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HOW NEW SWAP REGULATIONS MANDATED BY THE DODD-FRANK ACT COULD HELP STABILIZE THE REPO MARKET

Frederick Hearn[1]

I. Introduction

The financial crisis of 2008 was caused by the failures of a number of different financial institutions over a short period of time.[2] Those failures triggered a systemic collapse, resulting in massive financial losses felt not only by the participants involved directly, but also by the general public.[3] After such large-scale failures, it is only natural to attempt to identify those who "caused" the failure and either try to get rid of them, punish them, or both. A close look at the elements that contributed to the crisis reveals many factors that combined to create conditions necessary for the crisis to occur. As such, outside of instances of outright fraud, it is very difficult, if not impossible, to isolate a single culprit.

When the cause of a market failure cannot be traced to wrongdoing by a specific participant, one must determine if moral hazard caused the market failure. Moral hazard arises when one market participant makes himself better off at the expense of another market participant, in a situation where the better-off participant does not bear the full costs of his actions due to the presence of some force that prevents the full assignment of costs to that participant.[4] Costs shifted in this manner are called externalities.[5] More specifically, an externality is an indirect effect of consumption or production activity that is not worked through the market price system.[6] When

1. Florida State University College of Law, J.D. Candidate, 2013.

2. THE FINANCIAL CRISIS INQUIRY COMMISSION, THE FINANCIAL CRISIS INQUIRY REPORT 386 (2011) [hereinafter *FCIR*].

3. *Id.* at 389-90.

4. Y. Kotowitz, *moral hazard*, THE NEW PALGRAVE DICTIONARY OF ECONOMICS, http://www.dictionaryofeconomics.com/article?id=pde2008_M000259&edition=current&q=moral%20hazard&topicid=&result_number=1 (last visited Feb. 1, 2013).

5. J.J. Laffont, *externalities*, THE NEW PALGRAVE DICTIONARY OF ECONOMICS, http://www.dictionaryofeconomics.com/article?id=pde2008_E000200&edition=&field=keyword&q=externalities&topicid=&result_number=1 (last visited Feb. 1, 2013).

6. *Id.*

externalities are present, a market will not be efficient,[7] and market failure can eventually occur.[8]

The 2008 freeze of the credit markets and subsequent government intervention were negative externalities imposed on society as a result of the run on the market for interbank lending. Analogy to a traditional retail bank run helps illustrate this point. In a traditional bank run,[9] externalities caused by institutional moral hazard can lead to failure within those markets. Because banks lend out substantial portions of depositors' money, even well-capitalized banks do not hold enough cash to satisfy the demands of all their depositors should the depositors all simultaneously decide to liquidate their accounts. Given the fact that there is not enough cash to satisfy all claims, if a rumor starts that a bank is going to fail, the optimal individual strategy is to withdraw all your money as quickly as possible before the bank runs out of cash. This strategy is detrimental to depositors as a whole because the bank may go under even if it is not actually in financial trouble. Wide-spread bank runs deplete cash from the banks, causing lending to cease, and eventually resulting in frozen financial markets. Moral hazard is present in a bank run situation when banks do not bear the cost of their risk-taking through the purchase of insurance or the imposition of rules intended to keep the banks solvent. Negative externalities can result if society is forced to bear the cost of the risk of injecting money into the system to fix problems in which most of the general public may not have had any direct involvement. This results in a market failure because resources are allocated in a way that is not Pareto efficient.

Like retail banks, large financial institutions are susceptible to runs. Large financial institutions often lend money to each other using repurchase,

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7. *Id.* According to economist Vilfredo Pareto, a market is efficient when there is no other allocation of resources that can possibly make market participants at least as well off as they currently are. B. Lockwood, *Pareto efficiency*, THE NEW PALGRAVE DICTIONARY OF ECONOMICS, http://www.dictionaryofeconomics.com/article?id=pde2008_P000024&edition=current&q=pareto&topicid=&result_number=3 (last visited Feb. 1, 2013). This article relies upon Pareto's definitions and analyses of market efficiency.

8. John O. Ledyard, *market failure*, THE NEW PALGRAVE DICTIONARY OF ECONOMICS, http://www.dictionaryofeconomics.com/article?id=pde2008_M000056&edition=current&q=market%20failure&topicid=&result_number=1 (last visited Feb. 1, 2013).

9. "Traditional bank run" is defined by the author as a bank run in the absence of banking regulations such as reserve requirements and insurance such as that provided by the FDIC.

or "repo" agreements, which involve the temporary sale of a security by one bank in exchange for cash that the bank agrees to pay back by repurchasing the security at a future date.[10] The repo market is susceptible to the same incentive structures that can cause runs on depository institutions. Externalities produced by a run on the repo market led to the freeze of the credit market in 2008. Parts II.A and II.B of this paper provide background information and explain the basics of a repo transaction. Part II.C explains ways that market participants, through the use of credit default swaps, try to insure against the risks posed by repo and other transactions involving securities. Part II.D describes how the elements described in the preceding parts combined to cause a liquidity crisis in 2008. Finally, Parts III and IV explain how changes mandated by the Dodd-Frank Act, along with rules proposed by the author, could stabilize the repo market and force participants to internalize at least part of the costs associated with events such as those that occurred in 2008.

II. Background

Wide-spread mortgage defaults have been publicized as one of the primary causes of the 2008 financial crisis. The issuance of mortgages was a significant source of income for many retail banks and large financial institutions prior to the crisis.[11] Funding was dispersed through wholesale purchasing and securitization by large financial institutions that bought the loans from retail banks and mortgage companies that had originated the loans. Large financial institutions then pooled the loans and created securities based on the pools.[12] Many of the wholesale institutions ultimately began to use the securities as collateral for repo loans, which they utilized to satisfy short-term cash needs.[13] This section explains the securitization process, the repo market, and the market for insurance in the form of credit default swaps. An understanding of these components is vital to understanding what happened in 2008.

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10. Tobias Adrian et al., *The Federal Reserve's Primary Dealer Credit Facility*, 15 FED. RES. BANK OF N.Y. – CURRENT ISSUES IN ECON. & FIN., Aug. 2009, at 2, *available at* http://app.ny.frb.org/research/current_issues/ci15-4.pdf.

11. *FCIR*, *supra* note 2, at 102-03.

12. *Mortgage-Backed Securities*, U.S. SECS. & EXCH. COMM'N (July 23, 2010), http://www.sec.gov/answers/mortgagesecurities.htm [hereinafter *MBS*].

13. Adrian et al., *supra* note 10, at 2-4.

A. The Securitization of Mortgages

The traditional concept of home buying includes visiting the local retail bank and borrowing money in the form of a mortgage. Traditionally, a borrower dealt with a bank at origination and made payments to that bank throughout the life of the mortgage.[14] The originating bank would also hold the mortgage on its books until the borrower paid it off or re-financed.[15] Some of these elements still exist today, but for the most part, there has been a fundamental change in the mortgage industry over the last few decades.[16]

Modern mortgage lending has shifted to the origination and securitization model.[17] An originator, such as a bank or mortgage broker, is the first point of contact for a potential borrower.[18] The originator will review the borrower's application, evaluate creditworthiness, and issue the mortgage to the borrower.[19] The originator then often sells the mortgage to a larger financial institution, such as Goldman Sachs, Morgan Stanley, Fannie Mae, or Freddie Mac.[20] These institutions purchase large blocks of mortgages, then use the mortgages to create securities.[21]

Securities based on pools of mortgages are called Mortgage Backed Securities ("MBS").[22] MBSs are created by pooling mortgages and issuing bonds backed by the mortgage payments from the pool.[23] Payments made by the mortgage borrowers provide the cash used to pay the bond holders.[24] As such, MBSs are subject to both credit risk[25] and pre-payment risk.[26] Credit

14. *FCIR*, *supra* note 2, at 42.

15. *Id.*

16. *Id.* at 42-43.

17. *Id.*

18. *Id.*

19. *Id.* at 43.

20. *MBS*, *supra* note 12.

21. *FCIR*, *supra* note 2, at 8.

22. *MBS*, *supra* note 12.

23. *Id.*

24. *Id.*

25. Sunil Gangwani, *MBS Structuring: Concepts and Techniques*, 1 SECURITIZATION CONDUIT, at 26 (1998), *available at* http://www.vinodkothari.com/gangwani.pdf.

risk is the risk that some borrowers liable for the underlying mortgages will default, thus eliminating part of the stream of payments to the bond holders.[27] Pre-payment risk is the risk that falling interest rates will induce borrowers to re-finance to a lower rate and pre-pay their current mortgages.[28] Again, this will eliminate a payment stream from the pool and deprive the bond holders of potential income from interest payments that would have been made by the borrower had he or she not pre-paid.[29] Credit risk is the primary fear when wide-spread foreclosures occur.

When the housing market collapsed, many MBSs began to lose value because wide-spread foreclosures caused the MBSs' underlying mortgage pools to dry up.[30] Under normal conditions, the institution holding a foreclosed mortgage will sell the mortgaged property to recoup as much money as possible from the failed loan. Under normal conditions, such a sale can result in the institution recovering most or all of the balance of the loan, in which case MBS holders will lose only the future interest income that they would have received from mortgage payments made by the borrower. However, this type of recovery is not possible when wide-scale foreclosures occur in the manner that they did leading up to the 2008 crisis. Home prices plummeted during the crisis, leaving large financial institutions unable to recover large portions of the failed mortgages via sales of the mortgaged properties.[31]

The value of an MBS can be calculated by estimating the net-present value of the future cash flows generated by payments on the mortgages underlying the MBS.[32] Such a calculation requires discounting for the risks associated with MBSs.[33] Foreclosures remove mortgages from the underlying MBS pool, thus eliminating future cash flows and reducing the present value

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26. *Id.* at 28.

27. *Id.* at 26.

28. *Id.*

29. *Id.*

30. *FCIR*, *supra* note 2, at 226.

31. *Id.* at 213.

32. *See generally* Richard Stanton et al., *Pricing Mortgage Backed Securities in a Multifactor Interest Rate Environment: A Multivariate Density Estimation Approach*, 10 REV. FIN. STUD., 405 (1997) (assumes no credit risk due to government guarantees, but still provides a basic explanation of valuation methods).

33. *Id.*

of the MBS. Fear and uncertainty about falling housing prices likely caused the prices of MBSs to fall below their "true" value because nobody knew how much to discount the future cash flows generated by the MBSs.[34] This rapid reduction in the prices of MBSs had wide ranging effects, some of the most profound of which involved the repo market.[35]

B. Repurchase Agreements

Like any other business, large financial institutions need cash to operate. Cash is not a good thing for financial institutions to hold for very long (under normal market conditions) because idle cash is cash that could potentially be earning interest.[36] Cash that is not earning interest is not only failing to appreciate, it is depreciating when inflation is factored in. Given the fact that holding large amounts of cash is costly, financial institutions must constantly balance cash needs with investment opportunities by taking out short-term loans.[37] One way large financial institutions satisfy their short-term cash needs is through the use of repo agreements.[38]

A repo agreement is accomplished when party A sells a security to party B with the agreement that party A will buy the security back at a future date.[39] What this amounts to is a loan collateralized by the security.[40] Repo agreements usually last short periods of time, sometimes as short as overnight.[41] Assets commonly used in repo transactions include Treasury Securities, private mortgage-backed securities, agency securities, and corporate securities.[42] Lenders charge interest as compensation for the risk

34. *FCIR*, *supra* note 2, at 227.

35. Adrian et al., *supra* note 10, at 2-4.

36. *Time Value of Money – TVM*, INVESTOPEDIA, http://www.investopedia.com/terms/t/timevalueofmoney.asp#axzz1s9DtyyvV (last visited Apr. 16, 2012).

37. Morgan Ricks, *Regulating Money Creation After the Crisis*, 1 HARV. BUS. L. REV. 75, 91 (2011).

38. Adrian et al., *supra* note 10, at 2.

39. *Id.*

40. *Id.*

41. *Id.* at 2-4.

42. *Id.*at 2.

posed by the transaction and the opportunity cost of not being able to use the lent cash elsewhere. Repo lenders charge interest by purchasing the security at a discount, or "haircut."[43] When the repo transaction is complete, the borrower buys the security back at full price.[44] The spread is the lender's compensation. If the borrower fails to repay the loan, the lender can sell the security to recoup its loss.[45] This can be a problem if prices have dropped and the lender cannot sell the security at a price that will return all of the cash it lent. Such a situation results in cash being involuntarily converted to a potentially illiquid asset at a price below what the lender paid in the original transaction. As a result, the money supply is instantly reduced, causing interest rates to increase, which generally harms economic growth.[46]

Many repo lenders will impose margin requirements on borrowers to ensure that the haircut remains constant.[47] The lender can impose a margin call if the price of the collateral security drops enough to reduce the spread below the minimum margin requirement.[48] For example, say party A enters a repo with party B by selling a $100 bond to B for $99 with an agreement to buy it back in a week. If the price of the bond falls to $99 during the week, B may require A to post $1 in cash to ensure that B's $1 spread is protected. If A does not have the $1, it must sell something to get the cash. If the price of the bond later returns to $100, B will return the cash to A. If A cannot satisfy the margin call, then B will usually recognize this as a default and sell the bond to cover the loss.

Wide-spread margin calls can produce a domino effect if borrowers in need of cash to satisfy maintenance requirements are forced to sell similar securities en mass.[49] This can occur if an entire asset class, such as MBS,

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43. HIGH LINE ADVISORS, OUT OF THE SHADOWS: CENTRAL CLEARING OF REPO 2 (Apr. 2011), *available at* http://highlineadvisors.com/whitepapers/PDF/Cleared%20Repo%201.3.pdf [hereinafter *Repo Clearing*].

44. *Id.*

45. *Id.*

46. Ricks, *supra* note 37, at 106.

47. CACEIS INVESTOR SERVICES, SECURITIES LENDING & REPO MARKETS: A PRACTICAL GUIDE 52-53 (2010), *available at* http://www.caceis.com/fileadmin/pdf/reference_papers_en/securities_lending.pdf [hereinafter *Repo Guide*].

48. *Id.*

49. Adrian et al., *supra* note 10, at 3.

becomes compromised. Undercapitalized borrowers will be unable to satisfy margin calls or will be forced to sell assets in order to do so, which could cause the value of those assets to drop, potentially leading to further margin calls if the firm's financial situation worsens as a result.[50] These massive selloffs can cause trading to seize up, resulting in a bank-run-like scenario where borrowers are unable to liquidate their securities.[51]

The repo market has been criticized as being lightly regulated and for having no centralized exchange.[52] Critics claim that this is especially troubling considering how massive the repo market has become.[53] At its peak in 2008, outstanding repo transactions were estimated at more than $4.5 trillion;[54] however, nobody really knows the exact size of the repo market.[55] The lack of a central exchange for repo transactions makes it difficult to determine the true size of the market or where the money is flowing.[56] Parties to repo transactions currently either deal on a one-on-one basis or through a tri-party agreement under which a third party, or central clearing counterparty ("CCP"), clears the transaction and provides a guarantee that the transaction will be settled.[57] The CCP stands between the repo parties and acts as the buyer and the seller.[58] The CCP is paid to assume the risk that one party will default on the transaction and to manage the transaction throughout its life.[59] Tri-party clearing agreements provide protection in the form of capital and margin requirements;[60] however, systemic risk can still materialize and cause the third-party to become insolvent.

A specific concern about a lack of transparency is that participants in the repo market can potentially collateralize a large amount of risk in similar

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50. *Id.*

51. Ricks, *supra* note 37, at 104-05.

52. *See generally* Ricks, *supra* note 37; *Repo Clearing*, *supra* note 43.

53. *See* Ricks, *supra* note 37, at 85-87; *FCIR*, *supra* note 2, at 29-34.

54. Adrian et al., *supra* note 10, at 2.

55. Ricks, *supra* note 37, at 85-86.

56. *Repo Clearing*, *supra* note 43, at 7.

57. *Repo Guide*, *supra* note 47, at 38-39.

58. *Id.* at 39, 40.

59. *Id.*

60. Kenneth D. Garbade, *The Evolution of Repo Contracting Conventions in the 1980s*, 12 ECON. POL'Y REV. 27, 38 (2006).

assets, such as MBSs.[61] Repo defaults will become correlated if similar collateral begins to fail.[62] This defeats the idea behind insurance - that spreading risk results in a lower probability of large scale failures.[63] When a limited number of repo participants use a relatively limited universe of assets as collateral, the possibility of a liquidity crisis becomes very real. One way repo lenders can insure against loss is through the purchase of a Credit Default Swap ("CDS"). Section C explains what a CDS is and how CDSs are used by different market participants.

C. Credit Default Swaps

Derivatives have become infamous in the wake of the financial crisis.[64] CDSs are derivatives that are designed to insure against credit risk posed by an insured security.[65] If a pre-defined "credit event" occurs, the CDS issuer will make a payment to the CDS buyer as compensation for the loss that the buyer incurred as a result of the credit event, which may or may not involve the CDS issuer taking possession of the security.[66] "Credit events" are defined by the buyer and seller, and can include a variety of things such as credit rating downgrades or the complete collapse of the company backing

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61. *See* Ricks, *supra* note 37, at 104.

62. *Id.*

63. *Id.*

64. The word "derivatives" refers to a variety of financial instruments that derive their value from some underlying thing, such as pork, wheat, soy, securities, or even the weather. *FCIR*, *supra* note 2, at 45-46. Derivatives are often used as a form of insurance. *Id.* For example, a pig farmer may purchase a forward contract to sell a certain amount of pork at a given price at some point in the future. If pork prices fall, the farmer will be protected because he can still sell his pork at the previously agreed upon price. If prices increase, the farmer can sell his pork at the market price and lose only the premium he paid for the contract. This is an example of a positive use of a derivative contract, where both parties derive some benefit from the transaction. The farmer gains protection from future price uncertainty and the seller of the forward contract receives a premium for protecting the farmer.

65. NOMURA FIXED INCOME RESEARCH, CREDIT DEFAULT SWAP (CDS) PRIMER 1 (May 12, 2004) [hereinafter *CDS Primer*], *available at* http://www.securitization.net/pdf/content/Nomura_CDS_Primer_12May04.pdf

66. *Id.* at 4-5.

the insured security.[67] CDS issuers should maintain a proper level of cash or highly-liquid assets for use in paying claims if a credit event occurs. CDSs, though used as insurance, are not currently subject to the same strict regulations as traditional insurance.[68]

Prior to the Dodd-Frank Act, CDS regulation was almost non-existent.[69] When CDSs were regulated, their regulation was usually a secondary effect of other regulation, and was fractured amongst a number of agencies.[70] CDSs are primarily sold "over the counter (OTC)," meaning that parties contract in arms-length transactions outside of an exchange.[71] Financial institutions often deal directly with each other when they need to buy or sell CDSs.[72] Since no uniform price reporting mechanism currently exists, there is no way for the public to accurately determine the exact amount of CDSs outstanding or how risk is distributed across the market. This is troubling because prior to Dodd-Frank there were no laws specifically mandating margin and capital requirements for CDS dealers and buyers.[73] Margin and capital requirements force CDS issuers to retain certain amounts of cash on reserve so that they will be able to meet their liabilities if a credit event occurs.[74] Prior to the crisis, dealers clearing CDSs through exchanges such as the Chicago Mercantile Exchange (CME) were held to the margin and capital requirements of the exchange.[75] Dealers such as bank holding companies that were also subject to prudential regulation were subject to capital requirements set by those regulators.[76] However, OTC dealers not subject to prudential regulation and not trading through an exchange could potentially trade derivatives without being subject to any specific margin or capital

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67. *Id.*

68. *See* William K. Sjostrom, Jr., *The AIG Bailout*, 66 WASH. & LEE L. REV. 943, 983-89 (2009).

69. *FCIR*, *supra* note 2, at 46-48.

70. *See* Sjostrom*, supra* note 68*,* at 988.

71. *CDS Primer*, *supra* note 65, at 1.

72. *Id.*

73. *See* Sjostrom*, supra* note 68*,* at 983-89.

74. CME GROUP, CME CLEARING FINANCIAL SAFEGUARDS 6-11 (2012) [hereinafter *CME Safeguards*], *available at* http://www.cmegroup.com/clearing/files/financial safeguards.pdf.

75. *See generally id.*

76. *See* Sjostrom*, supra* note 68*,* at 989.

requirements.[77] AIG, although subject to supervision by the Office of Thrift Supervision, engaged in billions of dollars of CDS business without being subject to statutory capital requirements.[78]

An additional criticism of CDSs involves so-called "naked CDSs."[79] Naked CDSs are CDSs purchased by individuals or institutions who do not own the security being insured by the CDS.[80] These purchases are made in order to speculate that a credit event will occur, at which point the buyer will receive a payout. This is different from short-selling because a short-seller has to pay for the security up front and is exposed to the risk of financial loss caused by an increase in the security's value. A naked CDS purchaser pays a relatively small amount of money (the CDS premium) and profits if the underlying security fails. If the credit event never occurs, the CDS purchaser's loss is limited to the premium paid for the CDS. Traditional insurance policies differ from CDSs because they can only be purchased by the owner of the property being insured.[81] Critics argue that naked CDSs severely inflate the size of the CDS market, potentially magnifying any losses suffered when an institution defaults.[82] Some of these issues played a large part in the liquidity crisis of 2008.

D. The Liquidity Crisis of 2008

The 2008 financial crisis involved a number of separate events that combined to cause a massive freeze-up of the credit market.[83] Residential mortgage defaults increased dramatically leading up to 2008.[84] Many MBSs and other securities based on MBSs began to rapidly decrease in value as mortgages disappeared from the pools backing the securities.[85] MBSs were

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77. *Id.*

78. *Id.*

79. *FCIR*, *supra* note 2, at 50.

80. *Id.*

81. *Id.*

82. *Id.*

83. Ricks, *supra* note 37, at 87.

84. *FCIR*, *supra* note 2, at 256.

85. *Id.*at 226.

being used by many financial institutions as collateral in repo transactions.[86] When prices started to fall, lenders started imposing margin calls, and many borrowers began selling off securities, including MBSs, to satisfy the margin calls.[87] Lenders also began to terminate repo agreements when credit rating agencies began downgrading MBSs previously used as collateral, causing even more selling.[88] This eventually led to the domino effect discussed in Section II.B.[89]

These events caused enough fear in the market that lenders would accept only extremely safe securities as collateral for repo transactions.[90] At the time, large financial institutions were often very heavily leveraged, which means that they used debt to finance more investment than they could otherwise afford.[91] Leverage can be positive because it can allow an institution to magnify gains while paying a fixed price for the borrowed money.[92] Leverage can also be negative because losses are similarly magnified if the investments do not work out.[93] If that happens, the borrower will still be liable for the money borrowed and will have no money to pay off the debt. The borrower's loss is magnified as the borrower's leverage ratio increases. A company with a high leverage ratio can be brought to its knees overnight if it uses repo transactions to borrow money and it is unable to renew its repo agreements.[94] Circumstances similar to these are what led to the collapse of Bear Stearns and Lehman Brothers.[95]

The repo market freeze-up of 2008 can be compared to a run on a traditional bank.[96] Repo lenders can be viewed as depositors and repo

86. Adrian et al., *supra* note 10, at 2.

87. *Id.* at 2-3.

88. *Id.*

89. *Id.*

90. *Id.* at 4.

91. *FCIR*, *supra* note 2, at 32.

92. *Id.*

93. *Id.*

94. Adrian et al., *supra* note 10, at 3 (discussing Bear Stearns).

95. *Id.*

96. Ricks, *supra* note 37, at 84.

borrowers can be viewed as banks in the traditional bank run scenario.[97] In a traditional bank run, panic leads all depositors to demand withdrawal at once, causing the bank to collapse.[98] Repo lenders demanded withdrawal in a similar fashion in 2008 by increasing the haircuts they charged.[99] Between 2008 and 2009, repo lending dropped 44%.[100] Fear about the integrity of the MBS market was likely part of the reason for this.[101] Lenders likely feared that borrowers holding large amounts of MBSs would collapse before they would be able to complete a repo transaction.[102]

Runs on retail banks have not been a problem since the Great Depression.[103] FDIC insurance provides a government backed guarantee on individual bank deposits up to $250,000.[104] This guarantee prevents bank runs by eliminating depositors' fear that their money will not be there when they try to withdraw it.[105] When a financial institution or individual purchases a security, it is effectively depositing its money with the issuer.[106] CDSs can be purchased to provide protection similar to that provided by FDIC insurance to retail bank depositors. If a certain class of assets (like MBSs) begins to fail, those who hold CDSs will not be as fearful as others because they will receive cash for their MBSs from the CDS issuer. This holds true as long as the CDS issuer is solvent.

Many large financial institutions purchased and sold CDSs on MBSs leading up to the 2008 crisis.[107] In theory, those CDSs should have provided

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97. *See* Gary Gorton & Andrew Metrick, *Securitized Banking and The Run On Repo*, J. FIN'L ECON. 426 (2011), *available at* http://ac.els-cdn.com/S0304405X1100081X/1-s2.0-S0304405X1100081X-main.pdf?_tid=acee03a6cb962630725984cb2a52ba85&acdnat=1335470387_42b769e40b2a5484fcbb5e2242ea2768.

