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FINRA SIX-YEAR ELIGIBILITY RULE 12206: THE PURCHASE DATE IS OFTEN NOT THE TRIGGERING "OCCURRENCE OR EVENT GIVING RISE TO A CLAIM"

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I. INTRODUCTION

It is custom and practice in the brokerage firm industry to have clients sign pre-dispute arbitration agreements requiring both parties to arbitrate any dispute or controversy in an arbitration forum. In addition to requiring clients to forfeit their right to judicial adjudication, brokerage firms have attempted to preclude customers from presenting the merits of their case in the arbitration forum by filing motions to dismiss prior to the conclusion of a customer's case-in-chief. These types of motions to dismiss deny customers their fundamental right to a full and fair evidentiary hearing. As a result, FINRA's rules limit the circumstances when a motion to dismiss can be filed prior to the conclusion of a customer's case-in-chief. One of these circumstances arises "where six years have elapsed from the 'occurrence or event' giving rise to the claim" pursuant to FINRA Rule 12206.

In an attempt to avoid liability for wrongful conduct, brokerage firms argue the "occurrence or event" is the purchase date of the investment in issue. Accepting the brokerage firm's argument creates situations in which certain claims would be barred before they arose. This approach is contrary to the interpretation of FINRA rules, FINRA's guidance, interpretation and policies and case law. Moreover, this interpretation rewards brokerage firms for concealment of wrongful conduct.

This article addresses who decides the six year rule of eligibility under FINRA's Rule 12206 and its predecessors pre and post *Howsam*, the procedural requirements under the FINRA Rule 12206 and FINRA's interpretation and guidance on applicability of Rule 12206. The article concludes that, for over twenty years, the courts and FINRA have been telling the brokerage industry that the purchase date is not, as a matter of law, the "occurrence or event" that determines the eligibility of claims under FINRA Rule 12206 and its predecessors. Rather, post-*Howsam* the "occurrence or event" giving rise to a claim is a factual inquiry left to the arbitrators and the purchase date is often not the trigger for the six-year time limit.

II. FINRA'S CURRENT MOTION TO DISMISS RULES AND ELIGIBILITY RULE 12206

FINRA, formerly known as the NASD, "is the largest independent regulator for all securities firms doing business in the United States."[1] FINRA's current rules governing arbitration can be found in the Customer Code, the Industry Code and the Mediation Code.[2] Prior to the enactment of FINRA's current rules on motions to dismiss,[3] FINRA received complaints "that parties were filing prehearing motions routinely and repetitively which had the effect of delaying scheduled hearing sessions on the merits, increasing customers' costs, and intimidating less sophisticated customers."[4] In addition, through an independent study, FINRA learned there was an increase in the number of motions to dismiss filed in customer cases.[5] As a result, "FINRA became concerned that, if left unregulated, this type of motion practice would limit investors' access to the forum, either by making arbitration too costly or by denying customers their right to have their claims heard in arbitration."[6] Therefore, FINRA submitted a proposal to the Securities and Exchange Commission ("SEC") to approve the adoption of its current rules on motions to dismiss, which became effective in February 2009.[7]

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1. *About the Financial Regulatory Authority*, FINRA, http://www.finra.org/AboutFINRA (last visited Apr. 16, 2013).

2. *See* FINRA, Code of Arbitration Procedure for Customer Disputes, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4096; *see* FINRA, Code of Arbitration Procedure for Industry Disputes, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4193; *see* FINRA, Code of Mediation Procedure, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4293.

3. *See infra* notes 9 and 10.

4. FINRA, FINRA DISPUTE RESOLUTION PARTY'S REFERENCE GUIDE at 39 (May 21, 2013), *available at* http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbion/documents/arbmed/p011178.pdf [hereinafter "FINRA Reference Guide"].

5. *Id.* at 40.

6. *Id.*

7. *See id.*; *see also* Exchange Act Release No. 59,189 (Dec. 31, 2008), 74 Fed. Reg. 731 (Jan. 7, 2009) (File No. SR-FINRA-2007-021); *see also* FINRA, Regulatory Notice 09-07: Motion to Dismiss and Eligibility Rules (Jan. 2009), *available at*

FINRA believes that the current "rules will ensure that parties have their claims heard in arbitration, by significantly limiting motions to dismiss filed prior to the conclusion of a party's case-in-chief and by imposing stringent sanctions against parties for engaging in abusive practices under the rules." [8]

FINRA's current eligibility rule is contained in the Customer Code under FINRA Rule 12206 and the Industry Code under FINRA Rule 13206.[9] Additionally, FINRA Rule 12504 of the Customer Code and FINRA Rule 13504 of the Industry Code set forth other rules on motions to dismiss prior to the conclusion of a party's case-in-chief.[10] Currently, there are three (3) circumstances outlined in FINRA Rules when a motion to dismiss may be granted prior to the conclusion of a party's case-in-chief at an evidentiary hearing as follows:

1. The non-moving party previously released the claim(s) in dispute by a signed settlement agreement and/or written release (FINRA Rule 12504 (a)); or
2. The moving party was not associated with the account(s), security(ies) or conduct at issue (FINRA Rule 12504 (a)); or
3. The claim is ineligible as defined by FINRA Rule 12206 "*where six years have elapsed from the occurrence or event giving rise to the*

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http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p117757.pdf.

8. *See* FINRA Reference Guide*, supra* note 4, at 39.

9. *See* FINRA Rules 12206 and 13206, *Time Limits*, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4112 *and* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4209. The eligibility rules were previously known as NASD Section 15 and NASD Rule 10304. NASD Rule 10304 was superseded by the Customer Code Rule 12206 and the Industry Code Rule 13206 on April 16, 2007, for claims filed on or after that date. *See* NASD Rule10304, *Time Limitation Upon Submission*, *available at* http://finra.complinet.com/en/display/display_viewall.html?rbid=2403&element_id=4033&record_id=11676. For purposes of this article, NASD Section 15, NASD Rule 10304, and FINRA Rule 12206 are used interchangeably.

10. *See* FINRA Rules 12504 and 13504, *Motions to Dismiss, available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7377 *and* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=7378.

> *claim.* The panel will resolve any questions regarding the eligibility of a claim under this rule."[11]

"FINRA emphasizes that these exceptions do not constitute an invitation to parties to file motions to dismiss. The fact that a motion may be filed under one of these exceptions does not mean that the panel should or will grant a motion that does not have merit."[12]

In addition to the six-year limitation and the requirement that the arbitrators decide any questions regarding the eligibility of a claim, FINRA Rule 12206 contains stringent procedural requirements.[13] Specifically, the eligibility motion must be made in writing and filed separately from the answer at least ninety (90) days prior to the scheduled hearing.[14] Further, motions under this rule must be decided by the entire panel after the completion of a recorded in-person or telephonic prehearing conference (unless waived by the parties).[15] Moreover, if a panel grants an eligbility motion it must be a unanimous decision.[16] FINRA Rule 12206 also specifies procedures for the arbitration panel to follow if a party moves to dismiss on multiple grounds.[17]

Furthermore, FINRA Rule 12206 provides that if a panel denies a motion it must assess forum fees against the moving party and also grants the panel the authority to award reasonable costs, attorneys' fees, and issue sanctions if the panel deems an eligibility motion was frivolous and/or filed in bad faith.[18]

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11. *See* FINRA Rule 12206, *supra* note 10 *and* FINRA Rule 12504, *supra* note 11 (emphasis added). This article is limited to eligibility motions to dismiss pursuant to FINRA Rule 12206 and its predecessors NASD Section 15 and NASD Rule 10304.

12. FINRA Reference Guide*, supra* note 4 at 42.

13. *See* FINRA Rule 12206, *supra* note 10.

14. *Id.* at 12206(b)(1)-(2). In addition responding parties have thirty (30) days to oppose and the moving party has five (5) days to file a reply. *Id.* at 12206(b)(2).

15. *Id.* at 12206(b)(3)-(4).

16. *Id.* at 12206(b)(5). If the panel denies this type of motion, a party may not re-file unless permitted by order of the panel. *Id*. at 12206(b)(6).

17. *See* FINRA Rule 12206, *supra* note 10, at 12206(b)(7).

18. *Id.* at 12206(b)(8)-(10); *see also* FINRA Rule 12212, *Sanctions* (listing possible sanctions a panel may issue for a frivolous motion or motion filed in bad faith), *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4118.

Additionally, FINRA Rule 12206 explains that dismissal of a claim under this rule does not prohibit a party from pursuing a claim in court. While the rule does not extend the applicable statutes of limitations, the six-year time limitation does not apply to a claim that is directed to arbitration by a court. Any time limits in court will be tolled while FINRA retains jurisdiction of the claim and the six-year time limitation will not run while the court retains jurisdiction of the matter.[19]

III. HOWSAM RESOLVED THE CONFLICT AMONG THE CIRCUITS BY HOLDING THAT THE APPLICABILITY OF THE FINRA'S ELIGIBILITY RULE WAS PRESUMPTIVELY FOR THE ARBITRATORS TO DECIDE

Although FINRA's current Rule 12206 specifies "[t]he panel will resolve any questions regarding the eligibility of a claim under this rule," its predecessors did not make this clear.[20] As a result, courts had to resolve the issue of whether the court or the arbitrators decided a claim was eligible. Prior to the Supreme Court's 2002 decision in *Howsam v. Dean Witter Reynolds,*[21] discussed *infra*, the circuits were split on the issue. The Third, Sixth, Seventh, Tenth, and Eleventh Circuits found that the language contained in the eligibility rule creates a substantive jurisdictional requirement for the court's determination.[22] Contrariwise, the First, Second, Fourth, Fifth, Eighth, and Ninth Circuits found that the language in the rule creates a procedural question for the arbitrators to decide.[23]

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19. *See* FINRA Rule 12206, *supra* note 13, at 12206(c)-(d).

20. *Id.* at 12206(a); *see also infra* note 33 (Section 15 of the NASD did not specify who decided the question of eligibility and NASD Rule 10304 did not specify the arbitrators decide the question of eligibility until post-*Howsam*).

21. *Howsam,* 537 U.S. at 84 (concluded that NASD Rule 10304 was a gateway procedural matter expected to be decided by an arbitrator).

22. *See, e.g., PaineWebber Inc. v. Hofmann*, 984 F.2d 1372, 1378-79 (3d Cir. 1993); *Roney & Co. v. Kassab*, 981 F.2d 894, 898-900 (6th Cir. 1992); *Dean Witter Reynolds, Inc. v. McCoy*, 995 F.2d 649, 650-51 (6th Cir. 1993); *Prudential Sec., Inc. v. Yingling*, 226 F.3d 668, 671-72 (6th Cir. 2000); *Edward D. Jones & Co. v. Sorrells*, 957 F.2d 509, 512-13 (7th Cir. 1992); *PaineWebber, Inc. v. Farnam,* 870 F.2d 1286, 1292 (7th Cir. 1989); *Cogswell v. Merrill Lynch*, 78 F.3d 474, 478-81 (10th Cir. 1996); and *Merrill Lynch v. Cohen*, 62 F.3d 381, 383-84 (11th Cir. 1995).

23. *See, e.g., PaineWebber Inc. v. Elahi*, 87 F.3d 589, 598-99 (1st Cir. 1996); *PaineWebber, Inc. v. Bybyk*, 81 F.3d 1193, 1196, 1198-99 (2d Cir. 1996); *Conticommodity Servs. v. Philipp & Lion*, 613 F.2d 1222, 1224-26 (2d Cir. 1980);

In *Howsam v. Dean Witter Reynolds*, the Court resolved the conflict among the circuits of who determines whether a claim is eligible pursuant to NASD Rule 10304.[24] In that case, Dean Witter first brought suit in the District Court of Colorado seeking to enjoin the customer's NASD arbitration.[25] The district court dismissed the action holding that the NASD arbitrator should interpret and apply the eligibility rule.[26] The Court of Appeals for the Tenth Circuit reversed and found that the eligibility rule's application presented a question of arbitrability for the court to decide.[27] After granting certiorari, the Court reversed and held the applicability of NASD Rule 10304 was presumptively for the arbitrator, not for the court to decide.[28] The Court concluded that NASD Rule 10304 was a gateway procedural matter to be decided by an arbitrator and the rule did not present a question of arbitrability.[29] In addition, the Court reasoned "…the NASD

Miller v. Prudential Bache Secs., Inc., 884 F.2d 128, 132 (4th Cir. 1989), cert. denied, 497 U.S. 1004 (1990); *Smith Barney Shearson, Inc. v. Boone*, 47 F.3d 750, 753-54 (5th Cir. 1995); *FSC Secs. Corp. v. Freel*, 14 F.3d 1310, 1312 (8th Cir. 1994); *O'Neel v. Nat'l Ass'n of Secs. Dealers, Inc.*, 667 F.2d 804, 807 (9th Cir. 1982) (held that arbitrators are to decide statute of limitation issues).

24. *See Howsam*, 537 U.S. at 81-86. As mentioned in note 9, *supra*, for purposes of this article, NASD Section 15, NASD Rule 10304 and FINRA Rule 12206 are used interchangeably.

25. *Id.* at 79.

26. *Id.*

27. *Id.*

28. *Id.* at 79, 85-86.

29. *Howsam*, 537 U.S. at 85-86. The Court articulated that a "question of arbitrability" would exist:

> …in the kind of narrow circumstance where contracting parties would likely have expected a court to have decided the gateway matter, where they are not likely to have thought that they had agreed that an arbitrator would do so, and, consequently, where reference of the gateway dispute to the court avoids the risk of forcing parties to arbitrate a matter that they may well not have agreed to arbitrate. *Id.* at 83-84.

Further, the court found these circumstances to exist where there was "… a gateway dispute about whether the parties are bound by a given arbitration clause raises a 'question of arbitrability' for a court to decide… Similarly, a disagreement about whether an arbitration clause in a concededly binding contract applies to a particular type of controversy is for the court." *Id.* at 84 (internal citations omitted).

arbitrators, comparatively more expert about the meaning of their own rule, are comparatively better able to interpret and to apply it."[30] Moreover, the Court recognized:

> And for the law to assume an expectation that aligns (1) decisionmaker with (2) comparative expertise will help better to secure a fair and expeditious resolution of the underlying controversy -- a goal of arbitration systems and judicial systems alike.[31]

Thus, "*Howsam* contains a broader message recognizing the importance of minimizing judicial involvement in the arbitration process in order to promote the goal of 'a fair and expeditious resolution of the underlying controversy.'"[32]

As a result of *Howsam*, the NASD [now FINRA] amended Rule 10304 [now FINRA Rule 12206] adding language that "[t]he panel will resolve any questions regarding the eligibility of a claim under this rule." [33] Notwithstanding that *Howsam* ended the controversy on who decides whether a claim is eligible, controversy still exists about the interpretation and application of the "occurrence or event" giving rise to a claim in FINRA Rule 12206.

IV. PRE AND POST-*HOWSAM* COURTS HAVE INTERPRETED THE "OCCURRENCE OR EVENT" LANGUAGE AS BROADER THAN THE PURCHASE DATE

The pre-*Howsam* split among the circuits on whether the court or the arbitrators decided whether a claim was eligible also impacted courts' interpretations of the "occurrence or event" language in the eligibility rule. Pre-*Howsam*, if a court found the eligibility rule to be a substantive jurisdictional requirement for the court's determination, it was also common for the court to conclude that the eligibility rule was not subject to tolling

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30. *Id.* at 85.

31. *Id.*

32. Barbara Black, *The Irony of Securities Arbitration Today: Why do Brokerage Firms Need Judicial Protection?* 72 U. CIN. L. REV. 415, 418-19 (2003).

33. FINRA Rule 12206, s*upra* note 13; FINRA, Notice to Members 05-10: Arbitration Time Limits, (Jan. 2005) *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p013211.pdf.

(*i.e.,* point of purchase claims could not be tolled).[34] While some of these early decisions found the triggering "occurrence or event" to be point of purchase, many of these decisions still found and/or reasoned that there could be independent arbitrable claims beyond the point of purchase.[35] Likewise, pre-*Howsam,* if a court found that the eligibility rule created a procedural question for the arbitrators to decide, courts often concluded and/or reasoned that the relevant "occurrence or event" giving rise to a claim was a factual inquiry left to the arbitrators that did not always mean the point of purchase.[36] In addition, post-*Howsam* decisions are consistent with the finding that the eligibility rule creates a procedural question for the arbitrators to decide and further conclude that *Howsam* undermined the basic premise that courts relied upon to determine the eligibility rule was not subject to tolling.[37]

A. Pre-Howsam Decisions that Found the Eligibility Rule to be a Substantive Jurisdictional Requirement for the Court's Determination not Subject to Tolling and that the "Occurrence or Event Giving Rise to a Claim" is the Purchase Date

The pre-*Howsam* decisions finding the eligibility rule to be a substantive jurisdictional requirement, not subject to tolling, for the court's determination and the "occurrence or event giving rise to a claim" is the purchase date have been undermined by *Howsam*. Specifically, since *Howsam* concluded that the eligibility rule is a gateway procedural matter to be determined by arbitrators, the arbitrators, not the court, make a factual determination on the relevant "occurrence or event" giving rise to a claim.[38] Moreover, since it is a procedural question more akin to a statute of limitations, subsequent decisions have determined that the "occurrence or event" giving rise to a claim can be tolled.[39] Nonetheless, many of these pre-*Howsam* cases are still cited by brokerage firms in their motions to dismiss for the court's

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34. *See* Section V(A)-(B), *infra*.

35. *See* Section V(B), *infra*.

36. *See* Section V(C), *infra*.

37. *See* Section V(D), *infra*.

38. *See* Section III, *supra*; *see also* IV(D), *infra*.

39. *See* Section IV(C)-(D), *infra*.

interpretation that the purchase date is the "occurrence or event" triggering the six-year limitation.

For instance, the Seventh Circuit in *Edward D. Jones & Co. v. Sorrells* affirmed the dismissal of the customers' NASD arbitration claims based on the purchase date of the investments.[40] By way of background, the NASD arbitration panel entered an award in favor of the customers for their claims alleging, *inter alia*, fraudulent misrepresentations, failure to supervise, violation of federal securities laws, and violation of NASD and NYSE rules.[41] The award noted that the brokerage firm/broker moved for a dismissal of the customers' claims pursuant to Section 15,[42] but the award contained no further discussion of the motion.[43] Thereafter, the brokerage firm/broker sought to vacate the award in district court or, in the alternative, remand the case to the NASD panel to rule on the Section 15 motion to dismiss.[44] On remand, the arbitrators released an award clarification stating that the eligibility motion had been considered and denied.[45] In response, the brokerage firm/broker moved the district court to have the original award vacated or remanded to a new NASD panel.[46] Thereafter, the district court vacated the award, holding that the customers' claims were filed late and ineligible for arbitration pursuant to Section 15 since the customers' purchases were made over six years prior to filing their claim with NASD.[47] On appeal, the court stated it:

> declin[ed] to reconsider [its] explicit holding in *PaineWebber* [*Incorporated v. Farnam,* 870 F.2d 1286 (7th Cir. 1989)] that NASD Section 15 operates as an eligibility requirement which bars from arbitration claims submitted more than six years after the event which gave rise to them. Because more than six years elapsed from

40. *Sorrells,* 957 F.2d at 510, 514 (questioned by post-*Howsam* decision *Ray v. Von Bergen*, No. 2003-cv-01115, 2003 U.S. Dist. LEXIS 16560 at *5(N.D. Ill. Sept. 17, 2003) for holding the court decides the eligibility issue).

41. *Sorrells,* 957 F.2d at 510-11.

42. As mentioned in note 9, *supra*, for purposes of this article, NASD Section 15, NASD Rule 10304 and FINRA Rule 12206 are used interchangeably.

43. *Sorrells*, 957 F.2d at 511.

44. *Id.*

45. *Id.*

46. *Id.*

47. *Id.*

> the date the [customers] made the last of the ten investments which gave rise to their claims against [brokerage firm/broker] to the date on which they submitted their claims for arbitration, the district court correctly ruled that Section 15 rendered these claims ineligible for arbitration.[48]

The customers attempted to distinguish their claims from *Farnam* by arguing they made allegations of fraudulent concealment, unlike the *Farnam* customers.[49] Therefore, the customers argued that where a claim for fraudulent concealment is present "the doctrine of equitable tolling suspends the running of the limitation period."[50] The appellate court declined to accept the customers' argument since it found the eligibility rule to operate as a jurisdictional requirement that cannot be tolled rather than a statute of limitations.[51] Accordingly, the appellate court affirmed the district' court's order vacating the NASD award.[52]

This line of cases can be distinguished from decisions in Sections IV (C) and (D), *infra*, since they were decided pre-*Howsam*, which concluded the eligibility rule is a gateway procedural matter to be determined by arbitrators. As such, as stated in *Mid-Ohio Sec. Corp. v. Estate of Burns*: "*Howsam undermined the basic premise which courts relied upon to determine eligibility rules like Rule 12206 were not subject to tolling*."[53]

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48. *Sorrells*, 957 F.2d at 512.

49. *Id.*

50. *Id.*

51. *Id.* at 513-14.

52. *Id*. at 514; *see also Castellano v. Prudential-Bache Secs., Inc.*, No. 90 CIV. 1287, 1990 U.S. Dist. LEXIS 7352, at *6 (June 18, 1990) (finding that the "occurrence or event" language in NYSE's six-year eligibility rule relates to the point of purchase [NYSE Rule 605 is virtually identical to FINRA Rule 12206 and its predecessors]); *see also Merrill Lynch, Pierce, Fenner & Smith Inc. v. Jana*, 835 F. Supp. 406 , 408 (N.D. Ill. 1993) (holding that the "occurrence or event" for purposes of the eligibility rule is the date of the investment); *see also PaineWebber Inc. v. Allen*, 888 F. Supp. 53, 55 (1993) (finding the occurrence or event which triggers the six year eligibility rule is the date the customer purchased the limited partnerships).

53. *Mid-Ohio Secs. Corp. v. Estate of Burns*, 790 F. Supp. 2d 1263, 1271 (D. Nev. 2011) (emphasis added), Section IV(D), *infra*.

B. Pre-Howsam Decisions that Found the Eligibility Rule to be a Substantive Jurisdictional Requirement for the Court's Determination not Subject to Tolling and that the "Occurrence or Event Giving Rise to a Claim" can be Broader than the Purchase Date

While this line of cases is also undermined by *Howsam* for the presumption that the court rather than the arbitrator decides the eligibility issue, many of these decisions still found and/or reasoned that there could be independent arbitrable claims beyond the point of purchase. These findings and/or reasonings are consistent with pre-*Howsam* and post-*Howsam* decisions that found the eligibility rule to be a procedural question for the arbitrators to decide and the "occurrence or event" that triggers the six year time limit is broader than the purchase date. Although, these cases found that there could be independent arbitrable claims beyond the point of purchase, the current interpretation of the "occurrence or event" giving rise to a claim is even broader as discussed in Sections IV (C) and (D), *infra*.

The Third Circuit in *PaineWebber, Inc. v. Hofmann*, reasoned that active concealment could create an arbitrable claim pursuant to Section 15 of NASD.[54] In the underlying arbitration, PaineWebber requested that the NASD Director of Arbitration dismiss the customer's claims relating to purchases that were made six years prior to the initiation of the arbitration.[55] The NASD Director of Arbitration "decided that the motion would be left to the arbitrators hearing the merits."[56] Therefore, PaineWebber sought relief from the district court to enjoin the customer's NASD arbitration by arguing some of the customer's claims arose from an occurrence or event more than six years prior to the filing of the NASD arbitration claim.[57] The district court granted summary judgment in favor of the customer concluding that at least some of the customer's claims arose within the six year limitation and therefore the district court "could not say with positive assurance that the entire claim was barred" pursuant to NASD Section 15.[58] As a result, the Third Circuit vacated the district court's order granting summary judgment in

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54. *Hofmann*, 984 F.2d at 1378.

55. *Id.* at 1375.

56. *Id.* at 1376.

57. *Id.* at 1373, 1376.

58. *Id.* at 1374; *see also id.* at 1376, 1377.

favor of the customer and remanded the case for further proceedings.[59] The court concluded, prior to *Howsam* that the court is the proper body to determine the eligibility issue since Section 15 is a substantive contractual limitation.[60] In so concluding, the Third Circuit determined that Section 15 was not subject to tolling or discovery arguments.[61] In addition, the Third Circuit found that PaineWebber was entitled to a declaratory judgment and injunctive relief for the customer's claims that arose six years before the filing of the NASD arbitration (*i.e.,* point of purchase claims).[62] Notwithstanding the fact that PaineWebber was "entitled to summary judgment on some of the [customer's] claims" the court found the customer alleged other claims that were not so clear and could not be determined on the current record.[63] These claims included, *inter alia*, the broker's advice to hold the stock, PaineWebber's active concealment of the broker's misconduct, the customer's discovery of the wrongdoing, the continuation of an integrated pattern of wrongdoing (fraudulent inducement to buy and hold stock over the time period) and the continuation of a wrongful brokerage relationship.[64] The Third Circuit instructed the customer to list each specific claim or theory of recovery and ordered the district court to conduct a hearing with extrinsic evidence (if necessary) to determine what claims are arbitrable.[65] Furthermore, the Third Circuit recognized that determining whether a claim is arbitrable is not easy.[66] The district court must distinguish between what is a cause of action and what is an argument merely tolling the six year limit and in so doing, must not rule on the potential merits of the underlying claims.[67] By way of example, the Third Circuit reasoned that active concealment could create an independent arbitrable claim as follows:

> *As an example of how this analysis would work, consider [the customer's] claim that PaineWebber actively concealed [the broker's] wrongdoing.* This claim easily could be viewed as an

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59. *Hofmann*, 984 F.2d at 1374, 1383.

60. *Id.*

61. *Id.* at 1381.

62. *Id.* at 1374; *see also id.* at 1379.

63. *Hofmann*, 984 F.2d at 1374, 1380.

64. *Id.* at 1380.

65. *Id.*

66. *Id.*

67. *Id.* at 1381.

> attempt to toll the time period on claims arising out of [the broker's] underlying wrongdoing. At the same time, however, *this can also be viewed as an independent cause of action based on a duty owed by PaineWebber to its customers to inform them of a broker's wrongdoing or of the unsuitably speculative nature of their investments*. Whether PaineWebber in fact owes such a duty to its customers is a merits question that must be left to the arbitrators. In this type of situation, the court must assume for the purposes of determining arbitrability that such a duty is owed.[68]

The District Court for the Western District of Oklahoma in *Prudential Securities v. Moneymaker,* found that a brokerage firm's wrongdoing after point of purchase was properly considered for arbitration under Section 15.[69] In that case, the customers filed an arbitration before the NASD alleging that various partnerships purchased from the brokerage firm were unsuitable.[70] The brokerage firm filed the action before the district court "asking the court to determine that certain of [the customers'] claims [were] ineligible for arbitration and to enjoin their prosecution."[71] In response, the customers filed a motion to dismiss asserting that the eligibility determination should be decided by the arbitrators.[72] Pre-*Howsam*, the district court found that the eligibility determination is a substantive contractual limitation for the court to decide and denied the customers' motion to dismiss.[73] Additionally, the court granted in part and denied in part the brokerage firm's motion for summary judgment.[74] The court found that some of the customers' claims related to the brokerage firm's wrongdoing after point of purchase should proceed to arbitration as follows:

> Plaintiff has listed several limited partnership interests purchased by certain defendants more than six years prior to the NASD filing which are arguably ineligible for arbitration and on which it seeks summary judgment. However, defendants' claims are not limited to

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68. *Hofmann*, 984 F.2d at 1381 (emphasis added).

69. *Prudential Secs. v. Moneymaker* No. CIV-93-179, 1994 WL 637396, *2 (W.D. Okl. July 14, 1994).

70. *Id*. at *1.

71. *Id.*

72. *Id.*

73. *Id.*

74. *Moneymaker*, 1994 WL 637396, at *2.

> purchase or sale related claims, but allegedly include claims based on ongoing systemic mismanagement, diversion of funds, misrepresentations, conflict of interest and self-dealing…
>
> Defendants' claims which are based on purchases, mismanagement, diversion of funds, misrepresentations, conflict of interest or self-dealing which actually occurred within the six years prior to the NASD filing will proceed to arbitration.[75]

The Eleventh Circuit in *Merrill Lynch, Pierce, Fenner & Smith v. Cohen*, reasoned that an affirmative misstatement made after the purchase date could create an arbitrable claim pursuant to Section 15.[76] In that case, the customers filed their underlying NASD arbitration alleging that Merrill Lynch sold them various investments that were unsuitable and fraudulently concealed the loss in the investments by reporting false values.[77] In response, Merrill Lynch sought to enjoin the customer's arbitration in state court arguing that the customer's claims were time-barred since the customer purchased the limited partnerships over six years prior to filing their NASD arbitration.[78] The customer removed the case to federal district court based on diversity jurisdiction and sought to compel to arbitration.[79] The district court found that the eligibility issue under Section 15 was for the arbitrators to decide and granted the customer's motion to compel arbitration.[80] On appeal, prior to *Howsam*, the Eleventh Circuit found that the eligibility issue was a substantive requirement for the court to decide and, since it was a substantive requirement, the court believed that it was not subject to equitable tolling.[81] Nonetheless, the Eleventh Circuit recognized that an occurrence or event after the purchase date could create an independent arbitrable claim as follows:

> If the [customers] prove that Merrill Lynch reported false values for their investments through bogus statements, then Merrill Lynch's act of sending the false statements, rather than the initial purchase of the

75. *Id.*

76. *Cohen*, 62 F.3d at 385.

77. *Id.* at 382.

78. *Id.* at 382.

79. *Id.*

80. *Id.*

81. *Cohen*, 62 F.3d at 383, 385, n. 4.

> investments, may be the occurrence or event giving rise to their claims.[82]

Additionally, the Eleventh Circuit specified that it did not express an opinion as to the applicable occurrence or event where a customer was fraudulently induced to purchase securities and the broker subsequently concealed the fraud:

> We express no opinion, however, as to the applicable "occurrence or event" in a case in which a broker used fraud to procure the sale of securities and then continued to conceal the fraud. In this case, if the [customers'] allegations are correct, Merrill Lynch did not merely conceal the fraud, but rather affirmatively misstated the value of the [customers'] investments over a six year period.[83]

Therefore, the Eleventh Circuit reversed and remanded with instructions for the district court to "examine each of the [customers'] claims in order to determine what is the occurrence or event giving rise to that claim."[84] The district court should then "determine if more than six years has elapsed from that event and send any claims that remain viable to arbitration."[85]

As mentioned in Section V, *infra*, the Supreme Court of New York (New York's trial court) in *Goldberg v. Parker* rejected the argument that the occurrence or event that triggers the six-year limitation in Section 15 is the purchase date of the investment.[86] The customer commenced an NASD arbitration alleging that the brokerage firm recommended and purchased unsuitable investments.[87] In response, the brokerage firm initiated an action before New York's trial court seeking to bar the customer's claims on investments purchased six years prior to filing the NASD arbitration.[88] Although the court determined that the issue of eligibility was properly before it, the court rejected the brokerage firm's argument that the trigger for the six year limitation in the eligibility rule was the purchase date.[89] The

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82. *Id.* at 385.

83. *Id.* n. 6.

84. *Id.*

85. *Id.*

86. *Goldberg v. Parker*, No. 94-02670, 1995 WL 396568, at *2-4 (N.Y. Sup. Apr. 12, 1995).

87. *Id.* at *1-2.

88. *Id.*

89. *Id.* at *2.

court reasoned, "*[t]he effect of this interpretation in fraud cases is to reward the unscrupulous broker-dealer and to penalize the unsophisticated investor who does not discover the fraud for more than six years after the investment was purchased*."[90] The court further recognized that the First Department "has never expressly held that the only event which triggers the start of the six year eligibility period under Section 15 is the investment purchase date."[91] Additionally, as set forth in Section V, *infra*, the court acknowledged that the then current Director of NASD arbitration ruled in at least three cases that "the 'purchase date was not the event or occurrence that gave rise to the dispute."[92] Moreover, the court stated:

> Similarly, in appropriate cases the Second and Third Departments have declined to interpret Section 15 as merely involving a mathematical computation, counting six years from the date of purchase of the investment. In *Corbo v. Les Chateau Assocs.,* 127 AD2d 657 (2d Dept.1987), where the customer's claims raised issues of fraud, the Second Department held that arbitration was properly compelled, notwithstanding the allegations that the proceeding to compel arbitration had been brought more than six years after the transactions involved in the petitioner's claim and more than four years after the petitioner should, with reasonable diligence, have discovered the fraud. The court held that where it could not be said as a matter of law that the customer failed to exercise reasonable diligence in discovering the fraud, and where the factual issues underlying the limitations period were so intertwined with the ultimate substantive issues, it was not an abuse of discretion to leave all issues to the arbitrator (cf., *Matter of Prudential Bache Sec. v. Archard,* 179 AD2d [2d Dept.1992], lv. denied 80 NY2d 754).

In *Prudential Securities, Inc. v. Purello,* 206 Ad2d 713 614 NYS2d 638 (3d Dept.1994), the Third Department held:

> Due to the continuing nature of these claims and the uncertainty concerning the date of the occurrence or event giving rise to these claims, leaving these issues to the arbitrator will permit a more efficient resolution.[93]

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90. *Id.* (emphasis added).

91. *Goldberg v. Parker*, 1995 WL 396568, at *3.

92. *Id.* at *4.

93. *Id.*

Accordingly, the court held that since "[t]his case involves allegations of fraud and self-dealing by Goldberg" the discovery of the fraud rather than the purchase date is the starting point for computing the six-year eligibility period.[94]

In another Eleventh Circuit decision, the court in *Kidder Peabody & Co., Inc. v. Brandt*, held that the clock on the six year eligibility rule does not start ticking until the customer suffers damages.[95] Kidder filed suit in district court seeking an injunction of the customers' NASD arbitration and a declaration that the customer's claims were ineligible for arbitration pursuant to Section 15 since they purchased the limited partnerships more than six years prior to filing the statement of claim.[96] The district court entered summary judgment in favor of the customers as to their RICO claim, declaring it was eligible for arbitration since the occurrence or event giving rise to that claim was a "pattern of racketeering activity," which continued through the six-year window.[97] Kidder's appeal followed.[98] The Eleventh Circuit vacated and remanded because the district court failed to identify precisely the last occurrence or event necessary to make the customers' RICO claim viable.[99] In discussing the meaning of Section 15, the court held:

> [W]e hold that under § 15 the "occurrence or event" which "gives rise to the … claim" is the last occurrence or event necessary to make the claim viable. A claim is viable when all the elements of that claim can be established such that it could withstand a motion to dismiss for failure to state a claim for relief pursuant to Federal Rule of Civil Procedure 12(b)(6).
>
> Of course, the last "occurrence or event" necessary to make a claim viable depends on the nature of a particular claim. In some instances, a single "occurrence or event" will establish all the elements of a claim. For example, the single act of striking another may establish all the elements of a claim for battery. In that instance, the act of striking another may be the "occurrence or event" which "gives rise" to a claim for battery.

94. *Id.*

95. *See Kidder Peabody & Co., Inc. v. Brandt*, 131 F.3d 1001, 1004 (11th Cir. 1997).

96. *Id*. at 1002.

97. *Id.* at 1002-1003.

98. *Id.* at 1003.

99. *Id.* at 1004-05.

> In other instances, separate "occurrences or events" establish the various elements of a claim. For example, an action for negligence based on the defective design of a product is not viable until an injury is caused by that product. Although the duty and breach elements of such a claim are established by the company's act of marketing the product, that act does not establish the causation and injury elements of the claim. The incident in which the product causes injury, not the company's act of marketing a defective product, is the "occurrence or event which gives rise to the … claim" within the meaning of § 15. Hypothesizing some dates for the occurrences or events in this example reveals the flaw in Kidder's position. *Suppose that the company marketed the defectively designed product in year one and that, as a result of that defective design, the product caused injury in year eight. Under Kidder's theory, even if a claimant filed an arbitration complaint the moment after his or her claim arose--the moment after he or she was injured--the claim would be ineligible for arbitration. We decline to adopt an interpretation of § 15 that would render some claims ineligible for arbitration before they even come into existence.*[100]

Likewise, the District Court for the Eastern District of Virginia in *Smith Barney Inc. v. Vogele*, concluded that an occurrence or event under Section 15 is not always the date of purchase.[101] Smith Barney sought declaratory and injunctive relief barring arbitration of the customers' claims concerning investments that were purchased six years prior to the initiation of their NASD arbitration pursuant to Section 15.[102] Both parties agreed to a preliminary injunction of the arbitration pending resolution of this matter.[103] Since this case was decided pre-*Howsam*, the threshold issue before the court was whether a court or an arbitrator determines eligibility of a claim pursuant to Section 15.[104] The court determined that it was unnecessary for it to decide who determines eligibility since both parties agreed that Section 15 was part of their contract and the interpretation of a contract is for a court to decide.[105] Since the issue of contract interpretation was properly before the court, the

100. *Brandt*, 131 F.3d at 1004-05 (emphasis added).

101. *Smith Barney Inc. v. Vogele*, 967 F. Supp. 165, 170 (E.D. Va. 1997).

102. *Id.* at 167.

