Public Investors Arbitration Bar Association Vol. 9 No. 2 Summer 2002

PIABA Bar Journal

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Features And Columns

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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 Summer issue of the PIABA Bar Journal contains a new feature most members should find extremely helpful. PIABA Board member Chuck Austin recently agreed to become the Cases and Materials editor. This new section profiles cases and decisions that are relevant to securities law and our practice. It will likely become one of the most popular features in the Journal.

We are still looking for contributions from other members. It can be an article once a year or a regular feature. PIABA members who are interested in contributing in the future should contact any member of the Board of Editors or Robin Ringo. Your comments, suggestions and contributions are always welcome.

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Fall, 2002 issue of *PIABA Bar Journal* is September 20, 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.

By mail, send submissions to:

PIABA
Attn: Robin Ringo, Exec. Admin.
2241 W. Lindsey, Ste. 500
Norman, OK 73069
Office: 1.405.360.8776
Toll Free: 1.888.621.7484
Fax: 1.405.360.2063
E-Mail: PIABA@PIABA.ORG
Website: www.PIABA.ORG

Summer President's Message

by Philip M. Aidikoff

Dear Members,

Even the most cynical of us could not have foreseen how widespread the recent disclosures of corporate wrongdoing could be. First there was Enron. We marveled at a culture that seemingly encouraged such gross mismanagement and blatant disregard for the most basic concepts of corporate morality. The pundits told us that Enron was the largest bankruptcy in the history of our country. As it turns out, it stayed in the record books less time than did Mark McGwire's single season home rune title.

On the heels of Enron came Tyco, Imclone, Xerox, Adelphia and, of course, WorldCom. Examples of a remarkable lack of concern for shareholders and employees of companies while at the same time demonstrating an attitude that can only be described as an arrogant disregard for the consequences of actions that were bound to be revealed.

One common thread that connects all of this extraordinary conduct appears to be the executive pay structure that rewarded officers with stock options and became the engine that drove the greed train. The higher the price of the stock, the more zillions these folks made. When the house of cards collapsed, corporate insiders moaned that they would be forced to sell vacation homes, while untold numbers of employees lost everything in 401(k) plans over concentrated in company stock. In many cases this problem was exacerbated by brokerage firms that encouraged exercise and diversification thru the use of margin and seemed to forget that "hedge" is not a dirty word.

Shell shocked is a polite way to describe the state of mind of many of these people. One minute they can taste the fruits of their labor and have a comfortable retirement all mapped out, and the next they find themselves penniless, embarrassed and not knowing where to turn.

Some are told that Class Actions provide the remedy, but are never really aware of how little each investor receives even in the most successful of Class recoveries. Many just give up because they don't know where to turn. Hopefully, more and more are finding their way to PIABA members thru links to our website and our increasing visibility on the national stage. Most respected financial media outlets now recognize that our organization is representative of the views and concerns of retail investors in this country and we are being looked to for comments to express those positions. Keep up the good work.

An Introduction to State Securities Law

by Joseph C. Long

Copyright © 2002. All Rights Reserved. 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.

I. General Overview

To understand the state securities acts, it is necessary to understand some of the history and philosophy behind them and their interface with the federal securities acts. The first securities act was passed in the state of Kansas in 1911. After the adoption of the first act, the idea of securities regulation began to spread. By 1913, twenty-three other jurisdictions had adopted securities acts, and by the beginning of the depression in 1929, virtually all the states had some form of securities act. However, as some of the schemes in the 1920's illustrated, state securities regulation with its limited jurisdiction was not the total answer. The stock market crash of 1929 precipitate a movement to create a federal securities agency which could deal with schemes involving interstate commerce. This movement culminated in the passage of the Securities Act of 1933 and the Securities and Exchange Act of 1934. Thus, state securities regulation predated federal securities regulation by some twenty-two years. This fact is important in understanding both the scope of the federal securities act and the interface between the state and federal acts.

The state securities acts are generally known to those who deal with them as "Blue Sky Laws". This name apparently comes from the comment of the United States Supreme Court in one of the early cases upholding the constitutionality of the early state acts that these statutes were passed control schemes which had "no more substance than so many feet of blue sky." *Hall v. Geiger-Jones Co.*, 242 U.S. 539 (1917).

This statement highlights one of the very prevalent misunderstandings about the purposes of the state securities acts. Many people think that these acts are limited to regulating regular types of securities such as common stock, corporate debentures, and corporate bonds traded on national securities exchanges such as the New York Stock Exchange. Certainly, the state acts do cover these types of securities; but, unlike the federal acts which have their focus in regulating the national market, the state securities acts are largely focused toward the regulation of the irregular securities and the newly formed company or enterprise. Thus, in a very real sense, the state securities acts were the first consumer protection statutes.

As a result, the state acts can be made applicable to a wide range of criminal and fraudulent activity. Thus, in the mid-1970's the state securities acts, before the area was pre-empted by federal commodity legislation, were able effectively to control the fraudulent sale of commodity option contracts. Traditionally, the state securities acts proved effective in controlling the Ponzi-type[1] and get rich schemes such as pay telephone leases and viatical settlements.

The Securities Act can also be made to apply to the typical business opportunity frauds such as worm farms and the work-at-home schemes. It is also broad enough to cover the fraudulent get-rich-quick operations involving the sale of race horses, diamonds, coins, stamps, and art objects, coupled with some form of management contract.

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[1]A Ponzi scheme is an operation in which an investor receives his profits not from the earnings of the securities, but from money invested by the later investors. In a sense, it is very similar to the popular chain letter scheme. The name "Ponzi" comes from one Charles Ponzi who conducted a very successful scheme of this type in Massachusetts immediately after World War I.

Finally, the state acts have been used effectively to control the sales of “prime bank” notes and other forms of fraudulent promissory notes.

A. Different Emphasis

The difference in emphasis between the federal and state securities acts also calls for a word of caution. The SEC has indicated that it feels that its limited resources should be directed more to the oversight and regulation of the national market system. Therefore, it will not become involved to any great extent with what the SEC Commissions refer to as "the exotic securities areas", *i.e.* pay telephone scams and fraudulent note sales.

Moreover, there is a definite trend on the part of the United States Supreme Court to reduce the number of cases being brought in federal court. One way to do so is to define a security narrowly rather than expansively. By doing so, the Court limits access to the federal courts under the Federal Securities Act.

On the other hand, the state courts do not have the luxury of limited jurisdiction. Therefore, they will have to hear the cases whether they are brought on common law or securities fraud counts. As a result, the state courts have not shown an inclination to restrict the coverage of the securities acts, but have in the last two decades returned to the broad interpretation afforded these acts during the 1920's.

These factors have led to a noticeable split in what has been considered a security under the federal act and under the various state acts, even though the statutory language of the definitions is virtually identical. For example, in the case of *Stanley v. Commercial Courier Service*, 411 F.Supp. 818 (D. Ore. 1975), the court held that a business opportunity scheme in the form of a franchise was not a security under the Federal Act, but was a security under the Oregon Securities Act.

The point here is one of caution. The decisions of the federal court and the SEC often will be extremely helpful. However, in some cases they will seem contrary to the position that a state agency or prosecutor wants to or should take. In such case one should not blindly accept the federal position. The same result need not necessarily follow under the state law, and the state agencies and enforcement personnel should clearly point out this fact to the state courts.

B. Different Approaches

Finally, a word needs to be said about distinctions in the approach to regulation to securities regulation between the federal and state acts. The federal securities acts are based upon the concept of full disclosure. Thus, the SEC has no authority to prevent the sale of securities even though the deal is very risky and the chances of investor loss are very great, *if all the information about the transaction is fully disclosed in the prospectus*.

Thus, the SEC might require the issuer to stamp across the face of the prospectus in inch-high red letters: "This deal is a fraud and we are ripping you off", but it would have no authority to refuse registration if full disclosure is made.

This approach is based upon the concept that the investor is entitled to make a bad investment decision as well as a good one. *His only right is that he should not be required to make an uninformed decision*. Whether he wishes to avail himself of the information made available through the prospectus is his decision.

Many of the state acts, on the other hand, are based on a concept known as merit regulation. They embody the concept of full disclosure, but go on to embrace the concept that the state has an interest in protecting its citizens from the bad investments. Thus, the state securities administrator is given the authority to refuse to allow a particular issue of securities to be traded in his state, if he feels, in the language common to most state statutes, that the security is not "fair, just or equitable". Unfortunately, most state acts do not define what constitutes "fair, just or equitable.” This task has been left to administrative interpretation.

C. Differences in Coverage

There is another major difference between the federal and state securities acts. The federal acts are only directed toward the original distribution of the securities, *i.e.* when the issuer sells them to the first purchaser. Once the securities are in the hands of the general public (as opposed to persons controlling the issuer), under the federal act, they can be freely traded in the secondary trading market without further registration.

On the other hand, under the state acts, a registration must be effected or an exemption found ***each*** time the security is sold. *See e.g.* Uniform Securities Act § 301 (1957). Thus, the state acts regulate both the initial distribution of, and the secondary market in, securities. Normally, under the federal acts a security will be registered only once. However, under the state acts, the same security may have to be registered two or more times because the acts normally provide that registration is effective for no more than a year at a time. Uniform Securities Act § 305(h) (1957).

II. General Organization of the Securities Acts

Turning to the securities acts themselves, most state securities acts have three essential parts. First, there are those provisions requiring the registration of the securities sold within the state. Second, there are those provisions requiring the registration of persons involved in the securities industry. Finally, there are the anti-fraud provisions. It is obviously impossible to consider the laws of all fifty-two state and territorial jurisdictions having securities acts. Therefore, let us brief consider the Uniform Act provisions in each of these areas.[2]

A. Security Registration

1. Registration Provisions

The key provision dealing with the registration of the securities themselves is Section 301 of the Uniform Act. This provision requires that every security sold in the state be registered or exempt. The requirement for the most part is straightforward. The only difficult concept in this area is the question of when a security is "sold in the state". This issue is dealt with in Section 414 of the Uniform Act.

Registration under the Uniform Act can be accomplished in one of three ways. The most commonly used way in terms of dollar volume is registration by coordination. Uniform Securities Act, § 303 (1957).

Coordination registration at the state level can only be used when a full registration is also being made with the Securities and Exchange Commission. It normally would **not** be available when the issuer is seeking to avail itself of the provisions of Regulation A at the federal level.

The second most common method of registration is registration by qualification. Uniform Securities Act § 304. This method can be used by anyone, whether the transaction involves a primary distribution by the issuer or an offering in the secondary market. It will be used most frequently by the small issuer who is relying on one of the exemptions from registration under the federal act, such as the intra-state exemption found in Section 3(a)(iii). Finally, there is registration by notification. Uniform Securities Act § 302 (1957).

Registration by notification is not available to an issuer of securities either to make a primary distribution of those securities or for secondary sales (*i.e.* sale of treasury stock). Rather, notification registration is only available for securities which are trading in the secondary market for sales by non-issuers. Because one or more exemptions from registration are usually available for these securities, registration by notification is virtually unused.

2. Exemptions from Registration

As an alternative to registration, an exemption may be available. There are two basic types of exemptions which are found under the Uniform Act. Section 402(a) contains what are known as securities exemptions. Under these exemptions, the securities covered, because of their nature, will never need to be registered.

The general rationale for these exemptions is that regulation of these securities is not necessary or is supplied by another governmental agency. Among the more important exemptions in this group are: (1) the governmental securities exemptions; (2) the financial institutions exemptions; (3) the listed securities exemption; and (4) the charitable or nonprofit institutions exemption.

The second group of exemptions found in Section 402(b) of the Uniform Act is known as transactional exemptions. In effect, these exemptions are one-shot exemptions, excusing the particular transfer in question from registration. However, when the purchaser under a transactional exemption wishes to sell his securities, he will either have to register the securities or find another exemption. The more important transactional exemptions are: (1) the isolated nonissuer exemption; (2) the institutional buyers' exemption; and (3) the limited offering exemption.

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[2]The Uniform Securities Act was adopted by the Uniform Commission for State Laws in 1957. The statute was largely drafted by Professor Louis Loss of Harvard Law School. The Uniform Act has now been adopted with some modification in 34 jurisdictions. 1 Blue Sky L. Rep. (CCH)¶4901 (1978). There are both Official Comments and draftsmen's commentary which accompany each section of the Uniform Act. Both sets of commentary are found in L. Loss & E. Cowett, BLUE SKY LAWS (1958), *reprinted as* L. Loss, **Commentary on the Uniform Securities Act** (1976). Volume One of the *Blue Sky Law Reports* contains only the official comments. Decisions under the Uniform Act in one state should be considered binding on the courts in another state which has adopted the Act because Section 415 of the Act mandates uniform interpretation. The Uniform Act was revised in 1985. "RUSA". It is also presently in the process of being revised for the second time.

There is one important thing to note about these exemptions. They are merely exemptions from the registration provisions of the Act. *They do not constitute exemptions from the coverage of the Act itself*. Thus, the offer or sale of an exempt security is still subject to the coverage of the antifraud provisions of the Act.

3. Consequences of Non-Registration or Exemption

What happens when a security is sold in violation of Section 301, *i.e.* it was not registered or exempt? First, such sale constitutes a felony offense.[3] Second, the administrator may issue a cease and desist order or seek an injunction against further sales. Finally, such sale will result in civil liability upon the part of the person selling the security,[4] of the "seller". The extent of this civil liability is outlined by Section 410(a). The purchaser is entitled to the return of all the consideration he paid for the securities, plus interest and attorney's fees. However, he must return any profits made on the security. *See Bateman v. Petro Atlas, Inc.*, [1978-81 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,463 (S.D. Tex. 1977).

B. Broker-Dealer and Agent Registration

1. Definitions and Registration Requirements

The key broker-dealer and agent registration provision is Section 201. This section requires all broker-dealers, agents, and investment advisors who are operating in the state, selling securities or offering investment advice from outside the state into the state, to register under the local statute. The term "agent" is defined by Section 401(b) and excludes those persons who on *behalf of an issuer*, are selling securities which are exempt from the registration requirements by virtue of one of the transactional exemptions of Section 402(b) or certain of the securities exemptions of Section 402(a). Section 401(c) defines who is a broker-dealer while Section 401(f) defines "investment advisors".

2. Consequences of Non-registration

Failure to register as a broker-dealer, agent, or investment advisor is a felony punishable under Section 409. Such failure is also grounds for a prohibitive injunction under Section 408. Further, nonregistration as a broker-dealer or agent constitutes grounds for rescission of the transaction by the purchaser of the securities under Section 410.

For example, in *Stimmel v. Shearson, Hammill & Co.*, 411 F.Supp. 345 (D. Ore. 1976), the broker-dealer, Shearson Hammill, was registered locally and maintained an office in Oregon. However, the series of transactions in question were handled by an agent in Shearson's San Francisco office. This agent was not licensed in Oregon. The court properly allowed the purchaser to set aside those transactions in which he had suffered a loss while retaining those trades in which he made a profit.

It should be obvious that the fact of nonregistration of Shearson's agent had no bearing on the losses suffered, which were due entirely to unrelated facts. Nevertheless, Section 410 gives an absolute right to the purchaser to rescind, based upon the nonregistration of either the broker-dealer or the agent. No showing of causation, knowledge by either seller or purchaser, or injury need be shown to make such rescission. The mere violation of the act is sufficient.

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[3]Uniform Securities Act, § 409(a)(1). This is an absolute liability offense. It is no defense that the seller does not know that what he is selling is a security, or that it needs to be registered. *People v. Terranova*, 563 P.2d 363 (Col. App. 1977); *State v. Hodge*, 204 Kan. 98, 460 P.2d 596 (1969); *State v. Russell*, 119 N.J. Super., 344, 291 A.2d 583 (1973). Further, it is no defense to have sought advice of counsel and to have been told that the interests sold were not securities and need not be registered. *People v. Clem*, 114 Cal.Rptr. 359 (Cal. App. 1974); *People v. McCalla*, 63 Cal.App. 783, 220 P. 436 (1923); *State v. Whiteaker*, 118 Ore. 656, 247 P. 1077 (1926). The courts are split as to whether advice from the securities agencies will constitute a defense. *Compare United States v. Anzelmo*, 319 F.Supp. 119 (E.D.La. 1970), *holding no, with People v. Ferguson*, 134 Cal.App. 41, 24 P.2d 965 (1933), *holding yes.*

[4]Uniform Securities Act, § 410(a)(1). The term "seller" of the securities covers many people. It covers the person whose property is sold, *see e.g., Bond v. Koskot Interplanetary, Inc.*, 276 So.2d 198 (Fla. Dist. App. 1973). It also includes the broker-dealer who sells the securities on behalf of the owner, *see e.g., Cady v. Murphy*, 113 F.2d 988 (1st Cir. 1940); *Putenney v. Wildeman & Co.*, 318 Ill. 139, 149 N.E.2 (1925), as well as the registered representative that handled the sale, *see Giordano v. Auditore*, 355 Mass. 254, 244 N.E.2d 555 (1969). In addition, the term "seller" has been extended to persons involved in the selling process who have no direct contact with the buyer. Thus, those termed "aiders and abettors" of the actual seller are also considered "sellers" for the purposes of civil liability.

C. The Antifraud Provisions

1. Section 101

There are two antifraud provisions in the Uniform Securities Act. The main antifraud section is Section 101, which is patterned after Section 17(a) of the Securities Act of 1933, 15 U.S.C. § 77(q)(a) (1980), and SEC Rule 10b-5, 17 C.F.R. § 240.10b-5 (1981).

This section prohibits the following three types of conduct:

(a) the employment of any device, scheme, or artifice to defraud.

(b) the making of any untrue statement of a material fact or omission to state a material fact.

(c) the engaging in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

Again, violation of this section will subject the violator to criminal liability under Section 409 and to civil injunction under Section 408. However, Section 101 in most states does not impose civil liability upon its violators in the same way that Section 17(a) and Rule 10b-5 have been interpreted to create implied liability. Section 410(h) of the Uniform Act specifically disclaims the creation of any implied causes of action under the Uniform Act. *Mid-Continent Cas. Co. v. McAlister Aircraft, Inc.*, 349 F.2d 885 (10th Cir. 1965).

A major problem in connection with injunctions under Section 101 of the Uniform Act concerns the standards of conduct necessary to show a violation of its provisions. As was noted in the last paragraph, Section 101 is based upon Section 17(a) of the federal Securities Act of 1933 as well as SEC Rule 10b-5. In the landmark case of *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), the Supreme Court held that a private litigant must prove scienter in order to be able t recover under Rule 10b-5.

It is not entirely clear whether the Court meant scienter in the common law sense of not only an intentional act, but also one done with the intent to cause injury, or merely a knowing act. The lower federal courts, however, have been virtually unanimous in holding that scienter means only a knowing act or one done in total disregard of the truth. *See e.g. Sanders v. John Nuveen & Co.*, 554 F.2d 790 (7th Cir. 1977).

However, the Court in *Ernst & Ernst* did not indicate whether this standard would also apply to SEC enforcement actions under Rule 10b-5 or was the applicable standard under Section 17(a) of the 1933 Act.

These questions were subsequently answered by the Court in *Aaron v. SEC*, 446 U.S. 680 (1980). The Court first rejected the idea that there should be a different standard rule 10b-5 for agency action and held that the scienter standard of *Ernst & Ernst* was the correct standard for all actions under Rule 10b-5.

The Court then concluded that the standards developed under Rule 10b-5 would not automatically control Section 17(a) because that Section is a part of the Congressional enactment. This contrasts with the fact that Rule 10b-5 is merely an administrative rule adopted under Section 10b of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1980). Therefore, the court concluded that while the language used in Rule 10b-5 would support a negligence or even absolute liability standard, the language of the Rule was controlled by, and could not be inconsistent with, the language of Section 10b which talks in terms of fraud.

The Court then undertook a subsection by subsection analysis of Section 17(a). It concluded that subsection (1), which is identical to Section 101(1) of the Uniform Act, requires proof of scienter because the *Hochfelder* reasoning applies equally to the language "to employ any device, scheme, or artifice to defraud." The Court, however, then held that the SEC need not prove scienter in enforcement actions under either subsection (2) or (3), which are identical to Sections 101(2) and (3).

The state courts which have considered the issue generally agree with this analysis. Scienter is not required for either a criminal conviction or administrative action or injunction by the administrator, at least under Section 101(2) and (3).

The majority of state courts continue to require scienter for criminal convictions under Section 409 or civil administrative or injunction action under Section 101(a).

2. Civil Liability

Since there is no implied civil liability for violation of Section 101, civil liability for fraudulent activities must be based upon Section 410(a)(2). This section imposes liability virtually identical to that imposed by Section 12(a)(2) of the Securities Act of 1933. Liability is based upon the offering or selling of a security by means of any untrue statement of a material fact or any omission of such fact.

Liability here is imposed on what is basically an inverse negligence standard. The defendant, in order to avoid liability, must prove that he did not know or could not, in the exercise of reasonable care, have found out about the material fact omitted or misstated. Knowledge of the truth by the purchaser prevents liability, however, the knowledge requirement here is actual knowledge as there is **no** duty on the part of the purchaser to investigate.

Civil liability under this section does not depend upon reliance on the misstatement or omission by the purchaser.

Nor, is it significant to liability that the omission or misstatement is the basis of the plaintiff's loss or that the plaintiff has suffered a loss. The purchaser is entitled to rescind the transaction merely on the basis that the seller violated the provision.

III. Key Elements for Application of A Securities Act.

For a particular state securities act to apply to a transaction, there are three key elements which must be present: (1) there must be a security involved; (2) there must be an offer or sale of that security; and (3) the transaction must take place "in this state". The Uniform Securities Act deals with each of these elements.

A. Security.

Section 401(l) of the Uniform Act contains the definition of a "security". It reads as follows:

> "Security" means any note; stock; treasury stock; bond; debenture; evidence of indebtedness; certificate of interest or participation in any profit-sharing agreement; collateral-trust certificate; preorganization certificate or subscription; transferable share; investment contract; voting-trust certificate; certificate of deposit for a security; certificate of interest or participation in an oil, gas, or mining title or lease or in payments out of production under such a title or lease; or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for guarantee of, or warrant or right to subscribe to or purchase any of the foregoing. "Security" does not include any insurance or endowment policy or annuity contract under which an insurance company promises to pay [a fixed sum of] money either in a lump sum or periodically for life or for some other specified period.

1. "Securitiness".

It should be obvious that this language does not give a true definition of "securitiness". It is merely a list of things that are to be considered securities. However, it is possible to come up with a definition of "securitiness". As discussed earlier, the securities acts are meant to accomplish two things. First, the state acts are written so that the administrator may refuse the sale of a security in the state, if it is not "fair, just, or equitable." Second, both the state and federal acts are intended to provide the investor with the information he needs to make an intelligent or informed decision whether to purchase.

The definition of "securitiness" goes to this later point. There are two components which are critical here. The first component is that there must be an active effort to generate income or a return. The securities acts are not intended to regulate completely passive investments such as an investment in land. The second component is the degree to which the investors are going to participate in the management and control of the active effort. Again, an investor does not need information about a business opportunity over which he has total management control. As a result, the securities acts are not intended to cover sole proprietorships.

Securitiness, then, involves those transactions where there is an active effort to create a profit and the investor takes no direct participation in the management of the effort. **A rule of thumb here is, that if an investor is asked to turn over his money for someone else to manage to generate a profit in which the investor will share, the transaction involves a security.**

2. Definition of Security in General.

Returning to the statutory definition, it should be clear that some of the terms have rather specific meanings. For example, most people understand what stocks, bonds, and promissory notes mean. Some people will also know that a debenture is nothing more than an unsecured promise to pay, while a bond is a secured promise to pay. The remainder of the definition consists of terms which have no common usage or legal definition. These amorphous terms are intended to cover the unusual or exotic transactions which do not come within the more well-recognized terms. The most important of these amorphous terms is "investment contracts".

3. Investment Contracts.

The "investment contract" portion of the definition has been used to cover such investments as partnerships,[5] limited partnerships,[6] joint ventures,[7] interests in limited liability companies,[8] and viatical settlement agreements.[9] There are three separate tests used to define an investment contract.

(i) The *Howey* Test.

The definition used in the federal courts and most state courts is that developed *in SEC v. W.J. Howey Co.*[10] This test has four elements: (1) the investment of money; (2) in a common enterprise; (3) with the expectation of a profit; and (4) where the profit comes through the efforts of others.

As to the first factor, all that is required is that the investor give some tangible consideration, either money, property, or services, in exchange for the security.

The courts have not been able to decide on an appropriate test for the second element "common enterprise". There are three separate views as to what constitutes a "common enterprise". The first approach, which is known as horizontal common enterprise,[11] requires there to be multiple investors. If there is a single investor the investment is not a security. The second view is known as the narrow vertical common enterprise test.[12] This test requires that there be one or more investors and one or more promoters. The catch is that **both the investors and the promoters must share in the profits generated.** If the promoters do not share, then no security.

Finally, there is what has been called the broad vertical common enterprise test.[13] Under this test, nothing more is required than that one investor and one promoter join together to accomplish a common goal. The common goal may be as simple as making the investor a profit through some positive action on the part of the promoter. The broad vertical common enterprise test, is the one used by a majority of courts, both state and federal. However, it is increasingly common for courts to take the position that a common enterprise is present if any one of the three tests is met.[14]

The third element is the expectation of a profit to the investor. This means that the investor gives up his consideration in the expectation that he would receive a profit from its employment. The Supreme Court[15] has given this element a restrictive reading requiring either (1) capital appreciation resulting from the development of the initial

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[5]*See e.g.*, Williamston v. Tucker, 645 F.2d 404 (5th Cir. 1981).

[6]Ferguson v. Roberts, 11 F.3d 696 (7th Cir. 1993).

[7]*See e.g.*, Russell v. French & Assoc., 709 S.W.2d 312 (Tex.App. 1986).

[8]Mitek Inf. Systems, Inc. v. Arizona Corp. Comm., 194 Ariz. 104, 977 P.2d 826 (1999); Ak's Daks Communications v. Maryland Sec. Div., 138 Md. App. 314, 771 A.2d 487 (2001).

[9]Siporin v. Carrington, 200 Ariz. 97, 23 P.3d 92 (App. 2001).

[10]328 U.S. 293 (1946).

[11]*See e.g.,* Curran v. Merrill, Lynch, 622 F.2d 216 (6th Cir. 1980) and Milnarik v. M.S. Commodities, Inc., 457 F.2d 274 (7th Cir. 1972).

[12]*See e.g.*, Brodt v. Bache & Co., 595 F.2d 459 (9th Cir. 1978).

[13]*See e.g.*, SEC v. Koscot Interplanetary Inc., 497 F.2d 473 (5th Cir. 1974) and Villeneuve v. Advanced Business Concepts Corp., 730 F.2d 1403 (11th Cir. 1984)(en banc).

[14]*See e.g.,* Dagget v. Jackie Fine Art, Inc., 152 Ariz. 559, 733 P.2d 1142 (App. 1987) and Almaden Plaza Assoc. v. United Trust Fund, L.P., 123 Or. App. 372, 860 P.2d 289 (1993).

[15]United Housing Foundation v. Forman, 421 U.S. 837, 852 (1975).

investment or (2) participation in the earnings resulting from the use of investors' funds. However, this Supreme Court definition is too restrictive. It would appear to cover only equity interests and eliminate debt interests such as promissory notes from coverage. Payment of interest should also be recognized as a form of profits which the investor might expect.

The final element is that the profit come through the efforts of the promoter or some third party. This element means that the investor **as a result of his investment** has no right to participate in the entrepreneurial or managerial efforts of the common enterprise.[16] The promoter or some other third party is doing the work and making the business decisions which will determine whether the profit is made.

(ii) The Risk Capital Test.

The first alternative to the *Howey* test for investment contracts is the risk capital test.[17] It generally is thought to have three elements: (1) investment of money; (2) in the risk capital of an enterprise; and (3) the expectation of a valuable benefit. Element one is the same as the *Howey* test. Element two has the same concept of common enterprise, but requires that the money become part of the capital at risk, i.e. subject to loss, in the common enterprise. The third element is similar to expectation of profits in the *Howey* test, but here the test has broadened to cover **the expectation of any valuable benefit.** For example, the right to use a golf course is a valuable benefit, but not a profit as defined by *Howey*.

(iii) The Combined Howey-Risk Capital Test.

The final alternative test for investment contracts is known as the combined Howey-Risk Capital or ***Hawaii Market Center*** Test.[18] Again, it has four elements: (1) Offeree furnishes value; (2) which is subject to loss in the enterprise; (3) the expectation of a valuable benefit; and (4) the investor has no right to participate in the entrepreneurial or managerial efforts to run the common enterprise.

B. "Offer" or "Sale".

The second key element is that of "offer" or "sale". The securities acts do not apply even though a security is involved unless there is an offer or sale of that security. As a result, the true no-strings-attached gift of a security does not trigger either the registration or anti-fraud provisions of the act.

The concepts of offer and sale are defined in Section 401(j) which reads:

> (1) "Sale" or "sell" includes every contract of sale of, contract to sell, or disposition of, a security or interest in a security for value.
>
> (2) "Offer" or "offer to sell" includes every attempt or offer to dispose of, or solicitation of an offer to buy, a security or interest in a security for value.
>
> (3) Any security given or delivered with, or as a bonus on account of, any purchase of securities or any other thing is considered to constitute part of the subject of the purchase and to have been offered and sold for value.
>
> (4) A purported gift of assessable stock is considered to involve an offer and sale.
>
> (5) Every sale or offer of a warrant or right to purchase or subscribe to another security of the same or another issuer, as well as every sale or offer of a security which gives the holder a present or future right or privilege to convert into another security of the same or another issuer, is considered to include an offer of the other security.
>
> (6) The terms defined in this subsection do not include (A) any bona fide pledge or loan; (B) any stock dividend, whether the corporation distributing the dividend is the issuer of the stock or not, if nothing of value is given by stock holders for the dividend other than the surrender of a right to a cash or property dividend when each stockholder may elect to take the dividend in cash or property or in stock; (C) any act incident to a class vote by stockholders, pursuant to the certificate of incorporation or the applicable corporation statute, on a merger, consolidation, reclassification of securities, or sale of corporate assets in consideration of the issuance of securities of another corporation; or (D) any act incident to a judicially approved

[18] State v. Hawaii Market Center, Inc., 485 P.2d 105 (Haw. 1971).

reorganization in which a security is issued in exchange for one or more outstanding securities, claims, or property interests, or partly in such exchange and partly for cash

1. Things Included.

A reading of this definition indicates that it covers a great deal more than the concept of offer or sale used in contract law. It includes a number of things not generally thought to be a sale such as the gift of securities in connection with the sale of another security or other property real or personal. Further, Section 401(j)(5) indicates that often the offer or sale of an option on a security is an offer or sale of the underlying security as well.

2. Things Excluded.

The definition also excludes things which under the present view of securities laws should be included. Note that stock dividends and mergers are excluded. This exclusion is based upon the old no-sale theory of former SEC Rule 133. The SEC repealed Rule 133 over twenty years. As a result, stock dividends and mergers often **do constitute** offers and sales at the federal level.

C. "In This State".

The last element for the local securities act to apply is that an offer or sale of the security must take place "in this state". The Uniform Act, Section 414, defines when an "offer" or "sale" is deemed to have been made in this state. It is a complicated section to understand , but if the section is understood, no offeree or seller should be mislead as to the application of a particular act.

1. Key Issues.

It is important to note that, under Section 414, the local act attaches when an offer is made in this state even though the actual sale takes place some place else. Further, note that Section 414 is **geographically** based, and **not based upon the residence of either the offeror or offeree.** As a result, an offer made by a Illinois resident to an Oklahoma resident in Los Angeles International Airport, when both are changing planes, causes the California Act to attach. There will be no offer under either the Illinois or Oklahoma Acts, so they don't apply.

Finally, note that it is possible to have the Acts of two or more states apply to the same transaction. If there is a violation of any of the applicable acts, the administrator of that state and the purchaser has a cause of action. This is true even though the transaction may be perfectly legal in the other states.

2. Examples.

The simple situation here is where both the offeror and offeree are located in the same state and both the offer and sale are made at the same time. However, as Section 414(a) and (c) point out, an offer made over the telephone by a broker in Oklahoma City to a customer in Dallas causes **both the Texas and Oklahoma Acts to attach.** The offer is made from Oklahoma and directed into Texas.

Both acts will also apply were the offer is made in one state and the sale in another. For example, a Wisconsin resident goes to New York for a private placement presentation. If an offer is made, the New York Act applies. The Wisconsin resident indicates he wants to think about the deal. The promoter later contacts the resident in Wisconsin and makes the sale. The sale into Wisconsin makes the Wisconsin Act attach.

Let's change the above example slightly. Now, when the Wisconsin resident is called in Wisconsin, he indicates that he still thinking about the offer. He tells the promoter to call him at the end of the week in Florida where he is going on vacation. The promoter calls and the sale takes place. Now there are New York and Wisconsin offers and a Florida sale. All three acts attach.

IV. The Impact of NSMIA-Partial Federal Preemption

1. History of Cooperation

Traditionally, the state and federal securities paralleled each other because Section 18 of the Securities Act of 1933,[19] as originally enacted, preserved the states' authority to regulate securities. This meant that both state and federal regulators had authority to regulate all types of securities transactions and the professionals that made them.

As a result, issuers, broker-dealers, and investment advisers had to comply with *both* the state and federal securities acts.[20] Compliance with the federal act did not forgive compliance with the

[19]*See* Former 15 U.S.C. § 77r (1995).

[20]In many cases complying with state regulation meant complying with the acts of several states, if the seller or issuer was in one state and the purchaser or his agent in another.

state acts and vis versa. Therefore, failure to register or exempt the securities or the securities professionals handling the transaction at the state level could lead to administrative, private civil, and criminal liability under the state act even though the securities or the professional were in total compliance with the federal acts.

Despite the differences in statutory and regulatory philosophies between the state and federal acts discussed in the previous section, dual regulation appeared to work well as far as the state and federal regulators were concerned. Over the years, the regulators developed a good working relationship which effectively divided the regulatory turf. The SEC would concentrate its efforts on regulating the securities exchanges, securities professionals, and problems of a national or international scope. On the other hand, the state regulators would largely concern themselves with more local securities and problems with securities professionals and with more exotic "securities". This arrangement was informal and never codified in either the state or federal acts. As a result, both groups of regulators retained the *power*, even if that power was not often exercised, to regulate the entire field.

2. Industry Objection to Dual Registration

The issuers and securities professionals never liked the dual regulatory system and from the very beginning sought to pre-empt or drastically curtail state regulatory authority in the area. There were many reasons for this dislike, some legitimate and some not so legitimate. The issuers legitimately objected to having to deal with 54 different securities agencies, the SEC, the 50 states, and Guam, Puerto Rico, and the District of Columbia, to conduct a national offering. Various states would often impose differing disclosure requirements. As a result, it was extremely difficult to develop a truly "national" prospectus.

Less legitimately, the issuers often complained of merit regulatory requirements that the individual states would impose. They could legitimately complain that the merit requirements should not vary from state to state, but they could not legitimately complain about the use of merit regulation at the state level as opposed to pure disclosure regulation at the federal level.

The federal acts were enacted after twenty-two years of existing state merit regulation. The legislative history of the 1933 Securities Act makes clear that it would not have been a "disclosure-only" statute had the states not had a merit regulation system in place. Further, it was the expectation of Congress, in 1933, that such merit regulation system would continue into the future.

It is quite apparent that the state securities agencies were much more active than the SEC in the enforcement area. These factors, coupled with the fact that the state securities acts were more liberal both as the applicable statute of limitations,[21] the standard of proof for liability,[22] and categories of persons who could be held secondarily liable,[23] led the issuers and securities professionals to have a strong desire for federal pre-emption.

3. Partial Federal Preemption

In 1996, with the passage of the National Market Securities Improvement Act ("NMSIA"),[24] the issuers and securities professionals finally, at least partially, succeeded in curbing the state securities agencies' authority through partial federal pre-emption.

The impact of this NMSIA is not yet completely understood. However, it is clear that NMSIA curbs state authority in three significant areas: (1) regulation of the issuance and sale of securities; (2) record-keeping and licensing requirements for broker-dealer and agents, and (3) regulation of investment advisers.

The major element of NMSIA is its prohibition of the state, in certain instances, from registering securities. The key concept in NMSIA is the term "covered securities". "Covered securities" are defined to include four separate and diverse categories of securities.[25] The first category involves exchange listed

[21]Two years under Section 410(e) of the Uniform Act as opposed to one year under Section 13 of the Securities Act of 1933, 15 U.S.C. § 77m.

[22]Inverse negligence under Section 410 of the Uniform Act as opposed to scienter under SEC Rule 10(b)-5.

[23]Directors, officers, or control persons along with brokers and agents who materially aid or participate under Section 410(b) of the Uniform Act as opposed to direct participants in the selling process or control persons under either the Securities Act of 1933 or SEC Rule 10(b)-5.

[24]Pub. L. 104-290. For the legislative history and purposes of NMSIA, *see* 1996 U.S. Code Cong. & Admin. N. 3877.

[25]Securities Act of 1933, § 18(b), 15 U.S.C. § 78r(b) as amended in 1996.

securities,[26] while the second covers securities issued by investment companies.[27] The third group of "covered securities" is a new group consisting of offers and sales to "qualified purchasers" as defined by the SEC.[28] The final category is made up of various securities and transactions which are exempt at the federal level.[29]

In connection with the "covered securities" NMSIA prohibits the states from doing three things. First, the states can not "prohibit, limit, or impose" any conditions on the use of any offering document prepared by the issuer or on its behalf for use in connection with a covered securities.[30] Second, the states can not "prohibit, limit, or impose" any conditions on "any proxy statement, report to shareholders, or other disclosure document" used in connection a security or issuer registered under Section 15-3 of the Exchange Act.[31] Finally, it prohibits the states from imposing any merit standards in connection with the offer or sale of a covered security.

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[26]*See* 1933 Securities Act, §§ 77r(b)(1) as amended in 1996.

[27]Securities Act of 1933, § 18(b)(2), 15 U.S.C. § 77r(b)(2) as amended in 1996.

[28]The SEC is to further define this term by Rule. It may or may not be as broad the concept of "accredited investor" as found in Section 4(6) of the Securities Act of 1933, 15 U.S.C. § 77d(6), or Regulation D, Rule 501(a), 17 C.F.R. § 230.501(a) or "qualified institutional buyer" in SEC Rule 144A(a)(1), 17 C.F.R. § 230.144A(a)(1). The SEC is presently in the process of formulating this rule.

[29] For a more detailed discussion of the points made here, *see* 12-12B Joseph C. Long, Blue Sky Law (2001), available in Westlaw under the library heading "SECBLUE."

[30]Securities Act of 1933, § 18(a)(2)(A), 15 U.S.C. § 77r(b)(2)(A) as amended in 1996.

[31]15 U.S.C. § 78o

Proflipner's I Love New York (Law): Of Broker-Dealers, Investment Advisers, and Exculpatory Contracts

by Seth E. Lipner

Seth E. Lipner is one of the original PIABA Directors, a Past President of PIABA and the organizations Secretary. He is a member of Deutsch & Lipner, a Garden City, New York law firm. He is also Professor of Law at the Zicklin School of Business, Baruch College. Until recently, Mr. Lipner served on the Board of Editors of Securities Arbitration Commentator. His email address is proflipner@aol.com and he can be reached at 516.294.8899.

Many investment advisors are not licensed to sell securities. When these investment advisors act for individuals or other entities under a written power of attorney, they often open brokerage accounts in the name of their customer at a broker-dealer. Using a written trading authorization or other power of attorney, they then enter trades. The broker-dealer never questions the activity – after all, the advisor bringeth commissions, and margin interest.

Suppose these trades are unsuitable, and the investment advisor does not have sufficient assets to make good the wrong. Can one sue the broker-dealer?

Under New York law, the answer is "yes". In order to plead and prove such case, three aspects of New York law come into play. The first is the claim for "direct liability". The second a vicarious liability claim called "participating in a fiduciary's breach of duty" and the third is New York's law with respect to exculpatory clauses in contracts.

Direct Liability

The first thing that must be stressed to the arbitrator in third-party cases is that a brokerage firm owes its duty **to its customer**, not to the person holding the third-party authorization. New York law (which contractually governs almost all securities accounts) holds that a broker owes a fiduciary duty to its customer. *See Conway v. Icahn & Co., Inc.,* 16 F.3d 504, 510 (2d Cir. 1994), citing Restatement (Second) of Agency §381 (1958). While such a duty may not pertain to recommendations to buy or sell stock, it clearly pertains to the other types of things agents and custodians do: execute orders, and hold onto money.

A brokerage firm cannot rely blindly on an agent's supposed authority when it knows or has reason to know that that authority is circumscribed or that it is being exercised wrongly. *See* 2A N.Y.Jur.2d, sec.83, at p.134. In *Van Arsdale v. Metropolitan Title Guaranty Co.*, 425 N.Y.S.2d (N.Y.Dist.Ct. 1980), the court wrote:

> where reliance on apparent authority is inconsistent with . . . the terms of a contract [it] is ineffective to bind the principal.

Furthermore, where the third party's wrongs are obvious to Respondents, they cannot later claim that they fulfilled their duty to provide information to the principal by communicating only with the third party. In *Strip Clean Floor Refinishing v. New York District Council 9*, 333 F.Supp 385 (E.D.N.Y. 1971) the court wrote:

> The duty of diligence in ascertaining whether an agent is exceeding his authority devolves on those who deal with him, not on his principal. . . . A principal will not be bound by the act of his agent . . . where the facts and circumstances are such as to put [the third party] on inquiry notice as to the power and **good faith** of the agent. [citations omitted]" *Id.* at 396 (emphasis added)

The brokerage firms sometimes try to pretend that they are "sub-agents" of the investment advisor, not directly responsible to the customer/investor. The Rules of the New York Stock Exchange and the NASD demonstrate the flaw in that argument. Rule 406 of the NYSE requires that the account be titled "in the name of the customer". Rule 405 requires exercise of due diligence regarding every transaction, and "every person holding power of attorney." The

Rules thus recognize that the brokerage firm is never an agent of the investment advisor, but is rather an agent of the investor, and the duties are directly owed to the investor. And since the brokerage firm is compensated directly by the investor, and not by the investment advisor, there cannot be any rational claim of a sub-agency relationship.

Assisting a Fiduciary

Aside from the direct fiduciary breaches caused when a third party agent instructs his principal's broker to act in a manner violative of the duties the broker owes the principal, under certain circumstances, the broker can also be held vicariously liable for the third party's own fiduciary breach. There is a long-standing legal principle that "anyone who knowingly participates with a fiduciary in a breach of trust is liable for the full amount of the damage caused thereby." *S&K Sales Co. v. Nike, Inc.*, 816 F.2d 843, 848 (2d Cir. 1987).

The claim of participating in a breach of fiduciary duty has three (3) elements:

1) a breach by a fiduciary of obligations owed to another;
2) that the defendant knowingly participated in the breach; and
3) that the plaintiff suffered damage as a result.

Knowledge of the fiduciary's breach can be established whenever the third party is chargeable with constructive knowledge of the breach, *i.e.* if a reasonably diligent investigation would have revealed the breach. *See Diduck v. Kaszycki & Sons, Inc.,* 974 F.2d 270, 283 (2d Cir. 1992); *Whitney v. Citibank*, 782 F.2d 1106, 1116 (2d Cir. 1986). A few red flags is thus more than enough to create this type of liability.

