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STATUTES OF LIMITATION IN FINRA ARBITRATION ARE A SQUARE PEG IN A ROUND HOLE

Mark A. Tepper

I. INTRODUCTION

This year, in *Raymond James Financial Services, Inc. v. Phillips*, ____ So.3d ____, 2013 WL 2096252 (Fla.), the Florida Supreme Court issued a controversial opinion which held that "Florida's statute of limitations applies to arbitration . . . ." In its decision, the Florida Supreme Court reversed the Florida Second District of Court of Appeals based on the rationale that the words "civil action or proceeding" in Florida's statute of limitations is broad enough to include arbitration generally. Missing from the Florida Supreme Court's analysis, however, was any discussion of the fact that FINRA's own rules do not contemplate the application of statutes of limitation in FINRA arbitration. As such, the Court reached the wrong conclusion.

This article discusses how the application of statutes of limitation violates the fundamental fairness of FINRA arbitrations and should subject FINRA members to disciplinary proceedings. In addition, this article discusses the *Phillips* decision and points out how Raymond James' customer agreements violate FINRA rules.

II. FINRA RULES DO NOT PERMIT THE APPLICATION OF STATUTES OF LIMITATION TO FINRA ARBITRATIONS.

A FINRA member using its customer agreement to incorporate statutes of limitation into FINRA arbitration is an attack on the fundamental fairness of the process and should trigger a disciplinary proceeding. As a self-regulatory organization ("SRO"), FINRA must act to stop this violation of its rules – it cannot stand mute.

FINRA enforcement has sufficient grounds to initiate a disciplinary proceeding to protect investors and prevent its members from undermining the fundamental fairness of FINRA arbitration.

The motivation for advocating the application of statutes of limitation, which are not available in FINRA customer arbitration, is to obtain a strategic advantage. Statutes of limitation have shorter time limits than FINRA's six year time limit ("eligibility rule") for filing an arbitration claim.

Statutes of limitation are prejudicial to Claimants because they ". . . can be construed as limiting the ability of customers to file claims or of arbitrators to issue awards [which is] inconsistent with NASD rules." NASD Notice to Members ("NTM") 95-16.

Statutes of limitation have no place in FINRA arbitration any more than a square peg in a round hole. FINRA has delivered this message to its members through NTMs, FINRA's Rules including FINRA's Code of Arbitration Procedure for Customer Disputes ("FINRA Code") and FINRA's Submission Agreement.

FINRA's eligibility rule establishes that eligibility for FINRA arbitration is not related to or measured by statutes of limitation. FINRA Code 12206(a). According to FINRA, statutes of limitation apply only when customer claims are filed "in court." FINRA Code 12206(c).

FINRA says that "applicable statutes of limitation" are tolled or suspended when a civil matter is submitted to FINRA arbitration. FINRA Code 12206(c) and NTM 09-36. In FINRA arbitration, if statutes of limitation are suspended, then logic dictates that statutes of limitation cannot be the basis for dismissing a claim in FINRA arbitration, as untimely.

When a Panel decides a motion to dismiss pursuant to FINRA's Code 12504(c), alleging an untimely claim, the Panel must measure timeliness based on FINRA's six year eligibility rule, not statutes of limitation. FINRA Code 12206(a).

By design, statutes of limitation are not mentioned in FINRA Code 12206(a). Consequently, statutes of limitation have no role in determining the eligibility of claims filed in FINRA arbitration. The FINRA Code has no provision authorizing the filing of a motion to dismiss based on a statute of limitations.

In fact, if arbitrators find that a claim is ineligible for FINRA arbitration, based on FINRA Code 12206(a), then the Claimant may file in court as of the date the arbitration claim was filed. FINRA Code 12206(c).

Arbitration is a matter of contract. *Rent–A–Center, West, Inc. v. Jackson*, 561 U.S.____, 130 S.Ct. 2772, 177 L.Ed. 2d 403 (2010).

The parties initiate FINRA arbitration by routinely signing submission agreements confirming that the FINRA Code governs the parties' arbitration including eligibility:

> **The parties hereby state that they or their representative(s) have read the procedures and rules of FINRA relating to arbitration, and the parties agree to be bound by these procedures and rules.** FINRA's submission agreement form, ¶2.

By contract, in FINRA arbitration, the parties are bound to follow FINRA's procedures and rules including FINRA Code 12206(a).

FINRA has clearly defined the eligibility period for filing a timely arbitration claim in FINRA Code 12206:

> **(a) Time Limitation on Submission of Claims** No claim shall be eligible for submission to arbitration under the Code where **six years** have elapsed from the occurrence or event giving rise to the claim. The panel will resolve any questions regarding the eligibility of a claim under this rule. Emphasis added.

The plain meaning of the text is that eligibility for FINRA customer arbitration is determined in accordance with FINRA Code 12206(a) which does *not* include statutes of limitation.

FINRA Code 12206(c) is the only place in the 12000 series that mentions the words: "applicable statutes of limitation." The text of FINRA Code 12206(c) [1] was amended to add the title which emphasized that the words "applicable statutes of limitation" only applies to claims filed "in court":

> **(c) Effect of Rule on Time Limits for Filing Claim in Court** The rule does not extend applicable statutes of limitations; nor shall the six-year time limit on the submission of claims apply to any claim that is directed to arbitration by a court of competent jurisdiction upon request of a member or associated person. However, *when a claimant files a statement of claim in arbitration, any time limits for the filing of the claim in court will be tolled while FINRA retains jurisdiction of the claim.* Emphasis added.

FINRA Code 12206(c) clearly establishes that statutes of limitation do not apply in FINRA arbitration.

Statutes of limitation are the measure used to determine the timeliness of legal causes of action, filed in court. FINRA Code 12302(a) has no requirement that Claimants even plead a cause of action to initiate FINRA arbitration.

In fact, FINRA's Code 12302(a) simply requires "a statement of claim specifying the relevant facts and remedies requested." Linda Feinberg, President of FINRA Dispute Resolution, told the North American Securities Administrators Association ("NASAA") the same thing:

> **In . . . [FINRA] arbitration, unlike in court, you get an equitable result. You do not have to have a claim that is cognizable under state or federal law. It can be cognizable under NASD rules.** *Securities Arbitration Desk Reference*, Appendix N,

1. FINRA Code 12206 replaced NASD Rule 10304, for cases filed after April 26, 2007. NASD Rule 10304 replaced NASD Rule Section 15.

2011-2012 Edition, by Seth E. Lipner, Joseph C. Long and William A. Jacobson.

FINRA Rule 0140, "Applicability," states that "the rules shall apply to all members and persons associated with a member." FINRA Rules include the FINRA Code which addresses eligibility and statutes of limitation.

FINRA has provided its members with reasonable notice that statutes of limitation do not apply in FINRA arbitration, pursuant to FINRA Rules.

It is significant to note that FINRA arbitration is conducted pursuant to the Federal Arbitration Act ("FAA") which expresses a strong federal policy *favoring* arbitration. "The overarching purpose of the FAA, evident in the text of §§ 2, 3, and 4, is to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings." *AT&T Mobility, LLC v. Concepcion*, ___ U.S.___; 131 S.Ct. 1740, 1748; 179 L.Ed. 2d 742 (2011).

Judicial hostility to FINRA's eligibility rules through statutes of limitation is an example of what the FAA was intended to prohibit:

> **The United States Supreme Court has consistently explained that the FAA, which was enacted in 1925 as a response to judicial hostility to arbitration, establishes a liberal federal policy favoring arbitration agreements. *See CompuCredit Corp. v. Greenwood*, —– U.S. ——, 132 S.Ct. 665, 668–69, 181 L.Ed.2d 586 (2012); *Concepcion*, 131 S.Ct. at 1745; *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 25, 111 S.Ct. 1647, 114 L.Ed.2d 26 (1991). Section 2 of the FAA, referred to as the 'primary substantive provision of the Act,' *Concepcion*, 131 S.Ct. at 1745 (quoting *Moses H. Cone Mem'l Hosp. v. Mercury Constr. Corp.*, 460 U.S. 1, 24, 103 S.Ct. 927, 74 L.Ed.2d 765 (1983)), provides in relevant part:**
>
> **A written provision in any maritime transaction or a contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction . . . shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.** *McKenzie Check Advance of Florida, LLC v. Betts*, 112 So.3d 1176, 1181 (Fla. 2013).

The *Betts* court went on to find that conflicting state law was pre-empted:

> **[S]uch a state policy stands as an obstacle to the FAA's objective of enforcing arbitration agreements according to their terms, and is preempted.** *Id.* at 1184.

FINRA members with arbitration provisions in their customer agreements ". . . that can be construed as limiting the ability of customers to file claims or of arbitrators to issue awards [is] inconsistent with NASD rules." NTM 95-16.

Such a violation warrants disciplinary action to protect investors and stop the firm's violation of FINRA Rules as well as having a chilling effect on others who may be considering engaging in such violations.

III. DISCUSSION OF THE PHILLIPS DECISION AND HOW RAYMOND JAMES' CUSTOMER AGREEMENT VIOLATES FINRA RULES

Based on Raymond James' customer agreement, but contrary to FINRA's notice to its members, Raymond James asked the Florida Supreme Court (the "*Phillips* Court") to apply the shorter state statute of limitations in FINRA arbitration. In response, the Court held, that the words "civil action or proceeding" in Florida's statute of limitations is broad enough to include arbitration generally. *Raymond James Financial Services, Inc. v. Phillips*, ____ So.3d ____, 2013 WL 2096252 at *1 (Fla.).

The Court reasoned that "the issue in this case is not the validity of the arbitration agreement, but rather whether Florida's statute of limitations that is applicable to a 'civil action or proceeding' applies to arbitration proceedings." *Id.* The Court was not interested in violations of FINRA Rules. Such rule violations are FINRA's responsibility to regulate. See, FINRA's Mission Statement ("FINRA is dedicated to investor protection and market integrity through effective and efficient regulation of the securities industry").

The offending provision in the Raymond James' customer agreement is:

> **(d) Nothing in this agreement shall be deemed to limit or waive the application of any relevant state or federal statute of limitation, repose or other time bar. Any claim made by either party to this agreement which is time barred for any reason shall not be eligible for arbitration. The determination of whether any such claim was timely filed shall be by a court having jurisdiction, upon application by either party.** *Phillips v. Raymond James Financial Services, Inc.*, 110 So.3d 908, 909 (Fla. App. 2 Dist. 2011).

A compelling case can be made that Raymond James' arbitration provision in its customer agreement violates the FINRA Code and other FINRA Rules. Raymond James' customer agreement would apply State or

Federal time limits to a FINRA arbitration which conflicts with FINRA Rules.

According to the FINRA Code, an arbitration panel, not a court, determines the eligibility of an arbitration claim. FINRA Code 12206(a). Contrary to FINRA Rules, Raymond James' customer agreement also required its customers to "agree" that only a "court having jurisdiction" can determine the eligibility of the claim for arbitration.

The United States Supreme Court decided that arbitrators, not the court, determine gateway matters like eligibility:

> **. . . parties to an arbitration contract would normally expect a forum-based decisionmaker to decide forum-specific procedural gateway matters. And any temptation here to place special antiarbitration weight on the appearance of the word "eligible" in the NASD Code rule is counterbalanced by a different NASD rule; that rule states that 'arbitrators shall be empowered to interpret and determine the applicability of all provisions under this Code.' NASD Code § 10324.**
>
> **Consequently, without the help of a special arbitration-disfavoring presumption, we cannot conclude that the parties intended to have a court, rather than an arbitrator, interpret and apply the NASD time limit rule. And as we held in Part II, supra, that presumption does not apply.** *Howsam v. Dean Witter Reynolds, Inc.*, 537 U.S. 79, 86 (2002).

The *Phillips* Court did not consider preemption and did not discuss the federal policy favoring arbitration.

The *Phillips* Court decision was limited to the meaning of the words "civil action or proceeding" in the Florida statute of limitations:

> **Because the issue pertaining to statutory construction definitively answers the issue presented in this case, we resolve only that issue and do not reach the question of whether the contract expressly incorporated the statute of limitations.** *Phillips, supra.* at *3.

It is interesting to note that the *Phillips* Court acknowledged in its decision that it paid no attention to the FINRA eligibility rule for filing the claim. It also disregarded the fact that the FINRA eligibility rule was substantially longer than the Florida statute of limitations:

> **The investors assert that affirming the district court decision below does not mean the claim can be raised at any time because in this case, the rules of arbitration to which the parties agreed to follow includes a six-year time bar for claims.**[FN5] **However, the issue before this Court is one of statutory construction as to**

> **chapter 95, and these arguments do not assist the Court in resolving this question. Moreover, arbitration proceedings are utilized in a wide variety of contexts – not just for arbitration governed by NASD (now superseded by the Financial Industry Regulatory Authority or FINRA).** *Id.* at *7.

The *Phillips* Court opinion did not consider the current FINRA Code 12206(c), which is different from former FINRA Code 10324, because the new title confirms that statutes of limitation only apply to claims filed "in court."

Also, the *Phillips* Court did not consider how the Raymond James' customer agreement allegedly violated FINRA Rules. The investor did not challenge the legality of the customer agreement, leaving this key question unresolved.

In addition, the *Phillips* Court decision, as it applies in FINRA arbitration, is subject to preemption based on the FAA and FINRA Code.

Some members believe they can violate FINRA Rules in their customer agreements and evade responsibility for their violation of FINRA Rules. One argument suggests that the use of the word "nor" in FINRA Code 12206(c) indicates that the words used before it: "[t]he rule does not extend applicable statutes of limitations" has a more general application.

This argument lacks merit. There are no "applicable" statutes of limitation in FINRA arbitration according to the plain meaning of FINRA Code 12206(a) and (c).

As discussed above, FINRA's eligibility rule, FINRA Code 12206(a), exclusively applies in arbitration, while FINRA Code 12206(c) limits the application of statutes of limitation to claims filed "in court."

The perception that violating FINRA's customer agreement rules has no consequences must change if FINRA arbitration is to be perceived as fundamentally fair and FINRA Rule 0140 is to have any meaning. FINRA arbitration must be fair to all parties, if it is to remain mandatory.

FINRA has warned that members having arbitration provisions in their customer agreements that are inconsistent with its rules may be subject to disciplinary action:

> **Similar compliance problems are raised by provisions that attempt to limit the courts before whom awards may be confirmed or limit the role of arbitrators. Indeed, the use of a governing law clause or other clause anywhere within a customer agreement that thwarts any NASD arbitration provision will be deemed violative.**
>
> **NASD members having arbitration provisions in customer agreements that are inconsistent with NASD rules may be**

> **subject to disciplinary action. NASD staff, District Business Conduct Committee, and arbitration panels will view provisions in agreements that can be construed as limiting the ability of customers to file claims or of arbitrators to issue awards as being inconsistent with NASD rules. NASD members should promptly review their customer agreements to ensure that they fully comply with NASD rules.** NTM 95-16.

NTM 95-16 was issued following *Mastrobuono v. Shearson*, 514 U.S. 52 (1995), a case that enforced the strong federal policy favoring arbitration and blocked the use of a New York governing law clause to prevent the arbitrators from awarding punitive damages and attorney's fees.

FINRA members with arbitration provisions in their customer agreements ". . . that can be construed as limiting the ability of customers to file claims or of arbitrators to issue awards [is] inconsistent with NASD rules." NASD NTM 95-16. "NASD members should promptly review their customer agreements to ensure that they fully comply with NASD rules." *Id.*

In the past, when a member inserted a "choice of law" clause in its customer agreement, FINRA has disciplined some of those efforts with sanctions. See, NASD Case #CAF020052:

> **Prudential Securities, Inc. (CRD #7471, New York, New York) submitted a Letter of Acceptance, Waiver, and Consent in which the firm was censured, fined $20,000, and required to undertake to withdraw any New York choice-of-law defense asserted in any pending arbitration, not to assert a New York choice-of-law defense in any future arbitration proceeding, and to instruct all in-house and outside attorneys representing the firm in arbitration proceedings not to assert a New York choice-of-law defense.**
>
> **Without admitting or denying the allegations, the firm consented to the described sanctions and to the entry of findings that in arbitration proceedings filed with NASD, it had public customers sign a customer agreement stating that the terms of the agreement would be governed by the laws of the State of New York. The findings also stated that the firm asserted that New York law applied to the proceedings by virtue of the governing law clause in the customer agreement, and that New York law precluded an award of punitive damages or attorney fees.** NASD Case #CAF020052.

IV. CONCLUSION

Moving to dismiss a claim in FINRA arbitration based on a statute of limitations violates FINRA Rules.

FINRA initiating disciplinary proceedings against the offending firm is the most effective solution for controlling members that use customer agreements with arbitration provisions that violate FINRA Rules. A disciplinary proceeding would stop the violation of FINRA Rules. It would also have a chilling effect on other members doing the same thing, precluding an avalanche of bad decisions in multiple states.

FINRA must vigorously enforce its rules to prevent its members from undermining the fundamental fairness of FINRA arbitration.

Notes & Observations

TICS - WHAT ATTORNEYS NEED TO UNDERSTAND

Frederick Rosenberg

Tenancy In Common – known as TICs - is a form of concurrent ownership of property in which two or more persons simultaneously possess undivided interests in property. TICs s can be created by deed, will or operation of law. They have been around since the Magna Carta without much controversy, except where Section 1031 of the IRS Code is involved.

Section 1031 provides for a transfer of taxable basis in an exchange for like-type properties thereby deferring taxes. Prior to 2002, the IRS characterized a tenancy-in-common as a security in the ilk of a limited partnership and, therefore, TICs did not qualify under Section 1031 for like-kind exchanges. This was remedied in IRS Revenue Procedure Ruling 2002-22 in which, under prescribed conditions, a tenancy in common was determined to be a direct ownership and not a security for 1031 purposes and, therefore, TICs would qualify for 1031 like-kind exchange.

IT IS A SECURITY!

The first confusion about the IRS letter ruling is that it appears to conflict with *S.E.C v Howey,*[1] in which the U. S. Supreme Court adopted a definition of a security that included an "Investment Contract," which, under the '33 Act, encompasses TICs. In 1946, the Supreme Court stated in *Howey*:

> An "investment contract," as used in the Securities Act, means a contract, transaction, or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from efforts of promoter or a third party, it being immaterial whether shares in enterprise are evidenced by formal certificate or by nominal interests in physical assets employed in enterprise.

Is a TIC merely a real estate transaction subject to traditional caveat emptor real estate principles, or is it a security that is subject to the Securities Act of 1933 as well as the Securities Exchange Act of 1934, which affords substantial investor protections and imposes industry duties not found under local real estate law and practice?

Take care not to confuse the IRS letter ruling or Tax Opinions in which TICs are not securities for 1031 purposes with the rules that apply to selling

1. *S.E.C v Howey*, 328 U.S. 293, 66 S.Ct. 1100 (1946).

securities under the 1933 and 1934 acts. While a TIC is not a security for 1031 purposes, it is indisputably an "Investment Contract," a security under the 33 Act, which explains why these matters are litigated primarily in FINRA Arbitration and must be analyzed according to Securities Laws.

HOW IT SEEMS TO WORK IN MOST, BUT NOT ALL, CASES

In a TIC, a sponsor and its affiliated companies structure a real estate purchase in which a property is purchased by an affiliate, marked up with fees and promotions of 25% +/- on average and then sold off as TIC units to 35 investors. The investor forms a single- purpose LLC that in turn purchases the TIC, receives a deed and executes the Management and TIC Agreements drafted by the sponsor. The sponsor and its affiliates effectively retain control of the property and promise both an income stream and return of principal. Each investor assumes a pro-rata share of a non-recourse first mortgage on the property, typically an amount 150%-200% of their capital contribution. Distributions to investors are typically guaranteed by a Master Lease or otherwise supported by the sponsor's credit assurances.

Following the 2002 IRS Revenue Procedure, Investors could defer gains on exchanged property by "exchanging" the gross sales amount into a TIC, the principal attraction of a TIC. For example, an Investor originally paid $200,000 for a property with a current market sale of $1,000,000. The gain, $800,000, would generate a tax liability of $160,000 at 20% federal and state rates. There is $300,000 of debt on the property meaning the investor would net out $700,000 before taxes. Regardless of the debt, the Investor is compelled to invest the gross sales amount, $1,000,000, to defer the tax, including replacement of paid off debt with cash or similar recourse debt. This presents a nettlesome problem for investors seeking to exchange real estate with substantial recourse debt.

WHY A TIC IS A SECURITY PURCHASE

In *Howey*, the Supreme Court made clear that it is *immaterial* "whether shares in enterprise are evidenced by formal certificate *or by nominal interests in physical assets employed in enterprise.*" Consequently, where the investors' purchases are part of a common enterprise, their TIC purchases are Capital Contributions to the enterprise**,** not personal real estate investments. The sale of TICs must, therefore, be in compliance with the ‘33 and ‘34 Acts and that means that broker/dealers must abide by FINRA's rules and rulings including having a reasonable basis for a recommendation. FINRA Notice to Members (NTM) 03-71 laid out, as far back as 2003, what should be expected in the sale of a Non-Conventional Investment (NCI). TICs were specifically addressed in NTM 05-18, reinforcing NTM 03-71, and both Notices are referenced again directly in NTM 10-22 with regard to private placements.

WHAT IS DUE DILIGENCE?

Due Diligence is the underwriting process required to meet the Reasonable Basis suitability requirement of Rule 2310. It should be orderly and properly focused. Throughout the process, there will be:

1) Red Light issues that must be resolved before proceeding further,
2) Red Flag issues that add risk in a cumulative way and require caution or remediation and
3) Green Light issues that require no further examination.

Non-conventional investments (NCIs) are business ventures funded with private equity from passive investors. The fact that these ventures are packaged as securities merely adds an additional layer to the due diligence investigation. All private equity has unique underwriting areas related to the specific business activities and financial condition of its sponsors. Analyzing that information requires specific analytical skills and experience unrelated to securities registration issues. Absent those skills, the analysis will be incomplete and the risks will be inadequately evaluated.

The Loan Agreement in a TIC typically places significant and continuing reliance on the sponsor and its affiliate's financial condition as identified in the representations, warranties, and cash flow covenants of the Agreement. The financial entanglements identified by the Loan Agreement in a TIC commonly identify potential default risk for the investor far greater than the operational risks associated with the purchased property; those risks are foreseeable and quantifiable. Where substantial reliance on the sponsor exists, an experienced private equity analyst must focus on conducting a thorough credit and cash-flow analysis of the sponsor and its affiliates, hopefully supported by audited financials. Failure to assess the creditworthiness of the sponsor has foreseeable consequences under the Loan Agreement. Given most sponsor financial entanglements, it is a grave weakness in the underwriting process to green light a TIC without assessing known credit risks that set the stage for later problems.

Audited financials must also provide an assessment of the adequacy of the sponsor's internal systems and controls that protect Investors against foreseeable occurrences, such as commingling, defalcation, diversion, theft, title encumbrances, and process errors. "Controls" are the signature policies, reporting, signing authority, bonding, borrowing authority, chain of command, reviews and reporting, legal opinions, and exceptions policies. This area of investigation is the most basic in due diligence. Turning over millions of dollars and substantial portions of a customer's net worth to a sponsor that is unwilling to provide the maximum protections against foreseeable problems is a Red Light that cannot be ignored. Furthermore the costs of a thorough audit are relatively insignificant when compared to the funds raised and the fees and promotions earned. Each sponsor should be fully capable of providing verified up to date financials and no Private Equity review could continue once there is a determination of inadequate systems and controls that leave investors vulnerable to loss.

Finally, every offering requires an evaluation of the "sources of repayment," distributions, collateral valuation, and credit weaknesses. Understanding the sources of TIC distributions is crucial. Audited financials must be "spread" and analyzed for credit risk and cash flow. Analysis of borrowing, collateral covenants, and sponsor cash flows from new offerings must be assessed in addition to assessing operational income from the property. Predictably, large, highly leveraged sponsors can suffer substantial financial reversals that can trigger defaults in relatively short periods even while the investor's property interest is still performing on the underlying loan. Could financial failures elsewhere in the sponsor's portfolio trigger default for investors? These areas of investigation and analysis are totally unrelated to securities disclosure or compliance but essential to identify financial weaknesses that add risk to the Investment. Without understanding the risks, no recommendation can be said to have *reasonable basis*.

For a private equity investor, the reasonable basis question is whether the $160,000 (see example above) in tax deferral warrants taking on the substantial risk and encumbrance of a TIC. Investing in a TIC is with pre-tax dollars and the investor must contribute the entire $1 million. However after promotions and markups, the investor sees on average only $750K at work in contrast to the $840,000 remaining after taxes. And with the TIC, the $160K tax liability still continues. Regardless of the gain, if it is $800K ($160k in taxes) or $100K ($20K in taxes), the investor must roll over the entire $1 million into the TIC to qualify for 1031 treatment.

Next comes a more nettlesome issue. On the $1 million 1031 exchange, the actual real estate purchase requirement is only $1 million, yet with a TIC, regardless of the recourse nature of the debt, the investor will be purchasing $1.8 to $.2.6 million in leveraged real estate, two to three times the amount needed for 1031 purposes. Analytically, since 1031 is fully satisfied with the first million exchanged, any excess real estate purchased generates no 1031 deferral whatsoever, thereby negating the rationale for taking on the additional risk in the first place. A review of the Investor's IRS form 8824 filed in the year of the exchange should provide some information about the new basis versus the original basis.

Another onerous consequence of NCI and specifically TIC investments, is permanent Credit Impairment. A TIC is a highly leveraged security that is replete with various party agreements, loan agreements, representations and warranties, sponsor guarantees, and co-tenant liabilities and other encumbrances that disqualify a TIC as collateral for a loan. Since most TIC investors invest a substantial portion if not most of their net worth and typically are nearing or at retirement age, collateral value and credit availability becomes significant. The investor who purchases a $1 million TIC, permanently and instantly loses $1 million of credit availability offered by readily available non-leveraged investments, market securities, and conventionally owned real estate. The severe consequence of this credit impairment should be evaluated prior to any recommendation for one or multiple TICs, and then only after a determination of the tax deferral and duration of impairment.

This brings us to yet another perplexing question. I have read dozens of TIC PPMs and have no doubt that the speculative warnings are real and that catastrophic loss is a foreseeable possibility. And yet the projected returns are modest at best, 4-5% over the safe rate for a few years under perfect conditions. Are the relatively modest returns of TICs and the tax deferral sufficient basis to recommend a TIC? I've spent several years analyzing and reviewing hundreds of ppms and private equity proposals and from a Private Equity perspective, an investor should reasonably project a multiple return on any investment with a foreseeable risk of catastrophic loss and extended capital impairment. By analytical standards a TIC has speculative risk without the expectation of speculative return, essentially making it unsuitable as a speculative recommendation. Whether the modest projected returns warrant the potential for catastrophic outcomes is a fundamental question to be answered before a recommendation can be made.

THE SIGNIFICANCE OF CREDIT RISK

Since all TIC investors must assume a pro-rata share of the underlying debt, one place to focus on in a TIC analysis is the Loan Agreement with the primary lender, paying specific attention to the covenants, representations and warranties, conditions of default, conditions of non-recourse, and conditions of transfer or assumption of the debt. The primary loan is negotiated by the sponsor or affiliate and commonly identifies the sponsor's financial conditions, guarantees, and management covenants tied directly to the underlying financing, many unrelated to the performance of the TIC real estate. Most Loan Agreements have carve-outs from non-recourse liability that impose personal liability on a sponsor or principals for defined the "bad boy" acts and misrepresentations. TIC purchasers should also understand that their loan is risk paper that will be sold off and pooled into CMO's making the lender underwriting suspect.

When a TIC purchaser assumes a share of the loan, all a sponsor's liabilities, representations and warrantees, and financial covenants are also assumed while the sponsor still remains on the loan. What are they? TIC investors must execute a Loan Assumption Agreement directly with the Bank that memorializes terms and conditions, but which often fails to provide copies of the sponsor's guarantees, reps, and covenants that impact default risk. Most Assumption Agreements require the investor to assume proportionate liability for covenant breaches and defaults and even under rare conditions, personal liability if they engage in any defined conduct. That's a Red Light to recommending a TIC.

The consequence of failing to analyze properly the credit entanglements and Agreements is foreseeable. TIC sponsors are commonly integrated, both vertically and horizontally, and typically have raised hundreds of millions of dollars in multiple offerings over several years. The problem is that multiple offerings and businesses mean multiple credit facilities, loans, guarantees, covenants, reps and warranties, and multi-tasking personnel responsible for conflicting interests. A default in any of the sponsor's offering, or a general weakness within the sponsor finances or affiliated businesses could trigger defaults across the entire portfolio even among performing assets, including the investor’s TIC. In point of fact, it is not unusual to find that in most TIC defaults the underlying property is still performing operationally at a level sufficient to meet monthly debt service before investor distributions despite the condition of the real estate market.

What this comes down to for due diligence analysts is that the credit structure of the sponsor needs thorough evaluation to determine foreseeable investor vulnerability. There is substantial reliance on the sponsor's financials both by the investor and the primary lender collateralized by the property. Vulnerability arises from weakness in the sponsors' credit facilities unrelated to the real estate transaction underlying the offering. It means that in large part, the viability of the offering primarily depends on the credit quality of the sponsor and its financial entanglements not the real estate.

SOURCE OF REPAYMENT:

Due Diligence analysis must also focus on the sources of repayment to the investor and all the factors related to that objective. TIC Distributions have been sourced to operating income, debt, new investor capital, master lease payments, paid-in reserves, seller rental guarantees and financing, or a combination of those alternatives. It is paramount to evaluate each distribution source in the context of risk and return, and audited financials provide the source of verified numbers that can be spread and analyzed. Unfortunately most TIC sponsors offer nothing but out of date, unaudited financials at best and those are rarely analyzed adequately, if at all. Any unwillingness or excuse by a sponsor failing to obtain audited financials however, should be a Red Light, especially given the magnitude of the sponsor's equity-raising, fees, and markups when compared to the relatively modest cost of an audit.

Equally important, audits will also provide opinions on the adequacy of a sponsor's internal systems and controls that protect clients from defalcations, diversions, theft, commingling, self-dealing, collateral impairment, and the like. The issue is whether it is foreseeable given the operating environment, controls, systems, and management, that customer investments go unprotected and subject to default or diversion. The larger and more complex a sponsor grows, the greater the capacity for problems and the greater the need for adequate controls. This outcome has been born out in many failed TICs where the sponsor is found to have been engaged in Ponzi activities or other illegal or improper commingling or self dealing that would have been preventable or avoidable were adequate systems and controls demanded and implemented. It is true in many cases that defalcation, commingling, bankruptcy, theft, or diversion occurred after the investment, but the opportunities for abuse must be addressed by structuring investments with adequate controls that anticipate problems and dissuade and deter sponsors from jeopardizing the investors' capital through illegal or risky practices.

SALE LEASEBACK

A TIC investment structure is effectively a sale-leaseback of property. Sale leasebacks are normally common with high-credit-worthy tenants. For example, a company such as Kmart will sell its real estate to an investor who is induced by the credit worthiness of the seller to purchase the property and master lease it back to them. The investor avoids operational and market risks while Kmart gets the accounting benefit of an operating lease. The investor risk depends solely on Kmart's credit worthiness because the market risk is assumed by the master lessee. For the investor it makes no difference if the property is ever profitable, as the market risk remains at all times with Kmart.

TICs are sold as fixed income alternatives to passive income oriented investors with a tax benefit. They are functionally equivalent to sale leasebacks and consequently, Due Diligence must focus on the credit underwriting or ignore the principal risks. The real estate is no more than collateral to be liquidated at the end of the lease term.

MASTER LEASES:

One structure often used in TICs is a sponsor Master Lease of the entire property. The purpose of a Master Lease is to provide investors with a comfort level on the safety of their promised distributions. In a Master Lease, the Master Lessee (sponsor affiliate) agrees to absorb all the market and operational risks, and agrees to pay a fixed rent regardless of profitability or market conditions. In return, the investors pay on average 25%+/- in promotions. TIC investors are less interested in the real estate than they are with the income stream promised by the Master Lessee and the tax deferral. Here too, it is the Master Lessee that takes on the Market and Operational Risks not the investors who paid for that assurance with substantial fees and markups. Still, in most litigation Respondents typically rely on the "Market Loss" defense, when ironically, it is specifically the market risk that the Master Lessee contractually assumed from the investor. Finally, it is common to find covenants in the Loan Agreement making removal or replacement of the Master Lessee a condition of default and adding another entanglement.