103. *Id.*

104. *Id.*

105. *Id*. at 168-169.

analysis turned to whether the claims were eligible.[106] The court recognized that while the purchase date of an investment will often be the relevant occurrence or event giving rise to a claim, "*no persuasive authority holds that the purchase must be the 'occurrence or event*.'"[107] Additionally the court stated: "*in cases considering the purchase as the relevant event, it is unclear whether customers asserted any claims except for the purchase of the contested investment*."[108] Moreover, the court reasoned that it was not the NASD's intention to create a per se rule that the occurrence or event giving rise to a dispute is always the purchase date of a security as follows:

> Clearly, the drafters of the NASD Code could have provided that claims be brought for arbitration within six years of the purchase of the disputed investment. Their quite different choice of language is telling, and belies any conclusion *that an "occurrence or event" is [not] necessarily the date of purchase.*[109]

Nonetheless, the court agreed with prior decisions that eligibility cannot be tolled and a claim must state a genuine, independent cause of action in order to be submitted to arbitration.[110] In this case, the court determined that the customers' theories of recovery including, *inter alia*, fraudulent concealment, failure to advise and failure to review "[did] not attempt to recover on the basis of the original decision and advice to purchase the disputed investments."[111] As such, the court determined that the theories constituted independent claims and were not merely tolling or discovery arguments.[112] In so concluding, the court determined that the customers' claims were properly submitted to the arbitrator for resolution on the merits and denied Smith Barney's petition to enjoin the arbitration.[113]

In *Osler v. Ware*, the Sixth Circuit rejected the argument that the purchase date always triggers the running of the six year period in Section

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106. *Vogele*, 967 F. Supp. at 169.

107. *Id.* (emphasis added).

108. *Id.* (emphasis added).

109. *Id*. at 170 (emphasis added).

110. *Id.* at 171.

111. *Vogele*, 967 F. Supp. at 171-172.

112. *Id.* at 172.

113. *Id*.

15.[114] In that case, the broker filed two separate actions to enjoin the customer's NASD arbitration in district court claiming that the customer's claims were barred by Section 15 since the customer purchased the investments at issue more than six years prior to filing her NASD arbitration.[115] The first action to enjoin was voluntarily dismissed by the broker based on the impression that the customer would not be pursing certain damages stemming from pre-February 3, 1987 wrongdoing pursuant to a letter issued by the NASD Director of Arbitration.[116] After learning that the customer still maintained all damage claims, the broker filed the second action to enjoin.[117] The district court's order concluded that a claim of fraudulent concealment can toll the six-year eligibility provision in Section 15 and that whether or not there was fraudulent concealment is an issue for the arbitrators to decide.[118] Thereafter, the broker appealed the district court's decision.[119] The appellate court found that the application and scope of Section 15 is for the court to decide and is not subject to tolling.[120] Accordingly, the appellate court reversed and remanded.[121] Nonetheless, the appellate court conceded that some of the customer's claims, including false values on the customer's statements and churning, based on wrongdoing occurring after the initial investments and in those instances "'the occurrence or event giving rise to the act or dispute, claim or controversy' would not be the initial investment."[122] Moreover, the appellate court rejected the argument

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114. *Osler v. Ware*, 114 F.3d 91, 93 (6th Cir. 1997) (questioned by post-*Howsam* decision in *Smith v. Dean Witter Reynolds*, 102 Fed Appx. 940, 941 (6th Cir. 2004) for holding that the court decides the eligibility issue).

115. *Osler*, 114 F.3d at 92.

116. *Id.* The court cited to a letter issued by the NASD Director of Arbitration "which provided that 'claims regarding purchases made prior to February 3, 1987 will be permitted to go to the arbitrators but only as to allegations of wrongdoing made after February 3, 1987. All allegations of wrongdoing prior to February 3, 1987 are not eligible.'" *Id*. at 92.

117. *Id.*

118. *Id*. at 91-92.

119. *Osler*, 114 F.3d at 91-92

120. *Id.*

121. *Id.* at 92-93.

122. *Id.* at 93.

that the purchase date always triggers the running of the six year period in Section 15 as follows:

> Although counsel for [the broker] *contended at oral argument that the only relevant date for determining whether a claim is time-barred is when the initial investment was made, this theory does not comport with either the "occurrence or event" language contained in § 15 or the caselaw that has developed thereunder… Accepting [the broker's] proposed approach would create situations in which certain claims would be barred before they even arose. Needless to say, we refuse to interpret the "occurrence or event" language, which does not otherwise suggest that the purchase date always triggers the running of the six-year period, in this manner*.[123]

On remand, the Sixth Circuit instructed the district court to afford the customer "the opportunity to list each claim and the occurrence or event giving rise to such claim." The district court should then analyze each of the claims to determine which are time-barred.[124]

The Seventh Circuit in *J.E. Liss & Co. v. Levin*, found that post-purchase investment advice to retain/renew a security the customer already owned creates an arbitrable claim under NASD Rule 10304.[125] In that case, the brokerage firm and broker sought to vacate an arbitration award in favor of the customer since the customer purchased the limited partnership more than six years prior to the filing of his NASD arbitration.[126] The customer counterclaimed to confirm the award.[127] The district court vacated the arbitration award finding in favor of the brokerage firm and broker.[128] On appeal, the Seventh Circuit addressed whether NASD Rule 10304 had been waived by the brokerage firm and broker since they failed to plead it in their NASD answer and whether the court or the arbitrators make the eligibility determination.[129] The court concluded that the six-year bar is nonwaivable

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123. *Id*. (emphasis added) (internal citations omitted).

124. *Osler*, 114 F.3d at 93.

125. *J.E. Liss & Co. v. Levin*, 201 F.3d 848, 851-52 (7th Cir. 2000) (overruled in part by *Howsam*, 537 U.S. 79 (2002) for the finding that the court rather than the arbitrator decides the eligibility issue).

126. *Id.* at 849.

127. *Id*.

128. *Id.*

129. *Id.* at 851.

and that the court makes the eligibility determination.[130] In so concluding, the court stated:

> So the six-year bar is nonwaivable before the arbitrators and its applicability is to be determined by the court, but none of this helps [the brokerage firm and broker] because we conclude that the bar is inapplicable in the circumstances of this case. Rule 10304 does not bar a claim that arises within the six-year period merely because the securities involved in the claim were bought more than six years before the claim was filed. If the only basis for the claim were Rule 10b-5, which limits its protections to securities transactions, *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 44 L. Ed. 2d 539, 95 S. Ct. 1917 (1975), the plaintiff could not win a case based on post-sale conduct, such as a representation designed to prevent the plaintiff from selling the security. But the claim would fail on the merits, not because of the six-year bar. *If as in this case the plaintiff bases his claim on conduct that took place after he bought the security, the six-year period begins to run as of the date of that conduct, not the date of the purchase*…Otherwise if [the broker], driven to distraction by [the customer's] incessant complaints about the dismal performance of [the limited partnership], had hit [the customer] over the head with a mallet in year seven he would be immune from any claim under the dispute-resolution provisions of the NASD's arbitration code. We can't see the sense in that. It is true that [the customer] alleged fraud in the sale of the [limited partnership], as well as post-sale fraud. But the arbitrators said they were basing their award on the latter. The fact that the post-sale fraud could be said to have arisen from the sale fraud, in the sense that had [the customer] never bought the interest in [the limited partnership] the [brokerage firm and broker] would never have represented to him that [the limited partnership] would emerge intact from bankruptcy, no more brings the six-year limitation into play than the fact that in our hypothetical case the incident with the mallet would not have occurred had it not been for the sale of the security more than six years before the claim was filed. If a claim accrues as soon as a necessary condition to its existence arises, then [the customer's] claim accrued when Columbus discovered America, if not, indeed, at the time of the Big Bang.
>
> What is true is that if the only allegation about the post-sale conduct had been that it had lulled [the customer] into delaying the filing of a

130. *Levin*, 201 F.3d at 851.

> claim based on the fraudulent inducement of the sale, he would be arguing fraudulent concealment of the wrong and we know from Sorrells that fraudulent concealment would not extend the six-year deadline for filing the claim. 957 F.2d at 512-14. *But that is not the allegation. The allegation is of an independent fraud designed not to lull [the customer] into not suing but rather to dissuade him from selling his investment in [the limited partnership]*.[131]

The Seventh Circuit found that there was no defense to the suit to confirm the arbitrators' award and reversed the district court's judgment with directions to confirm the award.[132]

C. Pre-Howsam Decisions that Found the Eligibility Rule Creates a Procedural Question for the Arbitrators to Decide and that the "Occurrence or Event Giving Rise to a Claim" is Broader than the Purchase Date

Although this line of cases is pre-*Howsam,* the decisions discussed below are consistent with the finding in *Howsam* that the eligibility rule is a gateway procedural matter to be determined by arbitrators. Consistent with current FINRA guidance,[133] these cases reject the presumption that the "occurrence or event" language always relates to point of purchase.

In 1993, the District Court of Minnesota in *FSC Sec. Corp. v. Freel*, rejected the broker-dealer/broker assertion that the language in Section 15 "clearly indicated" that the six-year limitations period commenced on the date of purchase.[134] By way of background, the customers filed an arbitration claim before the NASD alleging that the broker-dealer/broker recommended unsuitable investments.[135] The broker-dealer/broker unsuccessfully moved to dismiss the underlying arbitration claim three times based on the allegation that most of the customers' claims were barred by Section 15 since four of the six investments were purchased more than six years prior to filing of the arbitration.[136] The broker-dealer/broker first brought their motion to dismiss

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131. *Id.* at 851-82 (emphasis added) (internal citations omitted).

132. *Id.* at 852.

133. *See* Section V, *infra*.

134. *FSC Secs. Corp. v. Freel*, 811 F. Supp. 439, 444 (D. Minn. 1993).

135. *Id.* at 440-441.

136. *Id.* at 441.

before the NASD staff, then before the NASD panel after their appointment, and again before the NASD panel at the arbitration hearing.[137] One month after the hearing, the NASD panel issued an award in favor of the customers.[138] The broker-dealer/broker then sought to vacate the award in district court arguing that the arbitrators exceeded their powers by rendering an award on claims not eligible for submission under Section 15 and that the arbitrators manifestly disregarded the law.[139] At the same time, the customers moved to confirm the award.[140] The court found that the arbitrators did not exceed their powers or manifestly disregard the law.[141] In determining whether the arbitrators exceeded their authority, the court addressed the issue of who decides eligibility and the interpretation of Section 15.[142] The court found that Section 15 is a procedural limitation to be interpreted and decided by the arbitrators.[143] Additionally, the court recognized that the six year limitation in Section 15 does not clearly relate to point of purchase as follows:

> Reading section 15 as a procedural limitation to be interpreted by the arbitrator is particularly appropriate given the broad language of the section. Contrary to plaintiffs' assertion, *the language of section 15 does not clearly indicate that the six-year limitations period commences on the date of purchase; rather, it measures the six-year period from 'the occurrence or event giving rise to the act or dispute, claim or controversy.' NASD § 15* (emphasis added and emphasis in the original). *The 'occurrence or event' triggering the claim could be the date of purchase; it could just as plausibly be some other occurrence or event*. Requiring courts to determine the point at which the six-year time limitation commenced would not only entangle courts in the merits of arbitrated disputes, but would provide an opportunity for delay and duplication of effort. These are

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137. *Id.*

138. *Id.*

139. *Freel*, 811 F. Supp. at 441.

140. *Id.*

141. *Id.* at 441-46.

142. *Id.* at 441-45.

143. *Id.* at 443-445.

> precisely the results that the principle of deference to an arbitrator's procedural determinations was designed to prevent.[144]

Furthermore, as set forth in Section V, *infra*, the court acknowledged that the then current Director of NASD arbitration ruled that the "'purchase date was not the event or occurrence that gave rise' to the dispute." [145]

In *PaineWebber, Inc. v. Landay*, the District Court of Massachusetts found that Section 15 of NASD was a procedural question that could be tolled.[146] In that case, PaineWebber sought declaratory and injunctive relief to bar the customers from seeking arbitration of certain claims.[147] As grounds for its motion for a preliminary injunction, Pain Webber argued, *inter alia*, that the customers' claims were not eligible for arbitration pursuant to Section 15 since the purchase of certain investments occurred six years prior to the filing of the NASD claim.[148] In response, the customers sought an order compelling arbitration arguing, *inter alia*, that "due to acts of fraudulent concealment they were unable to discover their cause of action" until a later date within the six-year limitation.[149] The court concluded that eligibility is a procedural question for the arbitrators to decide and nothing in Section 15 precluded tolling of the six-year time limitation.[150] The court stated:

> [N]othing either in the terms of the parties' agreement or in Section 15 itself which compels the conclusion that issues of "tolling" are precluded from consideration under Section 15's six-year eligibility requirement. The [customers] here assert that due to acts of fraudulent concealment they were unable to discover their cause of action until 1993. If one accepts tolling as an appropriate consideration, therefore, the issue of whether their claims are time-barred cannot be resolved without inevitable engagement on the merits of the claim…
>
> …the question of whether Section 15 of the NASD Code renders certain of the [customers'] claims ineligible for an arbitration award

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144. *Freel*, 811 F. Supp. at 444 (emphasis added and emphasis in original).

145. *Id.* at 444, note 6.

146. *PaineWebber, Inc. v. Landay*, 903 F. Supp. 193, 202 (D. Mass. 1995).

147. *Id.* at 194-95.

148. *Id.* at 195, 198.

149. *Id.* at 202.

150. *Id.* at 201-03.

> is a question to be determined by the arbitrator rather than the court. PaineWebber's objection to the arbitration on the ground that the bulk of the [customers'] claim is ineligible is therefore rejected.[151]

In 1995, the Court of Appeals for the Fifth Circuit in *Smith Barney Shearson, Inc. v. Boone*, also found that post-purchase wrongdoing could be an event or occurrence giving rise to a dispute under Section 15 and AMEX [now NYSE] Rule 605.[152] Smith Barney separately sought injunctive relief and a declaratory judgment from the district court on both customers' claims since the claims were filed more than six years after the last investment/purchase.[153] The district court dismissed both claims holding that timeliness is a procedural question to be determined by the arbitrators.[154] Smith Barney appealed the district court's decision and consolidated the cases for review.[155] On appeal, the court affirmed the district court's decision by finding that timeliness is a procedural issue for the arbitrators to decide.[156] In reaching its decision, the court refused to accept Smith Barney's contention "that the last act was the last purchase by each customer as follows:"

The [customers], however, allege that [Smith Barney] continued to act fraudulently after the last purchases were made and within six years of the filing of the arbitration complaint…Finally, both [customers] argue that the time bars should be tolled since [Smith Barney] engaged in fraudulent conduct which prevented the [customers] from learning several important facts until after the six year post-purchase date. Thus, there is substantial controversy over whether the time bars will act to bar the causes of action asserted by the [customers]. This Court cannot… prevent arbitration.[157]

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151. *Landay*, 903 F. Supp. at 202-03 (internal citation omitted).

152. *Boone*, 47 F.3d at 754. American Stock Exchange Rule 605 is virtually identical to Section 15. Rule 605 states as follows: "No dispute, claim or controversy shall be eligible for submission to arbitration in any instance where six (6) years shall have elapsed from the occurrence or event giving rise to the act or the dispute, claim or controversy." *Id.* at 751.

153. *Id.* at 751-52. One customer brought a claim before the American Stock Exchange [now NYSE] arbitration forum and the other customer brought a claim before the NASD arbitration forum. *Id.*

154. *Id.*

155. *Boone*, 47 F.3d at 752.

156. *Id.* at 751, 754.

157. *Id.* at 754.

D. Post-Howsam Decisions that Found the Eligibility Rule Creates a Procedural Question for the Arbitrators to Decide and that the "Occurrence or Event Giving Rise to a Claim" is Broader than the Purchase Date

Consistent with the holding in *Howsam*, recent decisions have found the eligibility rule is a gateway procedural matter to be determined by arbitrators. Additionally, these cases recognize that Howsam undermined the basic premise upon which courts relied to determine the eligibility rule was not subject to tolling.[158]

In 2011, the District Court of Nevada in *Mid-Ohio Sec. Corp. v. Estate of Burns*, determined that FINRA Rule 12206 is not a strict rule of eligibility but a question for the arbitrators to interpret as they see fit including adding in tolling provisions or a discovery rule.[159] By way of background, the customer initiated a FINRA arbitration against the brokerage firm alleging, *inter alia*, that the brokerage firm failed to conduct due diligence, negligence and breach of contract relating to the customers' investment in a private offering.[160] In the underlying arbitration, the brokerage firm filed a motion to dismiss raising the eligibility issue pursuant to FINRA Rule 12206 arguing that the relevant conduct (*i.e.,* purchase of investment at issue) occurred more than six years prior to the filing of the statement of claim which was denied

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158. In our practice, brokerage firms have only cited to one post-*Howsam* decision, *Chang v. Citigroup, Inc.*, No. 3:2009cv02966, 2010 U.S. Dist LEXIS 10167 (N.D. Cal. 2010), in support of their motions to dismiss pursuant to FINRA Rule 12206. In that case, the FINRA arbitration panel dismissed the customer's claims as ineligible and time barred pursuant to FINRA Rule 12206. *Id*. at 4-6. Thereafter, pursuant to FINRA Rules, the customer filed his claims in court. *Id.* at 1-3. In response, Citigroup filed a motion to dismiss in court. *Id.* at 4-6. In deciding Citigroup's motion, the court interpreted and applied statutes of limitations and found in favor of Citigroup. *Id.* at 1, 15. *Chang* can be distinguish on the grounds that the court does not interpret FINRA Rule 12206 but rather interprets the application of the statutes of limitation. Additionally, since the underlying FINRA order dismissing the customer's claims was not an explained decision, the reasoning of the FINRA panel is unknown. Nonetheless, based on the facts in the court's decision, the customer failed to allege any continuing fraud and/or continuing wrongdoing on the part of Citigroup sufficient to warrant tolling of the applicable statutes of limitation. *Id*. at 3-6.

159. *Mid-Ohio Secs. Corp.*, 790 F. Supp. 2d at 1271.

160. *Id.* at 1265.

by the panel.[161] The brokerage firm re-raised the eligibility issue in closing argument.[162] Thereafter, the panel issued an arbitration award in favor of the customer.[163] As a result, the brokerage firm filed a petition before the court to vacate the award.[164] The brokerage firm argued that the arbitrators manifestly disregarded the law because the wife did not have standing and the customer's claims were ineligible pursuant to FINRA Rule 12206 since the purchase of the investment at issue occurred six years prior to the initiation of the FINRA arbitration.[165] In response, the customer opposed the petition to vacate and filed a cross petition to confirm the award.[166] In deciding the eligibility issue, the court acknowledged that pre-*Howsam* and prior to the current FINRA Rule 12206, there was a split of authority on who makes the eligibility determination (*i.e.,* the court or the arbitrators).[167] However, the United States Court in *Howsam* ended the controversy when it ruled that the eligibility determination is a matter for the arbitrators to decide, which in turn was recognized by FINRA in the current language in Rule 12206.[168] Notwithstanding the fact that the brokerage firm conceded the question of eligibility was for the arbitrators to decide, the brokerage firm argued that the arbitrators "ignored the law that Rule 12206 is not subject to tolling and the limitation period runs from the purchase of the investment in this case…"[169] The court rejected the brokerage firm's argument and found that the arbitrators did not manifestly disregard the law as it relates to FINRA Rule 12206.[170] Specifically, the court addressed the post-*Howsam* interpretation of FINRA Rule 12206 as follows:

> *Howsam undermined the basic premise which courts relied upon to determine eligibility rules like Rule 12206 were not subject to tolling. Those courts relied on the premise that the eligibility rule was a*

161. *Id.* at 1266.

162. *Id.*

163. *Id.* at 1267.

164. *Mid-Ohio Secs. Corp.*, 790 F. Supp. 2d at 1267.

165. *Id.* at 1267, 1270.

166. *Id.* at 1267.

167. *Id*. at 1270-1271.

168. *Id.* at 1271.

169. *Mid-Ohio Secs. Corp.*, 790 F. Supp. 2d at 1271.

170. *Id.* at 1271-72.

> *substantive limit on the agreement to arbitrate, not a statute of limitations. Thus, the time period was not subject to tolling. However, Howsam eviscerated that premise, finding that the eligibility time limit was not a question of arbitrability, but a gateway procedural matter for the arbitrator. Thus, the entire line of cases that suggest Rule 12206 is not subject to tolling is undermined. Therefore, it would not be manifest disregard of the law not to follow this line of cases post-Howsam*.[171]

Further, the court concluded that the arbitrators were free to interpret FINRA Rule 12206 as they saw fit:

> Because Rule 12206 is not a strict rule of eligibility, but a question for the arbitrators more akin to a statute of limitations, the arbitrators were free to interpret the rule as they saw fit, including adding in tolling provisions or a discovery rule…If the arbitrators adopted tolling or discovery principles and used the [date of discovery of the fraud] as the triggering event, that would be within the six-year period in Rule 12206. The FINRA panel had comparatively more expertise about the meaning of its own rule, and it therefore could weigh the propriety of tolling or the discovery rule in any particular case. The Court therefore will deny the motion to vacate based on FINRA Rule 12206.[172]

Accordingly, the court denied the brokerage firm's petition to vacate the award and confirmed the award in favor of the customer.[173]

The Court of Appeals of Michigan in *Hantz Fin. Servs., v. Monroe*, concluded wrongful acts that occurred after the point of purchase such as bogus statements and fraudulent misrepresentations could have triggered the six year time limitation under FINRA Rule 12206 and as such the eligibility issue was properly decided by the arbitration panel.[174] In that case, the customers filed an arbitration claim before FINRA alleging negligent supervision and fraud.[175] Specifically, the facts demonstrate that the broker deposited the customers' funds into his personal account and provided the

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171. *Id.* at 1271 (emphasis added).

172. *Id.* at 1271-72.

173. *Id.* at 1272.

174. *Hantz Fin'l. Servs. v. Monroe*, No. 301924, 2012 Mich. App. LEXIS 147, *7-9 (Mich. Ct. App. Jan. 24, 2012).

175. *Id.* at *1-2.

customers with fraudulent account statements through 2007.[176] The broker's embezzlement became known in 2008 and he committed suicide days later.[177] Thereafter in 2009, the brokerage firm assured all of the broker's former clients that it would reimburse them for their losses but failed to reimburse the customers in this case.[178] In the underlying arbitration, the brokerage firm's answer stated that FINRA did not have the authority to arbitrate the dispute pursuant to FINRA Rule 12206 since the customers did not deliver any funds to the broker after 2003 and the arbitrators concluded otherwise.[179] The arbitration panel issued an award in favor of the customers and the brokerage firm moved to dismiss the award in circuit court arguing the arbitration panel erred when it determined the claims were eligible.[180] The circuit court denied the brokerage firm's motion and the brokerage firm appealed.[181] On appeal, the brokerage firm again argued that the circuit court erred and the arbitrators exceeded their powers because the occurrence or event giving rise to the claim is the date of investment and even if the occurrence or event is not necessarily the date of investment the customers' claims are still ineligible because none of the alleged wrongful conduct occurred after that date.[182] The appellate court rejected both arguments concluding that the occurrence or event giving rise to the claim is not always the investment date and wrongful acts such as bogus statements and fraudulent misrepresentations could have triggered the six year time limitation under FINRA Rule 12206.[183] Therefore, the court found the panel did not exceed its authority when it determined that defendants' claims were not barred under FINRA Rule 12206 and affirmed the circuit court's decision.[184]

In another recent decision, the District Court for the Northern District of California in *Oshidary v. Purpura-Andriola*, agreed with *Mid-Ohio Sec. Corp.,* and found that the arbitration panel was free to interpret FINRA Rule

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176. *Id.* at *1.

177. *Id.*

178. *Id.* at *1-2.

179. *Hantz Fin'l. Servs.* 2012 Mich. App. LEXIS 147 at *2.

180. *Id.*

181. *Id.*

182. *Id.* at *5-8.

183. *Id*. *5-9.

184. *Hantz Fin'l. Servs.* 2012 Mich. App. LEXIS 147 at *9-10.

12206 as it saw fit.[185] In that case, a broker gave investment advice to multiple clients to loan money to a technology company while employed by Smith Barney.[186] In advising the clients to loan money, the broker made false representations about the health and stability of the technology company.[187] The clients originally filed suit against the broker and Smith Barney in the California Superior Court and were ordered to proceed to FINRA arbitration.[188] In their FINRA arbitration, the claimants alleged claims for breach of fiduciary duty, failure to supervise, intentional misrepresentation, negligent misrepresentation, conspiracy and breach of contract.[189] The broker counterclaimed against the claimants for harassment, interference with contractual relations, defamation and extortion.[190] Following the conclusion of the claimants' case in chief, the arbitration panel granted Smith Barney's request for dismissal of all claims against it.[191] In addition, the panel dismissed all claims against the broker except for the claims for breach of fiduciary duty brought by six of the claimants.[192] Additionally, the panel denied the broker's request for dismissal for violation of the statute of limitations.[193] Thereafter, the broker filed a motion to dismiss the remaining claims for breach of fiduciary duty.[194] The arbitration panel conducted additional hearing sessions and issued an award in favor of two of claimants (four claimants settled their claims prior to the final hearing sessions) based on the broker's breach of fiduciary duty.[195] Thereafter, the broker filed a petition to vacate the arbitration award in the district court and the remaining

185. *See Oshidary v. Purpura-Andriola*, No. 3:2012cv02092, 2012 U.S. Dist. LEXIS 81367, *14-18 (N.D. Cal. June 12, 2012); *see also Mid-Ohio Secs. Corp.,* 790 F. Supp. 2d at 1271-72.

186. *See Oshidary*, 2012 U.S. Dist. LEXIS 81367 at *2.

187. *Id.*

188. *Id*. at *3.

189. *Id.*

190. *Id.*

191. *Oshidary*, 2012 U.S. Dist. LEXIS 81367 at *4.

192. *Id.*

193. *Id.*

194. *Id.*

195. *Id.* at *4-5.

claimants countered with a request to confirm the award.[196] The broker argued four theories on which the award should be vacated including, the panel manifestly disregarded the law since the claims were precluded from arbitration pursuant to FINRA Rule 12206 based on the purchase date (*i.e.,* date the loans were made).[197] The court denied the broker's petition on all four claims and confirmed the arbitration award.[198] In determining whether the panel manifestly disregarded the law with regard to FINRA Rule 12206, the court turned to the recent decision of *Mid-Ohio Sec. Corp.,* and concluded:

> This Court agrees with [the *Mid-Ohio Sec. Corp*] analysis and adopts it here. The Panel was free to interpret Rule 12206 as it saw fit, in particular with respect to the triggering date, i.e. the "occurrence or event giving rise to the claim." FINRA Rule 12206. It appears from a partial transcript of one arbitration hearing appended to [the broker's] Reply Brief that the Panel believed the triggering event was a 2006 board meeting "in which the claimants were informed that their loans and monetary investments into the company weren't worth anything…" It was not manifest disregard of the law to so find. … There is no "well defined, explicit, and clearly applicable" law regarding whether the trigger date must be the date of investment.[199]

V. FINRA'S INTERPRETATION AND GUIDANCE TO ARBITRATORS IS THAT THE "OCCURRENCE OR EVENT" LANGUAGE IN THE ELIGIBILITY RULE CAN BE LATER THAN THE PURCHASE DATE

"FINRA believes that parties have the right to a hearing in arbitration. *Therefore, motions to dismiss filed prior to the conclusion of a party's case-in-chief are discouraged and should be granted only under limited circumstances*."[200]

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196. *Oshidary*, 2012 U.S. Dist. LEXIS 81367 at *5.

197. *Id.* *7-8.

198. *Id.* at *21.

199. *Id.* at *15-17 (internal citations omitted).

200. FINRA, FINRA DISPUTE RESOLUTION ARBITRATOR'S GUIDE at 38 (Apr. 2013)

FINRA Dispute Resolution Arbitrator's Guide ("Arbitrator's Guide") provides arbitrators with guidance on FINRA rules, practice, and procedure.[201] The Arbitrator's Guide explains the eligibility rule and "a continuing occurrence or event" under the rule as follows:

> The panel determines whether a claim meets the six-year eligibility requirement by reviewing the submissions, pleadings and arguments of the parties. When appropriate, the panel may give the parties a reasonable opportunity to conduct discovery. As with any discovery request, arbitrators have discretion to grant, deny or modify the request. If the arbitrators have additional questions about the eligibility of the claim, they should ask the parties to brief the issue. *The arbitrators may find that there is a continuing occurrence or event giving rise to the dispute. For example, although a customer purchased stock 10 years ago, there are allegations of ongoing fraud starting with the purchase, but continuing to a date within six years of the date the claim was filed*.[202]

Further, the NASD has stated that the six year eligibility rule can be triggered by events occurring after the purchase date of the securities at issue, including a party's discovery of wrongdoing. In *Goldberg v. Parker*, discussed in detail in Section IV, *supra*, the New York Supreme Court observed that the NASD Director of Arbitration had determined "…that, at least in fraud cases, the 'occurrence or event' language in §15 is not automatically interpreted as the investment purchase date."[203] Specifically, the court quoted a letter written by the NASD Director of Arbitration which stated:

> It has been determined that the purchase date is not the event or occurrence that gave rise to this dispute. Also, Section 15 does not refer specifically to the purchase date as the time that the six year limitation begins to run. Therefore *it is equally appropriate that the*

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available at http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p009424.pdf (emphasis added).

201. *See Id*.

202. *Id*. at 37 (emphasis added); *see also* FINRA, *FINRA Dispute Resolution Arbitrator Training*: *Motions to Dismiss* at 9 (Aug. 2010) *available at* http://www.finra.org/web/groups/arbitrationmediation/@arbmed/@arbtors/documents/arbmed/p122123.pdf.

203. *Goldberg*, 1995 WL 396568 at *4.

> *discovery by the claimant be treated as the occurrence or event giving rise to the dispute...*[204]

Additionally, "[i]n at least five separate rulings, the NASD Arbitration Director held that the 'occurrence or event giving rise to the dispute, claim or controversy' is the date claimants discovered the fraud or wrongdoing, not the purchase date of claimants' investment."[205] This article cited to the NASD letter referenced in *Goldberg* and *FSC Sec. Corp* and went on to state:

> Using the same exact language [as the letter referenced in *Goldberg* and *FSC Sec. Corp*], the NASD Arbitration Director denied two more NASD Code Rule 10304 "eligibility" motions to dismiss filed by respondents on the same grounds, finding that the investment purchase date was not the "event or occurrence" giving rise to the claim. Priv. Ltr. Rul. 90-01342 (Sept. 17, 1991); Priv. Ltr. Rul. (Aug. 9, 1991).
>
> In two other fraud cases, the NASD Arbitration Director denied respondents' NASD Code Rule 10304 "eligibility" motions to dismiss and expressly held that the date claimants discovered the fraud was the date that triggered the six-year limitation period. Priv. Ltr. Rul. 91-02199 (Jan. 16, 1993) ("Jan. 1993 Ruling"); Priv. Ltr. Rul. 92-01717 (Oct. 20, 1992), ("Oct. 1992 Ruling").[206]

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204. *Id.* (emphasis added); *see also FSC Secs. Corp.,* 811 F. Supp. at 444, n. 6 (citing the same letter from the NASD Director of Arbitration holding that the occurrence of event triggering a claim "could just as plausibly be some other occurrence or event" as the date of purchase).

205. Ernest E. Badway and Anthony Del Guericio, *Timing Cuts to the Heart of the Matter; In NASD Arbitration proceedings, eligibility motions are not ordinary statute of limitations filings*, 182 N.J.L.J., 182, (Dec. 26, 2005).

206. *Id.* The article cited the NASD Arbitration Director's two other rulings in the fraud cases as follows:

> As to Section 15 of the NASD Code of Arbitration Procedure, the NASD National Arbitration Committee has provided me with discretion on a case by case basis in determining the occurrence or event giving rise to the act of dispute claim, or controversy from which the six (6) year eligibility time period will be calculated.
>
> In this matter, claimants have alleged that September 1989 was the date they learned of the continued misrepresentation and/or fraudulent inducement by the respondents. Therefore, I have determined the claim to be eligible under Section 15. See Jan. 1993 Ruling…

Moreover, the NASD Director of Arbitration's interpreted the eligibility rule in limited partnership disputes as follows:

> But arbitration directors are becoming more flexible on the six-year limit. The rules say an investor must file a claim within six years of the 'occurrence or event giving rise to the act or dispute,' said Deborah Masucci, director of arbitration at the National Association of Securities Dealers Inc. In the case of limited partnership disputes, Ms. Masucci has surprised the industry by beginning to interpret the 'occurrence or event' as being the date an investor becomes aware of a precipitous decline in a partnership's value on a statement.[207]

Therefore, FINRA's guidance, policies and interpretation of its own rules evidence that the purchase date is not always the triggering event for the six-year limitation under FINRA Rule 12206 and its predecessors.

VI. ARBITRATORS HAVE INTERPRETED THE "OCCURRENCE OR EVENT" LANGUAGE IN THE ELIGIBILITY RULE AS BEING BROADER THAN ALWAYS RELATING TO THE POINT OF PURCHASE

Consistent with the law, FINRA rules, FINRA policies and FINRA guidance, arbitration panels have recognized and applied the "continuing" occurrence or event under FINRA Rule 12206 and found brokerage firms liable for wrongful conduct that occurred post-purchase of the investment at issue.[208] Specifically, the arbitration panels denied Citigroup's motions to

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> In NASD #92-01717, the claimant's attorney alleges fraudulent concealment by the respondents which prevented the claimant from discovering the wrongdoing until 1989.
>
> Since the allegations of continuing fraud fall within the eligibility requirements of Section 15 of the Code of Arbitration, that is within six (6) years of May 6, 1992, the date claimant executed her submission agreement in this matter, the Director has determined that this case shall proceed. See Priv. Ltr. Rul. 92-01717.

207. Susan Antilla, *Wall Street; When Time to Complain Runs Out*, N.Y. TIMES, (Sept. 27, 1992), *available at* http://www.nytimes.com/1992/09/27/business/wall-street-when-time-to-complain-runs-out.html.

208. It is common for brokerage firms to cite to prior FINRA awards and/or orders granting motions to dismiss. These awards and/or orders can usually be distinguished on the grounds that the customer did not set forth a "continuing" occurrence or event giving rise to the dispute. *See, e.g., Boston Prop. Exch. Transfer Group v. Merrill Lynch*, FINRA Arb. No. 10-03330; *Tweed v. UBS, et al.*, FINRA

dismiss pursuant to FINRA Rule 12206 in *Reby v. Citigroup Global Markets, Inc*. (FINRA Arbitration No. 11-00809), *McKee v. Citigroup Global Markets, Inc*. (FINRA Arbitration No. 11-02483), *Halpern v. Citigroup Global Markets, Inc*. (FINRA Arbitration No. 11-01980) and *Moskowitz v. Citigroup Global Markets, Inc*. (FINRA Arbitration No. 11-01253).[209]

These cases involved a security that Citigroup sold to its clients as a fixed income alternative that would generate tax-free returns between 6-9%. In truth, the security was high risk and speculative. Citigroup failed to disclose, *inter alia*, the high risk and speculative nature of the security to its clients, continued to misrepresent the product and continued to mismanage the security until its implosion in 2008.

In these cases, Citigroup argued that the claimants' claims should be dismissed because they purchased the security at issue over six years prior to the filing of their statement of claims. In support of this argument, Citigroup argued that the only transaction at issue was the purchase of the security, suitability is determined at point of sale, the passage of time significantly prejudices Citigroup, the six-year limitation in FINRA Rule 12206 is absolute and cannot be tolled and numerous panels have granted similar motions.

In opposition, claimants argued that even though they purchased the security outside the six-year limitation, Citigroup misrepresented the security at the point of purchase, continued to misrepresent the security, continued to mismanage the security, and failed to disclose material facts to claimants. Further, claimants argued that as a result of Citigroup's misrepresentations, omissions, and active concealment, the claimants were induced to hold their investments in the security and suffered significant damages. Additionally, the claimants argued they were not aware of Citigroup's wrongful conduct until after the implosion of the security in February 2008. In summary, claimants argued that Citigroup's wrongful conduct was part of an "ongoing fraud" that continued into 2008 (*i.e.,* within the six-year time limitation) which supports the claims of breach of fiduciary duty, breach of contract,

Arb. No. 09-01782; *Bernard v. InterSecurities, Inc.*, FINRA Arb. No. 07-01272; *Thompson v. Pavek Investments, Inc.*, FINRA Arb. No. 09-00022; and *Lien, et al., v. Morgan Stanley DW Inc.*, FINRA Arb. No. 05-01345.

209. The orders issued by the panels were not explained decisions but denied Citigroup's motions to dismiss after briefing the issue in all matters and oral argument in *Reby, Mckee* and *Moskowitz*. Additionally, in *Metzger v. Citigroup*, FINRA Arb. No. 11-02832, the arbitration panel granted Respondent CGMI's motion to dismiss and the claimant is in the process of pursuing his claims in court pursuant to FINRA Rule 12206.

constructive fraud, failure to supervise, violation of federal securities laws; FINRA, NASD, and NYSE rules.

Claimants further pointed out to the panel FINRA's rules and guidance discussed in Section V, *supra* which state motions to dismiss prior to conclusion of party's case-in–chief are discouraged and arbitrators may find an ongoing fraud continuing within the six year limitation. Furthermore, claimants cited the relevant case law discussed in Section IV, *supra* and distinguished the cases and prior awards Citigroup cited on the grounds they did not involve an ongoing fraud. Finally, claimants set forth the policy argument that to bar claimants' claims before the ongoing fraud was discovered is contrary to the interpretation of FINRA rules and policies and, in fact, would serve to award Citigroup for its concealment of the truth. Moreover, claimants stressed that an evidentiary hearing is needed to enable them the opportunity to present evidence to the panel which will demonstrate Citigroup's "ongoing fraud" into early 2008.