98. *Id.* at 426.

99. *Id.* at 445.

100. Adrian et al., *supra* note 10, at 2.

101. *See id.*at 2-3.

102. Gorton & Metrick, *supra* note 97, at 448.

103. *Id.* at 426.

104. *Deposit Insurance Summary*, FED. DEP. INS. CORP., http://www.fdic.gov/deposit/deposits/dis/index.html (last updated Jan. 1, 2013).

105. Gorton & Metrick, *supra* note 97, at 426.

106. *Id.*

107. *FCIR*, *supra* note 2, at xxiv.

the institutions with cash when the MBSs began to fail. However, just five institutions traded 97% of the OTC derivatives.[108] Such a high concentration of trading by a relatively small number of institutions can easily lead to a panic if one of the institutions fails. AIG became the most infamous of the CDS issuers after it nearly collapsed under massive CDS liabilities. Since there were no statutory capital requirements for CDS issuers, AIG was not required to and did not have the liquidity needed to satisfy its liabilities.[109] This was the final piece required to cause the market for credit to seize up. Risk had been passed down-stream and stacked up by AIG (and others), and AIG was unable to cover its liabilities.

The effects of the repo market seize-up were not limited to large financial institutions. Banking has become so interconnected with brokerage and other lending channels that halting the primary means of lending for the largest market participants resulted in the entire system being put at risk.[110] Money-market mutual funds were particularly vulnerable because their managers invest heavily in very short-term lending to assure a reasonable amount of liquidity to investors of the funds.[111] Money-market mutual funds generally provide a higher return than standard savings accounts, but they are not FDIC insured,[112] so investors face the risk of loss of principal. When the short-term lending market froze up in 2008, there were runs on money-market mutual funds, putting many in fear of losing seemingly safe money.[113] If those funds would have been allowed to fail, the payment system upon which our economy is based would have come to a halt.[114] This would have resulted in large amounts of money being removed from the money supply almost instantly, causing interest rates to increase.[115] Higher interest rates mean that money costs more to borrow, which usually results in slower

108. *Id.* at 50.

109. *See* Sjostrom*, supra* note 68, at 960-61.

110. Gorton & Metrick, *supra* note 97, at 426.

111. *FCIR, supra* note 2, at 29-30.

112. *Insured or Not Insured?*, FED. DEP. INS. CORP., http://www.fdic.gov/consumers/consumer/information/fdiciorn.html (last updated Apr. 11, 2011).

113. *FCIR, supra* note 2, at 357-60.

114. *Id.* at 358-59.

115. Ricks, *supra* note 37, at 83.

economic growth.[116]

A lack of liquidity was causing the credit market to remain stagnant.[117] Nobody wanted to buy MBSs or accept them as collateral because there was no way to accurately determine how much they were worth or if they would default.[118] The Federal Reserve solved this problem by establishing the Primary Dealer Credit Facility (PDCF) under TARP.[119] Section 13(3) of the Federal Reserve Act of 1913 allows the Fed to provide credit to individuals, partnerships, and corporations in an emergency.[120] Through the PDCF, the Fed extended its "lender of last resort" powers to inject cash into the market.[121] Normally the Fed will accept only very high grade securities as collateral for overnight lending.[122] The PDCF allowed the Fed to begin accepting a wider variety of securities as collateral,[123] which turned the Fed into a massive repo lender for institutions holding assets they could not otherwise liquidate or use as collateral for loans. The strategy worked. Primary dealers stopped using the PDCF by May 2009, signaling that they no longer needed it.[124]

The success of the PDCF can be seen in the change in CDS spreads as the program progressed. CDS spreads are calculations made by measuring the difference between the price of a CDS and some relatively low-risk interest rate,[125]and they can be used to gauge counterparty risk in the repo market.[126] CDS spreads declined over the three month span following the creation of the PDCF,[127]indicating that the fear of firm-to-firm lending was

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116. *Id.* at 106.

117. Adrian et al., *supra* note 10, at 2-3.

118. *See FCIR*, *supra* note 2, at 226; Adrian et al., *supra* note 10, at 2-3.

119. Adrian et al., *supra* note 10, at 4.

120. The Federal Reserve Act § 13(3), 12 U.S.C. § 343 (2010); Adrian et al., *supra* note 10, at 5.

121. Adrian et al., *supra* note 10, at 4.

122. *Id.* at 4-5.

123. *Id.*

124. *Id.* at 7.

125. Gorton & Metrick, *supra* note 97, at 434-35.

126. *Id.* at 435.

127. Adrian et al., *supra* note 10, at 7.

subsiding. The Fed's action prevented a potentially catastrophic liquidity crisis, but the Fed was forced to expose itself to risks no private market participants would assume. To compensate itself for accepting those risks, the Fed charged rates higher than the repo rate would have been in the private market.[128] It also charged a usage fee that escalated if a firm used the facility longer than 45 business days.[129] Fortunately, all loans extended under the facility were repaid in full, with interest.[130] As discussed in the next section, the Dodd-Frank Act mandates new rules that could help prevent a similar scenario in the future.

III. The Dodd-Frank Act

The Dodd-Frank Act was passed in 2010 in response to the financial crisis of 2008.[131] The Act addresses many of the issues believed to have caused the crisis, including those that contributed to the liquidity freeze. The Act mandates an extensive new regulatory framework for swaps markets that aims to reduce risk, increase transparency, and promote market integrity.[132] Jurisdiction over swap regulation is granted to the SEC and CFTC.[133] CDSs fall under the "Security Based Swap (SBS)" designation and will be regulated by the SEC.[134] The Act:

(1) provides for the registration and comprehensive regulation of

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128. *Id.* at 8.

129. *Id.*

130. *Primary Dealer Credit Facility (PDCF)*, BD. OF GOVERNORS OF THE FED. RES. SYS., http://www.federalreserve.gov/newsevents/reform_pdcf.htm (last updated Dec. 13, 2012).

131. *Implementing The Dodd-Frank Wall Street Reform and Consumer Protection Act*, SECS. & EXCH. COMM'N, http://www.sec.gov/spotlight/dodd-frank.shtml (modified Dec. 21, 2012).

132. SECS. & EXCH. COMM'N & COMM. FUT. TRADING COMM'N, JOINT REPORT ON INTERNATIONAL SWAP REGULATION 15 (Jan. 31, 2012)[hereinafter *Swap Report*], *available at* http://www.cftc.gov/ucm/groups/public/@swaps/documents/file/dfstudy_isr_013112.pdf.

133. Dodd-Frank Wall Street Reform and Consumer Protection Act § 712 (2010) (codified as amended in scattered sections of 7 & 15 U.S.C.).

134. *Id.* § 721(a)(21)(amending the Commodities Exchange Act and Securities Exchange Act of 1934).

> swap dealers, security based swap dealers, major swap participants, and major security-based swap participants; (2) imposes clearing and trade execution requirements on swaps, subject to certain exceptions; (3) creates recordkeeping and real-time reporting regimes; and (4) enhances the Commissions' rulemaking and enforcement authorities with respect to certain products, entities, and intermediaries subject to the Commissions' oversight.[135]

The Act also calls for new margin and capital requirements for dealers and major participants.[136]

The SEC will have jurisdiction over "Security-Based Swap Dealers (SBSDs)" and "Major Security-Based Swap Participants (MSBSPs)."[137] The Act defines a SBSD as "any person who: (i) holds themselves out as a dealer in security-based swaps; (ii) makes a market in security-based swaps; (iii) regularly enters into security-based swaps with counterparties as an ordinary course of business for its own account; or (iv) engages in any activity causing it to be commonly known in the trade as a dealer or market maker in security based swaps."[138] A MSBSP is any non-SBSD that maintains a large amount of SBS, excluding positions held for hedging risk.[139] SBSDs and MSBSPs must register with the SEC in order to lawfully engage in swap trading.[140] Subsections B and C explain central clearing and margin requirements mandated by the Dodd-Frank Act.

A. Central Clearing

Central clearing is a process by which all trades are executed through a central counterparty (CCP).[141] The CCP becomes the buyer and the seller in

135. *Swap Report*, *supra* note 132, at 15.

136. *Id.* at 25.

137. Dodd-Frank Wall Street Reform and Consumer Protection Act § 761(a) (2010) (amending the Securities Exchange Act of 1934).

138. *Id.* at § 761(a)(71).

139. *Id.* at § 761(a)(67).

140. *Id.* at § 764(a).

141. *CME Safeguards, supra* note 74, at 4.

each transaction that clears through it.[142] It sets rules for its members and accepts liability for the terms of the trades that are executed through the exchange.[143] Rules implemented by CCPs include capital requirements, margin requirements, and collateral requirements.[144] Rules mandating minimum capital reserves require a firm to hold assets in excess of liabilities at a certain level.[145] Margin requirements, also known as performance bonds, are good-faith deposits to guarantee performance on open positions.[146] Each open position is marked-to-market at the end of each trading cycle, and the account holders must deposit money to the margin account if their positions have decreased in value (they receive a credit if their positions gain in value).[147] Collateral standards are implemented to make sure the collateral held by account holders will cover a potential default by the account holder.[148] CCPs implement these rules to ensure the integrity of their members and to make sure trades executed by their members will be covered in the event a member defaults.[149] If one party in a trade defaults, the CCP will pay the other party and absorb any loss from the default.[150] Rules implemented by the CCP are designed to give it the strength to survive such a default.[151] The creditworthiness and liquidity of the CCP is substituted for the creditworthiness and liquidity of the counterparties.[152]

The CME Group is an example of a CCP currently active in the derivatives market.[153] CME requires its members to post performance bonds

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142. *Id.*

143. *See Id.* at 3.

144. *Id.* at 6-12.

145. *Id.* at 11.

146. Id. at 7.

147. *CME Safeguards*, *supra* note 73, at 6.

148. *Id.* at 9-10.

149. *Id.* at 4.

150. *Id.*

151. *Id.* at 6.

152. Exemptions for Security-Based Swaps Issued by Certain Clearing Agencies, 77 Fed. Reg. 20,536, 20,537 (Apr. 5, 2012) (to be codified 17 C.F.R. pts. 230, 240, 260).

153. *CME Safeguards, supra* note 74, at 3.

in order to clear trades.[154] Each member's holdings are marked to market twice per day.[155] CME also maintains a guarantee fund that is designed to cover a default of its two largest net debtors.[156] Each firm trading CDSs using CME must contribute to this fund.[157] In addition, CME imposes minimum capital requirements of $500,000,000 for firms that wish to clear CDSs.[158] When it is fully implemented, the Dodd-Frank Act will require most swaps to clear through a CCP like the CME Group.[159] The Act aims to channel many OTC swaps through a CCP.[160] The CCP will be required to implement at least the minimum margin and capital requirement rules that will be set by the CFTC and SEC.[161] CCPs will also be subject to reporting requirements that will provide pricing information to the market.[162]

Section 723 of the Dodd-Frank Act makes it illegal to engage in a swap transaction unless the swap is cleared through a "derivatives clearing organization (DCO)," or the swap is exempt from clearing.[163] Swaps will need to pass through a registered or exempt CCP in order to be legal.[164] The SEC, CFTC, and/or the CCPs will be responsible for determining which swaps must clear through a DCO.[165] Five factors will be taken into account when making a mandatory clearing determination:

> (1) [T]he existence of significant outstanding notional exposures, trading liquidity, and adequate pricing data; (2) the availability of rule framework, capacity, operational expertise and resources, and credit support infrastructure to clear the contract on terms that are

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154. *Id.* at 7-8.

155. *Id.* at 6.

156. *Id.* at 9.

157. *Id.*

158. *Id.* at 11.

159. Dodd-Frank Wall Street Reform and Consumer Protection Act §§ 723, 763 (2010).

160. *Swap Report*, *supra* note 132, at 33.

161. *Id.* at 25.

162. *Id.* at 39.

163. *Id.* at 33.

164. *Id.*.

165. *Swap Report*, *supra* note 132, at 33-34.

> consistent with the material terms and trading conventions on which the contract is then traded; (3) the effect on the mitigation of systemic risk, taking into account the size of the market for such contract and the resources of the clearinghouse available to clear the contract; (4) the effect on competition, including appropriate fees and charges applied to clearing; and (5) the existence of reasonable legal certainty in the event of the insolvency of the relevant clearinghouse or one of more of its clearing members with regard to the treatment of customer and Swap counterparty positions, funds, and property.[166]

For end-users, the Act provides an exemption if one of the counterparties: "(1) is not a financial entity, (2) is using swaps to hedge or mitigate commercial risk, or (3) notifies the CFTC or SEC how the counterparty generally meets its financial obligations associated with entering into non-cleared Swaps."[167]

A criticism of mandating a central clearing requirement is that it could create another "too-big-to-fail" entity, similar to the large financial institutions we have today. Such an entity could be created if clearing becomes centralized in one or a few large CCPs. However, the benefit of the Dodd-Frank plan is that clearing institutions will be subject to the margin, capital, and reporting requirements discussed throughout this section. In theory, those requirements will allow regulators to better monitor the CDS market, which will put the regulators in a better position to prevent systemic failures. The requirements will also force CCPs to hold reserves, forcing them to pay at least part of the cost of a potential failure. Large financial institutions were not subject to such strict regulations prior to the Act.

B. Margin and Capital Requirements for Swaps Not Subject to Mandatory Clearing

Under Dodd-Frank, Security-Based Swap Dealers (SBSDs) and Major Security-Based Swap Participants (MSBSPs) not already overseen by a prudential regulator will be subject to capital and margin requirements set by the SEC.[168] SBSDs and MSBSPs that trade cleared swaps will be subject to

166. *Id.*

167. *Id.* at 34-35.

168. Dodd-Frank Wall Street Reform and Consumer Protection Act § 764 (2010) (amending Securities Exchange Act of 1934 § 15F by adding subsection (e)).

margin and capital requirements imposed by the clearing organization, which must meet, but may exceed, the minimum requirements imposed by the Act.[169] SBSDs and MSBSPs engaging in non-cleared swap activity will be subject to minimum margin and capital requirements set by the SEC.[170] Rules detailing the implementation of these requirements are currently in the works.[171] Prudential regulators will set rules for swaps dealers and major swaps participants under their regulation.[172] The SEC had not released proposed rules on capital and margin requirements as of the date of this writing.[173]

Prudential regulators presented a proposed rule in May 2011, which included rules for minimum margin and capital requirements.[174] The rules would allow covered swap entities to calculate minimum margin requirements in one of two ways: (1) the entity can use a "look up" table that specifies minimum initial margin that must be collected, expressed as a percentage; or (2) the entity may calculate its minimum initial margin requirements by using an internal model that has been approved by the applicable prudential regulator.[175] Covered swap entities will also be required to collect maintenance margin periodically, based on the relative risk of the counterparty.[176] Eligible collateral would be limited to immediately available cash funds and certain high-quality, highly-liquid U.S. government and agency obligations.[177] Institutions regulated by prudential regulators have

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169. *See Swap Report, supra* note 132, at 25.

170. Dodd-Frank Wall Street Reform and Consumer Protection Act § 764 (2010) (amending Securities Exchange Act of 1934 § 15F by adding subsection (e)(3)).

171. *See Swap Report, supra* note 132, at 26.

172. Dodd-Frank Wall Street Reform and Consumer Protection Act § 764 (2010) (amending Securities Exchange Act of 1934 § 15F by adding subsection (e)).

173. *See Swap Report, supra* note 132, at 26. "The term 'prudential regulator' is defined in CEA Section 1a(39), as amended by DFA Section 721, and includes the Federal Reserve Board, OCC, FDIC, Farm Credit Administration, and Federal Housing Finance Agency." *Id.* at 25-26 n.85.

174. *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564, 27,567-69 (May 11, 2011).

175. *Id.* at 27,567-68.

176. *Id.* at 27,568.

177. *Id.*

been subject to minimum capital requirements since 1989.[178] Because prudential regulators already had comprehensive capital requirements in place for the institutions under their jurisdiction, they chose not to make any changes.[179]

The Commodity Futures Trading Commission (CFTC) released proposed capital and margin requirements in May 2011.[180] Under current rules, the CFTC imposes capital and margin requirements on firms that it designates as "Futures Commodities Merchants (FCMs)."[181] Those requirements will be strengthened under the proposed rule.[182] Swaps dealers and major swaps participants that are non-bank subsidiaries of U.S. bank holding companies will be required to maintain a minimum ratio of qualifying total capital to risk-weighted assets of 8%.[183] Firms that are neither FCMs nor non-bank subsidiaries will be required to maintain tangible net equity of $20 million, plus additional amounts for market risk and over-the-counter derivatives risk.[184] Swaps dealers and major swaps participants not regulated by a prudential regulator will also be required to provide unaudited monthly financial reports and audited annual financial statements.[185]

The SEC will release proposed rules on margin and capital requirements sometime in 2012.[186]

178. *Id.*

179. *Id.* at 27,569.

180. *See* Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011).

181. *Id.*

182. COMM. FUT. TRADING COMM'N, *Proposed Rules Regarding Capital Requirements for Swap Dealers and Major Swap Participants*, *available at* http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/cr_factsheet.pdf.

183. *Id.*

184. *Id.*

185. *Id.*

186. *See Swap Report, supra* note 132, at 26.

C. How These Reforms Will Help Stabilize the Swap Market

Prior to the Dodd-Frank Act, regulation of the swap market was fragmented if it existed at all.[187] Regulation of CDSs appeared to fall under the jurisdiction of the SEC, but the Commodities Futures Modernization Act of 2000 (CFMA) amended the Securities Act and the Exchange Act to exclude CDSs from the definition of a security, thus removing the SEC's jurisdiction over CDSs.[188] The CFMA also amended the Commodities Exchange Act to exclude a wide range of OTC derivatives from the jurisdiction of the CFTC.[189] Indirect regulation of CDS participants already regulated by prudential regulators was the only real regulation that remained.[190] Some antifraud authority was also retained by the SEC.[191]

The Dodd-Frank Act reinstates the regulatory power of the SEC and CFTC over swaps, and further requires prudential regulators to set rules specifically geared towards swaps activity engaged in by institutions under the jurisdiction of the commissions.[192] The Act provides a new regulatory framework for participants in the CDS market. New rules made pursuant to Dodd-Frank will aim to improve the integrity of the dealers and participants in swaps through stronger margin and capital requirements that will provide greater liquidity in the event that claims must be paid.[193] This should increase the likelihood that most, if not all, of the value of CDSs will be paid out if a credit event occurs.[194] The rules also increase transparency through price reporting requirements that will provide market participants with a more accurate view of CDS spreads,[195] enabling them to better gauge credit risk. Through the implementation of more stringent reporting requirements for SBSDs and MSBSPs, regulatory agencies will be able to better gauge the risks being taken by those institutions and will be able to stop excessively

187. *See* Sjostrom, *supra* note 68, at 983-89.

188. *Id*. at 985-87.

189. *Id.*

190. *See id.* at 988-89.

191. *See FCIR*, *supra* note 2, at 48.

192. *See Swap Report, supra* note 132, at 25-26.

193. *See* Capital Requirements of Swap Dealers and Major Swap Participants, 76 Fed. Reg. 27,802 (May 12, 2011).

194. *See generally CME Safeguards*, *supra* note 74.

195. *Swap Report, supra* note 132, at 39-42.

risky activity before it becomes a systemic threat.[196]

A criticism of strict margin requirements, capital requirements, and mandatory clearing is that the requirements could decrease the volume of swaps traded due to increased costs.[197] This could be the case, considering dealers will be limited by the amount of capital they have, and they will need to spend more money on regulatory compliance. Like any other product, the price of CDSs will likely increase if fewer of them are able to be issued and the demand for risk-hedging instruments remains constant. This could have a secondary effect of pricing speculators out of the market. So-called "naked" CDS purchasers may be naturally pushed out of the market if prices increase as a result of a decrease in supply. Buyers seeking to hedge risk may be willing to pay more than a speculator gambling on negative events. New buyers may also be attracted by the improved solvency measures.[198]

D. Lack of Repo Reform

Some critics argue that Dodd-Frank should have mandated central clearing for repo transactions.[199] Repos are similar to derivatives because they are transactions that carry ongoing risk exposure beyond the initial trade.[200] Cash products, such as equities, can be cleared at the time the trade is executed, while derivatives and repos require the counterparties to satisfy obligations throughout the course of the contract period.[201] Critics argue that this necessitates central clearing in a manner similar to derivatives.[202]

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196. *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27,564, 27,567 (May 11, 2011).

197. *See* PWC, *Implications of Derivatives Regulation and Changing Market Infrastructure for Nonfinancial Companies*, A CLOSER LOOK 1, 5 (July 2011), *available at* http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/closer-look-derivatives-regulation-nonfinancial-companies.pdf; PWC, *Impact on OTC Derivatives Activities*, A CLOSER LOOK 1, 3 (Aug. 2010), *available at* http://www.pwc.com/us/en/financial-services/regulatory-services/publications/assets/closer-look-derivatives.pdf [hereinafter *Impact on OTC*].

198. *See Impact on OTC*, *supra* note 197 at 3.

199. *See generally Repo Clearing*, *supra* note 43.

200. *Id.* at 1.

201. *Id.*

202. *Id.*

This is a valid concern, for many of the reasons discussed in Part II.C concerning central clearing for CDSs. However, as discussed in the next section, a stable CDS market could make these measures a bit redundant. If the parties to repo transactions are required to purchase insurance, and that insurance is sound, there may not be a need to monitor the repo transactions themselves. Any risk involved in the transactions can be hedged away through the use of a CDS.

IV. Swaps and Repo

The 2008 liquidity crisis was caused in part by a fire sale of troubled assets by financial institutions in need of cash.[203] Some of the sellers were repo lenders converting collateral to recoup losses on bad loans.[204] The result was a reduction in the money supply caused by lending firms receiving far less cash than they loaned out in the first place.[205] All else held constant, a contraction in the money supply causes interest rates to increase, resulting in higher borrowing costs.[206] An increase in the cost of borrowing tends to slow down economic growth.[207] Solving this problem would require a quick means by which lenders could, in the event of a default, receive all or most of the cash that they lent for the asset held as collateral.[208] An insurance policy could provide this result.

A. Mandatory Insurance

As discussed in Part II.B, *supra*, the "lender" in a repo transaction is subject to the credit risk of the counterparty and the credit and market risk associated with the security held as collateral.[209] The haircut charged by the lender in a repo transaction will depend on the credit rating of the borrower

203. *See* Ricks, *supra* note 37, at 87.

204. *See* Adrian et al., *supra* note 10, at 2-7.

205. *See* Ricks, *supra* note 37, at 105-06.

206. *Id.*

207. *Id.*

208. *Id.* at 113.

209. Adrian et al., *supra* note 10, at 2.

and the quality of the security being used as collateral.[210] A lender will charge a higher haircut as the quality of the security declines, resulting in the borrower receiving less cash in the exchange.[211]

If the lender feels that the borrower's credit is not strong enough, and if the security used as collateral in the transaction is not of high quality, the lender could require the borrower to purchase a CDS on the security for the benefit of the lender.[212] This requirement makes the borrower internalize the cost of the credit risk of the security being used as collateral. Some mortgage lenders require borrowers to purchase similar protection in the form of mortgage insurance if the borrower does not provide enough collateral up front.[213] Purchasing a CDS on collateral could decrease the size of the haircut if the lender no longer needs to price in credit risk. The CDS can even be written in such a way that it pays out if the borrower defaults and the lender cannot sell the security; or if the price of the security has dropped below a certain threshold. The lender would then receive its cash back and the CDS issuer would absorb the loss or inability to sell the insured security. This plan works fine if the CDS dealer has the money to cover the CDS liability.

Dodd-Frank could be strengthened by a rule mandating that a CDS be purchased against repo collateral in all exchanges where the collateral is not of the highest grade. High grade collateral includes highly liquid securities such as Treasury and Agency Bonds. Such collateral does not require the same protection as lower grade collateral because it is backed by the United States Government and can easily be liquidated. In the event that a borrower cannot find a dealer that will issue a CDS, this hypothetical rule would allow the Fed to offer a means by which insurance can be purchased from it in a similar fashion. The Fed will be free to set rates depending on the grade of the security, and will even be allowed to refuse to insure securities that it deems too risky. The goal of this rule would be to force parties in repo transactions to internalize the cost of the risk posed by the repo transactions.

In response to the 2008 liquidity crisis, the Fed initiated the Primary Dealer Credit Facility.[214] All PDCF loans were paid back with interest,[215] but

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210. *Id.*

211. *Id.*

212. *See* Ricks, *supra* note 37, at 113 (discussing the use of insurance in repo transactions).

213. *The Federal Housing Administration (FHA)*, U.S. DEP'T OF HOUS. & URBAN DEV., http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/fhahistory (last visited Feb. 1, 2013).

214. Adrian et al., *supra* note 10, at 4.

that result was not certain when the program began. American taxpayers effectively became an after-the-fact insurer of the institutions that had engaged in risky repo transactions, resulting in those institutions' inability to liquidate distressed MBS collateral. Those institutions had not paid insurance premiums to the Fed prior to the events requiring its intervention. If the Fed is going to intervene in such a situation, firms that would benefit from its intervention should be obligated to pay insurance premiums just as they would to cover the risk of their buildings burning down. Premiums charged by private insurers would remain in circulation like any other business profits. Funds generated through premiums for insurance purchased from the Fed could be returned to taxpayers in the form of reduced tax rates or the funding of various social programs. The overall goal would be to compensate society for accepting the cost of the risk that it may be forced to fund a revival of the money market at some future date.

