Public Investors Arbitration Bar Association Vol. 9 No. 1 Spring 2002

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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The Bar Journal of the
Public Investors Arbitration Bar Association

From the Editor's Desk

by Andrew Stoltmann
PIABA Bar Journal
Managing Editor

The newly named PIABA Bar Journal has undergone extensive modifications in both style and content. The most apparent changes are the format and the new name, designed to better reflect the goal of the new publication. What has enabled PIABA to grow into the national force it is today in the securities industry are the contributions of the members. Therefore, the new PIABA Bar Journal seeks to tap the collective wisdom and contributions of some of the top securities arbitration attorneys in the country in order to provide dynamic information for both experienced practitioners and for those attorneys new to the field.

The new PIABA Bar Journal seeks to retain the best features from the Quarterly while at the same time adding new, regular features that will appear in each issue. For example, each PIABA Bar Journal will now have a regular column entitled From the Regulators which will provide an open forum for the regulators to communicate directly to PIABA members. In this issue, Joseph Borg, president of NASAA, writes about the profitability of white-collar crime and the need for regulators to work more closely to combat securities fraud.

More changes and additions are planned in upcoming issues. PIABA members who are interested in contributing in the future should contact any member of the Board of Editors. Your comments and contributions are always welcome.

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Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Summer, 2002 issue of PIABA Bar Journal is June 30, 2002. All submissions, regardless of length, should be accompanied by a computer disk of the submitted materials in word, word perfect or as a text document. Submissions may also be sent by e-mail to Robin Ringo at rsringo@piaba.org or Andrew Stoltmann at stoltmann1234@hotmail.com.

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From The PIABA President

by Philip Aidikoff

Dear Members,

Welcome to our first issue of the newly renamed *PIABA Bar Journal*. There was a time when our quarterly publication was the only way we communicated between annual meetings. Since the list serve now provides for real time discussion, Andrew Stoltman and the Board of Editors have worked hard to reshape and expand the *Journal* to serve the membership better.

We were fortunate to have so much to build on. Columns that have long been the foundation of the *Quarterly* such as "From the Professor" and a review of recent Awards and Cases will be joined by new regular features such as "Practitioners Corner," "The Experts Forum,," "Commodities Corner" and "Brief Spotlight."

Seth "Prof" Lipner inaugurates his "I Love New York [Law] column and in "From the Regulators", NASAA President Joe Borg kicks off another new column that will provide insight into issues that affect our clients. Of course, Feature Articles are always welcome, so if you have something to say send it in.

Since arbitration awards do not generally include reasoned decisions, in order for us to highlight significant cases we need your help. Don't just forward the award. Take a few minutes to fill out our form and put some flesh on the bones.

This is a work in progress, so your feedback is critical. Tell us what you like and what you don't. If there is something that you think should be included, let us know. We want this to be the finest publication in the field.

PIABA continues to grow. We now have over 450 members in 46 states. The list serve has become the lifeblood of our organization. It has truly turned membership in PIABA into belonging to a national law firm, but without the overhead. Robin Ringo is supervising the expansion of our website to include a Statement of Claim and Brief bank. Once we get this up and running, it will be fully searchable and should evolve into a tremendous resource and benefit of membership.

As this *Journal* goes to print, our Awards database is undergoing a final tune-up for release to the membership. Over the next few months we anticipate that all NASD awards will join our complete library of NYSE awards. This will be an invaluable tool in our fight to level the playing field for our clients by further refining the arbitrator selection process.

Last years Annual Meeting in Florida produced our largest attendance ever and the program was very well received. This years promises to be bigger and better. The Broadmoor is a one of a kind resort with something for everyone. We are already far ahead of last years pace for room reservations and the Program Committee is putting the finishing touches on a terrific agenda and speaker lineup. One of the best things about PIABA is our Annual Meeting and I hope to see all of you in Colorado Springs.

The meltdown that ended the bull market resulted in the loss of trillions of dollars in the market value of American securities. Not since the years of limited partnership litigation has there been such an extraordinary increase in the number of customer claims, but with a big difference. The tech run up and crash created losses far in excess of anything seen in the partnership days.

Cases are flooding into the system in unprecedented numbers While business has never been better, knowing what cases not to take and properly counseling those folks is as important as aggressively representing clients who are accepted. As securities practitioners we recognize that a large loss alone doesn't get you through the door; wrongdoing must be present. Unfortunately, some lawyers who don't regularly practice in our field seemed to have missed that day in law school.

Our firm has been called by a number of investors who hired attorneys to recover losses and who, just prior to the hearing, are told that they really don't have a case and should walk away for defense costs. Without exception, a review of their documents and some minimal conversation leads to the conclusion that a case never should have been filed. It's bad enough if the lawyer was retained on a contingency, but consider the plight of clients who put down large up front retainers and cost deposits or incurred and paid hourly billing for many months. I'm not talking about tough or marginal cases; I'm talking about zero liability cases.

We can do better. If you have any doubt about the viability of a potential case, I urge you to tap into and utilize the collective experience of PIABA. Helping each other is another step in leveling the playing field for investors.

Phil Aidikoff

From the Professor

New York Choice of Law Clauses: Their Effect and Defeat

by Joseph C. Long

Mr. Long is an attorney in Norman, OK. He is Professor Emeritus at The University of Oklahoma Law School where he taught Agency & Partnerships, Corporations, Federal Securities Law and State Securities "Blue Sky" Law. His e-mail address is jcllawou@aol.com and he can be reached at 405.364.5471.

It is increasingly common for brokerage houses to include choice of laws clauses[1] in their brokerage agreements. These clauses often appear in two separate places.[2] As a general term of the agreement, there is often a provision which states that "the agreement and its enforcement will be governed by the law of X." Then, in the arbitration provision itself, there is often a provision stating: "The arbitration under this clause shall be governed by the law of X without regard to the choice of law rules of X." The selection of the state law to govern is usually dictated by the state where the broker-dealer is incorporated or has its main office. Since most major firms have the main offices in New York, New York law is the most common law selected.

The rationale generally given for the inclusion of such choice of laws clauses is that the broker-dealer will have to deal with only one set of laws rather than the laws of the various jurisdictions where the clients are located. This rationale clearly shows an intent to cut off all investor rights under the local state securities statute. Cutting off investor rights under the local blue sky statute is insidious enough. However, when New York is selected as the governing law, because of an absurd interpretation of New York law, the investor also loses most of his common law causes of action.

This column will first examine the effect of a New York choice of laws clause and, then, outline ways to

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[1]This column does not address the similar choice of forum clauses. Under a choice of forum clause, the investor agrees to bring suit only in the courts of a particular state. For example, in Robbins & Meyers v. J.M. Huber Co., 2002 WL 418206 (Tex. App. Mar. 19, 2002), the clause provided:

> Any suit, action or proceeding seeking to enforce any provision of, or based on any matter arising out of or in connection with, this Agreement or the transactions contemplated hereby, shall be brought in the State and Federal Courts in the State of New York.

Id. at *1

These clauses are not in themselves choice of law clauses. As a result, the law of the place where the transaction took place should be applied by the designated courts. Because forum selection clauses do not limit the investors' substantive right, merely the place where those rights may be enforced, these clauses are much more frequently sustained than are choice of law clauses. See e.g, Robbins & Meyers v. J.M. Huber Co., supra.

However, it is not uncommon for a forum selection clause to be coupled with a choice of laws clause. The coupling may be a factor in whether a court will enforce the forum selection clause. America Online v. Superior Court, 90 Cal. App. 4th 1, 108 Cal. Rptr. 699 (2001).

These forum selection clauses also have been attacked on the basis that they do not apply to tort claims as opposed to contract claims. In Robbins & Meyers v. J.M. Huber Co., supra, held that a broadly drawn clause, such as the quoted language above, covered both contracts and torts. However, more narrowly drawn clauses have been held not to cover tort actions. See e.g., Busse v. Pacific Cattle Feeding Fund #1, Ltd., 896 S.W.2d 813 (Tex. App. 1995, writ denied).

[2]Sometimes, however, the two parts are combined in a single agreement as in the following clause:

> This agreement, its enforcement and the relationship between the Client and the Firm shall be governed by the laws of the State of New York, including the arbitration provisions contained herein, without giving effect to the choice of law or conflict of laws provisions thereof. . . .

combat such clauses and their effect.

I. THE EFFECT OF A NEW YORK CHOICE OF LAWS CLAUSE.

The best way to determine the effect of New York choice of laws clause is to compare the rights and remedies of a client-investor under a typical state's securities act and common act and common law and the rights the same client-investor would enjoy under same provisions in New York.

A. Rights Under A Typical State Other Than New York.

For the purpose of this discussion, it will be assumed the applicable local jurisdiction[3] has the Uniform Securities Act of 1956.[4] If the transaction takes place wholly or partially in the local jurisdiction, then, under Sections 414(a) and (c) of the Uniform Act, the local act attaches to the transaction.[5]

1. Non-Registration of Securities Professionals.

Section 201 of the Uniform Act requires the local registration of both the broker-dealer and the agent or registered representative handling the transaction. If **either is not registered**, the investor-client may set aside any or all transactions under Section 410(a)(1).

The operative facts for liability under this Section are that the broker-dealer or the registered representative was not registered locally and that the transaction took place at least partially in the local jurisdiction. There is no requirement that the seller, the broker-dealer, or the registered representative know that the securities professionals need to be registered.

If the broker-dealer has a local office and the registered representative is located in that office, there is a strong probability that both these professionals will be registered, and there is no cause of action under Section 410(a)(1). However, if the agent or registered representative is calling from an office outside the state, often the agent or registered representative will not be registered locally.[6] Likewise, many small or regional broker-dealers will not be registered outside of their home state or normal market area.[7]

It should be easy to determine whether there has been a registration violation. The local securities agency will provide a certificate of non-registration which can be introduced. Further, the states that both a broker and its registered representatives are licensed in appears on the CRD print-out.

In addition, some brokerage houses, both introducing and clearing, now subscribe to outside services which report, on a daily basis, any trade where the registered representative is not registered in the local state of sale. Since clearing brokers have the address where the confirmation slip is to be sent, they can easily check to see if the registered representative is licensed in that state **before** they complete the trade and send the confirmation.

2. Non-Registration of Securities.

Section 301 of the Uniform Act requires that all securities which are offered or sold in the local state be registered or exempt[8], or not be subject to state regulation because of federal pre-emption.[9] As in the case of non-registration of the securities professional, failure to register a security, if not exempt or pre-empted, results in civil liability under Section 410(a)(1) of the Uniform Act. The liability for unregistered securities is similar to that for non-registration of a securities professional. The operative facts for liability are that the securities were sold in the local jurisdiction and that they were

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[3]Normally, this will be the state of residence of the investor-client--not because it is the state of his residence, but because he is physically located there at the time the transaction takes place. See Unif. Sec. Act §§414(a) and (c). See generally, 12 Joseph C. Long, Blue Sky Law §§4:09 and 4:10 (2001) (“Long, § ___”). If, however, the investor-client is traveling or vacationing out of the state of his residence, the applicable local law will be the state in which he is physically located at the time of the transaction. Id.

[4]This assumption will be correct for some thirty-five states currently. Table, 7B Uniform Laws Annot. 137 (1994 Supp.).

[5]Under the same sections, if the offer is directed out of a state, then the law of that state will also attach. Therefore, if the offer to sell is directed from New York, New York law will attach **in addition to the local law where the investor-client is located.** Likewise, if the investor-client directs an offer to buy into New York, New York law may also attach under Sections 414(a) and (d).

[6]For example, a registered representative of Merrill Lynch located in the Dallas office calls a investor client in Ardmore, Oklahoma. Merrill Lynch, as a national firm, will be registered in Oklahoma, but the registered representative may not be.

[7]In such case, the registered representatives, of course, are also not registered.

[8]See Section 402(a) of the Uniform Act for the various securities and Section 402(b) for transaction exemptions. See generally, Long, Ch. 6 and 7.

[9]See Securities Act of 1933, §18(b), 15 U.S.C. §77r(b) (as amended 1996). See generally, Long, §§5:18-5:26.

unregistered. There is no requirement that the seller, the broker-dealer, or the registered representative know that the securities need to be registered.

As with non-registration of securities professionals, it is easy to establish whether the securities were registered by checking with the local securities agency. That agency can furnish the investor a certificate of non-registration which may be introduced to establish that fact in a court or arbitration.

Most brokerage transactions involve either secondary sales of securities or private placement offerings. Under Section 301, secondary transactions are subject to the registration, exemption, or pre-emption requirement just as primary issuer transactions are. Many secondary trades, however, will be exempt or pre-empted.

Section 402(a) outlines the various securities exemptions, while 402(b) contains the transactional exemptions. There are four major exemptions which are often used in connection with secondary brokerage transactions. They are the exchange-listed exemption[10]; the manual exemption[11]; the unsolicited offer exemption[12]; and the isolated non-issuer transaction exemption.[13]

In 1996, Congress passed the National Securities Market Improvement Act ("NSMIA") which pre-empted the states from requiring certain securities known as "covered securities"[14] to be registered or exempt.[15] NSMIA, however, did not restrict in any way the anti-fraud **jurisdiction of the states.**[16] The most often used category of "covered securities" is securities traded on the New York and American Stock Exchanges and the **top tier of NASDAQ, the National Market System**.[17] **However, it is important to note that this pre-emption does not apply to the NASD Small Cap listing and the NASD bulletin board.** Also, for some unknown reason, Congress pre-empted regulation of private placement securities under Rule 506 of Regulation D.[18] **Again, it is extremely important to recognize that the pre-emption does not extend to securities exempt at the federal level by Section 4(2) of the Securities Act of 1933**.[19]

Whether a security is pre-empted or exempt is an affirmative defense which the Broker must claim and establish.[20] A claim of exemption should definitely be taken with a

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[10]Unif Sec. Act §402(a)(8). This exemption covers securities listed on the New York, American, and Mid-West Stock Exchanges and any other exchanges designated by the local state legislature. This designating authority is often delegated to the local securities administrator. As a result, the exchanges recognized varies widely from state to state.

This exemption has been partially pre-empted by Sections 18(b)(1)(A)-(C) of the Securities Act of 1933, 15 U.S.C. §§77r(b)(1)(A)-(C) (as amended 1996), which makes certain exchange-listed securities "covered securities". See generally, Long, §§5:19-5:21. The coverage, however, is different between the exemption and the pre-emption. For example, Section 402(a)(8) covers the Mid-West Stock Exchange, which is not covered by Section 18(b)(1). On the other hand, Section 18(b)(1)(C) covers the first tier of the NASDAQ, the National Market System, not specifically covered by most state Section 402(a)(8) exemptions. Section 18(b)(1)(c) gives the SEC the authority, under certain stated conditions, to add securities traded on additional regional exchanges. The SEC has not yet exercised this power. Under state law, there are no conditions for the adding of additional exchanges, and the states have widely accepted many regional exchanges. See Table, 1 Blue Sky L. Rep. (CCH) ¶6401 (2001).

[11]Unif. Sec. Act §402(b)(2)(A). See Table, 1 Blue Sky L. Rep. (CCH) ¶6301 (2002) for a state by state listing of manuals accepted. **State regulation of securities covered by the Manual exemption have not been pre-empted.** See generally, Long, §§7:2-7:9.

[12]Unif. Sec. Act §402(b)(3). The administrator can, and often does, require that a broker get and preserve for a specified time a customer acknowledgment that the transaction is, in fact, unsolicited. The administrator may require this acknowledgment on a specific form. If the administrator has exercised this power and the broker can not produce the signed form, no exemption exists. See generally, Long, §§7:10-7:12.

[13]Unif. Sec. Act §402(b)(1). Section 401(h) defines non-issuer to mean "not directly or indirectly for the benefit of the issuer."

[14]See generally, Long, §§5-18-5:23.

[15]See generally, Long, §§5:1-5:23.

[16]See generally, Long, §5:15.

[17]As noted above, the SEC has authority to add additional exchanges to the pre-emption list, if they meet certain standards. Presently, the SEC has not acted to add additional exchanges. See generally, Long, §5:22.

[18]17 C.F.R. §§230.501-230.508. Congress did **not** pre-empt securities sold under either Rule 504 or 505. These securities continue to require registration or exemption at the state level.

[19]Again, these Section 4(2) securities must be registered or exempt at the state level.

[20]Unif. Sec. Act §402(d) provides: "In any proceedings under this act, the burden of proving an exemption or an exception from a definition is upon the person claiming it."

grain of salt as the broker often cannot establish the exemption. For example, the listings in the manual often do not meet the standards required by the statute.[21] Likewise, many less-than-ethical brokers will stamp all purchase tickets as being "unsolicited" when testimony of the client will establish that the sales were, in fact, solicited. Finally, many issuers will claim that their private placements qualify for Rule 506 when they know from the beginning that they can not sustain the exemption because there are too many non-accredited investors or the non-accredited investors are not sophisticated. In this latter case, a state law registration violation can be established by discrediting pre-emption under Rule 506.

3. Material Omission and Misrepresentations.

There is also liability under Section 410(a)(2) for any material misrepresentations or omissions made in connection with the sale of securities[22] in the local state. In most states, Section 101 of the Uniform Act, which reads similar to SEC Rule 10b-(5), does **not** result in civil liability. It is strictly an enforcement section to be used by the administrator or in criminal cases. As a result, there is no civil liability for employing any device, scheme, or artifice to defraud; or engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Obviously there can be many different material omissions or misrepresentations.[23] Some of the more important in broker cases are failure to disclose non-registration of the securities professionals or the securities,[24] prior criminal activity whether or not a criminal conviction has resulted,[25] prior injunctions or other sanctions,[26] and **pending** civil cases, investigations and stop orders.[27]

4. Common Law Actions.

If the local securities act applies to a transaction, the local common law will also apply. In most states this means that there will be causes of action for fraud, intentional misrepresentation, negligent misrepresentation, negligence, breach of fiduciary duty, and breach of contract. In addition in some states, there may be a cause of action under the state Deceptive Trade Practices Act.[28]

B. Rights Under New York Law.

1. New York Blue Sky Law.

The Martin Act is the New York Blue Sky Law.[29] For a number of reasons, the Martin Act differs substantially from most other state securities acts. The Martin Act, with certain exceptions not relevant here, does not require the registration of securities. It does, however, require the registration of brokers and registered representatives.

The Martin Act is an early blue sky statute, and as with most of these early statutes, it includes no civil liability provision. As a result, the Martin Act was, and still is, enforced only by civil enforcement actions by the New York Attorney General or by criminal prosecution. Therefore, in those limited cases where the securities required

[21] Unif. Sec. Act §402(b)(2)(A), requiring the names of the issuer's officers and directors, a balance sheet of the issuer as of a date within eighteen months, and a profit and loss statement for either the fiscal year preceding that date or the most recent fiscal year of operations. Often Initial Public Offerings of start-up companies listed in a manual immediately upon issuance will not qualify. Likewise, the information may allow a stock to qualify at the time the manual entry was issued, but at the time of sale, the information is out of date. In such case, no exemption is available. See generally, Long, §§7:2-7:9.

[22] This includes all material misrepresentations and omissions whether made by the registered representative, broker, issuer, or some third party. The person sought to be held liable is given an affirmative defense that he or she did not know or in the exercise of reasonable care could not have found out about the misrepresentation or omission. Thus, the broker and registered representative are potentionally liable for the misrepresentations and omissions of others.

[23] See generally, Arnold S. Jacobs, Litigation and Practice Under Rule 10b-5, §61.04 for a hundred-page list, with case citations, of various things which have been **alleged** to be material omissions and misrepresentation.

[24] See Long, §10:58. Failure to disclose that securities were not registered or exempt at the federal level is a material omission under the state act.

[25] See Long, §10:55. The SEC in its disclosure guidelines takes the position that criminal convictions over five years do not have to be disclosed. However, the federal courts have taken the position that such guidelines are a **minimum standard** for disclosure and that SEC Rule 10b-5 will require disclosure after five years. Long, §10:49. The states have generally taken a similar position that disclosure must be made after five years.

[26] See Long, §10:52. See the previous note for a discussion of the five year cut-off by the SEC.

[27] See Long, §10:60.

[28] See e.g., Tex. Civ. Stat. Art. 27.01.

[29] N.Y. Gen. Bus. Law Art. 23-A.

registration and were not, or where the broker or registered representative was not registered in New York,[30] the client investor would have no civil cause of action under the Martin Act.

Section 352-c of the Martin Act contains an anti-fraud provision similar to SEC Rule 10b-(5)[31] and Section 101 of the Uniform Securities Act. While, as noted above, the Martin Act has no express civil liability provision, the lower New York courts for many years implied a cause of action similar to that under SEC Rule 10b-(5).[32] However, in 1987, in CPC Int'l Inc. v. McKesson Corp.,[33] the New York Court of Appeals overruled the lower courts and held that there is no implied civil cause of action for violation of Section 352-c.

As a result of this analysis, it is clear that client-investors have no civil causes of action for registration or anti-fraud violations under the Martin Act. If a broker is allowed to insert a New York choice of laws clause, the net effect will be to strip the client-investor of his rights and remedies under the local state statute. Instead the client-investor must look to the Martin Act where he has no civil remedy. Thus, by the use of a New York choice of laws clause, if allowed, the brokers avoid any state securities liability.