After completion of parties' briefing in all matters and oral arguments in *Reby, Mckee* and *Moskowitz*, the panels denied Citigroup's motions to dismiss.[210]

In addition to the series of product cases, the panel in Barry *Burges vs. Morgan Stanley & Co., Inc.,* FINRA Case No. 10-00040, recognized a "continuing" occurrence or event giving rise to the dispute under FINRA Rule 12206, *even though the "continuing" occurrence or event was not the issue in that case*, as follows:

> Where, however, the claim alleges churning, *fraud, or other on-going activity by the respondent* (or respondent's agent), courts and *arbitrators have held that the six years does not begin to run until the conclusion of the wrongful activity*. This has been extended to very last day of the parties' association…[211]

210. *See* discussion in note 209*, supra.*

211. *Id.* (emphasis added).

VII. CONCLUSION

For over twenty years, the courts and FINRA have been telling the brokerage industry that the purchase date is not, as a matter of law, the "occurrence or event" that determines the eligibility of claims under FINRA Rule 12206 and its predecessors. Rather, post-*Howsam* the "occurrence or event" giving rise to a claim is a factual inquiry left to the arbitrators and the purchase date is often not the trigger for the six-year time limit.

ROLLING BACK THE ECONOMIC LOSS DOCTRINE IN SECURITIES DISPUTES AGAINST FINANCIAL INTERMEDIARIES

Benjamin P. Edwards[*]

I. INTRODUCTION

After originating in the products liability context, the economic loss doctrine somehow became a preferred defense in general commercial and securities litigation.[1] If applied vigorously, the defense can sometimes consume a complaint, incinerating tort claims and leaving the plaintiff with nothing more than a breach of contract claim, if that.[2] Plaintiffs burned by the economic loss doctrine may find that their contract claims are worth much less than fraud, negligence or breach of fiduciary duty claims.[3]

So what, exactly, is the economic loss doctrine? Courts and commentators struggle to define the doctrine and its scope. The short answer is that it is a common law rule developed to bar tort claims in favor of

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1. Jonathan Eisenberg, *Beyond the Basics: Seventy-Five Defenses Securities Litigators Need to Know*, 62 Bus. Law. 1281, 1314 (2007) ("depending on the particular state in which the tort action is brought, this doctrine may provide a very powerful defense"); Reeder R. Fox & Patrick J. Loftus, *Riding the Choppy Waters of East River: Economic Loss Doctrine Ten Years Later*, 64 Def. Couns. J. 260, 260 (1997) ("The economic loss rule has become a significant weapon in defense counsel's arsenal . . .").

2. *See* Interstate Sec. Corp. v. Hayes Corp., 920 F.2d 769, 777 (11th Cir. 1991) (affirming dismissal of negligence and fiduciary duty claims as barred by the economic loss doctrine). Notably, the rationale underlying *Interstate* has since been rejected by the Florida Supreme Court. *See* Tiara Condominium Ass'n Inc. v. Marsh & McLennan Companies, Inc., No. SC10–1022, 2013 WL 828003 (Fla. Mar. 7, 2013).

3. Because contract law generally seeks to protect expectancy interests, plaintiffs limited to contract claims generally cannot recover punitive damages. *See* Jeffrey A. Winikoff & Maxine Streeter Bradford, *Blue Sky Law: 1993 Survey of Florida Law*, 18 Nova L. Rev. 45, 115 n. 403 (1993) ("It is even questionable whether parties could contract for the award of punitive damages.").

contract claims in appropriate circumstances.[4] As discussed below, defining the appropriate circumstances remains difficult.

Perhaps because so many litigants have been burned by the economic loss doctrine, courts have begun to reconsider the doctrine's application. Notably, on March 7, 2013, Florida's Supreme Court decided *Tiara Condominium Association, Inc. v. Marsh & Mclennan Companies*.[5] The opinion returned the economic loss doctrine to its roots and "h[e]ld that the application of the economic loss rule is limited [in Florida] to *products liability cases*."[6] In light of the *Tiara* decision, this article considers whether a sensible basis exists for courts or arbitrators to apply the economic loss doctrine in securities disputes against financial intermediaries, such as stock brokers and registered investment advisers. Courts should recognize that financial intermediaries are often fiduciaries or, at the least, subject to heightened obligations to investors.[7] In any event, this legal doctrine has no place in arbitration because Financial Industry Regulatory Authority ("FINRA") rules prohibit broker-dealers from using contractual provisions to limit an investor's rights to bring particular claims and because such technical and inequitable legal doctrines have little relevance in an equitable forum.

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4. *See* All-Tech Telecom, Inc. v. Amway Corp., 174 F.3d 862, 866 (7th Cir. 1999) (Posner, C.J.) ("The function of the economic-loss doctrine in confining contract parties to their contractual remedies is particularly well illustrated by cases involving product warranties").

5. Tiara, __ So.3d__, 2013 WL 828003 (Fla. Mar. 7, 2013).

6. *Id.* (emphasis added).

7. Federal law imposes fiduciary duties on registered investment advisers. Transamerica Mortgage Advisors v. Lewis, 444 U.S. 11, 17 (1979) (*citing* Santa Fe Indus., Inc. v. Green, 430 U.S. 462, 471 n.11 (1977). Some states impose fiduciary obligations on stock brokers. *See e.g.* Duffy v. Cavalier, 215 Cal. App. 3d 1517, 1534, 264 Cal. Rptr. 740, 752 (Ct. App. 1989) ("As repeatedly stated . . . the relationship between any stockbroker and his or her customer is fiduciary in nature, imposing on the former the duty to act in the highest good faith toward the customer."). Other states impose a more limited set of fiduciary duties. *See e.g.* Saboundjian v. Bank Audi (USA), 157 A.D.2d 278, 283, 556 N.Y.S.2d 258, 261 (1990) ("relationship between a customer and his stockbroker is that of principal and agent; the duty owed by the stockbroker is that of a fiduciary."). For a thorough discussion about fiduciary duties governing brokers and investment advisors, *see* Christine Lazaro, *Fiduciary Duty—Now and in the Future*, 17 No.2 PIABA B.J. 129 (2010); *see also* Angela H. Magary, *Theories of Involuntary Fiduciary Liability*, 12 PIABA B. J. 29 (2005).

The case against extending the economic loss doctrine into securities disputes against financial intermediaries is simple: financial intermediaries have little in common with manufacturers of physical goods and should not be protected by a doctrine developed to balance risks between consumers and manufacturers. As discussed below the economic loss doctrine makes the most sense in the products liability context because it limits manufacturers' liability to products that are so defective and dangerous that they physically injure people. Unlike manufacturers, financial intermediaries generally have different relationships with investors: they do not sell hard assets and, moreover, may often be fiduciaries. A materially defective portfolio never directly causes physical injuries, only financial ones.

To ground the discussion, Section II surveys and explains some accepted rationales for applying the economic loss doctrine generally before Section III discusses *Tiara* and the Florida Supreme Court's reasoning for rolling back "the unprincipled extension of the" economic loss doctrine.[8] Section IV argues against applying the economic loss doctrine in disputes against financial intermediaries and argues that the economic loss doctrine has no place in arbitrations governed by FINRA's rules. Section V concludes.

II. THE ECONOMIC LOSS DOCTRINE AND SECURITIES DISPUTES

Despite its prevalence and power, the precise contours of the economic loss doctrine are difficult to define and vary by jurisdiction.[9] One author described the economic loss doctrine as "one of the most confusing doctrines in tort law."[10] Another scholar wrote that the economic loss doctrine does not "reflect any single normative principle" and that the cases under its name are not "guided by a unified set of underlying policy considerations."[11] To make the economic loss doctrine as clear and comprehensible as possible,

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8. Tiara, __ So.3d__, 2013 WL 828003, at *7.

9. *See* Paul J. Schwiep, *The Economic Loss Rule Outbreak: The Monster That Ate Commercial Torts*, 69 FLA. B.J. 34, 34 (Nov. 1995) ("First, it is clear that judges, lawyers, and commercial clients alike are all desperately struggling to define the parameters of the economic loss doctrine.").

10. R. Joseph Barton, *Drowning in a Sea of Contract: Application of the Economic Loss Rule to Fraud and Negligent Misrepresentation Claims*, 41 WM. & MARY L. REV. 1789, 1789 (2000).

11. Robert L. Rabin, *Respecting Boundaries and the Economic Loss Rule in Tort*, 48 ARIZ. L. REV. 857, 859 (2006).

this section traces the doctrine's origin and attempts to define and explain the economic loss doctrine and some of its underlying rationales.[12]

A. The Doctrine's Origins

Although the "exact origin of the economic loss rule is subject to some debate,"[13] the modern doctrine unquestionably developed in the products liability context to protect against limitless liability.[14] Consider, for example, the facts in the economic loss doctrine's seminal case, *Seely v. White Motor Company*.[15] In *Seely*, the plaintiff purchased a rattletrap truck for heavy-duty hauling which "bounced violently, an action known as 'galloping.'"[16] The defendant's repeated attempts to repair the truck proved unsuccessful and it eventually flipped over.[17] The plaintiff emerged unscathed from the wreckage and sued the truck's manufacturer in contract and tort for both the cost of repairs and for the profits he lost because he could not haul heavy-duty goods without a truck.[18]

In deciding the case, the California Supreme Court gave birth to the modern economic loss doctrine. It ruled that the truck's manufacturer could be held liable for breach of warranty on a contract theory but not also under a tort theory.[19] In this case, the California Supreme Court recognized that in some circumstances, a breach of warranty "can properly include lost profits" where the defendant has "repeatedly fail[ed] to correct the defect as promised."[20] Ordinarily, absent a breach of warranty, purely economic

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12. *See* Tiara, __ So.3d__, 2013 WL 828003, at *3 ("the roots of the [doctrine] may be found in the products liability context."); *see also* Amanda K. Esquibel, *The Economic Loss Rule and Fiduciary Duty Claims: Nothing Stricter than the Morals of the Marketplace?*, 42 VILL. L. REV. 789, 791 (1997) (the economic loss doctrine "originated in the products liability context, an area in which the prevention and redress of personal injury and property damage are of prime concern.").

13. Moransais v. Heathman 744 So.2d 973, 979 (Fla. 1999).

14. *See* Tiara, __ So.3d__, 2013 WL 828003, at *2.

15. Seely v. White Motor Co., 403 P.2d 145 (Cal. 1965).

16. *Id.* at 147.

17. *Id.*

18. *Id.*

19. *Id.* at 151.

losses from a product's failure are not recoverable.[21] The Court declared:

> [t]he distinction that the law has drawn between tort recovery for physical injuries and warranty recovery for economic loss is not arbitrary and does not rest on the 'luck' of one plaintiff in having an accident causing physical injury. The distinction rests, rather, on an understanding of the nature of the responsibility a manufacturer must undertake in distributing his products. He can appropriately be held liable for physical injuries caused by defects by requiring his goods to match a standard of safety defined in terms of conditions that create unreasonable risks of harm. He cannot be held for the level of performance of his products in the consumer's business unless he agrees that the product was designed to meet the consumer's demands.[22]

Twenty-one years later, the United States Supreme Court followed the California Supreme Court's lead in *East River Steamship Corp. v. Transamerica Delavel Inc.*, a case arising under its admiralty jurisdiction.[23] The facts largely paralleled those of *Seely*. Instead of a defective truck, the plaintiffs had purchased defective turbines for "four oil-transporting supertankers."[24] When the turbines failed, repeatedly, the plaintiff sued for damages on both contract and tort theories.[25]

On these facts, the U.S. Supreme Court limited the plaintiff to contract damages and barred a tort claim. In deciding the case, the Supreme Court recognized that "products liability, including strict liability," formed "part of the general maritime law."[26] Yet the Court refused to let the plaintiff proceed on a strict products liability theory. Citing *Seely*, the Court made clear that "[p]roducts liability grew out of a public policy judgment that people need more protection from dangerous products than is afforded by the law of warranty."[27] Because the case involved only a defective product and not any

20. *Id.* at 148.

21. Seely, 403 P.2d at 150.

22. *Id.* at 151.

23. *East River*, 476 U.S. 858 (1986).

24. *Id.* at 859.

25. *Id.*

26. *Id.* at 865.

27. *Id.* at 866.

personal injuries, the Supreme Court held "that a manufacturer in a commercial relationship has no duty under either a negligence or strict products-liability theory to prevent a product from injuring itself."[28] Considering the broken turbines, the Supreme Court found that the plaintiff had only suffered "economic losses" from the defective product and should be limited to contract theories.[29] After the *East River* decision, more and more states began to apply the economic loss doctrine to a variety of disputes.

B. Defining the Economic Loss Doctrine Today

Today, the most expansive formulation of the economic loss doctrine precludes "any recovery of economic loss in most tort actions unless the victim has also suffered some sort of personal injury or property damage."[30] Courts divide economic losses into two categories: (i) direct economic losses; and (ii) indirect or consequential economic losses. Direct economic losses include "the diminution in the value of the product because it is inferior in quality and does not work for the general purposes for which it was manufactured and sold."[31] Under this definition, a direct economic loss occurs when "a defective product injures only itself."[32] Indirect or consequential economic losses "include losses, such as lost profits" which occur because of the product's failure.[33] For example, a broken lawnmower

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28. *Id.* at 871.

29. *East River*, 476 U.S. at879.

30. *See* Esquibel, *supra* note 12, at 789.

31. Christopher Scott D'Angelo, *The Economic Loss Doctrine: Saving Contract Warranty Law from Drowning in a Sea of Torts*, 26 U. TOL. L. REV. 591, 592 (1986) (*quoting* Comment, *Manufacturers' Liability to Remote Purchasers for "Economic Loss" Damages—Tort or Contract?*, 114 U. PA. L. REV. 539, 541 (1966)). *See also* Casa Clara Condominium Ass'n, Inc. v. Charley Toppino and Sons, Inc., 620 So.2d 1244, 1246 (Fla. 1993) (defining economic losses as "damages for inadequate value, costs of repair and replacement of the defective product, or consequent loss of profits—without any claim of personal injury or damage to other property.").

32. Gennady A. Gorel, *The Economic Loss Doctrine: Arguing for the Intermediate Rule and Taming the Tort-Eating Monster*, 37 RUTGERS L.J. 517, 520-21 (2006) (defining economic losses).

33. *Id.* *See* Wash. Water Power Co. v. Graybar Elec. Co., 774 P.2d 1199, 1207 (Wash.) ("The broadest definition encompasses all damages attendant to the failure

might cause a landscaper indirect economic losses in the form of lost business because she cannot mow lawns. The economic loss doctrine, if applied, would bar any claim for economic losses against the lawnmower manufacturer but not a claim for personal injury.

This rule for products liability does not help to explain when or if the economic loss doctrine should be applied in other circumstances.[34] In *Tiara*, Florida's Supreme Court defined the economic loss doctrine as "a judicially created doctrine that sets forth the circumstances under which a tort action is prohibited if the only damages suffered are economic losses."[35] Huh? What are these circumstances? Perhaps recognizing the difficulty inherent in precisely defining the circumstances, the Florida Supreme Court did not create any clear edges to the doctrine before *Tiara*. As one court observed, "the economic loss rule is stated with ease but applied with great difficulty."[36]

In attempting to nail down the economic loss doctrine, Professor Jim Wren recently explained that courts often invoke two different rationales for applying it.[37] The first and most common rationale is to "properly protect the boundary between contract law and tort law."[38] Indeed, numerous courts describe the economic loss doctrine as marking "the fundamental boundary between contract law . . . and tort law."[39] This boundary rationale affirms the

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and loss of use of a product."), *amended sub nom* Wash. Power Co. v. Graybar Elec. Co., 779 P.2d 697 (Wash. 1989).

34. *See* Schweip, *supra* note 9, at 40 (describing the economic loss doctrine as a "hopelessly amorphous principle");Christopher J. Faricelli, *Wading into the "Morass": An Inquiry into the Application of New Jersey's Economic Loss Rule to Fraud Claims*, 35 RUTGERS L.J. 717, 718 (2004) ("Courts have struggled in their attempts to uniformly apply the economic loss rule.").

35. Tiara, __ So.3d__, 2013 WL 828003, at *1.

36. Sandarac Ass'n v. W.R. Frizzell Architects, Inc., 609 So. 2d 1349, 1352 (Fla. 2d D.C.A. 1992).

37. Jim Wren, *Applying the Economic Loss Rule in Texas*, 64 BAYLOR L. REV. 204, 214-221 (2012).

38. *Id.*

39. Calloway v. City of Reno, 993 P.2d 1259, 1263 (Nev.2000) (overruled on other grounds); Town of Alma v. AZCO Construction, Inc., 10 P.3d 1256, 1259 (Colo.2000) (The economic loss rule "maintain[s] the boundary between contract law and tort law."); Casa Clara, 620 So.2d at 1246 ("the fundamental boundary between contract law . . . and tort law").

"belief that the law of contracts is usually better suited to resolve an issue of purely economic loss between parties to a contract."[40] By requiring that a dispute be resolved by looking to contract law (and the parties' expectancy interests in entering into a contract) instead of tort law governing standards of reasonable care, courts shunt disputes into manageable troughs. Unfortunately, nearly every jurisdiction uses a different map and marks a different, constantly changing, border between contracts and torts.[41]

With respect to the second motivating rationale, Professor Wren said that the doctrine "has been invoked simply to place a limit on how far tort actions, particularly negligence actions, can reach."[42] Under this rationale, courts apply the doctrine to protect defendants against unpredictable amounts of liability and will even apply the doctrine in some instances "where there is no privity of contract" between the parties.[43]

Considering the doctrine's effects brings it into greater clarity. When a court or arbitrator applies the economic loss doctrine to a dispute, the adjudicator bars tort claims in favor of contract claims.[44] As mentioned above, courts may be policing the murky boundary between contract and tort law.[45] Courts reason that contract law should be applied so as not to disturb "the allocation of risks negotiated or at least agreed upon by the parties"

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40. Wren, *supra* note 37, at 215.

41. For example, New Jersey once extended tort liability on a products liability theory to defective products which injure only themselves before abrogating that decision to limit such claims to contract and warranty theories. *See* Santor v. A & M Karagheusian, Inc., 44 N.J. 52, 66, 207 A.2d 305, 313 (1965) (applying strict liability to defective products) *abrogated by* Alloway v. Gen. Marine Indus., L.P., 149 N.J. 620, 695 A.2d 264 (1997) (requiring claimants to proceed on contract theories).

42. Wren, *supra* note 37, at 218.

43. *Id.* at 220.

44. *See* Dakota Gasification Co. v. Pascoe Bldg. Sys., a Div. of Amcord, Inc., 91 F.3d 1094, 1101 (8th Cir. 1996) ("we hold that because the damage to the oxygen plant from Pascoe's defective product was a harm that was reasonably foreseeable to the parties to this commercial transaction, contract law, and not tort law, must provide the remedy for this purely economic loss.").

45. *See* Tiara, __ So.3d__, 2013 WL 828003, at *2; Makoto USA, Inc. v. Russell, 250 P.3d 625, 627 (Colo. Ct. App. 2009) ("Here, as in most economic loss rule cases, the dispute involves whether the tort duty was 'independent' of a contractual duty.").

when they formed the contract.[46] When the parties have not signed contracts with each other, courts may apply the doctrine anyway to limit the reach of tort actions. Indeed, if the litigant does not have a contract claim, she may find that the doctrine bars any relief.[47] A strong economic loss doctrine incentivizes parties to make contracts that allocate all risks and to buy insurance to protect against risk.

III. TIARA AND FLORIDA'S EXPERIENCE WITH THE ECONOMIC LOSS DOCTRINE

Although the economic loss doctrine began in the products liability context, it soon moved into different areas of law.[48] Although some jurisdictions declined to expand the doctrine outside of the products liability context,[49] Florida, more than any other state, applied the doctrine expansively, even to disputes when the parties were not bound by a contract.[50] Florida also applied the doctrine outside the products liability context when the parties were bound by a contract to limit the plaintiff to claims for breach of the contract between the parties.[51]

To illustrate the doctrine's ability to jump fences quickly, consider *AFM*

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46. Interstate Sec. Corp., 920 F.2d at 774 (*citing* Florida Power & Light Co. v. Westinghouse Elec. Corp., 510 So.2d 899 (Fla.1987)).

47. *See* Casa Clara, 620 So.2d 1244 (applying economic loss doctrine to bar all claims against concrete manufacturer).

48. *See* Esquibel, *supra* note 12, at 796 (describing how the economic loss doctrine "rapid[ly] expan[ded] into other areas of the law").

49. *See* Cargill, Inc. v. Boag Cold Storage Warehouse, Inc., 71 F.3d 545, 550-51 (6th Cir. 1995) (declining to apply the doctrine outside the products liability context); Scap Motors, Inc. v. Pevco Sys. Int'l, Inc., No. CV 970348461S, 1999 WL 643378, at *2 (Conn. Super. Ct. Aug. 12, 1999) (same).

50. In *Casa Clara*, the Florida Supreme Court applied the economic loss doctrine on the theory that a home buyer could have bargained with the person they bought the home from to protect against the economic losses that eventually materialized because of faulty concrete. 620 So.2d 1244. For a thorough discussion of Florida law before *Tiara*, *see* Esquibel, *supra* note 12, at 796-820.

51. *See* AFM Corp. v. Southern Bell Telephone & Telegraph Co., 515 So.2d 180 (Fla. 1987) (applying economic loss rule to negligence claim for economic losses premised on listing the wrong phone number in the telephone book).

Corp. v. Southern Bell Telephone & Telegraph Co.[52] Although prior cases centered around the purchase of goods, *AFM Corp.* involved the purchase of services.[53] The plaintiff had contracted to place its advertising "in the yellow pages."[54] Unfortunately, the wrong telephone number ended up in the phone book and, after initial attempts to fix the problem by using a "referral number" floundered, the parties went to court.[55] The dispute reached the Eleventh Circuit and it certified three questions about Florida law to the Florida Supreme Court which restated the questions as: "Does Florida permit a purchaser of services to recover economic losses in tort without a claim for personal injury or property damage?"[56] Applying the economic loss doctrine, the Florida Supreme Court ruled that "without some conduct resulting in personal injury or property damage, there can be no independent tort flowing from a contractual breach which would justify a tort claim solely for economic losses."[57] The opinion firmly signaled that Florida's economic loss doctrine would be applied to bar tort claims when the parties were bound by a contract even outside the products liability context.

Six years later, the doctrine's reach grew again when the Florida Supreme Court decided *Casa Clara Condominium Association, Inc. v. Charley Toppino & Sons, Inc.*[58] In *Casa Clara*, the plaintiffs had discovered that their homes were crumbling because they were built with defective concrete supplied by the defendant.[59] Because they had no contract or direct relationship with the concrete supplier, they sued in tort.[60] Although their homes were literally crumbling around them, the Florida Supreme Court applied the economic loss doctrine to bar the plaintiffs' claims, reasoning that "contract principles more appropriate than tort principles for recovering economic loss without an accompanying physical injury or property

52. 515 So.2d 180 (Fla.1987) (recognizing that the economic loss doctrine may be applied to the purchase of services as well as goods).

53. *Id.* at 180-81.

54. *Id.* at 180.

55. *Id.* at 181.

56. *Id.* at 180.

57. *Id.* at 181-82.

58. 620 So. 2d 1244 (Fla. 1993).

59. *Id.* at 1245.

60. *Id.*

damage."[61] Although the plaintiffs argued that the defective concrete had caused property damage to the other parts of their homes and, thus, fell outside the economic loss doctrine, the Florida Supreme Court disagreed, and collapsed the distinction between faulty concrete and the rest of the homes.[62] It bared tort claims against the concrete supplier and reasoned that the plaintiffs should have struck better contracts with the home builder to protect against faulty concrete when they contracted to purchase their homes.[63] The Florida Supreme Court explained that it applied the economic loss doctrine to their claims because the plaintiffs "bought finished products—dwellings—not the individual components of those dwellings. . . The concrete became an integral part of the finished product and, thus, did not injure 'other' property."[64] The decision established that the economic loss doctrine would be applied even between parties without a contract if some purchase contract governed the property.

Although the doctrine had been billed by the Florida Supreme Court as protecting the "boundary between contract law . . . and tort law,"[65] one Florida practitioner, Paul J. Schwiep, soon dubbed it the "Monster that Ate Commercial Torts" because, in his view, the doctrine had broken free from "its historical tethers" in products liability actions.[66] Schwiep criticized the "confoundingly expanding legal doctrine" on a variety of grounds.[67] Noting that "judges, lawyers, and commercial clients alike [we]re all desperately struggling to define the parameters of the economic loss doctrine," Schwiep first criticized Florida's economic loss jurisdiction because no one could agree "on what the doctrine meant, how it applied, or where it was headed."[68] He argued that courts should resist invoking the economic loss doctrine to dismiss tort claims and should instead focus on whether "the defendant

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61. *Id.* at 1247.

62. *Id.*

63. *Id.*

64. 620 So. 2d at 1247.

65. *Id.* at 1246.

66. *See* Schweip, *supra* note 9, at 34. The characterization stuck and a number of law review articles adopted it. *See e.g.,* Charles R. Walker, *Moransais v. Heathman and the Florida Economic Loss Rule: Attempting to Leash the Tort-Eating Monster*, 52 Fla. L. Rev. 769, 769 (2000); Gorel, *supra* note 32.

67. Schweip, *supra* note 9, at 34.

68. *Id.*

owe[d] the plaintiff a duty to avoid the type of harm alleged."[69]

Indeed after *AFM Corp.* and *Casa Clara*, courts were dismissing a wide variety of tort claims entirely unrelated to the products liability context under the economic loss doctrine. Perhaps more than any other case *Interstate Securities Corp. v. Hayes Corp.* exemplifies the economic loss doctrine's broadest reach.[70] In it, the Eleventh Circuit found that the doctrine barred even fraud and breach of fiduciary duty claims against broker-dealers.[71] The *Interstate Securities* decision influenced other federal courts charged with applying Florida's economic loss doctrine and led them to also dismiss breach of fiduciary duty claims against financial intermediaries.[72] The decisions show the economic loss doctrine's move from the products liability context to limiting disputes between investors and trusted advisers.

Eventually, the Eleventh Circuit encountered the issue again in *Tiara Condominium Ass'n, Inc. v. Marsh & McLennan Companies, Inc.*[73] The dispute involved an insurance broker retained to secure insurance coverage.[74] At the plaintiff's request the broker obtained a policy with a loss limit of $50 million.[75] After two hurricanes struck, the condominium association asked about its coverage and whether the $50 million policy limited damages under the policy to $50 million or whether it was $50 million per occurrence.[76] The broker assured the plaintiff "that the loss limits coverage was per occurrence (meaning that Tiara would be entitled to almost $100 million rather than

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69. *Id.* at 42.

70. Interstate Sec. Corp., 920 F.2d at 776 (finding that because "Florida courts dismiss fraud claims between parties to a contract . . ., it is probable that the Florida courts would also dismiss fiduciary duty claims"). A later, pre-*Tiara*, Florida Supreme Court decision subsequently recognized an exception for fraud claims. *See* HTP, Ltd. V. Lineas Aereas Costarricenses, 685 So. 2d 1238, 1240 (Fla. 1996).

71. *Id.*

72. *See e.g.* Medalie v. FSC Sec. Corp., 87 F. Supp. 2d 1295, 1304 (S.D. Fla. 2000) ("the court declines to depart from the established Eleventh Circuit precedent in Hayes and holds that the economic loss rule bars plaintiffs' breach of fiduciary duty claims."); McCutcheon v. Kidder, Peabody & Co., Inc., 938 F. Supp. 820, 824 (S.D. Fla. 1996) (dismissing "[p]laintiff's claims for breach of fiduciary duty [because they] arise solely as a result of the existence of a contract between the parties.").

73. 607 F.3d 742 (11th Cir. 2010).

74. Tiara, __ So.3d__, 2013 WL 828003, at *1.

75. *Id.*

76. *Id.*

coverage in the aggregate, which would be half of that amount)."[77] Understandably, the plaintiff relied on the broker and launched expensive remediation efforts.[78] Shortly thereafter, the insurance company claimed that the loss limit was $50 million total, not per occurrence.[79] Having spent nearly $100 million dollars on remediation, the plaintiff sued the insurance broker for, among other things, breach of contract, "negligence and breach of fiduciary duty."[80] When the case reached the Eleventh Circuit, it concluded "that the question of whether the economic loss rule bars tort claims brought against insurance brokers is unsettled under Florida law," and certified the multi-million dollar question to the Florida Supreme Court.[81] If the economic loss doctrine were applied to all tort claims, it would have left the plaintiff with only a breach of contract claim against the insurance broker.

In a decision that may provide guidance to other state courts and arbitrators struggling to apply the economic loss doctrine, the Florida Supreme Court reviewed "what has been described as the unprincipled extension of the [doctrine]" and held that in Florida "the economic loss rule applies only in the products liability context."[82] The majority opinion divided its discussion by focusing on two different applications of the economic loss doctrine: (i) the "Contractual Privity Economic Loss Rule" (the "Contract Rule") and (ii) the "Products Liability Economic Loss Rule" (the "Products Liability Rule").[83] These two different applications of the economic loss doctrine map almost exactly onto the two rationales discussed by Professor Wren.[84] The first aims to police the boundary between contract and tort law and the second to limit amorphous products liability.

The Contract Rule, which the Florida Supreme Court "recede[d] from" in *Tiara*,[85] had been applied to bar tort actions "where a defendant has not

77. *Id.*

78. *Id.*

79. *Id.*

80. 607 F.3d at 744.

81. *Id.* at 748.

82. Tiara, __ So.3d __, 2013 WL 828003, at *7.

83. *Id.* at *2 & *3.

84. *See*, Wren, *supra* note 37, at 214-221.

85. Tiara, __ So.3d __, 2013 WL 828003, at *7 ("We thus recede from our prior ruling to the extent that they have applied the economic loss rule to cases other than products liability").

committed a breach of duty apart from a breach of contract."[86] Application of the Contract Rule hinged on whether a tort claim was premised on any "torts independent of the contractual breach."[87] In situations where a defendant breached professional duties and contractual duties at the same time, the Florida Supreme Court had recognized a series of exceptions to allow tort claims for the breach of a professional duty, such as an action for legal malpractice.[88] Before backing away from the Contract Rule entirely, the Florida Supreme Court had cautioned that the economic loss doctrine should only be applied in "situations where the policy considerations are substantially identical to those underlying the product liability-type analysis."[89]

Recognizing that the Contract Rule had proved unworkable,[90] the Florida Supreme Court limited the economic loss doctrine's application to the Products Liability Rule.[91] In a separate concurrence, Justice Pariente explained that "[w]hile the contractual privity form of the economic loss rule has provided a simple way to dismiss tort claims interconnected with breach of contract claims, it is neither necessary nor a principled mechanism for doing so."[92] After all, the first question in analyzing any tort claim is whether the defendant owed the plaintiff any non-contractual duty.[93] If the defendant does not owe any duty apart from that created by the contract, the tort claim would fail anyway under "basic contractual principles."[94]

Florida's Supreme Court cabined the economic loss doctrine to the products liability context over dissents from Chief Justice Polston and Justice

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86. *Id.* at *2.

87. HTP, Ltd. V. Lineas Aereas Costarricenses, S.A., 685 So.2d 1238, 1239 (Fla. 1996).

88. *See* Moransais, 744 So.2d at 983.

89. *Id.* at 983.

90. Tiara, __ So.3d __, 2013 WL 828003, at *7 ("For some time, as reflected by the foregoing discussion, this Court has been concerned with what it perceived as an over-expansion of the economic loss rule.").

91. *Id.* at *7.

92. *Id.* at *9.

93. *See* Dan B. Dobbs, Paul T. Hayden and Ellen M. Bublick, The Law of Torts § 5 (2nd ed) ("Breach of contract is not in itself a tort.").

94. Tiara, __ So.3d __, 2013 WL 828003, at *9.

Canady.[95] Chief Justice Polston contended that the decision expanded "the use of tort law at a cost to Florida's contract law."[96] He argued that insurance brokers were not professionals under Florida law and did not fall within previously recognized exceptions to the Contract Rule portion of the economic loss doctrine.[97] Justice Canady's dissent agreed with Chief Justice Polston and argued that by limiting the economic loss doctrine to the Products Liability Rule, Florida courts now "face the prospect of every breach of contract claim being accompanied by a tort claim" and that the majority's decision had failed to explain "why the economic loss rule is appropriately applied in the products liability context but is unworkable or unwise in [a] broader context."[98]

The answer to Justice Canady's criticism flows from the history of the economic loss doctrine. *Seely*, which the Florida Supreme Court followed in recognizing the economic loss doctrine, created the doctrine to place a limit on the expanded tort duties created by modern products liability jurisprudence.[99] Absent the existence of some non-contractual duty, a litigant would not have a tort claim because a key element of any tort claim is that the defendant breached a duty owed to the plaintiff.[100]

IV. THE ECONOMIC LOSS DOCTRINE'S CONTINUED VITALITY IN DISPUTES INVOLVING FINANCIAL INTERMEDIARIES

Despite Florida's decision to roll back the economic loss doctrine to the products liability context, many other jurisdictions still apply a more expansive version of the economic loss doctrine.[101] Nonetheless, the Florida

95. *Id.* at *11-*14.

96. *Id.*

97. *Id.*

98. *Id.*

99. Seely, 403 P.2d at 151.

100. *See* Tiara, __ So.3d __, 2013 WL 828003, at *9 ("The economic loss rule is not a long-standing common law rule that has always existed in our jurisprudence to define the parameters of cognizable contract and tort causes of action, but is instead a doctrine that arose in the torts context to serve a specific purpose—to curb potentially unbounded liability following the adoption of strict products liability.") (Pariente, J. *concurring*).

101. *See* Barton*, supra* note 10, at 1802 ("the current trend expands the rule to apply

Supreme Court's decision in *Tiara* may persuade many courts to limit the doctrine's reach. For cases subject to FINRA arbitration, although the decision provides another helpful authority, arbitrators should not have been applying the economic loss doctrine in the first place because FINRA rules prohibit broker-dealers from using contracts to limit investors' rights to bring particular kind of claims.

A. Should the Economic Loss Doctrine Be Applied in Disputes with Financial Intermediaries?

Given its roots in the products liability context, the rationales undergirding the economic loss doctrine may be at their weakest when applied to financial intermediaries who are often fiduciaries, such as broker-dealers, stockbrokers and registered financial advisors.[102] Although the products liability rationales underlying the economic loss doctrine are clearly inapplicable to disputes against financial intermediaries,[103] courts and arbitrators may still be tempted to continue applying the doctrine because investors usually sign contracts with financial intermediaries.[104] Courts should resist this temptation because contracts between investors and financial intermediaries differ from those between ordinary arms-length parties for the sale of goods.[105]

As an initial matter, the relationships between investors and financial intermediaries differ in important ways from the relationships between manufacturers and consumers. Unlike financial intermediaries, manufacturers sell physical products which may malfunction and cause physical injuries. In the products liability context, the economic loss doctrine usefully limits liability to make products more affordable for consumers while imposing liability on manufacturers for products which cause physical

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in other contexts" outside of products liability).

102. *See* Esquibel, *supra* note 12, at 839-847 (arguing that the economic loss doctrine should not be applied to breach of fiduciary duty claims).

103. *See id.* ("products liability may easily be between strangers—an injured customer sues a faceless manufacturer far away in the distribution chain").

104. *See* Interstate Sec. Corp., 920 F.2d at 774.

105. *Id* at 839 (explaining that the economic loss doctrine breaks down "as it is applied in a fiduciary context").

injuries.[106]

Relationships between investors and financial intermediaries are also unique because the public places special, personal trust in financial intermediaries due to the nature of their business.[107] Simply by opening a brokerage business or by providing investment advice a person hangs a "shingle" that creates an implied representation that the person will deal fairly with the public.[108] When a person speaks with a stockbroker or financial advisor about purchasing securities, the person rightly expects that the securities recommended will be "suitable" purchases for her financial situation.[109] These default expectations should not be vitiated if they are not incorporated into a contract between the parties.

Moreover, the securities laws generally impose fiduciary duties or, at the least, heightened obligations on financial intermediaries to deal fairly and to protect investor interests. Many financial intermediaries fall under two extensive regulatory schemes designed to protect investors.[110] The Investment Advisers Act of 1940 (the "IAA") governs investment advisers[111] and the Securities Exchange Act of 1934 (the "'34 Act") governs brokers.[112]

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106. *See Seely*, 403 P.2d at 149.

107. *See* Barbara Black & Jill I. Gross, *Making It Up As They Go Along: The Role of Law in Securities Arbitration*, 23 CARDOZO L. REV. 991, 1006 (2002) ("Any discussion of a broker's duties to its customers under federal securities law must start with the "shingle theory").

108. *Id.* Professor Louis Loss first articulated the "Shingle Theory." Louis Loss, *The SEC and the Broker-Dealer*, 1 VAND. L. REV. 516, 518 (1948) (The theory is that even a dealer at arm's length impliedly represents when he hangs out his shingle that he will deal fairly with the public").