Furthermore, as the Second Circuit explained in *Diduck*, "one *participates* in a fiduciary's breach if he or she affirmatively assists, helps conceal, or by virtue of failing to act when required to do so enables it to proceed." *Diduck* at 284. (italics added). There is no requirement in the law that the third party profit from the breach, there is no requirement of intent, and the "assistance required is less than the 'substantial assistance' necessary to impose aider-abettor liability under the securities laws." *Id*. The cases reveal that it is enough if the third party's conduct was a "substantial factor" in the sequence of events, and "the failure to comply with a duty to investigate while continuing to deal with the [fiduciary] may be a proximate cause of the breach." *Id*. [citation omitted]. *See Neuberger, Loeb & Co., Inc. v. Gross*, 563 F.2d 1057, 1074 (2d Cir. 1977), *cert. den.*, 434 U.S. 1035 (1978).

Non Enforceability of Exculpatory Clauses

After pretending that they owe no direct duty to their customers, and ignoring arguments about the cause of action for assisting a fiduciary, the brokerage firm's next argument will be that the customer signed the contract acknowledging that the broker-dealer had no suitability obligations, and did not owe any duties to the customer, or, in any event, any liability in that respect was waived. Again, in this regard, New York law is especially helpful. *Gross v. Sweet*, 49 N.Y.2d 102, 400 N.E.2d 306, 424 N.Y.S.2d 365 was decided by the New York Court of Appeals in 1979. The case involved a sky-diving school which had induced potential students to sign bland-vanilla waivers contractually exculpating the sky-diving school from liability from "any injury". The New York Court of Appeals (our highest court) ruled the clause unenforceable:

> We begin with the proposition, too well settled to invoke any dispute, that the law frowns upon contracts intended to exculpate a party from the consequences of his own negligence and though, with certain exceptions, they are enforceable, such agreements are subject to close judicial scrutiny [citations omitted]. To the extent that agreements purport to grant exemption for liability for willful or grossly negligent acts they have been viewed as wholly void [citations omitted]. And so, here, so much of plaintiff's complaint as contains allegations that defendant was grossly negligent, may not be barred by the release in any event. But we need not explore further this possibility for we conclude the complaint in its entirety withstands the exculpatory agreement.
>
> Nor need we consider plaintiff's request that we ignore the release on the grounds that the special relationship of the parties and the public interest involved forbids its enforcement. While we have, for example, had occasion to invalidate such provisions when they were contained in the contract between a passenger and a common carrier [citations omitted], or in a contract between a customer and a public utility under a duty to furnish telephone service [citations omitted] when imposed by an employer as a condition of employment [citations omitted] the circumstances here do not fit within any of these relationships. And, though we

note that a recent statute renders void agreements purporting to exempt from liability for negligence those engaged in a variety of businesses that serve the public [citations omitted] defendant's occupation does not fall within any of these classes either. We also decline, at this point, plaintiff's invitation that we proceed further to consider what effect, if any, the alleged contravention of Federal regulations may have on the relationship of the parties or the public interest involved. Such questions need not be reached in view of our holding that the wording of the exculpatory agreement does not preclude plaintiff's suit for negligence.

As the cases make clear, the law's reluctance to enforce exculpatory provisions of this nature has resulted in the development of an exacting standard by which courts measure their validity. So, it has been repeatedly emphasized that unless the intention of the parties is expressed in unmistakable language, an exculpatory clause will not be deemed to insulate a party from liability for his own negligent acts [citations omitted]. Put another way, it must appear plainly and precisely that the "limitation of liability extends to negligence or other fault of the party attempting to shed his ordinary responsibility" [citations omitted].

Not only does this stringent standard require that the drafter of such an agreement make its terms unambiguous, but it mandates that the terms be understandable as well. Thus, a provision that would exempt its drafter from any liability occasioned by his fault should not compel resort to a magnifying glass and lexicon. [citations omitted] Of course, this does not imply that only simple or monosyllabic language can be used in such clauses. Rather, what the law demands is that such provisions be clear and coherent (cf. General Obligations Law, s 5-702).

By and large, if such is the intention of the parties, the fairest course is to provide explicitly that claims based on negligence are included [citations omitted]. That does not mean that the word "negligence" must be employed for courts to give effect to an exculpatory agreement; however, words conveying a similar import must appear [citations omitted].

We are, of course, cognizant of the fact that the general rule of strict judicial construction has been somewhat liberalized in its application to exoneration clauses in indemnification agreements, which are usually "negotiated at arm's length between *** sophisticated business entities" and which can be viewed as merely "allocating the risk of liability to third parties between themselves, essentially through the employment of insurance" [citations omitted]. In such cases, the law, reflecting the economic realities, will recognize an agreement to relieve one party from the consequences of his negligence on the strength of a broadly worded clause framed in less precise language than would normally be required, though even then it must evince the "unmistakable intent of the parties" [citations omitted].

The bland-vanilla forms that the broker-dealer has the client sign in cases of this kind are quite analogous to that of the sky-diving school (no metaphor intended). Allegations of intentional wrongdoing, recklessness and gross negligence cannot be defeated by reference to a contract provision. The allegations of negligence are also likely to survive such a clause, unless the clause is conspicuous and drafted in such a way as to put the investor on notice of the important rights he is giving up. I have yet to see a form from the securities industry that meets that stringent test.

Conclusion

The brokerage industry would like to do everything they can to shirk its duty and reap the rewards of executing orders for investment advisors without taking on the concomitant duty which they owe to their customers. New York law recognizes that fact, and would hold brokerage firms responsible for neglecting the interests of their customers, even when those customers operate through an investment advisor or other person holding power of attorney.

Commodities Corner: A Primer On Dispute Resolution at National Futures Association

by Heather A. Cook

Heather A. Cook is Manager of Arbitration and Mediation at National Futures Association. As Manager, Ms. Cook is responsible for overseeing the arbitration and mediation programs maintained by NFA. Ms. Cook joined NFA's Information Center in 1994 and transferred to the Arbitration Department in January of 1998. She has headed NFA's Arbitration and Mediation Department since September of 2001. Ms. Cook received her B.A. degree in Audiology and Speech Pathology from Michigan State University in 1993. Ms. Cook can be reached at Hcook@NFA.futures.org.

National Futures Association (NFA) is a congressionally authorized self-regulatory organization for the futures industry, that was developed to maintain the integrity of the futures industry and to protect the investing public. NFA has developed numerous programs to assure the futures industry meets its obligations to the investing public. One of the programs offered is a nationwide dispute resolution system that includes both arbitration and mediation. NFA is an innovator for dispute resolution in the financial services industry, and resolving a dispute through NFA is generally less expensive, faster and less formal than litigation or other dispute resolution forums.

NFA Arbitration

NFA began its arbitration program in 1983, providing investors with a convenient, inexpensive and prompt method for resolving futures-related disputes. Since its inception, NFA has received over 3,900 arbitration claims, with customer cases accounting for over 90 percent of those filings. NFA arbitration has become the primary venue for dispute resolution in the futures industry.

NFA's Arbitration Program promptly resolves disputes. Over the last 10 years, NFA has maintained an average turnaround time of approximately 8 months. NFA arbitration is also investor friendly. On average, 62 percent of the arbitration cases handled by NFA are resolved in favor of the customer. When customers win, they are awarded on average 60 percent of the compensatory damages requested.

Investors who file their claims at NFA get their "day in court" even if they would not get it in court. NFA Rules prohibit motions to dismiss for failing to state a claim, so customers know the arbitrators will consider the evidence before reaching a decision. Although NFA Rules do allow for motions for summary judgment, these motions are rarely granted because they require the moving party to show both that there are no material facts in dispute and that the law requires the arbitrator to decide in its favor.

In October of 2001, NFA became the first regulatory organization in the financial services industry to accept arbitration claims online. Customers are now able to file their initial arbitration and mediation claims on NFA's web site and receive a reply from NFA within minutes. The reply confirms that their claim has been received and the processing can begin.

NFA offers customers the option of having their cases decided by a Member panel or a non-Member panel. By choosing to have a Member panel, the arbitrators will be persons who are connected with NFA Members. If a customer selects a non-Member panel, the Chairperson and at least one other arbitrator will be persons who are not connected with an NFA Member. If the case is to be decided by one arbitrator and a non-Member panel is selected, that person will not be connected with an NFA Member.

NFA has also taken steps to ensure that our program is affordable for customers. NFA has conducted proceedings in over 70 different metropolitan areas, usually in a location chosen by the customer. This reduces any travel-related costs for the public investor and their attorney. NFA also offers free mediation in cases filed through arbitration, which increases the number of settled cases.

Educating the parties and their attorneys is very important to NFA. NFA provide the customers, NFA Members, and attorneys with a wide array of educational materials, including several written publications about NFA's arbitration and mediation programs at no cost. NFA Arbitration: Resolving Customer Disputes is designed as an overview of the arbitration process and how it works, NFA Arbitration: Procedural Guide for Customer Disputes, offers useful and practical information about NFA's customer arbitration procedures. These materials contain information that is practical, comprehensive, and presented in plain language. Additionally, NFA developed an informational video to help the parties gain a better understanding of NFA arbitration.

NFA recognizes the success of the program depends on the strength of our arbitrators and understands the importance of arbitrator training. NFA maintains a large pool of qualified arbitrators throughout the United States who are available to serve on NFA arbitration panels. Lawyers, futures industry professionals, accountants, professors and other business professionals comprise NFA's roster of more than 2,000 arbitrators.

NFA's arbitrators must satisfy a mandatory training requirement every three years. One way to meet this requirement is by completing the computer-based training program NFA developed. This program, available on CD-ROM, is free, and both new and experienced arbitrators have found the information on the CD to be very valuable. NFA also conducts in-person arbitrator training programs every few years. The free, half-day programs, mix discussion groups with lectures to give the attendees information on a variety of arbitration issues.

When arbitrators are appointed to a case, they receive a complete arbitrator education package. The package materials include, the Procedural Guide for NFA Arbitrators, offering information on arbitration procedures, Legal and Procedural Issues for NFA Arbitrators, summarizing some of the legal issues that arbitrators frequently encounter[1], and if appointed as Chairperson, the Chairperson's Handbook, focusing on specific issues and responsibilities individuals may face when chairing an NFA arbitration panel.

NFA Mediation

In August of 1991, NFA launched the first mediation program in the futures industry. Since then, more than 1,600 cases have been referred to mediation. NFA believes mediation provides a speedier and less expensive alternative to arbitration, so NFA fully subsidizes mediation for all cases filed through arbitration. Therefore the customers and Members pay nothing to mediate. NFA refers cases of $150,000 or less to an outside mediation service, Joan Protess & Associates, and cases over $150,000 are referred to one of several NFA attorneys trained to mediate.

NFA introduced a pre-arbitration mediation program in February of 2001. Once a request is filed, NFA will assign the dispute to one of several NFA attorneys who are trained mediators. If the parties agree to use NFA's mediation program, NFA will charge a $450 fee (each party pays $225). This fee covers mediator sessions up to four hours. Since the program began NFA has received 36 mediation requests. Parties are also able to file their requests online through NFA's web site.

NFA offers two publications to educate parties on NFA's mediation programs. NFA Mediation: Controlling the Outcome of Your Dispute and NFA Mediation: An Affordable and Efficient Alternative for Resolving Disputes offer highlights from the two mediation options at NFA.

Conclusion

NFA is committed to protecting investors through its Dispute Resolution Programs. Futures customers have a choice of where to file their claims, and most of them choose to file their claims at NFA. For more detailed information or copies of any materials discussed in the article, please visit NFA's web site at www.nfa.futures.org or contact NFA's Arbitration Department at (877) 731-5300.

[1]This brochure is an educational reference and is not intended to be a substitute for the parties' own legal research and analysis.

The Opening Statements and Summations That Arbitrators Want to Hear

by David E. Robbins

 Mr. Robbins is on the Board of Editors of this Journal and can be reached at 212-755-3100 or DRobbins@KFYGR.com. He is a partner in the New York City firm of Kaufmann Feiner Yamin Gildin & Robbins LLP and has chaired all of the PLI programs on securities arbitration since 1986. He is the author of Securities Arbitration Procedure Manual (5th Ed. Matthew Bender www.lexis.com) and is an arbitrator and mediator.

In our securities arbitration cases, there are three bookends - not two. Each bookend should look quite similar, should be sturdy enough to support our case and, most of all, should be consistent. The three bookends are our Statement of Claim, Opening Statement and Summation. Common themes should run through them, supporting one another. In my first contribution to the PIABA Bar Journal, I examined Statements of Claim from the customer attorney's viewpoint. In this article, I would like to share some observations on Opening Statements and Summations from the head of the table – where the arbitrators sit.

Generally an Unreceptive Audience

The first thing to keep in mind is that your Opening Statement and Summation have substantial psychological barriers to overcome to pierce the haze and into the minds of the arbitrators. Many of my Solomonic colleagues believe Opening Statements are like the lousy openers for the headliner; they come with the price of admission but you sure would like them to get off the stage so the Stars can perform. Having read the Statement of Claim and Answer (perhaps the night before), many arbitrators feel they have a pretty good grasp of the main issues. But they want to hear *what really happened* from the parties. And they want to hear it sooner rather than later.

The same principle applies to Summations. Although they do not like to admit it, most arbitrators I have worked with decide cases before the Summation, well before the "fat lady sings". They usually have determined the issue of liability right after the testimony of the customer and the broker, *before* the experts tell them how they should decide the case. Unless the hearings were spaced out over appreciable periods of time and the arbitrators need the Summations to recall earlier testimony and exhibits, they *watch* you perform your well-crafted closing statements but their *minds* are miles away.

One of the reasons I sit as an arbitrator – besides the SROs' financial largess – is that it always improves my subsequent performance as a practitioner because I observe what works and what doesn't, what gets through to me and what remains in the ether. Let me tell you about those practitioners who have overcome unreceptive Panels and who have combined the introduction of evidence with effective Openings and Summations.

But First – The Script

The orchestra is tuning up. Opposing counsel line up their binders of exhibits and other documents either on the hearing table (as a Maginot Line against the enemy) or on the floor (for all to trip over). The anxious customers look like they are at a funeral and the broker sits there still annoyed to be taken off from the production line for another obviously meritless case. The arbitrators have just had their first executive session - to determine when the lunch break will be - and the Chair calls all to order. After reading from a script written by the same people who author margin agreements, the Chair intones:

- **At the NASD**: "Each party may make an opening statement. It should be limited to what the party intends to prove and should not be a presentation of evidence or of the merits of the case."
- **At the NYSE**: "If the parties desire, they may first make opening statements preliminary to the calling of witnesses and the

presentation of evidence or the statements may be waived. The opening statements, if made, are presented first by the claimant and then by the respondent."

You're the customer attorney, so you begin (after having read what follows).

The Role of the Statement of Claim

Now is your chance to make a good, second impression. Hopefully, your Statement of Claim has laid the groundwork for a good first impression. That is, in addition to it being in letter format (without numbered paragraphs); providing a clear, concise explanation of the relationship between the parties and the transactions at issue; limiting the issues to those you can prove; naming the fewest Respondents as necessary; and, specifying the damages sought, your Statement of Claim has anticipated the countervailing facts and arguments set forth in the Answer. You have explained the dispute and stolen your adversary's thunder.

Ironically, the better written your Statement of Claim, the more desirous the arbitrators will be to bypass your Opening Statement and hear directly from your witnesses; they will be less inclined to hear the main points all over again in your Opening Statement. Conversely, if you presented the kitchen sink approach to pleading (from the Throw-It-On-The-Wall School), the arbitrators may be more curious to find out what you think your case is really about, especially since the Answer from your opponent was short and sweet, setting roadblocks of logic that will be difficult to surmount.

The Main Purposes of the Opening Statement

"The purpose of the opening addresses," said the great Louis Nizer in *My Life in Court,* "is to acquaint the jurors with the nature of the case and what each side intends to prove. This way the jury obtains a preliminary view of the entire case and the respective contentions of plaintiff and defendant. [They are] then better able to follow the testimony as it comes piecemeal from the witness stand. It is an old theory that opening statements should be conservative and not promise too much." (p. 37)

In a nutshell: the Opening Statement should greet the Panel, introduce counsel and client, and serve as a brief, non-emotional, factual table of contents of the case-in-chief. It should always be given with the Summation in mind, as well as your order of proof.

Specific Recommendations for the Opening

First, some general thoughts and then some specifics. In your Opening, be very careful not to gild the lily (e.g., an allegation of fraud where, in fact, no fraud exists). This gives the Respondent an excellent opportunity to cast doubt on your entire case. You should be prepared to prove every allegation made in the Opening, otherwise opposing counsel will remind the arbitrators of any failures to do so during Respondent's Summation.

Some of my customer-attorney colleagues recommend presenting most of the Claimant's evidence in their Opening Statements. As an arbitrator, this makes me antsy. I would rather hear general themes and a handful of critical facts. Among the facts that should be addressed are the weaknesses in your case before your adversary stresses them; steal the thunder, especially of those *new facts* set forth in the Answer, the ones previously *forgotten* by your client. Every case has weaknesses because every case is a reflection of life and the older I get, the less black and white these cases become. Slam dunks are usually reserved for basketball courts, not arbitration hearings.

If the Statement of Claim has *not* already limited the main issues that will be before the arbitrators, the Opening Statement should do that. All sub-themes should be made to fit into the primary themes of your case. It is my practice to wait until a week or so before the first hearing to draft the Opening Statement. By that time, the case has taken on a life of its own and the central issues have jelled. If time permits, the draft should be given to your client for review. This enables him or her to focus on the most important issues in the case, permitting your client to keep those issues in perspective when testifying.

Opening Statements are of crucial importance because while arbitrators may be less influenced by personality and more familiar with the facts of a case than a jury is, both are intently focused at the start of a case and initial impressions often remain unchanged throughout the hearing. Therefore, prior to delivering your Opening Statement, please give the following 11-point checklist some reflection:

1. **Your speaking style** should be natural and comfortable and should not be too fast or too slow. Try to open a one-sided conversation with the arbitrators, sounding forceful yet understanding of human frailties.

2. **Establish a theme** for the case which is consistent with the facts (and the Statement of Claim), appealing to the Panel and not reliant on technical legal

arguments. Hammer that theme home as often as you can, until you see it getting through to the arbitrators. How will you know if you have succeeded? When the arbitrators preface their own questioning of witnesses with a repetition of your theme (e.g. "Mr. Broker, Claimant insists his stated investment objective was X yet you recommended XXX. How come?")

3. **Look the arbitrators** directly in the eyes and speak with conviction.

4. **Tell the arbitrators** how your position differs from your adversary's on each key issue.

5. **Challenge the arbitrators** to judge your client at the conclusion of the case by the accuracy of the representations that you make during the Opening. In other words, ask them to determine the case solely on the evidence presented and not on their sympathy or antipathy towards a witness or party (which will nevertheless influence them).

6. **Sometimes, less is more.** It bears repeating that you should not promise more than you can produce. In fact, if you have an intriguing, somewhat hidden fact that you hope will be revealed during the course of the case, remain silent about it in the Opening. Let the arbitrators feel they uncovered it themselves; those are the facts they will remember.

7. **Avoid personally attacking** your adversary – as hard as that is becoming these days - and at all times maintain a demeanor of professionalism and sincerity.

8. **Avoid giving an extended speech**. If you know your facts and issues cold, you can simplify them in your Opening. It will take a few drafts and revisions, but it will be worth it.

9. **Consider illustrative aids**. Since an average person's retention abilities are stronger through his sense of sight, an arbitrator's attention dramatically increases when, while watching and listening to your Opening, there is a visual guide. However, this can backfire grandly if your demonstrative exhibit has an error in it, blown up so large that it can be seen across the room.

10. **Avoid making objections** during your opponent's Opening Statement. If your adversary says something that is worth objecting to – such as the claim that your client is a felon, when he is not - your objection should be saved for the contrary evidence you introduce during the hearing. Presenting it at that later time is more effective than objecting during the Opening; the contrast between your opponent's Opening and the subsequent testimony can then be dramatically highlighted in your Summation.

11. **Potential Adverse Witnesses**. In the event you will have Respondent or one of Respondent's witnesses testify at the beginning of your case, make sure the arbitrators understand that they may hear testimony from adverse witnesses. Ask the Panel to keep in mind that the Claimant will testify later on.

The Fat Lady Sings – Summations

The testimony is completed. Each side "states affirmatively [that they] have had a full and fair opportunity to be heard." Then the Chair says:

-At the NASD: "Each party may make a closing argument. The parties are directed to limit their closing argument to a summation of what he or she believes has been proven. The parties may now begin their closing argument, beginning with the Claimant. Rebuttal is allowed and the Claimant may reserve its entire closing for rebuttal."

-At the NYSE: "After each side has completed the presentation of all witnesses and documents and signified that [their] case is closed, each side will then be given an opportunity for summation, Respondent to sum up first and then Claimant. These summations may be waived by the parties."

Again – some general comments and then a checklist of specifics. When a hearing lasts only a day, consideration should be given either to waiving the Summation for fear of insulting a Panel or to limiting its scope. Telling a Panel what it just heard may be considered an exercise in pomposity. When there is more than one hearing, however, the Summation is an excellent opportunity to structure the evidence presented in a light most favorable to the client.

Exhibits or charts that should be referred to in Summation, if at all, are those which go to credibility or show damage calculations. In most cases, by the time Summations begin, the arbitrators have unanimously decided who will win. (They probably will not have told each other, however.) As a result, by the conclusion of each party's case-in-chief, the arbitrators' main focus is usually on damage calculations.

During the Summation, go back to your Opening Statement and the points you promised to establish. *Show how you proved what you set out to prove*. The Summation should also include issues raised through arbitrators' questions, since the arbitrators feel those issues to be important. The facts stated in the Summation should be interwoven with suggestions of why your client's position is more credible and more reasonable than the opposition's and why your position is more consistent with accepted industry practice.

Summations should be considered works in progress. They should be prepared during the hearing and revised as the case progresses, never drafted the night before. *Shooting from the lip* will usually backfire.

Start the Summation by thanking the Panel for their time and attention to your case. The next step is to summarize the pleadings and the central issues of the case. That is, discuss the causes of action that should form the basis of the Panel's Award.

Next, go back to those indisputable facts and hammer them home. The facts and the testimony which are the strength of your case have to be brought directly to the forefront - these are the reasons why you are fighting this cause. Review the contradictions and conflicts which have been established in a hearing. Review the testimony and draw the appropriate inferences. If you don't fully state the inference you are seeking, the Panel may not find it.

Don't be afraid of rhetorical questions - with the answer being obvious - that leaves the Panel wondering why your opponent is even fighting this case. Appeals that fully engage the arbitrators' rational side are most effective. Review and summarize the damage calculations. Finally, end with a request for the relief sought and thank the Panel once again.

Seven Pointers For All Summations

1. Refer by number to exhibits and specific testimony of witnesses in support of your arguments.

2. Do not read the Summation, unless absolutely necessary. Try to work from an outline and maintain eye contact with the arbitrators whenever possible.

3. Mistakes made by client and counsel should be admitted.

4. You should always consider how you would view your own actions if you were sitting as an arbitrator in the case. Arbitrators, like jurors, respect attorneys and parties who are forthright and sincere and not condescending.

5. Since the credibility of the parties and witnesses is always a key component of the Panel's deliberations, point out obvious inconsistencies while, at the same time, maintain an objective, professional tone so as not to antagonize the Panel or have them become sympathetic to your adversary.

6. Some experienced practitioners recommend creating a time-line of important events for the Panel's reference, again because of the greater retention of the visual. Use of a blackboard, charts of trading and other illustrative methods are, in their opinion, a useful way to spice up your presentation.

7. A leading defense attorney friend of mine breaks down his Summations into two parts: (1) How he established what he promised to prove and (2) How his adversary failed to live up to the assurances made in his Opening Statement.

The More Complex Cases

For the more detailed cases, especially those conducted over a period of weeks or months (e.g., market manipulation cases, selling away cases), you might consider these ten suggestions:

1. **Summation Binder** - From the initial intake of the case through the testimony and other evidence presented, you should be compiling a separate folder or binder on key facts or documents that you believe best prove your case.

2. **Opening Statements** - One of the most effective ways to structure your Summation is to look back at the promises made in each side's Opening Statement and determine whether those promises were fulfilled.

3. **During the Fray** – During the hearing, flag certain key points in your notes with the letter "S" for Summation and do the same for key exhibits. You should almost always mark an "S" in your notes of the arbitrators' questions and the witnesses' responses.

4. **Final preparations** -In preparing the outline and supporting arguments for your Summation, please keep in mind the limited attention span of many arbitrators. He or she will probably utilize your Summation to reinforce his or her conclusions. Therefore, keep your Summation as brief as possible; stress as few issues as possible; highlight only the most crucial testimony; focus on only a handful of exhibits; and, explain damage calculations clearly and simply. Subtleties in Summations are lost on arbitrators, who, for the most part, view the issues in more general terms.

5. **Form Should Fit Function** – The late architect Frank Lloyd Wright was known for designing the form of his buildings to fit their functions, to be part of the larger environment and to make statements in a simple yet effective way. The single question you want the arbitrators to focus on is: ``Why should you win?" Dispense with conclusory overviews and words like incredible, ridiculous, unbelievable or absurd. Arbitrators are looking to hear the most important specifics (and there rarely are that many) and an explanation of where the pieces fit in the puzzle.

6. **Finish With Flare** - Raise your voice, lower your voice, change your pace, make - and keep - eye contact, hold up the smoking gun exhibit, point to the relevant entry, write out the math on the damage claim, recalculate step by step the error you caught in your adversary's calculations, keep their attention, use simple analogies, and respect the fact that, unlike your role as the advocate, the arbitrators have been hearing the proof with impartiality.

7. **Remember Your Arbitrators** - If an arbitrator asked specific questions of witnesses, it usually indicates an area of importance to that arbitrator. Deal with those issues in your Summation. If a witness gives a strong, credible response to a particular arbitrator's question, quote that testimony and look directly at the arbitrator who asked the question while you are reading a brief portion of the record.

8. **Your Knowledge of the Record is Critical** - You simply cannot rely on the Panel to take detailed notes or listen to the NASD tapes or read transcripts. You be their Reader's Digest.

9. **Interruptions** – As Claimant's counsel, you sum-up last. If you believe opposing counsel will interrupt you, at the outset of your Summation tell the Panel that counsel has had the advantage of speaking first for some time and you have had to listen patiently. Tell the arbitrators that even though on many occasions you wanted to jump up and say that is not the way it happened, or that the testimony opposing counsel is relying on is patently false, you did not do that because it would have been improper. Then turn to opposing counsel and state that you hope he will afford you that same respect and not interrupt your closing. It may sound a little arrogant, but sometimes it is necessary.

10. **Damages** - Try to get all of your damage calculations on one page, in summary fashion. Then hand the page out as a worksheet for the arbitrators' deliberations. While you will feel strongly about your proven damages, give serious thought to presenting alternative damage calculations. You should advise the arbitrators that while you believe the customer is entitled to everything he has asked for, in the event they want to compare the customer's losses to other measures, tell them you have prepared an alternative (lower) damage computation available for consideration.

Conclusion

A final thought: In your Statement of Claim, Opening Statement and Summation, you want to keep the arbitrators interested and attentive since they will be more prone to issue larger Awards. You are putting on a serious drama. There must be coherency to all aspects of your presentation, from beginning to end. The three bookends, if well-articulated, will give you the advantage in a climate where substantial customer wins in contested cases are getting harder to achieve.

The Broker's Duty to Monitor Accounts and Recommend Protective Measures: Is There an Industry Standard?

by Jay H. Salamon and Anthony J. Hartman

Mr. Salamon and Mr. Hartman are partners in the Cleveland, Ohio law firm of Hermann, Cahn & Schneider. They decided in 2000 to devote their practice exclusively to the representation of investors after having spent decades representing major broker-dealers. They can be reached by telephone at 216.781.5515 and by e-mail at jsalamon@hcsattys.com and ahartman@hcsattys.com.Their website is www.stockmarketloss.com.

In seeking to advance negligence or fiduciary duty claims against a registered representative and broker-dealer, it is necessary to apprise the arbitrators of the standard of care applicable to stockbrokers in a variety of circumstances. Sometimes this is easy. For example, if you want to prove that a broker has the duty to make a suitable recommendation to buy or sell a security, your expert can simply point to NASD Conduct Rule 2310 as a basis for his or her opinion.

But what if you want to prove that the broker had a duty to take care of the customer's interests during periods between purchases and sales? Perhaps the gist of your case is that the broker should have monitored your client's account on an ongoing basis and made recommendations to sell certain stocks or to reallocate the portfolio in the face of the client's changing needs or objectives. Or perhaps you wish to argue that the broker had an obligation to recommend protective measures in the event of changing economic or financial conditions affecting a specific issuer, a market sector, or the market as a whole.

Obviously, your expert can testify that these duties exist, relying on his or her learning and experience. And the opposing expert can testify otherwise, citing his or her own contrary learning and experience. But unlike the case in which an unsuitable recommendation is at issue, the rules of the NASD and NYSE do not explicitly provide any prohibition against passivity and inaction by a broker. Indeed, respondents can and often do cite case law to the effect that a broker's responsibility to the customer in a non-discretionary account ceases entirely when the transaction is completed.[1]

It would be very convenient to have a concise, formal statement from the brokerage industry declaring that a broker's obligation to protect the customer's interests does not come to a halt once a transaction is completed, but instead is ongoing. It would be even more advantageous if such a statement established that it is a critical function of even an entry-level registered representative to both monitor the customer's portfolio and to make recommendations consistent with changes in either economic and financial conditions or the customer's needs and objectives. But the brokerage industry would never publicly utter such things, would it? Surprisingly, it would and it has. The statements exist in the form of a document entitled the "Content Outline for the General Securities Registered Representative Examination (Test Series 7)," and can readily be obtained from the NYSE web site at www.nyse.com/pdfs/series7.pdf.

Although a few PIABA members seem to know about and make use of the declarations in the Content Outline, it is the authors' observation that the great majority of practitioners and experts remain unaware of them or have failed to recognize their significance. But the Content Outline, together with certain SEC releases discussed below, constitutes at least one explicit source for the delineation of a standard of care applicable to all registered representatives.

Page 1 of the Content Outline contains a section captioned

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[1] e.g., *Lieb v. Merrill Lynch, Pierce, Fencer & Smith Inc.*, 461 F.Supp. 951 (E.D. Mich. 1981) aff'd 647 F.2d 165 (6th

"Development and Nature of the Series 7 Exam." It states:

> "A committee of RRs and professionals who supervise or train RRs identified and described seven critical functions performed by RRs.
>
> Under each critical function, the committee then determined the specific job tasks that the RR performs. This process is designed to ensure that all topics tested in the Series 7 Examination are relevant to the RR's responsibilities. To further ensure and sustain the job relevance of the examination, industry committees of experienced RRs and RR trainers or supervisors write and review all questions."

(Emphasis added). The following is the seventh of the "Critical Functions and Tasks of the Registered Representative" listed on page 3 of the Content Outline:

> 7) Monitors the customer's portfolio and makes recommendations consistent with changes in economic and financial conditions as well as the customer's needs and objectives.
>
> 7-1) Routinely reviews the customer's account to ensure that investments continue to be suitable.
>
> 7-2) Suggests to the customer which securities to acquire, liquidate, hold, or hedge.
>
> 7-3) Explains how news about an issuer's financial outlook may affect the performance of that issuer's securities.
>
> 7-4) Determines which sources would best answer a customer's questions concerning investments and uses information from appropriate sources to provide the customer with relevant information.
>
> 7-5) Keeps the customer informed about the customer's investments.

The above statements regarding the critical functions of a broker to monitor and make recommendations, including recommendations to sell, is evidence that could be highly persuasive to arbitrators. And the most striking thing about this unambiguous delineation of duties is that it is evidence created and published by the securities industry itself.

Industry representatives almost certainly would deny that the Content Outline's list of the seven critical functions constitutes an industry standard. If a registered representative respondent were confronted in arbitration with the Series 7 Content Outline, he or she might scoff that the registration exam is nothing more than a technical licensing requirement and that an outline of a registration exam is not reflective of any industry standard. In order to show otherwise, one must be prepared to demonstrate why the test exists and how the list of seven critical functions came into existence.

Initially, it is crucial to note that the Series 7 exam is not a mere technical hurdle to be jumped by aspiring securities salesmen. The test was designed solely to protect investors. Any doubt about that is put to rest in the first paragraph of the Content Outline:

> The Series 7 Examination is the *Qualification Examination for General Securities Registered Representatives*. As a qualification examination, it is intended to safeguard the investing public by helping to ensure that registered representatives are competent to perform their jobs. Given this purpose, the Series 7 Examination seeks to measure accurately and reliably the degree to which each candidate possesses the knowledge, skills and abilities needed to perform the critical functions of a registered representative (RR).

In light of the above declaration that the qualification examination is designed to safeguard the investing public, it seems perfectly appropriate to suggest to arbitrators that aspects of the exam and related materials are relevant to arguments about industry standards. It seems all the more appropriate when one considers how the "seven critical functions" listed in the Content Outline came to be identified.

The background to the pronouncement is provided not only in the above-quoted language from the section "Development and Nature of the Series 7 Exam" on page 1 of the Content Outline, but also in orders issued by the Securities Exchange Commission. These 1994 and 1995 releases announced the Commission's approval of NYSE and NASD requests to revamp the Content Outline.[2]

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[2]Also, while beyond the scope of this discussion, the statement in 7-2 that it is part of the broker's function to suggest a hedge is helpful to claimants' counsel seeking to argue that a broker has a duty to recommended protective measures to clients with concentrated stock positions. *See* French, James, *Expert's Forum - The Failure to Recommend Hedge Strategies as a Basis of Stockbroker Liability*, PIABA BAR Journal: Vol. 9, No. 1 (Spring 2002).

In the release approving the NASD's request, under the heading "II. Self-Regulatory Organization's Statement of the Purpose of and Statutory Basis for the Proposed Rule Change," the Commission explains where the "seven critical functions" came from:

> The Series 7 examination was created in 1974 as an industry-wide qualification examination for persons seeking registration as general securities representatives. [*3] The Series 7 examination is required under rules of the SROs for persons who are engaged in the solicitation, purchase and/or sale of securities for the accounts of customers. The purpose of the Series 7 examination is to ensure that registered representatives have the basic knowledge necessary to perform their functions and responsibilities. The Series 7 exam specifications detail the areas covered by the examination and break down the number of examination questions drawn from each area. The Series 7 content outline details the subject coverage and question allocation of the examination.

Revision of the Series 7 examination, specifications and *content outline* was initiated in April 1993 *by an industry committee of self-regulatory organizations and broker-dealer representatives* in order to update the examination in view of changes in the securities industry including changes in relevant rules and regulations, the development of new securities products and changes in the job of the registered representative as firms offer an increasingly wide range of financial services. The specifications and content outline for the Series 7 examination have not been revised since 1986. *The industry committee updated the existing statements of the critical functions of registered representatives to ensure current relevance and appropriateness, drafted statements of tasks expected to be performed by entry-level registered representatives, and conformed the existing content outline to the task statements.* The content outline reflects the revised content of the examination.

(Emphasis added).

The above language reveals that the seven critical functions and the related tasks expected to be performed by entry-level brokers were conceived by "an industry committee of self-regulatory organizations and broker-dealer representatives." In contrast to that somewhat terse description of the committee, a more expansive description can be found in footnote 3 to the Commission's earlier release approving the NYSE's request for revisions:

> "SROs on the committee include the New York, American, and Philadelphia Stock Exchanges, Chicago Board Options Exchange, the Municipal Securities Rulemaking Board, and the National Association of Securities Dealers. Broker-dealer representatives include branch office managers, compliance officers, training personnel and registered representatives."

It seems clear from the above that the seven critical functions of a registered representative as set forth in the Content Outline are functions delineated by the securities industry alone, through the efforts of a panel drawn not only from SROs, but also substantially from the ranks of broker-dealers.

It would be extremely beneficial in a case against, for example, Merrill Lynch to be able to argue that Mr. X from Merrill Lynch served on the committee that isolated and pronounced these seven critical functions. Likewise, it would be fascinating to read committee minutes, transcripts, or other items that might further elucidate the process by which these functions were identified.

Unfortunately, the authors' initial request for copies of these committee materials, including an item as basic as a list of committee members, has been refused by the New York Stock Exchange. The Director of Testing Standards for the NYSE has cited privacy concerns as the ostensible reason for withholding the information, a justification that seems untenable given the very public nature of the committee's conclusions and the fact that the NYSE as a self-regulatory organization should be inclined to release information beneficial to the investing public, rather than to presumptively cloak it with confidentiality. The authors will continue their efforts to obtain the information, whether from the NYSE or other available sources, and solicit the suggestions or collaborative efforts of PIABA members.

Nevertheless, even without access to the identities of committee members or other underlying information, it seems clear that the Content Outline and SEC releases present a strong basis for arguing that industry standards require brokers to do more than merely be forthcoming and diligent at the time of a transaction. An "industry committee of self-regulatory organizations and broker-dealer representatives" has declared that it is a critical function of even an entry-level registered representative to monitor the customer's account on an ongoing basis and, as market conditions or client needs change, to make recommendations necessary for securing the customer's interests. Arbitrators should be interested to hear that.

A Summary of the Rules of Evidence: Essential Tools for Survival Both in Court and in Arbitration

by Vincent DiCarlo

Piaban Vincent DiCarlo is a former staff lawyer for the Division of Enforcement of the SEC who began his legal career prosecuting criminal cases in Brooklyn, New York. His websites at www.dicarlolaw.com and www.investorrecovery.com contain information for both lawyers and investors. He can be reached at 916.444.4459.

I. Introduction.

The rules of evidence are relevant to Piabans for two reasons. First, some of our cases will be tried in a court where these rules are mandatory. Second, even though the rules of evidence are not mandatory in NASD or other industry arbitrations, most of our panels include one or more lawyers. The chair is usually one of these lawyers. Therefore, our panels often either apply the rules of evidence or look to them for guidance about what to hear and what to exclude. It is therefore essential to understand these rules even in arbitrations.

I cover below both the federal and California rules of evidence. Other state rules will vary in some particulars, but the main concepts here will apply in most U.S. jurisdictions.

I can only cover the entire law of evidence in this short space by a ruthless process of selection and compression. What I will cover can best be thought of as that essential kernel of the law of evidence that the trial lawyer must carry in his head.

Such a short summary would be impossible but for two important facts. First, all of you have studied the law of evidence before, either in a course on evidence or in preparation for the bar exam. Accordingly, most of the rules presented will already be familiar to you. What I will do here is to try to review, organize, and reinforce that law so that you can apply it with confidence when you need it.

Second, most of the rules of evidence need not be covered here because they are either so obvious that you already know all you need to know about them or they apply only in limited circumstances. For example, we would surely be wasting our time if we indulged in an extended discussion of the rule that evidence should be construed to achieve the ends of justice, and others like it. This and many other rules only state the obvious and will not be covered here. Rules that apply only in limited circumstances include ones like those relating to the scope of cross examination of a plaintiff in a case of sexual assault, a juror's incompetence to impeach his own verdict, and the proof of valuation of property. Evid. Code §§ 781, 1150, 810 et seq.; Fed. Rules Evid. 412, 606. You do not need to know those special rules unless you get a case where they apply. When that happens, it will be time enough to study them.

What is left after you eliminate all the rules that are obvious and all those that have only limited application are the rules that are used every day in ordinary cases and that are not trivial or obvious. They are used every day in courtrooms, and therefore they are the rules that will be most familiar to your panelists and that they are most likely to apply instinctively even to your arbitrations.

I recommend that you take the time to read whatever codification of the rules of evidence applies in your state. However, if you master the material below, I think that you will have an analytic framework that will allow you to read such a codification easily and with understanding.

II. The Four Types of Evidence.

There are four traditional types of evidence: real, demonstrative, documentary, and testimonial. Some rules of evidence apply to all four types and some apply only to some or one of them. First, we will cover general rules of admissibility that apply to all evidence. Then, we will cover foundational rules that relate to specific kinds of evidence.

Finally, we will cover some special topics, like the form of examination, the hearsay rule, and the lay opinion rule, that frequently cause problems in the courtroom.

III. General Rules of Admissibility.

The basic prerequisites of admissibility are relevance, materiality, and competence. In general, if evidence is shown to be relevant, material, and competent, and is not barred by an exclusionary rule, it is admissible. Evid. Code § 351; Fed. Rules Evid. 402.

Evidence is relevant when it has any tendency in reason to make the fact that it is offered to prove or disprove either more or less probable. Evid. Code § 210; Fed. Rules Evid. 401. To be relevant, a particular item of evidence need not make the fact for which it is offered certain, or even more probable than not. All that is required is that it have some tendency to increase the likelihood of the fact for which it is offered. Weighing the evidence is for the finder of fact, and although a particular piece of evidence, standing by itself, may be weak, it will be admitted unless it is otherwise incompetent or it runs afoul of an exclusionary rule. For example, if the fact to be proved is that the defendant bit off the plaintiff's nose in a fight, testimony by an eyewitness to the act would clearly be relevant, but so would testimony by a witness who heard the plaintiff and the defendant exchange angry words on the day before the fight, or even testimony by a witness who sold the defendant a disinfectant mouthwash shortly afterwards.

Evidence is material if it is offered to prove a fact that is at issue in the case. For example, if I offer the testimony of an eyewitness to prove that it was raining on the day of the signing of a contract, that evidence may be relevant to prove the fact for which it is offered, yet the fact that it was or was not raining may be immaterial to any of the issues in the case, which may turn entirely on whether one or both parties breached the contract.

The issues in the case are determined by the pleadings, any formal stipulations or admissions, and the applicable law. For example, if, in a case of breach of contract, the defendant has conceded that the plaintiff performed all his covenants, proof of that performance would no longer be material unless it were relevant to some other issue. Under both the California and federal rules, the concept of materiality is included in the concept of relevance. Evid. Code § 210; Fed. Rules Evid. 410.

Evidence is competent if the proof that is being offered meets certain traditional requirements of reliability. The preliminary showing that the evidence meets those tests, and any other prerequisites of admissibility, is called the foundational evidence. Evid. Code § 402, 403. When an objection is made that an answer to a question, a document, or a thing lacks a proper foundation, what the objector is really saying is that a showing of competence, or of another prerequisite of admissibility, has not yet been made. The modern trend in the law is to diminish the importance of the rules of competence by turning them into considerations of weight. See, e.g., Evid. Code § 700; Fed. Rules Evid. 601. The question of competence will be considered below for each category of evidence.

In general, if competent evidence is offered to prove a relevant and material fact, it is admissible even if it would have been improper to receive it for another purpose. Evid. Code § 355. For example, while evidence of prior bad acts is generally not admissible to show that a person acted similarly in the present case, it may be admissible to show motive, plan, intent, or lack of mistake or, in federal court, to impeach a witness's credibility. Evid. Code § 1101(b); Fed. Rules Evid. 404(b). When evidence is received for a limited purpose, the party who thinks a jury may make improper use of that evidence is entitled, upon his request, to a limiting instruction. Evid. Code § 355.

However, where the value of evidence for its proper purpose is slight and the likelihood that it will be used for an improper purpose by a finder of fact is great, a court may, in its discretion, exclude the evidence even though it would otherwise be admissible. Evid. Code § 352; Fed. Rules Evid. 403. In this situation, the probative value of the evidence is said to be outweighed by its prejudicial effect.

Prejudice means improper harm. The fact that evidence may be extremely harmful to one party's case does not necessarily make it prejudicial. Courts also have discretion to exclude otherwise admissible evidence to prevent confusion, delay, waste of time, or the needless presentation of cumulative evidence. Evid. Code § 352; Fed. Rules Evid. 403.