Not all TICs are master leased to the sponsor, however, which makes evaluation of the credit risks somewhat more problematic. Once again the place to start a review is with the underlying loan agreement. Most Agreements contain references to sponsor guarantees if any, either in the definitions or within the body of the loan agreement. And virtually all Assumption Agreements make the investor a party to the guarantees, warranties, representations, and covenants. Often the lending bank has obtained from the sponsor and its affiliates signed and identified guarantees and commitments and the investors typically stand in the shoes of the sponsor/guarantor. Consequently reading and evaluating all the consents, guarantees, and covenants referenced in the Agreements is paramount for risk evaluation. Commonly many ancillary documents are not included in the PPM or other investment documentation and must be requested and reviewed in advance of recommending the investment. The lender may also have cross collateral agreements with the sponsor and require debt coverage ratios relating to the sponsor's total credit facilities that also are not transparent to the inexperienced due diligence investigator.

Where there is substantial reliance on the sponsor's financial strength, the credit worthiness of the sponsor must be evaluated professionally and that requires an audit with full credit analysis. Most brokerages marketing TICs lack capable credit-trained personnel and consequently their due diligence efforts are simply unable to identify or evaluate the actual credit risks in most NCI offerings, which as it turns out are substantial and consequential.

DISCLOSURE OF SECURITIES RISKS

TICs are typically offered in private placements with an accompanying memorandum offered under section 506 of Regulation D. Sections 502 and 506 of Regulation D require no disclosure to Accredited Investors, but full disclosure to non-accredited investors. Consequently, sponsors limit offers to qualified, Accredited Investors only. Most sponsors prepare substantial placement memoranda that identify the real estate in detail and which contain sections on property management, deal structure, risks, and the like. While most PPMs are amply caveated with disclaimers as required by securities laws, disclaimers do not suffice for analysis. No amount of disclosure can make an unsuitable recommendation appropriate, nor does Disclosure equate to Due Diligence. With TICs, there often are substantial credit issues and financial considerations that impact default outside of the TIC but which require evaluation regardless. It is Private Equity experience that is required to identify not only those risks, but to assess the probability of default and to determine the adequacy of the systems and controls prior to recommending an investment.

In general as with any private equity consideration, a BD has no choice but to reject any offering until the sponsor can comply with the audit request, implement effective systems and controls, and produce for analysis all relevant documents, guarantees, credit facilities, contracts, and offering materials that impact the loans and default risk. These are obvious Red Light concerns. Third party due diligence is also an option if the credit issues are adequately identified and addressed, but in my experience third party due diligence for TICs is simply inadequate, focusing instead on real estate risk, PPM disclosures, Tax Opinions, and valuation, none of which is relevant to the investor's primary risk, a decline of the sponsor's financial condition that triggers a default, or internal controls that are inadequate to protect investors.

SOURCE OF REPAYMENT

Theoretically, the source of repayment for both the debt and investor distributions should come solely from the net operating income of the underlying real estate, but that is a rarity indeed. TICs permit sponsors to borrow short term both for distributions and working capital secured by the real estate. That is problematic. Also, TIC sponsors often rely on the mark-ups and fees from new investor money on subsequent offerings, or seller guarantees with which to fund a substantial portion of its current cash flow including guarantee obligations if needed. Paid in reserves may also be used for distributions, essentially returning the investors money. Distributions funded out of paid-in reserves, seller guarantees, borrowings, or new investor capital distort the distribution curve and often mislead as to past performance. Without a complete cash flow analysis, hopefully based upon audited financials, no due diligence analyst is able to opine on the risk of the TIC. The outcome is foreseeable.

Most due diligence by Independent BD's marketing TICs typically fails to underwrite the systemic risk that arises when a sponsor and its subsidiaries are making identical commitments on a half billion dollar portfolio of properties over several years multiplying default risk and potentially placing financial stress on the sponsor. A default anywhere could arguably trigger a cascade of defaults across all the sponsor's credit relationships.

In my observation, the majority of TIC failures were a consequence of sponsor over-leveraging and financial stress, and not TIC property operations directly. Were the syndication market to cool down for any reason and new money no longer be available, a sponsor's cash flow and financial stability could deteriorate precipitously, triggering default under the loan covenants. The same could occur if the CMO market could no longer absorb the sponsor's mortgages and financing dried up. The probability of those occurring is foreseeable and only an appropriate analysis of the sponsor's cash flow can avoid taking excessive risk. This means that absent new money or substantial reinvestment by existing investors, many sponsors would not have the financial strength to meet their continuing obligations to existing investors and the bank and that spells disaster for investors regardless of the property's performance. These risks need to be underwritten properly on a Private Equity basis before recommending the investment.

The fact that substantial investor risk is tied directly to the sponsor's credit worthiness is the most overlooked aspect of TIC's. Instead, PPMs typically spend pages upon pages on appraisal information, occupancy rates, and cash flow projections, leaving the impression that a TIC is actually a direct Real Estate investment when substantively it is an extension of credit to a large integrated syndicator/sponsor collateralized by real property. *Howey* makes it clear that "it matters not whether shares in enterprise are evidenced by formal certificate or by nominal interests in physical assets employed in enterprise", e.g. real estate. The individual investor has no control over the asset whatsoever, does not arrange financing or negotiate loans, and is a passive investor with no intention of ever holding title without sponsor assurances. It compares in no way to a direct purchase of a fee simple interest in any property.

Under ideal conditions property operations should serve as the principal if not sole source of investor repayment. Were the sponsor's financials to decline significantly, it could trigger a default under the covenants of any loan agreement resulting in a foreclosure or forced liquidation and leaving investors with a significant loss under existing market conditions.

Unfortunately, Tenancy in Common is the worst, most onerous form of common ownership for syndication. Unlike limited partnerships or LLCs, TIC owners are personally liable to upwards of 34 other co-tenants and may very well be liable pro-rata for any co-tenant's default.

In some cases liability may not even be limited to the TIC interest. Without a general partner or managing member, property decisions must be by vote, usually unanimous, including decisions on the removal of property management, selling one's unit, etc. The bankruptcy of one TIC owner could trigger defaults on the loan Agreement and Assumption Agreement, partition is impossible without triggering a loan default, and the sponsor's property management is a condition of the loan, meaning the sponsor's control is seen as essential to underwriting and loan approval. There may also be broader credit facilities to the sponsor along with other guarantees and contractual agreements. Investors or their single purpose LLCs are primary on both the deed and the loan, which affects their credit directly and yet ties their fortunes to 34 other persons unknown and unfamiliar to the investor. In the context of 1031 tax deferral, a TIC structure suffers from complexity and restriction, which brings into question whether the tax deferral is balanced by risk. This too should be considered before making a recommendation.

VALUATION OF A TIC

TICs have three values:

1) *Notional Value* - the par value upon which distributions are calculated;
2) *Implied Value* - the value of a TIC unit as a pro rata allocation of the equity in the real estate without discount for market risk; and
3) *Market Value* - the amount one could expect to receive from a willing buyer in the marketplace.

Commonly in litigation, the parties offer real estate appraisals that establish Implied Value, but such calculations fail to discount for the inherent risks and complicating factors related to the market value of the TIC security. For example, even if the property were under contract for sale, the time to closing, the legal complications, the uncertainty about terms of the sale and payout, and the probability of the sale falling through over time would still demand a discount from Implied Value to calculate Market Value if there were no other considerations

It is the Market Value of the security by which to measure damages, which in many TIC cases is zero. The complex relationship of the parties to the TIC, the detailed agreements referenced in the loan agreement, the credit risk, the covenants, warranties, hold harmless agreements, and covenants are all impediments to valuation. For these reasons, Implied Value matters little to an individual TIC owner. Regardless of whether the property is appraised at $12 million or $16 million there is no effective way to realize any value in the market place or exercise any contractual right that could. Furthermore, continued ownership at Implied Value carries unacceptable risk and uncertainty.

By contrast, consider a junk bond selling at a substantial discount from par in order to induce investors with a return comparable to the risk. If the coupon on junk bonds is 6-7% but market risk adjusted return is 12%, the bond sells at a substantial discount to adjust for risk and to raise expected returns. The same principal applies to TICs.

Market valuation relies on the discount for uncertainties, illiquidity, encumbrances, and risk. By comparison, a portfolio of high yield instruments provides return, diversification, marketability, and liquidity. An after-tax junk bond portfolio can offer nearly the same level of return without the credit impairment and illiquidity, and without having to assume proportionately all the debt, covenants, and representations and warranties required for the purchase of 2.5-3 times more real estate than is required.

Despite the fact that Market Value of the TIC is the most relevant, it is routinely ignored in litigation in favor of Implied Value based upon the real estate. Mere valuation of the real estate equity unfortunately is a far cry from the Market Value of the TIC. The reasons are obvious. By the time the investor proceeds in litigation, the TIC is typically in default, even if the property is performing. A subsequent investor interested in purchasing the TIC has to go over the following hurdles:

1. Assumption of debt on loan with pro rata acceptance by the primary lender;
2. Impairment of credit;
3. Assumption of the sponsor's representations, warranties, covenants, and guarantees;
4. An uncertain outlook as to litigation and bankruptcy or insolvency;
5. Uncertainty as to when, if ever, proceeds will be available;
6. An insolvent sponsor;
7. The absence of adequate internal controls within the TIC management;
8. The execution of the Tenant In Common Agreement with 35 strangers and surrendering control; and
9. Forecasted returns that are inadequate compensation for the risk at par value.

CONCLUSION

There is a distinction between securities Disclosure and Due Diligence that often appears to go unrecognized within the independent brokerage community when analyzing and recommending Private Equity investments. That distinction is exemplified in TICs where BD due diligence focuses more on the securities disclosures than on competently assessing the risks of the offering prior to a recommendation.

Disclosure is neither a free pass from due diligence nor a defense to an unsuitable recommendation, even when that recommendation comes in the form of a placement memorandum to an accredited investor. No recommendation can be made without a reasonable basis and delivering a PPM to any investor without Reasonable Basis would violate NASD Rule 2310, and its successors FINRA Rules 2109 and 2111.

In short, no customer/investor assumes the risk that the broker simply does not know what he or she is talking about.

- Due Diligence is the duty of the brokerage firm prior to making a recommendation, not the investor after the recommendation.

- Due Diligence is not a matter of "good faith," but of competence in risk assessment
- No amount of disclosure will make an unsuitable recommendation suitable.
- Good faith is not a defense to negligence or to a breach of contract.
- Private equity investors are entitled to expect competence, especially when brokerage firm expertise is reasonably relied upon.

TICs commonly wind up in default even when the property is performing. The reasons for a default varies, but besides market conditions, sponsor covenant or guarantee breaches, poor management, commingling of asset, and deferred maintenance could all be the precipitating factors that impact the sponsor's performance and financial condition. Where the property is in foreclosure, it is essential to review the foreclosure complaint or bankruptcy filings to determine if market conditions or other avoidable factors were to blame. It would be unconscionable if adequate internal systems and controls could have prevented loss or defalcation and protected assets from creditors and litigants, but were never properly instituted. When audits and proper credit analyses could have shown overstretched and overcommitted sponsors, insolvency and default become a foreseeable risk with avoidable consequence.

END NOTES:

1. As an analyst I have yet to find any Reasonable Basis to recommend a leveraged syndicated TIC to any investor. The risks are too great, projected returns are too small, and the tax deferral illusory.
2. My focus in this article has been on Private Equity due diligence as the first line of analysis. Collateral analysis is essential, but resolving the credit issues comes first.
3. TIC real estate serves principally as collateral securing credit extensions to the sponsor by the investor. The real estate purchased is a Capital Contribution, no more, no less, and carries none of the attributes of fee simple interests.
4. Most TICs are financing transactions, sale leasebacks, not traditional real estate deals. Proper credit analysis cannot be ignored.

Recommended: If you want to familiarize yourself with credit issues, I would recommend the Office of the Comptroller of the Currency (OCC) Handbook on "Rating Credit Risk." It can be downloaded free.[2]

Due Diligence Documents: Pre Recommendation

a. Assignments and Investor consents
b. Loan Agreement
c. Loan Assumption Agreement
d. Lender's Appraisal
e. Management Agreement
f. Master Lease
g. Mortgage
h. Notes executed
i. PPM
j. Purchase Agreement
k. sponsor's Financial Statements
l. sponsor's Guarantees
m. Tenant In Common Agreement

Litigation Analysis Documents: Post Investment:

n. Foreclosure complaint
o. Bankruptcy findings
p. Title search

2. See Examining Credit Risk, Page 21-28, OCC Handbook, "Rating Credit Risk," April 2001.

Notes & Observations

THE PRIORITY SENIOR SECURED INCOME FUND

Tim Dulaney, PhD, Tim Husson, PhD,
and Craig McCann, PhD, CFA[1]

The Priority Senior Secured Income Fund (PSSI) is the first registered investment company that invests primarily in leveraged loans and CLOs. Unlike the mutual funds with which most retail investors are familiar, PSSI investors are not able to redeem shares daily at PSSI's net asset value. In addition, PSSI is not listed on an exchange and traded like a closed-end fund and so investors will have neither an observable market price nor any opportunity to sell shares in the secondary market.

PSSI, like other non-traded investments, is an extremely high cost offering. Its upfront fees of at least 9% and annual fees of over 8%, in addition to the high cost of its underlying structured finance investments, require persistently high returns on its portfolio to generate a positive internal rate of return for fund investors. The increased risks borne by investors to generate that return are complex and are not likely to be appreciated by brokers or retail investors.

I. INTRODUCTION

Over the last decade there has been a growing number of "non-traded" investments, including non-traded real estate investment trusts (REITs) and business development companies (BDCs). Non-traded investments straddle the line between exchange-traded REITs and BDCs and private placement securities, such as hedge funds and limited partnerships. Non-traded investments are registered as investment companies with the SEC, and their shares can therefore be sold to retail investors, but are not listed on any public exchange. Non-traded REITs and BDCs are controversial: they

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haven't provided accurate mark-to-market values, are highly illiquid, charge high upfront fees and contain numerous conflicts of interest.

On May 9, 2013, one of the largest sponsors of non-traded REITs (Behringer Harvard) and the manager of one of the largest publicly traded BDCs (Prospect Capital Management) announced the initial public offering for their new joint-effort Priority Senior Secured Income Fund (PSSI).[2] PSSI has many of the controversial features of non-traded REITs and BDCs, including high upfront fees, lack of price transparency, and lack of liquidity. In addition, PSSI includes a remarkable 2/20 ongoing management fee, which is common in hedge funds but not in retail investments.

PSSI is a non-traded closed-end fund that will invest approximately 80% of its assets in senior secured loans, either directly or through junior and equity tranches of collateralized loan obligations (CLOs). Senior secured loans, also known as "leveraged loans," are private loans made to medium to large below investment grade companies. CLOs are complex asset-backed securities built upon portfolios of such loans, and the equity and junior tranches are typically the most risky class of CLO investments. While such a strategy would not be suitable for anyone without significant investment expertise, shares of PSSI are currently being sold through brokers to retail investors.

In this paper, we describe the structure and objectives of PSSI and illustrate its excessive costs and uncompensated risks. We develop an analysis that suggests PSSI will have to achieve 8.4% returns on its underlying investments each year to overcome the draconian annual fees, and that such returns are not characteristic of the senior secured loan market over long periods of time. Therefore, in order for PSSI to generate positive returns to investors, it must use leverage or other risky strategies (through the use of high-risk tranches of CLOs) which may not be understood by brokers or suitable for retail investors.

II. THE ISSUERS

Behringer Harvard is a Dallas-based issuer, manager, and distributer of more than $6 billion in equity real estate limited partnerships and non-traded

2. The initial offering document dated May 9, 2013 (accessed May 23, 2013) can be found at: http://www.sec.gov/Archives/edgar/data/1554625/000104746913005806/a2214895z497.htm; references to this document will follow the abbreviation "PSSI PPM pg. ###" where ### is the page number.

REITs.[3] Its non-traded REITs include Behringer Harvard REIT I, which is the subject of a class action suit alleging that the REIT misrepresented its share value to investors.[4] As we have discussed in a white paper on non-traded REITs, these investments were not required to inform investors of changes in the values of their underlying assets (and thus the value of the investors' shares) for many years. Instead, the value of non-traded REIT shares was reported at historical cost, even during the precipitous decline in real estate values in 2008.[5] In fact, this lack of price transparency was highlighted in marketing materials as an advantage of non-traded investments (a "lack of volatility"), until such claims were specifically prohibited by the SEC.[6]

The SEC has since required non-traded REITs' management to report estimated per share net asset values. While these values are still not market prices and allow significant discretion, the per share estimates for some Behringer Harvard non-traded REITs show significant declines in value from their offering prices. For example, Behringer Harvard REIT I has most recently reported a per share value of $4.64, having been sold at $10 as recently as 2009.[7] Likewise, Behringer Harvard Opportunity REIT I, which was also sold at $10 per share, has a current estimated value of $3.58.[8] Many of the issues and criticisms that have arisen in regards to non-traded REITs also apply to PSSI, which also will not have an observable market price.

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3. Press Release dated July 31, 2012. http://pressroom.behringerharvard.com/2012-07-31-Behringer-Harvard-and-Prospect-Capital-Management-Announce-Joint-Venture-to-Launch-Alternative-Investment-Programs.

4. Hohenstein v. Behringer Harvard REIT I, Texas Northern district court, filed Septermber 17, 2012.

5. Husson, McCann, and Taveras (2012). "A Non-Traded REITs Primer." Available at www.slcg.com/research.php.

6. SEC Corporate Finance Disclosure Guidance: Topic No. 3 dated December 19, 2011. Available at http://www.sec.gov/divisions/corpfin/guidance/cfguidance-topic3.htm.

7. Behringer Harvard REIT I 10-K for year ended December 31, 2012. http://www.sec.gov/Archives/edgar/data/1176373/000117637313000003/behringerharvardreitiinc10.htm.

8. Behringer Harvard Opportunity REIT I 10-K for year ended December 31, 2012. http://www.sec.gov/Archives/edgar/data/1308711/000104746913003591/a2213978z10-k.htm.

Prospect Capital Management is the investment advisor for Prospect Capital Corporation (ticker: PSEC), one of the largest traded BDCs. Prospect Capital Corporation is notable for its relatively large portfolio of $214.6 million in equity and $27.3 million in junior debt tranches of CLOs as of June 30, 2012.[9] Prospect Capital Management's role in PSSI will be to "lead the investment strategy for each investment program that the partners co-advise." Behringer Harvard "will lead capital-raising for such alternative investment programs through its relationships with a wide network of independent financial advisors."

III. LEVERAGED LOANS

Leveraged loans are loans issued to below investment grade corporations.[10] The loans are frequently large and extended by a syndicate of lenders intending to re-sell participations in the loans to other banks and institutional investors including hedge funds, mutual funds and CLO trusts.

Standard and Poor's (S&P) and the Loan Syndications and Trading Association (LSTA) produce benchmark indices of the market value of leveraged loans. Figure 1 plots the price and total return indexes from 2008 to 2013 for the largest loans of the type securitized into CLOs.[11] The index level declined substantially in late 2008 and has rebounded since. This leveraged loan market pattern coincides with the high yield bond market decline and rebound.[12] Notably, the average annual return of the total return

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9. Prospect Capital Corporation 10-K for fiscal year ended June 30, 2012. http://www.sec.gov/Archives/edgar/data/1287032/000104746912008467/a2210797z 10-k.htm. According to this 10-K, the maximum portfolio allocation to Senior Secured Loans and CLO assets is limited to 30%.

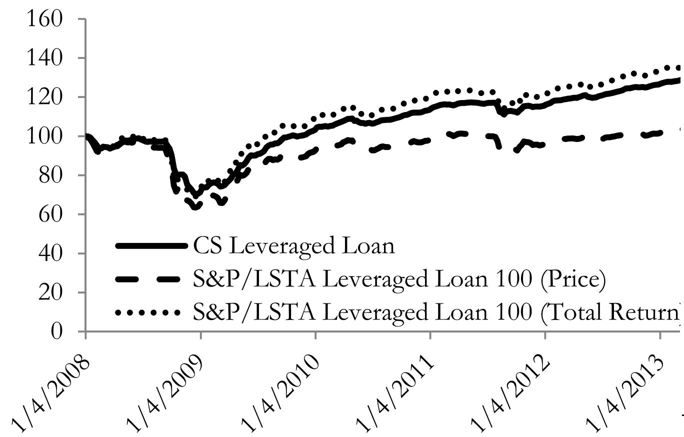
10. The qualifier "leveraged" might just as well be replaced with "high-yield" but we follow industry convention and refer to them as leveraged loans. For an extended discussion of this market please see Antczak, Lucas and Fabozzi [2009], Tavakoli [2008] and Standard and Poor's [2011].

11.www.standardandpoors.com/indices/sp-lsta-leverage-loan-100-index/en/us/?indexId=SPFI--LL--USD----T-------.

12. The decline in the market value of leveraged loans in July 2007 was as a result of credit risk not liquidity risk as credit spreads on these loans increased dramatically in July 2007. See slide 23 of www.lsta.org/assets/0/190/9DA26E16-92D9-4420-B866-08D22D896ACB.pdf.

index is only 6% from 2002-2012, suggesting that PSSI may not be able to clear its 8.4% break-even rate of return in most years investing solely in leveraged loans. Those returns are presented in Figure 1.

Figure 1: Leveraged Loan Market Indexes



Year	Total Return
2002	-0.09%
2003	9.85%
2004	5.01%
2005	5.00%
2006	6.60%
2007	1.65%
2008	-29.41%
2009	45.35%
2010	10.56%
2011	1.82%
2012	9.39%
Mean	5.98%

IV. COLLATERALIZED LOAN OBLIGATIONS

Collateralized Loan Obligations (CLOs) are securities issued by a trust which invests in leveraged loans. CLO trusts package exposure to the underlying leveraged loans into slices (called 'tranches') that represent varying degrees of risk. The leveraged loans serving as collateral for the CLO produce cash flows that used to pay the CLO investors. To illustrate the properties of CLO's, we will use the *Madison Park Funding IX, Ltd. CLO* ("Madison Park") and the *Halcyon Loan Advisors Funding 2012-1 Ltd. CLO* ("Halcyon"). We choose these as our examples because Prospect Capital Corporation invested in these two CLOs and PSSI will likely make similar investments.[13]

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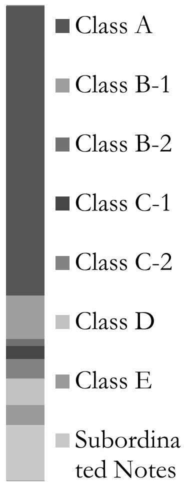
13. Prospect Capital Corporation 10-K for fiscal year ended June 30, 2012. http://www.sec.gov/Archives/edgar/data/1287032/000104746912008467/a2210797z 10-k.htm. Prospect Capital Corporation purchased 51% of the subordinated notes in Madison Park on June 22, 2012 and purchased 62.9% of the subordinated notes in Halcyon on August 6, 2012.

The Madison Park CLO was a $523 million deal at issuance with several tranches paying fixed interest, floating interest based on LIBOR or residual interest (in the case of the subordinated notes). Figure 2 shows the capital structure of the Madison Park CLO.

Figure 2: Capital Structure of Madison Park Funding IX, Ltd. CLO



Tranche	Face Value	Interest Rate	S&P Rating
Class A	$319,000,000	LIBOR+1.48%	AAA
Class B-1	$48,000,000	LIBOR+2.70%	AA
Class B-2	$8,000,000	4.55%	AA
Class C-1	$14,000,000	LIBOR+3.60%	A
Class C-2	$22,000,000	6.00%	A
Class D	$29,000,000	LIBOR+4.35%	BBB
Class E	$22,000,000	LIBOR+5.25%	BB
Subordinated Notes	$61,000,000		
	$523,000,000		

At the top of the Madison Park capital structure are the Class A notes. These notes have the first priority in terms of interest payments and principal repayment. Since these investors take priority over all others, this tranche is the least risky. At the bottom of the capital structure is the equity tranche, referred to in this deal as the Subordinated Notes. Capital invested in the subordinated notes is unsecured, subordinated and highly leveraged.

Investors in the Madison Park CLO are paid interest quarterly from the interest proceeds of the collateral, after base management fees, hedging costs and expenses are paid. The remaining proceeds are then used to pay accrued and unpaid interest to the Class A investors, then the Class B investors. At this point, the first "coverage test" is applied. If the test is passed, the remaining proceeds are used to pay Class C investors. Another coverage test is then applied. Remaining proceeds then pay the Class D investors, another coverage test is applied, then the Class E investors and a final coverage test is applied. Table 1 summarizes the criteria for the coverage tests.

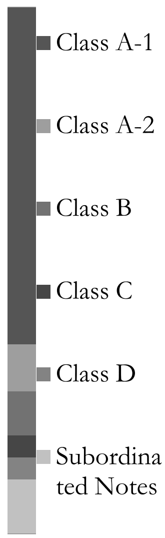
Table 1: Summary of Coverage Tests for Madison Park Funding IX, Ltd. CLO

Tranche	Required Overcollateralization Ratio	Required Interest Coverage Ratio
A/B	123.3%	120.0%
C	113.2%	115.0%
D	107.1%	107.5%
E	103.2%	102.5%

In the first few years of the deal, if the senior notes are not sufficiently collateralized then the remaining interest proceeds will be used to increase the collateralization of the senior notes. The subordinated management fee, administrative expenses and addition hedging costs are deducted from the remaining proceeds. If any proceeds remain, the subordinated notes may now be paid interest. If the annualized internal rate of return of the subordinated notes increases beyond 12%, an incentive management fee is then deducted from the remaining proceeds. Any proceeds remaining are paid to the subordinated notes. Principal repayment follows a similar payment waterfall where, again, the subordinated notes receive the leftovers resulting from the payment of fees, expenses and the senior tranches – if any remain.

The Halcyon CLO was a $359 million deal at issuance with several tranches paying floating interest based on LIBOR or residual interest (in the case of the subordinated notes). Figure 3 shows the capital structure of the Halcyon CLO.

Figure 3: Capital Structure of Halcyon Loan Advisors Funding 2012-1 Ltd. CLO



Tranche	Face Value	Interest Rate	S&P Rating
Class A-1	$230,000,000	LIBOR+1.50%	AAA
Class A-2	$32,000,000	LIBOR+2.50%	AA
Class B	$30,000,000	LIBOR+3.00%	A
Class C	$15,000,000	LIBOR+5.25%	BBB
Class D	$15,000,000	LIBOR+5.50%	BB
Subordinated Notes	$36,875,000		
	$358,875,000		

The payment waterfall for the Halcyon CLO is similar to that of the Madison Park CLO waterfall with a few exceptions. First, the incentive management fee is applicable when the subordinated notes realize an internal rate of return of 20%. In addition, the level of overcollateralization and interest coverage required to pass the coverage tests is different. Table 2 summarizes the criteria for passage of coverage tests in the Halcyon CLO.

Table 2: Summary of Coverage Tests for Halcyon Loan Advisors Funding 2012-1 Ltd. CLO

Tranche	Required Overcollateralization Ratio	Required Interest Coverage Ratio
A	123.6%	120.0%
B	111.9%	115.0%
C	108.0%	110.0%
D	104.7%	105.0%

The leveraged exposure to the underlying leveraged loans in each of these CLOs can be approximated by taking the ratio of total invested capital to the liquidation preference of the equity tranche. In the case of the Madison Park CLO, the leverage is approximately 8.6 and, in the case of the Halcyon CLO, the leverage is approximately 9.7. If the underlying collateral is adversely affected by market conditions, the coverage tests may begin to fail and at that point the likelihood of the equity tranche receiving any payments through the deal is greatly diminished.

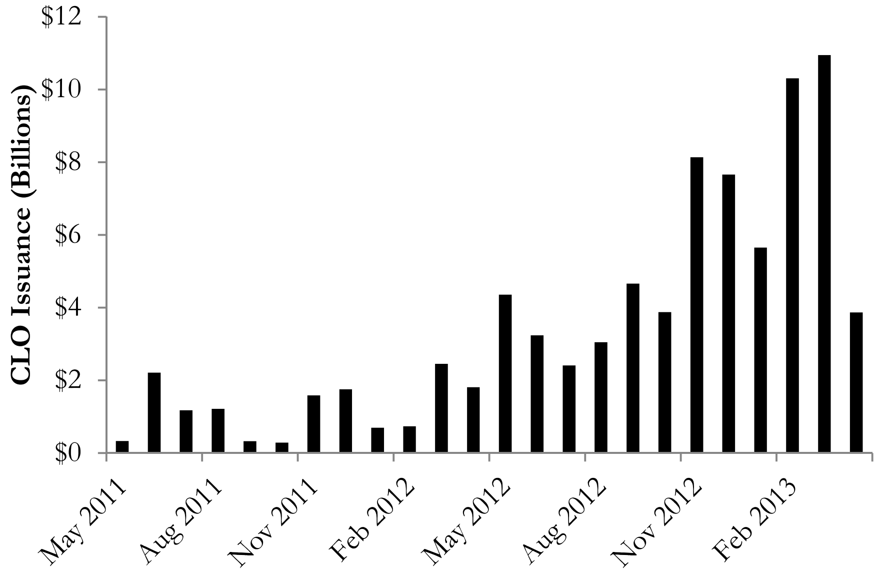
V. CURRENT CLO MARKET AND IMPLICATIONS

While large amounts of CLO assets were issued in the run-up to the financial crisis of 2008, issuance declined to near zero in subsequent years. Mutual funds and exchange traded funds (ETFs) also invested in leveraged loans are competing with CLOs for the same underlying assets.[14] Although still small compared to the levels seen prior to the financial crisis, the issuance of CLOs has grown in the past 18 months. CLO issuance increased dramatically in the second half of March ahead of the April 1, 2013 effective date of a new FDIC rule that will increase regulatory capital requirements for banks investing higher risk securitizations.[15]

14. Leveraged loan ETFs include the PowerShares Senior Loan Portfolio (BKLN) and the SPDR Blackstone/GSO Senior Loan ETF (SRLN), with a combined $4.5 billion in assets. Leveraged loan mutual funds include the Invesco Senior Loan fund (VSLAX) and the PIMCO Senior Floating Rate Fund, amongst many others.

15. 76 Federal Register 10672.

Figure 4: Recent Volume of CLO Issuances[16]



PSSI's prospectus states that during the investment period, the proceeds will be invested "cash, cash equivalents, U.S. government securities, money market funds, repurchase agreements and high-quality debt instruments maturing in one year or less from the time of investment."[17] Because the fees on PSSI are much higher than the yields on such instruments, the net asset value on the fund will likely decrease substantially during this period. The prospectus also states that regular cash distributions are to be determined quarterly and paid monthly starting within one calendar year of the completion of the minimum offering.[18] Any distributions made before significant CLO assets could be purchased would either be a return of investor principal or proceeds from borrowing.

Notably, the PSSI prospectus makes the following claim regarding CLO assets and their relative risk and return tradeoff:

16. Bloomberg Leveraged Finance Brief, May 2, 2013.

17. PSSI PPM pg. 13.

18. PSSI PPM pg. 17.

> The most junior tranches of all U.S. CLOs (typically referred to as CLO equity tranches) have delivered nearly 21% annual average cash yields since January 2003, as shown in the chart below, and, according to Moody's CLO Interest (July 2012) no CLO issued since 2002 has suffered a principal loss on a rated debt tranche (including during the credit crisis).[19]

Many investors will not realize that while both statements may be technically accurate, they are misleading with respect to the PSSI portfolio.

First, PSSI will invest mainly in equity tranches. Most US CLO equity tranches are *unrated* and therefore the fact that rated tranches have not suffered principal losses is irrelevant to assessing the riskiness of PSSI. Second, equity tranches are typically not secured, and technically have no principal amount that could be written down *even if* its mark-to-market value of the tranche has declined. Put differently, CLOs are often under no obligation to return the amount invested in an equity tranche, only income remaining after paying all other tranches (if any). In a similar sense, most distressed bonds do not suffer principal losses as defined in the context of a CLO, even though there is a significant chance an investor may lose some of their investment. The important point is that equity and junior CLO tranches are typically very highly leveraged and "are subject to a higher risk of total loss."[20]

19. PSSI PPM pg. 61.

20. PSSI PPM pg. 49.

VI. FEES AND EXPENSES

PSSI embeds significant fees, both upfront and on an annual basis, summarized in Table 3 below.[21]

Table 3: Upfront Fees and Annual Expenses of the Priority Senior Secured Income Fund.

Stockholder Transaction Expenses (Upfront Fees)	
Selling Concession	6%
Dealer Manager Fee	2%
Other Expenses	1.5%-5%
Total upfront expense:	9.5%-13%
Annual Expenses	
Management Fee	2%
Acquired Fund Fees and Expenses	4.75%
Other Expenses	1.65%
Total annual expense:	8.4%

There are additional expenses not included in Table 3. An example is the incentive fee, which is contingent upon the performance of the underlying assets exceeding the fixed fees for the fund by an amount that exceeds PSSI's hurdle rate of 6% annually. In addition, performance fees charged on the underlying assets would also increase annual expenses depending on returns.