This proposed rule would also help prevent a bank-run situation in the repo market. If a lender holds a security as collateral and that security is insured by a CDS or Fed insurance policy, the lender will be less likely to panic knowing that it will receive cash even if the counterparty and collateral security both default. This effect is similar to the effect that FDIC insurance has on retail bank depositors.

The insurance purchases required by this proposed rule could create a moral hazard issue if a lender becomes complacent with a borrower due to the lender knowing it will be paid even if the borrower defaults. Similar moral hazard issues are present in any form of insurance relationship and are usually alleviated through the use of a deductible, which leaves a portion of the risk with the insurance purchaser. The hypothetical rule would require a deductible-like feature to be worked into the terms of a CDS, incentivizing the lender to ensure that the borrower is properly capitalized and maintains adequate margin levels. Retail banks are heavily regulated by government agencies, so this problem isn't as pressing with retail institutions as it is with repo transactions, which are relatively lightly regulated. Retail depositors pay a "deductible" in the form of taxes and fees that fund the agencies overseeing the activities of the banks.

B. Criticism of This Plan

One criticism of the hypothetical rule outlined in Part IV.A, *supra*, is that

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215. *Primary Dealer Credit Facility (PDCF)*, *supra* note 129.

insuring such a large segment of the financial system would have a detrimental effect on economic growth.[216] It is argued that insurers would need to be fully equipped to cover sudden demands for large amounts of cash.[217] This would require the insurers to hoard cash and high-grade securities,[218] which could otherwise be invested elsewhere in more productive projects if the cash was not required to be held in reserve. Hoarding large amounts of cash causes a reduction in the supply of investable income, slowing economic growth.[219] This critique leads to the conclusion that the only way such an insurance scheme could be implemented is if the government is the insurer.[220]

As the creator of cash, the government does not need to hold cash against a promise to pay.[221] If a massive emergency arises, the government can just print the cash it needs to satisfy its insurance liabilities.[222] Printing money would cause a short term shock to the money supply, but since these crises don't come along very often, the long-term effects would likely be negligible. Under such a system, the cash already in the market would not be tied up in reserve accounts, as it would be under a private insurer system. This system is different from a "bailout" because it requires financial institutions engaged in repo transactions to pay an insurance premium at the time they engage in the transactions. A bailout involves the government intervening after the fact, at which point it can be difficult to charge weakened financial institutions for the assistance they receive. Financial institutions must pay a premium during the good times to receive assistance in the event of a crisis.

The argument presented in this criticism is valid given that private insurers would insure all money-market transactions. The severity of the effects outlined in the argument would also depend on how much cash insurers would be required to hold against insurance liabilities. If reporting and clearing regulations under the Dodd-Frank Act are implemented correctly, regulators will have the ability to assess risks taken by CDS issuers and prevent them from amassing large stakes in certain market segments,

216. Ricks, *supra* note 37, at 113.

217. *Id.*

218. *Id.*

219. *Id.*

220. *Id.*

221. *Id.* at 113-14.

222. Ricks, *supra* note 37 at 113-14.

thus preventing a crisis before it occurs.

The criticism outlined above also depends on how valuable cash is compared to potential income from CDS premiums. Under the hypothetical rule, the Fed can provide insurance if a borrower cannot secure a private CDS. Such a situation would likely arise when borrowers seek to use more risky collateral, which would require higher capital and margin requirements if a private dealer were to issue a CDS against the collateral. Private CDS issuers would likely insure assets that are less likely to default because such assets would likely require comparably small capital and margin reserves. The ideal result would be the Fed insuring collateral that would otherwise lock up large amounts of cash if insured by a private insurer. If the opportunity cost of investing cash is higher than the premiums that will be generated by issuing CDSs, then dealers will issue fewer CDSs. Under the hypothetical rule, the Fed would cover the difference.

Insurance is simply a means of shifting the cost of risk. Someone has to pay if risk exists and eventually materializes. If regulators require institutions to maintain certain capital requirements, then it will not matter whether those institutions bear the risk themselves or purchase a CDS to insure against the risk. The opportunity cost of cash held in reserves can be considered the price of holding risk, and it can be partially offset by fees paid for holding that risk. Having the Fed completely insure the market would effectively remove risk from the market. Risk takers would pay premiums to the Fed, but no firm would have the same incentive to moderate risk that it would if that firm stood to lose most or all of its assets in the event of a failure, like private CDS issuers do.

V. Conclusion

The liquidity crisis of 2008 was the result of many investors simultaneously trying to liquidate relatively illiquid assets. This caused the money supply to contract and the money market to freeze up when repo lending nearly came to a halt. Part of the problem can be traced to firms selling risk down-stream in the form of CDSs. Ordinarily this is not a problem if CDS issuers are prepared to absorb losses when risks materialize. Unfortunately, many of the CDSs issued against MBSs failed to pay-out.

Rules mandated by the Dodd-Frank Act can help prevent these events from happening again. These rules aim to ensure that CDS dealers will be properly capitalized in the event they have to pay CDS claims. Requiring the purchase of insurance against mid and low-quality repo collateral could have the same effects on repo lenders that FDIC insurance has on retail depositors, which could prevent another bank-run situation in the future. These solutions may not have prevented the crisis entirely if they were in effect at the time, but they could have helped reduce the negative externalities that occurred in 2008 as a result of the credit market seizing up.

SUITABILITY IN THE WAKE OF FINRA REGULATORY NOTICE 12-55

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I. Introduction

In December 2012, the Financial Industry Regulatory Authority ("FINRA") issued Regulatory Notice 12-55, setting a new interpretation of what constituted a "customer" for purposes of FINRA Rule 2111 (Suitability), and superseding related answers in Frequently Asked Questions format issued in Regulatory Notice ("RN") 12-25 earlier that year. In a seven month period, FINRA materially changed the definition of a customer for purposes of suitability from "an individual or entity with whom a broker-dealer has even an informal business relationship related to brokerage services, as long as that individual or entity is not a broker or dealer,"[2] to "a person who is not a broker or dealer who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer receives or will receive, directly or indirectly, compensation even though the security is held at an issuer, the issuer's affiliate or a custodial agent."[3] Essentially, FINRA "skipped" the step of rulemaking at the SEC level and in a back-door fashion added two qualifications for an investor to become classified as a "customer" for suitability purposes: either that the person opened a brokerage

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2. RN 12-25.

3. RN 12-55.

account at the broker-dealer, or purchased a security for which the member will receive compensation.

Falling between the cracks of the new definition of suitability are several types of cases that claimants' attorneys come across frequently in their practice, including individuals who have not opened accounts with a broker's member firm, but have invested in Ponzi schemes run by the broker, invested in private placements based on recommendations from the interested broker, or acted on recommendations of the broker where the broker could gain remuneration through uncommon means.

This article will review the history of the suitability rule (Part II). This article then argues that Regulatory Notice 12-55 was a one-sided overreaction in response to member concerns (Part III). This article next addresses the potential concerns raised by FINRA's action, including among other things, the deterioration of the suitability requirements of securities laws and FINRA rules (Part IV). Finally, the article reflects on the possible impacts the definition change has on claimants' cases in the future (Part V).

II. History

The requirement that members ensure the suitability of recommendations has consistently been an important aspect of securities regulation, helping to ensure that investors are recommended investments that match their goals and are appropriate for them. FINRA's currently suitability rule, Rule 2111, provides that:

> A member or an associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer, based on the information obtained through the reasonable diligence of the member or associated person to ascertain the customer's investment profile.[4]

This language was largely adapted from NASD Rule 2310(a),[5] which provided that:

> In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable

4. Rule 2111(a).

5. Rule 2111(a) was also based on implicit applications of NYSE Rule 405, as interpreted.

> grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs.[6]

Both Rule 2111(a) and its precursor 2310(a) rely on the term "customer" to limit the obligations of suitability of recommendations. A "customer" has been consistently defined as "not includ[ing] a broker or dealer."[7] In the interpretive Notices to Members ("NTMs") and Regulatory Notices ("RNs") that have followed, the word "customer" has not been further defined.[8]

FINRA has often used the term "customer" to refer to activities commonly directed to the investing public. For example, in NTM 01-23, the NASD listed various activities that may or may not constitute recommendations as a result of members' online activity, using the word "customer" throughout to refer both to activities that would generally be targeted to customers with brokerage accounts as well as prospective customers. According to NTM 01-23, a customer may be an individual who uses online search engines or online research databases maintained by the member, or who sign up for email alerts (all activities which would not generally constitute a recommendation).[9] On the other hand, a customer may also be someone the member emails regarding suggested investments, or an individual who is identified by the member through its own "data-mining" efforts to "analyze a customer's financial or online activity whether or not known by the customer and then, based on those observations, sends specific investment suggestions that the customer purchase or sell a security" (which may constitute making a recommendation).[10] NTM 01-23 did not delineate what constituted a "customer" for purposes of suitability.

Courts have ruled on the definition of "customer" but generally only on the basis of arbitrability, typically reading in a requirement of some sort of business arrangement between the investor and the FINRA member or its registered representative.[11] Where such a business arrangement exists, these

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6. NASD Rule 2310(a).

7. FINRA Rule 0160(b)(4) (Definitions); *see also* NASD Rule 0120(g) (Definitions).

8. *See, e.g.*, IM-2310-02, NASD NTM 96-32, NTM 01-23, RN 09-25, FINRA NTM 11-02.

9. NTM 01-23, pg. 3.

10. *Id*.

11. *See, e.g., UBS Secs., LLC v. Allina Health Sys.*, 12-CV-2090, 2013 U.S. Dist. LEXIS 17799 (D. Minn. Feb. 11, 2013) (finding broker who underwrote deal

courts will find a customer relationship, regardless of whether the investor had a brokerage account.[12]

FINRA finally provided some guidance of the definition of customer for purposes of suitability when it issued RN 12-25 in May 2012 in a Frequently Asked Questions format. In Answer 6, related to the definition of "customer" for purposes of Rule 2111, FINRA provided that:

> The suitability rule only applies to a broker's recommendation to a "customer." FINRA defines "customer" broadly as including anyone who is not a "broker or dealer." Although in certain circumstances the term may include some additional parameters, a "customer" clearly would include an individual or entity with whom a broker-dealer has even an informal business relationship related to brokerage services, as long as that individual or entity is not a broker or dealer. *A broker-customer relationship would arise and the suitability rule would apply, for example, when a broker recommends a security to a potential investor, even if that potential investor does not have an account at the firm.*[13]

This FINRA interpretation included individuals with informal business relationships, specifically those without accounts at the firm, as customers subject to the suitability requirements of 2111, aligning FINRA regulations with substantial case law finding that investors of Ponzi schemes, investments often sold away from employing broker-dealers, are generally defined as customers for arbitrability purposes.

Within the year, FINRA then issued RN 12-55 to supersede, *inter alia*, Answer 6 in RN 12-25:

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provided more than underwriting services and therefore was obligated to arbitrate claim brought by investor); *World Group Secs., Inc. v. Suggs*, 10-CV-2282, 2013 U.S. Dist. LEXIS 14134 (S.D. Cal. Feb. 1, 2013) (holding that firm that was alleged to have provided loan modification services was not obligated to arbitrate claim in FINRA because the defendant was not a customer); *Peyser v. Kirshbaum*, 12 Civ. 2857, 2012 U.S. Dist. LEXIS 176873 (S.D.N.Y. Dec. 11, 2012) (holding that firm that employed broker who sold away Tax Advantaged Stock Loans, a Ponzi scheme, was obligated to participate in the FINRA arbitration because the investor was a customer).

12. *Id*.

13. RN 12-25, pg. 6 (internal footnotes omitted, emphasis added).

> The suitability rule applies to a broker-dealer's or registered representative's recommendation of a security or investment strategy involving a security to a "customer." FINRA's definition of a customer in FINRA Rule 0160 excludes a "broker or dealer." *In general, for purposes of the suitability rule, the term customer includes a person who is not a broker or dealer who opens a brokerage account at a broker-dealer or purchases a security for which the broker-dealer receives or will receive, directly or indirectly, compensation* even though the security is held at an issuer, the issuer's affiliate or a custodial agent (e.g., "direct application" business, "investment program" securities, or private placements), or using another similar arrangement.[14]

Through its superseding Answer 6(a), FINRA essentially added requirements to the definition of "customer" for suitability purposes, including that the investor either open a brokerage account, or purchase a security for which the member receives compensation.

III. An Unnecessary Overreaction

Following the issuance of RN 12-25, industry members apparently became concerned with the scope of the rule, and appear to have voiced such concerns to FINRA.[15] Among these concerns was the fear of a perceived expansion of the suitability rule to cover "informal comments made at pitches or in social situations"[16] including "informal recommendations made at a social gathering, such as a holiday party."[17]

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14. RN 12-55, Answer 6(a) (emphasis added).

15. Bingham.com, *FINRA Issues Additional Guidance on its Soon to be Implemented New Suitability Rule*, May 31, 2012, http://www.bingham.com/Alerts/2012/05/finra-issues-additional-guidance-suitability-rule. It is worth noting that such comments appear to have been unprompted as no public request for comment on RN 12-25 was issued.

16. Bingham.com, *FINRA Issues Guidance Narrowing the Scope of its New Suitability Rule*, Dec. 17, 2012, http://www.bingham.com/Alerts/2012/12/FINRA-Issues-Guidance-Narrowing-the-Scope-of-its-New-Suitability-Rule.

17. Sutherland.com, *FINRA Reverses Course and Issues Guidance Changings Its Interpretation Regarding the Key Issues of 'Potential Investors' and Non-Security Recommendations*, Dec. 19, 2012, http://www.sutherland.com/files/upload/FINRAReversesCourseandIssues Guidance.pdf.

In response to these *member concerns* (as FINRA apparently did not solicit investor comment), FINRA "reversed course,"[18] recanting its previous guidance, which was consistent with the SEC's official release, and issuing a less consistent, but more member-friendly version, RN 12-55, in its stead. It took a mere seven months for FINRA to complete this "180" about to whom the new suitability rule applied and narrow its scope from "potential investors"[19] to only account holders. This highly unusual decision to recant on its previously issued guidance is curious for two reasons: (A) no official comment period was ever held, and (B) although not changing the text of the rule, FINRA materially changed its substance.

A. No Official Comment Period

While RN 12-55 represents a substantive change to and departure from the existing meaning of Rule 2111 of the FINRA Code, it has been couched as a change to rule guidance. RN 12-55 contradicts the previously issued guidance on the rule, and it materially alters Rule 2111 to read in additional requirements to the definition of "customer" not present in Rule 0160.

Changes to the FINRA Code require the approval of the Securities and Exchange Commission, to ensure compliance with the Securities Exchange Act of 1934.[20] Among FINRA's current obligations in the rulemaking process are the solicitation of comments from the public, filing with the SEC, responding to comments, amending the proposed rule based on comments, and finally obtaining SEC approval of the rule for inclusion in the Code.[21]

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18. *Id. See also*, Dan Jamieson, *FINRA Dials it Back on Suitability Rule*, InvestmentNews, December 16, 2012, http://www.investmentnews.com/article/20121216/REG/312169978 ("[t]he new guidance was welcomed by industry lawyers, who have complained that the earlier guidance, issued in May, caught the industry by surprise. 'Finra should be praised for listening to its member firms and reps,' said Brian Rubin, a partner at Sutherland Asbill & Brennan LLP"); *Newly Released Regulatory Notice 12-55 Provides Additional Clarity on Suitability Obligations*, December 17, 2012, http://www.financialservices.org/page.aspx?id=3984 ("[a]lthough we would have preferred FINRA providing clarity on these points at the time the final rule was adopted, we appreciate FINRA's effort to respond to our concerns by offering this guidance").

19. RN 12-25.

20. 15 U.S.C. § 78s (2013).

21. *Id*.

However, for the purposes of issuing guidance on the rules, FINRA's obligations are substantially less.[22]

FINRA's stated mission ("Investor Protection. Market Integrity") includes the protection of the investing public, but does not include the protection of its members. Formally modifying the language of Rule 2111 to be consistent with the meaning given to it by RN 12-55, which protects member firms at the expense of public investors, contradicts this stated mission and would certainly have been met by staunch opposition from the public, including investors' rights advocates, during any comment period – had one been provided.

B. FINRA Changed the Substance of the Rule Away From the Correct Interpretation

FINRA's initial interpretation in 12-25 is clearly what the rule was intended to mean. The official SEC release announcing the approval of the rule along with subsequent FINRA guidance support the interpretation in 12-25.

The official SEC Release approving the amendments to Rules 2090 and Rule 2111 supports this original interpretation by FINRA. *After* the official SEC comment period and *after* twenty-two comments from representatives of the industry, investors' rights advocates, and neutrals, the SEC published Release No. 34-63325 on November 17, 2010, officially approving the proposed rule changes to Rules 2090 and 2111. It was the stated goal of the SEC and FINRA to "retain the core features" of each rule, "while modifying both rules to *strengthen* and clarify them."[23] The SEC emphasized that these rules "are critical to ensuring investor protection" as well as "fair dealing with customers,"[24] two intertwined, yet independent objectives. The use of the term "investor" where the term "customer" could have been easily substituted is indicative of the intent of this suitability rule, even in the *post-comment period.* In response to comments concerning potential overlap between the amended rules and pending Dodd-Frank provisions, the SEC noted FINRA's affirmative indications that, among other things, "the proposed changes to those rules would provide greater protection to

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22. *Id.*

23. *Id.* (emphasis added).

24. Granting Accelerated Approval of Rule Changes, Exchange Act Release No. 63325, 75 FR 71479 (Nov. 17, 2010), *available at* http://www.sec.gov/rules/sro/finra/2010/34-63325.pdf.

investors."[25] Again, the option to substitute the word "customer" for "investor" was available, but not taken. Tellingly, nowhere in the official release does the SEC limit the applicability of the suitability rule only to an "account-holder" or the like.

Following the passage of these two rule amendments, FINRA offered three consistent instances of guidance, before taking the meaning of the rule in a different direction.[26] First, FINRA issued Regulatory Notice 11-02, announcing to members that the SEC had approved the rules as amended and their effective date of October 7, 2011. Next came Regulatory Notice 11-25, which provided additional guidance on the rule amendments to members. Finally came RN 12-25, issued in May of 2012, which provided further guidance, specifically on Rule 2111.

In issuing RN 12-55, FINRA overreacted in a knee-jerk fashion ostensibly without consulting investor advocates in response to member concerns. This is not how rulemaking was intended to occur. In RN 11-02, FINRA returned to the use of the word "customer," but in the same context as was previously understood.[27] Nowhere in 11-02 does it indicate that a customer must be an "account-holder" or the like.[28] Rather, FINRA focused on the act of making a recommendation: "The new rule continues to use a broker's "recommendation as the triggering event for application of the [suitability] rule…"[29]

Altering the application of the rule to alleviate any issue presented by social gathering discussions was unnecessary. This issue did not need to be addressed in the definition of a customer. Rather, this concern should have been addressed as a definition of what constitutes a recommendation. As seasoned attorneys in this field are aware, the determination of whether or not a recommendation has been made is flexible, while still being an

25. *Id*.

26. *See Burr Alert: FINRA Updates Guidance on its Suitability Rule*, Dec. 19, 2012, http://www.burr.com/News-,-a-,-Resources/Resources/Burr-Alert-FINRA-Updates-Guidance-on-its-Suitability-Rule.aspx#.UUnyjBymiPs ("This is FINRA's fourth regulatory notice concerning the rule – it previously published Regulatory Notice 12-25, Regulatory Notice 11-25, and Regulatory Notice 11-02 – but this notice takes the rule in a slightly different direction, at least appearing to soften the enforcement of the rule").

27. *See* NTM 11-02; *see also* Sec. II, *supra.*.

28. *See* NTM 11-02.

29. RN 11-02, p. 2.

"objective test."[30] The question of whether or not a recommendation has been made is answered by making an informed determination based upon the facts and circumstances present in light of FINRA's guiding principles and the precedent set by previously litigated decisions.[31] This makes the recommendation analysis a much more appropriate place to address these member concerns over the perceived breadth of Rule 2111.

Brokers present themselves to the public as professionals, whom the public should trust for financial advice. The flip side of that coin is that in dealing with public investors, brokers must understand the influence they wield as professionals, and refrain from making recommendations to public investors without a complete understanding of the specific facts and circumstances. This is not an unbearable burden. Such an issue did not require a modification of the rule, but simply an undertaking of basic responsibility in dealing with the investing public, account-holder or not.

IV. Potential Concerns

Since the publication of RN 12-55, several specific and serious concerns have arisen over the potential ramifications resulting from FINRA's about-face in the application of the suitability rule.

Since the interpretation propounded by RN 12-55 removes a broker's recommendations to investors from the purview of the suitability obligations so long as the purchases are not made at the firm and an account is not held with the firm, the issuance of 12-55 resulted in the loss of some related causes of action, including negligence *per se* based upon the violation of a standard-setting statute.[32] Not only will this complicate future civil complaints on behalf of defrauded public customers, but also likely future disciplinary proceedings brought by FINRA's Enforcement Division.

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30. *Id*.

31. RN 11-02 p. 3; *see also*, RN 12-25.

32. *See, e.g., Martin v. Herzog*, 228 N.Y. 164 (NY 1920) (the violation of a duty imposed by statute for the benefit of a particular class is negligence itself) (internal quotations omitted); *but see*, *Chen v. U.S.*, 854 F.2d 622 (2d Cir. 1988) ("it is long and firmly established in New York, that the violation of a rule of an administrative agency is merely some evidence of negligence but does not establish negligence as a matter of law because a regulation lacks the force and effect of a statute") (internal quotations omitted).

Take, for example, a situation where a broker is a stock holder in a thinly traded company and pushes public investors (none of whom have an account at the registering member firm) to buy stock elsewhere to boost the value of the broker's own account holdings. Under this set of circumstances, the suitability obligations appear not to attach. This presents a seemingly high, but clearly unwarranted, hurdle for both claimants and regulators to overcome.

RN 12-55 also injects an element of ambiguity in the definition of the term "customer" as used in the FINRA Code. While Rule 0160 clearly states that a customer "shall not include a broker or a dealer" without qualification, and caselaw interprets this definition broadly, RN 12-55 creates a carve out, imposing a qualification that essentially limits "customer" to "account-holder." This begs the questions: How much further will FINRA go in limiting to whom various rules do and do not apply? How slippery is this slope, and to where will it lead?

Oftentimes, ambiguities in the law and in regulation invite substantial abusive misinterpretations and misrepresentations to follow. The risk of the interpretation of "customer" in RN 12-55 being misapplied by litigants and arbitrators, alike, is so great as to appear to be an almost certainty. Since unsuitability forms the foundation of a majority of customer claims in FINRA arbitrations, it typically appears before arbitration panels as one of several alleged rule violations in any given case. In such a circumstance where unsuitability is one of multiple rules violations alleged, the prospect of distinguishing between a "customer" for the purposes of applying the suitability rule and a "customer" for purposes of applying other rules before an arbitration panel is not a bright one. To envision advocates for member firms arguing a misapplication of these distinctions in favor of their clients in an arbitration does not require a departure from the reasonably expected. How FINRA educates arbitrators on these nuances may ultimately prove to be critical.

V. Why The Impact of RN 12-55 is Limited

Simply speaking, the actual impact of RN 12-55 should be limited because claimants' attorneys possess sufficient alternate causes of action to obtain full recoveries for their clients who may also be subject to the rule interpretation. Considering the two hypotheticals of the investor in unsuitable securities recommended by a broker and the Ponzi scheme victim;

these and similar activities may still involve selling away and/or failure to supervise causes of action.[33]

Selling away and failure to supervise claims may be brought by investors against employing member firms, even if they did not have brokerage accounts with those firms. Generally, member firms must arbitrate claims when they are requested by a customer.[34] "Customers," for purposes of arbitrability, include those individuals that had a business relationship with the broker. It is well-settled under both New York and Federal Law that "the NASD's definition of "customer" is broad …, plainly including customers of an associated person as well as of the member itself."[35] The court in *Financial Network Inv. Corp.* went further by saying "[w]hen the investor deals with an agent or representative [of a member], the investor deals with the member …"[36] In *John Hancock*, the Second Circuit Court of Appeals held that "even assuming that the [i]nvestors' claims do not relate to [the member's] business," the investors can still be customers of the firm.[37] Even where the firm argues that "the promissory notes [that the associated person] sold to [i]nvestors were in no way related to [the member firm's] business … supervision arises in connection with the member's business."[38] Furthermore, "[c]ustomer status is not negated by an investment firm's lack of knowledge as to its representatives' customers."[39]

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33. Although not specifically addressed in this article, it should be noted that investors may also have other viable claims against member firms for the actions of their employees/registered representatives, including claims stemming from negligence, common law fraud, and SEC Rule 10-b5.

34. *See* FINRA Rule 12200.

35. *Financial Network Inv. Corp. v. Becker*, 305 A.D.2d 187, 762 N.Y.S.2d 25 (N.Y. App. Div. 1st Dept. 2003) (citing *John Hancock Life Insurance v. Wilson*, 254 F.3d 48 (2d Cir. 2001)).