109. For more information about legal requirements that financial intermediaries recommend only suitable securities purchases to their customers, *see* Jenice L. Malecki, Esq., Adam M. Nicolazzo, Esq., Robert M. Van De Veire, Esq., *Suitability in the Wake of Finra Regulatory Notice 12-55*, 19 PIABA B.J. 347, 348 (2012) ("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").

110. Lazaro, *supra* note 7, at 129-30.

111. 15 U.S.C. §§ 80b-1 *et seq.*

112. 15 U.S.C. §§ 78a *et seq.*

Although the IAA imposes a federal fiduciary duty on investment advisers,[113] under the '34 Act brokers must meet the "suitability" standard "created by the rules of the self-regulatory organization, FINRA."[114] Supplementing this regulatory framework, courts have recognized that financial intermediaries may also obe subject to "extra-contractual duties" if they are positioned to "take unfair advantage of their customers' incapacity or simplicity."[115] Applying the economic loss doctrine to foreclose tort claims in this context would effectively erase these duties to the extent they are not incorporated into a contract between an investor and a financial intermediary.

B. The Economic Loss Doctrine Should Not Be Applied in Securities Arbitration

At present, it is difficult to determine the economic loss doctrine's impact on securities disputes because courts began to expansively apply the economic loss doctrine and to consistently enforce agreements to arbitrate securities disputes at about the same time. Judicial application of the economic loss doctrine increased dramatically after the Supreme Court endorsed it in its 1986 *East River* decision.[116] In 1987, one year later, the Supreme Court validated pre-dispute arbitration agreements ("PDAAs") for investor disputes against financial intermediaries in *Shearson/American Express v. McMahon*.[117] Combined, the decisions make it impossible to assess whether investor claims against financial intermediaries have been stymied by the economic loss doctrine in arbitration.[118]

Nonetheless, specific forum-related rules implicitly bar arbitrators from applying the economic loss doctrine to dismiss tort claims. FINRA Rule

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113. *See* Transamerica Mortgage, 444 U.S. at 17.

114. *See* Lazaro, *supra* note 7, at 130-34.

115. *See id.*, at 136 (collecting cases).

116. *See* Fox & Loftus, *supra* note 1, at 261 (discussing the economic loss doctrine's post 1986 expansion).

117. Shearson/Am. Exp., Inc. v. McMahon, 482 U.S. 220, 238 (1987).

118. In 2002, Professors Barbara Black and Jill Gross explained that although the "development of the law ha[d] not yet, at least, been 'frozen,' courts have had few opportunities to generate relevant precedent" because courts have had substantially fewer opportunities to adjudicate disputes between investors and financial intermediaries. Black & Gross, *supra* note 107, at 992-93.

2268 provides specific requirements for broker-dealers using predispute arbitration agreements for customer accounts. Making clear that broker-dealers may not use a contract to limit an investor's rights to bring particular claims, FINRA Rule 2268(d)(2) mandates that "no predispute arbitration agreement shall include *any condition* that . . . limits the ability of a party to file *any* claim in arbitration."[119] To the extent that a broker-dealer argues that the contract between the parties bars any tort claims under the economic loss doctrine, FINRA Rule 2268(d)(2) explicitly prohibits the use of a contract to limit an investor's rights to bring any particular type of claim, which must be read as including tort claims.

In any event, applying the economic loss doctrine to securities disputes would be inequitable. The arbitration forum empowers arbitrators to do justice as fairness requires.[120] To the extent that the economic loss doctrine has crept into securities arbitration, investors may benefit from using the Florida Supreme Court's decision in *Tiara* to argue that arbitrators should not give any weight to the defense in coming to an equitable result.

V. CONCLUSION

For good reason, the economic loss doctrine remains a potent force in products liability litigation. As courts move further from that context, the doctrine breaks down and requires the importation of different rationales to support its use.[121] Florida's experience with the doctrine shows that courts should proceed carefully when considering whether the doctrine has application outside the products liability context.

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119. FINRA Rule 2268(d)(2) (emphasis added).

120. *See* Jennifer J. Johnson, *Wall Street Meets the Wild West: Bringing Law and Order to Securities Arbitration*, 84 N.C. L. REV. 123, 145 (2005) (*citing* Sec. Indus. Conference on Arbitration [SICA], The Arbitrator's Manual 2 (2005) ("In spite of the lack of current statistically significant evidence as to whether arbitrators are applying the law, there are many reasons to believe that they are not. First, each new NASD arbitrator is provided with a copy of the SICA Arbitrators Manual that begins with a reminder to arbitrators that they can ignore the law if fairness so requires.")).

121. As discussed above, the doctrine began to limit expansive products liability and soon began to guard the border between tort and contract.

Notes & Observations

ARBITRARY STANDARDS FOR
ARBITRATOR CONFLICTS OF INTEREST:
UNDERSTANDING THE "EVIDENT PARTIALITY" STANDARD

Bryn Fuller

An important element of the arbitration process is court confirmation of an arbitral award. Sometimes, awards are challenged based on alleged bias of an arbitrator. Courts need a clear standard to evaluate arbitrators' independence and impartiality and arbitrators need to know when to investigate or disclose potential conflicts of interest before agreeing to sit on a case and throughout its administration. This article: (1) examines the lack of a clear standard to evaluate conflicts of interest and (2) offers a recommendation to resolve the issue.

The Federal Arbitration Act ("FAA") provides only four statutory grounds, limited to procedural flaws, for vacating an award, including:

(2) where there was ***evident partiality*** or corruption in the arbitrators…

9 U.S.C. § 10(a)(2) (2012) (emphasis added).

When an award is challenged based on this provision, courts must conduct an analysis of the presiding arbitrators' independence and impartiality. The Supreme Court's seminal case interpreting the "evident partiality" standard, *Commonwealth Coatings Corp. v. Cont'l Cas. Co.*, presents a quandary for judges faced with applying the standard. 393 U.S. 145 (1968). Justice Black's majority opinion and Justice White's concurring opinion, impossible to reconcile, create two evident partiality standards. *Commonwealth Coatings* does nothing to alleviate the opacity of the FAA's language and leaves judges with little guidance on how to examine arbitrators' conflicts of interest. Given the complicated and meaningful nature of evaluating arbitrators' conflicts of interest, United States courts should use the International Bar Association's guidelines as a reference when presented with this issue.

In 2004, the International Bar Association ("IBA") promulgated guidelines on evaluating arbitrators' conflicts of interest ("IBA Guidelines").[1] The conflicts analysis set forth in the IBA Guidelines, although created for international arbitration, is consistent with United States public policy, and if referenced by arbitrators on a consistent basis would

1. IBA GUIDELINES ON CONFLICTS OF INTEREST IN INTERNATIONAL ARBITRATION (2004), *available at* http://www.ibanet.org/Publications/publications_IBA_guides_and_free_materials.aspx.

engender more predictability that courts would follow, and, as a result, likely lead to the reduction in the number of motions to vacate based on evident partiality.

UNITED STATES SUPREME COURT'S INTERPRETATION OF EVIDENT PARTIALITY: *COMMONWEALTH COATINGS CORP. V. CONTINENTAL CASUALTY CO.*

Commonwealth Coatings Corp. v. Continental Casualty Co. arguably established an evident partiality analysis, but, in fact, it created two potential standards that since have been inconsistently applied and have failed to address when or if an arbitrator has a duty to investigate and disclose conflicts of interest. 393 U.S. 145 (1968).

In *Commonwealth Coatings,* the Supreme Court's majority opinion vacated an award based on evident partiality. However, because of the concurrence of Justice White (joined by Justice Marshall) actually conflicts with the majority opinion, Black's majority opinion only reflected the opinion of four out of nine Justices. For this reason, some courts have adopted Justice White's concurrence instead of Justice Black's majority opinion. 393 U.S. 145 (1968). *Stone v. Bear, Stearns & Co., Inc.*, 872 F.Supp.2d 435 (E.D. Pa. 2012), *citing U.S. v. Naranjo*, 426 F.3d 221 (3d Cir. 2005).

Justice Black's opinion, labeled the "appearance of bias" standard, creates a low standard and broader base upon which a party may seek vacatur, when compared to White's "actual bias" standard. 393 U.S. 145 (1968), *see also, Stone v. Bear, Stearns & Co., Inc.*, 872 F.Supp.2d 435 (E.D. Pa. 2012). In support of his opinion, Justice Black cited the 33rd Canon of Judicial Ethics and found that an arbitrator must be unbiased *and* must avoid even the appearance of bias. *Id.* However, Justice White noted that arbitrators should not be held to the same standard as Article III Judges. *Id.*

Justice White's opinion, described as an "actual bias" standard, requires the moving party to show that an undisclosed conflict involved a significant compromising connection between the arbitrator and a party or the matter. *Id.* This is a much more difficult burden to meet. Furthermore, according to White's standard, "arbitrators are not automatically disqualified by a business relationship with the parties before them, if both parties are informed of the relationship in advance, or if they are unaware of the facts but the relationship is trivial." 393 U.S. at 151.

UNITED STATES ETHICS CODES AND IBA GUIDELINES STANDARD

In addition to the two standards espoused in *Commonwealth Coatings*, the issue is further complicated by the standards for impartiality that exist in arbitral institution rules and ethical codes. Notably, in the past, domestic arbitrations allowed the appointment of non-neutral arbitrators who were not held to the same standards as the neutral chair. Domestic arbitrations now impose a presumption of neutrality on all arbitrators. In contrast, international arbitrations always required arbitrator neutrality; as such, the IBA Guidelines offer a comprehensive and explicit set of standards for evaluating neutral arbitrators' conflicts of interest.

AAA-ABA Ethics Codes

The American Arbitration Association ("AAA") and the American Bar Association ("ABA") drafted the 1977 AAA-ABA Code of Ethics for Arbitrators in Commercial Disputes ("1977 Ethics Code").[2] Pursuant to the 1977 Ethics Code, each party appoints one "non-neutral" arbitrator, who is then expected to act as an advocate for the appointing party.[3] The non-neutral arbitrators were referred to as "embedded" and were considered to add value to the decision-making process as someone "more familiar with the facts and law of the situation."[4] The presumption was one of non-neutrality. This tradition, presuming the "non-neutral[ity] [of] party-appointed arbitrators . . . necessitated a stricter standard for chairpersons than for non-neutral co-arbitrators."[5] The 1977 Ethics Code imposed asymmetrical standards for party-appointed arbitrators as compared to chairpersons.

2. AMERICAN ARBITRATION ASSOCIATION CODE OF ETHICS FOR ARBITRATORS IN COMMERCIAL DISPUTES (1977), *available at* http://www.adr.org/sp.asp?id=32124.

3. Bruce Meyerson & John M. Townsend, *Revised Code of Ethics for Commercial Arbitrators Explained*, 59 DISP. RES. J. 10, 13 (Feb. - Apr. 2004).

4. Nancy A. Welsh, *What is "(Im)Partial Enough" in a World of Embedded Neutrals?*, 52 ARIZ. L. REV. 395 (2010).

5. *See* Matthias Scherer, Chair of the IBA Conflicts of Interest Subcommittee (2008/2009), The IBA Guidelines on Conflicts of Interest in International Arbitration: The First Five Years 2004-2009, 4 DISP. RES. INT'L 1, 6 (May 2010), *available at* http://www.ibanet.org/LPD/Dispute_Resolution_Section/Arbitration/Default.aspx.

In the early 2000s, the AAA and ABA formed a working group to revise the 1977 Ethics Code. A revision was proposed in 2004. Most notable was the change that unless the parties' agreement, the arbitral rules or applicable laws provide otherwise, a presumption of neutrality applied to all arbitrators – finally establishing corresponding ethical obligations between party-appointed arbitrators and chairpersons.[6]

The revised version of the AAA-ABA Code of Ethics ("AAA-ABA 2004 Ethics Code") was intended to enhance confidence in domestic commercial arbitrations.[7] There are similarities between the AAA-ABA 2004 Ethics Code and the IBA Guidelines. Both provide examples of scenarios when an arbitrator has failed to comply with the ethics canons or the guidelines standards. Unfortunately, the AAA-ABA 2004 Ethics Code still falls short of providing a comprehensive means of evaluating when conflicts require disclosure, and when conflicts rise to the level of evident partiality.

The IBA Guidelines Standard

By contrast, the IBA Guidelines, approved on May 22, 2004,[8] offer advice on how to analyze conflicts and when to investigate or disclose conflicts. The IBA Guidelines establish seven standards of independence and disclosure to govern the selection, appointment, and continuing role of an arbitrator. The IBA Guidelines apply an objective third party standard to analyze the materiality of a particular conflict. Under General Standard 2, conflicts of interest will disqualify an arbitrator if a reasonable and informed third party would reach the conclusion that there was a likelihood that the arbitrator may be influenced by facts other than the merits of the case as presented by the parties in reaching his or her decisions.

General Standard 2, Conflicts of Interest, details what kind of test should be applied when determining if an arbitrator should decline an appointment based on a conflict of interest:

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6. Meyerson, *supra* note 3.

7. John D. Feerick, *The 1977 Code of Ethics for Arbitrators: An Outside Perspective*, 18 GA. ST. U. L. REV. 907 (2002).

8. IBA GUIDELINES, *supra* note 1.

(2) Conflicts of Interest

(a) *An arbitrator shall decline to accept an appointment or, if the arbitration has already been commenced, refuse to continue to act as an arbitrator if he or she has any doubts as to his or her ability to be impartial or independent.*

(b) *The same principle applies if facts or circumstances exist, or have arisen since the appointment, that, from a reasonable third person's point of view having knowledge of the relevant facts, give rise to justifiable doubts as to the arbitrator's impartiality or independence, unless the parties have accepted the arbitrator in accordance with the requirements set out in General Standard (4).*

(c) *Doubts are justifiable if a reasonable and informed third party would reach the conclusion that there was a likelihood that the arbitrator may be influenced by factors other than the merits of the case as presented by the parties in reaching his or her decision.*

(d) *Justifiable doubts necessarily exist as to the arbitrator's impartiality or independence if there is an identity between a party and the arbitrator, if the arbitrator is a legal representative of a legal entity that is a party in the arbitration, or if the arbitrator has a significant financial or personal interest in the matter at stake.*

The IBA Guidelines also offer examples of scenarios that would require disclosure and/or disqualification. They provide a method for practical application of the general standards and contain four lists arranged by materiality of potential conflicts (non-waiveable red, waivable red, orange and green), and explain the proper procedure for handling each type of conflict.

CONFLICTING STANDARDS FOR CONFLICTS OF INTEREST

Despite the existence of helpful and clear standards in the IBA Guidelines, courts in the United States struggle with the meaning of evident partiality in order to evaluate arbitrators' conflicts of interest and an arbitrator's duty to investigate and disclose. Judge Kaufman of the Second Circuit put it well in *Morelite Constr. Corp. v. N.Y. City Dist. Council Carpenters Ben. Funds*, in observing that when faced with a motion to vacate an arbitration award based on evident partiality, courts are left to render a decision against the "murky backdrop of Supreme Court precedent." 748 F.2d 79 (2d Cir. 1984). Courts attempt reasoned-guesses at what duties should be imposed on an arbitrator to investigate potential conflicts and what standard should govern vacatur. *Stone v. Bear, Stearns & Co., Inc.*, 872

F.Supp.2d 435, 445 (E.D. Pa. 2012), *citing Positive Software Solutions, Inc. v. New Century Mortg. Corp.*, 476 F.3d 278 (5th Cir. 2007). Whether to apply Justice Black's "appearance of bias" standard or Justice White's practically oriented "reasonable impression of bias."

Conflicting Standards for Evident Partiality

In *Morelite Constr. Corp. v. N.Y. City Dist. Council Carpenters Benefit Funds*, the Second Circuit found evident partiality based on a father-son relationship. 748 F.2d 79 (2d Cir. 1984). The *Morelite* court, like Justice White, noted that the standard for arbitrators should be less stringent than the standard for judges, but rejected a standard that would require proof of actual bias, noting that it is often impossible to prove. *Id.*

The Fifth and Eleventh Circuits also tackled the evident partiality issue.[9] Both sided with Justice White, holding that evident partiality required a showing of an arbitrator's actual bias, rather than the appearance of bias, in order to vacate an award. The Fifth Circuit stated that an award may not be vacated for trivial prior relationships and must be interpreted ***practically*** rather than rigidly. *Id.*

More recent case law adopts Justice White's "actual bias" or practically oriented "reasonable impression of bias." In *Ecoline v. Local Union No. 12*, 2008 WL 833505 (2d Cir. Mar. 26, 2008), the Second Circuit held that the "mere appearance" of bias was not enough to vacate an award. The standard applied in *Ecoline* required that sufficient facts must be proved so that "the reasonable person would have to conclude that an arbitrator was partial to one party to the arbitration." *Id.*

In *Stone v. Bear, Stearns & Co., Inc.*, 872 F.Supp.2d 435, 445 (E.D. Pa. 2012), a federal district court acknowledged the conflicting standards, but ultimately determined that Justice White's standard was the appropriate one.

9. *Positive Software Solutions, Inc. v. New Century Mortg. Corp.*, 476 F.3d 278 (5th Cir. 2007) (reversing vacatur of an award based on an arbitrator's work with party's counsel in a previous arbitration where they were representing the same party); *Gianelli Money Purchase Plan & Trust v. ADM Investor Servs.*, 146 F.3d 1309 (11th Cir. 1998) (holding that evidence partiality under the FAA cannot be shown if the arbitrator did not have "actual knowledge of the information upon which [an] alleged conflict was founded."); *see also*, *Aviles v. Charles Schwab & Co.*, 435 Fed. App'x 824 (11th Cir. 2011) (granting defendant's motion to confirm FINRA award and rejecting plaintiff's claim of alleged bias noting that a plaintiff must show partiality is direct definite and capable of demonstration).

It reasoned that, "the law cannot make it too easy for arbitration losers to overturn unfavorable decisions by claiming that an arbitrator made a stray negative comment; rolled his eyes; or looked askance at one person or another." *Id.*

Conflicting Standard for Disclosures and Investigations

In 2007, the Second Circuit in *Applied Industrial Materials Corp. v. Ovalar Makine Ve Ticaret Sanayi*, affirmed the lower court's vacatur of the award, but criticized the lower court's focus on an "appearance of bias" standard and use of both the AAA-ABA 2004 Ethics Code and the IBA Guidelines. 492 F.3d 132 (2d Cir. 2007). The Second Circuit ignored the lower court's emphasis on the importance of enforcing uniform rules of ethics to maintain integrity in the arbitration process and instead added more layers to the evident partiality analysis. *Id.*

The Court applied the *Morelite* evident partiality standard,[10] but added that in the absence of actual knowledge of the conflict, an arbitrator's failure to investigate does not automatically warrant vacatur. *Id.* It held that "the mere possibility of a nontrivial conflict of interest" triggers an arbitrator's duty to act, but not to disclose; therefore, if an arbitrator knows of a potential conflict, he should either investigate the conflict *or* disclose his decision not to investigate. 492 F.3d 132 (2d Cir. 2007). The Court went out of its way to note that it was not imposing an affirmative duty to investigate on arbitrators. *Id.*

In contrast, the Ninth Circuit imposed affirmative duties on arbitrators to both investigate and disclose conflicts. *New Regency Prods. v. Nippon Herald Films*, *Inc.*, 501 F.3d 1101 (9th Cir. 2007). In *New Regency*, the court affirmed vacatur where an arbitrator failed to investigate a potential conflict related to the arbitrator's employment with a film group in negotiations with one of the parties to the arbitration. *Id.* The court generally referenced both the AAA-ABA 2004 Ethics Code and the IBA Guidelines as non-binding support for imposing an affirmative and continuing duty to investigate any conflicts, but did not take advantage of the IBA Guidelines specific categorization of conflicts or advice on analyzing conflicts. *Id.*

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10. The *Morelite* evident partiality standard requires a finding that "[A] reasonable person considering all of the circumstances would have to conclude that an arbitrator was partial to one side." *Applied Indus. Materials Corp. v. Ovalar*, 492 F.3d 132 (2d Cir. 2007).

ADOPTING THE IBA GUIDELINES STANDARD

In an attempt to resolve the confusion, courts have referenced ethical standards, arbitral institution rules and the IBA Guidelines, but the integrity of arbitration is threatened in the absence an agreement on which standards to use. By adopting the IBA Guidelines, courts would have one clear authority; but short of the courts adopting these standards, arbitrators can use the standards to inform their disclosure analyses. Further, the IBA Guidelines provide specific examples of what an arbitrator is required to disclose and would aid arbitrators and courts in conducting a conflicts of interest analysis, thereby strengthening the legitimacy of arbitration.

United States domestic arbitration has begun to resemble international arbitration in our increasingly connected global economy and with developments such as the requirement that all arbitrators be neutral. As such, it makes sense to apply international standards. The IBA Guidelines are consistent with the United States pro-arbitration policy and would likely lead to uniform analysis in case law and to a reduction in frivolous motions for vacatur based on evident partiality.

CONCLUSION

Courts are conflicted about the standard for evident partiality. There is no clear consensus on when an arbitrator should investigate potential conflicts and when the arbitrator has a duty to disclose conflicts. Arbitrators should use the IBA Guidelines to evaluate conflicts to maintain integrity in the arbitral process.

A SHORT STORY ABOUT THE COST OF VARIABLE ANNUITY OPTIONS (THESE "BELLS AND WHISTLES" CAN SINK YOUR INVESTMENT)

David M. Sanderford[1]

Summary: Over the last 20 years or so, insurance companies and the brokerage firms that distribute their products have added "riders" and optional benefit features to variable annuities at a torrid rate. These riders and optional features address such specifics as enhanced death benefits, living benefits (income options), "credit enhancements" (bonuses), long term care, and other subjects (which I will refer to collectively as "bells and whistles"). It is my opinion that this trend (and the annual fees associated therewith), at some level, amounts to "fee stacking"; and that the fee level may be so high that it may destroy any economic advantage that a variable annuity may otherwise offer. Further, "fee stacking" generally involves significant risks assumed by the variable annuity owner that are probably undisclosed by the seller.

I. THE EXAMPLE.

There was a time when variable annuities (as inherently complicated as "mutual fund like investments in an insurance wrapper" must be) were simple by today's standards. In a recent case where I served as an expert witness, the combined (variable annuity contract, and sub-accounts) prospectus for a popular variable annuity ran to 147 mind-numbing pages. The annuity contract itself was 34 more highly technical pages. The advertising materials, disclosure forms, and sales literature – produced approximately 60 pages more. The customer in this case, after a 15 minute presentation, was "closed" and asked to sign and/or initial 11 separate forms (one acknowledging the receipt and understanding of the above prospectus)

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1. David Sanderford is a long time Texas attorney that spent much of his career in the financial services industry; first as General Counsel, and later as Chief Marketing Officer for large insurance companies and mutual fund groups. For the last 12 years, Mr Sanderford has worked as an expert witness, usually for plaintiffs/claimants where insurance/annuity products are involved. His full CV is included in the 2012 PIABA Expert Directory.

and applications, in order to effectuate this transaction. This couple (age 75) now owned a variable annuity with dozens of esoteric investment choices, extra financial protection against death (even though they had ample life insurance), four variations of income protection (which carried liquidity restrictions beyond their life expectancy), and a "free bonus" (for which they paid dearly). Some of the forms were signed "in blank" at the request of the broker.

The annuity's annual fees for this "cutting edge package of benefits" totaled 4.45% per year (1.10% mortality and expense fee, 0.60% administrative fee, 0.60% enhanced death benefit fee, 0.75% "free bonus" fee, 1.50% average sub-account investment management fee) – and was increased to 5.45% when the broker's 1.00% Investment Advisory fee was tacked on.

The insurance industry, and brokerage industry will defend the above scenario (well, maybe not the blank forms) aggressively as appropriate and suitable for most customers. How did we get to such a point?

II. WHAT IS THE PURPOSE OF AN ANNUITY?

Historically, the primary benefit of an annuity (over any direct investment, such as a mutual fund) is the ability to defer taxes on the gains until the owner chooses to withdraw them. LIMRA (Life Insurance Marketing Research Association, an industry funded research organization) periodically surveys annuity owners on the issue of why they bought their annuity. Every time this question is asked, the number one survey response is "tax deferral."

Stunningly, it is common for insurance companies to sell a majority of their annuities to individuals under circumstances (IRA, 401-k, SEP, etc) where their assets already have tax deferral, and the annuity "tax-deferral" benefit is rendered redundant. Regulators have focused on this seeming contradiction, and have clearly stated that with tax-qualified assets, "there should be reasons for the annuity to be appropriate for a customer, other than the benefit of tax-deferral".

There are other embedded benefits in an annuity that are potentially valuable, but only marginally so. The ability to transfer amounts (without incurring tax) between sub-accounts in an annuity is a generally undervalued benefit. Also, only an annuity can uniquely provide income over a person's lifetime (although less than 2% of all annuities are ever committed to such mortality based options).

I believe that a major impetus for the creation of enhanced benefit riders and options described in this paper as “bells and whistles”, is to provide regulatory “cover’ for the continued selling of annuities to tax-qualified assets where annuity tax-deferral is not necessary. By “cover”, I mean that these rider benefits are put forward (should a complaint be lodged) as the primary reason for the annuity purchase, even though that may not be the case.

III. WHO PAYS THE COMMISSION AND WHY DOES IT MATTER?

One huge reason brokers love to sell annuities, is not only because annuities pay one of the largest commissions (gross up to 8%, sometimes with additional “trailers”) of any product they are authorized to sell – they don’t have to tell the customer how much that commission is. By “unlinking” commissions (not deducting sales “loads” from the purchase amount, ala class A mutual fund shares), the broker’s only legal obligation (absent the existence of a fiduciary duty) is to disclose the annuity’s fee schedule.

Brokers are trained to deflect the answer to the question, “What are your commissions?” They will most often respond, “The insurance company pays it, you don’t have to worry about them?”

Remember always that the primary nature of annual fees is to amortize the costs of putting the annuity “on the books”, and afterward to profit. It is this lethal combination of high commissions (requiring high fees to recoup) and the costs assigned (more on this later) to the various “bells and whistles” that produce the devastating level of annual fees that I call “fee stacking”.

It is always correct to conclude that “the customer pays the commissions”, no matter how indirectly they are paid. To understand the practical relationship of commissions to fees, it would help to compare the fees of a truly “no-load” variable annuity (Vanguard, in this case which pays no commissions) where there are no withdrawal charges to restrict liquidity to a fully commissioned one (at about 7-8%) which usually has about 7 to 8 years of withdrawal fees. The Vanguard annual Mortality and Risk fees are also about 60% lower than the fully commissioned product. The Vanguard investment sub account investment management fees are also substantially less on average.

IV. AREN'T THE "BELLS AND WHISTLES" VALUABLE?

They usually have some value. But now, we have excellent actuarial scholarship available so that these "extra" benefits can be effectively valued – and that value compared to the fees the insurance company charges.

To understand the insurance company's pricing decisions, you must first assume that each fee is **never** fully devoted to its stated purpose. Each fee should be thought of as a "mini slush fund" with three unallocated corporate purposes: (1) to cover the expense of the benefit or option, (2) to partially amortize the acquisition expenses (commissions primarily), and (3) for additional profits (usually toward an overall target in the range of 15-20%).

Let me give you an example of an "expensive" optional benefit:

> Enhanced death benefit fees are always much higher than what the economic risk to the insurance company would require. Remember, this is NOT insurance. If it was, there would be higher fees charged for males over females, the older over the younger, and when riskier sub-accounts were involved (more potential loss). Using the example provided above, the total Mortality and Risk fee and the enhanced death benefit rider fee of 1.70% would be approximately 250-300% more than the insurance company would expect to pay out in guaranteed death benefits.

Let me give you an example of an "illusory" optional benefit:

> The pernicious "credit enhancements" or "bonuses" have no intrinsic value for the average customer. To prove this, you would compare the fees associated with the bonus annuity with those of a non-bonus annuity from the same company. The fees will always be lower in the latter, and the higher in the former. When measured, they will reveal themselves to be greater than the bonus.

V. BUT WHAT IF I LIKE BELLS AND WHISTLES?

OK, so you like expensive options with little or no value. Let's just assume (to give the benefit of any doubt to the insurance company/broker) that the fees have some reasonable relationship to cost of the option's benefit. You should still not buy the variable annuity. In my example the annuity, because of "fee stacking", had a fee differential (over a similar mutual fund) of 4.45%. When the fee differential exceeds a certain "tipping point", which I estimate to be in the range of 3-4 % (depending on the age and circumstances of the individual), the annuity fails as a reasonable recommendation.

It is my position that all variable annuities with an annual fee level so high as this example (5.45%) have destroyed their potential economic value to the investing public -- and can therefore only be sold in situations involving misrepresentation and non-disclosure of the attendant risks associated with "fee stacking". Stated differently, the variable annuity illustrated, because of the excessive level of annual fees) could not be a suitable recommendation for any customer.

To illustrate, let's assume that you are an investor with a "capital appreciation" investment objective. By "capital appreciation", I mean that you might be properly invested (by experience and goals) in a diversified portfolio of common stocks of reasonable quality for long term capital appreciation. In this position, you have negotiated and accepted a "volatility risk" of plus/minus 20% per year, in the hope of realizing investment returns that have historically averaged about 10-12% per year (not guaranteed, of course).

There are dozens of prominent, well managed mutual funds that manage capital appreciation portfolios (as described) for an annual fee of about 1% (index funds, much lower). So, to compare the results of a typically efficient mutual fund with a variable annuity having an annual fee of 5.45% will lead inevitably to one of two results:

1. The broker/firm after selling the annuity will **select sub-accounts properly** for the desired capital appreciation objective. In this example, the customer is assuming the appropriate market risk (+ or – 20% volatility), but by deducting 4.45% more each year (5.45% minus 1.00%) than a comparable mutual fund, the customer cannot reasonably achieve the expected capital appreciation historical return. The return will always be "haircut" by the additional 4.45% in annual variable annuity fees. This discounted return destroys the "risk-reward bargain" made at the point of sale. No fully informed customer would accept capital appreciation risk for capital appreciation returns discounted (because of the higher fees) to the level of fixed income assets.
2. The broker/firm will buy the annuity and **NOT SELECT sub-accounts properly** for the desired capital appreciation objective. Because there is a 4.45% hurdle to overcome to achieve the expected 10-12% capital appreciation return average, the sub-accounts selected in this example will generally be far more speculative than a capital appreciation objective. The broker's "plan" being hopeful that the more aggressive and speculative sub-account choices might produce a higher gross return that will accommodate (and obscure) the higher fees, and yielding the expected capital appreciation level

of return. Again, no fully- informed customer would accept speculative market risk to achieve, at best, only capital appreciation returns.

Logically, where you are comparing identical investment scenarios, where the only difference is a higher annual fee – the above two alternatives are the only possibilities. In the case I am illustrating, the customer receives either 4.45% less annual return than expected, **or** takes on substantially more risk (and market volatility) than expected. In either case, the broker/firm is required to disclose all substantive risks associated with their recommendations. With the fiduciary duty imposed on any Registered Investment Advisor, the burden of proof would effectively be transferred to the broker to show he/she met their industry standards.

VI. DON'T THE BELLS AND WHISTLES JUST MAKE THE VARIABLE ANNUITY "PERFORM" BETTER.

No, in most cases. A carefully crafted scenario can be illustrated that can demonstrate how a hypothetical customer will benefit from any particular "Bell and Whistle" option. The reasonable analysis to make is to examine the likelihood of the scenario occurring, against the cost of the option designed to cover that event -- considering the age and circumstances of the customer. Such an analysis almost always reveals the benefits of the option to be incredibly overpriced. This is especially true when the broker recommendation includes the replacement of an existing annuity.

VII. 5.45% MAY NOT SOUND LIKE A LOT.

A good way to evaluate the reasonableness of an annuity's (cumulative) annual fee is to convert it to a "front-end load" equivalent. Most insurance insiders understand that it takes only 20-25 basis points (100 basis points comprising 1.00%) of an annual fee to equal 1.00% of a one-time front end charge. At this rate, 5.45% of annual fees would amount to a front-end charge of 21% - 27% (rounded in favor of the insurance company).

My belief is that while many annuities (sold to appropriate customers, and held for long term retirement purposes) may indeed be thought of as "suitable" investments produced from "reasonable" recommendations. However, annuities with annual fees stacked so high that they materially distort the risk-reward balance presented to the customer at the time of sale, have effectively destroyed their usefulness.

VIII. CONNECTING THE "DOTS".

- Numerous "enhanced benefit riders" (Bells and Whistles) have been created by insurance companies to attract buyers, and to support the proposition that the annuities have been purchased (with "tax-qualified" assets) for benefits other than tax-deferral.
- Higher commissions paid by insurance companies lead directly to higher fees and charges in annuity contracts to amortize those expenses.
- The fees charged for enhanced benefit riders far exceed the costs of the benefits provided by insurance companies.
- The total amount of annual fees (mortality and expense, administrative, investment management, enhanced benefits, and investment advice) can exceed a fatal "tipping point" (3-4 % more than a similar mutual fund) where the annuity product cannot (absent misrepresentation or fraud) deliver the "risk-reward" bargain negotiated at the point of sale.
- Many "bells and whistles" amount to options that are apparently sold for totally opposite purposes. Some options hedge against the possibility of dying too soon (enhanced death benefit options) and some hedge against outliving your assets (living benefit options). Purchasing options that are mutually exclusive in providing benefits – has the unwelcome result of eroding returns, or increasing risks – producing a cost to the owner that often outweighs the benefit of either option.
- Comparing two "after tax" investments of $10,000, each earning 10% gross return annually for 10 years would produce the following results where one had 1% annual fees and the other 5.45% annual fees:
    - The value of the 1% fee example would be $23,674.
    - The value of the 5.45% fee example would be $15,604.
    - Over the 10 year period the 1% example had a return ($13,674) that was 2.44 times higher than the return ($5,604) in the otherwise identical 5.45% example.

IX. CONCLUSION.

Think of variable annuities as a product manufactured for brokers to sell – that are complicated enough that their financial reality may be obscured. The "bells and whistles" contribute to that complexity and may be costly to the point that the variable annuity's real benefits are compromised.

SWIMMING NAKED WHEN THE TIDE GOES OUT
NAKED/SHORT OPTIONS 2013

Douglas J. Schulz[1]

INTRODUCTION

Warren Buffet probably had no idea that his famous quote, "After all, you only find out who is swimming naked when the tide goes out,"[2] would apply so perfectly to "naked" options. Let's analyze what the "Oracle of Omaha" may have been suggesting to Berkshire Hathaway shareholders. There are numerous business ventures and investments that can both survive and even thrive when market conditions are positive or even neutral. That is the easy part of the game. Savvy, successful entrepreneurs and investors are likely to tell you that to be successful long-term, one must fully understand downside risks—and be positioned to manage those risks.

Businesses are constantly impacted by cycles. A business that survives only in times of growth and prosperity but falters or fails during contractionary periods is probably a poorly managed business. Likewise, the securities markets have their own swings; one need only refer to a long-term chart of the S&P 500 to see evidence of recurring "boom and bust" patterns. History has proven there is no individual who is smart enough or lucky enough to guess exactly when the up or down cycles in the U.S. securities markets are going to change. Any investor, money manager or long-term

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2. Buffet, Warren, Chairman of the Berkshire Hathaway Board of Directors, *2001 Annual Letter to Shareholders*, (Feb. 28, 2002), *available at* http://www.berkshirehathaway.com/2001ar/2001 letter.html.

investor would not last long if s/he used investment strategies that worked only in "bull" market expansions, but were severely damaged in "bear" market contractions.

Such is the risk scenario for option writers. Because statistics indicate that only 17% of all options are ever exercised,[3] too many investors interpret this to mean that the buyers of options have most of the risk. But that 17% of the time is where the greatest damage/losses occur.[4] And when that 17% is combined with a significant move in the markets, all the profits gained from being right 83% of the time can be wiped out in an instant, causing the investor to lose more than was invested.

Now add to this dangerous investment philosophy the fact that many brokerage firms encourage investors to participate in these option-writing programs, only to constrain the investor in volatile times by limiting or even canceling the ability to trade out of the dilemma.

"FINANCIAL WEAPONS OF MASS DESTRUCTION"[5] – NAKED OPTIONS

When testifying as an expert witness in an option case, I am often asked to describe the risk of "naked" options trading.[6] When describing such risk,

3. Options Clearing Corporation, OCC, 2006, 17% of all options are exercised, 35% of options expire worthless, 48% of options are bought or sold to close the position. A later study, 2009, suggested only 10% of options are exercised, 30% of options expire worthless, and 60% of options are offered or sold before expiration.

4. There are some particular option strategies, though rare, where a trader might prefer to be exercised.

5. Mr. Buffet coined this phrase in a letter to shareholders, in which he opined, "In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal." Buffet, Warren, Chairman of the Berkshire Hathaway Board of Directors, *2002 Annual Letter to Shareholders*, (Feb. 28, 2002), *available at* http://www.berkshirehathaway.com/letters/2002pdf.pdf.