Expenses are increased through the use of leverage. For example, if PSSI's Advisor were to borrow 10% of fund assets, this would increase the base management fee by 10%. This borrowing would also incur interest costs that are not included in the annual expense estimates. If the interest rate is 5%, these two expenses alone would increase the annual expenses to over 9%.

To illustrate the detrimental effect of these fees on investors, we assume that the fund invests all net proceeds into CLOs with uniform base

21. We use the "Fees and Expenses" table (PSSI PPM pg. 19).

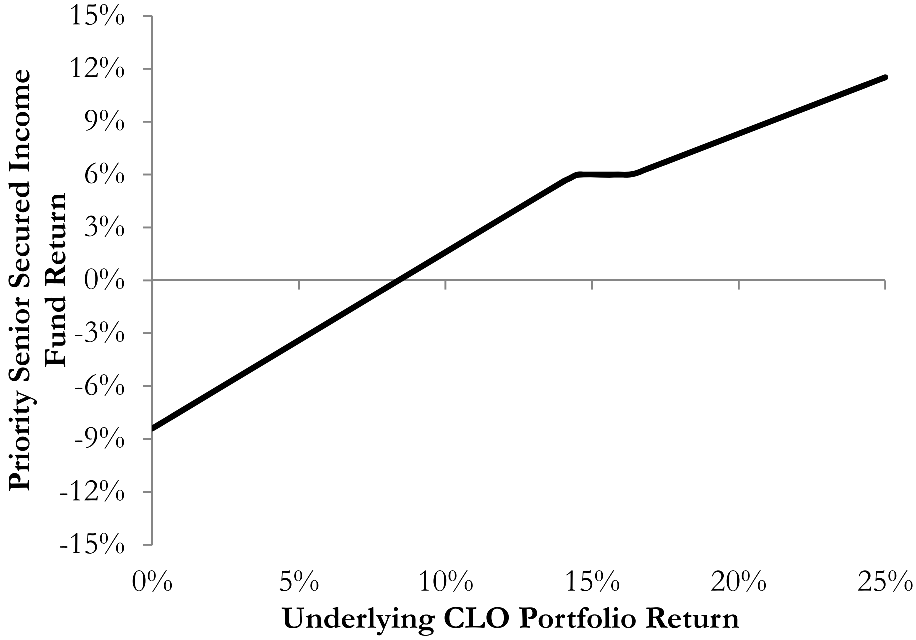
expenses.[22] We assume that incentive fees for the underlying CLOs are also uniform in their structure and that fees are based upon a hurdle rate of 14% and at a marginal rate of 20%.[23]

In Figure 5, we plot the annualized return an investor realizes as a function of the underlying CLO portfolio return. Due to the significant annual fees, the investor does not realize positive returns unless CLO assets return at least 8.4%. As the level of CLO asset returns increases, the net return also increases until the 6% hurdle rate is reached (CLO return of about 14.5%) for PSSI's incentive fee. After that point, the returns do not increase again until the net return reaches approximately 16%. When the investor returns do increase again, they do so at a slower pace as a result of the performance fee structure of PSSI. These annual fees make it more difficult for the investor to recoup the upfront fees charged by PSSI.

22. This is not an unreasonable assumption given the following quote: "The foregoing estimate assumes that 95% of the net proceeds of this offering are invested in CLOs" from PSSI PPM pg. 21.

23. This is consistent with Footnote (9) on PSSI PPM pg. 21 and in line with the Madison Park CLO and Halcyon CLO discussed above.

Figure 5: Priority Senior Secured Income Fund net return as a function of the return of the underlying CLO portfolio gross returns.



If the underlying CLO investments return 10% a year, every year, it would take more than 6 years for PSSI to return the investors' initial investment after the fees of the underlying CLOs are taken and PSSI fees are applied. If the underlying equity CLO tranches return 20% a year, it would take about 2.5 years to realize a 4% internal rate of return. Table 4 summarizes the result of these calculations for various levels of underlying CLO equity tranche returns and various internal rates of return.

Table 4: Number of Years Required to Obtain an Internal Rate of Return Given a Level of Underlying Asset Returns (NP = Not possible).

		Fund Asset Return			
		10%	15%	20%	25%
Internal Rate of Return	0%	6.3	1.7	1.2	0.9
	2%	NP	2.6	1.7	1.1
	4%	NP	5.2	2.5	1.4
	6%	NP	NP	4.6	2.0

Such high, consistent returns may not be possible given the conditions in the leveraged loan market described above. In fact, in order for PSSI to return 6% per year to investors in two years—the average total return of the S&P/LSTA Leveraged Loan 100 index—the underlying assets would have to return at least 25% according to Table 4. This suggests that PSSI would have to leverage their exposure to leveraged loans, likely through the use of risky first-loss tranches of CLOs.

VII. LIQUIDITY AND TRANSPARENCY

Shares of PSSI will likely be very illiquid. The prospectus states that "you should not expect to be able to sell your shares regardless of how we perform" and "[i]f you are able to sell your shares, you will likely receive less than your purchase price."[24] On the other hand, the issuers intend to implement a limited share repurchase program in which the total amount of shares that can be repurchased is limited to 20% of the weighted-average shares outstanding.[25]

In addition, there will be limited price transparency for the underlying assets. If there is no secondary market data available for the underlying CLO assets, the fair value of the securities in the PSSI's portfolio will be estimated. PSEC, Priority Capital Management's traded BDC, uses the discounted cash flow model to estimate the fair value of their CLO assets. Presumably, they would use similar approaches to value PSSI's assets as well. However, like other non-traded investments, they may not report this value to investors, either at the time of purchase or on an ongoing basis, and the price investors pay will likely not be based on this analysis

VIII. CONCLUSIONS

The Priority Senior Secured Income Fund is the first so-called "40 Act" fund that will primarily invest in leveraged loans and CLOs. PSSI, like other non-traded investments, is an extremely high cost, illiquid, and risky offering. Its upfront fees (at over 9%) rival that of non-traded REITs, while

24. PSSI PPM pg. 1.

25. PSSI PPM pg. 13.

its ongoing fees are very similar to the 2/20 fee structure employed by hedge funds, in addition to the high cost of its underlying structured finance investments. PSSI will not be listed on a public exchange and therefore have no observable market price nor any opportunity to sell shares in the secondary market. In addition, its portfolio of leveraged loans and junior and equity tranche CLO assets must be highly leveraged to overcome the onerous fees and expenses.

The question for investors is whether the enormous fees are worth the increased risk that comes from that leverage, as well as the risks inherent to equity and junior tranches of CLOs. Given that the CLO market consists of mostly institutional investors, it is unclear whether retail investors or their brokers could collect sufficient market data to accurately answer that question. To our knowledge, there are currently no publicly available indexes that track equity or junior mezzanine tranche CLO returns, and most market research and analysis of this type of security is not publicly available. Therefore it is unclear whether PSSI would be suitable for retail investors, even if they were willing to accept the enormous fees embedded in this product.

FINDING FAIRINESS IN ARBITRATION: A DISCUSSION ABOUT WHETHER SECURITIES CLASS ACTION WAIVERS SHOULD BE PROHIBITED

Thomas J. Greene†

I. INTRODUCTION

Since 2007, broker dealers have become increasingly more closely regulated, but there is still much room for improvement. Self Regulatory Organizations ("SROs") such as the Financial Industry Regulatory Authority ("FINRA") are largely responsible for implementing this regulation. FINRA, Wall Street's watchdog, has dedicated itself to protecting investors and establishing market integrity.[1] Nevertheless, investors are defrauded regularly and when rules are broken, investors often sue. Therefore, companies attempt to limit their prospective liability. Recently however, one company went so far as to prohibit investors from pursuing a legal course of action otherwise permitted by FINRA rules.

In an effort to shield itself from claims that could turn a $30 dispute into a $30 million dollar lawsuit, Charles Schwab & Co., Inc. (hereinafter "Schwab") amended its account agreement by adding a class action waiver.[2] This revised account agreement was delivered to nearly seven million investors during September, 2011, and since that date, Schwab has continued to provide new customers with a copy of the revised agreement.[3] Following a review of Schwab's class action waiver, FINRA informed Schwab that it

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1. FINRA's Mission Statement, http://www.finra.org/AboutFINRA/ (last visited Sep. 19, 2012).

2. *Charles Schwab & Co. v. FINRA*, 2012 WL 1859030 at *3 (N.D. Cal. 2012).

3. *Id*.

would seek disciplinary sanctions against it.[4] Subsequently, Schwab filed for declaratory and injunctive relief.[5] FINRA believes that its rules preclude Schwab from inserting a class action waiver in its pre-dispute arbitration agreement.[6] Schwab's position is that FINRA rules cannot reasonably be interpreted to prohibit class action waivers,[7] and, even if FINRA's interpretation is correct, Schwab relies upon recent Supreme Court decisions interpreting the Federal Arbitration Act of 1925 ("FAA"), which Schwab claims prevents FINRA from enforcing its own rule.[8]

There is plenty at stake for all parties involved. The absence of class action procedures will leave many investors without a legal process to recoup their losses because lawyers typically do not take on small complaints that guarantee little to no recovery.[9] Companies like Schwab however, seek to shield themselves from small claims turning into multimillion dollar claims. A Schwab win would likely lead other FINRA members to change their arbitration agreements. This could potentially weaken FINRA's hold over its own enforcement process, and leave the investing public without a viable legal recourse. As a result, this case raises significant investor protection issues. Unfortunately the case, *Charles Schwab v. FINRA*, was not decided on the merits. Instead, a magistrate judge held that Schwab did not exhaust its administrative remedies. Therefore, Schwab must proceed under FINRA's disciplinary process before the court will consider any of these issues.[10]

This article examines class action waivers that are included within pre-dispute arbitration agreements, and discusses the applicability of court decisions on this issue in securities disputes. Part II discusses the relevant case law, which has addressed the issue of the enforceability of class action waivers when they are contained within pre-dispute arbitration clauses. Part

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4. Complaint for Declaratory and Preliminary and Permanent Relief at 1, Charles Schwab v. FINRA, 2012 WL 1859030 (N.D. Cal. Feb. 1, 2012), (No.CV12-0518) 2012 WL 336121 at * 1.

5. Complaint, *supra* note 4, at 1.

6. FINRA's Reply in Support of Motion to Dismiss at 1, Charles Schwab v. FINRA, 2012 WL 1859030 (N.D. Cal. Mar. 14, 2012), (No. CV12-0518) 2012 WL 1408605 at *1.

7. Complaint, *supra* note 4, ¶ 32.

8. Complaint, *supra* note 4, ¶ 39.

9. *See AT&T Mobility v. Concepcion*, 131 S. Ct. 1740, 1760, 179 L. Ed. 2d 742 (2011) (Breyer, J., dissenting).

10. *Schwab*, 2012 WL 1859030 at *16.

III provides an overview of the recently decided case, *Charles Schwab v. FINRA*, and the disposition and reasoning of the District Court. Part IV analyzes the Supreme Court's decision and dissent in the landmark case of *AT&T Mobility v. Concepcion.* Part V examines the future of the arbitration process and suggests an outcome for *Charles Schwab v. FINRA* that will best protect investor's rights.

II. THE ENFORCEABILITY OF CLASS ACTION WAIVERS IN COURT

Enacted in 1925 in response to judicial hostility towards arbitration, the FAA establishes a strong federal policy favoring arbitration and the fundamental principle that arbitration is a matter of contract.[11] The FAA dictates are broad, encompassing any "contract evidencing a transaction involving commerce to settle by arbitration a controversy thereafter arising out of such contract or transaction" and provides that arbitration agreements "shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract."[12]

The Supreme Court has reviewed the FAA hundreds of times in its history, but the overall purpose of the Act is still disputed today. The policy arguments are addressed throughout the balance of this article. The underlying purpose of the FAA is the starting point for determining whether class action waivers in pre-dispute arbitration agreements are and should be enforceable.

Before the Supreme Court decided *Shearson v. McMahon* in 1987, brokerage firms could not compel their customers to arbitrate federal law claims. Therefore, investors could have filed a claim in court if they believed court-litigation better served their interests.[13] Today, investors generally do not have a choice. In *Shearson*, the Supreme Court announced a strong federal policy preference for arbitration and held that all claims brought by customers against their brokers were arbitrable under pre-dispute arbitration

11. *Concepcion*, 131 S.Ct. at 1745 (quoting *Moses H. Cone Mem'l Hosp. v. Mercury Const. Corp.*, 460 U.S. 1, (1983); *Rent-A-Center, Inc. v. Jackson*, 130 S.Ct. 2772, 2776 (2010)).

12. 9 U.S.C. § 2.

13. Seth Lipner, *Should Securities Arbitration be Mandatory?*, Forbes.com (Jun. 29, 2009, 4:00 PM), http://www.forbes.com/2009/06/29/lipner-mandatory-arbitration-intelligent-investing-consumer-choice.html.

agreements.[14] The Court held that Congress did not intend for any section of the Securities Exchange Act of 1934 to preclude enforcement of pre-dispute arbitration agreements.[15] Since then, "[s]ecurity firms uniformly require that customers sign arbitration agreements, and with the courts enforcing them [investors have] no choice at all."[16] The lack of choices remaining for aggrieved investors following the *Shearson* decision created a system later coined "mandatory arbitration."[17]

Since the *Shearson* decision, brokerage firms, as well as other types of companies, have continued to take advantage of the FAA's broad language and added pre-dispute arbitration provisions to any "contract evidencing a transaction involving commerce."[18] Brokerage firms have been limitedin the scope of their pre-dispute arbitration agreements because of SRO rules.[19] However, companies in other industries have modified their customer agreements to include broad class action waivers, waiving both class arbitration and judicial class actions. Those companies effectively compel their customers to arbitrate while prohibiting class arbitration, consolidation of claims in arbitration, and judicial class actions. As a result, the investor's right to litigate claims is restricted, unless the investor wants to spend money and effort litigating a small claim.

A. Discover Bank v. Superior Court – 2005

Because consumers are in a sense "stuck," they have taken their concerns to the courts. One of the first companies forced to defend its class action waiver was Discover Bank (hereinafter "Discover").[20] In August 2001, a customer filed a putative class action suit in court against Discover for

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14. *Shearson/American Express v. McMahon*, 482 U.S. 220, 227 (1987).

15. *Shearson*, 482 U.S. at 238.

16. Lipner, *supra* note 13.

17. *Id*.

18. 9 U.S.C. § 1.

19. For example, FINRA Rule 2268 tells brokerage firms what pre-dispute arbitration agreements cannot contain.

20. Most credit cards associated with the Discover brand are issued by Discover Bank.

breach of contract and violation of the Delaware Consumer Fraud Act.[21] The complaint alleged that Discover imposed a late fee of $29 on credit card payments that were received on the payment due date, but after Discover's undisclosed 1:00 p.m. "cut off time."[22] Two years prior to filing this complaint, however, Discover added an arbitration clause to its existing credit card holder agreement.[23] In addition to compelling arbitration, the clause precluded both sides from participating in classwide arbitration or consolidating claims: "[N]either you nor we shall be entitled to join or consolidate claims in arbitration by or against other cardmembers with respect to other accounts, or arbitrate any claim as a representative or member of a class or in a private attorney general capacity."[24] Accordingly, Discover moved to compel arbitration on an individual basis and dismiss the class action.[25]

The plaintiff claimed that class action waivers in consumer contracts should be invalidated as unconscionable under California consumer law.[26] California Civil Code § 1668 states: "[a]ll contracts which have for their object, directly or indirectly, to *exempt anyone from responsibility for his own fraud*, or willful injury to the person or property of another, or violation of law, whether willful or negligent, are against the policy of the law."[27] In short, the plaintiff asserted that Discover's class action waiver was meant to prevent customers from seeking redress for relatively small amounts of money which he alleged is against California policy. Discover argued that the FAA required the enforcement of the arbitration agreement including its class action waiver.[28] The California Supreme Court rejected Discover's argument and held that the agreement was unconscionable.[29] The court's

21. *Discover Bank v. Superior Court*, 36 Cal. 4th 148, 154 (2005), *abrogated by AT&T Mobility v. Concepcion*, 131 S.Ct. 1740, 179 L.Ed.2d 742(2011).

22. *Id*.

23. *Discover Bank*, 36 Cal. 4th at 153.

24. *Id*.

25. *Discover Bank*, 36 Cal. 4th at 154.

26. *Discover Bank*, 36 Cal. 4th at 160.

27. Cal. Civ. Code § 1668 (emphasis added).

28. *Discover Bank*, 36 Cal. 4th at 155.

29. The court held that such agreements are unconscionable if the agreement is in an adhesion contract, disputes between the parties are likely to involve small amounts of

decision rested on a critical distinction. Citing *Perry v. Thomas*, the court noted it was important to distinguish between "a state law principle that takes its meaning precisely from the fact that a contract to arbitrate is at issue," which is preempted by the FAA. And on the other hand, a "state law that governs issues concerning the validity, revocability, and enforceability of contracts generally," which is within the bounds of the saving clause and therefore, not preempted.[30] Ultimately, California is a consumer-friendly state that has refused to enforce bans on class action lawsuits, stating it is fundamentally unfair to consumers.[31] The court recognized that some class action mechanism, whether judicial or arbitration, must be left to consumers.[32] The court recognized California maintained a public policy interest in ensuring that consumers have a means of recovery of even small claims, and that companies should not be able to avoid liability due to the unlikelihood that consumers with small claims would pursue them individually in arbitration.[33]

B. AT&T Mobility, LLC v. Concepcion – 2011

Six years later, this issue reached the United States Supreme Court and California's landmark case was abrogated by *AT&T Mobility v.Concepcion*.[34] In this case, AT&T advertised to its customers that they would receive a free phone with the purchase of its service.[35] Shortly after the advertisement was

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damages, and the party with inferior bargaining power alleges a deliberate scheme to defraud. *See Discover*, 36 Cal. 4th at 162-63.

30. *See Perry v. Thomas*, 482 U.S. 483, 492, n.9 (1987).

31. *See Discover Bank*, 36 Cal. 4th at 169 (citing *Keating v. Superior Court*, 31 Cal. 3d 584, 608 (1982)).

32. Class arbitration has been developed and used throughout the state of California and this court recognized it as a valid class mechanism. *See e.g.*, *Green Tree Financial Corp v. Bazzle*, 539 U.S. 444 (lending no support to the imposition that class arbitration is a less efficient and less desirable mechanism).

33. The court specifically said, "[t]here is no indication… that, in the case of small individual recovery, attorney fees are an adequate substitute for the class action or arbitration mechanism. Nor do we agree… that small claims litigation, government prosecution, or informal resolution are adequate substitutes." *Discover Bank*, 36 Cal. 4th at162.

34. *Concepcion*, 131 S. Ct. at 1740.

35. *Concepcion*, 131 S.Ct. at 1744.

published, the Concepcions purchased AT&T's service. They later filed a putative class action suit in California when they realized that AT&T charged them the full retail value of the phone, cleverly hidden as sales tax on their invoice.[36] AT&T's contract with the Concepcions "provided for arbitration of all disputes between the parties, but required that claims be brought in the parties' *'individual capacity, and not as a plaintiff or class member in any purported class or representative proceeding*.'"[37] Accordingly, AT&T asked the court to compel arbitration but the District Court for the Southern District of California, relying on *Discover Bank*, found the arbitration provision unconscionable.[38] The Ninth Circuit affirmed and also held that the *Discover Bank* rule was not preempted by the FAA.[39]

The primary legal question in this case was whether the FAA (federal law) preempted the *Discover Bank* rule (state law).[40] A conservative Supreme Court held that the FAA preempted California state law in favor of individual mandatory arbitration.[41] The Court reasoned that the *Discover Bank* rule stood as an obstacle to the purpose and objectives of the FAA, which the court explained were "to ensure the enforcement of arbitration agreements according to their terms so as to facilitate streamlined proceedings. Requiring the availability of class-wide arbitration interferes with fundamental attributes of arbitration and thus creates a scheme inconsistent with the FAA."[42] The Court read the *Discover Bank* rule as requiring class-wide arbitration when the judicial class action mechanism was unavailable.

The Supreme Court gave two examples of how the *Discover Bank* rule stood as an obstacle to the FAA's purpose. First, the Court explained that the switch from individual to class arbitration magnifies the issues that accompany a lack of formality while sacrificing the advantages of informality. The majority in *Concepcion* feared that if procedures were too informal, absent class members would risk not being bound by the judgment

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36. *Id*.

37. *Id.* (emphasis added).

38. *Concepcion*, 131 S.Ct. at 1745.

39. *Id*.

40. *Concepcion*, 131 S.Ct. at 1744.

41. David Savage, *Consumer's Legal Rights Before Court*, Baltimore Sun, Nov. 10, 2010, at 2, available at 2010 WLRN 22537819.

42. *Concepcion*, 131 S.Ct. at 1748.

in the case of procedural errors.[43] Moreover, the Court believed that "the switch" would make the arbitration process "slower, more costly, and more likely to generate procedural morass."[44]

Second, the majority noted that class arbitration would greatly increase the risks to defendants.[45] The majority concluded that defendants would be pressured into settling questionable claims because of the absence of multilayered review, which makes it more likely that errors would go undetected.[46] With limited exceptions, the FAA does not allow for appeals in arbitration hearings. In fact, it does not address class arbitration procedures at all.[47] The United States judicial system naturally provides a system of checks and balances because a plaintiff has the right to appeal certain questionable decisions to the appellate level. The risks associated with this lack of review are minimal when defendants are defending an individual arbitration claim because the stakes are not as high.[48] Nevertheless, when damages are allegedly owed to thousands of claimants, the Court explained that, "the risk of error will often become unacceptable."[49]

Overall, the majority believed the *Discover Bank* rule increased the complexity of arbitration, thereby discouraging parties from entering into arbitration agreements, and to that extent, discriminating in practice against arbitration.[50] The majority's conclusion that the *Discover Bank* rule will discourage arbitration rests upon the wrong comparison. The correct

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43. *Concepcion*, 131 S.Ct. at 1751.

44. *Id*.

45. *Concepcion*, 131 S.Ct. at 1752.

46. *Id*.

47. The FAA and FINRA do not address class action procedures however, the American Arbitration Association has an elaborate procedural process governing class arbitrations.

48. *Concepcion*, 131 S.Ct. at 1752.

49. *Id*. *But see*, Loftus, *Rivals Resolve Dispute Over Drug*, WALL STREET JOURNAL, Apr. 16, 2011, at. B2 (discussing $500 million settlement in dispute submitted to arbitration); Ziobro, *Kraft Seeks Arbitration In Fight With Starbucks Over Distribution*, WALL STREET JOURNAL, Nov. 30, 2010, at B10 (describing initiation of an arbitration in which the payout "could be higher" than $1.5 billion); Markoff, *Software Arbitration Ruling Gives I.B.M. $833 Million From Fujitsu*, N.Y. TIMES, Nov. 30, 1988, at A1 (describing both companies as "pleased with the ruling" resolving a licensing dispute).

50. *See Concepcion*, 131 S.Ct. at 1758 (Breyer, J., dissenting).

comparison is not class arbitration to individual arbitration, but rather class arbitration to class action litigation.[51] Yet, the majority failed to even mention class litigation. The dissent highlighted several reasons why a defendant would prefer class arbitration to class litigation. Most notable is that class arbitration is statistically speedier than average judicial class action proceedings.[52] If a defendant valued time spent in litigation, single class arbitration is surely more efficient than thousands of separate individual arbitration claims. However, what is left unsaid is that a defendant likely will not face thousands of separate individual arbitration claims because most individuals will not pursue their claims in these circumstances. Justice Breyer explained:

> In general, agreements that forbid the consolidation of claims can lead small-dollar claimants to abandon their claims rather than to litigate. I suspect that it is true even here, for as the Court of Appeals recognized, AT & T can avoid the $7,500 payout (the payout that supposedly makes the Concepcions' arbitration worthwhile) simply by paying the claim's face value, such that “the maximum gain to a customer for the hassle of arbitrating a $30.22 dispute is still just $30.22.” (citation omitted).What rational lawyer would have signed on to represent the Concepcions in litigation for the possibility of fees stemming from a $30.22 claim?[53]

Additionally, the dissent provided a number of examples that show how class arbitration is a well developed form of arbitration and is widely used.[54]

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51. *Id*. at 1759.

52. *Id*.

53. *Id*. at 1761.

54. *Id*. In response to defendants argument that class actions were not amenable to arbitration, associate Justice Feinberg, in *Keating v. Superior Court*, said “[w]e have concluded that there is no insurmountable obstacle to conducting an arbitration on a class-wide basis. In an appropriate case, such a procedure undoubtedly would be the fairest and most efficient way of resolving the parties' dispute.” *Keating v. Superior Court, Alameda County*, 109 Cal. App. 3d 784, 167 (Ct. App. 1980) *vacated*.*Keating v. Superior Court*, 31 Cal. 3d 584, 645 (1982) *rev'd in part, appeal dismissed in part*, *Southland Corp. v. Keating*, 465 U.S. 1 (1984). Moreover, alternative dispute resolution service providers like the American Arbitration Association (“AAA”) and Judicial Arbitration and Mediation Services, Inc. (“JAMS”) have written their own class action procedures for arbitration hearings. *See* The American Arbitration Association Supplemental Rules for Class Arbitration, available athttp://www.adr.org/aaa/faces/rules/searchrules/rulesdetail?doc=ADRSTG_004129 &_afrLoop=1245644765859719&_afrWindowMode=0&_afrWindowId=y3ukgybr5

Although the dissent acknowledged the procedural and cost advantages that arbitration can provide it cautioned against thinking this was Congress' primary objective when enacting the FAA. Rather the dissent contended that Congress' intent was to place agreements to arbitrate on the same footing as other contracts. The dissent explained that the *Discover Bank* rule achieves this by "appl[ying] equally to class action litigation waivers in contracts without arbitration agreements as it does to class arbitration waivers in contracts with such agreements."

Finally, the *Concepcion* dissent argued that federal arbitration law normally leaves contract defenses to the States.[55] In *Rent-A-Center v. Jackson*, the Supreme Court held that arbitration agreements may be invalidated by generally applicable contract defenses.[56] Therefore, the dissent contended California is free to define unconscionability as it sees fit provided the state does not adopt rules that disfavor arbitration.

C. CompuCredit v. Greenwood - 2012

A year after the Supreme Court resolved *Concepcion*, the Court decided *CompuCredit v. Greenwood*. In this case the Supreme Court went even further to limit consumer's rights. This case involved customers who applied for and received a Visa credit card, marketed by CompuCredit.[57] The customers filed a class action suit against CompuCredit, alleging violations of the Credit Repair Organizations Act ("CROA"), in part for misleading representations that the credit card could be used to rebuild poor credit.[58] As in the other cases discussed, the customers had agreed to be bound by a pre-dispute arbitration agreement when they opened their accounts and thus CompuCredit asked the Court to compel arbitration.[59]

_1#%40%3F_afrWindowId%3Dy3ukgybr5_1%26_afrLoop%3D1245644765859719 %26doc%3DADRSTG_004129%26_afrWindowMode%3D0%26_adf.ctrl-state%3Dy3ukgybr5_53 and JAMS Clause Workbook, available at http://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS-ADR-Clauses.pdf.

55. *Concepcion*, 131 S. Ct. at 1760.

56. *Rent-A-Center v. Jackson*, 130 S. Ct. 2772, 2775 (2010).

57. *CompuCredit Corp. v. Greenwood*, 132 S. Ct. 665, 668, 181 L. Ed. 2d 586 (2012).

58. *Id*.

59. *Id*.

The District Court for the Northern District of California and Ninth Circuit both denied CompuCredit's motion, "concluding that Congress intended claims under the CROA to be non-arbitrable."[60] The Supreme Court reversed, holding that arbitration agreements must be enforced according to their terms "even when the claims at issue are federal statutory claims, unless the FAA's mandate has been "overridden by a contrary congressional command."[61] In other words, according to *CompuCredit*, arbitration agreements cannot be unenforceable under federal statutes or regulations based on implied interpretations of Congressional intent, agency intent, or public policy. The recent case history of the Supreme Court clearly favors businesses and their use of broad pre-dispute arbitration agreements which limit the rights of their customers. However, until 2011, no brokerage firm had tried to limit investors' access to class procedure through the use of a class action waiver.

III. CASE-IN-CHIEF: AN OVERVIEW OF *CHARLES SCHWAB V. FINRA*

After the Supreme Court's ruling in *AT&T Mobility v. Conception*, Schwab amended its account agreement in September 2011 to add a class action waiver.[62] This amendment was delivered to nearly seven million customers.[63] The amendment adding the class action waiver to Schwab's customer agreements read as follows:

> **Waiver of Class Action or Representative Action.** Neither you nor Schwab shall be entitled to arbitrate any claims as a class action or representative action, and the arbitrator(s) shall have no authority to consolidate more than one parties' claims or to proceed on a representative or class action basis. You and Schwab agree that any actions between us and/or Related Third Parties shall be brought solely in our individual capacities. You and Schwab hereby waive any right to bring a class action, or any type of representative action against each other or any Related Third Parties in court. You and Schwab waive any right to participate as a class member, or in any

60. *Id*.

61. *Id*. at 669.

62. *Schwab*, 2012 WL 1859030 at *2.

63. *Id.* at *3.

> other capacity, in any class action or representative action brought by any other person, entity or agency against Schwab or you.[64]

This waiver effectively does two things: (1) it precludes Schwab-customers from starting or joining judicial class actions against the brokerage, and (2) it requires those customers to agree that industry arbitrators would not have the authority to consolidate claims into a class arbitration hearing or otherwise.

Schwab's class action waiver came to the attention of FINRA, which thereafter, decided to seek disciplinary sanctions against Schwab for violating FINRA Rule 2268, by attempting to circumvent FINRA Rule 12204.[65] Rule 2268 contains guidelines for brokerage firms when utilizing pre-dispute arbitration agreements with their customers, and section (d) specifically limits the terms a brokerage firm may include in such an agreement.[66] Rule 12204 provides that customers may participate in class action claims in court.[67] FINRA ordered Schwab to refrain from enforcing its arbitration agreement before the disciplinary proceedings were completed.[68] Subsequently, Schwab filed suit in the Northern District of California seeking a declaration that FINRA Rules cannot be enforced to bar class action waivers.[69]

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64. *Id*.

65. *Id*.

66. FINRA Rule 2268(d) reads: "[n]o predispute arbitration agreement shall include any condition that: (1) limits or contradicts the rules of any self-regulatory organization; (2) limits the ability of a party to file any claim in arbitration; (3) limits the ability of a party to file any claim in court permitted to be filed in court under the rules of the forums in which a claim may be filed under the agreement; (4) limits the ability of arbitrators to make any award."

67. *See* FINRA Rule 12204.

68. *Schwab*, 2012 WL 1859030 at *3.

69. Complaint, *supra* note 4, ¶ 47.

A. Schwab's Position

Schwab argued that the text and history of Rule 2268(d) demonstrates that it cannot reasonably be interpreted to prohibit class action waivers.[70] Furthermore, Schwab argued that even if FINRA rules barred class action waivers, the rules were preempted by the FAA following recent Supreme Court decisions.[71]

B. FINRA's Position

It is undisputed that Schwab failed to complete the FINRA administrative process before it filed suit.[72] Therefore, FINRA primarily argued that Schwab failed to exhaust its administrative remedies which deprived the court of proper jurisdiction in this case. In order for Schwab to exhaust its administrative remedies the following must happen: (1) a FINRA hearing panel hears the complaint;[73] (2) either party has the right to appeal the hearing panel's decision to the FINRA National Adjudicatory Council ("NAC");[74] (3) FINRA then has the right, at its discretion, to review the NAC's decision;[75] and lastly, (4) Schwab has the right to apply for review by the Securities Exchange Commission ("SEC").[76] Once those steps are completed, Schwab then has therightto appeal an adverse determination by the SEC to a federal circuit court of appeals.[77] FINRA argued that Schwab cannot appeal to a federal court unless the preconditions to filing outlined above are met.[78]

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70. Memorandum in Support of Schwab's Motion for Preliminary Injunction at 13, *Charles Schwab & Co. v. FINRA* (N.D. Cal. Feb. 21, 2012) (No. CV12-0518) 2012 WL 1408607 at *11.

71. *Schwab*, 2012 WL 1859030 at *3.

72. *Id*. at *5.

73. FINRA Rule 9231(b).

74. FINRA Rule 9311(a).

75. FINRA Rule 9349, 9351.

76. FINRA Rule 9370(a).

77. 15 U.S.C. § 78y(a).

78. *Schwab*, 2012 WL 1859030 at *5.