36. *Financial Network Inv. Corp.*, 305 A.D.2d at 188 (quoting *Vestax Sec. Corp. v. McWood*, 280 F.3d 1078, 1082 (6th Cir. 2002)).

37. *John Hancock Life Insurance*, 254 F.3d at 58-59 (citing *First Montauk Sec. Corp. v. Four Mile Ranch Dev.*, 65 F. Supp. 2d 1371, 1379 (S.D. Fl. 1999)).

38. *MONY Securities Corp. v. Bornstein*, 390 F.3d 1340 (11th Cir. 2004) (citing *John Hancock, 254 F.3d* at 59, and *Multi-Financial Sec. Corp. v. King,* 386 F.3d 1364, 1366 (11th Cir. 2004)).

39. *Financial Network Inv. Corp*, 305 A.D.2d at 188 (citing *Oppenheimer & Co., Inc. v. Neidhart*, 56 F.3d 352, 357 (2d Cir. 1995)).

In a situation where an investor does not have an account with the member firm, but purchases an investment through the member's registered representative, a selling away claim may be pursued. Additionally, even where a purchase was not made at the member firm or through the member's registered representative, but rather was made at the registered representative's recommendation, investors may pursue claims against member firms for failure to supervise.

Such claims are based on the broker's activities that should have been appropriately and adequately supervised by the member, but were not. NASD Rule 3010 requires that members provide a baseline level of supervision and compliance of branch offices, and imposes upon members the obligation to review the activities of each office, which includes the period examination of customer accounts to detect and prevent irregularities and abuse.[40] NTM 99-45 highlights that:

> [i]t is important that members not only review their supervisory systems and procedures to ensure that they are current and adequate, but also conduct inspections to determine whether the systems and procedures are being followed.

The rules serve to protect investors and the public interest by involving member firms in the prior review of all business activities of their associated persons. "Ultimately, the duty to supervise is a firm's obligation . . . Thus, the burden falls to a firm to implement effective procedures, staffing, and to provide sufficient resources and a system of follow-up and review to determine that any responsibility to supervise is being diligently exercised."[41]

Additionally, in a situation where a broker steered a public investor into an investment in a company in which the broker has an interest, the investor may pursue a claim based on failure to supervise the broker's outside business activities. Member firms also are required to properly supervise and achieve compliance in activities conducted by the broker, which are considered to be outside business activities. FINRA Rule 3270 states in part that "[n]o registered person may be … compensated, or have the reasonable expectation of compensation, from any other person as a result of any

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40. *See* Rule 3010 ("Final responsibility for proper supervision shall rest with the member"); NASD NTM 99-45; *see also* NASD NTM 98-38 (providing guidance on supervision of unregistered and branch offices, especially in the presence of "red flags"); *In re Royal Alliance Associates, Inc.*, Exchange Release No. 34-38174 (January 15, 1997), *available at* http://www.sec.gov/litigation/admin/3438174.txt.

41. *Dept. of Enforcement v. Magellan Securities, Inc.,* NASD Disciplinary Proceeding No. C3B010016 (December 30, 2002).

business activity outside the scope of the relationship his or her member firm" unless notice of such arrangement has been provided to the member.[42] NASD NTM 01-79 reminded members of their responsibilities to ensure that their supervisory procedures are "reasonably designed to achieve compliance" regarding outside business activities.[43] "[A]llowing a registered representative to engage in outside business activities involves the risk that the representative will use his outside business to carry out or conceal violations of the securities laws."[44]

The SEC has repeatedly instructed firms to "be alert to and investigate possible 'red flags' indicating possible undisclosed outside business activities and assess all outside business activities by a representative, whether or not related to the securities business."[45] In the 1999 written decision by the NASD imposing sanctions on an individual for failure to supervise, the NASD noted that "the [Securities and Exchange] Commission has held, when faced with indicators of irregularities or misconduct (many times referred to as 'red flags'), a 'supervisor cannot discharge his or her supervisory obligations simply by relying on the unverified representations of employees.'"[46]

VI. Conclusion

There is no question that FINRA has substantially altered the applicability of suitability of recommendations by re-defining who is a "customer" as pertains to suitability. The ambiguity between the historic definition of "customer" and that now applicable to suitability will require

42. *See* FINRA Rule 3270.

43. NASD NTM 01-79, pg. 697.

44. Signal Secs., Exchange Release No. 43350, 2000 SEC LEXIS 2030 (Sept. 26, 2000), *available at* http://www.sec.gov/litigation/admin/34-43350.htm.

45. SEC Staff Legal Bulletin No. 17: Remote Office Supervision, 2004 SEC No-Act. LEXIS 933 (March 19, 2004), *available at* http://www.sec.gov/interps/legal/mrslb17.htm; *cf.* Press Release, SEC Release 2000-143 (September 27, 2000) ("Heightened supervision is needed … where there are indications of potential misconduct").

46. *Dist. Bus. Conduct Comm. Dist. 8 v. Freedom Investors Corp.,* 1997 NASD Discip. LEXIS 21, 44 (January 27, 1999) (citing In re Michael H. Hume, Exchange Act Release No. 35608, 1995 SEC LEXIS 983, 52 S.E.C. 243 (April 17, 1995)).

careful lawyering by claimants' attorneys to avoid confusion and pitfalls before arbitration panels.

While the claimants' bar has arguably lost claims for unsuitability and other negligence-related causes of action, other claims, including selling away and failure to supervise will still (as they always have) provide a route to full recourse for investors who have fallen for fraudulent or unsupervised investments recommended by unscrupulous brokers.

401(k) PLANS: AN ERISA FIDUCIARY RESPONSIBILITY PRIMER *PART TWO*

*Charles G. Humphrey**

I. INTRODUCTION

This is the second of a two-part series on 401(k) plans. The first part discussed the general requirements that apply to plan fiduciaries under the federal law known as ERISA. This part discusses plan fees and, in particular new service fee disclosure rules that in the author's opinion will change the landscape of fiduciary obligation and liability.

Beginning on July 1, 2012[1] those who provide services to 401(k) plans are required by regulation to provide sponsoring employers[2] with certain information about their fees and services (the "rule" or "new rule"). There is no doubt that an intensive effort has been made in the retirement industry to prepare employers for the rule. Despite this new regulation, many employers are ill prepared to deal with its requirements and, likely, are not now, nor will be fully compliant. This article explains how the new requirements expose employers to greater risk and exposure to liability.

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1. The new rule applies to contracts and arrangements between plans and service providers as of the effective date regardless of whether the arrangement was entered into prior to the effective date and the disclosures must have been provided no later than the effective date. 29 C.F.R. § 2550.408b-2(c)(i)(xii) (2012).

2. When reference is made herein to "sponsoring employers" or "employers" it is to them in their capacity as a fiduciary under section 3(21) of ERISA or as "named fiduciary" under the plan. In practice, responsibility for service provider selection and monitoring may be delegated to a committee responsible for such matters or to individual officers or employees of the employer.

II. THE STATUTORY FRAMEWORK

A. Rules Relating to the Furnishing of Goods and Services. Section 406(a)(1)(C) of ERISA[3] makes the furnishing of goods and services (and certain other transactions) between a plan and a service provider a prohibited transaction subject to substantial excise taxes under Section 4975 of the Internal Revenue Code.[4] This broad prohibition can be saved from application by the statutory exemption contained in Section 408(b)(2) of ERISA.[5] It provides:

The prohibitions of section 406 shall not apply to . . . [c]ontracting or making reasonable arrangements with a party in interest[6] for office space, legal, accounting, or other services necessary for the establishment or operation of the plan, if no more than reasonable compensation is paid therefor.

The new regulation expounds upon this provision.

B. General Fiduciary Responsibility Rules. Section 404(a)(1) of ERISA[7] imposes broad fiduciary responsibilities on employers and plan fiduciaries. In pertinent part, this rule requires fiduciaries to discharge their duties solely in the interest of plan participants and beneficiaries and

1. for the exclusive purpose of defraying reasonable expenses of the plan;[8] and
2. with the care, skill, prudence, and diligence under the circumstance then prevailing that a prudent man acting in like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims.[9]

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3. 29 U.S.C. § 1106(a)(1)(C) (2012).

4. 26 U.S.C. § 4975 (2012).

5. 29 U.S.C. § 1108(b)(2) (2012).

6. Section 3(14)(B) of ERISA defines a "party in interest" as including "a person providing services to such plan." 29 U.S.C. § 1002(14)(B) (2012).

7. 29 U.S.C. § 1104(a)(1) (2012).

8. 29 U.S.C. § 1104(a)(1)(A)(i) (2012).

9. 29 U.S.C. § 1104(a)(1)(B) (2012).

If the thrust of the new rule is to require service providers to provide useful and potentially actionable information to employers, the intent of section 404(a)(1) is to compel employers to act prudently on the information provided.

III. New Regulations Needed to Address Today's Problems

Regulations interpreting Section 408(b)(2) were first promulgated by the United States Labor Department ("DOL") in 1977. [10] This was a time when defined benefit pension plans dominated and the mutual fund and insurance industries had not begun to penetrate the retirement plan market. Fee arrangements were rather simple then, and fees paid by plans to service providers tended to be paid directly from plan assets or by their employer sponsors. The plan or employer would be invoiced on a periodic basis and payments authorized by the employer. It was quite easy for an employer to know what it or the plan was paying for services. All fees were known because there was direct payment from the assets of the plan.

This simple fee model began to change and was replaced by the dominant model in existence today after the IRS issued regulations in 1981 interpreting Section 401(k) of the Internal Revenue Code.[11] The regulations unleashed 401(k) plans and the fee model that flourishes today. The model comes in several variations, but, significantly, is characterized by complex, *indirect* fees such as 12b-1 and sub-transfer agent ("sub-TA") fees, paid by fund managers under revenue sharing arrangements, described in more detail below.

In general, fee information delivered under the model is often opaque and delivered to employers in a manner difficult to understand. This complexity, combined with the expertise and knowledge gap that exists between service providers and employers, puts employers at a serious disadvantage when they evaluate the services and products they are offered. Often employers rely on agents and brokers for "independent" advice. The

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10. Regulation section 2550.408b-2 was added August 30, 1977. Exemption for Loans to Employee Stock Ownership Plans, 42 Fed. Reg. 44,384 (Sept. 2, 1977); *officially corrected by* Exemption for Loans to Employee Stock Ownership Plans Correction, 42 Fed. Reg. 45,907 (Sept. 13, 1997).

11. Certain Cash or Deferred Arrangements under Employee Plans, 46 Fed. Reg. 55,544 (Nov. 10, 1981).

broker's role is not well understood by employers who assume the agent is presenting the best product available. Of course, this advice is not unbiased or disinterested, as the agent or broker will be receiving compensation on the sale of the product or service and may be incentivized to choose a product that produces the greatest fee revenue. Many employers have not fully understood this inherent conflict. There is no doubt excess fees have been paid by plans because of these asymmetric relationships.

In 2007, in an effort to level the playing field, the DOL proposed a new rule requiring service providers to provide certain basic information to employers about their services and fees, or risk engaging in a prohibited transaction under Section 406.[12] Prior to the proposed rule, service providers were under no legal compulsion under ERISA to deliver any particular information to participants. In other words, the burden was on employers to gather this information, and they had to be sufficiently knowledgeable about fees to know what information to request.

DOL issued an interim final rule in 2010 and, after several extensions, the rule was made effective July 1, 2012. [13] In the preamble to the interim rule, DOL reiterated its original aims in promulgating the rule:

> [S]ection 404(a) of ERISA requires plan fiduciaries, when selecting or monitoring service providers and plan investments, to act prudently and solely in the interest of plan participants and beneficiaries and for the exclusive purpose of providing benefits and defraying reasonable expenses of administering the plan. Fundamental to a plan fiduciary's ability to discharge these obligations is the availability of information sufficient to enable the plan fiduciary to make informed decisions about the services, the costs, and the service provider. [T]he Department continues to believe that, given plan fiduciaries' need for complete and accurate information about compensation and revenue sharing, both plan fiduciaries and service providers would benefit from regulatory guidance in this area.[14]

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12. Reasonable Contract or Arrangement Under Section 408(b)(2)--Fee Disclosure, 72 Fed. Reg. 70,988 (Dec. 13, 2007).

13. *See* 29 C.F.R. § 2550.408b-2 (2012); Reasonable Contract or Arrangement Under Section 408(b)(2)—Fee Disclosure, 75 Fed. Reg. 41,600 (July 16, 2010). The rule was finalized on February 3, 2012. *See* Reasonable Contract or Arrangement Under Section 408(b)(2)—Fee Disclosure, 77 Fed. Reg. 5,632 (Feb. 3, 2012).

14. *See* 29 C.F.R. § 2550.408b-2 (2012); Reasonable Contract or Arrangement Under Section 408(b)(2)--Fee Disclosure, 75 Fed. Reg. 41,600 (July 16, 2010).

IV. Disclosures to Employers under the New Rule

Heretofore employers had very little guidance from DOL as to what information they should seek from service providers when hiring or monitoring them. The new rule now tells them very specifically what they must receive and when it must be delivered. This part, in very basic terms, describes these requirements.

A. Covered Service Providers. The new rule adds a definition to the already crowded list of ERISA definitional terms for what is a "covered service provider" or "CSP."[15] CSPs are the people or entities from which employers must expect to receive the required information.

A CSP is a service provider who enters into an arrangement or contract with a plan for the performance of services, who "reasonably expects to receive $1,000 or more" in compensation under the arrangement, and is one of the following: (1) a fiduciary within the meaning of Section 3(21) of ERISA[16] or a registered investment adviser; (2) a record keeper or broker to a plan under which participants may direct investments in their accounts to one or more designated investment alternatives;[17] and (3) a service provider who receives indirect compensation for accounting, legal, auditing, actuarial, appraisal, banking, custodial, insurance, investment advisory, third party administration, or valuation services.[18]

An affiliate or subcontractor of one of the foregoing service providers is not a covered service provider, even if that affiliate or subcontractor performs the services that would otherwise make it a covered service provider.[19] Nor will a person or entity be a covered service provider solely by

15. Not all retirement arrangements are covered by the rule. For example, service providers to a simplified employee pension, simple retirement account, an individual retirement account or annuity or certain section 403(b) arrangements if contributions ceased to be made for them before January 1, 2009. *See, e.g.*, 29 C.F.R. § 2550.408b-2(c)(1)(ii) (2012).

16. 29 U.S.C. § 1002(21) (2012).

17. Inasmuch as nearly all 401(k) plans are set up so that individual participants may invest in investment alternatives selected by their employers, most brokers and record keepers will be covered service providers.

18. 29 C.F.R. § 2550.408b-2(c)(1)(iii)(A)(1)-(3) (2012).

19. 29 C.F.R. § 2550.408b-2(c)(1)(iii)(D) (2012).

providing services to an investment contract, product or entity (e.g., a mutual fund) in which the covered plan invests.[20] Thus, a mutual fund manager providing bundled services under one contract to a plan through its affiliated custodial, investment, and record keeping entities need provide only a single disclosure covering the services provided by the affiliated entities.

B. Required Disclosures - Generally. Covered service providers must make the required disclosures "reasonably in advance of the date the contract or arrangement is entered into, and extended or renewed.[21] No guidance is provided in the final rule as to what constitutes "reasonable time" and this, therefore, will be a subjective determination. There is no question, however, that a contract signed on the same day or even a few days after the delivery of the required information would leave both the employer and the service provider vulnerable to a claim that the timing requirement has not been met and, perhaps, to other claims that the information had not been properly considered by the employer.

Additional disclosures also will be required when there is a change or addition of an investment alternative under the arrangement. Under the new rule, disclosures must be provided as soon as practicable, but not later than when the investment is designated by the plan.[22]

Further, changes to the information in a previously provided disclosure must be made as soon as practicable, but not later than 60 days after the service provider is informed of the change.[23] Annual disclosures are required for any changes in investment, fiduciary, record keeping, and brokerage services.[24]

The disclosures must be in writing and contain the following information:

(1) A description of the services to be provided under the arrangement;

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20. 29 C.F.R. § 2550.408b-2(c) (2012).

21. 29 C.F.R. § 2550.408b-2(c)(1)(v)(A) (2012). The rule actually requires covered service providers to provide the required information to a responsible plan fiduciary. Whenever in this article reference is made to a disclosure of information to the employer, it means to a responsible plan fiduciary designated by the employer.

22. 29 C.F.R. § 2550.408b-2(c)(1)(v)(A)(ii) (2012).

23. 29 C.F.R. § 2550.408b-2(c)(1)(v)(B)(1) (2012).

24. 29 C.F.R. § 2550.408b-2(c)(1)(v)(B)(2) (2012).

(2) If the service provider or an affiliate will be providing or reasonably expect to provide services to an investment entity as a fiduciary, a statement to that effect;

(3) If the service provider or an affiliate or subcontractor reasonably expects to provide services under the arrangement directly to the plan as an investment advisor registered under the Investment Advisors Act of 1940 or any state law, a statement to that effect; and

(4) A description of all the direct or indirect compensation that the service provider, an affiliate, or subcontractor reasonably expects to receive for the covered services.[25]

V. Disclosure of Fees

Service providers can be compensated for their services either directly from the plan or plan sponsor or indirectly through sources other than the plan or plan sponsor. Typically, service provider compensation comes in the form of fees charged as a percentage of total plan assets, per participant, an itemized fixed rate, or a combination of all three. How fees are charged depends on the type of service provided and the plan sponsor. For example, fees for investment management services, which can vary by investment option, are generally charged as a percentage of assets and indirectly charged against participant accounts because they are deducted directly from investment returns. Record keeping fees will likely be a combination of fixed base fees and per participant charges.

The phrase "revenue sharing" is used quite often when talking about fees and is an indirect payment that it is from one service provider, such as an investment fund provider, to another service provider in connection with services provided for plan services, rather than payments made directly by the plan for services. For example, a plan's record keeper and investment fund manager might have an agreement where the investment fund manager collects sub-TA fees from plan assets invested in a particular fund that may be used as a credit to offset the record keeper's fees. Revenue sharing may also be paid from marketing and distribution fees (or so called "12b-1 fees") and from sub-TA fees. Marketing and distribution fees are fees paid by the fund manager and used to pay commissions to brokers and other salespersons, to pay for advertising and other cost of promoting the fund to

25. 29 C.F.R. § 2550.408b-2(c)(1)(iv)(C)(1), (2) (2012).

investors, and to pay various service providers of a 401(k) plan, pursuant to a bundled arrangement. Sub-TA fees are fees that are typically used to reimburse a plan's record keeper for shareholder services that the fund would otherwise have provided, such as maintaining participant level accounts and distributing the fund's prospectus.

The new rule snares for disclosure all compensation that might be received by a service provider, affiliate, or subcontractor in connection with services to a plan. The final rule, therefore, generally defines "compensation" as "anything of monetary value (for example, money, gifts, awards, and trips) . . . during the term of the arrangement" and requires the disclosure of both "direct" and "indirect" compensation. Direct compensation is defined as any compensation paid from the plan and indirect compensation as compensation received from any source other than the plan.[26]

Record keepers will be required to disclose the following information under bundled arrangements:

(1) A description of any compensation that will be charged against a plan investment, such as commissions, sales load, sales charges, deferred sales charges, redemption fees, surrender charges, exchange fees, and purchase fees, not included in the annual operating expenses of the investment;

(2) A description of the annual operating expenses (e.g. expense ratio) if the return is not fixed, and any ongoing expenses or, for designated investment alternative,[27] the total annual operating expenses expressed as a percentage; and

(3) For a designated investment alternative, any other information or data that is within the control of, or reasonably available to, the

26. 29 C.F.R. § 408b-2(c)(1)(viii)((A), (B)(1),(2) (2012).

27. Paragraph (c)(1)(viii)(C) defines a ''designated investment alternative'' as any investment alternative designated by a fiduciary into which participants and beneficiaries may direct the investment of assets held in, or contributed to, their individual accounts. The term ''designated investment alternative'' does not include brokerage windows, self-directed brokerage accounts, or similar plan arrangements that enable participants and beneficiaries to select investments beyond those specifically designated. This definition is consistent with the definition used by the Department for purposes of defining ''designated investment alternative'' in its proposed participant-level fee disclosure regulation. *See* Fiduciary Requirements for Disclosure in Participant-Directed Individual Account Plans*,* 73 Fed. Reg. 43,014, 43,015 (July 23, 2008) (contains proposed 29 C.F.R. § 2550.404a– 5(h)(1)).

> covered service provider and is required to be disclosed under the individual account plan disclosure regulations. [28]

The potential impact of the new rule is illustrated by the following: A broker presents to an employer two options for a 401(k) plan arrangement. The first option consists of separately provided services, offered by unrelated and independent service providers, including a custodian to hold plan assets, a recordkeeping and investment platform, third party administrator to allocate contributions to accounts and to perform various other administrative tasks for the Plan, and an investment manager. The total cost to the plan for these separately contracted services is $20,000 per year. The broker offers alternatively a "bundled arrangement" through a mutual fund complex with a menu of mutual fund investments, under which the services in the aggregate cost $15,000 per year. Under this later option, the service provider receives indirect compensation from the fund manager, making the total cost to the plan $25,000. Prior to the new rule, service providers were not required to disclose this indirect compensation. Therefore, the employer would not have known the true cost of the plan, unless it had been sufficiently sophisticated to ask for or understand it.

As illustrated by this example, indirect fees pose a significant challenge when it comes to understanding plan costs. Even with the disclosures required under the final rule, employers will be challenged to determine whether the disclosures given them are complete and to make sense of them in terms of their duty to acquire them for their plans at no more than reasonable cost.

VI. Disclosures That Are Deficient

A. Consequences and Challenges. Employers face two basic challenges when disclosures do not satisfy the new rule.

The First: Because Section 408(b)(2) of ERISA provides an exemption from the prohibited transaction rules that is conditioned in part on the adequacy of the disclosure, the deficiency results in a prohibited transaction. This means employer fiduciaries will have liability for the failure and there will be prohibited transaction excise tax consequences to the service provider. The responsible plan fiduciary, by causing the transaction, will have violated ERISA section 406(a)(1)(C) and (D). The service provider, as a ''disqualified person'' under the Internal Revenue Code's prohibited

28. 29 C.F.R. § 2550.408b-2(c)(1)(iv)(E) (2012).

transaction rules, will be subject to the excise taxes that result from the service provider's participation in a prohibited transaction under Section 4975 of the Code.

The Second: Fiduciaries are under a general obligation to act in the best interests of plan participants and beneficiaries and to follow a prudent process. If the service provider fails to disclose the information required by the final rule, the contract or arrangement will not be ''reasonable.'' If the disclosure does not meet the final rule requirement, the fiduciary will be hard pressed to convince anyone that his/her decision to engage a service provider, based on a determination of necessity and the reasonableness of the fee, involved a process that was prudent.

B. Fixing a Broken Disclosure. What actions must an employer take when it knows a disclosure is not compliant? Under a companion prohibited transaction class exemption to the rule,[29] steps are set forth, which if followed, will protect the employer.

If the employer discovers that the covered service provider failed to disclose the required information, a request must be made in writing to the service provider to furnish the information. If the service provider fails to provide the information within the 90-day period after the request, the employer must notify the Labor Department of the failure. This notice must be filed within 30 days after the expiration of the 90-day period and contain pertinent information required by the exemption.[30]

It is significant that the relief provided in the exemption is further conditioned on the employer, not knowing at the time of the disclosure that the service provider failed to provide the required disclosures, reasonably believed that the service provider disclosed the required information. The use of the words "reasonably believed" puts the burden squarely on the employer to read and understand the information provided or to seek competent and independent assistance if it is not capable of doing that itself. No one will be able to argue persuasively that they "reasonably believed" the information was sufficient in the absence of an effort to understand what is in the information provided by the service provider.

There are open questions about how the exemption will work in practice and how it will impact employers. Will smaller employers who typically rely on brokers and agents who are not independent for financial and plan advice

29. 29 C.F.R. § 408b-2(c)(1) (ix) (2012).

30. 29 C.F.R. § 408b-2(c)(1)(ix)(A), (B), (C), (D), (E) (2012).

be able to make determinations regarding the adequacy of the information delivered? The author's opinion is that many will not. And, if not, can independent assistance be provided to them at reasonable cost? Will there be impasses between employers and service providers over the adequacy of the disclosures? This is likely. What happens when the 90-day period passes with no resolution regarding the adequacy of a disclosure? The exemption tells the employer the "failure" must be reported to the Labor Department. Perhaps this gives leverage to employers against service providers who most certainly will not want a failure reported.

The exemption also requires the employer to determine whether to continue or terminate the arrangement, consistent with its general fiduciary responsibility to act prudently under ERISA, when the requested information is not provided within the 90-day period. When the requested information relates to the provision of *future* services, the exemption requires that the employer "*shall* terminate the contract or arrangement as expeditiously as possible, consistent with such duty of prudence."[31] There is now, therefore, a legal compulsion to terminate a relationship with a service provider if there is an unresolved and uncured failure to cure a disclosure failure.

