Public Investors Arbitration Bar Association Vol. 9 No. 3 Fall 2002

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

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The Bar Journal of the Public Investors Arbitration Bar Association

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Fall President's Message

by J. Pat Sadler

J. Pat Sadler is the current President of PIABA and a member of the PIABA Board of Directors. He is a member of Sadler & Hovedesven in Atlanta, Georgia. His email address is jps@sandhlaw.com and he can be reached at 1.770.587.2570.

Dear Members,

The call came in around mid-morning while I was plowing through a large stack of document requests. The guy said he needed my help. He said he had no choice--he had to take action. He knew that I had successfully handled a similar case, and he asked me to represent him.

He was one of those people whom you know you are going to like from the moment you start talking with him. I knew that this case had merit because I had in fact handled a similar one. But there was one fact that kept me from immediately agreeing to represent him: The guy was a stockbroker.

The case was an employment case between the broker and his firm. No public customer was involved. I didn't like what the firm was doing, but heck, I'm a claimants' lawyer. Did I really want to represent this guy?

We talked some more. He told me that his previous firm had been acquired by his current firm two years ago, and he had been required to sign a long-term employment agreement with onerous post-employment restrictions. He said he built his business on customer service, and the new firm's policies would not allow him to serve his customers the way they deserved to be serviced. He didn't like the products that he was pressured to sell. He said he knew that leaving the firm would jeopardize his career and his family's security. He said he had no choice, that he couldn't ask his clients to stay at that firm.

I took the case. Within days, we were in Federal court, fighting a TRO and preliminary injunction motion. We lost. The judge issued a harsh injunction. Now the battleground shifted to the NASD arbitration hearing where the firm's request for permanent injunction and damages would be heard.

In preparing for the hearing, I talked to several of my client's customers. One after another they told me stories of how much this man had done for them. They told me of their trust in my client and their fear that some other broker might take advantage of them. One customer, an elderly lady with serious health problems asked me to promise her that we would win. What had I gotten myself into?

At this point, I recognized that this case very much did involve public customers. I felt all the same pressure we all feel every time a customer entrusts her claim to us and we have to fight the monolithic brokerage firm. Our cases affect people and their futures. A tremendous responsibility is placed upon us, but that's okay. In fact, for most of us, it's why we do what we do: to have a positive impact on people's lives.

Well, we won, and the multiple emotions we all know so well rained down: elation, exhaustion, release of fear, satisfaction, humility. All were there.

It's always nice to win, but the win won't be the lasting impression from this case. The case taught me two lessons. he first I already knew, but it wasn't important to me before. In this case, it hit home to me that not all brokers are bad brokers. There are good people out there who care about their clients and who work hard for them. I guess that point is pretty obvious.

The second lesson is more profound. It dawned upon me that when we bring a case against a bad broker or a bad firm, we are not just fighting for the client. We are also fighting for the good brokers. For the public to have trust in the securities industry, the wrongful actions of brokers and firms must have consequences. Honest brokers benefit when dishonest acts of brokers and firms are punished.

Many of us are seeing cases now where honest, hard working brokers gave bad advice based on bad research given to them. In some cases, those brokers are additional victims of the wrongdoing. This makes the wrongdoing even worse.

PIABA exists to protect the public investor. Do your work proudly. You are heroes for justice. And, if your work benefits honest brokers and firms, that's okay too.

ProfLipner's "I Love New York Law" –

The Impropriety of Confidentiality Orders in Securities Arbitration

by Seth E. Lipner

Seth E. Lipner is Professor of Law at the Zicklin School of Business, Baruch College, in New York. He is one of the original PIABA Directors, a two-time Past President of PIABA and the organization's Secretary. He is also a member of Deutsch & Lipner, a Garden City, New York law firm. 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 646-312-3595 or 516.294.8899.

Defense requests for omnibus confidentiality agreements and orders in securities arbitrations have become commonplace, but few lawyers and arbitrators stop to consider the proporiety of such orders. This article seeks to demonstrate that such orders should not be issued, and the reasons they should be resisted.

Any discussion of confidentiality orders must start with the proposition that justice in this country is and ought to be public. A free and open society like ours is best off if the light of day shines brightly on its affairs. Recent events in the business world show all-too-vividly the horrible effect that secrecy and cover-ups can have on American public.

Truth Seeking: The purpose of arbitration, like all legal proceedings, is to seek and determine the truth. The process requires that attorneys be able to compare situations and documents relevant to our clients' cases, not only amongst clients, but also with other attorneys prosecuting similar cases. Such collaboration improves the truth-seeking process, while a respondent's plea for confidentiality retards and hinders that process.

The language in the Arbitrator's Manual advising arbitrators to treat the matters they learn in arbitration as confidential should not be misconstrued as grounds for arbitrators to order parties to maintain strict confidentiality. The language in the Manual is intended to convey to the arbitrators the simple notion that they should not discuss the cases in which they sit with anyone outside the process (for example, at a social gathering or a professional event).

The language in the Manual goes back to old American Arbitration Association ("AAA") publications. The AAA was formed in the 1890s by wealthy individuals who wanted the disputes among them to be private. Unlike the situation in most securities arbitrations, those individuals then agreed, **post-dispute,** to go to arbitration.[1] The AAA model, from which the "private" language comes, is totally inapposite to the present situation.

In 1987, when the United States Supreme Court approved the securities industry's practice of requiring arbitration of customer disputes (overruling a long standing opinion to the contrary), the Court (and the SEC, in its amicus brief) emphasized that the rights of the investor were not being diminished by mandatory arbitration, only that the forum was being changed. If any corporate defendant were to appear in court and ask for all encompassing omnibus confidentiality protection as to all documents and testimony, their request would be summarily denied.

Especially (but not exclusively) in multiple-victim cases, a respondent's demand for confidentiality is often designed to prevent Claimants from effectively examining witnesses, and from coming to understand fully the motivations, incentives and actions of the firm and its representatives. It is the responsibility of counsel for the parties to discover and demonstrate to the arbitrators the facts that underlie these cases, and it is inherent in our legal system that full discovery and openness are essential to that process.

If customer/securities cases were in court, there is no doubt that there would be no confidentiality order. No real "trade secrets" of Respondent are involved in these cases. In order to qualify as a trade secret, the item

[1] In those days, all pre-dispute agreements were unenforceable under the law.

claimed to be secret must such that it is "gives [the owner] an opportunity to obtain an advantage over competitors who do not know . . . it" See Restatement of Torts. See also Uniform Trade Secrets Act, 14 U.L.A. 537, 538 (1980)(requiring claimed secret to have "independent economic value"). Most sales documents used in the securities business are, by the time the case comes up, so old as to no longer provide the requisite "advantage" or "value", thus disqualifying them as trade secrets. So too, due diligence files and trading records are not trade secrets, and they are thus not the proper subject of confidentiality orders. To the extent the names of other customers are involved, the NASD guidelines on discovery permit redaction. And, to the extent truly "private" information is disclosed (e.g. private personnel records), there is a common law duty not to publicize it, a remedy for doing so. See Warren & Brandies, The Right to Privacy, 4 Harvard L.Rev. 193 (1890). Adding an arbitrators' order is unnecessary and unwise.

The orders respondents submit in arbitration often go much farther than law or good conscience permits. For example, they sometimes seek an order so broad it would, in effect, seal the record. No such order should ever be entered.

Concealment: Securities arbitrations exist because brokerage firm agreements require arbitration. By compelling these cases to arbitration and then demanding confidentiality, firms try to conceal their wrongdoing from other litigants, other aggrieved investors, and from the news media (which often considers these matters important and newsworthy). *See Danco Laboratories, Ltd. v. Chemical Works*, 274 A.D.1, 711 N.Y.S.2d 419 (1st Dept. 2000), discussed *infra.*
A clients' First Amendment rights become paramount when a respondent goes so far as to try to use arbitrators (and the supposedly "private" nature of arbitration) as the instrumentality for hiding from the public evidence of corporate wrongdoing. Neither the SEC nor the Supreme Court could have envisioned such a result when it sanctioned arbitration in the securities industry in 1987.

Divide and Conquer Strategy: Often in securities cases, the grievance of the claimant is not an isolated circumstance. Respondents in arbitration, however, want panels to see only, and thus treat, each case as an isolated incident, or at least to isolate the victims from each other. A respondent's request for confidentiality thus becomes a naked attempt to "divide and conquer", making each claimant less well able to prosecute the cases effectively.

Covering Up Systemic Fraud: A court or arbitrator confidentiality order should never be issued to protect the "privacy or confidentiality" of an enterprise involved in a systemic fraud. What better way to cover up a systemic fraud than to require each victim of the fraud to litigate separately, and to not share discovery? As one court stated:

> "Shared discovery is an effective means to ensure full and fair disclosure. Parties subject to a number of suits concerning the same subject matter are forced to be consistent in their responses by the knowledge that their opponents can compare those responses."

Garcia v. Peeples, 734 S.W.2d, 343, 347 (Texas 1987).

NEW YORK LAW

Most brokerage firms are corporations with their principal place of business in New York. Most broker-customer contracts provide for the application of New York law. New York clearly disfavors confidentiality orders and orders sealing court records. As one influential court recently wrote:

> The issue often arises in the context of criminal proceedings, but both the First Amendment and common law principles apply equally to civil proceedings *Herald Company v. Weisenberg*, 59 N.Y.2d 378, 383, 465 N.Y.S.2d 862, 452 N.E.2d 1190; *see, also,* Comment, "The First Amendment Right of Access to Civil Trials After Globe Newspaper Company v. Superior Court," 51 Univ. Chicago Law Rev. 286 [1984]. As the United States Supreme Court has noted, "[w]hile the operation of the judicial process in civil cases is often of interest only to the parties in the litigation, this is not always the case.... Thus, in some civil cases the public interest in access, and the salutary effect of publicity, may be as strong as, or stronger than, in most criminal cases," *Republic of the Philippines v. DePasquale*, 443 U.S. 368, 386-387, n. 15, 99 S.Ct. 2898, 61 L.Ed.2d 608). Among the values of access in civil cases is that "the bright light cast upon the judicial process by public observation diminishes the possibilities for injustice, incompetence, perjury and fraud." *Republic of the Philippines, supra*, at 660; *Littlejohn v. BIC Corp.*, 3rd Cir., 851 F.2d 673, 678. Publicity about trials "[tends] to insure that the truth will be told and the secrecy of inquisition-like proceedings

> will not occur." *Coopersmith v. Gold*, 156 Misc.2d 594, 601, 594 N.Y.S.2d 521; *Westchester Rockland Newspapers v. Leggett*, 48 N.Y.2d 430, 437-438, 423 N.Y.S.2d 630, 399 N.E.2d 518. The public interest in openness is particularly important on matters of public concern, even if the issues arise in the context of a private dispute *Brown & Williamson Tobacco, supra*, at 1179), about which secrecy, then, may well prove the greater detriment to the public (*see generally,* Doggett and Mucchetti, "Public Access to Public Courts: Discouraging Secrecy in the Public Interest," 69 Texas Law Rev. 643, 648 [1991]). . . .

In New York, too, we have stated that "statutory and common law ... have long recognized that civil actions and proceedings should be open to the public in order to ensure that they are conducted efficiently, honestly and fairly" *Matter of Conservatorship of Ethel Brownstone*, 191 A.D.2d 167, 594 N.Y.S.2d 31. New York's presumption of public access is broad *Newsday v. Sise*, 71 N.Y.2d 146, 153, n. 4, 524 N.Y.S.2d 35, 518 N.E.2d 930, *cert. denied* 486 U.S. 1056, 108 S.Ct. 2823, 100 L.Ed.2d 924; *Herald Company v. Weisenberg*, 59 N.Y.2d 378, 381-382, 465 N.Y.S.2d 862, 452 N.E.2d 1190; *see,* Carpinello, "Public Access to Court Records in Civil Proceedings: The New York Approach," 54 Albany Law Rev. 93 [1989]. We have required that a "legitimate basis" justify the sealing of court documents *Matter of Conservatorship of Ethel Brownstone, supra*. Pursuant to these general policy objectives, New York promulgated Rule 216.1[a] of the Uniform Rules of Trial Court. This section directs that "[e]xcept where otherwise provided by statute or rule, a court shall not enter an order in any action ... sealing the court records, whether in whole or in part, except upon a written finding of good cause, which shall specify the grounds thereof. In determining whether good cause has been shown, the court shall consider the interests of the public as well as of the parties ..."22 NYCRR 216.1[a]. Although the rule does not further define "good cause," a **standard** that is "difficult to define in absolute terms," a sealing order should rest on a "sound basis or legitimate need to take judicial action," a showing properly burdening the party seeking to have a **sealed record** remain **sealed.** *Coopersmith v. Gold*, 156 Misc.2d 594, 606, 594 N.Y.S.2d 521).

Danco Laboratories, Ltd. v. Chemical Works, 274 A.D.1, 711 N.Y.S.2d 419 (1st Dept. 2000)

CONCLUSION

There should be no confidentiality orders in arbitration. No real "trade secrets" of respondents are involved in these cases. Usually, the only issues in discovery are a respondent's sales practices, and the motivations for them.

Before any arbitration panel even considers Respondent's request for confidentiality, the Respondent should be required to identify each and every document for which they seek protection, and to describe to this panel the exact nature of the trade secret they seek to protect, as required by the NASD Discovery Guide.

Attorneys should challenge panels to take very seriously whether they are prepared to assert the authority to deny a claimant his or her right to free speech about the documents and facts discovered by their lawyers in a case. Arbitrators should be warned not to be drawn in to brokerage firm attempts at cover-ups, and told that there is no good authority for imposing confidentiality orders on arbitration claimants and their attorneys.

The Supreme Court could not have envisioned turning arbitration into a trap door when it sanctioned mandatory arbitration agreements in the securities industry. The confidentiality orders that the industry tries to foist on claimants should be resisted, so that investors will not be deprived of the advocacy they deserve.

Practitioner's Corner–

Securities Arbitration: An Alternative, Not A Substitute

by David W. Oppenheim and David E. Robbins

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Introductory Conversation

New PIABA Member with a Litigation Background: "I thought the Supreme Court compelled customer securities cases to arbitration because that system is an effective substitute for litigation. You know, where the triers-of-fact are enthusiastic volunteers with a wealth of business experience and the courage of their convictions; where the precedents of generations and self-regulatory rules are the standards by which they judge the conduct at issue; where a customer always prevails if he meets his burden of proof; and, where the consistency of arbitration Awards allows the customer's attorney to better evaluate the likely success of a potential claim?
Seasoned PIABA Member: "Fuhgeddaboutit."

Welcome to Securities Arbitration – Where Night is Gray

The burst of the Internet bubble and revelations from the New York Attorney General's Office about the largest and most well-known brokerage firms and their research analysts have caused the number of securities arbitration claims to skyrocket. From January 2001 through July 2002, the NASD and NYSE opened 11,302 and 1,211 cases, respectively. Along for the ride on the skyrocket are experienced and not-so experienced customer attorneys. The latter are finding that membership in PIABA, by itself, does not buy a ticket to success.

For even the most experienced trial attorney, participating in an SRO arbitration can be a daunting experience. Most of the rules typical of litigation in court (the rules you spent countless hours learning in law school and the ones you saw played out in your favorite courtroom drama series) simply do not apply. Because arbitration is a relatively new and still maturing process, its procedures and hearing advocacy skills (unlike civil procedure and trial advocacy) are not taught in most law schools. As a result, young lawyers and even some experienced trial lawyers are unprepared for trying a case in an arbitral forum.

The purpose of this article is to discuss some of the differences between arbitration and litigation – from filing the initial claim through the appellate process. It is our hope that after reading this article, you, the inexperienced arbitration attorney, will have an understanding of the arbitration process, appreciate how it differs from litigation, and be better prepared to represent your clients in arbitration. Given the scope of this subject, our article can only touch on the most important distinctions.

While arbitration and litigation are both adversarial proceedings, they are drastically different. Lest there being any misunderstanding – arbitration is not litigation. It is not a substitute for litigation. It is an alternative. From the filing of the Statement of Claim or the Complaint, through the discovery process, at the hearing and beyond, the practice and procedures are different. Those differences could depress and frustrate experienced trial attorneys, but since arbitration is the only game in town, it is important that you understand the distinctions.

The Initial Claim – Outlines Versus Stories

When an experienced trial lawyer sets out to prepare a court complaint, the attorney must carefully research the specific elements of each claim that he or she wishes to advance in the litigation. If the complaint is filed in the federal court or other notice pleading forums (such as New Jersey), the attorney need only set forth the bare-boned facts and elements of each claim. The lone

exception is for claims for fraud for which federal and most state courts require more specific pleading. For example, in order to state a claim for breach of contract, a plaintiff in court need only state that it had a contract with the defendant, it performed its obligations under the contract, the defendant failed to perform its obligations and as a result of the defendant's non-performance, the plaintiff suffered damages.