In addition, FINRA contended that Rule 2268(d) was "capable of expressing the clear congressional command needed to override the FAA."[79] FINRA argued that Rule 2268(d)(1) is the equivalent of a federal regulation, and therefore provides express congressional command that FINRA members are prohibited from placing any provision in a pre-dispute arbitration agreement that contradicts its rules and therefore overrides the FAA's "freedom of contract" principle. FINRA argued that the once a FINRA rule has been approved by the SEC to be consistent with the purposes of the Exchange Act, the rule has the force of federal law. Accordingly, FINRA argued that its rules are not subordinate to the FAA.[80]

C. The Court's Position

Before discussing the merits of this case, the court needed to consider whether it had jurisdiction. It was undisputed that Schwab had not filed a complaint with FINRA.[81] Accordingly, Schwab had not exhausted its administrative remedies prior to seeking relief from the court.[82] The court concluded the failure to exhaust administrative remedies is jurisdictional.[83] However, the court acknowledged two exceptions to this rule.[84] If the administrative process is clearly shown to be inadequate to prevent irreparable injury or there is a clear and unambiguous statutory or constitutional obligation that would obviate the need for Schwab to comply with FINRA's disciplinary process before seeking relief from the court.[85]

Schwab argued it was entitled to the first exception. First, Schwab argued it would be irreparably harmed because the FINRA disciplinary process could take up to four years, during which time Schwab risks waiving its right to compel arbitration.[86] The court, however, explained that delay is

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79. FINRA's Opposition to Motion for Preliminary Injunction at 6, *Charles Schwab & Co. v. FINRA*, (N.D. Cal. Mar. 6, 2012) (No. CV12-0518) 2012 WL 1408602 at *6.

80. FINRA's Opposition to Motion for Preliminary Injunction, *supra* note 79 at 6.

81. *See Schwab*, 2012 WL 1859030 at *3.

82. *Id*. at *5.

83. *Id*.

84. *Id*. at *6.

85. *Id*.

86. *Id*. at 11.

not an excuse "unless it is combined with a showing that the remedies are palpably inadequate."[87] Next, Schwab argued that it cannot obtain effective relief at the administration level because FINRA panels lack experience and competence to decide a complicated constitutional issue.[88] The court easily dismissed this argument stating, "[t]hese issues are squarely within the expertise of FINRA."[89] Finally, Schwab argued that the FINRA disciplinary procedure is not an effective path of review because Schwab must decide whether to "bet the farm" by enforcing its class action waiver and face further discipline, or risk losing the right to compel individual arbitration.[90] In response to this argument, the court reasoned that Schwab was not challenging the very existence of FINRA, which would have been classified as a collateral issue and rendered review in FINRA's administrative process a practical impossibility.[91] Rather, Schwab only sought to enjoin the administrative process in order to obtain a contrary interpretation of the FINRA rule at issue.[92] Accordingly, FINRA's motion to dismiss was granted.[93]

D. Going Forward for Schwab

Schwab is now placed in a difficult position after the court refused to issue Schwab declaratory judgment because Schwab must now decide whether to continue using its current agreements containing the class action waivers.[94] However, if Schwab does so, it could face additional penalties

87. *Schwab*, 2012 WL 1859030 at *11.

88. *Id*. at 12.

89. *Id*.

90. *Id*. at 15.

91. *Id*.

92. *Id*.

93. *Schwab*, 2012 WL 1859030 at *16.

94. The decision to enforce its class action waiver is even more difficult in light of the fact that Schwab was recently sued in San Francisco Superior Court in a putative class action. *See Kamberian v. Charles Schwab & Co.*, No. CGC-12-518383 (Schwab-customers are claiming they had their telephone conversations illegally recorded).

because it would amount to a continued and, knowing violation of FINRA rules. Other brokerage firms are waiting to see what the outcome of this case will be, to determine whether or not they should also add class action waivers to their pre-dispute arbitration clauses.

IV. WAS CONCEPTION DECIDED CORRECTLY?

A. What is the purpose of the FAA?

Above all, the FAA reflects a liberal federal policy favoring arbitration.[95] Although courts agree generally on FAA policy, not all courts agree about the underlying purpose of the FAA. For instance, Justice Scalia wrote in *Concepcion*: "[t]he overarching purpose of the FAA… is to ensure the enforcement of arbitration agreements according to their terms *so as to facilitate streamlined proceedings*."[96] Whereas, in *Dean Witter* Justice Marshall wrote: "the purpose behind [FAA] passage was to *ensure judicial enforcement of privately made agreements to arbitrate*. We therefore reject the suggestion that the overriding goal of the Arbitration Act was to promote the expeditious resolution of claims."[97] The *Concepcion* dissent adopted Justice Marshall's interpretation of the FAA's purpose,[98] explaining that the FAA sought to eliminate judicial hostility to arbitration, "by placing agreements to arbitrate '*upon the same footing as other contracts.*'"[99] One year later, Justice Scalia – part of the *Concepcion* majority – recognized that

*** Editor's Note: As of the time of publication, Schwab had ceased enforcing or using class action waivers in customer agreements pending conclusion of the administrative adjudicatory process. Schwab currently awaits a hearing and decision from the NAC. *See* Susan Antilla, *Schwab Case Casts Spotlight on Securities Arbitration and Its Flaws*, New York Times, Sept. 4, 2013, available at http://dealbook.nytimes.com/2013/09/04/schwab-case-casts-spotlight-on-securities-arbitration-and-its-flaws/.

95. *Concepcion*, 131 S. Ct. at 1745.

96. *Id*. at 1748 (emphasis added).

97. *Dean Witter Reynolds, Inc. v. Byrd*, 470 U.S. 213, 220 (1985).

98. *Concepcion*, 131 S. Ct. at 1758 (citing *Dean Witter*, 470 U.S. at 221) (Breyer J., disenting).

99. *Concepcion*, 131 S. Ct. at 1757 (Breyer J., disenting) (emphasis in original).

the FAA "requires courts to enforce agreements to arbitrate according to their terms."[100]

If the purpose of the FAA is to facilitate streamlined proceedings, then allowing classwide arbitration would increase the complexity of arbitration and interfere with this purpose.[101] Conversely, if the purpose is to enforce arbitration agreements on the same footing as other contracts, a state law which prohibits class action waivers in adhesive contracts puts agreements to arbitrate on the same footing as other contracts.[102] Under this analysis, the *Discover Bank* rule did not stand as an obstacle to the purposes and objectives of the FAA. The *Discover Bank* rule equally set aside agreements that prohibited class procedures regardless of whether they were included within pre-dispute arbitration agreements or contracts without pre-dispute arbitration clauses.[103] Accepting that the legislative purpose is to *ensure judicial enforcement of privately made agreements to arbitrate* on the same footing as other contracts, one must next examine whether FINRA's Rules at issue obstruct the purpose of the FAA in this context.

1. The Use of Arbitration Agreements are not Discouraged by FINRA

FINRA Rule 12204 unequivocally states that class action claims may not be arbitrated under the applicable FINRA code of arbitration procedure despite the existence of a pre-dispute arbitration agreement between the parties. Contrary to the concerns raised by the *Concepcion* majority, Schwab cannot make the argument that FINRA rules are increasing the complexity of arbitration because FINRA has chosen to leave class action proceedings exclusively to the jurisdiction of the courts while enforcing pre-dispute arbitration agreements in other contexts.[104] Brokerage firms still benefit immensely from these agreements because they can streamline a proceeding whilst saving the firms money on litigation expenses.

Investors on the other hand, will continue to sign pre-dispute arbitration agreements because they cannot avoid them, at least if they want to open a brokerage account. In cases where investors have claims against brokerage

100. *CompuCredit*, 132 S. Ct. at 669 (quoting *Dean Witter*, 470 U.S. at 221).

101. *Concepcion*, 131 S.Ct. at 1748.

102. *Id*. at 1757. (Breyer J., dissenting).

103. *Concepcion*, 131 S. Ct. at 1759 (Breyer J., dissenting).

104. FINRA Rule 12204.

firms, they will have to take into consideration the fact that FINRA does not offer class arbitration when developing their legal strategy, if there is a parallel class action pending. For example, a person with a large claim may choose to opt-out of any pending class action and pursue the claim in arbitration in hopes of controlling the proceeding and reaping a larger award. On the contrary, someone with a smaller claim may choose to bring or join a class action claim in Federal court in order to share litigation cost and benefit from the work of lead counsel on the case. For individual claims, arbitration agreements are enforced. Therefore, neither of these scenarios will discourage brokerage firms from using pre-dispute arbitration agreements. Accordingly, FINRA Rule 12204 does not obstruct the purpose of the FAA.

V. FINRA Rules are Not Preempted by the FAA

There are two types of preemption, express and implied. Express preemption exists when there is Congressional language that defines the existence and scope of preemption. In addition to express preemption there are two types of implied preemption. There is field preemption that occurs when the federal interest is so dominant that the federal system is assumed to preclude enforcement of state laws on the same subject and there is conflict preemption, which, *inter alia*, occurs when state law stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress. The majority in *Concepcion* based its holding on conflict preemption.

The majority decision in *Concepcion* does not lead to the conclusion that Schwab may enforce its class waiver. FINRA rules are not comparable to state statutes. Furthermore, the FAA has never been held to dictate the terms of SRO rules.[105] Therefore, FINRA, a SRO, likely is not impacted by the *Concepcion* decision because the FAA does not have preemptive power over a conflicting federal statute. The issues are different here, because the invalidation of a class waiver is not found in a state law, but rather a rule that has the effect of Congressional command.

105. No court has ever interpreted the FAA to require an SRO's rules to select arbitration as the means of resolving disputes between its members and their customers. In addition, Schwab points to no such case. FINRA's Opposition to Motion for Preliminary Injunction, *supra* note 79 at 5.

VI. THE FUTURE OF MANDATORY ARBITRATION

Pre-*Shearson*, the by-laws of the New York Stock Exchange and the National Association of Securities Dealers ("NASD")[106] required members to arbitrate disputes with customers if the customer elected arbitration,[107] while the *Wilko* decision and its progeny invalidated pre-dispute arbitration agreements as to federal claims.[108] In other words, investors who had federal claims against a brokerage firm could choose to bring the claims in arbitration and the firms would be required to arbitrate under NYSE or NASD rules, or could choose to bring the claims in court, and the firms could not enforce any existing pre-dispute arbitration agreements. However, since *Shearson*, firms have the power to enforce their pre-dispute arbitration agreements and the mandatory arbitration system has been used widely by the securities industry.[109] Although, in Shearson, the Court recognized that there was SEC oversight of FINRA's arbitration process, and that the SEC had "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs."[110] In light of Schwab's attempt to now limit FINRA's authority over its arbitration process, the court may have an opportunity and a reason to revisit the legitimacy of mandatory arbitration.

The first logical question to ask is whether investors are better off in court or in arbitration. Unfortunately, it is nearly impossible to measure which system produces better results for investors. For starters, most cases do not go to court because the investor signed a pre-dispute arbitration agreement, so there is little with which to compare arbitration outcomes.[111] In addition, many cases settle and confidentiality bars the public from discovering the results.[112] Moreover, arbitrators do not have to explain their awards, and most do not.[113]

106. In 2007, sections of the New York Stock Exchange merged with the NASD to form FINRA.

107. Lipner, *supra* note 13.

108. *See Wilko v. Swan*, 346 U.S. 427 (1953).

109. Lipner, *supra* note 13.

110. *Shearson*, 482 U.S. at 233.

111. Lipner, *supra* note 13.

112. *Id*.

113. *Id*.

Nevertheless, even if arbitration hearings produce better results for investors, some may still wish to pursue their claims in court and it should be their right to do so. Many that advocate against mandatory arbitration contend that consumers have no choice but to sign the pre-dispute arbitration agreements because, otherwise, they will not have access to the services the businesses are offering.[114] The argument that mandatory arbitration is unfair has led to the thrice-proposed Arbitration Fairness Act.

A. Is the Arbitration Fairness Act a Fair Solution?

Senators Al Franken and Richard Blumenthal reintroduced the Arbitration Fairness Act of 2011 ("AFA") after the *Concepcion* case was decided.[115] This proposed bill effectively would amend the FAA to invalidate all pre-dispute arbitration agreements in consumer contracts and would allow consumers to choose arbitration after a dispute arises, effectively invalidating *Concepcion* and *CompuCredit*.[116] Senator Blumenthal explained that: "the Arbitration Fairness Act would reserve [*Concepcion*] and restore the long-held rights of consumers to hold corporations accountable for their misdeeds."[117]

Enacting the AFA could be an extreme measure in response to the Supreme Court's decision in *Concepcion* because businesses can now avoid class litigation. If the Supreme Court ruled differently in *Concepcion* and permitted California to invalidate class action waivers, pre-dispute arbitration agreements would still be valid under Federal law – the FAA ensures that. Prohibiting class action waivers instead of prohibiting pre-dispute arbitration agreements altogether would be a more measured response. There are reasons why brokerage firms, employers, and companies use arbitration agreements besides avoiding class proceedings, including speedier resolutions, less expensive proceedings than judicial-litigation, non-public

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114. *Id*.

115. Christopher Drahozal, *Concepcion and the Arbitration Fairness Act*, SCOTUS blog (Sep. 13, 2011 11:46 PM), http://www.scotusblog.com/2011/09/concepcion-and-the-arbitration-fairness-act/.

116. *See Washington D.C. Employment Law Update*, Littler (May 18, 2011) http://www.dcemploymentlawupdate.com/2011/05/articles/arbitration/arbitration-fairness-act/.

117. Drahozal, *supra* note 115.

hearings, the ability to get arbitrators who have experience in the subject matter, limited discovery, and a more informal procedure.[118]

The dissenters in *Concepcion* rightfully pointed out that federal law normally left contract defenses to the States.[119] California should have been able to define "unconsionability" as it sees fit, as long as the state does not adopt a rule that disfavors arbitration.[120] Currently, the FAA saving clause allows courts to invalidate unconscionable arbitration agreements.[121] Each case is unique and therefore any issues could be better addressed on a case-by-case base, rather than by broad sweeping legislation. A clear mandate from Congress that states may invalidate arbitration agreements or clauses within arbitration agreements if the grounds used are not tainted towards arbitration may be a more appropriate response to the *Concepcion* decision.

B. Is There a Better Solution?

Perhaps a more practical way to protect investor rights is simply to keep the current system and recognize that FINRA rules do and may prohibit class action waivers. Although FINRA has not done so explicitly, it believes its rules do prohibit the use of class action waivers.[122] The bad news for investors however, is that case law is not on their side.

Assuming that Schwab makes its way through FINRA's disciplinary process, that both FINRA and the SEC believe Schwab's agreement violates FINRA's rules, and that Schwab decides to appeal an adverse determination made by the SEC, a Federal Circuit Court of Appeals could reasonably side with Schwab and hold that its class action waiver is valid. No one disputes

118. Arthur Mazirow, *The Advantages and Disadvanatages as Compared to Litigation*, (Apr. 13, 2008) http://www.cre.org/images/MY08/presentations/The_Advantages_And_Disadvantages_of_Arbitration_As_Compared_to_Litigation_2_Mazirow.pdf.

119. *Concepcion*, 131 S. Ct. at 1761 (Breyer J., dissenting).

120. *Id*.

121. *Concepcion* held that the FAA preempted California state law because the *Discover Bank* rule disfavored arbitration and thus conflicted with the purpose and objectives of the FAA. It is important to note that the court did not hold that state courts could not invalidate unconsicionable arbitration agreements. *See Concepcion*, 131 S. Ct. at 1747.

122. FINRA's Reply in Support of Motion to Dismiss, *supra* note 6 at 1.

that recent precedent favors Schwab. However, this does not mean that Schwab should win.

Through the use of a class action waiver in what is effectively a contract of adhesion, Schwab is forcing its investors to arbitrate their claims as individuals. The class action waiver effectively precludes Schwab customers from starting or joining judicial class actions against Schwab. This will mean investors with small claims will be left without a viable legal means to recoup their losses because the amount at issue is too small to be worth pursuing. Lawyers typically will not take on small claims which guarantee little to no recovery.[123] This is what happened to the plaintiffs in *Discover* and *Concepcion*.

The class action process is a common way for investors to unite and recover their losses in court. Therefore, the court should use its discretion and apply equity principles to invalidate class action waivers. The court could hold that Schwab's class action waiver violates investors' rights, thereby benefiting investors immensely while not irreparably harming brokerage firms. In *Discover Bank*, the court recognized the California law at issue was concerned with businesses utilizing class action waivers as an exculpatory contract clause.[124] In other words, it is not fair or just to allow business to manipulate the terms of consumer contracts to insulate its author from liability for its own frauds while "deliberately cheating large numbers of consumers out of individually small sums of money."[125]

For the court to hold in favor of investors, it will not have to strain itself in search of support. FINRA rules already include restrictions on arbitration agreements, including a restriction on brokerage firms limiting investor's rights to file court cases.[126] Schwab is a member of FINRA and therefore must abide by its rules. In addition, in response to Judge Laporte's decision to halt Schwab's suit against FINRA, Ryan Bakhitari, President of the Public Investors Arbitration Bar Association, said "[i]t's a good decision for all investors and customers of Charles Schwab. The rules are clear and unequivocal that Schwab did not have the right to prohibit class actions."[127]

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123. *Concepcion*, 131 S. Ct. at 1761 (quoting *Carnegie v. Household*, 376 F.3d 656, 611 (2004) (Breyer J., dissenting)).

124. *Discover*, 36 Cal. 4th at 161.

125. *Concepcion*, 131 S. Ct. at 1761 (quoting *Discover*, 36 Cal. 4th at 162-163 (Breyer J., dissenting)).

126. *See* FINRA Rule 2268.

127. *Schwab Loses Suit to Halt FINRA Action*, 19 No. 5 WL Journal Class Action 8 (Jun. 21, 2012).

Furthermore, the National Labor Relations Board ("NLRB"), found on June 2, 2012 a class action waiver that interfered with employee rights under the National Labor Relations Act ("NLRA"), was unlawful.[128] In *Advance Services v. Howard et. al.*, plaintiffs claimed that Advance Services (hereinafter "Respondent") prohibited discussions among employees about their terms and conditions or employment, including discipline issues, and that Respondent terminated a plaintiff, Howard, because she engaged in such concerted discussions with other employees.[129] In addition, the respondent implemented a retroactive dispute resolution program called "Solutions Policy Agreement," which was applicable to all their employees.[130] The program made arbitration mandatory and included a class action waiver.[131] Relying primarily on *Concepcion*, respondent argued that its class action waiver did not violate the NLRA and further argued that agreements between employers and employees to arbitrate employment disputes are enforceable under the FAA.[132]

Despite *Concepcion*, the NLRB held Respondent's class action waiver was unlawful.[133] Pursuant to Section 7 of the NLRA "[e]mployees shall have the right to… bargain collectively through representatives of their own choosing, and to engage in other concerted activities for the purpose of collective bargaining or other mutual aid or protection."[134] The NLRB concluded that imposing a mandatory arbitration agreement that precludes

128. *Advance Services v. Howard et. al.*, 2012 WL 2562584 at *5 (2012).

129. *Id*. at *1.

130. The ADR program identified as "Solutions Policy Agreement" read: "Covered Employees and the Company waive their right to bring any Covered Claims as, or against a representative or member of a class or collective action (whether opt-in or opt-out) or a private attorney general capacity, unless all parties agree to do so in writing. All covered claims must be brought on an individual basis only in Solutions. Without waiving the Company's right to enforce this Procedure's provisions regarding class and collective action waivers, nothing in this Procedure prohibits employees from acting concertedly to challenge the terms of Solutions by pursing class or collective actions and they will not be subject to discipline or retaliation by the Company for doing so." *Id*.

131. *Id*.

132. *Id*. at *4.

133. *Id*. at *5.

134. 29 U.S.C. § 157.

employees from filing a judicial or arbitration class claim interferes with the right guaranteed to employees in Section 7 of the NLRA.[135]

Although the Solutions Policy Agreement contained slight differences from Schwab's customer account agreements,[136] similarities existed in the issues raised. The right restricted in *Advance Services* was codified in the NLRA – a federal statute – whereas in the *Schwab* case, the right restricted was codified in FINRA Rule 12204 and 2268(d) collectively which, in Schwab's own words, "have the force of federal laws."[137] Both companies are effectively trying to achieve the same goal; limit its liability for its own wrongdoing. The NLRB summed up the problem nicely: "the Solutions Language in issue is likely to have a chilling effect on employees'… rights." Schwab asserts that its reason for implementing its class action waiver was to "protect its shareholders and customers from the high cost and inefficiencies associated with customer class actions."[138] However, this is not a justifiable reason for utilizing an agreement which will likely have a chilling effect on an investor's legal rights.

Collectively, FINRA's rules, the recent decision of the NLRB, and equitable principles should be enough support for a reasonable court to render a decision against Schwab and hold its class action waiver to be unenforceable.

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135. It shall be an unfair labor practice for an employer to interfere with, restrain, or coerce employees in the exercise of the rights guaranteed in section 7 of this title. 29 U.S.C. § 158(a)(1).

136. One key difference between the two agreements is that the Solutions Agreement permitted challenges to the agreement itself. The NLRB however, held this "does not eliminate the requirement for employees to bring their claims individually rather than collectively." In addition, the class waiver provision may be waived if both parties agreed to do so. In response to this wrinkle, the NLRB noted the agreement did not clarify the circumstances in which the Respondent would agree to do so and thus without "written assurances, the language was hollow."

137. Complaint, *supra* note 4 at ¶16.

138. *Id*. at ¶ 25.

VII. CONCLUSION

If Schwab were to win and be permitted to enforce its class action waiver, the legacy of *McMahon* suggests nearly every brokerage firm would amend its customer agreements to include class action waivers. Every investor-brokerage firm dispute would be relegated to individual arbitration. Although FINRA does not currently administer class arbitrations, it could not in the future, because class arbitrations would be prohibited by the agreements. Many investors might be left with no viable means of recouping their losses, even if their losses are due to widespread wrongdoing on behalf of the firm.

If FINRA wins, its oversight of pre-dispute arbitration agreements would be maintained. Although pre-dispute arbitration agreements would likely be enforced otherwise, investors would have a means of recovery available if their case is one that would be appropriate for class proceedings.

Even though Congress did not consider class actions when writing the FAA, class action procedures are a necessary tool for investors today. As class arbitration becomes increasingly utilized throughout FINRA and other arbitration forums, it may offer a viable alternative to judicial class actions. The point is that investors deserve to have their case heard. For some, this means having the ability to pursue their claims in a class action setting. Winning their claims however, is a different story.

FAILURE TO SUPERVISE: AN INSIDE PERSPECTIVE

Alan Besnoff

This article will examine the variety of steps and actions that can and should be taken by a firms' Supervising Principal to assure that the proper degree of supervision of brokers is being performed.

Let's begin with a quick review of why it is that in so many circumstances, supervisory responsibilities are not fully being met.

A review of the typical field Supervisory Principal or Branch Manager compensation package reveals the true priorities of the firm and therefore how field supervisors are encouraged to spend their time and effort. There are two primary results for which Supervising Principals are rewarded; branch sales production and recruiting.

The firm culture may be so centered on these two primary activities as to include constant reinforcement through bulletins, e-mails, meetings, conference calls, quarterly campaigns, reward trips, added bonuses, and other incentives. The message to Supervising Principals in the field becomes quite clear. Spend as much time as possible to obtain these desired results and as little time as possible on other "distractions" (such as the proper supervision of brokers). In some company cultures' the high level of sales production by top producers may be so valued that Supervising Principals are encouraged to not "rock the boat" when it comes to thorough supervision of such highly valued producers..

In my 25 years of personal experience with supervisory responsibilities, I have received significant compensation, including bonuses, stock awards, luxurious trips, and other incentives for branch sales production and recruiting. During the same time period however, no compensation was received for such accomplishments as having surprise branch inspections by regulators conclude with the outcome of "no findings", or having a total lack of customer complaints within the branch, or for having developed and implemented systems to assure thorough supervision of brokers within the branch was occurring.

For a Supervising Principal to have a true dedication and commitment to fulfill his or her supervisory duties and responsibilities he or she must have the ability to resist all of the short-term incentives (as described above), challenge the company culture, and develop and implement local policies and procedures to assure that thorough supervision of brokers are in place and consistently executed. What assisted me in meeting this challenge was to view my role as having the ultimate responsibility to assure that any and all transactions, trades, or recommendations by brokers within the branch were truly in the best interest of the client. It was also helpful for me to view my career as being long-term, and recognizing therefore that my most valuable of assets included reputation, integrity and an unblemished record. As one who truly valued the good and ethical work being performed by the majority of practitioners within the financial services industry, I have been honored to do my small part to protect the industry and community from the "bad apples" that would spoil the reputation of ethical practitioners.

What are the steps that a Supervising Principal can and should take to assure adherence to FINRA regulations, the highest of ethical standards, and Supervisory duties are being met?

It is my belief that it is most important for the Supervising Principal to develop and maintain a culture of absolute adherence to FINRA regulations, company compliance guidelines, and the highest of ethical standards. To accomplish this desired culture, the Supervising Principal must always be consistent in his or her dealings with brokers and in demonstrating such a mindset in all of the Principal's behaviors, actions, and policies and procedures.

In many organizations the compliance requirements may be handled simply by following minimum guidelines such as the conducting of an annual compliance meeting. This "check the box" approach is in my view a mistake as it sends the message that compliance requirements are an inconvenient burden that must be met even though it distracts from sales productivity. An atmosphere and culture may develop in which compliance requirements are met by "going through the motions" for the sole purpose of being able to indicate that a compliance requirement has been satisfied.

The Supervising Principal who takes a long-term view recognizes that the preceding attitude and approach is a huge mistake that threatens the best interests of the company, the brokers and managers within the branch, and the investing public.

Steps that a Supervising Principal can take to foster an ethical and compliant culture include:

1) At every group or individual meeting in which specific investment products or recommendations are discussed, always include a discussion of the suitability and other compliance issues associated with the product. Supervising Principals who take this action will help his or her brokers learn and understand the importance of FINRA rule 2090 "Know your customer", and FINRA rule 2111 "Suitability". Regularly conducting discussions of this nature clearly help to foster a culture in which only suitable transactions are valued and accepted.

2) During group meetings, moderate discussions in which brokers will share why a specific product, transaction, or recommendation was in the best interest of the client as compared to other alternatives. Supervising Principals who take this action will be able to gauge the degree to which brokers under his or her supervision understand, practice, and comply with FINRA rule 2090 "know your customer", and FINRA rule 2111 "Suitability". Providing brokers an opportunity to exhibit their compliance with FINRA rules and their commitment to the highest of ethical standards will greatly enhance the compliance learning experience for all brokers within the branch, and help the Supervising Principal with his or her goal of fostering a culture in which compliance and high ethical standards are the norm.
3) Frequently review disciplinary actions and arbitration awards against brokers. Discuss the harm done to the broker and his or her family, the firm and the investor. Initiate discussion as to what should have been done differently.
4) When discussing various products to be marketed, always emphasize how and in what circumstances such products should be used for the benefit of the client. Care must be taken to not overemphasize the commissions or payout to the broker.
5) The Supervising Principal should monitor what is being discussed by brokers during individual sales appointments by joining brokers periodically on appointments with clients.
6) The Supervising Principal can select a sampling of trades and transactions received and call the client to discuss the transaction. Confirm suitability and financial information and make sure the client understands all aspects of the transaction including charges and expenses, illiquidity and risk. Supervising Principals that take this action will help to assure that several FINRA rules are being observed. FINRA rule 2090 "Know your customer" requires that "every member shall use reasonable diligence in regard to the opening and maintenance of every account, to know (and retain) the essential facts concerning every customer…" FINRA rule 2111 "Suitability" requires that "a member or associated person must have a reasonable basis to believe that a recommended transaction or investment strategy involving a security or securities is suitable for the customer…." The fact that the Supervising Principal is taking this action will be known by all brokers within the branch. Brokers are therefore

likely to take extra care to assure that all "know your customer" detail on account applications are accurate and that all transactions are suitable for the customer.

7) The Supervising Principal should regularly attend public sales seminars and workshops conducted by brokers under his or her supervision. Supervising Principals that take this action will help to assure that brokers under his or her supervision are in compliance with applicable sections of FINRA rule 2210 "Communications with the public".
8) The Supervising Principal can add the names of his or her brokers to "Google alerts" in order to be notified and stay informed of any new events or news stories in which the broker may be named.
9) The Supervising Principal must never "look the other way" when any compliance violation or breach of ethics may occur.
10) Care must be taken to make all hiring decisions not only upon anticipated productivity, but upon anticipated ethical conduct. Great care must be taken to safeguard the ethical and compliant culture once created. Since behaviors tend to be repeated, it is wise to prevent anyone with a poor ethical record to join the branch.

Supervising Principals can and should view their firm's written compliance guidelines and FINRA rules and regulations as minimum standards. Above are just a sampling of steps that can be taken by the Supervising Principal to assure that supervisory responsibilities are being fulfilled.

When the Supervisor has been successful in fostering an ethical and compliant culture and is fully committed to his or her supervisory duties and responsibilities it is far less likely for incidents of broker misconduct to occur.

* Omitted from the original article: Alan J. Besnoff is the founder of Securities Expert Witness & Litigation Support, LLC and serves as an expert witness and litigation consultant throughout the United States. Mr. Besnoff has served as a General Securities Principal with over 25 years of supervisory experience. He holds the designations of: Certified Financial Planner (CFP), Chartered Financial Consultant (ChFC), Chartered Life Underwriter (CLU), as well as several FINRA registrations and insurance licenses. Mr. Besnoff has earned numerous industry awards, and has served on several boards and commissions including President of the National Association of Insurance and Financial Advisors in Connecticut.

ERRONEOUS TRIAL COURT RULING REMAINS ON THE BOOKS BECAUSE OF PROCEDURAL FLUKE: EXAMINING PUNITIVE DAMAGES AND STATE COURT JURISDICTION TO CONFIRM FINRA AWARDS

Jon Black and Ari Diaconis[1]

I. INTRODUCTION

This article explores a recent New York trial court order that could have severe consequences for securities arbitration. On April 4, 2011, a FINRA arbitration[2] panel rendered an award against Michael H. Sloane, awarding William T. Copperill compensatory and punitive damages related to his investment account once under Sloane's control (the "arbitration award" or the "FINRA arbitration award").[3] On February 29, 2012, New York Supreme Court Justice, Nassau County, initially confirmed the FINRA award, but deleted the punitive damages portion (the "February order").

Then, on November 28, 2012, the court *sua sponte* vacated its February order, asserting it lacked subject-matter jurisdiction and should never have confirmed any portion of Copperill's arbitration award (the "November order").[4] The court based this decision on an erroneous assumption that Copperill's arbitrators predicated their award on Securities Exchange Act of 1934 ("Exchange Act") violations, over which federal courts possess exclusive jurisdiction.[5] Copperill appealed to New York's Second

1. Jon Black and Ari Diaconis are currently third-year students at Cornell Law School. The two serve as an Editor and Articles Editor on the Cornell Journal of Law & Public Policy and the Cornell Law Review, respectively.

2. FINRA, the Financial Industry Regulatory Authority, is the "largest independent securities regulator in the U.S." and "operates the largest dispute resolution forum in the securities industry." FINRA, "About FINRA" (Aug. 16, 2013), available at http://www.finra.org/AboutFINRA/.

3. *See* Copperill v. Shapiro, No. 09-07046 (FINRA Arbitration Awards Online, Apr. 5, 2011), http://finraawardsonline.finra.org/search.aspx?.

4. *See generally* Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060 (N.Y. Sup. Ct. 2012).

5. *Id*. at *7–8. Justice Bucaria was unclear as to which section of the Exchange Act he believed Copperill's arbitrators predicated their award, referring only generally to the "Securities Exchange Act."

Department. However, before the Second Department heard argument, Sloane filed for bankruptcy, staying the appeal. As a result, the trial court's November remains viable precedent.

The November order sets an unsightly precedent in large part because Copperill's arbitrators quite obviously predicated their award exclusively on FINRA Rule violations[6] and New York common law claims. The November order effectively rules that New York courts lack the subject-matter jurisdiction necessary to confirm any FINRA award, so long as an award deals with substance remotely resembling Exchange Act subject matter or FINRA Rule violations. To the extent this order becomes accepted precedent, those seeking confirmation of FINRA awards may find themselves without a forum, unable to confirm their awards in either federal or state court.[7]

This article focuses primarily on summarizing several of the obvious problems with the November order.[8] We also explain why the initial February order relating to punitive damages was erroneous. Lastly, we explore some of the more nuanced jurisdictional issues raised by the November order. This article equips attorneys with sufficient defenses should they confront the arguments found in either of the two orders.

II. BACKGROUND

Copperill is a retired New York City firefighter who placed much of his savings with Sloane for purposes of prudent investment. After Sloane mishandled the investment account, Copperill brought a FINRA arbitration action, alleging: fraud, misrepresentation, churning, unsuitable investing, unauthorized trading, mismanagement, breach of fiduciary duty, negligence, failure to supervise, and breach of good faith and fair dealing.[9] At no point did Copperill allege violations of the Exchange Act or any other federal law.

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6. FINRA Rule violations when brought by private parties do not invoke the Exchange Act; they do not constitute private causes of action and are thought of as contract violations. *See infra* section III.B.3.