6. *Investopedia* defines a "naked" option trade as follows:

> A trading position where the seller of an option contract does not own any, or enough, of the underlying security to act as protection against adverse price movements. If the price of the underlying security moves against the trader, who does not already own the underlying security, he or she would be required to purchase the shares regardless of how high the price is. The potential for losses, then, can be unlimited, and as a result, brokers typically

it is most effective to do so by comparing one investment vehicle against another. I often compare naked options to commodities because a majority of people assume that commodities are the riskiest of all investments. Having done extensive trading in both naked options and commodities, it is my professional opinion that naked options can often be the riskier. Let me tell you why that is so:

- *How risk is defined or understood.* Whether a naïve investor or a professional, almost 100% of them would admit to believing that commodities are incredibly risky. The opposite is often true for options, in that many investors believe that options are relatively safe and that this includes naked/short options. A misunderstanding of the inherent risks of any investment increases the risk of that investment.
- *Commodities obviously are more complex.* The mere fact that commodities are not regulated by the Securities Exchange Commission ("SEC") or Financial Industry Regulatory Authority ("FINRA") scares off many investors. While stock and index options appear, on the surface, to be correlated to the underlying security, commodities are in an entirely different category. Investors may possess a greater (false) sense of security with options due to their correlation with the underlying security and because they are regulated.
- *Trading commodities is more restricted than trading options*. A broker must receive separate training and a separate license (Series 3) to trade commodities and the brokerage firm must be commodity-licensed. For commodities trading, the investor is required to maintain a totally separate account. The opposite is true for options. Any Series 7 registered representative and registered brokerage firm can trade options alongside stocks, bonds and other traditional investment products. The investor is required only to sign an options trading customer agreement, inculcating them with a false sense of security about the perceived safety of options trading.
- *Options are a "wasting" asset*.[7] Yes, commodity futures contracts do expire on dates certain. However, one should not lose sight of the fact

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> have specific rules regarding naked trading. Inexperienced traders, for example, would not be allowed to place this type of order.

Available at http://www.investopedia.com/terms/n/nakedoption.asp#ixzz2JCutREk6.

7. Option contracts are considered "wasting" assets because all options expire after a finite time period. The expiration month is specified for each option contract. The specific date on which expiration occurs depends on the type of option. For instance, stock options on the CBOE expire on the Saturday immediately following the third

that there can be cost in renewing or "rolling over" a commodity futures contract, a cost that is incomparable with the total loss of the options price/premium at its expiration date.[8]

- *The misperception that commodities pose greater risk because of the leverage and volatility of commodities contracts.* Commodities have limits on the amount they can move in any given trading day. Stock can have a massive percentage move within a given day and stock options can experience even greater price movements and volatility. When it comes to leverage, both stock and index options allow investors to control millions of dollars of underlying securities and indices, with investments of only thousands of dollars. The common misunderstanding of volatility and leverage can result in significant losses for both long and short option investors.
- *The misunderstood price and premium of options*. The price of corn is the price of corn and a futures contract on corn is generally synonymous with that underlying commodity.[9] Not so for options. The price/premium of an option has numerous, complicated nuances understood by only a small percentage of investors.

Regarding the general risk of naked options trading, consider this quiz:

Q: *Who loses money in a "bull" market?*

A: Few investors because most use "long" investment strategies.

Q: *Who loses money in a neutral or sideways market?*

A: Few investors because the only real losses might be opportunity cost compared to out-of-pocket cost. Stocks that pay dividends can create positive results even during a "flat" market.

Q: *Who loses money in a "bear" market?*

A: For a long-term stock investor, historical market statistics show that as long as an investor can stay invested, bear markets are generally short-term interruptions to long term,

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Friday of the expiration month. Once a stock option expires, the contractual right to exercise no longer exists and the security becomes worthless. *See* http://www.cboe.com/LearnCenter/Concepts/Beyond/expiration. aspx.

8. Option contracts to purchase (or sell) commodity futures contracts exist, but exceed the scope of this article.

9. Commodity futures contracts prices sometimes disconnect from the underlying commodity, an occurrence commonly known as "divergence."

positive returns.[10] Aggressive stock investors utilizing margin, on the other hand, can sustain significant losses. Because of leverage, naked option writers can be totally wiped out and even lose more than their original investment.

OPTION COMMISSIONS AND INHERENT CONFLICTS OF INTEREST

When investing in any security, one must first determine what conflicts of interest exist.[11] When dealing with a brokerage firm, the natural built-in conflicts of interest include the commissions and fees paid by a customer. Brokerage firms take none of the risk,; they receive commissions and fees regardless of whether the client loses money or not.[12] It is often the most illiquid and highest risk investments that provide the highest commissions and fees. This is especially true when it comes to options. With the advent in 1975 of un-fixing brokerage commissions and with the explosive growth in online discount trading firms in the late '90s, brokerage firms saw their basic stock and bond commission rates shrink. Option trading represents a lucrative commission stream for the brokerage industry, and, with it, a substantial conflict of interest in the form of a financial incentive to sell option contracts to customers.

While, brokerage firms do not charge for options that expire worthless, only 30% to 35% of option contracts expire worthless.[13] When an option

10. The last 12 years have seen both more frequent and longer bear market cycles in stocks in the U.S. markets. Additionally, many investors do not have the luxury of waiting out bear markets.

11. DOUGLAS J. SCHULZ & TRACY PRIDE STONEMAN, BROKERAGE FRAUD-WHAT WALL STREET DOESN'T WANT YOU TO KNOW, (Dearborn Publishing, 2002).

12. Brokerage firms' business platforms are designed so that all the various risks taken by their clients are borne by the client and not the firm. One of the main reasons for the margin requirements is to protect the brokerage firms' capital. Technically, the firm does have risk exposure when the trading in an account creates a debit. Yet, the brokerage firm can always sue the client for any deficiencies created based on the terms and conditions of the typical customer margin agreement.

13. According to Options Clearing Corporation (OCC) data, 2006, 17% of options are exercised, 35% of options expire worthless, 48% of options are bought or sold to close the position. A similar 2009 study suggested only 10% of options are exercised, 30% of options expire worthless, and 60% of options are offered or sold before expiration.

contract is exercised, the customer is charged commissions for having the underlying stock either "put" to or "called away."[14] When one considers that most options traded are only a few months in duration, and that between 45% and 60% of the time the customer trades out of options held, substantial trading activity and commissions are the result.

UBS COMMISSION SCHEDULE[15] - PROVING THE POINT

If a UBS customer buys 500 shares of a $20 stock, which equates to an investment of $10,000, a commission of $248.75 plus a $5.25 processing fee, or a total cost of $254, is incurred. The customer pays an effective 2.54% commission. Alternatively, if this same UBS customer invests $10,000 to purchase (or sell) 20 option contracts, the cost will be: 1.4492% of the principal; a fee of $35.69; $9.355 per each of the first ten contracts; and, $5.84 for every contract after the first ten. This results in a total transaction cost of $332.56. Thus, the transaction cost for the options is 30% *greater* than an investment of the same amount of money used to purchase stocks.

FIDELITY COMMISSION SCHEDULE – ANOTHER EXAMPLE

If a Fidelity customer buys 500 shares of a $20 stock, a $7.95 commission is charged. If the customer were to invest $10,000 in 20 option contracts, a $7.95 commission and $.75 per contract is charged, for a total transaction cost of $22.95, an almost 90% higher cost to purchase options contracts versus shares of stock.

Nevertheless, options are time sensitive, which means that when they expire, an investor is forced to either close out the open options position or "roll out." [16] When one considers that the average price of a stock listed on

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14. American versus European options: American-style options can be exercised any time before the expiration date. European options, on the other hand, may be exercised only on the expiration date. Currently, all of the stock options traded domestically are of the American variety.

15. UBS Commission Schedule, *available at* http://www.ubs.com/content/dam/static/wmamericas/commission_schedules.pdf.

16. A "roll" is a follow-up transaction in which the investor closes options currently in the position and opens other options with different terms, on the same underlying stock/index. This assumes the investor wants to maintain his position/strategy.

the New York Stock Exchange ("NYSE") is a multiple of the average price of an option traded on the Chicago Board Options Exchange ("CBOE"), one quickly realizes that you can get more "bang for your buck" (leverage) with options. Active options traders generate substantially more commission dollars for brokerage firms when compared to stock or bond traders using the same dollar amount of capital to invest. Where there are huge commissions and profits to be made, there is by nature a built-in conflict of interest. It has been my experience that the trading, compliance and supervisory departments of brokerage firms often become "see no evil, hear no evil, speak no evil" with regard to such customer accounts.

ONLINE OPTION TRADING – "COME ENTER MY WEB" SAID THE SPIDER

Perhaps within the next decade, online gambling will be legalized across this country. But Americans need not wait; they can gamble to their hearts' content (and to their financial detriment) by trading options at any online trading firm. For decades, the self-regulatory organizations required licensed broker-dealers to ensure that all solicited trades were suitable for their customers. With the technology and telecommunications boom of the late '90s and the advent of online trading, the securities industry pressured regulators to relax suitability requirements. Regulators reversed their earlier regulations and requirements in Notice to Members (NTM) 01-23, which was indeed a sad day for investors.[17] As of 2001, if the brokerage firm – be it a typical brick and mortar firm such as Merrill Lynch, Morgan Stanley and UBS or an online firm such as TD Waterhouse, Charles Schwab and Ameritrade – could establish that the disputed trades were unsolicited,[18] the

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LAWRENCE G MCMILLAN, OPTIONS AS A STRATEGIC INVESTMENT, NEW YORK INST. OF FINANCE, Penguin Putnam – Prentice Hall (4th Ed. 2002).

17. *See* NASD Notice to Members 01-23 (April 2001), *available at* http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003887.pdf.

18. For the definition of and discussion regarding securities regulations related to the term "unsolicited," see two of my earlier articles: *Unauthorized Trading, Time and Price Discretion & The Mismarking Of Order Tickets*, Securities Arbitration 2001, Practicing Law Institute (PLI), New York City (Aug. 15, 2001), and *When Is An Order An Order? Unauthorized Trading By Securities Brokers*, Securities Arbitration, PLI (1994).

firms could allow an investor to totally blow himself up regardless of how unsuitable the activity might be. Now even a "little old lady in tennis shoes" can wipe out her life savings, while her brokerage firm sits idly by.

Let's fast-forward to the last few years. Online brokerage firms realized that incredible revenues/commissions could be generated by offering investors somewhat sophisticated option trading platforms. As a result of the opportunity to generate substantial revenues, online brokerage firms specializing in such trading were created. For example, the firm Interactive Brokers states the following:

We offer multiple trading platforms that provide the ideal environment for all types of traders:

- *Traders who prefer a clean and simple interface can use our HTML-based WebTrader, which makes it easy to view market data, submit orders, and monitor your account and executions.*
- *Traders who require more sophisticated trading tools can use our market maker-designed Trader Workstation (TWS), which optimizes your trading speed and efficiency with an easy-to-use spreadsheet interface, support for more than 50 order types, task-specific trading tools for all trading styles, and real-time account balance and activity monitoring.*
- *Traders on-the-go can use one of our mobile solutions, including mobileTWS for iPhone™, TWS for Blackberry® and MobileTrader.*[19]

OptionsXpress, a division of Charles Schwab, states:

> ***Experience Powerful, Easy-to-Use Tools***
> *Find ideas and place your trades with intuitive, easy-to-use trading tools including:*
> ***All-In-One Trade Ticket***
> *Called by Barron's a "model for the industry"*[20] *our All-In-One Trade Ticket lets you easily build strategies and place all your trades from a single screen.*
> ***Strategy Scan***
> *Identify options strategies based on your personal risk tolerance and sentiment of the underlying symbol.*
> ***Trade & Probability Calculator***
> *Quickly identify the opportunity and risk of an options trade with the Trade & Probability Calculator.*
> ***Virtual Trade***

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19. *See* http://www.interactivebrokers.com.

20. http://www.optionsxpress.com/security_risks/disclosures.aspx#awards.

> *Test your strategies and ideas risk-free with $25,000 in a Virtual Trade account.*[21]

TD Ameritrade's Web site - the "Sink or Swim" option trading platform/program - states:

> *Finally, a trading platform that lives up to its traders.*
> *Take your game to the next level with thinkorswim*
> *Get elite-level trading tools and analytics with thinkorswim. Trade equities, options, futures, and Forex in your own personal trading HQ powered by insights, education, and tools to help you nail even complex strategies and techniques. Plus, if you are leveraging portfolio margin to diversify, hedge risk, and potentially lower margin requirements in your qualified account, only the thinkorswim platform displays Portfolio Margin* requirements using a theoretical pricing model.*[22]

TDAmeritrade's CEO, Fred Tomczyk, wrote to customers during the market turmoil of 2009:: *"Our robust technology and tools allowed our clients to navigate these difficult market conditions."*[23]

Come on in, said the spider to the fly.

THE HOTEL CALIFORNIA ACCOUNT RELATIONSHIP

The Eagles sung it best in their hit song, *Hotel California*, "You can check out any time you like, but you can never leave."[24] Online trading firms far too often implement a "Hotel California" business model Large active option trading accounts are lucrative for online brokerage firms. The firms market and advertise their option trading platforms as being "state-of-the-art" tools. They entice customers into active option trading activity by promising special and sophisticated services.

Sometimes customers are offered special margin interest rates and other privileges. Additionally, under the new FINRA "Portfolio Margin" guidelines, investors are allowed, if they meet certain requirements and minimum equity balances, to increase the size of their leverage/margin positions in ways that would otherwise not be permitted.

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21. http://www.optionsxpress.com.

22. http://www.tdameritrade.com.

23. https://www.tdameritrade.com/retail-en_us/resources/pdf/TDA6312.pdf.

24. Don Felder, Glenn Frey, Don Henley, on *Hotel California* (Asylum 1977).

But when markets become volatile, many of those firms get nervous and take action that is adverse to their customers' best interests. It is not only the broker-dealers, but also the regulators, who go to great lengths to ensure firms do not risk their capital, but instead that all the risk is squarely on the customers' shoulders (at least as it relates to margin).

Brokerage firm policies and customer agreements are typically one-sided contracts of adhesion and when customers sign the firms' "customer agreements," they acquiesce to this one-sided contract. This is especially true when it comes to the margin agreement, which is required when a customer seeks to trade naked/short options. All naked/short option contract transactions are by definition margined trades.[25] The terms and conditions of these agreements essentially state that the brokerage firm can do whatever it wants and whenever it wants with respect to margin accounts. One might wonder why *any* customer would ever sign such a one-sided contract of adhesion. The likely answer is that every brokerage firm has these provisions in their contracts and retail customers possess no bargaining power to take their business to a broker-dealer that does not require these conditions.

Too often brokerage firms abuse their one-sided contracts. There are many ways in which they do this, but here I am referring to the "Hotel California" maneuver, where the brokerage firms allow clients to put on thousands of contracts worth millions of dollars, but when volatility escalates, and the firms gets nervous, they just "pull the rug out from under" their customers.

Many investors begin option trading aware of the volatility and risk. Many sophisticated option traders thrive on volatility, because it swells option prices/premiums (increase in value) and opportunities to capture profits. There is even an accepted measure of this volatility known as the "VIX," the CBOE implied volatility index of S&P 500 index options, which expresses expected market volatility over a 30-day period.

Investors should only conduct their brokerage business with reputable, large brokerage firms that have been in business for decades. You want to make sure your brokerage firm is there when you need it. Volatile times and bear markets come and go: what an investor and especially an active, large trader wants and needs is a firm that can handle his business in all kinds of markets. Why would anyone open an account with a brokerage firm that panics during volatile or bear markets?

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25. This does not mean there is margin interest being charged, but only that there is a margin requirement.

The sad reality is that these brokerage firms are more than willing to sit by and allow customers, especially active large investors who are generating millions of dollars in commissions and fees for the firms, to build up massive large option positions, including naked options positions. Months and years can go by with thousands of trades taking place on an annual basis and the brokerage firm collects millions in commissions. Eventually there is a major move in the market. Many sophisticated, experienced option traders are not surprised by these trends or increases in volatility. But broker-dealers are staffed with young, inexperienced individuals who tend to panic when markets are volatile. The first steps these firms take when they become nervous is to start limiting and restricting the trading in their customers' accounts, especially those with large, naked options positions. The firms immediately hold up their one-sided customer contracts and point to the language that says they can do what they want when they want.

Every state's law recognizes that in every contract or agreement there is an implied promise of good faith and fair dealing. This means that each party will not do anything to unfairly interfere with the right of any other party to receive the benefits of the contract. Securities regulators have for decades had a similar rule that states, "A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade."[26] These are powerful provisions to help ensure that brokerage firms treat their customers and their customers' accounts fairly and professionally.

THE BLIND LEADING THE BLIND

Some option trading can be relatively simple. With just a little work, most people can quickly figure out what it means to buy an option. Even then, it is a lot more complicated than just buying a stock. When buying an option contract, customers need to know the answers to these basic questions:

- How many shares of the underlying stock does one option contract control?
- What are the various cycles (time periods/expiration dates) available for each option?
- What is the exact number of days until expiration?

26. FINRA Rule 2010

- What is the mathematical equation to determine the cost and fees of purchasing one contract?
- What is the difference between a "put" and "call" option contract?

It is essential to understand additional nuances, such as: what makes up the value/premium of an option contract, which includes such things as time value and intrinsic value. And this is the simple part of trading options.

What if an investor wants to trade options by shorting them, often referred to as selling naked options? It is somewhat similar to selling a stock short, but with more variances and complications. One of the complications attendant to "option writing" (i.e., selling options short/naked) is understanding obligations that are incurred by being short an option contract. The person who purchases options has no such obligations as the owner of the option contract.

The opposite is true for shorting options. Because the customer sold something s/he did not own, the seller of short options has obligations that must be observed, such as the fact that an investor who has sold options short has given the counterparty (who took the other side of the contract, who purchased the contract the customer sold)– the right to demand certain actions.[27] On a short put contract, the short seller can be forced to buy 100 shares/units times the number of contracts sold short or to deliver 100 shares/units times the number of call contracts sold short. And if this short seller does not have those shares/units to deliver, s/he must go out into the open market and buy them in order to deliver them.

Problems occur for large, active naked option traders in the area of margin. Determining exactly how margin (both initial and maintenance margin) is calculated, much less trying to do the actual margin calculations, is something that few people comprehend. It is very dangerous when investors enter into the arena of large-scale selling of naked options, especially when they do not fully comprehend margin requirements. What is worse is when the brokerage firms that advertise sophisticated option platforms with the ability and staff to calculate margin requirements fail to do so. That is a recipe for disaster – for the customer.

With regard to options trading, brokerage firms are often staffed by people ill-equipped for their positions. I have participated in a number of option trading cases in which the testimony of brokerage firm employees responsible for option trading and margin calculation, reveals that either

27. In actuality, though there is a person on the other side of every option contract, the OCC matches all trades, and an investor is not technically dealing directly with the person who purchased his naked contract.

they: 1) have never traded options; 2) have worked in the brokerage industry for only a few years; 3) are new to the options departments; and 4) are unfamiliar with the option strategy being utilized by the claimant-investor. Internal e-mails and voice recordings between employees of these brokerage firms is like listening to an Abbott and Costello skit. No one can figure out the risk parameters or current margin requirements on client positions. Since most investors are not capable of fully understanding or calculating margin requirements, they must rely on the brokerage firm's margin departments. Particularly in volatile markets, "the blind are leading the blind" into calamities.

PROFESSIONALISM, ADEQUACY & ABILITY

Though brokerage firms would like customers to believe all the obligations and duties that flow from the "customer agreement" and "margin agreement" are borne by the client, that is not the case. Customers are not regulated; brokerage firms are. Though the firms advertise their expertise, sophisticated trading platforms and the ability to fully manage an option traders' every need, firms also agree to know, implement and follow securities regulations.[28] When firms fail to fulfill their obligations, they can be held liable for negligence and be responsible for client losses.

The technology boom caused online trading to skyrocket. E*TRADE, TD Waterhouse, Ameritrade, Brown and Company, DLJ, Fidelity and Charles Schwab are just a few of the firms for whom business exploded. However, their marketing departments were not talking to their trading departments, or if they were talking, one of them was not listening. If they had been communicating, they would have known they were opening customer accounts so quickly that the trading departments could not keep up with the order volume. Investors were soon learning that their trades were not filled properly.[29]

When regulators became aware of trading problems at online firms, they released a series of regulatory interpretations, including:

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28. The source of this obligation is through the firm's licensing with FINRA, though often the obligation to adhere to the securities rules is also found in "customer agreement."

29. I was inundated with phone calls at the time, because I was writing a series of articles on the risk of Internet/online trading and personally had six different online trading accounts.

1. *NASD Notice to Members 99-11*[30] *- Guidance Regarding Stock Volatility*

- Member firms must have adequate systems capacity to handle high volume or high volatility trading days. Firms should provide adequate, clear disclosure to customers about the risks arising out of evolving volatility and volume concerns and any related constraints on firms' ability to process orders in a timely and orderly manner.
- Firms' procedures for handling customer orders must be fair, consistent and reasonable during volatile market conditions and otherwise.
- Firms may use advertisements or sales literature to make claims about the speed and reliability of their trading services. These communications must not exaggerate the members' capabilities or omit material information about the risks of trading and the possibilities of delayed executions. Members should have the system capacity to support any claims they make about their trading services.
- Misrepresentations or omissions of material facts in public communications violate NASD Rule 2210 as well as Rule 2110, which requires members to observe high standards of commercial honor and just and equitable principles of trade.

2. *NASD Notice to Members 99-12*[31] *- Guidance Concerning The Operation Of Automated Order Execution Systems During Turbulent Market Conditions*

- NASD Regulation believes that members' best execution obligations require that such algorithms and procedures treat customer orders in a fair, consistent, and reasonable manner.
- As a general matter, these systems[32] should be designed to process and execute orders during non-turbulent market conditions in a fair, consistent, and reasonable manner and have a capacity that is

30. http://www.finra.org/Industry/Regulation/Notices/1999/p004563, February 1999.

31. http://www.finra.org/Industry/Regulation/Notices/1999/P004554.

32. These "systems" are automated order execution systems for smaller customer orders, generally 3,000 shares or less.

adequate to handle reasonably anticipated trading volume in an efficient manner.

The SEC had issued the following legal bulletin which resulted from the volatile markets on October 27 and 28, 1997 when "circuit breakers" were instituted during the trading day.[33]

3. *SEC Staff Legal Bulletin No. 8 (MR) - Division of Market Regulation - September 9, 1998*

- Broker-Dealers Need to Have Enough Systems Capacity to Ensure a High Degree of Operational Capability Access Problems Faced by Customers of Online Broker-Dealers - The Division seeks to emphasize to broker-dealers the importance of having adequate capacity to handle high volume or high volatility trading days, and conducting capacity planning on a regular basis.
- Outsourcing Does Not Excuse Broker-Dealers from Focusing on Capacity Issues.

DAYDREAM TRADING EXAMPLE

Allow me to give you a specific example on brokerage firms "pulling the rug out from under" their clients when they get nervous in volatile markets. In FINRA arbitration Case No. 09-02054: *Daydream Trading, LLC, et al. v. TD Ameritrade, Inc*,[34] my client ran Daydream Trading, a sophisticated option trading program firm that specialized in trading "Iron Condor's," an advanced option strategies using spreads.[35] It opened an Ameritrade option trading account because of its claimed ability to deal with sophisticated trading demands. For years, the client traded through an Ameritrade account,

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33. Circuit Breakers (Trading Curbs) are market regulation mechanisms put in place by the regulators to halt trading when certain market movement criteria are triggered. The goal is to allow the markets to regroup and cool down during volatile market conditions.

34. This case was referred to in an earlier PIABA BAR JOURNAL Vol. 17 No 3, as one of the more significant awards.

35. The "Iron Condor" is an advanced option trading strategy utilizing two vertical spreads – a Bull Put Spread and a Bear Call Spread, each with the same expiration and an equal number of call spreads as put spreads.

which was profitable for him and very profitable for Ameritrade. As the market volatility escalated in 2008, Ameritrade panicked and abruptly halted all trading in the client's account except for closing transactions. Because of the nature of the type of option spreads that the client held and the timing of Ameritrade's trading restrictions, the client's account was nearly wiped out.

The defense by Ameritrade was that the "customer agreement" gave Ameritrade the right to halt or limit my client's trading at any time, hence the "pulling the rug out from under" the client. As the expert witness, I testified that regardless of what the customer agreement stated, the norms and standards of the securities regulations require licensed broker-dealers to deal in good faith and fairly with their clients. I cited what is now FINRA Rule 2010, entitled *Standards of Commercial Honor and Principles of Trade*. The arbitrators rejected Ameritrade's "contract" defense and awarded the claimant $6,924,538, assessing all of arbitration costs against the firm.

In the Daydream case, Ameritrade would not let the claimant roll his positions or make new positions to try to adjust his account to the fast volatile market. This is basically a death sentence for an option trader, especially one who uses spreads, straddles, strangles and naked options. In that case, the claimant-customer also had been trading extensively with the brokerage firm without incident. He held numerous short option positions as part of various options strategies, but generally he tended to be short both puts and calls on a particular stock index. When market volatility escalated and the claimant's margin buying power was eliminated, his account was subject to a margin call. Just as in the Daydream case, the brokerage firm restricted the trading activity, allowing only "closing orders."

In another naked option case in which I participated, employees at an online brokerage firm refused to allow the claimant-customer to enter closing transactions, even when he explained that the trades were closing transactions and that he was not establishing a new position. The brokerage firm allowed the claimant to establish thousands of contracts, risking millions of dollars (checking into the Hotel California). But when the claimant tried to enter closing transactions (checking out of the hotel), the firm refused to effect the closing orders. When a brokerage firm confuses the customer's closing orders for open positions, the negligence is somewhere beyond comprehension, not to mention a serious violation of the norms, standards and regulations of the securities industry.

KNOWINGLY UNDERSTATING NAKED OPTIONS RISKS

Some brokerage firms knowingly understate the risk and exposure to a client in naked option contracts. When I conferred with other margin option experts in preparation for my expert testimony in a naked option arbitration, I was told that naked option margin requirements are never adequate when you have a stock that is dropping fast. Naked option exposure is the number and contracts and ultimately the number of dollars that a customer's account can be committed to buy (or sell) if the naked options are exercised against the customer. In one case in which I was the customer's expert, it was $85 million. Simple arithmetic explains how this account, with only $17 million in equity, cannot buy $85 million worth of stock. Even on margin, a $17 million equity account can only buy $34 million worth of stock, and that assumes the $17 million was all in cash and not invested in other securities.

When reviewing page after page of the broker dealer's internal reports on the accounts' "Naked Option Exposure," I learned the firm had calculated the naked option exposure by taking the "in the money"[36] option contracts and subtracting the difference between the strike price and the current price of the underlying stock. The firm's naked option exposure calculations ignored the naked options that were not in the money. This partially explained the broker-dealer's understatement of risk and exposure on these naked option contracts. The second fallacy in the firm's naked option exposure reports was its calculation of the exposure of those options that were in fact in the money.

PORTFOLIO MARGIN – ADDING FUEL TO THE FIRE

In 2008, FINRA announced the permanence of a portfolio margin pilot program that which contains a new margin calculation system for certain types of accounts. The FINRA Notice to Members is NTM 08-41 - FINRA Announces Amendments to Make Permanent the Portfolio Margin Pilot Program

- Portfolio margin is a methodology that computes margin requirements for an account based on the greatest projected net loss of all positions in a product class or group, and uses computer

36. If the underlying stock is trading at $50 per share, a put contract with a strike price of $50 is considered to be "at the money." A put contract with a strike price of $55 is considered to be "in the money." A put contract with a strike price of $45 is considered to be "out of the money."

modeling to perform risk analysis using multiple pricing scenarios. The pricing scenarios are designed to measure the theoretical loss of the positions, given changes in the underlying price and implied volatility inputs to the model.

- Accordingly, the margin required is based on the greatest loss that would be incurred in a portfolio if the value of its components move up or down by a predetermined amount.

The following is excerpted from TD Ameritrade's Web site, at a page titled "Portfolio Margin Risk-Disclosure Statement." It minimally describes this new Margin Portfolio policy.

OVERVIEW OF PORTFOLIO MARGIN

1. Portfolio margin is a margin methodology that sets margin requirements for an account based on the greatest projected net loss of all positions in a "security class" or "product group" as determined by an options theoretical pricing model using multiple pricing scenarios. These pricing scenarios are designed to measure the theoretical loss of the positions given changes in both the underlying price and implied volatility inputs to the model.
2. The goal of portfolio margin is to set levels of margin that more precisely reflect actual net risk. Lower margin requirements allow the client more leverage in an account.

CLIENTS ELIGIBLE FOR PORTFOLIO MARGIN

3. To be eligible for portfolio margin, clients (other than broker/dealers or members of a national futures exchange) must be approved for writing uncovered options.

There are problems/issues with the relatively new portfolio margin policy. Compliance with it policy is even more complicated than it was under the previous policy, particularly when calculating an account's margin requirements. Secondly, because portfolio margin has a minimum account equity, if an account drops below that minimum, just that alone can trigger new additional margin requirements and possible margin calls. Thirdly, it allows investors to increase their leverage, which by definition expands their risk exposure.

MARGIN CALL LIQUDATION – A NOT SO ONE-SIDED EVENT

If a customer's account is highly leveraged either through margined purchases or short sales, there is only one thing more dreaded than a margin call, and that is a forced liquidation. If you are managing and trading your account aggressively, having your investments sold out due to margin call liquidations is going to do permanent damage to your portfolio.

Embedded in most margin agreements is language that gives the brokerage firm the power to liquidate margined positions under special circumstances. But to repeat, brokerage firms must be fair in dealing with clients' accounts even when they have signed margin account agreements. And as you might imagine, experts and lawyers battle at arbitration hearings over the meaning of "fair." What is fair becomes more complicated in an option trading account where the client's positions consist of spreads, straddles, strangles and other complicated options trading strategies. A brief description of option strategies is necessary so the reader can understand the complexities of margin liquidation.[37]

- *Spread Strategy* – Options strategy in which both long and short options of the same type on the same underlying security are acquired at or about the same moment and are held in tandem.
- *Straddle* – The purchase or sale of an equal number of puts and calls having the same terms.
- *Strangle* – A combination involving a put and a call at different strikes with the same expiration date.

These terms are among the simplest and only begin to describe the most basic of strategies. The key point to understand here is that in each options strategy, there are two sides to each of them, that is, the option trader establishes two positions (two different option contracts) for each spread/combination. As the underlying security/index moves or as time elapses, the relationship between each of these contracts adjusts and most often adjusts differently, hence, the reason for putting on a spread, straddle or strangle.

When there is a margin call and the brokerage firm is going to make forced margin call liquidations in an account that has various options spread contracts, how does the brokerage firm decide just what to liquidate? This is not as complex in a brokerage account that is holding stocks and bonds or in an account that is long options, or even in an account that has simple short options, versus an account with spreads. This is because in those accounts,

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37. McMillan, *supra* note 16.

there is no spreading or other option strategies, which are essentially combinations (i.e., where each option contract is linked to another option contract).

I have been participated in a great number of option liquidation cases, dating back to the 1987 stock market crash. The reoccurring issues typically involve questions pertaining to fairness, arbitrariness or just plain unprofessionalism in the context of a respondent brokerage firm that did margin call liquidations. Over the decades, I have observed that all too often little to no thought went into liquidation decisions, such as exactly which positions a brokerage firm will or will not liquidate. In a simple stock or bond account the question of what to liquidate is generally not overly complex or material, but when a firm intends to liquidate options spread positions, the matter gets very sticky.

If a brokerage firm lifts[38] one side of a spread, it may increase the risk and the potential losses to the account by leaving only the other side of the spread in place, effectively creating a naked position. This is not in the customer's best interests, yet I have seen this practice on a fairly regular basis. Even with the powerful margin agreement in hand, brokerage firms must act fairly, prudently and professionally, especially when conducting margin call liquidations in an account with linked option trades.

BROKERAGE FIRMS CAN'T PICK AND CHOOSE WHICH RULES TO FOLLOW

As an expert witness, my job is to advise and testify regarding pertinent rules, regulations, norms and standards of the securities industry. I concur with roughly 99% of the regulations. But as an expert and Certified Regulatory Compliance Professional,[39] I do not have the luxury of disagreeing with the regulations any more than brokerage industry members. Securities regulators require broker-dealers to be licensed and their licensed

38. "Lift" is an option trading term for closing out one side of the spread also known as "legging."

39. The Certified Regulatory Compliance Professional ("CRCP") professional certification is offered by the Wharton School of Business in conjunction with FINRA at the Wharton School of Business at the University of Pennsylvania, Philadelphia. CRCP was an extensive course covering such topics as the history of securities regulations, the securities regulations, and supervision and compliance of registered broker-dealers. The author was among the first graduates of this program in 2001.

registered representatives to follow and abide by *all* the relevant regulations. At hearings, brokerage firms often wave around the client's signed customer account agreement.

But the brokerage firms - especially when dealing with option margin cases - often try to convince arbitrators that they need not look beyond the customer agreement, which gives the brokerage firms almost absolute power to close out or restrict a customer's trading activities, regardless of the consequences to the customer's account and his or her portfolio. My testimony on these issues generally goes along the following lines in response to such a hard line contract defense:

> It would serve no purpose, as a securities regulatory expert, to argue against the contractual rights of the brokerage firm under their customer agreement. But the mere fact that the brokerage firm in this case has certain rights under their agreement does not by any means give the firm the right to breach its other regulatory requirements.
>
> The securities regulations do not allow brokerage firms to cherry pick which regulations and policies they choose to follow and which they choose to ignore. The mere fact that the firm was within its rights with regards to certain margin liquidation policies, the licensed broker dealer *still* must follow and adhere to *all* the regulations, at *all* times.

It is at this point in the case I often refer the triers-of-fact to the following securities regulations and interpretations, in addition to regulatory notices listed earlier in this article.

FINRA 2220(d) Options Communications - Standards Applicable to Communications

(2) General Standards

(A) No member or associated person of the member shall use any options communications which:

(i) contains any untrue statement or omission of a material fact or is otherwise false or misleading;

(ii) contains promises of specific results, exaggerated or unwarranted claims, opinions for which there is no reasonable basis or forecasts of future events which are unwarranted or which are not clearly labeled as forecasts;

(iii) contains cautionary statements or caveats that are not legible, are misleading, or are inconsistent with the content of the material;

(iv) would constitute a prospectus as that term is defined in the Securities Act, unless it meets the requirements of Section 10 of the Securities Act;

(v) contains statements suggesting the certain availability of a secondary market for options;

(vi) fails to reflect the risks attendant to options transactions and the complexities of certain options investment strategies;

(vii) fails to include a warning to the effect that options are not suitable for all investors or contains suggestions to the contrary; or

(viii) fails to include a statement that supporting documentation for any claims (including any claims made on behalf of options programs or the options expertise of sales persons), comparison, recommendations, statistics, or other technical data, will be supplied upon request.

(C) Any statement in any options communications referring to the potential opportunities or advantages presented by options shall be balanced by a statement of the corresponding risks. The risk statement shall reflect the same degree of specificity as the statement of opportunities, and broad generalities must be avoided.

Because of the high risks involved in options trading, regulators tend to be stricter regarding communications between brokerage firms and customers. FINRA Rule 2220 does not allow member firms or Associated Persons to make "exaggerated or unwarranted claims," and this would necessarily apply to their abilities to handle the client's sophisticated option trading strategies.

FINRA 2010. Standards of Commercial Honor and Principles of Trade

A member, in the conduct of its business, shall observe high standards of commercial honor and just and equitable principles of trade.

IM-2310-2. Fair Dealing with Customers

(a)(1) Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing. Sales efforts must therefore be undertaken only on a basis that can be judged as being within the ethical standards of the Association's Rules, with particular emphasis on the requirement to deal fairly with the public.

(2) This does not mean that legitimate sales efforts in the securities business are to be discouraged by requirements which do not take into account the variety of circumstances which can enter into the member-customer relationship. It does mean, however, that sales efforts must be

judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers.

CONCLUSION

It is my expert opinion that it is not fair, proper business conduct - let alone consistent with high standards of just and equitable business practices - for a FINRA member firm to allow a customer to build large, complex option positions, while being paid substantial commissions and then limiting or restricting the client's trading activity, because the firm got "nervous" or was no longer "comfortable" with the trading strategies.

Further, it is the brokerage firm that is responsible for losses when its option trading platforms and option margin computers or clerks fail or malfunction. It has been my experience that most judges, juries and arbitrators who hear these cases side with FINRA Rule 2010 and with its underlying principle of fairness.

USING EMMA TO ASSESS MUNICIPAL BOND MARKUPS

Geng Deng, PhD, FRM and Craig McCann, PhD, CFA[1]

In the past, assessment of the reasonableness of municipal bond markups depended on anecdotal recollection of markups and subjective judgment about what was customary. Interested parties including regulators can now use the Municipal Securities Rulemaking Board's (MSRB) EMMA (Electronic Municipal Markup Access) service to determine the markups charged on a set of transactions and can make precise and accurate statements about how unusual such markups were, controlling for many factors thought to affect the reasonableness of markups.

We analyze over 13.6 million customer trades, totaling $2.5 trillion in par amount traded in fixed-coupon, long-term municipal bonds. We estimate that investors were charged $10.58 billion in municipal bond markups between 2005 and 2013 in our sample – of which $6.38 billion appear to be excessive markups.

Our sample includes about 30 percent of the fixed-coupon municipal bond trades. Thus, the total markups charged from 2005 to 2013 is likely to be at least $20 billion. $10 billion of this $20 billion appear to be excessive markups. These markups are a transfer from taxpayers and investors to the brokerage industry and could be largely eliminated with simple, low-cost improvements in disclosure.