2. New York Common Law.

If taking away rights under the local blue sky statute is bad, a New York choice of laws clause is even worse because it also deprives the client-investor the right to sue on most common law actions. New York common law, like that of most states, recognizes claims for breach of fiduciary duty, negligent misrepresentation, negligence, and breach of contract. However, the New York State[34] and Federal[35] Courts have interpreted the Martin Act to pre-empt such claims involving securities. The New York courts have reasoned that to allow these claims in the securities fraud context "would effectively permit a private action under the Martin Act, which would be, inconsistent with the Attorney-General's exclusive enforcement powers thereunder."[36] As a result the lower federal courts have held that common law claims for breach of duty may not be brought.[37] Likewise, the lower federal courts have dismissed claims for both negligence[38] and negligent misrepresentation.[39]

Only common law claims for fraud survive. The rationale for allowing common law fraud claims to go forward is that the Martin Act does not require the proof of scienter while common law fraud in New York does.[40] Therefore, because of this additional element not found under the Martin Act, a common law fraud claim does not impinge

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[30]This is unlikely if the broker and registered representative are located in New York. However, some of the major brokerage houses use New York choice of laws provisions in client agreements where the client is served by a registered representative located in a local office in another state. In such case, the local registered representative might not be registered in New York. However, under the Uniform Act, since the transaction is not considered a New York transaction, see Unif. Sec. Act §§414(a) and (c), the local registered representative would not have to be registered in New York. As a result, there would be no actionable violation for failure to register in New York.

[31]In fact, Rule 10b-(5) was modeled on this provision.

[32]There is one major difference. None of the operative parts of Section 352-c has ever been held to require proof of scienter, merely negligence. Therefore, in those states which make a violation of Section 101 of the Uniform Act civilly actionable, it can be argued that scienter is not required for any of the operative clauses. This contrasts with the federal approach where Section 17(a)(1) and SEC Rule 10b-(5)(a) have been held to require proof of scienter.

[33]70 N.Y.2d 268, 519 N.Y.S.2d 804, 514 N.E.2d 116 (1987).

[34]Rego Park Gardens Owners, Inc v. Rego Park Gardens Assoc., 191 A.D.2d 621, 595 N.Y.S.2d 492 (2d Dep't 1993); Horn v. 440 E. 57th Co., 151 A.D.2d 112, 547 N.Y.S.2d 1 (1st Dep't 1989).

[35]See e.g., Castellano v. Young & Rubicam, Inc., 257 F.3d 171 (2d Cir. 2001); Granite Partners, L.P. v. Bear Stearns & Co., Inc., 17 F. Supp.2d 275 (S.D.N.Y. 1998).

[36]Eagle Tenants Corp. v. Fishbein, 182 A.D.2d 610, 582 N.Y.S.2D 218, 219 (1992), quoted with approval in Castellano v. Young & Rubicam, Inc., 257 F.3d 171, 190 (2d Cir. 2001).

[37]See e.g., Castellano v. Young & Rubicam, Inc., 257 F.3d 171 (2d Cir. 2001); Gabriel Capital, L.P. v. Natwest Fin., Inc., 137 F. Supp.2d 251, 266-267 (S.D.N.Y. 2000); Bibeault v. Advanced Health Corp., 1999 WL 301691 at *10 (S.D.N.Y. May 12, 1999); Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc., 919 F. Supp. 149, 153 (S.D.N.Y. 1996).

[38]See e.g., Gabriel Capital, L.P. v. Natwest Fin., Inc., 137 F. Supp.2d 251, 266-267 (S.D.N.Y. 2000)

[39]Spirit Partners, L.P. v. Audiohighway.Com, 2000 WL 685022 at *6 (S.D.N.Y. May 25, 2000); Bibeault v. Advanced Health Corp., 1999 WL 301691 at *10 (S.D.N.Y. May 12, 1999); Independent Order of Foresters v. Donaldson, Lufkin & Jenrette, Inc., 919 F. Supp. 149, 153 (S.D.N.Y. 1996).

[40]Lehman Bros. Commercial Corp. v. Minmetals Int'l Non-Ferrous Metals Trading Co., 179 F. Supp.2d 159 (S.D.N.Y. 2001).

upon the Attorney-General's authority under the Act.[41]

In conclusion, if a New York choice of laws clause is honored, not only will the client-investor be stripped of his causes of action under the local state securities statute, but also of any common law claims. This clearly should be against public policy.

II. WAYS TO DEFEAT THE EFFECT OF A NEW YORK CHOICE OF LAWS CLAUSE.

There would appear to be three ways to defeat the effect of a New York choice of laws clause. First, it can be argued that the present interpretation of the effect of the Martin Act on common civil causes of action is simply wrong. Second, the clause itself can be attacked as void under the anti-waiver provision of the state securities act. Finally, an argument can be made that such clauses violate the NASD Rules of Fair Practice.

A. The Current Interpretation of the Martin Act is Wrong.

After the initial rash of decisions barring common law causes of action based upon their pre-emption by the Martin Act, both the New York and federal courts are beginning to re-evaluate this position. The Second Circuit in Suez Equity Investors, L.P. v. Toronto-Dominion Bank[42] did not decide the pre-emption issue but indicated that it considered the issue an open question. It said:

> The New York Court of Appeals has not yet addressed this issue, and the lower court cases...do not explore the issue with the level of depth that would justify a ruling by us in the first instance. ... We are not immediately persuaded that the Court of Appeals would follow [the] lead [of these lower court decisions].[43]

At about the same time, the Fourth Department of the Appellate Division, in Scalp & Blade, Inc. v. Advest, Inc.,[44] disagreed with the pre-emption conclusions of the First and Second Departments. It held:

> Nothing in the Martin Act or in the Court of Appeals cases construing it, precludes a plaintiff from maintaining common-law causes of action based on such facts as might give the Attorney-General a basis for proceeding civilly or criminally against a defendant under the Martin Act.[45]

Finally, Judge Cote in Cromer Finance Ltd. v. Berger,[46] rejected the pre-emption argument. Echoing the language of Suez Equity and Scalp & Blade, Judge Cote wrote:

> [T]here is nothing in either the New York Court of Appeals cases ... or in the text of the Martin Act itself to indicate an intention to abrogate common law causes of action. ... In particular, there does not appear to be any basis in the Martin Act's provisions for a distinction between claims of fraud and claims for negligent misrepresentation, and both New York Court of Appeals decisions allowed plaintiffs' common law fraud claims to proceed.

Accordingly, the plaintiffs' negligence claims are not precluded by the Martin Act.[47]

Judge Cote then went on to predict that the Second Circuit would adopt the Scalp & Blade analysis.[48]

B. Choice of Laws Clauses Are Void Under the Anti-Waiver Provision of the Local Securities Act.

The second way to attack New York choice of laws clauses is to argue that such clauses are against the public policy of the local state and are void under the anti-waiver provision of the local statute.[49]

The Uniform Securities Act has such an anti-waiver provision in Section 410(g) which reads:

Any condition, stipulation, or provision binding any person

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[41]Eagle Tenants Corp. v. Fishbein, 182 A.D.2d 619, 582 N.Y.S.2d 218, 219 (1992). See also Castellano v. Young & Rubcam, Inc., 257 F.3d 171, 189-190 (2d Cir. 2001).

[42]250 F.3d 87 (2d Cir. 2001). But see Castellano v. Young & Rubicam, Inc., 257 F.3d 171 (2d Cir. 2001), decided by another Panel of the Second Circuit a month after Suez, which, without mentioning Suez, adopts the pre-emption theory without discussion.

[43]Id. at 104.

[44]281 A.D.2d 882, 722 N.Y.S.2d 639 (4th Dep't 2001).

[45]Id. at 884, 722 N.Y.S.2d at 640.

[46]2991 WL 1112548 (S.D.N.Y. Sept. 19, 2001). See also In re Rickel & Assoc., Inc., 272 B.R. 74 (Bnkrcy, S.D.N.Y. 2002).

[47]Id. at *4.

[48]Id. at *4, N.6.

[49]In those states which do not have an anti-waiver statute, the argument will have to be based upon public policy along. Restatement (2d), Torts §§187-188, outline the general rule as to choice of law clauses and the public policy exception. Hall v. Superior Court, 150 Cal. App. 3d 411, 197 Cal. Rptr. 757 (1983), discussed below. indicates this argument should be successful.

acquiring any security to waive compliance with any provision of this act or any rule or order hereunder is void.[50]

Currently there are four cases[51] which have considered Section 410(g) or a similar clause in the context of a choice of laws clause. All have found the choice of laws clause to be void.

The first of the four cases is Boehnen v. Walston & Co., Inc.,[52] where Boehnen alleged that the stocks he purchased were not registered in South Dakota, his state of residence. The broker's standard customer agreement provided that New York law should govern.[53] In rejecting the defendants' argument that New York law controlled, the court stated:

> However, the plaintiff is alleging acts of the defendants, in selling or offering for sale securities, which fall within the clear language of the South Dakota Blue Sky Laws. The agreement's choice of law provision, selecting New York law as governing, simply does not apply to the alleged actions of the defendants in alleged violations of the South Dakota Blue Sky Laws.
>
> Thus a stipulation by which the parties select the law to govern the contact is valid and will be given effect only if it is not contrary to public policy generally, or to the public policy of the forum, ..., or in violation of a statute of the forum enacted for the protection of its citizens ....
>
> The purpose of the South Dakota Blue Sky Laws is to protect the public. State v. Martin, 187 N.W.2d 576, 580 (S.D. 1971). To permit the choice of law stipulation in question to control the determination of whether or not South Dakota law will apply, would be to provide an effective means of circumventing legislation designed to protect the citizens of South Dakota. This would clearly be against public policy.[54]

The court in Getter v. R. G. Dickinson Co.[55] again considered the waivability of the local securities act. Again, the customer agreement contained a New York choice of law provision. As in Boehnen, the Court concluded that the protection of Iowa securities act could not be waived.[56]

The third case to consider the waiver issue is Hall v. Superior Court.[57] The court again concluded that a choice of laws clause could not defeat the application of the local securities act, saying:

> In this case of first impression, we consider whether a choice of forum provision in a private California securities agreement is enforceable. Because the choice of law provision in the same agreement violates the Corporations Code and the public policy of this state, we hold enforcement of the choice of forum provision is unreasonable.[58]

The court continued:

> California's policy is to protect the public from fraud and deception in securities transactions. The Corporate Securities Law of 1968 was enacted to effectuate this policy by regulating securities transactions in California and providing statutory remedies for violations of the Corporations Code, in addition to those available under common law. The cornerstone of the law is Section 25701.[59] Section 25701 applies where there is an offer to sell or buy securities in California. The facts before us (i.e., the negotiations in Laguna Hills and the interstate telephone call to California) support the notion that an offer to sell or buy a security was made in this state (§§ 25008, subds. (A) and (b) and 25017, and the parties may not waive or evade the application of California law to the transaction by private agreement.[60]

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[50]Emphasis Added.

[51]Hopefully by the time this column appears, there will be a fifth case. The author argued this issue in early March before the Kansas Supreme Court in the case of Klein v. Oppenheimer & Co. A decision is expected in mid-May. At oral argument the Court seemed receptive to the idea that such clauses were void.

[52]358 F. Supp. 537 (D.S.D. 1973).

[53]The agreement provided in part: "The provisions of this agreement shall in all respects be construed according to, and the rights and liabilities of the parties hereto shall in all respects be governed by, the laws of the State of New York."

[54]Id. at 540-541.

[55]366 F. Supp. 559 (S.D.Iowa 1973).

[56]Id. at 575-76.

[57]150 Cal. App. 3d 411, 197 Cal. Rptr. 757 (1983).

[58]Id. at 413, 197 Cal. Rptr. at 759.

[59][Author's note.] Section 25701 provides: "'Any condition, stipulation or provision purporting to bind any person acquiring any security to waive compliance with any provision of this law . . . is void.'"

[60]Id. at 417, 197 Cal. Rptr. at 761. [Footnotes and citations omitted.]

Finally the court concluded that the contractual provision would not be enforced, saying:

> California's policy to protect securities investors, without more, would probably justify denial of enforcement of the choice of forum provision, although a failure to do so might not constitute an abuse of discretion; but section 25701, which renders void any provision purporting to waive or evade the Corporate Securities Law, removes that discretion and compels denial of enforcement.
>
> Similarly, we believe the right of a buyer of securities in California to have California law and its concomitant nuances apply to any future dispute arising out of the transaction is a "provision" within the meaning of section 25701 which cannot be waived or evaded by stipulation of the parties to a securities transaction. Consequently, we hold the choice of Nevada law provision in this agreement violates section 25701 and the public policy of this state and for that reason deny enforcement of the forum selection clause as unreasonable.[61]

The last case to consider a choice of laws clause is Ito Int'l Corp. v. Prescott.[62] Again, the court rejected the conflict of laws clause. It said:

> The [Washington State Securities Act] states that any provision binding a person acquiring a security to waive compliance with the statute is void. RCW 21.20.430(5). Washington courts will not implement a choice of law provision if it conflicts with a fundamental state policy or if the state has a materially greater interest than the other jurisdiction in the resolution of the issue. ...Here, the State has a strong interest in applying its securities act to a partnership involving several Washington defendants, Washington plaintiffs, and property located in Washington. Because the WSSA expressly invalidates provisions waiving compliance with the statute, we do not rely on the choice of law provision and instead conduct a choice of law analysis.[63]

These cases clearly demonstrate that a New York choice of laws clause which deprives the client-investor of the protection of the local securities acts are against the public policy of the local state. Further, where there is an anti-waiver provision as in Section 410(f) of the Uniform Act, the courts have no discretion to invalidate such a clause.

The Use of a New York Choice of Laws Clause Violates the NASD Rules of Conduct.

Finally, a strong argument can be made that a New York choice of law clause violates NASD Rule of Conduct IM-3110(f)(4).[64] The SEC mandated in 1989 that all Self-Regulatory Organizations adopt rules prohibiting in plain language any contract provision that purports to limit customer claims or remedies arbitrators can utilize. Rule 3110(f)(4) currently reads in part:

> No agreement shall include any condition which limits or contradicts the rules of any self-regulatory organization or limits the ability of the arbitrators to make any award.[651]

In 1995, the NASD issued Notice to Members 95-16[66] which warned that the use of a New York choice of laws clause to prohibit the award of punitive damages would violate Rule 3110(f)(4). The NASD then warned that enforcement action would be taken against member firms which continued to use such clauses to prohibit punitive damages.

While NASD and the SEC were focusing on an attempt to deprive the client-investor of punitive damages, the argument should be equally valid here where the choice of laws clause has the effect of depriving the client-investor of any recovery short of common law fraud.

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[61] Id. at 418, 197 Cal. Rptr. at 762-63. [Citation omitted.]

[62] 83 Wash. App. 282, 928 P.2d 566 (1996).

[63] Id. at 288-289, 928 P.2d at 570.

[64] This is old Rule 21(f)(4) of the NASD Rules of Fair Conduct.

[65] NASD Manual 4892-4893 (July 2001).

[66] 1995 WL 1712330 (NASD Mar. 1995). See also NASD Notice to Members 95-85, 1995 WL 1712413 (Oct. 1995).

I Love New York (Law)

The Easter Bunny, the Self-Critical Analysis Privilege, and Other Figments of the Securities Industry's Imagination

by Seth E. Lipner

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One of the more creative fictions that the securities industry seems eager to try to peddle to unsuspecting arbitrators these days is the so-called self-critical analysis privilege. For example, in a series of cases which we filed against Salomon Smith Barney, we face an objection to production under this supposed privilege, as well as "other immunities from discovery". SSB is trying to use "privilege" as an excuse to hide documents and statements that it submitted to regulators in response to investigations being conducted. These "statements" are clearly discoverable in our proceeding, unless they are "privileged".

We asked our adversary what the "immunities" were (perhaps he means "vaccinations"), and received no reply. We also asked about the foundation under New York law (the law of the contract) for the "self-critical analysis privilege", and similarly received no reply. Having gone to law school before such privileges were invented, we had to do a little research, and were pleased by the results.

The New York courts have consistently rejected the so-called self-critical analysis privilege. The leading case comes from the Appellate Division, Third Department (an intermediate level appellate court) and is titled *Lamitie v. Emerson Electric Co.*, 142 A.D.2d 293, 535 N.Y.S.2d 650 (3d Dept. 1988). The opinion is written by Justice Levine, who would soon thereafter ascend to the Court of Appeals, where he continues to sit. *Lamitie* was a personal injury/wrongful death action arising out of a propane gas explosion allegedly caused by a defective hot water heater control valve made by the Defendant. Plaintiffs sought disclosure of various documents and records in Defendant's possession including the contents of certain of Defendant's files containing the reports and correspondence exchanged between the Defendant the Consumer Product Safety Commission, minutes of Defendant's meeting with Consumer Product Safety staff and a consultant's report on the efficacy of Defendant's program for recall of the allegedly defective products. The lower court rejected Defendant's claim of privilege, and granted Plaintiff's Motion to Compel. The court, however, granted a protective order, requiring that all trade secrets, if any, in the disclosed documents be kept confidential. Defendant appealed.

The principle ground for discovery was the "common law" critical self-analysis privilege. The court wrote as follows:

> "No New York court has applied such a privilege, but it has been recognized in a number of federal cases in varying contexts [citations omitted]. These decisions accepting the critical self-analysis privilege are in conflict as to its scope. Some courts have limited the privilege (1) to reports by persons mandated by law to engage in such self-evaluation, viewing as its purpose the encouragement of more complete and candid cooperation of the reporter with the governmental agency to whom the report must be made; and (2) to only the subjective, evaluative materials in such reports [citation omitted]. Other courts have more generally applied the privilege to reports incident of voluntary, confidential in-house evaluations by organizations and institutions aimed at rectifying problems or improving products or services [citations omitted]. Still other courts have questioned the

> foundation for the privilege and have been reluctant to apply it [citation omitted]. The most that can be said regarding the federal cases is that "the privilege remains largely undefined and is generally recognized" (*see Federal Trade Commission v. TRW, Inc.*, D.C. Cir., 628 F.2d 207, 210. . .) Moreover, the United States Supreme Court, in *United States v. Arthur Young & Co.*, 465 U.S. 805, 104 S.Ct. 1495, 79 L.Ed.2d 826, rejecting policy arguments similar to those underlying the critical-self analysis privilege in holding that no privilege applies to work papers of independent auditors used in preparation of financial reports of publically held corporations required under securities laws."

The court then ruled that state (and not federal) law applies in any event . In our arbitrations, we can easily make the state law argument, because (a) most of us don't bother with federal claims anymore and (b) the FRCP does not apply outside the District Court anyway (see FRCP 1).

Describing New York law, the *Lamitie* court wrote:

> "With the rarest of exceptions, and then only when there has been a strong showing that the harm to the public interest from disclosure outweighs the interest of the litigant seeking disclosure [citation omitted] or that disclosure would impair fundamental rights [citation omitted], New York courts have deferred to the Legislature as to the creation of any new evidentiary privilege. In our view Defendant has not show any compelling circumstances here to depart from the generally restrictive policy against blocking the truth-seeking process in litigation by extension of the classes of privilege communications (see, *United States v. Nixon*, [citation omitted]). Notably, Defendant has not shown that confidentiality is essential to the full maintenance of the relationship between it and the Consumer Product Safety Commission or that the Defendant's full candor with the Consumer Product Safety Commission, mandated in any event by statute, would be sufficiently enhanced by making its communications with that agency privileged to outweigh the benefits of the truth-seeking process from disclosure [citation omitted]."

No New York State case that we could locate accepts the critical self-analysis privilege as being the law in the State of New York. The Appellate Division, First Department (Manhattan) has even gone so far as to question whether investigatory documents, and conclusory documents in the hands of investigatory governmental panels are privileged from discovery in related cases. The court, in *Martin A. v. Gross*, 194 A.D.2d 195, 605 N.Y.S.2d 742 (1st Dept. 1993) addressed the question of whether the findings of an investigatory panel convened by the government was immune from discovery in a related private law suit. In that case, the party resisting discovery raised a "public interest privilege", arguing that disclosure of the government panel's findings should be excluded from discovery. The court spoke about a narrow privilege of this kind, limited it to "official information" in the hands of government agencies, and stated that there was a required balancing between the interests of the litigants and that of the general public, and found that such a privilege only existed "when the public interest would be harmed if the material were to lose its cloak of confidentiality". Thus, the SSB documents we mentioned at the outset might even be discoverable for the NYSE, but we prefer to watch SSB try to hide them.

New York's attitude about privilege is nicely displayed in these two cases. Our courts and our law are designed to encourage openness and discovery as important parts of the "truth-seeking process". Privileges cannot be manufactured out of thin air by some vague reference to "common law", and are in any event, always confined to very narrow circumstances. In short, New York wants advocates and parties to have a full opportunity to discover information and present their cases. The self-critical analysis privilege has no place in the law of the State of New York. Be sure to tell that to the arbitrators.

Making a Suitability Claim in NASD Arbitration

by Barry D. Estell

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"Unsuitability claims are the most common and yet the most ambiguous of all customer claims" . . . and are "creating significant problems for brokers. . ." according to *Suitability in Securities Transactions*, by Lewis D. Lowenfels and Alan R. Bromberg, *The Business Lawyer*; Vol 54, August 1999. The authors opined that customer complaints, with the advent of mandatory arbitration, shifted from the anti-fraud provisions of the federal securities laws to the unsuitability rules of the self-regulatory organizations. This meant a shift from a legal standard of intent to defraud or recklessness, to "a comparatively nebulous, quasi-legal, quasi-ethical standard of due care and fair dealing between brokers and customers." They further believed that this shift in forum and standards made customer recovery much easier and "increased the customer's leverage to compel a significant settlement." Didn't know you had such a easy go of it did you?