IV. Real Evidence.

Real evidence is a thing the existence or characteristics of which are relevant and material. It is usually a thing that was directly involved in some event in the case. The written contract upon which an action is based is real evidence both to prove its terms and that it was executed by the defendant. If it is written in a faltering and unsteady hand, it may also be relevant to show that the writer was under duress at the time of its execution. The bloody bloomers, the murder weapon, a crumpled automobile, the scene of an accident--all may be real evidence.

To be admissible, real evidence, like all evidence, must be relevant, material, and competent. Establishing these basic prerequisites, and any other special ones that may apply, is called laying a foundation. The relevance and materiality of real evidence are usually obvious. Its competence is established by showing that it really is what it is supposed to be. Proving that real or other evidence is what it purports to be is called authentication. Evid. Code § 1400; Fed. Rules Evid. 901.

Real evidence may be authenticated in three ways--by identification of a unique object, by identification of an object that has been made unique, and by establishing a chain of custody. You only have to be able to use one of these ways, though it is prudent to prepare to use an alternate method in case the court is not satisfied with the one you have chosen.

The easiest and usually the least troublesome way to authenticate real evidence is by the testimony of a witness who can identify a unique object in court. For example, the curator of a museum may be able to testify that he is familiar with, say, Picasso's "Dames de Avignon" and that what has been marked as exhibit so-and-so is in fact that seminal work. It is important to remember, however, that many more mundane objects may be amenable to this kind of identification. A unique contract, or one that has been signed, may be authenticated by a person who is familiar with the document or its signatures. A ring may have an inscription by which it can be identified. Even a manufactured object, like a wallet, may be identifiable by its owner after years of use have given it a unique personality.

The second method--identification in court of an object that has been made unique, is extremely useful since it sometimes allows a lawyer or client to avoid the pitfalls of proving a chain of custody by exercising some forethought. If a witness who can establish an object's relevance to the case marks it with his signature, initials, or another mark that will allow him to testify that he can tell it from all other objects of its kind, that witness will be allowed to identify the object in court and thus to authenticate it. Often, if a member of the lawyer's staff or another person early in the chain of custody marks the evidence, big problems can be avoided if a later link in the chain turns out to be missing.

The third and least desirable way to authenticate real evidence is by establishing a chain of custody. Establishing a chain of custody requires that the whereabouts of the evidence at all times since the evidence was involved in the events at issue be established by competent testimony.

The proponent of the evidence must also establish that the object, in relevant respects, has not changed or been altered between the events and the trial. This can sometimes be a tall order, or can require the testimony of several witnesses. If there is any time from the events in question to the day of trial during which the location of the item cannot be accounted for, the chain is broken. In that case, the evidence will be excluded unless another method of authentication can be used.

V. Demonstrative Evidence.

Demonstrative evidence is just what the name implies--it demonstrates or illustrates the testimony of a witness. It will be admissible when, with accuracy sufficient for the task at hand, it fairly and accurately reflects that testimony and is otherwise unobjectionable. Typical examples of demonstrative evidence are maps, diagrams of the scene of an occurrence, animations, and the like. Because its purpose is to illustrate testimony, demonstrative evidence is authenticated by the witness whose testimony is being illustrated. That witness will usually identify salient features of the exhibit and testify that it fairly and accurately reflects what he saw or heard on a particular occasion, such as the location of people or things on a diagram.

For some time in California, there was a controversy over whether photographs were only demonstrative in nature or whether they had evidentiary value independent of the testimony of the witness who authenticated them. This problem was particularly pressing when there was no witness who could confirm what the camera saw as, for example, where crucial identifying photographs were taken by automatic cameras.

Fortunately, the courts in this state seem to have reached the only sensible solution, which is that photographs can be either real or demonstrative evidence depending on how they are authenticated. When a photograph is authenticated by a witness who observed what is depicted in it and can testify that it accurately reflects what he saw, the photograph is demonstrative evidence. When it is authenticated by a technician or other witness who testifies about the operation of the equipment used to take it, it is real evidence and is, in the language of the courts, a "silent witness."

VI. Documentary Evidence.

Documentary evidence is often a kind of real evidence, as for example where a contract is offered to prove its terms. When a document is used this way it is authenticated the same way as any other real evidence--by a witness who identifies it or, less commonly, by witnesses who establish a chain of custody for it. However, because they contain human language, and because of the historical development of the common law, documents present special problems not presented by other forms of real evidence, such as when they contain hearsay.

When dealing with documentary evidence, it is a good idea to ask yourself four questions:

1. Is there a parol evidence problem?

2. Is there a best evidence problem?

3. Is there an authentication problem?

4. Is there a hearsay problem?

The parol evidence rule, which bars the admission of extrinsic evidence to vary the terms of a written agreement, is usually considered a matter of substantive law, not of rule of evidence. Accordingly, we will not deal with it here.

As has been noted above, documents can be authenticated the same way as any other real evidence. Evid. Code § 1400, 1401, 1410-1416. Material alterations must be accounted for. Evid. Code § 1402. There are also specifically approved methods of authenticating documents listed in the Evidence Code, including the submission to the finder of fact of a known exemplar of a signature for comparison with the signature on a disputed document, Evid. Code § 1417, authentication by evidence of a reply, Evid. Code § 1420, and authentication by content, Evid. Code § 1421.

In addition, some documents, such as certified copies of public records, official documents, newspapers, periodicals, trade inscriptions, acknowledged documents to prove the acknowledgment, certificates of the custodians of business records, and certain commercial paper and related documents are, to one extent or another, self authenticating under either California law or the federal rules. Evid. Code § 1450 et seq., 1530 et seq., 1562; Fed. Rules Evid. 901, 902.

We will cover the hearsay rule as a separate topic.

The best evidence rule provides that, where a writing is offered in evidence, a copy or other secondary evidence of its content will not be received in place of the original document unless an adequate explanation is offered for the absence of the original. Evid. Code § 1500 et seq.; Fed. Rules Evid. 1002. In California, testimonial and other secondary evidence of the document's content is also generally forbidden. Evid. Code §§ 1500, 1508.

The best evidence rule arose during the days when a copy was usually made by a clerk or, worse, a party to the lawsuit. Courts generally assumed that, if the original was not produced, there was a good chance of either a scrivener's error or fraud. Now that "copy" usually means "photocopy," the chance of a copy being in error, as opposed to simply illegible, is slight. In addition, courts are reluctant to require needless effort and delay where there is no dispute about the fairness and adequacy of a photocopy.

Accordingly, both California law and the federal rules allow the use of mechanically produced duplicates unless a party has raised a genuine question about the accuracy of the copy or can show that its use would be unfair. Evid. Code §§ 1500 et seq.; Fed. Rules Evid. 1003. However, there is always a danger of a party questioning a document, so it is important to remember that, unless you have a stipulation to the contrary, or your document fits one of the exceptions listed in the statute, you must be ready to produce originals of any documents involved in your case or to produce evidence of why you can't.

Under both California law and the federal rules, compilations or summaries of voluminous records may be received where the originals are available for examination by the other parties. Evid. Code § 1509.

VII. Testimonial Evidence.

Testimonial evidence is the most basic form of evidence and the only kind that does not usually require another form of evidence as a prerequisite for its admissibility. See Evid. Code § 702(b); Fed R. Evid. 602. It consists of what is said in the court at the proceeding in question by a competent witness.

In general, a witness is competent if he meets four requirements:

1. He must, with understanding, take the oath or a substitute. Evid. Code §§ 710, 701; Fed. Rules Evid. 603.

2. He must have personal knowledge about the subject of testimony. In other words, the witness must have perceived something with his senses that

is relevant to the case. Evid. Code § 702; Fed. Rules Evid. 602.

3. He must remember what he perceived.

4. He must be able to communicate what he perceived. Evid. Code § 701(a)(1).

There are other rules of competence that relate to special circumstances, such as the rule that a juror is generally incompetent to impeach his own verdict or that, at least in federal court, a judge is not competent to testify in a trial over which he is presiding, but these and other rules like them rarely come up in practice. Evid. Code §§ 1150, 703; Fed. Rules Evid. 606, 605.

In addition, in keeping with the modern trend to view issues that were previously thought to involve questions of competence, which could result in the exclusion of evidence, as presenting instead questions of weight for the finder of fact to evaluate, the rules of competence are very liberally construed and will rarely result in the exclusion of evidence. For example, the requirement that a witness take the oath or a substitute permits virtually any kind of affirmation by which the witness, in effect, promises to tell the truth. Evid. Code § 165. The "understanding" of the oath or affirmation that is required can be that of a small child or mentally disabled person. Evid. Code § 701, 710; People v. McIntyre (1967) 256 Cal.App.2d 894, 898; 64 Cal. Rptr. 530, 533. The communication that is required may be in writing or through an interpreter, whether of spoken or of sign language. Evid. Code § 701, 752, 754; Fed. Rules Evid. 604. In addition, deficiencies in knowledge generally affect only weight, so long as the witness perceived something relevant.

Even if a witness forgets what he is supposed to be testifying about, the law allows you to supplement his memory in at least four ways. First, you can ask for a recess so that the witness can walk around and calm his nerves. Second, you can ask a leading question to try to refresh his recollection. This is an exception to the usual rule against the use of leading questions during direct examination.

Third, you can attempt to refresh the witness's recollection in another way. This method is commonly called "past recollection refreshed." Before you can try to refresh the witness's memory he must say that he can't remember the fact you are trying to elicit. Then he must say that the refreshing object might help him remember. Anything that the witness says might help him may be used--his own notes, notes or documents prepared by others, a videotape of events, the smell of a decedent's perfume, a sno-cone, or a recording of the Beach Boys singing "Surf City USA."

If the memory refresher is a writing, it must be provided to opposing counsel. This is true whether the witness looks at it on the stand or before he testifies, as for example, during preparation by counsel. In California, the unexcused failure to produce writings that have been used by a witness to refresh his memory will result in his testimony being stricken! Evid. Code § 771. The witness is permitted to look at, smell, listen to, touch, or taste the memory refresher. When he is done, you withdraw it from him and ask whether he can now remember the fact you are interested in. If, after all this, the witness remembers what you are after, he is permitted to answer. Fed. Rules Evid. 612.

The memory refreshing thing is not evidence and cannot be received as such, though it must be made available to the opposing party and may be used by him for cross examination or for any other proper purpose, including the introduction of portions of it that relate to the witness's testimony. Fed. Rules Evid. 612. With present recollection refreshed, it is the answer of the witness, after his memory has been refreshed, that is evidence. Of course, your adversary may comment on the frailty of your witness's memory when he argues about the weight to be attached to the testimony.

Even if your efforts to fan the embers of memory with memory refreshers fail to produce a flame, there is still hope. If the witness has previously recorded, directed the recording of, or verified the accuracy of a writing or other portrayal of the fact you are interested in, you can use the fourth method of aiding or supplementing his memory by offering the writing as a past recollection recorded. Evid. Code § 1237. First, the witness must say that he no longer remembers the fact. Then you try to refresh the witness's memory with the writing or other recording you intend to use. If you can refresh the witness's memory, he will be permitted to answer the question. If the writing fails to refresh the witness's memory, he must identify it as one that he made or saw when he did remember the fact in question and that he knew then that the writing was accurate. Evid. Code § 1237. With past recollection recorded, the witness never answers the question and the writing is the evidence.

Because it is an out of court statement that is offered to prove the truth of its content, a past recollection recorded is hearsay. However, it is admissible under its own exception to the hearsay rule. Evid. Code § 1237(a); Fed. Rules

Evid. 803(5). In addition, like any other documentary evidence, a past recollection recorded must meet the requirements of the best evidence rule. Unlike other documentary evidence, while a past recollection recorded may be read into the record, it may not be shown to the jurors or taken with them when they retire to deliberate. Id.

Bias, interest, prejudice, and other grounds to doubt the credibility of a witness go only to the weight of his testimony and do not affect his competence. In particular, it is not a valid objection to say that a statement by a witness is "self-serving." Presumably, most or all statements by party witnesses are or are intended to be self serving.

VIII. Form of Examination.

On direct examination, you are generally not permitted to ask leading questions. Fed. Rules Evid. 611(c). Direct examination is questioning by the lawyer who calls the witness to testify concerning matters that into which he is the first party to inquire. Evid. Code § 760. A leading question is one that suggests an answer or substitutes the words of the lawyer for those of the witness. These are questions like "You told the defendant that you were relying on him for advice, didn't you?"

Questions that call for an answer of "yes" or "no" are not necessarily leading. For example, most courts would allow you to ask a question like "Did you ever tell the defendant that you wanted the goods?" However, questions that call for a yes or no answer can be leading if they form a pattern that leads the witness through his testimony or reduces the witness to adopting the descriptions of his lawyer. For example, the following is clearly leading:

Q: When you entered the room did you see the defendant there?

A: Yes.

Q: Was he visibly agitated?

A: Yes.

Q: Did you ask him whether he intended to deliver the goods you had ordered?

A: Yes.

Q: Did he tell you that he had no intention of doing so?

A: Yes.

Other cases are not so clear:

Q: When you met the defendant that night, what was his physical condition?

A: He was swaying from side to side.

Q: Did he seem to you to be drunk?

A: Yes.

As you can see, in many ways, leading is a matter of degree, and borderline cases are matters of judgment and within the court's discretion, as is the question of when to allow such leading questions on direct. Most of the time, when an objection is sustained to a leading question, it is not difficult to rephrase the question to make it unobjectionable:

Q: When you saw the defendant that night, was he drunk?

Counsel: Objection. Leading.

Court: Sustained.

Q: What was the defendant's physical condition when you saw him?

A: He was drunk as a skunk.

As this last exchange shows, not only is eliciting testimony with nonleading questions proper, it is also usually more effective to let the witness tell the story if he can.

Leading questions are permitted on direct in several circumstances. We have already discussed the propriety of a leading question to refresh a witness's recollection. Leading questions are also usually permitted in dealing with matters of background, or to direct the witness's attention to a particular time and place or to a particular aspect of a situation. For example, the following should usually be permitted:

Q: Were you at Sloppy Louie's on the evening of the twenty fifth of January?

A: Yes.

Q: Did you see the defendant's car parked outside?

A: Yes.

Q: Was there anyone inside the car?

A: Yes.

Q: Who?

A: The defendant, that dirty rotten skunk.

Counsel: I move to strike everything after "the defendant" as unresponsive, irrelevant, incompetent, immaterial, and prejudicial.

Court: So stricken.

In the example above, while part of the witness's answer was objectionable for other reasons, the questioning would probably not be considered improper, although the first three questions might be considered leading.

Leading questions may be allowed where, in the judge's sound discretion, they will help to elicit the testimony of a witness who, due to tender age, incapacity, or limited intelligence, is having trouble communicating his evidence. Fed. Rules Evid. 611(c). They are also allowed when examining an adverse or hostile witness. Evid. Code § 776; Fed. Rules Evid. 611(c). Witnesses are adverse or hostile when their interests or sympathies are likely to lead them to resist testifying forthrightly or who fall into certain defined categories. Generally, an adverse party or a witness identified with an adverse party is considered hostile for the purposes of this rule. Evid. Code § 776; Fed. Rules Evid. 611(c).

The converse of a leading question is one that calls for a narrative answer. Questions that require a witness to tell a story without responding to specific questions deprive your opponent of the opportunity to interpose an objection before the witness says something that is inadmissible. They often also elicit rambles that waste the time of the court and the parties. The following is an example:

Q: What happened next?

A: Then Smittie told me about how he had seen the defendant attack the plaintiff from behind with a baseball bat.

Counsel: I move to strike that entire answer as hearsay.

Court: So stricken. The jury is instructed to disregard the last answer.

Of course, the damage may already be done.

The problem with the "leading" rule and "narrative" rule is that, if they are both interpreted broadly, they can completely prevent any meaningful examination. This is an area where the advocate must be alert to the judge's preferences.

On cross examination, leading questions are generally permitted and often necessary or desirable. Evid. Code § 767; Fed. Rules Evid. 611(c). Harassment of the witness is not. Evid. Code § 765; Fed. Rules Evid. 611(a).

Cross examination is only permitted to inquire into subjects that were raised upon direct, including credibility. Evid. Code § 761; Fed. Rules Evid. 611(b). If the cross examiner strays into a new area, the judge has the discretion to permit him to do so, in effect permitting him to present part of his case out of turn for the sake of efficiency or other good cause. Evid. Code § 320, 772; Fed. Rules Evid. 611(b). However, for the purposes of eliciting the new matter, the witness is considered to have been adopted by the cross examiner and counsel is therefore required to confine himself to the kind of questioning permitted for direct examination. Id. If, on redirect, the original sponsor of the witness explores the new subjects, he is permitted the same latitude that is allowed in a normal cross examination.

IX. The Lay Opinion Rule.

Witnesses are required to give their answers in the form of statements of what they saw, heard, felt, tasted, or smelled. They are generally forbidden to express opinions or draw conclusions. As anyone who gives this matter any thought soon discovers, this distinction between fact and opinion is not always clear. In addition, many witnesses find it impossible to give their testimony in the required form, and certain perceptions are very difficult to communicate without using language that suggests judgments and opinions. *Osborn v. Mission Ready Mix* (1990) 224 Cal. App.3rd 104, 112-113; 273 Cal Rptr. 457, 461-462. As a result, both California law and the federal rules have substantially relaxed the rule against lay opinions to facilitate the reception of evidence.

In general, a person who is not testifying as an expert will be allowed to testify in the form of an opinion if the opinion is both rationally based on his perception and helpful to an understanding of his testimony. Evid. Code § 800; Fed. Rules Evid. 701. In addition to this general rule, opinions by a competent layperson on certain subjects are specifically permitted by rule, statute, or cases. Some of these are:

1. A person's identity, whether identified by appearance, voice, or otherwise. *Corey v. Corey* (1964) 230 Cal.App.2d 813, 826, 41 Cal.Rptr. 379, 387; Fed. Rules Evid. 901(b)(4)-(6).

2. A person's sanity. Evid. Code § 870.

3. Quantities, such as speed, distance, and size. *Rash v. City and County of San Francisco* (1962) 200 Cal. App.2d 199, 204, 19 Cal.Rptr. 266, 269.

4. Demeanor, mood, or intent. *People v. Deacon* (1953) 117 Cal.App.2d 206, 210, 255 P.2d 98; *People v. Harris* (1969) 270 Cal.App.2d 863, 872, 76 Cal.Rptr. 130, 137 (testimony that a person was "trying" to break up a fight).

5. Intoxication or sobriety. *In re*

Joesph G. (1970) 7 Cal App.3d 695, 704, 764, 87 Cal.Rptr. 25, 31.

6. Physical condition of health, sickness, or injury. *Waite v. Goodfrey* (1980) 106 Cal. App.3d

760, 764, 163 Cal.Rptr. 881, 883.

7. Ownership. *Strauss v. Dubuque Fire & Marine Ins. Co.* (1933) 132 Cal.App. 283, 294, 22 P.2d 582.

8. The value of one's own property. Evid. Code § 813; *Schroeder v. Auto Driveaway Co.* (1974) 11 Cal.3d 908, 921, 114 Cal.Rptr. 622, 630.

9. Identification of handwriting. Evid. Code § 1416; Fed. Rules Evid. 901(b)(2).

Opinion testimony is not objectionable merely because it embraces the ultimate issue to be decided. Evid. Code § 805; Fed. Rules Evid. 704(a). This is true notwithstanding a common misunderstanding to the contrary among some old timers.

Expert opinions have been covered separately in these materials.

X. Accrediting and Discrediting a Witness.

A witness may not be accredited until he has first been impeached. Under both California law and the federal rules, any party may impeach any witness at any time. Evid. Code § 785; Fed. Rules Evid. 607.

A witness's credibility could traditionally be impeached by inquiry into any of nine areas. The first four of these nine areas relate to the requirements of competence. They are:

1. The firmness and sincerity of the witness's belief that any violation of his oath would result in his certain and eternal consignment to the nether regions. This method is probably no longer available. See Fed. Rules Evid. 610.

2. The quality of witness's perception or ability to perceive.

Evid. Code § 780(c)-(d)

3. The witness's ability to remember. Evid. Code § 780(c).

4. The accuracy of the witness's communication of what he perceived. Evid. Code § 780(c). "Isn't it a fact that when you said that you were coerced, all you meant was that my client asked you to do it?"

The cross-examiner may always inquire into these four areas without having any basis whatever for believing that there is any infirmity in the witness's testimony. For example, one could ask a witness "Isn't it a fact that without your glasses you are legally blind?" without having any reason to believe that the witness's eyesight is anything but perfect, though this might not be wise.

In addition, extrinsic evidence, which in these circumstances is evidence other than the answers of the witness whose testimony is being impeached, may always be offered to prove facts relevant to these first four methods of impeachment. Thus, whether or not you ask a witness whether it was too dark for him to see, and whether or not he denies it,
you may call another witness or offer other evidence to show that it was in fact too dark for him to have seen what he says he did.

The other five ways to attack credibility are to attempt to show

1. bias, prejudice, interest, or corruption,
2. criminal convictions,
3. prior bad acts,
4. prior inconsistent statements, or
5. untruthful character.

The first four of these methods require that, before the witness is questioned concerning the relevant facts, counsel have a good faith basis to believe that the facts to be asked about are true. These methods differ with respect to when extrinsic evidence is permitted to prove the facts based upon which the witness's credibility is being attacked.

It is error not to allow inquiry into possible bias, prejudice, interest, or corruption. Evid. Code § 780 (f). In addition, extrinsic evidence of bias is always admissible.

Under the federal rules, a witness may generally be questioned about criminal convictions when the crime was punishable by a sentence of more than a year or involved fraud or false statement. There are other limits relating to the age of the conviction, to a witness who is also the accused in a criminal case, and to juvenile adjudications that you should learn before you attempt to offer such evidence.

In California, a witness may generally be questioned about criminal convictions only if the convictions are for felonies and the witness has not been pardoned for innocence, been granted a certificate of relief from civil disabilities, or obtained other similar relief. Evid. Code § 788. Under both sets of rules, if the witness denies a criminal conviction, it may only be proved by offering a certified record of the conviction.

The federal rules allow questions

about prior bad acts of a witness to impeach credibility where, in the court's discretion, they are probative of truthfulness. Fed. Rules Evid. 608(b). However, if the witness denies the act, it may not be proved by other evidence unless the act to be proved has some relevance to the case that is independent of its bearing on credibility. Under California law, inquiry concerning prior bad acts that have not resulted in a criminal conviction is not permitted to attack the credibility of a witness. Evid. Code § 787.

Questions concerning prior inconsistent statements are permitted under both federal and California law under the following conditions:

1. The questioner must have a good faith basis for believing that the inconsistent statement was made.

2. The witness must be reminded of the time, place, and circumstances of the statement. This requirement is dispensed with in California. Evid. Code § 769.

3. In federal court, if the statement is written, a copy of it must be provided to opposing counsel upon request. Fed. Rules Evid. 613. In state court, counsel is only entitled to a copy if the writing is shown to the witness. Evid. Code §§ 768, 769.

If the witness denies making the inconsistent statement, the federal rules allow other evidence to be offered to prove it if

1. the witness has first had an opportunity to explain or deny it and counsel for the other parties have had an opportunity to ask about it, and

2. the statement is about a fact relevant to a material issue in the case, other than credibility.

Fed. Rules Evid. 613(b). California adds the requirement that the witness not have been excused and therefore be available for further examination. Evid. Code § 770. As has been said, if the prior inconsistent statement is not relevant to a material issue in the case, other than credibility, extrinsic proof of it is not permitted. In that case, the courts say that the proffered proof of the inconsistent statement is "collateral."

The last method of impeachment is to show that the witness has a character of untruthfulness. This is an exception to the general rule that character may not be proved to show action in conformity with it. Evid. Code § 1101(c). There are three possible ways to prove a character of untruthfulness--testimony of specific instances of untruthfulness, the opinion of another witness who knows the target witness concerning his honesty, and testimony concerning the target witness's reputation in the community for truthfulness. The federal rules allow all three methods. Fed. Rules Evid. 405, 608. California allows opinion and reputation evidence but not evidence of specific dishonest acts. Evid. Code § 1100, 786.

After a witness's credibility has been attacked, he may be accredited any of three ways:

1. He may explain any damaging facts.

2. Where the witness's character for truthfulness has been impugned, testimony of another witness concerning his opinion of the honesty of the target witness or of the target witness's reputation in the community for honesty may be offered. Evid. Code § 790; Fed. Rules Evid. 608(a).

3. Where the witness's testimony has been attacked as a recent fabrication, extrinsic evidence may be offered of a prior consistent statement made before there was a motive to lie. Evid. Code § 791(b); Fed. R. 801(d)(1). California also allows the use of such a prior consistent statement where a prior inconsistent statement has been received to attack credibility whenever the consistent statement was made before the allegedly inconsistent statement. Evid. Code § 791(a).

The testimony of witnesses used to impeach the veracity of another witness may be impeached in the same ways as that of other witnesses. In particular, where a witness has offered an opinion of the honesty or reputation for honesty of another witness, the character witness may be asked whether he knew of, or whether his opinion would have been influenced by, knowledge of various alleged misdeeds of the target witness. Fed. Rules Evid. 608.

XI. Character Evidence.

Above we have discussed the impeachment of a witness through another witness who testifies concerning the character for veracity of the first witness. This is an exception to the general rule that evidence of character is not admissible to show action in conformity with it. Evid. Code § 1101; Fed. Rules Evid. 404.

While character cannot be proved to show action on a particular occasion in conformity with it, habit can. Evid. Code § 1105; Fed. Rules Evid. 406. Character is a generalized quality usually attributed to a person, such as truthfulness, violence, drunkenness, and the like. A habit is a specific, regular, and consistently repeated behavior, such as a practice of always locking one's doors. *People v. Charles G.* (1979) 65 Cal.App.3d 62, 66, 156 Cal.Rptr. 832, 834. Of course, some qualities of character can be associated with a habit, such as a tendency to drunkenness with a habit of getting drunk every Saturday night, so this distinction can at times be difficult.

While, in a civil case, character generally cannot be proved to show action on a particular occasion in conformity with it, character may be proved where it is directly in an issue or is put in issue in a particular case. Evid. Code § 1101(b). As we have discussed, a witness's character for veracity is put in issue when he takes the stand. A plaintiff's character or reputation for violence may be an issue in a case of assault where the defendant claims self defense and is trying to show that he was in reasonable fear of harm. A plaintiff's character and reputation may also be in issue in an action for slander or libel where the defendant attempts to show that the plaintiff's reputation was already so bad that he could not have suffered any harm from the disparaging statement. Many other such cases could be cited, but you will know it when you have one.

Character other than character for truthfulness when used to impeach or accredit a witness may be proved in the same ways as is character for truthfulness of a witness, except that California's proscription of proof of specific bad acts when impeaching a witness does not apply to proof of character for other purposes. Evid. Code § 786, 1100. This kind of character witness may be questioned in the same ways as a witness to the character for truthfulness of a witness and he may be impeached in the same ways.

The only exceptions to the rule that character may not be proved to show action in conformity with it, other than the exception for impeaching a witness, relate to criminal cases. The first one is that, in a criminal case, a defendant can call character witnesses to testify that his character was inconsistent with the acts with which he is accused. Evid. Code § 1102; Fed. Rules Evid. 404(a)(1). When a defendant calls such a character witness, he puts his character for the traits about which the character witness testifies in issue. Then, and only then, the prosecutor may offer his own witnesses to the defendant's bad character for the same traits to show that he acted in conformity with that character. Evid. Code § 1102; Fed. Rules Evid. 404(a)(1). A criminal defendant may also offer evidence of the character of a victim of a crime to show action in conformity with it. Evid. Code § 1103; 404(a)(2). When he does so, the prosecutor may respond in kind. Id.

The different kinds of character evidence are a perennial source of confusion, and care must be taken to keep them distinct. The character of truthfulness of any witness, including a criminal defendant, is placed in issue when he testifies, and is received to show action in conformity with it. The character of a criminal defendant or his alleged victim for other traits of character to show action or nonaction in conformity with it is put in issue only when the defendant calls a character witness. The character of other persons can be in issue in a variety of ways, but it cannot be used to show action in conformity with it.

XII. The Rule Against Hearsay.

The rule against hearsay is simply stated, sometimes confusing to apply, and riddled with exceptions. Evid. Code § 1200(b); Fed. Rules Evid. 802. You all know it. Hearsay evidence is evidence of a statement that was made other than by a witness while testifying at the hearing in question and that is offered to prove the truth of the matter stated. Evid. Code § 1200(a); Fed. Rules Evid. 801(c). A statement can be in words or conduct that is intended by the actor as a substitute for words. Evid. Code § 225. The first step in any analysis of possible hearsay is the determination of whether the statement being offered is in fact hearsay. If the statement is not hearsay, the analysis ends. If the statement is hearsay, step two is a determination of whether the hearsay statement fits into one of the exceptions to the hearsay rule.

Since evidence of an out of court statement that is used to prove something other than the truth of its content is not hearsay, whether a statement is hearsay may depend on why it is being offered. If a statement has a possible use as hearsay and another nonhearsay purpose, it is generally admissible subject to a limiting instruction if requested, and subject to the court's discretion to keep it out if the judge believes that its prejudicial effect outweighs its probative value. As a result, the following out of court statements are not hearsay:

1. "Help!" Help is not a statement about a fact, it is a cry for assistance and cannot be either true or false. Whether, even if it were hearsay, it would be subject to the exception for an excited utterance is beside the point.

2. "I accept your offer." This is also not a statement of fact that can be true or false. In, a contract action, the issue would not be whether

these words were true, but whether they were said.

3. "Jonesie is a low down rotten scoundrel." If offered to show that the speaker had a motive to kill Jonesie, rather than to show that Jonesie is in fact a low down rotten scoundrel, evidence of this statement would not be hearsay. If the evidence were offered to prove that Jonesie is a scoundrel, it would be hearsay, and probably also objectionable on other grounds.

Even if a statement is found to be hearsay, it may be admissible under one of the many exceptions to the hearsay rule. The federal rules contain at least 27 explicit ones, depending on how you count. A few of them may be used only when the declarant is unavailable, the remaining 24 are always available. Fed. Rules Evid. 803, 804. In addition, the federal rules arbitrarily define some kinds of hearsay statements as nonhearsay. Fed. Rules Evid. 801(d).

One of the federal exceptions is the well known catchall provision. This provision, which does not require that the declarant be unavailable to testify, says that evidence of a hearsay statement not included in one of the other exceptions may nevertheless be admitted if it has equivalent guarantees of trustworthiness, it is offered to prove a material fact, it is more probative than other reasonably obtainable evidence, its admission would serve the interests of justice, and the other parties have been given notice of its intended use. Fed. Rules Evid. 803(24).

California's evidence code also recognizes many exceptions to the hearsay rule, and many more can be found in the cases. However, while California's appellate courts enjoy the right to recognize new exceptions to the hearsay rule, no catchall provision similar to Federal Rule 803 has ever been recognized.

Obviously, we don't have time to examine the substance of either the federal or state exceptions in detail, but you should at least read their descriptions in the federal rules and the Evidence Code.

In the federal rules, the kinds of statements defined as nonhearsay are:

1. Prior statements by a witness that are inconsistent with his present testimony and that were made under oath.

2. Prior statements by a witness that are consistent with his present testimony and are offered to rebut a charge of recent fabrication. See also Evid. Code § 1236.

3. Statements consisting of an out of court identification of a person. See also Evid. Code § 1238.

4. A statement by a party opponent, or a person authorized to speak for or the party, or an agent of the party concerning a matter within the scope of the agency, or a statement of a coconspirator in furtherance of the conspiracy. Also such a statement made by another when adopted by one of the foregoing. See also Evid. Code §§ 1220-1223. Fed. Rules Evid. 801(d).

The 24 exceptions in the federal rules that do not require a showing that the declarant is unavailable are listed below. Analogous provisions in California's Evidence Code are also noted.

1. Statements about the declarant's present sense impressions. Evid. Code §§ 1250, 1252.

2. Excited utterances or spontaneous statements. Evid. Code § 1240.

3. Statements about the declarant's then existing mental, emotional, or physical condition. Evid. Code §§ 1250, 1252.

4. Statements made by the declarant for the purpose of medical diagnosis or treatment.

5. Past recollections recorded. Evid. Code § 1237.

6. Business records, including those of a public agency. Evid. Code §§ 1271, 1280.

7. Evidence of the absence of a business record or entry. Evid. Code § 1272.

8. Certain public records and reports. Evid. Code §§ 1282, 1283.

9. Records of vital statistics. Evid. Code § 1281.

10. Statements of the absence of a public record or entry. Evid. Code § 1284.

11. Records of religious organizations concerning personal or family history. Evid. Code § 1315 .

12. Marriage, baptismal, and similar certificates. Evid. Code § 1316.

13. Family records concerning family history. Evid. Code § 1312.

14. Recorded documents purporting to affect interests in land. Evid. Code § 1600.

15. Statements in other documents purporting to affect interests in land and relevant to the purpose of the document. Evid. Code § 1330.

16. Statements in authentic ancient documents (at least 20 years old).

Evid. Code § 1331 (at least 30 years old).

17. Market reports, commercial publications, and the like. Evid. Code § 1340.

18. Learned treatises used to question an expert witness.

19. Reputation concerning family history. Evid. Code §§ 1313, 1314.

20. Reputation concerning boundaries or general history. Evid. Code § 1320, 1322.

21. Reputation of a person's character. Evid. Code § 1324.

22. Evidence of a judgment of conviction for certain purposes. Evid. Code § 1300 (felonies only).

23. Judgments of a court concerning personal history, family history, general history, or boundaries, where those matters were essential to the judgment.

24. The catchall rule.

Fed. Rules Evid. 803.

The federal exceptions that do require proof that the declarant is unavailable are:

1. Former testimony of a witness offered against a party where that party, or a predecessor in interest with similar motives, had an opportunity to question the declarant. *See also* Evid. Code §§ 1290, 1291, 1292.

2. Dying declarations. *See also* Evid. Code § 1242.

3. Statements against interest. *See also* Evid. Code § 1224, 1225, 1230.

4. Statements by certain persons of personal or family history. *See also* Evid. Code § 1310, 1311. Fed. Rules Evid. 804.

Most of California's hearsay exceptions are contained in Sections 1220 through 1350 of the Evidence Code. You should read these sections, since even where a similar exception is recognized under both sets of rules there are often differences in the scope of the exceptions. California law does not have exceptions that are as broad as the federal exceptions for learned treatises or as the catchall provision. However, it does have additional exceptions, not explicitly found in the federal rules, for the following:

1. Evidence of a statement by a minor child if offered in certain actions against a person alleged to have injured the child. Evid. Code § 1226, 1228.

2. Evidence of a statement by the deceased in a wrongful death action. Evid. Code § 1227.

3. All prior inconsistent statements of a witness offered in accordance with required procedures. Cal. Evid. § Code 769, 1235.

4. Statements made by the declarant to explain or qualify his conduct and made while he is engaged in the conduct. Evid. Code § 1241.

5. Statements of the declarant's prior mental or physical state, including his intentions, if the declarant is unavailable and that prior mental or physical state is an issue in the suit. Evid. Code § 1251, 1252.

6. Certain statements of a declarant in an action against his estate. Evid. Code § 1261.

7. Judgments determining the liability, obligation, or duty of a third person to prove the existence of that liability, obligation, or duty. Evid. Code § 1302.

8. Statements concerning the family history of another where the declarant is unavailable under certain circumstances. Evid. Code § 1311.

9. Statements concerning boundaries. Evid. Code § 1323.

10. Certain statements in serious felony prosecutions. Evid. Code § 1350.

11. Certain statements by unavailable declarants concerning injuries inflicted on them. Evid. Code § 1350.

Sometimes a lawyer will want to present evidence that consists of multiple levels of hearsay. For example, suppose I want to introduce a patient's hospital file to show that when he was struck by the defendant he began bleeding from the head. The hospital's file, which is what I want to offer, has a note by the staff physician on duty saying that, when the patient came to the emergency room for treatment, he told the staff physician that when he was hit by the defendant he began bleeding profusely from the head. The only live witness I have is a records clerk from the hospital.

My evidence in this case consists of double hearsay. The hospital record is an out of court statement offered to prove the truth of its content--what the patient told the emergency room physician. In addition, even if I could call the physician as a witness, his testimony concerning what the patient told him would also be hearsay, since it would be offered to show that the patient did in fact start bleeding when the defendant hit him. Thus, I have one hearsay declaration--the patient's statement about what happened to him--

wrapped in another hearsay declaration--the doctor's statement about what the patient said.

The analysis for multiple hearsay is simple if it is taken one step at a time. The rule is that, in order for multiple hearsay to be admissible, there must be an exception to the hearsay rule that is applicable to each level of the hearsay. Evid. Code § 1201; Fed. Rules Evid. 805. The best way to start the analysis is to imagine the ultimate eyewitness on the stand. In this case it is the patient. His statement is not hearsay and would be admissible if it is relevant to the case.

Next, imagine the person who forms the next link in the chain of hearsay on the stand. In this case it is the doctor. His testimony would clearly be hearsay. However, the doctor's imaginary testimony about the patient's statement might well be admissible under the excited utterance exception or, in Federal Court, the exception for statements made in aid of medical treatment or, in state court, the exception for statements about the declarant's prior physical condition. Next, imagine offering the medical record that contains the doctor's statement. It may be subject to the hearsay exception for business records and therefore be admissible to prove that the doctor made the statement if a proper foundation is laid through the custodian of records.

Thus, it looks like the medical record comes in to prove that the patient did start to bleed from the head when he was struck. On the other hand, if any level of the hearsay fails to fall within an exception, the proof will not be received. All multiple hearsay problems, no matter how involved, will ultimately yield to the same type of analysis.

The credibility of a hearsay declarant may be attacked in the same ways as that of any witness. Evid. Code § 1202.

XIII. PRIVILEGES.

Evidentiary privileges are rights held by certain persons that allow them either to refuse to provide evidence or to prevent evidence from being offered against them. Privileges are contrary to the general rules that all relevant and competent evidence is admissible and that every citizen has an obligation to give evidence in a judicial proceeding. Evid. Code § 911. Privileges also hinder the basic function of the judicial system, which is the search for truth. Accordingly, privileges only exist to serve important interests and relationships, they are construed narrowly, and new ones are rarely created, at least by the courts.

Since privileges are meant to vindicate a private or public interest in confidentiality, and since they are disfavored, they can be waived by the persons or entities they are meant to protect. The person or persons who can waive the privilege are called "holders" of the privilege. Where more than one person holds a privilege, sometimes the act of only one is required to waive it and sometimes an act of both is required. Evid. Code § 912. In many cases, the nonholder who is a party to a privileged communication is required to assert the privilege on behalf of the holder.

In California, no adverse inference may be drawn from the exercise of a privilege in any kind of case. Evid. Code § 913. In federal courts, an adverse inference may sometimes be drawn in a civil case or administrative proceeding. *Baxter v. Palmigiano* (1976) 425 U.S. 308, 317 96 S. Ct. 1551, 1557. Under federal law, the proponent of the privilege always has the burden of showing that a particular communication was confidential. In California, communications between a lawyer and a client, a physician and a patient, a clergyman and a penitent, and a husband and a wife are presumed confidential, and the opponent of the privilege has the burden of showing that a particular communication was not confidential. Evid. Code § 917.

California's Evidence Code deals with the law of privilege at Sections 900 through 1070. You should at least skim these sections. The privileges explicitly created by statute are the only ones recognized in California and the courts are powerless to create new ones. Evid. Code § 911. The privileges included in the Evidence Code are listed below:

1. The privilege against self-incrimination. Evid. Code § 940 et seq.

2. The attorney-client privilege. This one is held by the client. Evid. Code § 950 et seq.

3. The privilege of a married person not to testify against his spouse. Evid. Code § 970. This one belongs to the spouse called to testify.

4. The privilege for confidential marital communications. Evid. Code § 980 et seq. This one belongs to both spouses.

5. The physician-patient privilege. Evid. Code § 990 et seq. This one belongs to the patient. Evid. Code § 993.

6. The psychotherapist-patient privilege. Evid. Code § 1010 et seq. This one belongs to the patient.

Evid. Code § 1013.

7. The clergyman-penitent privilege. Evid. Code § 1030 et seq. This one belongs to both parties. Evid. Code §§ 1033, 1034.

8. The privilege for sexual assault counseling. Evid. Code § 1035 et seq. This one belongs to both the victim and the counselee. Evid. Code §§ 1035.6, 1035.8.

9. The privilege for domestic violence counseling. Evid. Code § 1037.1. This one belongs to the counselee.

10. The privilege for official information. Evid. Code § 1040 et seq. This one protects official information the disclosure of which is forbidden by law or the disclosure of which is against the public interest because the need to preserve confidentiality outweighs the necessity for disclosure in the interest of justice. Evid. Code § 1040. It belongs to the public entity.

11. The informer's privilege. Evid. Code § 1041. This one belongs to the government but may not be used to prevent the informer from voluntarily revealing his identity. Id.

12. The privilege to protect the secrecy of a vote. Evid. Code § 1050.

13. The privilege to protect a trade secret. Evid. Code § 1060 et seq.

14. The newsman's privilege. Evid. Code § 1070.

Since congress couldn't agree on a codification of privileges when it approved the federal rules, it left this area completely to the federal courts and the states. Under Federal Rule 510, when evidence is offered on a federal claim, the applicable privileges are determined by the federal common law. When the evidence is offered on a state claim, the state's law of privilege is applied. Since the federal law of privilege is still evolving, and since the federal courts are much more hostile to privileges than California's legislature, I recommend that you study the list of California privileges. If a privilege didn't make it there, it probably won't make it in the federal courts. The reverse is not true.

XIV. Presumptions.

There used to be considerable controversy over the effect of presumptions. Some courts held that a presumption went away as soon as evidence on the subject it covered was received. Others treated presumptions like evidence, to be weighed either against the other evidence in the case or against the burden of proof. Luckily, these disagreements have been largely ended by statute in California and by rule in the federal system.

In California, presumptions are either conclusive or rebuttable. Evid. Code § 601. Rebuttable presumptions are of two kinds--those affecting the burden of producing evidence and those affecting the burden of proof. Most presumptions are interpreted to be rebuttable.

A list of the rebuttable presumptions affecting the burden of producing evidence is given starting at Section 631 of the Evidence Code. They include the presumptions that money or property delivered is due to the recipient, that a written obligation that has been surrendered to the debtor has been paid and the reverse, that when a receipt for an installment on a debt is given all previous installments have been paid, that a possessor of a thing is also its owner, that a writing is truly dated, that a letter correctly addressed and properly mailed is received in the ordinary course of mail, that certain ancient documents are authentic, that where the requirements of res ipsa loquitur are met the defendant was negligent, and that the facts stated in the return of a process server are true.

Under California law with respect to rebuttable presumptions affecting the burden of producing evidence, and under the federal rules with respect to all presumptions, unless the statute or rule creating them explicitly says otherwise, a presumption shifts the burden of going forward but not the burden of proof. Fed. Rules Evid. 301. The presumption itself is not considered evidence. Evid. Code § 600(a). However, if no evidence is received to rebut the presumption, the finder of fact must assume the existence of the presumed fact if the existence of the basic fact upon which the presumption depends has been established. Evid. Code § 604.