I. INTRODUCTION

Broker-dealers exercise broad discretion when selling municipal bonds to the public at markups over the price at which they buy bonds from issuers, other dealers and investors. The absence of any pre-trade price transparency

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and post-trade markup disclosure has allowed some broker-dealers in recent years to charge investors billions of dollars in excessive markups.

In the past, evaluation of the excessiveness of suspect markups compared to customarily charged markups has often relied on the professional judgment of municipal bond traders or brokerage industry supervisors. Such judgment is subjective and based on the professionals' imperfect recollections. MSRB's recent widespread dissemination of transaction data and advances in computing technology allow us to empirically determine where markups charged fall in the range of observed municipal bond markups. The tools we describe significantly improve the ability of investors, regulators and the industry's compliance and supervision personnel to identify and correct excessive markups.

We estimate that $10.58 billion in markups were charged on trades in municipal bonds in our sample. Our sample includes about 30% of the fixed-coupon municipal bond trades so the total markups and markdowns charged from 2005 to 2013 is likely to be at least $20 billion.

We identify potentially excessive markups if the percentage markup charged is twice the median markup for similar sized trades or is more than 0.5% larger than percentage markup charged on recent trades in the same bond. $6.38 billion in markups were charged on the twenty-one percent of trades in our sample flagged by this procedure as being potentially excessive.

II. ELECTRONIC MUNICIPAL MARKET ACCESS OR EMMA

One half of the $3.7 trillion in municipal bonds outstanding at the end of 2012 was held directly by individual investors; and another quarter was held by individual investors indirectly through mutual funds.[2] Table 1 reports the par amount traded from 2005 to 2012. The amount traded increased from $5.1 trillion in 2005 to $6.7 trillion in 2007 and declined to $3.2 trillion in 2012. This pattern is almost entirely due to the increase in the trading in variable rate bonds including auction rate securities and variable rate demand obligations prior to 2007 and the decline thereafter. Trading in fixed-rate bonds changed little from 2007 to 2012.

2. SIFMA *Outstanding U.S. Bond Market Debt.*

Table 1: Par Amount Traded in $ Million, *MSRB 2008, 2010, 2012 Fact Books*.

	2005	2006	2007	2008	2009	2010	2011	2012
Total	5,113,146	6,081,093	6,685,128	5,514,420	3,791,271	3,749,730	3,285,766	3,225,803
Trade Type								
Customer Bought	2,526,943	2,841,565	3,156,765	2,722,682	2,029,305	1,956,906	1,670,951	1,619,769
Customer Sold	1,976,700	2,294,673	2,519,994	1,970,188	1,186,992	1,220,495	1,088,513	975,487
Inter-Dealer	609,503	944,854	1,008,370	821,550	574,974	572,330	526,302	630,547
Coupon Type								
Variable	3,394,072	4,222,021	4,612,810	3,072,472	1,485,005	1,584,165	1,271,220	1,195,640
Fixed Rate	1,345,385	1,485,042	1,646,518	1,970,885	1,756,439	1,734,705	1,614,755	1,677,625
Source of Repayment								
General Obligation	790,675	894,899	993,515	950,757	756,960	748,160	704,025	731,491
Revenue	3,730,663	4,548,557	5,082,029	3,875,546	2,392,348	2,496,929	2,132,012	2,112,740
Tax Status								
Tax Exempt	3,810,983	4,399,138	4,824,632	4,131,213	2,848,863	2,921,186	2,656,646	2,736,514
Taxable	280,718	402,839	438,619	315,193	327,701	503,719	294,909	272,799

The MSRB distributes market statistics, disclosure documents, issuer and investor education material, and trade data through EMMA.[3] It has web-pages, presentation slides and online videos to help users search for and interpret trades in specific bonds. Users access documents and trade data by entering a CUSIP or security name into a "Quick Search" dialog box in the navigation bar across the top of most of the EMMA webpages. There is also a search page which allows users to narrow the list of bonds by specifying the state of issuance, the first 6 digits of a CUSIP, the coupon rate or range of coupon rates, the issuer name, dated dates (the date from which interest due starts to accrue) and maturity dates. With a subset of this identifying information and a little bit of practice, users can easily locate specific municipal bonds and review offering documents, continuing disclosures and trade history.

Our research relies on the EMMA trade data covering 73,750 municipal securities made available since January 2005. To be included in our sample, bonds have to have been issued after January 1, 1995 with a maturity of greater than 19.5 years when issued and must pay a fixed coupon rate. Our sample includes 20.8 million transactions totaling $3.9 trillion from January 1, 2005 to April 15, 2013 in bonds from all 50 states plus the District of Columbia, Guam, Puerto Rico and the Virgin Islands. See Table 2.

3. emma.msrb.org.

Table 2: Sample Statistics, January 1, 2005 to April 15, 2013.

	All States	California	New York	Texas	Florida
Number of Issues	73,750	10,919	7,677	7,435	4,433
Number of Trades	**20,824,108**	**3,454,422**	**2,416,282**	**1,345,041**	**1,595,498**
Customer Bought	10,674,659	1,690,126	1,210,199	697,973	771,680
Customer Sold	4,026,028	700,681	453,326	234,798	335,562
Interdealer Trades	6,123,421	1,063,615	752,757	412,270	488,256
Par Amount Traded	**3,944**	**839**	**564**	**311**	**213**
Customer Bought	1,696	359	236	128	87
Customer Sold	1,040	227	150	78	57
Interdealer Trades	1,208	252	178	105	68
Average Trade Size	189,386	242,761	233,383	231,129	133,292

III. MARKUPS

The MSRB instructs members to calculate markups on municipal bond trades as the difference between the prices charged to the customer and the prevailing market price and to calculate markdowns as the difference between the prices paid to investors and the prevailing market price. The broker-dealers' contemporaneous cost of acquiring - or proceeds from disposing of - the bonds through inter-dealer trades or offsetting trades with investors establishes a presumption of the prevailing market price.[4]

Two of the MSRB's rules place limits on the prices broker-dealers can charge investors. Rule G-17 admonishes broker-dealers to deal fairly and refrain from deceptive practices. Rule G-30 requires that broker-dealers only charge prices including markups which are fair and reasonable given the facts and circumstances surrounding the trade.

Rule G-17 Conduct of Municipal Securities and Municipal Advisory Activities

> In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.[5]

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4. www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2010/2010-10.aspx.

5. www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx.

Rule G-30 Prices and Commissions (in part)

(a) *Principal Transactions.* No broker, dealer or municipal securities dealer shall purchase municipal securities for its own account from a customer or sell municipal securities for its own account to a customer except at an aggregate price (including any mark-down or mark-up) that is fair and reasonable, taking into consideration all relevant factors, including the best judgment of the broker, dealer or municipal securities dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, the expense involved in effecting the transaction, the fact that the broker, dealer, or municipal securities dealer is entitled to a profit, and the total dollar amount of the transaction.[6]

Financial Industry Regulatory Authority (FINRA) has disciplined member firms for violations of MSRB Rule G-17 and Rule G-30 which closely track FINRA Rule 2110 (fair dealing) and Rule 2440 (reasonable pricing). A FINRA Hearing Officer found that David Lerner Associates, Inc. charged excessive markups on municipal bond sales and collateralized mortgage obligations sales.[7] FINRA and Morgan Stanley entered into a settlement under which Morgan Stanley paid a $1 million fine and $371,000 in restitution for excessive markups and markdowns on corporate and municipal bonds in violation of Rule 2110, Rule 2440, G-17 and G-30.[8]

The recent widespread availability of municipal bond trade data has allowed researchers to more effectively study the range of markups charged. The published research on municipal bond trading costs includes Hong and Warga (2004), Harris and Piwowar (2006), Green, Hollifield and Schürhoff (2007a,b), Green, Li and Schürhoff (2009), Ciampi and Zitzewitz (2010), Li and Schürhoff (2012), Schultz (2012) and Cestau, Green, and Schürhoff (2013).

Hong and Warga (2004) found that retail investors are charged, on average, a premium of 2.5% of the market value of a bond compared to institutional investors. Harris and Piwowar (2006) found that markups charged on municipal bond trades decreased dramatically with trade size and

6. www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-30.aspx.

7. *Department of Enforcement v David Lerner Associates, Inc. and William Mason*, Disciplinary Proceeding No. 20050007427, April 4, 2012.

8. http://www.finra.org/web/groups/industry/@ip/@enf/@ad/documents/industry/p125084.pdf.

attribute this phenomenon to a lack of transparency in the municipal bond market.[9]

Green, Hollifield and Schürhoff (2007a) found that in an opaque trading market, such as the municipal bond market, dealers could exercise significant bargaining power, which decreases with trade size and increases with complexity of the bond traded. Green, Hollifield and Schürhoff (2007b) found that brokers' sales to customers of newly issued municipal bonds occurred at increasing and highly variable prices in the first weeks after a new issue but that broker's purchases from customers and inter-dealer trades occurred at prices close to the reoffering price.

Ciampi and Zitzewitz (2010) found that the spreads on corporate bonds and municipal bonds traded during times of economic crisis were much higher than the spreads reported in previous research, especially for small trades, low-credit quality bonds, and longer dated bonds.[10] Schultz (2012) found that the MSRB's dissemination of transaction data in 2005 reduced the dispersion in markups but not their overall level. Cestau, Green, and Schürhoff (2013) analyzed markups in the offerings of Build America Bonds and found them to be higher than in the offering of tax-exempt bonds.

The Government Accountability Office's *Municipal Securities: Overview of Market Structure, Pricing and Regulation*[11] found that percentage markups charged on large municipal bond trades are substantially smaller than markups charged on smaller trades. The GAO Report attributed the much higher trading costs incurred by investors on small trades to the information disadvantage smaller traders suffer compared to larger traders and dealers. The Securities and Exchange Commission issued the *Report on the Municipal Securities Market* on July 31, 2012 and found that markups in the municipal bond market are higher than in the corporate bond and equity markets and that they are much higher for small municipal bond trades than for large trades.[12] The SEC Report recommends new regulations to increase

9. Edwards, Harris, and Piwowar (2007) implements the same methodology and draws similar conclusions on corporate bond trades. The analysis of corporate bond trades is based on FINRA's Trade Reporting and Compliance Engine (TRACE) database.

10. Marlowe (2013) provides a good discussion of liquidity of municipal bonds during the financial crisis.

11. Available at gao.gov/assets/590/587714.pdf.

12. Available at www.sec.gov/news/studies/2012/munireport073112.pdf. See pages 112-133.

trade and quote transparency in the expectation that more information on available prices will lead to lower markups.

Methodology

The MSRB transaction data allows for several alternative measures of markup. In the spirit of the MSRB guidance, if there are sufficient interdealer transactions in the same bond on the same date, we measure the percentage markup as the difference between the price at which the customer transacts and the volume weighted average price on the interdealer transactions divided by the volume weighted average price on the inter-dealer transactions. If there are no inter-dealer prices to estimate the prevailing market price, we estimate the markup as the difference between customers' transaction prices and the volume weighted average of customer transaction prices occurring in the same bond on the same date. If there are neither interdealer trades nor other customer trades on the same date as the customer transaction, we expand the window to two business days before and two business days after the customer transaction and estimate the markup as the difference between the transaction price and the volume weighted average price of interdealer trades. If there are no interdealer trades in this expanded window we use the volume weighted average of customer trades in this expanded window to estimate the prevailing market price.The trade prices on different dates are adjusted according to a municipal bond index before calculating the volume weighted average price. This procedure allows us to estimate markups for over 93% of the 14.7 million customer transactions in our sample.[13]

Figure 1 plots the median, 71st percentile, and 95th percentile percentage markups at various trade sizes for all bonds in our related research.[14]

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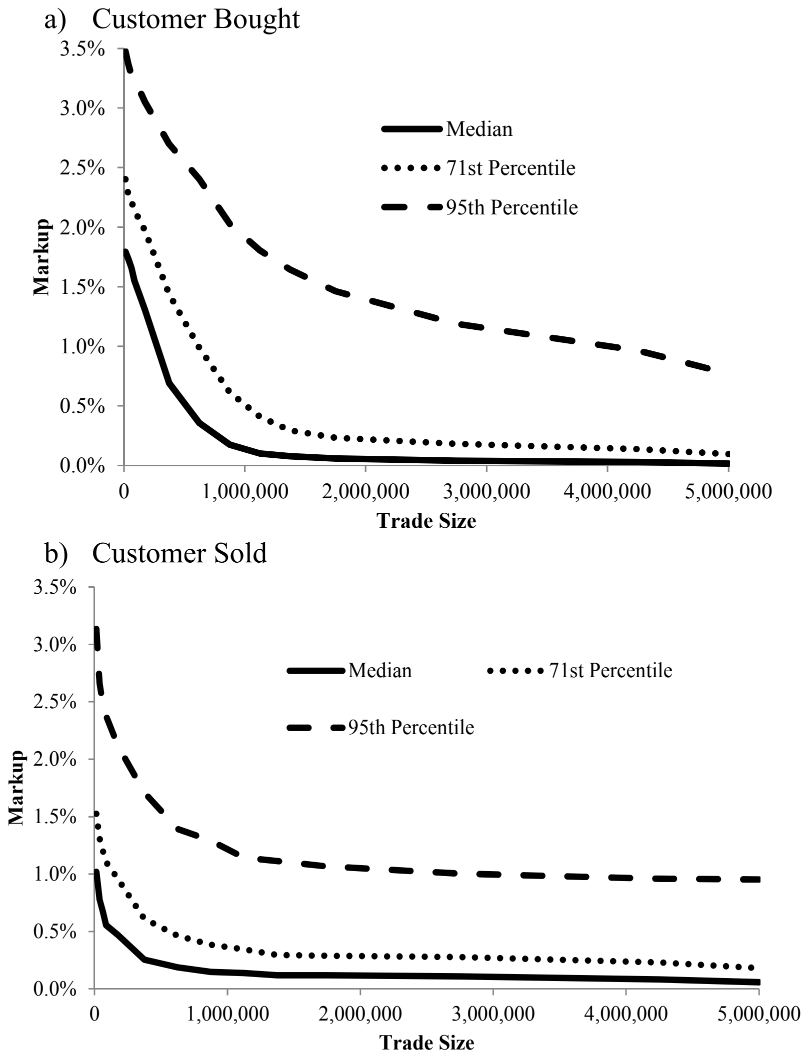
13. Some researchers use yield benchmarks or regression analysis to estimate half-spreads for transactions. These more complicated approaches would allow us to capture the remaining transactions in our data but the published literature shows these more complicated alternative approaches yield quite similar results on the issues we are addressing. 6.1 million transactions of the 20.8 million trades in our dataset are inter-dealer trades.

14. We report the 71st percentile markup percentage because of the NASD's prior use of that percentile for determining what markup percentage was presumptively excessive. See Ferrell (2008).

Figure 1: Markups, 2005-2013.



Markups decline substantially with trade size so that percentage markups which are commonplace on $25,000 trades are excessive when applied to $1,000,000 trades. Median markups decline approximately 90% as trade sizes increase from $25,000 to $1,000,000 and another 80% as trade size increases from $1,000,000 to $5,000,000.

We list median, 71st percentile and 95th percentile markups by trade size separately for customer purchases and customer sales in Table 3. Median markups on customer purchases are greater than on customer sales for trades of less than $1,000,000 but are less for trades greater than $1,000,000.

Table 3: Markups by Trade Type and Size.

	Customer Bought			
Size	N	Median	71st Percentile	95th Percentile
0-$25,000	4,883,761	1.79%	2.40%	3.48%
$25,000 - $50,000	2,387,964	1.73%	2.27%	3.37%
$50,000 - $75,000	1,127,125	1.66%	2.21%	3.27%
$75,000 - $100,000	206,267	1.55%	2.14%	3.24%
$100,000 - $250,000	839,305	1.31%	1.97%	3.05%
$250,000 - $500,000	165,009	0.69%	1.44%	2.70%
$500,000 - $750,000	75,498	0.36%	0.99%	2.40%
$750,000 - $1,000,000	15,595	0.17%	0.61%	2.03%
$1,000,000 - $1,250,000	52,423	0.10%	0.41%	1.81%
$1,250,000 - $1,500,000	8,436	0.08%	0.29%	1.64%
$1,500,000 - $2,000,000	17,314	0.06%	0.23%	1.46%
$2,000,000 - $3,500,000	48,239	0.04%	0.18%	1.19%
$3,500,000 - $5,000,000	14,658	0.03%	0.14%	0.96%
$5,000,000 +	69,707	0.02%	0.10%	0.77%
	9,911,301			

	Customer Sold			
			71st	95th
Size	N	Median	Percentile	Percentile
0-$25,000	1,597,557	1.02%	1.52%	3.14%
$25,000 - $50,000	851,935	0.78%	1.31%	2.66%
$50,000 - $75,000	427,566	0.67%	1.20%	2.48%
$75,000 - $100,000	106,189	0.55%	1.10%	2.38%
$100,000 - $250,000	396,189	0.47%	0.96%	2.12%
$250,000 - $500,000	105,689	0.25%	0.61%	1.71%
$500,000 - $750,000	57,557	0.19%	0.46%	1.39%
$750,000 - $1,000,000	13,609	0.15%	0.39%	1.29%
$1,000,000 - $1,250,000	47,084	0.14%	0.34%	1.14%
$1,250,000 - $1,500,000	7,382	0.12%	0.29%	1.11%
$1,500,000 - $2,000,000	15,325	0.12%	0.29%	1.07%
$2,000,000 - $3,500,000	40,682	0.11%	0.28%	1.00%
$3,500,000 - $5,000,000	11,237	0.08%	0.23%	0.96%
$5,000,000 +	50,273	0.06%	0.18%	0.95%
	3,728,274			

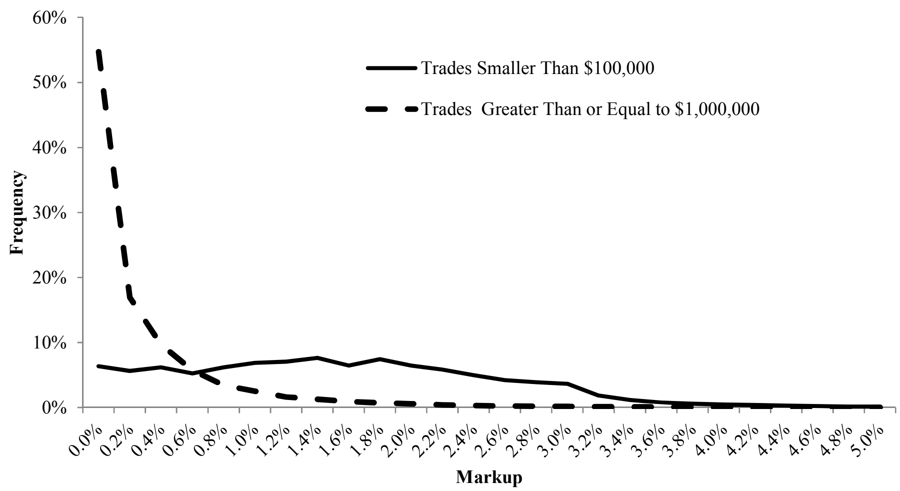
The 95th percentile markups remain quite high on large trades compared to the median markups. The 95th percentile markup exceeds the median by three times the amount the 71st percentile markup exceeds the median markup for trades less than $500,000. Beyond the $500,000 trade size, the 95th percentile markup exceeds the median markup by six times the amount the 71st percentile exceeds the median markup. That is, while the median and the 71st percentile markups decline significantly with trade size the highest 5% of markups remain quite high in percentage terms, yielding extraordinarily high dollar markups.

Median percentage markups illustrated in Figure 1 and listed in Table 3 generate a hump shaped pattern of median dollars markups by trade size. The 1.7% median markup generates an $850 markup on a $50,000 purchase and the 0.7% median markup generates a $3,500 markup on a $500,000 trade. The median dollar markup declines as the size of the trade increases beyond $500,000 though, remaining consistently between $1,200 and $1,500 for trade sizes between $1,000,000 and $5,000,000.

Figure 2 plots the distribution of markups for a range of trade sizes from the 21 million bond trades we analyzed. Reflecting the same phenomena as

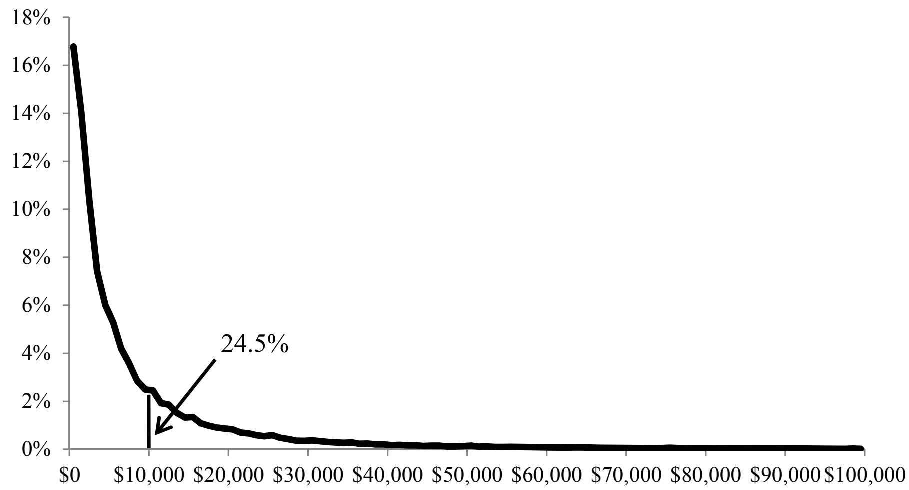
Figure 1, markups are lower on average and more tightly bunched on larger trades than on smaller trades but there remain many large markups on large trades.

Figure 2: Distribution of Percentage Markups by Trade Size, 2005-2013.



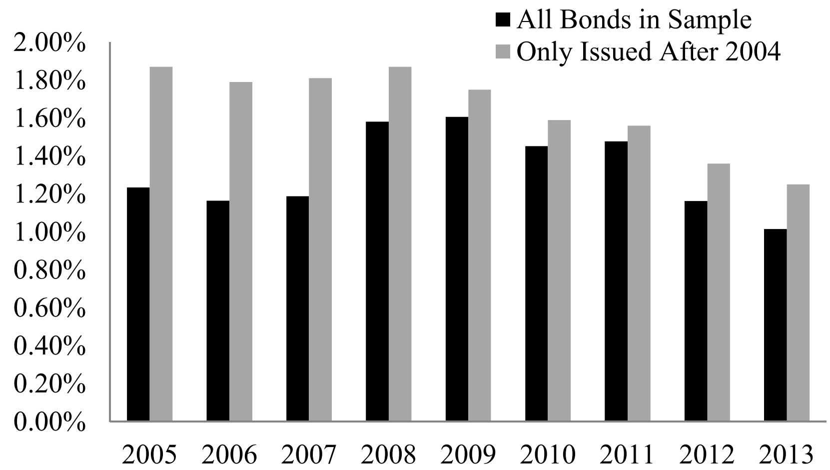
The large percentage markups on large dollar trades in Figure 3 generate even more dramatic markups in terms of dollars. Figure 4 plots the distribution of markups on trades of greater than $1,000,000. While the median markup on trades of greater than $1,000,000 is only $1,752, markups of greater than $10,000 were charged on 24.5% of the trades greater than or equal to $1,000,000.

Figure 3: Distribution of Dollar-Markups for trades greater than $1,000,000, 2005-2013.



Median markups have declined over time since the MRSB started reporting trades in January 2005. The markups declined from 2005 to 2007, increased slightly in 2008 and then declined through the end of our data period. See Figure 4.

Figure 4: Markups by Year, 2005-2013.



Year	All Bonds in Sample	Only Issued After 2004
2005	1.23%	1.87%
2006	1.16%	1.79%
2007	1.19%	1.81%
2008	1.58%	1.87%
2009	1.61%	1.75%
2010	1.45%	1.59%
2011	1.48%	1.56%
2012	1.16%	1.36%
2013	1.02%	1.25%

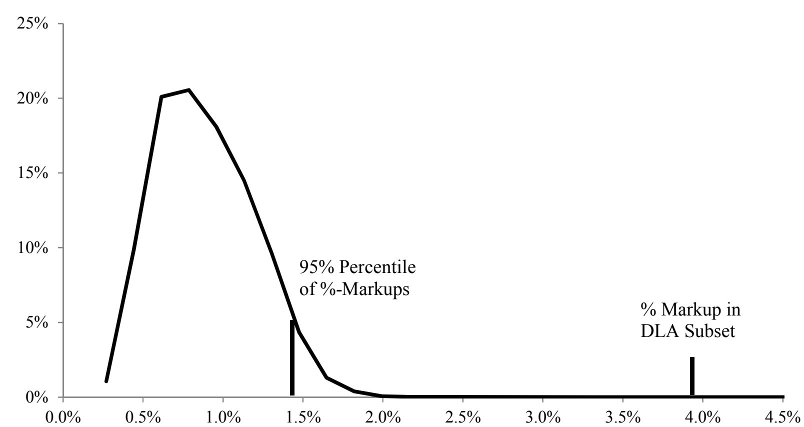
Municipal yields were about the same on average in 2011 as they were in 2005 and 2006 and so the decline in median markups from 1.87% in 2005 to 1.56% in 2011 in bonds issued after January 1, 2005 is not related to a decline in municipal yields and maybe the result of improved transparency due to EMMA. However, municipal yields did decline substantially from 2011 to 2013 and so the further decline in median markups from to 1.25% in bonds issued after January 1, 2005 and 1.48% to 1.02% in our entire sample may be the result of declining yields and not a continuing benefit of improved transparency.

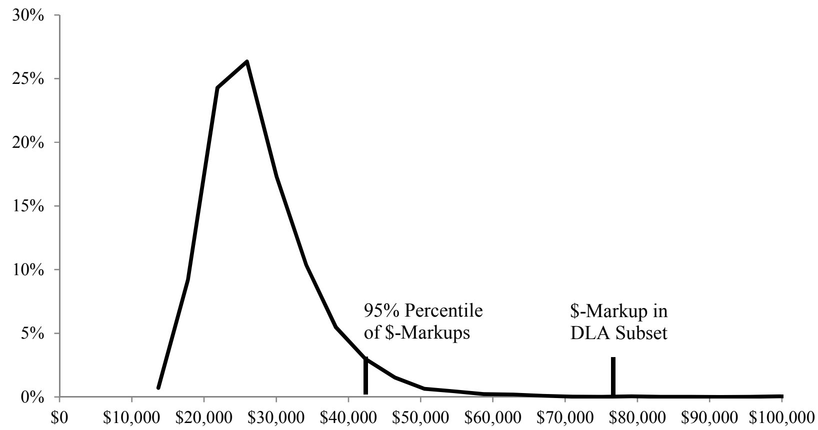
IV. EXCESSIVE MARKUPS IN INDIVIDUAL PORTFOLIOS

The distributions of weighted average percentage markups and dollar markups in Figure 2 and Figure 3 can be drawn for subsets of the EMMA trade data and used to assess the unusualness of observed markups in an investor's accounts or in groups of accounts serviced by the same brokerage firm or advisor. To illustrate, we select 10,000 random samples of 50 trades each which have similar characteristics to a set of 50 trades selected from the trades reported in the *FINRA vs. David Lerner Associates* case. We filtered the trades by time period, size and remaining maturity to match the characteristics of the trades in the DLA case.

Figure 5 plots the distribution of weighted average percentage markups and dollar markups from the 10,000 samples of 50 bonds each. The 4.0% weighted average markup charged on DLA trades we analyze is at the 99.99th percentile in the distribution of percentage markups on similar bond trades. The $78,000 in markups charged in the subset of DLA trades we analyze is more than three times the $23,900 median markup and is at the 98.2nd percentile in the distribution of dollar markups on similar bond trades.

Figure 5: Assessment of FINRA v DLA Markups in Weighted Average Percentage and Aggregate Dollar Markups.





V. EXAMPLES OF EXCESSIVE MARKUPS IDENTIFIABLE BY INSPECTION

We review four examples of excessive markups before we report our systematic assessment of markups.

City of Commerce, California Infrastructure Bond, CUSIP 20058RBA

Our first example is from trading in a City of Commerce, California infrastructure bond listed in Table 4.[15] On January 17, 2013 a customer bought $1,450,000 for $101.36 that had just been sold 4 minutes earlier for $99.00. Compared to the average inter-dealer trade price that day of $99.22, the investor paid a $30,909 markup. The median markup on a purchase of this size of 0.075% would have generated $1,077. This investor was charged nearly 30 times the median markup.

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15. Trading in this bond can be found at emma.msrb.org/SecurityView/Security DetailsTrades.aspx?cusip=AA26831D723177D0DF520958201EDF2D9.

Table 4 City of Commerce, California

Trade Date/Time	Settlement Date	Price	Yield (%)	Trade Amt ($)	Trade Submission Type	
01/17/2013 : 09:24 AM	2/1/2013	$100.88	3.493	$50,000	Customer bought	
01/17/2013 : 10:12 AM	2/1/2013	$100.48	3.541	$50,000	Customer bought	
01/17/2013 : 12:51 PM	2/1/2013	$99.19	3.652	$1,450,000	Inter-dealer Trade	
01/17/2013 : 12:52 PM	2/1/2013	$99.88	3.607	$20,000	Customer bought	
01/17/2013 : 12:57 PM	2/1/2013	$99.25	3.648	$1,450,000	Inter-dealer Trade	
01/17/2013 : 01:39 PM	2/1/2013	$101.37	3.435	$50,000	Customer bought	
01/17/2013 : 01:39 PM	2/1/2013	$99.38	3.639	$50,000	Inter-dealer Trade	
01/17/2013 : 01:39 PM	2/1/2013	$99.38	3.639	$50,000	Inter-dealer Trade	
01/17/2013 : 02:39 PM	2/1/2013	$99.00	3.665	$1,450,000	Customer sold	$30,900
01/17/2013 : 02:43 PM	**2/1/2013**	**$101.36**	**3.436**	**$1,450,000**	**Customer bought**	Markup

City of Moberly, Missouri IDA CUSIP 607010AE5

Our second example comes from trading in a City of Moberly Missouri industrial development bond listed in Table 5.[16]

After the $3,025,000 par amount in this series was sold to investors in the offering, there was no further trading until October 21, 2010 when two positions totaling $1,110,000 face value were sold to a dealer (or less likely to two different dealers). This dealer then sold the bonds to investors over the next four weeks for $1,143,090 – a $33,090 or $2.48 average markup over the $100.50 paid to the selling customers.

On October 22, 2010 a dealer charged a customer $105.419 for a $25,000 trade despite three other customer trades for $25,000 the same day at $102.669 and two trades for $20,000 the day before at $102.671. The $105.41 price was clearly unfair and the markup charged excessive. It appears the same dealer a few days later made sales of $20,000 and $10,000 at $105.414 despite a sale of $10,000 at $102.664 the same day. The $105.414 charged twice on October 27, 2010 was unfair and the markup excessive.

16. Trading in this bond can be found at emma.msrb.org/SecurityView/Security DetailsTrades.aspx?cusip=AF4F36FB38E73DB8C2962F0CA104AFD6E.

On April 3, 2013 Missouri's Secretary of State submitted a Petition for an Order to Cease and Desist and to Show Cause against Morgan Keegan over taxable municipal bonds Morgan Keegan underwrote for the City of Moberly in July 2010.

Table 5: City of Moberly, Missouri

Trade Date/Time	Settlement Date	Price	Yield (%)	Trade Amt ($)	Trade Submission Type	
10/21/2010 : 02:16 PM	10/26/2010	100.5	5.255	$610,000	Customer sold	
10/21/2010 : 02:16 PM	10/26/2010	100.5	5.255	$500,000	Customer sold	
10/21/2010 : 02:51 PM	10/26/2010	102.671	4.75	$20,000	Customer bought	
10/21/2010 : 03:49 PM	10/26/2010	102.671	4.75	$20,000	Customer bought	
10/22/2010 : 10:50 AM	10/27/2010	102.669	4.75	$25,000	Customer bought	
10/22/2010 : 01:40 PM	10/27/2010	102.669	4.75	$25,000	Customer bought	
10/22/2010 : 01:43 PM	10/27/2010	102.669	4.75	$25,000	Customer bought	
10/22/2010 : 03:19 PM	10/27/2010	102.669		$25,000	Inter-dealer Trade	
10/22/2010 : 03:19 PM	10/27/2010	102.419		$25,000	Inter-dealer Trade	
10/22/2010 : 04:37 PM	**10/27/2010**	**105.419**	**4.128**	**$25,000**	**Customer bought**	$719 Markup
10/22/2010 : 04:37 PM	10/27/2010	103.669		$25,000	Inter-dealer Trade	
10/25/2010 : 08:19 AM	10/28/2010	102.668	4.75	$10,000	Customer bought	
10/26/2010 : 09:38 AM	10/29/2010	102.666	4.75	$10,000	Customer bought	
10/26/2010 : 02:35 PM	10/29/2010	102.535		$180,000	Inter-dealer Trade	
10/26/2010 : 02:35 PM	10/29/2010	102.476		$180,000	Inter-dealer Trade	
10/26/2010 : 02:55 PM	10/29/2010	102.666	4.75	$10,000	Customer bought	
10/26/2010 : 02:56 PM	10/29/2010	103.536	4.551	$180,000	Customer bought	
10/27/2010 : 10:14 AM	11/1/2010	102.664	4.75	$5,000	Customer bought	
10/27/2010 : 01:24 PM	11/1/2010	102.414		$30,000	Inter-dealer Trade	
10/27/2010 : 01:24 PM	11/1/2010	102.664		$30,000	Inter-dealer Trade	
10/27/2010 : 01:33 PM	11/1/2010	105.414	4.127	$20,000	Customer bought	
10/27/2010 : 01:33 PM	11/1/2010	103.664		$30,000	Inter-dealer Trade	
10/27/2010 : 01:33 PM	**11/1/2010**	**105.414**	**4.127**	**$10,000**	**Customer bought**	
10/27/2010 : 03:51 PM	11/1/2010	102.664	4.75	$10,000	Customer bought	
10/28/2010 : 01:37 PM	11/2/2010	102.412	4.808	$100,000	Customer bought	
11/01/2010 : 12:26 PM	11/4/2010	102.658	4.75	$25,000	Customer bought	
11/01/2010 : 04:36 PM	11/4/2010	104.199	4.398	$5,000	Customer bought	
11/01/2010 : 04:36 PM	11/4/2010	102.658		$5,000	Inter-dealer Trade	
11/02/2010 : 09:15 AM	11/5/2010	102.658		$5,000	Inter-dealer Trade	
11/02/2010 : 09:15 AM	11/5/2010	102.858	4.704	$5,000	Customer bought	
11/04/2010 : 11:49 AM	11/9/2010	102.651	4.75	$5,000	Customer bought	
11/04/2010 : 01:52 PM	11/9/2010	102.651	4.75	$15,000	Customer bought	
11/05/2010 : 11:59 AM	11/10/2010	103.302	4.6	$260,000	Customer bought	
11/05/2010 : 12:02 PM	11/10/2010	102.401		$260,000	Inter-dealer Trade	
11/19/2010 : 11:47 AM	11/24/2010	102.631	4.75	$25,000	Customer bought	
11/19/2010 : 03:36 PM	11/24/2010	100.472		$150,000	Inter-dealer Trade	
11/19/2010 : 03:37 PM	11/24/2010	101.99	4.9	$150,000	Customer bought	
11/19/2010 : 04:44 PM	11/24/2010	102.631	4.75	$125,000	Customer bought	

Bexar County, Texas Revenue Bond, CUSIP 088518JF3

Our third example comes from trading in a Bexar County, Texas revenue bond listed in Table 6.[17] On January 8, 2013 a customer bought $950,000 face value for $104.86. The average interdealer trade price that day was $102.41 so this investor paid a $2.45 markup. The average interdealer trade price over the prior five days was $101.15 and so against this benchmark, the customer paid a $3.71 markup. The median markup on trades this large is only 0.17%. The average price charged on ten much smaller customer purchases over the prior five days was $103.28. The $104.86 charged on the $950,000 trade was clearly excessive.

17. Trading in this bond can be found atemma.msrb.org/SecurityView/SecurityDetails Trades.aspx?cusip=A4F707A59EFF635A0E825F2AFADFB28E1.