The hard fact is that in securities arbitration it doesn't generally make any difference what you plead in your statement of claim, you're going to be trying a suitability case in one form or another. The basic SRO rules are from the NASD and the NYSE. NASD Rule 2310(a) Recommendations to Customers requires that a member "have reasonable grounds for believing that the recommendation is suitable for each customer upon the basis of the facts, if any disclosed by such customer as to his other security holdings and as to his financial situation and needs." Rule 2310(b) codifies a brokers duty to inquire by making "reasonable efforts to obtain information concerning (1) financial status (2) tax status (3) investment objectives and (4) other information used or considered to be reasonable by the registered rep in making the recommendation to the customer. IM-2310-2(a)(1) says, "Implicit in all member and registered representative relationships with customers and others is the fundamental responsibility for fair dealing" IM-2310(a)(2) says "that sales efforts must be judged on the basis of whether they can be reasonably said to represent fair treatment for the persons to whom the sales efforts are directed, rather than on the argument that they result in profits to customers."

NYSE Rule 405, the Know Your Customer Rule, requires a broker to (1) Use due diligence to learn the essential facts relative to every customer, every order, every cash or margin account accepted or carried by such organization and every person holding power of attorney over any account accepted or carried by such organization."
The NYSE doesn't define what the "essential facts" might be except when approving an options account under Rule 721. And there is remarkably little interpretive information. The authors of *Suitability in Securities Transactions* say that the NYSE staff examiners informally define "essential facts" as "any information that affects the customer's ability to accept risk."[1] Whatever the definition, the burden is on the broker to define what is "essential" with respect to every customer, every account, and every order.
The big difference, of course, is that the NYSE doesn't say anything about a "recommendation" which is the rub in the NASD rule. There are brokers with many years in the business who will swear under oath that they have never ever made a recommendation to anyone . . . ever. They provide alternatives for the customer to make his or her own choice. They provide information. Or they simply never

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[1] The Business Lawyer; Vol. 54, August 1999, page 1571.

do anything but answer the phone and take orders with no comment. But they never make a recommendation that would subject them to any suitability determination. They might also like to interest you in a bridge between Manhattan and Brooklyn.

What is a "Recommendation" anyway? Well if the broker is with a NYSE firm, there is a good working definition in NYSE Rule 472, Communications With The Public. Supplementary Material in the NYSE Manual 472.40, titled Specific Standards for Communications, under (1) Recommendations, says only that, "A recommendation (even though not labeled as a recommendation) must have a basis which can be substantiated as reasonable." Interpretive Memo No. 90-5, issued in August 1990, which is not in the Manual, however, provides that

> For purposes of these standards, the term "recommendation" includes any advice, suggestion or other statement, written or oral, that is intended, or can reasonably be expected, to influence a customer to purchase, sell or hold a security.

That's good stuff. For one thing, it means that oral advice meant to influence a customer to **hold** a security is subject to the same suitability requirements and duty to know the essential facts as a recommendation to purchase a stock. We are currently seeing a bulge of cases involving inducement to hold stocks during the "tech wreck" which cost customers 90% of their portfolios. Put that with a suitability requirement to diversify and you may have a case. That, however, is outside the scope of this article.

The NASD hasn't arrived at a very good definition of the term "recommendation." NASD Rule 8211 like NYSE Rule 410A requires the reporting of an order as "solicited" or "unsolicited" in Automated Submission of Trading Data, commonly known as electronic "blue sheets." But the NASD doesn't define the term. Is "solicited" the same as "recommended?" Or can a rep at a NASD firm solicit a stock, as some brokers claim, by sending "information" without recommending the stock and coming under the "suitability rule". The NYSE seems to consider the terms interchangeable. For example, in levying a censure and fine for "conduct inconsistent with just and equitable principles of trade" a NYSE hearing panel concluded that the broker "marked order tickets **unsolicited**, when in fact he had **recommended** the trades to the customers." (emphasis added)[2]

Until recently, the only source of the NASD's position on the subject was in Notice to Members and the Association was less than precise. In Notice 96-32, Members Reminded To Use Best Practices When Dealing in Speculative Securities, it said, "In addition, the know-your-customer requirement embedded in . . . the Rules of Fair Practice requires a careful review of the appropriateness of transactions in low-priced, speculative securities, **whether solicited or unsolicited**." (emphasis added) Several months later, the NASD issued 96-60 Clarification of Members' Suitability Responsibilities Under NASD Rules With Special Emphasis On Member Activities In Speculative And Low Priced Securities to "clarify" certain issues in 96-32. The only issue was the reference to "unsolicited transactions" and it reaffirmed that a suitability obligation applies only to securities that have been recommended. Suitability considerations do not apply when a member acts solely as an order-taker. "However, a broad range of circumstances may cause a transaction to be considered recommended, and this determination does not depend on the classification of the transaction by a particular member as 'solicited' or 'unsolicited'. **In particular, a transaction will be considered to be recommended when the member or its associated person brings a specific security to the attention of the customer through any means**, (emphasis added) including, but not limited to, direct telephone communication, the delivery of promotional material through the mail, or the transmission of electronic messages." This "clarification" provoked more protest and the NASD was forced to issue a "Clarification of Notice To Members 96-60." This clarification of the clarification said that "the staff did not intend to expand the reach of the Rule," but it did just that. We now have an official publication that says that how a broker marks a ticket does not determine if the order was "solicited" or "recommended". And that is applicable to all speculative and/or low-priced securities. Nothing in any of the Notices refers specifically to penny stocks or SEC Rule 15g-9. If the broker brings the specific security to the attention of the customer through any means, it should be considered as recommended. That's pretty close to the NYSE version. No more presenting various alternatives and letting the client make an "unsolicited" choice.

SEC opinions of cases on appeal from NYSE and NASD disciplinary panels tend to cite the same precedent for sanctions under

[2] In re Kelly R. Fradet, Exchange Hearing Panel Decision 89-69, August 9, 1989.

either suitability rule. The NYSE opinions, available on its website are, unfortunately, brief with a minimum of explanation and little citation of authority. The NASD National Business Conduct Committee (NBCC) and new Adjudicatory Council, however, provide far more extensive discussion. The decisions are readily available on the NASDR website in adobe.pdf or text format. On an ongoing basis, I prefer them because the SEC documents are hard to format and older cases aren't available online. I have overlooked this resource until recently and recommend that everyone review new decisions on a regular basis looking for new SEC citations and fact patterns that complement individual cases. Here then are some of my favorite cases concerning suitability. I encourage everyone to supplement these cases on the list-serve with any others that meet specific fact patterns or case types.

Before the National Adjudicatory Council, NASD Regulation

In the Matter of Jack H. Stein, December 3, 2001:

Before recommending a transaction, a registered representative must have reasonable grounds for believing, on the basis of information furnished by the customer, and after reasonable inquiry concerning the customer's investment objectives, financial situation, and needs, that the recommended transaction is not unsuitable for the customer." Rafael Pinchas, Exchange Act Rel. No. 41816, at 10 (Sept. 1, 1999). As we stated in our decision in Daniel Richard Howard, Complaint No. C11970032 (NAC Nov. 16, 2000), the suitability rule can be violated in a number of ways. Most often, the rule is violated based on the quality of the recommended transactions when compared to the customer's financial situation and needs. *See Pinchas, supra*. The rule also can be violated if a representative's recommendations are quantitatively unsuitable. As the Securities and Exchange Commission ("SEC") has recognized, "excessive trading represents an unsuitable frequency of trading and violates NASD suitability standards." *Paul C. Kettler*, 51 S.E.C. 30, 32 (1992); *see also Harry Gliksman*, Exchange Act Rel. No. 42255, at 4 (Dec. 20, 1999); *Michael H. Hume*, Exchange Act Rel. No. 35608, at 4 n.5 (April 17, 1995).[11] In either case, a representative may make only such recommendations -- or effect such transactions in cases where the representative controls the account -- as would be consistent with the customer's financial situation and needs. *See Rafael Pinchas, supra*, at 10. **Even in cases in which a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile.** (*emphasis added*) *See Pinchas, supra*, at 11 (customer's desire to "double her money" does not relieve registered representative of duty to recommend only suitable investments); *John M. Reynolds*, 50 S.E.C. 805, 809 (1992) (regardless of whether the customers wanted to engage in aggressive and speculative trading, the representative was obligated to abstain from making recommendations that were inconsistent with their financial situation).

That's pretty good stuff in one place. It establishes both qualitative and quantitative unsuitability, aka churning. Because churning is a very broad subject on its own, I don't have room to provide full coverage in this article. However, in light of a recent spate of recreational churning in fee only accounts, I offer the following:

> *Erdos* agues that he did not act with scienter. However a finding of scienter is unnecessary in order to establish excessive trading under the NASD's Rules of Fair Practice. *In re Eugene J. Erdos*, 47 S.E.C. 985, Release No. 34-20376, citing In re First Securities Corporation, 40 S.E.C. 589, 592 (1961). Release No. 34-6497, March 20, 1961 (Nor do we deem it necessary to finding of violation of the NASD rule relating to the suitability of recommendations to determine the motivation or intentions of the broker-dealer or salesman involved.) See also, *In re John M. Reynolds*, Release No. 34-30036, 1991 (FN4 It is well-established that a finding of scienter is unnecessary to establish excessive trading under the NASD's rules.)

Because commissions are the normal scienter for churning under 10b-5 case law, it might be hard to show in a fee only account. But you don't need scienter in a suitability claim based on violation of the NASD Rules of Fair Practice. The NASD website has a page for "Prohibited Conduct" under Investor Protection. No. 1. "Recommending to a customer the purchase or sale of a security that is unsuitable . . . Investment in a particular type of security may be unsuitable or the amount or frequency of transactions may be excessive and therefore unsuitable for a given customer." The older SEC releases include several NASD cases with lower level trading that doesn't necessarily have a high turnover number but is characterized as unsuitable trading rather than "churning." See, for example, *In re Walter S. Grubbs*, Release No. 34-

4138, July 30, 1948 (a turnover of 2.5X in 3+ years was found to be excessive.) In re R.H. Johnson & Co., Release No. 34-4694, April 2, 1952 (Chart showing turnover rate over five (5) years: 1944-2.35, 1945-3.29, 1946-1.99, 1947-.83, 1948-.82 held excessive)

"Stein also concerns over concentration: "The speculative and risky nature of the stocks that Stein recommended and the high concentration of those stocks in EA's account made Stein's recommendations unsuitable. . . Even assuming, as Stein contends, that EA sought to speculate, Stein concentrated EA's account too highly in speculative securities" establishing that it constitutes unsuitable recommendations.

In the Matter of Wayne B. Vaughan, October 22, 1998,

At the NAC Hearing, Vaughan and his counsel tried to paint VB as a "sophisticated investor" who enjoyed trading in speculative securities. Vaughan asserted that VB had previously engaged in a risky trading strategy . . . in index options and junk bonds. Vaughan's counsel described VB as someone who had engaged in "sophisticated trading, enjoyed that, and insisted upon it." **A customer's prior transactions, however, are not relevant in a suitability determination**, and we do not find that VB's history of risky trading mitigates Vaughan's conduct. In re Larry Ira Klein, *see also In re Douglas Jerome Hellie*, (prior transactions are irrelevant in suitability determinations). The fact that VB traded junk bonds and index options in the past does not mean that she understood the risks involved. She could very well have been following the recommendations of her broker at that time. (*Emphasis Added*)

Has anyone ever had a client who wasn't a sophisticated investor? It's not supposed to matter and I also think this line of cases can be used effectively in discovery disputes when Respondents want ten years of trading records prior to retirement. Other issues covered in Vaughan:

The delivery of a prospectus does not absolve a broker of his duty to inform the customer fully of the risks associated with the proposed investment.

Even if Vaughan had explained the risks to VB, the securities he recommended for her account would still have been unsuitable. The SEC has made clear that even in those situations where a customer seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. Citing In re John Reynolds.

We also find that the frequent use of a margin account was *per se* unsuitable for VB.

In the Matter of James B. Chase, August 15, 2001,

Chase's Suitability Obligation. NASD Conduct Rule 2310, also known as the "suitability" rule, requires a broker, in recommending a security to a customer, to have reasonable grounds for believing that the security is an appropriate investment for that customer, based on the customer's financial situation and needs. **Chase demonstrated a profound lack of understanding of his customer-specific suitability obligation under Rule 2310. Chase's attorney argued during the proceedings below that Chase's "primary responsibility [was] to make sure that the customer [was] fully advised of all the facts and [could] make intelligent decisions."** Again, during the hearing on appeal, Chase's attorney argued that Chase had fulfilled his suitability obligation by disclosing to YH the risks associated with following his recommendations to purchase FHC and to open a margin account. Although it is important for a broker to educate clients about the risks associated with a particular recommendation, **the suitability rule requires more from a broker than mere risk disclosure**. *See Patrick G. Keel*, 51 S.E.C. 282, 286 (1993) (noting that a broker must ensure that the customer understands the risks involved in a recommended securities transaction, in addition to determining that the recommendation is suitable for the customer). (Emphasis Added)

Hey! It doesn't matter that you warned them of the risk, marked all the tickets unsolicited just like all the other customers and they insisted you do it to them. Even if we believed you, you still have a duty to only recommend investments that are suitable. Other points made in Chase:

> Furthermore, a broker cannot rely upon a customer's investment objectives to justify a series of unsuitable recommendations that may comport with the customer's stated investment objectives but were nonetheless not suitable for the customer, give the customer's financial profile.
>
> The concentration of high risk and speculative securities [in the customer's] account . . . was not suitable. *In re Clinton H. Holland, Jr.*
>
> A college economics course and access to information do not, however, constitute

"investment experience" or "sophistication". *In re Peter C. Bucchieri* (noting that customer's graduate degree from Harvard did not make him a sophisticated investor).

In the Matter of Michael R. Euripides: July 28, 1997 (Before the National Business Conduct Committee, NASD Regulation.

Euripides' asserted defenses are meritless. First, Euripides claims that he relied on material and information supplied by his superiors or the issuer in recommending Primedex bonds to RL. **Euripides, however, cannot shift his responsibility to comply with regulatory requirements to his firm or the issuer.** *In re Stephen Thorlief Rangen*, Exchange Act Rel. No. 38406 (Apr. 8, 1997); *In re Thomas Kocherhans*, Exchange Act Rel. No. 36556 (Dec. 6, 1995); *In re David Joseph Dambro*, 51 S.E.C. 513, 516 (1993). (Emphasis Added)

Second, Euripides claims that he **believed that RL had read the Primedex prospectus. This does not excuse Euripides' failure to inform RL fully of the investment risks** associated with the Primedex offering. *See In re Larry Ira Klein*, Exchange Act Rel. No. 37835 (Oct. 17, 1996); *In re Ross Securities, Inc.*, 41 S.E.C. 509 (1963). (Emphasis Added)

We have concluded, *infra*, that RL and Euripides did not speak about the Acorn stock before Euripides purchased it for RL's account, and that that transaction was unauthorized. **The Commission has determined that unauthorized trades are "recommended" and may be found to be unsuitable as well as unauthorized.** *In re Patrick G. Keel*, 51 S.E.C. 282 (1993) (in executing securities transactions for a customer, the broker implicitly recommended such securities). (Emphasis Added)

Because the NASD's decisions are reviewed by and it's authority ultimately comes from the SEC, I provide below some of the most relevant and quoted SEC decisions that I have collected.

In re Philips & Company and Gerald G. Bernheimer, Release No. 34-5294, April 9, 1956 Applicants contend that in recommending the purchase of the Quebec stock Bernheimer had no reason to believe it was not suitable under the circumstances, that the customers were mature and intelligent persons who at the time had unrealized profit on prior purchases and that their own independent judgment and desire to make more profits was the chief reason for making further purchases. They also point out that after the transaction complained of customers recommended to another person, and themselves purchased from a former employee the same type of stock and considered it suitable. We can not accept applicants' contention . . . Whether or not customers considered a purchase of the stock a suitable investment is not the test for determining the propriety of (Bernheimer's) conduct. The test is whether Bernheimer fulfilled the obligation he assumed when he undertook to counsel the customers, of making only such recommendations as would be consistent with the customer's financial situation and needs.

In re Eugene J. Erdos, Release No. 34-20376, November 16, 1983: Even though Mrs. C may have desired 'quick profits' that did not entitle Erdos to ignore her individual situation and place her limited assets in risky investments. Whether or not Mrs. C considered the transactions in her account suitable is not the test for determining the propriety of Erdos' conduct. *Citing Philips & Company*. . . Even assuming that Mrs. C's objective was to make quick profits, the activity in her account was clearly excessive in the light of her financial situation. And the fact that Mrs. C. may have authorized the transactions in her account does not alter that conclusion.

In re John M. Reynolds, Release No. 34-30036, 1991: As a fiduciary, a broker is charged with making recommendations in the best interests of his customer even when such recommendations contradict the customer's wishes. Thus, even if the committee suggested that Reynolds engage in aggressive and speculative trading, Reynolds was obligated to counsel them in a manner consistent with the fund's financial situation. [Note: Reynolds is widely quoted, but since it concerns a church board, not an individual, I prefer some of the others.]

In re Peter C. Bucchieri, Release No. 34-37218, May 14, 1996: FN9 The fact that Robert Dibble had a graduate degree from Harvard, a consideration stressed by Bucchieri does not establish that he was a sophisticated investor.

In re Patrick G. Keel, 53 S.E.C. 460, Release No. 34-31716, 1993: That (customer) failed to complain at the time of the transactions that the options purchases were unauthorized is no defense.

In re F.J. Kaufman and Company of Virginia, 45 S.E.C. 97, Release No. 34-27535. 1989: Kaufman points out that each of the customers at issue requested the margined buy-write strategy and therefore claims he did not "recommend" it We disagree.

In re Charles W. Eye, 49 S.E.C. 85, Release No. 34-29572, 1991: Her request for a plan to increase income was not a warrant to

escalate risks unduly. If the only approach capable of producing the desired income involved significant dangers, Eye should have advised against it.

In Re Michael J. Fee, 52 S.E.C. 1082, Release No. 34-31070, 1992: Scienter is further demonstrated by the fact that, although he solicited all of his sales of Airwave, he marked most of the order tickets "unsolicited" . . . it seems clear that Fee was seeking to avoid any inquiry into his Airwaves sales. [Note: I like this one because it says Fee heard about Airwave from a stranger in a bar frequented by brokers, who said the stock had 'real good potential growth. Sounds like the guy could be an analyst at Morgan Stanley.]

In re Shearson, Hammill & Co., Release No. 34-7743, November 12, 1965: . . . the responsibility for refraining from excessive trading, which even if each transaction shows a profit, will deplete the account or reduce the overall profit that might otherwise be made because of the commission paid on each transaction, cannot properly be avoided by pointing to the failure of an unsophisticated customer to object. [Note: Broker recommended to a 13-year old boy, who had asked to purchase Smith Corona stock, that he buy instead 25 shares of USAMCO stock at 18½, pointing out that favorable developments regarding USAMCO were imminent which he was not then at liberty to disclose where USAMCO was an obscure Reg A stock. [Note: Reminds me of the Taxi episode where Louie DePalma, played by Danny DiVito, became a broker.]

In re Douglas Jerome Hellie, 49 SEC 637, Release No. 34-29468, 1991: In our view , Trust's prior trades are irrelevant. A broker must "make a customer specific determination of suitability and . . . tailor his recommendations to the customers financial profile and investment objectives. *citing F.J. Kaufman & Company of Virginia*. SEC Release No. 27535 (December 13, 1989) 45, SEC 120.

In re Arthur Joseph Lewis, Release No 34-29794, October 8, 1991: The fact that a customer such as Mrs. McGowan, may be wealthy does not provide a basis for recommending risky investments

In re Frederick C. Heller, Release No. 34-31696, January 7, 1993: A customer's wealth certainly "does not provide a basis for engaging in excessive trading in his account, *citing In re Arthur Joseph Lewis*.

In re David Joseph Dambro, Release No. 34-32487, June 18, 1993: Suitability is determined by the appropriateness of the investment for the investor, not simply by whether the salesman believes that the investor can afford to lose the money invested. *citing In re Arthur Joseph Lewis.*

In re Larry Ira Klein, Release No. 34-37853, October 17, 1996: Suitability relates to whether a specific securities transaction is appropriate for a particular investor, not whether that individual can afford to lose the money invested. Citing Douglas Jerome Hellie. . . Klein's delivery of a prospectus to Towster does not excuse his failure to inform her fully of the risks of the investment package he proposed . . . Klein argues that (customers) all wanted to earn a higher yield than that offered on CDs. FN28 Klein argues that his recommendation to James on her earlier investment in a high-yield bond fund somehow supports the suitability of his recommendation to her of the TWA notes. We previously have rejected this argument. *Citing Douglas Jerome Hellie* (prior transactions irrelevant in suitability determination).

In re Clinton Hugh Holland, Release No. 34-36621, December 21 1995: Nor does the fact that (customer) was not, at the time those investments were made dependant on income from the investments at issue mean that she would not subsequently need these funds. . . Even if we conclude that Bradley understood Holland's recommendations and decided to follow them, that does not relieve Holland of his obligation to make reasonable recommendations. *Citing Paul F. Wickswat*

In re Gordon Scott Venters, Release No. 34-31833, February 8, 1993: Whatever interest in speculation Avallone may have had was whetted by the aggressive and extremely optimistic promotional campaign by Venters and the firm. At the very least, when Venters learned about his customer's age and situation, he had a duty to abandon the promotion. Citing Eugene Erdos (the issue is not whether or not the client considers the transactions in her account suitable, but whether the salesman, when he undertakes to counsel the client, fulfills the obligation he assumes to make only such recommendations as would be consistent with the client's financial situation and needs.)