But in securities arbitration, the attorney representing the claimant needs to do more. For example, in an NASD arbitration, as set forth in the NASD Uniform Guide:

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

And, as suggested in an earlier column for this Law Journal, entitled "How to Write a Statement of Claim":

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

Thus, there is a stark difference between the pleading elements for a complaint in court as opposed to the more effective form for the Statement of Claim in arbitration. A Statement of Claim in arbitration must be more in depth than a complaint in court. After all, unlike a court proceeding, the arbitrators will often use your Statement of Claim as a roadmap to the case throughout the arbitration proceeding. Thus, unlike in court, the Statement of Claim is your only opportunity to make a good first impression by persuasively telling the arbitrators your side of the story. In court, such an in depth presentation of your case in the initial pleading is simply not required. Indeed, if your case is before a jury, you can be fairly confident that the complaint will not even be read by the fact finder.

Dispositive Motions – A Preview of Respondent's Summation

If your adversary is an experienced trial attorney, he or she may receive your Statement of Claim and immediately begin to prepare a motion to dismiss. After all, in federal court, a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6) - for failure to state a claim upon which relief can be granted - is almost routine. And on such a motion to dismiss, the standard for the court to apply is clear: it must determine whether the complaint, on its face, adequately sets forth a claim upon which relief could be granted. Generally, if the plaintiff pleads the requisite elements for each claim, the motion will be denied. Experienced court room trial lawyers also know that if a motion to dismiss raises factual issues, the court can *sua sponte* treat the motion to dismiss as a motion for a summary judgment. In that event, when you oppose the motion, you must respond, in kind, by putting forth evidence sufficient to raise a triable question of fact in order to defeat the motion.

The procedures for filing and deciding motions to dismiss or dispositive motions in arbitration are very different from court. The experienced trial lawyer might be surprised to learn that dispositive motions are frowned upon in arbitration. As the Directors of Arbitration for the NASD and NYSE explained in PLI's course book for *Securities Arbitration* 1994:

> Although it comprises a large part of court room practice, there is no provision for motion practice in arbitration. The issues which are resolved in advance of the hearing, most frequently, are those which relate to discovery... Under certain circumstances, the panel will convene to address motions relating to the substantive issues in the case (i.e., motions to dismiss). This lack of motion practice may appear to present difficulties in the ability of a party to prepare for aspects of a case. However, the flexibility of the arbitration process permits the arbitrators to proceed with a case to the extent possible and then have short

adjournments during which time the parties can prepare for any aspects of the case which may require additional time.

Since 1994, there has indeed been a growing trend to permit motions to dismiss and motions for a summary judgment in arbitration. But such motions are still rarely, if ever, granted. While arbitrators today generally agree that they have the authority to decide motions to dismiss or motions for a summary judgment, most of them usually realize that arbitration is a forum for dispute resolution which differs from court and is designed to give litigants a full and fair opportunity to present their case. Therefore, most motions to dismiss are denied, without prejudice to the movant to renew the motion after the claimant has presented his or her case at an arbitration hearing.

Even though the odds are stacked against your opponent on a motion to dismiss, he or she will still file it in order to tell the story from the defense perspective, to attempt to reduce the real issues in controversy and put the claimant on the defensive. Essentially, your adversary will use the motion as an opportunity to give a summation to the panel, either prior to the commencement of the hearing or even during the hearing itself.

Discovery – Crucial Limitations

When you, the experienced trial lawyer, first become involved in a new litigation, your first instinct is to prepare and serve discovery. The prudent trial lawyer will prepare document requests, interrogatories, notices of deposition, and, if warranted, requests for admissions. All of the aforementioned discovery tools are permitted by the federal and state rules of civil procedure. By conducting extensive and oftentimes exhaustive discovery, the trial lawyer can fully investigate the bases for the claims against his or her client and, especially through the deposition process, fully understand the opponent's case. Revealing depositions can give rise to successful motions to dismiss and other procedures to limit the triable issues.

While it is also advisable for you to conduct discovery early in an arbitration case, you should be aware that the means by which you can conduct the discovery are severely limited. As a formerly full-time litigator, you may be surprised to learn that save for very limited, extreme circumstances, you will not be allowed to depose any witnesses or even a party to the arbitration. You will also not be able to serve interrogatories on your adversary. As the NASD explained in its Notice to Members 99-90, "Standard interrogatories, as utilized in state and federal courts, are generally not permitted in arbitration." Thus, additional discovery methods such as depositions and interrogatories are generally unavailable as discovery tools in arbitration. You may, however, serve traditional document requests and requests for information on the opposing party. But requests for information are not interrogatories; they are strictly limited – if enforced by the arbitrators - to identification of individuals, entities, and time periods related to the dispute.

Discovery in arbitration is therefore much more limited than in court. Again, the reason for limited discovery is the recognition by all the participants in an arbitration that it is not a substitute for litigation; it is an alternative. The parties have "voluntarily selected" arbitration as a more cost-effective means by which to resolve their dispute. Most arbitrators and experienced arbitration attorneys agree that if traditional discovery was permitted in arbitration it would not be the cost-effective, expedient forum it was designed to be. However, they also know that more cases would be settled faster.

Witness Preparation – Few Objections Will be Sustained

In both litigation and arbitration, one of the tasks of an attorney is to make witnesses out of human beings. Not a simple undertaking. Most people who feel they were wronged and are emotional about it want to tell their story to the triers-of-fact with as few interruptions as possible. Unfortunately, in doing so, their "warts and all" narratives can be (to mix metaphors) two-edged swords. In court, if they try to tell the jury what they overheard, there will be an objection based on the rules of evidence. If they want to refer the jurors to a document they did not author, but which, they claim, bears directly on the case, there could be another objection sustained. If they answer a "soft ball" question from their attorney on direct with a long narrative, they will be cut off at their first breath by the judge. As such, witnesses in litigation must be taught about the rules of evidence, in addition to getting the story straight and consistent.

Not so in most arbitration. The most stunning difference for trial lawyers to accept is that in arbitration, the rules of evidence do not apply (see below discussion). As a result, trial lawyers have to prepare their witnesses differently. A party's credibility is usually the main issue at a securities arbitration hearing. Since arbitrators, unlike jurors, can and usually will question a witness, they are very sensitive to the credibility of that individual. If an arbitrator feels that a witness is not believable on one point, it is likely that the entire testimony will be discredited. And, for some reason, many arbitrators give

brokers a license to "lie a little" at an arbitration, while they give no such privilege to customers.

It is therefore necessary that witnesses be thoroughly prepared so they are as relaxed as possible and can present their testimony in a precise narrative fashion. It is important for witnesses to understand how their testimony fits within the entire case. Creating this understanding is the practitioner's goal. For example, customers alleging unsuitability, misrepresentations, or omissions must be forewarned about distinguishing between their knowledge of an investment when the transaction occurred and the knowledge they subsequently acquired from their attorney. It is often difficult for customers to articulate this distinction when testifying.

The Hearing – Gun Fight at the OK Coral

After you have submitted your detailed Statement of Claim to the NASD or NYSE; after Respondent's motion to dismiss has been denied without prejudice to raise it at the close of your case; and, after you have taken your limited discovery, you are ready to proceed to the arbitration hearing. Like a trial, you will be given an opportunity to make an Opening Statement, to present your evidence (both testimonial and tangible), to cross-examine witnesses and to make a Summation. If you begin your Opening Statement with "Ladies and Gentlemen of the Jur…", you clearly need to refocus.

While the procedures employed in arbitration are generally the same as in a courtroom trial, there are many differences. Two such differences are the applicability of evidentiary rules and the extent of participation of fact finders.

With respect to evidentiary rules, you need to know that they simply do not apply in arbitration. While some arbitrators refer to the federal rules of evidence for guidance, such rules usually do not control and the arbitrators are free to allow any evidence, including testimony or documents based on hearsay. Arbitrators, unlike judges, will typically advise the parties that they will hear the evidence and give it the "weight it deserves." Thus, your objections based on hearsay, although informative, will most likely be denied; you should use them sparingly. The extent to which your particular arbitration panel will adhere to or disregard the rules of evidence will be evident in the first few objections made by you or your adversary. If the objections are met with a withering, "But counsel, those rules don't apply here" or, "You do know, do you not, that the rules of evidence are inappropriate in arbitration?" then you should give up your role of a salmon spawning and go with the flow. However, you may want to test the waters initially to see how strictly – if at all – the arbitrators will permit rank hearsay and otherwise objectionable evidence. While the Chair will usually make evidentiary rulings alone, he or she may not be familiar with the rules of evidence. On the other hand, the Chair could be a litigator, offended by the attempt to introduce such evidence.

Likewise, your objections at arbitration based upon your adversary's failure to properly authenticate exhibits or her failure to offer the Best Evidence as required by the Federal Rules of Civil Procedure will usually be denied. Arbitrators typically accept all documents into evidence, whether or not they have been authenticated. For example, if one party is introducing telephone records, you will not see him or her produce a representative from the telephone company to describe how the records are compiled in the ordinary course of the phone company's business, how they were maintained and how they were produced. The parties generally accept the notion that, for purposes of arbitration, phone records and other business records need not be authenticated. You must remember, however, that if you have reason to doubt the accuracy or authenticity of such business records, you are free to call whichever witnesses you feel you need in order to prove you case. But generally, in arbitration as opposed to litigation, records need not be authenticated before they are introduced into evidence.

While you will not find any NASD or NYSE arbitration rules relating to arbitrator participation in the hearing, as a general matter, you, the lawyer, with limited arbitration experience, will be very surprised to learn that arbitrators do actually listen to the evidence presented. And oftentimes, they ask questions while your examination is ongoing. If an arbitrator does ask questions, you should listen very carefully because it is a wonderful opportunity to understand the panel's concerns about the testimony or, more importantly, about your entire case. At trial, on the other hand, fact finders rarely, if ever, are permitted to ask questions and it is therefore difficult, if not impossible, to understand their thinking before the verdict is rendered. However, unlike arbitrators, they are free – after they render their verdict – to discuss their reasoning with you.

The Award – Often a Cracker Jacks Surprise

After the hearings have concluded, you will receive an Award from the arbitrators. (Dismissals seem to find their way into the mail sooner than money Awards.) Unlike a decision in court, the arbitration Award will be

general. There is a very good chance that you will have absolutely no idea of the facts and law relied on by the arbitrators in rendering their decision. As you know, decisions in court are quite the opposite. Whether your trial is a bench trial or jury trial, you can rest assured that when the decision is rendered, you will know the specific findings and law upon which the decision is based. This will give you a better opportunity to evaluate future, similar potential cases (especially important if you make your living on a contingency fee basis).

In arbitration, while any party can request that the panel issue a Reasoned Award, the panel is not obligated to do so and they usually do not. And when they do, it is not uncommon for them to write the wrong thing, opening up an otherwise correct decision to attack in court. Thus, it is not uncommon to receive a one paragraph Award advising the parties that the Claimant has been awarded a specific amount against one or more of the Respondents, without any additional explanation. That is the primary reason – along with the inapplicability of the rules of evidence – that arbitration Awards, unlike court decisions, have no precedential value.

The "Appeal Process"

When litigators are retained, they assume it is for the long haul – through trial and then through the appeals process. Not so in arbitration. In litigation, parties are free to ask the trial court to set aside a jury verdict or to reduce or add to damages after the trial. Moreover, following all post-trial motions, the parties are free to appeal any and all aspects of the case. Appellate courts review decisions and frequently overturn or reverse decisions of the trial court if reversible error has been committed. In arbitration, on the other hand, it is difficult, if not impossible, to overturn an arbitration Award (despite the increased number of such motions to vacate). Essentially, an arbitration Award will not be overturned unless the party seeking vacatur can prove that it was rendered as a result of corruption, fraud, by undue means or other arbitrator misconduct. Not that the arbitrators "got it wrong" but that they engaged in some sort of misconduct in arriving at their wrong decision. Most of the bases for vacatur of Awards are codified in Section 10(a) of the Federal Arbitration Act ("FAA") and corresponding state arbitration statutes.

Aside from the FAA, there are additional, judicially created bases for vacatur of an Award, including the often misunderstood "manifest disregard of the law". Manifest disregard of the law is the most popular ground for vacatur of an Award, although it is rarely granted. You must understand that a simple error in the law is not sufficient to vacate an arbitration Award on this ground. The manifest disregard of the law inquiry is very limited: the court must decide whether the arbitrators completely ignored governing legal principles that were brought to their attention during the hearing. The legal principle must be obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator. The arbitrator must have appreciated the existence of the clearly governing legal principle, but he or she must have decided to ignore it or pay no attention to it. Thus, it is not sufficient on a motion to vacate an arbitration Award on this ground to simply show that the panel knew the law. You must show that the arbitrators knew the law, but intentionally disregarded it in rendering its decision. Given the fact that arbitrators seldom, if ever, render Reasoned Awards, it is usually impossible to determine the factual or legal bases for the decision and therefore, it is even more difficult to convince a court that the decision was rendered in manifest disregard of the law.

The difference between your client's right to "appeal" an arbitration Award as opposed to your client's right to appeal a decision in court is perhaps the most significant difference between the two dispute resolution processes. Usually, when you receive the Award, good or bad, the show is over; not so in litigation.

Conclusion

We have jointly authored this article because one of us recently came from a litigation-only background and the other has practiced securities arbitration for many years. After the first few arbitrations that the former attended, he remarked how frustrating and bewildering the process was, compared to the predictability and consistency of litigation. Exasperation soon gave way to acceptance and, with it, an understanding of and sometimes appreciation for the differences.

Arbitration is indeed an alternate dispute resolution process. The rules that apply in court cases do not apply there. From the initial pleading stage through the hearing and motions to vacate, the two processes could not be more different. As an attorney practicing in securities arbitration for the first time, your client will be well served if you recognize these differences and tailor your case's prosecution accordingly. You can be sure that your adversary will.

View from the West –

Causal Challenges and the Chinese Wall

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.

PIABA's birthstone is the Rock of Gibraltar. Pervasive wrongdoing by Prudential Securities, combined with its obnoxious defense tactics, necessitated the cohesiveness that created this association.

The value of associating and sharing information is driven in part by the similarities among the cases we pursue. When limited partnership disputes dominated the SRO arbitration fora, the product similarities among our cases far outweighed the differences. Limited partnerships were, after all, start-up companies with no operating history and with all of the risks attendant to that. They were burdened by huge front-end costs that made long-term success highly unlikely. Those front-end costs included large commissions for the selling brokers, which motivated brokers to sell partnership interests on a large scale to anyone who would buy, including the most vulnerable members of the investing public. And, by virtue of their lack of a public market and inadequate reporting of their financial condition, the partnerships' problems were unknown to the vast majority of their investors until many years after the interests were purchased. Those and other similarities made the exchange of information among claimants' counsel even more valuable than it otherwise might have been.

Now we find ourselves in a similar situation. For perhaps the first time since the limited partnership era, we find ourselves with large numbers of very similar cases. This time, the broker-dealers are major wirehouses, and the common thread is that the securities sold were issued by companies that were investment banking clients of the selling firms.

In recent years, the investment banking activities of major wirehouses have been far more remunerative than their retail operations. Thus, currying the favor of the investment banking clients' executives became extremely important. And because those executives' compensation often was tied to their companies' stock prices, an investment banking firm's ability to drive those prices up by having its analysts tout the shares to the firm's retail customers and the rest of the public became the best tool for keeping investment banking clients happy. The Chinese wall crumbled.

The desire to make money on the investment banking side of the business does not justify turning retail customers into cannon fodder. Recommending the purchase of speculative securities, not because they are good investments, but instead because doing so achieves a separate business objective of the entity making the recommendation, is the taking of a secret profit. When a fiduciary takes a secret profit, it breaches its fiduciary duty. If securities brokers are doing something that would cost a real estate agent his or her license, something is very wrong.

In any event, there are many cases now in which retail customers lost vast amounts of money – and large percentages of their accounts – by relying on advice that left them concentrated in speculative securities issued by their brokerage firms' investment banking clients. Déjà vu.

Similarity among cases does not just give us a reason to exchange information. It also creates a legal environment in which what happens to one frequent defendant is likely to happen to another. That likelihood can impair the neutrality of certain arbitrators.

In particular, the similarities among these current cases give securities industry defense counsel – especially in-house counsel – a

financial interest in how each of these cases turns out. If Morgan Stanley faces billions of dollars of potential liability arising out of investment banking/analyst conflict of interest issues, it is impossible for its lawyers not to care how Merrill Lynch fares in a case involving the identical issues. If its lawyers care about the outcome, they are not neutral. If they are not neutral, they cannot serve as neutrals. This forms the basis for the causal challenge I have included in modified form below.

The case in which this challenge arose involved advice to invest in investment banking clients of a major wirehouse. Of the three arbitrators appointed by the New York Stock Exchange, one – the industry arbitrator – was in-house counsel at another broker-dealer that was being accused in arbitrations and the press of engaging in the identical misconduct. It was on that basis that my co-counsel George Trevor and I challenged the industry arbitrator for cause.

Many of us have observed that, while the securities industry's causal challenges routinely are granted, ours frequently are not. Nonetheless, the New York Stock Exchange granted this challenge, and we were able to eliminate the offending arbitrator without using our peremptory challenge.

When an arbitration panel includes securities industry defense counsel – particularly in-house counsel – I encourage members to consider making a causal challenge along the following lines.

