and NASD rules] ... has been the source of debate in numerous cases in which purported customers of ... member firms sought to compel arbitration despite not having directly maintained brokerage accounts or signed written agreements with the firms."

Numerous courts have held that under the applicable FINRA (or NASD) rules, a customer of a firm whose assets are subsequently acquired by another firm may not compel the successor firm to arbitrate a dispute if, as here, the events giving rise to the claim occurred before the acquisition. Rather, these courts have held that "customer" status must be determined as of the time of the events underlying the dispute.

There was no evidence of any connection between Branch Avenue and Royal Alliance other than Royal Alliance's acquisition of many of United Securities' assets two years after the alleged misrepresentations made by United Securities and its broker, Ackerman.

As a secondary argument, Branch Avenue maintained that even if Rule 12200 does not directly require Royal Alliance to arbitrate, Royal Alliance inherited United Securities' obligation to arbitrate under FINRA because

Royal Alliance is a successor-in-interest to United Securities under state common law. However, the facts in this record did not support the conclusion that Royal Alliance is a successor-in-interest to United Securities, and as such, it cannot be compelled to arbitrate under Branch Avenue's second theory.
Branch Avenue argues that Royal Alliance was a "mere continuation" of United Securities, or, alternatively, that United Securities and Royal Alliance entered into a de facto merger.

Branch Avenue supported this position by pointing out, among other things, that two owners of United Securities, Jones and Sutherland, are now "managing executives" with Royal Alliance, that United Securities engaged in a "mass registration transfer of all its registered representatives" to Royal Alliance, that United Securities "effectively ... cease[d] operations as a retail broker-dealer," that United Securities's offices were "absorbed" into Royal Alliance, and that Royal Alliance termed the transaction an "investment" in United Securities.

This evidence was insufficient to support a finding that Royal Alliance was a mere continuation of United Securities. According to the undisputed evidence in the Form ADV filed with the SEC, there was no common identity of ownership. United Securities currently lists eight owners, whereas Royal Alliance was wholly owned by AIG. There was insufficient common identity of directors, as at most two principals of United Securities are now officers of Royal Alliance. Finally, there was no evidence in the record that the stockholders of United Securities became stockholders of Royal Alliance. In sum, Branch Avenue provided no evidence to support a view of Royal Alliance as a "mere continuation" of United Securities under either New York or Virginia law.

Here, the most important factor, continuity of ownership, was not present. Royal Alliance was wholly owned by AIG, while United Securities has eight owners, none of whom include AIG. Under the Transfer Agreement, the assets of United Securities were purchased for cash, not for shares of stock in Royal Alliance. In addition, although significant portions of United Securities have been purchased and are now owned and operated by Royal Alliance, United Securities still exists as an independent company and manages its own accounts, including the Branch Avenue account. Thus, Royal Alliance and United Securities did not engage in a de facto merger.

Finally, the court observed that, "the successor-in-interest doctrine is employed to prevent the transferor business from fraudulently escaping outstanding debts and liabilities." No evidence suggested that this occurred here. Royal Alliance purchased a significant portion, but not all, of United Securities-its entire broker-dealer operation. A large and significant asset transfer, however, does not necessarily implicate the successor-in-interest doctrine. Moreover, at no time did Branch Avenue assert, nor does any evidence show, that United Securities has become incapable of paying off its creditors as a result of the Transfer Agreement. Indeed, there is nothing to suggest that United Securities was any less capable of paying debts or claims after the Transfer Agreement than before. As such, the rationale underlying the successor-in-interest doctrine is not present.

The court concluded that Royal Alliance could not be compelled to arbitrate Branch Avenue's claims against it.

Arbitration Required Under FINRA Rules: Terminated Member

Medina v. Holguin
(N.M. App. 10/31/2008) 197 P.3d 1085

An associated person may not compel arbitration of a former customer's claim where, at the time the former customer commences suit, the member firm with which the associated person is registered has had its NASD membership terminated.

On appeal, Medina argues that because the NASD memberships of both Holguin and WMAS had terminated by the time of his suit, neither may enforce the arbitration agreement against him. The appellate court agreed and held that the defendants failed to meet the requirements of Rule 10301(a). The Court stated it could locate no language in the rule to indicate that an associated person enjoys any rights independent from those of its parent member. The Court therefore held that such an associated person may not compel arbitration with a customer after the lapse of the member's NASD membership. The appelate court reversed and remanded the case to the district court for proceedings in accordance with this opinion.

In this case, Medina, a former customer of WMAS, submitted an arbitration claim to the NASD, asserting his claims against WMAS and Holguin, an associated person of WMAS. WMAS's NASD membership was terminated before the arbitration claim was filed. As a consequence, the NASD suspended the broker's membership as an associated person of WMAS, and though he was eligible to do so, the broker did not renew his license until joining another firm after the initiation of this litigation.

In response to Medina's arbitration filing, the NASD informed Medina that nonmembers of NASD are not automatically subject to arbitration. The organization further stated that neither WMAS nor the associated person were current members and that WMAS, as a nonmember, could not invoke the arbitration clause against the customer under NASD Rule 10301(a).

However, as to the associated person, the NASD took the position that the associated person could still enforce the arbitration agreement. The NASD stated that "[t]he exemption from required arbitration in Rule 10301(a) does not apply to claims against associated persons, regardless of their registration status [,]" and that NASD "has limited disciplinary authority over former associated persons."

Medina then filed his complaint in district court against the firm and the associated person, claiming breach of fiduciary duty, negligence, fraud, and negligent misrepresentation. The associated person sought enforcement of the arbitration agreement under Rule 10301(a), because of his status as an associated person of WMAS.

The broker stated that he was a member at all material times pertaining to his former customer's lawsuit (an assertion which the Court noted was in conflict with information furnished by NASD). The broker argued that despite the suspension of his membership as a result of WMAS's membership lapse in 2002, he remained eligible to re-apply during a two-year time period without re-testing. He claimed that such eligibility rendered his suspended membership valid "for a period of two years." After the filing of his former customer's claim, the broker's membership in the NASD was reinstated when he became an associated person with a different securities firm.

Because of its status as a nonmember, WMAS conceded that it was not entitled to enforce the arbitration clause. WMAS instead attempted to bootstrap its arbitration right from the broker's asserted status.

The court rejected the broker's argument, as well as WMAS's argument, and also rejected the NASD's interpretation of Rule 10301(a) to the extent that the NASD believed that the rule did not apply to associated persons. Despite the rule's apparent vagueness, it was clear to the Court that an associated person obtains status under Rule 10301(a) only through employment by or association with a member. Thus, when the member's status under NASD ends, so does the status of the associated person.

In support of its conclusion, the Court considered the language in NASD Rule 1031(c) that allows a grace period for reinstatement. Without a lapse in the associated person's membership, there would be no need for reinstatement.

Subsequent reinstatement depends on association with a current NASD member. From this the Court concluded that when the status of WMAS changed to that of nonmember, so did the broker's status.

The language of Rule 10301(a) allowed at least three interpretations. First, the rule's exception may be read to include employees of members when the dispute "involves" a member whose membership has been revoked. Because the instant dispute arose from events occurring during WMAS's membership, which ended in 2002, and the broker's employment by WMAS, which began on May 17, 2001, this interpretation would disallow the broker from asserting the arbitration clause, thus supporting the customer's argument.

A second interpretation would also support the customer's argument. Based on the statutory canon of construction, *noscitur a sociis*, a court must look to the neighboring words in a statute to construe contextual meaning. Under this reading, the term "member" in the exception would be read to include "associated person" from the preceding section. Once so included, the associated person is likewise covered by the exception.