California also has certain rebuttable presumptions that shift the burden of proof. Cal. Evid. § Code 606. All rebuttable presumptions that are established to implement some public policy other than the correct determination of the issues in the case are put in this category. Cal. Evid. § Code 605, 660. A list of some of the rebuttable presumptions affecting the burden of proof begins at Section 662 of the Evidence Code. They include the presumptions that the legal owner of property is the sole beneficial owner, that a ceremonial marriage is valid, that official duties have been regularly performed, that a person intends the ordinary consequences of his voluntary act, that a court of any state or of the United States whose judgment is being collaterally attacked acted within its jurisdiction, that a person not heard from in five years is dead, that a person doing an unlawful act had an unlawful intent, that a person who causes injury by violating a protective provision of law acted negligently, and that there are proper grounds for the enactment of certain kinds of local ordinances restricting the occupancy of buildings.

Conclusive presumptions are just that--conclusive. A presumption will not be interpreted to be conclusive unless the law creating it specifically says that it is. Evid. Code § 620. A list of the most common conclusive presumptions is given in the Evidence Code starting at Section 621. They include presumptions relating to legitimacy, facts recited in a written instrument, and estoppel.

XV. Judicial Notice and Other Substitutes for Evidence.

The need for evidence on some issues in a case can sometimes be dispensed with by means of formal admissions, stipulations, and judicial notice.

In California, courts must take judicial notice of facts and propositions of generalized knowledge that are so universally known that they cannot be the subject of reasonable dispute. Cal. Evid. § Code 451. Courts may take judicial notice of facts that are not reasonably subject to dispute and that can be immediately and accurately determined by resort to sources of reasonably indisputable accuracy, Evid. Code § 452, and they must do so where a party requests such notice, supplies the court with the necessary materials, and gives sufficient notice to his opponent. Evid. Code § 453.

Likewise, under the federal rules, judicial notice may be taken of adjudicative facts that are not subject to reasonable dispute because they are either generally known or can be accurately and readily determined. Where a party requests such notice and supplies the court with the necessary information, the court must take notice and instruct the jury accordingly. The court may notice eligible facts on its own motion as well. Fed. Rules Evid. 201(c).

In addition, both state and federal courts can take notice of the laws of the states and of the federal system. However, if you need to rely on a local statute or ordinance, a foreign law, or the like, you will need to refer to the specific rules to determine what you must do to prove or obtain judicial notice of their provisions. Evid. Code § 451, 452; Fed. R. Civ. P. 44, 44.1.

Where a fact has been judicially noticed or is the subject of a binding admission or stipulation, the court may, and upon request must, instruct the jury to accept that fact as conclusively established. Evid. Code § 457.

XVI. Making and Opposing Objections.

To preserve the right to appeal based on an adverse ruling, when an objection is made the objector must specify the ground of the objection. Evid. Code § 353; Fed. Rules Evid. 103(a)(1). Only the grounds stated will be reviewed upon any appeal, so if you have more than one ground you need to state them all. This is why so many lawyers start out all their objections with "Objection. Irrelevant, incompetent, immaterial . . . " and so on. In stating the grounds for your objection, it is best to be as specific and concise as possible, citing the number of the applicable statute or rule if you know it, although that is not necessary.

Specifying the ground for your objection is different from arguing your objection. You have no right to argue your objections and should not attempt to do so unless the court permits or invites it. "Objection. Hearsay," is sufficient to preserve your right to appeal based upon the erroneous reception of the hearsay. You also have no right to argue your opposition to objections, though a judge may permit you to do so.

Because of the lack of a right to argue objections, it is important for you to attempt to anticipate significant evidentiary issues and to brief them in a motion in limine, which is submitted to the court at the beginning of the trial. If you raise an evidentiary issue in a motion in limine, you should refer to the motion when the evidence in question comes up, but doing so does not relieve you of the obligation of specifying the grounds of your objection at that time and making an offer of proof if necessary.

If you are offering evidence and an objection is sustained, in order to preserve the exclusion as a possible ground for appeal you must make an offer of proof. Evid. Code § 354; Fed. Rules Evid. 103(a)(2). When the ruling is made, ask the court for an opportunity to make such an offer.

Usually this is done outside the presence of the jury, often at the next break in the testimony. Evid. Code § 402; Fed. Rules Evid. 103(c). Thus, it is important to keep a running list of any such offers you need to make since, if you forget, you will not be able to complain of the ruling on appeal. A proper offer must include a description of the substance, purpose, and relevance of the evidence that you would present if permitted. Evid. Code § 354; Fed. Rules Evid. 103(a)(2).

An offer of proof, can also provide you with a means of mitigate the effect of the rule that you have no right to argue evidentiary rulings. A well formulated offer of proof can sometimes persuade the court that its initial decision to exclude your evidence was incorrect.

XVII. Miscellaneous Other Rules.

A list of other commonly encountered rules follows:

1. Evidence of subsequent remedial measures is not admissible to show previous negligence or culpable conduct. Evid. Code § 1151; Fed. Rules Evid. 407.

2. Evidence of mediation or settlement discussions is not admissible to prove liability for the claims that were being discussed. Evid. Code § 1152, 1152.5; Fed.

Rules Evid. 408. Nor is evidence of the payment of medical expenses to show liability. Fed. Rules Evid. 409. Nor, in California, is evidence of partial satisfaction of any asserted claim to prove the validity of the claim. Evid. Code § 1152. Nor is evidence of a guilty plea that is later withdrawn, nor any statements made in connection with it. Evid. Code § 1153; Fed. Rules Evid. 410.

3. The court may call its own witnesses and may question any witness. Evid. Code § 775; Fed. Rules Evid. 614.

4. When part of an act, declaration, conversation, or writing is given in evidence by one party, such other parts of the act, declaration, conversation, or writing, as are necessary in fairness to a complete understanding of the parts admitted will also be admitted. Evid. Code § 356; Fed. Rules Evid. 106.

XVIII. Conclusion.

While this whirlwind summary of the law of evidence is by no means complete, if you have mastered the concepts it contains and read the materials suggested, you will be able to deal with the vast majority of evidentiary problems that you will encounter both in court and in arbitration and will usually have a good idea when you need to look up a rule or statute or to research the cases. Knowledge of the rules of evidence will enable you to put your proof before the finder of fact and maybe to keep some of your opponent's proof from being received. Confidence in your knowledge of the rules will free you to concentrate on the kind of effective presentation and argument that will help you to win your case.

Select References

1. *Federal Rules of Evidence*. The federal rules are short, and you should read them through, including the notes of the advisory committee and congressional committees.

2. B. Jefferson, *California Evidence Bench Book*. Many judges consider this treatise to be holy writ. You will see it on many of their benches.

3. B. Witkin, *California Evidence*. The other leading treatise on California's law of evidence.

Spreads, Markups, Sales Credits and Trading Costs

Craig McCann, Ph.D., CFA and Richard G. Himelrick, Esq.

© Craig McCann and Richard Himelrick. Dr. McCann of Securities Litigation and Consulting Group in Fairfax, VA was a consultant and testifying expert for the plaintiff class. He may be reached at (703) 830-3893 or craigmccann@investmentdisputes.com. PIABA member, Richard Himelrick of Tiffany & Bosco in Phoenix, AZ was lead counsel for the class. He may be reached at (602) 255-6021 or rhimel@dancris.com.

On May 11, 2001 H&R Block announced the settlement[1] of a 1996 state class action[2] involving sales practices at Olde Discount Corporation. H&R Block had acquired Olde in 1999. After a three week trial, the case settled during jury deliberations for $21 million, which represented a return to investors of over 115% of their out-of-pocket losses. The successful result was in large part accomplished by showing that Olde's advertising fooled investors by using technical industry terms to create misleading impressions.[3]

The class claims centered on deceptive statements in the advertising Olde used to attract business.[4] To prove the falsity of the advertising the meaning of industry terms like spreads, markups, sales credits and trading costs moved center stage. We found the task of explaining these terms challenging, especially in the context of a trial where the other side's experts were spinning the words to defend Olde's advertising. This note examines these industry concepts and the manner in which they affect the prices customers pay. Intermittently we use Olde's advertising to illustrate the discussion.

From April 1993 through 1996 Olde advertised that qualifying trades under its SmartTrade and SmartTrading programs would be done without commissions or markups of any kind. Olde went on to claim in a press release that it absorbed all trading costs on qualified trades. Some of the firm's brochures went so far as to say Olde was executing trades free of charge. Olde reinforced this message of free trading by failing to answer direct customer questions honestly and by representing that the trading it offered under the Smart programs was analogous to banks offering loss leader services. In 1998, two years after the class action was filed, the NASD found that Olde violated its advertising rules[5] by failing to disclose information necessary for the public to evaluate the services Olde described as "commission-free" or "commissionless."[6] Contemporaneously, the SEC found that Olde and some of its registered representatives violated the antifraud provisions of the securities laws by omitting or misrepresenting material information concerning the profits Olde and its registered representatives earned from the "commission-free" or "commissionless" trading.[7]

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[1]http://biz.yahoo.com/prnews/010511/cgf042.html

[2]Sabet v. Olde Discount Corporation, Maricopa County Superior Court Case No. CV 96-17622.

[3]For examples of cases prohibiting such practices see *Madsen v. Western American Mortgage Co.*, 143 Ariz. 614, 618, 694 P.2d 1228, 1232 (App. 1985) ("Technical correctness of the representations is irrelevant if the capacity to mislead is found."); *In re District Business Conduct Committee v. Gene Morgan Financial*, 1995 WL 1093358 *4 (NASDR 1995) (explaining that advertisements by a brokerage firm may be "deceptive and misleading in their overall effect even though when narrowly and literally read, no single statement of a material fact was false." (quotation omitted)).

[4]One of Olde's defenses was that its advertising was not "in connection with" class purchases. *See generally* Francesca Muratori, *The Boundaries of the "In Connection With" Requirement of Rule 10b-5: Should Advertising be Actionable as Securities Fraud*, 56 Bus. Law. 1057 (2001).

[5]NASD Conduct Rule 2210.

[6]The NASD's summary of its findings and the disciplinary sanctions imposed on Olde and its officers are available in its Disciplinary Actions Reported for October 1998, *available at* 1998 WL 1707982 * 19.

[7]*See In re Olde Discount Corp., Ernest Olde, Stanley A. Snider, and Daniel D. Katzman,* SEC Release Nos. 33-7577 & 34-40423, *available at* 1998 WL 575171 (September 10, 1998).

While the class litigation focused on Olde's advertising, our analysis of Olde's market making activities and its compensation practices has implications in a broad range of brokerage disputes. Bid-ask spreads and sales credits create potential conflicts of interests for brokers.[8] The spreads and credits also impose significant trading costs on investors, costs which are usually ignored in casual analyses.[9] In the discussion that follows we explain that the bid-ask spread is a markup and that sales credits are commissions, as those terms are generally understood.

Spreads

In the class litigation a key issue was the truthfulness of Olde's advertised claim that purchasers under its Smart programs could buy stocks "without markups of any kind." The class alleged that the statement was misleading because Olde charged its customers markups in the form of undisclosed spreads. We argued, successfully, that Olde's advertising should be evaluated, not by technical industry definitions, but by the standard of a reasonable investor, i.e., how would a reasonable investor interprets the ads? To show that reasonable investors would view the difference in price between the bid and the ask as a markup, we offered dictionary definitions which commonly define markup as "an amount added to the cost to determine the selling price."[10] On a more intellectual level, we presented an explanation of pricing in the over-the-counter (OTC) market to make our point.

OTC stocks are traded in a dealer market in which firms called market makers or dealers buy from and sell to investors through brokers acting as intermediaries. Both exchange-listed and Nasdaq stocks trade in the OTC market. Market makers generally sell OTC stocks to brokers at prices that have been marked up from the prices at which the market maker is simultaneously buying the same stocks from brokers.

The difference between the prices market makers pay for shares (the "bid") and the higher prices at which they sell shares (the "ask" or "offer") is the market makers' gross profit. The difference is euphemistically known in the industry as the bid-ask spread, or just the "spread." The spread is simply a distribution or inventory markup.[11] It is a cost investors pay for the services market makers provide in creating liquidity so that stocks can be immediately bought and sold regardless of supply and demand.[12]

Market makers control their exposure to market risk by holding only very small inventories; they are said to try to be essentially *flat* at the end of each day. A market maker accumulates an inventory when it receives more sell orders than it receives buy orders. To remain flat, the market maker must either lower its ask price to attract more buy orders or sell shares to another market maker to cover the order imbalance.

Each OTC stock has more than one market maker. Market makers post bid and ask quotes for each OTC stock in which they make a market. For instance, a market maker might offer to buy up to 1,000 shares of ABC at $20 per shares and offer to sell up to 1,000 shares of ABC at $20.75 per share.

The highest bid price and lowest offer price in a security posted by maker makers is known as the National Best Bid or Offer (NBBO) to securities professionals, i.e., securities market makers, brokers and regulators. Continuing the example above, if the only other market maker in ABC has quotes to buy at $20.25 per share and to sell at $21.25 per share, the NBBO are $20.25 bid, $20.75 ask.

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[8]*See, e.g., Chasins v. Smith, Barney & Co., Inc.*, 438 F.2d 1167, 1168-69 (2d Cir. 1971) (holding failure to disclose market maker status a material omission); *In re Scientific Control Corp. Lit.*, 71 F.R.D. 491, 509 (S.D.N.Y. 1976) (finding classwide common issues as to whether nondisclosure of production credits was a material omission); *In re Matthew I. Balk*, NASD Notice to Members of Disciplinary Actions (Oct. 10, 2000), *available at* 2000 WL 1538683 * 9 (sanctioning broker and finding that incentive compensation in the form of special sales credits was a material omission); s*ee also* Norman S. Poser, *Broker-Dealer Law and Regulation* § 2.03[A], at 2-54 to 56 (3d ed. 1999) (discussing conflicts of interest and disclosure duties arising from broker-dealer compensation).

[9]*See, e.g.,* Brad M. Barber and Terrance Odean, *Trading is Hazardous to Your Wealth: The Common Stock Investment Performance of Individual Investors*, 55 Journal of Finance 773 (2000) (documenting the largely ignored performance penalty individual investors pay for active trading and linking it to increased trading costs).

[10]*E.g., Webster's Unabridged Third New International Dictionary of the English Language* (1993).

[11]*See* Harold Demsetz, *The Cost of Transacting*, 34 Quarterly J. of Economics 32, 35-36 (1968).

[12]*Id.*

Securities regulators assess the fairness of retail prices by comparing the prices brokers transact with the public at relative to the NBBO.[13] This practice makes sense if the NBBO is set competitively.[14] In a genuinely competitive market the bid-ask spread is reduced to the level that compensates market makers for the functions they perform, including compensation for the risk they bear in providing liquidity. However, the regulatory structure of the industry and collusion amongst market makers may cause bid-ask spreads to remain significantly larger than necessary to compensate maker makers. In fact, the Department of Justice and the SEC found that market makers colluded to maintain spreads above competitive levels during part of the class period covered in the Olde litigation.[15] Olde was one of the market makers found to have engaged in such collusion.[16]

Market makers are required to execute transactions at prices no worse for the customer than the NBBO. That is, market makers are required to buy shares from brokers at the highest bid price contemporaneously posted by any market maker, and to sell to brokers at the lowest offer price contemporaneously posted by any market maker. In our example, both market makers must buy from brokers at prices no less than $20.25 and sell to brokers at prices no higher than $20.75, even though neither market maker is posting both these quotes.

Because all market makers must transact at the inside quotes.[17] a market maker that reduces it ask price will only get a share – perhaps only a small share – of the increased buy orders generated by the lower ask price. Narrowing the quotes is therefore not an effective method for a market maker to reduce its inventory; market makers layoff inventories by trading with other market makers at, or inside, the quotes.

Markups

Retail brokerage firms are required to buy OTC stocks from the public at a price no lower than the highest market maker bid price less a reasonable additional markdown and are required to sell OTC stocks to the public at a price no higher than the lowest market maker offer price plus a reasonable additional markup.[18]

For instance, when market makers are paying $20.25 per share for stock they buy from brokers, brokers may deduct an additional markdown of, say, $0.50 making the price paid to the retail investors only $19.75. At the same time, brokers may add an additional markup of, say, $0.50 to the $20.75

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[13]NASD Notice to Members 92-16, *Markups/Markdowns in Equity Securities, available at* 1992 WL 1319225. In this context, for expositional purposes regulators sometimes refer to the NBBO as the *prevailing market price*.

[14]*Id.* * at 3 ("an integrated market maker that risks its capital by continuously buying and selling a security in an active, competitive market may look to prices it charges other dealers in actual sale transactions, or validated quotations, as the best evidence of prevailing market price from which to calculate markups and markdowns, as opposed to its contemporaneous cost.").

[15]*See In the Matter of Certain Market Making Activities On Nasdaq*, SEC Release No. 40900, January 11, 1999, *available at* 1998 WL 919673.

[16]*See In the Matter of Certain Market Making Activities On Nasdaq*, SEC Release No. 24-40917, January 11, 1999, *available at* 1998 WL 6692 (sanctioning Olde and three of its traders).

[17] The words "inside quotes," "inside market," "inside bid" and "inside ask" are industry expressions used to identify the highest and lowest prevailing prices. As explained by the SEC,

> The "inside bid" is the highest prevailing bid price in a stock at any given time, while the "inside ask" is the lowest prevailing asked price. Together, the inside bid and inside ask represent the "inside market." The difference between the inside bid and the inside ask is commonly referred to as the "spread" or "inside spread."

In the Matter of Certain Market Making Activities On Nasdaq, SEC Release No. 40900 January 11, 1999, *available at* 1998 WL 919673 *1.

[18]NASD Notice to Members 92-16, *Markups/Markdowns in Equity Securities, available at* 1992 WL 1319225.

per share market makers are charging for sales, making the price paid by retail investors $21.25.[19]

Broker-dealers which perform both the dealer function of a market maker and the retail service function of a brokerage firm are known as integrated broker-dealers. During the class period, Olde acted as an integrated broker-dealer with respect to the stocks on its recommended list. Under Olde's internal rules the only stocks for which the firm's brokers were allowed to solicit orders were stocks on the firm's recommended list, all of which were stocks in which the firm made a market. Through this system Olde insured that its traders always had the opportunity to capture a spread when an order was filled. Most customers, untutored in the intricacies of market making, were oblivious to the firm's profit incentives or the trading cost the spreads imposed.

In our continuing example, an integrated broker-dealer is buying shares from public investors at $19.75 and selling the shares the same day for $21.25. The broker-dealer has clearly marked up the price of the shares it has purchased $1.50 and sold them the same day. Part of this markup is the spread measured by the NBBO and the remainder is the additional markdown and markup from and to the NBBO. In our example, if Olde elected not to charge an additional markdown from the inside bid price or add an additional markup to the inside ask price, it would sell shares it had just bought at $20.25 for $20.75. Still, however, Olde would be charging a $0.50 markup for its services as a market maker. In these circumstances in which a brokerage firm is selling stock acquired at $20.25 for $20.75 it is misleading to advertise, as Olde did, that it sells shares without *a markup of any kind*.[20]

Brokerage firms set the markups (i.e., the difference between the price they charge their customers and the price they pay their customers) with considerable discretion. While the regulatory structure of the industry requires that customers receive a price no worse that the inside bid or offer, brokerage firms occasionally execute trades for customers inside the inside quotes. This is referred to as "price improvement."[21] In our example, if brokerage firms are required to sell to the public at a price no higher than $20.75 plus a reasonable additional markup but can and do occasionally sell shares at $20.50, then it is obvious that the true markup is the difference between the sale price and the price the brokerage firms have just paid public investors for the shares.

Sales Credits

Olde paid its stockbrokers undisclosed "sales credits" to sell its recommended stocks, which the firm called Special Ventures. The sales credits were quoted within the firm as a fraction of the spread and were paid from the traders' profits. The credits were set by the firm's trading department and changed throughout the day. They were displayed on the brokers' computer screens. The traders varied the sales credits so that they could sell off inventory they had accumulated while capturing some of the total markup. Through the credits the traders were able to induce the retail brokers to sell what the traders wanted sold by temporarily giving them (or increasing) sales credits.[22]

At trial the class alleged that Olde's advertised promise of commission-free trading was deceptive because the firm's sales credits were commission-equivalents. Alternatively, the class argued that regardless of whether the credits were commissions, it was misleading not to disclose them. We pointed to the SEC's finding that Olde's differential sales credits created potential conflicts of

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[19]The NASD's rule against excessive markups is often thought to allow additional markups and markdowns of up to 5%. *See id.* 3 (explaining that the 5% benchmark "serves as a guideline, not a rule"). Commissions charged by brokerage firms on trades in exchange-listed stocks are effectively the same as the additional markups and markdowns charged on trades in OTC stocks.

[20]It is irrelevant to the determination of whether a markup was charged that some part of the markup can be described as compensating for a service rendered or a risk taken. In every example where the sale price of a good is marked up from its acquisition cost, some service has been provided or some risk has been taken.

[21]For a simple discussion of price improvement, see John Schott and Chris Schott, *Trading – Price Improvement, available at* http://invest-faq.com/articles/trade-price-impr.html.

[22]Sales credits were used primarily to sell positions in Special Ventures to customers. This allowed Olde to keep more of the spread than it otherwise would have because it did not need to lay off inventory to other market makers. Occasionally, Olde would have an excess demand for a particular Special Venture and it would offer sell side sales credits. These sell side sales credits allowed Olde to buy in inventory without paying other market makers their ask price.

interest[23] and cited case law holding that any special compensation which could influence a broker's recommendation must be disclosed. [24]

Sales credits (or production credits as they are sometimes called) are part of a broker-dealer's total markups paid to the retail sales force for selling certain stocks. These markups (to the extent they come from capturing the bid-ask spread) represent the revenue realized by a broker-dealer's trading department. From this revenue, the credits are paid. In their economic impact, the sales credits increase the prices investors pay when they buy and lower the prices investors receive when they sell.

To understand this, suppose that brokerage firm **A** has accumulated 100,000 shares of a stock it makes a market in. **A** might reduce its inventory by reducing its asking price. But, as noted above, regulations require all broker-dealers to sell at the inside quotes. If **A**'s asking price is at or higher than the lowest ask price posted by other market makers, **A**'s action has no impact. If **A'**s lowered asking price is below the previous inside quote, all other market makers must match **A**'s new lower asking price. Because all other market makers must, by regulation, match any announced price cuts, lowering the ask price would not increase the flow of buy orders to the firm significantly.[25]

After **A** lowers the inside ask other market makers become short the stock if the order flow to other market makers had been balanced at the previously prevailing quotes. This aggregate short position at other market makers develops because at the previous inside quotes the buy and sell orders were, by assumption, balanced. Now with the reduced asking price in effect through all market makers, there will be more public buy orders than public sell orders. The developing short position at other market makers would allow **A** to lay off its excess inventory without further affecting the quotes. **A** only captures the bid-ask spread on the shares it sells to its customers; most or all of the bid-ask spread on shares **A** lays off to other market makers is captured by the other market makers.

Instead of lowering its asking price below the current inside ask, **A** could simply start laying off its 100,000 shares to other market makers at the inside bid. As the other market makers see their bids hit repeatedly and their inventories building, they will lower their quotes. This process continues until the market makers in aggregate, including **A**, are holding zero inventories. By lowering the inside quotes, this process eliminates **A**'s excess inventory and benefits all market makers' purchasers. But once again, **A** would not be keeping the bid-ask spread on shares it lays off to other market makers at the inside bid. Sales to the public would be done by other market makers who would capture the difference between the inside bid paid to **A** for its shares and the higher inside ask charged to public investors.

There is a direct relationship between the existence and magnitude of sales credits and the prices paid by a brokerage firm's customers. If, instead of paying sales credits, Olde had narrowed its quotes by the amount of the credits, it would have netted the same amount on its trades with the public and all buyers (not just the firm's customers) would pay less. Instead, Ode kept the quotes wider and paid its stockbrokers a commission (sales credit) to sell the firm's Special Venture stocks. From the public investor's perspective, no meaningful

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[23] *In re Olde Discount Corp., supra* note 8, 1998 WL 57517 * 2, 6.

[24] *See Addeo v. Braver*, 956 F. Supp. 443, 452 (S.D.N.Y. 1997) (concluding that failure to disclose commission of .25% on the interest paid in connection with solicited investments bought on margin was a material omission even though commission was small); *SEC v. Feminella*, 947 F. Supp. 722, 730-31 (S.D.N.Y. 1996) (discussing disclosure of sales credits); *SEC v. Hasho*, 784 F. Supp. 1059, 1073, 1110 (S.D.N.Y. 1992) (holding that nondisclosure of 12% commission on house stocks was a material omission because nondisclosure "deprives the customer of the knowledge that his registered representative might be recommending a security based upon the registered representative's own financial interest rather than the investment value of the recommended security."); *see also* Note, *Differential Commissions as a Material Fact*, 34 Emory L.J. 507 (1985).

[25] The impact of competitors matching behavior on the effectiveness of price cuts is a well-known phenomenon, referred to in introductory economics textbooks as a "kinked demand curve" where competitors match price cuts but don't match price increases. Consider a situation where local gas stations vigorously compete with one another, swiftly matching any price cuts posted. The first gas station to lower its posted price may take customers away from other gas stations for a very brief time but once the other stations match the lower prices, the price cutting gas station will be getting the same customers as before the price cuts but now will be selling gas at lower, perhaps unremunerative, prices. Rules requiring market makers to match the inside quotes have exactly the same discouraging impact on price competition.

difference exists between sales credits and undisclosed sales commissions.

Trading Costs

When investors buy and sell stocks they incur costs imposed on them by other market participants; we call these trading costs.[26] Trading costs are easy to understand. Suppose that an investor buys 100 shares of ABC Company shares for $105 each and sells those shares before the quotes change for $100 each. The investor has incurred $5 per share in trading costs.

Trading costs are a significant drag on investment performance.[27] The investment management industry measures trading costs to include bid-ask spreads, any additional markups or markdowns and explicit commissions and price impact.[28] From the point of view of the investor there is no meaningful distinction between these components of costs.

Dozens of published papers on investment returns and market microstructure issues measure the bid-ask spread component of trading costs incurred by investors as the difference between the transaction price before markups, markdowns or explicit commissions and the mid-point of the NBBO. The SEC recently also measured the spreads paid by investors as the difference between the price paid or received and the mid-point of the NBBO.[29]

The scientific community and the SEC measure the bid-ask spread relative to the mid-point of the NBBO because the quotes and the spread change between the time an investor purchases and the time an investor sells. For example, an investor might buy when the inside quotes are $20.25 bid and $20.75 ask and sell the acquired shares when the quotes are $21.50 bid and $21.75 ask. The spread was $0.50 when the investor bought but only $0.25 when the investor sold. What is the spread cost actually incurred by this investor?

The developed scientific convention is to measure the bid-ask spread cost incurred on this round-trip as $.0375. The spread cost incurred on the purchase is the $0.25 difference between the $20.75 paid and $20.50. The spread cost incurred on the sale is the $0.125 difference between the $21.50 received and $21.625. The total spread cost is $.0375.[30]

At trial we showed that by insinuating through its advertising and direct representations to customers that trading in the SmartTrade and SmartTrading programs were free of costs Olde misled investors by not, at least, disclosing that investors were incurring these spread costs.

[26]We ignore for present purposes the time and out-of-pocket costs (postage, subscriptions, computer expenses, etc.) incurred by investors.

[27]*See, e.g.,* Barber and Odean, *supra,* note 10.

[28]Price impact is the term given to the temporary effect purchases or sales can have on market prices. The price impact of small retail orders in actively traded securities is negligible but large institutional orders can change market prices.

[29]See *Office of Economic Analysis: Report on the Comparison of Order Executions Across Equity Market Structures, available at* http://www.sec.gov/news/studies/ordrxmkt.htm.

[30]The method academic researchers and the SEC use to measure the bid-ask spread implies that the mid-point of the NBBO is the best estimate of a security's value. The literature on investment returns that adjusts for "bid-ask bounce" likewise implies that the best estimate of a security's value is the mid-point of the NBBO. In our example, the correct measure of the change in the value of the stock is $1.125 (i.e. $21.625 - $20.50) and the simple percentage return is 5.5% ($1.125 ¸ $20.50).

Public Citizen Releases The Costs of Arbitration

by Jackson Williams and Morgan Lynn

Jackson Williams is a Legislative Representative at Public Citizen's Congress Watch in Washington D.C. Morgan Lynn is his Legislative Assistant. They can be contacted at 202-546-4996. Mr. Williams' email address is jwilliams@citizen.org and Ms. Lynn's is mlynn@citizen.org.

Introduction

In a report released May 1, 2002, Public Citizen shows that arbitration, although widely billed as a low-cost alternative to court, is actually far more expensive than litigation for consumers and employees who seek redress for discrimination, fraud and malpractice. The findings of the report outline precisely how the administrative costs related to arbitration can extend up to 700 percent beyond the costs of litigating a case in the public legal system. These costs are not only prohibitive, but are also hidden; shrouded behind the myth that arbitration is a cheaper, quicker, and more accessible route to justice than the public system. Public Citizen argues that costs become hindrances to consumers, employers and investors in their pursuit to seek justice when wrongdoing has occurred.

While court fees will seldom amount to more than a couple hundred dollars, arbitration fees can run into the thousands, prompting one federal judge to describe them as "staggering."[1]

Public Citizen's report points to the example of the Cook County Circuit Court where the filing fee for an $80,000 consumer claim is $221. Under the American Arbitration Association's rules of procedure, the filing fee for the same claim is $1,250. Filing fees are only the beginning, because each action requested of an arbitrator incurs additional costs. For instance, a court would require no additional fee for the judge to issue written findings of fact and conclusions of law. However, the National Arbitration Forum's (NAF) rules of procedure mandate a $1,500 fee for such findings in an $80,000 case. American Arbitration Association (AAA) and Judicial Arbitration and Mediation Services (JAMS) arbitrators would bill by the hour to write such an explanation. The arbitration provider organization may also charge fees for the privilege of exercising various procedural steps, such as discovery.

Arbitration costs will probably always be higher than court costs because the forum costs of a private legal system are so substantial. Public Citizen points out that the same support personnel that expedite cases at a courthouse, such as file clerks and court administrators, are also needed to manage arbitration cases. While it costs the Clerk of the Circuit Court of Cook County an average of $44.20 to administer a case, AAA's administrative cost per case averages $340.63, about 700 percent more.

Arbitration saddles claimants with a plethora of extra fees that they would not be charged had they gone to court. For example, the NAF charges $75 to issue a subpoena, which is provided for free by most courts. The NAF also charges fees for discovery requests ($150) and continuances ($100), which are also free in court.

NASD arbitration cases are not immune to these costs, nor are these cases immune to the myths that hide the costs or the staggering effects these costs have on consumers.

Myths about Arbitration Costs

In *The Cost of Arbitration* Public Citizen outlines the specifics of precisely how forum costs for

[1] *Ting v. AT&T*, C01-02969 (N.D.Cal. January 15, 2002).

arbitration far outweigh the costs of the public legal system. They also argue that it is important to dispel the myths around other costs associated with arbitration. Public Citizen challenges the assertion, often taken as common knowledge, that arbitration is cheaper because of lower discovery costs, simplification of procedures, and lack of appeals.

Discovery

Superficially it may seem that arbitration proceedings cut cost through the reduction of discovery procedures. According to this theory:

> Depositions, virtually unlimited during litigation, are rare in arbitration. The number of depositions needed in litigation, of course, will depend on the case's complexity and number of potential witnesses.
>
> Depositions require parties to pay for court reporters, witness fees and transcribing fees for the deposition. Additional costs include lost work time by employees.
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> ***
>
> By far, the greatest cost-saving advantage to arbitration is likely to be found in the area of
>
> attorney's fees. Attorneys may spend countless hours with depositions, in addition to interrogatories... Although rarely used during arbitration, interrogatories are a routine part of litigation.
>
> Another reason the discovery process generates significant attorneys' fees is the almost inevitable use of motions to resolve discovery disputes. These disputes consume dozens to hundreds of hours of attorney time. Compared to litigation, time-consuming and costly discovery disputes are rare in arbitration. This may be due in part to the fact that there is normally less time before the hearing to wage such battles. [2]

Some attorneys would quarrel with the assertion that there is always less extensive discovery in arbitration. However, it is certainly true that many arbitration clauses on their face either restrict or ban discovery.

In *The Costs of Arbitration*, Public Citizen uses reliable information on discovery costs obtained by the Federal Judicial Center several years ago to begin to quantify the costs of discovery as well as project cost savings that might come from a process that restricts discovery.

The Federal Judicial Center surveyed attorneys about specific closed cases that they had litigated. The survey found:

- In 15 percent of the cases, no formal discovery took place.
- The median total litigation cost per case was $13,000, about half of which was attributable to discovery. The median total litigation cost for plaintiffs was $10,000, and for defendants was $15,000. In other words, on average, the cost of discovery for plaintiffs was about $5,000 and for defendants was $7,500.
- Fifteen percent of the attorneys felt that discovery expenses, in relation to the amount of money at stake in the lawsuit, were high. Eighty five percent of the attorneys felt the discovery expenses were about right or low, or had no opinion.
- Only nine percent of the attorneys felt that the discovery process had yielded too much information in relation to the informational needs of the case. Defendants' attorneys were more likely to hold this opinion (11 percent) than plaintiffs' attorneys (6 percent).[3]

Three conclusions are apparent from this survey. First, discovery was deemed excessive, either in dollar cost or the amount of information produced, in a relatively small percentage of the 85 percent of cases in which discovery took place. Second, excessive discovery is more of an issue for defendants than for plaintiffs.

Third, the dollar costs involved in discovery are not particularly high relative to the costs of opting out of court-managed discovery and into an arbitration process, unless the case involves exceptionally high stakes. The amount at stake in the median case, for which litigation costs averaged $13,000, was $150,000. If discovery costs in the median case were cut in half by utilizing an arbitration procedure, the resulting savings would be

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[2]B. Metzloff , "The Unrealized Potential of Malpractice Arbitration," 31 Wake Forest L. Rev. 203 (1996): "Arbitration hopefully reduces the amount of discovery required."

[3]Willging et al, *Discovery and Disclosure Practice, Problems, and Proposals for Change: A Case-based National Survey of Counsel in Closed Federal Civil Cases*, December 1997.

$2,500 for the plaintiff and $3,250 for the defendant. However, for the plaintiff to avail himself of these savings by taking the case to AAA arbitration, his filing fee and "case service fee" would be $3,750—more than offsetting half the discovery costs before the arbitrator has been paid. Public Citizen found that discovery cost savings would be more of a factor in high-end cases. At the 95th percentile of federal cases, where $5 million is at stake, discovery costs can amount to $150,000 per party. Here, AAA arbitration, with an $11,000 filing fee, could indeed result in cost savings if a 50 percent cut in discovery expenses can be realized.

In any event, most judges have come to agree with the proposition that shortening time to trial provides less time to engage in costly discovery, and have instituted policies of firm, short trial dates with discovery cut-off dates. Thus, in most jurisdictions, it is unnecessary to go to arbitration to obtain lower discovery costs.

Public Citizen suggests that it is quite possible that the cost savings said to arise from arbitration are caused not by the process but rather by the underlying attitudes toward dispute resolution that lead the parties to choose arbitration as their forum. AAA and other arbitration providers clearly markettheir services to parties who prefer a less confrontational means of adjudication. Therefore, Public Citizen posits that parties who voluntarily submit a case to arbitration after a dispute has arisen will be more likely to narrow discovery requests, make admissions and stipulations, and agree on other routine matters.

When arbitration has not been chosen jointly and voluntarily after a dispute has arisen, what Public Citizen refers to as an "informal" tribunal is being imposed on parties who may not feel such a tribunal is appropriate. AAA has suggested in its testimony before the House Judiciary Committee that "a pre-dispute clause is the only way to get people to arbitrate."[4] This is the fundamental paradox Public Citizen points to as at the root of the problems with arbitration—it is a process designed for parties with the "best of intentions" whose disputes involve "misunderstandings," but is being required in those cases that businesses expect to generate the most antipathy. The fanciful term "coercive harmony" has been coined to describe this paradoxical situation.

In *The Cost of Arbitration*, Public Citizen outlines three reasons that saving legal fees and expenses through reduced discovery is not a tradeoff that a consumer or employee claimant is likely to find appealing. First, as noted above, discovery in low-end and middle-range cases is more costly to the defendant than to the plaintiff. Second, many consumer-initiated lawsuits are brought by attorneys on a contingency-fee basis. The contingency fee has been called the "poor man's key to the courthouse" because it requires little if any out-of-pocket payments by the consumer. The requirement of a large upfront filing fee and deposit toward arbitrator fees severely restricts, or eliminates, the advantage a consumer has under the contingency fee system.

Third, the claimant is more likely than the defendant to need information obtainable only through discovery. In an employment discrimination case, for instance, the plaintiff's counsel often must explore the defendant's state of mind when the plaintiff was discharged. Extensive document discovery, and numerous depositions, may be necessary to determine whether the reason given by the employer for discharging the plaintiff was a pretext.

Simplification

In their report, Public Citizen admits that arbitration, in theory, saves time and money. If administered properly, arbitration offers the potential for significantly shorter "trial" time. The length of malpractice trials varies considerably; recent evidence suggests that the median trial length is five days, but a significant number of much longer trials occur. Arbitration hearings can be shorter in part because there is no need to select, instruct, or manage a jury. In addition, conflicts over evidentiary issues are minimized because arbitration hearings are typically less formal than a jury trial.[5]

Relaxing the rules of evidence to permit hearsay testimony, such as testimony by affidavit or deposition, or the use of business records without "foundation" testimony, can shorten proceedings. However,

[4] Hearing Transcript, "Fairness and Voluntary Arbitration Act," House Judiciary Subcommittee on Commercial and Administrative Law, June 8, 2000, at 59.

[5] Metzloff, supra note 47.

Public Citizen explains, all of these savings can be accomplished in a public courtroom, if the parties are willing to stipulate to uncontested facts and admissibility of documents. Parties are also free to waive a jury trial and submit to a "bench trial" before a judge.

Arbitration, as argued by Public Citizen, could particularly benefit consumers if it were simplified to the point that it makes retaining an attorney unnecessary. An example used by Public Citizen to show this type of arbitration procedure is the Better Business Bureau's (BBB) Auto Line program for resolving warranty and "lemon law" disputes with automakers. Under this program, the consumer need not draft legal pleadings or obtain service of process to initiate a case. Moreover, BBB arbitrators are charged with "the responsibility of ensuring all information needed to make a fair decision has been presented or submitted by the parties, or has been obtained [by the arbitrator] in a manner that gives all parties the opportunity to comment on the information." BBB instructs its arbitrators that "there is no burden of proof in the legal sense in the BBB Auto Line program. As you conduct the hearing, please remember the parties may not have expertise in presenting a case at the arbitration hearing. Consequently, you are responsible for taking reasonable steps to ask both parties for any information you feel is necessary in order to render a fair decision."[6]

Public Citizen reminds the readers of its report that any activity undertaken by an arbitrator to protect the interest of a pro se litigant will incur a fee. This fee would differ significantly from the standard contingency fee utilized by claimants' counsel, because the party would be required to deposit the fee in advance and would be liable for it even if that party did not prevail. In the event that the respondent filed a motion to dismiss or motion for summary judgment, an arbitrator performing the same research or investigation as the claimant's attorney would most likely do so at a higher fee, because the claimant will not have shopped for an attorney fee lower than the arbitrator's fee. Some claims, such as those for medical malpractice, cannot be proven without expert testimony and it would hardly be appropriate for an arbitrator to secure an expert witness for a claimant.

In short, Public Citizen shows that it is difficult to imagine how arbitration's simplified procedures could advantage individuals in more than a few categories of routine cases. Unfortunately, they argue, businesses are unlikely to agree to arbitration in those categories because it is not in their interest. Lemon law claims obviously fit the type of case in which arbitration can be pro-consumer, but the BBB Auto Line program exists only because it is mandated by the Federal Trade Commission. As one lawyer familiar with the process concludes, arbitration "does not avoid employment of attorneys."[7]

Lack of Appeals

Public Citizen agrees that proponents of arbitration are undoubtedly correct that the limited, narrow grounds upon which an arbitration award can be appealed will reduce litigation costs. Parties will avoid paying court reporters to record or transcribe hearings or appellate attorneys to write briefs.

However, these savings come at rather high costs. The lack of appealability of arbitration awards generates high information costs for the public at large. Litigants suffer from the inability to rectify errors of law made by arbitrators. All 52 court systems in the United States have appellate tribunals to correct errors. Not a single state is confident enough in its trial judges' decisions to forgo appealability of their orders—only arbitration providers have such certitude.

The same benefits arising from non-appealability can be achieved without incurring additional arbitration costs, because, Public Citizen argues, parties who are so inclined may litigate a case in court and agree not to appeal. This frequently occurs in the context of "high-low" agreements, where a plaintiff agrees to a cap on a jury verdict in exchange for a guaranteed minimum recovery. The high-low agreement ensures lack of appealability while transferring money to the claimant rather than to arbitration providers.

Arbitration Costs and the Securities Industry

Public Citizen's report, while not focused solely on the securities industry, does illustrate the costs related to securities related arbitration. Standard practice in the securities industry requires individual investors to arbitrate any disputes they have with brokers.

[6]Council of Better Business Bureaus, *BBB Auto Line Arbitrator Training Manual* (2001).

[7]David S. Steuer, "A Litigator's Perspective on the Drafting of Commercial Contracts," 1219 PLI/Corp. 539 (2000).

To appreciate the true cost of initiating securities arbitration, Public Citizen argues, one must know the context. Public Citizen points to recent study by the General Accounting Office to highlight the industry-wide problems:

> On the basis of our survey of investors who received arbitration awards during 1998, we estimated that 49 percent of the awards were not paid, and an additional 12 percent were partially paid. Our estimates showed that these investors did not receive nearly 80 percent of the $161 million that they were awarded.[8]

Public Citizen explains that this means that ripped-off investors must make a huge investment in arbitration costs while faced with the prospect of collecting little or no damages afterward. Meanwhile, they point out, delays caused by the arbitration requirement aid dishonest brokers in hiding or liquidating assets that could satisfy an award. It is likely to take more time for a small investor to raise the money to pay thousands in arbitration fees than to raise $150 in court filing fees.

Scot Bernstein, an arbitrator and member of Public Investors Arbitration Bar Association (PIABA) writes "The justice we seek for our clients can be achieved only if we are able to collect any award or judgment we obtain."[9] Even if securities cases brought before arbitration are decided in the favor of the investor, it is often the case that brokers cannot pay their settlements. Even firms with liability insurance that would generally cover these sorts of litigation claims, are often denied by their insurance provider.

Furthermore, arbitrators cannot enforce their awards, so if the broker refuses to pay or is unable to pay, the investor must file a lawsuit in the broker's home county to collect the money. This costs additional sums and provides further time to dispose of assets.

In response to pressure, Public Citizen notes, the National Association of Securities Dealers changed its rules to permit direct court action against brokers who have left the industry. Yet, they warn that this change may create a perverse incentive for sleazy or reckless brokers to remain in business, knowing that the costs of initiating arbitration, and its accompanying delays, will discourage many investors from seeking redress.

Public Citizen points out that according to its website,[10] the mission of the National Association of Securities Dealers (NASD) is "to facilitate capital formation by creating the markets of choice–operated and regulated to achieve the most liquid, cost-efficient, technologically advanced, and fair securities markets in the world–for the benefit and protection of investors."