\\
Staff Counsel
New York Stock Exchange, Inc.
20 Broad Street
New York, New York 10005

VIA FACSIMILE ONLY TO 212-656-2727

**RE: **

CHALLENGE FOR CAUSE

Dear \\:

This is a follow-up to our several telephone conversations over the last few days. Claimants challenge proposed arbitrator \\ , Esq., for cause on each and all of the following grounds:

1. \\ 's arbitrator profile states that she was with the litigation unit of Dean Witter Reynolds (now known as Morgan Stanley) from 1984 through 1997. From 1997 to the present, she has been the Director of Compliance at Morgan Stanley Online.

I have had cases against Morgan Stanley in the past (including while \\ was with the litigation unit) and have them currently -- some filed, some to be filed, and even a case in court. My co-counsel, George S. Trevor, also has pending matters against Morgan Stanley alleging supervision and compliance issues. In one or more of those cases, Mr. Trevor and/or I may have to call Morgan Stanley's (and that includes Morgan Stanley Online's) head(s) of compliance as adverse witnesses. That includes \\, the proposed industry arbitrator in this case. To have to decide whether to call \\ as a witness and how to examine her while, at the same time, knowing that she was an arbitrator in another of my cases would put me -- or Mr. Trevor or any other similarly situated attorney -- in an untenable position. It would put \\ -- and the arbitration forum -- in an untenable position as well.

2. This case -- against Merrill Lynch -- involves analyst conflicts of interest. In numerous pending arbitrations, Morgan Stanley is accused of the same kind of wrongdoing with respect to its own research analysts. Morgan Stanley also is the target of investigations by regulatory agencies for the same conduct -- conduct that led to Merrill Lynch agreeing to pay a $100 million settlement to the State of New York. Moreover, my co-counsel George Trevor and I represent claimants with pending claims against Morgan Stanley in this forum and others alleging the same wrongful conduct as to its analysts that is at issue in this arbitration

An attorney -- particularly one with a high level of responsibility within a company -- cannot objectively adjudicate a controversy when the practices she is called upon to condemn are the very practices in which her own employer engaged (and which she may well have approved or to which she may have failed to object). As a high-level employee and probable shareholder of Morgan Stanley, she has a substantial personal and financial interest in preventing claimants who prove that kind of misconduct from being compensated for the harm they have suffered. Indeed, it would be shocking if the Exchange were to allow an arbitrator to decide an issue that could cost her employer hundreds of millions of dollars in the next several years.

3. This is a corollary to item 2, above. Anyone desiring evidence that Morgan Stanley knows it is guilty of the same kind of wrongdoing that New York Attorney General Elliot Spitzer discovered at Merrill Lynch should consider this: Morgan Stanley and a few other large wirehouses led an effort to add a

provision to Senator Sarbanes' accountancy reform bill that would have prohibited state attorneys general from investigating securities industry wrongdoing, including the analyst conflict issue. If Morgan Stanley and the others felt their conduct to be defensible, they would not need to try to get a law passed to disable the regulators.

4. Morgan Stanley takes the position that it has valid causal challenges against potential arbitrators who ever have had a case against Morgan Stanley. If the role of lawyer for an opponent disqualifies an individual from serving as an arbitrator, as Morgan Stanley believes, then any attorney who works for Morgan Stanley is disqualified from any panel of mine. What's good for the goose is good for the gander.
\\ must be removed from the panel for this reason as well.

Each matter discussed above supports claimants' view that \\ has, in the words of NYSE Rule 610, a "direct or indirect financial or personal interest in the outcome of the arbitration" and an "existing or past financial, business, professional, family or social relationship[s] that [is] likely to affect impartiality or might reasonably create an appearance of partiality or bias." Arbitrator \\ must be removed from this panel.

Thank you for your attention to this important matter.

Very truly yours,

Scot D. Bernstein

SDB:msw

cc:

Expert's Corner –

Variable Annuities: A Primer for Claimants' Counsel

by John J. Duval

John J. Duval retired from Merrill Lynch in 2001 after 19 years with that firm. He currently works full time as an expert witness, mediator, and arbitrator in investment-related disputes. During his tenure with Merrill Lynch, he was an account executive, Vice-President, and Resident Manager. He also served as the Manager of the Merrill Lynch New York City District Professional Resource Center, a group of approximately 40 specialists providing expertise to over 600 retail brokers and their clients in the areas of trusts, mortgages, managed money, mutual funds, 401-K, business finance, life insurance, and annuities, in addition to ensuring compliance in these respective disciplines. Mr. Duval has a web site at www.johnduval.com and can be reached at 212-371-1132.

As an expert witness, mediator, and arbitrator, most of the cases in which I've been involved have concerned suitability or supervision in the context of the usual retail disputes between brokers and customers. But because I formerly held a unique management position with Merrill Lynch as the District Annuity Specialist in its New York City District, I also am being retained in many cases involving the sale of variable annuities. Since such disputes seem to be becoming more prevalent, it behooves a claimant's attorney to have at least a basic familiarity with certain concepts and problems inherent in this unique form of investment. While the subject can be explored with differing degrees of complexity, this article is intended as a primer on the features, benefits, and drawbacks of variable annuities.

An annuity is a contract between an insurance company and a customer who, as purchaser, is designated as the "owner." The owner pays the insurer a specified amount of principal. In return, the owner can either receive regular payments for life or another stated period of time or can instead choose to simply let the contract grow on a tax-deferred basis until withdrawn, usually after age 59 1/2. At this latter point, the owner can mitigate his or her tax bite by "annuitizing" the money -- in other words, converting the assets into a monthly stream of income which will be subject only to partial taxation, i.e. since the monthly payment consists of both interest and a return of principal, only the portion representing interest will be taxable.

There are two broad categories of annuities – fixed and variable. Fixed annuities provide a specified rate of return from the outset. Variable annuities, on the other hand, contain numerous investment choices known as sub-accounts, which are similar to mutual funds. With the exception of various money market selections made available to variable annuity owners, the value of assets allocated to the sub-accounts will fluctuate according to the performance of their underlying securities. This daily fluctuation renders the annuity "variable" in value from day to day. The sub-accounts are priced at the close of each trading day, just like mutual funds.

Variable annuities are registered with and approved by state insurance commissioners. But because these annuities are investment contracts and thus securities, the broker selling them also must be registered and licensed to sell securities in the states in which they are sold.

I should note in passing that because variable annuity sub-accounts operate like mutual funds, their use or recommendation by financial professionals is subject to the same suitability requirements as any other investment. Brokers and RIAs who ignore these requirements can leave annuity investment portfolios in shambles through the same types of incompetence, malfeasance, and unsupervised activities seen with other types of investments. Moreover, the insurers and their captive distributors typically do not supervise the representatives who ultimately sell their products, leaving supervision to dispersed broker-dealers and insurance agencies. These subjects are beyond the scope of this article, but the practitioner may well find that his or her first exposure to variable annuities will come in the form of complaints about performance of sub-accounts rather than the appropriateness of the contract.

Investment performance aside, variable annuities are a notorious vehicle for abusive sales practices. The reason many brokers are prone to commit these abuses is that the combined commissions from the sale of a typical variable annuity are

higher than commissions from almost any other product. Not only does the broker get a sales commission, but the broker-dealer also gets sales credits or "trailers" which in turn are partially passed on to the registered representative on a quarterly basis. These additional payments consist of a percentage of the asset base, usually .25% or higher. But since there is no front-load to variable annuities – in other words, since 100% of the principal goes into the contract -- one might wonder where the insurer gets the money from which to pay these higher commissions. The answer is that the insurance carrier "fronts" the commission to the broker-dealer and recoups this money through the death benefit charge, known as the "mortality and expense risk" or "M&E."

In order to ensure that the M&E will be kept in place long enough to compensate the insurer for the fronted commission expense, the insurer includes a contract feature called a Contingent Deferred Sales Charge or "CDSC." (It also is known as an Early Surrender Charge). If, for example, the M&E is 1.25%, it will take the carrier six or seven years to recover the commission and turn a profit. Thus, most variable annuities carry a long surrender period. The owner must pay a penalty for premature withdrawals or for surrendering the contract during this period. The penalty decreases each year until it disappears completely in some pre-specified year of ownership. Recently, variable annuities without surrender charges have begun to emerge, but most contracts still contain some form of penalty to impede immediate and unfettered liquidity.

The M&E charge isn't the only reason variable annuities are expensive. They also are loaded with other costs as well, including annual administrative fees and sub-account management fees. The combination of all standard fees associated with a variable annuity usually will cost the owner in the neighborhood of 2.5% annually. With the election of certain optional features, that cost can go even higher. In comparison, the fees for mutual funds are typically 1.5% a year or less. It obviously is a disadvantage for any investor to start out in the hole by the amount of these fees.

Unfortunately, a lot of customers aren't told about the surrender period and the high charges. Financial professionals, when called to task for failure in this regard, often will argue that the information was disclosed in a prospectus, but all too often clients rely on the broker and don't read or fully understand prospectuses.

Another significant abuse can occur when the customer is told that the contract is "guaranteed," meaning he or she supposedly will receive at a minimum the amount of purchase payments less sums withdrawn. The problem is that brokers and advisors don't always explain that the owner (or third-party annuitant) must die before that money is payable. A person who buys the annuity solely or primarily as a means of funding retirement rather than as a substitute for life insurance would obviously be unwilling to incur substantial additional expense for a death benefit. Moreover, the guarantee is illusory for most customers since the industry only experiences about a 2% mortality rate among holders of variable annuities. Consequently, the M&E expense is a tremendous moneymaker for insurance companies.

Another frequent abuse in the variable annuity arena is the practice of soliciting exchanges of annuity contracts primarily for the purpose of generating commissions. This is equivalent to the practice of "twisting" in the sale of life insurance policies. With respect to customers whose surrender period in the original contract has partially or completely expired, this practice can be totally inappropriate and a serious sales abuse since it can subject that customer to a new long-term holding period encumbered by a new CDSC.

With all of these negative qualities and the incentives presented for sales abuses, one might wonder if variable annuities have anything going for them. In fact, they do have several attractive features. But, unfortunately, these features sometimes are accompanied by other problems or play a role in additional potential abuses.

The key benefit of variable annuities, without doubt, is tax deferral. Growth in both the fixed and variable annuity sub-accounts is not subject to income tax until it is withdrawn. (Of course, if the value of the contract has depreciated, withdrawals will be from original capital and are not subject to tax for that reason.)

While tax deferral is a seductive benefit, there also are tax drawbacks to variable annuities. Withdrawals from growth in variable annuities do not enjoy the potential capital gains treatment applied to profits earned from mutual funds, bonds, or stocks. Rather, withdrawals from variable annuities are taxed as ordinary income. Moreover, the <u>entire</u> value of the annuity will be included in the estate tax calculation. This combination of income tax and estate tax constitutes double taxation without the luxury of the stepped-up cost basis that occurs with most other investments. For this reason, variable annuities are almost always unsuitable for high net worth individuals. In fact, during my tenure as an annuities specialist in the wealthy New York City District, I discouraged many annuity sales for

this very reason.

A second attractive feature of variable annuities is the opportunity they present for guaranteed income. An owner obtains this income stream by "annuitizing" the contract. When the contract is annuitized, the principal is transferred, usually irrevocably, to the insurance carrier in exchange for income for the life of either the owner or a non-owner annuitant. An annuitant is the person on whose life expectancy the annuity payments will be calculated. The annuitant and the owner usually are one and the same, but they need not be. Most annuity contracts can be annuitized at any time. Insurance companies generally offer several income selections in addition to a life-only option. For example, the customer might choose life with 20 years certain: if death occurs during the first 20 years, the income is guaranteed to the beneficiary for the balance of the 20 years. In any event, once the customer has selected an income option, payments begin based on prevailing interest rates and the age of the annuitant. Again, this decision is irrevocable.
Having a guaranteed income scheme is great for some people, but annuitizing the contract has a serious drawback in that it renders the investment entirely illiquid. Since the balance in the account must be irrevocably transferred to the carrier, there would be no recourse to the annuitized principal in the event the client should need capital.

Along with tax deferral and the opportunity for an income stream, the third key selling point to a variable annuity is the death benefit. A guaranteed death benefit pays to the beneficiary the greater of the principal deposits, less withdrawals, or the value on the date of death (i.e, the 'stepped-up' value). But again, death benefits are rarely paid and the feature is very expensive. Even after the death benefit levels off at age 80 or less, as is the case with most contracts, the M&E cost continues to rise over time as the value of the investment increases. And, of course, the death benefit is no benefit at all absent a death. This seemingly obvious fact sometimes is purposely obscured by rogue financial professionals who refer to the "guaranteed value" of the contract, confusing the purchaser into believing that the value of his or her principal payments is guaranteed during the purchaser's <u>life</u>. This is a particularly egregious sales abuse.

In sum, the three primary selling points for investing non-qualified funds in an annuity are tax deferral, income stream, and death benefit. And, as now should be clear, each of these features carries baggage.

What about variable annuities in IRA's or ERISA accounts? About one-third of total sales go into ERISA accounts, excluding TIAA-CREF. Here the need for justification and close supervision is even greater. Why use tax-deferred funds in a tax-deferred vehicle? In my mind there are only two plausible rationales, and neither is particularly strong in itself.

One is the death benefit. I've discussed that feature above, but there is an additional problem that can mitigate the value of this benefit for many retirees. When income is withdrawn from the contract, the death benefit is reduced by the amount of the withdrawal. Since people who attain the age of 70 1/2 are required by the IRS to take mandatory withdrawals, it is conceivable that the death benefit could be substantially reduced in a relatively short period of time. Yet the <u>cost</u> of the benefit remains predicated upon the initial investment. This also would apply to people under age 59 1/2 who elect under IRS 72-T to withdraw funds without the 10% excise tax.

The second rationale for investing qualified funds in a variable annuity is the ability to reallocate or exchange among sub-accounts involving multiple fund families. For example, within the annuity one can quickly and easily transfer money out of a sub-account managed by Putnam Funds and into a sub-account managed by American Funds. Outside of an annuity, such a transfer between fund families would be a more complicated and time-consuming procedure and would probably cause the customer to incur new charges. While this multi-family exchange feature inside annuities is an advantage, it hardly seems to be sufficient grounds in itself for purchasing a variable annuity to invest qualified funds.

Consequently, there appears to be little justification for placing qualified funds in a variable annuity or vice-versa. Reasons can be mustered, but when one eliminates the primary benefit – tax deferral – the higher costs and disadvantages of a variable annuity render it a suspicious choice for qualified accounts.

Having discussed many of the standard features of variable annuities, I wish to briefly mention some of the new wrinkles beginning to appear in these contracts.

One of these is a bonus credit feature. The insurance company promises to add a bonus to the customer's purchase payments in some pre-stated percentage. For example, if the contract calls for a 3% bonus, and the customer deposits $50,000.00, the insurer will add a bonus of $1,500.00 to the account.

But bonus credits come at a cost, usually in the form of higher surrender charges, longer surrender periods, increased M&E expenses, or other fees. The customer may

eventually pay more in the way of penalties and fees than he or she has received as a credit. Moreover, unscrupulous or even careless brokers often use promises of bonus credits to entice annuity owners to engage in tax-free Section 1035 exchanges from one carrier's product to another. The broker will get a commission, but the customer frequently will be hit with a CDSC from the original carrier, and the new contract may start a new surrender period running. I say "may" because contracts without surrender charges do exist. They can be freely surrendered at any time without penalty, although they still have higher fees than alternatives like mutual funds.

The most eyebrow-raising feature to appear lately is the "living" performance guarantee or "guaranteed minimum income benefit." Different carriers have different names for it, but the feature generally is described as providing a 6% per year minimum performance guarantee, regardless of actual performance. Customers are told they will receive that 6%, even if the account loses money, but can receive the actual value if that proves to be higher than the 6% guarantee. Talk about seductive – this guarantee seems like a no-lose proposition. Unfortunately, not every broker makes clear that the feature requires the contract to be kept in force for a long time, usually 10 years, before it can be utilized. Furthermore, the client must annuitize the contract in order to get the guarantee. In other words, the customer must irrevocably transfer the principal to the carrier in exchange for payments (factored at a very low interest rate) during a selected optional period such as life or 10 years certain. Of course, if the client dies before the value of the funds has been paid out, the insurance carrier wins the mathematics game. And this feature adds an extra cost above the regular M&E fees, putting the total contract fees at around 3%, a staggering expense.

In conclusion, variable annuities are not completely devoid of beneficial features and are not unsuitable for everyone. Yet sales abuses abound, the features of variable annuities often are misrepresented or not properly explained, and there usually are less expensive alternative choices available for most investors.

If you are called upon to review a client matter involving possible misconduct in the sale of variable annuities, the following checklist might be helpful in determining whether the seller has engaged in sales abuses:

1. Age of purchasers. Above 70 is highly questionable.

2. Need for income. If the client's original objective was for immediate income then the purchase of a variable annuity is definitely unsuitable.

3. Use of qualified funds. It is extremely difficult to justify the higher costs of variable annuities versus mutual funds when investment assets are already tax deferred, especially if income is needed soon via IRS 72-T.

4. High net worth purchasers. Variable annuities generally are not suitable.

5. Bonus contracts as a rationale for 1035 exchanges. The exchange is improper if it could result in surrender penalties, even if the bonus is greater than the penalty.

6. Performance "living" guarantees. These are very expensive and the customer's access to the principal is denied if this option actually is exercised.