In re Paul F. Wickswat, Release No. 34-29907: Dr. Evalyn Taylor was a self-employed psychologist. Dr. Taylor could have done more to monitor Wickswat's handling of her account. She testified that she was lax in reviewing her confirmations and monthly account statements. . . Despite concern expressed over the trading by her accountant, the administrator of her pension plan, and a friend who was a broker, and despite an inquiry from Prudential's management, Taylor continued to rely on Wickswat and to acquiesce in the trading. Regardless of Taylor's acquiescence in the options transactions in her account,

Wickswat having undertaken to act as her investment counselor, was charged with making only such recommendations s were consistent with her financial situation and needs. The proper inquiry is not whether Taylor viewed Wickswat's recommendation as suitable, but whether Wickswat fulfilled his obligation to his client. Wickswat cavalierly disregarded his customer's investment objectives and exposed

In re Paul C. Kettler, Release No. 34-31354, October 26, 1992: FN15 Kettler contends that the customer contractually assumed the responsibility to alert the firm regarding excessive trading and seems to place significance on the fact that Price's daughter, who had an MBA, assisted her in opening her account. Kettler points to language in Price's account documents whereby she undertook to inform the firm of substantial changes in her financial situation and purportedly agreed to ratify confirmation and account statements if she failed to object within a period following receipt of the documents. However, responsibility for compliance with regulatory requirements cannot be shifted to the customer. *citing In re Paul F. Wickswat.*

The next three cases are all reviews of New York Stock Exchange enforcement actions rather than NASD enforcement or SEC actions initiated directly. Note that the citations used are the same as for the NASD cases. This cross-citation of authorities indicates that the SEC has only one suitability standard and claimant's counsel should use any applicable cases regardless of which SRO's rules are being enforced. Both concern "just and equitable principals of trade" contained in NASD Rule 2110 encompassed by Rule 2310 and NYSE Rule 476(a)(6) contained in Rule 405.

In re Clyde J. Bruff, Release No. 34-31141, September 3, 1992 **[NYSE]:** Having undertaken to act as an investment counselor for the Pattersons, Bruff was required to make only such recommendations as were in their best interest. Thus, even if the Pattersons wished to engage in aggressive and speculative options trading, Bruff was obliged to counsel them in a manner consistent with their financial situation. *Citing In re John W. Reynolds* and *In re Paul F. Wickswat* (both NASD cases) in upholding a NYSE finding that Bruff violated Rule 723 of the NYSE Options Rules in that he improperly recommended options transactions.

In re Stephen Thorlief Rangen, Release No. 34-38486, April 8, 1997 **[NYSE]:** . . . by concentrating so much of their equity in particular securities, Rangen increased the risk of loss for these individuals beyond what is consistent with the objective of safe, non-speculative investing. Rangen admits that (customers) were investing in a manner that was not suitable for them; however, he contends that they were aware of the risks and it would have been wrong for him to refuse their orders merely because he felt that the investments were not suitable. Even if we were to accept Rangen's view that these clients wanted to speculate and were aware of the risk. . . . the Commission has held on many occasions that the test is not whether (customers) considered the transactions in their account suitable, but whether Rangen "fulfilled the obligation he assumed when he undertook to counsel [them], of making only such recommendations as would be consistent with [their] financial situation and needs. *Citing Eugene J. Erdos, Clinton Hughs Holland, Jr.* and *Paul F. Wickswat*. (All NASD cases) Rangen contends that it was Shearson's research department that recommended the purchase of STRIPS because interest rates were expected to fall. He further contends that the stocks recommended were all in "top rated" categories of the Lehman Research Division. However, Rangen cannot shift his responsibility as an investment counselor to his employer. It was Rangen's duty to make only such recommendations as were in the best interests of his clients. . . obligated not only to consider Shearson's recommendations, but his clients' investment objectives and financial situations.

In re Henry James Faragalli, Release No. 34-37991, November 26, 1996 **[NYSE]:** Faragalli defends his recommendations by pointing to the purported affluence of his customers, citing Frederick Heller. . . A customer's wealth, in other words, does not give a salesperson a license to disregard the customer's investment objectives, *citing Arthur Joseph Lewis*. Omissions of Facts: Moreover, although Faragalli strongly recommended EECO to his customers, he failed to disclose that Standard & Poors had rated EECO "B" or "below average" with respect to the company's "past performance of earnings and dividends and relative current standing.

Congressional Intervention Needed to Solve Brokerage Firm Research Department Conflicts of Interest

by Andrew J. Stoltmann

I. Introduction

In the last twelve months, brokerage firm research departments have come under intense scrutiny for alleged undisclosed conflicts of interest. In April of 2002, New York Attorney General Eliot Spitzer filed an injunction against Merrill Lynch alleging the stock rating system the firm used did not reflect the analysts' true opinions of the companies followed and for failing to disclose to clients that the firm's ratings were tarnished by undisclosed conflicts of interest. Shortly thereafter, the SEC announced they were launching a formal inquiry, along with the New York Attorney General's Office, the NYSE, the NASD, and the North American Securities Administrators Association to determine the necessity of additional rulemaking and whether any laws have been violated.

II. The Perceived Problem

Many individual investors relied upon the research provided by analysts at major brokerage firms believing it to be unbiased and credible. However, the same securities firms whose analysts purport to give investors' unbiased stock advice also employ investment bankers who profit significantly from investment banking relationships with the same companies followed by the research department. Some argue this has made research analysts at brokerage firms salesmen rather than unbiased evaluators of the merits of a company as an investment leading to the publishing of unrealistic and overly optimistic projections of a company's future stock price.[1]

The undisclosed conflicts of interest in brokerage firm research departments are well known on Wall Street. Scott Black, President of Delphi Management, stated in the February 12, 2001 edition of American Prospect "[M]ost analysts are simply putting out promotional literature. They're there to sell stocks and drum up other business."[2] Tweedy, Browne Company, in their May of 2001 letter to shareholders, stated "If you pardon our cynicism, many of these analysts also work for investment banking houses that are collecting generous fees for bringing Internet and Internet related companies public. In a more rational world, this would be called a conflict of interest."[3] Byron Wein, stock market strategist for Morgan Stanley, in Time Magazine on April 2, 2001, stated "It is clear that the profession has some serious work to do to rebuild confidence" as he urged analysts to be "intellectually honest and independent."

There are four factors that commonly compromise the objectivity of analysts. **First**, there are the investment banking relationships between the brokerage firms and the companies they follow. The investment banking business is an extremely lucrative business for brokerage firms. Jay Ritter, economist at the University of Florida, estimates the underwriting revenues for Wall Street from 1999-2000 were $7.3 billion. Underwriting a company's securities offerings and providing other investment banking services

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[1] See July 5, 2001 USA Today Editorial concluding "Until the hoodwinking ends, investors should see analysts for what they are-salesman, not researchers."

[2] Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street, David W. Tice, Congressional Testimony for the Committee on Financial Services, June 14, 2001.

[3] Id.

can bring in more revenues for firms than brokerage firm operations. As a result, some believe analysts are prohibited from providing any negative information about companies who employ the firm's investment banking services.

When hiring a securities firm for investment banking business, many companies assume the firm's research analysts will provide glowing reports regardless of the actual merits of the company. An unfavorable analyst report may harm the firm's efforts to cultivate investment banking relationships that most brokerage firms deeply covet. A negative research report is many times enough for that company to take their future investment banking business elsewhere.

Recent academic studies and surveys indicate this problem is widespread. A survey of analysts and companies by Tempest Consultants found that 88 percent of brokerage analysts polled said the companies they cover would retaliate against a 'sell' recommendation by replacing their firm with competitors for future investment banking business. 54 percent of analysts surveyed said they believe companies would temporarily exclude them from company briefings while 25 percent of companies surveyed admitted they would cut off access if an analyst issued a sell rating on their company.[4]

Maureen McNichols, a professor of Public and Private Management at Stanford University, published a study that concluded that analysts "bow to pressure from investment bankers or clients and issue more favorable reports than warranted." Her study concluded that analysts for underwriting firms had more favorable recommendations and long-term growth forecasts than analysts that were unaffiliated with an underwriting deal.

A study entitled "Analyst Credibility: The Investor's Prospective" published in the Journal of Managerial Issues by Jane Cote, Associate Professor of Accounting at Washington State University, found that analysts are frequently pressured to offer favorable recommendations or at least temper negative opinions. No fewer than 61 percent of analysts responding to a survey reported personal experience with management threatening reduced future access to the company, severing business ties to the investment firm, lawsuits and even having the analyst terminated.[5]

The *second* factor that compromises analysts' objectivity is the compensation structure for research analysts. An analyst's pay and job security is often directly linked to the number of investment banking deals the analyst lands or to the profitability of the firm's investment banking division. The analyst therefore has an incentive to help ensure that the brokerage firm continues its investment banking relationship with the brokerage firm by providing positive research on the company.

Unfortunately, brokerage firm analysts typically know that a negative research report means no future investment banking business and can sometimes even cause an analyst to lose his or her job. Mitch Zacks of Zacks Investment Research stated in 2001 that the "way an analyst can get fired is to damage an existing investment banking relationship with a company or sour a future investment banking relationship."[6] In 1994, Bell South refused to rehire then Salomon Bros. as a lead underwriter for a large bond issue after a Salomon analyst described the company as one of the worst run of the seven Baby Bells.[7] Marvin Roffman, an analyst of Janney Montgomery Scott, a well-known regional brokerage firm, was fired by the firm after he issued a report concluding that Donald Trump's Taj Mahal was too risky of an investment.[8] Richard Lilly, an analyst for JW Charles Securities, was fired by the firm after he unearthed fraud by the management of a company he was following. Lilly's employer refused to let him file a scathing research report against the company[9]

The *third* factor that compromises analysts' objectivity is personal ownership in the shares of the company the analyst follows. Some brokerage firms engage in "venture investing" where firms and analysts acquire a stake in a start-up by acquiring discounted, pre-IPO shares. Analysts therefore profit from owning the securities they follow and they have an incentive to provide glowing recommendations, regardless of the merits of the company. An analyst who owns the security he follows clearly has a conflict of interest making it possible that the

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4 Analysts Avoid Sell Ratings Out of Fear, CFO.com, April 26, 2001.

5 Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street, David W. Tice, Congressional Testimony for the Committee on Financial Services, June 14, 2001.

6 The Pied Pipers of Wall Street, Benjamin Mark Cole, Bloomberg Press, 2001.

7 Id.

8 Id.

9 Id.

analyst would be less than honest in an assessment of the merits of the company.

The **final** factor that tarnishes analyst's objectivity is the extra commissions brokerage firms typically receive for a positive research report. A "buy" or "strong buy" recommendation by a brokerage firm research department helps the firm generate more purchases of securities which leads to additional commissions for the brokerage firm. Stockbrokers often use glowing research reports as a sales tool when soliciting the purchase of a stock from their clients or prospective clients. It is easier to convince a client to purchase a security when the firm's research department has a "strong buy" or "buy" recommendation on a stock.

Academic research indicates the above noted conflicts are more than just theoretical problems. Kent L. Womack, a finance professor at Dartmouth's Amos Tuck School of Business, and Roni Michaely, a Cornell University finance professor, found that the stock recommendations of brokerage firms without investment banking ties tend to be more accurate. Their stocks rose an average of 3.5 percent within a year, versus a decline of 11.6 percent over the same period in stocks recommended by brokerage firms involved in investment banking with the companies they cover.[10] study from the Harvard and Wharton Business Schools entitled "The Relationship Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings" concluded:

> Our evidence suggests that the coexistence of brokerage services and underwriting services in the same institution leads sell-side analysts to compromise their responsibility to brokerage clients in order to attract underwriting business. Investment banks claim to have 'Chinese Walls' to prevent such conflicts of interest. Our evidence raises questions about the reliability of the 'Chinese Walls.' We document that analysts affiliated with the lead underwriter of an offering tend to issue more overly optimistic growth forecasts than unaffiliated analysts. Furthermore, the magnitude of the affiliated analysts' growth forecast is positively related to the fee basis paid to the lead underwriter. Finally, equity offerings covered only by affiliated analysts experience the greatest post-offering underperformance, suggesting that these offerings are the most overpriced.

David Dreman, a well-known Wall Street contrarian and financial columnist, and Michael Berry, a professor of business at James Madison University, published a study in The Financial Analysts Journal in 1996 that reviewed 94,251 analyst forecasts between 1971 and 1996. The conclusion of their study was that the typical analyst forecast missed the target (that is, varied from the actual result) by 42 percent. While the average error over the 25 year period was 42 percent, in the last eight years they examined (1989 through 1996), analyst forecasts missed the target by an average of 50 percent.[11]

III. The Proposed Solution by the Securities Industry Association

In June of 2001, the Securities Industry Association ("SIA"), backed by the 14 largest underwriting firms in the securities industry, released "best practice" suggestions on how to ensure analysts work in the best interest of investors and not their investment banking clients. In releasing the guidelines, SIA President Marc Lackritz stated "Analysts play a very important role by providing thoughtful and independent analysis for investors. These 'best practices' are part of many efforts to ensure that our industry abides by the highest professional standards."[12]

The primary suggestions released by the SIA involve the following:

*Don't link analysts' pay "directly" to investment-banking deals;

*Don't allow analysts to sell if they've recommended others buy;

*Don't let investment bankers review an analyst's research;
*Don't have analysts report to investment banking;

*Bankers should not promise or propose specific ratings to clients when pursuing business; and

*Analysts should disclose if they or household members own stakes in the companies they cover.

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[10] Analyzing the Analysts: Are Investors Getting Unbiased Research from Wall Street, David W. Tice, Congressional Testimony for the Committee on Financial Services, June 14, 2001.

[11] The Pied Pipers of Wall Street, Benjamin Mark Cole, Bloomberg Press, 2001.

[12] Keeping Wall Street Clean, TheStandard.com, June 12, 2001.

The guidelines led some brokerage firms to make immediate changes. Merrill Lynch instituted a new policy days after the guidelines were released that prohibit its equity analysts from buying shares of stock in the companies they cover. Prudential Securities, which had already started advertising their investment banking-free research, began requiring analysts to reveal whether they or family members have $10,000 or more invested in companies they cover. Credit Suisse announced that its technology analysts would no longer report to high profile investment banker Frank Quattrone.

IV. Analysis

The blindly optimistic "research" reports emanating from Wall Street brokerage firms are well documented. According to First Call/Thomson Financial, as of July 1, 2001, 98.6 percent of the 24,000 individual stock recommendations offered by analysts were "strong buys," "buys" or "holds" with only 1.4 percent of the recommendations being either "sells" or "strong sells." For example, as late as November 8, 2001, 10 of 15 analysts who followed Enron still rated the stock a "buy" or "strong buy" even though it was disclosed three weeks earlier in the Wall Street Journal that Enron was hiding its extensive losses and the SEC disclosed two weeks prior that the firm was being investigated. The token attempts by the securities industry to resolve the problems resulting in these glowing recommendations are simply too little too late thereby necessitating Congressional intervention and the actions by the New York Attorney General's Office and the SEC. While overwhelming evidence has existed for at least the last decade that the analysts at major brokerage firms are often nothing more than glorified salesmen for the investment banking division, it is only now after approximately $3.0 trillion has been lost from the NASDAQ and on the heels of Congressional investigations that Wall Street offered its token "solution" to the problem. Rep. Richard Baker, Chairman of the House Committee on Financial Services, stated at the hearings examining research analysts in June of 2001 that he was "naturally skeptical of a document that contains a disclaimer that, to me, essentially says, 'We promise to be honest – unless of course circumstances warrant that we can't be."[13] As noted by Rep. Paul Kanjorski at the same hearings, "It's nice, but a little late."[14]

The voluntary guidelines outlined by the brokerage firms have no enforcement powers of their own.[15] While the industry groups do plan on monitoring enforcement on a continuing basis, their past efforts make these assurance dubious at best. It is highly unlikely the recommendations made by the securities trade organizations or other efforts will have any real impact on the way brokerage firm analysts do business. Most of the recommendations by the securities trade organizations were already in place during the last five years when most of the problems ensued. For example, the guidelines suggest such obvious solutions as investment bankers shouldn't "promise or propose specific ratings to current or prospective clients when pursuing business," and that "management should encourage analysts to indicate both when a security should be bought and when it should be sold."

The "Chinese Wall" that is supposed to separate brokerage firm research and banking divisions has completely crumbled. The primary solution for purging these conflicts of interests is the reestablishment of the Chinese Wall between analysts and investment bankers. Nothing short of total separation between analysts and investment bankers will suffice to rebuild the Wall. Analysts' pay cannot be linked in any way to the investment banking division and the fees generated by the investment bankers, directly or indirectly, or the same problems will continue to exist.

Unfortunately, Wall Street appears unwilling to take this needed step and separate analyst pay from the investment banking business because of the lucrative fees associated with investment banking. Therefore, Congressional intervention and the combined efforts of the New York Attorney General's Office, the SEC and the NASD are needed to mandate that the two divisions be separated both in theory and in practice. As noted by former SEC Chairman Arthur Levitt, the "franchise" relationship between analysts and investment bankers will be very difficult for brokerage firms to separate since they are "built into the investment banking culture."[16] Brokerage firms will likely be unwilling to jeopardize these fees in order to ensure the less profitable retail investor receives unbiased information from the firm's research department. Only Congress can mandate, and actually force, that the two be separated through legislation in

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[13] Investors Cast Wary Eye on Wall Street, American City Business Journal, July 27, 2001.

[14] Id.

[15] *SIA Sets Best Practices Ahead of Hearings*, CNetnews.com, June 12, 2001

[16] Levitt Expects Wall Street To Fall Short, Wall Street Journal, July 2, 2001.

order to provide the retail investor the best chance at receiving unbiased information regarding the stocks being recommended.

V. Conclusion

Unfortunately Wall Street has shown repeatedly throughout the years that it is unable to police itself. It was only after $3 trillion were eliminated from the NASDAQ and only days before Congressional hearings into the undisclosed conflict of interests at brokerage firm "research" departments that the securities industry provided voluntary guidelines to help eliminate the problem. It took the unified efforts of the New York Attorney General's Office along with the SEC and NASD just to bring the major brokerage firm's to the table to talk settlement. Congressional intervention is needed in order to firmly reestablish the Chinese Wall between brokerage firm research departments and investment banking divisions.

Commodities Corner

The Validity of Pre-Dispute Forum Selection Clauses in CFTC Reparations and NFA Arbitration Cases

by Dan Harty

Mr. Harty is in his last semester at DePaul University College of Law. Prior to law school, he worked as a regulator at the Chicago Board of Trade for seven years. In the summer of 2001 he interned at the CFTC's Office of General Counsel where he participated in the reparations process. Mr. Harty appreciates and would like to acknowledge the assistance of Les Blau of Blau & Bonavich.

Commodity brokerage firms often include forum selection clauses in their account agreements, potentially requiring customers to litigating in extremely inconvenient locations. Courts often honor such clauses, but two other forums are far less likely to honor them: the National Futures Association ("NFA"), which administers an arbitration program, and the Commodity Futures Trading Commission ("Commission" or "CFTC"), which administers a reparations program. The reparations program is available to many customers even if they signed an agreement to resolve their disputes exclusively through arbitration.[1] Thus, attorneys can often pick between these two programs.

There are limitations to choosing between the programs, however. Attorneys or their customers cannot embark on both roads simultaneously in an attempt to determine which program will honor the customer's choice of hearing locations and which will honor the brokerage firm's forum selection clause. Commission Rule 12.24 requires the CFTC Director of Proceedings to refuse to initiate a reparations proceeding where parallel proceedings are pending. *See* 17 C.F.R. §12.24(c)(1) (2002).[2] Thus, an attorney deciding between the CFTC reparations and NFA arbitration programs ought to know the answer to the following questions:

1. How much weight does each organization give to forum selection clauses in customer agreements?

2. Regardless of forum selection clauses, how much weight is given to the customer's preference for hearing location?

3. Who, at each organization, has the power to decide where the hearing will be held?

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[1] Even if a customer signs a binding agreement to arbitrate, that agreement has no legal effect if the customer later chooses the reparations forum. The Commodity Futures Modernization Act ("CFMA"), maintained a broker's obligation under the Commission's rules to give the claimant notice in any arbitration clause presented to the customer of his or her right to bring the action in the Commission's Reparations Program. See 17 C.F.R. § 166.5(c)(3) (2002).

Institutional investors or "eligible contract participants" that sign a pre-dispute clause waiving their right to a reparations proceeding, however, are bound to that agreement unless it is otherwise unenforceable. See Commodity Exchange Act § 118(g) (*as amended* by CFMA, 7 U.S.C. § 18(g) (2001)). The eligibility of a contract participant is generally based on financial qualifications of the person or entity. See Commodity Exchange Act § 1a(12) (*as amended* by Commodity Futures Modernization Act of 2000, 7 U.S.C. § 101(12) (2001)). This article refers to non-eligible contract participants as "small retail customers."

[2] Section 12.24(a)(1) defines parallel proceedings to include "an arbitration or civil court proceeding, involving one or more of the respondents as a party, which is pending at the time the reparations complaint is filed and involves claims or counterclaims that are based on the same set of facts . . . ." Id.
While a customer cannot initiate a reparations proceeding after initiating an action in another forum, the customer may withdraw a reparations proceeding after initiating it, provided the customer does so before the Director of the Office of Proceedings serves notification of intent to forward the complaint to the registrant. See 17 C.F.R. § 12.14 (2002).

Reparations Proceedings at the CFTC

Generally, the Administrative Law Judge ("ALJ") assigned to the reparations case decides the hearing location. The ALJ is afforded broad discretion by Commission Rules.

Their decisions are reversible only upon a finding of abuse of discretion.