However, a third interpretation would read the exception as inapplicable to associated persons and would also allow associated persons to invoke arbitration agreements "regardless of their [NASD] registration status." Both the broker and WMAS urged the court to adopt this third interpretation.

The Court's examination of the purpose behind Rule 10301(a) resolved this conflict and left little doubt in the Court's opinion as to the rule's proper construction. The right to arbitration under Rule 10301(a) belongs primarily to the customer. As such, the exception provision of Rule 10301(a) was written to protect the customer, and NASD has been explicit in its espousal of this concept.

The text itself of Rule 10301(a) also conveys the purpose of customer protection. As the rule's exception states, members with invalid memberships may not compel arbitration. In its letter suggesting that the public customer may pursue a remedy in court, the NASD explained that in the arbitration forum its coercive power over nonmembers for the benefit of customers is limited. Nevertheless, customers may choose to arbitrate as long as their choice is in writing. Such language reflects the intentions of the drafters to place customer protection before the interests of members and their associated persons. It also ensures the customer's affirmative choice of what NASD views as a weakened option owing to nonmember status.

Allowing associated persons to enforce arbitration agreements in the way sought by the broker would frustrate this purpose. Of the privileges NASD members enjoy, one of the most valuable is the protection afforded by mandatory arbitration clauses and the forum in which to pursue them. Upon termination of a membership, NASD Rules cease to apply to the former member. It follows, then, that an associated person, being dependent for its status on and derivative of the member's, should likewise lose NASD privileges upon termination of the qualifying membership. It makes little sense to prohibit nonmember firms from enforcing arbitration while the associated persons of such firms remain free to do so.

WMAS and the broker contended that, by its own terms the rule exempts only "members" from arbitration when their memberships become invalid. However, the status of an associated person is inextricably dependent on the status of its parent member. Indeed, it is the member's registration that defines the status of the associated person. Necessarily, any privileges enjoyed by the associated person must flow from that person's relationship with the member. A privilege held by an associated person, by its nature, cannot exist independently of the member.

In a Notice to Members and in its letter to the public customer in this case, the NASD stated that "[T]he rule does not apply to claims against associated persons [and] such claims remain eligible for arbitration pursuant to Rule 10301(a)."

WMAS and the broker's reliance on this interpretation-to the extent that such "does not apply" language might be read to indicate a greater right accorded to an associated person than to a member - was equally unpersuasive to the court. Associated persons have no status apart from that of their qualifying member. The NASD interpretations cited by the broker and WMAS, if followed, would fail to achieve this purpose. They would allow nonmember associated persons to enforce arbitration agreements when members in like circumstances would be foreclosed from doing so. The Court refused to embrace such a result.

The broker's NASD membership was suspended simultaneously with that of WMAS. At the moment of suspension, the broker was no longer a licensed member of NASD, and he remained ineligible to sell securities until such time as he was again employed by an NASD member and had his license reinstated. These events did not occur until after the customer had filed suit and after the broker had gone to work for another firm.

Hence, the Court concluded that neither the broker nor the brokerage firm had the right to compel the customer to arbitrate his claims.

Arbitration Agreements: Class Action Exclusion

Finn v. Smith Barney
(S.D.N.Y. 12/08/2008) 2008 WL 5215699

An individual investor could not pursue an individual court action and avoid arbitration based on a class action exclusion in an arbitration agreement, where a class action had been filed but not yet certified.

A client of a securities firm brought this individual court case arising in connection with Auction Rate Securities. A class action involving the same firm and same product had been filed, but the class certification process had not yet begun. The arbitration agreement between the client and the firm contained an exclusion from arbitration for class action claims.

The firm moved to stay the individual court action, arguing that the firm would either move to compel arbitration of the individual's claim if the class action was not certified; or, if class was certified, then this individual's court action would be encompassed within class action.

The client opposed the firm's stay application on what the Court characterized as the questionable premise that the pendency of the putative class actions negates the arbitration exclusivity provision of the contract to the extent that, at least during the period in which the firm is precluded from seeking to compel arbitration pursuant to the agreement, the client has the right to litigate his claim in Court on an individual basis.

The client's argument was found to be inconsistent with the plain language of the arbitration agreement, which only delays rather than negates the firm's ability to enforce the pre-dispute arbitration provision.

The class action exclusion provision of the Client Agreement, which is required by the rules of the Financial Industry Regulatory Authority ("FINRA"), protects the client's ability to litigate claims on a class action basis rather than through individual arbitration proceedings; nothing in the clause or the records of the agency proceedings relating to the FINRA rule suggests any intention to permit individual litigation of claims.

The court then addressed numerous factors regarding imposing a stay, finding that permitting the individual action to proceed would prejudice the firm through the

imposition of premature and potentially duplicative discovery burdens.

Further, the Court had a substantial interest in staying the individual action. Considerations of judicial economy and efficiency weigh against allowing Plaintiff to proceed with this matter at this stage. Denial of the stay application would essentially require the Court to maintain duplicative proceedings, each having a different schedule and potentially doubling the amount of time and energy the Court must expend on these issues.

Allowing the client to proceed individually at this stage would have not only undermined the ability of the class to move forward in a coordinated, harmonious manner, but would have the disruptive consequence of providing an incentive for individual members to break from the putative class to seek an individual resolution of their claims, at least at this stage.

The court granted the firm's request for a stay of this individual action.

Waiver of Arbitration: Litigation Conduct

In re H&R Block Financial Advisors, Inc. (Tex. App. 8/28/2008) 262 S.W.3d 896

A party filing a dispositive motion is not, in and of itself, always sufficient to find that the party waived its right to compel arbitration.

In this matter, the plaintiff's father had opened two Uniform Gift to Minor Act accounts for the benefit of the plaintiff, with H & R Block. The plaintiff sued H & R Block and his ex-stepmother, contending that H & R Block wrongfully released his account proceeds to the stepmother, who then absconded with the funds. H & R Block timely answered the suit, and asserted as an affirmative defense that plaintiff's claims were subject to a contractual arbitration clause.

In resisting H & R Block's motion for arbitration, the plaintiff claimed mootness, on the grounds that both the NYSE and NASD – the only two forums mentioned in the arbitration agreement -- ceased offering arbitration in July 2007. Plaintiff further claimed that the rules and procedures of both entities no longer exist, and that the court therefore lacked jurisdiction to order relief that was impossible to render – i.e., compelling arbitration at the NASD or NYSE under those forum's rules.

The court rejected the mootness claim. Although the NASD changed its name to FINRA, FINRA continues to apply the NASD arbitration rules and procedures. Therefore, it was not impossible for the parties to arbitrate their dispute under the NASD arbitration rules and principles. In fact, courts continue to enforce NYSE or NASD arbitration clauses by referring parties to FINRA arbitration

The plaintiff then argued that H&R Block had waived any right to compel arbitration by participating in the litigation, and in particular by moving for summary judgment. In rejecting that argument, the court applied the test recently adopted by the Texas Supreme Court for waiver of an arbitration agreement. Waiver is decided not on one factor but, rather, on a totality-of-the-circumstances test. Whether a party seeks a judicial decision on the merits of the case may be one factor in determining waiver, but it is not the only factor. Applying those factors to the case before it, the court concluded:

• H & R Block is the defendant and did no more than respond to the plaintiff's lawsuit (in contrast to the situation where a plaintiff, after voluntarily commencing litigation, moves to compel arbitration);

• H & R Block immediately asserted the arbitration clause as an affirmative defense and moved for enforcement within two weeks of answering the lawsuit; and

• though H& R Block filed a dispositive motion in the litigation, it was presented as an alternative to its arbitration demand, and then

only after the plaintiff claimed that he was not a party to the contract containing the arbitration clause; hence, filing a dispositive motion did not waive H & R Block's contractual right to compel arbitration.