Commodities Corner–

Defeating a One-Year Statute of Limitations Clause

By Dan Harty

Dan Harty is not yet admitted to the Illinois Bar and an Associate of Blau & Bonavich, focusing on futures and securities litigation. Mr. Harty was employed by the Chicago Board of Trade's Market Surveillance Department for over seven years. He spent the summer of 2001 at the CFTC's Office of General Counsel reviewing cases in the Reparations Program and assisting its Litigation Team. *Mr. Harty would like to acknowledge the assistance and guidance of Mr. Leslie A. Blau in writing this article.*

In the futures industry, futures commission merchants often limit customers' ability to bring actions by contractually agreeing to one-year limitations periods in their customer account opening documents.[1] These limitation periods regularly apply to any action arising from the opening of an account. Absent a contractual limitation either the National Futures Association's Code of Arbitration (Code) or the Commodity Exchange Act (CEA), each containing two-year limitations periods, would apply.[2]

The National Futures Association (NFA) and the Commodity Futures Trading Commission (CFTC or Commission) treat the contractual limitations differently, however. A customer whose cause of action exceeds the one year contractual limit may still litigate at the CFTC. Unlike NFA litigation in this area,[3] the CFTC's position is clear, a customer has the two-year statutory period to bring her case, regardless of other contrary agreements -- a position that the NFA has never taken.

CFTC's Interpretation of Reduced Limitations Periods

The CFTC will enforce the CEA's two-year limitations period despite customer agreements for a lesser period. In *McGough v. Bradford*, the respondents raised a one-year limitations agreement as a bar to recovery.[4] The full Commission found that such an agreement was "incompatible with both Congress' intent in enacting Section 14(a)(1) and the Commission's intent in enacting Rule 12.13(a)."[5] In this respect, the CFTC views the statutory limitations period as fundamental to the success of its reparations program.[6] Thus, the CFTC treats agreements waiving a customer's right to bring a reparations action in a similar manner to those that waive a customer's right to bring a reparations case at all.

The CFTC concluded that the real issue is whether the parties should be able to "rewrite basic statutory

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[1] A recent review of the implications of contractually agreed to statutes of limitations in securities arbitrations, and a potential source of arguments in futures arbitrations, can be found at: Scott Bernstein, *Brief Spotlight: The Inapplicability of Statutes of Limitations on Actions to Private Contractual Arbitration Proceedings*, PIABA B.J., Summer 2002, at 79.

[2] *See* 17 C.F.R. 12.13(B)(4)(ii) (2002); NFA Code of Arbitration [*hereinafter* NFA Code] §5 ¶ 6035 (2002); *see e.g.*, *Edwards v. Balfour Maclaine Futures, Inc.*, [1992-1994 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 26,108 at 41,664 (CFTC Jun. 16, 1994) (applying the CEA's two-year limitations period in dismissing a customer complaint); *WFC Commodities Corp. v. Alston*, [Transfer Binder 1999-2000] Comm. Fut. L. Rep. (CCH) ¶ 28,171 (N.D. Ill. Mar. 8, 2000) (ordering NFA arbitration proceedings to be permanently enjoined because a contractually agreed to one-year limitations period was valid, enforceable, and the proceedings were untimely).

[3] The dispute over an arbitration panel's decision regarding a statute of limitations defense often extends beyond its final decision because the award is confirmed or parties appeal. Thus, these issues are often re-litigated in the federal and state courts. *See e.g.*, *Scott v. Prudential Securities, Inc.*, 141 F.3d 1007 (11th Cir. 1998); *WFC Commodities*; *Engle v. Refco, Inc.*, No. 01-604187 (N.Y. Sup. Ct. Aug. 21, 2001).

[4] *See McGough v. Bradford,* [1999-2000 Transfer Binder] Comm. Fut. L. Rep. (CCH) ¶ 28,265 at 46,271 (CFTC 2000). *See also* Commission Rule 166.5(c).

[5] *Id*. At 50,602.

elements of the Commission's reparations program . . . ."[7] The programs' statutory elements include the "just, speedy and *inexpensive* determination of the issues presented with full protection for the rights of *all* parties."[8] As long as the goal of the reparations program emphasizes the program's availability as much as the fairness of the proceedings, the CFTC will view these one-year clauses with apprehension.

NFA's Interpretation of Reduced Limitations Periods

NFA's position on contractual limitations periods is less clear. The Code, like the CEA, sets a limitations period of two-years.[9] However, limited access to NFA panel decisions and a larger pool of panel members compared to CFTC decision makers, e.g. Judicial Officers, Administrative Law Judges ("ALJs"), and Commissioners, hinders an attorney's ability to interpret NFA's position. Those difficulties aside, it appears that NFA is more willing than the CFTC to enforce agreements that reduce this period.

Section 3 of the Code enforces pre-dispute arbitration agreements to the extent they comply with Commission Rule 166.5(c).[10] As the Commission noted in *McGough*, however, the CFTC must administer the reparations program in light of congressional dictates and protect it from underutilization.[11] Conversely, NFA requires its members and their employees to settle any disputes against other members,[12] their employees,[13] or customers in NFA arbitration.[14]

NFA Panels are more likely to enforce customer agreements that shorten limitations periods than the CFTC's ALJs. One reason may be the natural consequence of NFA's larger pool of decision makers with invariably diverse opinions on the validity of shorter limitations periods. Another possible reason is the absence of incentives similar to the CFTC's. Remember, NFA arbitrations are mandatory;[15] thus, NFA need not protect its arbitration program from the potential underutilization facing the CFTC's Reparations Program. Finally, NFA arbitrators may recognize that courts are willing to enforce statute of limitations agreements when reviewing arbitrators' decisions.[16]

PRACTICAL IMPLICATIONS FOR ATTORNEYS REPRESENTING CUSTOMERS

An attorney representing a customer must first review the account opening documents to determine pertinent issues. Not all account opening agreements will contain statute of

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[6] *See* NFA Member Arbitration Rules ¶ 6517.1 (2002).

[7] *See* NFA Member Arbitration Rules ¶ 6517.2.

[8] *See* NFA Code ¶ 6017.1.

[9] NFA requires disputes involving commodity futures contracts to be "arbitrated under this Code" if the customer "seeks arbitration" against NFA members or their employees and:

> (A) the customer is not an FCM, floor broker, Member or Associate; (B) the dispute does not solely involve cash market transactions that are not part of or directly connected with a commodity futures transaction; and (C) if brought against a Member or employee thereof, the Member is an FCM, and IB, a CPO, a CTA or an LTM.

NFA Code ¶ 6017.1(1)(i).

[10] *See e.g., WFC Commodities.*

[11] Account opening agreements may contain other clauses that limit the customer's rights in other ways. For instance, the agreement may contain a forum selection clause that requires disputes to be heard in the FCM's home city or state. The NFA and the CFTC treat those clauses differently as well.

[12] No. 02-R030 (CFTC 2002).

[13] *See Halbur*, No. 02-R030, Respondents' Answer and Affirmative Defenses, Affirmative Defense No. 5, (CFTC Jun. 11, 2002); Respondents' Pre-Hearing Memorandum, ¶ 5 (CFTC Jul. 15, 2002).

limitation clauses.[17] Part of an attorney's research in this area should include contacting the CFTC and NFA for information regarding each forum.

Those attorneys who contact the CFTC will find that its incentive for providing access and an alternate forum extends beyond mere lip service. For instance, in *Halbur v. Gleason,* complainant brought a reparations action after a contractually agreed one-year limitations period expired.[18] Respondents' claimed that complainant was time-barred from bringing his complaint because he contractually agreed to a one-year limitations period.[19] Although, the ALJ has yet to rule on these defenses, the likelihood of success is marginal for the above reasons.

Moreover, part of the defense strategy included a letter from respondents' counsel to complainant's counsel suggesting that respondents' will bring federal court actions if the complaint is not voluntarily dismissed. The ALJ interpreted this letter as a threat.[20] The ALJ ordered respondents' attorney to show cause why the claims in his letter to pursue a statute of limitations defense in an alternate forum should not result in debarment from the reparations proceedings.

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[14] *See Halbur*, No. 02-R030, Order to Show Cause (CFTC Jul. 26, 2002).

[15] *See id.*; Notice and Order (CFTC Aug. 10, 2002). The ALJ later debarred counsel, finding that the threat combined with counsel's unwillingness to retract the threat constituted contemptuous conduct. *See Halbur*, No. 02-R030, Debarment Order (CFTC Sep. 12, 2002).

[16] The Commission "did not have the occasion to participate as *amicus curiae* in any non-bankruptcy case during [Fiscal Year] 2001." 2001 CFTC Ann. Rep. 84, http://www.cftc.gov/files/anr/anr2001.pdf.

[17] The CFTC's opinion on a matter or issue that pertains to the statute it administers is entitled to deference as long as the statute is silent or ambiguous on the matter and the agency's opinion is based on a permissible construction of the statute. *See Chevron, USA, Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984).

[18] No. 02-R030 (CFTC 2002).

[19] *See Halbur*, No. 02-R030, Respondents' Answer and Affirmative Defenses, Affirmative Defense No. 5, (CFTC Jun. 11, 2002); Respondents' Pre-Hearing Memorandum, ¶ 5 (CFTC Jul. 15, 2002).

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[23] The CFTC's opinion on a matter or issue that pertains to the statute it administers is entitled to deference as long as the statute is silent or ambiguous on the matter and the agency's opinion is based on a permissible construction of the statute. *See Chevron, USA, Inc. v. Natural Resources Defense Council, Inc.*, 467 U.S. 837, 843 (1984).

Brief Spotlight–

Resisting a Motion to Exclude Expert Testimony in Arbitration

by Jay Salamon

Jay Salamon, a member of the Board of Editors of the PIABA Bar Journal, is an attorney in the Cleveland, Ohio law firm of Hermann, Cahn & Schneider. After spending many years representing major broker-dealers, he and his partner, Anthony J. Hartman, decided in 2000 to devote their practice exclusively to the representation of investors. Mr. Salamon can be reached at 216.781.5515. His e-mail address is jsalamon@hcsattys.com.

Anecdotal evidence from posts on the PIABA listserv indicates that Respondents have begun to inject *Daubert/Kumho Tire* challenges into securities arbitrations with increasing frequency. In fact, in Cleveland, Ohio, where I practice, Merrill Lynch has begun making these arguments as a matter of course with respect to expert testimony on the well-managed account theory. Presented below is an argument that partially addresses this type of challenge. But first, a short refresher might be in order.

In *Daubert v. Merrell Dow Pharmaceuticals, Inc.*, 509 U.S. 579 (1993), the U.S. Supreme Court established that when a trial court judge is confronted with expert scientific evidence, the judge must, pursuant to Evid. R. 104(a), determine whether the expert witness is testifying to "scientific knowledge" (thus meeting a reliability standard) and whether this testimony will assist the trier of fact to understand or determine a fact in issue (thus meeting the relevance requirement). In other words, the *Daubert* majority abandoned the "general acceptance" test for determining admissibility of expert testimony and replaced it with a reliability/validity standard. Under this approach, trial judges are instructed to assess the "reasoning and methodology" of an expert's testimony by focusing on a non-exhaustive list of factors. Judges are to undertake their roles as "gatekeepers" by not only considering whether the technique or theory is generally accepted by the relevant scientific community, but also by considering its error rate, whether it is testable or has been tested, and whether it has been scrutinized by peer review.

In *Kumho Tire Co., Ltd v. Carmichael*, 526 US 137 (1999), the Court held that "*Daubert's* 'gatekeeping' obligation applies not only to 'scientific testimony,' but to all expert testimony." The Court also declared that "Rule 702 does not distinguish between 'scientific' knowledge and 'technical' or 'other specialized' knowledge." According to the Court, the word "knowledge" "establishes a standard of evidentiary reliability." The Court noted that with respect to non-scientific experts, the test for reliability is flexible. The trial judge, while free to consider *Daubert's* list of factors if they apply, nonetheless has broad latitude to consider the facts and circumstances of the particular case in determining reliability.

In his excellent and exhaustive article, *Challenging Experts in Securities Arbitration*, PIABA member Tom Mason helpfully "recharacterized" the *Daubert* criteria to make them more directly applicable to arbitration:

1. Professional Standards - Was the expert as careful in preparing for testimony in this case as s/he or another expert would be in real life, outside the courtroom?

2. Verifiability/falsifiability - Can the opinion be objectively corroborated, or is it just "one person's opinion?" Can the conclusions be tested against other explanations? Did this expert test the conclusions against other possible explanations?

3. Methodology - Methodology is fundamental to assessing the reliability of the proposed testimony. How the expert reaches a conclusion is, for

> admissibility purposes, much more important than the conclusion itself. Are this expert's techniques or methodologies (even if he is, e.g., a perfume tester) of a kind that others in his field would recognize as acceptable?

C. Thomas Mason III*, Challenging Experts in Securities Arbitration*, Securities Arbitration 2000 (Practicing Law Institute, 2000), pp. 762-763.

My partner and I recently had an arbitration in which a *Daubert/Kumho Tire* attack was presented by way of a motion in limine. In successfully opposing the motion, I included an argument that may be of benefit to other PIABA members faced with similar challenges. After pointing out the obvious fact that the Federal Rules of Evidence are not binding on NASD arbitration panels, I analogized arbitrations to bench trials and argued that motions in limine, including motions based upon *Daubert/Kumho Tire* challenges to expert testimony, are often held to be unnecessary where the trier of fact and law are one and the same. The following is a small excerpt from that brief:

* * *

A. Evidence Rule 702 Does Not Apply to NASD Arbitrations.

Respondents base their motion in limine on *Daubert v. Merrell Dow Pharmaceuticals, Inc*, 509 U.S. 579 (1993) and *Kumho Tire Co. Ltd v. Carmichael*, 526 U.S. 137 (1999), cases interpreting the requirements of Rule 702 of the Federal Rules of Evidence. NASD Arbitration Rule 10323 expressly states that the arbitrator shall not be bound by rules governing the admissibility of evidence. Thus, Evid. R. 702, as interpreted by *Daubert* and *Kumho Tire*, is not applicable to the determination of whether an expert can testify in this proceeding.

Obviously, the arbitrators are free to seek guidance from whatever principles might seem just and equitable relative to the admission of evidence. Some of these principles may even be embodied in rules of evidence. But the Panel clearly is not *bound* by any rule of evidence, including Evid. R. 702.

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B. Motions in Limine Usually Are Denied in Proceedings Where the Trier of Fact and Trier of Law Are One and the Same.

A Motion in Limine is a request to a judge to keep prejudicial evidence from the hearing of lay jurors at trial. This arbitration proceeding is not a trial. No jurors will be present. The arbitrators will decide both the law and the facts. Consequently, this arbitration is the functional equivalent of a bench trial.

Motions in limine rarely are granted in bench trials. Indeed, in cases where no jury will be present, most courts view such motions with disdain. In some states, courts even go so far as to treat the granting of a motion in limine in a bench trial as error.

For example, in *Beta Alpha Shelter of Delta Tau Delta Fraternity, Inc.*, 446 N.E. 2d 626 (Ind. App. 1983), an Indiana appellate court discussing a trial court's granting of a motion in limine stated:

> We initially note that motions in limine are designed to keep prejudicial matter from the jury. *Indiana and Michigan Electric Co. v. Pounds* (1981) Ind. App. 426 N.E. 2d 45, 47, trans. denied; *Baldwin v. Inter City Contractors Service, Inc.* (1973) 156 Ind. App. 497, 501, 297 N.E. 2d 831, 834, trans. denied (1974). The instant case was tried to the court. No jury was present. As the court in *Baldwin* noted, the granting of a motion in limine in a bench trial is error.

Similarly, in *Shark v. Thompson*, 373 N.W.2d 859 (N.D. 1985), the Supreme Court of North Dakota has stated:

> A motion in limine is a procedural tool used to ensure that potentially prejudicial evidentiary matters are not discussed in the presence of the jury. It can serve no useful purpose in a non-jury case.

In a Texas case, *Cramer v. Sabine Transportation Company*, 141 F. Supp. 2d 727 (SD Tex. 2001), a federal judge was less polite, actually referring to the making of such a motion in limine as "asinine":

> First, this is a bench trial, making any motion in limine asinine on its face. Motions in limine are intended to prevent allegedly prejudicial evidence from being so much as whispered before a jury prior to obtaining a court's permission to broach the topic. In a bench trial, such procedures are unnecessary, as the court can and does readily exclude from its consideration inappropriate evidence of whatever ilk.

Other such statements abound in case law.

From an Illinois appellate court in *State of Illinois v. Daniels*, 164 Ill. App. 3d 1055, 518 N.E. 2d 669 (Ill. App. 1987):

> Further, as the state points out, a motion in *limine* would have been unnecessary in any case inasmuch as this was a bench trial, and a trial judge is presumed to ignore any improper evidence.

From a Texas court of appeals in *Unitarian Universalist Service v. Lebrecht*, 670 S.W.2d 402 (Tex. App. 1984):

> A motion in limine is not usual in a bench trial. The purpose of a motion in limine is to avoid the injection into the trial of matters which are irrelevant, inadmissible, and prejudicial; that is, to keep these matters from the jury. *Wilkins v. Royal Indemnity Company*, 592 S.W.2d 64 (Tex.Civ.App. -- Tyler 1979, no writ). *See* 4 Dorsaneo, Texas Litigation Guide, § 114.01, et seq. (1983).