7. *See infra* section III.B.5.

8. As New York is one of the securities centers of the world, decisions from its courts are often considered persuasive and require close scrutiny. Thus, while this article focuses mostly on New York law and procedure, its implications are broad.

9. *See Copperill*, No. 09-07046, at *1. Though Sloane was the named party in the confirmation proceeding, Copperill also brought claims against the brokerage firm Westrock Advisors, Inc. and one Andrew Shapiro. *Id*.

On April 4, 2011, three FINRA arbitrators unanimously awarded Copperill approximately $490,000, representing compensatory damages, disgorgement, interest, attorneys' fees, and $211,592.11 in punitive damages.[10] In rendering their award, the arbitrators cited almost exclusively FINRA Conduct Rules and New York court cases.[11] Only once did the arbitrators cite federal law, and they did so merely to provide additional support for their authority to award punitive damages.[12]

On November 3, 2011, Copperill sought confirmation of his FINRA award pursuant to New York CPLR Article 75. New York Supreme Court Justice, Stephen A. Bucaria, confirmed the award on February 29, 2012 but deleted the punitive damages portion.[13] In deleting the punitive damages, the court wrote only that punitive damages violate public policy. Neither Copperill nor Sloane appealed this February order.

Soon after the February order, Copperill began an enforcement proceeding against Sloane, also before Justice Bucaria.[14] During the course of this enforcement proceeding, the court asked *sua sponte* for briefing on the issue of subject-matter jurisdiction related to its initial February confirmation of the FINRA arbitration award. Parties briefed the issue by November 2012, some eight months after the February order.

On November 28, 2012, the court issued an opinion fully vacating its February order, stating that it lacked the subject-matter jurisdiction necessary to confirm any aspect of Copperill's FINRA arbitration award.[15] This November order rested primarily on the court's misunderstanding and misapplication of *FINRA v. Fiero*,[16] a 2008 New York Court of Appeals case that deals not with confirmation of arbitration awards, but with actions brought by FINRA Regulation to enforce sanctions against its associated persons. In addition, the court conflated statutory grounds for confirmation of

10. *See id*. at *2–4.

11. *See id*. at *2–3.

12. *Id*. at *3 (citing Mastrobuno v. Shearson Lehman Hutton, 514 U.S. 52 (1995)). For more discussion of punitive damages, see *infra* section III.A.

13. *See* Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *3 (N.Y. Sup. Ct. 2012).

14. *See supra* note 2 and accompanying text.

15. *See Copperill*, 20212 N.Y. Misc. at *7–8.

16. 882 N.E.2d 879 (N.Y. 2008).

an award with those needed to modify or vacate an award, an issue we explore below.[17]

Though the trial court correctly noted that, under *Fiero*, a state court does not have jurisdiction to confirm an action brought *by* FINRA pursuant to the Exchange Act, the court failed to recognize the inapplicability of *Fiero* to cases involving private litigants.

Having observed that only courts of the United States have jurisdiction to hear Exchange Act violations, the court then framed the dispositive issue as one turning on "whether the award is based upon a violation of the [] Exchange Act."[18] Although Copperill never alleged Exchange Act claims, the court concluded that the arbitrators predicated their award on at least one Exchange Act violation.[19] In support thereof, the court first provided the following erroneous conclusions of law:

> The FINRA arbitration award does not expressly state which of the causes of action were sustained in finding for the customer. Nevertheless, the court notes that fraud, misrepresentation, churning, unsuitable investing, unauthorized trading, mismanagement, breach of fiduciary duty, negligence, and failure to supervise are all [] Exchange Act violations. *See* FINRA Rule 12000 et seq available at www.finra.complinet.com, viewed on November 21, 2012.[20]

Next, the court erroneously concluded that Copperill's FINRA "award of disgorgement and punitive damages . . . makes clear that the arbitrators found one or more [] Exchange Act violations."[21]

Because it assumed the arbitrators predicated Copperill's award on Exchange Act violations, and that Copperill's common law claims were merely Exchange Act claims by another name, the court determined that it lacked subject-matter jurisdiction. In rationalizing its decision, the court described how the lack of state court jurisdiction precluded it from conducting a necessary review of the award for "irrationality," something the parties had not raised in the first instance.[22] The court nevertheless believed it

17. *See infra* section III.A.1.

18. *Copperill*, 2012 N.Y. Misc., at *7.

19. *Id*. at *8.

20. *Id*. at *7–8.

21. *Id*. at *8.

22. *See id*. at *6.

was required to review the "merits of the Exchange Act claims" that it concluded were at issue in Copperill's award.[23]

For all of these reasons, the court vacated its February confirmation order. Its opinion instructs that Copperill seek confirmation in federal court, the only court it believed had jurisdiction to confirm the award.[24] Copperill appealed the order to New York's Second Department Appellate Division in December 2012. Before the appeal was heard, however, Sloane filed for bankruptcy, forcing a stay on the appeal. As a result, the trial court's November order remains as a precedent.

This is an unfortunate result. As this article will show, the court's November order was both bad law and bad policy. It is based on a misunderstanding of relevant New York case law, the role of FINRA arbitration, and the procedural mechanisms for confirming arbitration awards. If other courts follow this precedent, federal courts would be inundated with petitions to confirm even the most trivial of state common law claims, which, aside from forcing federal courts to deal with a host of new and unwanted claims, could drastically raise the cost of confirmation proceedings. In any event, federal courts would be unlikely to exercise jurisdiction over these claims, as we show below. Indeed, this article spells out exactly why the trial court's February and November orders are both mistaken. The article also provides insight for practitioners who must work alongside the specter of these unfortunate cases.

III. WHY THE ORDERS ARE ERRONEOUS

A. THE COURT'S FEBRUARY ORDER RELATED TO PUNITIVE DAMAGES WAS ERRONEOUS.

The court was wrong to vacate Copperill's award for punitive damages. First, it did not follow the proper procedure for considering the demand to vacate punitive damages. Second, having heard the demand, it was incorrect to hold that an award of punitive damages violated public policy.

23. *Id*.

24. *Id*. at *8.

1. The court was incorrect in considering Sloane's demand.

The court's February order modified Copperill's arbitration award by deleting punitive damages. Sloane demanded the deletion of punitive damages in his answer to Copperill's confirmation petition, which Copperill filed more than ninety days after Copperill's arbitrators rendered their decision. The preliminary question is therefore whether the trial court was correct in hearing Sloane's demand at all.

New York law governing arbitration provides that "an application to vacate or modify an award may be made by a party within ninety days after [the award's] delivery to him"[25] and may do so "only upon the grounds enumerated [in CPLR section 7511] for vacating or modifying arbitration awards."[26] The law further provides that applications[27] during the confirmation proceeding must be made by motion.[28] Unless, on a party's application, the court modifies or vacates the award for one of the causes in CPLR 7511, the court must confirm the arbitration award.[29] The court may not *sua sponte* vacate an award.[30]

Under CPLR 7511, the court shall *modify* the award if (1) there is a miscalculation or mistake in the description of anything referred to in the award, (2) the award is based on a matter which was not submitted to arbitration, or (3) the "award is imperfect in a matter of form, not affecting the merits of the controversy."[31] The court may only *vacate* the award if:

> (1) the rights of a party were prejudiced by corruption, fraud or misconduct in procuring the award, or by the partiality of the arbitrator; (2) the arbitrator exceeded his or her power or failed to make a final and definite award; or (3) the arbitration suffered from an unwaived procedural defect. Even where the arbitrator makes a

25. N.Y. C.P.L.R. 7511(a) (MCKINNEY 2012).

26. Vilceus v. N. River Ins. Co., 150 A.D.2d 769, 769–70 (N.Y. App. Div. 2d 1989).

27. Application include demands for modification or vacatur of an arbitration proceeding.

28. *See* N.Y. C.P.L.R. 7502(a)(iii).

29. *See* N.Y. C.P.L.R. 7510; *but see generally* Sawtelle v. Waddell & Reed, Inc., 304 A.D.2d 103 (N.Y. App. Div. 1st 2003) (discussing the constitutional due process limits of punitive damage awards).

30. *See* Boggin v. Wilson, 14 A.D.3d 523, 524–25 (N.Y. App. Div. 2d 2005).

31. *See* N.Y. C.P.L.R. 7511.

> mistake of fact or law, or disregards the plain words of the parties' agreement, the award is not subject to vacatur "unless the court concludes that it is totally irrational or violative of a strong public policy" and thus in excess of the arbitrator's powers.[32]

The above language based on CPLR Article 75 appears to allow modification or vacatur only upon motion and only upon the enumerated grounds listed in CPLR 7511. However, some New York courts, including the Second Department and at least one district court in the Second Circuit, hold that "[w]hile an aggrieved party has only [ninety] days within which to move to vacate or modify an arbitration award, such a party may elect not to make a motion and, instead, raise the objection [in an answer] when the successful claimant moves to confirm the award," despite the fact that the ninety day limit has passed.[33]

Here, Sloane made his December 6, 2011 demand for modification by answer rather than motion and did not make it within ninety days of the delivery of the April 4, 2011, arbitration award. On first glance the demand appears to be improperly before the court under the plain language of CPLR Article 75.[34] Nevertheless, because the Second Department currently permits applications for modification by answer after ninety days from award delivery, the trial court would likely have been correct to review this

32. Hackett v. Milbank, 654 N.E.2d 95, 100 (N.Y. 1995).

33. *See Vilceus*, 150 A.D.2d at 769–70 (internal citations omitted); Local 205 v. Day Care Council, 992 F. Supp. 388, 394 (S.D.N.Y. 1998); *In re* Sutorius, 166 Misc. 2d 465, 468 (N.Y. Sup. Ct. 2d 1995). Courts allowing modification or vacatur in response to CPLR 7510 motions to confirm have based their decisions on rulings from cases decided under CPA section 1463, the predecessor to CPLR Article 75, or other laws. These courts do not consider the statutory requirements of CPLR 7502 (application must be made by motion), CPLR 7510 (court must confirm award except on application by party under CPLR 7511), or CPLR 7511 (application for modification or vacatur must be made within ninety days of award). *See, e.g.*, *Vilceus* 150 A.D.2d at 769–70 (citing Katz v. Uvegi, 18 Misc. 2d 576 (N.Y. Sup. Ct. 1959)); State Farm Mut. Auto. Ins. Co. v. Fireman's Fund Ins. Co., 121 A.D.2d 529 (N.Y. App. Div. 2d 1986) (citing Morris v. Government Employees Ins. Co., 95 Misc. 2d 696 (N.Y. Civ. Ct. 1978)). Whether the holdings of these courts have merit under the statutory language of CPLR article 75 is beyond the scope of this article.

34. *See* N.Y. C.P.L.R. 7502(a)(iii), 7511 (stating that application for modification must be made by motion and within ninety days of delivery of award).

application for modification had the demand asserted grounds for modification under CPLR 7511.[35]

In this case, however, Sloane's demand to modify did not contain any grounds for modification or vacatur based on CPLR 7511, nor did it allege the punitive damages to be violative of public policy.[36] The court was therefore incorrect in considering Sloane's demand at all.

2. The court's deletion of punitive damages based on public policy was erroneous.

Even if Sloane's answer had properly stated grounds for modification, the court would still have been mistaken in modifying the award as violative of public policy.

Although the New York Court of Appeals holds that the award of punitive damages in arbitration is against public policy (the "*Garrity* rule"),[37] the Supreme Court of the United States holds that where a contract calls for arbitration according to NASD Rules, and NASD Rules specify that arbitrators can consider punitive damages as a remedy, the *Garrity* rule does not apply.[38] In other words, the Supreme Court determined that the national policy favoring arbitration supports enforcing a punitive damages award where such award is within the scope of the parties' agreement.[39]

Here, the pre-dispute arbitration agreement governing the account in question requires that controversies be determined by arbitration according to the prevailing NASD Rules. Thus, the arbitrators' award of punitive damages was not against public policy and the court was erroneous in its modification of the award.

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35. *See, e.g.*, *Vilceus* 150 A.D.2d at 769–70 (stating that applications for modification may be made in answer, but only on grounds enumerated under CPLR 7511).

36. *See id.*

37. *See* Garrity v. Lyle Stuart, Inc., 353 N.E.2d 793, 794 (N.Y. 1976).

38. *See* Mastrobuono v. Shearson, 514 U.S. 52, 56–64 (1995). NASD is the predecessor to FINRA.

39. *See id.* at 64.

B. THE COURT'S NOVEMBER ORDER ON SUBJECT-MATTER JURISDICTION WAS ERRONEOUS.

There are several reasons why the court was incorrect in holding that New York courts lacked subject-matter jurisdiction to confirm Copperill's award. These reasons are discussed in detail below.

1. *Fiero does not apply to this case whatsoever.*

The court based its order in large part on the New York Court of Appeals case *FINRA v. Fiero*.[40] However, *Fiero* does not apply to the facts here at all.

In *Fiero*, FINRA's (then NASD's) Department of Enforcement began a disciplinary proceeding against Fiero, the sole employee of the Fiero Brothers, a NASD member firm, for launching a "bear raid" to drive down the price of securities held by another NASD member. The raid ultimately caused the target member to financially collapse.[41] A NASD disciplinary panel found that Fiero engaged in illegal short sales, extortion, and market manipulation; assessed approximately a $1 million fine, plus costs; and expelled Fiero Brothers from NASD membership.[42] The decision was affirmed by NASD's National Adjudicatory Council.[43] NASD then brought a proceeding in state court to enforce the judgment against Fiero, which was granted.[44]

On appeal, however, the New York Court of Appeals reversed, holding that the lawsuit fell under the Exchange Act and that, therefore, a state court had no subject-matter jurisdiction.[45]

The court in Copperill seems to interpret *Fiero* as making the confirmation of all FINRA arbitrations matters of exclusive federal law.[46] For instance, it cites FINRA "Rule 12000, et seq.," for the proposition that

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40. *See* 882 N.E.2d 879 (N.Y. 2008).

41. *Fiero*, 882 N.E.2d at 880.

42. Nat. Ass'n of Sec. Dealers v. Fiero, 2006 N.Y. Misc. LEXIS 9293, at *2 (N.Y. Sup. Ct. 2006) (original trial court decision).

43. *Id*. at *3.

44. *Fiero*, 882 N.E.2d at 880.

45. *Id*. at 881–82.

46. *See* Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *3–5 (N.Y. Sup. Ct. 2012).

"fraud, misrepresentation, churning, unsuitable investing, unauthorized trading, mismanagement, breach of fiduciary duty, negligence, and failure to supervise are all [] Exchange Act violations."[47] This is a very strange interpretation of FINRA 12000 et seq., which is not a substantive rule, but a chapter of rules outlining only FINRA Arbitation procedures.[48] Indeed, Rule 12000 does not so much as mention the Exchange Act. Moreover, the substantive FINRA Rules, to which Rule 12000's procedures apply, involve familiar common-law state claims, such as fraud or misrepresentation,[49] negligence by way of unsuitable investing,[50] and breach of fiduciary duty.[51] None of these claims necessarily involve federal law.[52]

By citing to Rule 12000, it seems that the trial court glossed over the dispositive distinction between FINRA as a forum for private arbitration of securities disputes and FINRA as a federal self-regulatory body under the oversight of the SEC. FINRA serves as a forum for private arbitrations; exercises "the authority to enforce the requirements of the Exchange Act;" and serves as "the primary regulator of the broker-dealer industry."[53]

Fiero, quite unlike the case here, was entirely about FINRA as a regulator of industry misconduct. The *Fiero* court itself made clear that the issue there concerned only an "*action to enforce a penalty* imposed . . . *as a result of disciplinary proceedings* provided for by the [] Exchange Act for violations of the [] Exchange Act and its implementing rules."[54] The case had nothing to do with private plaintiffs who bring actions in the FINRA forum, and there is no hint in the *Fiero* decision that the Court of Appeals thought its decision would apply to non-regulatory matters. Because *Fiero* concerned only federal regulation of broker-dealers, it was perfectly valid for the state court there to refuse confirming a penalty, the basis of which entirely depended on the Exchange Act.

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47. *Id*. at *7–8.

48. *See* FINRA Rule 12000, Code of Arbitration Procedure for Customer Disputes, *available at* http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=4096.

49. FINRA Rule 2020.

50. FINRA Rule 2111.

51. FINRA Rule 2060.

52. *See* FINRA Rules 12200–01 (listing when the parties must and when they may arbitrate under the FINRA arbitration code).

53. Rosenberg v. Metlife, Inc., 8 N.Y.3d 359, 366 (N.Y. 2007).

54. FINRA v. Fiero, 882 N.E.2d 879, 882 (N.Y. 2008) (emphasis added).

The facts here are entirely distinct from *Fiero*. Copperill is private person—not a federal regulator—who asserted time-honored, state-law tort claims[55] against a broker-dealer and its Associated Persons. Copperill only used FINRA as an arbitration forum because FINRA was the forum specified in the account agreement with his broker. Indeed, brokerage contracts are free to specify FINRA as an arbitration forum.[56] Accordingly, there was no issue of federal law being raised, making the application of *Fiero* totally mistaken.

The fact is, New York courts have continued confirming awards similar to those involved here in the years since *Fiero* was decided.[57] This should come as no surprise; for the courts to have done anything else would have made the sleepy *Fiero* decision into a truly revolutionary one.[58] If *Fiero* really means what the New York trial court interpreted it to mean, then it would have totally changed the way that both federal and state courts have traditionally confirmed FINRA arbitration awards.

To hold that FINRA awards involving garden-variety common-law claims may only be confirmed in federal court would radically overturn the system for confirming arbitrations as it has existed for years. As a practical matter, the federal courts would be burdened with a host of new, unwanted claims, mainly centered around such bland tort issues as those brought here. Indeed, federal courts would not even have jurisdiction to review such claims.[59]

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55. *See* Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *1 (N.Y. Sup. Ct. 2012).

56. *See, e.g.*, Cowen & Co. v. Anderson, 76 N.Y. 2d 318, 321–22 (N.Y. 1990) (allowing securities disputes to be arbitrated in a number of forums, as specified in the original contract, and including NASD arbitration).

57. The cases so confirming are extensive. But, for a representative sample, see Irina Aronson Irrevocable Trust v. Bretton, 2011 N.Y. Misc. LEXIS 3557 (N.Y. Sup. Ct. 2011); Walzer v. Muriel Siebert & Co., 31 Misc. 3d 1240(A) (N.Y. Sup. Ct. 2011); Cantor Fitzgerald Sec. v. Refco Sec., LLC, 2010 N.Y. Misc. LEXIS 3595 (N.Y. Sup. Ct. 2010); D.B. Toy Prods., Inc. v. Sky Capital, LLC, 2010 N.Y. Misc. LEXIS 2473 (N.Y. Sup. Ct. 2010); D. Weckstein & Co. v. Trinity Bui, 2009 N.Y. Misc. LEXIS 5816 (N.Y. Sup. Ct. 2009).

58. The "Shepardize" tool on Lexis Nexis shows that only 16 individual decisions (excluding the later federal appeals in the *Fiero* case) have cited *Fiero*. One of those decisions is *Copperill* itself. If *Fiero* were really as important of a case as Justice Bucaria believed, one would expect a lot more than 15 other citations.

59. *See infra* section III.B.5.

2. FINRA Rules and the use of FINRA's forum do not compel the conclusion that the Exchange Act is at play.

One theme running through the court's November order suggests that FINRA arbitration necessarily invokes the Exchange Act.[60] However, materials from FINRA and the Securities Exchange Commission both make clear that use of FINRA does not compel the conclusion that the Exchange Act is at play. "[FINRA] arbitrators are not bound to follow the substantive law . . . that govern[s] litigation"—substantive law such as the Exchange Act.[61] FINRA aims to "protect investors by prohibiting agreements that would limit the ability of any investor to file any claim in arbitration or that limits the power of arbitrators to make any award. For example, arbitrators can and do award punitive damages in favor of investors."[62]

Like was the case here, parties typically agree to FINRA arbitration through an arbitration clause signed at the inception of the parties' relationships.[63] When parties agree to FINRA arbitration, they agree to "giv[e] up the right to sue each other in court," and they recognize "that arbitration awards are generally final and binding."[64] FINRA registered "Member Firms" and "Associated Persons" working for the firms further agree to conform their "business activity" to FINRA Rules, which are wholly distinct from the conduct scheme outlined in the Exchange Act.[65] Of course,

60. *See, e.g.*, Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *7–8 (N.Y. Sup. Ct. 2012).

61. Statement on Key Issues, Securities and Exchange Commission Investor Advisory Committee (May 17, 2010), http://www.sec.gov/spotlight/invadvcomm/iacmeeting051710-finra.pdf.

62. *Id.*

63. An Outline of the FINRA Arbitration Process for Customer-Broker Disputes, Smiley Bishop & Porter LLP, http://www.sbpllplaw.com/2011/04/an-outline-of-the-finra-arbitration-process-for-customer-broker-disputes/ (last visited April 26, 2013).

64. *See, e.g.*, Customer Agreement, Koonce Securities, Inc., http://www.koonce.net/applications/CUSTOMER_AGREEMENT.pdf (last visited April 26, 2013)

65. *See* How Does FINRA Differ From the SEC?, INVESTOPEDIA, http://www.investopedia.com/ask/answers/112.asp (last visited April 26, 2013).

FINRA itself does not become a party to these arbitrations; FINRA merely provides the forum for arbitration.[66]

The court's assumption that FINRA's Rules and forum necessarily equate to Exchange Act violations is preposterous. Nothing in FINRA's or the SEC's material so much as suggests FINRA arbitrators are bound by the Exchange Act when rendering their awards.

Sloane had agreed in writing to FINRA arbitration and to FINRA's "business activity" standards. The FINRA Dispute Resolution arbitrators—who are not employed by FINRA—found in their wide discretion that Sloane breached his duties, and Copperill's award should have been confirmed in full.[67]

3. *All of Copperill's claims were predicated on state law and FINRA Rules.*

It is clear that Copperill's arbitrators did not invoke the Exchange Act or any other federal law while rendering their award. The court thus had no grounds for dismissing based on subject-matter jurisdiction.

In arbitration, Copperill brought the following claims, all of which constitute New York common law claims and FINRA Rule violations: fraud, misrepresentation, churning, unsuitable investing, unauthorized trading, mismanagement, breach of fiduciary duty, negligence, failure to supervise, breach of duty of good faith and fair dealing, and unjust enrichment.[68] While some of these claims could theoretically constitute an element of a 10b-5 action under the Exchange Act, everything on the record reflects that Copperill alleged either FINRA Rule violations or New York common-law claims, not Exchange Act claims.[69] The record further reflects that the arbitrators applied only FINRA Rules and New York common law in rendering their award.

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66. *See* FINRA's Dispute Resolution Process, FINRA, http://www.finra.org/web/groups/industry/@ip/@edu/documents/education/p117486.pdf (last visited April 26, 2013).

67. *See* Arbitrator Selection, FINRA, http://www.finra.org/ArbitrationAndMediation/Arbitration/Process/ArbitratorSelection/index.htm (last visited April 26, 2013).

68. *See* Copperill v. Shapiro, No. 09-07046, at *1 (FINRA Arbitration Awards Online, Apr. 5, 2011), http://finraawardsonline.finra.org/search.aspx?.

69. *See* 17 C.F.R. 240.10b-5.

First, all of Copperill's claims at arbitration constitute New York common law claims.[70] Second, all of Copperill's claims at arbitration constituted FINRA Rule violations,[71] which as stated above, are conduct schemes wholly distinct from those outlined in the Exchange Act.[72]

Third, the record reflects that Copperill's arbitrators applied only FINRA Rules and New York common law in rendering their award, not any statute under the Exchange Act. Nowhere did Copperill plead an Exchange Act violation, and nowhere did the arbitrators' final decision cite the Exchange Act. The arbitrators' final decision cited only FINRA Rules and New York

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70. *See, e.g.*, MBIA Ins. Corp. v. Countrywide Home Loans, Inc., 87 A.D.3d 287, 297 (N.Y. App. Div. 2011) (recognizing breach of the duty of good faith and fair dealing as a cause of action but dismissing on other grounds); Scalp & Blade, Inc. v. Advest, Inc., 309 A.D.2d 219, 220 (N.Y. App. Div. 2003) ("[W]e hold that in a case such as this, involving claims of churning, investment unsuitability, or other acts of unauthorized trading by defendants, an appropriate measure of damages is . . ."); Montoya v. Cousins Chanos Casinos, LLC, 2012 WL 118475, at *5 (N.Y. Sup. Ct. 2012) (analyzing common-law claims for mismanagement and unjust enrichment within securities context). In addition to constituting common-law claims, many of Copperill's allegations also constitute actions under New York statutory law. *See, e.g.*, N.Y. GEN. BUS. LAW § 339-a (McKinney 2012) (covering fraudulent and negligent transactions in securities).

71. *See, e.g.*, FINRA Rule 2020 (encompassing fraud and misrepresentation); FINRA Rule 2060 (recognizing a fiduciary duty owing from brokers to clients); NASD Rule 2510 (encompassing unauthorized trading as well as excessive trading (often referred to as churning)); FINRA Rule 2010 (encompassing good faith and fair dealing as well as negligence and unjust enrichment).

72. *But see* Laufer v. Rothschild, 143 A.D.2d 732, 733–45 (N.Y. App. Div. 1988) (suggesting FINRA Rules create causes of action within the exclusive jurisdiction of federal courts). Laufer, however, is unpersuasive for a number of reasons. First, the case has faded into obscurity, having not been cited since 1995. Second, the overwhelming majority of case law directly contradicts it. *See, e.g.*, Smith Barney, Inc. v. Painters Local Union No. 109 Pension Fund, 976 F.Supp. 1293, 1296 (D.Neb.1996) (remanding the case because, *inter alia*, no federal question jurisdiction exists for a violation of NASD rules); Raymond James & Assoc. v. NASD, Inc., 844 F.Supp. 1504, 1507 (M.D.Fla.1994) ("[T]he NASD rules themselves do not give rise to federal question jurisdiction."); *In re* Application of Prudential Sec. Inc., 795 F.Supp. 657, 659 (S.D.N.Y.1992) (remanding case for lack of subject-matter jurisdiction: "NASD rules are established and enforced by a private association and do not give rise to federal question jurisdiction.").

court cases.[73] The arbitrators made no mention whatsoever of the Exchange Act. There is no body of securities law which presumes an Exchange Act violation from the use of everyday, common-law terminology. The court was wrong to determine that Copperill's award implicated the Exchange Act.

4. The court erroneously reasoned that disgorgement and punitive damages can only result from Exchange Act violations.

In its November order, the court concluded that Copperill's FINRA "award of disgorgement and punitive damages . . . makes clear that the arbitrators found one or more [] Exchange Act violations."[74] This notion that only Exchange Act violations can result in disgorgement and punitive damages is bizarre. Disgorgement is merely "the act of giving up something (such as profits illegally obtained) on demand or by legal compulsion."[75] Punitive damages are "damages awarded in addition to actual damages when the defendant acted with recklessness, malice or deceit."[76]

While it is true that the word disgorgement may be used in association with Exchange Act violations, courts regularly use the word as it relates to any number of common-law claims.[77]

Similarly, punitive damages are available in almost every area of intentional tort law, not just Exchange Act violations.[78] In fact, although at least one court has gone the other way,[79] there was a recent period when

73. Copperill v. Shapiro, No. 09-07046 (FINRA Arbitration Awards Online, Apr. 5, 2011), http://finraawardsonline.finra.org/search.aspx?. The arbitrators' final award did cite one United Stated Supreme Court case, but this case was only cited in further support of the arbitrators' authority to award punitive damages. *See id.*

74. Copperill v. Sloane, 2012 N.Y. Misc. LEXIS 6060, at *8 (N.Y. Sup. Ct. 2012).

75. BLACK'S LAW DICTIONARY 501 (8th ed. 2004).

76. *See id.* at 418.

77. *See, e.g.*, S. Shore Neurologic Ass'n, P.C. v. Ruskin Moscou Faltischek, P.C., 32 Misc.3d 746, 747 (N.Y. Sup. Ct. 2011) (discussing disgorgement of attorneys' fees).

78. *See, e.g.*, Don Buchwald & Assoc. v. Rich, 281 N.Y.S.2d 8, 8 (N.Y. App. Div. 2001) (describing when punitive damages are appropriate) (citing Swersky v. Dreyer & Traub, 219 A.D.2d (N.Y. App. Div. 1996)).

79. *See generally Sheldon v. Vermonty*, 2004 WL 1730348 (10th Cir. 2004) (suggesting that 10b-5 violations may sometimes result in punitive damages).

courts stated in unanimity that Exchange Act violations (especially 10b-5 violations) could not produce punitive damages.[80]

5. Copperill could not confirm his award in federal court.

In dismissing Copperill's motion for confirmation, the court instructed Copperill to seek confirmation in federal court. But because the issues underlying Copperill's arbitration award are matters of state law and because the parties are not diverse, the federal courts have no jurisdiction to confirm Copperill's award. The court's determination that it lacked subject-matter jurisdiction over the arbitration award left Copperill with no recourse.

The federal courts have jurisdiction to confirm an arbitration award only when there is diversity of citizenship or a federal question, or where a case concerns admiralty or maritime law.[81] Here, all parties are citizens of New York, and there is no admiralty or maritime issue contemplated, so the federal courts do not have jurisdiction unless there is a federal question.

For federal question jurisdiction to exist, it is not sufficient that the controversy in question could involve a federal law. Rather, under the well-pleaded complaint rule, federal questions arise only when an issue of federal law appears on the face of a complaint.[82] In the case of arbitration, however, it is the complaint submitted to arbitration, not the motion to confirm, that must plead a federal cause of action.[83]

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80. *See, e.g.*, Flood v. Miller, 2002 WL 1135932, at *3 (9th Cir. 2002) ("[T]he Securities Act of 1934 disclaims punitive damages in securities actions."); Boguslavsky v. Kaplan, 159 F.3d 715, 721 (2d Cir. 1998) ("[P]unitive damages are unavailable under the 1934 Act"); Flaks v. Koegel, 504 F.2d 702, 706 (2d Cir. 1974) (holding that punitive damages are unavailable under § 10(b) and the regulations promulgated thereunder).

81. *See* 28 U.S.C. §§ 1331-1333. The FAA does not constitute a grant of jurisdiction to federal courts. Dorn v. Dorn's Transp., Inc., 562 F.Supp. 822, 824 (S.D.N.Y. 1983).

82. *See* Louisville v. Mottley, 211 U.S. 149, 152 (1908). "As a general rule, absent diversity jurisdiction, a case will not be removable if the complaint does not affirmatively allege a federal claim." Beneficial Nat. Bank v. Anderson, 539 U.S. 1, 6 (2003).

83. *See Dorn*, 562 F.Supp. at 824 (holding that the FAA does not convey subject-matter jurisdiction on the federal courts). *See also* Vaden v. Discover Bank, 556 U.S. 49, 70 (2009); *Vaden* asserts the "look through" principle, under which federal courts look to the controversy underlying the dispute in arbitration to determine subject-matter jurisdiction. *See id.*

Here, because Copperill did not allege a federal claim in his complaint submitted to arbitration, the federal courts have no jurisdiction over this controversy.[84] The New York court's failure to accept jurisdiction over the Copperill's confirmation motion thus abandoned Copperill in limbo, with no forum in which to confirm his award.

Such a result runs directly counter to the national policy in favor of arbitration reaffirmed in *Mastrobuono* because, among other things, it causes complainants to lose confidence in the courts' abilities to enforce an arbitration judgment.[85]

IV. ANALYZING JURISDICTION TO CONFIRM FINRA AWARDS PREDICATED ON EXCHANGE ACT CLAIMS

Although all claims in this case were pled as state law causes of action,[86] it is probable that the state courts would have jurisdiction to confirm Copperill's arbitration award even if it was predicated on Exchange Act violations.

A. LEGAL SCHOLARSHIPS SUGGESTS THAT ARBITRATION AWARDS PREDICATED ON THE EXCHANGE ACT CAN BE CONFIRMED IN STATE COURTS.

Noted securities-law expert Thomas Lee Hazen writes that, even though the Exchange Act vests exclusive jurisdiction in federal courts, "the policies favoring arbitration and freedom of contract with regard to pre-dispute arbitration agreements *might validate the selection of a state court* pursuant to the Federal Arbitration Act."[87] This kind of jurisdiction is to be distinguished from direct state litigation of an Exchange Act claim, which would clearly be barred by the "exclusive federal jurisdiction" element of the

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84. *See supra* section III.B.3. (discussing that the causes of action in Copperill's complaint were all matters of state law).

85. *See* 514 U.S. at 56.

86. *See supra* section III.B.3.