Section 12.312(a) of the Commission's Rules, 17 C.F.R. § 12.312(a), gives the ALJ the power and duty to set the location of oral hearings. This Rule identifies twenty "default" hearing locations but permits the ALJ to name a more convenient location in certain cases. *See* 17 C.F.R. § 12.312(a), (b) (2002). In those circumstances, once again, it is the ALJ's prerogative to decide whether or not to select the special location requested.[3]

The case law parallels the Commission's Regulation in deferring to the ALJ. The Commission has recognized that determining the location of a reparations hearing is largely a factual issue best assessed by the ALJ. *See Cooper v. Amato*, [1990-1992 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,111 at 38,175-76 (CFTC Aug. 20, 1991) (affirming an ALJ's selection of an Alabama location requested by the customer rather than a Florida location requested by the broker); *In the Matter of Grossfeld*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 25,726 (CFTC May 20, 1993) (affirming an ALJ's decision to hold a hearing in Washington, D.C. as requested by the Division of Enforcement over a Florida location as requested by the broker). Thus, the ALJ's determination is not only discretionary, but typically is given deference by the Commission. *See Cooper,* at 38,175-76. The Commission reviews the ALJ's decision under an abuse of discretion standard. *See id.*, at 38,176.[4]

None of the CFTC's current regulations directly address pre-dispute forum selection clauses for non-institutional investors that are now standard in most account opening agreements.[5] In issuing its reparations rules, however, the Commission indicated that it will not bind the parties to pre-dispute forum selection clauses. *See* 49 F.R. 6602 (Feb. 22, 1984); Final Rules Relating to Reparations, [1982-1984 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 22,006 at 28,483 n.47.

In *Cooper v. Amato*, *supra*, the Commission held that an ALJ's decision as to hearing location may only be reviewed as an abuse of discretion. *Id.* ¶ 25,111 at 38,176. Based upon the Commission's own pronouncement that the pre-dispute forum selection clauses are not binding, it appears that the majority of ALJ decisions on this issue will withstand appeal.[6]

While the Commission pronouncement in 1984 that pre-dispute forum selection clauses should be given little weight is encouraging for small retail customers, the post-1984 reparations rules are less favorable to the customer than the pre-1984 rules.[7] Even if the forum selection clauses are not binding, the parties' convenience is considered -- not merely the complainants' preference. Thus, the customer's preference as to hearing location is not accorded any special deference by the CFTC.

As noted above, venue determinations before April 1984 were governed by former CFTC Rule 12.71(d). *See supra* note 5. That rule permitted the ALJ to hear oral testimony "giv[ing] careful consideration to the convenience of the parties" but required the hearing to Abe in a place where the respondent [typically the broker] is engaged in business . . . ." *See id.* Despite the wording of that rule, the Commission subjected brokerage firms to hearings located in the complainant's home state when the only jurisdictional connections were tenuous and based solely on mail and telephone contacts with the customer at their residence. *See Apache Trading Co. v. Toub*, 816 F.2d 605, 610-11

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[3] Section 12.312(b) of the CFTC's reparations rules, 17 C.F.R. § 12.312(b), lists those twenty locations, but allows other locations if the ALJ determines that administrative economy or practical necessity require otherwise. The ALJ can only make such a determination after a party has submitted an affidavit averring that none of the twenty locations are within three hundred miles of the party's principal address.

[4] The Commission likens the ALJ's authority and the discretion afforded their decisions to those of district court judges. See Id.

[5] A prior Commission Rule, however, addressed the location of oral hearings. See 17 C.F.R. 12.71(d) *repealed by* Futures Trading Act of 1982, Pub. L. No. 97-444, § 239, 96 Stat. 2294, 2327 (1983).

[6] The Commission hears interlocutory appeals only in certain circumstances. See 17 C.F.R. § 12.309(a)(3) (2002); Cooper, at 38,175 (reviewing an appeal regarding the location of an oral hearing).

[7] As noted above, the CFMA reparations rules are even less favorable for "eligible contract participants." See supra, note 1.

(11th Cir. 1987); *Harvey v. Seevers*, [1977-1980 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 20,816 at 23,325 (N.D. Ill. 1979), *aff'd* 626 F.2d 27 (7th Cir. 1980). Thus, under the prior rule, the Commission and some federal courts considered these contacts sufficient to constitute being "engaged in business" in the complainant's home state, and requiring venue in the customer's home state.

NFA Arbitration Proceedings

The first step in the NFA process, similar to the NASD or NYSE, is the filing of a Demand for Arbitration. See National Futures Ass'n, Code of Arbitration (hereinafter NFA Code Arb.) § 6(c) (2001).[8] At this initial point, the customer must specify his or her preferred hearing locations for the action.[9] The NFA selects the site of any hearing before selecting the arbitration panel. Site selection rests "sole[ly within the] discretion of the Secretary . . . ." NFA Code Arb. § 9(b).

The site selection process begins with each party ranking their site preferences. *See* NFA Arbitration Claim Form, *available at* http://www.nfa.futures.org/odr/claimcust.asp (visited Mar. 13, 2002). If possible, the site is determined by common locations. If none exist, generally the claimant's first choice is selected. Thus, the customer's preference for hearing locations is generally given deference by the NFA. *See id.*

A party seeking to enforce a pre-dispute site selection agreement must raise the issue or the NFA will not weigh it when determining the site. *See* Cain Memorandum, at 2; NFA Arbitration: Procedural Guide for Customer Disputes (hereinafter NFA Customer Dispute Guide), available at http://www.nfa.futures.org/dispute/ProGuideCustDisp.pdf, at 11 (1998). Additionally, the party must provide a copy of the agreement to the NFA. *See* Cain Memorandum, at 2; NFA Customer Dispute Guide, at 11. Only after meeting these procedural requirements will the NFA consider the merits of a pre-dispute site selection agreement.

If a party raises the issue of a pre-dispute agreement the site cannot be determined solely from the parties ranked choices on the Demand for Arbitration and the Answer. In arbitrations involving pre-dispute site selection clauses, NFA policy requires the Secretary's designee, an employee from the NFA's Office of General Counsel, to review the agreement and determine a location in light of the agreement and other factors. *See* Cain Memorandum, at 3. The NFA specifically reserves the right to honor a site selection clause in customer agreements. *See* NFA Customer Dispute Guide, at 24.

If the arbitration panel has not been selected yet, the NFA will inform the parties of its initial location decision in writing. *See* Cain Memorandum, at 3. Nothing in the NFA Code of Arbitration prohibits a party from objecting to this decision at this time. The Code, however, does not provide any appellate process. The Secretary's designee makes the final location decision at the time the panel is ready to be selected. The designee will consider: (1) the availability of arbitrators in sites chosen by the parties, (2) the merits of the pre-dispute agreement, (3) the initial site decision, and (4) other relevant factors. *See id.*

A party's alternatives in the face of an adverse decision at this juncture are uncertain.[10] NFA, however, provided some recent statistical information to guide this author. According to the NFA, of the 215 cases heard in 2000 and 2001, the NFA deliberated over a pre-dispute site clause only 22 times.[11] The NFA enforced the clause 7 times, or 32%. Although the possibility of losing the site selection issue is real, NFA's policy of preferring a customer's choice may not factor much if brokerage firms raise the issue more often. Further, even where the final decision conflicts with the customers choice, the customer is well to challenge the ruling and raise any issues it feels relevant to the determination.

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[8] In some cases, the first step is the filing of a Notice of Intent to arbitrate under NFA Code Arb. § 6 (a), (b). This step is effective if the customer's claim will soon expire under the statute of limitations. The Notice of Intent tolls the statute of limitations for 35 days. See id.

[9] If the customer did not initiate the arbitration (such as in the case of a debit account), the customer may still opt to bring the matter into reparations, assuming there is a violation of the CEA.. The claimant must exercise the reparations election within forty-five days of the respondents demand for arbitration. See 17 C.F.R. § 166.5(c)(3). This is the only scenario in which the NFA evaluates an agreement and its compliance with Reg. 166.

[10] The NFA Code does not specify the appellate process for site location issues. The same Secretary designee is likely to review their own final decisions involving pre-dispute site selection agreements. Thus, it is uncertain what a customer can do to prevail at this point.

[11] In the other 193 cases, either; (1) the agreement did not contain a site clause, (2) the parties did not bring the clause to NFA's attention, or (3) the parties settled or withdrew the action before NFA selected the site.

Conclusion

Pre-dispute forum selection clauses become more important as they become more common. The CFTC's pronouncement against forum selection clauses is no longer an absolute. It is unlikely, however, that the CFTC will strictly enforce these clauses against the small retail customer unless it changes its policy as it has for eligible contract participants. The CFTC's policy requiring ALJs to balance the convenience to all parties in selecting a location is fair to both parties and may be the best result a customer can ask for.

The NFA's policy on selection clauses appears to favor the small retail customer because it defers to the customer's choice absent a site clause. This aspect should compel the small retail customer to chose arbitration absent the clause. Some uncertainty exists, however, in the factors that NFA considers in the final site decision and the process for appealing these decisions.

When the hearing location is critical and no site selection clause exists, the small retail investor will fare better at the NFA than at the CFTC. When a clause does exist, the CFTC process will balance the convenience to both parties, providing the customer an opportunity to address the relevant issues. The NFA provides substantially the same process and affords the parties the same opportunities but uncertainties regarding the appeal process suggest that the customer would be wise to favor the CFTC.

Practitioner's Corner

How to Write a Statement of Claim

by David E. Robbins

Mr. Robbins is a founding member of PIABA; a partner in the New York City firm of Kaufmann, Feiner, Yamin, Gildin & Robbins, LLP; chair, since 1986, of the annual Practicing Law Institute programs on securities arbitration; author of Securities Arbitration Procedure Manual (5th Edition, Dec. 2001, 2 Volumes, Matthew Bender); Practice Commentator for McKinney's Consolidated Laws of New York; member of the Board of Editors of Securities Arbitration Commentator; and, an arbitrator and mediator.

How can you tell you have written a convincing Statement of Claim? You won't know until it's too late: not until the Summations. By then, the allegations in the Claim will have been put to the test - by testimony, by interpretations of documents, by the perspicacity or obtuseness of arbitrators and by your adversary's ability to poke holes in it. In drafting Summations, experienced securities arbitration attorneys go back to the promises made in their Opening Statements and sometimes even further back - to their Statements of Claim. The Statement of Claim is your one opportunity to make a good first impression with the arbitrators.

Who should the Claim be written for? The arbitrators only. Don't actually think it will sway your adversary. Nor should you try to satisfy your client, although he or she must approve the final version before it is filed, since the arbitrators will usually consider the claimant to have adopted its contents.

What standards do the rules set for Claims? Not many. Scant guidance is contained in the identically worded NASD Rule 10314(a) and NYSE Rule 612(a):

> "The Statement of Claim shall specify the relevant facts and the remedies sought."

More guidance is provided, however, in the NASD's *Uniform Forms Guide*:

> "The Statement of Claim is a written narrative that sets forth the facts of the dispute. While the Statement of Claim does not have to be in a special form, it should set forth the details of the dispute, including all relevant dates, names and account numbers, in a clear, concise and chronological fashion, and should conclude by indicating what relief (e.g., the amount of money damages, specific performance, interest) is requested. If your Statement of Claim refers to documents, copies of the documents should be attached as exhibits."

Based on years of writing and reading Statements of Claim, I have developed the following criteria:

(1) They should provide a clear, concise explanation of the relationship between the parties, why the customer made the investments in question, what documents, if any, the customer relied on, the response of the brokerage firm to the customer's compliant, the precise damage award sought from the arbitrators and how those damages were calculated.

(2) They should contain the road map for the customer's case at the hearing, serving as the basis for his or her direct examination.

(3) They should not include any allegation that cannot be proven at the hearing. Blunderbuss claims, alleging every possible cause of action, will distract the arbitrators and may cause them to lose sight of the meritorious claims. However, alternative theories of liability should be set forth if each can be reasonably supported by the anticipated evidence.

(4) Exhibits attached to the Claim (which will be admitted into evidence unless a motion *in limine* is granted) should be those that relate to the issues of liability, trading activity and damages. Instead of attaching monthly statements, a summary trading analysis is more effective. Instead of appending hard-to-read opening account forms, a chart listing their highlights should be referred to in the narrative. The more Statements of Claim I write, the fewer exhibits

are attached. But if there is a critical expert analysis or the proverbial "smoking gun" (e.g., correspondence admitting liability, SRO sanctions for similar misconduct) attach it.

(5) They should be a fact-specific, chronological presentation of events, leading up to and describing the dispute, as well as the efforts made by the customer to mitigate damages.

(6) They should avoid opinions, probabilities, and purple prose, which are not appreciated by arbitrators. Likewise, boilerplate, legalized "complaint-type" drafting with numbered paragraphs should not be your style because it rarely elicits an emotional response from arbitrators and begets Answers that say no more than "deny" and "admit."

(7) They should specify money damages in a certain, not approximate, amount. If your damage calculation cannot be more specific without the discovery of necessary documents from your adversary (e.g., commission runs), explain that you might need to amend your damage claim at that time.

(8) They should only name the most important individuals or entities as respondents. I am naming brokers less and less, unless they engaged in intentional or grossly reckless wrongdoing. This results in a greater focus on the brokerage firm's supervisory failures.

In "letter format," with as many bold headings as possible, inform the arbitrators up front, in a summary portion of the claim, about the entire case and the damages sought. Follow the summary with a discussion of your client's interactions with the broker before the trades in dispute; this will enable you to explain how the trust relationship was established. That explanation should be followed by a description of the broker's breach of the trust relationship. Describe the breach with only a handful of issues presented in a chronological fashion, giving relevant factual data, such as dates, phone conversations, meetings, names and titles.

Statements of Claim for the more common causes of action:

1. For claims of *misrepresentations and omissions,* the primary element of the Claim is the customer's recollection of the representations made by the broker. It is essential that you articulate why it was reasonable for your client to rely on the misrepresentations of the broker and not know enough to ask about material omissions by the broker. With respect to materiality, representations cannot be 20/20 hindsight; they must meet the Supreme Court's test - that the information would have significantly altered the total mix of information made available to the customer. It helps if you can allege (and prove) that the misrepresentations were based on the broker's ignorance of the product's risk, as opposed to his intent to harm your client. Arbitrators prefer concluding that a broker's conduct was negligent rather than fraudulent.

2. For claims of *churning or excessive trading*, your Statement of Claim must always "follow the money" (i.e., the broker's payout on commissions and his sharing in spreads, margin interest and management fees). You must clearly explain your client's investment objective, the degree to which the broker controlled the trading activity (*de jure or de facto* control), the sheer number and frequency of trades and how profitable the trading had to be just to break even, after paying commissions and margin costs. No Statement of Claim alleging churning or excessive trading will be taken seriously without turnover and cost-maintenance analyses and a convincing articulation that the customer's investment objective was contrary to the way in which the broker controlled the trading activity in the account.

3. For claims involving *unauthorized trading*, your primary goal is to prove a negative – that conversations did not take place in which the particular trade or trades were authorized. You must carefully recreate events *before* the unauthorized trades and the reaction of your client upon learning of the wrongdoing. Your Claim should present patterns of trading activity – before and after the trades in issue – to show how the unauthorized trading was atypical of that pattern. Phone records should be referred to, along with any documents that will substantiate the allegation that your client was either inaccessible or otherwise engaged during the unauthorized trading. If there are no documents to support your client's assertion of unauthorized trading, you might consider stating that he or she is willing to take a polygraph examination prior and that you will seek to introduce the results into evidence. The Claim should invite your adversaries to attend the examination and submit their own questions.

4. For claims of *unsuitability*, you must allege that the trading that took place was inconsistent with and contrary to the stated and obvious investment objectives of your client. You will need to stress your client's prior investment experiences, prior life experiences (educational and work-wise) and his or her reasonable reliance on the broker. You will have to allege (and prove) that others, besides

you, consider the investments or strategies at issue to be at a risk level much higher than your client's risk tolerance.

An interesting guide for what should be in your Claims for specific causes of action can be found in NASD Notice to Members 99-90: *The Discovery Guide*, since it lists documents, in the NASD's opinion, that you will need to obtain to prove specific claims. For example, a claim of churning should refer to those documents in List 3 of the Guide (commission runs relating to the customer's accounts at issue; documents reflecting compensation of any kind, from all sources; and, documents that describe the basis upon which the broker was compensated, including any bonus or incentive program). Claims of misrepresentations and omissions, negligence, breach of fiduciary duty and unsuitability should refer to List 7, 9 and 13 documents (materials prepared or used by the firm or broker relating to the transactions or products at issue). A claim of unauthorized trading should state the inferences that could be reached from an examination of the List 11 documents (order tickets; telephone records, including telephone logs).

How detailed should the Statement of Claim be? In other words, how do you say enough but not too much? The simple answer is: Let the particular facts and issues of your case dictate the level of detail. Once your expert has shown you what actually happened in the account (as opposed to what your client recalls); once you have asked your client the obvious and more subtle questions; once you have organized the key documents your client has given you or the ones you have managed to obtain; and, based on your experience in securities arbitration and knowledge of the securities industry, once you have discarded tangential issues and allegations, you are prepared to write the Claim. It is at that point that the Claim writes itself.

Keep your eye on the goal: to win money. You want to get your client's funds returned and, if called for, you want to punish the broker and his firm. Your allegations should not be conclusory. If the broker's recommendations to your client were unsuitable, explain why they were inappropriate. If excessive trading took place, explain what your client did with all those confirmations and margin calls when he received them. If unauthorized trading took place, describe how your client learned of his obligation to mitigate damages and, once armed with that knowledge, how he took action to cut his losses.

You must address those issues in your Statement of Claim because the arbitrators will want to know the answers before reading the respondent's Answer. Just as importantly, if you do not address those issues, your adversary will provide his own spin in his Answer.

You know you have written enough in your Claim when you have convincingly explained how your client was able to lose the money he did and why he should be given a financial "mulligan"; why he, as opposed to millions of other investors who lost millions in the market, is entitled to a refund.

Every Statement of Claim should include the standards by which you want the arbitrators to judge the conduct of the broker and firm. Since the securities laws are all based on the overriding precept of full disclosure, describe how the broker failed to fulfill that mandate. Since the cornerstone of self-regulation is the suitability rule of the SROs, describe how it was not followed. If the relationship between your client and the broker was ongoing, explain how the securities industry believes in the ongoing obligation of a broker to apprise his client of changes in the companies whose securities the broker recommended, as soon as the broker becomes or should become aware of those changed circumstances.

A central task of each Claim is to show how your client's reliance on the broker's representations was reasonable. It is also important to explain who, in reality, made the ultimate investment decisions in the account. Lastly, before you specify the damages sought, explain how the firm's failure to establish a reasonable supervisory system and its failure to reasonably implement that system lead directly to your client's losses.

Finally, *should your Statement of Claim stress the law or equitable principles*? Both. Arbitration is not a substitute for litigation. It is a contractually agreed upon alternative. By giving up certain procedural rights afforded a party in litigation – extensive discovery, strict adherence to the rules of evidence, the requirement to follow precedents of prior court decisions – participants in securities arbitration are compensated by the fact that it is a forum of equity in which the letter of the law does not have to be strictly followed in all respects. What this means is that arbitrators should judge a broker's conduct, and that of the brokerage firm, by the same standards that brokers and firms are required by the SROs to deal with their customers. These rules may not necessarily mirror the federal securities law, but they are based, in large part, on equitable principles. They are a reasonable adaptation of the law and equity to the realities of the marketplace.

In conclusion, you really know you have written a good Statement of Claim when, during the hearing, a witness makes a point and, all of a sudden, you can see a light go on in the arbitrator's head. You watch as he thumbs through your Claim and then nods knowingly, rewarding himself (and you, by inference) with a smile.

Expert's Forum

The Failure to Recommend Hedge Strategies as a Basis of Stockbroker Liability

by James French

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In recent years, we have seen the spectacular rise and fall of many IPO millionaires whose wealth disappeared seemingly overnight when the value of their company's stock plummeted. Similar financial disasters have befallen those who had exercised stock options, inherited large quantities of a single issuer's stock, or otherwise found themselves with a concentrated position they could not or preferred not to sell. Many attorneys who are approached by such a client know intuitively or have some rudimentary knowledge that something could have been done to protect the client's wealth, but don't know whether the client's broker or financial advisor bears legal responsibility. As will be discussed below, a broker's negligent failure to make defensive use of hedging strategies will sometimes be to blame for the plight of a riches-to-rags client.

Hedging: The Broker's Duty[1]

One must examine the facts of each case to determine whether a broker/financial advisor has a duty to provide hedging advice for a client's consideration. Based upon industry standards, the most important determining factor is whether the client had a concentrated equity position. A second, though much less crucial, factor for consideration is the volatility of the concentrated equity position.

What constitutes a concentrated equity position? The answer depends upon the degree to which true diversification exists in a given portfolio. Mathematically, the greater the number of stocks contained in a portfolio, the more optimal is the diversification. As a practical matter, a portfolio of ten different stocks generally is considered "diversified" and a portfolio of twenty different stocks generally is considered "well diversified", assuming the stocks are not highly, positively correlated. At a minimum, any portfolio with more than 10% of its total value in a single stock is considered to be non-diversified, both mathematically and intuitively. Such a non-diversified portfolio should alert the investment professional to the potential of excessive risk, and warrants a discussion with the client regarding that risk

The volatility of the concentrated equity position is important only on a comparative basis and as a matter of degree. A portfolio with 25% of its value in General Motors probably will not fluctuate as much as a portfolio with 25% of its value in Amazon. Yet a portfolio with 25% of its value in General Motors still is not diversified and contains excessive risk. Examples exist of blue chip equities that have suffered ruinous losses in value. For instance, no one thought Penn Central would go to zero. Thus, while volatility is relevant with respect to the broker's duty to discuss hedging strategies, the investor's counsel must educate the finder of fact to the reality that a portfolio with 25% of its value in any stock had excessive risk, even if that stock appeared highly stable at the time.