The court concluded that because plaintiff's claims against H & R Block were arbitrable, the trial court judge was required, at a minimum, to stay the proceedings and order those claims to arbitration.

Compelling Arbitration: Uniform Submission Agreement

Harris v. A.G. Edwards & Sons, Inc. (Mo. App. 11/18/2008) --- S.W.3d ----, 2008 WL 5158591

A Uniform Submission Agreement is a binding agreement to arbitrate for which there is sufficient consideration, even where the USA is executed under the mistaken belief that there was a binding pre-dispute arbitration agreement.

Plaintiff Harris, acting as personal representative for a deceased individual, brought a lawsuit against the deceased's brokers in Illinois, alleging breach of fiduciary duty in addition to other claims. The brokerage firm produced an account agreement which contained an arbitration clause. (Harris subsequently discovered that the account agreement was only for her own IRA account, and not for the deceased's account.) On the basis of that account agreement, the court stayed the litigation pending arbitration.

Harris then initiated arbitration against the brokers with the NASD. In conjunction with that arbitration, Harris executed a Uniform Submission Agreement ("USA") in her capacity as executor of the estate of Deceased, which was filed with the NASD.

Several months after commencing the arbitration, Harris filed the present action against the brokers in Missouri court, asserting causes of action similar to those asserted in the arbitration and in the original Illinois action. The brokers moved to dismiss or stay the action, based on the pending arbitration proceeding.

The court first concluded that the USA, which was executed by Harris, the party against whom the contract was sought to be enforced, was a valid written agreement to arbitrate. Accordingly, it was valid, enforceable, and irrevocable, unless there is a basis at law or in equity to void or revoke the contract.

Harris asserted two different grounds for voiding the USA: mistake of fact and lack of consideration. The first argument was based on Harris's apparent mistake of fact that as the Deceased's personal representative, she was obliged to arbitrate because the Deceased's account agreement with A.G. Edwards included an agreement to arbitrate disputes. This alleged mistake was induced by brokers showing Harris a copy of her own IRA account agreement with A.G. Edwards, which has an arbitration clause, but which Harris thought was for Deceased's account.

The court concluded that this evidence was insufficient to prove that Harris made a mistake of fact, whether unilateral or mutual, sufficient to void the USA.

Harris also contended that the USA was void because it lacked consideration in that the brokers were obligated to arbitrate if Harris so wished, due to their membership in the Financial Industry Regulatory Authority ("FINRA") even without the execution of the USA.

Harris failed to show a lack of consideration for the USA, according to the court. The brokers admitted that their membership in FINRA requires them to arbitrate customer disputes when the claims arise in connection with the business of A.G. Edwards or the activities of its agent, Waller, and the customer demands to arbitrate. That is all that is required by the FINRA Code.

In contrast, the USA requires that the parties agree to do more than just arbitrate. Though a promise to carry out a pre-existing duty does not constitute consideration, if the subsequent contract imposes new or different obligations, i.e., it is not identical to the pre-existing duties, this constitutes sufficient consideration.

The court held that there was sufficient consideration to support the USA, and hence the trial court erred in not staying the court action pending arbitration.

During the Arbitration

Parallel Arbitration and Court Proceedings: Stay

Rogers v. Ameriprise Financial Services, Inc.
(N.D. Ill. 11/4/2008) 2008 WL 4826262

Where a court proceeding is parallel to an arbitration proceeding, the court proceeding should be stayed and not the arbitration proceeding, even though the party commencing the arbitration had first commenced the court proceeding.

Ameriprise is a financial services firm that distributes a wide variety of financial planning products and services to the public through a national sales force. Plaintiff Joshua Rogers was hired by Ameriprise in 1999 as a financial advisor and was promoted to Field Vice President ("FVP") in 2003. Rogers alleges that he was wrongfully discharged from Ameriprise in 2007 for objecting to and refusing to follow two illegal company policies.

Specifically, Rogers first alleged that he was wrongfully discharged for refusing to employ the "million dollar step-down sales technique" when selling universal variable life insurance policies ("VULs"). This technique purportedly involves fallaciously representing to prospective purchasers that it would be cheaper to purchase $1,000,000 VULs rather than purchasing the next lower steps of the same policy (i.e. $750,000 and $500,000 policies).

Second, Rogers alleged that he was wrongfully discharged for refusing to forge delayed effective dates of financial advisor terminations of employment in the company's 15(d) disclosures that were filed with the Securities and Exchange Commission. Management allegedly directed all financial advisors to forge delayed termination of employment dates in order to make it appear as if Ameriprise had a significantly greater number of financial advisors than it actually did. According to Rogers' Complaint, he was ordered by Ameriprise senior management to follow these directives throughout 2006, and when he voiced his objections to these policies and refused to comply, he was fired.

Notwithstanding the arbitration clause in the FVP agreement, Rogers filed a civil complaint against Ameriprise in this court based upon diversity jurisdiction, asserting claims arising out of his termination by Ameriprise. Shortly after Ameriprise answered the civil complaint, Rogers filed a Statement of Claim with the Financial Industry Regulatory Authority ("FINRA"), thus commencing an arbitration proceeding. The Statement of Claim filed with FINRA also alleges that Rogers was wrongfully terminated by Ameriprise.

In the arbitration, Ameriprise filed a request with FINRA not to proceed with the arbitration because Rogers had waived his right to arbitration by filing this lawsuit. However, FINRA's Director of Arbitration denied Ameriprise's request. Ameriprise then moved the court to stay the FINRA arbitration.

The court agreed with Ameriprise that Rogers could not pursue the same dispute in two forums and force Ameriprise to defend two separate actions regarding substantially the same claims. However, the court denied Ameriprise's request to stay the arbitration, but instead ordered that the lawsuit be stayed pending the resolution of the arbitration proceeding.

Rogers' attempt to frame his lawsuit as one involving Ameriprise's violations of law and the arbitration proceeding as one involving violations of company policy did not change the fact that both proceedings involve the same parties and the same facts and conduct surrounding the allegations of wrongful discharge. Furthermore, even if there are slight variations in the claims before the court and the claims in the arbitration proceeding, the requirement for a stay is that of parallel suits, not identical suits. A suit is parallel when substantially the same parties are contemporaneously litigating substantially the same issues in another forum.

In this case, the parties do not dispute the arbitrability of the dispute, and the contract signed by both parties contains an arbitration agreement that neither side disputes. Furthermore, arbitration will likely result in a quicker resolution by arbitrators intimately familiar with the type of dispute at issue here. Thus, the court exercised its discretion and concluded that it was consistent with considerations of equity and judicial economy to stay the court proceedings pending the resolution of the arbitration proceeding.

Discovery From Non-Parties

Life Receivables Trust v. Syndicate 102 at Lloyd's of London
(2nd Cir. 11/25/2008) 549 F.3d 210

Section 7 of the FAA does not authorize arbitrators to compel prehearing discovery from non-parties.

In this non-securities arbitration case, the court held that section 7 of the Federal Arbitration Act does not enable arbitrators to issue pre-hearing document subpoenas to entities which are not parties to the arbitration proceeding.

In the underlying arbitration, the arbitration panel ordered a company which was not a party to the arbitration ("Peachtree") to produce various documents in its possession that related to one of the parties to the arbitration. The arbitration panel issued a subpoena requiring Peachtree to produce responsive documents.

Peachtree filed suit in federal court and moved to quash the subpoena, which the court granted.