VI. Implications for Fiduciary Behavior and Exposure to Liability

The costs of non-compliance are high for employers. For the first time, the final rule requires service providers to put comprehensive information before employers about their direct and indirect fees. An employer's duty is to evaluate that information and to make a determination about the reasonableness of the fees charged for the services provided. If that evaluation is not done or performed in a pro forma manner without proper diligence, employers may have liability for fees paid by the plan that are in excess of "reasonable" and may be required to make the plan whole for its losses.[32] This due diligence should include benchmarking against the fees of other service providers.[33] A fiduciary who breaches any of the responsibilities, obligations, or duties imposed on fiduciaries may be

31. 29 C.F.R. § 2550.408b-2(c)(1)(ix) (2012) (emphasis added).

32. 29 U.S.C. § 1109(a) (2012).

33. Although ERISA and related regulations do not explicitly require benchmarking, it is arguable that this is a best practice, especially with the reasonably priced benchmarking services available from independent parties that have become available in recent years.

personally liable to make good to the plan any such losses resulting from the breach. Civil actions could be brought for the breach by participants under Section 501(a)(2)[34] for appropriate relief under section 409(a) of ERISA.[35] This prospect is heightened by new participant fee disclosure rules that are likely to sensitize employees to the fees charged their accounts.[36] Those employers and their fiduciaries that do not take seriously the burdens associated with the final rule are likely to be caught up by it.

34. 29 U.S.C. § 1132 (2012).

35. 29 U.S.C. § 1109 (2012).

36. These rules go into effect generally effective September 1, 2012 and require employers to provide to plan participants information regarding the fees charged their accounts. *See* 29 U.S.C. § 1104(a)(5) (2012); 29 C.F.R. § 2550.404a-5 (2012).

WHAT IS A TIC WORTH?

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Tenants-in-common interests are passive real estate investments which are sold based on two claimed benefits: stable “cash on cash” returns and deferral of capital gains tax through 1031 exchanges. The “cash on cash” returns are found in financial projections in TIC offering documents. Using a stylized TIC cash flow projection based on our review of these materials, we show that TICs use aggressive assumptions to inflate the apparent returns to investors.

Projected cash flows must be discounted to determine whether a TIC investment is reasonably priced or not. A TIC’s projected cash flows should be subject to sensitivity analysis to determine the risk of unrealistic projections. This traditional risk-return analysis, as part of a reasonable basis suitability analysis, would have determined that TICs had expected returns which were insufficient to compensate for the risk of their leveraged investments in undiversified real estate and that the claimed tax deferral benefits were small compared to the mispricing in TIC offerings.

I. Introduction

Tenants-in-common agreements (TICs) are private placement real estate investments that can be sold to investors for the purpose of a 1031 exchange.[2] 1031 exchanges allow investors to defer taxes on a realized gain from the sale of a property if it is exchanged for a like-kind property within a short time period. TICs make it easier to match the value of a property sold with a replacement property by splitting up large properties into smaller units which could be purchased individually or in combination. TIC issuance increased

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2. See Internal Revenue Code, Title 26, Section 1031.

dramatically after 2002, when the IRS adopted Rev. Proc. 2002-22 "clarifying when acquisition of a tenant-in-common interest in real estate qualifies as replacement real estate under Section 1031."[3] The total amount of equity invested in TICs increased from $167 million in 2001 to $3.7 billion in 2006.[4]

TICs' fees and commissions are much larger than any possible tax deferral benefit from a 1031 exchange. TICs are not diversified; unlike traded real estate investment trusts (REITs) or real estate mutual funds which hold large portfolios of properties or related securities, TICs hold individual, or a few closely related, properties. TICs are almost completely illiquid. No public secondary market exists for TIC interests, and no issuer or other entity exists to redeem interests.[5]

FINRA March 2005 NTM 05-18 on TICs states

> if the offering document contains projections, members should understand the basis for those projections, and the degree of likelihood that they will occur. For example, members should determine whether any projected yields can reasonably be supported by the property operations.[6]

TICs' projected "cash on cash" returns are not really investment returns and can be easily manipulated by sponsors. The best way to detect such manipulation and determine whether a TIC investment is fairly priced is to calculate the net present value of the TIC's projected cash flows and to determine how sensitive the TIC's net present value is to changes in a few critical assumptions. We present a TIC financial model which captures the fundamental economics of a TIC and allows for the systematic analysis of TIC financial projections.[7]

3. (Whitman, 2007)

4. (Flamm, 2007)

5. Discussions of the legal structure and implications of TIC agreements can be found in (Pederson, 2005), (Berkeley, 2006), (Whitman, 2007), and (Borden B. T., 2009).

6. (FINRA, 2005), page 5.

7. A version of our model is available in Excel format for free at *www.slcg.com/free_tools.php.*

II. A TIC's Projected Cash Flows Can be Valued

a. Base case projections

Table 1 presents our stylized TIC cash flow model. The top of the table lists assumptions. The middle section, ending with the "cash on cash" returns, corresponds to the financial projections found in TIC offering documents. In our example, the TIC sponsor purchases property for $51.4 million and charges $6.9 million in upfront fees and reserves for a "fully loaded" purchase price of $58.2 million. $20.5 million is raised through the sale of TIC interests to investors and $37.7 million is obtained through a mortgage. The property has $3.4 million in base rent in the first year, increasing by 5% every year.[8] The vacancy rate is 5%. Expenses are 8% of base rental income, and the interest rate on the mortgage is 6.1%.[9,10] The sale of the property is assumed to occur in 10 years at a capitalization ('cap') rate of 7% and will incur 5% in broker fees. We also assume $2.1 million in mezzanine borrowing is available over the life of the TIC and is repaid upon sale of the property.

Operating expenses are subtracted from gross revenue to yield net operating income (NOI). Operating expenses include ongoing costs related to the property, such as landscaping, lighting and heating, etc., and may be reimbursed to some degree by tenants. Principal and interest payments on the

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8. This is a simplifying assumption. Annual market rent increases are not typically reflected immediately in TIC rental revenues, as they can only be realized when current lease contracts expire. TIC sponsors calculate base rental income from current lease terms and expirations by making assumptions about when current leases will expire and require re-leasing. Some TICs calculate this turnover vacancy explicitly and subtract it from base rental income to calculate gross revenue. Another approach, sometimes used in addition to turnover vacancy, is to assume a general vacancy as a fixed percentage of rental income.

9. Modeling expenses as a fixed percent of base rent is also a simplifying assumption. Expenses as modeled here are also different than the explicit modeling of operating expenses that sometime appear in TIC projections. Our expenses are effectively operating, leasing, or tenant improvement costs that are net of tenant reimbursements but are eligible to be paid by drawing from reserves.

10. In our base case, we assume a 30 year mortgage wherein the first five years are interest-only, and then amortized over a 30 year period (such that there is a balance due at the end of the mortgage term). We have seen this arrangement multiple times in TICs and its implications are discussed below.

mortgage are subtracted from NOI and any transfers from the reserve accounts are added to determine distributions or net cash flow to investors. Distributions to investors are divided by the total amount of investors' contributed capital to determine "cash on cash" returns, which are not really investment returns since in early years these distributions typically include a return of the investors' capital.

TIC sponsors project the sale price for the property held in the TIC based on a cap rate (7% in our example), and calculate the resulting cash flows to investors at that time ($24.7 million in our example). The sum of all annual cash flows plus the final net proceeds resulting from the sale of the property equals the total cash inflows in the deal ($40.1 million in our example). The projected distributions in excess of the investors' contributed capital divided by the investors' contributed capital further divided by the number of years covered by the projection arrives at the average annual "cash on cash" return (9.5% in our example) often quoted by TIC offering documents.

b. Cash flows must be discounted to determine value

TIC projections are misleading and the "cash on cash" returns deserve special skepticism. The cash on cash returns highlighted by TIC marketing materials are not a direct reflection of the operating income from the property, but are easily manipulated distribution rates. They often include a return of investors' contributed capital and so are not investment returns as that term is typically used. As discussed below, 'yield enhancements' such as reserves and mezzanine financing redistribute cash flows from one period to another. A TIC sponsor could use these levers to increase or smooth apparent cash on cash returns.

Sponsors' financial projections to do not discount cash flows to reflect the time value of money or the riskiness of the investment. This step is critical to know whether the projected cash flows are sufficient to warrant the amount paid by investors. This is the same basic analysis required to determine whether a bond that pays a 10-year, 5% coupon is fairly priced or not. The projected coupon and maturity payments are discounted to the present at a discount rate which reflects the riskiness of those cash flows the resulting present value is compared to the asking price of the bond. A TIC's projected cash distributions and net property sale proceeds are very similar to the coupon and maturity payments from a bond and are discounted in exactly the same way.

Since the TIC financial models project cash distributions to equity investors, the correct discount rate to apply to determine the net present value is the cost of equity which is equal to the risk free interest rate plus the levered beta multiplied by the equity risk premium. The levered beta takes into account the underlying real estate investments covariance with the market portfolio and the amount of leverage used in the TIC.[11,12]

$$\begin{aligned} \mathit{Cost\ of\ Equity} \\ &= \mathit{Riskfree\ Rate} + \mathit{Levered\ Beta} \\ &\quad * \mathit{Equity\ Risk\ Premium} \end{aligned}$$

$$\mathit{Levered\ Beta} = \mathit{Unlevered\ Beta} * \left(1 + \left(\frac{\mathit{Debt}}{\mathit{Equity}}\right)\right)$$

We assume the risk free rate of interest is 4.66%, the equity risk premium is 6%, and the unlevered beta is 0.5.[13] Given these assumptions and the debt to equity ratio in our example TIC, the cost of equity is 13.2%. Using this discount rate, the resulting discounted cash flows are shown in the lower panel of Table 1. The sum of the discounted cash flows minus the contributed capital is the net present value, and reflects the value of the TIC. Despite the stylized TIC's reported 9.5% average annual "cash on cash" returns, the discounted present value is -$5,746,324.[14]

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11. These formulas are generally applicable to discounting any investment's future cash flows and can be found in most introductory corporate finance or investments textbook. They are applicable specifically to discounting cash flows from real estate investments. See (Corgel & Djoganopoulos, 2000), (Damodaran, 2001), and (Gyourko & Nelling). Analysts publish discount rates for particular real estate markets and submarkets. The discount rates reported by many market sources only reflect the appropriate discount rate on an all-equity transaction. If the property is purchased with debt (that is, with leverage), the discount rate should be adjusted higher.

12. We do not adjust the debt to equity ratio for any tax shield that may arise due to the debt financing because TICs do not pay entity tax. If we adjust the debt to equity ratio for a tax shield assuming a 35% entity tax rate, the cost of equity described below would change from 13.2% to 11.2%. For a description of these alternative methods see (Pratt & Grabowski, 2010), chapter 11.

13. The risk-free rate is the 2007 total return on US Treasury Bills presented on page 203 of (Ibbotson 2011).

14. We do not include any modification to the discount rate to reflect any small-firm premium, liquidity premium, or any other additional risks that may be present in the TIC. As all of these adjustments would increase the discount rate, and therefore

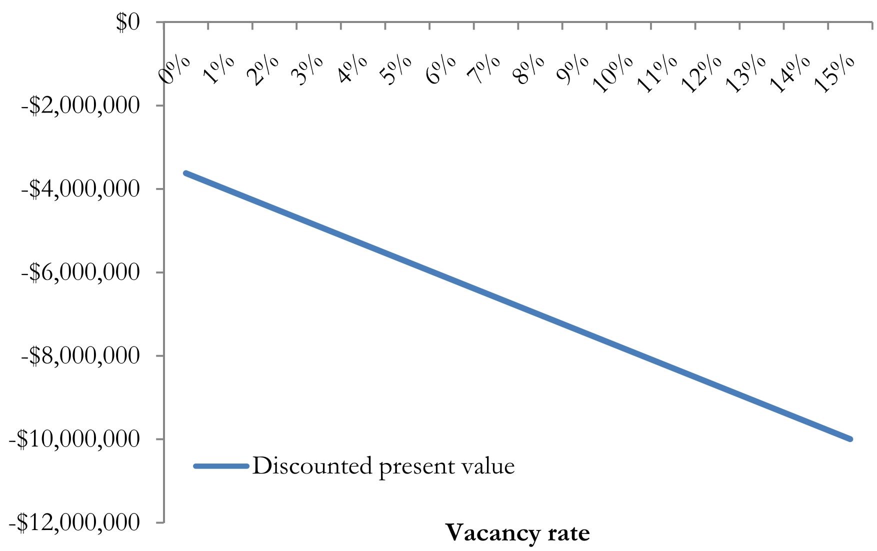
III. Unreasonable assumptions inflate the apparent value of a TIC

a. Vacancy rates

TICs use aggressive vacancy assumptions, increasing effective gross income, net operating income, and cash available to investors. Using more realistic vacancy rates lowers net operating income, lowers total distributions to investors, lowers the anticipated sale price of the property at maturity and reduces the net present value of the TIC.[15]

For example, changing our base case scenario's general vacancy from 5% to 10% lowers the net present value of TIC to -$7,871,083. The resulting cash flows are shown in Table 2. The effect of systematically changing vacancy rates on the discounted value of the TIC is shown in Figure 1.

Figure 1: Effect of vacancy rate on net present value



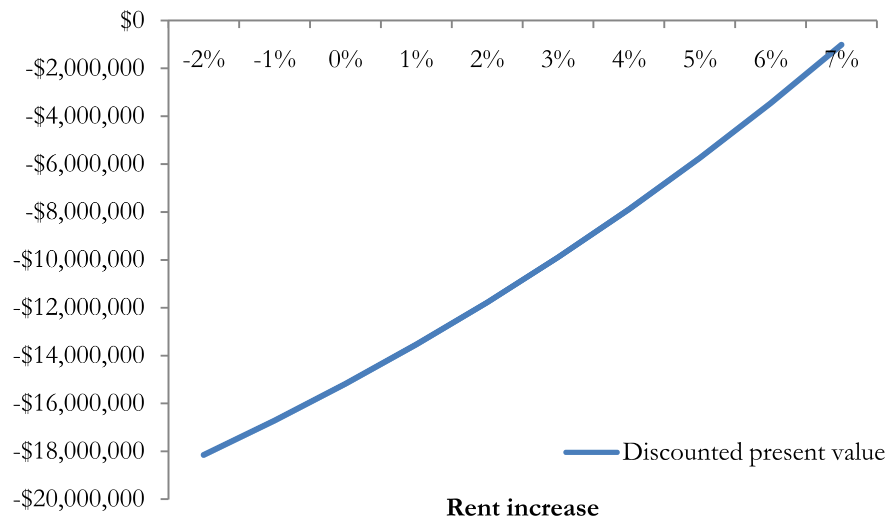
lower the net present value calculated here, we consider this a conservative assumption.

15. For a discussion of the use of discounted cash flow analysis for real estate projections see (Kolbe & Greer, 2009), Chapter 13 and (Brown, 2012), Chapter 4.

b. Market rent increases

TIC sponsors also sometimes project more rapid growth in base rents than general market conditions support. Our base case projection used a 5% annual growth in base rents. Reducing the base rent growth rate from 5% to 3% holding the other base case assumptions constant lowers the net present value to -$9,898,509. See Table 3. The effect of varying the market rent increase rate on the net present value of our base case TIC is shown in Figure 2.

Figure 2: Effect of rent increase rate on net present value



c. Capitalization ("Cap") rate

TICs calculate an expected sale price by projecting future NOI to the date of the sale, then assume that the market value of the property will equal 1 divided by an assumed cap rate multiplied by the terminal NOI:

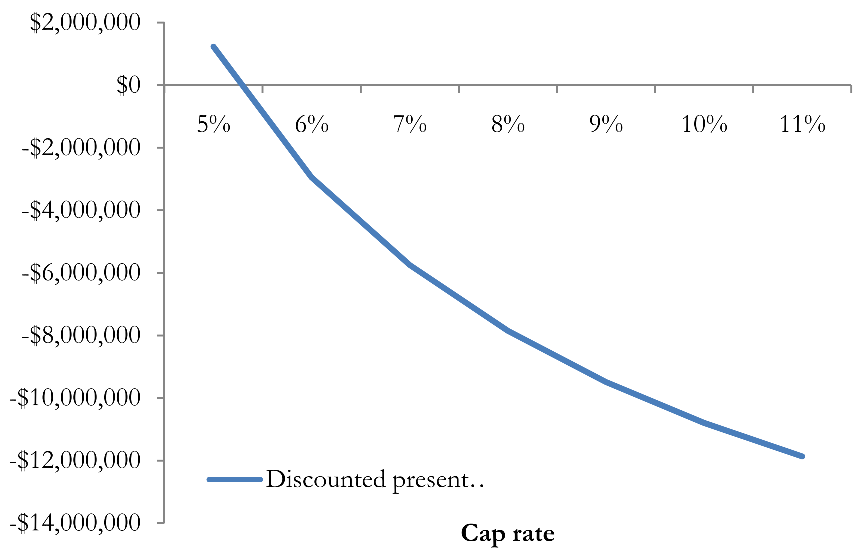
$$Value = \frac{1}{Cap\ Rate} \times NOI$$

A cap rate is a simple rule of thumb, closely related to price-to-earnings ratios with which an analyst will calculate the value of a business based on projections of its future earnings and assuming the market value of the property or business will be a fixed multiple future earnings. A higher cap rate implies a lower "price earnings" ratio and therefore a lower market value for the TIC for any given level of projected earnings.

TIC offering documents often include calculations showing the effect of different assumed cap rates. For example, a TIC may show five potential outcomes assuming cap rates of 6.5%, 6.75%, 7.0%, 7.25%, and 7.5%. This range may not reflect the going cap rate in the local market—cap rates in 2007 were as high as 11% in some markets. In contrast, the TICs we have seen often purchase their properties at very low cap rates, suggesting they overpaid for a given amount of NOI.

Table 4 demonstrates the impact on our base case of changing the assumed cap rate at sale from 7% to 8%. This decreases the projected sale price (because the NOI has not changed), and lowers the proceeds from sale. This one modest change alone causes the net present value of the TIC to fall to -$7,849,025. The effect of varying the cap rate is shown in Figure 3.

Figure 3: Effect of cap rate on cash flows and present value



Because the cap rate method relies only on an assumed cap rate and the NOI of the final year of the projection, the resulting terminal sales price is critically dependent on projected conditions in that final year. For example, if vacancies are anticipated to be particularly high in that year, the NOI could be depressed leading to a lower anticipated sales price. Similarly, any assumptions that bias the final year NOI higher would inflate the terminal sales price and the terminal cash flow to investors.

The cumulative effect of the example changes in assumptions described above is very large. Table 5 shows that changing the market rent increase, the vacancy rate, and the cap rate to values that may more accurately reflect market values reduces the net present value of the TIC to -$13,453,489, or -65% of the investors' contributed capital.

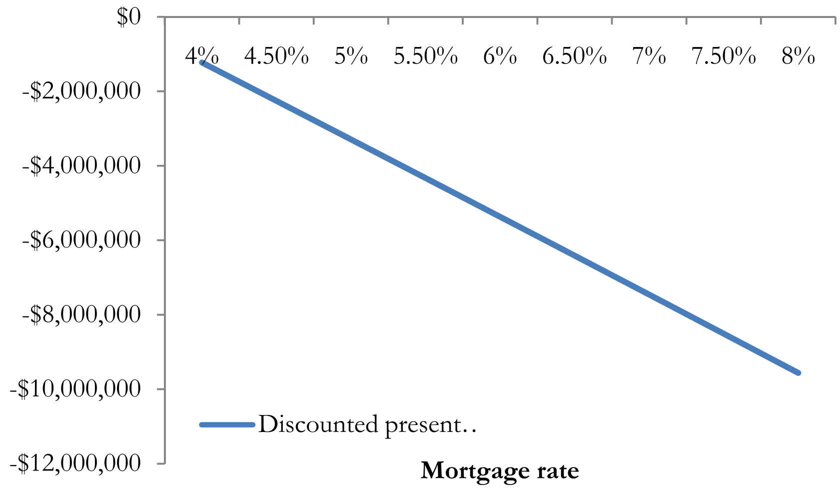
IV. Financing terms and reserve accounts can increase reported "cash on cash" returns while reducing investment value

a. Mortgage features have a significant impact on net present value.

Many TICs use interest-only financing for the early years of the mortgage, thereby lowering mortgage payments in early years, increasing payments in later years, and leaving a larger mortgage balance to be repaid when the property is eventually sold. In our base case, if instead of a 30 year fixed rate, 5 year interest-only mortgage the TIC obtains a 30-year fixed rate fully amortizing mortgage, the present value of the TIC is reduced to -$6,237,129.

The effect of switching to a fully amortizing mortgage is to reduce cash on cash returns in early years, but increase them in later years. Of course, the mortgage rate itself greatly affects cash on cash returns and the net present value of the deal. While this rate may not be a factor the TIC sponsor directly controls, sponsors sometimes obtain interest-rate buydowns or other loan modifications that affect the effective rates in certain periods. The sensitivity of the TIC's net present value to changes in mortgage rates is shown in Figure 4.

Figure 4: Effect of mortgage rate on cash flows and present value



Mezzanine funding is available borrowing used by many TIC to fund expenses after the reserve accounts have been depleted. This borrowing effectively increases later-year cash on cash returns and increases the mortgage balance that must be paid off at maturity. Mezzanine funding is usually reported below NOI, and therefore does not affect the terminal value of the property.

b. Leverage increases fees and lowers net present value

If a TIC purchased a property that cost only the amount of investors' contributed capital minus the upfront fees and reserves, this 'unlevered' property would generate less rental income but would have no mortgage payments and no mortgage balance to eventually pay off. The fees and commissions on such an unlevered deal would be lower, because many fees are a percentage of initial purchase price and ultimate sale price of the property. This would of course generate less revenue for the sponsor (and none for the lender), but would improve the net present value of the deal for investors.

We can model such a deal by eliminating the mortgage and proportionally reducing the purchase price, upfront fees and reserves, and first year rent of our property such that the investors' contributed capital of $20.5 million is the sole source of capital for the deal. The resulting purchase price is $18.1 million, with $2.4 million in upfront fees and reserves, the first year rent is reduced to $1.2 million, and the mezzanine draw is reduced to $746,473 (each factor is reduced by approximately 35%).[16] Because the property is unlevered, the discount rate adjusts to 7.7%, reflecting a smaller market exposure. Using the assumptions presented in Table 1 and the modified discount rate, the resulting net present value increases from -$5,746,324 with the mortgage to -$1,033,032 without the mortgage. These results suggest that the leverage embedded in TIC deals primarily benefits the sponsor at the expense of the investors.

c. Reserves smooth cash on cash returns and lower net present value

Reserve accounts set aside some of the investors' contributed capital or proceeds from borrowing to pay for anticipated future expenses such as leasing commissions, tenant improvements, and capital expenditures.[17] Reserves may be required by the lender, and are often given separate accounts. Reserves increase the amount of investors' contributed capital and pay that money back into the TIC at a later date.

Reserves reduce expenses in early years (before the reserves run out) and thereby 'smooth' cash on cash returns over the life of the TIC. However, in a discounted cash flow context, the effect is to reduce the TIC's net present value. In our model, we created a $3.2 million reserve account and used it to pay down expenses each year. We credited the balance of the reserve account with 3% annually, as is common in most TIC projections, to reflect the interest rate on a money-market or similar account.[18] If we reduce the TIC reserves to zero, the amount of investors' contributed capital decreases by $3.1 million, the expenses increase in early years, and the cash on cash

16. The fee reduction may actually be larger in some deals which have substantial lender fees—if there were no mortgage, the sponsor's fees would be reduced proportionally, but the lender fees would not be paid at all. There might also be no reserves in such a deal, as many reserves are required by the lender. However, we preserve these features as conservative simplifications.

17. Usually not operating expenses, especially not those reimbursable by tenants.

18. If this rate were equal to the discount rate of the TIC (13.2% in our base case), the effect would be the same on discounted and undiscounted cash flows. However, if the reserve account earned 13.2%, it would presumably be as risky as the TIC itself.

returns are reduced but the TICs net present value increases from -$5,746,324 to -$5,347,559. This is a simple illustration of how "cash on cash" returns are not really returns and can be easily manipulated to mislead investors.

V. TIC fees and commissions outweigh tax benefits

a. TICs are saddled with high fees and commissions

The fees and commissions in a TIC agreement tend to be extremely high—in our experience, upfront fees of 15% or more of investors' contributed capital is common. In its Notice to Members, FINRA highlights that these fees could be larger than the value of the tax deferral benefit:

> … a member must also consider whether the fees and expenses associated with TIC transactions outweigh the potential tax benefits to the customer. TICs structured with high up-front fees and expenses paid to the sponsor and/or salespersons of the selling broker-dealers raise particular concerns about the ability to make a suitable recommendation.[19]

TIC fees go by different names and are distributed amongst the sponsor, the property manager (often an affiliate of the sponsor), the broker-dealers (also potentially affiliated), and the lender. Selling commissions are often the largest single expense, accounting for approximately 6-8% of investors' contributed capital. Other offering and organization fees include due diligence allowances, placement fees, marketing expenses, etc. In addition, there are often fees related to the purchase of the property, such as lender fees, loan origination fees, closing costs, and promotional fees.