Most cases in which the investment professional owed a duty to present a hedging alternative to the client will be clearly evident and far beyond the baselines presented above.

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[1]See Randall H. Borkus, *A Trust Fiduciary's Duty to Implement Capital Preservation Strategies Using Financial Derivative Techniques*, 36 Real Property, Probate and Trust Journal, 127, University of South Carolina School of Law, (2001) (a review of trust doctrine, fiduciary duties, modern portfolio theory, contemporary legal thought and case law as applied to fiduciaries).

Assume, for example, that a client had $5 Million of a highly volatile "tech stock," which stock represented 95% of his equity portfolio and 90% of his total net worth. The stock has subsequently lost most of its value and now is worth $500,000. The client's financial professional never mentioned "hedging", yet touted himself and/or his firm as having expertise in handling the accounts of high net worth individuals.[2] One hardly needs to be an expert to recognize that a duty and breach exists in this case. Even if the investment professional and his firm did not hold themselves out to be experts or specialists in handling the accounts of high net worth individuals, the standards of the industry would require them to have basic equity "hedging" knowledge and to share that knowledge with the client.

Consider another situation. The investment professional never mentions the concept of hedging, but convinces the client to "diversify" his equity holdings by buying numerous other stocks, purportedly to reduce the client's risk. If the client can't or won't sell some of the tech stock, the investment professional inevitably will introduce the client to the concept of margin, since the only source of funds to purchase these additional stocks is to borrow on margin, using the $5 Million value of the "tech stock" as collateral. The investment professional proceeds with the margin borrowing/stock purchase program. In our hypothetical case, he can buy an additional $5 Million worth of stocks on margin. The client now has $10 Million worth of stocks, but owes the brokerage firm $5 Million and is paying monthly interest on this margin debt.

This is not diversification, which reduces risk. It is pure leverage, which increases risk, and also increases the income of the investment professional and his firm. The client still has 50% of his portfolio in one highly volatile stock which he can't or won't sell. Under no standard in the financial industry does this constitute diversification. The margin debt of $5 Million constitutes leverage and presents dire risk should there be a sharp decline in the value of the tech stock.

Why does the investment professional have a duty to present a hedging strategy to a client with a concentrated equity position? Because the concentrated equity position is an asset at risk and that risk is insurable through methods that are commonly known or should be known by every investment professional and investment firm – methods that have been in common usage for a number of years.[3]

The existence of a duty to discuss and recommend implementation of a hedging strategy can best be illustrated by analogizing to a situation in which the investor's sole or primary asset is not a stock, but rather is a building. Assume that our hypothetical client owns, free and clear, a commercial building worth $5 Million, (ignoring, for this Illustration, the value of the land.) A competent investment professional advising the client would be under a duty to caution the client that the building must be properly insured against loss. Why? Because the risk of loss is easily insurable and it is a standard practice in the industry to insure buildings against risk of loss.

It is illuminating to further assume that the investment professional or his firm convinces the client that he should diversify his investments by purchasing a portfolio of common stocks. The client's only asset is the building, which he won't or can't sell, so the investment professional sends the client to the bank that owns the brokerage house to obtain a loan using the building as collateral. Will the bank make the loan if the building is uninsured? Of course not, any more than the brokerage house should make the $5 Million loan using the "tech stock" as collateral if the stock is uninsured.

"Insuring" A Concentrated Stock Position

Three common methods of hedging concentrated equity holdings are the use of Exchange Funds, Equity Swap Contracts, and Put & Call options. In most cases, the preferred method for the client is the use of Put and Call options contracts, a method any competent investment professional should know.

There are two sources of equity Puts and Calls -- Exchange Traded Options and Custom Options. Exchange Traded options are those traded on the regulated option exchanges, such as the Chicago Board Options Exchange, and have preset strike prices and expiration dates (except for FLEX options). Custom Options are created by

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[2] See *Levy v. Bessemer Trust Company, N.A.*, 1997 WL 431079 (S.D.N.Y.) Motion to Dismiss (Contains the Background) 7/30/1997; 1999 WL 199027 (S.D.N.Y.) Defendant Motion for Summary Judgment – 4/8/1999; 2000 WL 1300402 (S.D.N.Y.) Motions in Limine – Defense – 9/14/2000

[3] *Too Much Money in Just One Stock? Get Rid of the Risk, Not the Stock*, BARRON'S, August 1, 1994, at 7 (an advertisement by Banker's Trust Company promoting the use of privately negotiated transactions with a derivatives broker/dealer or bank for estate planning dilemmas of non-diversified portfolios.)

private contract between the client and a broker/investment bank. Custom Options can have any terms the parties agree upon, and are usually the preferred method of "insuring" the risk of a concentrated equity position. This preference may be dictated because the client's stock does not have options listed on any regulated Exchange, because of the margin requirements of Exchange Traded options, or because of the flexibility of terms of the private contract.

The two most common "stock insurance" strategies are discussed below, with the warning that the universe of strategies is far greater than could be discussed in this article.

Also, tax issues are not presented in this article, but be aware that they are important and may affect the client's case. Finally, this article does not reach the question of the legality of the client entering into the hedge based upon federal/state securities laws. The attorney must be confident and prepared to prove that a particular transaction would have been legal in the time frame contemplated.

To describe the two strategies, we will consider a hypothetical client who owns $6,900,000 (100,000 shares @ $69/share) of "tech stock" (with the same volatility as Microsoft) and illustrate using Custom Options. The values presented below are approximations and for purposes of illustration only.

Buy Custom Puts:

The client would enter into a contract with the broker/investment bank to purchase 1,000 Custom Put options (representing 100,000 shares) with a strike price of $60 per share and an expiration date two years in the future, at a cost of $800 per Put option for a total cost of $800,000. The client has thus insured a value of $6,000,000 (87% of current value) for his "tech stock" for the next two years at a cost of $800,000 (annual premium of 5.8%). The advantage of this strategy is that the client retains all of the appreciation in the stock. The disadvantages are that the client still has $900,000 of risk ($69 current price less $60 insured price times 100,000 shares) and must pay the insurance "premium" (i.e., the cost of purchasing the puts).

One solution to the high cost of insurance (put premium) is to purchase lesser amounts of insurance, or in other words, purchase puts with a lower strike price. For example, as an alternative to $6,000,000 of insurance above, the customer could purchase:

$5,500,000 (80% of current value)
Cost = $600,000 (annual premium of 5.8%)

$5,000,000 (72% of current value)
Cost = $450,000 (annual premium of 4.3%)

$4,000,000 (58% of current value)
Cost = $200,000 (annual premium of 1.5%)

Custom Collar Contract:[4]

A collar is a combination of options in which the client has bought one out-of-the-money puts and sold one out-of-the-money calls for each 100 shares to be hedged. This locks in the minimum and maximum price that the client will realize in the underlying stock at expiration.

The type of collar most commonly employed in hedging a large, low cost equity position is a "zero cost" collar. The strike price of the put purchased is normally set at or lower than 90% of the market price of the equity. A mathematical model determines the value of this put. The same model then mathematically determines the strike price of the call sold, so that the value of the call sold equals the value of the put purchased. The money received from the sale of the call equals the money paid for the put. Thus, there is no out-of-pocket cash cost to the client in utilizing a "zero cost" collar.

In our "tech stock" example, the client purchases 1,000 puts with a strike price of $60 per share that expires in two years, at a cost of $800,000 (the same as "Buy Custom Put"). In addition, the client sells 1,000 call options on his "tech stock" with the same expiration date as the purchased puts, with a mathematically determined strike price that will generate cash proceeds equal to the $800,000 cost of the puts. The client has initiated a "Custom Collar Contract". It is the author's experience that the majority of clients overwhelmingly prefer this strategy.

In our case, the mathematically derived strike price is $90 per share. A two year call option with a strike price of $90 per share will sell for $800, which is exactly equal to the $800 paid for each two year put with a strike price of $60 per share. The client has now "collared" his risk/return between a downside risk to $6,000,000 (87% of current value) and limited his potential upside return to $9,000,000 (130% of current value) at zero cash cost. The client has traded any stock appreciation above $9,000,000 over the next two years for the cash

[4] See *Private Banks Tout More Aggressive Strategies* - The Wall Street Journal - July 2, 1997; *Collars Give Insiders Way to Cut Risk* - The Wall Street Journal - September 17, 1997; *WorldCom Director Uses Exotic Play to Hedge Stake* - The Wall Street Journal - October 15, 1997

to pay the insurance premium to insure a minimum value of $6,000,000 for the next two years.

The Broker/Investment Bank Perspective

The above illustrations are presented from the client's perspective. The broker/investment bank assumes the risk that the client has transferred through the implementation of the "Custom Collar Contract" or the "Buy Custom Put" strategy. In virtually all cases (with a possible rare exception) the broker/investment bank must "short" some quantity of the "tech stock" in order to hedge their own position. The broker/investment bank may attempt to raise such issues as the inability to borrow stock, lack of liquidity in the client's stock, or other technical reasons as a defense that it would have been impossible to provide a "Custom Collar Contract" or the "Buy Custom Put" strategy to the client. These defenses should rarely be successful, but preparation must be made to meet them.

Calculation Of Damages

The calculation of damages should normally be based upon an insured value of 90% of the market value at the time the "Custom Collar Contract" would have been initiated. The 90% number is a standard used in the industry based upon interpretation of IRS Reg. 1259 that the taxpayer be "at risk" to avoid a constructive sale.

This calculation is not as simple as it first appears. In most cases, a hedge involved in a "Custom Collar Contract" cannot be completed in one or two days. Depending upon the circumstances, it may take two weeks, and possibly even a month or more, to complete a hedge. Prices will vary over this time period and an analysis of the circumstances at the time of the contemplated hedge must be undertaken to determine potential damages.

The damages will vary depending on the trier of fact's determination of the date that the client would have initiated the hedge, had the client been advised to do so. Since the client's case usually is based on the investment professional's failure to present hedging information, the time frame could be from day one up until disaster struck. The determination will be fact driven. However, it is easy to point to one significant occurrence – namely, the act of borrowing money on margin using the client's stock as collateral-- as a time trigger to initiate a hedge in a minimum amount, equal to the amount borrowed.

Conclusion

The following is a quick, though unscientific, method to determine if your client may have a case against a broker for breach of duty to present a hedging strategy. In order to have a case, the answer to number 1 must be "yes" and the answer to number 2 must be "no." For numbers 3 through 14, each "yes" answer indicates a stronger case, but negative answers will not "knock you out of the box". All of these questions (3 through 14) carry different weights and are not listed in any particular order of importance.

1. Did your client have a concentrated equity position?

2. Did your client's investment professional ever discuss "hedging" this concentrated equity position with the client?

3. Was this concentrated equity position a significant percentage of his total net worth?

4. Had this concentrated equity position significantly increased in value from his initial investment?

5. Was this concentrated equity position eligible for long-term capital gains treatment during the period in question?

6. Did your client express concern about a price decline in this concentrated equity position to his investment professional?

7. Did your client specifically ask if there was a way to protect this concentrated equity position against a price decline, except by selling the stock?

8. Did your client's investment professional and/or firm claim to be experts or specialists in handling high net worth individuals?

9. Did your client borrow money on margin using this concentrated equity position as collateral?

10. If your client borrowed money on margin, was it on his investment professional's recommendation?

11. Did your client use this borrowed money to purchase additional stocks?

12. If so, were these purchases portrayed as diversification of risks by the investment professional?

13. Did the investment professional know that your client could not or would not sell his stock?

14. Was the client's stock actively traded during the time period when a hedge would have been considered?

View from the West

Getting Paid -- Part 1

by Scot Bernstein

Mr. Bernstein is a member of PIABA's board of directors. His law firm – Law Offices of Scot Bernstein -- is located in Sacramento, California. Mr. Bernstein can be reached at 916-447-0100. His email address is swampadero@aol.com.

Private litigation is in many ways the best tool ever invented for the enforcement of laws. It is the democratization of the enforcement process. Like all tools, however, it has limitations. The most prominent one is that a judgment or award against a party is meaningless if the losing defendant or respondent cannot pay. The justice we seek for our clients can be achieved only if we are able to collect any award or judgment we obtain.

Some areas of private litigation undoubtedly face no such concern. But the magnitude of the problem in securities arbitration proceedings was revealed recently by the GAO, which reported that approximately half of all securities arbitration awards go unpaid. It is mind-boggling that the industry that exists to serve the needs of investors cannot afford to pay for fully half of the damage it inflicts on them.

Reforming SIPC would make this problem go away. So would requiring broker-dealers below a specified size to carry errors and omissions insurance. In either case, a lot of the most obnoxious compliance problems would disappear because the industry's worst offenders would find it impossible to obtain the required coverage. And those investors who were damaged would be compensated for the harm inflicted on them.

Unfortunately, systemic solutions like SIPC reform and mandatory insurance coverage will require legislative action. Other solutions, such as broader liability for the clearing firms that make many introducing firms' misconduct possible, will require a significant expansion of the body of favorable case law. With neither of those large-scale solutions imminent, we are left to work within the current system. Collection problems will remain a part of that system for the time being.

Of course, when the prospective respondent is a large wirehouse, collection is not a concern. But for those of us with claims against securities industry participants other than the very largest, the ability to collect often will depend upon whether the respondent carries liability insurance applicable to the claim.

Thus, knowing whether a prospective respondent has liability insurance often will determine whether we accept a case. Determining whether there is insurance coverage applicable to a potential claim is an important part of an investor representation practice.

Unfortunately, though, knowing that a policy exists turns out too frequently to be just the starting point. The propensity of carriers to deny coverage on the basis of real or imagined policy exclusions creates the next hurdle.

This article will discuss ways to determine in advance whether a prospective respondent is likely to have insurance coverage. In the next issue, I will discuss techniques to increase the likelihood that coverage will apply to the claim -- and what to do when the carrier is denying policy benefits to the insured.

Is There a Policy?

Broker-dealers and associated persons who have insurance coverage have a strong incentive to keep that coverage secret. If their publicly available financial statements look weak, and the attorneys considering whether to accept a case do not believe that the respondents have insurance, those attorneys may well decline

the case. If the claim ultimately is not made, the insured respondent benefits in many ways: it saves the deductible; it avoids adverse claim experience that drives premiums upward; it eliminates the possibility of an uncovered claim; and it may prevent a public record of the dispute from appearing in the Central Registration Depository.

In the face of those strong incentives, industry participants' and their defense counsel's representations about the absence of insurance lack credibility. Thus, if we want to determine before accepting a case whether there is insurance coverage, we have to make that determination -- or our best guess -- using our own resources.

What are those resources? There may be many. Here are four.

1. Financial Statements. The broker-dealer's most recent Form X17A-5 financial statement, filed annually with the Securities and Exchange Commission and available publicly, may be useful. Of course, the first and most obvious use of the X17A-5 is to determine whether the firm's net capital is sufficient to pay an award. Secondarily, the profit and loss statement may indicate whether the income being generated for the firm's owners will give them an incentive to keep the firm alive.

But there are clues about coverage as well. For example, some firms' profit and loss statements have a separate line item for insurance. If the premiums are large -- more than one would expect the firm to be paying for a commercial general liability policy -- that may indicate the presence of an errors and omissions policy. Footnotes to the financial statements deserve examination as well, as they may say whether defense of other litigation is being provided under an insurance policy.

The lack of either of these indicia of coverage does not prove the absence of insurance, however. I have seen several cases in which high-payout broker-dealers required each of their registered representatives to obtain and pay for a separate policy. That policy, which covered the registered representative as the primary insured, named the broker-dealer as an additional insured.

2. Industry Publications. Sometimes the information that miscreants and their counsel will conceal or lie about is published and publicly available in industry periodicals. Registered representatives and investment advisers who are trying to choose broker-dealers want to know a lot of things besides the payout. One such issue is the kind of insurance coverage that the broker-dealer will provide, make available, or require them to carry. Thus, publications catering to those individuals occasionally provide broker-dealer comparison tables that tell whether the broker-dealer's representatives have insurance, how much they are required to pay for it and so on.

3. The Defense Firm. Some law firms exist for the purpose of doing insurance defense work. If one of those firms regularly defends the prospective respondent, that representation often will indicate the existence of an insurance policy. Friends and colleagues in the city where the law firm is located often will know whether the firm is known primarily as an insurance defense firm. Your fellow PIABA members may be able to provide some information in that regard.

4. The List Serve. Finally, your fellow PIABA members may know whether the prospective respondents have insurance. Sometimes, they may know because the issue of coverage or coverage denials arose expressly in a prior case. Sometimes they may remember a mediator saying something about opposing counsel having to call the carrier for increased settlement authority. Sometimes they will know because the check for a prior settlement or award came from an insurance company.

Ultimately, of course, this is information that should be compiled in the members' area of the PIABA website.

Next Time -- After You Have Accepted the Case

If the respondent has errors and omissions insurance, the nature of the claims asserted can make or break the availability of coverage under the policy. Thus, how the claim is pled can be critical.

Beyond that, insurance carriers' denials of coverage are not always proper. Indeed, some carriers write what I like to call "premium only" policies. Those carriers will deny coverage of virtually every claim that is tendered by the insured. In those cases, the broker-dealer's right to sue to enforce the policy and to seek extra-contractual damages for bad faith is a valuable asset that can form a basis for resolving disputes, even -- or especially -- when the broker-dealer is on the ropes financially. I recently was involved in a case in which the sole source of recovery for a number of public customers was the broker-dealer's settlement of its coverage and bad faith case against its carrier. Without the funds from that settlement, no one would have been paid.

Part 2 of this article will discuss how claims can be pled to maximize the likelihood of

coverage; discovery issues relating to insurance coverage; and ways to structure settlements when a carrier is denying policy benefits to a respondent.

From the Regulators

The Profitability of White Collar Crime

by Joseph Borg

In 1995, Joseph Borg became the Director of the Alabama Securities Commission and continues to serve in this position. Mr. Borg is currently the president of the North American Securities Administrators Association (NASAA). Mr. Borg has also served as Chair of the Enforcement Section, as a member of the Board of Directors, and as the Treasurer for NASAA. He has testified before various committees of Congress in the areas of micro-cap securities fraud, criminal elements in the markets, and most recently in support of law enforcement data-base information sharing among state and federal regulators.

Stock market and investor fraud has hit TV and the big screen, first, there was "Wall Street" the movie, then "The Sopranos" showing stock swindles on prime time television and more recently, it was the movie "Boiler Room" detailing high-pressure stock sales. Also, major news magazines have detailed stock scams that have shaken Wall Street with articles such as: "The Mob Goes Downtown", *U.S. New and World Report*; "The Dark Side of the Brokerage Business"; *Research Magazine*; "Don't Get Suckered By The Latest Stock Scams", *Money Magazine*; and of course the latest market fraud soap opera – ENRON.

With the onset of the bull market in the "90s, Main Street America discovered the securities markets. From a mere 10% of Americans investing in the markets, over 52% of households now hold IRAs, Keoghs, 401ks, retirement accounts, mutual funds, and equities. But as with any new "opportunity", there are always those who seek to profit at the expense of others. The securities markets certainly are no different and the bull market created an unexpected and unwanted element: the bad broker, the fraudulent promoter, and the international financial scam.

State securities regulators have always been the national "early warning radar system", looking into investor complaints against promoters, brokers, and unlicensed personnel. These same state securities regulators have seen old scams dusted off and repackaged with new hype and new "once in a lifetime opportunities" often created by ripping headlines right out of the newspaper.

As one of my esteemed colleagues, Bill McDonald, the former Chief of Enforcement for the California Department of Corporations, stated, "These people have no respect for their victims. They think the world is divided into wolves and sheep and the sheep are meant to be sheared." "It's all just a big game and it's all about salesmanship." Whether its the personal pitch, radio and late-night TV, boiler rooms with high-pressure cold calling, or infomercials and now the Internet, these are all venues that are used in a new generation of investment fraud. The internet is especially favored by fraudsters. For just a few hundred dollars, they can be on the 'net'—and the credibility is enormous. I've heard it said that "… any con artist who doesn't use the internet ought to be sued for malpractice". ---and in jest we find truth.

Historically, white-collar crime has been treated differently than street crime. Where a mugger could get 5, 10 or even 15 years for stealing a handbag containing $25.00, white collar criminals steal millions and get fined and have their license revoked. Let's face it; criminal prosecution is the only real deterrent when it comes to controlling criminal activity- the 'street' or the 'paper' kind. Criminal cases are time intensive, paper intensive and expensive. But either criminals go unchecked because it is a hard case to try or regulators must invest the resources to make a difference. Here is a scenario that could have come out of "Boiler Room".

> The impeccably dressed principal of the firm walked into the "Boardroom". There were almost 200 crowded desks and every phone was being worked. He jumped up on the center desk and called for everyone's attention. " … After a year and a half, we have settled with the regulators and it is costing us a million dollars." Silence and some hushed "Oh no's." As the principal walked to his office,

> one of the newer cold callers approached. "A million dollars" he said with awe and disbelief. "That's OK", said the principal. "In the year and a half that it took, we took in over $40 million. It's just the cost of doing business."

This did not come from a TV or movie script, this was an actual event as related to state securities regulators.

As long as society, prosecutors, courts and judges think white collar crime is different than street crime, then these attitudes are not only continuing, but also encouraging white-collar criminal activity. Steal my car, snatch a purse and no one questions that prison time is deserved. But a con man who steals money with a pen...who ruins your dreams of buying a home...who steals from your retirement fund … who wrecks your dream of a secure future … these white collar criminals will get a fine and they will be barred from the industry, and they will laugh all the way to the bank.