But, as argued in *The Cost of Arbitration*, there is no market, and no choice, for small investors when it comes to dispute resolution. All cases must be referred to NASD Dispute Resolution, Inc. With no competition between NASD and the court system, and no competition among private dispute resolution providers, there is no incentive to achieve the "cost-efficiency" that NASD cites as its goal. Public Citizen asks: Would NASD arbitration be cheaper and more efficient if it had to compete with the judicial system or other ADR providers?

Conclusion

Public Citizen's *The Cost of* Arbitration concludes by noting that it is sometimes said that "character is what you do when nobody is watching." When the arbitration cost barrier prevents access to the courts, the drafter of an arbitration clause finds himself in a position where, in a figurative sense, no one is watching him. In these circumstances, "character" truly takes on great importance. Individuals' own consciences will become the primary motivation to engage in fair play. For those who believe that human nature is basically benign, this will not raise great concern. For those who believe that recent years have seen a decline in adherence to traditional values, this will cause alarm. Some social commentators, notably William Bennett, argue that "our society now places less value than before on what we owe others as a matter of moral obligation [and] less value on social conformity, respectability, and observing the rules."[11]

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[8] General Accounting Office, *Securities Arbitration: Actions Needed to Address the Problem of Unpaid Awards* (June 2000)

[9] Scot Bernstein, "View from the West: Getting Paid - - Part 1" *PIABA Bar Journal*, Spring 2002 at 37

[10] www.nasd.com

[11] William J. Bennett, *Index of Leading Cultural Indicators: American Society at the End of the 20th Century* (1999) at 9.

Bennett's pronouncements on this subject are seen as strident by some, but many attorneys who represent consumers would probably agree with his views. Often when close scrutiny is given to seemingly routine business transactions, investigators find evidence of overreaching, corner-cutting, or outright fraud—and this with the courts available to redress such misconduct. With access to the courts shut off by arbitration clauses, such misconduct can only be expected to increase. In the securities industry this will translate into numerous investors being kept from litigating their claims against unscrupulous brokers. Ultimately, notes Public Citizen, this will be the greatest cost of arbitration.

For more information about *The Cost of Arbitration* or to order a complete report call Public Citizen's Publication Office, 1-800-289-3787. The report's publication number is B9028. For more information about Public Citizen's work on arbitration visit: www.arbitrationwatch.org.

View from the West: Getting Paid-Part 2

by Scot Bernstein

Scot Bernstein is a member of PIABA's board of directors. He has assisted in the resolution of securities disputes through proceedings against insurance carriers denying coverage on errors and omissions policies. His law firm -- Law Offices of Scot Bernstein -- is located at 10510 Superfortress Avenue, Suite C, Mather Field, California, near the City of Sacramento. Mr. Bernstein can be reached at 916-447-0100. His email address is swampadero@aol.com.

Part 1 of this article discussed ways to determine in advance whether a prospective respondent is likely to have insurance coverage. Those included broker-dealers' publicly-available X17A-5 financial statements, securities industry periodicals, the identity and reputation of the defense firm that usually defends the prospective respondent and -- last but never least -- posts to our list-serve. Part 2 assumes that you have accepted the case. This discussion will address

- Pleading the claim to increase the likelihood of invoking insurance coverage,
- discovery issues, and
- what to do when the carrier is denying policy benefits to the insured.

Pleading the Claim

If the respondent has a professional liability or errors and omissions insurance policy, 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.

Two general principles apply here. First, errors and omissions insurance policies exclude coverage for intentional acts of wrongdoing. Second, insurance policies tend to cover acts of negligence. Thus, at the pleading stage, it is important to allege negligence and negligent supervision. Further, it may be wise to tone down the assertions of intentional wrongdoing by including the possibility that the respondent's conduct was reckless.

Of course, the general principles outlined above -- and all others applicable to insurance -- are subordinate to the overriding principle of insurance coverage: insurance companies like to collect premiums. They do not like to pay claims. So the continuum is the degree of ruthlessness and dishonesty the carrier is willing to employ to achieve its primary objective of denying coverage for your client's claim.

Anything that you can do to make it difficult to deny coverage, therefore, is in your client's interest. That means that it is a good idea to use coverage-triggering words – "negligence," "negligent supervision," "failure to supervise," "negligent hiring, training and retention," and "breach of fiduciary duty" -- in your statement of claim. If the carrier is determined to deny a claim, mere assertion that the broker-dealer has violated a particular rule, identified by number -- for example, NASD Conduct Rule 3010 or California Corporate Securities Rule 260.218.4, both of which require supervision -- may not be enough.

Moreover, if the facts compel you to allege intentional wrongdoing in addition to the negligence claims, it may be best to state that the conduct was "intentional or reckless," as recklessness may trigger coverage under an errors and omissions policy while intentional misconduct does not. Additionally, in the context of intentional wrongdoing, one should not overlook the possibility that a broker-dealer respondent may have a fidelity bond insuring it against losses caused by its employees' dishonest or fraudulent acts. Fidelity bonds are beyond the scope of this article. Nonetheless, in some jurisdictions and under some circumstances, intentional wrongdoing by an employee of a broker-dealer respondent can trigger coverage under a fidelity bond. *See* Peloso, John F. X., and Wager, Lisa Klein, "Insurance Coverage for Broker-Dealer Liabilities" (February 20, 1997) *The New York Law Journal*.

If the carrier does not see immediately that coverage denials will not work, it may decide to keep its options open by denying coverage at the outset. And once the carrier has taken an adverse position -- and its personnel have become emotionally committed to the savings expected to result from that denial -- it may be very hard to shake the carrier from that point of view. Problems of this kind are not path-independent. Insurance carriers are staffed by people. They therefore are subject to the human tendency to become enamored of a position, once taken. The best course is to minimize the likelihood of serious coverage denials as early as possible.

Beyond using key words in the claim, things can become a bit more complicated. One issue that has come up frequently in a variety of contexts is whether a public customer should or should not name the registered representative as a respondent. Good arguments have been made both ways, and the decision must be made on a case-by-case basis.

It is unfortunate, of course, that the arguments have to go on at all. The reason most often given for not naming the registered representative is that some arbitration panels are so confused about the obligations of employers to the public that they give awards that are not joint and several. In most cases, a judgment against a registered representative is more valuable to a person practicing origami than to one practicing law.

Thus, if a wrong decision by an arbitration panel is possible, that may militate in favor of naming the broker-dealer only. That is particularly true when the broker-dealer is a large wirehouse and clearly is able to pay any award that might be obtained.

The flipside, of course, occurs when collection from the broker-dealer is not assured. Then it may be best to name the registered representative because of the small but real possibility that he or she may be more solvent than the broker-dealer.

Of course, this article would not address the question about whether or not to name the registered representative as a respondent but for an insurance connection. Some securities industry errors and omissions policies cover the broker-dealer as the primary insured, with the registered representative as an additional insured. Some do the reverse. The question that arises in the latter situation is whether the policy has been written to exclude coverage when the primary insured is not named. In that unlikely event, naming the registered representative may be the safer route.

Discovery

Insurance policy information should be discoverable. It is in most cases and in most courts. The Federal Rules of Civil Procedure require it to be disclosed automatically, early in a lawsuit, without so much as a request from the opposing party. F.R.C.P. 26 (a)(1)(D). Many states, though statute or case law, make insurance information discoverable as well. See Appendix 2.

Of course, the rules making insurance discoverable exist because they are good public policy. Among other things, having insurance coverage information available to all parties to a controversy facilitates settlement and speeds the resolution of disputes. It also prevents judicial resources from being wasted on cases that will yield judgments that will be worth less than the paper on which they are printed.

Yet, all of the obvious policy and legal arguments notwithstanding, arbitrators almost never order securities industry respondents to produce information about insurance coverage. In fact, counsel for investors often do not even request it. It is an absurd departure from the norms of non-securities tort practice.

What argument can industry respondents conceivably make against discovery of insurance information? That they -- who are in the business of managing other peoples' savings -- want to be able to feign poverty to stave off future claims? It is one thing to prevent claims by having a reputation for putting forth successful, meritorious defenses. It is quite another to prevent claims by creating a false show of inability to pay, especially if one is advertising one's own money management acumen at the same time.

The sad truth is that the securities industry has been successful with this ridiculous approach to claim prevention. Virtually everyone reading this article has settled cases for less than they are worth because of the respondents' claimed inability to pay and threats of bankruptcy. Often, those decisions are correct, distasteful as they are. Statistically speaking, however, insurance must have been available in some of those cases.

The importance of insurance information as a discovery issue is not limited to the need to assess the ability to collect on a potential award. In one case, although no information was forthcoming from opposing counsel, I had reason to suspect that a well-known insurance carrier insured the respondent. Through voir dire, I learned that the prospective panel chairman's law firm did substantial work for that carrier. I requested that the chair recuse himself. Opposing counsel objected vociferously, yet he did not deny my assertions about coverage. The chair recused.

We as PIABA members need to become proactive about this issue. We need to request insurance information in every case. (Sample document requests are included in appendix 1.) We need to educate panels -- through on-the-job training during motions to compel, if nothing else -- about the importance of ordering securities industry respondents to produce information about both errors and omissions policies and fidelity bonds that might be applicable to the claim. We need to share briefs on the subject. We need to have panels sign written discovery orders when they order insurance information to be produced, and we need to share those orders with our fellow members through the list-serve and the website. And when we get insurance information or policies, we should share those as well.

As a start, it might help to show arbitrators F.R.C.P. 26(a)(1)(d), together with examples of state statutes and cases that make insurance information discoverable. *See* Appendix 2.

Other Indicia

Formal discovery is not the only post-filing way to determine whether an insurance policy might cover your client's claims. Other clues may exist as well. For example, do the broker-dealer and the registered representative have separate counsel? If so, that might be because the registered representative has insurance coverage and the broker-dealer does not.

In one such case involving a REIT and two limited partnerships, my office obtained selected pages of the registered representative's errors and omissions policy during mediation. As a result, I knew about a policy exclusion that eliminated coverage for the two limited partnerships. We therefore demanded full damages on the larger REIT investment, which was covered. The registered representative agreed to our demand, and my client was paid on that failed investment. Moreover, we were able to proceed against the broker-dealer and its president/controlling shareholder with the remaining, unsettled portions of the claim.

Of course, the coverage clues that exist at the case evaluation stage -- the identity and reputation of defense counsel and posts to the list-serve -- continue to apply after you have received the respondents' answer. Among other things, the answer will erase any doubt about what law firm will be defending the respondents.

In some cases, opposing counsel may provide insurance information, either directly or in a more oblique way. Insurance defense counsel walk an ethical tightrope. On the one hand, their client is the insured. On the other, the repeat purchaser of their services -- their paying customer -- is the insurance carrier. Defense counsel do not want to do anything to anger the paying customer; but they have an ethical obligation to do what is best for the client. And the client clearly is better off with coverage than without.

Thus, if opposing counsel says something about the carrier denying coverage, or defending under a "reservation of rights" to deny coverage later, those statements deserve aggressive follow-up to determine whether an amendment to the statement of claim might eliminate the coverage problem.

Defense counsel's statements may be untrue, of course. Defense counsel may be assuming that you believe a policy exists and, instead of making a futile attempt to deny it, using assertions about lack of coverage to lower your and your client's expectations. On the other hand, defense counsel may be giving you valuable hints that can benefit both his client and yours. After all, if the case can be settled within policy limits, defense counsel's client benefits as much as yours does.

Coverage Disputes, "Premium Only" Policies, and Getting Your Client Paid

Many coverage disputes cannot be cured by amending pleadings. This may be because there are legitimate questions of policy interpretation. It may be because the carrier makes it a practice to deny all claims, much like the "street 'surance" vendor in *The Rainmaker*. Or it may be because the carrier has sold a policy that is largely illusory.

A couple of examples may illustrate the latter points. One arises out of a recent discussion I had with an insurance defense lawyer in the northwest. His client's carrier was denying coverage -- unfairly, he thought -- and he was not afraid to say so. Apparently, the carrier was taking the position that the events that set the alleged lack of supervision in motion began when the registered representative was hired, a date that was before the retroactive date of the policy.

The carrier's argument was nonsensical, of course. Every event that might give rise to securities industry liability has infinitely many precursors. If the stockbroker had not been born, the dispute would not have arisen. If the United States had not declared its independence from Britain, the dispute would not have arisen. Ultimately, if the insurer is permitted to look to the first causative event, all policies with retroactive dates after the big bang are illusory.

Absurdity abounds. I recently wrapped up a case in which the errors and omissions policy contained an exclusion for any act that violated a securities statute or regulation. Try to imagine a securities claim that does not involve a violation of a statute or regulation. Even negligence in the securities context -- for example, making unsuitable investment recommendations -- violates regulations. So, if the policy were interpreted literally, it would be completely illusory -- as would an automobile liability policy containing a similar exclusion.

That case turned out to be quite interesting. The broker-dealer's liability arose out of the actions of one bad representative, the first bad hire in the small firm's history. The insurer in question had denied five out of five claims brought against the now-defunct broker-dealer. The carrier was not defending under a reservation of rights; it simply was not defending at all. Instead, it was straight-out denying coverage.

The attorney for one of the claimants -- a PIABA member -- put defense counsel in touch with my office. That attorney and others, representing other investors, were able to settle their claims with the broker-dealer and its principals by taking small amounts up front and agreeing not to collect the remaining amounts except against sums that the broker-dealer might recover through its coverage dispute with the carrier. The broker-dealer and its principals, in turn, were obligated to prosecute their coverage case diligently.

I associated, as co-counsel, a very capable coverage lawyer. Insurance coverage law is an area that, like securities arbitration, requires a substantial body of specialized knowledge and expertise. Working together, representing the broker-dealer against the carrier, co-counsel and I were able to bring about a settlement that put money into the pockets of all five public customer claimants. Everyone's position was improved by the infusion of funds from the carrier.

This experience is significant for what it teaches about collecting from small broker-dealers: the insurance policy may be the biggest asset or even the only asset available for recovery. This can be so even when the carrier is denying coverage. The broker-dealer's right to sue to enforce the policy and to seek extra-contractual damages for bad faith can form a basis for resolving disputes, even -- or especially -- when the broker-dealer is on the ropes financially.

Of course, the insured's claim against the carrier will not always be a big asset. Sometimes the coverage denial will be justified, and the policy will be no asset at all. But it merits careful review in each instance. **Whenever coverage is being denied, counsel for both claimant and respondent owe it to their clients to explore the potential for a solution that comes from neither client's pocket. Doing so can have a substantial impact on the value of the claimant's case.**

Conclusion

Insurance issues deserve careful attention in cases against all but the largest broker-dealers. That attention should begin before representation is undertaken, and should continue through pleading, discovery and, if applicable, negotiating and structuring settlements.

When appropriate, counsel for both sides should be mindful of the possibility of resolving their differences and restructuring the dispute from one between customer and broker into one between an insured and an insurer that is unfairly denying policy benefits.

Appendix 1. Examples of discovery requests seeking insurance policy information.

a. A short form of document request:

\\ . Insurance Policies. Copies of all insurance policies and declaration sheets which Recipient contends should or do afford Recipient or any Respondent either coverage, a defense, or both, to any claim asserted in this case. Insurance policies, for purposes of this request, include but are not limited to policies described by any form 10-Q, X17A-5 or other public document filed by Recipient.

b. A form of document request based on a request used by Allan Fedor

\\ . Insurance Policies.

A. All insurance and surety policies and declaration sheets, including but not limited to primary and excess policies, errors and omission policies and fidelity bonds, under which any insurance company or other entity carrying on the insurance or surety business may be liable to satisfy part or all of an arbitration award or judgment which may be rendered in this case, to defend any Respondent, or to indemnify or reimburse any Respondent for payments made to satisfy any award or judgment.

B. All reservation of rights letters and non-waiver agreements sent to any Respondent or any other person concerning or relating to any tender or demand for coverage to defend any Respondent or to indemnify or reimburse any Respondent for payments made to satisfy any award or judgment.

c. Modified version of California Judicial Council form interrogatory:

At the time of the claim, was there in effect any policy of insurance through which you were or might be insured in any manner (for example, primary, pro-rata, errors and omissions or excess liability coverage) for the damages, claims or actions that are alleged in the statement of claim or have arisen out of the events underlying the claim? If so, for each policy state:

i. the kind of coverage;
ii. the name and address of the insurance company;
iii. the name, address and telephone number of each named insured;
iv. the policy number;
v. the limits of coverage for each type of coverage contained in the policy;
vi. whether any reservation of rights or controversy or coverage dispute exists between you and the insurance company; and
vii. the name, address and telephone number of the custodian of the policy.

Appendix 2. Laws making insurance information discoverable.

Federal Law

Rule 26. General Provisions Governing Discovery; Duty of Disclosure

(a) Required Disclosures; Methods to Discover Additional Matter.

(1) Initial Disclosures.

Except in categories of proceedings specified in Rule 26(a)(1)(E), or to the extent otherwise stipulated or directed by order, **a party must, without awaiting a discovery request, provide to other parties:**

(A) the name and, if known, the address and telephone number of each individual likely to have discoverable information that the disclosing party may use to support its claims or defenses, unless solely for impeachment, identifying the subjects of the information;

(B) a copy of, or a description by category and location of, all documents, data compilations, and tangible things that are in the possession, custody, or control of the party and that the disclosing party may use to support its claims or defenses, unless solely for impeachment;

(C) a computation of any category of damages claimed by the disclosing party, making available for inspection and copying as under Rule 34 the documents or other evidentiary material, not privileged or protected from disclosure, on which such computation is based, including materials bearing on the nature and extent of injuries suffered; and

(**D) for inspection and copying as under Rule 34 any insurance agreement under which any person carrying on an insurance business may be liable to satisfy part or all of a judgment which may be entered in the action or to indemnify or reimburse for payments made to satisfy the judgment.**

. . .

California

California Code of Civil Procedure section 2017(b) provides as follows:

(b) A party may obtain discovery of the existence and contents of any agreement under which any insurance carrier may be liable to satisfy in whole or in part a judgment that may be entered in the action or to indemnify or reimburse for payments made to satisfy the judgment. This discovery may include the identity of the carrier and the nature and limits of the coverage. A party may also obtain discovery as to whether that insurance carrier is disputing the agreement's coverage of the claim involved in the action, but not as to the nature and substance of that dispute. Information concerning the insurance agreement is not by reason of disclosure admissible in evidence at trial.

New York

"A party may obtain discovery of the existence and contents of any insurance agreement under which any person * * * may be liable to satisfy part or all of a judgment which may be entered in the action or to indemnify or reimburse for payments made to satisfy the judgment." CPLR 3101(f). "The primary motivation for this kind of disclosure provision is to facilitate and encourage settlement." *Krogh v. K-Mart Corp*., 108 A.D.2d 966, 967, 484 N.Y.S.2d 950 (N.Y.App.Div. 1985).

Other States

See McDonald, Kevin Wayne, Tuller v. Shallcross: Pretrial Discovery of Automobile Liability Insurance Coverage in Oklahoma (1996) 32 Tulsa L.J. 101. Mr. McDonald states as follows:

> It is time that Oklahoma joined the ranks of the federal court system and most other states in allowing full discovery of information relating to any liability insurance policy, not just those issued under the Compulsory Liability Insurance Law.

Id., at 116 - 17. *See also* Annot., Pretrial Examination or Discovery to Ascertain from Defendant in Action for Injury, Death, or Damages, Existence and Amount of Liability Insurance and Insurer's Identity (1967) 13 A.L.R.3d 822.

Origins of The Siedle Directory of Securities Dealers and NASD Opposition to its Publication

by Edward Siedle

Edward Siedle formerly served as an attorney with the U. S. Securities and Exchange Commission and as Director of Compliance and Associate Legal Counsel with one of the largest international money management firms. Since 1990, he has owned and operated several institutional brokerages firms, all of which have been members in good standing of the NASD. He is regarded as an expert in the securities and money management industries and conducts investigations of brokerage and money manager abuses on behalf of pension funds and other institutional clients. He frequently provides expert commentary to the media regarding current developments in the brokerage industry and articles he has written are often reprinted in financial publications. He is a retired member of the Massachusetts Bar.

"It (the NASD) has successfully resisted many proposals inimical to the best interests of the securities businesses at large as well as to its members."

History of the NASD, nasd.com website

"Necessity" is said to be the mother of invention and it was necessity that caused me to create The Siedle Directory of Securities Dealers. Let me explain. My job is to investigate illegal and unethical conduct by pension funds, money managers and brokerage firms. My qualifications to provide this service include having formerly served as an Attorney Advisor in Finance with the United States Securities and Exchange Commission and as the Director of Compliance and Associate Counsel to one of the largest international money managers. For over a decade, I have also owned brokerage firms that are members in good standing of the National Association of Securities Dealers, Inc. I hold every license required to operate a brokerage, including the general securities representative, general securities principal and financial and operations principal. In summary, I possess regulatory, corporate and entrepreneurial experience in the field. I refer to my background here because to ferret out wrongdoing, one must know the spirit and literal requirements of the law, understand how large financial institutions operate, including how they conceal their misdeeds, and be keenly aware of the myriad ways in which individuals and firms may be compensated.

Over the course of my career I have conducted hundreds of investigations, virtually all on behalf of institutional clients. Some cases were referred to regulators and law enforcement. A few cases have received public attention, the vast majority have not. From my experience I have learned wrongdoing in the money management and securities industry is far more pervasive than the public is aware. This lack of public awareness is no accident. Pensions, money managers, securities dealers and their regulators have all contributed to concealing the problems. There has been no conspiracy; rather, it is simply in no one's interest (except the investing public's) that violators be exposed. Once misdeeds have been uncovered and the perpetrator suitably convinced the victim is both knowledgeable and prepared to go forward with a complaint, the parties generally agree to a confidential settlement. Public confidence in "the system" is preserved by this secrecy. The unfortunate consequence of this method of operating is that the public remains vulnerable to known but concealed risks and each new victim must seek recompense without the benefit of any precedent. Only those with substantial resources find some degree of justice.

Brokerage firms often are in the midst of wrongdoing because they serve as the lynch-pin between pensions, money managers, pension consultants and securities trading. Virtually every time money moves, whenever money managers or securities in a portfolio turnover, a brokerage facilitates the transactions and gets paid a commission. While massive studies regarding money managers have been published, little attention has been paid to brokerages. It is as if brokerages are regarded as unworthy of serious attention.

While conducting a complicated investigation last year on behalf of a large pension fund, I was frustrated to find that certain information regarding wrongdoing of a significant magnitude by brokers was not being properly disclosed to the public. It occurred to me at that time there was no comprehensive source for researching securities dealers. Rather than continue to conduct private investigations of brokerages on behalf of institutional clients who pay thousands of dollars in fees for research on a limited number of brokerages, I proposed to publish a Directory that would provide investors with valuable information regarding *all* the firms. Given my regulatory and legal background, I chose to begin the task by contacting the appropriate regulatory and self-regulatory organizations. The most expeditious route seemed to be to advise them of my project and enlist their support. After all, the goal of the Directory was investor education, the supposed mission of these organizations. I never envisioned they would oppose what I was seeking to do.

On July 20, 2001, I wrote to Ms. R. Clarke Hooper of the NASD's Office of Disclosure and Investor Protection and to Ms. Annette Nazareth, Director of the SEC's Division of Market Regulation. In that letter, I outlined my proposal to create The Siedle Directory of Securities Dealers which would provide the following information:

- a list of the regulatory history of all NASD member firms, as disclosed on the NASD Regulation Public Disclosure Program;
- a list by town or city of all NASD member firms; and
- a possible rating system which would consist of my opinion regarding each firm.

The primary purpose of my letter was to request the data I needed from the Public Disclosure Program in a format that would enable me to review it readily, as opposed to requiring me to download the information firm-by-firm.

Ms. Nazareth of the SEC never returned any of my phone calls or responded to my letter. When two members of her staff did call, they questioned why I was writing to the SEC since the Public Disclosure Program was administered by the NASD, not the SEC. I reminded them that under Section 15 of the Securities Exchange Act, the NASD was required to make the disciplinary history of its membership publicly available and the SEC had oversight authority regarding whether the NASD was complying with its statutory duties. Thus, the SEC had a very real role to play in determining whether the NASD should grant me access to the public disclosure data. Presumably, if it was in the public interest, it seemed reasonable to believe the SEC would suggest to the NASD that the Association cooperate with my project.

Chief Counsel and Director of CRD/Public Disclosure at the NASD, Richard Pullano, responded to my July, 2001 letter with a telephone call to me on or about August 27, 2001, during which we discussed the Directory. I mentioned that I did not need to access the data through the Public Disclosure Program website if the NASD would provide the data in an alternative form. Additionally, I informed the NASD of my ability to access the data through a hired programmer or secretarial pool via the website. Mr. Pullano indicated no preference as to the method I would employ in obtaining data via the website, but indicated orally he did not believe that the NASD would provide me with *enhanced* access. That is, I probably would not be given the information on a compact disc, ready for use.

On that same day I wrote to Mr. Pullano stating that I believed that The Siedle Directory would supplement, and not replace, the Public Disclosure Program. I listed several advantages to The Siedle Directory, all of which would serve the NASD's stated goal of benefiting and protecting the public, including:

- affords unlimited number of inquiries compared to the limited current system;
- permits the reader to simultaneously compare one firm's disciplinary records against another; and
- provides the reader with an overview of industry norms.

On October 2, 2001, Mr. Pullano responded to my letters of August 1, 2001 and August 27, 2001 by reiterating his understanding of The Siedle Directory. Mr. Pullano affirmed that "while we do not object to your accessing the Public Disclosure Program consistent with the policies underlying the IM-8310-2 and the terms and conditions applicable to the Program, we are not able to offer any additional or enhanced access." Mr. Pullano's letter indicated that he sent a copy to Ms. Annette Nazareth of the SEC.

Based upon Mr. Pullano's October 2nd letter indicating that the NASD did not object to my proposal, I retained a computer consultant to download the data from the Public Disclosure Program in December 2001 and January 2002. In January 2002 I retained an attorney to negotiate with two publishers that were interested in the Directory. Each of these publishers was given Mr. Pullano's letter; each indicated they saw no reason to seek any further approval from the NASD.

On February 5, 2002, Mr. Pullano, Ms. Anne Bushey and another individual from the NASD initiated a telephone conference with me when they noticed that I, through my hired programmer, had downloaded all of the Public Disclosure Program information from the NASD website. They mentioned to me that the NASD had concerns about my plans to publish the data upon completing The Siedle Directory. I reiterated my intended use of the data and informed them that if they had any objections that they should inform me immediately as I was involved in final contractual negotiations with a publisher concerning publication of The Siedle Directory.

Three weeks later, at 10:00 p.m. on Friday, February 22, 2002, Mr. Pullano faxed a letter to me informing me that the NASD had "concerns" with my proposed uses of the PDP data and that it had not "in any way authorized" me to use the data for The Siedle Directory or any other commercial purpose. This was the first time anyone at the NASD had indicated that the NASD believed it could prohibit commercial use of the data. Mr. Pullano also stated that the NASD was reviewing my "method of accessing, compiling and using" the PDP data to determine whether these actions had been undertaken "consistent with the terms and conditions" of the "subscription agreement" and the "policies under Interpretive Material 8310-2." The NASD at its website has a "click agreement" with respect to the use of information obtained from the website. Notably, I had hired a computer programmer to legally access the site and obtain the PDP information.

The letter closed by reiterating that I was not authorized to use the PDP for The Siedle Directory and that the NASD would pursue "all legal remedies available to it" should I attempt to publish the Directory. Unlike his earlier letter, Mr. Pullano apparently did not send a copy of this threatening letter to Ms. Annette Nazareth of the SEC. I faxed to the two publishers who were interested in publishing the Directory the letter Mr. Pullano had faxed to me. Both publishers responded that while they were still very much interested in publishing the Directory, they would not proceed until the matter of the NASD's threatened litigation had been resolved.

On February 28, 2002, my counsel, Richard M. Gelb, wrote to Mr. Pullano explaining that the data contained in the CRD was not copyrightable and that any "click agreement" should not be enforced.

On March 1, 2002, my counsel and I had a telephone conference to discuss the issues raised in Mr. Pullano's February 22, 2002 letter with Derrick Linden, Senior Vice President Of Public Disclosure and Terri Reicher, Esquire, NASD's Associate General Counsel. They informed me that I was bound by the terms and conditions of the website not to use the information for commercial purposes. My counsel informed them that a repository of otherwise public data is not copyrightable and that the terms and conditions of the NASD's "click agreement" were not enforceable against me. He also informed them that even if the "click agreement" restricted use to non-commercial purposes as the NASD maintained, I was not prevented from publishing the information for a non-commercial purpose (i.e. for free). As discussed below, the "click agreement" was subsequently modified to attempt to close what the NASD perceived during our conversation as loopholes.

A plain reading of the old click agreement did not prohibit the commercial use of the information. Under the PDP terms and conditions information provided through the PDP can be used only as follows:

> "a. to assist in determining whether to conduct or continue to conduct securities or commodities business with NASD Member Firms or Associated Persons;
> b. in judicial proceedings or arbitration proceedings related to securities or commodities transactions; **or**
> c. for other non-commercial purposes consistent with the promotion of just and equitable principles of trade and the protection of investors and the public interest." (emphasis supplied)

Contrary to the NASD's position, the PDP terms and conditions did not prohibit commercial use of the information for purposes (a) and (b). Indeed, subparagraph (c) does not modify (a) and (b) at all because of the use of the disjunctive "or." Therefore, I maintained that to the extent I wished to use the information in The Siedle Directory for purposes (a) and (b), there was no agreement with the NASD preventing me from so doing.

During the above-mentioned conference, the NASD informed my counsel and me that it intended to revise the "click agreement." We questioned whether the NASD had the authority under the federal securities laws to unilaterally change the terms and conditions under which the public could access information about brokerages through the PDP without the advice and consent of Congress and the SEC, since it was Congress and the SEC that had required the NASD to establish the PDP. On or about March 12, 2002, the NASD informed my counsel that the "click agreement" had been revised. The new "click agreement" which appears on the NASD's website today is far more restrictive than the original. It prohibits anyone from accumulating information about more than a few firms for any purpose. Any excessive or repetitive requests for information is prohibited. A taped message has also been added to the Public Disclosure Program's telephone hotline indicating that telephone requests for information are governed by the website "click agreement." (A copy of the old and new "click agreements" is provided in the Exhibits section.)

On the conference call, the NASD also stated that I was "data mining". This is simply incorrect as I was not attempting to use confidential information compiled by the NASD, but rather I was attempting to use public information that is merely deposited with the NASD by the SEC and other regulatory organizations. Moreover, to the extent the NASD was concerned about misuse of information, I informed the NASD that I was willing to provide assurances of proper use of the data. Additionally, my counsel informed the NASD that my vast experience as a former attorney for the SEC and my experience in the securities industry coupled with a reputable publisher should be an indicator of my intended proper use of the information.

At approximately the same time, a summary of the NASD's actions was sent via e-mail to all of the state securities regulators and the staff of the North American Securities Administrators Association. No response to these e-mails has been received, although in private conversations I initiated to several of these individuals, all agreed the data in question is public information and publication of the Directory is consistent with the states' objective of enhanced disclosure to investors.

On March 13, 2002, my counsel sent a letter to Harvey Pitt, Chairman of the SEC, regarding the NASD's attempts to thwart publication of the Directory. A copy of the April 12th letter my counsel received from the SEC's Division of Market Regulation in response to his letter is provided in the Exhibits section. In summary, despite the significant investor protection issues involved, the SEC deferred the matter to the NASD.

So much for SEC oversight of the NASD.

Preliminary Findings

The strength of the NASD's objections to The Directory caused me to wonder why the Association so opposed its publication. My initial plan had been to simply publish the disciplinary data regarding the brokerages in the first edition of the Directory and in subsequent editions analyze and supplement it with information collected from myriad other sources. However, the NASD's opposition caused publishers to retreat and eliminated the possibility of immediate publication of The Directory in the form I originally envisioned. While I awaited a resolution with the NASD, I became interested in further scrutinizing the data I now had at my fingertips. I began an investigation of the disclosure systems applicable to the brokerage industry, including the NASD's Public Disclosure Program. I undertook this investigation as if I had been retained by a client to investigate the NASD. The investigation I conducted over the course of several months was one of the most complex I have ever undertaken. The results were alarming, with far-reaching implications for investors.

At the outset of The Siedle Directory I advised readers that a thorough due diligence review of brokerage firms prior to investing and on an ongoing basis made sound financial sense for both individual investors and fiduciaries. However, at the end of my investigation I concluded that an analysis of regulation of the industry and the sources of information available regarding brokerages indicated that such a due diligence review is virtually impossible for all but the most sophisticated investors.

My analysis revealed that the disclosure information provided to the public regarding the nation's brokerages is confusing, incomplete and misleading. The disclosure systems are cumbersome and seem calculated to discourage anything other than superficial inquiries. Investors simply cannot rely upon the Central Registration Depository, the Public Disclosure Program, SEC, or state data alone. Yet piecing together a complete picture of even a single firm from the fragments of information available from these sources is challenging, to say the least. It is striking how little can be established with confidence about any firm through this maze of exceptions, loopholes and conflicting definitions. The current state of affairs is not beneficial to investors seeking to make informed decisions regarding brokerages with which to do business. Furthermore, the current disclosure scheme does not reward brokerages that are beyond reproach because it does not provide investors with industry disciplinary averages or permit a broad comparison between firms which would identify the most meritorious. It only shields the less scrupulous brokerages from public scrutiny.

Furthermore, there are significant differences between the information individual brokers and brokerage firms are required to disclose. There is no apparent reason for these different disclosure obligations and the result is that firm disciplinary histories are frequently unencumbered by the misdeeds of their broker-employees. While this state of affairs may be in the best interest of the member firms of the industry's self-regulatory organization, it is not consistent with the goal of investor protection.

To summarize my findings, 60% of all NASD member firms have no disciplinary histories whatsoever disclosed through the Public Disclosure Program or PDP. Data regarding the estimated millions of nationwide brokerage firm *customer complaints* is not disclosed through the PDP. This information is only available from the states on a state-by-state, firm-by-firm basis. Comprehensive customer complaint information is not compiled by the states, the SEC or the NASD, even though each apparently keeps records on the number of complaints they receive annually. Only data regarding NASD *arbitrations* is reported with respect to firms. Arbitration cases from other forums, perhaps an additional 10-15%, are not included (even though the NASD has access to these awards). Cases that end short of a final decision by arbitrators are not disclosed. Cases decided by arbitrators that are subsequently "expunged" are not disclosed. Arbitrations between brokerages and their employees and between firms are not disclosed. Only 15% of NASD arbitration cases filed are disclosed through the PDP—less than two arbitrations per firm over a 15-year period. Only one-half to a third of *regulatory actions* in CRD are disclosed to the public through the PDP. Only two *criminal actions* and no *bankruptcies* are disclosed through the PDP. Data regarding firms that become insolvent, are expelled by the NASD or otherwise cease business operations is removed from the PDP within two years, thereby purging the system of its most damning statistics.

These findings indicate that the NASD's Public Disclosure Program is woefully inadequate as an investor education or due diligence tool.

As I note in the opening pages of The Siedle Directory of Securities Dealers, the brokerage industry is unique in that it has been permitted to self-regulate, self-insure, self-adjudicate and even control the information the public receives about brokerages. The degree of control the NASD and its members has been granted may well explain the tangled web investors seeking to conduct serious due diligence reviews encounter.

It is my hope that The Siedle Directory will be an important resource for educating investors on the issues involved in reviewing brokerages and the disciplinary norms of the brokerage industry. The very fact that the publication of The Directory has been so strongly opposed by the industry's self-regulator, alone, should be enough to convince even the most skeptical of the need for change.

Information Regarding The Siedle Directory

The Siedle Directory of Securities Dealers has been the subject of articles in The Wall Street Journal, Bloomberg News, Fortune Magazine, Bloomberg Markets Magazine, Pension & Investments and numerous other periodicals. The Directory has also been reviewed on National Public Radio's Marketplace, CBS Radio and other local radio programs. Purchasers of The Directory include law firms, brokerages, pension funds and money managers. The Directory draws certain data from the NASD's Public Disclosure Program that is edited for inclusion. Firms are presented alphabetically, four firms per page. The number of disciplinary events per firm is given by category in the 1600 printed pages that follow. A compact disc or CD is included which provides a description of all the activity listed in the summary data in the print volume. Most importantly, The Directory includes a 50-page overview of the industry and an in depth investigative analysis of the various disclosure systems applicable to brokerages, including the NASD's Public Disclosure Program, the Central Registration Depository and the files of state securities regulators.

While the introduction to the Directory discusses the different disclosure requirements related to firms and individual brokers, The Directory does not provide data regarding individual brokers. The Directory focuses on brokerage firms, the brokerage industry, loopholes in disclosure systems and the conflicts of interest inherent in self-regulation.

The Directory sells to the public for $850. To purchase a copy of The Siedle Directory of Securities Dealers at a discounted rate offered to PIABA members, please call (954) 784-6282 or e-mail me at esiedle@aol.com.

Concentration: Too Much of a Good Thing?

by Tracy Pride Stoneman and Douglas J. Schulz

Tracy Pride Stoneman is a long-time PIABA member, PIABA Board Member and securities lawyer who has her own firm with offices in Colorado and Texas. She can be reached at 719-783-0303 and TStone1000@aol.com. Douglas J. Schulz is a Registered Investment Advisor and NASD Certified Regulatory Compliance Professional and securities fraud expert witness. He can be reached at 719-783-3230. His website is www.securitiesexpert.com. Together they authored the book Brokerage Fraud: What Wall Street Doesn't Want You To Know, Dearborn Trade, 2002.

The brokerage firm puts out a strong buy on a particular stock. The broker begins recommending it to the majority of his clients. The stock goes down and the broker increases his sales efforts in the guise of an averaging down strategy. The broker does some of his own research on the stock and buys some for himself and for some of his family members. The stock continues to go down. Adding fuel to the fire, the firm's analyst keeps a "strong buy" on the stock, which makes the broker feel comfortable in continuing to recommend it. The broker reasons that if he liked the stock at $40, he certainly loves it at $20. The broker throws caution to the wind and buys larger blocks for all of his clients. The stock continues to plummet. Finally, the broker's initial optimism transforms into a sort of frenetic desperation. The broker feels handcuffed. He's got the majority of his book in the stock in far too high a percentage, and he has loaded up himself and his family on it. A recommendation to sell is not a viable option in his eyes, because of the negative impact not only on his clients but on his business. About this time, investor complaints and arbitration claims mount.

The above scenario shows how many investors ended up highly concentrated in securities that may have been totally unsuitable for them.

I. The Explosion in Concentration Cases

While complaints regarding concentration and lack of diversification have always existed, we have seen a surge in such complaints over the last few years. One of the reasons for so many concentration cases is that one portion of the market became significantly hotter than others. In the late nineties, the NASDAQ and more speculative technology stocks started to significantly outperform other markets and sectors. Far too many brokerage firms, analysts and stockbrokers chased that trend. What exacerbated the concentration problem was that as these stocks started to correct, stockbrokers continued to recommend that their clients average down and add more to these stocks.

A concentration problem is not something that rears its ugly head only in chop shops. Concentration cases have been brought against all the major firms, as well. With the bust of dot.coms, telecoms and tech, many firms and their brokers got a rude reminder of the principles of proper diversification. Diversification's nemesis, of course, is concentration. Not since the early eighties when all energy related stocks took it on the chin have we seen such a broad decline across industry sectors. Despite being required to know, younger brokers who had not previously experienced such a debacle were blindsided when they witnessed their clients' accounts plunge in value.

The investigation by the New York Attorney General Eliot Spitzer and other state regulators into analyst recommendations, to some degree, was a byproduct of the concentration problem. If Merrill Lynch and other firms had put only a very small percentage of each of their clients' portfolios in the telecom and technology industries, then the damages sustained by investors may not have warranted such high-profile investigations.

II. How to Plead a Concentration Case

Concentration, or overconcentration as many like to say (though we wonder if that is redundant), falls under two primary causes of action – negligence and fraud related claims (common law and statutory). Negligence is the easier to prove and easier for the arbitrators to grasp. Stockbrokers have a myriad of duties, one of which is the duty to recommend only suitable investments. When an account is overconcentrated, it is de facto unsuitable. The duty has been breached, and the stockbroker and firm (through respondeat superior) are negligent. If you are in a state where you can establish a fiduciary duty on the part of the stockbroker, then the broker's negligence is most certainly a breach of fiduciary duty, as well.

Invariably, if you can blame the stockbroker for concentrating the account, you can likewise blame management for allowing it to happen. The firm would be negligent in failing to adequately supervise the broker and the account. Allege in your claim that management failed to spot the concentration problem, because the firm had no or inadequate procedures to detect concentration, or because the supervisor failed to take reasonable steps once the problem was red flagged. Through discovery, you will learn which one it was. Either way, it is a violation.

Making this allegation will set you up for a specific discovery request requesting documents evidencing how the firm supervised for concentration. Some firm manuals state that supervisors should monitor for concentration when reviewing monthly statements. However, our experience is that it is not uncommon for firms to fail to produce anything responsive to such a request. Some firm compliance and supervisory manuals are vague or devoid of the concentration issue. The firm's lack of evidence, however, should be the claimant's strength.

The NASD sanctions firms with deficient written supervisory procedures, and the NASD has imposed sanctions where procedures failed to outline the methodology for supervision of concentration. See the NASD's January 1999 sanction of Securities America, Inc. below. And the NASD has a Sanction Guideline for this precise type of misconduct. The NASD Sanction Guidelines are available from the NASDR website. The Guidelines allow for a complete suspension of the responsible individual for up to a year. The NASD considers the following two factors in assessing sanctions for deficient written supervisory procedures:

1. Whether deficiencies allowed violative conduct to occur or to escape detection.

2. Whether the deficiencies made it difficult to determine the individual or individuals responsible for specific areas of supervision or compliance.

Be sure and ask for the identity of the individual responsible for monitoring and supervising for concentration. Although many brokerage firms have abused requests for information and gone far beyond asking for "identification of individuals, entities, and time periods related to the dispute," as set forth in the NASD Discovery Guide, we feel that this is a proper request.

Support for concentration as a negligent act can be found in NASD Rule 2310(a) which requires that a member "have reasonable grounds for believing that the recommendation is suitable for each customer…" and in NASD IM-2310-2(a)(1) which imposes on stockbrokers "the fundamental responsibility for fair dealing."

In order to avoid page after page of a brokerage firm's answer devoted to the proposition that there is no private cause of action for a violation of NASD or NYSE rules, it is advisable to structure your claim so that all of your violations of such rules, including failure to supervise, are a subset of your negligence claim. Include language to the effect that "The industry standards of care are set forth by the rules of the NASD (including its Notice to Members), the NYSE, and the SEC; the regulators' interpretations of their rules, federal and state statutes, including the [state] Securities Act; the Securities and Exchange Act; and compliance manuals of the Respondent firm, as well as other firms. Respondents are obligated to provide Claimants and Claimants are entitled to rely upon Respondents for competent, professional securities services in accordance with those industry rules, regulations, customs and practices."

If a brokerage firm should be so bold as to try to attach meaning to the fact that concentration is not specifically referred to in the NASD or NYSE rules, as is the case with unauthorized trading (IM 2310-2(b)(4)(iii) of the NASD Manual and Rule 408 of the NYSE manual) and excessive trading (IM 2310-2(b)(2) of the NASD Manual and Rule 435 of the NYSE manual), there are several ways to counter this argument. First, NASD IM-2310-2(c) makes it clear that the enumerated prohibited practices "are not all inclusive." Therefore, the NASD clearly envisioned violations that it chose not to describe.