The language of section 7 is straightforward and unambiguous, according to this court. Documents are only discoverable in arbitration when brought before arbitrators by a testifying witness.

The FAA was enacted in a time when pre-hearing discovery in civil litigation was generally not permitted. The fact that the Federal Rules of Civil Procedure were since enacted and subsequently broadened demonstrates that if Congress wants to expand arbitral subpoena authority, it is fully capable of doing so.

There may be valid reasons to empower arbitrators to subpoena documents from third parties, but the court must interpret a statute as it is, not as it might be, since "courts must presume that a legislature says in a statute what it means and means in a statute what it says....". A statute's clear language does not morph into something more just because courts think it makes sense for it to do so. Thus, the court joined the Third Circuit in holding that section 7 of the FAA does not authorize arbitrators to compel pre-hearing document discovery from entities not party to the arbitration proceedings.

Although section 7 does not distinguish between parties and non-parties to the actual arbitration proceeding, an arbitrator's power over parties stems from the arbitration agreement, not section 7. Where agreements so provide, that authority includes the power to order discovery from the parties in arbitration since "the FAA lets parties tailor some, even many features of arbitration by contract, including ... procedure." A n arbitrator can enforce his or her discovery order through, among other things, drawing a negative inference from a

party's refusal to produce, and, ultimately, through rendering a judgment enforceable in federal court, see 9 U.S.C. § 9.

In contrast, arbitrators have no such power to compel discovery from third parties-even those (like Peachtree) that signed the underlying arbitration agreements. However, the court did not decide whether entities can, by contract, agree to comply with discovery orders in arbitrations to which they are not parties.

The court noted that where the non-party to the arbitration is a party to the arbitration agreement, there may be instances where formal joinder is appropriate, enabling arbitrators to exercise their contractual jurisdiction over parties before them. Arbitrators possess a variety of tools to compel discovery from non-parties. However, those relying on section 7 of the FAA must do so according to its plain text, which requires that documents be produced by a testifying witness.

After the Arbitration

Challenging/Confirming Arbitration Awards

Confirming/Vacating The Award: Subject Matter Jurisdiction

Hansen Beverage Co. v. DSD Distributors, Inc.
(S.D. Cal. 12/12/2008) 2008 WL 5233180

In the absence of a request to reopen the arbitration, the amount in controversy for purposes of diversity jurisdiction is measured by the amount of the arbitration award.

In this matter, Hansen Beverage sought federal court confirmation of an arbitration award in its favor. DSD Distributors opposed confirmation, but did not move to vacate the award (DSD had filed an action in Wisconsin state court to vacate the award). The award was for zero dollars.

This federal court concluded it did not have subject matter jurisdiction over the petition to confirm, as the amount in controversy requirement for diversity jurisdiction was not met. As the court described it, if Hansen obtained all the relief requested in its Petition to Confirm Arbitration Award, it will receive zero dollars. Likewise, the losing party in the arbitration (DSD Distributors) will receive zero dollars if Hansen's petition was denied.

Thus, in the court's opinion, this case differs significantly from cases where the amount-in-controversy requirement was satisfied by reference to damages sought in the underlying arbitration. In the present case, neither of the parties was asking this Court for an order reopening arbitration or awarding damages. The Court noted that the situation might be different if DSD were pursuing a motion to vacate the award and reopen arbitration in the federal court rather than in Wisconsin state court. However, the only issue pending before the federal court was Hansen's request to confirm a zero-dollar arbitration award.

Vacatur: Failure to Allow for Cross Examination

Lunsford v. RBC Dain Rauscher, Inc.
(D. Minn. 12/17/2008) --- F.Supp.2d ----, 2008 WL 5273822

Where plaintiff investors did not request the arbitrators to subpoena brokerage firm employees to testify, there was no affirmative misconduct by the arbitrators in deciding the claim without first hearing cross-examination of those employees. Further, prisoners in a Federal Correctional Institution have no constitutional right to maintain a securities account at a private institution.

In this matter, plaintiffs (who were prisoners at a Federal Correctional Institute) established securities accounts at Nations Financial Group, which cleared through RBC Dain Correspondent Services ("RBC").

Plaintiffs filed this lawsuit against those brokerage firms, asserting various claims arising from the brokerage firms' decision to no longer maintain plaintiffs' financial accounts. Plaintiffs asserted claims for conspiracy to interfere with civil rights pursuant to 42 U.S.C. §§ 1985(3), 1986 and the due process clause of the Fifth Amendment to the United States Constitution, and also asserted securities-related claims for omission or misstatements of material facts and control person liability pursuant to Securities Exchange Act, breach of contract and breach of fiduciary duty.

After the court ordered the non-civil rights claims to arbitration, the plaintiffs initiated a FINRA arbitration proceeding against the brokerage firms, asserting securities claims and violation of the Equal Credit Opportunity Act.

In the arbitration, the brokerage firms moved to dismiss the arbitration. In response, plaintiffs demanded an evidentiary hearing before the Panel. A telephonic hearing was held during which the Panel considered the pleadings, testimony, and evidence presented. However, during this hearing, plaintiffs did not cross-examine defendants (as only counsel for the defendants was present), the Panel denied plaintiffs' requests to subpoena recordings of their phone conversations with the brokers, and the Panel did not consider Nations Financial's compliance manuals. Subsequently, in a written order, the Panel rejected plaintiffs' claims.

Plaintiffs then moved to vacate the award, and requested the court to rule on the merits of their claims under the SEA and their civil rights claims. The brokerage firms moved to confirm the arbitration award and dismiss all remaining claims in the civil suit.

Plaintiffs first argued that they should have been allowed to cross-examine the defendants in-person at the evidentiary hearing. However, the court held that arbitrators generally exercise broad discretion to limit cross-examination. Here, the Panel's pre-hearing order did not contemplate cross-examination but plaintiffs could have requested that the Panel subpoena defendants for examination. See FINRA Code of Arb. Rule 10322(b) (describing procedure for issuance of subpoenas to parties). Without such a request, the Panel's failure to permit cross-examination did not reflect bad faith or amount to affirmative misconduct.

The Panel denied several requests by plaintiffs to subpoena recordings of the conversations but allowed plaintiffs to testify about the conversations during the telephonic hearing. See FINRA Code of Arb. Rule 10322(c) (arbitrator decides whether to issue subpoena). After considering plaintiffs' testimony, the Panel concluded that the recordings were immaterial to its award. See FINRA Code of Arb. Rule 10323 (arbitrators determine relevance of evidence). Based upon the Panel's conduct, the court determined that the Panel's decision not to subpoena the recordings did not reflect bad faith or amount to affirmative misconduct.

The plaintiffs' civil rights claims were dismissed. The court concluded that prisoners are not a protected class, there is no fundamental right to maintain a securities account with a private institution, and a private entity is not subject to a Fifth Amendment due process claim.

Other Issues

SRO Immunity

In re Series 7 Broker Qualification Exam Scoring Litigation
(C.A.D.C. 11/7/2008) 548 F.3d 110

SRO's are not liable under common law causes of action based on the SRO's negligent performance of its duties that it is required to perform under the Securities Exchange Act.

On January 6, 2006, NASD issued a press release, publicly acknowledging that the Series 7 test results for 1,882 applicants had been misreported as failing scores. All affected applicants had their results corrected and their applications approved.

Some of the applicants who received incorrect Series 7 scores filed suit and these actions became part of a nationwide consolidated class complaint asserting causes of action for common law breach of contract, negligence, and negligent misrepresentation. The district court dismissed the complaint, and this court affirmed.