And from a Texas District Court in *Eterna Benefits L.L.C. v. Hartford Life and Accident Insurance Co.*, No. 3:96-CV-3065-D, 1999 U.S. Dist. LEXIS 4726 (N.D. Tex. 4/5/99):

> A motion in limine and voir dire questions are unnecessary in a bench trial.

The reason many courts reject the concept of filing motions in limine in a bench trial was aptly explained by the U.S. Court of Appeals for the Eighth Circuit in *Donnelly Garment Co. v. National Labor Relations Board*, 123 F.2d 215 (8th Circuit, 1941):

> One who is capable of ruling accurately upon the admissibility of evidence is equally capable of sifting it accurately after it has been received, and, since he will base his findings upon the evidence which he regards as competent, material and convincing, he cannot be injured by the presence in the record of testimony which he does not consider competent or material.

Respondents in this proceeding, invoking *Daubert* and *Kumho Tire*, have asked the panel to prohibit Claimant's damage expert from testifying, asserting that his method of calculating damages constitutes "junk science." But the common sense rationale that generally results in denial of motions in limine in bench trials clearly applies when parties seek to exclude experts based on *Daubert /Kumho Tire* challenges. Examples are plentiful.

For instance, in *Barna v. United States of America*, 183 FRD 235 (ND Ill. 1998), the court refused to grant motions in limine to exclude an expert in a bench trial, explaining:

> As noted earlier, motions in limine to strike party experts are of less importance in bench trials. I will be better able to assess [the expert's] expertise at trial. The motion is therefore denied.

Similarly, in *Fierro v. Ruiz*, 856 F. Supp. 1387 (ND Cal. 1994), the court rejected a *Daubert* challenge in a bench trial, stating:

> Under *Daubert*, the court concludes that the better approach in this bench trial is to admit the testimony of all of the recognized experts that it permitted to testify and, in the words of the Supreme Court, allow "vigorous cross-examination, presentation of contrary evidence" and careful weighing of the burden of proof to test "shaky but admissible evidence." Id. at 2798. Further, the court's concerns about the usefulness of various portions of the scientific testimony more appropriately can be addressed through determination of the weight to be accorded the testimony, rather than through the threshold determination of admissibility.

In *Gibbs v. Gibbs*, 210 F. 3d 491 (5th Circuit 2000), the Fifth Circuit Court of Appeals noted,

> Most of the safeguards provided for in *Daubert*, are not as essential in a case such as this where a district court sits as a trier of fact in place of a jury.

Likewise, in *Volk v. United States of America*, 57 F. Supp. 888 (ND Cal. 1999), the court stated:

> The fact that defendant was convicted after a bench trial further highlights the need for flexibility that the court emphasized in *Kumho Tire*. Here, the "gatekeeper" and the trier of fact were one and the same. Under these circumstances, it was particularly reasonable for the judge to admit the evidence pertaining to the

> FSTs, knowing that she would be responsible for assessing the probative value of this evidence at trial. Although this court's ruling by no means turns on the fact that the trier of fact below was a judge rather than a jury, it bears noting that the *Daubert* gatekeeping obligation is less pressing in connection with a bench trial.

As a final example, in *Ekotek Site PRP Committee v. Self*, 1 F. Supp. 2d 1282 (D. Utah 1998), a federal district court denied *Daubert* motions seeking exclusion of an expert, stating:

> The court now denies both remaining motions. Although the court has reservations about Mr. Scott's methodology in this regard, the court does not deem it necessary in this instance, when acting as the trier of fact itself, to exercise its discretion as gatekeeper and exclude the testimony, especially given MA's and the court's own ability to examine the witness and flush out any weaknesses in that testimony.

The members of this Panel act as both triers of fact and triers of law. Just like judges in bench trials, the arbitrators are more than capable of listening to expert testimony and deciding whether to afford it great weight, some weight, or no weight at all. Respondents' assertion that "due process requires the Panel to exercise its authority as 'gatekeeper'" with respect to the testimony of Claimant's expert clearly is belied by the numerous cases cited above.

* * *

Should I Sue My Stockbroker? Pitfalls a Practitioner Faces When Naming the Individual Broker in an Arbitration

by Melanie S. Cherdack

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Many Claimant's lawyers have made it their practice to forego naming the individual broker as a Respondent in their statement of claim. While no wholesale policy for or against this issue should be adopted by the Claimant practitioner, there are a number of factors to take into consideration, on a case by case basis, in determining whether to name the broker as a Respondent. The considerations to take into account on this issue include the following: (1) whether the broker himself committed the primary wrongdoing; (2) the broker's importance within the firm; (3) the possibility of a conflict requiring two sets of defense counsel; (4) the broker's CRD history; (5) whether the broker is still employed by the Respondent firm or is still in the industry; (6) whether the broker was fired for cause; and (7) the collectability of the broker and firm. By careful analysis prior to filing the claim, you can determine whether naming the broker as a Respondent has perceived benefits which outweigh the inherent costs in so doing.

It goes without saying that, first and foremost, you should only name the individual broker if the broker in fact committed the primary wrongdoing. The threshold consideration is whether and in what fashion the broker has committed a violation of a statute, common law rule, or regulatory provision. In the situation where the broker has simply sold a bad product, the firm has defective back office operations, or the case is really a analyst defalcation, Claimant's counsel should name only the firm. Also, in this situation, ask your client if their account is still with the broker. Where the broker has a good relationship with the client and feels that the firm pushed their sales force to market or sell a bad product, or otherwise failed in its responsibilities to the customer, the broker may provide testimony that actually helps your client at the hearing if the broker is not named.

Similarly, the branch manager or other company officers should only be named where there is evidence that they actively participated in the wrongful conduct through some deliberate means. When the Claimant has named a broker or other party who is not the wrongdoer, this will only serve to garner sympathy for that Respondent. If the broker or other named party is still employed at the Respondent firm, naming that party where the blame is on the firm will not assist your case unless the party points the finger at their employer (which is unlikely if the firm is providing their defense). You should always pull a copy of the broker's CRD from the NASD as well as the state regulatory agency, and read the broker's employment and complaint history before filing your claim. If your broker is "clean" and has no blemishes on his or her record, naming the broker may cause a joust to the "death" as the broker may want to vigorously protect his or her reputation. If, on the other hand, the broker is named, and the firm wants to keep a favored broker's record clean, this may help to precipitate a settlement whereby the parties agree to an expungement of the entry of the claim on the broker's CRD.

A review of the CRD will also let you know if the broker is still employed at the Respondent firm and whether there has been a termination of the broker for any defalcation at the Respondent firm. Some firms as a matter of policy simply do not provide counsel to their former brokers even if their termination was voluntary. If the CRD states that the broker's termination was involuntary or that the broker was permitted to resign, this likely means that the broker

committed a latent wrong against the firm. Under this scenario, you can almost count on separate counsel being retained.

Likewise, even where the broker is still employed at the Respondent firm, certain claims, such as those demonstrating that the broker has intentionally concealed something from his employer (e.g. selling away or taking money from a client), or has acted in a criminal or quasi-criminal manner, will make it likely that the broker be represented by separate counsel. Under such facts there is almost always an inherent conflict between the broker and the firm, requiring separate counsel for each. Sometimes, if more than one broker is named, you can actually have three or more defense counsel appear in an action.

The multi-defense attorney scenario is nightmarish to Claimants' counsel. Such a happenstance truncates the proceedings in that each time there is a motion or objection by the Respondents, there will be two sets of lawyers briefing and arguing the issues. Additionally, because at least one of the lawyers will be outside counsel (instead of an in-house lawyer), you can be certain that the case will receive microscopic attention and thus require more work and motion practice on your part than if handled in-house alone. Moreover, the opportunity to "double or triple team" is a pitfall which creates havoc at prehearing conferences as Respondents get several bites at the apple, and can reargue each other's "brilliant" positions. Significantly, the extra lawyers create obstacles to scheduling as the Panel must accommodate a variety of schedules and stated "hearing conflict" dates from busy defense counsel who claim they have no availability until the next decade or because of the excuse dejure of post-September 11th issues.

Be aware that where you have named the broker for acts constituting a fraud on the firm such as theft from a customer's account, forgery, or outside business dealings, the Respondent firm may argue at the hearing that the fraud was perpetrated on it as well, placing the blame on the individual broker. Naming the broker in this circumstance exposes you to the risk of ending up with an award solely against the broker, or an award allocating a large percentage of your client's losses to the broker and only a small fraction against the Respondent firm. Unless the award is joint and several, the Claimant may never collect on an award in this situation. Therefore, if you are certain that your respondeat superior and failure to supervise claims are airtight, consider not naming the broker if you fear the fault allocation issue looming. If, however, the financial viability of the brokerage firm is in doubt, it may be helpful to name the broker if you believe he or she is collectable.

Not naming the individual broker may also make the broker more likely to cooperate with you or be a more friendly witness. The broker may be less hostile if you are not after his or her funds personally. Remember, though, that the firm can still seek contribution from the broker for any sums it is required to pay your client, so there is still and incentive for the broker to assist in the firm's defense.

Notwithstanding whether the broker is or is not a hostile witness, not naming the broker will effectively bar the broker from being allowed in the hearing room other than his or her appearance as a witness. The unnamed broker will not be able to sit through any of the proceedings to hear the arguments you make in your opening statement or what your other witnesses say. If he or she is called to testify first, the Respondent firm will be stuck with whatever tale the broker tells. Strategically, this will impede the defense of the case by the firm.

Finally, if the broker is out of the business and is no longer registered, the NASD or NYSE may not be able to serve the broker with the claim. This may delay the appointment of arbitrators in you case greatly while service attempts are made. Additionally, if you do not name the unregistered broker, there may be jurisdictional problems if the firm tries to subpoena the broker to appear at trial. This can work to your advantage. Where the firm is the sole Respondent, and cannot compel the broker's attendance at the hearing, there will be no witness to directly refute your client's version of history. This "empty chair" at a hearing where the broker is absent will taint the defense of the case as the arbitrators will have to rely on the picture you have painted through your witnesses. Indeed, if the firm believes that there will not be enough evidence to put on a defense at a hearing, this fact alone may cause your case to settle.

Conclusion

While there is no bright line test for naming the broker in your statement of claim, a Claimant's attorney should weigh the pros and cons before carefully before going down a minefield laden path.

Clearing Firm Liability: Promoting The Duty To Disclose

by Michael Wilson

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Recently, well publicized arbitration cases holding clearing firms liable have generally focused on state securities law and breach of contract theories.[1] Unfortunately, these theories can be complex and confusing because they often hinge on a plethora of factors and conditions for liability to attach. For this reason, non-attorney arbitrators may look for more simplistically logical and intuitive theories on which to rely. Furthermore, state securities and contract theories may be deficient to attach liability under certain sets of facts. More importantly, the trend in the law is to impose a duty of disclosure upon clearing firms aware of their introducing firm's shenanigans.

Restatement of Torts 2d Section 551 should be argued in conjunction with other theories to promote this trend. Although the Restatement is not primary authority in any jurisdiction, the law recognizes that once the courts of a state rely upon the Restatement Section in its judicial decisions, the Restatement is elevated to primary, binding authority. At this point, California and Florida have arguably adopted a Section 551 theory in the context of clearing firm liability. Other states may have also, or have at least adopted use of Section 551 in other contexts.

I. The Policies Of Clearing Firm Liability

The law provides limited protection to clearing firms from the acts of its introducing firms. This protection is accomplished by authorizing a division of responsibility between introducing and clearing firms. NYSE Rule 382 and NASD Rule 3230 provide a list of responsibilities that can be allocated between the firms. The

policy behind this division of responsibility and ensuing limitation of liability derives from the effects the division brings about.

Allowing clearing firms to focus on back office functions without the responsibilities traditionally relegated to introducing firms promotes several desirable outcomes for the general investing public. This system promotes availability of capital, smooth reliable functioning of securities markets, and competition in markets that otherwise would be without competition.[2]

Basically, the rules do not require "policing" of the introducing firms. If clearing firms were required to "police" the thousands and perhaps millions of transactions introduced to it by its introducing firms the argument goes, the administrative burdens would be too great. High costs to "police" these transactions would make clearing transactions unprofitable and the benefits of the system would disappear because clearing firms would no longer clear for introducing firms.

The law, however, also seeks to protect the investor. The law recognizes the fact that clearing firms cannot enjoy complete immunity for their actions. Most commonly, courts and arbitration panels have imposed liability on clearing firms when it can be proven that the clearing firm knew of an introducing firm wrong(s), however, under differing legal theories.

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[1] See *Koruga v. Hanifen Imhoff, Inc., et.al.,* NASD Arbitration No. 98-04276; *McDaniel v. Bear Sterns*, NASD Arbitration No. 97-00497.

[2] Henry F. Minnerop, *The Role and Regulation of Clearing Brokers*, 48 BUS. LAW. 841, 844 (May, 1993).

But why hold a clearing firm liable when they have allocated all supervisory responsibility to the introducing broker? When fraud and other wrongs are taking place and knowing clearing firms turn a blind eye towards the introducing firm's conduct, all the while collecting fees for processing the wrongful transactions, the public benefits of providing insulation from liability to clearing firms disappears.

The policies balance the system for the overall benefit of the public, not the benefit of the clearing firms or the securities industry. Clearing firms should clearly act in certain situations. But what should they do when they become knowledgeable of wrongs perpetrated by the introducing firm? This article suggests they have a duty to disclose that information to their customers and securities regulators.

II. Section 551

Section 551 falls under the Restatement of Torts section dealing with misrepresentation and concealment. In the securities context, Section 551 has traditionally been the source of analysis in insider trading cases beginning with the Supreme Court decision in *US v. Chiarella*.

Section 551 naturally involves the concept of duty to determine when a disclosure is required and imposes a duty under five very broadly worded sets of circumstances. Section 551 provides:

> (1) One who fails to disclose to another a fact that he knows may justifiably induce the other to act or refrain from acting in a business transaction is subject to the same liability to the other as though he had represented the nonexistence of the matter that he has failed to disclose, if, but only if, he is under a duty to the other to exercise reasonable care to disclose the matter in question.
>
> (2) One party to a business transaction is under a duty to exercise reasonable care to disclose to the other before the transaction is consummated,
>
> (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them; and
>
> (b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading; and
>
> (c) subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so; and
>
> (d) the falsity of a representation not made with the expectation that it would be acted upon, if he subsequently learns that the other is about to act in reliance upon it in a transaction with him; and
>
> (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

Section 551(1) provides liability for nondisclosure when there is a duty to disclose. Section 551(2) lists when a duty would arise. Part (a) and part (e) are particularly relevant to clearing firm liability because clearing firms generally refrain from making representations to their customers. Thus, the clearing firm's prior or concurrent statements are generally a non-existent basis for liability. Clearing firms, however, do have a relationship with their customers. It is this relationship that provides the nexus for imposing a duty upon them to disclose the wrongs of the introducing firms.

III. Knowledge

The first element of proving a §551 claim is knowledge. While much can be said about what amounts to knowledge, this topic is beyond the scope of this article. Generally, however, because knowledge is essentially a conclusion as to a state of mind, the more egregious the conduct, the more knowledge can be inferred, and the more likely liability will attach.

It should be noted, however, that there is ample precedent for using a recklessness standard for the knowledge element. See *Raymond L. Dirks*, 47 S.E.C. 434, 447 (1981), *rev'd on other grounds*; *Dirks v. SEC,* 463 U.S. 646 (1983); *Lanza v. Drexel & Co.*, 479 F.2d 1277, 1306 n. 98 (2d Cir. 1973); *Sauders v. Superior Court* (1994) 27 Cal.App.4th 832, 33 Cal.Rptr.2d 438; also see cases discussing the general awareness test See *Kevin Upton*, 58 SEC Docket 1993, 2001 (1995); *Dominick & Dominick, Inc.*, 50 S.E.C.571, 577 (1991). *Schneberger v. Wheeler*, 859 F.2d 1477, 1480 (11th Cir. 1988), *cert. denied,* 490 U.S. 1091 (1989);

Investors Research Corp. v. SEC, 628 F.2d 168, 178 (D.C. Cir.), *cert. denied,* 449 U.S. 919 (1980); *Woodward v. Metro Bank*, 522 F.2d 84, 94-95 (5th Cir. 1975); *SEC v. Coffey*, 493 F.2d 1304, 1316 (6th Cir. 1974), *cert. denied,* 420 U.S. 908 (1975).
It also appears that the two main cases discussed below supporting a §551 theory use recklessness or awareness as the standard for constituting knowledge. When a clearing broker is aware its investing customer is ignorant of some important fact, it may be held liable. *Petersen v. Securities Settlement Corp*., 226 Cal.App.3d 1445, 1457 (1991); also see *Tew v. Chase Manhattan Bank, N.A.,* 728 F. Supp. 1551, 1564 (1990)

Duty Fiduciary Duty

Clearing firms can cite many cases establishing there is no fiduciary duty to their customers. See, e.g., *Petersen v. Securities Settlement Corp*., 226 Cal.App.3d 1445, 1457; *Tew v. Chase Manhattan Bank, N.A.,* 728 F. Supp. 1551, 1564 (1990); *Flickinger v. Harold C. Brown & Co.*, 947 F.2d 595, 599 (2d Cir. 1991), *In Re Adler Coleman Clearing Corp.*, 198 B.R. 70, 73 (Bankr. S.D.N.Y. 1996) Indeed, these holdings can be viewed as consistent with amended NYSE Rule 382 and 405 which eliminates supervisory responsibilities for clearing firms and allows full allocation of this role to the introducing firm. If there are no supervisory duties via the fully disclosed clearing agreement or the SRO rules, it should logically follow that the duties of a fiduciary, which are similar, are not present either.