If the NASD and NYSE described every conceivable wrong that could be perpetrated on an investor, the respective manuals would easily expand into numerous volumes. For example, the rules do not set forth every aspect of proper supervision, but rather require firms to "establish and maintain a system to supervise the activities of each registered representative and associated person that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with the Rules of this Association." NASD Rule 3010.

Second, compliance and supervisory manual references to concentration issues should be referred to in the Statement of Claim where possible. Your expert should opine that when a stockbroker violates sales practice guidelines set forth in the firm's compliance manual, it is as serious as violating an NASD or NYSE rule. Ask for production of the firm's training manuals, as this elementary precept of investing should be spelled out there.

Third, the concept of diversifying is so basic that it simply "goes without saying." Morgan Stanley's May 2002 Perspectives document states:

> When something stands the test of time, proving its worth again and again, we call it a classic. In the investment world there's a classic piece of advice: Diversify.

However, the most compelling evidence of the seriousness of concentrating a client's account consists of regulatory decisions evidencing suspensions and fines on brokers for overconcentration. It is important to educate your panel early by incorporating such decisions into your Statement of Claim or attaching them as exhibits. The NASD, the NYSE and the SEC offer search capabilities on their websites that allow you to pull up such decisions. You might find a regulatory decision that involves very similar concentration facts and levels as the facts in your case, which would be very persuasive to the arbitration panel.

For years, the NASD has routinely fined and sanctioned brokers for concentrating their clients' accounts. Some NASD sanctions are as follows:

> <u>October 1998</u>
>
> Jeffrey L. Salzwedel (Registered Principal, Tualatin, Oregon)...censured, fined $107,000, and suspended from association with any NASD member in any capacity for 30 days...findings that he made unsuitable recommendations for the purchase and/or sale of various securities in the accounts of public customers without having reasonable grounds for believing that such recommendations were suitable for these customers in view of the number of shares purchased and held, the nature of the recommended securities, the **concentration** of securities held in the accounts, and the customers' specific financial situations, circumstances, and needs.
>
> <u>February 1999</u>
>
> Daniel Richard Howard (Registered Representative, Cambridge, Massachusetts) was named as a respondent in an NASD complaint alleging that he recommended and initiated purchase and sales transactions in the securities account of a public customer without having reasonable grounds for believing that the recommendations and resulting transactions were suitable for the customer in view of the size, frequency, **concentration** of speculative securities; the nature of the recommended transactions; and in light of the customers' financial situation, investment objectives, circumstances, and needs.
>
> <u>October 2000</u>
>
> John Robert Van (CRD #2102824, Registered Principal, Corinth, New York) and Michael Edward Murphy (CRD #1528815, Registered Principal, Clifton Park, New York) - fined $10,000 and suspended from association with any NASD member for 15 business days...findings that they recommended unsuitable trading to public customers that resulted in excessive and inappropriate use of margin. The findings also stated that Van and Murphy recommended transactions in which the customers borrowed against existing stock positions to purchase additional shares of, among other things, "high-risk" over-the-counter stocks. The NASD found that Van and Murphy acted in disregard of their customers' interests when they disregarded the impact of use of margin and the **concentration** levels of certain securities, excessive trading, and the risks incurred in their recommendations that resulted in a total loss of approximately $211,000 and margin interest of approximately $15,300.
>
> <u>April 2001</u>
>
> William Joseph Shaughnessy (CRD #870259, Registered Representative, Tucson, Arizona) submitted an Offer of Settlement in which he was censured and fined $10,000. Without admitting or denying the allegations, Shaughnessy consented to the described sanctions and to the entry of findings that he made unsuitable recommendations for the joint securities account of public customers that

resulted in an over-**concentration** of precious metals-related investments in the account. The findings also stated that Shaughnessy completed a new account form for the customers' securities account that contained material inaccuracies. (NASD Case #C3A000036)

February 2002

John Richard Coleman (CRD #600684, Registered Principal, Orange, California) submitted a Letter of Acceptance, Waiver, and Consent in which he was fined $7,500 and suspended from association with any NASD member in any capacity for 10 business days. Without admitting or denying the allegations, Coleman consented to the described sanctions and to the entry of findings that he recommended transactions of a speculative and high-risk stock, and recommended a covered call strategy, which involved writing options against highly volatile and speculative stocks for the trust account of a public customer without having reasonable grounds for believing that such recommendations were suitable for the customer in light of the size and nature of the transactions, the **concentration** of speculative securities, and the facts disclosed concerning the customer's other securities holdings, financial situation, investment objectives, circumstances, and needs.

The NYSE also has a history of sanctioning brokers for concentration. The NYSE has fewer on point decisions generally, because there are fewer brokerage firms that are NYSE members. Every brokerage dealer must register with the NASD, however.

> *In Re Fulton Gregory Cook*, NYSE 99-170 (1999)("Cook over-concentrated the C Account in XYZ and UVW, which constituted approximately 78% and approximately 16.8%, respectively, of the market value of the account portfolio... the highly margined over-concentration in two speculative securities was unsuitable, in light of the investment objectives, financial resources and investment experience of AC and his wife.")

> *In Re William Kerber*, NYSE 00-221 (2000) (over concentration of aggressive high risk growth stocks).

In addition, regulators have fined brokerage firms for not having in place supervisory procedures designed to catch over concentration and for failing to implement those procedures:

January 1999

Securities America, Inc. (Omaha, Nebraska) submitted a Letter of Acceptance, Waiver, and Consent to the NASD pursuant to which the firm was censured and fined $10,000...The findings also stated that the firm's supervisory procedures failed to include procedures for all the types of business in which the firm engaged, failed to designate the principal responsible for the supervision of registered representatives and principals in the firm's Offices of Supervisory Jurisdiction, and failed to identify the individual responsible for the updating of the written procedures. Moreover, the procedures failed to outline the methodology for supervision of account activity, **concentration**, and use of margin in connection with accounts located in single person Offices of Supervisory Jurisdiction and branch offices.

> *In the Matter of PaineWebber*, SEC Administrative Proceeding File No. 3-8928 (1996)("The Branch Office Manager...failed reasonably to supervise the RR's activities...by failing to take reasonable measures to investigate clear signs of **overconcentration** in accounts of the RR's customers...")

Finally, in addition to negligence, concentration in unsuitable securities operates a fraud on the investor when there is a failure to disclose the concentration and its attendant risks. The NYSE has opined as follows in a case involving concentration:

> Moreover, for all these customers, Mr. Faragalli owed a duty, under these circumstances, to inform them of the extraordinary **concentration** of this particular stock among his customers. We believe that failure to disclose this information constituted a material misrepresentation, necessarily misleading such customers into accepting his recommendations to purchase still more of the stock without regard to potential illiquidity. The failure to disclose was particularly outrageous when, after the market downturn, the stock's potential for illiquidity was fully realized, and yet he recommended more of the stock to customers.

> *In the Matter of Henry James Faragalli*, NYSE Hearing Panel Decision, 94-61, page 25 (1995)(the broker was suspended for 9 years).

III. What is Concentration and How to Spot It

Classically, people think of concentration as putting a large percentage of an investor's assets in one stock. But if an investor had numerous stocks in the telecommunications industry, for example, the diversification in numerous securities provided no protection due to the concentration within a particular industry. Generally, diversification requires investment in securities that are not affected by the same variables. "For example, an investor would not want to combine large investment positions in airlines, trucking, and automobile manufacturing because each industry is significantly affected by oil prices and interest rates." See David L. Scott, Wall Street Words, 1998. Also, Barron's Dictionary of Finance and Investment Terms, 1985, defines diversification as the "spreading of risk by putting assets in several categories of investments – stocks, bonds, money market instruments, and precious metals, for instance, or several industries, or a mutual fund, with its broad range of stocks in one portfolio."

As of late, investors found themselves not only invested in technology stocks but in technology filled mutual funds. The concentration problem was exacerbated by many firms, like Merrill, that created mutual funds heavily weighted in technology. Brokers will sometimes mislead clients into believing they are diversified simply because they are in mutual funds.

When discussing the issue of concentration and lack of diversification, realize that there are two different aspects to it. The first is what percentage of the investor's portfolio should be in stocks - versus cash, bonds or other investments. The second is what percentage of only the stock portion of the investor's portfolio should be in certain types of stocks, industries or sectors of the market. The following pronouncements deal with the first aspect.

Concentration is relatively easy to spot when a single security comprises a significant portion of a client's portfolio. It's also easy to spot when you are able to obtain the firm's guidelines regarding concentration. Merrill Lynch counseled its brokers through its training program books in the early 1980s as follows:

> As a general rule, high-risk money should not exceed 10 – 20% of the client's investment funds, unless high risk is suitable.

More recently, the following is what Merrill Lynch states to clients in its Financial Foundation Reports:

> <u>Managing a Diversified Portfolio</u>
>
> Allocating assets among the three investment classes (equity, fixed income and cash) helps to protect investors against adverse market conditions affecting any one class. In addition, you should consider diversifying your investments within each asset class.
>
> Portfolio theory has statistically shown that a diversified portfolio typically reduces overall risk without necessarily reducing the expected return on that portfolio. This is typically achieved with a mix of different classes of securities representing a wide range of industry sectors that respond differently to various economic forces.

It is also helpful to utilize guidelines that are "sponsored" or attributable to certain firms. In the prospectus for the Equity Investor Fund - Focus Series - Broadband Portfolio 2000 (A Unit Investment Trust) which the prospectus specifically states is sponsored by Merrill Lynch, PaineWebber, and Morgan Stanley, in the section entitled "The Risks You Take", it states:

> When stocks in a particular industry or country make up 25% or more of the Portfolio, it is said to be 'concentrated' in that industry, which makes the Portfolio less diversified.

At the CNN Money Website, there are a multitude of tools designed to assist investors in making their own financial decisions. The site offers a variety of calculators, such as a mutual funds screener, a retirement planner, a savings calculator and a mortgage refinance calculator where the user answers questions to which the output is tailored. Among them is an asset allocator calculator that presents the viewer with various allocation plans depending on the answers to the following questions.

When do you need the money?

a) 3 – 5 years
b) 5 – 10 years
c) 10+ years

How much risk can you handle?

a) Not much at all
b) A reasonable amount
c) As much as possible

How much wiggle room do you have?

a) I can't afford to miss my target.
b) If I miss my goal by a year or two, I'll still be okay.

As the market downdraft intensified in 2001, did you:

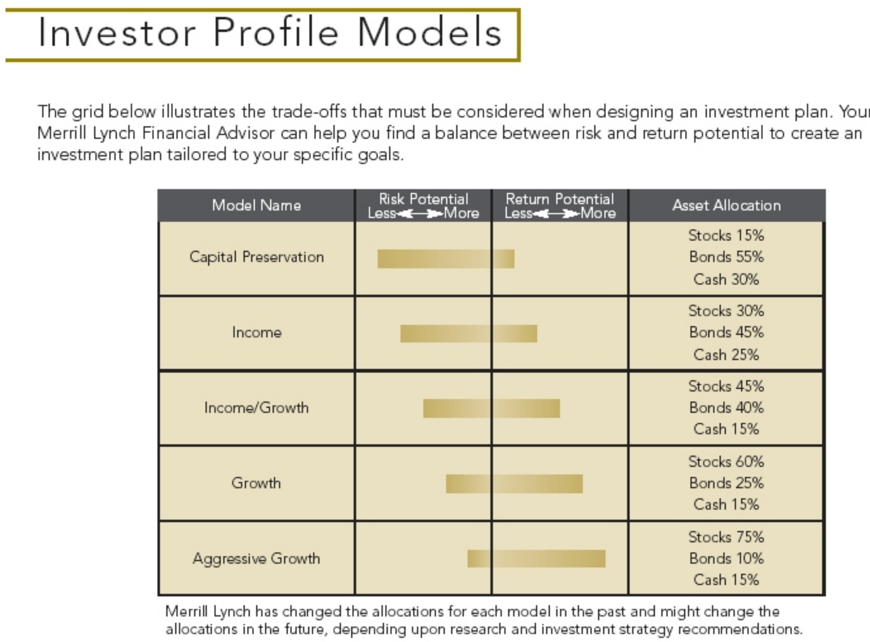
a) Sell stocks thinking things would only get worse
b) Do nothing
c) See an opportunity to buy more stocks

Interesting, if one selects the answers that would be given by the least conservative type of investor (answers a[1], c, b, and c), the suggested allocation has 60% of that investor's account in bonds, as shown below![2]

[1] An argument could be made that the least conservative investor would choose c), however, our rationale was that the risk taker is a mover and shaker and needs access to his funds for risky ventures.

[2] This result was obtained on June 30, 2002 by going to www.cnnfn.com, clicking on calculators and then selecting asset allocator, answering the questions and clicking on "get allocation."

Also, be sure to explore the websites of the brokerage firm at issue to see what they are currently advising folks about. At Merrill Lynch's website, we recently found the following Investor Profile Models[3]:



Investor Profile Models

The grid below illustrates the trade-offs that must be considered when designing an investment plan. Your Merrill Lynch Financial Advisor can help you find a balance between risk and return potential to create an investment plan tailored to your specific goals.

Model Name	Risk Potential Less ← → More	Return Potential Less ← → More	Asset Allocation
Capital Preservation			Stocks 15% Bonds 55% Cash 30%
Income			Stocks 30% Bonds 45% Cash 25%
Income/Growth			Stocks 45% Bonds 40% Cash 15%
Growth			Stocks 60% Bonds 25% Cash 15%
Aggressive Growth			Stocks 75% Bonds 10% Cash 15%

Merrill Lynch has changed the allocations for each model in the past and might change the allocations in the future, depending upon research and investment strategy recommendations.

The second aspect of concentration is focused solely on the stock portion of the account. Brokerage firms have likewise provided documentation to their clients and the public on this issue, as well.

Morgan Stanley's May 2002 Perspectives document states:

> <u>Looking to Reduce Risk? Diversification is Key</u>
>
> Suppose you own just one stock and it declines 20%.
>
> The value of your "portfolio" has fallen 20%. Now suppose you have two stocks, and while one drops 20%, the other stays flat. The value of your portfolio, in this case, has declined by just 10%. If you own 20 stocks, at 20% decline in one reduces the value reduces the value of your portfolio by just 1%! That's how diversification can help to reduce risk and optimize your overall return.

In a document entitled, "Five Strategies for Diversifying a Concentrated Position," which was available on Merrill Lynch's website, Merrill Lynch wrote:

> A concentrated position is a double-edge sword. When the stock's price is rising, the position can boost the value of an investor's overall portfolio. However, when the price falls, the portfolio value will suffer proportionately.

The long held investment norm is that for a stock portfolio to be considered diversified, the stock portion of the account should hold at least 20 (5%) to 30 (3.3%) different stocks. This standard is supported by numerous documents. A November 5, 1997 A.G. Edwards Compliance Note refers to 5% or more in a speculative security as a "concentrated" position.

[3]This chart was obtained on June 30, 2002 at http://askmerrill.ml.com/example/display/1,,534,00.pdf

Even mutual funds, which are professionally managed, must follow certain guidelines under the Investment Company Act of 1940 (ICA) to be considered "diversified." The guideline states that with respect to at least 75% of the fund, the securities of any single issuer do not account for (a) more than 5% of the investment company's assets, or (b) more than 10% of the outstanding voting securities of that issuer. ICA §5(b)(1).

Concentration definitions and levels vary among firms and companies. This makes it all the more important to determine the standards at the respondent firm during the time period at issue – standards for the entire portfolio and standards for the equity investments. However, just because the firm had a standard in effect, does not mean that it was an appropriate standard. If the firm had no standards at the time in question, then look to more recent guidelines by the firm, as well as guidelines from other firms, all of which can serve to establish the standard of care that was breached. Do not hesitate to incorporate standards that you find at respectable websites, like the CNNFN example above, either.

IV. The Impact of Margin in Concentration Cases

The use of margin plays a significant role in concentration cases. Stockbrokers have been known to portray margin to clients as a way to diversify the account, and thereby lessen the risks when, in reality, margin increases the risks. An investor on margin is much more susceptible to price swings in the stocks owned and, accordingly, risks having to liquidate either the core holding or the new stocks purchased using margin. The investor not on margin, on the other hand, has the ability to weather price drops without being forced to take action. Even Olde Discount's 1993 Compliance Manual stated "Investing in one security, a few securities, or securities in the same industry exposes the customer to greater risk, especially in a **margin** account."

With more frequency, we have seen the situation where an employee of a publicly traded company opens a brokerage account with a deposit of a huge amount of his company stock acquired through employee stock options. Brokers may mislead clients into believing that there is no need to sell the company stock and that, instead, diversification can be accomplished by using margin and purchasing additional securities. The problem is that the broker has not lessened that client's risk in the concentrated position. The client has the same exposure – in terms of risk of loss if the stock nosedives – as he did when he came to the firm. For this reason, margin is not an effective tool to lessen the risk in a concentrated position.

Diversification works in the absence of margin, because in order to diversify, the client has to sell some of the underlying security, which in turn lessens the risk of the concentrated position.

Ask your clients if the broker brought up margin as a way to diversify. Explore the broker's financial incentives to utilize margin. In a commission based account, margin increases the account's buying power and the broker's ability to generate commissions. Establish that what the broker made in subsequent margin purchases was greater than what he would have made if he had sold some of the concentrated security. If the broker was compensated on a percentage or flat fee basis, show that the broker made money by margining the account, since such compensation is based on the market value of the account, as opposed to the equity.[4] Compare this to what the broker would have made if he had recommended that a portion of the underlying security be sold - nothing.

Margin almost never decreases the risks, and almost always increases the risks. If the broker or brokerage firm argues that the use of margin diversified the account and thus lessened the risks, it will be clear that the firm not only misled your client, it is trying to mislead your arbitration panel.

V. Brokerage Firm Defenses to Concentration Cases

Brokerage firms utilize a variety of tactics to defend concentration cases. First, they often paint a picture that your client is a speculator, and so the concentration was not unsuitable. Second, they may attempt to show that there was no concentration by, what we call, "diversification by hindsight." Third, they almost always blame the investor for loving the stock or the industry and wanting to load up on it. Where possible, the firm will support that claim with evidence that the broker marked the order tickets "unsolicited". And finally, if your client came to the firm with the concentrated position, they will claim "no duty." Each of these defenses can be dealt with as follows:

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[4]Some firms also pay their brokers a percentage of the margin interest paid by the client.

A. Your Client Was A Speculator

The classic defense to almost any claim that hints of unsuitability is that the client had speculation as an investment objective and, hence, the firm had carte blanche to recommend anything and everything. The problem with such a premise is that it presupposes two things that undermine the premise. The first is that even stupid recommendations are suitable and the second is that historical precepts for investing no longer have any validity.

A true speculator, be he in real estate or stocks, takes calculated risks by conducting research and using historical data to measure and evaluate the potential risk and return. The true speculator doesn't make stupid investments. And he doesn't throw out the window the historical precepts regarding investing. He probably makes rather intelligent investment decision; they just happen to be higher risk. It has been written that "the speculator is the advance agent of the investor...the road to success in speculation is the study of values."[5]

Though you likely dispute the contention that your client was a speculator, you may be able to show that the conduct in question failed to meet the investment objectives of speculation, assuming for the sake of argument, their validity.

B. Diversification Through Hindsight

In determining the percentage of concentration, the top number – or numerator in the equation - is the dollar value of the concentrated position, whether that is a single security, a group of "high risk" securities, or a particular industry. There is usually little dispute about that figure.

However, in one of Mr. Schulz's recent cases, where the registered investment advisor had placed roughly 80% of the investor's account in technology stocks, at the arbitration the advisor attempted to dispel the concentration by fiddling with the numerator. The advisor contended that the "technology" stocks were not really technology stocks per se, but rather could be broken down into the following different and diversified industries: hardware, software, communications, micro-chips, etc. Do not let your arbitration panel be fooled by this unsupportable argument. There are roughly 10 accepted "sectors," and not all of them are technology.[6]

More commonly, brokerage firms muddy the water by attempting to increase the denominator. Doing so results in a lower percentage of the concentrated position, perhaps so much so that it enables the firm to argue that there was no concentration.

This is the same tactic used by brokerage firms and their experts in churning cases. In determining the turnover number, brokerage firm experts try to use the market value of the account as the denominator, as opposed to the account equity, which is the accepted way to perform the calculation. It is ironic that firms want to use the account value figure as the denominator – the figure that evidences that the firm margined the account and, by definition, increased the risk – to lower the turnover number, thereby masking the risk level of the account. Fortunately, regulators have rejected these defense arguments. *See, In the Matter of Dean Witter, et. al.*, SEC Administrative Proceeding File No. 3-9686 (2001)(SEC accepted claimant's turnover and concentration calculations).

What figure you use for the denominator will depend upon the facts of your case. Again look to any pronouncements by the firm in question. Merrill Lynch states that it does not include "other assets," such as the value of life insurance policies or business interests, in its asset allocation analysis "because this type of asset may not be readily reallocated." Under that theory and generally speaking, the value of assets in a separate IRA account should not be a part of the denominator, nor should other accounts that are earmarked for specific purposes or specific goals, such as a trust fund for a child's education. Additionally, brokerage firm attempts to look to assets in accounts outside the firm to lessen the concentration figure usually fail and are viewed as Monday morning quarterback behavior.

C. It Was The Client's Idea - Confirmations Are Marked Unsolicited

At one end of the spectrum, we have the situation where the broker has marked all of the purchases

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[5]Philip L. Carret, The Art of Speculation, 1975.

[6]Merrill Lynch, on some of its CMA Account statements, lists the following 10 sectors: Financials, Services, Consumer Staples, Consumer Cyclicals, Capital Goods – Technology, Capital Goods – Industrial, Energy, Basic Industries, Transportation, and Utilities. Morgan Stanley, in its May 2002 Perspectives document, lists the following 10 sectors: Consumer Discretionary, Consumer Staples, Energy, Financials, Health Care, Industrials, Information Technology, Materials, Telecommunications Services, and Utilities.

resulting in the concentrated position unsolicited, meaning it was the client's idea. Yet, your client has told you that none of the transactions were her idea. We have seen numerous cases involving this fact pattern.

In this situation, it is critical that you obtain the broker's unredacted commission runs in discovery, the document that shows all of the broker's transactions in all of his accounts. By unredacted, we mean other customers' account numbers are not fully redacted so that you can see how many different accounts there are. The NASD Discovery Guide speaks to such redaction, however, it is faulty in that it only mentions unredacted commission runs being discoverable in churning cases. This is presumably because the issue of control is an element of churning claim. If the broker had all or many of the same investments in his other clients' accounts, this would be evidence that the broker controlled the client's account.

Unredacted commission runs are equally important in concentration cases. The broker's mismarking of order tickets can be swiftly refuted by showing that the broker was making the same trades in other clients' accounts. When making this argument in the pre-hearing conference, point to language in the respondent's answer claiming that the trades were the claimant's idea – to show that the same issue of control exists in your concentration case.

Even where a claimant affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a broker is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. *See, In re Gordon Scott Venters*, 51 S.E.C. 292, 294-95 (1993); *In re John M. Reynolds*, 50 S.E.C. 805, 809 (1992). This is especially true where a brokerage firm's recommendation leads to a high concentration in the customer's account of a particular security or group of securities that are speculative. *See, e.g., In re Clinton Hugh Holland*, Exchange Act Rel. No. 37991, at 8 (Dec. 21, 1995), aff'd, 105 F.3d 665 (9th Cir. 1997).

Oftentimes brokers, in defense of a concentrated position, will testify that they advised the client against the concentration levels but the client insisted on it. Make sure you find out where the broker and/or his supervisor documented this "unsuitable" activity. Some firms such as A.G. Edwards, Dean Witter, and First Union state in their compliance manuals that their brokers are not required to accept trades that they think are unsuitable but if they do, they must, at a minimum, document the incident. Some require the broker to obtain a signed "unsolicited" letter from the client.

At the other end of the spectrum, do not think you are safe if the purchases that collectively resulted in the concentrated position were "solicited" by the broker (meaning the confirmations do not say "unsolicited"). We have had cases where brokers testified that they did not check "unsolicited" on the order ticket because, for example, the stock was on the firm's recommended list which meant an automatic "solicited" trade. Nonetheless, the broker's testimony was that it was the client who called up begging to load up on more of the stock. Again, ensure you obtain the unredacted commission runs. If there are just a few trades in other clients' accounts in the same security, you may need to make a second request for the order tickets for those trades to actually see how they are marked. It's not too late if you first confront this situation in the arbitration. We had one panel order the production of order tickets in other customer accounts to examine this very issue – right in the middle of the arbitration!

Lastly, we have encountered brokers who think that an adequate defense to a concentration claim is that the investor was consulted on every purchase and never complained about the concentration. We have found that defense to be ineffective. A broker has a duty to make suitable recommendations; the mere fact that the client goes along with the strategy does not somehow relieve the broker of that duty.

D. The Investor Was Concentrated Upon Arrival at the Firm – We Didn't Do It

There has been a rash of complaints by individuals who accumulated large blocks of employee stock options. If the individual worked for one the successful tech or telecom companies, it was not uncommon for such folks to have become millionaires almost overnight. Many of these employees flocked to brokerage firms for advice on not only how to handle the exercising of their employee stock options, but also for investment advice on their accumulated wealth. Many companies directed their employees to brokerage firms with which the company had a relationship, for the purposes of having the firm counsel the employee regarding the stock options.

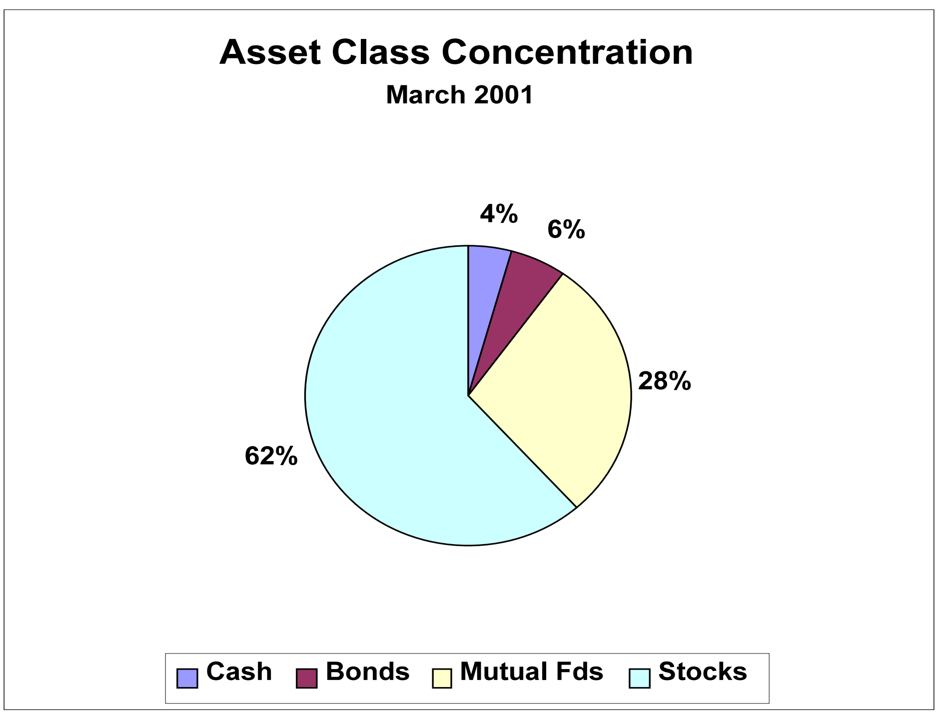
This scenario also raises concentration issues, except that opposed to the broker having recommended the concentration; the investor has comes to the broker with the concentration in hand.

Many times, instead of recommending that the client liquidate some or all of the concentrated position or hedge it, the broker recommends that the client retain it. The broker may advise the client to use margin to pay the taxes and to pay the cost of the option stock price and, as we discussed earlier, may recommend that the client use margin to "diversify" the account. We have seen time and time again where this combination of using margin to handle the options and using margin to buy more stocks was a disaster waiting to happen.

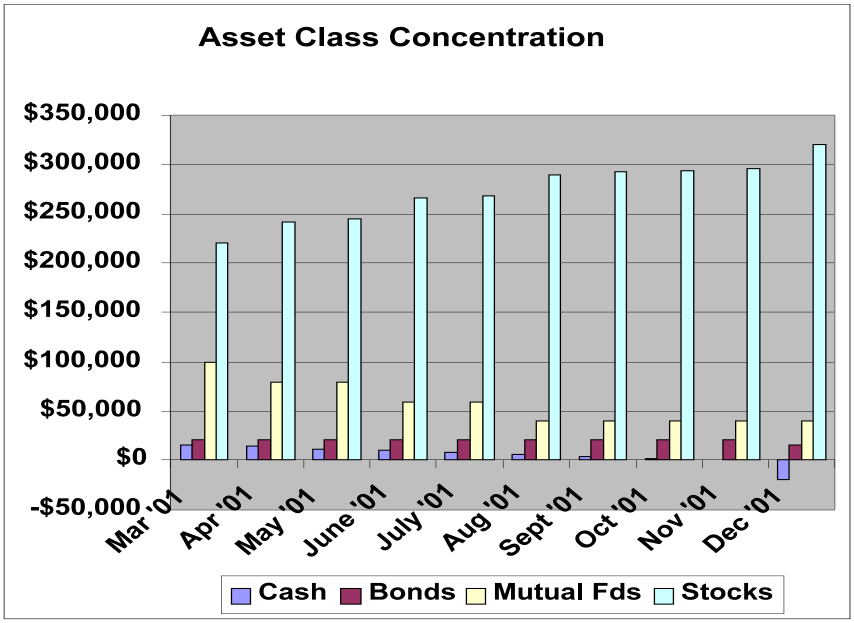
If a broker improperly induced a client to hold a security, there is authority that such conduct is negligent. See NYSE Interpretive Memo No. 90-5 which defines "recommendation" to include a broker's influence to hold a security and NYSE Rule 405 which requires due diligence to learn essential facts of every account. If you can establish a fiduciary relationship between the client and the broker or advisor, then such relationship gives rise to a duty to speak or act. *Insurance Co. of North America v. Morris*, 981 S.W.2d 667, 674 (Tex. 1998). Such a failure to act gives rise to liability. *See, In re Saxton*, 712 N.Y.S.2d 225 (N.Y.App.Div., Aug. 10, 2000) and *Matter of Estate of Janes*, 659 N.Y.S.2d 165, 681 N.E.2d 332, 90 N.Y.2d 41 (N.Y. 1997)(fiduciary retained stock in inadequately diversified account while the stock lost substantial value); *In re Rowe*, 712 N.Y.S.2d 662 (N.Y.App.Div., Aug. 10, 2000) (a fiduciary "can be found to have been imprudent for losses resulting from negligent inattentiveness, inaction or indifference."). If your client arrived at the brokerage firm in a concentrated position, whether it be because of stock options or a previous negligent firm, your client may have a viable claim.

VI. Using Graphics to Present Your Concentration Case to the Panel

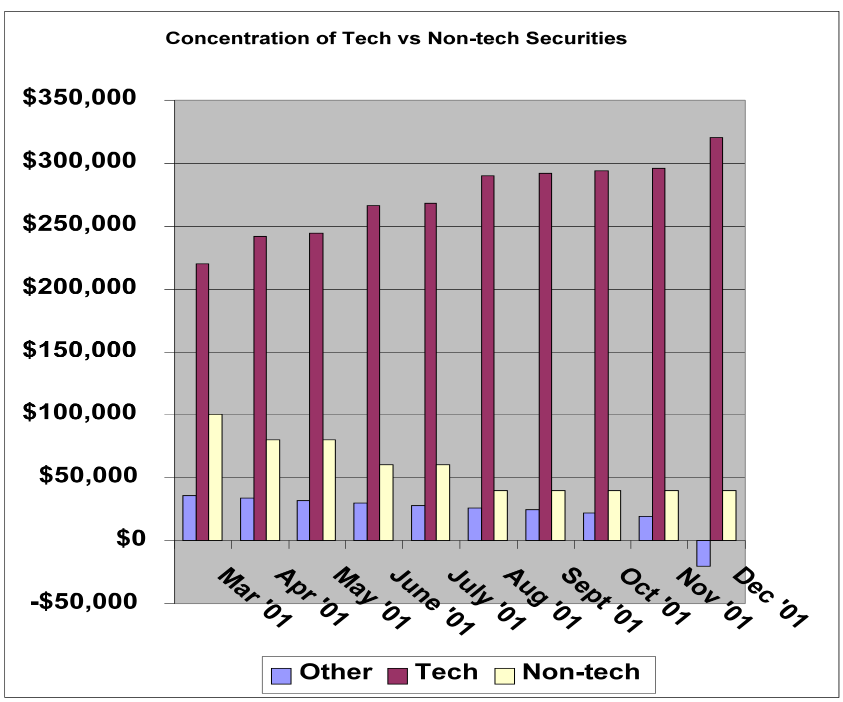
Charts and graphs are very useful tools in a concentration case. The unsuitability of concentration delivers much more of a punch when the arbitrators are staring at a color, graphic presentation. The classic illustration is the pie chart wherein the pie is investors' entire portfolio and the pieces of the pie are broken down by sector and percentages.



Additionally, bar charts can be used to illustrate the same point.



It's also quite effective to display, for example, the percentage of technology stocks versus non-technology stocks in a bar chart.



Charts and graphs can tell your client's story in a vivid manner that will hammer home the points you need to make in a concentration case.

VII. Conclusion

NASD statistics reflect a record number of arbitrations claims being filed by investors who have sustained record losses. The brokerage industry would have the investing public and arbitrators believe that this is no fault of theirs, but rather the responsibility of the bear market. For at least the last decade, almost every brokerage firm and defense law firm has argued to arbitrators that comparing the investor's losses to the markets was improper. They claimed that "lost opportunity damages" and "market comparative analysis" was not appropriate.

How quickly they have changed their tactics. Now, these same brokerage firms and defense lawyers fill their answers and exhibits with charts showing what the investor would have lost in the market. The more aggressive defense lawyers dare to compare the client's losses to the NASDAQ, the most speculative of indices. Yet, hardly a claimant's lawyer compared client's losses to the NASDAQ when it was doubling.

But there is justice. Hopefully, you have an experienced panel that will remember the defense's dislike for market comparison damages. If not, dig out answers from some of your earlier cases. Make them an exhibit and show the panel the hypocrisy. To bolster that same point, obtain the firm's television and print ads during the time period of your client's account. The arbitration panel may find quite a contrast between what the firm was representing to the public compared to a) what it did to your client's portfolio; b) what it stated in its answer, and c) the positions it takes at the arbitration.

With Henry Blodgett and Mary Meeker pushing tech and Jack Grubman pumping telecom to their brokers and the investing public, it is not happenstance that millions of investors ended up concentrated in volatile, speculative securities. The sad reality is that millions of investors not only paid for this advice in the form of commissions and fees, but they also paid for it with their life savings.

Brief Spotlight: The Inapplicability of Statutes of Limitation on Actions to Private Contractual Arbitration Proceedings

By Scot Bernstein

Scot Bernstein is a member of PIABA's board of directors. His law firm -- Law Offices of Scot Bernstein -- is located at 10510 Superfortress Avenue, Suite C, Mather Field, California, near the City of Sacramento. Mr. Bernstein can be reached at 916-447-0100. His email address is swampadero@aol.com

Some truths are expected. Others come as a surprise. It was heresy at one time to suggest that two objects of different weights, dropped simultaneously from the same height, should hit the ground at the same time. What once was heresy has become nearly universal knowledge. Yet even now, many might find it hard to believe that a helium balloon and a ten-pound dumbbell dropped simultaneously from the same height in a vacuum chamber would hit the floor at the same time.

The observation that not all truths are equally obvious applies as well outside of physics. Some legal principles are unsurprising. Others are counterintuitive until their underlying reasons are examined in some detail. The subject of this month's Brief Spotlight is a good example of that phenomenon. Most of us had some general awareness of the existence of statutes of limitation long before we entered law school. Because the disputes that have been reported in the media for most of our lives have been in court, statutes of limitation almost invariably were applicable. So the tendency is simply to assume that they are applicable to all disputes. They are not.

My introduction to this issue came courtesy of Joe Long's excellent discussion of it as part of his "From the Professor" column in the December 1997 *PIABA Quarterly.* From the Professor: Dispositive Motions (1997) 4 *PIABA Quarterly* number 4, pages 3 - 9. The persuasiveness of Joe Long's article motivated me to look at the ALR annotation on the subject -- Annot., Statute of Limitations as Bar to Arbitration Under Agreement (1979) 94 ALR 3d 533. Typically, ALR annotations present cases on both sides of an issue. In an astonishing departure from that norm, the annotation on this subject was entirely one-sided. Apparently, its author was unable to find a single case for the proposition that statutes of limitations were applicable to private contractual arbitration proceedings.

The theory underlying the cases that have addressed this issue is that statutes of limitation are, by their own terms, limitations on actions, and arbitration cases are not "actions." Far from being an excessively legalistic parsing of a statute, this analysis reflects a realization that limitations on actions exist, in part, to protect courts from the obligation to resolve cases that may be dominated by older evidence. Legislatures have no reason to impose those rules on parties who have chosen alternative dispute resolution by agreement and have not chosen to import those rules into that agreement.

Of course, due to the paper-intensive nature of the securities business and its long record retention requirements, documents are a far greater fraction of the evidence in SRO arbitration cases than in other kinds of cases. Documents do not age as quickly as other kinds of evidence. Thus, older broker-customer disputes may not be dominated by stale evidence even when other kinds of cases alleging similar common law causes of action might be. Accordingly, it is not unreasonable that the only time limitation would be six years from the occurrence or event giving rise to the controversy as set forth in NASD Rule 10304 and NYSE Rule 603.

One clear conclusion from this analysis is that counsel who want to make this argument should not refer to arbitration cases as "actions."

The number of cases on this issue is relatively small. Not many courts have spoken to it in a direct way. In part, perhaps, that paucity of case law may reflect the relative infrequency with which the internal details of cases in arbitration are resolved by appellate courts.

Practitioners in those states in which the appellate courts have addressed this issue should have the easiest time with this argument, of course, because they will have precedent directly on point. But many other states, while lacking cases directly on point, do have case law establishing in other contexts that an arbitration proceeding is not an "action" and, therefore, that limitations on "actions" do not apply to arbitration proceedings. See, *e.g.*, *Miele v. Prudential*, 656 So.2d 470 (Fla. 1995) (arbitration is not considered a "civil action"); Chuck Austin's excellent contribution on the subject in the members-only area of the PIABA website; and the California cases discussed in the brief below.

Many states, in addition, will have codes of civil procedure that (1) define "action" in a way that clearly does not include arbitration proceedings and (2) contain statutes of limitation that limit only the time within which "actions" may be brought, thus leaving private contractual arbitration out of the picture. See, *e.g.*, the discussion of California statutes in the brief below; Tennessee Code Annotated 28-1-101.

The letter brief below is based on a brief I prepared for use in a franchise fraud case at the American Arbitration Association's San Francisco office. I have modified it to emphasize theories applicable to SRO arbitration proceedings. I have left the additional arguments specifically applicable to the AAA proceedings in the brief, italicized and in brackets. While those bracketed, italicized arguments may not be helpful in cases before the SROs, they will be useful to PIABA members involved in AAA proceedings, as typically occurs in cases against registered investment advisers.

Further modification will be required, of course, to fit the laws of the state in which the brief is being used.

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, determine whether to keep or delete bracketed text 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.

A final comment about the counterintuitive character of the argument embodied in this brief is in order. Arbitrators may reject the asserted inapplicability of statutes of limitation out of hand. If they do so, their ruling may have little to do with the merits of the argument and much to do with its being contrary to their preexisting beliefs. That is, perhaps, one reason for submitting this argument in a separate, single-subject letter brief. It is important, however, that this argument be raised each time it is potentially applicable. Exposure to correct legal arguments eventually will allow those arguments to prevail, notwithstanding their counterintuitive nature.

///
///

\\ Date

\\, Esq.
Arbitrator
\\
\\, California \\

VIA FEDEX

Re: \\ , LLC v. \\ , Inc.

**AAA Case No. **

CLAIMANT'S SUPPLEMENTAL ARBITRATION BRIEF REGARDING INAPPLICABILITY OF STATUTES OF LIMITATION TO PRIVATE CONTRACTUAL ARBITRATION PROCEEDINGS

Dear \\ :

In this letter, Claimant will address the question whether statutes of limitation governing actions in court are applicable to private contractual arbitration proceedings. We are sending this letter directly to you in keeping with the parties' agreement that arbitration briefs in this matter should be handled in that way and need not be routed through AAA.

Overview

The Respondent in this matter will argue that statutes of limitation exonerate it from its wrongdoing. But the statutes of limitation, or parts thereof, on which Respondent will rely are discovery-based. That is, they begin running only when the Claimant discovers or should have discovered the Respondent's wrongdoing.

Thus, the Respondent will be forced into the contradictory position that typifies defendants' attempts to assert discovery-based statutes of limitation. Respondent will argue in one breath that it did no wrong. In the next, it will argue that its wrongdoing was so obvious that the Claimant should have discovered it long ago. The weakness in that position is self-evident.

In a separate brief, Claimant will address the factual and legal aspects of Respondent's assertions regarding statutes of limitation. Claimant's discussion of those issues, taken together with the evidence presented at the hearing, will show that, even if those statutes of limitation were applicable to

Claimant's claim, Claimant's filing was timely. To determine otherwise would be to hold the Claimant to an impossible standard of astuteness in discovering Respondent's violations of the law. Such a holding would run contrary to laws designed to level an extremely unlevel playing field and would eviscerate the legislature's intended protection of investors.

This brief will not address the Respondent's statute of limitations arguments. Rather, it will examine an issue that frequently is ignored: whether statutes of limitation are applicable to private contractual arbitration proceedings at all. Cases that have addressed this question *uniformly* have held that statutes of limitation are inapplicable to private contractual arbitration proceedings and that, in arbitration, the only time limitations are those that are set forth in the parties' arbitration agreement.

Case Law Makes Statutes of Limitation Inapplicable to Arbitration Proceedings

Relatively few cases address the applicability of statutes of limitation to private contractual arbitration proceedings. Those cases that address the issue, however, uniformly have determined that where the statutes of limitation are, on their face, limitations on "actions" in court, they are inapplicable to private contractual arbitration proceedings. Instead, the only time limitations that apply in arbitration are those that have been agreed upon by the parties.

Far from being an excessively legalistic reading of a statute, this analysis reflects a realization that limitations on actions exist, in part, to protect courts from the obligation to resolve cases that may be dominated by older evidence. Legislatures have no reason to impose those rules on parties who have chosen alternative dispute resolution by agreement and have not chosen to import those rules into that agreement.

There is, of course, a contractual time limitation in securities industry arbitration proceedings: the six years set forth in NASD Rule 10304 and NYSE Rule 603. It is not surprising that this longer period was chosen for securities cases. Evidence in broker-customer disputes does not age as rapidly as evidence in other kinds of cases. The paper-intensive nature of the securities business and its long record retention requirements and practices make documents a greater fraction of the mix in securities industry arbitrations than in other kinds of proceedings. Thus, the documents and refreshed testimony in a five-year-old broker negligence case are likely to be far more reliable than the unrefreshed testimony in a five-year-old automobile accident case.