Not too long ago, during the micro cap fraud epidemic, we came across a script taken from a trashcan at a brokerage house in New York. The script begins with a stage instruction to "speak slowly and nonchalantly". Then it goes on,

> "Two or three times year, we get our preferred clients involved with a niche area of the market where we can turn a 6 – 7 figure profit within the course of a few trading hours …". And after more hype about a particular stock, the script goes on to say, "In other words, a return of $100 in 20 minutes perhaps sounds a bit unrealistic … but that's exactly how our trades work. We did these deals last year … yielding 34 points within the first 10 days of trading … that's a fact."

But Wall Street is not cresting in 2002. The IPO hubbub has subsided, and yet, investment scams are continuing to rise. It's not micro cap and IPOs anymore, now it's prime bank programs, corporate "safe as a CD" promissory notes, defense technology stock, offshore foreign currency exchange, and a myriad of others. Whether it's a rogue broker or a con artist who steals your money or just someone who would sell you anything by any means, let's call it what it is … lying, cheating and stealing. And the resulting devastation and emotional scars that white-collar crime leaves is no different than street crime and should be treated no differently. Whether its churning accounts, selling unrealistic investments, promising high no-risk returns, manipulating a stock or selling investments in non-existent technology, the effect is the same. Billions of dollars lost, hard working citizen's retirement funds, college money, or savings for a home are stolen and lost forever.

We had a case not too long ago in the northern part of Alabama. One victim made the point very clear when she said, "I'm over 70 years old and I don't have 30 more years to again save all the money that I will need for the rest of my life. I would rather have been robbed and beaten up on the street than to have lost all my retirement savings."

Unless regulators are given the necessary enforcement tools and resources to strike back with criminal sanctions, the "cost of doing business" factor will remain just that. Federal, state, SRO and local regulators and authorities must discourage "investment fraud entrepreneurs" by bringing criminal cases and let it be known that the "cost of doing business" just went up. Rogue firms, brokers and other scamsters will easily agree to pay a civil fine of $100,000 or even millions as a cost of doing business as long as they can continue to bilk investors of hundreds of millions of dollars. *Securities Week* recently quoted veteran prosecutor and New York's Chief Deputy District Attorney, John Moscow as saying "I do not see how we can deter highly profitable misconduct by having people sign pieces of paper." Moscow is right on point – the answer is – we can't.

More than ever before, regulators must pool resources, share information and act jointly. Too often the punishment dished out just isn't tough enough to deter future frauds. Boundaries, whether state, national, or continental have little, if any, meaning in today's Internet-technology driven society and international cooperation is now of greater importance.

America cannot take white-collar crime lightly. The damage that it inflicts emotionally and financially can be more harmful and devastating than street crime. There will always be those who seek to take advantage of others. As the infamous bank robber Willie Sutton once stated when asked why he kept robbing banks – "That's where the money is" – now the money is in the investment field, in securities and through the Internet. We are no longer a nation of savers, we are now a nation of investors – and we must be ever vigilant. The old "street crime" saying: "If you do the crime – you do the time" must increasingly become applicable to investment fraud – it's the only real deterrent.

Brief Spotlight

Your Clients' Right to a Hearing

by Scot Bernstein

Mr. Bernstein is a member of PIABA's board of directors. His law firm -- Law Offices of Scot Bernstein -- is located in Sacramento, California. Mr. Bernstein can be reached at 916-447-0100. His email address is swampadero@aol.com.

Ten years ago, pre-hearing "dismissal motions" were seldom if ever seen in securities arbitration proceedings. That has changed. In the mid-1990s, securities industry respondents began filing "motions to dismiss" under section 15 (now known as Rule 10304) with increasing frequency. Next came motions asserting that statutes of limitation barred recovery. Now we are seeing motions to dismiss asserting every imaginable theory.

The absurdity of all of this is that there is no such thing as a "motion to dismiss" under the Code of Arbitration Procedure. The Code contains no procedure for pre-hearing dispositive motion practice. Indeed, granting a pre-hearing "motion to dismiss" would violate the public customer's right to a hearing. That right is contained in NASD Rule 10303, quoted in the brief below. The New York Stock Exchange and the Pacific Exchange have identical rules. See NYSE Rule 602 and Pacific Exchange Rule 12.3.

Like most generalizations, this one has an important exception: the right to a hearing under Rule 10303 ceases to exist if all parties waive the hearing in writing. Arbitration is, after all, a creature of contract.

Thus, if the goal is to get to a hearing, it is essential to do nothing that might be construed as a waiver of the customer's rights under Rule 10303. The danger, of course, is that certain actions by a public customer might constitute a waiver of the hearing, even if that was not the customer's intent. If the customer makes a motion for summary judgment, for example, that might constitute assent to pre-hearing dispositive motion practice in that case. So a customer who wants a hearing should not attempt to deprive the industry respondent of the same right.

Making a summary judgment motion, by the way, appears to be what cost the claimant in *Sheldon v. Vermonty*, 269 F.3d 1202 (10th Cir. 2001), his right to a hearing. Industry respondents no doubt will argue that *Sheldon v. Vermonty* vindicates their right to make pre-hearing dispositive motions. A closer look, however, reveals a different picture. When the industry respondents made a summary judgment motion in the underlying arbitration proceeding, Dave Sheldon countered with one of his own. Having done so, it would be hard for Sheldon to argue that pre-hearing dispositive motion practice was unacceptable to him. Rather, making his own summary judgment motion was a written consent to pre-hearing dispositive motion practice and a waiver of Sheldon's right to a hearing.

Incidentally, the appellees' successful brief in the *Sheldon* case can be made available to members on the PIABA website. The brief may be useful in showing arbitration panels that, far from eliminating public customers' rights under Rule 10303, the *Sheldon* case actually is consistent with that Rule, in that dispositive motion practice was permitted when all parties agreed to it and waived the hearing in writing.

Is filing an opposition to a dismissal motion an assent to dismissal motion practice? That would seem to be a harsh result. Still, why take the chance?

My practice is to refrain from calling my response to a dismissal motion an "opposition." Instead, when I receive a dismissal motion, I file a separate, free-standing letter brief in support of the public customer's right to a hearing. The thrust of the brief is that the customer is entitled to a hearing, and that any issues raised by the respondents' motion

should be taken up, if at all, only after the presentation of evidence.

I keep discussion of the specifics of the dismissal motion to a minimum, and instead point out the need for evidence -- documents and testimony -- to resolve the issues raised by the respondents' motion. I do not want to do anything to give the arbitration panel the mistaken impression that it has enough information to resolve the issues raised by the motion without holding the evidentiary hearing guaranteed by the Code. Rather, I specifically reserve the right to file a brief responding to the issues raised by the respondents' "motion to dismiss" after the presentation of evidence or at such other time as the panel orders.

The letter brief approach has another advantage: unlike an "opposition" to the Respondents' motion, it's an initial filing. If the respondents file a response to the letter brief, I am free to reply. The respondents will object to this, of course, but the panel usually will see through the objections and consider all writings on the issue.

Of course, the respondents' objections to "replying to a reply" are without merit for another reason: there is no procedure for dispositive motion practice in the first place. Their objection actually serves to emphasize the meritlessness of their position.

The letter brief below is an updated version of a brief that I have used on numerous occasions. While it relates to Rule 10304 motions (1), the primary thrust is the customer's right to a hearing. Thus, the brief is easy to modify for situations in which the respondents have based their motion to dismiss on statutes of limitation or other theories. Similarly, references to California law should be replaced with references to the applicable state law.

Finally, I should point out that the double backslash ("\\") character marks certain places in the brief where there is a need to replace a variable, make a decision, pluralize or singularize a word, and so on. Members who adapt the brief for their own use will want to be sure to find and remove all of the backslashes before putting the brief into final form.[1]

____

\\ date

\\
\\ Arbitration Administrator OR Staff Attorney
\\ Forum
\\ Address
\\ City State Zip

VIA FACSIMILE TO \\ 415-546-6990 AND U.S. MAIL

**\\\ Re: **

LETTER BRIEF IN SUPPORT OF A DECISION TO TAKE UP RULE 10304 ISSUES AFTER THE PRESENTATION OF EVIDENCE

Dear \\:

Granting a pre-hearing conference on Respondents' "motion to dismiss" under Rule 10304 (formerly section 15) of the Code of Arbitration Procedure, or otherwise deciding that motion prior to the presentation of evidence in this case, would deprive the Claimants of the one thing that they came to the NASD to receive: an opportunity to be heard. This letter is written to encourage this panel to decide, as so many other panels have decided, that any Rule 10304 issues should be taken up following the presentation of evidence. There are numerous reasons for this.

The Code Entitles All Customers to a Hearing

The Claimants signed a Uniform Submission Agreement that incorporated the NASD Code of Arbitration Procedure. Rule 10303(a) of the Code (formerly section 14(a)) provides as follows:

> (a) **Any dispute, claim or controversy** except as provided in Rule 10203 (Simplified Industry Arbitration) or Rule 10302 (Simplified Arbitration), **shall require a hearing** unless all parties waive such hearing in writing and request that the matter be resolved solely upon the pleadings and documentary evidence. [Emphasis added.]

Claimants have not waived their right to a hearing.

The right to a hearing in securities arbitration proceedings is even more inviolable than the strong language of Rule 10303 would seem to suggest. That Rule appears at first glance to allow for the hearing to be dispensed with in Simplified Arbitration proceedings under Rule 10302. But Section 10302(f) provides that, in Simplified Arbitration proceedings (involving claims not exceeding $25,000), the case will be decided solely upon the pleadings and evidence filed by the parties **"[u]nless the public customer demands or consents to a hearing."** Thus, even in Simplified Arbitration, a public customer who

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(1) Members interested in a very thorough treatment of Rule 10304 should obtain a copy of PIABA member Tom Mason's extensive article on the subject. See C. Thomas Mason III, *Irreducible Disagreements: The Six-Year Rule Revisited*, 1 SECURITIES ARBITRATION 1997 557-759 (Practising Law Institute, Corp. Law & Pract. Course Handbook Series #998, vol. B4-7195, 1997).

wants a hearing cannot be deprived of a hearing.

Likewise, in a Simplified Industry Arbitration under Rule 10203, a party who wants a hearing cannot be deprived of one. Rule 10203 (a) states that cases under that Rule will be decided solely upon the pleadings and documentary evidence filed by the parties **"unless one of the parties to the proceeding files with the Office of the Director of Arbitration within ten (10) business days following the filing of the last pleading a request for a hearing of the matter."** So a party who wants a hearing cannot even be deprived of one in Simplified Industry Arbitration.

The Code of Arbitration Procedure has specifically been made a part of Mr. and Mrs. \\ [claimants'] contract with the NASD and the arbitrators. When they entered into that contract, Claimants believed that the Code allowed them to present evidence to the arbitrators, in the form of documents and testimony, in support of this claim. Claimants do not believe that the panel can fairly adjudicate this claim without the benefit of reviewing those documents and hearing that testimony. All that Claimants are requesting is a hearing.

The Code Contains No Provision for Dismissal Motion Practice

None of this should come as a surprise. No one can point to a procedure anywhere in the Code for pre-hearing dismissal motion practice. There is a reason for this: pre-hearing dismissal motions are not allowed by the Code of Arbitration Procedure unless all parties consent and waive the hearing in writing. If dismissal motion practice were permitted, and if parties could be deprived of the opportunity to present oral and documentary evidence in a hearing, there would be elaborate procedures designed to assure that the parties' due process rights would not be violated. The Code contains no such procedures.

All of this makes a great deal of sense. A court deciding a summary judgment motion has a substantial body of evidence -- both oral and written -- upon which to base its decision. It has deposition testimony. It has answers to interrogatories. It has documents that have been produced in response to demands from the opposing parties. All of those discovery tools are backed by the court's power to sanction and, ultimately, to cite for contempt.

In contrast, there are no depositions and no interrogatories in arbitration proceedings. Even the document request procedure is flouted frequently by industry respondents. Documents frequently are withheld even after arbitration panels have ordered them to be produced. Thus, an arbitration panel deciding a pre-hearing dismissal motion would have to do so on the basis of an inadequate body of written evidence and on the basis of a complete absence of testimony. A fair decision is not possible in that kind of evidentiary vacuum. The Code of Arbitration Procedure makes up for these problems by guaranteeing a hearing to every customer who wants one. The Claimants in this case want a hearing.

Federal and California Arbitration Law Require an Evidentiary Hearing

Both federal law (9 U.S.C. Section 10) and state law (California Code of Civil Procedure Sections 1282.2 and 1286.2) expressly require an evidentiary hearing in arbitration unless the parties expressly waive that right. In fact, the Federal Arbitration Act specifically provides that the U.S. District Court may vacate an arbitration award:

> "Where the arbitrators were guilty of misconduct ... in refusing to hear evidence pertinent and material to the controversy."

9 U.S.C. Section 10.

> Section 1282.2 of the California Code of Civil Procedure states as follows:
>
> Unless the arbitration agreement otherwise provides, or unless the parties to the arbitration otherwise provide by an agreement which is not contrary to the arbitration agreement as made or as modified by all the parties thereto:
>
> . . .
>
> **(d) The parties to the arbitration are entitled to be heard, to present evidence and to cross-examine witnesses appearing at the hearing,** but rules of evidence and rules of judicial procedure need not be observed. On request of any party to the arbitration, the testimony of witnesses shall be given under oath." [Emphasis added.]

It is hard to imagine a clearer affirmation of the right to a hearing. But California law goes still further, providing explicitly that

> ". . .the court **shall** vacate the award if the court determines any of the following:
>
> . . .
>
> **(e) The rights of the party were substantially prejudiced . . . by the refusal of the arbitrators to hear evidence material to the controversy. . . ."**

California Code of Civil Procedure Section 1286.2 [emphasis added].

Evidence that will come forth at the hearing will be material to the issues raised by Respondents' motion to dismiss.

In *Prudential Securities, Inc. v. John B. Dalton*, 929 F.Supp. 1411 (N.D. Okla. 1996), a federal district court vacated an arbitration award that granted a pre-hearing motion to dismiss. The court found the arbitration panel "guilty of misconduct in refusing to hear evidence pertinent and material to the controversy." The *Dalton* court went on to explain its position as follows:

> “The issue before the Court at this time is not who is ultimately going to prevail. The issue is whether or not claimant Dalton was granted a fair hearing under the Arbitration Code to offer evidence in support of his factual claims. As previously stated, the Court concludes [that] by sustaining the motion to dismiss of Prudential ***the arbitration panel improperly denied claimant the right to a fundamentally fair hearing***. Therefore, the Court hereby vacates the underlying arbitration award for the reasons stated above and **directs the parties and the matter be remanded to a duly constituted NASD arbitration panel to proceed with an evidentiary hearing and ruling on the merits**, within six months from this date.” [Emphasis added].

See also *Neary v. The Prudential Insurance Company of America,* 63 F. Supp. 2d 208 (D.Conn. 1999).

Interpretation of Rule 10304 Requires an Evidentiary Hearing

Respondents in limited partnership cases like to pretend that the six-year issue is simple. They like to pretend that the six-year period automatically begins on the date of purchase of the securities in question. The law, however, is otherwise. Substantial numbers of cases from around the country have held that the "occurrence or event" giving rise to the claim may be something other than the date of purchase. Several recent federal appellate decisions have held specifically that the six-year period for each claim or cause of action commences when that cause of action accrues -- a date that may be long after the purchase date. When each of Claimant’s various causes of action accrued is a question of fact that requires examination of the evidence.

Indeed, for many years, the NASD's position regarding the six-year rule has been that discovery of wrongdoing by a claimant could be the relevant "occurrence or event." For example, in a widely circulated letter, the NASD took the position that

> "[S]ection 15 does not refer specifically to the purchase date as the time the six year limitation begins to run. **Therefore, it is equally appropriate that the discovery by the claimant be treated as the occurrence or event giving rise to the dispute."**

(Letter from D. Masucci to R. James, dated May 24, 1991 [emphasis added]).

Further, a New York state court recently quoted a phrase from a similar letter from the NASD Director of Arbitration as reflective of NASD policy that:

> "at least in fraud cases, the 'occurrence or event' language in Section 15 is not automatically interpreted as the investment purchase date."

Goldberg v. Parker, Fed. Sec. L. Rep. (CCH) Paragraph 98,749, at 92,547-548 (N.Y. Sup. Ct. April 12, 1995).

Federal appellate decisions from circuits that regard the interpretation of Rule 10304 to be a matter for the courts are consistent with this interpretation. Those circuits have adopted the view that **it is the *accrual* of a cause of action that starts the six-year period with respect to that cause of action. In other words, purchase date is not dispositive.** *PaineWebber, Inc. v. Hofmann* 984 F.2d 1372 (3d Cir. 1993); *Osler v. Ware* 114 F.3d 91 (6th Cir. 1997); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Lauer* 49 F.3d 393 (7th Cir. 1995); *J.E. Liss & Co. v. Levin*, 201 F.3d 848 (7th Cir. 2000); *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Cogswell* 78 F.3d 474 (10th Cir. 1996); and, most recently, *Kidder Peabody v. Brandt* 131 F.3d 1001 (11th Cir. 1997).
In *Kidder Peabody v. Brandt,* the court stated as follows:

> Therefore, we reject Kidder's interpretation of the "occurrence or event giving rise to the ... claim" language of Section 15 [now known as "Rule 10304"]. **Instead, we hold that under Section 15 the "occurrence or event" which "gives rise to the ... claim" is the last occurrence or event necessary to make the claim viable.**

Kidder Peabody v. Brandt, supra, at 1004 [emphasis added].

Claimants will be able to establish clearly and easily that the accrual of their causes of action and their discovery of Respondents' wrongdoing occurred far more recently than six years ago. This statement alone should dispose of the dismissal motion in its entirety. More importantly, however, when a cause of action accrued requires an

examination of facts -- facts that can come forth only in the evidentiary hearing provided by the Code. A hearing is necessary to resolve any issues raised by Respondents' motion.

Claimants' Claim Arose Within the Last Six Years

The Respondents were the \\ [claimants name]'s \\ financial planners. The \\ [claimants' name]s placed their complete trust and confidence in the Respondents and were depending upon the Respondents' honesty and expertise to assure the safety of their savings. The relationship between Respondents and Claimants would be a fiduciary relationship in any state on the basis of the facts that will come forth at the hearing of this case.

Perhaps most importantly, it is a settled matter of California law that the relationship between a stockbroker and a customer **always** is fiduciary in nature. See *Twomey v. Mitchum, Jones & Templeton Inc.* (1968) 262 C.A. 2d 690; *Duffy v. Cavalier* (1989) 215 Cal.App. 3d 1517; *Hobbs v. Bateman Eichler, Hill Richards, Inc.* (1985) 164 Cal.App.3d 174, 210 Cal.Rptr. 387.

Thus, this is a breach of fiduciary case. Respondents breached their duties to Claimants. They placed more than $\\ ,000 of this couple's savings into speculative investments which had only their favorable commission structures to recommend them. Then they embarked upon a program of preventing the Claimants from learning of the wrongdoing, and they succeeded in doing so nearly to the present day.

The relationship between Respondents and Claimants continued until recently. Claimants' cause of action did not accrue until they discovered the Respondents' wrongdoing and the relationship terminated. All of this occurred well within the last six years.

Other Panels Have Decided Against Dismissal Motion Practice

A recent case involving similar issues \\ and two of the Respondents from this case was \\ [local case # 1], NASD Case No. \\ . In \\ [local case # 1], the panel chair decided that all issues raised by a motion to dismiss under Rule 10304 would be taken up at the evidentiary hearing and not before. A copy of that ruling is attached to this letter. The respondents in that case did not like the panel's ruling, so they ran to court and sought a temporary restraining order to prevent the hearing from going forward. The San Francisco Superior Court refused to grant the temporary restraining order and allowed the hearing to proceed as scheduled.

Yet another recent case involving these issues and the same respondent firm was \\ [local case #2] , NASD Case No. \\ . As in \\ [local case # 1] , above, the panel in \\ [local case # 2] refused to hold a separate pre-hearing conference on the motion to dismiss. Instead, it ruled that all issues raised by a Rule 10304 motion would be taken up only after the presentation of evidence.

The respondents in \\ did not like that decision; so, using \\ Respondents' current legal counsel, they sued the \\ [claimants, local case # 2] in Calaveras County, again seeking a temporary restraining order and a preliminary injunction to prevent the arbitration hearing from going forward. The Calaveras County Superior Court denied the application for a temporary restraining order. Following an OSC hearing, the court denied the preliminary injunction as well, and directed the case to arbitration. Copies of the panel's ruling and the court's order are attached to this letter.

Yet another recent case involving similar issues was \\ [local case # 3], NASD Case No. \\. In \\ [local case # 3], the panel initially decided that it would hold a pre-hearing conference on a motion to dismiss. Upon the request of the claimants in that matter, the panel agreed to reconsider its decision, and held a pre-hearing conference limited to the question of whether the Rule 10304 motion should be taken up in a subsequent pre-hearing conference or, instead, at the evidentiary hearing. After reconsideration, the panel reversed its initial ruling and decided that it would not convene a separate pre-hearing conference on the Rule 10304 motion. Rather, the Rule 10304 issues were to be addressed only after the presentation of evidence. A copy of that ruling is attached as well.

I could provide numerous additional examples of identical rulings by arbitration panels. These rulings are not an accident. Arbitration is a streamlined process in which public customers give up the elaborate discovery rights that they would have in a court proceeding. What they get in return is the guarantee that they will have a simple hearing. I urge the panel not to allow the Respondents to take that away. I urge the panel to insist upon hearing the evidence before deciding this case.

Conclusion

Federal and state arbitration laws and the NASD Code of Arbitration Procedure entitle Mr. and Mrs. \\ [claimants' name] to be heard unless they waive that right. They have not waived that right. Further, Claimants specifically reserve their right to file a brief opposing Respondents' motion after the presentation of evidence or at such other time as the panel directs them to do so.