87. THOMAS LEE HAZEN, TREATISE ON THE LAW OF SECURITIES REGULATION, VOL. 2, 139 (6th ed. 2009) (emphasis added).

Exchange Act.[88] Hazen gives his conclusion tentatively, as the case law on this precise issue is sparse. However, at least one New York court has confirmed an arbitration award predicated on an Exchange Act claim, indicating that state courts do in fact have such power.[89]

B. THE FEDERAL ARBITRATION ACT SUPPORTS STATE COURTS CONFIRMING ARBITRATION AWARDS, EVEN WHEN THE AWARDS ARE PREDICATED ON THE EXCHANGE ACT.

The FAA mandates that "[a] written provision in . . . a contract evidencing a transaction involving commerce [among the several states] to settle by arbitration a controversy thereafter arising out of such contract . . . shall be valid, irrevocable, and enforceable . . . ."[90] "Section 2 of the FAA, which does bind the state courts . . . 'carries with it duties [to credit and enforce arbitration agreements] indistinguishable from those imposed on federal courts by FAA §§ 3 and 4.'"[91] Section 3 compels federal courts to stay trial proceedings pending arbitration where there is a valid agreement to arbitrate.[92] Section 4 allows a party aggrieved by another's refusal to arbitrate under a valid arbitration agreement to petition federal courts for an order directing arbitration.[93]

In addition to binding the state courts to credit and enforce arbitration agreements, the FAA substantiates "a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway."[94] Consistent with the policy that supports applying sections 3 and 4 of the FAA to the state courts, section 9 should also bind the state courts in compelling confirmation. Section 9

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88. *Id*. at 379.

89. Baker v. Merrill Lynch, Pierce, Fenner, & Smith, Inc., 2012 N.Y. Misc. LEXIS 1123, at *3–4, 13 (N.Y. Sup. Ct. 2012). Note that this case also involved state law claims of unsuitability, common-law fraud, breach of fiduciary duty, breach of contract, negligence, and other similar common-law claims.

90. *See* 9 U.S.C. §§ 1–2 (2012).

91. Vaden v. Discover Bank, 556 U.S. 49, 71 (2009).

92. *See* 9 U.S.C. § 3 (2012).

93. *See* 9 U.S.C. § 4.

94. Hall Street Assocs. v. Mattel, 552 U.S. 576, 588 (2008).

requires courts to confirm arbitration awards on application of a party to the award, unless modifying or vacating under enumerated grounds.[95]

C. COURTS ARE SEVERELY LIMITED IN MAKING SUBSTANTIVE INQUIRIES INTO ARBITRATION AWARDS, THUS MOOTING MANY JURISDICTIONAL ISSUES.

A proceeding to confirm an arbitration award under CPLR section 7510 does not in itself permit a substantive inquiry into the basis of the award.[96] A court is compelled to confirm an award unless the opposing party demands modification or vacatur for grounds that are enumerated in CPLR 7511.[97] Where the opposing party does not demand modification or vacatur, there is thus no opportunity for substantive inquiry.[98] Therefore, many New York court confirmations of FINRA awards pursuant to CPLR section 7510 should not violate the exclusive federal jurisdiction clause of the Exchange Act even when Exchange Act claims underlie the award.[99]

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95. *See* 9 U.S.C. § 9

96. *See supra* section III.A.1. (discussing the procedure under which New York courts confirm, modify, and vacate arbitration awards).

97. *See id.*

98. *See id.*

99. *See id. Shearson/American Express v. McMahon* determined that section 29 of the Exchange Act (prohibiting waiver of substantive obligations imposed by the Exchange Act) is not violated by agreements to arbitrate conflicts in FINRA arbitration, despite the existence of section 27 of the Exchange Act (giving exclusive jurisdiction to the federal courts to resolve conflicts arising thereunder). *See* 482 U.S. 220 at 228 (1987).

> What the antiwaiver provision of § 29(a) forbids is enforcement of agreements to waive "compliance" with the provisions of the statute. But § 27 itself does not impose any duty with which persons trading in securities must "comply." By its terms, § 29(a) only prohibits waiver of the substantive obligations imposed by the Exchange Act. Because § 27 does not impose any statutory duties, its waiver does not constitute a waiver of "compliance with any provision" of the Exchange Act under § 29(a). . . . [W]here, as in this case, the prescribed procedures are subject to the Commission's § 19 authority, an arbitration agreement does not effect a waiver of the protections of the Act.

Id. at 234. Because an agreement to arbitrate under FINRA Rules does not impinge upon the restrictions of Exchange Act sections 27 and 29, FINRA

Moreover, even when an opposing party does demand modification or vacatur, a state court could confirm the award without conducting an inquiry into Exchange Act law. For example, at least one federal court has recognized that not all grounds for review of arbitration awards require an inquiry into the underlying law:

> In contrast to grounds of review that concern the arbitration process itself—such as corruption or abuse of power—review for manifest disregard of federal law necessarily requires the reviewing court to do two things: first, determine what the federal law is, and second, determine whether the arbitrator's decision manifestly disregarded that law.[100]

Thus, while "manifest disregard" may require a substantive inquiry, a review for abuse of power[101] or corruption does not.[102] A review for abuse of power or corruption, therefore, would not necessarily violate section 27 of the Exchange Act if conducted by a state court.

V. CONCLUSION

The New York trial court's *Copperill* orders were both bad law and bad policy. The orders were bad law because they were based on a misreading of the *Fiero* case as well as misunderstandings of the Exchange Act, the role of

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arbitration agreements are enforceable under the Federal Arbitration Act even when they pertain to Exchange Act claims. *See id.* at 238.

100. *See* Greenberg v. Bear, Stearns & Co., 220 F.3d 22, 27 (2d Cir. 2000) (emphasis added) (abrogated in part on other grounds by *Vaden*, 556 U.S. 49). *Greenberg* relied on *Westmoreland Capital Corp. v. Findlay* for the principle that the presence of Exchange Act violations underlying an agreement to arbitrate does not create federal question jurisdiction, and to that extent it is abrogated by *Vaden*. *See* Westmoreland Capital Corp. v. Findlay, 100 F.3d 263 (2d Cir. 1996); *Vaden*, 556 U.S. at 70; *supra* note 83.

101. "*Abuse* of power" is not a ground for review under the FAA or CPLR section 7511, but both the FAA and CPLR section 7511 list "*exceeding*" power, which is presumably synonymous, as grounds for vacatur of an award. *See* 9 U.S.C. § 10(a)(4); N.Y. C.P.L.R. 7511(b)(1)(iii).

102. *See Greenberg*, 220 F.3d at 27. "Under certain federal decisions, an arbitration may be reviewed to determine whether it was made in 'manifest disregard' of law. The New York Court of Appeals has, however, not recognized such grounds . . . ." Banc of Am. Sec. v. Knight, 4 Misc. 3d 756, 759 (N.Y. Sup. Ct. 2004).

FINRA arbitration, and the procedural mechanism for confirming arbitration awards, even when those awards involve Exchange Act claims. The orders were bad policy because to deny state-court review of such garden-variety arbitration procedures would be to flood federal courts with a host of unwanted and unneeded claims—claims federal courts likely would not hear anyway.

Nevertheless, once Sloane filed for bankruptcy, those who oppose the order lost the opportunity for appellate review. As a result, the unfortunate orders remain on the books.

We hope that this article will provide material for practitioners who must navigate these difficult concepts and who, some day, may help to toss *Copperill* on the ash heap of history.

RECENT ARBITRATION AWARDS

John S. Burke

DAVID L. BOBO v. UBS FINANCIAL SERVICES, INC.
FINRA Case No. 11-04768

Claimant asserted the following causes of action: (1) misrepresentation and omission of material facts in connection with the purchase of securities; (2) unsuitable recommendations; (3) violations of Kentucky Securities Act rules and regulations including KRS 292.480, KRS 292.320, KRS 292.480, and 808 KAR 10:030; (4) breach of fiduciary duty; (5) common law fraud; (6) common law negligence; and (7) punitive damages pursuant to KRS 411.184 and KRS 411.186. Claimant alleged that upon Respondent's recommendation, he reallocated a portion of his account by selling off various equity mutual funds and individual bonds and reinvesting the proceeds in a Lehman Brothers 100% Principal Protected Note ("PPN"). Claimant alleged that Respondent's representative told him that the PPN investment was guaranteed against loss of principal and that it was perfectly suited to Claimant's conservative investment objectives. Claimant stated Respondent knew of Lehman Brothers' dire financial situation and failed to disclose this information to its sales force and its customers, and, as a result of Lehman Brothers' bankruptcy, this investment is now virtually worthless.

In the Statement of Claim, Claimant requested (1) compensatory damages in the amount of $146,933.00; (2) loss of principal; (3) pre-judgment interest; (4) reasonable attorney fees; (5) costs; (6) punitive damages; (7) post-judgment interest; (8) forum and session fees; and (9) other and further relief as may be appropriate.

Respondent denied the allegations in the Statement of Claim. Respondent asserted that at the time of the November 2007 purchase date, it could not have foreseen Lehman Brothers' collapse. Respondent stated in its Answer that the confirmation of the purchase of the Lehman Notes provided to Claimant contained a link to the SEC's website where Claimant could have reviewed the prospectus. The prospectus contained disclosures as to the risk of Lehman's creditworthiness, amongst other risks. Respondent further argued that structured notes like the PPN investment were not high-risk and complex investments, and were suitable and appropriate for a purchaser with investment objectives of capital appreciation and moderate risk tolerance. Respondent also asserted various affirmative defenses, including: (1) failure to mitigate; (2) contributory negligence; (3) ratification; (4) acquiescence; (5)

waiver; (6) estoppel; (7) all losses were caused by Claimant's own decisions and/or market conditions, not by any wrongdoing on the part of Respondents; (8) Failure to meet conditions precedent; (9) assumption of the risk; (10) no basis for attorney fees or punitive damages; and (11) failure to state a claim.

Award: The Panel found that Respondent was liable and ordered Respondent to pay Claimant as follows: (1) compensatory damages in the amount of $76,289.00; (2) post-award interest at the rate of 12% per annum from the date of service of the award through and including the date the Award is paid in full; (3) attorney fees in the amount of $26,701.15 pursuant to KRS 292.80; and (4) costs in the amount of $300.00 as reimbursement of non-refundable filing fees. The Arbitrator also assessed $2,700.00 in hearing session fees to Respondent.

Claimant's Counsel: Charles C. Mihalek, Esq., and Steven M. McCauley, Esq., Charles C. Mihalek, PSC, Lexington, Kentucky.

Respondent's Counsel: Brian F. Amery, Esq., and David J. Butler, Esq., Bressler Amery & Ross, PC, Morristown, New Jersey.

Claimant's Expert: Louis L. Straney of Arbitration Insight, LLC, Santa Fe, New Mexico (*testified*).

Respondent's Experts: Christopher Laursen, NERA Economic Consulting, Washington, D.C. (*testified*); Professor Roberta Karmel, of Brooklyn Law School, NY (i*dentified*), and John Maine of Belvedere, CA, (*identified*).

Arbitrator: Joseph V. Simeri, (Public Chairperson).

This case is significant because the single arbitrator awarded Claimant over $100,000 in total damages. The Arbitrator rejected the "prospectus defense" of Respondent in awarding damages in a Lehman Brothers Principal Protected Note (PPN) case. Respondent's agent solicited the sale of a portfolio made up of 65% AAA-rated government bonds to make the PPN investment. Respondent's agent claimed the PPN was guaranteed against loss of principal and was a good substitute for Claimant's AAA-rated government bonds.

COLLEGE HEALTH AND INVESTMENT, LTD. V. WELLS FARGO ADVISORS, LLC (F/K/A WACHOVIA SECURITIES, LLC) V SHARI JACOBOWITZ, ESTHER SPERO, THIRD-PARTY RESPONDENTS
FINRA Case No. 10-03554

Claimant asserted the following causes of action: (1) breach of fiduciary duty; (2) negligence; (3) negligent supervision; and (4) breach of contract. The causes of action related to the alleged theft of cash and unspecified securities deposited in Claimant's account held by, and in the custody of, Respondent.

In the Amended Statement of Claim, Claimants requested (1) compensatory damages in excess of $6,000,000.00; (2) margin interest expense; (3) pre-judgment interest at the legal rate; (4) punitive damages; (5) cost of proceedings; and, (8) such other and further relief as was deemed just and appropriate. At the close of hearing, Claimant requested damages in the amount of $4,437,507.00 inclusive of margin interest expense and prejudgment interest through the date of hearing.

In its Answer to the Statement of Claim, Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses. Respondent also asserted Third Party Claims for indemnification and/or contribution against Third Party Respondents Jacobowitz and Spero.

In its Answer to the Amended Statement of Claim, Respondent Wells Fargo requested that the Panel (1) issue an award dismissing the Amended Statement of Claim in its entirety; (2) recommend expungement of this matter from any applicable registration records; (3) assess the costs and expenses of this proceeding against Claimant; and (4) award such other and further relief as was deemed just and proper. Respondent also adopted from its Answer the Third Party Claims against Jacobowitz and Spero.

Award: The Panel found Respondent Wells Fargo liable and ordered the Respondent to pay Claimant as follows: (1) compensatory damages of $2,298,062.00, which includes pre-judgment interest through May 17, 2013 at the legal rate provided by Florida law; (2) margin interest expense in the amount of $418,987.00, which includes pre-judgment interest through May 17, 2013 at the legal rate provided by Florida law; and (3) costs in the amount of $35,000.00.

Claimant’s Counsel: Robert W. Pearce, Esq. and Adam Kara-Lopez, Esq., Robert Wayne Pearce, P.A., Boca Raton, Florida.

Respondent’s Counsel: Brian Amery, Esq., Matthew Plant, Esq. and Alex Sabo, Esq., Bressler, Amery & Ross, P.C., Fort Lauderdale, Florida.

Third-party Respondents: Did not appear.

Claimant’s Experts: Sander Ressler of EMG Capital, Inc., Miami, Florida; David Lanxner of Statement Analysis, Winter Park, Florida.

Respondent’s Experts: John Maine of Belvedere, California; Andrew Daniel of Bates Group LLC, Lake Oswego, Oregon.

Arbitrators: Will Murphy (Public Chairperson); Paul W. Sterman (Public); Kenneth E. Merklen (Public)

This case is significant because, in a reasoned decision, the Arbitrators made a substantial award for Claimant in a claim involving unauthorized wire transfers. The Panel explained in the Award that Claimant’s claim for unauthorized wire transfers was not governed exclusively by the UCC and barred by the one year Statute of Repose.

The Panel stated that it had considered Respondent Wells Fargo's argument that Claimant's only claim was for wire fraud under the Uniform Commercial Code and that Florida Statutes Section 670.505 and/or Section 8.4A-5-5 of the Virginia Code provided a one-year statute of repose on such a claim. The Panel found that the Claimant is not barred from other common law causes of action. The Panel relied on *Gilson v. TD Bank, NA,* 2011 U.S. Dist. Lexis 7805, 73 UCC Rep. Serv. 2d (Callaghan) 430; 2011 WL 294447 quoting *Regions Bank v. Provident Bank, Inc.,* 345 F.3d 1267, 1275 (11th Cir. 2003), in stating, "[T]he only restraint on a plaintiff [seeking to redress an alleged harm arising from a funds transfer] is that resort to principles of law or equity outside of Article 4A is not appropriate to create rights, duties and liabilities inconsistent with those stated in this article. Therefore, the Panel must resolve those common law claims on the merits."

The Panel also awarded sanctions in the amount of $5,000.00 for discovery interference by one of the parties. According to the Award, Claimant sent letters to recipients of Respondent's subpoena that attempted to "discourage the recipients from producing all responsive documents." The Panel imposed the sanction by reducing the original award of $2,303,062 by $5,000.00. The Panel noted that the sanction was limited because Respondent's counsel limited the damage of the letter by being diligent in responding to the letter.

Finally, the Panel also determined based on post-hearing submissions by the parties that it did not have jurisdiction over Third-party Respondents Jacobowitz and Spero. The Panel determined that Jacobowitz and Spero were not associated persons of a FINRA member and did not submit Submission Agreements or Answers.

REID HOSPITAL & HEALTH CARE SERVICES V. OXFORD FINANCIAL GROUP, LTD.

American Arbitration Association Case No. 52 Y148 00144 12

Claimant asserted the following causes of action: (1) negligent account management; (2) breach of fiduciary duty; (3) constructive fraud; (4) breach of contract; (5) negligent supervision; (6) *respondeat superior*; (7) misrepresentations of material facts; and (8) omissions of material facts. Claimant alleged that Respondent failed to timely act upon a written sell order to sell securities in Claimant's account.

In the Statement of Claim, Claimant requested (1) unspecified damages; (2) pre-judgment interest from the date of investment; (3) post-judgment interest at the highest legal rate; (4) costs; (5) attorney's fees; (6) consulting fees; and (7) any other relief deemed appropriate by the Panel. The Claimant requested compensatory damages in the amount of $2,207,147.96.

Respondent denied the allegations in the Statement of Claim and asserted various affirmative defenses. Respondent claimed that the sell order was tied to other written orders.

Award: The Panel found that Respondent was liable and ordered the Respondent to pay Claimant $2,207,147.96 in damages.

Claimant's Counsel: Mark Maddox and Thomas Caldwell, Maddox Hargett & Caruso, P.C., Fishers, Indiana.

Respondent's Counsel: Anne DePrez and Larry Mackey, Barnes & Thornburg, LLP, Indianapolis, Indiana.

Claimant's Expert: Brian Underwood, of Compliance & Regulatory Consulting Services, LLC, St. Louis, Missouri.

Respondent's Expert: Chet Bjerke.

Arbitrator: Peter Silverman (Public Chairperson).

This case is significant because it represents that, even when investors entrust their assets to one of the largest investment advisory firms in the country, investors have various alternatives for the pursuit of their claims when their investment advisors fail to adhere to their obligations. In this AAA arbitration the single Arbitrator awarded substantial damages against the Respondent in an arbitration decided pursuant to the Commercial Arbitration Rules of the American Arbitration Association. In addition to the award, the Arbitrator allocated AAA administrative filing fees totaling $11,450 and the arbitrator's fee and costs in the amount of $21,007.04 to be shared equally by both Claimant and Respondent. Respondent was ordered to reimburse Claimant in the amount of $5,725.00 for the aliquot portion of the administrative fees that Claimant prepaid.

Notes & Observations

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 the *Proposed Rule Change Relating to Supervision in the Consolidated FINRA Rulebook* was submitted to the Securities and Exchange Commission by Scott C. Ilgenfritz on July 29, 2013.

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: SR-FINRA-2013-025– Proposed Rule Change To Adopt Rules *Regarding Supervision in the Consolidated FINRA Rulebook*

Dear Ms. Murphy,

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"), 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 securities and commodities arbitration forums, while also advocating for public education regarding investor rights. Our members and their clients have a profound interest in rules promulgated by the Financial Industry Regulatory Authority ("FINRA") to govern the conduct of securities firms and their representatives. These rules are in place primarily to protect the nation's investors and savers, as well as to provide a minimum industry standard upon which the public and regulators can rely.

PIABA supports FINRA's efforts to consolidate existing National Association of Securities Dealers ("NASD") and New York Stock Exchange (NYSE) supervisory rules as its own rules. PIABA commends FINRA for clarifying and strengthening the express provisions of proposed Rule 3110 with respect to one-person OSJs and supervision of multiple OSJs by a single principal and supplementary material paragraphs .03 and .04. However, the proposed amended rules (the "Proposed Rules") do not do enough to ensure adequate supervision or record retention for the protection of investors. Portions of the Proposed Rules stray beyond mere consolidation and actually weaken protections for the investing public. Troublingly, we note that, in certain instances, the Proposed Rules enlarge existing grey areas and make securities firms' responsibilities for their personnel even more vague than under the current standards. By introducing greater uncertainty into the rules and removing clear bright line requirements, the Proposed Rules diminish the investing public's ability to hold broker/dealers accountable for violations of rules, regulations and laws. Securities firms' near universal insistence on pre-dispute arbitration agreements specifying the FINRA arbitration forum further compounds the potential harm to investors by each additional degree of vagueness and uncertainty introduced. Because public investors do not generally have access to courts of law which may provide controlling guidance on the interpretation of rules and the scope of obligations, investors and industry members often face the Sisyphean task of proving the same obligations again and again.[1] We are concerned that a misplaced desire for flexibility may lead to reduced and diminished supervision and harm to the investing public. We strenuously oppose any changes that reduce the protection of the investing public or that make proof of misconduct more difficult.

To the extent that FINRA seeks to achieve its stated "core mission[s]" of "investor protection and market integrity" by "overseeing virtually every aspect of the brokerage industry", it must move to clarify and strengthen its supervisory rules and guidance and also improve its currently inadequate rules governing the creation, retention and destruction of records.[2] PIABA encourages the Securities and Exchange Commission ("SEC") to actively oversee these changes and to request additional rules and guidance providing bright line rules to protect investors. Our specific concerns with respect to these two areas are detailed below.

Comments Regarding the Supervisory Rules

PIABA strongly encourages the SEC to require FINRA to implement clearer standards governing securities firms' supervision of their associated persons. Public investors place their trust in industry personnel because of their affiliation with established securities firms. Cloaked in securities firms' apparent authority and prestige, associated persons all too often place their own financial interests ahead of the best interests of the investing public.

1. *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, 992-93(2002) (finding that because of mandatory pre-dispute arbitration agreements, "courts have had few opportunities to generate relevant precedent" because courts have had substantially fewer opportunities to adjudicate disputes).

2. FINRA, *About the Financial Industry Regulatory Authority* (visited July 18, 2013), available: http://www.finra.org/AboutFINRA/.

Adequate investor protection cannot be achieved without requiring securities firms to supervise associated persons adequately.

In this vein, we request that the SEC exercise its supervisory authority to require FINRA to ensure adequate investor protection in at least the following additional ways: (i) clarifying amorphous "risk-based" standards; (ii) requiring heightened supervision of any associated person who reaches a certain threshold of customer complaints; (iii) requiring securities firms to supervise withdrawals from investor accounts in certain circumstances, particularly where several clients of the same associated person withdraw large amounts of money at the same time; and (iv) requiring firms to supervise outside business activities of the representative.

"Risk-Based" Review and Examination

Proposed FINRA Rule 3110 employs the terms "risk-based review", "risk-based principles", and other "risk-based" qualifiers with respect to critical investor protection functions without providing any clear bright line criteria for assessing whether supervisory systems meet minimum standards. See Proposed FINRA Rule 3110(c)(2)(B) and Supplementary Material paragraphs .06 and .07. By way of explanation, the Proposed Rule Change vaguely states that "risk-based approach for specified aspects of a member's supervisory procedures is intended to allow firms the flexibility to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concerns may be warranted." (Proposed Rule Change at 30.) We fear that flexible "risk-based" systems designed to accommodate different "business models" may be improperly accommodating "business models" which produce profits by cutting compliance and investor protection out of the business. In many instances, the "need" for "risk-based" systems may be illusory because the real need may be for member firms to invest in adequate compliance personnel and training.[3]

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3. For a case where this may have been the case, *see* Nathaniel Popper, *Fast-Growing Brokerage Firm Often Tangles With Regulators,* N.Y. Times (March 21, 2013) at A1, available: http://www.nytimes.com/2013/03/22/business/as-lpl-financial-expands-scrutiny-of-its-practices-intensifies.html?pagewanted=all ("high commissions leave LPL less money for compliance and can attract brokers interested in skirting the rules.").

For example, Proposed FINRA Rule 3110(b)(2) and Supplementary Material .06 provide that a FINRA member may use "risk based" systems to review transactions related to a member's investment banking or securities business. The Proposed Rule Change claims that dues-paying FINRA "members may need to prioritize their review processes due to the volume of information" and use "reasonable sampling of information ... to discern the degree of overall compliance[.]" (Proposed Rule Change at 47.) We are concerned that FINRA members may use these provisions to justify sporadic checks or spotty "sampling" methods for ensuring compliance instead of devoting necessary personnel and resources to ensure compliance.

As we mentioned in our July 20, 2011, letter on this subject,[4] we are concerned that "risk-based" supervision will focus on risks to the broker/dealer and not on risks to investors. Moreover, securities firms may attempt to deny supervisory fault after this "risk-based" review system goes awry by contending that they fulfilled their obligations by creating a "risk-based" review system which, unfortunately, will not capture many manifested risks affecting consumers. In response to our concerns, FINRA contends that the "risk-based approach for specified aspects of a member's supervisory procedures is intended to increase, not diminish, investor protection by allowing firms the flexibility to establish their supervisory programs in a manner that reflects their business models, and based on those models, focus on areas where heightened concern may be warranted." (Proposed Rule Change at 35.)

To the extent that "risk-based" approaches provide an additional layer of supervision above present requirements, PIABA supports the move to increase investor protection. Nonetheless, we remain concerned that FINRA's proposed move toward "risk-based" standards may actually erode and displace existing investor protections by making it more difficult for investors and arbitrators to determine whether a supervisory system fulfilled the rules' requirements.

Increased Supervision after Repeated Customer Complaints

At present, FINRA's supervisory rules impose no additional obligation to more closely monitor likely bad actors. When multiple investors have

4. Letter from Peter J. Mougey, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (July 20, 2011), http://www.sec.gov/comments/sr-finra-2011-028/finra2011028.shtml.

complained about a particular associated person, securities firms have effective notice that serious problems may exist. Effective investor protection requires that securities firms ratchet up their supervision, training, and oversight to address likely problems.

The benefits to investors substantially outweigh the slight additional burden of requiring additional supervision and oversight for associated persons with a history of customer complaints. A decade ago, the NASD proposed this common sense reform to improve investor protection.[5] For reasons that remain unclear, neither the NASD nor FINRA ever acted on the proposal. At that time, the NASD released statistical information about the distribution of customer complaints among associated persons. The information shows that a very small percentage of associated persons generate multiple complaints:

> The preliminary data show that of the 29,500 persons subject to customer complaints within the last five years, 3.3 percent of all registered persons (22,003 persons) were subject to 1 complaint, .71 percent of all registered persons (4,726 persons) were subject to 2 complaints, .22 percent of all registered persons (1,487 persons) were subject to three complaints, .09 percent of all registered persons (568 persons) were subject to four complaints, and .04 percent of all registered persons (290 persons) were subject to 5 complaints.[6]

Because only approximately one percent of associated persons have two or more customer complaints filed against them within a five-year period, securities firms face a minimal burden to increase their supervision responsibilities for associated persons who generate abnormally high numbers of customer complaints. Accordingly, PIABA requests that the SEC require FINRA to impose heightened supervisory plans for associated persons with an anomalous number of complaints within a five-year period. This reform may appropriately incentivize associated persons to carefully consider whether their recommendations are suitable for a particular investor.

If supervisory responsibility does not increase after repeated customer complaints, securities firms may be able to ignore known problems without any cost. Instead, securities firms may rationally conclude that it makes prudent economic sense to employ associated persons who generate abnormal amounts of customer complaints if they also generate substantial revenues. Our experience shows that securities firms may be making this

5. See NASD, *Notice to Members*, 03-49, available: http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003181.pdf.

6. *Id.* at Endnote 4.

calculation and continuing to employ brokers who play fast and loose with the rules.

The decision to ignore the need for additional supervisory responsibility is not without cost. At present, the absence of heightened supervisory requirements forces public investors, who reasonably trust and rely on associated persons, to bear the losses created by these customer complaint-generating brokers. Even though securities firms know that particular associated persons generate statistically anomalous numbers of customer complaints, they seek to disclaim responsibility for the financial wreckage they cause by contending that they complied with "customary" supervisory requirements.

Supervising Suspicious Withdrawals

The SEC should require FINRA to create and implement rules requiring securities firms to actively supervise suspiciously concentrated withdrawals. At present, the current supervision rules impose no explicit obligation on securities firms to supervise repeated suspicious withdrawals.[7] We remain particularly concerned that current supervisory standards fail to require enhanced supervision when several clients of the same broker withdraw large amounts of money at around the same time. It would be difficult to imagine a clearer red flag that a particular broker is selling away from the securities firm or running a Ponzi scheme.

This responsibility must be borne by securities firms, because they alone sit in a position to stop ongoing theft, conversion, and dissipation of investor assets. Securities firms have custody and control over customer accounts, and they alone possess the information needed to disrupt Ponzi schemes and other frauds before they metastasize and cause even greater losses.

Moreover, imposing supervisory responsibility to identify and closely supervise suspicious withdrawals is a nearly costless reform. If anything, enhanced supervision for suspicious withdrawals may help securities firms retain assets already under management and improve profitability. Securities firms already track their assets under management and maintain systems which associate brokers with individual accounts. We encourage FINRA to promptly develop appropriate supervisory rules which appropriately define

7. The Proposed Rules aim to incorporate currently applicable NASD Rule 3012(a)(2)(B) into FINRA Rule 3110(c)(2). This rule contains generally applicable procedures and does not address the concern detailed here.

criteria for identifying suspicious withdrawal patterns and remain committed to providing support and ongoing comments on this issue.

Supervising Outside Business Activities

The SEC should also require FINRA to implement rules regarding the supervision of outside business activities. Under FINRA Rule 3270, associated persons must disclose outside business activities to member firms, and the representative must do so before participating in such activities. It would make sense to require firms to monitor these outside business activities, especially because many incidents of selling away or theft stem from outside business activities. Since the firm can already place specific conditions on the activities or prohibit the representative from engaging in the activity, pursuant to Rule 3270, Supplemental Material .01, firms should be mandated to supervise such activities.

While FINRA has stated that it would consider addressing NASD Rule 3040 in a separate proposal, Rule 3040 only addresses private securities transactions of representatives. In order to better protect the investing public from theft and selling away, FINRA must address outside business activities as part of its supervisory rules and regulations.

Record Retention and Document Preservation

Record creation, maintenance, and preservation are other components of adequate supervision. We also write to raise concerns about supervisory rule inadequacies in these areas. We initially wrote to FINRA to address these issues on June 13, 2008, and were disappointed that the Proposed Rule Change and the Proposed Rules failed to heed our concerns or provide any principled basis for rejecting our comments.[8] Today, we write to voice our concerns again and highlight the following issues: (i) the Proposed Rules remove responsibility for acknowledging and responding to oral complaints; (ii) the Proposed Rules condone inconsistent periods for customer arbitration claims and document retention; and (iii) the Proposed Rules do not require

8. Letter from Lawrence S. Schultz, President, Public Investors Arbitration Bar Association to Marcia E. Asquith, Office of the Corporate Secretary, FINRA (June 13, 2008), http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/noticecomments/p038775.pdf.

securities firms to refrain from destroying documents and records about a particular customer account after receiving a customer complaint.

Exclusion of Oral Complaints

As we explained in our July 20, 2011, letter, Proposed FINRA Rule 3110 substantially weakens investor protections by removing the explicit requirement that securities firms acknowledge and respond to oral customer complaints. (Proposed Rule Change at 16; Proposed FINRA Rule 3110(b)(5).) To justify removing this consumer protection, FINRA makes two assertions: (i) that "oral complaints are difficult to capture and assess;" and (ii) oral complaints "raise competing views as to the substance of the complaint being alleged." (Proposed Rule Change at 16.)

These two asserted concerns do not justify removing the explicit requirement that member firms acknowledge and respond to oral customer complaints. As an initial matter, many FINRA member firms and members of the NYSE have been capturing oral complaints for years without any apparent difficulty. FINRA cannot credibly contend that oral complaints are too difficult to "capture" without explaining why capturing an oral complaint is somehow more difficult than taking a message and writing it down. Once a member firm has "captured" an oral complaint by writing it down, it may be processed in the same manner as any other written complaint. In addition, securities firms frequently record the telephone communications of their brokers. In many instances, a securities firm may simply consult its audiotape to determine whether the message was faithfully transcribed. To the extent that competing views may exist over the substance of the complaint, competing views may also arise with written complaints, yet FINRA has not removed the requirement that its member firms acknowledge and respond to written complaints.

FINRA's member firms may avoid many of these difficulties simply by providing a complaining customer with a complaint form. If the customer does not feel comfortable writing her complaint out, FINRA's member firms may solve the problem simply by writing the complaint down and then asking the customer to verify whether the complaint recorded accurately reflects her concerns.

Oral complaints cannot be excluded because the vast majority of communications between brokers and clients occur orally, typically over the telephone. Unsurprisingly, most complaints will also be voiced orally, as

FINRA itself instructs customers to do.[9] In our experience, many unsophisticated customers are not comfortable reducing their thoughts to writing, may not type well, or are otherwise intimidated by the thought of formally writing a letter about a problem. As FINRA does not currently restrict its members to only conducting business with persons possessing a college education or otherwise possessing skill in writing, its members should be obligated to take oral complaints as seriously as written ones and respond to them.