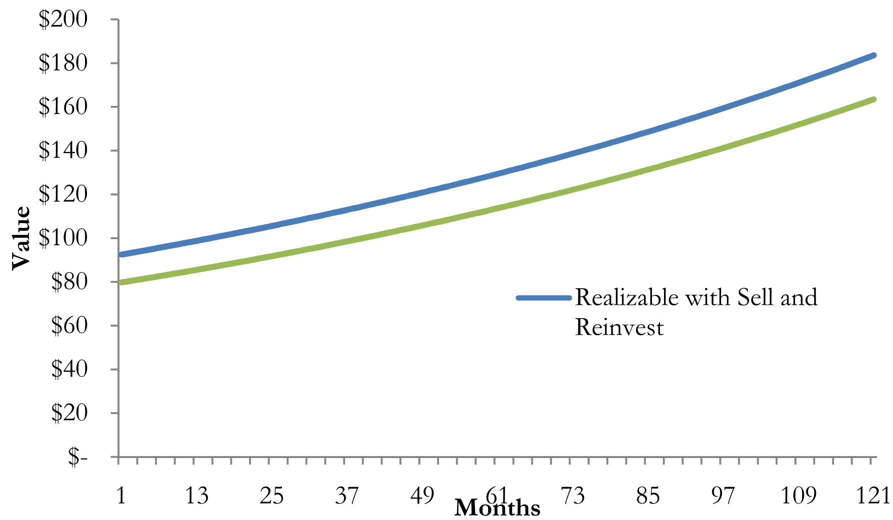
The property manager receives an ongoing fee for running the day-to-day operations of the property. This fee is typically 2-3% per year and is included in the projected schedule of fees. Property managers also often receive a commission on the sale of a property, which is a fraction not of the investors' contributed capital but the sale price of the property. Therefore, sponsors and their affiliates achieve revenues from the sale of the TIC, its management, and its termination.

19. (FINRA, 2005), page 4.

b. Fees and commissions reduce the benefit of a 1031 exchange over a fully taxable sale.

The tax implications of 1031 exchanges have been discussed thoroughly in the academic literature.[20] Briefly, in Figure 5 we contrast a 1031 exchange with a fully taxable sale of $0 cost basis property for $100 and immediate purchase a new investment property. If the investor sells and pays 15% capital gains taxes she will have $85 to reinvest in property with a total return of 8% per year. After 10 years, the property value has increased to $183.51 and 15% capital gains taxes are paid on the $98.51 increase in value from the $85 cost basis, leaving the investor with $168.73 after taxes.[21]

Figure 5: Sale-and-purchase strategy is superior to TIC with 15% fees



If the investor buys a TIC with 15% in upfront fees, the $100 paid for the TIC buys $85 worth of property which then grows at 8%.[22] After 10 years,

20. See especially (Ling & Petrova, 2008).

21. The capital gains tax rate has increased to 20% as of January 2013. We use 15% in our example because many TICs currently under dispute were sold to investors from 2006-2008.

22. We conservatively assume that the TIC's property with the same returns after all fees and expenses that transparent real estate investments earn - unlikely given the high costs and conflicts of interest in TICs.

the TIC property has grown in value to $183.51 but the cost basis is $0, not $85 and so the investor pays $27.53 in taxes and is left with only $155.98 compared to the $168.73 after tax value outside the TIC.

In this example, a fully taxable sale and subsequent reinvestment in a property is superior to a TIC investment.[23] If the cost basis is $0 ($25, $50) TIC fees would have to be less than 8% (6%, 4%) in our example for the after tax value of the TIC after 10 years to exceed the after tax value of a simple sale and reinvestment.

VI. Conclusion

In this paper, we have constructed a TIC model based on cash flow projections found in actual TIC agreements. We used this model to demonstrate the effect of changing critical parameters on the TIC's net present value. We have found that most TICs used aggressive assumptions and that more reasonable market rates drastically reduce the already poor undisclosed value of TIC interests. Many features of TIC projections appear to reduce the net present value of the deal for the sake of making their "cash on cash" returns appear greater and less volatile than their actual operating income would suggest. We also find that most, if not all, of the potential tax deferral benefits are too small to warrant the high costs of the inefficient TIC structures.

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23. We could add some complexity to this example. For instance we could include taxation of periodic distributions at ordinary income tax rates and incorporate annual depreciation expense and depreciation recapture at sale but the basic economics of our example would remain. The tax deferral benefit of a TIC is only a benefit if the TIC's fees are lower than we observe in the market place.

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Table 1: TIC Base case projected cash flows of $40,109,263 are worth only $14,803,676 when discounted to the present, or $5,746,324 less than the $20,550,000 investors pay for this TIC.

Features and Assumptions

Property Purchase		Rent and Expenses		Capital Sources		Property Sale		Discount Rate	
Purchase price	$51,357,000	Base rent	$3,400,000	Equity	$20,550,000	Years to sale	10	Debt	**65%**
Upfront fees	$3,708,000	Annual increase	5.0%	Mortgage	$37,690,000	Cap rate at sale	7.0%	Equity	**35%**
Reserves	$3,175,000	Vacancy rate	5.0%	Interest rate	6.1%	Fees on sale	6%	Risk-free rate	4.66%
Fully loaded price	**$58,240,000**	Expenses	8.0%	Interest-only period	5	Final year NOI	**$4,588,829**	Risk premium	6.00%
		Mezzanine draw	$2,115,553			Projected sale	**$65,554,698**	Unlevered beta	0.50
								Discount rate	**13.2%**

Projections

Year	1	2	3	4	5	6	7	8	9	10
Base rent	$3,400,000	$3,570,000	$3,748,500	$3,935,925	$4,132,721	$4,339,357	$4,556,325	$4,784,141	$5,023,349	$5,274,516
Vacancy	$170,000	$178,500	$187,425	$196,796	$206,636	$216,968	$227,816	$239,207	$251,167	$263,726
Gross revenue	**$3,230,000**	**$3,391,500**	**$3,561,075**	**$3,739,129**	**$3,926,085**	**$4,122,389**	**$4,328,509**	**$4,544,934**	**$4,772,181**	**$5,010,790**
Expenses	$272,000	$285,600	$299,880	$314,874	$330,618	$347,149	$364,506	$382,731	$401,868	$421,961
Net operating income	**$2,958,000**	**$3,105,900**	**$3,261,195**	**$3,424,255**	**$3,595,467**	**$3,775,241**	**$3,964,003**	**$4,162,203**	**$4,370,313**	**$4,588,829**
Mortgage P&I payments	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,738,895	$2,738,895	$2,738,895	$2,738,895	$2,738,895
Payments from reserves	$272,000	$285,600	$299,880	$314,874	$330,618	$347,149	$364,506	$382,731	$401,868	$421,961
Cash distributions to investors	**$933,360**	**$1,094,860**	**$1,264,435**	**$1,442,489**	**$1,629,445**	**$1,383,495**	**$1,589,614**	**$1,806,040**	**$2,033,286**	**$2,271,896**
Cash-on-cash returns	4.5%	5.3%	6.2%	7.0%	7.9%	6.7%	7.7%	8.8%	9.9%	11.1%
Reserve balance	$3,175,000	$2,990,090	$2,785,625	$2,560,317	$2,312,806	$2,041,654	$1,745,341	$1,422,260	$1,070,714	$688,912
Present value of cash flows	$824,798	$909,508	$928,203	$935,745	$934,079	$700,842	$711,595	$714,442	$710,783	$701,820

Proceeds from Property Sale

Projected sale price	$65,554,698
Fees on sale	$3,933,282
Reserve balance	$266,951
Mortgage loan balance	$37,228,023
Net proceeds from property sale	$24,660,344
Discounted proceeds from sale	$6,731,859

Return on Capital

	Undiscounted	Discounted
Cash flow over 10 years	$15,448,919	$8,071,817
Proceeds from property sale	$24,660,344	$6,731,859
Total projected cash flows	$40,109,263	**$14,803,676**
Investor's contributed capital	-$20,550,000	-$20,550,000
Return on capital	$19,559,263	**-$5,746,324**

Table 2: Reasonable vacancy rates further lower the net present value. In this case, increasing the vacancy rate from 5% to 10% reduces the net present value to -$7,871,083.

Features and Assumptions

Property Purchase		Rent and Expenses		Capital Sources		Property Sale		Discount Rate	
Purchase price	$51,357,000	Base rent	$3,400,000	Equity	$20,550,000	Years to sale	10	Debt	**65%**
Upfront fees	$3,708,000	Annual increase	5.0%	Mortgage	$37,690,000	Cap rate at sale	7.0%	Equity	**35%**
Reserves	$3,175,000	Vacancy rate	10.0%	Interest rate	6.1%	Fees on sale	6%	Risk-free rate	4.66%
Fully loaded price	**$58,240,000**	Expenses	8.0%	Interest-only period	5	Final year NOI	**$4,325,103**	Risk premium	6.00%
		Mezzanine draw	$2,115,553			Projected sale	**$61,787,187**	Unlevered beta	0.50
								Discount rate	**13.2%**

Projections

Year	1	2	3	4	5	6	7	8	9	10
Base rent	$3,400,000	$3,570,000	$3,748,500	$3,935,925	$4,132,721	$4,339,357	$4,556,325	$4,784,141	$5,023,349	$5,274,516
Vacancy	$340,000	$357,000	$374,850	$393,593	$413,272	$433,936	$455,633	$478,414	$502,335	$527,452
Gross revenue	**$3,060,000**	**$3,213,000**	**$3,373,650**	**$3,542,333**	**$3,719,449**	**$3,905,422**	**$4,100,693**	**$4,305,727**	**$4,521,014**	**$4,747,064**
Expenses	$272,000	$285,600	$299,880	$314,874	$330,618	$347,149	$364,506	$382,731	$401,868	$421,961
Net operating income	**$2,788,000**	**$2,927,400**	**$3,073,770**	**$3,227,459**	**$3,388,831**	**$3,558,273**	**$3,736,187**	**$3,922,996**	**$4,119,146**	**$4,325,103**
Mortgage P&I payments	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,738,895	$2,738,895	$2,738,895	$2,738,895	$2,738,895
Payments from reserves	$272,000	$285,600	$299,880	$314,874	$330,618	$347,149	$364,506	$382,731	$401,868	$421,961
Cash distributions to investors	**$763,360**	**$916,360**	**$1,077,010**	**$1,245,692**	**$1,422,809**	**$1,166,527**	**$1,361,798**	**$1,566,833**	**$1,782,119**	**$2,008,170**
Cash-on-cash returns	3.7%	4.5%	5.2%	6.1%	6.9%	5.7%	6.6%	7.6%	8.7%	9.8%
Reserve balance	$3,175,000	$2,990,090	$2,785,625	$2,560,317	$2,312,806	$2,041,654	$1,745,341	$1,422,260	$1,070,714	$688,912
Present value of cash flows	$674,571	$761,227	$790,617	$808,083	$815,625	$590,932	$609,613	$619,816	$622,982	$620,351

Proceeds from Property Sale

Projected sale price	$61,787,187
Fees on sale	$3,707,231
Reserve balance	$266,951
Mortgage loan balance	$37,228,023
Net proceeds from property sale	$21,118,883
Discounted proceeds from sale	$5,765,100

Return on Capital

	Undiscounted	Discounted
Cash flow over 10 years	$13,310,677	$6,913,817
Proceeds from property sale	$21,118,883	$5,765,100
Total projected cash flows	$34,429,561	**$12,678,917**
Investor's contributed capital	-$20,550,000	-$20,550,000
Return on capital	$13,879,561	**-$7,871,083**

Table 3: Reasonable assumed rent increases also further lowers the net present value. Reducing the increase in rents from 5% to 3%, but keeping the vacancy at only 5%, reduces the net present value to -$9,898,509.

Features and Assumptions

Property Purchase		Rent and Expenses		Capital Sources		Property Sale		Discount Rate	
Purchase price	$51,357,000	Base rent	$3,400,000	Equity	$20,550,000	Years to sale	10	Debt	**65%**
Upfront fees	$3,708,000	Annual increase	3.0%	Mortgage	$37,690,000	Cap rate at sale	7.0%	Equity	**35%**
Reserves	$3,175,000	Vacancy rate	5.0%	Interest rate	6.1%	Fees on sale	6%	Risk-free rate	4.66%
Fully loaded price	**$58,240,000**	Expenses	8.0%	Interest-only period	5	Final year NOI	**$3,859,519**	Risk premium	6.00%
		Mezzanine draw	$2,115,553			Projected sale	**$55,135,987**	Unlevered beta	0.50
								Discount rate	**13.2%**

Projections

Year	1	2	3	4	5	6	7	8	9	10
Base rent	$3,400,000	$3,502,000	$3,607,060	$3,715,272	$3,826,730	$3,941,532	$4,059,778	$4,181,571	$4,307,018	$4,436,229
Vacancy	$170,000	$175,100	$180,353	$185,764	$191,336	$197,077	$202,989	$209,079	$215,351	$221,811
Gross revenue	**$3,230,000**	**$3,326,900**	**$3,426,707**	**$3,529,508**	**$3,635,393**	**$3,744,455**	**$3,856,789**	**$3,972,493**	**$4,091,667**	**$4,214,417**
Expenses	$272,000	$280,160	$288,565	$297,222	$306,138	$315,323	$324,782	$334,526	$344,561	$354,898
Net operating income	**$2,958,000**	**$3,046,740**	**$3,138,142**	**$3,232,286**	**$3,329,255**	**$3,429,133**	**$3,532,007**	**$3,637,967**	**$3,747,106**	**$3,859,519**
Mortgage P&I payments	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,738,895	$2,738,895	$2,738,895	$2,738,895	$2,738,895
Payments from reserves	$272,000	$280,160	$288,565	$297,222	$306,138	$315,323	$324,782	$334,526	$344,561	$354,898
Cash distributions to investors	**$933,360**	**$1,030,260**	**$1,130,067**	**$1,232,868**	**$1,338,753**	**$1,005,561**	**$1,117,894**	**$1,233,598**	**$1,352,773**	**$1,475,523**
Cash-on-cash returns	4.5%	5.0%	5.5%	6.0%	6.5%	4.9%	5.4%	6.0%	6.6%	7.2%
Reserve balance	$3,175,000	$2,990,090	$2,791,228	$2,577,743	$2,348,937	$2,104,082	$1,842,423	$1,563,170	$1,265,503	$948,570
Present value of cash flows	$824,798	$855,844	$829,566	$799,764	$767,440	$509,391	$500,428	$487,993	$472,894	$455,809

Proceeds from Property Sale

Projected sale price	$55,135,987
Fees on sale	$3,308,159
Reserve balance	$593,672
Mortgage loan balance	$37,228,023
Net proceeds from property sale	$15,193,477
Discounted proceeds from sale	$4,147,564

Return on Capital

	Undiscounted	Discounted
Cash flow over 10 years	$11,850,656	$6,503,927
Proceeds from property sale	$15,193,477	$4,147,564
Total projected cash flows	$27,044,133	**$10,651,491**
Investor's contributed capital	-$20,550,000	-$20,550,000
Return on capital	$6,494,133	**-$9,898,509**

Table 4: Higher cap rate lowers net present value. Assuming a cap rate of 8% rather than 7%, and using base case values for all other parameters, lowers the net present value to -$7,849,025.

Features and Assumptions

Property Purchase		Rent and Expenses		Capital Sources		Property Sale		Discount Rate	
Purchase price	$51,357,000	Base rent	$3,400,000	Equity	$20,550,000	Years to sale	10	Debt	**65%**
Upfront fees	$3,708,000	Annual increase	5.0%	Mortgage	$37,690,000	Cap rate at sale	8.0%	Equity	**35%**
Reserves	$3,175,000	Vacancy rate	5.0%	Interest rate	6.1%	Fees on sale	6%	Risk-free rate	4.66%
Fully loaded price	**$58,240,000**	Expenses	8.0%	Interest-only period	5	Final year NOI	**$4,588,829**	Risk premium	6.00%
		Mezzanine draw	$2,115,553			Projected sale	**$57,360,361**	Unlevered beta	0.50
								Discount rate	**13.2%**

Projections

Year	1	2	3	4	5	6	7	8	9	10
Base rent	$3,400,000	$3,570,000	$3,748,500	$3,935,925	$4,132,721	$4,339,357	$4,556,325	$4,784,141	$5,023,349	$5,274,516
Vacancy	$170,000	$178,500	$187,425	$196,796	$206,636	$216,968	$227,816	$239,207	$251,167	$263,726
Gross revenue	**$3,230,000**	**$3,391,500**	**$3,561,075**	**$3,739,129**	**$3,926,085**	**$4,122,389**	**$4,328,509**	**$4,544,934**	**$4,772,181**	**$5,010,790**
Expenses	$272,000	$285,600	$299,880	$314,874	$330,618	$347,149	$364,506	$382,731	$401,868	$421,961
Net operating income	**$2,958,000**	**$3,105,900**	**$3,261,195**	**$3,424,255**	**$3,595,467**	**$3,775,241**	**$3,964,003**	**$4,162,203**	**$4,370,313**	**$4,588,829**
Mortgage P&I payments	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,738,895	$2,738,895	$2,738,895	$2,738,895	$2,738,895
Payments from reserves	$272,000	$285,600	$299,880	$314,874	$330,618	$347,149	$364,506	$382,731	$401,868	$421,961
Cash distributions to investors	**$933,360**	**$1,094,860**	**$1,264,435**	**$1,442,489**	**$1,629,445**	**$1,383,495**	**$1,589,614**	**$1,806,040**	**$2,033,286**	**$2,271,896**
Cash-on-cash returns	4.5%	5.3%	6.2%	7.0%	7.9%	6.7%	7.7%	8.8%	9.9%	11.1%
Reserve balance	$3,175,000	$2,990,090	$2,785,625	$2,560,317	$2,312,806	$2,041,654	$1,745,341	$1,422,260	$1,070,714	$688,912
Present value of cash flows	$824,798	$909,508	$928,203	$935,745	$934,079	$700,842	$711,595	$714,442	$710,783	$701,820

Proceeds from Property Sale

Projected sale price	$57,360,361
Fees on sale	$3,441,622
Reserve balance	$266,951
Mortgage loan balance	$37,228,023
Net proceeds from property sale	$16,957,667
Discounted proceeds from sale	$4,629,158

Return on Capital

	Undiscounted	Discounted
Cash flow over 10 years	$15,448,919	$8,071,817
Proceeds from property sale	$16,957,667	$4,629,158
Total projected cash flows	$32,406,586	**$12,700,975**
Investor's contributed capital	-$20,550,000	-$20,550,000
Return on capital	$11,856,586	**-$7,849,025**

Table 5: Reasonable assumptions drastically lower net present value. The combined effect of reasonable vacancy rates, rent increases, and cap rates reduces the value of the TIC interests to - $13,453,976. Investors would be paying $20,550,000 for a TIC interest which is only worth $7,096,024.

Features and Assumptions

Property Purchase		Rent and Expenses		Capital Sources		Property Sale		Discount Rate	
Purchase price	$51,357,000	Base rent	$3,400,000	Equity	$20,550,000	Years to sale	10	Debt	**65%**
Upfront fees	$3,708,000	Annual increase	3.0%	Mortgage	$37,690,000	Cap rate at sale	8.0%	Equity	**35%**
Reserves	$3,175,000	Vacancy rate	10.0%	Interest rate	6.1%	Fees on sale	6%	Risk-free rate	4.66%
Fully loaded price	**$58,240,000**	Expenses	8.0%	Interest-only period	5	Final year NOI	**$3,637,708**	Risk premium	6.00%
		Mezzanine draw	$2,115,553			Projected sale	**$45,471,345**	Unlevered beta	0.50
								Discount rate	**13.2%**

Projections

Year	1	2	3	4	5	6	7	8	9	10
Base rent	$3,400,000	$3,502,000	$3,607,060	$3,715,272	$3,826,730	$3,941,532	$4,059,778	$4,181,571	$4,307,018	$4,436,229
Vacancy	$340,000	$350,200	$360,706	$371,527	$382,673	$394,153	$405,978	$418,157	$430,702	$443,623
Gross revenue	**$3,060,000**	**$3,151,800**	**$3,246,354**	**$3,343,745**	**$3,444,057**	**$3,547,379**	**$3,653,800**	**$3,763,414**	**$3,876,316**	**$3,992,606**
Expenses	$272,000	$280,160	$288,565	$297,222	$306,138	$315,323	$324,782	$334,526	$344,561	$354,898
Net operating income	**$2,788,000**	**$2,871,640**	**$2,957,789**	**$3,046,523**	**$3,137,919**	**$3,232,056**	**$3,329,018**	**$3,428,888**	**$3,531,755**	**$3,637,708**
Mortgage P&I payments	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,296,640	$2,738,895	$2,738,895	$2,738,895	$2,738,895	$2,738,895
Payments from reserves	$272,000	$280,160	$288,565	$297,222	$306,138	$315,323	$324,782	$334,526	$344,561	$354,898
Cash distributions to investors	**$763,360**	**$855,160**	**$949,714**	**$1,047,104**	**$1,147,417**	**$808,484**	**$914,905**	**$1,024,519**	**$1,137,422**	**$1,253,711**
Cash-on-cash returns	3.7%	4.2%	4.6%	5.1%	5.6%	3.9%	4.5%	5.0%	5.5%	6.1%
Reserve balance	$3,175,000	$2,990,090	$2,791,228	$2,577,743	$2,348,937	$2,104,082	$1,842,423	$1,563,170	$1,265,503	$948,570
Present value of cash flows	$674,571	$710,387	$697,171	$679,259	$657,757	$409,557	$409,560	$405,285	$397,613	$387,289

Proceeds from Property Sale

Projected sale price	$45,471,345
Fees on sale	$2,728,281
Reserve balance	$593,672
Mortgage loan balance	$37,228,023
Net proceeds from property sale	$6,108,714
Discounted proceeds from sale	$1,667,576

Return on Capital

	Undiscounted	Discounted
Cash flow over 10 years	$9,901,797	$5,428,448
Proceeds from property sale	$6,108,714	$1,667,576
Total projected cash flows	$16,010,511	**$7,096,024**
Investor's contributed capital	-$20,550,000	-$20,550,000
Return on capital	-$4,539,489	**-$13,453,976**

AN EXPERT'S VIEW ON CURRENT TOPICS IN THE SECURITIES AREA

Mark Passacantando,[1] *RFC, MBA*

In an ever-changing world of fast shifting securities arbitration issues, a changing advisory landscape and an overburdened regulatory structure, it makes sense to offer an update on topical issues. I have written about three particular areas that will be of interest to practitioners: the role of university securities law clinics, the use of independent monitors in the securities area, and identification of tools for effective risk management.

University Law Clinics: Arbitration Alive and Strong

University law clinics in the United States have made tremendous strides, but more work remains to be done. We hold academia in a special place in our hearts and souls. As Mark Twain said in a February 25, 1989 speech made to Trinity College Alumni about their President, Dr. George Williamson Smith, "he stands at the summit of human usefulness." *Hartford Daily Courant*, February 26, 1889, p. 3. Global universities are places where the future is shaped. It is a place where young, relatively inexperienced people are exposed to a world of possibilities and inspiration.

Therefore, it is gratifying that at these special places, the trend in legal education towards more hands on experiences for law students is including securities arbitration practice. Securities law is actively and vigorously taught at select U.S. universities. A further advancement is the establishment and expansion of law clinics – a place where theory meets practice. As of this writing, there are at least eighteen U.S. universities that have securities arbitration clinics. Some of these university law programs have been in place for many years. Others have only recently been established. Examples

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1. *Mark Passacantando is an expert witness serving plaintiff and defendant attorneys throughout the U.S. He is an expert witness for the Suffolk University Securities Arbitration Law Clinic. He is also the CFO of Affiliated Monitors, Inc. in Boston, MA and teaches Personal Finance at Boston University. He has served as Senior Audit Officer, Director of Compliance and Compliance Officer for major investment firms in the Boston area. Mark was the President of the Financial Planning Association of MA and Chairman of the Alliance Forum, notable trade associations in the U.S.*

include Pepperdine University School of Law, University of San Francisco School of Law, Albany School of Law, Northwestern School of Law, Howard University School of Law, University of Miami School of Law, and Suffolk University School of Law. Irrespective of a clinic's tenure, the universities are delivering our future practitioners – a bullpen of next-generation talent. They also represent the hopes, dreams, and desires of the U.S. civilian population who yearn for professional help to ensure that their human, civil, business, and individual rights are protected. When Wall Street missteps, it is you (they) who step in to demand justice.

Typically, a university law clinic handles cases below a pre-determined damage amount sought by claimants. Cases are either below that threshold dollar amount, are good teaching opportunities in cases that have been rejected by private practitioners for reasons other than the dollar amount at issue, or both. Cases arrive at the law clinics through private practice attorney referrals, internal university leads, bar associations, or general public awareness initiatives. Plaintiffs who agree to use the clinic have a thorough understanding that their case will be used as a teaching tool for university law students in exchange for the pro bono services the students provide.

I have had the pleasure of personal experience with one such clinic. One middle aged couple I met with spoke fondly of the clinic, its law students, and their satisfaction in using the program. There appeared to be a complete acceptance of the process and structure involving the clinical program and the client's particular case. As an expert witness, I was thrilled to be part of that structure as well – it was positive, different, good-willed, and new!