The SRO argued that causes of action such as those alleged in this case are impliedly preempted by federal law and, alternatively, that they are immune from suit based on regulatory immunity. Whether analyzed under preemption doctrine or a theory of regulatory immunity, the court reached the same result: plaintiffs cannot raise a common law complaint against the SRO based on duties arising under the Exchange Act.

As to preemption, any actions against SEC regulators, or those acting in their stead (such as the SROs), are limited to the four levels of review specified by the Exchange Act. The multiple layers of review evince Congress's intent to direct challenges based on denials of membership to the avenues Congress created. Had Congress been silent on this issue, a more plausible case for common law suits might be made. But Congress's clear designation of an appellate process shows a contrary intent: rather than allowing plaintiffs to sue under common law theories, Congress created a self-contained process to review and remedy such complaints.

Turning to an immunity analysis, the Exchange Act reveals a deliberate and careful design for regulation of the securities industry. This regulatory model depends on the SEC's delegation of certain governmental functions to private SROs, such as the NASD's administration and the scoring of the Series 7 exam. Absent the unique self-regulatory framework of the securities industry, these responsibilities would be handled by the SEC - an agency which is accorded sovereign immunity from all suits for money damages.

Where courts accord immunity to SROs, the protection has been absolute. Courts have declined to craft exceptions for bad faith, fraud, negligence, or even gross negligence.

As the court described it, unable to breach this formidable barrier of precedent or sneak past it in disguise, plaintiffs attempted to vault over it. Even if there is no exception for negligence generally, plaintiffs insist no immunity should exist for the negligent performance of purely ministerial functions.

Regardless of the approach taken, the conclusion did not change: plaintiffs cannot bring a common law cause of action based on errors in design, scoring, or reporting of results of the Series 7 exam. These duties arise only under the Exchange Act, and they are not open to suit under state common law theories. The court concluded that both preemption and regulatory immunity supported its holding, and the intent of Congress is clear under each approach.

Theft Loss Deduction

Electric Picture Solutions, Inc. v. C.I.R. (U.S. Tax Ct., 9/08/2008) T.C. Memo. 2008-212, 2008 WL 4132050

An SEC complaint against an issuer alleging fraud, and two arbitration awards against a brokerage firm for selling stock in the issuer, were insufficient to support a theft loss deduction claimed by an investor.

In this tax court proceeding, the issue decided was whether an investor was entitled to a theft loss deduction under Internal Revenue Code section 165, arising out of an investment in corporate shares that became

worthless because of alleged fraud by the issuer and the stockbroker.

Petitioner purchased shares in the issuer (Novatek) through a stockbroker, Joseph Roberts & Co., Inc. (Roberts), with which petitioner had a history of doing business. Novatek's common stock was traded on NASDAQ until October 14, 1996, when trading in the stock was suspended. Shortly thereafter, Novatek filed a voluntary petition for protection pursuant to chapter 11 of the Bankruptcy Code. When petitioner later attempted to sell its Novatek shares, there was no market for them.

On June 18, 1998, the U.S. Securities and Exchange Commission (SEC) filed a civil enforcement action against Novatek's successor-in-interest and Novatek's principals and officers. The complaint alleged that the defendants had committed a massive fraud on investors by, among other things, orchestrating a series of sham transactions, announcing highly profitable nonexistent contracts, and filing materially false and misleading financial statements. Subsequently, without admitting or denying the SEC allegations, one of the individual defendants consented to the entry of a final judgment that imposed civil sanctions against him for his role in the Novatek matter and in a related fraud action.

Applying California law as to whether there was a “theft”, the court first rejected petitioner’s claim of “theft” by the issuer. Generally, a taxpayer who purchases securities on the open market cannot support a claim of theft under California law because there is no privity between the perpetrator and the victim.

Petitioner also contended that it was defrauded by the brokerage firm (Roberts) because Roberts was aware that it was making claims about the company in order to sell its stock. To support this allegation, petitioner asserted that statements made by Roberts's representative were “breaches of the stockbroker's duty of truth and fitness for his customer's portfolio.” Petitioner alleges that Roberts was sued and lost in two separate arbitrations held before the National Association of Securities Dealers (NASD) with respect to complaints made by other investors in the same stock.

The Tax Court concluded that this evidence was inadequate, however, to establish that Roberts or its agents had “guilty knowledge or intent”. Similarly, the evidence was inadequate to establish that Roberts or its agents made any false pretense or representation to petitioner with intent to deceive. Neither the filing of the SEC complaint against Novatek and its principals nor the entry of judgment against one of the defendants establishes criminal intent on the part of Roberts or its agents. Similarly, petitioner's allegation that Roberts was unsuccessful in NASD arbitration proceedings involving other investors, even if true, does not establish that Roberts or its agents had the requisite criminal intent with respect to petitioner's investment in Novatek.

The Tax Court concluded that the “theft loss” deduction claimed by the petitioner should be disallowed.

Bankruptcy

In re Tallman
(N.D. Ind. 11/12/2008) 397 B.R. 451, 2008 WL 4999220

Bankruptcy filing by a stockbroker seeking only to discharge an NASD arbitration award in favor of his former employer was not filed in bad faith.

Former broker for Securities America was sued by Securities America to recover broker’s portion of a settlement of a customer claim against the firm. After having lost an arbitration hearing, the broker filed for chapter 7 bankruptcy. Securities America moved to dismiss the bankruptcy, on grounds the broker filed for bankruptcy in bad faith.

After a short detour discussing bad faith and Vincent Van Gogh's "The Starry Night", the court denied Securities America's motion.

Securities America's first argument was that the debtor singled out his obligation to Securities America for discharge, that his sole purpose in filing this case was to discharge that particular debt, and that he intended to reaffirm or repay all of his other debts. As the court stated, even if this is true, so what? Debtors are permitted to enter into agreements with creditors reaffirming debts, and the Bankruptcy Code specifically recognizes that nothing prevents a discharge of debts that have not been reaffirmed.

The second factor Securities America pointed to is that the debtor filed bankruptcy in direct response to the arbitration award and its efforts to enforce that award. This is true, but, once again, according to the court, so what? It is not uncommon for debtors to put off filing bankruptcy until there is no other available alternative and the movant does not identify a more appropriate time for the debtor to have filed. More importantly, the debtor disputed Securities America's claim and actively litigated it, with some success, before the NASD's arbitration panel.

Securities America also contended that the debtor should have adjusted his lifestyle, so as to be able to pay his debts. However, there is no evidence that the debtor or his family indulged in a lavish standard of living or have consistently been living beyond their means. Their home has a value of no more than $220,000 and the only particular expense that has been singled out for criticism is the time share in Hawaii, purchased from his wife's friend. While the debtor and his family have obviously enjoyed a comfortable living, the information before the court does not suggest a free-spending debtor who has pursued a lavish lifestyle it could not afford, all the while ignoring obligations to creditors. It was not indicative of bad faith.

Where We Stand

Historically, PIABA has commented on a number of issues, on both a formal and an informal basis, which are directly applicable to our promotion of the interests of public investors in securities arbitration proceedings that are conducted before the Financial Industry Regulatory Authority ("FINRA").

For example, among the issues that generated the most interest, from and/or on behalf of the members of our association, were proposed amendments to the rules concerning:

- Abusive pre-hearing dispositive motion practices; and
- The adoption of specific procedures that arbitrators will be required to follow before granting the extraordinary remedy of the expungement of prior customer complaints from the registration records of registered representatives.

In this section of the *PIABA Bar Journal*, we will share with our readers the comment letters and formal positions that have been submitted on behalf of our association, during the quarter, to the various regulatory authorities so that all of our constituents will know exactly where we stand.