If the SEC approves the current form of Proposed FINRA Rule 3110, FINRA will increase the amount of vagueness existing in its rules. By removing the explicit requirement that member firms acknowledge and respond to oral complaints, FINRA creates uncertainty about what obligations its member firms have to address oral complaints. The Proposed Rule Change does not help clarify the extent of member firms' obligations. At the most, the Proposed Rule Change "remind[s] members that the failure to address any customer complaint, written or oral, *may be* a violation of FINRA Rule 2010 (Standards of Commercial Honor and Principles of Trade)." (Proposed Rule Change at 17 (emphasis added).) If the standards of commercial honor applicable to FINRA member firms require them to acknowledge and respond to oral complaints anyway, no good reason exists for removing the explicit requirement from the rules. Removing it will only serve to reduce investor protection.

Retention of Correspondence and Internal Communications

FINRA rules provide that customer disputes may be arbitrated unless "six years have elapsed from the occurrence or event giving rise to the claim," (Rule 12206(a), FINRA Code of Arbitration Procedure). The Proposed Rule Change introduces inconsistency by authorizing member firms to destroy internal communications and correspondence related to a customer's account after three years. (Proposed FINRA Rule 3110, Supplementary Material .10 (Retention of Correspondence and Internal Communications).)

9. FINRA, Avoid Common Investor Problems, (visited July 20, 2013) ("If you believe you have been subjected to unfair or improper business conduct by a securities professional, FINRA encourages you *to voice* your concerns") (emphasis added).

To explain its decision to maintain a record retention period inconsistent with the time limits for arbitration, FINRA cites 17 C.F.R. § 240.17a-4(b) and claims that "the proposed rule purposefully aligns the record retention period for communications with the SEC's record retention period for the same types of communications *to achieve consistent regulation in this area*." (Proposed Rule Change at pg. 136 (emphasis added).) As an initial point, no inconsistency would arise if FINRA required member firms to keep records relating to a customer account for longer than the bare minimum required by SEC regulations. FINRA's response makes little sense, because it serves only to increase inconsistency, hinder investor protection, and bless the destruction of important documents after the minimum amount of time required under SEC Rules.

FINRA's stated objective of consistency would be better served by a uniform minimum six-year document retention requirement for all documents related to a customer account. Indeed, under the current regulatory structure, securities firms must already retain certain customer account records for at least six years. 17 C.F.R. § 240.17a-4(c) (regulated broker dealers "*shall preserve for a period of not less than six years after the closing of any customer's account* . . . records which relate to . . . the opening and maintenance of the account) (emphasis added). Instead, Proposed FINRA Rule 3110 would allow broker/dealers to destroy correspondence and internal communications after only three years. In fact, FINRA's three-year retention period may confuse securities firms about which types of documents they may destroy and lead them to destroy documents after three years even though the SEC requires many documents to be kept for at least six years. *See* 17 C.F.R. § 240.17a-4(a), (c).

To be sure, a three-year period increases consistency only if FINRA defines "this area" narrowly as communications and correspondence about a customer account and not customer account documents, generally. Curiously, despite our prior comments on this issue, FINRA's Proposed Rule Change provides no principled explanation for allowing its member firms to destroy documents related to a customer's account before the six-year period for filing an arbitration expires. By blessing the destruction of customer account documents halfway through the arbitration-filing period, FINRA disregards its responsibility to protect investors and only requires its dues-paying member firms to retain records for the shortest possible period applicable under current SEC regulations.

Most troublingly, FINRA's Proposed Rule Change effectively seeks "consistent regulation" at the expense of public investors. (Proposed Rule Change at pg. 136.) When investors rely on FINRA's rule that they may bring an arbitration action within six years of the events giving rise to the claim, they are likely not aware that after three years, FINRA authorizes their securities firm to quietly destroy the evidence they may well need to establish their claim. This betrays investor interests and expectations and, as we pointed out in our July 20, 2011, letter, may significantly impede "the ability of consumers to pursue legitimate claims."[10] The events giving rise to many claims – such as claims for self-dealing, commission seeking, and unsuitable investment advice – may be viewed as taking place at the time the broker sold the unsuitable securities. The risks associated with recommended investments or strategies – risks the investor may never have been warned about – may not even materialize until after more than three years have passed. For example, the so-called dot-com bubble lasted from 1997 to 2000. Investors convinced to invest unsuitably risky securities in 1997 might not have even suffered damages from the unsuitable advice until after three years passed from the time they purchased the unsuitable securities.

As we pointed in our July 20, 2011, letter on this issue, we live in an age of electronic storage.[11] Securities firms incur nearly zero costs by retaining documents for six years instead of three years. To put this in perspective, today, any person can purchase an external hard drive which will store a terabyte of data for about seventy dollars or less.[12] According to electronic discovery expert Ralph Losey, just one gigabyte of electronic storage may contain about 75,000 pages worth of text, or enough paper to fill a pickup truck.[13] A terabyte contains 1,024 gigabytes, or enough storage for over a thousand pickup trucks worth of documents, each containing 75,000 pages of text. In our experience, even document intensive customer disputes are highly unlikely to approach 75,000 pages of text.

Because electronic storage costs have sunk to be incredibly low and will continue to grow even cheaper, FINRA's failure to require a consistent six-year document retention period reflects a failure to properly weigh the interests of investor protection against the minimal cost associated with a six-

10. Letter from Peter J. Mougey, President, Public Investors Arbitration Bar Association, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (July 20, 2011), http://www.sec.gov/comments/sr-finra-2011-028/finra2011028.shtml.

11. Id.

12. http://www.amazon.com/Passport-Portable-External-Drive-Storage/dp/B006Y5UV4A/ref=sr_1_1?ie=UTF8&qid=1374189715&sr=8-1&keywords=terabyte+external+hard+drive.

13. See Ralph Losey, e-Discovery Team, http://e-discoveryteam.com/.

year retention period. We strongly urge the SEC to either change its own regulation to a six-year period or require FINRA to alter Proposed FINRA Rule 3110 to provide for a six-year document preservation period which matches the six year eligibility period.

A Need for More Tailored Preservation Obligations

Although a consistent six-year record retention requirement would be the most expeditious way to solve many record retention issues, at the least, FINRA should require securities firms to prevent the spoliation of evidence once it is reasonably foreseeable that an arbitration might be filed. Spoliation is "'the destruction or significant alteration of evidence, or the failure to preserve property for another's use as evidence in pending or reasonably foreseeable litigation.'" *Zubulake v. UBS Warburg LLC*, 220 F.R.D. 212, 216 (S.D.N.Y. 2003) (quoting *West v. Goodyear Tire & Rubber Co.,* 167 F.3d 776, 779 (2d Cir.1999)). In ordinary litigation, it is well established that the "scope of a party's preservation obligation can be described as follows: Once a party reasonably anticipates litigation, it must suspend its routine document retention/destruction policy and put in place a 'litigation hold' to ensure the preservation of relevant documents." *Zubulake*, 220 F.R.D. at 218.

At present, FINRA's rules do not adequately protect investors from the spoliation of evidence. Even though arbitration may be reasonably anticipated after a customer makes an oral or written complaint, the supervisory rules do not require securities firms to immediately preserve all documents related to an account after a customer files a complaint. When the Supreme Court upheld mandatory pre-dispute arbitration agreements in *Shearson/American Express, Inc. v. McMahon*, it relied on the SEC's "expansive power to ensure the adequacy of the arbitration procedures employed by the SROs." 482 U.S. 220, 233 (1987). Although arbitration provides a forum for resolving disputes, ensuring adequate arbitration procedures should include the enactment of rules to prevent the spoliation of evidence once arbitration is foreseeable. We respectfully request that the SEC require, at the very least, that FINRA issue a rule requiring "litigation holds" as soon as arbitration is reasonably foreseeable.

Conclusion

In summary, PIABA appreciates and supports FINRA's commitment to consolidating and streamlining its rules and its strengthening of certain aspects of Proposed FINRA Rule 3110. Although the Proposed Rules contain significant flaws addressed above, PIABA supports the ongoing consolidation of the FINRA rulebook. Nonetheless, PIABA hopes that FINRA will take the opportunity to use this process to not only streamline its rules, but to also ensure effective investor protection and supervisory procedures. PIABA thanks the Securities and Exchange Commission for the opportunity to comment on this proposal.

Sincerely,
Scott C. Ilgenfritz,
President

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The following PIABA Comment Letter regarding the *Proposed Rule Change Relating to FINRA Rule 5123 (Private Placements of Securities)* was submitted to the Securities and Exchange Commission by Scott Ilgenfritz on July 22, 2013.

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street NE.
Washington, D.C. 20549-1090

Re: SR-FINRA-2013-026 – Proposed Rule Change Relating to Member's Filing Obligations Under FINRA Rule 5123 (Private Placements of Securities)

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 securities and commodities arbitration forums, while also advocating for public education regarding investor rights. Our members and their clients have a strong interest in FINRA rules relating to both investor protection and disclosure concerning investment products.

PIABA supports FINRA's efforts to encourage firms to conduct reasonable due diligence before selling private placements. Under the proposed rule, requiring firms that sell private placements to submit any copies of offering materials used in connection with the sale to FINRA within 15 days of the sale and requiring members to complete and submit forms answering questions regarding what due diligence has been performed will encourage increased due diligence before the sale of private placements.

However, PIABA would like the rule to go further in three ways:

1. FINRA should add a question to the Private Placement Form to ask the broker-dealer to indicate whether the proceeds from the issuance will be used to pay existing creditors, investors, noteholders, shareholders, partners, officers, directors, etc;
2. FINRA should add another question to the Private Placement Form, asking whether firms have made a determination of the categories or types of investors to whom the private placement can be sold in compliance with FINRA's suitability rule; and

3. FINRA should require firms to answer each question instead of providing the option to answer questions with “unknown”.

Aside from the suggestions noted above, PIABA supports FINRA’s proposed rule change. We appreciate the opportunity to comment on the proposed rule change.

Sincerely,
Scott C. Ilgenfritz,
President

The following PIABA Comment Letter regarding *SR-FINRA-2013-024 (Rule Change to Amend the Discovery Guide Used in Customer Arbitration Proceedings)* was submitted to Securities and Exchange Commission by Scott C. Ilgenfritz on July 11, 2013.

Ms. Elizabeth M. Murphy
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: SR-FINRA-2013-024 – Proposed Rule Change to Amend the Discovery Guide Used in Customer Arbitration Proceedings

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, while also advocating for public education regarding investor rights. Our members and their clients have a profound interest in FINRA rules relating to the dispute resolution process.

When FINRA updated the Discovery Guide in 2011, it created a Discovery Task Force committed to reviewing e-discovery issues and discovery in product cases. PIABA supports FINRA's efforts to update the coverage of the Discovery Guide to include guidance on electronic discovery and discovery in product cases. The proposed amendments should be approved by the staff of the Commission.

Because the proposed changes to the Discovery Guide are in the form of guidance to arbitrators, FINRA should have its Discovery Task Force monitor the implementation of its guidance, including the polling of arbitrators and claimants' counsel. Specifically, FINRA should attempt to determine whether the guidance with respect to e-discovery results in electronic documents being produced in reasonably usable formats within the meaning as the terminology that FINRA proposes to include in its training materials and whether electronic documents are being produced in "native" format when requested by claimants' counsel. With respect to both e-discovery and product cases, FINRA should seek to determine whether its guidance results in the voluntary production of documents described in the guidance without the need to file motions to compel. If the guidance does not result in electronic documents being produced in reasonably usable format and product discovery occurring without a fight, then FINRA should implement the following proposals.

With respect to e-discovery, FINRA may need to require arbitrators to ask a question during the initial pre-hearing conference relating to the extent of cooperation that has occurred between the parties with respect to production of electronic documents. Requiring such an inquiry would encourage cooperation and may in some instances encourage discussion concerning taking appropriate steps to preserve electronic documents.

FINRA may need to implement more specific guidance and state that documents such as emails which, in the ordinary course of business, are stored in a searchable format and/or in a format that includes metadata, must be produced in a format that is searchable and that contains metadata, if a party so requests. FINRA's guidance may need to specify that a .pdf file which does not comply with the definitions of appearance, searchability, metadata, and maneuverability as proposed by FINRA is an unacceptable format in which to produce electronic documents. This additional guidance may be necessary, in part, because many FINRA arbitrators are retirees who do not appear to have familiarity with e-discovery issues, yet they are called upon to make the same kinds of discovery rulings that are made in federal court by highly trained and experienced magistrates.

FINRA may need to require that brokerage firms search their e-mail servers and reasonably accessible backups and produce any and all e-mails referencing the customers and/or their accounts. Brokerage firms frequently attempt to avoid undertaking such a search based on claimed cost and burden, and sometimes even attempt to limit production to copies of e-mails that have been printed out and placed in a paper file at the branch. Finally, such guidance should provide that e-mail searches are not limited to searches for e-mails between the brokerage firm and the customer. Experience shows that brokerage firms frequently attempt to limit their searches for e-mail to e-mails to and from the customer's e-mail address, even though internal e-mails at the brokerage firms referencing the customers and/or their accounts may be highly relevant to issues such as supervision or the firm's knowledge of a registered representative's activities.

With respect to discovery in product cases, FINRA may need to change its guidance into a list of documents and categories of documents which are presumptively discoverable. The inclusion of documents on a list would provide specific guidance to arbitrators as to the presumptively discoverable documents in product cases, lessening the potential for inconsistent discovery rulings in similar cases which claimants' counsel have experienced in many product cases.

Regardless of the results of FINRA's monitoring of the implementation of its guidance, PIABA remains concerned that brokerage firms will continue to object to any production of e-documents on the grounds that the production is overly burdensome and too costly. Most documents kept by brokerage firms are maintained in an electronic format. Firms must not be allowed to raise objections as to documents kept in the ordinary course of business simply because the firms maintain those documents in electronic format. Guidance should be implemented now to make it clear that objections made by brokerage firms as to cost or burden must be highly specific[1] and be supported by an affidavit of a representative of the brokerage firm. Further, such objections should be scrutinized with great care, particularly if the records are the varieties that the SEC or FINRA requires be maintained. Brokerage firms should not be able to get away with making claims of burden with regard to documents that the SEC requires to be readily accessible.

In summary, PIABA commends FINRA's work toward making the Discovery Guide more comprehensive and specifically designed to address electronic discovery issues. PIABA also commends FINRA's recognition of the additional categories of documents that arbitrators should be aware are appropriate subjects of document requests in product cases. PIABA believes FINRA needs to monitor the implementation of its guidance to determine whether the more specific guidance and the product case document list as described above should be incorporated into the Discovery Guide. PIABA thanks the Securities and Exchange Commission for the opportunity to comment on this proposal.

Very truly yours,
Scott C. Ilgenfritz,
President

1. Courts do not consider discovery objections of cost or burden unless specific factual evidence is presented. Arbitrators often sustain such objections by firms based on the unsubstantiated arguments of counsel.

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The following PIABA Comment Letter regarding *SR-FINRA-2013-023 (Rule Change to Amend FINRA Rule 12403)* was submitted to the Securities and Exchange Commission by Scott C. Ilgenfritz on July 11, 2013.

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

Re: Comment on File No. SR-FINRA-2013-023
Proposed Rule Change to Amend FINRA Rule 12403

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 and securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forms, while also advocating for public education regarding investor rights. Our members and their clients have a profound interest in FINRA rules relating to the dispute resolution process.

PIABA supports the proposed rule change to amend FINRA Rule 12403 of its Code of Arbitration Procedure to simplify the arbitration panel selection process in cases with three arbitrators. The proposed rule change advances the interest of investors and should be approved.

In 2008, FINRA initiated a Public Arbitrator Pilot Program which gave investors a greater choice when selecting an arbitration panel. Specifically, investors in eligible cases were allowed to choose a panel consisting of three public arbitrators, rather than two public arbitrators and one non-public arbitrator. After a twenty-seven month period, results showed that investors chose the new method of arbitrator selection almost 60% of the time. In a September 28, 2010 FINRA News Release, Richard Ketchum, FINRA Chairman and Chief Executive Officer, stated that "giving each individual investor the option of an all-public panel will enhance confidence in and increase the perception of fairness in the FINRA arbitration process."

The Public Arbitrator Pilot Program was such a success that effective February 1, 2011, FINRA announced the amendment of its rules regarding the selection of arbitration panels with three arbitrators. Under the newly adopted Rule 12403, investors have had the option to have had an all-public panel hear their cases, but investors have been required to notify FINRA in writing of their election to have an all-public panel hear their cases in the statement of claim or within thirty-five days of the service of the statement of claim.

FINRA's proposed rule change eliminates the requirement for an investor or his or her counsel to notify FINRA of the investor's election to have an all-public panel hear the investor's case. The rule change insures that parties in cases with three arbitrators will be provided with the same method for selecting a panel of arbitrators. In addition, to the extent that an investor or his or her counsel believes that it is in the best interest of the investor to have the case heard by an arbitration panel that includes a non-public arbitrator, the investor has the option to rank non-public arbitrators.

The elimination of the requirement that investors submit a written election to have an all-public panel is a significant improvement in the arbitrator selection process for investors. However, pro se investors and investors represented by less experienced arbitration counsel may not be aware of the investor's right to have his or her case determined by an all-public panel, despite the proposed rule change. PIABA believes that it would be in the best interest of investors for FINRA to emphasize in its transmittal letter accompanying the arbitrator ranking form and the arbitrator disclosure reports that each party has the ability and right to have the case heard by an arbitration panel comprised of only public arbitrators. FINRA's current transmittal letter to parties has the information about the arbitrator ranking process is in the middle of a lengthy letter. PIABA believes a revision of the text would be appropriate and beneficial to investors to emphasize the two alternative types of panels available under the revised rule and the ability and right of the parties to have their cases heard by an all-public panel.

PIABA appreciates the opportunity to comment on this proposed rule change.

Very truly yours,
Scott C. Ilgenfritz,
President

The following PIABA Comment Letter regarding *File No. 4-606; Duties of Brokers, Dealers, and Investment Advisers (Request for data and other information)* was submitted to the Securities and Exchange Commission by Scott C. Ilgenfritz on July 3, 2013.

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
rule-comments@sec.gov

Re: File No. 4-606; Duties of Brokers, Dealers and Investment Advisers (Request for data 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 the standards of conduct to which brokers and investment advisers are held when giving investment advice. We welcome this opportunity to provide further information related to the Commission's study of this issue.

We will provide information in response to the Commission's "Request for Data and Other Information Relating to the Current Market for Personalized Investment Advice". For clarity, we have included the requests to which we are responding below. We have responded to those requests where we believe we can provide the most relevant data.

2. **Data and other information describing the types and availability of services (including advice) broker-dealers or investment advisers offer to retail customers, as well as any observed recent changes in the types of services offered. Provide information as to why services offered may differ or have changed. Have differences in the standards of conduct under the two regulatory regimes contributed**

to differences in services offered or any observed changes in services offered? If possible, differentiate by retail customer demographic information.

A survey of the websites for five of the largest broker-dealers and five of the largest registered investment advisory firms leads to the conclusion that both generally offer the same comprehensive financial planning and advice:

BROKER-DEALERS

(i) Merrill Lynch

Merrill Lynch's website is full of materials detailing the comprehensive financial services offered to prospective customers. Interestingly, nowhere on its website does it discuss order execution. Instead, there are a myriad of goals Merrill Lynch will assist with, including:

- Caring for My Family
- Preparing for Retirement
- Growing My Business
- Pursuing My Dreams
- Estate Planning and Philanthropy

See Exhibit 1. Merrill Lynch goes to great lengths to describe itself as a "Wealth Manager", not merely a securities broker that buys and sells securities or simply places orders. Merrill Lynch also includes numerous client testimonials on its website describing the substantial and personal relationship the clients have with their Merrill Lynch Financial Advisor. The website describes "access to world class market research and the industry's top financial analysts" and references the importance of finding the right financial advisor. Poignantly, the website includes a quote from Charles Merrill, who said in 1914, "The interests of our customers must come first." *Id*.

These current representations are not new. Before the financial crisis, Merrill Lynch represented itself as "Total Merrill" to its customer base. Attached as Exhibit 2 is a PowerPoint presentation which was shown at a Merrill Lynch conference on June 19, 2008, by Vice President Marilyn Pearson. This presentation was geared to Merrill Lynch financial advisors using inter-networking skills to expand their business. Importantly, the basis of the presentation is "Total Merrill", which, as the second page of the presentation illustrates, is far more than merely executing orders or even simply making investment recommendations. Instead, "Total Merrill" was an integrated concept designed to provide customers with comprehensive service, including advice, retirement planning, banking, credit and lending, and estate planning. In fact, "investments" is just one piece of this fully integrated, comprehensive service.

(ii) Morgan Stanley

Morgan Stanley is more bombastic about the impact it can have for its clients, proclaiming rhetorically in large, bold print: "**WHO CAN PROVIDE A HIGHER LEVEL OF FINANCIAL ADVICE BACKED BY THE BEST THINKING ON WALL STREET?**" Of course, the answer is Morgan Stanley. It also represents that it offers services to its customers similar to those offered by Merrill Lynch. Morgan Stanley states, "At Morgan Stanley, our dedicated Financial Advisors are ready to work closely with you. With a clear understanding of your unique circumstances, we'll find the right services and solutions to help meet your objectives today and tomorrow." *See* Exhibit 3. Morgan Stanley also touts its "access to Banking services" and represents itself as a "wealth manager", not simply a company that brokers securities transactions.

Morgan Stanley's website also details its "Wealth Planning" services, which include investing, managing risk, strategic borrowing, and setting objectives to plan "for the long term".

(iii) UBS

Much like its peers, UBS is not shy about the quality of the services offered to its customers. On its website, it states in bold: "**Advisors without peer. Advice without equal.**" *See* Exhibit 4. It goes on:

> At UBS, our clients are the focus of everything we do. And with access to the best resources and intellectual capital in the industry, our Financial Advisors are in the best position to help clients reach their goals. In addition to having exceptional credentials, experience and perspective, our Advisors know it's essential to listen to you and truly understand your goals in order to help you achieve the financial future you envision.

Id. UBS, like Merrill, has customer testimonials and video stories on its website which provide a provocative glimpse into how UBS will make your dreams come true. In fact, the website states: "At UBS, we can help you pursue all of your financial goals – including those that go beyond investing – to help you live the life you've always imagined." UBS represents its services to include retirement planning and investing along with education funding, estate planning, and charitable giving, all of which is presented as a "collaborative approach". Much like its peers, there is nothing on UBS' website which describes it as an order executor. In fact, nothing represented by UBS indicates it actually brokers transactions. Instead, it repeatedly represents itself as an advisory firm focused on providing planning and advice in all facets of someone's financial life.

(iv) Ameriprise Financial

The tenor of Ameriprise's website is somewhat different than the previous three firms. It clearly and unmistakably represents that it provides services far more substantial than simply executing orders or making investment recommendations. In fact, one of the key components of the "ongoing advisor relationship" is to "track ongoing progress". *See* Exhibit 5. Ameriprise's website includes client testimonials and videos which explain the important and substantial impact Ameriprise has had on their lives.

Ameriprise represents that it provides numerous services to its clients. These include investments, insurance/annuities, financial planning, credit cards, and lending services. Specifically, Ameriprise identifies several different investment products offered by the firm to its customers, including:

- IRAs & retirement plans
- Mutual Funds
- Stocks and ETFs
- Bonds
- Education savings
- Real estate and alternative investments
- Managed accounts
- Structured products
- Certificates
- Options
- Unit Investment Trusts (UITs)
- Syndicates, including closed-end funds and preferred stock

Id. at 4-5. Unlike the "big three" above, Ameriprise specifically identifies what investments it offers to its customer base. Importantly, it wraps this list up by calling attention to Ameriprise advisors as being "investment professionals". Nowhere on the website are Ameriprise advisors referred to as securities brokers or traders.

(v) LPL Financial Services

LPL Financial represents its financial advisors as "experienced professionals" who provide "objective guidance and advice". It also makes a specific point that LPL "does not offer any proprietary products …" resulting in "unbiased investment products and strategies …." *See* Exhibit 6. LPL also focuses on a "holistic approach to life planning":

> No matter where you are in life – just getting started or winding down a successful career – you have goals and dreams. Your advisor engages you in an ongoing conversation about your needs, goals, and objectives to create the life plan that's right for you.

Id. LPL goes even further, touting a neighborly approach:

> Your LPL Financial advisor more than likely lives and works in your community. And because your LPL Financial Advisor cares as much about your personal satisfaction as the performance of your portfolio, he or she serves as a true partner to help you live the life you desire.

Id. LPL also focuses on the support it provides to its financial advisors as a selling point to prospective customers. It emphasizes the training and management programs LPL advisors attend to stay on the cutting edge of the investment field. Like the "big three" above, LPL clearly represents itself as a fully engaged wealth management, life-planning partner.

Also, like Ameriprise, LPL identifies specific securities products it offers to its customers. These include:

- Mutual Funds
- Annuities and other tax-efficient investments
- Domestic and international securities
- Insurance
- Fee-based asset management programs
- Estate and financial planning
- Trust services
- Group retirement plans
- Exchange-traded funds (ETFs) and exchange-traded notes

Id. at 3. Importantly, LPL leaves the door open, stating, "From these and *other investment options,* your LPL Financial advisor can construct individual investment portfolios by using our unbiased research on the economy and a range of other investment-related topics." (Emphasis added)

REGISTERED INVESTMENT ADVISORS

(i) Fisher Investments

Fisher Investments, located in Woodside, California, represents on its website that as of April 1, 2013, it had over $46 billion in assets under management. It represents itself as a money manager. It does not proclaim to be a "wealth manager" or "life planner" like the large broker-dealers. It simply represents that it uses its talent, market insight, technology, and strategies to adjust its clients' portfolios accordingly.

The website identifies specific benefits to being a Fisher "private client". These include:

- Direct, Proactive Customer Service
- Regular Communications
- Fisher Forecast Seminars
- Investment Roundtables
- Fisher Friends Events
- Client Conference Calls
- Marketminder.com

See Exhibit 7. Fisher Investments is a fee-based, discretionary, investment advisor. It pretty clearly represents itself as such, leaving out much of the flowery hyperbole the brokerage firms use in their marketing and website pieces.

(ii) Aspiriant

Aspiriant was the nineteenth ranked investment advisory firm in 2012, having over $4 billion of assets under management. The Los Angeles-based firm represents on its website that it "employ[s] all the rigor of institutional manager selection and performance monitoring and analysis." *See* Exhibit 8. Much like Fisher, Aspiriant represents that it uses technology and market research to maximize performance.

Unlike Fisher, Aspiriant does represent that it performs more than just financial planning, purporting to perform "strategic planning" also. This includes:

- Budgeted expenses
- The amount and timing of family and charitable gifts
- Whether to continue employment or business involvement or to "retire"

- What investment returns and risks to pursue…or accept.

Id. at 4-5.

(iii) Oxford Financial Group

Oxford Financial Group is an Indianapolis-based investment advisor with over $10 billion in assets under management, making it the sixth largest investment advisor in 2012. Oxford represents that it provides services a bit broader than Aspiriant or Fisher, sounding more like one of the "big three" brokerage firms above.

Oxford's website is not shy. In touting its family office services, it states: "[t]he sole commitment of our Family Office Services group is to enhance the financial lives of our clients and to enrich family legacies. This means helping you to organize and deploy your wealth in ways that enable you and your family to lead lives that are happier, more harmonious and secure." *See* Exhibit 9.

Oxford also represents on its website that it offers "Alternative Investments" in addition to its investment services. These include:

- Private equity
- Private real estate partnerships
- Hedge funds
- Natural resources

Id. Oxford also offers a proprietary plan called Savile Row, which provides pooled investment vehicles.

(iv) Shepherd Kaplan, LLC

Shepherd Kaplan, LLC, is a Boston-based fee only investment advisory firm with over $7 billion in assets under management. Its website is straightforward and specifically identifies itself as a fiduciary. *See* Exhibit 10. It also identifies its role in providing alternative investments to its qualified investor clients, but stops short of identifying specific types of investments, merely stating it offers private equity and venture capital offerings.

(v) Ronald Blue & Co.

Ronald Blue & Co. is an Atlanta-based fee only investment advisory firm with over $6 billion in assets under management. On its website, Ronald Blue represents the firm to be a more comprehensive wealth management firm, not merely a "money manager". It identifies:

- Financial Planning
- Investment Management
- Tax & Business Services
- Estate Planning
- Philanthropic Counsel

See Exhibit 11. This level of service is quite similar to the services represented by the broker dealers above.

CONCLUSION

After reviewing the publicly available materials advertising the representations and services offered by both brokerage firms and registered investment advisors, there is an inevitable conclusion: Brokerage firms represent themselves as if they were fiduciary investment advisors.

3. Data and other information describing the extent to which different rules apply to similar activities of broker-dealers and investment advisers, and whether this difference is beneficial, harmful or neutral from the perspectives of retail customers and firms. Also, provide data and other information describing the facts and circumstances under which broker-dealers have fiduciary obligations to retail customers under applicable law, and how frequently such fiduciary obligations arise. If possible, differentiate by retail customer demographic information.

There are many differences in the rules applicable to broker-dealers and investment advisers. The most notable difference is the standard governing the provision of investment advice – brokers are held to a suitability standard under FINRA rules and investment advisers are held to a fiduciary standard under federal law. There are wide differences in state law regarding whether or not a broker is deemed a fiduciary.

Courts have routinely held that when an account is discretionary, the broker has a fiduciary duty to the client. In *Leib v. Merrill, Lynch, Pierce, Fenner & Smith*[1], the court specifically set forth the duties a broker owed the customer when the account is a discretionary account:

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1. 461 F. Supp. 951, 953 (E.D. Mich.1978).

> Such a broker, while not needing prior authorization for each transaction, must (1) manage the account in a manner directly comporting with the needs and objectives of the customer as stated in the authorization papers or as apparent from the customer's investment and trading history, *Rolf v. Blyth Eastman Dillon & Co., Inc.*, 570 F.2d 38 (2d Cir. 1978); (2) keep informed regarding the changes in the market which affect his customer's interest and act responsively to protect those interests (see in this regard, *Robinson v. Merrill Lynch*, *supra*) ; (3) keep his customer informed as to each completed transaction; and (5) explain forthrightly the practical impact and potential risks of the course of dealing in which the broker is engaged, *Stevens v. Abbott, Proctor and Paine*, 288 F. Supp. 836 (E.D. Va. 1968).

However, apart from discretionary accounts, the discussion of the duties a broker owes to a customer gets more complicated. Courts have addressed the issue of the existence and extent of a fiduciary relationship between a broker and a customer differently. In *Marchese v. Nelson*[2], the court laid out the ways various courts have addressed this issue:

> Unlike the present case which involves nondiscretionary accounts, "the broker handling a discretionary account becomes the fiduciary of his customer in a broad sense." *Leib v. Merrill, Lynch, Pierce, Fenner & Smith,* 461 F. Supp. 951, 953 (E.D. Mich. 1978) (interpreting Michigan law). Accordingly, numerous courts have held that the lodestar for determining the existence of a fiduciary relationship is whether the account is discretionary or nondiscretionary. *See, e.g., Refco, Inc. v. Troika Inv. Ltd.,* 702 F. Supp. 684, 687 (N.D. Ill. 1988) (interpreting Illinois law). In *Refco,* the court held that "[i]n general only a broker operating a discretionary account is viewed as a fiduciary." *Id.* at 686. The *Refco* court tempered its absolute view by acknowledging that "[e]ven in the most limited type of agency – the nondiscretionary account where the broker is simply called on to carry out its principal's orders – the concept of faithfulness to duty operates to preclude the agent's dealing to its own advantage rather than its principal's." *Id.* at 687 n. 9.
>
> Similarly, in *Leib,* the court indicated that in a nondiscretionary account, the "broker is bound to act in the customer's interest when transacting business for the account; however, all duties to the

2. 809 F. Supp. 880, 893 (D. Utah 1993).

customer cease when the transaction is closed." *Leib,* 461 F. Supp. at 952-53. Notwithstanding this apparently limited duty, the *Leib* court identified six duties associated with nondiscretionary accounts: (1) the duty to recommend stock only after becoming informed about the stock; (2) the duty to promptly carry out the customer's orders; (3) the duty to inform the customer of the risks involved in a transaction; (4) the duty to refrain from self-dealing; (5) the duty not to misrepresent any fact material to a transaction; and (6) the duty to transact business only after prior authorization from the customer. *Id.* at 953.

The Tenth Circuit, rather than using the nature of the account as the dispositive factor, balanced the nature of the account with the nature of the relationship between the parties. *Hotmar v. Listrom & Co.,* 808 F.2d 1384, 1386 (10^{th} Cir.1987) (interpreting Kansas law). The *Hotmar* court, in finding no fiduciary relationship, analyzed whether the broker agreed to manage or otherwise control the account, or rather, whether he merely rendered advice. *Id.* at 1387. Finding no agreement by the broker to monitor his clients' nondiscretionary accounts, the court found no fiduciary relationship. *Id.*

Other courts have rejected the nondiscretionary-discretionary dichotomy, in favor of an analysis of the actual relationship. *See, e.g., Baker v. Wheat First Sec.,* 643 F. Supp. 1420, 1429 (S.D. W.Va. 1986) (interpreting West Virginia law); *Davis v. Merrill, Lynch, Pierce, Fenner & Smith,* 906 F.2d 1206, 1216-17 (8^{th} Cir.1990) (interpreting South Dakota law). In so doing, the *Baker* court found a fiduciary relationship where the broker exerted "de facto control" over the account. *Baker,* 643 F. Supp. at 1429. To the *Baker* court, such de facto control existed when "'the client routinely follows the recommendations of the broker.'" *Id.* (quoting *Mihara v. Dean Witter & Co.,* 619 F.2d 814, 821 (9^{th} Cir.1980)).