The most thorough judicial treatment of this issue appears in *NCR Corp. v. CBS Liquor Control* (*"NCR"*), in which an arbitrator's refusal to apply a statute of limitations was found not to be manifest disregard of the law. *NCR Corp. v. CBS Liquor Control*, 874 F. Supp. 168, (S.D. Ohio 1993), *partially modified on unrelated grounds,* 1993 WL 767119 (S.D.Ohio Dec 24, 1993) (NO. C-3-91-027, C-3-01-031), *aff'd sub nom.* NCR Corp. v. Sac-Co., 43 F.3d 1076 (6th Cir. Ohio 1995), *rehearing en banc denied,* 1995 U.S. App. LEXIS 3559 (6th Cir. Ohio Feb. 21, 1995), *cert. denied sub nom. Sac-Co Inc. v. AT&T Global Info. Solutions Co.*, 516 U.S. 906, 116 S. Ct. 272, 133 L. Ed. 2d 193 (1995).

During the arbitration underlying that recent case, NCR Corp. was able to make a forceful argument that the claims against it were barred by a number of potentially applicable statutes of limitation. The arbitrator refused to apply those statutes of limitation and awarded damages to CBS Liquor Control. NCR Corp. then petitioned to vacate the award, claiming that the arbitrator's refusal to apply a statute of limitations was manifest disregard of the law. The U.S. District Court disagreed, stating that

> **"the effect of a statute of limitations is to bar an action at law, not arbitration."**

Id., at 172 [emphasis added]. The court went on to point out that, if NCR had allowed the claims against it to remain in court, rather than forcing them into arbitration, it might well have defended successfully on statute of limitations grounds:

> Had these claims remained pending in the New York Supreme Court, NCR would have had an excellent motion to dismiss the counterclaims as barred by the statute. It chose instead to demand the claims be arbitrated.

Id.

The *NCR* court recognized the critical difference between statutes of limitation that extinguish ***claims***, on the one hand, and those which place time limits on the filing of ***actions***:

> **If the statutes of limitations on which NCR relies were of the sort that purport to extinguish claims, rather than limit actions in court, they might be relevant, but they do not purport to be statutes of that sort. Rather, on their face they limit the bringing of actions.**

Id. [emphasis added]. Thus, the statutes of limitation in NCR, like those that Respondent attempts to assert in its defense here, were limitations on actions in court rather than on the underlying claims. They are not a defense in an arbitration proceeding.

The court went on to point out that the parties could have included an express time limitation in their arbitration agreement or incorporated a statute of limitations by reference. Because they did neither, there was no time limitation defense in the underlying arbitration. In this regard, the court stated as follows:

> *In Son Shipping Co. v. DeFosse & Tanghe*, 199 F.2d 687 (2d Cir. 1952), relied upon by the Arbitrator, the Second Circuit specifically held a statute of limitations on an underlying claim did not apply when the claim was to be arbitrated. In *Office of Supply, Government of the Republic of Korea v. New York Navigation Co.*, Inc., 469 F.2d 377 (2d Cir. 1972), it was held not to be a manifest disregard of the law for an arbitrator to honor a limitations clause from a statute incorporated by reference into the contract between the parties. **There is no doubt that NCR and Acme could have lawfully incorporated into the 1982 Agreement either an express limitation on claims or incorporated a statute of limitations by reference, but they did not do so.**

Id., at 172 - 173 [emphasis added]. The court concluded that the arbitrator was correct in holding that the statute of limitations was not directly applicable in arbitration and in not applying a statute of limitations defense.

In *Son Shipping Co. v. De Fosse & Tanghe*, 199 F.2d 687 (2d Cir. 1952), cited favorably in *NCR*, the court held that a claim made outside of the time limit provided by a statutory cause of action was not barred. The court stated as follows:

> "Nor does the reservation to the carrier in the charter party of all rights it would have under the Carriage of Goods by Sea Act, 46 U.S.C.A. section 1300 et seq., make the demand for arbitration untimely. It is true that the demand was not made within the one year limitation upon suits, contained in section 1303(6) of the above Act, but there is, nevertheless, no time bar because arbitration is not within the term "suit" as used in that statute. Instead, it is the performance of a contract providing for the resolution of a controversy without suit."

Id, at 689.

The *Son Shipping* court, like the *NCR* court, went on to impose upon the parties the obligation to include in their arbitration agreement any time limitations that they would like to see imposed.

Similarly, in *Har-Mar, Incorporated v. Thorsen & Thorshov, Inc.*, 218 N.W.2d 751 (Minn. 1974), the court stated that the term "action" had been restricted to "the prosecution in a court of justice of some demand or assertion of right by one person against another." The court went on to hold that the six-year time limitation at issue "was intended to be confined to judicial proceedings" and did not apply in arbitration. That court stated as follows:

> "Based upon the special nature of arbitration proceedings and both the statutory and common-law meaning of the term "action," we feel compelled to hold that section 541.05(1) [the six year statute of limitations] was not intended to bar arbitration of Thorsen's fee dispute solely because such claim would be barred if asserted in an action in court."

Likewise, in another recent case, *Carpenter v. Pomerantz* (1994) 36 Mass. App. Ct. 627, 634 N.E.2d 587, the court held Massachusetts' statute of limitations on actions for breach of contract to be inapplicable to demands for arbitration. The court pointed out that the statute limited the time for commencement of "actions" and stated that

> "As used in statutes of limitation, the word "action" has been consistently construed to pertain to court proceedings."

See also Lewiston Firefighters Association v. City of Lewiston, 354 A.2d 154, 167 (Maine 1976) ("Arbitration is not an action at law and the statute is not, therefore, an automatic bar to the Firefighters' recovery"); *Skidmore, Owings and Merrill v. Connecticut General Life Insurance Company*, 25 Conn.Sup. 76, 197 A.2d 83 (1963) ("Arbitration is not a common-law action, and the institution of arbitration proceedings is not the bringing of an action under any of our statutes of limitation").

Thus, courts around the country that have addressed the issue have arrived at the same result: statutes of limitation governing the filing of "actions" do not apply to claims brought in arbitration. Moreover, perhaps even more persuasive than the case law in Claimant's favor is the absence of any case law supporting the Respondent's position on this issue. Respondent has no statute of limitations defense.

The Parties' Arbitration Agreement Contains No Time Limitation

The time limitations that apply to demands for arbitration are those that are included in the contract between the parties. The NASD and NYSE arbitration rules recognize this and provide for it specifically. Rule 10304 of the NASD Code of Arbitration Procedure, for example, requires that claims be filed within six years after the "occurrence or event" giving rise to the controversy. The NYSE's parallel provision is Rule 603. The rules of the securities industry arbitration forum are incorporated into the arbitration agreements of parties to securities disputes.

Indeed, both NASD Rule 10304 and NYSE Rule 603 expressly recognize that statutes of limitation on actions may not be applicable to NASD arbitration proceedings. Both rules state in relevant part as follows:

> "This Rule shall not extend ***applicable*** statutes of limitations . . . ."

[Emphasis added.]

The use of the word "applicable" underscores the drafters' awareness that some statutes of limitation are **inapplicable** to securities arbitration proceedings. Whether or not they are applicable depends on the relevant law. If the law of the state in question were to define an "action" to include private contractual arbitration proceedings, for example, statutes of limitation on actions might well be applicable to those proceedings. Lacking that, however -- or in states which define "action" to include only court proceedings -- the six-year period set forth in NASD Rule 10304 and NYSE Rule 603 is the *only* time limitation that applies to arbitration proceedings under those securities industry arbitration rules.

\\ [*In contrast, the AAA Commercial Arbitration Rules governing this case impose no specific limitations on the time within which claims must be filed. Instead, the AAA rules leave it to the parties to craft their arbitration agreement as they see fit. Section 6 of those rules provides as follows:*

> *"Arbitration under an arbitration provision in a contract shall be initiated in the following manner:*
>
> *a. The initiating party (hereinafter claimant) shall,* ***within the time period, if any, specified in the contract(s****), give written notice to the other party (hereinafter respondent) of its intention to arbitrate (demand)...." [Emphasis added.]*] \\

\\ *[Thus, the AAA rules contain no time limitation that would bar Claimant's claim; nor do they import into AAA proceedings the statutes of limitation that govern "actions" in courts of law. Rather, they explicitly recognize both (1) that the time limitation that applies is that which is set forth in the agreement of the parties and (2) that there may not be any time limitation at all.]* \\

The parties' arbitration agreement is silent on this issue. Respondent drafted that provision in its entirety and included it in a lengthy account agreement that was presented to Claimant on a take-it-or-leave-it basis. The arbitration provision is long and goes into substantial detail about the rights of the parties. \\ *[For example, it goes on at some length about a New York choice of forum and specifically acknowledges that the choice of forum may be unenforceable as a matter of California law.]* \\ In all that detail, however, the parties' agreement says nothing about any limitation on the time period within which arbitration must be demanded. Nor, for that matter, does the arbitration provision import into the agreement the limitations periods that would apply to actions in court.

Perhaps this is by design. Broker-dealers bring claims against customers, just as customers bring claims against broker-dealers. Respondent may well have decided that its own interests were best served by not attempting to impose time limitations on (or import statutes of limitation into) the arbitration agreement.

> \\ *[Significantly, Respondent's arbitration clause expressly states that the parties' rights in arbitration will differ markedly from their rights in court. That clause includes the following statement:*
>
> *"By agreeing to an ADR format, both Operator and Franchisor are also waiving a number of rights, remedies and privileges which may arise in a judicial resolution format."]* \\

What is good for the goose is good for the gander. If Respondent is not constrained in arbitration by time limitations, including the time limitations that would be applicable if the case were an action in court, then neither is Claimant.

It is disingenuous for Respondent to set up an account agreement containing a dispute resolution system with no time limitations other than the SROs' six-year rules -- a system under which it hopes to face no such limitations in bringing claims against its customers -- and then assert that limitations periods applicable to actions in court somehow apply to these private proceedings.

All of this is, in a sense, just a simple matter of contract interpretation. Respondent was, after all, the drafting party. If it wanted to impose or import time limitations or statutes of limitation into the arbitration agreement, it could have sought to do so. It did not. That failure must be construed against Respondent.

California Statutes and Case Law

California does not have a case directly on point. That is, no California case addresses the question whether statutes of limitation on actions in court are applicable to private contractual arbitration proceedings. Nevertheless, California's statutes -- and the California courts' refusal to treat proceedings outside of the courts as "actions" in other contexts -- are consistent with the reasoning of the cases discussed above

Statutory Analysis

Consistent with the statutes of limitation construed in the cases discussed above, California's statutes of limitation, by their own terms, clearly apply only to "actions." They govern the administration of justice by the courts. Arbitration proceedings, as a matter of statutory definition, are not "actions." Statutes of limitation therefore do not apply to claims brought in arbitration.

The California Code of Civil Procedure (the "CCP") is massive. Apart from the arbitration provisions contained in sections 1280 through 1298.8, the great bulk of the CCP's provisions have no application whatsoever to arbitration proceedings. This is well known and well accepted. Arbitration proceedings are governed instead primarily by the parties' arbitration agreement and the rules of the arbitration forum, which are incorporated into that agreement. In this case, the applicable rules are contained within the NASD Code of Arbitration Procedure.

Notwithstanding the inapplicability of the CCP, respondents for years have baldly asserted that their favorite provisions of the CCP -- statutes of limitation and the ability to engage in pre-hearing dismissal motion practice, to name two examples -- apply in arbitration as well. They do not.

The NASD, for its part, could have sought SEC permission to include a provision in the Code of Arbitration Procedure making statutes of limitation on claims in court applicable to claims brought in arbitration. It did not. There is no provision of the Code of Arbitration Procedure that "imports" state and federal statutes of limitation into NASD arbitration proceedings. In fact, as discussed above, the Code of Arbitration Procedure explicitly recognizes that there may be ***no*** applicable time limitation other than six years from the occurrence or event giving rise to the controversy.

Similarly, the CCP could have made state statutes of limitation applicable to claims brought in arbitration. It does not; on the contrary, its terms make state statutes of limitation ***inapplicable*** to arbitration proceedings.

The CCP addresses statutes of limitation at section 335, *et seq.* CCP section 335 provides as follows:

> "The periods prescribed for the commencement **of actions** other than for the recovery of real property, are as follows."

[Emphasis added.]

The CCP then goes on to describe each limitation period as the time within which an "action" must be commenced. The significance of this is that an arbitration proceeding is not an "action."

The CCP defines an "action" as follows:

> "**22. Action defined. An action is an ordinary proceeding in a court of justice** by which one party prosecutes another for the declaration, enforcement, or protection of a right, the redress or prevention of a wrong, or the punishment of a public offense.**"**

[Emphasis added.]

Obviously enough, a securities industry arbitration proceeding is not "an ordinary proceeding in a court of justice." It therefore is not an "action" as that term is defined by the CCP, and the CCP's statutes of limitation for "actions" do not apply.

The CCP is consistent in its treatment of these issues. For example, those few provisions of the CCP dealing with arbitration (sections 1280 through 1298.8) consistently refrain from referring to arbitrations as "actions." The statutes of limitation contained within the CCP clearly are intended to govern the courts' management of cases brought before them. Since, by their own terms, those statutes of limitation apply only to "actions," they have no application to private contractual arbitration proceedings.

Statutory time limitations regarding the Claimant's California Corporate Securities Law claims likewise govern only the time within which an "action" may be brought. They do not purport to govern the bringing of arbitration claims. See, *e.g.,* sections 25506 and 25507 of the California Corporations Code, both of which begin with the words,

> "No **action** shall be maintained . . . "

[emphasis added]. Thus, statutes of limitation on actions in court are no more applicable to Claimant's California Corporate Securities Law claims than they are to Claimant's common law claims.

California Cases

Several California cases have addressed the question of whether a proceeding other than one taking place in court is an "action" for purposes of California law. In *Triad Data Services, Inc. v. Jackson* (1984) 153 Cal.App.3d Supp. 1, 200 Cal.Rptr. 418, the court held that a wage claim prosecuted before the Labor Commissioner was not an "action." That case is instructive because of its thorough analysis of this issue. The court began by examining the historical meaning of "action," stating as follows:

> "Perhaps the oldest statement of the meaning of the clause "commence an action" is set forth in *Cohens v. Virginia* (1821) 19 U.S. (6 Wheat.) 264, 408 L.Ed. 257, 292, wherein the court states that 'to commence a suit is to demand something by the institution of process in a court of justice."

Id, at 12.

The court then goes on to state that "**[t]his position has been adopted in California.**" *Id* [emphasis added].

The *Triad* court continues its analysis with a discussion of *People v. Honey Lake Valley Irr. Dist.* (1926) 77 Cal.App. 367, 246 P. 819. In *People v. Honey Lake*, a California appellate court held that filing with the California Attorney General of a petition for the dissolution of an irrigation district did not constitute the commencement of an "action" because "[a]n action is an ordinary proceeding in a court of justice." *Id*.

Thus, California law is consistent with the out-of-state authorities discussed above. Since a private contractual arbitration is not "an ordinary proceeding in a court of justice," it is not an "action." Accordingly, limitations on actions are inapplicable to arbitration proceedings.

Conclusion

A well-established and well-reasoned body of case law holds that statutes of limitation applicable to actions are not applicable to private contractual arbitration proceedings. California's statutes and case law are wholly consistent with the reasoning of those cases. The lack of contrary authority is persuasive as well.

Most significant, however, is that the NASD Code of Arbitration Procedure imposes no time limitation other than the six-year period set forth in Rule 10304, and that the arbitration agreement in this case does not impose or even attempt to impose any other time limitation. Under these circumstances, any attempt by Respondent to raise a defense based on statutes of limitation is improper. Statutes of limitation are not an issue in this case.

Thank you for your attention to these important matters.

Respectfully submitted,
Scot Bernstein
Attorney for Claimant

SDB:msw

cc: \\

Increasing the Likelihood of Settlement in Mediation

by Joan Protess

Joan Protess is a graduate of Northwestern University School of Law and has been an Illinois attorney for twenty-two years. Ms. Protess is the President of Joan Protess & Associates, a firm located in Chicago, which specializes in providing dispute resolution services in commodity futures, securities, employment and other business matters. Ms. Protess uses a combination of a neutral evaluation and facilitative mediation approach. Ms. Protess has settled approximately 90% of the over 600 futures and securities cases which she has mediated, thanks to the excellent preparation, superb communication and negotiation skills and the fine personal attributes of the parties and attorneys with whom she has been honored to mediate. She can be reached at JPA@mediatenow.net.

One of the best-kept secrets of mediators is that their successful settlement rates are not necessarily attributable to their own experience or skill. Rather, in over twenty years as an attorney, the last eleven spent mediating investment, employment and other business disputes, I have found that the outcome of a mediation is more often than not dependent upon the preparation, communication abilities, negotiation skills, creativity, humor, and patience of the parties and attorneys who negotiate a dispute rather than those individuals who mediate it. While this revelation may get me barred for life from professional mediator associations, hopefully it may prove helpful to those parties and their attorneys who are involved in mediation and enable them to better control the resolution of their case.

Given the fact that it is the negotiator's skills, talents and personal traits which provide the best predictor of the success of a mediation, there are a number of steps that parties and their attorneys can take to increase the likelihood that a case will settle.

Decide on Mediation Format: In-person or Telephonic Mediation

First, parties and their attorneys should give careful consideration to which mediation format is appropriate for their particular case. Many people, including many mediators, are under the misimpression that the best way to resolve a dispute is to bring together all the parties who are currently in conflict with one another in the same room. Common sense, however, dictates that getting people who are upset with one another to meet in a room together often is not the best way to get a matter resolved. This especially is true in those matters where emotions run high, such as employment disputes or raiding cases.

In attempting to improve the chances of resolving a case through mediation, one needs to decide which format will be most conducive to settling. In-person mediation allows the parties to meet one another and the mediator face to face and provides an opportunity to size up one another and any witnesses who participate in the mediation. However, it is the rare case when an attorney allows his or her client or the witnesses to utter a word during the joint session of an in-person mediation. Hence, it is highly unlikely that one will learn anything substantive from the other parties or their witnesses beyond what can be gleaned from their appearances.

Telephonic mediation may be a better option for parties who do not want the other side to get a glimpse of them or their witnesses. The telephonic process also eliminates or significantly reduces the possibility that the parties and their counsel will offend one another with their eye rolling, sighing or other disruptive behavior.

In evaluating the best format for mediation, it also is important to keep in mind that the telephonic process facilitates face-saving, which often is crucial to a successful mediation. I have found that it is easier for a party or attorney to gracefully back away from a "line in the sand" that he may have previously drawn, if the other side is not staring at him across a conference room table while he is doing it.

Also, I find that both attorneys and *pro se* parties report that they feel more comfortable using the telephonic process because they can refer to their notes without having the other party observe them. By allowing the parties to remain on their own turf, the

telephonic process also usually makes the attorneys and parties feel more at ease. Moreover, the telephone is the common instrumentality by which most investors and their brokers communicate, so both sides normally are comfortable communicating with each other that way during a mediation
.

The telephonic process also allows the parties the time they may need to resolve the case. Sometimes parties are not ready during an eight or ten hour day to settle their case. During an in-person mediation there is often pressure to get a case resolved because the parties or the mediator may have traveled to the mediation site and set aside the day to work on the case. In contrast, a telephonic mediation allows the parties to take the time they may need to carefully decide whether and at what level to settle the case by allowing the parties to resume the mediation a day or two after the first session.

When evaluating whether to mediate telephonically or in-person, the parties and their counsel will want to select the format in which they will feel most comfortable. It has been my experience that parties who are at ease are generally able to better negotiate and achieve a common ground with their opposing parties.

Select an Appropriate Mediator: Facilitative, Evaluative or a Mediator Who Uses Both Methods

Once the parties and their attorneys have agreed upon a mediation format, they will want to select the right mediator for their dispute. They will need to decide if they want a mediator who uses a facilitative approach, an evaluative approach, or a combination of both methods. If attorneys think that their clients will best respond to a mediator who acts as an intermediary between the parties by clarifying their respective views, asking pointed questions, and inventing settlement options that will work for all sides, they will want to choose a facilitative mediator. If attorneys determine that their clients will benefit from working with a mediator who is qualified to provide a neutral assessment of the case, they will want to select an evaluative mediator. If attorneys want a neutral assessment of the case, but think that they also may need help in settling the case, they will want to choose a mediator who not only can provide them with a neutral evaluation but also can facilitate a resolution of the case.

Since the key variable in achieving a successful mediation is the caliber of the negotiators, the settlement rate of the mediator is more a reflection of whom the mediator has mediated with rather than an indication of his or her capabilities. Thus, the mediator's settlement rate is less important than most people think.

In fact, parties should be wary of mediators who seem overly concerned with their own settlement rates. Mediators who are overly impressed with their own settlement rates are more inclined to force the parties to settle cases or to settle them at unacceptable levels, even when that may not be in the parties' interests.

A final note on mediator selection: One should consider giving the other side latitude in selecting the mediator if one has a strong case. If the case is, in fact, as good as one thinks, it is likely that the mediator will recognize the merits of the case and will be in a better position than a mediator of one's own choosing to convince the other side to settle at an acceptable level.

Prepare Your Client for Mediation

One sure way for attorneys to increase the likelihood that a mediation will succeed is to prepare their clients for what to expect from the mediation. Before a mediation, attorneys should inform their clients about its ground rules, format, and purpose.

It is also imperative that attorneys discuss with their clients how they will conduct themselves during the mediation. Especially in the case of an in-person mediation, the client needs to be prepared for the possibility that the other side may be using the session to obtain free discovery about the case or to size them up as witnesses in the event that the case does not settle.

It also is a good idea for attorneys to prepare their clients for the possibility that the other side may use the mediation to vent their anger or vigorously assert their version of the facts, or their point of view of the case. The client who is well prepared for what to expect from the other side is less likely to feel sandbagged or blind-sided if the other side engages in aggressive negotiation tactics during the mediation.

It is also critical for attorneys to explain to their clients in advance of the mediation the approach they will be taking during the mediation. Many clients unfamiliar with mediation expect their attorneys to be strong advocates on their behalf. Clients who are ill prepared for mediation are frequently surprised and confused when their attorney behaves more like a negotiator than an advocate.

This situation sometimes requires the mediator to spend time mediating between an attorney and his client, which can be time consuming and disruptive.

Moreover, it is wise to identify the client's underlying interests in resolving the dispute before the mediation. Further, attorneys should offer their clients an honest assessment of the strengths and weaknesses of the case. It is more likely that a case will settle if the client hears a realistic assessment of the case first from their own attorney rather than from opposing counsel or the mediator.

It also facilitates settlement if attorneys discuss with their clients their Best Alternative to a Negotiated Agreement (BATNA) and their Worst Alternative to a Negotiated Agreement (WATNA) prior to the mediation. In addition, attorneys should try to improve their client's BATNA and reduce their client's WATNA prior to the mediation. With their client's assistance, attorneys also should attempt to assess the other party's BATNA and WATNA so that they have a sense of the factors affecting the other side's decision whether to resolve the case.

The likelihood of a successful mediation increases when attorneys discuss with their clients the possible resolutions of the dispute that they would deem acceptable. As part of this discussion, they will want to come up with options that will work for all parties, not just their own client.

It has been my experience that there is a substantial likelihood of settling the case when clients are well informed in advance of the mediation about their own role, the role of their attorney, the possible behavior of the other side, all aspects of the mediation process, the strengths and weaknesses of their case, and possible resolutions which they would deem acceptable.

Do Your Homework in Advance of the Mediation: Don't Wing it

Likewise, cases where the attorneys do their homework in advance of the mediation are far more likely to settle than those cases where they shoot from the hip. Adequate preparation generally includes providing the mediator with all necessary pleadings, correspondence and relevant documents as well as a mediation submission statement at least one week before the mediation.

Mediators who have been trained by the NASD generally request a mediation submission which includes the following items:

- a brief review of the procedural status of the case;
- a brief factual overview;
- an explanation of the key factual and legal issues;
- a bullet-style list of the party's factual/legal strengths;
- bullet-style list of what the other party asserts to be their factual/legal strengths, along with candid responses thereto;
- the underlying business or personal needs of both parties from a non-monetary perspective;
- past and current barriers to settlement;
- a summary of any other information that will assist the mediator;
- a list of the key parties, witnesses and professionals so the mediator can check for conflicts; and
- a detailed damages analysis.

When the parties timely provide the mediator with a submission that addresses these key points, it helps the parties focus their attention on the case and enables the mediator to be better prepared for the mediation. A mediator who is better prepared is less likely to waste valuable time during the mediation session getting up to speed on the case or becoming sidetracked on irrelevant issues.

Of course, it is not enough for attorneys to prepare the mediator they also need to prepare themselves for the mediation. The most effective negotiators are those who have a good command of the facts and the law relevant to the case and who are prepared to respond to the other party's version of the facts and their take on the law.

As noted above, it is also critical for attorneys to brainstorm with their clients before the mediation about ways in which to resolve the dispute that would work for all the parties, not just their own clients. Finally, it is absolutely essential that attorneys get their signals straight with their clients about the extent of their authority.

Experienced mediators expect the parties and attorneys to be less than forthcoming about their "bottom line", so when attorneys truly have reached the extent of their authority they need to make sure they convey that fact in no uncertain terms to the mediator.

I have found that when attorneys take these steps to prepare sufficiently for a mediation, not only is the mediation process streamlined, but the case also is usually settled.

Demonstrate Strong Communication Skills

While working as a mediator, I have found that the cases in which the parties are represented by attorneys who are active listeners, who are plainspoken and who possess strong communication skills have a substantial likelihood of settling. Active listeners allow the other party or their counsel to let off steam. They usually clarify what the other side says and they also try and identify the other party's real interests. These negotiators attempt to understand the dispute from the other party's point of view. They also display a talent for putting the other side's position in the best light, while at the same time explaining the flaws in their arguments.

Another observation about effective communicators is that they are masters at articulating their own client's interests in a clear and specific way. In other words, they are very good at making themselves understood. They also have a knack for disagreeing without being disagreeable. They refrain from making personal attacks, blaming or stereotyping the other party, or using threats or ultimatums. They also avoid behaving in a condescending or patronizing manner toward the other side.

Interestingly, I have found that effective communicators state their interests and reasoning first and their conclusions and proposals later. For example, a claimant's attorney recently explained the factual and legal merits of her client's case and then closed with an explanation of why she thought the case warranted the damages she was seeking. This approach allowed the attorney to communicate her version of the facts and her legal arguments to the other side before turning them off with her damage request.

Contrast such an approach with that of another counsel who began a joint mediation session by declaring, "We will never settle this case for less than six figures and let me tell you why." Within less than 30 seconds, the respondent's counsel, who had just flown across the country that morning, picked up her suitcase and headed for the door. While I managed to coax the respondent's counsel back into the room and we ultimately settled the case, a lot of time, energy and unnecessary hassle occurred because the claimant's counsel led with his bottom line rather than with his interests and reasoning.

Over the years, I also have observed that effective negotiators recognize the difference between a mediation and arbitration and do not waste time trying to ingratiate themselves with the mediator.

Instead, mindful that a mediation provides them with an opportunity to connect with the other side, they concentrate on persuading the other party of their views, rather than the mediator. Moreover, during in-person mediations, effective negotiators try to make eye contact with the other side rather than with the mediator.

It has been my experience that attorneys who actively listen, who speak clearly and directly, and who have polished their communication skills increase their chances of settling their cases in mediation considerably.

Use Proven Negotiation Techniques

During the last eleven years mediating hundreds of futures and securities disputes filed at the National Futures Association, the Commodity Futures Trading Commission, the NASD and the NYSE, I have had the opportunity to observe a variety of negotiation techniques. I have found that, without question, attorneys who use the Harvard Negotiation Project's method of principled negotiation usually settle their cases. Harvard's method of principled negotiation is explained clearly in a series of books entitled, *Getting To Yes, Getting Past No, Getting Ready to Negotiate: The Getting to Yes Workbook*, and *Getting Together: Building Relationships as We Negotiate*, written by Roger Fisher, William Ury and their co-authors. I highly recommend that anyone interested in honing their negotiation skills read these well-written books. While these volumes fully explain the principled negotiation method, it can be summarized into four simple concepts:

1. Be soft on the people, hard on the problem;
2. Focus on underlying interests, not hard line positions;
3. Invent options for mutual gain; and
4. Insist on using objective criteria.

Attorneys using these techniques often exhibit an inexhaustible supply of patience and persistence. They look for ways to help the other side as well as their own clients save face. Principled negotiators also generally measure all offers and counter-offers against their client's BATNA and WATNA.

I have found that effective negotiators also have an ability to check at the door any preconceived notions of what settlement terms the other side might find acceptable. This ability to keep an open mind about what may be achieved in the mediation usually enables skilled negotiators to settle cases at levels that less experienced negotiators would never even allow themselves to entertain.

Experienced negotiators also are mindful of cultural and regional differences in negotiation styles. Such diversity awareness enables skilled negotiators to carefully plan their own presentations and react appropriately to their opponent's comments and behavior.

Further, effective negotiators do not let the other side's inappropriate negotiation tactics or offensive offers or counter-offers get in the way of working out a settlement agreement that makes good business sense for their own client. In other words, they counter inappropriate bargaining tactics by ignoring them or by using humor or silence. For example, a few years ago, during an in-person mediation session, a particularly hard- driving respondent's attorney waited until 5:00 p.m. to finally make a rather low ball offer of $15,000. The claimant's attorney, who is a wise and an incredibly patient man, instructed me to go back to the respondent's counsel and inform him that if he had understood the offer to be $15,000, then he and his client planned to take the 6:00 p.m. train home. However, if what the respondent's counsel had meant to communicate was a $50,000 offer, then I could convey a counter-offer of $100,000. I was a bit flabbergasted by this approach, thinking that maybe the claimant's counsel had lost it. I carefully explained that the respondent's counsel had clearly said $15,000, not $50,000, and if I followed the claimant's instructions the respondent's counsel would likely think that I was an idiot. The claimant's counsel laughed and told me to just go ahead and do what he had requested. Strangely enough, when I followed his directions, the respondent's counsel did not flinch, but instead gave me a counter-offer which allowed the parties to settle the case with enough time for the claimant and his counsel to make the 7:00 p.m. train.

This anecdote serves as a reminder that when the other side engages in inappropriate tactics, sometimes humor and a little "Alice in Wonderland" reasoning of one's own can be a very effective tool for getting the negotiation back on track.

Conclusion

If my thesis is correct that the best predictor of a successful mediation is the caliber of the negotiators' preparation, communication abilities, negotiation skills, and personal traits, then it follows that attorneys can increase the likelihood of settling their disputes by preparing better for mediation, by developing their communication abilities, by honing their negotiation skills, and by injecting some creativity, humor and patience into their negotiations. Doing so, however, may prompt attorneys to inquire why they need a mediator after all. That, of course, is the subject for a whole other article which thankfully I have not been asked to write.

Recent Arbitration Awards

by Ryan 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.

***Philip J. Buchanan Living Trust v. Merrill Lynch, Pierce Fenner & Smith, Inc. and Daniel F. Friel, Jr.*, NASD Case No. 00-03568**

Claimant asserted the following causes of action: negligence, breach of contract, recission and breach of fiduciary duty involving shares of LOOK common stock. Claimant requested compensatory damages, interest, costs and attorneys fees.

Respondents denied the allegations made in the Statement of Claim and requested dismissal of the Statement of Claim, reimbursement of arbitration costs and expungement.

Prior to the arbitration, Respondent Merrill Lynch filed a motion to dismiss based on the execution of a release by the Claimant for a transaction not related to the instant claim. Merrill Lynch argued that the release was a general release which did not subject Merrill Lynch to liability. The Claimant died three weeks after the filing of the Statement of Claim and prior to the filing of the motion to dismiss. The panel decided that the motion to dismiss required the presentation of evidence at the hearing.

1. Respondent Merrill Lynch was found liable and ordered to pay Claimant $135,444.10 in compensatory damages inclusive of interest through April 10, 2002 and $31.40 in interest from April 10, 2002 until payment of the Award was made in full.

2. All claims against Respondent Friel, Jr. were denied.

3. Respondent Merrill Lynch was found liable for the claim filing fee of $500 and forum fees in the amount of $8,400.

The case is interesting because the basis for the award of $135,444.10 was the tax detriment caused by Respondent Merrill Lynch in connection with the mishandling of a Rule 144 sale. Merrill Lynch failed to obtain Rule 144 clearance on the subject shares during a time when the price of the stock declined precipitously. As a result, Merrill Lynch claimed to have made the customer whole by recasting the Rule 144 long sale as a short sale and a cover of a short position. However, Merrill Lynch caused a long term capital gain to be converted into a short term gain with different tax consequences. The Award compensated the investor for the difference between the tax treatment on the long term gain versus the tax paid on the short term gain from the short sale and cover.

Claimant's Counsel -
George S. Trevor, Esq. of Trevor & Weixel, LLP
Respondents' Counsel -
Eric J. Glassman, Esq. ofMennemeier, Glassman & Stroud
Claimant's Expert -
Steven Piper (liability) and David Kuhner (damages)
Respondents' Expert -
Chester T. Bjerke, Jr.
Hearing Situs -
San Francisco, California
Arbitrators -
Matthew V. Brady, Esq., Public/Chairman
James H. Schilt, Public
Rudy E. Thorwirth, Industry

***Cyril and Willena Burke, et al. v. A.G. Edwards & Sons, Inc. and Paul R. Vogel, Jr.*, NASD Case No. 01-01223**

Claimants asserted the following causes of action: violations of state securities law and common law of the state of Florida including chapter 517 of the Florida statutes, respondeat superior and negligent supervision, negligence and gross negligence, breach of fiduciary duty, and breach of contract/violation of industry standards relating to Claimants' large positions and over concentration of Able Telecom Holding Corporation and American International Foods shares in their accounts. Claimants requested compensatory damages, interest, costs, attorneys fees and punitive damages.

Prior to the arbitration, Respondents motion to bifurcate the hearing was denied. The arbitration panel made the following findings and award:

1. Respondent Vogel was found liable on the claims of unsuitability and negligence. Respondents A.G. Edwards & Sons, Inc. was found liable on the claim of negligent supervision.

2. Claimant was awarded $287,000 plus interest at the rate of 10 percent from May 1, 2002 until the date of payment of the Award.

3. Respondents were found jointly and severally liable for Claimants' attorneys fees in an amount to be determined by a court of competent jurisdiction. Attorneys fees were awarded by operation of law and pursuant to the attorneys' fees provision of the account card.

4. Respondents were found jointly and severally liable for witness fees in the amount of $16,006.93 and $11,000.

5. Respondents were found jointly and severally liable for the claim filing fee of $375 and forum fees in the amount of $18,450.

The broker, Paul Vogel, over concentrated the account of 81 year old customer in two highly speculative penny stocks. The case is interesting because the Claimants' attorney offered physician testimony as to Claimant Barsion's diminished capacity during the time that the account was active. The panel also made a significant fact finding in awarding Claimants attorneys fees based on the A.G. Edwards & Sons, Inc. "provision on the account card."

Claimants' Counsel -
  Jeffrey P. Coleman, Esq. of the Coleman Law Firm
Respondents' Counsel -
  Nuviah Shirazi on behalf of A.G. Edwards & Sons, Inc. and Marc Dobin, Esq. on behalf of Mr. Vogel
Claimants' Expert -
  John Reven of Stephens, Reven & Associates
Respondents' Expert -
  None
Hearing Situs -
  Tampa, Florida
Arbitrators -
  Lee C. Conser, Esq., Public/Chairman
  Russell W. Merriman, Esq., Public
  Michael N. Gonatos, Industry

***Daljit S. Buttar and Paramjit Buttar v. Robert Jacob Winston et al. v. Vivek Verma*, NASD Case No. 00-03950**

Claimants asserted the following causes of action: unauthorized, unsuitable and over-concentrated transactions, churning, material misrepresentations and omissions, fraud, failure to supervise in violation of the federal securities laws, common law, NASD and securities industry rules and regulations relating to the investments in shares of CNF Technologies, Inc. ("CNF") and Skynet Holdings, Inc. ("Skynet"). Claimants requested compensatory damages, well managed account damages, disgorgement of commissions, disgorgement of margin interest, lost opportunity damages, attorneys fees and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims, costs and attorneys fees. Respondents Wallace, Jacaruso and Scotti alleged causes of action for indemnification and contribution against Third Party Respondent Verma. Respondent Winston joined in this claim. Third Party Respondent Verma request dismissal of the Third Party Statement of Claim, attorneys fees, costs and expungement of the arbitration from his Central Registration Depository ("CRD") record.

Respondents Winston, Scott and Jacaruso did not appear at the arbitration hearing. The panel found that they were properly served despite not having properly executed uniform submission agreements and had participated in the arbitration process.

Prior to the hearing the panel decided that the stay entered by the United States District Court for the Souther District of New York in *SIPC v. Montrose Capital Managment, Ltd.* did not apply to Respondents Winston, Wallace, Scotti and Jacaruso.

1. The panel found Respondent Winston liable for misrepresentation, unauthorized, unsuitable and over-concentrated trading in Skynet and CNF and fraud. The panel found Respondents Wallace, Scotti and Jacaruso liable for fraud and also as "Control Persons" pursuant to 15 U.S. C. 78(t)(a), 15 U.S.C. 771, N.C.G.S. 78A-56(a)(2)(c).

2. Respondents Winston, Wallace, Scott and Jacaruso were found jointly and severally liable and ordered to pay Claimants compensatory damages of $1,064,543, plus pre-judgment interest from June 1, 2000 to

January 30, 2001 in the amount of $127,629 and post-judgment interest in accordance with NASD Code of Arbitration Procedure 10330(h).

3. Respondents Winston, Wallace, Scott and Jacaruso were found jointly and severally liable and ordered to pay Claimants $604,820 in punitive damages based on the panel's finding of fraud with post-judgement interest to accrue in accordance with NASD Code of Arbitration Procedure 10330(h).

4. Third Party Respondent Verma was found liable for misrepresentation and unauthorized trading, unsuitable and over-concentrated trading in Skynet and CNF. Third Party Respondent Verma was found liable to Respondents Winston, Wallace, Scott and Jacaruso in an amount equal to five per cent of each payment made by Respondents to Claimants and to the NASD for forum fees.

5. Respondents Winston, Wallace, Scott and Jacaruso were found jointly and severally liable and ordered to pay Claimants $6,267 in costs.

6. Respondents Winston, Wallace, Scott and Jacaruso were found jointly and severally liable and ordered to pay Claimants expert witness fees of $11,262.

7. Respondents Winston, Wallace, Scott and Jacaruso were found jointly and severally liable and ordered to pay Claimants $500 for the claim filing fee and forum fees in the amount of $14,400.

The case is interesting because of the panel's finding against Respondents and the control persons. Specifically the panel applied North Carolina and federal law in finding the control person respondents liable and awarded Claimant 100 percent of his out of pocket loss. The award is also significant because the panel in this second tier firm case appears to have found the principals of the firm primarily (*i.e.*, 95 percent responsible) and the broker (Third Party Respondent Verma) culpable for five percent of the payments of the award because of his participation in the fraud. The panel's award also included damages for costs, expert witness fees, the filing fee, post-judgment interest and forum fees which were assessed against Respondents.

Claimants' Counsel -
Stanley T. Padgett, Esq. of Morgan, Padgett & Associates, P.A.
Respondents' Counsel -
Stuart A. Jackson, Esq. of Re, Parser & Partners on behalf of Respondents Wallace, Scotti and Jacaruso; Robert L. Herskovits, Esq. of the Law Offices of Michael F. Bachner on behalf of Respondent Winston
Third Party Counsel -
David Crystal II, Esq of Gilbride, Tusa, Last & Spellane
Claimants' Expert -
William Collison
Respondents' Expert -
None
Hearing Situs -
Raleigh, North Carolina
Arbitrators -
Murray E. Bovarnick, Public/Chairman
Harold G. Koger, Public
G. Lewis Nichols, Industry

***Steven Carico v. Stifel, Nicholaus & Co., Inc. and William G. Nelson*, NASD Case No. 01-02611**

Claimant asserted the following causes of action: unsuitable investment recommendations, unauthorized and excessive trading, misrepresentations and omissions, violated the Ohio and Missouri securities acts, violated NASD Rules of Conduct, breached of contract, common law fraud and misrepresentation, breach of fiduciary duty, constructive fraud and failure to supervise in connection with the receipt by Claimant of a lump sum bonus (subject to future taxes) from Claimant's employer and the handling of Claimant's account thereafter. Claimant requested compensatory damages, interest pursuant to the Ohio Securities Act, disgorgement of commissions, costs, attorneys fees and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimant's claim, attorneys fees and costs. After commencement of the hearing Respondents' counsel advised the panel that the claim for attorneys fees was withdrawn.

1. The panel made findings of fact including, *inter alia*, the fact that Respondents had switched Claimant from his holdings in cash and high yield securities (in one month) to a single banking stock involving a micro-capitalized, remote bank in Southwest Oklahoma (Southwest Bankcorp). The panel further found that Respondents continued to solicit the purchase of shares of Southwest Bancorp in Claimant's account.

2. The panel determined that Respondents' purchases and recommendations of Southwest Bancorp stock were unsuitable and were evidence of "clearly excessive over-concentration." In addition, the panel found that Respondents decision "to not set aside into a conservative and safe investment, a prudent sum for the payment of Claimant's taxes...was unsuitable."

3. Respondents Stifel and Nelson were found jointly and severally

liable and ordered to pay Claimant $87,895.14 in compensatory damages, $25,000 in punitive damages, $35,000 in attorneys fees, $3,802 in expenses incurred in the prosecution of the arbitration and $300 for the filing fee cost paid by Claimant.

4. The panel ordered payment thirty days from receipt of the award, which if not paid will accrue simple interest at the rate of 10 percent pursuant to Ohio Revised Code Section 13443.03 until paid in full. Forum fees were assessed solely to Respondent Stifel.

The case is significant because the panel issued a reasoned award supported by findings of fact. The panel found that the practice of opening a margin account when dealing with a customer who lacked significant experience was evidence of a conscious and deliberate disregard of a customer's interests and rights. The panel's discussion of the failure to follow the firm's supervisory procedures coupled with the manner in which the margin account was opened led to this make whole award which included punitive damages.

Claimant's Counsel -
    Andrew Stoltmann, Esq. of Maddox, Koeller, Hargett & Caruso
Respondents' Counsel -
    Peter B. Sonderby, Esq.
Claimant's Expert -
    None
Respondents' Expert -
    None
Hearing Situs -
    Cincinnati, Ohio
Arbitrators -
    Peter F. von Meister, Esq., Public/Chairman
    Mitchell B. Goldberg, Esq., Public
    David A. Hertl, CMFC, Industry

***Dennis C. Gaddy et al. v. A.G. Edwards & Sons, Inc. and Parks Brown*, NASD Case No. 01-01817**

Claimant asserted the following causes of action: unauthorized transactions, Georgia and federal securities act violations, unsuitability, excessive concentration, churning, breach of fiduciary duty, controlling person liability, respondeat superior liability and violations of the NASD Conduct Rules in connection with Claimants' investments in a variety of stocks. Claimants requested well managed account damages, disgorgement of commissions, disgorgement of margin interest, prejudgment interest, attorneys fees and punitive damages. Respondents requested dismissal of all claims with prejudice, costs, expenses and expungement of the reference of this arbitration on Respondent Brown's Central Registration Depository ("CRD") record.