One recent clinical program had this to say about the program, "there is no question that, by far, this is one of the best educational experiences I've had in law school and possibly, throughout my entire educational career!" The student told me of his different experiences with the clinic and how it has shaped him in his desire to be a practicing attorney and an overall professional. He also said, "working with an expert has been great and gives me a different perspective on the case." One clinical director provides a tremendous endorsement when he states "ultimately, the clinic delivers a very high quality product. The end product is just as good as they (clients) get elsewhere." However, the director adds that cases handled by the law clinic generally take longer than the average of fourteen to seventeen months. The law students at the clinic that I assisted work independently in teams of two after being chosen by the law school in a competitive process for slots in the program. Some other law clinics work in teams of three and/or are chosen only after taking a particular course, with the best students being invited into the clinic.

While the clinics appear to be making great strides, a potential looming hurdle exists. Funding for some of the clinics is in question. Funding sources currently come from three sources: university (fixed) budgets, the $1.4 billion 2003 global settlement made under former New York Attorney General Eliot Spitzer, and the FINRA Foundation. The FINRA Foundation has been very helpful in funding many of the programs according to its web site in funding commitments to each program of $250,000.00 during 2009 and 2010. These sources have produced a meaningful product in educating and serving the various communities in which we work and live, we wonder whether the academic, economic, and regulatory environment can continue to sustain the law clinics in the long-term. Additional funding mechanisms are being explored and considered at this time. I wonder how Mark Twain would respond to this dilemma?

A Newer Tool In Securities Cases

Independent monitors add unique value and should be considered as a useful tool to implement and enforce settlements. Their usefulness is particularly true as the volume of cases and disciplinary actions increase.

Arbitration, mediation, and securities lawsuits clearly serve as important private tools of enforcement in the most heavily regulated industry in existence. Investment transactions have become much more complex and the transactions themselves can take place in a nanosecond as evidenced by high frequency trading systems. Clearly, a need exists to resolve conflict in an expeditious manner at low cost. Arbitration is advantageous for this reason. At the same time, class action lawsuits continue to play an important role in the enforcement landscape. Newer tools like the use of independent consultants/monitors are available to ensure compliance with regulatory decisions or settlements.

First, let's take a quick look at the volume of activity in several forums. Arbitration activity is on the uptick. FINRA fines for 2012 totaled $68 million, up from $63 million in 2011. The 2011 number represented a 51% increase over 2010. Furthermore, the number of disciplinary actions has increased by 13%, 13% and 8% for 2011, 2010 and 2009, respectively. Through June 30, 2012, FINRA reported 609 cases. Cases topping the list include research analyst communications, suitability, unit investment trusts, markups/markdowns and municipal securities.

Cases topping the list for 2011 include causes of action for breach of fiduciary duty, negligence, misrepresentation, and failure to supervise.

Security types topping the list in 2011 include common stock, mutual funds, variable annuities, corporate bonds, and options (in that order).

Mediation activity experienced a decrease, based on cases closed, from a volume of 262 to 227 in 2010 and 2011, respectively. Cases settled averaged 85% in 2010 and 2011.

The number of enforcement actions brought by the CFTC or Commodity Futures Trading Commission, in the fiscal year ended September 30, 2011, increased 74% from the previous year, resulting in $450,000,000 in fines and forfeiture of illegal gains.

While these forums can handle much of the activity in the conflict resolution area, there are other situations that can be more complex or that simply do not "fit" the arbitration/mediation model and require other enforcement mechanisms. Examples from recent headlines include the Facebook IPO debacle, the JP Morgan "London Whale" $6 billion trading loss that internal controls failed to predict, the Barclays LIBOR issue, and the $210 million Capital One fine/refunds assessed by the new Consumer Financial Protection Agency. While these situations will "play out" using traditional measures, there is a newer, highly effective enforcement tool that should also be considered.

The Department of Justice (see DOJ's "Morford Memo," 2008, http://www.justice.gov/dag/morford-useofmonitorsmemo-03072008.pdf) and other government agencies have utilized independent corporate monitors for some time. These independent monitors ("IM") assess and monitor a corporation's compliance with the terms of a settlement or deferred prosecution agreement specifically designed to address and reduce the risk of repeat misconduct. An IM can add value to a broker/dealer, registered investment adviser, hedge fund, bank, insurance company or other financial services company. The IM will provide comfort to the corporation and licensing body or government agency that the issues of concern are now being handled properly. Periodically, the IMs produce reports that are sent to government regulators to update and show progress of the enhanced program and to attest to ongoing compliance.

The IM model uses private sector resources to independently assess a specific situation. For example, a broker/dealer or registered investment adviser that allegedly violated FINRA regs in the coding of new accounts or e-mail retention could use the IM model. Failure to supervise, outside business activities, and trading away cases might lead to the installation of an IM for a period of 3 years. This IM would perform limited testing on registered rep or supervisory personnel activities around new client account coding to ensure that firm and regulatory procedures are being conducted properly to establish good suitability standards.

The contribution of an IM comes from their true independence and their value-added expertise. Unlike internal personnel, including general counsel, compliance personnel, and investigative units, outside counsel, certified public accountants and auditors, an IM can bring an impartial view to the situation and clear communication without fear of retaliation which might otherwise exist with internal personnel. A true independent will call the "balls and strikes" as they see it. This true independence will carry the necessary weight and credibility with not only the FINRA/SEC/CFTC/State Securities Departments, but also with the company's management, staff, stakeholders and other interested parties.

The IM approach offers transparency and accountability. It offers an alternative approach to violations of law that keeps the licensee in business. It is a free service to the government during a fiscally challenging time. It gives counsel a tool with clients and regulators in negotiation. It simply has merit. I would not be surprised to see more and more use of this remedial practice in the financial services industry. Stay tuned…

Risky Business

There is an absolute duty to identify and manage risk in an investment portfolio. [cite source of this? That is a pretty strong statement without pointing to a source] In evaluating a potential claim, a practitioner should consider whether any risk management tools were used by the broker or his firm. Chances are that they were not if the trading losses were substantial.

Risk is an amorphous concept to most people. The investment world seems to focus on returns 90% of the time. Risk is often an afterthought. Securities arbitration has taught me that discussions of risk arise only as the result of some large financial loss when questions circulate around the risk that must have existed at the time of the loss. It is as if risk is the oxygen in the room that always exists, but gets attention only when something goes wrong. Do we have this right? Should we be questioning risk only after the fact? Should advisers, broker/dealers, financial planners, insurance agents, bankers, and other financial services providers be held accountable for risk management only when things go wrong?

I would invite you to take a look at risk in a different light. There are powerful risk management strategies and techniques. Consider the following:

A. An impending hurricane is barreling up the coast toward your large real estate investment. You decide to hope for the best and stay in your home during the Category 3 hurricane. Government officials communicate the hazard and ask you to make prudent choices. Clearly, you have a lot at stake in real and personal property and the chance of injury or death in the worst case.

B. You embark on a business expansion strategy and bring on new personnel to assist in a new line of business offerings (e.g. criminal law practice). You have done some homework, understand the upside potential, and launch forward to create a best-of-class organization.

C. You decide to undergo elective surgery on an issue that has plagued you for years. You have done your research, talked to family members, consulted with doctors and specialists, and are ready finally to get this done. The financial cost has been considered for last 2 years and you are financially ready to have the surgery.

D. You have worked your whole life to save money for your retirement. You have built an investment portfolio which you believe will allow you and your wife to meet your lifestyle needs in retirement and possibly to provide for your children's/grandchildren's future educational needs. You feel great about what you have done and the sacrifices you have made for a noble purpose.

What do these vignettes have in common? They all have foreseeable and manageable risk. [not sure they do – the plan is identified, but not the risk] How many of these events and actions are controllable? Can we quantify the possible outcomes? Can we avoid risk? Can we reduce or mitigate risk? Of course, we can.

Risk exists in everyday life. From the moment we wake up in the morning, we embark on decision-making that inherently creates a level of risk – the uncertainty of an outcome [are these the same? Risk does not necessarily equal uncertainty of an outcome]. It starts with climbing out of bed and evolves into everyday activities like taking a shower, walking down our sidewalk, driving to work, eating a piece of fish or chicken for lunch, having a cocktail after work, and so on. We naturally hope for the best as we proceed in our everyday activities. In other circumstances, our amygdala kicks into high gear by protecting us in sudden, shocking events. In unfortunate circumstances, we can rely on insurance coverage to minimize out-of-pocket loss.

A proper risk-management system, however, is a process. Risk is first identified. What could possibly go wrong? Next, can we measure the risk or downside? Third, let us make a decision on whether to transfer part or all the risk to a third party; and last, how do we effectively manage the ongoing risk?

Investment management is all about risk. Risk exists at all times (and yes, even United States Treasury bonds are now considered to have risk!). Prospectuses, offering memorandums, and other literature abound with risk management discussion on the possibility of losing some or all your money! Discussions cover risk categories such as credit risk, interest rate risk, call risk, foreign exchange risk and a myriad of others. This leads to the question, how does one navigate the investment markets given all of these inherent risks?

The good news is that risk can be identified, risk can be measured, and risk can be reduced and mitigated. An investment adviser et al should know the level of risk that a customer is willing to bear and design a portfolio that reflects that desire…it is that simple, but it is not always easy. This is why people engage the services of a competent financial adviser. The adviser should bring all the tools generally available to the table to serve the client optimally. Those tools should clearly be stress tested against certain future market or global events so that there are no surprises. Clients are smart and understand that "Black Swan" events can occur. What clients should not accept is a "hope and pray" approach where there has not been the education, there has not been a discussion about powerful risk reduction tools, and there has not been action to protect a client's hard-earned retirement portfolio.

Here is an example of a partial risk management strategy:

We have exposure to our international investment portfolio and have used individual stocks, bonds and mutual funds as our investment vehicles. We have ongoing concerns about a U.S. economic crisis, European bail-outs, a declining dollar and specific company "headline risk." What are some things we can and should do to protect our investment portfolio? Possible risk reduction strategies include:

(a) reducing bond duration; (b) diversifying among industries, sectors and companies, (c) measuring risk using Modern Portfolio Theory statistical measures such as Sharpe Ratio, Treynor Ratio, Sortino Ratio, standard deviation, R-squared, up-market beta, down-market beta, up-market alpha, down-market alpha, and my favorite, Beta; (d) buying foreign exchange protection using options, futures, or ETFs; (e) using protective puts, (f) establishing valuation levels for each investment showing current fair value (i.e. relative to its current market value); (g) establishing price exit points with desired time frames; (h) using a mutual fund x-ray tool to identify possible security overlaps; (i) selling mutual funds that have portfolio manager turnover or low tenure; (j) using third party evaluators like Morningstar and using only high risk-adjusted return funds; and (k) performing technical analysis and to identify where the support and resistance levels exist. Wow...that was exhausting…but well worth the effort.

A well-managed portfolio is one where the uncertainty lives only in a certain space. Advisers have not only the opportunity, but the duty to mitigate risk wherever possible and to employ the tools commonly available to practitioners in this highly specialized field. Whether or not an adviser is a fiduciary, they owe a duty of care to their clients. The consequences of not exploring, not educating, not employing risk management tools where necessary can be material. It can lead to the significant loss of assets that impact many generations of a family tree. Risk management should not be an option or an afterthought. It is an essential component to any investment program. Furthermore, its absence can lead to an action that is all too familiar to us…securities arbitration.

RECENT ARBITRATION AWARDS

Howard B. Prossnitz

Greg Kipple v. Wells Fargo Advisors, LLC and Wachovia Securities LLC
FINRA Case No. 10-02871

Claimant asserted violation of the New Jersey's Conscientious Employee Protection Act, violation of New Jersey's public policy, defamation, interference with advantageous business relations/ employment offers, breach of contract, and indemnification/ advancement of fees in connection with his alleged wrongful termination.

Claimant requested compensatory damages of \$26,082,000. Claimant Kipple was a New Jersey broker for Wachovia Securities, which became part of Wells Fargo Advisors in 2008. In April 2009, the firm settled a customer complaint that the broker and his branch manager had failed to supervise an associate's handling of the account. On his BrokerCheck report, the broker said that he never had any dealings with the customer. The customer sought \$250,000 and the firm settled for \$160,000 in June 2009. Wells Fargo told regulators that broker Kipple had been fired for failure to follow the firm's policies.

The broker explained the facts surrounding the customer dispute to FINRA without first advising Well Fargo. He alleged that he was fired two weeks after telling Wells Fargo of his contact with FINRA.

Kipple had been in the industry for 26 years. After his termination, he was registered with Saxony Securities. He had been the subject of five customer complaints during his career prior to his termination. One prior suitability complaint had been settled for \$86,000 and another complaint alleging that twice as many options had been sold as authorized was settled for \$150,000.

Kipple's attorney was quoted in Thomson Reuters as saying his client was fired because "(h)e was a sacrificial lamb for what was a lengthy series of institutional and systemic failures to address another broker's conduct." Claimant was a top producer and retained a damages expert who came up with a \$26 million damage analysis for lost income.

Respondents denied the allegations and asserted affirmative defenses.

Award: The Panel found Respondents liable and ordered them to pay Claimant as follows:

1. Compensatory damages of \$4,300,000.00;
2. Damages in the amount of \$1,000,000.00 on the defamation claim;

3. Punitive damages in the amount of $1,000,000.00 under the New Jersey Conscientious Employee Protection Act, Title 34, Section 19-5;
4. Attorneys' fees of $500,000.00 under the New Jersey Conscientious Employee Protection Act; and,
5. Costs of $30,000.00.

In addition, the Panel recommended expungement of the termination comment in the broker's U-5 and that the termination comment be changed from discharged to "terminated without cause." Further, the answer "yes" as to whether the broker had been permitted to resign after allegations of violating industry rules (Question 7(f)(1)) had to be changed to "no."

Claimant's counsel: David Weschsler, Esq., Weschler & Cohen, New York, New York.

Respondents' counsel: Jill Rosenberg, Esq., Orrick, Herrington, Sutcliffe, New York, New York.

Arbitrators: Ronald P. Wertheim, Chairperson, Alan J. Blocher, and Jason Thomas Laird.

This case is significant because of the innovative use of the New Jersey Conscientious Employee Protection Act to turn a U-5 defamation case into an employee whistle blower type claim. The statute allowed for recovery of punitive damages and attorney's fees. The case reflects a trend towards significant awards in broker wrongful termination cases. Further, these U-5 defamation and wrongful termination cases represent a significant percentage of FINRA case filings. Other recent broker termination cases are discussed below.

Mel H. Schonhorst v. RBC Capital Markets Corporation
FINRA Case No. 10-03097

Claimant asserted claims of breach of contract, fraud, tortious interference with business relations, and defamation. The causes of action arose out of Respondent's alleged breach of an employment agreement and defamatory statements on the broker's U-5.

Claimant sought compensatory damages of $3,000,000.01 and punitive damages of $2,000,000.01.

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

The Panel granted Claimant's request for an explained decision.

Award: The Panel found Respondent liable and ordered it to pay Claimant as follows:

1. $4,400,000.00 in compensatory damages;

2. $314,224.00 for Wealth Accumulation Plan; and,
3. $483,871.00 for unpaid bonus.

The Panel's decision had an explanation of why it did not grant expungement. The Claimant's U-5 had a statement from the Respondent that Claimant was a subject of investigation by a federal agency. The Panel said that this was a true statement at the time the claim was filed and at the time the hearing was held. The fact of the investigation was verified by the United States Attorney General.

The Panel wrote:

> We firmly believe that removal of this statement is not possible at this time, since the statute of limitations has not run as a possible action by the federal agency against the Claimant. Expungement of this statement will in no way change history or 'un-ring the bell. We suggest that at a future time the Claimant could seek an amended Form shedding light on the situation at the end of the pending FBI/ USAG investigation.

The Claimant's current BrokerCheck report reflects no disclosure events. His last FINRA affiliation ended in August 2007.

The Panel explained the monetary award by saying that $2,200,000.00 represented lost income from termination through the date of the hearing. An additional $2,200,000.00 represented lost potential earnings through age 67. The Panel said it awarded $314,224.00 as the return of what had accrued in a Wealth Accumulation Plan and another $483,871.00 as the unpaid bonus.

The Panel offered these comments explaining its decision to award a total of $5,198,095.00:

> We came to our conclusion that a financial award was necessary and due Claimant as we unanimously believe that the events preceding Claimants termination would warrant a different outcome based on facts presented and reviewed by the panel. We have an opinion that had the termination of employment been of a mutual decision and with a more level headed approach other than the reliance of information from an industry publication and possibly overly quick reaction to such 'news' the panel would not have been requested to hear and rule on what we consider to be 'thin' evidence.

The Panel seems to be saying that the Claimant should not have been terminated so hastily on what amounted to rumor and gossip rather than hard facts of wrongdoing, and that notwithstanding an ongoing federal investigation, there was no real evidence of any bad acts.

Claimant's Counsel: Robert M. Thornton, Esq., Kilgore & Kilgore, Dallas, Texas.

Respondent's Counsel: Richard A. Rohan, Esq., Carrington, Coleman, Sloman, Blumenthal, Dallas, Texas.

Arbitrators: Phillip L. Scheldt, Chairperson, Lawrence R. Maxwell, Jr., and Kenneth D. Bingham.

This case is significant because it reveals something about the arbitrators' thought processes boiling down to the Claimant being hastily fired without good reason. It also shows that panels are willing to give substantial recoveries in the wrongful termination area without any "splitting of the baby" that often happens in customer suitability cases.

Other recent large awards in this area include *Concepcion v. Lincoln Financial Advisors*, No. 08-04833, ($2,037232.00 award for wrongful termination and U-5 defamation after abrupt termination where Respondent raised belated objections to deal being negotiated by Claimant and tried to force him into non-competition agreement after he had already worked at Respondent for twenty years); *Paladino v. Morgan Stanley*, No. 11-01633 (two claimants awarded $4,600,000.00 in compensatory damages plus $354,816.54 in attorney's fees and $10,000.00 in discovery sanctions in employment case); *Colavito v. Deutsche Bank Securities, Inc.*, (No. 10-01557)(Respondent to pay $1,664,431.00 in compensatory damages, punitive damages of $1,664,431.00, attorneys' fees of $317,966.00, and award on counterclaim against Claimant of $854,492.70 due on promissory note); *Minchello v. Citigroup Global Markets, Inc*., (No. 09-02800)($15,800,000.00 compensatory damages and sanction of $1,000,000.00 in case alleging breach of contract to pay institutional advisors); and *Torretta v. Morgan Stanley*, (No. 11-01914)($1,000,000.00 in wrongful termination case).

Lindsey Abbott v. Morgan Keegan & Co., Inc.

FINRA No. 11-03241

This was a simplified case where Claimants were seeking $25,000.00 from Morgan Keegan relating to purchase of its bond funds. The allegations included breach of fiduciary duty, breach of contract, unsuitability, failure to supervise, violations of securities regulatory rules, violations of the Alabama Securities Act, and common law claims.

The single arbitrator awarded $25,000.00 in compensatory damages and $8,500.00 in attorney's fees. Morgan Keegan sought to vacate the award asserting that the arbitrator exceeded her authority in awarding damages exceeding $25,000.00 and in ruling on claims that were derivative in nature.

A petition to vacate was denied in the Circuit Court of Jefferson County, Alabama (CV-2012-0404). The court issued a memorandum opinion that the arbitrator had the authority to decide whether FINRA Rule 12800 allowed attorney's fees to be awarded in addition to the damages capped at $25,000.00 citing *Howsam v. Dean WitterReynolds*, 537 U.S. 79 (2002)(procedural questions are for the arbitrator, not a court to decide). A similar result was reached in *Morgan Keegan v. Puckett*, Circuit Court of Morgan County, Alabama (Case No. CV 2012-000046). The court refused to vacate a simplified award for $25,000.00 in compensatory damages plus $7,500.00 in attorney's fees.

Claimant's counsel: Richard S. Frankowski, Esq., Robert E. Norton, Esq., Burke Harvey Frankowski, Birmingham, Alabama.

Respondent's counsel: W. Preston Martin, Esq., Maynard Cooper & Gale, Birmingham, Alabama.

Arbitrator: Pamela H. Roderick

This case is significant because it deals with an interesting question which is not specifically addressed in FINRA rules, ie. whether an arbitrator in a simplified case can award attorney's fees in addition to the cap on allowable damages.

Hooman Moshar v. Wells Fargo Advisors, LLC

FINRA No. 11-00556.

Claimants sought $1.9 million in compensatory damages on claims of breach of fiduciary duty, breach of contract, fraud by misrepresentation and omission, failure to supervise and control, violation of federal and state security statutes, common law claims, and NASD and NYSE rules of fair practice.

Respondent denied all allegations and pled affirmative defenses.

The case involved an unsuitable investment strategy that had been discussed with and recommended to a California couple by Respondent. Claimants had an account with Wachovia Securities, which was acquired by Wells Fargo. The Claimants had taken out a $5 million loan from Wachovia Bank to invest in real estate. Respondent had advised them to use their brokerage account as collateral for the loan. The clients became concerned when their $7 million portfolio began to fall. The advisor told them to ride it out. When the account went down to $5 million, the broker tried to stem the losses by buying both regular and leveraged ETFs, which amplified the risk. In 2009, the bank called the loan, liquidated the securities and $23,000 was left. As a result, the clients missed out when the market went back up. Claimants argued that they would have made $ 2 million if their portfolio had not been tied to the loan and liquidated.

Award: The Panel found liability and entered an Award of $1,333,333.00 against Respondent plus all hearing fees of $24,000.00.

Claimants' counsel: Marc I. Zussman, Esq., Law Offices of Marc I. Zussman, Los Angeles, California.

Respondent's counsel: Elizabeth H. Lindh, Esq., Keesal, Young & Logan, Long Beach, California.

Arbitrators: Donald S. Simons, Chairperson, Brent J. Rosenbaum, and Joel D. Davidman.

The case is significant because it points to the conflict of interest that arises when customers are pressured to put up their securities as collateral for loans issued by a bank who is an affiliate of the brokerage firm.

Myrna Wechsler v. Jodi Isdith, Mitchell Holeve, and Raymond James Financial Services, Inc.

FINRA Case No. 10-04291

Claimant asserted fraud, breach of fiduciary duty, exploitation of an elderly person, civil theft, conspiracy, breach of contract, failure to supervise, negligence and violation of the Florida Investor Protection Act. The allegations related to an alleged conversion of funds from the joint account at issue.

Claimants asked for compensatory damages of $269,496.93, interest, attorneys' fees and treble damages.

Respondent requested dismissal of the claim, forum fees, attorneys' fees, expert fees, and expungement.

Award: The Panel found Respondents liable on the claim of exploitation of an elderly person under Florida Statute 825.103 and entered an award for a total of $800,000.00, inclusive of treble damages. It divided the $800,000.00 into three awards of compensatory damages -$270,000.000 against Respondent Isdith, $265,000.00 against Respondent Holeve, and $265,000.00 against Respondent Raymond James. The request for expungement was denied, as were Claimant's requests for attorneys' fees and punitive damages.

Claimant's counsel: Bruce Katzen, Esq. and Josh Rubens, Esq., Kluger, Kaplan, Silverman, Katzen & Levine, Miami, Florida.

Respondents' counsel: Erin Linehan, Esq. and Terrance A. Bostic, Esq., Legal Department, Raymond James Legal Department, St. Petersburg, Florida.

This case is significant because of the Panel's decision to grant treble damages under the Florida statute dealing with elder abuse.

Gillman Family Trust v. Wachovia Securities, LLC d/b/a Wells Fargo Advisors, LLC, Shirley Polidori
FINRA Case No. 12-00996

Claimant asserted negligence, breach of fiduciary duty, negligent supervision, breach of contract, and fraud in connection with Claimant's investment in Fannie Mae preferred stock, FNMA PFD PERP SER S 8.25%.

Claimant asked for compensatory damages of $50,000.00; and then at the close of the hearing, Claimant requested rescission.

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

Award: The Panel found Wachovia liable on claims of negligence, negligent supervision, fraud, and breach of contract. It entered an award for rescission requiring that Wachovia repurchase from Claimant all shares of the preferred stock at its original purchase price totaling $48,399.70. All claims against the broker were denied, expungement was granted, and all hearing fees were assessed against Wachovia.

The single Arbitrator made the following finding:

> Respondent Wachovia's liability was predicated on the manner in which it marketed Fannie Mae preferred stock to Claimant. Respondent Polidori testified that she marketed the securities in question by reference to research information provided to her by Respondent Wachovia. I was impressed by Respondent Polidori's candor, professionalism, and apparent concerns for and loyalty to the client, and believe that she marketed the securities based on the research information provided to her by her firm, and that she accurately conveyed the information to Claimant. No evidence was introduced by Wachovia to the contrary.

Claimant's counsel: Lars K. Soreide, Esq., Soreide Law Group, PLLC, Fort Lauderdale, Florida.

Respondents' counsel: Nuviah Shirazi, Senior Legal Counsel, Wells Fargo Law Department, Wells Fargo Advisors, LLC, St. Louis, Missouri.