The Eighth Circuit in *Davis* followed the rationale of the *Baker* court, concluding that a fiduciary relationship may exist in cases where the broker exerts de facto control over a nondiscretionary account. *Davis,* 906 F.2d at 1216-17. In reaching this result, the *Davis* court relied heavily on the fact that the aggrieved customer was an unsophisticated investor who never failed to follow her broker's recommendations. *Id.* at 1217. Even then, however, the court found it significant that the broker had made numerous unauthorized trades. *Id.*

> Finally, other courts assume the existence of a fiduciary relationship even if the account is [non]discretionary [sic], and then analyze the facts to determine the scope of the duty and whether the broker breached the duty. *See, e.g., Romano v. Merrill, Lynch, Pierce, Fenner & Smith,* 834 F.2d 523, 530 (5th Cir.1987) (interpreting federal securities law). Applying this analysis, the *Romano* court found no breach where the customer, an alert and vigilant businessman, controlled his nondiscretionary account and made all decisions regarding activity in the account. *Id.* (citations omitted).
>
> The cases discussed above illustrate four methods that courts employ in answering whether a fiduciary relationship exists between a broker and a customer with nondiscretionary accounts. Two of these methods involve an absolute rule: either finding no fiduciary relationship because the account is nondiscretionary, *see Refco, Inc. v. Troika Inv. Ltd.,* 702 F. Supp. 684, 687 (N.D. Ill. 1988), or finding a fiduciary relationship regardless of whether the account is discretionary, *see Romano v. Merrill, Lynch, Pierce, Fenner & Smith,* 834 F.2d 523, 530 (5th Cir.1987). Other courts, using a flexible approach, base the existence of a fiduciary relationship, not on the nature of the account, but on the nature of the relationship, and find a fiduciary relationship either if the broker has agreed to manage the account, *see Hotmar v. Listrom & Co.,* 808 F.2d 1384, 1386 (10th Cir.1987), or if the broker exercises de facto control over the account, *see Davis v. Merrill, Lynch, Pierce, Fenner & Smith,* 906 F.2d 1206, 1216-17 (8th Cir.1990).

In *Leib*, the court recognized that apart from discretionary and non-discretionary accounts, there exists a hybrid-type account. "Such an account is one in which the broker has usurped actual control over a technically non-discretionary account. In such cases, the courts have held that the broker owes his customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation."[3] *Leib* further set forth the factors the court should consider when determining whether the broker has usurped control over the account:

> In determining whether a broker has assumed control of a non-discretionary account the courts weigh several factors. First, the courts examine the age, education, intelligence and investment experience of the customer. Where the customer is particularly

3. 461 F. Supp. at 954.

young, *Kravitz v. Pressman, Frohlich & Frost*, 447 F. Supp. 203 (D. Mass. 1978), old, *Hecht v. Harris*, *supra*, or naive with regard to financial matters, *Marshak v. Blyth Eastman Dillion & Co., Inc.,* 413 F. Supp. 377 (N.D. Okl. 1975), the courts are likely to find that the broker assumed control over the account. Second, if the broker is socially or personally involved with the customer, the courts are likely to conclude that the customer relinquished control because of the relationship of trust and confidence. *Kravitz v. Pressman*, *supra*; *Hecht v. Harris*, *supra*. Conversely, where the relationship between the broker and the customer is an arms-length business relationship, the courts are inclined to find that the customer retained control over the account. *Shorrock v. Merrill Lynch*, *supra*. Third, if many of the transactions occurred without the customer's prior approval, the courts will often interpret this as a serious usurpation of control by the broker. *Hecht v. Harris*, *supra*. Fourth, if the customer and the broker speak frequently with each other regarding the status of the account or the prudence of a particular transaction, the courts will usually find that the customer,by maintaining such active interest in the account, thereby maintained control over it. *Robinson v. Merrill Lynch*, *supra*.

The differing standards applicable to investment advisers and brokers in some jurisdictions is discussed in more detail below in response to Item 9.g.-h. The differences in the standards are generally harmful to retail customers who do business with brokers instead of investment advisers.

There are several circumstances other than purchasing broker recommended securities in an account in which it would be beneficial to retail customers for brokers to be subject to a fiduciary duty. Common situations that manifest how beneficial the fiduciary standard is include situations where the following occurs: 1) an investor follows a broker to a new brokerage firm; 2) the investor has a change in circumstances or objectives; 3) the investor changes brokers; and 4) the broker is aware of impending doom for a portfolio.

The investor following a broker to a new brokerage firm. This is probably the most common situation in which a fiduciary standard for brokers would directly benefit investors. Brokers commonly move to different brokerage firms over the course of a career and will try to get their clients to follow them when making such moves. When a broker sells investments that are unsuitable and then changes brokerage firms, it can place the investor's portfolio in supervisory limbo. Despite requiring the completion of account suitability documents at the new firm, the new firm commonly will do nothing to warn the investor that the portfolio previously purchased for the investor by the firm's new broker is grossly unsuitable for the investor. It will then justify the inaction by saying it is only responsible for trades made after the broker had transferred to it. The investments are then left to decline in value until the investor's nest egg is gone. Further, the initial firm, at which the investment purchases were made, will deny responsibility because it had no ability to supervise the broker, to recommend investment changes, or to discover the impropriety after the broker left. A fiduciary duty on the part of the broker and the new firm to inform the investor of an unsuitable portfolio, irrespective of whether the investments were recommended by the broker after he changed firms, would protect the investor.

The change of circumstances or objectives. When an investor's circumstances change, such as when the investor retires, becomes unemployed, or becomes disabled, the needs of that investor change. Likewise, investors can manifest a change in risk tolerance and objectives that causes the portfolio of that investor to no longer be suitable. This is a very common situation where a fiduciary duty benefits the investor. The lack of a fiduciary duty means that a broker does not need to inform an investor that the investor's portfolio is no longer suitable – no matter how strongly the information given the broker would indicate to the contrary. Typically, the change in circumstances will be deemed relevant only to new advice given. To make matters worse, investors commonly think their broker will volunteer such advice. Brokerage firms, through advertising and other marketing, give investors reason to believe that they are watching over investors' savings and guiding them through the transitions in their lives.

An example of how such a fiduciary duty benefits investors can be found in a recent case filed in the American Arbitration Association ("AAA") and settled prior to arbitration[4]. The case involved an individual who informed his registered investment adviser that he had developed cancer and stopped working and wished to live on income from his investments. Despite the significant life change, the investment adviser failed to advise the investor that his aggressive portfolio was inconsistent with such a life change. The fiduciary duty of the investment adviser meant that the adviser had the duty to do so. Without such a duty, the adviser could have kept his mouth shut and let the portfolio do little to help the investor sustain himself during this time when he was not working. The existence of a fiduciary duty in this case, arising because of the investment adviser status, gave the investor legal

4. Names of the parties have been withheld due to the confidentiality provision of the settlement agreement between the parties.

recourse. A broker may not have had similar obligations under the FINRA rules or applicable state law.

Investor changing from one broker to a new broker. When an investor comes to a new broker with a portfolio that requires some future action, the broker may fail or refuse to take any action. When losses subsequently occur, the new broker attempts to disclaim liability for losses by stating that the recommendation for the investment was not the broker's, but rather the prior broker's, and that the broker has no duty with respect to investments he did not recommend. The losses could be prevented if the broker were a fiduciary with a duty to disclose relevant information.

The importance of fiduciary duties being applicable to brokers is demonstrated in another recent case in which an investor purchased a substantial variable annuity from her first broker. She then changed brokers and retired. Despite the request for income to sustain the investor during retirement and a need for stable investments, the new broker never advised the client to annuitize the annuity. Annuitizing would have furthered both objectives. When the investor questioned why the broker failed to take this action after years of doing business together, the broker responded that the investor should have done so on her own. Like many investors, the investor in this matter barely understood what a variable annuity was. Under a fiduciary standard, the broker and her firm could be held liable for not disclosing such important information.

In another case, a broker convinced an elderly investor to take a loan secured by the investor's portfolio that would be paid for by income from the portfolio. The investor's new broker did not make any payments on the loan and did not inform the investor that failing to pay the loan off could result in the investor's entire life savings being liquidated without notice. In this case, the investor was able to recover only because the new broker was found to be a fiduciary. Without such a duty, the elderly investor would likely be left with no recourse.

Not advising about impending disaster. When investors only get information at the time of the purchase of an investment, situations arise in many cases where the broker knows information indicating that a particular investment is about to implode but fails to take action or inform the investor. This circumstances occurs often in cases involving proprietary products that a firm does not want its customers to sell.

The many cases involving Morgan Keegan in the past five years exemplify this situation. Morgan Keegan was selling certain proprietary mutual funds as conservative bond funds. Ultimately, Morgan Keegan came to learn that a substantial portion of these funds were invested in collateralized debt obligations – an investment vehicle carrying substantial risk. Internal emails recognized those risks and the fact that individuals invested in such investments were not aware of the substantial risk. Despite the knowledge that the investors misunderstood the risk of holding the investments, Morgan Keegan never notified the investors of the substantial risk. Whether Morgan Keegan had a duty to warn depended in part upon whether the brokers and Morgan Keegan were fiduciaries of the investors. In *Warfel v. Morgan Keegan*, (FINRA No. 11-726 and U.S. District Court for the Middle District of Florida, 12cv1250), the FINRA arbitration panel found that a fiduciary duty existed and, as such, the Morgan Keegan broker had a duty to warn of the risk of continuing to hold the Morgan Keegan bond funds. Morgan Keegan was ordered to reimburse the claimant for his losses as the result of not being informed of such risk. This case should be contrasted with a large number of other cases in which the investors were not told of the risk of continuing to hold such investments and in which the arbitration panels found no fiduciary duty and, therefore, no liability on the part of the broker or the firm.

9. Data and other information related to the ability of retail customers to bring claims against their financial professional under each regulatory regime, with a particular focus on dollar costs to both firms and retail customers and the results when claims are brought. We especially welcome the input of persons who have arbitrated, litigated, or mediated claims (as a retail customer, broker-dealer or investment adviser), their counsel, and any persons who presided over such actions. In particular, describe the differences between claims brought against broker-dealers and investment advisers with respect to each of the following:

9.a. The differences experienced by retail customers, in general, between bringing a claim against a broker-dealer as compared to bringing a claim against an investment adviser. – For the time being, there is very little difference between bringing suit against licensed investment advisers or broker dealers, because most claims will end up in arbitration. It is commonly believed that the use of mandatory arbitration by investment advisers is widespread. A recent survey conducted by the Massachusetts Securities Division found that nearly half of registered investment advisers responding to the survey had pre-dispute mandatory arbitration clauses in their advisory contracts.[5]

Of course, nearly all claims brought by retail customers against broker-dealers are subject to mandatory arbitration, either through an express arbitration provision in the customer's account documentation, or as a result of FINRA rules. *See UBS Fin. Servs. v. W. Va. Univ. Hosps., Inc.*, 660 F.3d 643 (2d Cir. 2011).

9.b. Any legal or practical barriers to retail customers bringing claims against broker-dealers or investment advisers. – Retail customers must ordinarily bring claims against investment advisers in either state court or in arbitration. Save for claims for rescission of an investment advisory contract and restitution, the Investment Advisers Act of 1940 ("IAA") does not provide for a federal private right of action or jurisdiction. *See Transamerica Mortgage Advisers, Inc. v. Lewis*, 444 U.S. 11, 18-19 (1979).

> Most investment adviser arbitration takes place before private dispute resolution forums such as the AAA or JAMS. Traditionally, FINRA has not been used as an arbitration forum for disputes between investment advisers and their clients, because the advisers have not been FINRA members. However, FINRA has launched a pilot program, under which the forum may be used if the adviser and the customer submits a post-dispute agreement to arbitrate in the forum.[6]
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> There is a wide variation among these forums' procedural rules. For example, discovery may be limited to simply an exchange of documents, or may include pre-hearing depositions of all of the principals. Similarly, the forum rules may allow for pre-hearing, dispositive motions. The forums may be prohibitively expensive for some retail customers. Participants in AAA arbitrations may be required to share a pre-hearing deposit of as much $25,000. The neutrals are often retired judges who may or may not have significant securities experience.

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5. *See* http://www.sec.state.ma.us/sct/sctarbitration/Report%20on%20MA%20IAs%27%20Use%20of%20MPDACs.pdf.

6. *See* http://www.finra.org/ArbitrationAndMediation/Arbitration/Special Procedures/P196162. To date, only a small number of investment advisers have made use of this pilot program.

FINRA arbitration, in contrast, is much more tailored to the retail customer than these other forums. Its discovery rules and procedures specifically focus on securities-related documents and information and require disclosure of certain documents. Pre-hearing dispositive motions are no longer allowed in FINRA proceedings, except in a few limited circumstances. The forum fees are significantly lower than in other forums. Finally, FINRA neutrals may not have the pedigree of private forum neutrals, but likely have more experience with arbitrating disputes within the securities industry.

Of course, litigants in arbitration have little recourse if an arbitrator returns a legally erroneous award. Litigants in court may seek appellate review of judicial errors.

Another legal barrier faced by retail customers is the satisfaction of a judgment or award in their favor. Under FINRA rules, industry parties must comply with an arbitration award or settlement related to an arbitration or mediation within 30 days or risk suspension or cancellation of that party's registration with FINRA. *See* FINRA Rule 9554. However, retail customers that litigate in court or in an arbitration forum other than FINRA must enforce any judgment like any other civil judgment – by levying and executing on property wherever it can be found.

9.d. The amount of awards. – Claims against brokers or broker-dealers are generally adjudicated in the FINRA arbitration forum. FINRA provides statistics as to how often investors are awarded monetary damages in arbitration claims against broker-dealers or brokers. From 2008 to 2012, customers have received some monetary damage recovery in a range of 42% to 47% of the cases for each year.[7] However, FINRA does not keep statistics as to what percentage of the damages claimed by investors are recovered through arbitration against broker-dealers.

Edward O'Neal and Daniel Solin performed a statistical analysis of arbitration awards against broker-dealers, with data from January 1995 to December 2004. *See* "Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare", Edward S. O'Neal, PhD., and Daniel R.

7. *See* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/.

Solin[8] (hereinafter "Mandatory Arbitration").

O'Neal and Solin sampled over 13,800 cases – 90% of those cases were from NASD arbitration and 10% were from NYSE arbitration. Mandatory Arbitration at 6. They found that the average "win rate" – where the investor was awarded at least some money – was about 50.7% over this ten year period. Mandatory Arbitration at 10. Of those investors who "won", their average recoveries ranged annually from 68% of the amount requested to 49% of the amount requested. Mandatory Arbitration at 11.

The percentage of requested damages recovered went down significantly depending on how much money was requested. For example, when the amount claimed was less than $10,000, investors who "won" received 76% of their losses back, on average. When the claims requested damages of between $100,000 and $250,000, investors who "won" only received 52% of their requested damages. Even worse, for claims with damage requests of over $250,000, investors who "won" only received 37% of their requested damages. Mandatory Arbitration at 12. Thus, investors who brought larger claims were likely to recover less of their losses.

While this analysis by O'Neal and Solin was helpful to determine how investors fared against brokers and broker-dealers, no similar analysis has been performed on cases involving investment advisers. As such, it is impossible to compare the awards/recoveries against each other.

9.e. Costs related to the claim forum, as it affects retail customers, firms, and associated persons of such firms. – When an aggrieved investor sues a broker-dealer and its representatives, that investor is generally required to bring claims in FINRA arbitration, due to the fact that FINRA-member broker-dealers generally have an arbitration clause in their account agreements. The initial filing fees for claims filed in FINRA arbitration are $1,425 for claims with losses between $100,000 and $500,000; and $1,800 for claims with losses over $1 million. The parties are also required to pay forum fees for the initial pre-hearing conference, disputes over discovery and subpoenas, and the evidentiary arbitration hearing. The forum fees for the evidentiary

8. Available at http://smartestinvestmentbook.com/pdf/061307%20Securities%20Arbitration%20Outcome%20Report%20FINAL.pdf.

hearing can be significant, ranging from a few thousand dollars, to $30,000, or even more. These forum fees can be a significant financial burden on investors who are required to arbitrate their claims.

> Often, when an aggrieved investor sues an investment adviser and its representatives, that investor is required to arbitrate his or her claims, pursuant to an arbitration clause in the investment advisory agreement, in one of the following forums: a) AAA; b) JAMS; or c) even FINRA. The forum fees associated with AAA or JAMS are generally higher than FINRA forum fees and can be substantial for an aggrieved investor to have his or her "day in court." As discussed above, some forums, other than FINRA, have substantial deposit requirements.
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> However, some investment advisory agreements do not have any arbitration clause. The absence of an arbitration clause allows the investor to proceed in court. Court filing fees are typically much smaller and often range from $300 to $600 (including jury fees). There are also costs associated with serving process on a party for a court action (which an investor typically does not have to deal with in arbitration). Courts typically do not charge parties "trial fees", "forum fees", or other fees to appear before a judge or jury to determine the outcome of the case. Thus, investors who sue their investment advisers in court generally will have significantly lower forum fees associated with bringing a claim. However, there may be significantly higher costs associated with discovery and motion practice for claims filed in court.
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> Hence, the differences in forum costs associated with suing a broker-dealer or suing an investment adviser are dependent on the forum in which the case is litigated. The costs can vary significantly, depending on whether the investment adviser has an arbitration clause in its agreement, and, if so, which forum has been selected. Without such a clause, the forum fees for an aggrieved investor are significantly less.

9.f. Time to resolution of claims. – As with forum costs above, the difference between suing a broker-dealer or an investment adviser depends on the existence of an arbitration clause. One of the benefits to arbitration is that claims filed in an arbitration forum are generally resolved more quickly than those filed in court. Claims filed in FINRA arbitration, AAA, or JAMS are generally resolved in a range of one year to eighteen months. FINRA's website indicates that from 2011 to 2013, the average time from start to resolution of a FINRA arbitration claim ranged from 14.2 to 14.8 months.[9] However, cases that went to final evidentiary arbitration hearing had lasted, on average, from 15.9 to 17.7 months.

> Claims that are filed in court can be resolved quickly, but generally take significantly longer to be resolved than claims filed in arbitration. The length of time to resolution is somewhat dependent on how busy the court dockets are, which varies from court to court. For example, a case in a rural court with a relatively light docket may proceed more rapidly than one in an urban court with a loaded docket. Additionally, court cases are subject to more motion practice and greater discovery (such as depositions, which are generally not allowed in securities arbitration). Discovery and motion practice can add time and expense to the resolution of the case in court.
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> The United States Government keeps statistics on how long it takes cases to proceed in the federal courts.[10] For each year ending in September, from 2007 to 2012, the median time from filing of a civil case to *trial* has ranged from 24.3 months to 25.5 months. However, these statistics only include cases that get that far – the median time from filing to disposition of a civil case has ranged from 7.3 to 8.9 months. While these statistics include all civil cases, they can be used to estimate the length of time an investor should anticipate for the resolution of his or her claims in court.
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> Thus, the differences between suing a broker-dealer or an investment adviser again depend on whether there is an arbitration agreement. An aggrieved investor that is suing an investment adviser in court may anticipate a greater length of time for the resolution of his claims.

9. *See* http://www.finra.org/ArbitrationAndMediation/FINRADisputeResolution/AdditionalResources/Statistics/.

10. *See* http://www.uscourts.gov/Statistics/FederalCourtManagementStatistics/district-courts-september-2012.aspx.

9.g. The types of claims brought against broker-dealers (we welcome examples of mediation, arbitration and litigation claims);

9.h. The types of claims brought against investment advisers (we welcome examples of mediation, arbitration and litigation claims); and

9.i. The nature of claims brought against broker-dealers as compared to the nature of claims brought against investment advisers (e.g., breach of fiduciary duty, suitability, breach of contract, tort).

The nature of claims against broker-dealers and investment advisers is generally similar. The majority of claims made against either broker-dealers or investment advisers generally involve two types: a) that the broker or adviser misrepresented the risks or characteristics of a particular investment; and b) that the investment was unsuitable for the investor in light of the investor's financial resources, risk tolerance, investment objectives, age, and other characteristics. The former type of claim typically is asserted in numerous causes of actions, such as common law fraud, violation of a state securities statute, or violation of a state consumer fraud statute. The latter type of claim typically is asserted in causes of action for negligence or breach of fiduciary duty. The extent of the broker's or adviser's duty in a negligence or breach of fiduciary duty claim is what differentiates the two claims.

Investment advisers are fiduciaries under federal law and have extensive duties to their clients, including the duties to put the best interests of the client first and duties of fair dealing. *SeeS.E.C. v. Capital Gains Research Bureau, Inc*., 375 U.S. 180, 191 (1963) (describing the "delicate fiduciary nature of the investment advisory relationship"). On the other hand, the law varies from state to state concerning whether a broker owes his client a fiduciary duty. Courts in some states, like California, have found that brokers are fiduciaries and have the same duties as an investment advisor would. *SeeDuffy v. Cavalier*, 215 Cal. App. 3d 1517, 1533 (Cal. App. 1989); *see alsoBrown v. Wells Fargo Bank, NA*, 168 Cal. App. 4th 938, 960 (Cal. App. 2008) (stating that "A stockbroker is a fiduciary"). Courts interpreting the law of other states have determined whether a broker is a fiduciary on a case-by-case basis. For example, some courts have looked to who had *de facto* control over the account at issue (*see Davis v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 906 F.2d 1206, 1216 (8th Cir. 1990)), or whether the client was unsophisticated (*seePatsos v. First Albany Corp.*, 741 N.E.2d 841, 849-50 (Mass. 2001)).

Because of the clear law regarding the fiduciary nature of the investment advisory relationship, proving liability on the part of an investment adviser in some jurisdictions can be more readily accomplished than proving liability on the part of a broker or his firm. Likewise, proof of a common law fraud claim against a broker who is a fiduciary under state law and investment advisers can, in some jurisdictions, be an easier task. For example, under Oregon law, common law fraud must be proved by only a preponderance of the evidence in a claim against a fiduciary,[11] whereas fraud must be proven by clear and convincing evidence against a non-fiduciary.[12]

Consumer protection statutes prohibiting unfair trade and deceptive practices are more likely to reach investment advisory services than securities trading. Some courts have held that securities transactions are not within the scope of such statutes. *See, e.g., Paine Webber Jackson & Curtis, Inc.*, 839 F.2d 1095 (5th Cir. 1988) (Louisiana Act not applicable to securities transactions); *Spinner Corp. v. Princeville Dev. Corp.*, 849 F.2d 388 (9th Cir. 1988) (Hawaii's "baby FTC Act" not applicable to securities). Other courts have held that securities claims are within the scope of these statutes. *See Onesti v. Thomson McKinnon Securities, Inc.*, 619 F. Supp. 1262 (N.D. Ill. 1985) (Illinois consumer fraud statute applicable to securities transaction since securities are merchandise); *Segal v. Goodman*, 851 P.2d 471 (N.M. 1993) (court upheld award of treble damages under New Mexico Unfair Practices Act for sale of unregistered securities).

However, the courts that have considered the issue have generally determined that the provision of investment services falls within these consumer protection statutes. *See Denison v. Kelly*, 759 F. Supp. 199 (M.D. Pa. 1991) (although securities are

11. *Lindland v. United Business Invs., Inc.*, 298 Ore. 318, 693 P.2d 20, 25 (Or. 1984).

12. *Dizick v. Umpqua Community College*, 287 Ore. 303, 599 P.2d 444, 448 (1979).

not "goods" within the meaning of the Pennsylvania Consumer Protection Law, the Act is applicable to investment services); *Johnson v. John Hancock Funds*, 217 S.W.3d 414, 424 (Tenn. Ct. App. 2006) (investment counseling and advice is consumer transaction covered by Tennessee statute); *Strigliabotti v. Franklin Res., Inc.*, 2005 U.S. Dist. LEXIS 9625, *29-30 (N.D. Cal. Mar. 7, 2005) (California statute reaches scheme to overcharge investors in the management of securities).

9.j. The types of defenses raised by broker-dealers and investment advisers under each regime. – Broker-dealers and investment advisors raise many similar defenses in investor claims against them. Those defenses include the negligence of the investor, the sophistication of the investor, ratification, waiver, estoppel, and failure to mitigate. There are, however, defenses raised by broker-dealers and brokers which are not available to investment advisors. Most brokers and broker-dealers will contend that they owe no fiduciary duty to an investor. Rather, the only obligation that they contend they have is to make suitable investment recommendations and that their duties begin and end with the securities transaction. One case frequently cited by brokers and broker-dealers is *De Kwiatkowski v. Bear Stearns & Co.*, 306 F.3d 1293, 1302 (2d Cir. 2002). Brokers and broker-dealers also frequently assert that there is no private right of action for violation of rules of a self-regulatory organization. Because investment advisers owe an ongoing fiduciary duty to act in the best interests of their customers, and they are not governed by the rules of a self-regulatory organization, these defenses are not available to investment advisers.

12. Data and other information describing the effectiveness of disclosure to inform and protect retail customers from broker-dealer or investment adviser conflicts of interest. Describe the effectiveness of disclosure in terms of retail customer comprehension, retail customer use of disclosure information when making investment decisions, and retail customer perception of the integrity of the information. Please provide specific examples. If possible, differentiate by the form of disclosure (oral or written), the amount of information the disclosure presents, and retail customer demographic and account information. Also, if possible, measure disclosure effectiveness by associated activity.

The Commission's studies of the financial literacy of investors suggests that disclosure is insufficient to protect investors. *See* Office of Investor Education and Advocacy and U.S. Securities and Exchange Commission*, "*Study Regarding Financial Literacy Among Investors" (August 2012)[13] (the "Financial Literacy Study").

The Commission's Financial Literacy Study recognized that "American investors lack basic financial literacy. For example, studies have found that investors do not understand the most elementary financial concepts, such as compound interest and inflation. Studies have also found that many investors do not understand other key financial concepts, such as diversification or the differences between stocks and bonds, and are not fully aware of investment costs and their impact on investment returns. Moreover, based on studies cited in a Library of Congress report, investors lack critical knowledge about investment fraud. Surveys also demonstrate that certain subgroups, including women, African-Americans, Hispanics, the oldest segment of the elderly population, and those who are poorly educated, have an even greater lack of investment knowledge than the average general population."[14]

The Financial Literacy Study identified: "(i) methods to improve the timing, content, and format of disclosures; (ii) useful and relevant information for investors to consider when either selecting a financial intermediary or purchasing an investment product; and (iii) methods to improve the transparency of expenses and conflicts of interest."

It is important to note that mere disclosure is not sufficient to protect an investor or for a broker or investment adviser to satisfy his obligations to an investor. *SeeIn re Dept. of Enforcement v. Gerald J. Kesner Lakewood, Co.*, 2010 WL 781456, *9 (N.A.S.D.R.); *see also In re Chase*, SEC Release No. 47476, 2003 WL 917974 ("Mere disclosure of risks is not enough. A registered representative must 'be satisfied that the customer fully understands the risks involved and is . . . able . . . to take those risks.'" (quoting *In re Patrick G. Keel*, SEC Release No. 31716, 1993 WL 12348)).

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13. Available at http://www.sec.gov/news/studies/2012/917-financial-literacy-study-part1.pdf.

14. *See* Federal Research Division, Library of Congress, *Financial Literacy Among Retail Investors in the United States* (Dec. 30, 2011). The Library of Congress Report is incorporated by reference in the Commission's Financial Literacy Study and is attached thereto as Appendix 1.

Disclosures must be set forth in plain English. If the risks or the conflict cannot be adequately expressed to be fully understood by the client, the disclosure is meaningless.

14. Data and other information describing the extent to which retail customers are confused about the regulatory status of the person from whom they receive financial services (i.e., whether the party is a broker-dealer or an investment adviser). Provide data and other information describing whether retail customers are confused about the standard of conduct the person providing them those services owes to them. Describe the types of services and/or situations that increase or decrease retail customers' confusion and provide information describing why. Describe the types of obligations about which retail customers are confused and provide information describing why.

In its original report to Congress, the "Study on Investment Advisers and Broker-Dealers" (the "SEC Study")[15], the Commission studied the extent to which retail customers were confused about the status of the person from whom they receive financial services. The Commission reviewed two studies which it sponsored, and a study conducted by Consumer Federation of America (the "CFA Survey").

Commission-sponsored Studies

(i) **Siegel & Gale Study:** Siegel & Gale, LLC, and Gelb Consulting Group, Inc., were retained by the Commission in 2004 to conduct focus group testing. The focus group participants had the same issues as those raised by investors in the publicly solicited comments, namely that they did not understand that the roles and legal obligations of investment advisers and broker-dealers can be different, and that the different titles used are confusing. The participants also did not understand terms such as "fiduciary".

(ii) **RAND Corporation Report**: The Commission retained RAND in 2006 to conduct a study of broker-dealers and investment advisers.

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15. "Study on Investment Advisers and Broker-Dealers", available at http://www.sec.gov/news/studies/2011/913studyfinal.pdf.

a) **Firm Analysis**: RAND found it difficult to identify with certainty the business practices of investment advisers and broker-dealers. RAND noted that it could be difficult for investors to understand the differences in the services provided by financial firms as the information was not presented uniformly, with some firms providing so much information it would be difficult to process and others providing scant information. RAND found that the firms believed investors tend to trust a particular firm without necessarily understanding the firm's services and responsibilities.
b) **Investor Survey**: Survey respondents and focus group participants reported that they did not understand the differences between investment advisers and broker-dealers, and found the titles used confusing. Focus group participants noted that "the interchangeable titles and 'we do it all' advertisements made it difficult to discern broker-dealers from investment advisers."[16] Participants also did not understand the legal duties owed to investors by investment advisers and broker-dealers. "The primary view of investors was that the financial professional – regardless of whether the person was an investment adviser or a broker-dealer – was acting in the investor's best interest."[17]
c) **RAND's Conclusion**: RAND came to the conclusion that the "financial services market had become more complex over the last few decades in response to market demands for new products and services and the regulatory environment."[18] Therefore, there has been a blurring of the distinctions between investment advisers and broker-dealers.

CFA Survey

Industry advocates and certain industry groups also conducted a survey. The results of the survey again suggest that investors do not understand the differences between investment advisers and broker-dealers, nor do they understand that there are differing standards of conduct related to each.

16. *See* SEC Study, p. 98.

17. *See* SEC Study, p. 98.

18. *See* SEC Study, p. 99.

SEC Study Conclusion

The SEC Study found that, based on the comments, studies and surveys it had reviewed, investors do not understand the differences between investment advisers and broker-dealers. This misunderstanding is compounded by the fact that many retail investors may not have the "sophistication, information, or access needed to represent themselves effectively in today's market and to pursue their financial goals."[19] The SEC Study concluded that, "it is important that retail investors be protected uniformly when receiving personalized investment advice or recommendations about securities regardless of whether they choose to work with an investment adviser or a broker-dealer. It is also important that the personalized securities advice to retail investors be given in their best interests, without regard to the financial or other interest of the financial professional, in accordance with a fiduciary standard."[20]

Finally, we provide some comment with respect to the "Request for Data and Other Information Relating to Potential Areas for Further Regulatory Harmonization." We are supportive of harmonizing the regulations applicable to broker-dealers and investment advisers. To the extent the individuals are providing the same, or very similar, services to investors, they should be subject to the same regulations.

Specifically, brokers and investment advisers should be subject to the same advertising regulations. However, as noted above in response to Item 2, broker-dealer advertisements are very misleading to investors, despite the fact that their advertisements are regulated. Any regulatory scheme governing advertisements must ensure that the advertisements accurately describe the services offered by a broker-dealer, broker, or investment adviser and that the advertisements are consistent with the legal duties owed to investors. To the extent there are conflicts of interests, those conflicts should be prominently disclosed in advertisements; however, both brokers and investment advisers should endeavor to eliminate conflicts.

With respect to continuing education requirements, both brokers and investment advisers should be subject to such requirements. The materials used to satisfy the continuing education requirements should be retained by the firms to ensure that their representatives have received adequate training.

PIABA supports harmonizing the regulation of brokers and investment advisers and ensuring that brokers are held to the same stringent fiduciary

19. *See* SEC Study, p. 101.

20. *See* SEC Study, p. 101.

duty. PIABA thanks the Commission for the opportunity to provide additional information on this very important issue.

Sincerely,
Scott C. Ilgenfritz,
President