This logic, however, does not rule out the possibility that a duty other than a fiduciary one is due. A close reading of many of the cases holding there is no fiduciary duty reveals that courts fail to distinguish that other duties exist or erroneously conclude there are no other duties. In §551, the phrase "or other similar relation of trust and confidence" in part (a) and the entirety of Part (e) give rise to other duties absent a fiduciary duty. To ensure that arbitrators are not confused with the concepts of fiduciary duty and a duty under §551, counsel should make clear from the start what duty is being argued.

The Duty to Disclose

At least two courts have determined that liability for nondisclosure exists in the context of a clearing firm and its customers. *Petersen v. Securities Settlement Corp*., 226 Cal.App.3d 1445, 1457; *Tew v. Chase Manhattan Bank, N.A.,* 728 F. Supp. 1551, 1564 (1990). *Petersen* held that a clearing firm, while not under a fiduciary duty, may have had a duty to disclose under certain circumstances and specifically referred to Section 551 part (e) as a basis for this duty. *Petersen* at 1457.

The *Petersen* court dealt primarily with an underlying unsuitability claim and recognized that if the clearing firm knew that the introducing firm had failed to advise of the suitability, there would be a basis for liability. Further, the court recognized that the "facts basic to the transaction" language of Section 551 (2)(e) was akin to the concept of materiality, which has been a fairly well defined concept in the securities context. *Id.* Material facts are defined in the 1933 Act as those matters to which there is a substantial likelihood that a reasonable investor would attach importance in deciding whether to purchase the security. SA Rule 405; Also see *Feit v. Leasco Data Processing Equipment Corp.*, 332 F.Supp. 544 (E.D.N.Y. 1971).

Petersen is important for a few reasons. First, the court recognized the viability of a Section 551 claim without those arguments being presented by counsel. Inferentially, the court must have felt it important to delineate the concept in the context of clearing firm liability. Second, the court road-mapped Section 551 (2)(e) as the basis for liability in certain sets of circumstances. Third, the court effectively adopted Section 551 as a basis for clearing firm liability in California.

Analysis of the policy implications of clearing firm liability can be found in the case of *Tew v. Chase Manhattan Bank, N.A.,* 728 F. Supp. 1551, 1564 (1990). Although *Tew* involved a clearing bank in the context of double hypothecation of government securities, these potentially distinguishing factors lose muster because the roles of clearing banks and clearing firms are virtually identical. The policies behind holding clearing banks liable under a Section 551 theory are analogous to those for holding a clearing firm liable.

In *Tew*, the court noted several reasons why a clearing bank should have a duty to disclose despite not having a fiduciary duty. The court recognized that the trend of the law is to impose liability upon "professionals" dealing in "complex commercial transactions." *Tew* at 1567. The court noted there is a strong public interest in deterring fraudulent conduct upon the public and in protecting the integrity of the government securities market. *Id.* Further, imposing liability would serve the purpose of compensating victims.

Notably, *Petersen* applied part (e) without analysis of whether the customer in the securities clearing firm context "would reasonably expect a disclosure" due to the "relationship between them, the customs of the trade or other objective circumstances." The *Tew*

court, however, recognized the fact that "...the public generally...may justifiably rely on nondisclosure in the industry as evidence of the absence of fraud." *Id.* Lastly, when a clearing bank knows of a fraud and allows it to continue without disclosing it to customers and the government, to not hold the clearing bank liable "would condone" the conduct and "would legalize sheer greed." *Id* at 1566.

Similarly, clearing firms are in the best position to stop clearing transactions for introducing brokers who are committing fraud and disclose the fraud to customers and securities regulators. Imposing liability upon clearing firms would also serve the policies of deterrence, compensation, and protecting the integrity of the securities markets. Moreover, when a clearing firm knows of an introducing broker's fraudulent activity and continues to clear transactions for that broker without disclosing that information, not holding the clearing firm liable would also "legalize greed" and "condone" their conduct. Thus, the policies enunciated in *Tew* for imposing a duty to disclose are one in the same for imposing the same duty upon clearing firms.

The *Tew* court recognized several policies supporting a Section 551 theory. There are, however, are other practical reasons that would support disclosure to the customer and securities regulators. For example, although *Koruga*[3] and *McDaniel*[4] suggest that terminating the clearing relationship is an adequate course of conduct, this conduct alone may not suffice. Consider the situation where a clearing firm discovers an ongoing fraud at one of its introducing brokers. Without a duty to disclose, the clearing firm would only have to terminate the relationship. This would allow the introducing broker to form a new clearing relationship with another clearing firm and essentially allow the introducing broker to continue the fraud. Under a theory merely requiring termination of the agreement, the clearing firm is rewarded for concealing the frauds of the introducing broker. Hence, clearing firms must have a duty to disclose the fraud to their customer and securities regulators.

In conclusion, clearing firms should be held liable for breaching a duty to disclose the wrongs of their introducing brokers to their customers and securities regulators for the public policy reasons of promoting the integrity of the securities markets, deterrence, and compensation of victims, among others. To hold otherwise would allow clearing firms to profit from the illegal activities of their introducing brokers and enjoy complete immunity for their participation and concealment. Clearing firms owe a duty to disclose as well as other duties such as terminating the clearing relationship in certain situations. These duties work in conjunction with each other to promote the healthy functioning of the system while still accomplishing the goals behind NYSE Rule 382 and NASD Rule 3230 and should be consistently presented to arbitration panels deciding clearing firm liability cases.

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[3] *Koruga v. Hanifen Imhoff, Inc.*, NASD Arbitration No.98-04276

[4] *McDaniel v. Bear Sterns*, NASD Arbitration No. 97-00497

The Canard of the Privilege for Regulatory Materials

by Wayne M. Josel

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As the SEC steps up its investigations of a number of broker-dealers, countless documents and materials are being created that could profoundly alter the course of private actions against the broker-dealers and their representatives. Yet, as counsel for claimants seek access to these materials, they are often met with a refusal to produce the materials based on "regulatory privilege."

Not surprisingly, such a privilege has not been recognized in the sweeping sense that industry counsel claim. In nearly all instances, materials generated in the course of an SEC investigation by a witness or target that are in the possession of the witness or target are discoverable.

The Theory - Privileges 101

First, a brief bit of background on the theory of privileges. Under the traditional view of privileges, as stated by Wigmore, four conditions must be satisfied in order for a privilege to attach: (1) the communication must originate in an expectation that it will not be disclosed; (2) the element of confidentiality must be essential to the will and satisfactory maintenance of the relationship between the parties; (3) the relationship must be one that, in the opinion of the community, ought to be sedulously fostered; and (4) the injury that would inure to the relationship by the disclosure of the communications must be greater than the benefit that would be gained by disclosure.[1] This utilitarian approach essentially asks whether the necessity for a privilege to encourage communications was sufficient to outweigh the costs imposed in impeding the search for truth.

A more modern approach avoids the strict balancing of costs and benefits and asks whether granting the protection of the privilege "puts the adversary in [any] worse position than if the communications had never taken place."[2]

Regardless of the approach used, it is clear that neither testimonial evidence nor materials provided to the SEC by a witness or target should be considered privileged and thus shielded from third parties. The caselaw examining the issue uniformly reaches the same conclusion.

The Real World

The dispute over the production of materials generally arises in straightforward fashion. In the discovery phase, claimant's counsel asks defendant to produce copies of documents and transcripts of testimony given in a related SEC proceeding. Ironically, a broad, but not unrealistic, interpretation of the NASD Discovery Guide would lead one to conclude that such materials must be produced in all customer cases. The Guide includes lists of documents to be produced and includes a category of "[r]ecords of disciplinary action taken against the Associated Person(s) by any regulator or employer for all sales practices or conduct similar to the conduct alleged to be at issue."[3]

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[1] J. Wigmore, 8 Evidence § 2285 at 527 (McNaughton rev. 1961).

[2] *Upjohn v. United States*, 449 U.S. 383, 395 (1981).

[3] NASD Notice to Members 99-90, List 1, item 12.

Arguably, those "records" would include materials from any SEC investigation. In any event, such a request is often met with a blanket denial on "privilege" grounds.

To the credit of counsel for the broker-dealers, the asserted claim of privilege in materials related to an SEC investigation was not pulled from thin air. In fact, SEC regulations provide that the materials are confidential by default unless the SEC determines otherwise.[4] This regulation was an "articulation of the discretion possessed by the agency in determining whether to disclose information acquired in the course of certain investigatory proceedings."[5] In essence, because it is the SEC which is controlling the investigation, the SEC alone should have the right to disclose the relevant materials.

The SEC regulations also provide that a person may seek a transcript of his own testimony in an investigation by filing a written request with the SEC. Such a request can be denied only for "good cause."[6] Thus, the SEC is the party to determine "whether the cloak of confidentiality is essential to the conduct of a particular investigation," not the target of such an investigation.[7] It is this point that counsel for the broker-dealers conveniently overlook.

Not surprisingly, a witness involved in an investigation will generally seek, and be provided, a copy of his or her transcript. It is this copy which subsequently becomes the object of a discovery dispute. A private claimant will seek the transcript in preparing a case against the witness or the witness' firm. The witness will assert that the transcript is privileged. In many cases, the witness will "contend that merely because [the] transcripts are the product of an SEC investigation, they are somehow imbued with a patina of 'confidentiality' that entitled them to special protection from discovery."[8]

Access to Witness Testimony

Courts have consistently held that once the transcript has been provided to the witness, there is no privilege the witness can use to shield its disclosure to private litigants.[9] The theory behind these decisions is consistent with both the traditional view of privileges and the more modern approach. One court, echoing the traditional bases on which any privilege is grounded, expressly rejected the argument that the testimony should be shielded to encourage witnesses to testify fully in administrative hearings, stating:

> Since the witness . . . is bound by subpoena to give full and frank testimony in such proceedings (as well as here) we question whether the SEC's regulations are designed for the benefit of the witness rather than to permit the SEC to enjoy confidentiality, where it is deemed necessary, in order effectively to complete its investigation.[10]

In other words, the witness has no expectation of confidentiality where the regulations provide that the SEC is the sole party to determine whether or not the materials may be disclosed. A witness cannot assert a privilege in materials which the SEC has already determined need not remain confidential. It is clear then that transcript testimony that has already been provided to a witness is freely discoverable in a later proceeding.

Documents Provided to the SEC

Where a target of an investigation provides documents and other materials to the SEC in connection with an investigation and later

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[5] *LaMorte v. Mansfield*, 438 F.2d 448, 450 (2nd Cir. 1971).

[6] 17 C.F.R. § 203.6.

[7] *Zients v. LaMorte*, 319 F. Supp. 956 (S.D.N.Y. 1970).

[8] *Baxter v. A.R. Baron & Co., Inc.*, 94 Civ. 3913 (JGK) (THK), 1996 U.S. Dist. LEXIS 18242 (S.D.N.Y. Dec. 10, 1996).

[9] *See e.g., Baxter*, 94 Civ. 3913 (JGK) (THK), 1996 U.S. Dist. LEXIS 18242 (S.D.N.Y. Dec. 10, 1996) (granting motion to compel production of transcripts of testimony before SEC; "SEC testimony is discoverable, at least in the absence of an objection by the SEC") (citing cases); *Zients v. LaMorte*, 319 F. Supp. 956 (S.D.N.Y. 1970) (granting motion to produce SEC transcript); *Kirkland v. The Superior Court of Los Angeles County*, 95 Cal. App. 4th 92, 115 Cal. Rptr. 279 (Ct. App. 2nd Dist. 2002).

[10] *See Zients*, 319 F. Supp. at 958.

seeks to shield them from production to a private litigant, a different but related analysis comes into play. In many instances, the target will assert the so-called "self-critical analysis" privilege. So-called because, despite its invocation by numerous parties, no judicial authority has recognized it as a valid rationale for shielding materials from disclosure.[11]

One of the first decisions discussing, then rejecting the privilege for self-critical analysis was *Westinghouse Elec. Corp. v. Republic of the Philippines*, 951 F.2d 1414 (3rd Cir. 1991). In that case, the defendant sought documents generated by Westinghouse's outside counsel in response to an investigation by the SEC that Westinghouse had obtained certain contracts by bribing officials of defendant. The Circuit Court rejected Westinghouse's claim of privilege finding that the disclosure of the materials to the SEC[12] served as a waiver of any claim of privilege.

Several recent decisions have involved attempts by parties to shield materials provided to the SEC. The Sixth Circuit in *In re: Columbia/HCA Healthcare Corporation Billing Practices Litigation*[13] analyzed the question of whether a party may limit the waiver of privileged materials by providing them to the SEC in the course of an investigation. After an exhaustive discussion and analysis of the caselaw related to "selective waivers,"[14] the Court rejected the attempt by Columbia/HCA to shield from production materials provided to the Department of Justice. "Just as the attorney-client privilege itself provides certainty to litigants that information relayed to one's attorney will not be disclosed, rejection of selective waiver provides further certainty that waiver of the privilege ensures that the information will be disclosed."[15]

Again, whether weighing the costs and benefits of disclosure under the traditional view, or using a more individualized analysis, it is clear that once materials are disclosed to the SEC, they cannot be shielded from production to a private claimant.

Practical Advice

As most attorneys practicing before arbitrators will attest, the greatest frustration is a panel's ability to ignore precedent. Thus, the caselaw cited here may prove cold comfort to many.

However, one of the great advantages to arbitration is the ability of counsel to appeal to the common sense of the panel (assuming, for sake of argument, that the panel has such sense). In that regard, this privilege analysis should prove valuable. None of the pleas of privilege should be heeded in light of the fact that the logical bases for any privilege do not apply in these cases. Unless the witness can demonstrate that the SEC has sought to maintain the confidence of the material (which will be impossible if the witness has copies of the transcript), disclosure of the materials should be freely granted.

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[11] For a comprehensive deconstruction of the so-called privilege under New York law, see Lipner, "I Love New York (Law): The Easter Bunny, the Self-Critical Analysis Privilege, and Other Figments of the Securities Industry's Imagination," 9 PIABA Bar Journal 1 at 11 (Spring 2002).

[12] Interestingly, the materials at issue in the Westinghouse case were never actually provided to the SEC, nor did the SEC retain a copy of the materials. See 951 F.2d at 1418.

[13] 293 F.3d 289 (6th Cir. 2002).

[14] *See* 293 F. 3d at 295-302 (citing *Permian Corp. v. United States*, 665 F.2d 1214 (D.C. Cir. 1981) (rejecting theory of selective waiver in all cases); *In re: Subpoenas Duces Tecum*, 738 F.2d 1367 (D.C. Cir. 1984) (same); *Bowne of New York City, Inc. v. AmBase Corp.*, 150 F.R.D. 465 (S.D.N.Y. 1993) (same); *United States v. Massachusetts Institute of Technology*, 129 F.3d 681 (1st Cir. 1997); *Diversified Indus., Inc. v. Meredith*, 572 F.2d 596 (8th Cir. 1978) (permitting selective waiver); *In re Steinhardt Partners, L.P.,* 9 F.3d 230 (2nd Cir. 1993) (permitting selective waiver only where party reserved right to assert privilege when disclosure to SEC is made); *Teachers Insurance & Annuity Association of America v. Shamrock Broadcasting Co.*, 521 F. Supp. 638 (S.D.N.Y. 1981) (same).

[15] *Id.* at 304.

Investor Claims Against Stock Analysts

by Jacob H. Zamansky

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This article examines the question of whether major securities' brokerage firms analysts can be held liable for securities fraud or a violation of Industry Rules as a result of stock recommendations they make which fail to disclose conflicts of interest and are premised upon the use of baseless "valuation"criteria. The issue is of great importance as the U.S. Congress and securities regulators are currently examining the role and potential liability of stock analysts. As shown below, existing securities law does, in fact, hold analysts liable for misleading statements or failure to disclose conflicts.

Background

The fall of the NASDAQ market (Internet/high technology) stocks from its high of 5,000 in March 2000 to 2,000 in March 2001 has been largely attributed by many financial market observers to false and misleading "buy" recommendations issued by major brokerage firm "superstar" Internet analysts such as Henry Blodget of Merrill Lynch, Mary Meeker of Morgan Stanley and the former superstar telecom analyst Jack Grubman of Salomon Smith Barney ("SSB"). These analysts have been criticized for failure to disclose material conflicts of interest, namely, their firms' financial interest in the stocks they were touting and the use of newly minted "valuation criteria" to justify their buy recommendations and high stock price targets.[1]

During the 1998-2000 Internet stock market frenzy, major brokerage firms such as Merrill Lynch and Morgan Stanley created media "superstar" Internet analysts as a means of enticing the investing public (who watch CNBC and other financial shows) to purchase Internet and high technology stocks. The superstar analysts were also used to generate investment banking business for their firms. Thus, critics argue that the research "analysts" no longer perform objective unbiased analytical functions (as required by Industry Standards) but, instead, are mere"touters" or "cheerleaders" for the companies they cover.