\\ [Moreover, Claimants have received none of the documents that they requested from Respondents. In fact, Respondents have made it clear that they do not intend to provide any documents unless and until the panel either denies their timeliness motion or decides that it will not address those issues prior to the presentation of evidence.
\\ OR

\\ Discovery in this case has scarcely begun.]

Until discovery is complete, it will be impossible for Claimants to provide the documentary evidence necessary to oppose Respondents' motion. Without the opportunity to testify and to cross-examine witnesses, it will be impossible for Claimants to provide the testimonial evidence necessary to oppose Respondents' motion.

Fairness requires that the parties have their "day in court." Fairness requires that the parties be given an opportunity to present their best evidence to the arbitrators and to cross-examine witnesses, as is set forth in the California Code of Civil Procedure, quoted above. Fairness requires that parties not be confronted with an adverse, dispositive ruling on their case before they have even been introduced to the panel.

Note that Claimants are not asking the panel for a summary judgment. Claimants are not asking the panel for a ruling that would deprive Respondents of any of their potential defenses. Respondents are and should be free to argue their defenses after the evidence is presented. Claimants only want to present their evidence. All they want is a hearing.

\\ [claimant's name] is \\ 82 years old. \\ is 76. Both are retired. They trusted Respondents with their savings and ended up in \\ a Ponzi scheme. They need the savings that were lost through Respondents' misconduct. If the panel agrees to decide the Respondents' dismissal motion on the basis of a zero-evidence pre-hearing conference, Mr. and Mrs. \\ [claimants' name] will be deprived of the one thing they came to the NASD to receive: an opportunity to be heard by neutral arbitrators.

Thank you for your consideration of these important matters.

Very truly yours,

Scot D. Bernstein

SDB:kes

cc: \\\

Attachments (\\)

Recent Arbitration Awards

by Ryan K. Bakhtiari

Mr. Bakhtiari is an attorney with the law firm of Aidikoff & Uhl in Beverley Hills, CA. His email address is RBAKHTIARI@aol.com and he can be reached at 310.274.0666.

1) ***Robert & Karen Weingarten v. Merrill Lynch***, NYSE Case No. 2001-009364

Claimants asserted the following causes of action: negligence, breach of contract, negligent supervision based on the failure to properly advise claimants respecting the handling of their Incentive Stock Options, Non-Qualified Options and Employee stock. Claimant requested compensatory damages, interest, costs attorneys fees and punitive damages.

Respondents denied the allegations of the Statement of Claim and asserted that Claimant was at fault.

The arbitration panel made the following findings and award:

1. Claimant is awarded $3,000,000.

2. Claimant was awarded $1,500 in costs as a return of the hearing deposit.

3. Claimants claims for interest, punitive damages and attorneys fees were denied.

4. Forum fees in the amount of $11,400 were assessed against Respondent Merrill Lynch.

This case is significant in that it is the first known arbitration award involving a claim by a public customer, who was the employee of a publicly traded company, against a brokerage firm relating to the failure of the brokerage firm to provide proper advice regarding the employee stock options.

Claimant's Counsel - Seth Lipner, Herbert Deutsch, Stuart Goldberg

Respondent's Counsel - Roger J. Hawke, Brown & Wood

Claimant's Expert - None

Respondents Expert - None

Hearing Situs - New York, New York

Arbitrators - Winthrop J. Allegart, Chairperson; Howard Breindel; William A. Potter, Industry

2) ***Estate of Lauren W. Wolfe v. J.C. Bradford & Co. et al.***, NASD Case No. 00-03351

Claimants asserted the following causes of action: churning, breach of fiduciary duty, unauthorized trading, unsuitability, misrepresentation, failure to supervise, violation of IM 2310-2(b)(4)(A)(iv) of the NASD Code of Conduct (borrowing money from clients). Claimant requested compensatory damages, interest, costs attorneys fees and punitive damages.

Respondents denied the allegations of the Statement of Claim and asserted: that all of Claimant's investments were part of an overall investment plan and strategy, Claimant was an experienced investor and had previously invested in a variety of aggressive and speculative investments, Claimant contributed to the loss by refusing to sell stock that Respondent Considine recommended he sell, Claimant approved all transactions made in this account and failed to complain to Respondent Considine's supervisor about any alleged misconduct.

Prior to the hearing Respondents J.C. Bradford & Co. and Mark J. Bannon, III settled with Claimant. The arbitration panel made the following findings and award:

1. Granted Respondent Considine's Motion to Dismiss Claimant's Claim for Repayment of Personal Loans;

2. Claimant is awarded $424,183 against Respondent Mark E. Considine.

3. Claimants claims for interest, punitive damages and attorneys fees were denied.

This case is interesting in that the broker, Considine, churned the account of his wife's father. The NASD arbitration was filed after the broker and his wife separated and had filed for divorce. The arbitration award resulted in a written reasoned decision. The panel made specific findings including that "the account had been churned" and that "Claimant also established that [the broker] invested in unsuitable stocks".

Claimant's Counsel - Edward B. Lowry and Robert A. Kantas of Michie, Hamlett, Lowry, Rasmussen & Tweel, P.C.

Respondent's Counsel - Mark Considine

Claimant's Expert - Dr. Craig McCann

Hearing Situs - Baltimore, Maryland

Arbitrators - David B. Hamilton, Esq., Public/Chairman; Jeffrey M. Cohen, Public; Henry Friedman, Industry

3) *Herbert and Lorine Coutee v. Barington Capital Group, LP et al.*, NASD Case No. 00-02444

Harvey F. Donner v. Barron Chase Securities, Inc. et al., NASD Case No. 00-04852

In both cases Claimants asserted the following causes of action: breach of fiduciary duty, unauthorized trading, unsuitability, misrepresentation, failure to supervise. Claimant requested compensatory damages, interest, costs attorneys fees and punitive damages.

Respondents denied the allegations of the respective Statements of Claim.

These case are significant in that both arbitration panels awarded Claimant's attorneys fees under the California Welfare and Institutions Code Sections 15600 et seq. which is the elder abuse statute in California.

In addition, both panels awarded punitive damages to the Claimants. The Donner case is also significant because the Donner panel found that each of the Respondents "acted willfully and maliciously and engaged in actual fraud as contemplated under the United States Bankruptcy Code Section 523". After confirming this award, the finding of fraud pursuant to the Bankruptcy Code may prevent the debt from being discharged in a later bankruptcy proceeding.

Claimant's Counsel - Ryan K. Bakhtiari and Keith D. Fraser, Aidikoff & Uhl

Hearing Situs - Los Angeles, California

4) *Dale K. Nohre, Elwood Mason et al. v. Stock USA, Inc. James Gerwick, W.J. Gallagher & Company, Inc., Lewis Akmakjian, Ernest B. Arnold, William J. Gallagher, Jr. and Interfirst Capital Corporation*, NASD Case No. 99-02935

Claimants asserted the following causes of action: negligence, fraud, deceit, omission of material fact, suitability, breach of fiduciary duty, violation of Securities Exchange Act of 1934, failure to supervise and violation of NASD Rules and Regulations in connection with margined purchases and sales of Starwood Hotels and Resorts and other securities.

Respondents denied the allegations of the Statement of Claim. Respondents Stock USA, Inc. and James Gerwick requested dismissal of Claimants' original and amended Statements of Claim. Respondents W.J. Gallagher & Company, Inc., Lewis Akmakjian, Ernest B. Arnold and William J. Gallagher, Jr. requested dismissal of the Claimants' Statements of Claim, an award of costs and expungement of this matter from their records.

Prior to the arbitration hearing Claimants dismissed Respondent Interfirst Capital Corporation without prejudice.

The arbitration panel made the following findings and award:

1. The arbitration panel dismissed with prejudice Respondents Stock USA, Inc. and James Gerwick.

2. Respondents W.J. Gallagher & Company, Inc., William J. Gallagher, Jr. and Lewis Akmakjian (hereinafter "Respondents") were found liable to Claimant Nohre for $78,000 in compensatory damages, $60,000 in punitive damages pursuant to California Civil Code Section 3294(a), $6,900 for expert witness fees, $225 for the cost of filing the Statement of Claim, $2,000 in interest to the date of the award.

3. Respondents were found liable to Claimant Maren Mason for $26,500 in compensatory damages, $20,000 in punitive damages pursuant to California Civil Code Section 3294(a), $2,300 for expert witness fees, $75 for the cost of filing the Statement of Claim.

4. Respondent Arnold was found liable to Claimant Elwood Mason

for $1,000 in compensatory damages.

5. The panel assessed forum fees in the amount of $20,025 against Respondents W.J. Gallagher & Company, Inc., William J. Gallagher, Jr. and Lewis Akmakjian.

6. The Panel recommended expungement of the award pursuant to NASD Notice to Members 99-09 for Respondents Stock USA, Inc. and James Gerwick.

This case is significant in that a California panel of arbitrators awarded punitive damages, costs, interest and expert witness costs to the Claimants.

Claimant's Counsel - Jonathan Evans, Law Offices of Jonathan W. Evans

Respondent's Counsel - Jefrey S. Kob, Miller, Milove & Kob for Respondents Stock USA, Inc., and James Gerwick; Stephen Acker, Acker, Kowalick & Whipple for Respondents W.J. Gallagher & Company, Inc., William J. Gallagher, Jr. and Lewis Akmakjian; Jodi S. Cohen, Keesal Young & Logan for Respondents Interfirst Capital Corporation; Respondents Ernest Arnold and Lewis Akmakjian In Pro Per

Claimant's Expert - Stephen Butler, Butler, Adams, Karpesh & Associates

Respondents Expert - none

Hearing Situs - Los Angeles, California

Arbitrators - Alan J. Mayer, Esq., Chairperson; Melvin S. Feldman, Esq.; Mary K. Foust, Industry

5) *Portia Arutunian and Diane Torres v. U.S. Pacific Financial Services, Wayne Miller and Roger Fan*, NASD Case No. 00-02492

Claimants asserted the following causes of action: negligence, unsuitability, fraud by misrepresentation, failure to supervise, churning, excessive trading, unauthorized trading, breach of fiduciary duty, violation of NASD, state and federal securities rules and regulations.

Respondents denied the allegations of the Statement of Claim.

The arbitration panel made the following findings and award:

1. Respondents Fan, Miller, Hu and Lau were found liable and ordered to pay Claimant Arutunian $267,925 in damages inclusive of compensatory damages and pre-award interest. Respondents were found jointly and severally liable, except for Hu and Lau who are responsible for a maximum of $1,000 for this relief.

2. The panel made a specific finding of fraud pursuant to California Civil Code Section 3194. Respondents Fan, Miller, and Lau and ordered to pay Claimant Arutunian $133,961 in punitive damages. Respondents were found jointly and severally liable, except for Hu and Lau who are responsible for a maximum of $1,000 for this relief.

3. Respondents Fan, Miller, Hu and Lau were found liable and ordered to pay Claimant Torres $90,550 in damages inclusive of compensatory damages and pre-award interest. Respondents were found jointly and severally liable, except for Hu and Lau who are responsible for a maximum of $1,000 for this relief.

4. The panel made a specific finding of fraud and elder abuse pursuant to California Civil Code Section 3345. Respondents Fan, Miller, Hu and Lau were found liable and ordered to pay Claimant Torres $181,000 in punitive damages. Respondents were found jointly and severally liable, except for Hu and Lau who are responsible for a maximum of $1,000 for this relief.

5. The panel assessed forum fees in the amount of $12,450 against Respondents Miller and Fan.

6. U.S. Pacific Financial Services, Inc., is dismissed without prejudice.

This case is significant in that a California panel of arbitrators awarded both punitive damages and damages under the California Civil Code Section 3345 for fiduciary abuse of an elder who pursuant to the code section is more than 65 years of age.

Claimant's Counsel - Jonathan Evans, Law Offices of Jonathan W. Evans

Respondent's Counsel - Laurence D. Strick, Laurence D. Strick & Associates for all Respondents except Wayne Miller who was In Pro Per

Claimant's Expert - Stephen Butler, Butler, Adams, Karpesh & Associates

Respondents Expert - None

Hearing Situs - Los Angeles, California

Arbitrators - Andrew J. Zafis, Esq., Chairperson; Kenneth L. Swett; Rose Marie Wright, Industry

6) *Jimmy L. Shawver et al. v. Sigma Financial Corporation, Michel J. Brooks, Jerome S. Rydell, Genesis Financial Services Corporation, Robert W. Fergan and Leann Fergan*, NASD Case No. 99-3362

Claimants asserted the following causes of action: breach of fiduciary duty, misrepresentations, omissions, deceptive devices, violation of NASD Rules, breach of contract, respondeat superior, control person liability under Section 410 of the Michigan Uniform Securities Act, failure to exercise due diligence, sale of unregistered securities.

Respondents denied the allegations of the Statement of Claim and asserted the following affirmative defenses: failure to state a claim, claimant assumed the risk, estoppel, statute of frauds, laches, unclean hands, lack of consideration, claimants did not suffer damages and the claim lacks proximate cause.

Prior to the hearing Claimants settled with Respondent Leann Fergan.

The arbitration panel made the following findings and award:

1. Respondents Sigma Financial Corporation, Robert W. Fergan and Genesis Financial Services Corp. ("Respondents") were found jointly and severally liable and ordered to pay Claimants $250,451 in compensatory damages, $55,655.77 in attorneys fees pursuant to statutory authority and case authority and $11,989.53 in costs.

2. The panel dismissed Respondents Rydell and Brooks with prejudice.

3. Respondents Robert Fergan and Leann Fergan were ordered to pay $1,125 in adjournment fees.

4. The Claimants were ordered to assign to Respondents all investments sold by Respondents to Claimants. The Claimants were further ordered to relinquish all payments received from the investments from the date of the assignment.

5. The panel assessed forum fees in the amount of $20,700 against Respondents jointly and severally.

This case is interesting in that the panel in dismissing certain claims made a finding of fact in the award as the dismissed claims. In addition, the panel awarded attorneys fees pursuant to Michigan statutory and case authority and granted Claimants the remedy of rescission of their investments.

Claimant's Counsel - Laurence S. Schultz, Driggers, Schultz & Herbst

Respondent's Counsel - Joseph H. Spiegel for Respondents Sigma Financial Corporation, Jerome S. Rydell and Michael Brooks; Dennis K. Egan, Egan & Mazzara for

Respondents Genesis Financial Services Corporation and Robert W. Fergan; Gary Saretsky, Hertz, Schram & Saretsky for Respondent Leann Fergan

Claimant's Expert - none

Respondents Expert - none

Hearing Situs - Southfield, Michigan

Arbitrators - James C. Steffl, Esq., Chairperson; Francis C. Flood, Esq.; Kenneth Rochlen, Industry

7) *Christopher J. Peers, et al. v. William Sedkey Saydein, George Clarence Bowen, Mark Stephen Vandehey, Kenneth Charles Eich, Peter Kenneth O'Leary, Arlene Marie Wilson, Andrew John Donohue, Oppenheimer Funds, Inc., Oppenheimer Acquisition Corp., Massachusetts Mutual Life Insurance Co., Mass Mutual Holding Co. and MultiSource Services, Inc.*, NASD Case No. 00-00027

Claimants asserted the following causes of action: violation of Section 10(b) and Rule 10b-5 of the Securities Exchange Act, common law fraud, common law negligence, breach of fiduciary duty and/or constructive fraud, violation of the NASD Conduct Rules, violation of Section 20(a) of the Securities Exchange Act of 1934, common law respondeat superior, violations of the Indiana Securities Act, violations of Indiana regulations relating to the purchases of SureQuest Systems for Claimants' accounts.

Respondents denied the allegations of the Statement of Claim. In addition, Respondents asserted the following affirmative defenses among others: failure to state a claim, waiver of right to make claim against the clearing firm pursuant to the terms of the clearing agreement, waiver by conduct and by law, ratification, estoppel pursuant to the terms of the clearing agreement, claimants caused their own injury, comparative fault of claimants, laches, statutes of limitations and failure to mitigate damages.

Respondents Oppenheimer Funds, Inc., Oppenheimer Acquisition Corp., Massachusetts Mutual Life Insurance Co., Mass Mutual Holding Co. which are non-NASD member firms did not submit to arbitration.

Respondent Peter Kenneth O'Leary was dismissed prior to being required to file an answer.

Respondent William Sedkey Saydein did not appear.

Prior to commencing this arbitration Claimants had sought and obtained awards against the introducing broker for losses as a result of the same transactions.

The arbitration panel made the following findings and award:

1. The panel found that in connection with the Claimants purchases of SureQuest Systems (ASQS") that MultiSource Services, Inc. (AMSI") acted as a clearing broker. The panel found that MSI had materially aided in the introducing broker's sale of unregistered, non-exempt securities in the State of Indiana and that but for MSI's services as a clearing broker, the processing of the sales of SQS shares could not have taken place.

2. The panel further found that MSI knew or should have known of various "red flags" in its dealings with the introducing broker , including the introducing broker's weak capitalization, concentration of transactions in a few thinly traded stocks, certain disquieting episodes between its principals and employees, numerous exception reports notifying MSI that the transactions were not per se exempt.

3. The panel found that MSI was not a seller of SQS stock and that in neither solicited or executed sales under the Indiana Code 23-2-1-19(a)

4. The panel found that the sales of SQS stock via MSI violated Indiana Code sections 23-2-1-3, 23-2-1-19(a) and that MSI materially aided the introducing broker in violation of Indiana Code which states:

A person who directly or indirectly controls a person liable under subsection (a),... an employee of a person who materially aids in the conduct creating liability and a broker-dealer or agent who materially aids in the conduct are also jointly and severally ...

5. The panel found Respondent MSI liable and ordered MSI to pay Claimants a total of $151,453. This awarded represented a recovery from Respondent MSI who the panel found to be 20 percent responsible for Claimants' losses. The awarded damages are inclusive of interest at the rate of 8 percent for four years and $30,000 in attorneys fees.

6. The panel assessed forum fees in the amount of $6,000 against Respondent MSI.

This case is significant in that it is believed to be the first known decision extending liability to a clearing firm for the sale of an unregistered security. The arbitration panel also made findings of fact and conclusions of law which itself is uncommon. The conclusions of law are supported by both Indiana Code and state and federal case authority.

Claimant's Counsel - Mark E. Maddox, Maddox Koeller & Hargett & Caruso

Respondent's Counsel - Philip R. Forlenza, Patterson, Belknap, Webb & Tyler LLP for all

Respondents except Oppenheimer Funds, Inc., Oppenheimer Acquisition Corp., Massachusetts Mutual Life Insurance Co., Mass Mutual Holding Co., Peter Kenneth O'Leary and William Sedkey Saydein

Claimant's Expert - Joe Long

Respondents Expert - none

Hearing Situs - Indianapolis, Indiana

Arbitrators: William H. Torbin, Esq., Chairperson; Randall Scott Strause, Esq.; Robert H. Springer, Industry

In Memory of Mike O'Neill

by Joseph J. Dehner

Mike O'Neill and I were in the middle of a 2-session arbitration, where we teamed up to try a case, when we got word of Mike's untimely death. Mike won't be physically with us in June when we complete the hearing, but his forceful presentation during the November hearing session won't be forgotten.

Mike was a detail guy. He combed documents. He mined for gold. He believed and proved that hard work pays off. Investment losses of his clients became his personal crusades. By uncovering the realities of the financial world, Mike got beneath the covering and into what really lay inside of how a person's savings were handled.

The striking thing about Mike's presentation was not just in the depth of detail, but in the kindly manner of proceeding. He respected his professional adversary, and did not turn a dispute into a battles of attorneys. Instead, the battles were to expose the truth, trusting equity for a just result. He used flip charts to write down what adverse witnesses said, so that there was no mistake when a broker admitted a point. It was written down for all to see and remember.

At their best, attorneys are champions for their clients, but most of all revealers of the truth. Few acquire the knowledge and wisdom to penetrate the mists of another profession and to tell the true story of how and why something bad happened. Mike was one of the few. We will miss him greatly.

Joseph J. Dehner is an attorney with the law firm of Frost Brown Todd in Cincinnati, Ohio His email address is jdehner@fbtlaw.com and he can be reached at 513.651.6949..

Announcements From The PIABA Office

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Upcoming Events:

PIABA Board of Directors Meeting. June 1 - 2, 2002. Beverly Hills, California.

The Fourth Annual Securities Law Seminar, October 2, 2002
The *PIABA 11th Annual Meeting*, October 3-5, 2002
at The Broadmoor in Colorado Springs, Colorado.

For more information or a copy of the brochure, contact Karrie Ferguson at 1.888.621.7484.

Important Meeting Deadlines:

Early Meeting Registration: Registration form received in PIABA Office on or before August 26, 2002

Late Meeting Registration: Registration form received in PIABA Office between August 27 - October 3, 2002 ($100/person late fee attaches)

Meeting Cancellation: Refunds will be granted, less $200/person cancellation fee, if cancellation is received in writing in the PIABA office on or before September 23, 2002. There is no refund for cancellations received on or after September 24, 2002.

Hotel Cancellation: Cancellations must be received by The Broadmoor seven (7) days prior to scheduled arrival. This policy is subject to change.

New Members:
(since publication of March 2002 Membership Directory)

Name	Location
Samuel Giberga	New Orleans, LA
Jeffrey P. Lendrum	San Diego, CA
Kenneth A. Martyn	Del Mar, CA
Stephen P. Meyer	Charleston, WV
Stanley T. Padgett	Tampa, FL
Hardin Ramey	Dallas, TX
Charles Thompson	Birmingham, AL
Staten L. Wilcox	Charlotte, NC
Russell Yamashita	Honolulu, HI

Directory information for all members is available in the members area of the PIABA website.