To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Brian Smiley, bnsmiley@sbpllplaw.com, Scott Shewan, scottshewan@att.net or Robin S. Ringo, rsringo@piaba.org for assistance.

Public Investors Arbitration Bar Association

October 20, 2008

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2008-047
Proposed FINRA Amendment to Customer Code Rule 12401
Increase in Limits for Single Arbitrator Cases

Dear Ms. Harmon:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") in support of the proposed revision to Rule 12401 of the NASD Customer Code of Arbitration Procedure[1] to provide that claims for $100,000 or less be heard by a single arbitrator. We believe this rule should be approved and implemented on an accelerated basis.

PIABA is a national association of attorneys who represent public investors in securities arbitration proceedings. Since its formation in 1990, PIABA has pursued its mission of promoting and protecting the interests of public investors in all securities and commodities arbitration forums. Our members and the investors we represent have a strong interest in the rules that govern the arbitration process at FINRA.

One of the benefits of resolving disputes by arbitration is that arbitration typically is more efficient and less costly than litigation. This rule proposal advances the interests of efficiency and cost saving. Hearing fees will be reduced for both parties, as the fees are significantly lower for single arbitrators as opposed to three-arbitrator panels. Furthermore, it will be easier to schedule hearings, and have them set earlier, when the parties need only be concerned with a single arbitrator's calendar. During list selection, the parties will save time vetting only eight potential arbitrators, instead of the twenty-four names provided for a three-member panel. These cost savings may enable investors to obtain legal representation for claims which might otherwise be considered too small to handle.

[1] FINRA's filing also seeks to amend Rule 13401 of the Industry Code in the same manner.

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Florence E. Harmon, Acting Secretary
October 20, 2008
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While PIABA applauds the increase from $50,000 to $100,000 for the amount in controversy, exclusive of interest and expenses, we encourage FINRA to consider raising the threshold further. We believe the benefit to the parties of having these cases resolved by a single arbitrator should be expanded to cases seeking $250,000 or less, at the option of the investor. While we see no reason to delay the implementation of this proposed rule, we hope that FINRA will propose such an increase in the threshold before long.

An important aspect of this rule change is the removal of the current provision which permits any one party to request a three-person panel for cases over $25,000. While we have no firm data on this issue, we have anecdotal evidence that industry respondents have routinely defeated the benefits of having a single arbitrator by demanding a full panel for cases between $25,000 and $50,000. The new rule would provide for a single arbitrator in all cases where the amount in controversy is between $25,000 and $100,000, exclusive of interest and costs, unless all parties agree in writing to submit the dispute to a full panel. Thus, it will no longer be possible for a single party to unilaterally defeat the single-arbitrator provision. PIABA supports this aspect of the proposed rule change.

FINRA's rule filing states that FINRA will realize cost savings with the implementation of this rule change. This makes sense. FINRA staff spends much of its time contacting arbitrators about a myriad of issues, and calling parties and arbitrators to schedule or reschedule telephonic hearings. This time will be reduced significantly when only a single arbitrator needs to be contacted. PIABA believes these savings ought to be passed on to the parties who use FINRA's forum. We encourage FINRA to quantify its own cost savings, and to adjust the fees charged to the parties accordingly.

Finally, we note that this rule may exacerbate a problem we addressed in a previous comment letter. In our letter concerning the change to the chairperson training requirements,[2] we pointed out that the current list selection rules give preferential treatment to the "chair-qualified" arbitrators. As chair-qualified arbitrators can appear on both the chairperson list and the

[2] Letter of Laurence S. Schultz to Nancy M. Morris regarding SR-FINRA-2008-009, dated April 16, 2008. All PIABA comment letters are available on the Newroom link at piaba.org.

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non-chair public arbitrator list, they are much more likely to be chosen to serve on arbitration panels. This reduces the participation of non-chair-qualified arbitrators and makes it more difficult for them to get the service they need to become chair-qualified.[3] The current proposed rule will exaggerate that effect, as all of the cases which will now be assigned to a single arbitrator will be heard by a "chair-qualified" arbitrator. This will disqualify non-chair arbitrators from sitting on a substantial number of cases. PIABA believes it is in the best interest of public investors to have a robust arbitrator pool, supplemented regularly with new faces. We therefore are concerned about the negative effect this rule change will have on the appointment of non-chair arbitrators. As we have stated before, we feel that the solution to this problem would be to modify or scrap the "chair-qualified" system altogether.

On balance, however, we believe the proposed rule change is an improvement to the arbitration process, and we support its adoption.

Thank you for allowing us to comment on this proposed rule change.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

s/Laurence S. Schultz
Laurence S. Schultz
President, 2007-2008

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[3]Rule 12400 requires non-lawyer arbitrators to sit on three cases through award before they are eligible to serve as chairpersons; a lawyer must sit on two cases through award to qualify.

Public Investors Arbitration Bar Association

September 30, 2008

VIA E-MAIL TO PUBCOM@FINRA.ORG

Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1500

Re: FINRA Regulatory Notice No. 08-39
Variable Insurance Products

Dear Ms. Asquith:

The Public Investors Arbitration Bar Association ("PIABA") appreciates the opportunity to comment on the above-referenced rule proposal to rewrite IM-2210-2, regarding communications with the public about variable annuities and variable life insurance policies.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules relating to the advertising and sale of variable insurance products, due to their extremely large annual sales volume and widespread sales practice abuses by the brokerage industry in marketing these products.

We recognize that the proposed rule will effect important changes in the marketing of variable insurance products by the brokerage industry and that any proposed rule will be subject to SEC publication for public comment. We also appreciate that the sale of variable insurance products is an extremely lucrative business for the brokerage industry and that the proposed rule may be considered controversial to the extent it affects current brokerage sales practices. We therefore offer our comments with the acknowledgment that PIABA may submit additional and more detailed commentary at such time as the SEC publishes the proposal.

Our members have extensive experience working with the victims of sales practice abuses associated with variable insurance products, and we generally support adoption of the proposed new language for IM-2210-2, which should give the public better information before buying a variable insurance product. However, the proposed language is inadequate to address some widespread and serious abuses which are commonly visited upon members of the investing public.

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Sales Commissions

The large commissions salespeople receive for selling variable insurance products create a substantial incentive to recommend them to customers through misrepresentations and where the investments may be unsuitable based on the customers' financial situation, needs, and other investments. Customers are seldom advised that the salesperson often has a material economic incentive for recommending the variable insurance product. Indeed, rather than being told of the broker's commission, customers are commonly assured that they are paying no commission in connection with the sale.

To assure full and accurate disclosure to the customer, PIABA urges that new IM-2210-2 require that written disclosure to the customer include an up-front, clear, and prominent statement similar to the following:

> **The salesperson will be paid a commission by the insurance company equal to one-half of the first year's planned premium.[1] The sales load/deferred contingent sales charge and a portion of the annual charges assessed to you under the contract reimburse the company for this commission payment to the salesperson.**

Investment vs. Insurance

Customers simply looking for investment advice, with no interest in insurance or an annuity, are often sold variable insurance products described as tax-advantaged investments, with the insurance touted as an extra benefit over and above the investment returns. IM-2210-2 should require that communications with the public include a clear and prominent statement that:

> **This is an *insurance* product. It is not primarily intended as an investment. If your objective is to invest your funds, instead of buying insurance, it may be more advantageous to purchase investments that do not include an insurance component.**

[1] Obviously the description of the payment would change according to the sales structure involved with each particular product.

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Risks – Insurance Company Failure

Salespeople frequently market variable insurance products by stressing *guarantees* against principal loss, or guarantees of a certain minimum stream of income. Particularly in light of recent unsettling economic events, when discussing any "guaranteed" benefit, communications with the public should disclose that if the insurance company fails or becomes unable to pay, then the benefit is not guaranteed and may not be paid.