Arbitrator: Steven Ira Weinberger

This case is significant because it provides a template for other Fannie Mae preferred securities claims. The arbitrator granted full rescission and put the liability squarely on Wachovia's research and marketing efforts while exonerating the broker.

Robert E. McCarthy et al. v. Alliance Bernstein L.P., Alliance Capital Management L.P., and Sanford C. Bernstein & Co., LLC
FINRA Case No. 10-05687

Claimants alleged breach of fiduciary duty, breach of contract, negligence, negligent supervision, fraud, misrepresentation, violations of the Investment Advisors Act of 1940, violations of NYSE and FINRA Rules, suitability, and violations of New York and New Jersey law. The action involved real estate investment trusts. Claimants requested an unspecified amount of compensatory damages to be proved at hearing.

At the conclusion of the hearing, Claimants made an oral motion for discovery sanctions. Claimants' allegations of discovery abuse related in part to the manner in which Respondent produced documents. Respondent made a voluminous production without specifying which documents were responsive to which requests and without identifying those requests for which it had no responsive documents. Respondents had failed to comply with a discovery order from the Panel directing that they identify which documents were responsive to which requests.

Award: The Panel denied all claims in their entirety but awarded \$30,000.00 to Claimants for discovery abuses of Respondent. The \$30,000.00 was based on an affidavit of Claimants' counsel about the number of extra hours spent on discovery due to Respondents' abuses. The Panel reimbursed counsel for 60 hours out of a requested 95.4 hours at a rate of \$500 an hour.

Claimants' counsel: Seth E. Lipner, Esq. and Herbert M. Deutsch, Esq., Deutsch & Lipner, Garden City, New York.

Respondent's counsel: Sean Murphy, Esq. and Ateesh S. Chanda, Esq., Milbank, Tweed, Hadley & McClory, New York, New York.

Arbitrators: Lowell D. Johnston, Chairperson, and Carol Maria Luttati.

The case is significant because of the ruling concerning discovery abuses by Respondents.

WHERE WE STAND

Historically, PIABA has commented on a number of issues,[1] 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.

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Ryan Bakhtiari at rkb@aublaw.com, Scott Ilgenfrtiz at scotti@jpfirm.com or Robin S. Ringo, rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding *Proposed rule change to amend FINRA's Customer & Industry Codes of Arbitration Procedure* was submitted to the Financial Industry Regulatory Authority by Ryan K. Bakhtiari on October 4, 2012.

Marcia Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: SR-FINRA-2012-041

Dear Ms. Asquith:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). 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 both investor protection and disclosure.

FINRA proposes amendments to the Customer and Industry Codes of Arbitration Procedure (collectively, "Codes") regarding procedures to direct the appearance of witnesses and non party production of documents, procedures for non-parties to object and for service of arbitrator issued subpoenas or orders. PIABA supports the proposed rule changes to the extent that the new rules codify and make consistent the procedures by which PIABA members and their clients may seek to compel the appearance of non-party witnesses and the production of documents.

PIABA also supports the proposed rule changes to the extent that the amended rules require arbitrators to grant, by order rather than by subpoena, the appearance of non-party FINRA members and the production of documents unless circumstances dictate the need for a subpoena.

PIABA notes, however, that the proposed rule only provides for allocation of costs when the arbitrators issue a subpoena, rather than an order, to non-party FINRA members. In the instances where arbitrators order non-party FINRA members to appear as witnesses and/or to produce documents, the new rules are silent as to allocation of costs. PIABA does not believe that public customers should bear the cost burden. Generally, FINRA rules require the requesting party to pay the reasonable costs of the appearance of all non-party witnesses and/or the production of documents from same. FINRA should revise its proposed amendments to both Codes to clarify this important issue.

Very truly yours,
Ryan K. Bakhtiari
President

The following PIABA Comment Letter regarding *Regulatory Notice 12-34 – Crowdfunding Activities* was submitted to the Financial Industry Regulatory Authority by Ryan K. Bakhtiari on August 30, 2012.

Marcia Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, DC 20006-1506

Re: Regulatory Notice 12-34 – Crowdfunding Activities

Dear Ms. Asquith:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). 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 both investor protection and disclosure.

FINRA has yet to propose any additional specific rules or regulations in response to the JOBS Act and specifically, Crowdfunding activities. To the extent a registered broker/dealer participates in Crowdfunding activities, all existing FINRA Rules and regulations apply to that conduct. A uniform set of rules for all business activities will enable broker/dealers to institute appropriate controls and procedures over Crowdfunding activities. Exceptions to current rules and regulations – for example, allowing broker/dealers to "isolate" Crowdfunding activities – would potentially confuse investors and diminish investor protection. Carve-outs and loopholes in existing regulations will only serve to put investors at risk. Regardless of whether a broker/dealer is a "funding portal," its activities must be subjected to FINRA Rules.

The Crowdfunding exemption looks to be more complicated and create more obligations than existing private placement legislation. These types of potential investments are often speculative and a fertile area for investor fraud. PIABA believes that it is critical that all existing FINRA rules and regulations should continue to be enforced and adhered to without exception.

FINRA should take this opportunity to enhance its oversight and investor protection, not diminish it.

Very truly yours,
Ryan K. Bakhtiari

The following PIABA Comment Letter regarding SB 978 (Price and Vargas) - Securities transactions: exemption from qualification requirements was submitted to the California State Capitol by Ryan K. Bakhtiari on June 28, 2012.

Senator Juan Vargas
Chair, Senate Banking and
Financial Institutions Committee
State Capitol, Room 3092
Sacramento, California 95814

Senator Curren Price
Chair, Senate Business, Professions &
Economic Development Committee
State Capitol, Room 2057
Sacramento, California 95814

Re: SB 978 (VARGAS and PRICE) – SUPPORT

Dear Senators Vargas and Price:

The Public Investors Arbitration Bar Association (PIABA) is a national association of more than 400 attorneys that represent victims of investment fraud including stockbroker and financial planner misconduct. PIABA members represent investors who have suffered devastating losses resulting from violations of laws and other regulations that govern the securities industry in an effort to protect investors. Disproportionately, these financial losses fall on the elderly and other vulnerable savers and investors.

Sadly, deregulation of securities offerings and financial services coupled with rollbacks in investor protection at the federal level have created an incubator for malfeasance during the most recent real estate boom and bust cycle. PIABA believes that protecting offerees and purchasers of investments in hard-money real estate loans and other real estate securities is a step in the right direction that serves to better protect the investing public and will improve the honesty and transparency of this segment of California's financial markets.

PIABA supports the availability of loans and capital to those who need it – but not at the risk of harming investors who do not understand what they are getting into or for whom the investments are otherwise unsuitable or impose risks beyond their risk tolerance or investment objectives.

SB 978 will improve investor protection in several ways. One, discussed at Item 2 of the Background Information Sheet, is the requirement that offerors and sellers of real estate securities file more detailed information with the Department of Corporations (the "Department"). The Department is the local cop on the beat and likely the only protection for many investors. Providing the Department with the information it needs to be able to do its job in this problematic area of investor protection is fundamental and should not be a matter for debate.

As discussed at Item 4 of the Background Information Sheet, SB 978 also will give investors in single-lender hard-money real estate loans the same protections currently enjoyed by investors in multi-lender hard money real estate loans. There is simply no reason why single investors should have less protection than participants in a multiple-lender loan. Indeed, the amount invested by a single investor will, by definition, fund the entire loan. Thus, the amount that the investor places at risk in a single loan often will be greater than the sum that participants in multiple-lender loans place at risk.

Perhaps the most important improvement to be brought about by SB 978 is the one discussed at Item 5 of the Background Information Sheet: a suitability requirement for investors in hard-money loans. The idea that an investor, particularly an elderly or retired investor, might put more than 10% of his or her net worth into a hard-money loan is shocking. The fact that this is going on is proof that the law needs revision.

In the current market especially, with interest rates on savings at all-time lows, large numbers of seniors and retirees are particularly vulnerable to promises of higher returns. They can compare the promised returns because the numbers can be stated, plain as day. What isn't clear or easy for these unsophisticated investors to quantify is the difference in risk. And the money they lose is, all too often, unrecoverable. They suffer not just financially but emotionally and physically as well when they lose the nest-egg that they have accumulated over a lifetime. To be put at that kind of risk so that their capital can be turned into raw material for promoters of high-risk, hard-money real estate loans is grossly inappropriate.

PIABA believes that money lost by investors in what prove to be bad hard-money loans is likely never to be recovered. To the extent that part of what made the loan unattractive to banks and other traditional lenders in the first place was concern about the security for the loan, a foreclosure or trustee's sale may yield insufficient sums to make the lenders whole.

PIABA has seen the opposition to SB 978 and disagrees with certain of its assertions. The opposition asserts, for example, that the bill is "over-inclusive" because it regulates all real estate securities and not just securities backed by hard-money loans. What the objection misses is that real estate securities *as a whole* are responsible for a third of all of the Department's enforcement actions since 2009. While hard-money loans are a serious problem, they are not the only problem. Many PIABA members have seen the damage inflicted on investors by all kinds of real estate offerings, including both equity programs and debt programs. The scope of SB 978 is appropriate. Restricting it to debt-based programs would be an unfortunate narrowing of the investor protections contained in the bill.

The opposition also seeks to eliminate oversight of offers of real estate securities and to limit the regulation to sales. That could have the effect of preventing the Department from protecting investors before the harm occurs and limiting it to trying to undo harm that already has been inflicted. There is a reason why securities laws have, from their early days, regulated *offers and sales* of securities. A weakening of that longstanding pillar of investor protection would be inappropriate.

Further, the opposition asserts that two phrases in section 5 the bill (proposed Corporations Code section 25102.2(a)), addressing additional information required to be provided in these offerings, are unclear. Both of the allegedly unclear phrases appear and are italicized in the following quote:

> ". . . a list of all state and federal licenses required to *further the purposes of the investment*, and the names of all licensed persons that will undertake *those activities*."

PIABA believes that the phrases are clear and do not require revision.

Finally, the opposition seeks to replace the 10 CCR 260.140.212.2 suitability standard expressly applicable to real estate programs with the far weaker 10 CCR 260.218.2 standard applicable to broker-dealers. PIABA views this additional proposed weakening of investor protections to be unjustified and inappropriate. The primary impact of the proposed change will be to strengthen the legal defenses of promoters that make inappropriate sales of real estate securities and to embolden them to make those sales given the lower risk that they will be held accountable. The investors, often elderly, who are approached with offerings of these kinds of securities need the protections afforded by the stronger suitability standard.

We as a people have a long history of learning and relearning the harsh lessons of the past. We are being battered mercilessly this time around for forgetting repeated lessons about the dangers financial industry deregulation, including the lessons of the 1920s and 1930s. Continuing efforts at further deregulation of financial and securities markets should be resisted. We instead should remember and move back toward the regulatory environment that, for the approximately six decades that ended in the mid-1990s, imbued U.S. capital markets with a level of honesty and transparency that made them the envy of the world. And closer to home, SB 978 affords us an excellent opportunity to improve that honesty and transparency for California's savers and investors, and for seniors and retirees in particular.

Thank you for your consideration of our views on this important bill.

Very truly yours,
Ryan K. Bakhtiari

The following PIABA Comment Letter regarding *Proposed Rule Change to Adopt FINRA Rule 5270 (Front Running of Block Transactions) in the Consolidated FINRA Rulebook* was submitted to the Financial Industry Regulatory Authority by Ryan K. Bakhtiari on June 26, 2012.

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street NE.
Washington, DC 20549–1090

Re: SR-FINRA-2012-025 - Proposed Rule Change to Adopt FINRA Rule 5270 (Front Running of Block Transactions)

Dear Ms. Murphy:

Thank you for the opportunity to comment on SR-FINRA-2012-025 concerning the proposed rule change to adopt FINRA Rule 5270 (Front Running of Block Transactions) in the Consolidated FINRA Rulebook. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), an international bar association, consisting of over 500 members, dedicated to the protection of investors' rights in securities arbitration proceedings. PIABA is generally supportive of the above-referenced rule proposal.

PIABA believes that codifying NASD IM-2110-3 ("Front Running Policy") in the consolidated rulebook is a common sense approach. It is also logical for FINRA to extend this prohibition to cover any securities and financial instruments (not just option contracts and futures). The proposal would be a step in the right direction to further FINRA's efforts to better protect the investing public.

PIABA remains concerned that the Supplementary Materials provide some exceptions (or "permitted transactions") to this rule. PIABA hopes that FINRA will closely monitor these exceptions to ensure that member firms are not using "permitted transactions" as a loop-hole to engage in activity that the proposed rule intends to end.

For the foregoing reasons, PIABA supports the proposed rule.

Very truly yours,
Ryan K. Bakhtiari

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The following PIABA Comment Letter regarding *File No. S7-10-00; Amendments to Form ADV* was submitted to the Securities and Exchange Commission by Ryan K. Bakhtiari on June 18, 2012.

Mary L. Schapiro, Chairman
Securities Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Amendments to Form ADV

Dear Chairman Schapiro:

I am writing in my capacity as President of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is national bar association comprised of attorneys, including law school professors and regulators, both former and current, who devote a significant portion of their practice to the representation of public investors in securities arbitrations. On April 1, 2011 our colleague Bob Banks wrote to you with concerns about amendments to Form ADV and the disclosure of arbitration awards. In your response dated April 20, 2011 you stated that you believed the issue warranted further evaluation. Copies of the correspondence are attached for your convenience.

On October 12, 2010, the amendments to Form ADV became effective. At the time, the Commission considered whether it should require disclosure of arbitration awards and claims. In the federal release, No. IA–3060, File No. S7–10–00, the Commission noted that some commenters objected, "with some reasoning that arbitration claims are easy to make and that arbitration settlements and awards may not necessarily include findings of wrongdoing (*i.e.*, parties may settle arbitration proceedings and/or arbitration awards may be granted even in the absence of legal violations)." The Commission decided that it would not require disclosure of arbitration awards in the client brochure. The Commission cautioned that investment advisers should consider whether particular arbitration awards or settlements do, in fact, involve or implicate wrongdoing or reflect on the integrity of the adviser, and should be disclosed to clients in the brochure or through other means.

The rationale offered by the Commission for not requiring disclosure is troubling. First, arbitration claims are not easy to make. The costs associated with filing arbitration claims are not insignificant, and in fact, are often substantially higher than filing a claim in court. In addition, attorneys are subject to the same ethical rules whether they file an arbitration claim or a court proceeding. Second, arbitration awards typically do not contain explicit findings of wrongdoing because FINRA's Code of Arbitration Procedure (CAP) does not require an explained decision. FINRA's CAP contemplates an explained decision only if all parties jointly request one. This rarely happens.

If the Commission has concerns about the legitimacy of the arbitration process, those concerns should be addressed to FINRA, and the process should be fixed or eliminated. The Commission has approved all of FINRA's rules, including those related to the arbitration process. In addition, virtually every brokerage firm customer is subject to mandatory arbitration at FINRA. It is troubling that the Commission is expressing concerns about the legitimacy of the process, but has done nothing to change it. Pursuant to section 921 of Dodd-Frank, the Commission is to issue rules, as it deems appropriate, addressing agreements that require customers or clients of any broker, dealer or investment adviser to arbitrate disputes. However, to date, the Commission has not enacted any rules. The Commission continues to list this issue under "dates still to be determined" on its Dodd-Frank agenda. As long as arbitration is the only way to resolve customer disputes, the Commission should not undermine the legitimacy of arbitration awards to customers.

Moreover, arbitration claims and awards are disclosable on an associated person's CRD. If the rationale offered by the Commission was valid, it would not have permitted FINRA to adopt rules requiring that this information be disclosed when it pertains to an associated person. The Commission may permit the investment adviser to provide an explanation of an arbitration claim or award as it does for associated persons. However, failing to mandate disclosure is another example of inconsistent standards for investment advisers and broker-dealers, when it is clear that investors do not understand the difference between the two. Investment advisors should be subject to the same disclosure obligations as brokers.

Further, according to its website, the Commission is the "Investor's Advocate". It provides information on its website educating investors about how they may protect themselves. It instructs investors as follows:[1]

> Before you invest or pay for any investment advice, make sure your brokers, investment advisers, and investment adviser representatives have not had disciplinary problems or been in trouble with regulators or other investors.
>
> …

1. http://sec.gov/investor/brokers.htm

> To find out about an investment adviser and whether it is properly registered, read its registration form, called "Form ADV." Form ADV has two parts. Part 1 contains information about the adviser's business and whether the adviser has had problems with regulators or clients. Part 2 sets out the minimum requirements for a written disclosure statement, commonly referred to as the “brochure,” which advisers must provide to prospective clients initially and to existing clients annually. The brochure describes, in a narrative format, the adviser’s business practices, fees, conflicts of interest, and disciplinary information. Before you hire an investment adviser, always ask for and carefully read both parts of the Form ADV.

These instructions imply that an investor will receive complete information if he or she follows the steps outlined. However, that may not be the case. By failing to require disclosure of arbitration claims and awards, investors have no way of ensuring that they have complete information about whether the investment advisor has “been in trouble with other investors.”

Cautioning investment advisers that they may be required to disclose information about particular arbitration awards or settlements that involve or implicate wrongdoing and/or reflect on the integrity of the adviser is not sufficient protection to ensure that an investor is receiving full and fair disclosure. On the one hand, the Commission’s position is that arbitration claims are easy to make and that arbitration awards may be granted even in the absence of legal violations. On the other, the Commission is of the view that an award or settlement may implicate wrongdoing. It is difficult to imagine the situation in which an arbitration award is granted against an investment advisor that does not implicate some wrongdoing. Based on the Commission’s own rationale, it seems an investment advisor would have a valid ground to argue that, notwithstanding an adverse award, the advisor did nothing wrong. The presumption should always favor disclosure.

Accordingly, we request that the Commission reconsider its position, and harmonize the Form ADV with the Forms U4 and U5 to require disclosure of both arbitration claims and awards. To require anything less would not be in the best interest of investor protection.

Very truly yours,
Ryan K. Bakhtiari

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The following PIABA Comment Letter regarding *File No. S7-08-07; Amendments to Financial Responsibility Rules for Broker-Dealers* was submitted to the Securities and Exchange Commission by Ryan K. Bakhtiari on June 8, 2012.

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Release No. 34-66910, File No. S7-08-07, *Amendments to Financial Responsibility Rules for Broker-Dealers*

Dear Ms. Murphy:

Thank you for the opportunity to comment on the proposal to adopt the rule changes reflected in File No. S7-08-07, A*mendments to Financial Responsibility Rules for Broker-Dealers* (the "Proposal"). I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). 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 SEC rules relating to both investor protection and disclosure. PIABA is generally supportive of the Proposal. PIABA believes that it will marginally increase the financial stability of broker-dealers and diminish the risk that public investors who prevail in arbitration proceedings conducted under the auspices of FINRA Dispute Resolution will be unable to collect damages awarded in their arbitrations.

Public investors are almost universally required to arbitrate disputes with broker-dealers before FINRA Dispute Resolution under pre-dispute arbitration agreements. Broker-dealers require customers to sign such agreements on a "take-it-or-leave-it" basis as a condition of opening customer accounts, and the courts have held that such pre-dispute arbitration agreements are binding and enforceable. *See Shearson/American Express v. McMahon,* 482 U.S. 220 (1987). These arbitration proceedings require a filing fee (waivable for customers who can demonstrate financial hardship) ranging from $50.00 to $1,800.00 (*see* FINRA Customer Code Section 12900, accessible at *http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4188)* and may cost customers additional sums of up to tens of thousands of dollars to prosecute to cover arbitration session fees, attorneys' fees and expert witness fees.

Public customers face an unacceptable risk that FINRA member firms will lose an arbitration and thereafter give up their license and not honor the arbitration award. Historically, approximately 15% to 33% of FINRA arbitration awards have gone unpaid by member firms and associated persons. Presently there is no requirement that broker-dealers carry insurance to cover potential losses in FINRA arbitration. Many firms do not carry such insurance, and a large proportion of the unpaid FINRA arbitration awards are reportedly rendered against firms and associated persons who have simply become insolvent, gone out of business or left the securities business.

The insolvency or failure of thinly-capitalized brokerage firms due to customer arbitration claims has been a perennial problem but was recently highlighted by a proliferation of claims against smaller firms for sales of unregistered securities such as non-traded real estate investment trusts (REITs) and tenancies in common (TICs).

In these circumstances, any measures (such as those in the Proposal) that marginally increase the financial stability of broker-dealers will necessarily diminish the risk of non-payment of arbitration awards. PIABA believes that the Proposal should go a step further and require that all broker-dealers carry errors and omissions insurance to cover customer claims.

Based on the foregoing, PIABA is generally supportive of the rule changes reflected in File No. S7-08-07.

Very truly yours,
Ryan K. Bakhtiari

The following PIABA Comment Letter regarding *Regulatory Notice 12-18; FINRA Requests Comment on Proposed New In re Expungement Procedures for Persons Not Named in a Customer-Initiated Arbitration* was submitted to the Financial Industry Regulatory Authority by Ryan K. Bakhtiari on May 18, 2012.

Ms. Marcia E. Asquith
Office of the Corporate Secretary
FINRA
1735 K Street, NW
Washington, D.C. 20006-1506

Re: Regulatory Notice 12-18, *In re* Expungement Procedures

Dear Ms. Asquith:

Thank you for the opportunity to comment on the proposal to adopt *In re* Expungement Procedures. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). 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 both investor protection and disclosure. PIABA is generally supportive of FINRA's efforts to adopt the newly proposed *In re* Expungement Procedures, however, PIABA has certain concerns that should be addressed before an *In re* rule is finalized.

In 2009, FINRA adopted changes to the forms U4 and U5 which closed a loophole regarding the public reporting of customer complaints. Allegations of wrongdoing are no longer omitted from a broker's CRD simply because the broker was not named as a respondent in a Statement of Claim. While this was an important and necessary change to promote accurate public disclosure of sales practice complaints, PIABA appreciates that this change has created issues for non-named parties who have a legitimate right to seek expungement. PIABA is concerned that without a well defined procedure in place, brokers may seek to intervene in pending arbitrations, or worse file new arbitrations which name the customer as the respondent. As a consequence, PIABA believes that the proposed *In re* process is necessary to address these and other issues to adequately protect the rights of investors and preserve the integrity of the dispute resolution process.

PIABA supports the establishment of a separate *In re* proceeding for non-named parties. Separating the expungement process from the hearing of the customer's arbitration claims ensures that requests for expungement are considered only after a resolution of the underlying claim. The proposed rule correctly limits the rights of parties from seeking any relief beyond expungement in an *In re* proceeding. Public customers are also best served by eliminating the possibility that brokers might name them as a respondent in a later expungement proceeding. The proposed rule also strikes the right balance in imposing a time limitation on expungement requests. These are positive steps which address unintended gaps in the present system.

PIABA is concerned about proposed Rule 13807(c) which requires brokers to notify FINRA of their intention to file for expungement relief. On page five of Regulatory Notice 12-18 it states that "The Notice of Intent to File would alert FINRA staff and the arbitrators on the underlying customer case to prepare for a possible *In re* claim." While FINRA staff should be alerted, PIABA believes that it is anti-investor and an unnecessary intrusion to provide notice at this stage to the arbitrators. The issue of expungement is not for consideration by the arbitrators until the underlying case is resolved. Some might argue that notice to the arbitrators should be given so that arbitrators retain documents and notes from the underlying arbitration. There are however better alternatives such as instructing all arbitrators to retain documents and notes for a certain period following the conclusion of an evidentiary hearing. PIABA also believes that the final rule ***and*** subsequent arbitrator training should make it clear that all parties in the underlying would receive timely notice when the broker has filed a notice of intent and also when a broker files the actual *In re* statement of claim.

PIABA is also concerned about the possible burden *In re* proceedings may place on customers including the possibility that a customer might be compelled to testify and produce documents. During the settlement process, all parties bargain for closure and finality. Not every settlement reflects the merits of the dispute. Cases settle for various reasons, including health and personal issues that a customer may not wish to disclose or make public. Notwithstanding, customers may be forced to appear in the *In re* proceeding, subjecting them unnecessarily to the rigors of preparing for and giving sworn testimony to an arbitration panel, in a matter that they believed had been resolved. This is especially troubling because many customers who bring arbitration claims are senior citizens, some of whom may have considered avoiding the stress and the associated health risks as a reason for pursuing settlement rather than proceeding to a hearing. It would be inequitable to force customers to appear in person and defend themselves at an expungement hearing. PIABA appreciates the attempts to limit discovery and testimony, however, a final rule ***and*** subsequent arbitrator training must make it clear that *In re* proceedings are not full blown arbitration hearings.

Many requests for expungement continue to be rubber stamped by panels, especially when unopposed. Customers that do wish to participate should be provided every opportunity to appear at the *In re* proceeding to oppose an expungement request. Truthful reporting of customer complaints is a cornerstone of fair and effective disclosure. Regardless of whether a customer appears, PIABA believes that both the final rule ***and*** subsequent training should instruct arbitrators that no inference should be made from a failure of customer or brokerage firm to appear at an *In re* hearing.

PIABA is generally supportive of FINRA's attempts to address the issues that have arisen through necessary revisions to public reporting requirements. We look forward to FINRA's revisions and commenting on a final rule.

Very truly yours,
Ryan K. Bakhtiari
President

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