Table 6: Bexar County, Texas

Trade Date/Time	Settlement Date	Price	Yield (%)	Trade Amt ($)	Trade Submission Type	
01/02/2013 : 11:51 AM	1/23/2013	$104.208	3.479	$40,000	Customer bought	
01/02/2013 : 11:51 AM	1/23/2013	$101.910	3.76	$40,000	Inter-dealer Trade	
01/02/2013 : 11:51 AM	1/23/2013	$104.208	3.479	$30,000	Customer bought	
01/02/2013 : 11:51 AM	1/23/2013	$101.910	3.76	$30,000	Inter-dealer Trade	
01/02/2013 : 12:48 PM	1/23/2013	$101.298	3.836	$2,000,000	Inter-dealer Trade	
01/02/2013 : 12:52 PM	1/23/2013	$101.358	3.828	$2,000,000	Inter-dealer Trade	
01/04/2013 : 11:53 AM	1/23/2013	$102.395	3.7	$100,000	Inter-dealer Trade	
01/04/2013 : 11:53 AM	1/23/2013	$102.395	3.7	$100,000	Customer bought	
01/04/2013 : 04:12 PM	1/23/2013	$102.638	3.67	$150,000	Inter-dealer Trade	
01/04/2013 : 04:14 PM	1/23/2013	$102.638	3.67	$150,000	Customer bought	
01/07/2013 : 10:00 AM	1/23/2013	$102.270	3.715	$50,000	Inter-dealer Trade	
01/07/2013 : 10:00 AM	1/23/2013	$102.395	3.7	$50,000	Inter-dealer Trade	
01/07/2013 : 10:00 AM	1/23/2013	$104.270	3.471	$50,000	Customer bought	
01/07/2013 : 10:41 AM	1/23/2013	$102.395	3.7	$50,000	Inter-dealer Trade	
01/07/2013 : 10:41 AM	1/23/2013	$104.745	3.414	$50,000	Customer bought	
01/07/2013 : 12:12 PM	1/23/2013	$102.335	3.707	$100,000	Inter-dealer Trade	
01/07/2013 : 12:14 PM	1/23/2013	$102.395	3.7	$100,000	Inter-dealer Trade	
01/07/2013 : 12:22 PM	1/23/2013	$102.720	3.66	$100,000	Customer bought	
01/07/2013 : 12:22 PM	1/23/2013	$102.720	3.66	$100,000	Inter-dealer Trade	
01/07/2013 : 03:41 PM	1/23/2013	$102.395	3.7	$15,000	Inter-dealer Trade	
01/07/2013 : 03:41 PM	1/23/2013	$103.795	3.529	$15,000	Customer bought	
01/07/2013 : 03:46 PM	1/23/2013	$102.395	3.7	$15,000	Inter-dealer Trade	
01/07/2013 : 03:46 PM	1/23/2013	$103.795	3.529	$15,000	Customer bought	
01/07/2013 : 03:49 PM	1/23/2013	$104.704	3.419	$25,000	Customer bought	
01/07/2013 : 03:49 PM	1/23/2013	$102.395	3.7	$25,000	Inter-dealer Trade	
01/08/2013 : 12:31 PM	1/23/2013	$102.395	3.7	$2,115,000	Inter-dealer Trade	
01/08/2013 : 12:35 PM	1/23/2013	$102.420	3.696	$2,115,000	Inter-dealer Trade	
01/08/2013 : 01:04 PM	1/23/2013	$102.910	3.637	$220,000	Customer bought	
01/08/2013 : 01:13 PM	**1/23/2013**	**$104.860**	**3.4**	**$950,000**	**Customer bought**	$23,299 Markup
01/08/2013 : 01:26 PM	1/23/2013	$102.910	3.637	$700,000	Customer bought	
01/08/2013 : 01:28 PM	1/23/2013	$103.860	3.521	$245,000	Customer bought	

California State General Obligation Bond, CUSIP 13063BP7

Our fourth example comes from trading in a California State General Obligation listed in Table 7.[18]

On March 20, 2013 a customer bought $1,880,000 for $101.625. The average interdealer price that day was $99.286 and the average price charged on much smaller quantities in the same bond the same day was $99.98. The customer paid a $2.37 markup - $43,972 – relative to the interdealer price that day when the median markup on a trade of this size would have been

18. Trading in this bond can be found atemma.msrb.org/SecurityView/Security DetailsTrades.aspx?cusip=A00F107479E462AE214AF012F4DD203D7.

less than $2,000. This customer paid $42,000 more than the median markup for this trade size and $31,000 more than what she would have paid if she had just been charged the average markup charged on the smaller trades the same day in this bond.

Table 7 State of California

Trade Date/Time	Settlement Date	Price	Yield (%)	Trade Amt ($)	Trade Submission Type
03/20/2013 : 10:14 AM	3/27/2013	$99.375		$100,000	Inter-dealer Trade
03/20/2013 : 10:14 AM	3/27/2013	$99.475	4.03	$100,000	Customer bought
03/20/2013 : 10:14 AM	3/27/2013	$99.315		$100,000	Inter-dealer Trade
03/20/2013 : 10:16 AM	3/27/2013	$102.000	3.754	$10,000	Customer bought
03/20/2013 : 10:53 AM	3/27/2013	$99.200		$1,000,000	Inter-dealer Trade
03/20/2013 : 10:55 AM	3/27/2013	$99.125		$1,000,000	Inter-dealer Trade
03/20/2013 : 11:02 AM	3/27/2013	$99.477		$35,000	Inter-dealer Trade
03/20/2013 : 11:02 AM	3/27/2013	$99.227		$35,000	Inter-dealer Trade
03/20/2013 : 11:06 AM	3/27/2013	$99.577	4.024	$10,000	Customer bought
03/20/2013 : 11:06 AM	3/27/2013	$99.477		$10,000	Inter-dealer Trade
03/20/2013 : 11:25 AM	3/27/2013	$99.315		$1,750,000	Inter-dealer Trade
03/20/2013 : 11:26 AM	3/27/2013	$99.375		$1,750,000	Inter-dealer Trade
03/20/2013 : 11:57 AM	3/27/2013	$99.477		$55,000	Inter-dealer Trade
03/20/2013 : 11:57 AM	3/27/2013	$99.352		$55,000	Inter-dealer Trade
03/20/2013 : 11:57 AM	3/27/2013	$99.577	4.024	$55,000	Customer bought
03/20/2013 : 12:37 PM	**3/27/2013**	**$101.625**	**3.8**	**$1,880,000**	**Customer bought** $43,937 Markup
03/20/2013 : 02:01 PM	3/28/2013	$101.250	3.846	$15,000	Customer bought
03/20/2013 : 02:03 PM	3/27/2013	$101.250	3.846	$20,000	Customer bought
03/20/2013 : 02:37 PM	3/27/2013	$101.418	3.825	$20,000	Customer bought
03/20/2013 : 02:37 PM	3/27/2013	$99.700		$20,000	Inter-dealer Trade
03/20/2013 : 02:49 PM	3/27/2013	$99.650	4.02	$50,000	Customer bought
03/20/2013 : 02:59 PM	3/27/2013	$102.000	3.754	$15,000	Customer bought
03/20/2013 : 04:09 PM	3/27/2013	$99.700	4.017	$35,000	Customer bought

VI. EXCESSIVE MARKUPS IN THE AGGREGATE

The four examples reflect our proposed markers of excessive markups. Each example involved a markup which was a multiple of the median markup for similar-sized trades. In several of the examples, the investor was charged a higher markup than the weighted average markup charged on smaller purchases of exactly the same bond on the same day or during the previous five trading days. We estimate the amount of excessive markups in the aggregate in our sample by first selecting trades on which excessive markups appear to have been charged based on these two proposed markers.

We identify trades as having been charged an excessive markup if either Condition 1 or Condition 2 holds.

> **Condition 1:** Markup (markdown) charged is more than twice the median markup (markdown) for similar-sized trade in the same calendar year.
>
> **Condition 2:** Markup (markdown) charged is greater than the weighted average markup (markdown) charged on smaller-sized trades in the same bond during the prior five trading days by 0.50% or more.

The first condition judges a markup based on how large it is relative to the same size purchase or sale in the same year. We identify the markup as excessive if it is twice the percentage markup on similar-sized trades in similar bonds in the same calendar year.

The second condition more narrowly focuses on trades in exactly the same bond in the prior week. This criterion is motivated by FINRA's assessment of the fairness of prices charged by dealers in light of prices charged to other investors at the same time for the same bond. We identify the markup as excessive if the dealer has charged a markup that is at least 0.5% greater than charged on average on smaller trades in the prior week. For example, our procedure would flag a 2.0% markup on a $1,000,000 if ten customer purchases of between $25,000 and $100,000 in exactly the same bond had been executed over the prior five days at a weighted average markup of 1.50% or less.

Both conditions take into account current market conditions and attributes of the trade being evaluated. Both conditions can be relaxed or made more stringent by varying the threshold to be greater than or less than twice the median markup or greater or less than 0.5% of the average markup on smaller trades in the same bond.

Table 8 reports the results of applying these two conditions to trading in long term municipal bonds.The markup charged on nine and a half percent of the trades in our sample is at least twice the median markup for similar-size trades. Dealers charged $5.24 billion in markups on these trades, $4.30 billion of which was in excess of the markups which would have resulted from applying the median markup for similar-size trades.

Table 8 Excessive Markups in the Aggregate

Condition	Percent of Trades	Aggregate Markups	Markups in excess of Median
1	9.5%	$5.24 billion	$4.30 billion
2	16.0%	$3.24 billion	$2.10 billion
1 and 2	4.4%	$2.10 billion	$1.76 billion
1 or 2	21.1%	$6.38 billion	$4.64 billion

The markups charged by dealers on just 9.5 percent of the trades equal as much of the $10.58 billion total in our sample as the markups dealers charged on the remaining 90.5 percent of the trades. In other words, the average markup on the nine and a half percent of trades flagged by our first condition are ten times as great as the average markup charged on the remaining ninety percent of the trades.

The markups charged on sixteen percent of the trades in our sample satisfy the second condition. Dealers charged $3.24 billion in markups on these trades, $2.10 billion of which was in excess of the markups which would have resulted from applying the median markup for similar-size trades.

Four percent of the trades in our sample satisfy both conditions. $2.10 billion in markups were charged on these trades, $1.76 billion of which was in excess of the markups which would have resulted from applying the median markup for similar-size trades.

Twenty-one percent of the trades in our sample satisfy one or the other or both conditions. $6.38 billion in markups were charged on these trades, $4.64 billion of which was in excess of the markups which would have resulted from applying the median markup for similar-size trades.

VII. CONCLUSION

Based on our analysis of a portion of the MSRB's EMMA data, we estimate that investors have been charged at least $20 billion in markups and markdowns since 2005. We have provided four examples of how the EMMA data can be used to determine whether the price charged for a municipal bond was fair and the markup not excessive. We have determined that between $1.76 billion and $6.38 billion of excessive markups and markdowns have been charged since 2005 on our subset of publicly available municipal bond trades. Given our large but not exhaustive data set, the aggregate amount of excessive markups since 2005 likely substantially exceeds $10 billion. This same publicly available data – supplemented by non-public information available to dealers and regulators – could improve surveillance of pricing in the municipal bond market.

Transparency would eliminate much of the municipal bond markup abuses we have identified. Dealers are already required to determine that the prices and markups charged are fair. This can only be done by reference to prevailing market values, typically grounded in the dealer's contemporaneous cost. Prevailing market values and markups are already estimated by dealers every time they execute a trade. If dealers disclosed to investors what markup was being charged, the markups charged on municipal bonds would quickly drop to markups found on other securities. This disclosure would benefit both taxpayers and investors.

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RECENT ARBITRATION AWARDS

John S. Burke

Benjamin Bosowski et al. v E*Trade Securities, LLC
FINRA Case No. 11-02285

Claimants asserted the following causes of action: (1) negligence; (2) breach of fiduciary duty; (3) failure to supervise; (4) common law fraud; (5) breach of contract; (6) violations of Florida Statutes, Chapter 517; and (7) violations of industry standards. The causes of action related to excessive trading, use of margin and short sales of various securities in Claimants' accounts.

In the Statement of Claim, Claimants requested (1) compensatory damages in excess of $4,500,000.00; (2) interest; (3) disgorgement of commissions and other revenue generated from accounts; (4) costs, expenses, disbursements and FINRA fees; (5) attorney fees in an amount to be determined by a court of competent jurisdiction; (6) punitive damages; and (7) such other and further relief as the Panel may deem just and proper. At the close of hearing, Claimants sought compensatory damages, inclusive of interest, in the amount of $13,177,299.00.

In the Statement of Answer, Respondent requested the panel to deny Claimants' claims in their entirety, and requested their costs and confirmation of their entitlement to recover attorney fees from Claimants.

Award: The Panel found Respondent was liable for violations of the N.H. Rev. Statutes 421-B and the Indiana Code (Uniform Securities Act (23-19) and ordered Respondent to pay Claimants as follows: Q. Peter Nash, $415,000.00; M. Nash $240,000; D. Nash $210,000; Nash Foundation, $45,000.00; P. Clegg, $115,000.00; Mitchell, $120,000.00; Cacdac, $40,000.00; Bosowski, $60,000.00; Clegg, $60,000.00; and J. Clegg, $60,000.00. In addition, the panel found Respondent liable to these Claimants for attorney fees pursuant to N.H. Rev. Statutes 421-B in an amount to be determined by a court of competent jurisdiction and expert and witness fees in the amount of $57,211.34.

The panel also found for Respondent and against Claimants L. Nash and G. Nash whose claims were denied in their entirety with prejudice.

Claimants' Counsel: Jeffrey P. Coleman, Esq., Coleman law Firm, Clearwater, Florida.

Respondent's Counsel: Lonnie L. Simpson, Esq., Shutts & Bowen, LLP, Tampa, Florida.

Claimant's Expert: Joseph C. Long, Norman, Oklahoma, testified regarding registration of investment advisors under New Hampshire Law.
Kevin A. Carreno, Tampa, Florida, testified on industry practices and use of "unaffiliated" investment advisors.

David Lanxer, Statement Analysis, Winter Park, Florida, testified on losses in accounts and turnover ratios.

Respondent's Expert: None

Arbitrators: Frank Brenner (Public Chairperson); Ian S. Greig (Public); Noel K. Evans (Public)

This case is significant because the Panel found the broker dealer, E*Trade, liable for aiding and abetting an unregistered investment advisor. Despite the investment advisor not being an employee or independent contractor of E*Trade, the Panel found that E*Trade was liable under New Hampshire and Indiana Uniform Securities Act, for assisting the unregistered investment advisor in several ways, giving rise to liability for aiding the violation of securities laws.

The investment advisor was a former registered representative who formed an advisory firm that managed client accounts through E*Trade's Platinum Investment Account. The investment advisor's management of the accounts included excessive trading, margin trading, and shorting of securities. The investment advisor's activities resulted in significant profits to E*Trade.

E*Trade paid the investment advisor directly from the E*Trade accounts. It assigned the investment advisor a production code. E*Trade supported him from an E*Trade Office of Supervisory Jurisdiction designated for the Platinum Investment Accounts, and referred to the advisor as a registered investment advisor both internally and to customers. However, he held no license and was not registered as an investment advisor of stockbroker.

In defense, E*Trade relied upon written exculpatory language contained in its Customer Agreements. It also argued that E*Trade provides no investment advice and that Claimants received such advice from their own investment advisor. E*TRADE only provided privately-advised customers "advisory accounts." Each Claimant provided E*Trade with documentation instructing E*Trade to conduct business with the investment advisor as authorized attorney-in-fact to make investment decisions, buy and sell securities and engage in margin and options. E*Trade also cited express indemnification language contained within various documents.

The Panel found liability based on New Hampshire Rev. Stat. 421-B and Indiana Code 23-19. The New Hampshire statute and Indiana Code similarly prohibited providing investment advice for compensation based on profits or appreciation in a customer account. E*Trade entered into agreements for compensation based on appreciation and profits in the E*Trade customer accounts managed by the investment advisor. It also paid the compensation based on these unlawful agreements with the investment advisor.

Martina A. Nimphie, Trustee Martina A. Nimphie Rev. Trust Dtd 09/06/2002 Et Al. v. Raymond James Financial Services, Inc. Et Al.
FINRA Case No. 11-02791

Claimants asserted the following causes of action in their initial statement of claim: (1) breach of contract; (2) failure to supervise; (3) violations of State of Florida rules and regulations; (4) violations of FINRA Conduct Rules; (5) violation of the Investment Advisor Act of 1940; and (6) actual and apparent agency. The claims related to sales of illiquid alternative investments including private placements, real estate limited partnerships, loans, and commodity pools.

In the Statement of Claim, Claimants requested (1) compensatory damages in excess of $4,000,000.00; (2) prejudgment interest; (3) costs; (4) attorney fees; and (5) any and all relief that the panel deems just and appropriate. At the close of hearing, Claimants requested damages in the amount of $3,800,000.00.

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

Award: The Panel denied Claimants' claims in their entirety by a majority decision of two panel members to one. The dissenting panel member stated that on the issue of failure to supervise, it was his finding that Respondents had a responsibility to supervise and did not do so.

Claimants' Counsel: Garry W. O'Donnell, Esq. Buckingham, Doolittle & Burroughs, LLP, Boca Raton, Florida.

Respondent's Counsel: George L. Guerra, Esq., Wiand Guerra King P.L., Tampa, Florida.

Claimant's Expert: Donn Rett, Tallahassee, Florida, Florida Statute Chap. 517 expert

James F. Garwood, Broker/Dealer, Compliance and supervision, and suitability.

Pat Huddleston, Page Perry, LLC, SEC expert.

Eric Nordstedt, Eric Nordstedt, P.A., damages.

Respondent's Expert: David E. Paulukaitis, Mainstay Capital Markets Consultation, Inc., Atlanta, Georgia.

Arbitrators: Richard J. Kaplan (Public Chairperson); Mark I. Roth (Public);

Dissenting George H. Rausch (Public).

This case is significant because it focuses on the liability for supervision of a registered investment advisory firm and registered investment advisor that cleared through a broker dealer and its subsidiary. The initial Statement of Claim asserted claims against Raymond James Financial Services and Raymond James & Associates for their failure to supervise the sale of alternative investments, including private placements and loans to Unity, a company that the RIA was also an investor.

Claimants moved to file an Amended Statement of Claim that was apparently denied (no mention of it was included in the FINRA order) that sought to make the RIA and RIA firm Respondents as well. In their Motion in Support of Leave to File Amended Statement of Claim, Claimants argued that the RIA and RIA firm were "Associated Persons" under Florida Statutes §517.021, FINRA Rules 1011(b) and 12100(a), Sec. 3(a)(18) of the Securities Act of 1934 and FINRA Notice to members 05-48 that calls for an expansive reading of "Associated Person." Facts alleged in support included the RIAs being identified like Raymond James registered representatives as "Financial Advisors" on account statements, being provided a Raymond James Financial Advisor Number and a Raymond James Branch Office Number, maintaining a Raymond James email account, as well as other matters. Claims brought in the amended statement of claim included: (1) breach of contract; (2) violation of Section 206 of the Investment Advisor Act; (3) Violation of Chapter 517.301 of Florida Statute; (4) negligence; (5) breach of fiduciary duty; and (6) failure to supervise. The panel denied the motion to file amended statement of claim and found that the RIA and RIA firm were not associated persons of Raymond James Financial Services or Raymond James & Associates.

Prior to hearing, Claimant also moved to compel production of documents including compliance manuals. The Panel ruled in favor of Claimant. When Respondent failed to produce said documents, the Panel failed to enforce its ruling, or make an evidentiary negative inference at hearing as requested by Claimant.

At hearing, the parties argued their respective positions concerning the duty to supervise an RIA. Claimant asserted that the relationship between the RIA and Raymond James gave rise to a duty to supervise similar to that of an associated person. Respondents argued that member firms do not supervise, and are not required or obligated to supervise, the activity of registered investment advisors for whom they provide clearing and custodial services.

The Panel was split in its decision. Two arbitrators ruled in favor of Respondent in denying Claimants' claims in their entirety and recommending expungement of all references to the arbitration from Respondents' CRD. The two majority arbitrators found that Respondents were not handling the Claimants' Raymond James investment accounts and had no liability or responsibility to oversee the account other than in a clearing house capacity. They went on to find that FINRA does not regulate Registered Investment Advisors under the Investment Advisors Act of 1940 and thus they found no grounds to hold Respondents liable to Claimants for violation of FINRA rules. The Dissenting arbitrator wrote that he dissented from the Panel's majority opinion on the issue of failure to supervise. He concluded that Respondents had a responsibility to supervise and did not do so.

Louise Bosco, Annette Bosco, The Bosco Family Trust Dtd 7/31/96, by Its Turstees Louis and Annette Bosco, Mary Borowiak, The Mary Borowiak Trust, By Its Trustee, Mary Borowiak, Michael Borowiak, Richard Rubel, and Diane Rubel, v. Community Bankers Securities, LLC, Waterford Investor Services, Inc., George J. Gilbert, AIC, Inc., Nicholas D. Skaltsounis, and James Marvin Mitchell
FINRA Case No. 10-01778

Claimants asserted the following causes of action: (1) securities fraud and common law fraud; (2) securities recommended and purchased were unsuitable under Illinois law, Federal law, and FINRA conduct rules; (3) failure to conduct proper due diligence on recommended product; (4) negligence; (5) breach of fiduciary duty; (6) violation of the Illinois Consumer Fraud and Deceptive Practices Act; (7) breach of contract; and (8) firm and controlling person liability.

The causes of action related to the recommendation of purchase and investment in private placements in Medical Capital, LLC and Shale Royalties. Claimants alleged that the investments were fraudulent Ponzi schemes and that Respondents failed to conduct proper due diligence, which would have uncovered facts about the true nature of the investments.

Claimants requested (1) compensatory damages in the amount of $1,107,000.00; (2) interest; (3) attorney fees; (4) costs, (5) punitive damages; and (6) such other and further relief as the Panel may deem just and proper. At the close of hearing, Claimants requested compensatory damages in the amount of $1,227,638.22.

Respondent Community Bankers Securities, LLC denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondent Waterford Investor Services, Inc. denied the allegations in the Statement of Claim and raised various affirmative defenses. Respondents requested dismissal of the claims asserted against them in their entirety, and that they be awarded its costs and attorneys' fees.

Award: The Panel found that Respondents Allied Beacon f/k/a Waterford Investor Services, Inc., Community Bankers Securities, LLC, George J Gilbert, and James Marvin Mitchell were jointly and severally liable and ordered these Respondents ("Respondents") to pay Claimants as follows: 1.) Claimant The Bosco Family Trust DTD 6/25/96, the sum of $ 600,000.00 in compensatory damages; 2.) Claimant The Bosco Family Trust DTD 6/25/96, interest on the above-stated sum at the rate of 10% per annum from and including April 14, 2010 through and including the date the Award is paid in full; 3.) Claimant, Michael Borowiak, the sum of $ 28,000.00 in compensatory damages; 4.) Claimant, Michael Borowiak, interest on the above-stated sum at the rate of 10% per annum from and including April 14, 2010 through and including the date the Award is paid in full; 5.) Claimant, Mary Borowiak, the sum of $ 376,000.00 in compensatory damages; 6.) Claimant, Mary Borowiak, interest on the above-stated sum at the rate of 10% per annum from and including April 14, 2010 through and including the date the Award is paid in full; 7.) to Claimants, Richard Rubel and Diane Rubel, the sum of $ 196,000.00 in compensatory damages; 8.) Claimants, Richard Rubel and Diane Rubel, interest on the above-stated sum at the rate of 10% per annum from and including April 14, 2010 through and including the date this Award is paid in full; 9.) Claimants, The Bosco Family Trust DTD 6/25/96, Michael Borowiak, Mary Borowiak, Richard Rubel, and Diane Rubel, the sum of $ 7,500.00 in costs; and 10.) Claimants, The Bosco Family Trust DTD 6/25/96, Michael Borowiak, Mary Borowiak, Richard Rubel, and Diane Rubel, the sum of $ 400,000.00 in attorneys' fees pursuant to the Illinois Securities Act.)

Claimants' counsel: W. Scott Greco, Esq., Greco & Greco, P.C., McLean, Virginia.

Respondent Community Bankers Securities, LLC counsel: Steven S. Biss, Esq., Charlottesville, Virginia.

Respondent Waterford Investor Services, Inc. counsel: Dennis J. Kelly, Esq., and Hsiao C. (Mark) Mao, Esq., Dillingham & Murphy, LLP, San Francisco, California until on or about January 17, 2011, and after that date, by Steven S. Biss, Esq., Charlottesville, Virginia.

Respondent Nicholas D. Skaltsounis counsel: Dennis J. Kelly, Esq., and Hsiao C. (Mark) Mao, Esq., Dillingham & Murphy, LLP, San Francisco, California until on or about January 17, 2011 and after that date, Skaltsounis appeared pro se.

Respondent George J. Gilbert counsel: appeared pro se and at the hearing was represented by Steven S. Biss, Esq., Charlottesville, Virginia.

Respondent AIC and James Marvin Mitchell did not appear.

Claimant's Expert: Frederick W. Rosenberg, PCA Forensics, South Orange, New Jersey

Respondent's Expert: none

Arbitrators: Michael S. Jordan (Public Chairperson); James F. Carlson (Public); Steven P. Gomberg (Non-Public)

This case is significant because the case involved multiple unsuitable private placement sales including MedCap, Shale Royalties, and others. The FINRA arbitration was filed against Community Bankers Securities LLC (CBS), its alleged successor in interest Waterford Investor Services, Inc., and several control persons. CBS had shut down in 2009 after multiple arbitration claims against it and transferred representatives to its sister company, Waterford. Respondent Waterford (which later changed its name to Allied Beacon Partners, Inc.) filed a Declaratory Judgment action in the Eastern District of Virginia seeking a ruling that it was not the successor in interest and thus could not be forced to arbitrate.

The Court granted summary judgment finding Waterford to be the successor in interest, and alternatively finding that Waterford had indirectly controlled the sales representative at CBS. Waterford appealed to the Fourth Circuit which affirmed the lower Court.

The award caused a net capital violation for Waterford.

Joseph Pappy v. TD Ameritrade
FINRA Case No. 11-04256

Claimants asserted the following causes of action: (1) negligent supervision; (2) violation of industry standards; (3) negligence; (4) breach of fiduciary duty; (5) breach of contract; (6) violations of Chapter 517, Florida Statutes; (7) common law fraud; and, (8) fraudulent inducement.

In the Statement of Claim, Claimants requested (1) compensatory damages in the approximate amount of $ 100,000.00; (2) interest; (3) disgorgement of commissions; (4) costs; (5) expenses and disbursements; (6) reimbursement of the FINRA filing fee and all forum fees advanced by Claimant; (7) a determination of entitlement to attorneys' fees in an amount to be determined by a court; (8) punitive damages; and, (9) such other and further relief as the Arbitrator deemed just and proper. At the close of hearing Claimant requested: compensatory damages in the amount of $ 88,000.00; interest in an unspecified amount; costs in the amount of $ 5,393.50 and attorneys' fees in an unspecified amount.

Respondents denied the allegations in the Statement of Claim and requested dismissal of Claimant's claims.

Award: The Panel found that Respondent was liable for negligent supervision, negligence and violation of industry standards. The Panel ordered the Respondent to pay Claimant compensatory damages in the amount of $ 45,000.00; costs incurred in the amount of $2,366.00; and post award interest in accordance with the Code of Arbitration Procedure ("Code").

Claimants' Counsel: Jeffrey P. Coleman, Esq., Coleman Law Firm, Clearwater, Florida.

Respondent's Counsel: Hollie M. Mason, Esq., TD Ameritrade.

Claimant's Expert: David Lanxner of Statement Analysis on Losses in Account.

Respondent's Expert: David Paulukaitis of Mainstay Capital Markets Consultants, Inc.

Arbitrator: Scott David Anton, Sole Public Arbitrator.

This case is significant because Respondent was held responsible for negligently supervising its employees in opening margin and option accounts for Claimant, despite the Respondent relying on written affirmations by Claimant of receipt and understanding of margin and options.

The Claimant, in his 70's and unfamiliar with online trading, was encouraged to open an account at TD Ameritrade upon stopping at a TD Ameritrade office location. The TD Ameritrade registered representative who greeted the Claimant, instructed him in online trading, facilitated the transfer of the Claimant's savings to TD Ameritrade, and referred him to a TD Ameritrade "options specialist" who "walked the Claimant through" completing an options/margin form without questioning the suitability of options trading for the Claimant or explaining that the assets in the Claimant's TD Ameritrade accounts would serve as collateral for any margin loan.

Claimant argued that Respondent failed to know its customer in violation of NASD Rule 2110 (now FINRA Rule 2010), which required members to observe high standards of commercial honor and just and equitable principles of trade. Claimant further argued that TD Ameritrade's failure to know the Claimant, his limited knowledge of options trading, his limited income and net worth, and his lack of understanding of the ramifications of margin trading constituted negligence. Moreover, TD Ameritrade sending the required disclosure forms to the Claimant did not rectify the prior failures to supervise.

In addition, Claimant argued that TD Ameritrade failed to use the due diligence required by NASD Rule 2860 (now FINRA Rule 2360) governing the opening of an options account. Claimant argued that the due diligence requirement was not satisfied by the Claimant's completion of a form reviewed by a supervisor who never spoke with the Claimant or made any further inquiry into the suitability of options trading for the Claimant. Lastly, the immediate supervisors of the TD Ameritrade "options specialist" lacked the necessary registrations and licenses to supervise options-related activities. The Arbitrator found Respondent TD Ameritrade liable on the grounds of negligence, including negligent supervision and violation of industry standards.

Notes & Observations

CASES & MATERIALS

Bradley Stark

Merrill Lynch Fenner & Smith, Inc. v. Estate of Robert C. Postell and Joan P. Postell
No. 11-CV-1997, (N.D. Ga. Oct. 25, 2011)

In Merrill Lynch Fenner & Smith, Inc. v. Estate of Robert C. Postell and Joan P. Postell, No. 11-CV-1997, (N.D. Ga. Oct. 25, 2011) the court confirmed a controversial award of $520,000 to investors. This is controversial because shortly after the award, Respondent complained to FINRA that the three experienced arbitrators (that included lawyers) were too aggressive in questioning witnesses for Respondent. FIRNA investigated and dismissed the three arbitrators. After much public outrage reported in the news, FINRA conducted a second review and reinstated the arbitrators. The U.S. District Court held that the complained of questioning did not effect "the fundamental fairness of the hearing."

Merrill Lynch Fenner & Smith, Inc. v. Smolchek
2012 WL 4056092 (S.D.Fla.)

Merrill Lynch Fenner & Smith, Inc. v. Smolchek, 2012 WL 4056092 (S.D.Fla.) is a broker employment case of interest to investors because it discusses claims of arbitrator bias. Merrill complained that the chairwoman of the arbitration panel Mrs. Bonnie Pearce was biased because her (PIABA member) husband had, years earlier, obtained a large verdict against Merrill. Merrill admitted to having a copy of the husband's website in its file that clearly delineated the favorable verdict but claimed it had not read the material. The court made a finding of waiver because Merrill did not claim bias "until the panel announced several adverse rulings with which it disagreed."

Regarding the claim of presumptive bias under Federal Arbitration Act (FAA) 9 U.S.C.10(a)(2) "(a)t the very least, the Court finds that Merrill Lynch's acceptance of the panel with knowledge of what Mrs. Pearce allegedly failed to disclose eliminates the presumption of bias that generally arises in failure to disclose cases, as it signifies that Merrill Lynch did not view the withheld information as significant enough to suggest partiality even alongside Mrs. Pearce's failure to disclose it." The court also confirmed the award of sanctions imposed on Merrill for violating arbitration panel orders.

Morgan Keegan & Company, Inc. v. Garrett
2012 WL 5209985 (C.A.5 (Tex.)

In Morgan Keegan & Company, Inc. v. Garrett, 2012 WL 5209985 (C.A.5 (Tex.) the court reviewed "de novo the vacatur of an arbitration award" and reversed a controversial case in which the District Court had erroneously found that expert Dr. Craig McCann had committed fraud in helping to obtain a favorable arbitration panel award for the Claimant. The Fifth Circuit reversed and held "(h)ad Morgan Keegan performed its due diligence, the fact that Dr. McCann's calculations failed to include some internally-priced securities would have been discovered even before Dr. McCann testified in the Garrett arbitration, thus obviating any concern that the arbitration panel would rely on erroneous calculations in issuing the award."

The Fifth circuit also held that "FINRA Rule 12409 vested the arbitration panel with 'the authority to interpret and determine the applicability of all provisions under the Code.' Thus, it was clearly within the arbitration panel's scope of authority to decide whether, under the FINRA Rules, Appellants' claims were derivative and" whether Co-Claimants "were 'customers' for purposes of arbitration."

Morgan Keegan & Company, Inc. v. Grant
2012 WL 5350949 (9th Cir.)

Morgan Keegan & Company, Inc. v. Grant, 2012 WL 5350949 (9th Cir.) affirmed the $1.45 million award to former NBA All Star Horace Grant. Morgan Keegan claimed arbitrator bias and pointed to "the arbitrators' inadvertently recorded conversation during the hearing--in which they refer to the securities at issue in the case as 'crap' and a 'sucker play'--is not grounds for vacating the award for 'other misbehavior.'" The court noted that this "conversation suggests that the arbitrators had begun to form some opinions based on the evidence presented so far, but it does not prove that they had so made up their minds that they were unwilling to consider Morgan Keegan's evidence."

Finally, the 9th Circuit affirmed the amount of the award holding "(t)he $1.45 million award was authorized under a benefit-of-the-bargain damages theory for fraud committed by one owing fiduciary duties."

Amgen Inc. v. Connecticut Retirement Plans & Trust Funds
No. 11-1085 (Feb. 27, 2013) 568 U. S. ____ (2013)

The Supreme Court addressed 'fraud-on-the market' in a class action under 10(b)5 claim filed by investors in Amgen Inc. v. Connecticut Retirement Plans & Trust Funds, No. 11-1085 (Feb. 27, 2013) 568 U. S. ____ (2013). The court decided 6 to 3 that "fraud-on-the-market premise is that the price of a security traded in an efficient market will reflect all publicly available information about a company; accordingly, a buyer of the security may be presumed to have relied on that information in purchasing the security." "While Connecticut Retirement certainly must prove materiality to prevail on the merits, we hold that such proof is not a prerequisite to class certification. Rule 23(b)(3) requires a showing that questions common to the class predominate, not that those questions will be answered, on the merits, in favor of the class. Because materiality is judged according to an objective standard, the materiality of Amgen's alleged misrepresentations and omissions is a question common to all members of the class Connecticut Retirement would represent."

Raymond James Financial Services, Inc. v. Barbara J. Phillips, etc., et al.
(SC11-2513)

In Raymond James Financial Services, Inc. v. Barbara J. Phillips, etc., et al. (SC11-2513) the Florida Supreme Court interpreted Fla. Stat. 95.11 (the basis for statutory claims by investors for sales of securities) to be "civil actions and proceedings" and thus concluded that the legislature intended for the statute of limitations in Fla. Stat. 95.11 claims to apply to FINRA arbitrations, regardless of the 6 year rule articulated by FINRA.

This opinion makes no mention of common law causes of actions favored by many Florida practitioners. Because the statutory remedy also provided for attorney fees and costs to the prevailing party, which were seldom awarded to successful Claimants making statutory claims, in practice many Florida practitioners have avoided statutory claims for years, instead relying on common law claims. Because this opinion is solely limited to statutory claims and makes no mention of common law claims, it is unclear if this opinion will have much impact on claims in Florida.

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 Scott Ilgenfrtiz at scotti@jpfirm.com, Jason Doss at jasondoss@dossfirm.com or Robin S. Ringo, rsringo@piaba.org for assistance.

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The following PIABA Comment Letter regarding *AB 783 (Daly) – Opposition and Concerns* was submitted to the California State Assembly by Scott C. Ilgenfritz on April 17, 2013.

Honorable Assembly Member Tom Daly
State Capitol
P.O. Box 942849
Sacramento, California 94249-0007

Re: AB 783 (DALY) – OPPOSITION AND CONCERNS

Dear Assembly Member Daly:

The Public Investors Arbitration Bar Association (PIABA) is a national association of more than 400 attorneys who represent victims of investment frauds and stockbroker and financial planner misconduct in securities industry arbitration forums and the courts. On a daily basis in our practices, we see devastating losses resulting from violations of investor protection laws and regulations that govern the securities industry and issuers of securities. Disproportionately, those losses fall on elderly and vulnerable savers and investors. We believe that further deregulation of securities offerings would be a big mistake. PIABA believes that allowing general solicitation and general advertising of exempt securities offerings diminishes investor protection and likely will lead to enormous losses for California's most vulnerable savers and investors.

Our nation learned harsh lessons from the late 1920s through the 1930s about the dangers of inadequately regulated securities markets and capital formation activities. The lessons were sufficiently lasting that it was not until nearly 70 years later, in the mid- to late 1990s, that the nation began dismantling the regulatory framework that for most of a century had preserved the stability and transparency of those markets. The increasingly violent gyrations in the markets, culminating in 2008's meltdown and the years of misery that have followed, should not have been a surprise. What is a surprise is the speed with which those more recent lessons have been forgotten. Here we are, not five years after the calamity that was 2008, talking about deregulation again.

PIABA understands that businesses sometimes need additional capital. Our concerns are the people who are the sources of that capital and the methods by which those people are approached. The concerns are greater when the target population, by virtue of age, cannot reasonably expect to recoup losses and when those most likely to say "yes" to an investment "opportunity" lack the investment acumen necessary to evaluate the offerings.

The enterprises that raise capital under the proposed Corporations Code § 25102(r) exemption will likely fit one of two molds:

(1) small or start-up companies that may be making good faith attempts at building new, growing enterprises but which are too risky for traditional capital sources to be willing to invest in them; and

(2) companies whose key personnel believe that the real money is made by putting investment deals together, not by putting years of hard work into growing the companies after the capital is raised.

Finding capital for the risky but potentially promising businesses that make up the first group might seem a laudable goal. But one should question whetherbusiness should be permitted to find capital for ventures that are too risky for traditional funding sourcesby targeting the life savings of senior citizens and retirees who cannot replace the savings they lose.

The second group will consist largely of repeat purveyors of cookie-cutter investment programs with no societal value. There simply is no justification for exposing California's seniors, retirees or anyone else to their sales efforts.