1. Respondent A.G. Edwards & Sons, Inc. ("Edwards") is liable for failing to supervise. Respondents Edwards and Brown are jointly and severally liable on the claim of unsuitability and shall pay Claimant Gaddy IRA $59,505.29, plus pre-judgment interest of $3,570.37 calculated at the rate of 6 percent from March 31, 2001 until March 31, 2002. In addition, Respondents Edwards and Brown were ordered to pay Claimant Gaddy compensatory damages for churning the account in the amount of $141,172.37, disgorge $22,473.86 in commissions and $3,117.19 in margin interest. On this amount, prejudgment interest of $10,005.80 calculated at the rate of 6 percent from March 31, 2001 until March 31, 2002.

2. Respondents Edwards and Brown were found jointly and severally liable to pay Claimant Gaddy IRA $29,752.64 in attorneys 10-5-14(a). In addition, Claimant Gaddy was awarded $83,381.71 in attorneys fees pursuant to O.C.G.A. Section 10-5-14(a).

3. Respondents Edwards and Brown were found jointly and severally liable for the claim filing fee of $375 and forum fees in the amount of $12,000.

The case is interesting because of the panel's specific finding of Edwards' failure to supervise and award of damages beyond compensatory damages. The panel applied O.C.G.A. as the basis for the award of attorneys fees. The panel's award of attorneys fees represented approximately one-third of total damages.

Claimants' Counsel -
    Daniel I. MacIntyre, Esq. and Samuel T. Brannan, Esq. of Shapiro Fussell Wedge Smotherman Martin & Price LLP
Respondents' Counsel -
    Steve Sneeringer, Esq. and Michael Naccarato, Esq.of A.G. Edwards & Sons, Inc.
Claimants' Expert -
    William K. Love
Respondents' Expert -
    James E. Brucki, Jr.
Hearing Situs -
    Atlanta, Georgia
Arbitrators -
    Joe E. Manuel, Esq., Public/Chairman
    Roger A. Kirschenbaum, Esq., PhD, Public
    Peggy Lewis Kennedy, Industry

***Ted Kaly and Mary Jo Kaly v. Emmett A. Larkin Co., Inc., Royal Hutton Securities Corp, et al.*, NASD Case No. 00-04128**

Claimants asserted the following causes of action: violation of Section 10b of the Securities Exchange Act of 1934, liability under Section 20 of the Securities Exchange Act of 1934, violation of the Utah Securities Act Section 61-1-22(1)(a), misrepresentations, omissions, suitability, churning, liability under the Utah Uniform Securities Act Section 61-1-22(4)(a), violation of Utah Uniform Securities Act Sections 61-1-22(2), breach of fiduciary duty, breach of contract, negligence, negligent supervision, and respondeat superior. Claimants requested compensatory damages, pre-judgment interest, lost opportunity damages, attorneys fees pursuant to section 61-1-22(1)(a) of the Utah Securities Act, post-judgment interest, costs and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim.

1. The panel found Respondents Royal Hutton Securities Corp., Medaglia, Figueiredo and Ciofalo jointly and severally liable and ordered them to pay claimant $690,390.39 in treble damages pursuant to Utah Code Section 61-1-22(2) based on a compensatory award of $230,130.39, interest at the rate of 12 percent from March 22, 2000 until the Award is paid and $276,156.15 in attorneys fees representing 40 percent of the judgment pursuant to Utah Code Section 61-1-22(2).

2. Respondents Emmet A. Larkin Co., Inc. was found liable and ordered to pay Claimants $150,000.

3. The award against all Respondents except Emmet A. Larkin Co., Inc. was unanimous. The chairman, Mr. Lawrence, stated that he believed the panel should have determined whether Emmet A. Larkin Co., Inc. materially aided in the sales and whether they met their burden of proof for an affirmative defense.

4. The panel assessed forum fees equally between the Claimants and Respondent Emmet A. Larkin Co., Inc. and ordered each party to pay $4,425.

The case is interesting because the panel held the clearing firm Emmet A. Larkin Co., Inc. liable for Claimants losses. The award is also significant because of the award of attorneys fees of 40 percent and treble damages under the respective Utah Securities Code sections. The amount of interest and attorneys fees awarded by the panel is more than twice the amount of the compensatory damages awarded.

Claimant's Counsel -
 Randall R. Heiner, Esq.
Respondent's Counsel -
 David W. Brown, Esq. on behalf of Emmett A. Larkin Co., Inc., Lawrence R. Gelber, Esq. on behalf of Respondent Pisapia
Claimant's Expert -
 None
Respondents' Expert -
 None
Hearing Situs -
 Salt Lake City, Utah
Arbitrators -
 Richard J. Lawrence, Esq., Public/Chairman
 George H. Speciale, Esq., Public
 Elwood A. Crandall, Industry

***Hae Sim Lee and Hak Boong Choi v. Charles Schwab & Co., Inc.*, NASD Case No. 01-00947**

Claimants asserted the following causes of action: violation of state and federal securities laws, common law fraud, misrepresentation, conversion, churning, breach of fiduciary duty, unjust enrichment and failure to supervise. Claimants requested compensatory damages, interest, lost opportunity damages, costs, attorneys fees and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claim.

1. The panel found that Respondent Charles Schwab & Co., Inc. ("Schwab") provided its agent with business cards containing the designation of Investment Specialist I and later Investment Specialist II and rewarded their agent for opening accounts which were converted into trading accounts. The panel specifically found that the designations of Investment Specialist on the agent's business card gave the agent apparent authority to act and to recommend investments to Lee.

2. Choi directed Lee, his agent, to invest in mutual funds chosen by Lee and not in an investment portfolio. In reliance on Schwab's agent, Lee (without the knowledge or authorization of Choi) invested Choi's funds in common stocks on margin. Lee received margin calls and could not contact the Schwab agent and moved the account to another brokerage firm. Thereafter, Schwab's agent persuaded Lee to move the account back to Schwab, liquidate the portfolio and day trade in a few speculative stocks incurring losses in Choi's account. The panel found that this trading occurred at Schwab and at the other brokerage firm based on the advice of the Schwab agent. Without Choi's authorization, Schwab's agent began to recommend options trading which resulted in additional losses.

3. The panel found Schwab responsible in part for the losses at Schwab because Schwab "cloaked its agent [] with apparent authority to make recommendations by allowing him the designation of Investment Specialist I and Investment Specialist II on his business card."

4. Respondent Schwab was found liable and ordered to pay Claimant Choi $156,250 in compensatory damages. The panel found that Claimant Lee acted on behalf of her brother Choi and was his agent pursuant to a general power of attorney, however Lee's claims for the money commingled in Choi's account were dismissed.

5. Respondent Schwab was found liable and ordered to pay Claimant Choi $11,646.88 in costs.

The case is significant because the panel's finding of facts in support of the award. Since, Schwab has joined the ranks of brokerage firms giving investment advice, this appears to be one of the first awards against Schwab for the advice given by one of its agents. The panel's finding that the representations set forth on the agent's business card are significant in holding Schwab responsible for the wrongful conduct. The case is interesting in that the customer, Choi, apparently had no direct contact with Schwab and acted solely through his agent.

Claimants' Counsel -
Erwin J. Shustak, Esq. of Shustak Jalil & Heller
Respondent's Counsel -
Thomas L. Taylor, III, Esq. of Morgan, Lewis & Bockius, LLP
Claimants' Expert -
Peter Pfeffer
Respondent's Expert -
John Maine and Phil Einhorn
Hearing Situs -
Los Angeles, California
Arbitrators -
Michael R.E. Sanders, Esq., Public/Chairman
Royal D. Heisser, Public
Kenneth L. Rosenblum, Industry

***Majik Enterprises, LLP, Keith A. Spizzirri Charitable Remainder Unit Trust v. Everen Securities, Inc. and Dennis Stack*, NYSE Case No. 2000-008495**

Claimants asserted the following causes of action: misrepresentation, unsuitable margin and options trading, lack of supervision, violation of securities laws, breach of fiduciary duty, fraud, negligence, and breach of contract. Claimants requested compensatory damages, interest, costs, punitive damages and attorneys' fees against all Respondents jointly and severally.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim.

1. Respondent Stack was found severally liable and ordered to pay Claimant Majik Enterprises $360,000 in compensatory damages and to Claimant Spizzirri $40,000 in compensatory damages.

2. Respondent Everen was found severally liable and ordered to pay Claimant Majik Enterprises $180,000 in compensatory damages and to Claimant Spizzirri $20,000 in compensatory damages.

3. Claimants' claims for punitive damages, attorneys fees and costs were denied. The forum fees were split equally between Claimants and Respondents

This case is instructive, because the arbitrators rendered a several award, as opposed to a joint and several award. Yet, the Respondents did not contend in their Answer or at the arbitration that the broker was acting outside the scope of his employment. Nor was any evidence introduced during the sixteen days of arbitration that justified or raised the specter of a several award, as opposed to a joint and several award. The case highlights one rationale for not naming the broker in an arbitration, particularly in cases against solvent broker-dealers where payment of the award is not an issue.

Claimants' Counsel -
Tracy Pride Stoneman, Esq. of Tracy Pride Stoneman, P.C.
Respondents' Counsel -
Jon Rewinski, Esq. and Eric Shapland, Esq. of Heller Ehrman White & McAuliffe, LLP
Claimants' Expert -
Douglas J. Schulz, Invest Securities Consulting, Inc.
Respondents' Expert -
Rodger Marting
Hearing Situs -
Phoenix, Arizona
Arbitrators -
Richard L. Merkel, Public/Chairman
Burt H. McIntosh, Public
James B. Vessey, Industry

***Donald Onofrey v. Leader Investment, Inc. and Harry Cavallaris*, NASD Case No. 01-02004**

Claimant asserted the following causes of action: misrepresentation, omission, churning, unsuitability, negligence, negligent supervision and fraud in connection with the handling of Claimant's account at Leader Investment, Inc ("Leader"). Claimant requested compensatory damages, interest, costs, attorneys fees and punitive damages. Respondents denied the allegations made in the Statement of Claim and alleged the following affirmative defenses: ratification, waiver, estoppel and laches.

Prior to the arbitration, Respondents filed a motion for change of venue on the grounds of forum non conveniens which was granted by the panel:

1. Respondents Leader and Cavallaris were found jointly and

severally liable to pay Claimant losses in trades of $1.

2. Respondents Leader and Cavallaris were found jointly and severally liable to pay Claimant $49,868 for commissions and margin interest paid by Claimant.

3. Respondents Leader and Cavallaris were found jointly and severally liable to pay Claimant $4,459 in costs.

4. Respondents Leader and Cavallaris were found jointly and severally liable to pay Claimant $42,250 in attorneys fees.

5. Respondents Leader and Cavallaris were found jointly and severally liable for the claim filing fee of $225 and forum fees in the amount of $2,250.

6. Respondents Leader and Cavallaris were found jointly and severally liable for statutory interest at the rate of 8 percent from the date of filing of the Statement of Claim until the Award is paid.

The case is interesting because of the panel's award of $1 in compensatory damages in contrast with the award of $104,322 for attorneys fees, costs, interest, margin interest and commissions. It appears that the panel awarded damages because Respondents' actions were "egregious" in connection with the mishandling of Claimant's account.

Claimant's Counsel -
Andrew Stoltmann, Esq. of Maddox, Koeller, Hargett & Caruso
Respondents' Counsel -
James L. Fox, Esq. of Abramson & Fox
Claimant's Expert -
None
Respondents' Expert -
John Parkes
Hearing Situs -
Chicago, Illinois
Arbitrators -
Bruce M. Fingerhut, Public/Chairman
Stanley G. Rives, PhD, Public
Thomas J. McAllister, Industry

Cases & Materials

by Charles W. Austin, Jr.

Charles W. (Chuck) Austin, Jr. is an officer and director of PIABA and a member of its executive committee. His practice is dedicated exclusively to the representation of investors in disputes with the securities industry. Mr. Austin can be reached at (804) 379-3590. His e-mail address is cwajr@mindspring.com

Editor's Note: This is the debut version of the new "Cases & Materials" section of the Journal. Set forth below is a collection of selected federal and state court decisions, SEC Administrative Proceeding decisions and materials from the NASD and NYSE, including Notices to Members, Information Memos and disciplinary proceeding decisions, issued since the beginning of the year together with a brief description of the subject matter. Each forthcoming issue will contain similar materials issued since the last Journal went to press. We encourage members to bring matters of interest from the SROs and courts to the attention of the "Cases & Materials" editor.

COURT DECISIONS

1/1/02 - 6/21/02

Federal Decisions

U.S. Supreme Court

SEC v. Zandford, No. 01-147 (U.S. Supreme Court, 6/3/02)

Broker's theft of money entrusted to him to invest with discretionary constitutes activity "in connection with the purchase or sale of a security" under 10b-5.

Second Circuit

Salim Oleochemicals v. M/V Shropshire, No. 01-7624 (2d Cir. January 22, 2002)

A dismissal without prejudice in favor of arbitration is an appealable final decision under Section 16 of the FAA.

Stuart Bell v. Cendant Corp., et al., No. 01-7622 (2nd Cir. June 11, 2002)

Under Connecticut law, a broadly worded arbitration clause in Bell's consulting agreement with Cendant required that the issue of whether, and to what extent, the dispute was arbitrable must be decided by the arbitrator, not by the court.

McDaniel v. Bear Stearns & Co., Inc., 2002 U.S. Dist LEXIS 762 (S.D.N.Y. January 17, 2002)

Confirmation of arbitration award and entry of judgment against Bear Stearns in its capacity as a clearing broker for aiding and abetting the introducing broker's (A.R. Baron) fraud.

Dassero, et al v. Edwards, et al, 190 F. Supp. 2d 544 (W.D.N.Y. February 12, 2002)

Entitlement of non-signatory to arbitration agreement to rely on agreement; waiver of right to compel arbitration; whether court or arbitrators decide the issue of the validity/existence of arbitration agreement.

In re Hagerstown Fiber Limited Partnership, 277 B.R. 181, 2002 Bankr. LEXIS 382 (Bankr. S.D.N.Y. April 26, 2002)

Excellent discussion of the interaction between bankruptcy law/rules and the FAA.

Papayiannis v. Zelin, No. 01 Civ. 8585, 2002 U.S. Dist. LEXIS 10129 (S.D.N.Y. June 5, 2002)

Discussion of "manifest disregard of the law" in arbitration where principal failed to appear at arbitration and submitted very little evidence in his defense.

Photopaint Technologies v. Smartlens Corp. 01 Civ. 8877 (S.D.N.Y. June 13, 2002)

1 year confirmation period under 9 U.S.C. §9 is mandatory rather than permissive.

Fourth Circuit

Vulcan Chemical Technologies, Inc., et al. v. Phillip Barker, No. 01-1943 (4th Cir. May 21, 2002)

Plaintiff sued in California state court for breach of contract. Defendant moved for arbitration under terms of contract and California arbitration law. Arbitrator awarded plaintiff substantial damages. Thereafter, defendant filed motion to vacate in federal court in Virginia, after which, California state court confirmed arbitration award - a decision defendant appealed. Subsequently, while California case was still on appeal, federal trial court in Virginia vacated arbitration. Fourth Circuit holds that federal trial court in Virginia should have abstained from ruling on motion to vacate

J.H. Scott, et al v. USA, 186 F. Supp. 2d 664 (E.D. Va. February 28, 2002)

Court decides that, because Virginia law does not require trustees to follow "prudent investor rule" so long as securities purchases and sales are among those enumerated in code, trust could not take tax deduction for investment advisor fees. "A trustee in Virginia is not required to consult financial advisor and will suffer no penalties or potential liability for mismanagement of trust assets so long as he invests in one of the securities listed [in the Code]."

Fifth Circuit

Hill v. G. E. Power Systems, Inc., No. 01-20061 (5th Cir. February 11, 2002)

Discusses when non-signatory to arbitration agreement is entitled, under Section 3 of the FAA, to stay litigation between non-signatory and another party pending outcome of arbitration between other party and signatory to arb agreement.

Jason v. American Arbitration Association, 2002 U.S. Dist LEXIS 9645 (E.D. La. May 23, 2002).

Immunity of arbitration tribunal from suit arising out of the arbitration process.

Sixth Circuit

WMA Securities v. Wynn, No. 00-4232, 2002 U.S. App. LEXIS 6247 (6th Cir., April 1, 2002)

Discussion of what constitutes an "associated person" for the purpose of compelling arbitration; whether arbitrators have power to award attorneys' fees in absence of contract calling for the same ("American Rule" not applicable to arbitrations); *functus officio* doctrine.

Seventh Circuit

Belom v. National Futures Assoc., et al, No. 01-3684 (7th Cir. March 28, 2002)

Discussion of whether NFA rules, which allow a customer to initiate arbitration against any NFA member and its employees for disputes involving commodity future contracts, violate the Commodity Exchange Act.

Sphere Drake Insurance v. All American Life Insurance Co., No. 01-C-5226, 2002 LEXIS 9026 (N.D. Ill. May 17, 2002)

Plaintiff's arbitration award vacated because arbitrator failed to disclose relationship with company related to plaintiff and later discovery that arbitrator had, in fact, appeared as counsel for plaintiff's company in prior litigation. Good discussion of "evident partiality" in 7th Circuit.

Sirotzky v. NYSE & Sanford C. Bernstein & Co., No. 02 C 0970, 2002 U.S. Dist. LEXIS 9026 (N.D. Ill. May 20, 2002)

Good discussion of diversity jurisdiction in the context of post-award motions.

Eighth Circuit

Owens v. Miller, No. 00-3720 (8th Cir. January 10, 2002)

Dischargeability in bankruptcy of liabilities incurred by virtue of "control person" status.

Jong Lee, et al v. Ernst & Young, No. 01-1369 (8th Cir. June 18, 2002)

Purchasers of securities in aftermarket have standing to bring claim under §11 of the 33 Act so long as they can make *prima facie* showing that shares purchased can be traced to the registration statement alleged to be false and misleading.

Ninth Circuit

Nickel v. Bank Of America, No. 01-15452 (9th Cir. May 17, 2002)

Under California law, remedy for a breach of trust by a professional trustee is a proportionate share of the profits the professional trustee made with the misappropriated trust funds.

Tenth Circuit

Wilson v. American Investment Services, 2002 U.S. App. LEXIS 6409 (10th Cir. April 5, 2002) (Unpublished)

Dispute between registered rep and BD over arbitrability of E&O insurance coverage. Interesting procedural twists.

D.C. Circuit

David Gorman v. Ameritrade Holding Corporation and Freetrade.Com, Inc., No. 01-7085 (D.C. Cir. June 14, 2002)

Exercise of in personam jurisdiction over online BD solely on basis of its web presence in the jurisdiction.

State Court Decisions

Alabama

In re Thicklin, No. 1000224 (Ala. 01/11/2002)

Provision of arbitration agreement prohibiting award of punitive damages is void as against public policy and therefore severed from arbitration agreement.

J.C. Bradford & Co., L.L.C. v. Vick, No. 1010280 (Ala. 04/12/2002)

Reversal of trial court decision to deny JCB's motion to compel arbitration on grounds that customer agreements violated NASD Rules because they weren't signed by authorized representatives of JCB. "The NASD rules are designed primarily to regulate the conduct of NASD members -- not contract formation; thus, we hold that the NASD rules cannot be used to void an otherwise valid and binding contract."

California

Kirkland v. Superior Court of Los Angeles County, 95 Cal.App.4th 92, 115 Cal.Rptr.2d 279 (Cal.App. Dist.2 01/09/2002)

Transcripts of testimony given before the SEC in the course of an investigation are discoverable in civil litigation where the party from whom discovery is sought has possession of or ready access to the documents and transcripts.

Cranstal Resources, Ltd. v. Dean Witter Reynolds, Inc., No. D038191 (Cal.App. Dist.4 01/09/2002)

Reversal of summary judgment in favor of Dean Witter on claims against it for conversion and breach of fiduciary duty arising out of its role in "prime bank guaranties" scheme.

Paul v. Friedman, 95 Cal.App.4th 853, 117 Cal.Rptr.2d 82 (Cal.App. Dist.2 01/29/2002)

Whether activity of claimants' attorney in connection with unsuccessful arbitration fell within the ambit of California's anti-SLAPP statutes.

Nyko, Inc. v. First Union Securities, Inc., No. B150211 (Cal.App. Dist.2 02/07/2002)

Plaintiffs' motion to confirm arbitration award and acceptance of award proceeds did not constitute waiver of right to appeal award when plaintiffs had objected to arbitration in the first instance.

Benasra v. Mitchell, Silberberg & Knupp, 96 Cal.App.4th 96, 116 Cal.Rptr.2d 644 (Cal.App. Dist.2 02/13/2002)

Arbitration panel's denial of party's motion to disqualify opposing counsel does not bar a party's subsequent suit against same attorney for breach of duty of loyalty on *res judicata* grounds.

Quality Assurance Technologies, Inc. v. Systems Partners, Inc., No. C034061 (Cal.App. Dist.3 02/20/2002)

Discussion of what constitutes "waiver" of right to arbitrate under California law.

CIBC Oppenheimer Corp. v. Friedman, No. B141521 (Cal.App. Dist.2 02/21/2002)

Arbitrators lacked authority to levy sanctions against attorney representing Claimants in losing arbitration effort because attorney was not a party to the arbitration.

Florida

Prudential Securities, Inc. v. Katz, 807 So.2d 173 (Fla.App. Dist.3 02/13/2002)

Terminated rep required to arbitrate his claim under Florida Whistle Blower Act.

Black v. State, No. 1D99-3682 (Fla.App. 05/31/2002)

Lengthy and detailed discussion of violation of Florida securities laws in connection with CMO transactions between First Montauk Securities and Escambia County, Florida.

Georgia

Mosley v. State, 560 S.E.2d 305 (Ga.App. 02/13/2002)

Discussion of what constitutes a "security" under the Georgia Securities Act.

McKesson HBOC, Inc. v. Adler, No. A01A1836 (Ga.App. 03/27/2002)

Discussion of the applicability of the "attorney-client privilege" and "work-product doctrine" under Georgia law to documents produced by a party to the SEC when the producing party was not a subject of the SEC's investigation.

Idaho

State v. Gertsch, No. 27319 (Idaho 04/09/2002)

Discussion of what constitutes a

"security" under the Idaho securities laws.

Illinois

Integrated Research Services, Inc. v. Illinois Secretary of State, No. 1-00-3102 (Ill. App. Ct., 1st Dist., 4th Div. 02/07/2002)(Unpublished)

Discussion of what constitutes "security" under the Illinois securities laws, particularly as it pertains to investment contracts that involve trading in foreign currencies.

Kansas

Brenner v. Oppenheimer & Co., Inc., No. 87,452 (Kan.App. 04/19/2002)

Long, exhaustive discussion of the propriety of applying New York law to securities case per the parties' contractual agreement.

Kansas Public Employees Retirement System v. Kutak Rock, No. 87,044 (Kan.App. 04/19/2002)

Affirmation of trial court grant of summary judgment to Kutak Rock on KPERS's claims of breach of contract, professional negligence and breach of trust in connection with KPERS's purchase of failed investment.

Michigan

First of Michigan Corporation v. Richard J. Mansour, No. 228521 (Michigan Court of Appeals 5/17/02).

Discussion of manifest disregard, arbitrators exceeding authority and award procured by undue means.

Minnesota

Churchill Environmental and Industrial Equity Partners, L.P. v. Ernst & Young, L.L.P., No. C7-01-1905 (Minn.App. 04/30/2002)

The parties' agreement to arbitrate "[a]ny issue concerning the extent to which any dispute is subject to arbitration" shows that they clearly intended that arbitrators would decide the arbitrability of respondents' claims.

Missouri

Estate of Burford v. Edward D. Jones, No. WD60369 (Mo.App. W.D. 06/11/2002)

Court affirms denial of Jones' motion to compel arbitration. Account agreement and the arbitration provision contained therein were void because the co-conservators lacked authority to enter into that agreement without court approval.

Montana

Kloss v. Edward D. Jones & Co., 2002 MT 129 (Mont. 06/13/2002)

Order compelling arbitration reversed because arbitration agreement was "contract of adhesion" under Montana law. Broker's fiduciary duty to client included explaining the arbitration provisions of the customer agreement, which was not done.

Nebraska

Kalinski v. Robert W. Baird & Co., No. 4:01CV461, 2002 U.S. Dist LEXIS 1455 (D.Neb. January 7, 2002)

Whether terminated registered rep was required to arbitrate claims for "dissemination of false information" about rep by firm after rep was terminated from firm.

Nevada

State v. Friend, 40 P.3d 436 (Nev. 02/15/2002)

Reversal of trial court order granting a motion to dismiss six counts of securities violations, holding that one-year notes issued in exchange for investment funds were not securities under NRS 90.295

New Jersey

Merrill Lynch Pierce Fenner & Smith Inc. v. Nora-Johnson, No. A-5420-00T1 (N.J.Super. App.Div. 05/23/2002)

Refusal to enjoin arbitration brought by trust when only one of the trustees consented to filing of arbitration.

North Carolina

Sciolino v. TD Waterhouse Investor Services, Inc., No. COA01-422 (N.C.App. 04/02/2002)

Trial court decision to deny TDW's motion to compel arbitration due to TDW's inability to produce arbitration agreement signed by customers AFFIRMED.

Ohio

Cohen v. Wilhelm, No. C-010312 (Ohio App. Dist.1 01/18/2002)

Intermediate Ohio appellate court ruled that, notwithstanding broad arbitration agreement, customer and BD could not have possibly intended it to cover allegations of theft.

This action spawned significant collateral litigation in federal court, including the decision in *PaineWebber, Inc. v. Cohen*, 276 F.3d 197 (6th Cir. December 27, 2001) which contains a good discussion of "proper" vs. "necessary" parties in the context of exercising diversity jurisdiction in a proceeding to compel arbitration.

McDonald Investments, Inc. v. Fearn, No. 01CAE08039 (Ohio App. Dist.5 02/28/2002)

Registered rep granted "relief from judgment" on suit by former employing BD to collect on 4 "forgiveable loan" notes executed by registered rep pending outcome of registered rep's claims against BD in arbitration.

Mathias v. Rosser, No. 01AP-768 (Ohio App. Dist.10 05/30/2002)

Discussion of what constitutes a "security" under the Ohio securities laws; the burden to prove exemption for the securities laws; fiduciary status of broker or investment advisor; successor liability.

Goldberg v. Cohen, No. 01 CA 49 (Ohio App. Dist.7 06/13/2002)

If a common-law fraud claim is predicated on the purchase or sale of securities, the appropriate statute of limitations to apply is that found in the Ohio Securities Act (RC 1707.43), not the general limitations period provided for all other claims based on common-law fraud found in RC 2305.09.

Texas

Mariner Financial Group, Inc. v. Bossley, No. 00-0325 (Tex. June 13, 2002).

Does arbitrator's failure to disclose prior adverse relationship with one of Claimants' experts constitute evident partiality sufficient to justify vacatur?

Texas Capital Securities Management, Inc. v. Sandefer, No. 06-01-00131-CV (Tex.App. Dist.6 06/19/2002)

Summary judgment against alleged "control persons" who were not parties to underlying claim inappropriate.

Washington

Herrington v. Hawthorne, No. 47962-8-I (Wash.App.Div.1 05/20/2002)

Discussion of control person liability under Washington State Securities Act.

SEC ADMINISTRATIVE PROCEEDINGS
(1/1/02 - 6/21/02)

In the Matter of Josephthal & Co., Administrative Proceeding File No. 3-10793, 1934 Act Release No. 46039, 2002 SEC LEXIS 1515 (June 6, 2002)

Failure to maintain adequate supervisory system; misappropriation of customer funds through wire transfers.

In the Matter of Mark David Anderson, Administrative Proceeding File No. 3-9499, Initial Decisions Release No. 203, 2002 SEC LEXIS 1165 (April 30, 3003)

Excessive markups in municipal securities, CMOs.

In the Matter of J.W. Barclay & Co, Administrative Proceeding File No. 3-10765, 1933 Act Release No. 8094, 1934 Act Release No. 45815, 2002 SEC LEXIS 1082 (April 24, 2002)

Failure to supervise; unauthorized and unsuitable trading.

In the Matter of Sandra K. Simpson, Administrative Proceeding File No. 3-9458, 1934 Act Release No. 45923, 2002 SEC LEXIS 1278 (May 14, 2002)

Prudential broker and her sales assistant barred from industry for defrauding customers by engaging in unauthorized transactions, unauthorized use of margin, unsuitable and excessive trading, churning, and abusive mutual fund sales practices.

In the Matter of Wayne Miller, Administrative Proceeding File No. 3-10755, 1933 Act Release No. 8085, 1934 Act Release No. 45738, 1940 Act Release No. 25520, 2002 SEC LEXIS 912 (April 11, 2002)

Unsuitable options trading in accounts of unsophisticated investors.

In the Matter of Roundhill Securities, Administrative Proceeding File No. 3-10751, 1933 Act Release No. 8080, 1934 Act Release No. 45707, 2002 SEC LEXIS 871 (April 8, 2002)

Broker dealer and its President and Chief Compliance Officer failed to adequately supervise 2 registered representatives (one of whom should have been subjected to heightened supervision) who engaged in excessive and unsuitable trading and misappropriation of customer funds.

In the Matter of Fu-Sung Peter Wu, Administrative Proceeding File No. 3-9024, 1934 Act Release No. 45694, 2002 SEC LEXIS 843 (April 4, 2002)

Registered rep and control person of BD defrauded customers by recklessly predicting the opening price of an IPO and defrauded another BD by misrepresenting his intent to buy shares from BD in aftermarket.

In the Matter of Howard R. Perles, Administrative Proceeding File No. 3-10288, 1934 Act Release No. 45691, 2002 SEC LEXIS 847 (April 4, 2002)

Market manipulation by engaging in prearranged, matched trades with another member firm and failure to accurately reflect prearranged trades on books and records.

In the Matter of Harvest Financial Corporation, Administrative Proceeding File No. 3-10739, 1933 Act Release No.8077, 1934 Act Release No.45637, 2002 SEC LEXIS 750 (March 25, 2002)

Broker engaged in a scheme to defraud investors by recommending and executing an unsuitable, aggressive trading strategy in four customer accounts at Harvest in contradiction of the customers' conservative investment objectives. He also misrepresented or omitted to disclose to customers the risks inherent in this strategy. Broker knew or was reckless in not knowing that he had recommended and executed securities transactions in his customers' accounts that were unsuitable and contrary to the customers' conservative investment objectives and their best interests. Furthermore, broker churned the accounts of those four customers. Firm failed to establish adequate supervisory procedures and President of firm, who was sole supervisor, failed to respond meaningfully to indications of broker's questionable activities.

In the Matter of Richmark Capital Corporation, Administrative Proceeding File No. 3-9954, Initial Decisions Release No.201, 2002 SEC LEXIS 601 (March 18, 2002)

Failure to disclose investment banking and other business relationships with company whose stock BD was recommending. Failure to disclose that registered reps were selling shares of stock at the same time they were recommending purchases of same stock to customers.

In the Matter of Norwest Investment Services n/k/a Wells Fargo Brokerage Services, Administrative Proceeding File No.3-10706, 1934 Act No.45460, 2002 SEC LEXIS 397 (February 20, 2002)

From February 1999 to August 1999, a former registered representative ("RR") of Respondent's Aurora, Colorado branch office, engaged in various sales practice violations, including fraudulent mutual fund switching in at least seven customer accounts. Respondent failed reasonably to supervise the RR to prevent or detect the RR's mutual fund switching violations. During the violative period, Respondent had inadequate mutual fund switching procedures to prevent or detect the RR's misconduct. Further, Respondent did not have a system in place to communicate, implement, and enforce effectively the switching policies and procedures it did have.

In the Matter of the Application of Keith Springer, Admin Proceeding File No. 3-10247, 1934 Act Release No.45439, 2002 SEC LEXIS 364 (February 13, 2002)

Improper post-execution allocation of trades; delayed allocation of trades with better executions to personal account to detriment of customers; attempt to obstruct internal investigation; recordkeeping violations.

In the Matter of the Application of David Wong, Administrative Proceeding File No.3-10360, 1934 Act Release No.45426, 2002 SEC LEXIS 339 (February 8, 2002)

Former registered representative of a former member firm of national securities exchange conceded on appeal that he violated exchange rules when he failed to use due diligence to ascertain his customer's investment objectives and financial situation, included false information about the customer on new account forms he prepared for that customer, engaged in improper discretionary trading, churned the customer's account, and effected unsuitable investments for the customer.

In the Matter of Pryor, McClendon, Counts & Co. n/k/a/ Pryor, Counts & Co., Admin Proceeding File No. 3-9884, 1933 Act Release No. 8062, 1934 Act Release No.45402
2002 SEC LEXIS 284 (February 6, 2002)

This matter concerns a series of federal securities law violations by PMC and two of its principals, and others scheming with them. The first group of violations relates to PMC's handling of the city of Atlanta's portfolio of zero-coupon securities issued by the United States Treasury ("Separate Trading of Registered Interest and Principal Securities" or "STRIPS"). The second group of violations concerns a series of concealed payments and political contributions to public officials and candidates for public office in Atlanta and New York.

In the Matter of Brian A. Schmidt, Administrative Proceeding File No.3-9402, 1933 Act Release No.8061, 1934 Act Release No.45330, 2002 SEC LEXIS 180 (January 24, 2002)

Respondents engaged in a fraudulent scheme that purported to lease United States treasury bills. Broker-dealer failed to supervise associated person to prevent his violations.

In the Matter of the Application of Kevin D. Kunz, Admin. Proceeding File No.3-9960, 1934 Act Release No.45290, 2002 SEC LEXIS 104 (January 16, 2002)

Registered representative of a member firm and member firm of a registered securities association offered and sold securities using private placement memoranda containing material misrepresentations and omissions. Securities were neither registered nor exempt from registration under the Securities Act of 1933. Registered representative authorized firm's compensation of an unregistered person in connection with securities transactions. Violation of NASD Conduct Rule 2110.

In the Matter of Performance Analytics, Administrative Proceeding File No.3-10802, 1934 Act Release No.46081, 2002 SEC LEXIS 1552 (June 17, 2002)

This proceeding is based on Performance's and Golembo's material misrepresentations and omissions to one of its clients, a union pension fund ("Client"). In or about 1994, a registered representative of East West Institutional Services, Inc. ("East West), a Michigan broker-dealer, entered into an illegal kickback agreement with two trustees of the Client ("the two trustees") whereby the two trustees caused the Client to hire investment advisers who were willing to direct brokerage trades to East West, and East West then paid kickbacks of commissions to the two trustees. In 1995, the Client hired Performance as a consultant to provide advice concerning the retention of new investment advisers. In fact, Performance, through Golembo, obtained the consultant position by agreeing to recommend to the Client only those investment advisers that were willing to direct brokerage to East West. Also in 1995, Golembo, on behalf of Performance, recommended to the Client at least one investment adviser, Duff & Phelps Investment Management Co., Inc. ("Duff"), that he knew or was reckless in not knowing was willing to direct brokerage to East West. In 1996, Performance entered into a separate soft-dollar arrangement with Duff, whereby it received $ 100,000 annually in brokerage commission business directed for the benefit of Performance's affiliated broker dealer, in exchange for a continuing recommendation of Duff to the Client. Performance and Golembo failed to disclose to the disinterested representatives of the Client their arrangement to recommend only those advisers that agreed to direct brokerage to East West. They further failed to disclose to the disinterested representatives of the Client their soft dollar arrangement with Duff pursuant to which they continued to recommend Duff's advisory services to the Client in exchange for Duff's direction of $ 100,000 per year in brokerage commission business to Performance's affiliated broker-dealer.

In the Matter of the Barr Financial Group, Administrative Proceeding File No. 3-9918, Initial Decisions Release No. 206, 2002 SEC LEXIS 1594

The Respondents, the Barr Financial Group, Inc. (BFG) and Alfred E. Barr (Barr), violated Section 207 of the Investment Advisers Act of 1940 by willfully making material misstatements in their Form ADV filings; they were also enjoined, pursuant to a 1999 United States District Court order, from violating Section 204 of the Investment Advisers Act of 1940. This Initial Decision (Decision) imposes sanctions on BFG and Barr, including a cease-and-desist order, a bar, and a revocation of BFG's registration.

In the Matter of Portfolio Advisory Services, Administrative Proceeding File No.3-10807
Investment Advisors Act of 1940 Release No.2038, 2002 SEC LEXIS 1591 (June 20, 2002)

From 1993 to 2000, PAS failed to seek best execution in securities transactions for certain advisory clients by systematically interposing a broker-dealer between clients and a market maker on over-the-counter (OTC) trades to compensate the broker-dealer for referring clients to PAS. The interposed broker-dealer received commissions despite having no role in executing the trades. Clients therefore paid unnecessary commissions over and above the markups or markdowns already charged by the market maker. The opinion notes that the Commission has repeatedly sanctioned investment advisers that have failed to seek best execution of client trades involving referral arrangements.

Around the SROs

NASDR

Notices to Members

02-07 NASD Adopts Interpretive Material Prohibiting Interference With The Transfer Of Customer Accounts In The Context Of Employment Disputes

02-13 SEC Approves Permanent Injunctive Relief Rule

02-28 Member Obligations Regarding Long-Term Or Brokered Certificates Of Deposit

02-34 SEC Approves Proposed Changes to Rule 3070 Concerning the Reporting of Criminal Offenses by Members and Persons Associated with Members

02-35 NASD Adopts Amendments Regarding the Posting of Margin Disclosure and Day-Trading Risk Disclosure Statements on Web Sites

National Adjudicatory Council Decisions

Department of Enforcement v. Franklyn Ross Michelin & L.H. Ross & Co., Complaint No. C07000033 (January 3, 2002)

Respondents failed to implement supervisory tape-recording procedures.

Department of Enforcement v. Roger A. Hanson, Complaint No.C8A000059 (March 28, 2002)

Registered representative stipulated that he had engaged in private securities transactions, acknowledged his liability for violating Rules 2110 and 3040, and was suspended for 90 days, ordered to disgorge his commissions to his customers, and fined $5,000. Held, suspension increased to 180 days and monetary sanctions modified.

Department of Enforcement v. George M. Goritz, Complaint No.C10000037 (April 26, 2002)

The Hearing Panel found that the respondent had participated in private securities transactions without giving written notice to and obtaining written approval from the member firms with which he was associated and distributed an offering memorandum that misrepresented his experience in the investment banking field. Held, Hearing Panel's findings and sanctions sustained.

Department of Enforcement v. Josephthal & Co., Complaint No.CAF000015 (May 6, 2002)

Hearing Panel found that firm had violated just and equitable principles of trade when it failed to comply with an arbitration panel's order to produce a document. Held, findings and sanctions affirmed.

NYSE

Information Memos

02-05 NYSE announces availability of new "Independent Broker Activity Report," which it describes as a tool to assist members and member organizations in the supervision of floor brokers and floor employees, in accordance with NYSE Rule 342 (Offices-Approval, Supervision, and Control). The Broker Chron Report consists of NYSE prints and audit trail data submissions, identifies trade and clearance data for a given member's badge number, and is available on T+1.

"The Broker Chron Report can be useful in determining if a floor broker has submitted all of his/her order tickets for review by the Compliance Department as well as identifying instances of front-running customer orders or on-floor trading by comparing the activity to a floor broker's personal accounts. Further, the report identifies the give-up and in what capacity the member is acting (e.g., if he/she is acting in the capacity of a two-dollar floor broker) or whether the execution is a proprietary transaction, for a firm account or client. This will enable compliance staff to monitor the floor brokerage activities of the organization's floor broker(s) and his/her sources of revenue earned on the floor."

02-07 Discussion of NYSE's new mandatory error account requirements and error transaction procedures.

02-24 Disclosure and reporting requirements regarding analyst conflict of interests.

Hearing Panel Decisions

Richard C. Naso Company, Inc., No.02-004 (February 12, 2002)

Violated Exchange Rule 346(f) by associating with a person subject to a statutory disqualification; engaged in conduct inconsistent with just and equitable principles of trade and engaged in acts detrimental to the interest or welfare of the Exchange by associating with a person suspended from membership, allied membership, approved person status and from employment or association in any capacity with any member or member organization; violated SEA Regulation 15b3-1 by failing to file promptly an amendment to its Form BD disclosing the
suspension of a control affiliate; and violated Exchange Rule 351(a)(9) by failing to report promptly its association with a person subject to a statutory disqualification – Censure.

Floor Broker Network, Inc., No.02-005 (February 12, 2002)

Violated Exchange Rule 346(f) by associating with a person subject to a statutory disqualification; engaged in conduct inconsistent with just and equitable principles of trade and engaged in acts detrimental to the interest or welfare of the Exchange by associating with a person suspended from membership, allied membership, approved person status and from employment or association in any capacity with any member or member organization; violated SEA Regulation 15b3-1 by failing to file promptly an amendment to its Form BD disclosing the
suspension of a control affiliate; and violated Exchange Rule 351(a)(9) by failing to report promptly its association with a person subject to a statutory disqualification – Censure.

Lehman Brothers, Inc., No. 02-062 (March 21, 2002)

Violated Rule 345A by permitting persons with inactive registrations to perform in capacities which required registration and violated Rule 342 by failing to provide appropriate supervisory procedures – Consent to censure and $250,000 fine.

Announcements From The PIABA Office

Office Staff:

Robin S. Ringo, Exec. Admin.
rsringo@piaba.org

Karrie Ferguson, Office Asst.
kferguson@piaba.org

Josh Edge, Website
joshedge@piaba.org

2241 W. Lindsey St., Ste. 500
Norman, OK 73069
Toll Free: 1.888.621.7484
Office: 1.405.360.8776
Fax: 1.405.360.2063
E-Mail: piaba@piaba.org
Website: www.PIABA.org

Upcoming Events:

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 meeting brochure, contact Karrie Ferguson at 1.888.621.7484

Important Annual 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 receivedin writing in 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. Registrants are advised to check cancellation policy with the Broadmoor at least fourteen (14) days prior to anticipated arrival if there might be an arrival change or reservation cancellation.

PIABA Board of Directors Meeting, 2001-2002 Board, October 2, 2002 at 9:00 p.m., The Broadmoor

PIABA Board of Directors Meeting, 2002-2003 Board of Directors, October 6, 2002 at 8:30 a.m., The Broadmoor

New Members:

(since publication of Spring 2002 issue of *PIABA Bar Journal*)

J. Anklowitz	Bohemia, NY
S. David Anton	Tampa, FL
John Calhoun Bales	Tampa, Fl
Ariel Berschadsky	New York, NY
Robert Bertsch	Port Washington, NY
Alton Burkhalter	Irvine, CA
Jerry L. Colclazier	Seminole, OK
C. Richard Collins	Evansville, IN
Stacy Costner	Tampa, FL
Robert B. Crotty	Dallas, TX
Donald C. Deagle	Denver, CO
Robert M. Duffy	Providence, RI
Samuel Benton Edwards	Houston, TX
Jeffrey S. Feinberg	New York, ny
Richard Gelb	Boston, MA
Sheldon E. Goldstein	New York, NY
Gary Greenwald	Columbus, OH
April Halle	Boca Raton, FL
Richard Heller	New York, ny
Edwin Hull	Chicago, IL
Kerry N. Jardine	Englewood, CO
Kevin Kinne	Pittsfield, MA
Marc Koplik	New York, NY
Alois (Al) Lemke	Santa Cruz, CA
John McGovern	Scranton, pa
Robert G. McIver	Greensboro, NC
Kevin D. Mehling, Jr.	Houston, TX
Jonathan Michaels	Irvine, CA
Deidre O'Brien	New York, NY
Joanne A. Schultz	Buffalo, NY
Stephen H. Slabach	San Mateo, CA
Brian Smiley	Atlanta, GA
Stephen Thomas	Peoria, IL
James V. Weixel, Jr.	Corte Madera, CA