Liquidity

One of the most common abuses in the sale of variable insurance products is the salesperson's failure to adequately explain the limitations on the customer's access to his or her funds. Proposed IM-2210-2(c) provides:

> **Presentations regarding access to account values must be balanced by a description of the potential effect of all charges, penalties, or tax consequences resulting from redemption or surrender.**

This limited generalization will permit descriptions which are less than clear and may even result in misrepresentation of the impact of limitations on liquidity. The new interpretive memo should prescribe mandatory language for a liquidity disclosure, in bold type, such as:

> **You may not have ready access to money you commit to this product. You may incur substantial penalties on early withdrawal.**

The rule should also specifically state that the salesperson must explain clearly limitations and charges that apply should the customer withdraw money.

Qualified Plans

The addition of material at IM-2210-2(e) concerning qualified plans is particularly important. Variable insurance products are routinely sold to IRA accounts and other retirement plans which themselves provide tax-deferred treatment of earnings. While IM-2210-2(e) will prohibit disclosure that tax-deferred treatment is available only through investment in the contract and also requires disclosure that the contract does not provide additional tax-deferred treatment of earnings beyond that provided in the tax-qualified retirement plan, this language does not go far enough.

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While in theory the investment objectives of a customer may justify purchasing a variable insurance product inside an IRA or a retirement plan, the experience of PIABA's members in representing victims of improper variable insurance product sales through such plans indicates that such sales typically are made for a very simple reason: that is where the money is. Our observations are that the vast majority of variable insurance product sales in tax-qualified accounts are unsuitable. Accordingly, we believe that specific written disclosure is necessary to address this issue. The interpretive memo should prescribe minimum mandatory language such as:

> **Generally, variable insurance products are not suitable for purchase in an IRA or other retirement account. Variable insurance products provide no tax deferral beyond that already provided in an IRA or retirement account.**

Illustrations

Proposed IM-2210-2(f) permits historical performance to be shown without including the effect of "fees and charges disclosed in the prospectus other than at the investment option level," so long as the communication discloses that such fees are not included in the illustration. IM-2210-2(g) similarly permits the use of hypotheticals that consider only "the maximum guaranteed charges." It is difficult for many customers to understand charts and graphs. Simply including a proviso noting that a chart or graph does not consider the effect of certain fees is inadequate to inform the customer of the potential magnitude of the those fees, or how those fees might affect the customer's account over time. A second hypothetical should be required, taking into account the effect of all of the fees that could be charged in connection with the product at issue.

Conclusion

PIABA appreciates the opportunity to comment on this rule change before it is submitted to the SEC, and subject to our comments above, we support the FINRA rewrite of IM-2210-2. Due to the importance of this rule proposal, we anticipate that we may have further substantive comments at the time the proposal is published by the SEC for comment.

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Thank you for considering these comments.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

s/Laurence S. Schultz
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Public Investors Arbitration Bar Association

September 10, 2008

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. S7-14-08
Proposed Rule Change Regarding Indexed Annuities and Certain Other Insurance Contracts

Dear Ms. Harmon:

The Public Investors Arbitration Bar Association ("PIABA") appreciates the opportunity to express its support for the above-referenced rule proposal which would bring indexed annuities within the ambit of the federal securities laws.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums.

While we do not comment on the definitional elements, areas of requested guidance, or other technical elements of the rule, PIABA believes it is important to state our position concerning the regulation of indexed annuities as securities.

PIABA supports this rule proposal because on its face it is in the best interest of investors. Throughout the nation, senior citizens have fallen prey to false and misleading marketing tactics by insurance professionals who, although they are selling investments, are neither licensed nor regulated under state or federal securities laws. These senior citizens are the most vulnerable segment of our society, and it is essential that they are protected by securities laws.

Indexed annuities are securities. These products are in fact investments and are actively marketed as investments. As such, their sale should be subjected to the same standards and regulations applied to the sales of other investments, including the basic investor protection provisions of the anti-fraud statutes and suitability rules. Many state insurance laws do not

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provide investors a cause of action against insurance agents for misleading and defrauding their clients. This is in contrast to the federal securities laws and state blue sky laws which allow investors to recover against the seller of a security for the wrongdoing.

The imposition of statutory liability on insurance agents selling indexed annuities as investments is particularly important where the investment decision directly impacts an investor's financial security and ability to retire.

Indexed annuities also qualify as securities under traditional legal analysis. While most such annuities provide a minimum return guarantee, the guarantee is limited to only a portion of the customer's investment, and the primary success of an indexed annuity investment is dependent upon the performance of stock indices. As such, indexed annuities subject investors to the investment risk of both the issuing insurance company and the stock market.

Another important reason for including indexed annuities within the definition of securities is that indexed annuities are aggressively marketed with limited disclosures to investors who are unable to understand these confusing products. Full disclosure mandated by securities laws, and regulation and oversight by both the SEC and FINRA, are therefore particularly appropriate.

A review of the existing comment letters indicates that hundreds of insurance professionals have been mobilized by their professional organizations to oppose this rule proposal. This is not surprising in view of the indexed annuity commission structure. These products generate some of the highest sales commissions of any products on the market, including both securities and insurance products.

We note that FINRA shares many of our concerns. In Notice to Members 05-50, FINRA pointed out that indexed annuities are often marketed as investments. FINRA questioned the marketing practices of its members with regard to indexed annuities and the lack of supervision of those sales practices. If the proposed rule is adopted, FINRA will impose its suitability and supervisory obligations upon the sellers of indexed annuities. We believe these regulatory protections are essential to investors.

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Florence E. Harmon, Acting Secretary
September 10, 2008
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We urge the Commission to adopt the rule and take this important step toward protecting millions of American investors from deceptive and unsuitable sales of indexed annuities.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

s/Laurence S. Schultz
Laurence S. Schultz
President, 2007-2008

LSS/ch

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Public Investors Arbitration Bar Association

August 6, 2008

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV

Florence E. Harmon
Acting Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: File No. SR-FINRA-2008-031
Proposed Rule Change Regarding Uniform Submission Agreements

Dear Ms. Harmon:

Thank you for the opportunity to comment on the above-referenced rule proposal to rename and amend the submission agreements to be filed by claimants and respondents in FINRA arbitration proceedings. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") to request that the Commission require further changes before approving this proposed rule change.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums.

We ask that the Commission return this proposed rule to FINRA and request a rule which treats FINRA member firm respondents in the same manner as public customer claimants. As presently administered by FINRA, filing a submission agreement is optional for member firms and registered persons. FINRA has trained its arbitrators that a submission agreement from respondents is not necessary because they are already bound to submit to arbitration, and therefore claimants suffer no disadvantage. Under both federal and state law, this position is false. This practice should not be allowed to continue.

PIABA also has serious concerns about the insertion and deletion of certain language in the proposed new submission agreement, as detailed below. On the positive side, the proposed submission agreement deletes the requirement that public customers certify that they have read, and presumably understand, the procedures and rules of FINRA. Few, if any, investors read or understand the rules in the increasingly complex practice that FINRA Dispute Resolution has become. PIABA therefore believes this is a change that is long overdue.

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Rules Concerning Initiating and Responding to Claims

Customer Code Rule 12303(a) requires respondents to file and serve other parties with a signed and dated submission agreement. However, the rule imposes no penalty for non-compliance. Indeed, FINRA routinely sends out arbitrator lists and accepts rankings from respondents who have failed to sign and file a submission agreement. Many cases actually proceed to final award with respondents never having filed a submission agreement. There is simply no incentive for respondents to comply with Rule 12303. As a result, member firms and registered persons often decline to file a submission agreement.