The "newly minted" valuation criteria used by these analysts do not appear to comport with Industry Standards such as the standards of the Association for Investment Management and Research ("AIMR") which requires that analysts use"objective" and "unbiased" research backed by proper and adequate due diligence.[2] Instead, the Internet analysts have moved from the Industry Standard of "price to earnings" valuation methodology to price to "revenue multiples" to justify their valuations.[3] In fact, many analysts have moved "of fthe charts" to value stocks based on "visits to web sites", "mouse clicks"

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[1] "How Did So Many Get It So Wrong?" by Gretchen Morgenson, Sunday Business, New York Times (December 31, 2000).

[2] Association for Investment Management and Research, Standards of Professional Conduct for Chartered Financial Analysts.

[3] Salomon Smith Barney Research Report of March First (April 26, 2000) ("In late 1999, the investment community adopted revenue multiples as a valuation method for the Internet and Technology providers" stocks).

and other "statistics" which may bear no basis in reality and are not consistent with Industry Standards.[4] Lastly, research analysts and investment bankers are by regulation required to be separate and to maintain a "wall" between their functions. In reality, the"wall" no longer exists and analysts have been criticized for becoming mere tools for their investment banking departments to generate underwriting and other business.[5]

Securities Law Standards

The failure to disclose a material conflict of interest (a firm's financial interest in the stock it is recommending – such as investment banking fees)may serve as the basis for a securities fraud claim. The use of baseless valuation criteria which are inconsistent with Industry Standards may constitute fraud and/or gross negligence on the part of an analyst or a violation of New York Stock Exchange ("NYSE") Rule 405 which requires a broker or analyst to have a "reasonable basis" for making a recommendation.

SEC Rule 10b-5 provides that it is unlawful for any person to make an untrue statement of a material fact or to omit to state a material fact necessary in order to make the statement made, in the light of the circumstances under which it was made, not misleading, or to engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person in connection with the purchase or sale of any security.[6]

In the leading case on point, Credit Suisse First Boston Corp. Securities Litigation,[7] the Court held that an analyst's research report, could, in fact, serve as the basis for a securities fraud complaint where the report made falseor misleading statements in connection with stocks and that the firm which issued the research report failed to disclose that it had a "short" position in the securities which were being analyzed.

In that case, a CSFB analyst issued a report entitled "Trading Notes, The Year 2000 Bubble," which recommended the sale of Data Dimensions and Viasoft stock, two companies involved in attempting to solve the Year 2000 computer problem. The report stated that the software companies highlighted in the report could not fix the problem and had no possibility of earning close to what the market capitalization indicated. The report, however, failed to disclose that CSFB had a significant "short" position in the stock of the two companies and stood to profit if the stocks' price fell as a result of the report.

The defendants moved to dismiss the complaint claiming that the alleged misstatements in the report were merely "statements of opinion" that are not verifiably false and are thus not actionable. In denying the motion to dismiss, the Court held that projections and opinions could provide the basis for liability under Section 10(b) and Rule 10b-5 and that forward-looking statements or predictions can be considered "facts" within the meaning of the rule's proscription of fraud. The Court also observed that the failure to disclose the firm's short position in the stocks could constitute a material omission sufficient to support a securities fraud claim.

Investors can expect that brokerage firms will claim that analysts'"recommendations" cannot serve as the basis for a fraud claim or for investor recovery. Investors can counter by citing the case of Korinsky v. Salomon Smith Barney in which Judge Shirley Kram of the Southern District of New York dismissed a class action based on alleged misleading analyst recommendations but held that such allegations "regarding an alleged scheme by defendants to issue artificially positive ratings on AT&T stock rise to the level of material misrepresentations or omissions regarding the value of the securities."[8]

In *Korinsky,* the class plaintiffs claimed that on November 29, 1999, Grubman issued a "buy" rating for AT&T at a time when AT&T was beginning to prepare fora large public offering of stock and was allegedly was looking for a number of different investment banks for underwriting assistance with the stock offering. The plaintiffs further alleged that SSB and Grubman breached their fiduciary duties to SSB's retail customers by issuing and maintaining positive recommendations on shares of AT&T despite defendants'

[4] "Can We Ever Trust Wall Street Again?: Where Mary Meeker Went Wrong," Fortune Magazine, May 14, 2001.

[5] *Id*.

[6] 17 C.F.R. 240.10b-5.

[7] 1998 U.S. Dist. LEXIS 16560; Fed. Sec. L. Rep. (CCH) . 90, 306, (October 20,1998).

[8] 2002 U.S. Dist. Lexis 259 (S.D.N.Y. January 9, 2002).

knowledge that AT&T faced serious financial problems.

This decision is significant because it confirms that an analyst's buy recommendations can, in fact, be the basis for a securities fraud claim.

Lastly, investors can expect that in claims asserted against Morgan Stanley Dean Witter ("MSDW") and Mary Meeker that MSDW will rely upon a decision by Judge Milton Pollack of the Southern District of New York which dismissed"without prejudice" class action claims filed against MSDW and Meeker form is leading research on the grounds that the suit contained pleading improprieties, which Judge Pollack described as "gross and unrestrained."[9] Although given leave to replead, the plaintiffs chose not to do so. Thus, the decision was based on the pleadings and was not a decision on the merits of the claims.

The Merrill Lynch - Henry Blodget Analyst Arbitration

In a groundbreaking NYSE arbitration in which this author represented the Claimants, *Kanjilal v. Merrill Lynch and Henry Blodget*, NYSE Case No. 2001-894, Dr. Kanjilal, an Indian-American physician, claimed securities fraud

and gross negligence based on Henry Blodget's buy recommendation on Infospace which was issued without disclosing Merrill Lynch's financial interest in the stock which Blodget was rating a strong buy. The case alleged that Blodget issued his buy recommendation at a time when Merrill Lynch stood to receive substantial compensation in connection with its role as a financial advisor to a merger of Infospace and Go2Net. Blodget's buy rating did not disclose Merrill Lynch's financial interest – a material fact which Dr. Kanjilal claimed affected his decision to buy, sell or hold the stock.[10]

On July 20, 2001, Merrill Lynch reportedly agreed to pay $400,000 in order to settle the arbitration claim, thus ending the case.[11] The case was reported worldwide in the television and print media as a potentially precedent-setting case.

The Merrill Lynch - New York Attorney General Settlement

On April 8, 2002, New York Attorney General ("NYAG") Elliot Spitzer commenced an action pursuant to the "Martin Act", against Merrill Lynch & Co., Inc.("Merrill Lynch"), Henry Blodget, Merrill Lynch's "Superstar" Internet analyst and other analysts at the firm seeking immediate equitable relief to "prevent further fraud, to protect the rights of the investing public, and to educate it "pending completion by the NYAG of its "investigation into Merrill Lynch and other financial institutions."[12]

The Martin Act provides the NYAG with broad criminal and civil powers to proscribe a wide array of fraudulent conduct and practices in connection with the sale of securities. Unlike the federal securities laws, no purchase or sale of stock is required, nor is the NYAG required to prove intent, reliance or damages as elements of a violation. There is no private right of action under the Martin Act and the NYAG has exclusive jurisdiction to enforce the Act.

The NYAG made public an affidavit and supporting exhibits which contained information and "smoking gun" email evidence of alleged fraudulent conduct by Merrill Lynch. The now infamous Merrill Lynch Henry Blodget emails reference that Merrill Lynch's stock research analysts privately disparaged the Internet stocks they took public as "dogs", "crap" and "pieces of junk" while touting these stocks to the public with "strong buy" recommendations.

Following the press coverage of the NYAG investigation and Merrill Lynch emails, Merrill Lynch's Chief Executive Officer issued a public "apology" citing the email discussions as "inappropriate."

On May 22, 2002, Merrill Lynch

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[9] *Pludo v. Morgan Stanley Dean Witter and Mary Meeker*, 01 Civ. 7072 (August 21, 2001).

[10] "All-Star Analyst faces Arbitration After Internet Picks Hit the Skids",Charles Gasparino, Wall Street Journal (March 2, 2001).

[11] Merrill Settles Arbitration Claims Over Analyst's Tech Stock Recommendations," Securities Regulation Law Reporter, BNA vol 30, no. 30 (July30, 2001).

[12] The "Martin Act", is the General Business Law "Article 23-A. The case against Merrill Lynch was initiated by the filing of an affidavit by Eric R. Dinallo, Chief of the Investment Protection Bureau of the State of New York, together with various exhibits.

agreed to a settlement of all charges with the NYAG. The settlement terms required Merrill Lynch to pay a $100 million fine to New York State and to other state regulators; create new policies to separate analysts' pay from the firm's investment-banking business; create a new committee to oversee "objectivity" of stock picks; and to establish a new system to monitor emails between investment bankers and stock analysts.

While the Attorney General had sought a "restitution fund" to compensate investors for losses relating to purchases of Merrill Lynch Internet stocks, the settlement did not contain any provision for restitution and instead left investor compensation to be determined in individual securities industry arbitrations and class action lawsuits. Merrill Lynch claimed that the settlement did not contain any "admission of wrongdoing" but in a public "statement of contrition" Merrill admitted that its employees had engaged in"inappropriate communications" some of which "violated internal policies" and which "failed to meet the high standards" of the firm.

Following the Merrill settlement, Salomon Smith Barney ("SSB") agreed to change the structure of its stock research department to mirror the changes agreed toby Merrill Lynch. SSB stated that it would create a research review committee to oversee research analysts' recommendations and would also separate "the evaluation and compensation of equity research analysts from investment banking". SSB will likely be the target of investor lawsuits largely based upon the research reports issued by its superstar telecom analyst Jack Grubman on telecom stocks, many of which have filed for bankruptcy or are selling at a fraction of their share prices from Year 2000.

SEC Analyst Rules

On May 10, 2002, following the NYAG investigation, the Securities and Exchange Commission ("SEC") approved New York Stock Exchange ("NYSE")[13] and National Association of Securities Dealers ("NASD")[14] rules to address conflicts of interest that are raised when research analysts recommend securities in public communications. The rules require, among other things, that firms are barred from tying their analysts' compensation to related investment-banking business; analysts must clearly disclose in public reports if they own shares in companies they are recommending; analysts are prohibited from offering or threatening to withhold a favorable research rating or specific price target for a stock to attract investment banking business from companies; research analysts cannot be supervised by the investment banking department of the firm and analysts and members of their households are barred from investing in a company's stock before it is first offered to the public if the company is in a business sector covered by the analyst. The new rules follow widespread public criticism that the SEC was too slow to act after conducting an examination of analysts' conflicts last year.

Investor Claims

Following the *Kanjilal* case and the NYAG investigation, numerous investors have filed arbitration claims and various class actions have been filed claiming that investors were misled by analyst research which failed to disclose material conflicts of interest. In the case of the Merrill Lynch Internet stocks, investors are arguing that the research was misleading insofar as it did not disclose that the research analysts privately disparaged the stocks while recommending that the public buy these stocks. Claims against other firms, such as SSB, argue that analyst recommendations were misleading because they did not disclose the firm or the analyst's financial interest or compensation for recommending stocks of companies with which their investment banking departments had lucrative financial arrangements.[15]

In Industry arbitrations, investors can forcefully argue that the NYAG-Merrill Lynch settlement contains tacit admissions that Merrill Lynch violated Securities Industry standards and its own internal policies in issuing misleading research which failed to disclose

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[13] The SEC approved amendments to NYSE Rule 472 ("Communications with the Public") and Rule 351 ("Reporting Requirements").

[14] The SEC approved new NASD Rule 2711 addressing Research Analysts and Research Reports.

[15] "As Lawyers Target Analysts, Now It's Grubman's Turn", Charles Gasparino, *Wall Street Journal* April 12, 2002 (investor filed claim against SSB and Grubman claiming analyst research on Global Crossing failed to disclose conflict of interest regarding analyst's compensation for investment banking business).

material conflicts of interest. These investors can reference the publicly available "smoking gun" emails and can likely obtain discovery relating to analyst compensation which may be linked to generating investing banking revenues.[16]

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[16] "Analysts' Contracts Link Pay To Deal Work", Charles Gasparino, *Wall Street Journal* May 6, 2002 p. C1.

Law School Clinic Offers Assistance to Small Investors

by Barbara Black

Barbara Black is a Professor of Law and Founder and Co-Director of the Securities Arbitration Clinic at Pace University School of Law. Her email address is bblack@law.pace.edu.

Pace University School of Law (located in White Plains, New York, about a 30 minute train ride from New York City) opened the first securities arbitration clinic in the country in fall 1997, to provide assistance to small investors. The impetus for starting the clinic came from former SEC Chair Arthur Levitt's desire to "level the playing field" for small investors. Investors had complained to him at SEC-sponsored Town Meetings that they were unable to obtain legal representation because of the small amount of their claims and yet they faced opposition from the brokerage firm's lawyers in the arbitration process.

The clinic represents only claimants in SRO arbitration forums. While the clinic can represent clients with claims up to $50,000, in fact, most of its clients' claims are considerably less that that amount, often less than $10,000. The legal referral service of the Bar Association of the City of New York refers prospective clients to the clinic when it knows from its own experience that a practitioner will not consider the case because of the small amount involved. Prospective clients also learn about the clinic's services from other sources. Newspapers have interviewed the clinic's directors about investor fraud and the clinic, the clinic is identified on the SEC's website, and my listing in the PIABA directory has generated inquiries. When the prospective client's inquiry comes from a source other than the bar referral service, the clinic requires the individual first to make efforts to obtain a lawyer to handle the matter. Only after the clinic is certain that the prospective client cannot obtain the services of a practitioner will it consider representing the individual.

Student interns, most of them in their final year of law school, handle all of the clinic's work under the supervision of one of the clinic's two supervising attorneys, one of whom is a tenured professor and the other, a visiting professor with an extensive practice background. The clinic makes certain that prospective clients understand from the outset that students will be their attorneys and that they are comfortable with this arrangement. The students' educational experience is enhanced, and their transition from law school to practice eased, because they have to assume the responsibility for making the critical lawyering decisions. While a supervising attorney is present at any significant discussion involving the case (for example, the initial meeting with the prospective client, settlement discussions with opposing counsel, the pre-hearing conference with arbitrators, and the arbitration hearing itself), her presence serves to assess the student's performance and to step in should something go irremediably wrong. Throughout the case, the supervising attorney provides guidance to the students, reviews all student work and makes certain that the case is moving forward at an appropriate pace. The supervising attorney, however, gives the student interns considerable freedom to make all decisions, beginning with the basic question of whether to offer a prospective client representation.

Because of the necessity of close supervision, the clinic needs to keep its numbers small. During the academic year, between six and eight students enroll in the clinic, which is run as a year-long course. Because the students need to learn at least the basics of broker-dealer law and arbitration procedure -- specialized areas of law not typically covered in other law school courses -- before they can handle these matters, much of

the class time in the fall semester is spent covering these topics. In the spring semester, the students are more knowledgeable and can devote more time to client representation. But because of the need to service ongoing cases, the students must do a lot of self-education on a "need to know" basis, a circumstance typical of practice. The clinic also enrolls a few students over the summer so that it can continue to respond to new inquiries and there is no gap in coverage of ongoing cases.

Typically the clinic receives about 70 inquiries a year. Some require little follow-up work. Every year there are a few heartbreakers, when the students reluctantly, but quickly, conclude that the clinic cannot help, as, for example, where the perpetrator of a fraud was not a registered broker-dealer. In addition, each year the clinic receives inquiries from across the country and even from abroad. Since the students must meet the clients in person, the clinic limits its representation to clients within driving distance of the law school. In other instances, all the students can do, unfortunately, is recommend that the person seek a referral from his local bar association, knowing that in all likelihood an investor with a small claim will not find assistance. While there are three law schools in the New York metropolitan area with securities arbitration clinics, we know of only two located in other parts of the country, and there are none in the entire western region.

When following up on an inquiry where there is no obvious barrier to taking the case, the students undertake an extensive investigation even before making a determination about whether to offer the individual representation. The clinic usually assigns two students to work on each matter, so that they can learn collaboration skills and to assure that two students are available to answer questions from the investor. The investigation will involve, at a minimum, the students' conducting an in-person interview with the investor, carefully reviewing the investor's documentation, researching the applicable legal theories, and drafting a detailed memorandum recommending a course of action. Last year, the students extensively investigated approximately ten inquiries in which a decision was made not to offer representation, usually due to lack of sufficient evidence or lack of a plausible claim.

The students did, in the course of the academic year, file several new arbitration claims with the NASD and continue with the ongoing cases. As is typical of the practice, few of the clinic's cases ever proceed to a hearing, only two in the clinic's five years of operations. Students have negotiated a number of settlements successfully for the clinic's clients, including a few that have been settled prior to filing a statement of claim.
Last year the clinic was particularly proud of its successful advocacy on behalf of a retired couple whose broker engaged in unauthorized trading. Since the firm was defunct, the students persuaded the SEC to recommend to SIPC to begin a liquidation proceeding that resulted in reimbursement for the full amount of the client's loss.

Establishing the securities arbitration clinic has been a "win-win" situation for the law students and the small number of investors the clinic has been able to assist. Regrettably, however, there are many more small investors all over the country whose need for legal assistance goes unanswered. The existence of a few securities arbitration clinics does not go far to meet the demand.