Yet the exemption, as drafted, applies equally to both categories of issuers of securities. Gone would be the experienced oversight necessary to prevent predictable financial disasters and assure basic fairness to investors. It is critical that the types of offerings contemplated by this bill be qualified with the Commissioner of Corporations to ensure that what is being advertised is in fact what is delivered to investors. Substituting advertising and solicitation for the Commissioner's oversight would be a mistake from which countless seniors will suffer irreparable harm.

PIABA has reviewed AB 783's proposed new Corporations Code § 25102(r) exemption in the context of existing exemptions, most notably § 25102(n). We might well question § 25102(r)'s permission to cold call persons viewed as prospects for investment pitches (many or most of whom will be seniors and retirees) in their homes, but a correction to that problem would require modification of both of those subsections of § 25102. While modifying that aspect of existing §25102(n) might be desirable, it is not the issue before us today.

Rather, the focus of this comment letter is the additional securities deregulation that will be occasioned by § 25102(r). Comparing proposed § 25102(r) with existing § 25102(n) reveals that the additional deregulation primarily takes the form of a dramatic broadening of the kind of advertising permitted. In contrast to existing § 25102(n)'s permission for very limited announcements in the nature of tombstone ads, proposed §25102(r) would allow – indeed, it would *require*– general solicitation and general advertising. The provision that would do so appears in the first sentence of § 25102(r).

We note that the kind of general solicitation and general advertising that is *required* by proposed § 25102(r) is the very kind of advertising that is *prohibited* in offerings that are exempt under SEC Regulation D. Proposed § 25102(r) exempts *[a]ny offer or sale of a security by an issuer using any form of general solicitation or general advertising,**as specified in Rule 502(c) of Regulation D under the Securities Act of 1933** (17C.F.R. 230.502(c)),* . . . . [Emphasis supplied.][12]

The words "as specified in" leave the reader with the false impression that the advertising permitted by § 25102(r) is the same kind of advertising that is permitted by SEC Rule 502(c). ***But the reality is exactly the opposite:*** "as specified in" really means "prohibited by." The proposed exemption

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[1]The full text of Rule 502 (17 CFR 240.502) can be found athttp://www.ecfr.gov/cgi-bin/retrieveECFR?gp=&SID=79d488bf15f9118e68cc32e2574be8fd&n=17y2.0.1.1.12&r=PART&ty=HTML#17:2.0.1.1.12.0.42.177

[2]Rule 502(c) states:

> (c) *Limitation on manner of offering.* Except as provided in § 230.504(b)(1),**neither the issuer nor any person acting on its behalf shall offer or sell the securities by any form of general solicitation or general advertising**, including, but not limited to, the following:
>
> (1) Any advertisement, article, notice or other communication published in any newspaper, magazine, or similar media or broadcast over television or radio; and
>
> (2) Any seminar or meeting whose attendees have been invited by any general solicitation or general advertising; *Provided, however,* thatpublication by an issuer of a notice in accordance with § 230.135c or filing with the Commission by an issuer of a notice of sales on Form D (17 CFR 239.500) in which the issuer has made a good faith and reasonable attempt to comply with the requirements of such form, shall not be deemed to constitute general solicitation or general advertising for purposes of this section; *Provided further,* that, if the requirements of § 230.135e are satisfied, providing any journalist with access to press conferences held outside of the United States, to meetings with issuer or selling security holder representatives conducted outside of the United States, or to written press-related materials released outside the United States, at or in which a present or proposed offering of securities is discussed, will not be deemed to constitute general solicitation or general advertising for purposes of this section.
>
> [Emphasis Supplied.]

permits the very forms of solicitation and advertising that are forbidden by the SEC rule it cross-references. Thus, the permission for general solicitation and general advertising in AB 783 represents a dramatic rollback in the longstanding protection of California's savers and investors.

The § 25102(r) exemption, as currently drafted, would allow the full range of print, radio, television and in-person seminar advertising. This type of advertising will put large numbers of Main Streetsavers and investors at risk. One's status as an "accredited investor" is based primarily on an outdated computation of net worth. It offers no guarantee or even likelihood of investment sophistication or the ability to evaluate risky but legitimate startup ventures, let alone the profusion of highly speculative, cookie-cutter capital raising programs that will spring up to take advantage of the new exemption.

Because it indicates far less about investment acumen than it does about assets, accredited investor status correlates best with age. Elderly retirees make up a disproportionately large percentage of people who meet the definition of accredited investors simply because their property has had longer to appreciate;their savings have had longer to accumulate; they have taken rollovers or lump-sum payouts of pension assets that have accumulated through decades of hard work; and, sadly, many are widowed and hold the proceeds of their spouses' life insurance policies. The funds they lose cannot be replaced. They have neither the time nor the employment prospects to recoup their losses.

With regard to this latter point, the sponsors undoubtedly will point to the purported protection inherent in limiting the investment to 10% of the saver's or investor's net worth. Taking comfort from that limitation would be misguided. In speculative programs that cannot interest traditional funding sources, the losses that occur are likely to be *total* loses. Thus, having 10% of one's life savings in securities offered under the proposed exemption will not be like having 10% of one's assets in a broad stock market index fund. A total loss of 10% of one's life savings can be devastating to a senior retiree who relies on the income from those savings to put food on the table and to meet other expenses. Imagine being told that you are going to take a 10% cut in pay – *for the rest of your life*.

Further, for the reasons discussed below, violations of the 10% ceiling are likely to occur on a broad scale because the only viable remedial mechanism – private litigation – is not practical on the scale that many of these investments are likely to take.

Aggressive advertising is very effective when directed at non-professional investors, who will be the vast majority of offerees under the proposed exemption. The initial sales pitch drives the yes-or-no decision regarding an investment. An advertisement that makes promises is likely to be relied upon, even though the inches-thick, already-filled-out official documents in the stack of paper that the investor is required to sign will disclaim the representations made in the ads. That reality is why Regulation D and existing § 25102(n) allow only tombstone-style announcements – bare-bones factual announcements that, in and of themselves, are unlikely to have investors clamoring to risk a substantial fraction of their savings.

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. The money they lose is, in many cases, 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 made available for ventures too risky to merit bank or traditional venture capital financing is inappropriate. To allow their savings to be lost in cookie-cutter deals devoid of social value is worse still.

PIABA believes that money lost by investors in these deals as a result of wrongdoing is likely never to be recovered. First, there is a collectibility issue. By the time bilked savers or investors sue, and certainly by the time they obtain a judgment or award, there often is no defendant with funds to pay it. Second, even when the funds might exist, securities litigation is so expensive that it may be impossible or impractical to pursue the matter. Much of this is due to the high cost of expert witnesses in these cases. Thus, a $150,000 loss, which might be devastatingly large to the senior who has suffered it, might well be too small to pursue due to the high cost of securities litigation.

Sadly, PIABA's members have seen this scenario play out far too many times. The likely futility of attempts to remedy these losses after they occur makes it imperative that laws designed to prevent the losses be allowed to operate in their current form, unimpaired by the proposed exemption. This is an area where prevention is by far the best medicine.

PIABA believes that leaving the broad, permissive advertising provision in the first sentence of proposed § 25102(r) unchanged will invite large-scale financial carnage, with seniors vastly overrepresented among those harmed. On the other hand, changing that advertising provision to allow only a more restrictive tombstone-style of advertising will leave proposed § 25102(r) so similar to existing § 25102(n) that its adoption won't add much to the law besides unneeded complexity. Thus, PIABA's preference would be to see the section not adopted. But if it must be enacted, we hope that general solicitation and general advertising will be prohibited and that, if any advertising is to be permitted at all, it will be limited to tombstone-style advertising of the kind described in SEC Rule 135c.

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, we should maintain for California's savers and investors, and for seniors and retirees in particular, the level of protection that currently exists.

Thank you for your consideration of our concerns about AB 783.

Sincerely,
Scott C. Ilgenfritz
President

The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to FINRA Rule 8313 (Release of Disciplinary Complaints, Decisions, and Other Information)* was submitted to the Securities and Exchange Commission by Jason Doss on April 15, 2013.

Ms. Elizabeth M. Murphy
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: SR-FINRA-2013-018—Proposed Rule Change Relating to FINRA Rule 8313 (Release of Disciplinary Complaints, Decisions, and Other Information)

Dear Ms. Murphy,

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure.

PIABA supports FINRA's efforts to increase the public's access to disciplinary and other relevant information. It shares FINRA's belief that greater public access to information regarding its disciplinary actions provides valuable guidance and information to members, associated persons, other regulators, and investors.

Current Rule 8313 governs and limits the public release of disciplinary and other information by FINRA. However, current Rule 8313 sets forth different standards for the release of such information depending on the underlying violation or applicable rule. In addition, the standards in current Rule 8313 may prohibit FINRA from releasing information that is publicly available from other sources. Accordingly, FINRA proposes amending Rules 8313, 9268, 9552-9558 and 9620 to clarify the scope of publicly-accessible disciplinary and other information establish general standards for its public dissemination.

With a few exceptions, PIABA strongly supports the Rule amendments proposed in SR-FINRA-2013-018. Specifically, PIABA supports the proposed amendments to Rule 8313 providing for mandatory disclosure of un-redacted copies of (and discretionary disclosure of information related to) disciplinary decisions and complaints, temporary cease-and-desist orders ("TCDOs"), statutory disqualification decisions, summary actions, and membership appeals. Public dissemination of disciplinary information serves to deter future misconduct, improve overall business standards in the industry, and empower investors by providing them with relevant disciplinary information concerning firms and associated persons.

PIABA supports and opposes in part the proposed amendments to Rule 8313(c). PIABA believes that FINRA should have the discretion to redact confidential customer information or information that raises significant identity theft, personal safety, or privacy concerns (which are not outweighed by investor protection concerns) from disciplinary and other publicly-available information on a case-by-case basis. However, PIABA does not believe that FINRA should have the discretion to waive the requirement to publicly release disciplinary complaints or decisions "under those extraordinary circumstances where the release of such information would violate fundamental notions of fairness or work an injustice." FINRA has not identified examples of extraordinary circumstances that would outweigh the benefit for publicly releasing disciplinary information. The deterrent effect of public dissemination is undermined if disciplinary decisions and information are withheld by FINRA out of concern for the disciplined firm or associated person. In the case of third parties, any unfairness or injustice resulting from public dissemination could be ameliorated by redaction.

PIABA supports in part and opposes in part the proposed amendments to Rule 8313(a)(5), which make permissive the release of certain decisions and notices under Rules 6490 (Processing of Company Related Action), 9610-9630 (Procedures for Exemptions) and 9710-9770 (Procedures on Grievances Concerning the Automated Systems). FINRA does not currently release decisions and notices issued pursuant to Rules 6490 and 9710-9770. Because these rules do not serve investor protection or education functions, PIABA has no opinion on the proposed changes.

However, PIABA is opposed to the proposed changes to existing Rule 9620, which would make the publication of exemption applications and decisions permissive in FINRA's discretion. Instead, PIABA believes that exemption applications and decisions should be subject to mandatory publication to protect and educate the investing public.

Rules 9610-9630 provide procedures for members and associated persons to be exempted from certain FINRA rules. Under current Rule 9620, all exemption "application[s] and decision[s] shall be publicly available unless FINRA staff determines that the Applicant has shown good cause for treating the application or decision as confidential in whole or in part." The proposed rule would amend Rule 9620 to permit FINRA to make public disclosure of exemption applications and decisions at its discretion.

Exemptive relief is currently available to firms and associated persons to relieve them of compliance with certain FINRA and NASD investor protection rules. Thus, the proposed rule changed would afford FINRA unfettered discretion to make public (or keep private) exemption applications and decisions geared toward investor protection. Examples of such applications and decisions include, but are not limited to:

- A waiver of qualification examinations and registration requirements (NASD Rules 1021, 1050 1070);
- A waiver of a member's obligation to file certain public communications aimed at public investors with FINRA (FINRA Rule 2210);
- A waiver of a member's obligation to review certain issuer information before recommending over-the-counter equity securities to the member's customers (FINRA Rule 2210);
- A waiver of the requirements for issuing, underwriting, or participating in Direct Participation Programs (FINRA Rules 2310, 5122);
- A waiver of the requirements for participation in a public offering of securities when a member is operating under a conflict of interest (FINRA Rule 5121);
- A waiver of the requirement to file a sales materials with FINRA in connection with the sale of certain private placements exempt from registration under the Securities Act of 1933 (FINRA Rule 5123);
- A waiver of certain restrictions on a member's purchase and sale of initial equity public offerings (FINRA Rule 5130); and
- A waiver on the standardized rules and procedures for transferring customer accounts (FINRA Rule 11870).

Beyond stating that the member conduct rules for which exemptive relief is available have "differing benefits to publication," FINRA provides no explanation for why decisions exempting firms from complying with investor protection and business conduct rules should no longer be presumptively public and should be publicly disseminated only in the exercise of FINRA's discretion.

PIABA believes that FINRA should publicly disseminate all decisions granting firms exemptions from investor protection and business conduct rules. Such a rule is consistent with FINRA's stated commitment to ensuring greater public access and protecting and empowering public investors.

Furthermore, to the extent that FINRA would reserve to itself the discretionary authority to publicly disseminate exemption application and decisions, PIABA believes that FINRA should be required to identify and codify criteria governing the exercise of its discretion in this regard. Adoption of such criteria serves to promote transparency and accountability, prevent arbitrary conduct, and reassure public investors of FINRA's even-handedness and integrity.

Finally, PIABA strongly opposes the proposed rule's deletion of current Rule 8313(a), which provides for the release of identified disciplinary complaints and decisions to a requesting party. In a footnote to SEC Release No. 34-69178, FINRA represents that, notwithstanding the deletion of this provision, it will continue to respond to requests from the general public for such matters.

The proposed change to Rule 8313(a) is unsatisfactory. Current Rule 8313 makes FINRA's response to specific requests for information mandatory. By omitting any provision requiring a response to specific requests for information, the extent and scope of FINRA's obligation to respond becomes unclear. Certain disciplinary information can only be obtained from FINRA by request because the decisions and complaints in FINRA's online database date back only to early 2005. Absent an express mechanism for requesting information in proposed Rule 8313, public investors will not be aware that they may request otherwise publicly-available information directly from FINRA. This is plainly inconsistent with FINRA's stated goal of giving investors greater access to disciplinary and other information. If FINRA intends to continue responding to specific information requests, then this provision should be harmonized with the changes to Rule 8313, not eliminated.

In summary, PIABA appreciates and supports FINRA's commitment to investor protection and education and to provide greater public access to disciplinary and other decision-making by FINRA. Although Rule 8313 is not perfect, it is a step in the right direction. PIABA hopes that FINRA will take the opportunity to use this process to not only afford public investors with greater information concerning members and associated persons, but to increase the transparency and accountability of its decision-making processes. PIABA thanks the Securities and Exchange Commission for the opportunity to comment on this proposal.

Very truly yours,
Jason R. Doss
Executive Vice-President/President-Elect

The following PIABA Comment Letter regarding Regulatory Notice 13-07; Markups, Commissions, and Fees was submitted to the Financial Industry Regulatory Authority by Scott C. Ilgenfritz on March 26, 2013.

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

Re: Regulatory Notice 13-07; Markups, Commissions, and Fees

Dear Ms. Asquith:

The Public Investors Arbitration Bar Association ("PIABA") appreciates the opportunity to provide the Commission with comments regarding FINRA Regulatory Notice 13-07 and the proposed rule changes regarding mark-ups, mark-downs, and commissions. PIABA is an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure.

After FINRA proposed amending these same rules with Regulatory Notice 11-08, FINRA received a number of comment letters. In Regulatory Notice 13-07, FINRA has made changes to the rule proposals based on the comments responding to Notice 11-08.

Notice 13-07 proposes to retain the prior "5% Policy" under proposed FINRA Rule 2121. The proposed rule continues to make clear that the "5% Policy" is a guide, not a rule. The proposed rule requires the firm to buy or sell at a price which is fair and reasonable, taking into consideration a number of factors that would be codified in proposed rule 2121(c). Under proposed Rule 2121, a mark-up or mark-down of over 5% would be considered unreasonable and unfair, but the firm would be allowed to rebut that presumption and provide justification that such a mark-up or mark-down is fair and reasonable.

While PIABA supports the use of some threshold as guidance, PIABA believes that a 5% guide is simply too high. The 5% Policy came from a 1943 survey, to which Notice 13-07 alludes. FINRA acknowledges that advancements in technology have significantly reduced execution costs and that 5% is "significantly higher" than the average markup.

An April, 2011, study by Harvard Law School estimates that the average mark-up in today's markets is about 40% lower than in 1943. *See* Ferrell, Allen, "The Law and Finance of Broker-Dealer Mark-Ups", Harvard Law School (Apr. 6, 2011), at 12 (hereinafter "Ferrell"). The study also estimates that the average mark-up (weighted by the size of the trade) is 1.6%, and the weighted average mark-down is 1.2%. *Id*. at 14. Not taking into account the size of the trade, the average mark-up is 2.2% and the average mark-down is 1.9%. *Id*. at 13.

The study by Harvard also indicated that of the sample size taken, only 1.2% of mark-ups were above the 5% threshold, and about 1.7% of all mark-downs were above the 5%. *See* Ferrell at 14. Based on FINRA's own acknowledgements and this recent study, the 5% Policy is unfair and unreasonable.

FINRA needs to lower this threshold not only in light of technological advancements and market data, but its own regulatory investigations, as well. The Harvard study indicated that FINRA fined a number of firms in the last ten years for charging excessive mark-ups and mark-downs. This included $5 million in fines, each, for Goldman Sachs, Deutsche Bank Securities, Miller Tabak Roberts Securities, and Citigroup in 2004. A 2007 investigation into Morgan Stanley, resulted in a $1.5 million fine and $4.6 million in restitution to customers. *See* Ferrell at 3; citing NASD Letters of Acceptance, Waiver, and Consent with Deutsche Bank Securities, Inc., Miller Tabak Roberts Securities LLC, Citigroup Global Markets, Inc., and Goldman Sachs & Co. (July 28, 2004); and FINRA, News Release (Aug. 2, 2007). Similarly, in April, 2012, FINRA fined David Lerner Associates $1 million and ordered restitution to affected customers in the sale of municipal bonds and collateralized mortgage obligations. *See In re David Lerner Associates, Inc*., Case No. 20050007427 (Apr. 4, 2012). There are numerous other regulatory matters involving excessive mark-ups, mark-downs, and commissions.

In light of the regulatory history, market data concerning mark-ups and mark-downs, and the data demonstrating the reduced costs, which mark-ups and mark-downs are intended, in part, to cover, PIABA believes that FINRA should lower the "5% Policy" to a "2% Policy". This reduction would be consistent with the prevailing market mark-ups and mark-downs. PIABA supports the proposition that the fairness and reasonableness of mark-ups, mark-downs, and commissions must be determined on a case-by-case basis, considering the factors enumerated in Rule 2121(c). The reduction of the upper limit guidance would be fair and equitable to member firms, as it would still allow a firm to overcome this presumption after consideration of the enumerated factors in proposed Rule 2121(c).

Regulatory Notice 13-07 also proposes the deletion of the "Proceeds Provision". When a customer sells one security and then buys another at or about the same time, using the proceeds of the sale to purchase the second security, the current "Proceeds Provision" rules require that both trades are treated as a single transaction for mark-up and mark-down purposes. PIABA can understand the difficulty in consistent enforcement of this provision without additional guidance. That difficulty could be addressed by setting a fixed time period, such as one week or a purchase within a specified number of days from the trade date of the sale transaction. PIABA urges the retention of the "Proceeds Provision" with a direction that FINRA issue interpretive guidance.

Conclusion

In sum, PIABA believes that the 5% threshold is far too high in light of technological advances and market data. FINRA should lower this threshold to a number that more accurately reflects the reality of the securities markets. This reduced threshold should continue to serve as a "guide", and the fairness and reasonableness of mark-ups, mark-downs, and commissions should continue to be assessed on a transaction-by-transaction basis. Thank you again for the opportunity to comment on these rule proposals.

Sincerely,
Scott Ilgenfritz
President

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The following PIABA Comment Letter regarding *Regulatory Notice 13-02 – Disclosure of Conflicts of Interest Relating to Recruitment Compensation Practices* was submitted to the Financial Industry Regulatory Authority by Scott C. Ilgenfritz on March 5, 2013.

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

Re: Regulatory Notice 13-02—Disclosure of Conflicts of Interest Relating to Recruitment Compensation Practices

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 believes that public investors would benefit from being informed of enhanced compensation being paid to a registered representative to change firms so that investors are made aware of the material conflicts of interest created by that compensation. Accordingly, FINRA seeks comment on a proposed rule that would require specific disclosure by the recruiting member firm of the financial incentives a representative receives as part of his or her relationship with the new firm.

PIABA supports the proposed rule. Enhanced compensation creates potential (if not actual), material conflicts of interest by incentivizing conduct harmful to customers, including churning of accounts, recommending unsuitable investment products, or otherwise engaging in activity that generates commission revenue but is not in investors' interests. <u>See</u> SEC Chairman M. Schapiro, Open Letter to Broker-Dealer CEOs (Aug. 31, 2009).

In light of the risks posed by these material conflicts, PIABA believes that disclosure of enhanced compensation is necessary to permit investors to weigh a representative's solicitation to switch firms or recommendation to purchase investment services or products against the representative's economic self-interest.

Consistent with FINRA's reasoning, PIABA believes that the proposed rule should be broadened to also require disclosure of such incentives to all of the registered person's new customers with the recruiting firm. A recently-recruited registered person will feel the same need to justify enhanced compensation in transactions with new customers as he or she would with a transferring customer. Indeed, that pressure may be greater with new customers, who otherwise lack a preexisting relationship with the registered person.

Moreover, enhanced compensation based on post-recruitment production does not differentiate between new and transferring customers. Enhanced compensation is ordinarily calculated on 12 month's trailing production at the old firm, taking into account the registered person's book of business and years of service. However, FINRA correctly observes that some enhanced compensation packages are made contingent on the registered person's production at the new firm. Under those circumstances, new and transferring customers face the same exposure to the conflict of interest created by enhanced compensation. Accordingly, PIABA believes that FINRA should adopt a broader rule requiring disclosure of enhanced compensation to new and transferring customers alike.

PIABA believes that the first individualized contact with the customer about the enhanced compensation should be in writing. Enhanced compensation packages may be very detailed. An oral disclosure creates the risk of incomplete disclosure, would be difficult to monitor, and could lead to possible misunderstanding by the customer that would not always be cured by a later writing. Furthermore, if the writing is not required until the transfer documentation is provided to the customer, it could easily be overlooked. A universal written disclosure protects investors, members, and representatives alike.

In addition, the proposed rule's one-year time limit for disclosure may be too narrow. FINRA notes that some firms calculate enhanced compensation based on current production. Consistent with the proposed rule's purposes, PIABA believes that registered persons should disclose enhanced compensation for so long as he or she receives it.

The proposed rule contains a *de minimus* exception that would not require disclosure of enhanced compensation less than $50,000. The proposed rule's purpose is to protect investors from a registered person's conflicts of interest, including the pressure felt by the associated person to justify the new firm's investment. Since transition assistance amounts to an out-of-pocket cost to the member, the pressure felt by a registered person to justify such an expense remains. PIABA believes that for recruiting compensation to be classified as *de minimus*,the amount should be lowered from $50,000 to $25,000.

Finally, PIABA notes that the proposed rule is consistent with existing federal and state law, which may require disclosure under the circumstances identified by Regulatory Notice 13-02. Bonus commissions are generally considered material to a reasonable investor's investment decisions. *See, e.g., Press v. Quick & Reilly*, 218 F.3d 121, 130 (2d Cir. 2000) (extra commissions represent a "conflict of interest" that is "material"); *Gary Plastic Packaging Corp. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 756 F.2d 230, 242 (2d Cir. 1985) ("Commissions that defendants receive on the CDs they sell to the public are relevant and must be disclosed."). Representative persons who assume fiduciary obligations toward customers must disclose all facts material to that relationship. *See, e.g., United States v. Laurienti,* 611 F.3d 530, 540 (9th Cir. 2010); *United States v. Skelly*, 442 F.3d 94, 97-98 (2d Cir. 2006). Even in the absence of fiduciary obligations, a registered person may be exposed to securities antifraud liability if his or her failure to disclose bonus commissions makes other statements by the registered person materially misleading. *Laurienti*, 611 F.3d at 541; *Chasins v. Smith, Barney & Co.,* 438 F.2d 1167, 1172 (2d Cir. 1970) ("Failure to inform the customer fully of its possible conflict of interest, in that it was a market maker in the securities which it strongly recommended for purchase by [plaintiff], was an omission of material fact in violation of Rule 10b-5.").

PIABA supports FINRA's efforts to educate investors as to the risks posed by the conflicts of interest arising from enhanced compensation and recruiting practices. We appreciate the opportunity to comment on the proposed rule and look forward to commenting on a final rule.

Sincerely,
Scott C. Ilgenfritz
President

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The following PIABA Comment Letter regarding *SR-FINRA-2013-002 -- Proposed Rule Change to Amend FINRA Rule 2267 (Investor Education and Protection)* was submitted to the Securities and Exchange Commission by Scott C. Ilgenfritz on February 13, 2013.

Ms. Elizabeth M. Murphy
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

Re: *SR-FINRA-2013-002 -- Proposed Rule Change to Amend FINRA Rule 2267 (Investor Education and Protection)*

Dear Ms. Murphy,

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is an international bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums, while also advocating for public education regarding investment fraud and industry misconduct. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure.

PIABA supports FINRA's efforts to make BrokerCheck more accessible for investors. FINRA has long recognized the importance of BrokerCheck as a source of critical information for the public investor. Since the system was established in 1988 (then known as the Public Disclosure Program), the means of accessing information about associated persons and broker/dealers have evolved and improved dramatically: from information requests via U.S. mail or facsimile, to include oral requests via a toll-free telephone number and requests by email. Now, anyone with an Internet connection can access BrokerCheck reports instantly through FINRA's website.

While it is easier than ever for investors to access BrokerCheck, there is a troubling gap in general knowledge about the existence and use of BrokerCheck. As noted in this Proposed Rule Change, a 2009 study of financial capability in the U.S. (prepared for the FINRA Investor Education Foundation) found that only 15% of survey respondents claimed that they had checked a financial advisor's background with a state or federal regulator. *See also* Regulatory Notice 12-10, footnote 9. As also noted in this Proposed Rule Change, more recent focus group surveys found that many participants were unaware of BrokerCheck.

Current Rule 2267 requires FINRA member firms to provide in writing to each customer, only once per year, the general BrokerCheck telephone number and website address. Member firms must also give notice, again only once per year, that an investment brochure containing BrokerCheck information is available to customers. Certain member firms are excluded from even these minimal disclosure requirements regarding the very existence of BrokerCheck.

PIABA strongly believes that the amendments to Rule 2267 proposed in SR-FINRA-2013-002 are in line with FINRA's commitment to improving public access to investment advisor and broker-dealer registration information. A September 2012 survey conducted by the Pew Internet and American Life Project found that 81% of adult Americans use the Internet, and of that group, the vast majority looks for information online about a service or product they are thinking of buying. Simply put, a public investor is very likely to look at a member firm's or associated person's website or social media page for information. By requiring a prominent, uniform text description (drafted by FINRA) and hyperlinks to not only BrokerCheck but a page specific to that member or associated person, FINRA will greatly improve public use of BrokerCheck. By natural extension, it will also improve public access to and use of FINRA's other investor tools on its www.finra.org/Investors webpages.

With the proposed hyperlink tailored to directly link to a particular firm's or individuals' BrokerCheck search result, PIABA requests that this resulting report be available as a webpage rather than as a stand-alone PDF document. Doing so would allow the investor to then easily click on links back to the BrokerCheck homepage for another search, to FINRA's general website, or to other information. Embedded links to pop-up explanations of terms or cross-references could also be included in the page. In general, this Proposed Rule Change presents a great opportunity to overhaul the design and format of the summary report and/or the full detailed report for easier reading by the viewing public. These reports, and in particular the disclosure pages, could be improved by simple formatting changes.

PIABA strongly encourages FINRA to consider the range of Internet user ages and capabilities in determining the size, clarity of description, and mandatory placement of the required text description and hyperlink to BrokerCheck. The description should be large and distinguished from other "boilerplate" text unlikely to be closely read.

The most prominent location for the BrokerCheck description and hyperlink may be its placement on customer account statements. PIABA requests that FINRA consider this additional application. Compliance would be no more difficult for electronically produced statements, and an investor would gain the repeated message of BrokerCheck's availability in the place he or she is most likely to regularly review.

Specific to this proposed change to Rule 2267, PIABA notes that the amended rule language may raise questions as to what constitutes a "comparable Internet presence" for purposes of identifying what webpages must display the description and hyperlink to BrokerCheck. We request clarification on this topic in future Regulatory Notices.

In addition to these issues of public awareness and access to the BrokerCheck website, we believe that FINRA can improve investor education and financial literacy in other ways:

1. PIABA encourages FINRA to harmonize the information available on BrokerCheck with information available from state regulatory websites, such as Florida's. This additional information may include a broker's educational background and professional designations.
2. PIABA requests that FINRA eliminate the artificial time limits on what information must be disclosed on BrokerCheck. Lapse of time should not take critical information away from the investing public.
3. PIABA asks that FINRA consider making BrokerCheck information available to for-profit companies who may make this information more accessible, or offer comparative reports about different member firms or associated persons. So long as FINRA continues to support a free basic level of service through BrokerCheck, PIABA supports the idea of private companies who may enhance public education through data analysis services.
4. In addition to making BrokerCheck more accessible, investors should have easier access to information about fees paid by the customer to the financial institution. The most successful way to do this would be requiring investment institutions to prominently display the amount of fees charged on the first page of customer account statements. PIABA believes that to be most effective, this fee disclosure should include both the dollar amount of fees charged for that statement time period and year to date, and the annual percentage fee charged with respect to both the net asset value of the account and as a percentage of the net gains and losses for the account. These figures are a basic "red flag" for potential misconduct in the account.

PIABA appreciates and supports FINRA's commitment to investor protection. We recognize that FINRA has made many improvements to BrokerCheck and other investor educational resources on its website. We hope that with this amendment to Rule 2267, more public investors get the benefit of discovering and accessing those resources. Thank you for giving us the opportunity to comment.

Very truly yours,
Scott C. Ilgenfritz
President

The following PIABA Comment Letter regarding *Proposed Rule Change to Amend FINRA's Customer and Industry Codes of Arbitration Procedure to Revise the Public Arbitrator Definition* was submitted to the Securities and Exchange Commission by Scott C. Ilgenfritz on February 7, 2013.

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

Re: SR-FINRA-2013-003: Proposed Rule Change to Amend FINRA's Customer and Industry Codes of Arbitration Procedure to Revise the Public Arbitrator Definition

Dear Ms. Murphy:

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission ("SEC"), the Public Investors Arbitration Bar Association ("PIABA") submits this comment to the SEC concerning SR-FINRA-2013-003 and FINRA's proposed changes to FINRA Rule 12100. Theproposal seeks to revise the definition of a "public arbitrator" under the rules governing arbitrations brought by investors. PIABA believes that these changes are a step in the right direction and should be approved. At the same time, PIABA believes that additional changes to the definition of the term "public arbitrator" should be pursued and approved to promote the fairness and the perception of fairness of the FINRA arbitration forum.

PIABA is a bar association, which promotes the interests of the public investor in securities arbitrations and advocates for investor rights. PIABA frequently comments upon proposed rule changes that affect the arbitration process to seek to protect the rights and fair treatment of the investing public. PIABA submits this comment because it believes the proposed rule changes should be approved and because it believes further changes to the "public arbitrator" definition are needed.

FINRA Rule 12100 defines the terms used within the Code relating to investor claims. The proposed changes seek to revise the definition contained in subsection (u) of the term "public arbitrator". FINRA's proposed rule changes incorporate two improvements to Rule 12100. The first change is to subsection (u)(3) and adds that, in addition to investment advisers, persons associated with, including registered through, a mutual fund or hedge fund shall not be considered public arbitrators. The second modification to Rule 12100 proposes to add a two-year "cooling off" period before persons with certain affiliations to the securities industry can become public arbitrators. Such affiliations include, in addition to investment advisers and those associated with mutual funds and hedge funds; attorneys, accountants, and other professionals with a requisite amount of business from customer disputes relating to investment accounts or in representing members of the securities or commodities industry; those affiliated with entities that control a securities related entity; and an immediate family member of an officer or director of an entity controlling a securities related entity.

These changes improve the FINRA arbitration forum and should be approved.

Additional changes to the definition of "public arbitrator" which should be pursued and adopted include the following. First, changes should be implemented to exclude from the "public arbitrator" definition a wider range of persons who are affiliated with entities that sponsor or issue investment products. Second, certain persons should be precluded from ever being classified as public arbitrators, and the "cooling off" period for certain persons directly or indirectly affiliated with the securities industry should be lengthened.

I. *Changes should be implemented to expressly exclude from the definition of "public arbitrator" persons associated with issuers or sponsors of private placements, publicly offered non-traded REITs, variable insurance products, and other investment products.*

Changes to Rule 12100(u)(3) which should be pursued and adopted include expanding the persons who cannot be classified as public arbitrators beyond those persons associated with hedge funds and mutual funds. FINRA has proposed adding to the list of persons expressly excluded from the public arbitrator classification individuals affiliated with hedge funds or mutual funds because of their "association with the securities industry". SR-FINRA-2013-003, Pg. 10. However, this exclusion does not go far enough.

FINRA's Conduct Rules, including, but not limited to, FINRA's suitability and know your customer rule (Rule 2111 and Rule 2090), apply to many products in addition to hedge funds and mutual funds.Some of these other investment products have become more frequent subjects of investors' arbitration claims. Professionals who are affiliated with the sponsors or issuers of such products or any securities products, for that matter, should not be allowed to serve as public arbitrators.

For example, many current investor claims involve private placements, publicly offered non-traded REITs (non-traded REITs), and variable annuities. Under the current rule and the proposed modified rule, all three arbitrators on a panel could be employees of a sponsor or issuer of private placements, non-traded REITs, or variable annuities and could still hear a case concerning the suitability of such investments.

In five years, investor claims could concern investment products which are not currently in the marketplace or even contemplated. Therefore, changes to the definition of the term "public arbitrator" are needed to exclude from the definition individuals who are affiliated with issuers or sponsors of private placements, non-traded REITs, variable products, and other investment products that may arise in the future. The definition of "public arbitrator" should be amended to exclude individuals who are affiliated with entities which act as sponsors, issuers, marketers, or sellers of securities or other investment products with embedded securities.

II. *Certain individuals affiliated with the securities industry should never be classified as a "public arbitrator" and as to others the cooling off period should be extended.*

The proposed changes to Rule 12100 would require a two year cooling-off period from the date on which the persons described in subsections (3)-(8) of section (u) of Rule 12100 cease their direct or indirect affiliations with the securities industry. PIABA believes that the implementation of a cooling-off period of two years for the persons described in these subsections of the Rule is an improvement over the current rule. However, further changes to the "public arbitrator" definition need to be implemented.

PIABA believes that persons who have worked for more than a de minimis period of time as a stockbroker or investment advisor should be precluded from ever being classified as a "public arbitrator". In addition, persons with more than a de minimis length of affiliation with a member firm, an investment advisory firm, a hedge fund, a mutual fund, or an issuer, sponsor, marketer, or seller of securities or investment products with embedded securities should, likewise, be precluded from ever being classified as a "public arbitrator". Allowing such persons to be classified as public arbitrators after a "cooling-off" period engenders to the perception of unfairness with respect to the FINRA arbitration forum and creates the possibility that persons with loyalties or connections to the securities industry are presiding as arbitrators over investors' claims.

With respect to persons with less direct affiliations with the securities industry, including attorneys, accountants, and other professionals and family members of persons directly affiliated with the securities industry, a "cooling-off" period of more than two years should be implemented. A two year "cooling-off" period is inadequate for attorneys, accountants, and other professionals who meet the representation criteria specified in subsections (u)(4) and (5) of Rule 12100. A professional who does not meet the representation criteria set forth in the above-listed subsections during a two year period of time may well still intend to continue such representation. Under the proposed modified rule, professionals who have devoted their careers to representing entities or persons involved in the securities industry would qualify as a "public arbitrator" two years after such individual ceased representation of or work for securities industry participants. Such persons being able to be classified as public arbitrators two years after ceasing such representation or work, again, engenders the perception of unfairness with respect to the FINRA arbitration forum. Consideration should be given to excluding from "public arbitrator" classification professionals who have individually represented or who have worked with firms that have represented securities industry participants for more than a specified number of years.

Likeise, extending the "cooling-off" period of persons with less direct connections with the securities industry, such as family members of securities industry participants, would improve the perception of the FINRA arbitration forum.

III. *Conclusion.*

As the Supreme Court has said, the SEC has broad authority to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect investors. *Shearson/American Express v. McMahon*, 482 U.S. 220, 234-35 (1987). The stated objective of FINRA's proposed rule change is to "improve investor confidence in the neutrality of FINRA's public arbitrator roster." SR-FINRA-2013-003, Pg. 8. PIABA supports the proposed rule changes, but it believes that the above-described rule changes should be pursued and implemented to improve investor perception of the FINRA arbitration forum and to promote FINRA's stated mission of investor protection.

Sincerely,
Scott C. Ilgenfritz
President