This scenario stands in stark contrast to Rule 12307(a), Deficient Claims, which provides that FINRA will refuse to serve a claim where the claimant has failed to file a submission agreement or to sign a submission agreement (or even where the claimant failed to date the agreement, or failed to provide FINRA with enough copies). If FINRA sends the claimant a deficiency notice, the claimant has 30 days to cure the submission agreement problem or face dismissal and forfeiture of the entire filing fee. Rule 12307(b). In short, claimants who fail to comply with the rules relating to submission agreements are subject to the most serious possible consequences. In contrast, the Customer Code provides no consequences to a respondent who fails to sign and file a submission agreement. It is important to bear in mind that this double standard is imposed on investors by a regulator claiming its objective is investor protection.

FINRA takes the position that an industry respondent's failure to file a submission agreement is harmless because members are required to submit to arbitration under Section 12200 of the Customer Code. This is a misstatement of the law. There are legally compelling reasons that a claimant needs a signed submission agreement at the outset in every case. For example:

1) The Federal Arbitration Act, 9 U.S.C. § 2, mandates a "written" arbitration agreement as a condition of proceeding under the Act. Section 13 of the Act requires a party moving for an order confirming, modifying, or correcting an award to file a copy of the arbitration agreement. Absent respondents' signed submission agreement, claimants seeking confirmation of an award cannot comply with this statutory requirement. Of course, respondents pursuing confirmation suffer no such impediment since they have a submission agreement signed by a claimant in hand. Thus, the claimant may be forced to go to court to enforce an award without the written agreement required by statute and, as a result, may face dismissal. This could prove fatal to a claimant's recovery.

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2) In addition, without a submission agreement, a claimant may not be able to gain personal jurisdiction over a firm or registered representative in order to confirm, modify or correct an award. This may typically occur in cases of control person liability or officer and director liability under state Blue Sky statutes. These individuals may be required to arbitrate, but they may not be located or registered in the state where claimant resides. The submission agreement provides consent for jurisdiction to any court of competent jurisdiction where the customer resides or a hearing is held. Without a submission agreement signed by respondents, defrauded customers may be forced to chase elusive respondents through courts in distant states just to confirm the award. Particularly in smaller cases, hiring out-of-state counsel at additional expense may prove prohibitive. Claimants should not be forced to spend time and money in court and even potentially give up their claims because FINRA is unwilling to require its members to follow the same rules imposed on investors.

3) The submission agreement may be the only place that members and registered persons agree to be bound by the Code of Arbitration Procedure. Arbitration agreements often do not incorporate the FINRA Code of Arbitration Procedure. Rather, the Code incorporates itself, which is circular reasoning if one has not previously agreed to abide by the Code.[1] Having never signed a submission agreement, there may be no legal basis to require respondents to abide by the Code. They are arguably free to ignore the rules, including discovery requirements. The Code becomes a buffet from which industry respondents may pick and choose those provisions which they find advantageous; an all-too-frequent strategy. FINRA's advice to arbitrators to simply recite in the award that industry participants were required to submit to arbitration by the rules or by some other agreement, somewhere, which neither the panel nor Dispute Resolution has ever seen, is simply not tenable if challenged.

4) A related problem is that FINRA members may submit modified submission agreements adding provisions that seek to limit their liability, include choice of law provisions, or provide other legal advantage. It becomes the customer's responsibility to find the changes and ask the arbitrators for relief. The random Notice to Members warning that FINRA may someday take some unspecified action is ineffective. Advising arbitrators that they may sanction the member is also ineffective. The arbitrators have been trained that a member's submission agreement is irrelevant. If the problem is not addressed by the Commission in the context of rulemaking, nothing will change.

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[1] Customer Code section 12200 and IM-12000 of the Code require a member firm to submit customer disputes to arbitration under the Code. However, this is meaningless if there is no corresponding Conduct Rule.

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Simply stated, the Commission should direct FINRA to treat both claimants and respondents by the same standard. Failure of respondents to submit the submission agreement with the answer should mean that the answer cannot be accepted for filing. Failure to provide the submission agreement within 30 days after receiving a deficiency notice from FINRA should mean that all claims are deemed admitted. Without mandated sanctions for respondents' failure to file a submission agreement, FINRA members and registered persons have little incentive to abide by any provision in the Code.

FINRA's double standard for filing submission agreements is particularly difficult to accept in view of FINRA's so often repeated mantra of investor protection. It seems clear FINRA is balancing its regulatory function between investors on the one hand and its membership on the other, and when it comes to signing and filing submission agreements, the investors lose.

FINRA's Proposed Revisions to Submission Agreement

As previously stated, PIABA supports the revision to paragraph "2" that allows customers to certify that their representative has read the rules for them and that the parties agree to be bound by these procedures conditioned on all parties being required to sign a submission agreement in every case in order to participate. The revisions in paragraph "4" are also acceptable if all parties are required to sign the agreement.

PIABA strongly objects to the modification of paragraph "3" deleting the requirement that the arbitration must be conducted in accordance with the Constitution, By-laws, Rules, and Regulations of FINRA or any other organization, and limiting the reference to the FINRA Code of Arbitration Procedure. This may effectively remove the arbitration from the purview of FINRA Conduct Rules. Certainly, respondents may be expected to make this argument. This could have the following ramifications:

1) It would mean a member could not be sanctioned for violation of just and equitable principles of trade under FINRA Rule 2110 for conduct related to arbitration.

2) The same principle is applicable to member and associated person conduct during the arbitration process. Refusal to follow the Code, destruction of documents and other common industry defense tactics would be punishable only by the arbitrators because the FINRA rules, other than the Code of Arbitration Procedure, have been effectively rescinded in arbitration. In addition, if FINRA

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rules other than the Code of Arbitration Procedure do not apply to arbitration, then FINRA may have no further role in enforcement or collection. It becomes a serious legal problem for the claimant.

Conclusion

PIABA urges the Commission to return this rule proposal to FINRA for further revision. Having a rule requiring submission agreements is futile if there is no procedure in place to enforce the rule. Currently there is such a mechanism for enforcing the rules against investor claimants, but not against industry respondents. This disparity must be rectified.

Thank you for your consideration of these comments.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

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

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Spring, 2009 issue of *PIABA Bar Journal* is February 23, 2009. All submissions should adhere to the following format:

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

1. One inch margins top, bottom and sides.
2. Single Space text; double space between paragraphs.
3. Do not indent paragraphs.
4. Put the title of the article at the top followed by the author's name and a short author biography.
5. Do not use footers or headers.
6. Use footnotes rather than endnotes.
7. Articles shall be submitted for black and white reproduction.
8. Attachments should be a clear, quality copy suitable for reproduction.
9. Attachments requiring reprint permission should be submitted with written authorization from the prior publisher.
10. PIABA reserves the right edit or reformat materials as required.

Submissions may be sent by e-mail to Robin Ringo at rsringo@piaba.org or Samuel Edwards at sedwards@sselaw.com.

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Upcoming Events:

PIABA Board of Directors Meeting, July 18-19, 2009.
Renaissance, Chicago, Illinois.

PIABA Securities Law Seminar, October 28, 2009.
La Costa Resort & Spa, Carlsbad, California

PIABA Annual Meeting, October 29-31, 2009.
La Costa Resort & Spa, Carlsbad, California

PIABA Annual Business Meeting and Election of Directors. October 29, 2009. La Costa Resort & Spa, Carlsbad, California

PIABA Board of Directors Meeting, November 1, 2009
La Costa Resort & Spa, Carlsbad, California

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

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