Why, then, does not the clinic increase its caseload? Because the clinic is part of the educational program at a law school, its primary objective has to be the education of law students, to provide them with the best possible knowledge and training for the practice of law. Of necessity, then, the clinic must keep both the number of students in the program and the number of cases they handle small, to assure that every aspect of the student's work is carefully supervised. Numbers are also kept small to allow for ongoing critique of the student's performance by the faculty supervisors and, perhaps most importantly, for the student's own introspective analysis of the decisions she made and their consequences. The clinic hopes, in this way, to instill in its students the ability for self-reflection that they will retain and refine throughout their years in practice.

Why, then, do not more law schools operate securities arbitration clinics? Clinical legal education involving the operation of an in-house clinic is the most expensive method of educating law students. Think back on your memories of 100 students or more in a first year Contracts class or an upper-level Corporations or Evidence class and compare it with this brief description of the clinic – the difference in costs involved is obvious. Even law schools, like mine, that are committed to clinical education can afford to operate only a few clinics, and there are many other worthy clinics to compete for the law school's resources, such as criminal defense, environmental litigation, immigration, domestic violence, and human rights law.

Therefore, law school clinics cannot cure the problem of small investors

who cannot obtain legal representation. I urge PIABA, the one organization that exists solely to represent investors, to advocate for other solutions. Perhaps it is time for an SEC-sponsored "small claims court" where small investors could present their claims in an informal setting before a SEC hearing officer, where the registered representative and brokerage firm would have to appear to tell their side of the story, without the participation of their attorneys. The amount of claims would have to be limited, and no punitive damages would be assessed. Unless serious consideration is considered to finding a forum that is truly accessible to small investors, small investors should be warned that Wall Street may be a stacked deck.

Contingent Attorney Fees – An Approach

by Jeffrey J. Scott

Jeff Scott is a PIABA member in Denver. His practice is entirely devoted to litigation and arbitration, and he has represented claimants in securities arbitrations for over ten years. His firm's motto is, "Where There's a Wrong, There's a Remedy."

In a recent arbitration in which I represented the Claimant, the Panel awarded substantial damages, including Claimant's attorneys fees based on the contingent fee agreement between Claimant and my firm.[1] Because a substantial number of PIABA attorneys frequently represent Claimants on a contingent fee basis,[2] this article will present a rationale for and method of seeking contingent attorney fees in arbitration proceedings.

I. Introduction

The law of the forum state which applies to the arbitration in question must be reviewed to determine what that state's standard is for determining the basis for awarding attorney fees. There is substantial authority that a "reasonable" fee must be measured by time records kept by the attorney. But there is compelling authority that there is a better yardstick for what is "reasonable." That yardstick is the contingent fee agreement between claimant and his or her attorney.

> **The best measure of a reasonable attorneys' fee is the prevailing market rate, reflected in the standard contingent fee contract entered into by the parties.**

United States Court of Appeals in *Bandura*.[3]

II. Arbitrators Have Broad Powers, Including the Authority to Award Attorney Fees

It is well settled that the powers of arbitrators are broad, and they are given great deference by the courts in their efforts to achieve just results. As stated in *The Arbitrators Manual* (p. 32):

> Arbitrators are not strictly bound by case precedent or statutory law. Rather, they are guided in their analysis by the underlying policies of the law and are given wide latitude in their interpretation of legal concepts.

The Colorado courts have recognized that arbitrators have virtually unfettered discretion to render awards they deem appropriate in any given case.

> Arbitrators are not bound by any particular substantive or procedural rules of law unless the agreement to arbitrate so provides. *Cabus v. Dairyland Insurance Co.*, 656 P2d 54 (Colo. App. 1982). The arbitrators do not exceed their powers by rendering a decision that is contrary to the rules of law that would have been applied by a court, so long as there is no violation of an express term of the agreement to arbitrate.

Byerly v. Kirkpatrick Pettis Smith Polian, 996 P2d 771, 774 (Colo. App. 2000).

The broad powers of arbitrators

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[1] NASD arbitration no. 01-02319.

[2] Over 60% of PIABA attorneys represent claimants on a contingent fee basis either "always" or "almost always," according to the informal poll recently conducted by PIABA member Martin H. Aussenberg.

[3] *Bandura v. Orkin Exterminating Co. Inc.*, 865 F2d 816, 822 (7th Cir. 1988).

include the authority to award attorney fees. The prevailing rule is for courts to confirm awards that contain attorney fees. This rule is based upon the courts' virtually ironclad resistance to requests that arbitration awards be vacated.

> Nevertheless, the prevailing rule, consistent with the deference that the courts show to arbitrators, is to confirm the arbitrators' award with respect to attorneys' fees.
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> * * *
>
> The courts' principal basis for upholding arbitrators' decisions to award attorneys' fees is the deference to be shown to the arbitrators and the principle that all doubts must be resolved in favor of arbitration. Arbitrators have a broad power to fashion appropriate remedies, which includes attorneys' fees. Thus, a court will not vacate an arbitrators' decision to award (or alternatively, not to award) attorneys' fees unless the complaining party has carried the burden of showing that the arbitrators either clearly exceeded their powers or acted in a completely irrational manner. Likewise, the arbitrators' determination of the amount of attorneys' fees to be awarded is a finding of fact, which the court must accept. In the area of attorneys' fees as in other areas, the court will defer to the arbitrators' decision on factual and legal questions falling within their authority, and will confirm the arbitrators' award if it can find any possible rational basis for it.

Poser, *Broker-Dealer Law and Regulation*, Aspen Law 1998, pp. 10-20, 10-21.

The prevailing rule also finds support in Rule 10324 of the NASD Code of Arbitration Procedure, which empowers arbitrators to make all interpretations and decisions regarding cases before them. The Rule provides that such interpretations are final and binding upon the parties.

III. A Claimant May Also Be Entitled to His or Her Attorney Fee Pursuant to the Relevant State Securities Act, Such as the Colorado Securities Act

In our recent case, Claimant asserted in his Statement of Claim a number of claims for relief, including Breach of the Securities Laws, alleging that the respondent firm and its agent and employee, Claimant's account representative, breached and were in violation of the federal and Colorado securities acts. The Statement of Claim asked for an award of damages, including an award of attorney fees.

The Colorado Securities Act specifically provides for an award of attorney fees, as well as actual damages, interest at the statutory rate (8%), and costs. Section 11-51-604, CRS (Civil Liabilities under the Colorado Securities Act) so provides regarding actions brought for violation of Section 11-51-501, Fraud and Other Prohibited Conduct. That section is the state analog to Rule 10b-5 of the federal act, which also prohibits misrepresentations and omissions in connection with the offer or sale of any security.

As the Tenth Circuit Court of Appeals said in *O'Connor v. Lafferty*, 965 F2d 893, 897 (10th Cir. 1992), a suitability claim is based on a violation of the statutory prohibition against misrepresentations and omissions (Rule 10b-5):

> Ms. O'Connor claims Defendants bought securities which were unsuitable for her investment needs. Federal courts recognize such a claim as a violation of section 10(b) and Rule 10b-5. . . . Some courts examining a section 10(b), Rule 10b-5 unsuitability claim have analyzed it simply as a misrepresentation or failure to disclose a material fact. *See, e.g., Lefkowitz v. Smith Barney, Harris Upham and Co., Inc.*, 804 F2d 154, 155 (1st Cir. 1986). In such a case, the broker has omitted telling the investor the recommendation is unsuitable for the investor's interests.

Because Claimant's claims arose in part under the Colorado Securities Act, we proposed to the Panel that he was entitled to recover his actual damages, interest, costs and attorney fees.

IV. An Award Including an Attorney Fee of X% Is Customary and Reasonable

We attached to the Brief submitted at the request of the Panel the Affidavit of the Claimant, the Affidavits of two Colorado attorneys who are experienced in securities arbitration matters, and my Affidavit as Claimant's counsel. Those documents affirm that the contingent fee agreed to by Claimant was fair and reasonable, and that a contingent fee of X% is

the usual, customary and reasonable practice in cases involving customers' securities claims. Of course, these proofs should be tailored to the custom and practice in the area where the arbitration in question is conducted.

One of the attorney affidavits points out that contingent fees are approved by the Colorado Supreme Court, and that a contingent fee is justified because the attorney risks all of his or her time and effort to prepare and present the client's case, risking that time and effort because the outcome is uncertain and unknown. The Colorado Supreme Court has approved the validity of these fee agreements.

> Under a contingent fee contract, the attorney, if he is successful, receives for his services in litigating his client's cause a stipulated percentage or portion of the recovery. *See 1 S. Speiser, Attorney's Fees sec. 2:1 (1973)*. This type of fee arrangement is generally valid in Colorado, *Bell v. Board of County Commissioners*, 26 Colo. App. 192, 141 P. 861 (1914), and C.P.R. EC2-20, except in criminal and divorce cases.

People v. Nutt, 696 P2d 242, 247 (Colo. 1984).

The affidavits of the attorneys also pointed out that it is common for attorneys to charge a contingent fee of more than X% of the recovery in securities arbitration cases.

The Claimant's attorney's affidavit we provided reviewed my qualifications and the tasks performed and efforts made in my representation of Claimant. The affidavit stated that the fee agreement with Claimant was the standard contingent fee agreement for this type of case.

The Claimant's affidavit supported the claim for a contingent attorney fee, stated that because he was financially bereft he could not retain me on an hourly basis, and affirmed the contingent fee agreement we entered into. The fee agreement itself was not an exhibit, on the theory that it was protected by the attorney client privilege; the arbitrators in our case did not require its production.

Courts have frequently held that a contingent fee is the proper measure of an attorney fee to be awarded a successful claimant. The Court said in *Citizens Bank v. C & H Const.*, 600 P2d 1212, 1217 (Ct. App. N.M. 1979), "[A] standardized, unambiguous contingency fee contract is not subject to alteration or amendment by a court. In any event, there should not be trial court contract fee fixing. The amount of the contract fee would vary with every judge. It is the function of the court to enforce the contract as made."

The attorney fee contract of the parties is controlling:

> In determining the measure of the attorney's compensation under an agreement for a contingent fee, the contract of the parties is controlling. Ordinarily, payment is properly computed according to the percentage formula set forth in the contract itself rather than on a quantum meruit basis, and the actual time spent by the attorney on the case or the difficulties involved are immaterial. The amount of the fee as fixed by the contract is binding on the client in the absence of fraud practiced, or error induced, by the attorney, and the client cannot impair or destroy the attorney's rights to the stipulated fee.

7A CJS Attorney & Client '319, p. 610.

The federal courts will affirm a finding that the contingent fee contract is the best measure of a reasonable attorney fee.

> The district court, citing *Kirchoff v. Flynn*, 786 F2d 320 (7th Cir. 1986), found that 'the best measure of a reasonable attorneys' fee is the prevailing market rate, reflected in the standard contingent fee contract entered into by the parties.' We hold that the district court was well within its discretion to make such an award.

Bandura v. Orkin Exterminating Co. Inc., 865 F.2d 816, 822 (7th Cir. 1988).

We attached to our Brief several NASD arbitration awards demonstrating that panels have awarded claimants' contingent attorney fees in other cases.

V. CALCULATION OF THE AWARD

Our final exhibit to our Brief set forth Claimant's several damage cases. Claimant requested that the Panel choose which damage case, or combination thereof, best fit an award in the case.
We then gave several examples of possible awards based on the several damage cases, actually laying out the math involved in calculating a gross award including a 40% contingent attorney fee, after

arriving at a decision on what the Claimant's "net" should be.

We then suggested that an alternative approach would be to simply decide on a total damage number and divide it by .60 (60%), thereby arriving at a final damage number incorporating a 40% attorney fee, with a net damage figure equal to 60% of the total. For example, if the total damage number is $400,000, divide by .60 for a final damage number of $666,666, resulting in a net damage figure of $400,000.00 (60% of $666,666).

VI. CONCLUSION

Arbitrators have authority to award a Claimant his or her attorney fee. In the proper case, the gross amount recovered can include a contingent attorney fee, if the arbitration panel thinks it is warranted. I suggest that if claimant's counsel is proposing the award include a contingent attorney fee, that proposal should appear in the claimant's damage calculation, and the panel should be made aware at the close of the case that counsel is prepared to submit a brief on the subject. The panel will be informed by *The Arbitrators Manual* (p. 34) that, "It is appropriate for the arbitrators to request the parties to brief this issue."

The Measurement of Excessive Trading in a Securities Account

by Mary Calhoun

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I. Introduction

The purpose of this article is to provide a brief compendium of the many ways by which the frequency of trading in a securities account can be measured and evaluated, to explain briefly the reasons for using each of the calculations, to advise where they may not appropriate, and to help counsel anticipate common defenses to the calculations.

Counsel may use this reference to:

Run preliminary calculations in the course of case evaluation;

A. Check your expert's calculations to make certain that they conform to authoritative standards;

B. Ensure that your expert's testimony with regard to the calculations will be bulletproof upon cross-examination; and

C. Cross-examine the opposing expert.

II. The Basics

A. Average Annualized Turnover Rate ("ATR")

This is the most basic calculation of frequency of trading in a securities account. It measures the number of times that an account's equity has been "turned over" by repeated purchases and sales.

A formula is necessary because, if I know that in one year, an account purchased $2,000,000 in securities, I have no way of knowing whether trading may have been excessive unless I can compare it to the size of the account. ATR compares purchases to the measure of the size of the account, its equity.

Turnover is generally expressed as an annualized number, and as a rate rather than as a percentage.

ATR *Average Annualized - Turnover Rate*	=	Total purchases / Average account	X	12 / # of

For example, in an account with $100,000 in purchases over a 3-year period, during which the average account equity was $25,000, ATR = $100,000 ÷ $25,000 X 12 ÷ 36 = 1.3.

Dozens of cases and commentators have written about the interpretation of turnover rate. However, one of the most insightful articles is that written by Howard Berg and Julie Jason. Analyzing ATR in terms of industry norms from 1947 through 1996, as well as how it has been interpreted through the decades, they opine that "The shrine that has been erected around the magic number of 6 should be dismantled and the benchmark lowered to a suggested level of 3."[1]

B. Break-even return ("BER") / Cost-to-equity maintenance factor ("CEMF")

The break-even return, formally known as "cost-to-equity ratio," "cost-to-equity maintenance factor," or "Goldberg Cost Maintenance

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[1] Berg, Howard G. and J. Julie Jason, "Does the Literature of Churning Reflect the Current State of the Brokerage Industry?" *Securities Arbitration 1996,* Volume Two, Practicing Law Institute, 1996.

Factor,"[2] measures the cost of trading in commissions, spreads, and margin interest, in relation to the size of an account. Since, without cost, there is no actual or theoretical harm in an otherwise-suitable portfolio that is frequently turned over, the measurement of cost is typically the single most significant indicator in evaluating excessive trading:

> *"A primary test for excessive trading is the relationship between the net amount of money invested and the transaction costs that are incurred."* [3]

BER Break-even Return Return (Cost-to-equity Ratio)

$$\text{BER} = \frac{\text{Commissions} + \text{Margin Interest}}{\text{Average Account Equity}} \times \frac{12}{\text{\# of Months}}$$

For example, in an account with $100,000 in purchases over a 3-year period, during which the average account equity was $25,000, ATR = $100,000 ÷ $25,000 X 12 ÷ 36 = 1.3. For example, in an account with $25,000 in commissions and costs plus $6,000 in margin interest over a 3-year period, during which the average account equity was $25,000, BER = ($25,0000 + $6,000) ÷ $25,000 X 12 ÷ 36 = 41.3%

As in the example, with an average annualized break-even return of 41.3%, an account needs to earn at least that much, on average, each and every year just to break even after covering the costs of trading.

Just what is a "commission"? Commissions are confusing because the cost of the trade to the customer may differ from the commission credit earned by the registered representative, which in turn differs from the profit or loss made on the trade by the firm.

For the purpose of calculating BER, however, the only relevant "commission" is the cost to the customer, which equals any agency commission plus the spread and/or slippage on the trade.[4] Because of the difficulties in determining historical spreads, the commission credit paid to the broker is commonly used as a reasonable approximation of the cost to the customer.

Here again, the insights of Berg and Jason,[5] writing many decades after the abolition of fixed commissions, are instructive:

> *"In view of expected performance over time...commissions of about 5% to 6% annually in a brokerage account with a growth and income or conservative investment objective over which a broker exercises control is probably about the limit the account can bear."*

C. Holding Periods

1. The holding period of **individual securities** should be calculated in days for each security.

2. The calculation of **average holding period** is far simpler than many realize.

$$\textbf{\textit{Average holding period}} = \frac{\text{365 days}}{\text{ATR}}$$

For example, if ATR = 12.2, the average holding period = 365 ÷ 12.2 = 30 days. If ATR is low and the time period analyzed is relatively short, the calculation may generate a number that is longer than the number of days in the period analyzed. For example, 365 days ÷ .2 ATR = 1825 days.

3. A **"days held"** chart may be illustrative in helping the panel determine whether the short-term trading was appropriate. In calculating days held, consider how received and delivered securities are handled; often, it is wise to omit them, but this will depend on the facts and circumstances of the account and the securities. Often, days held tables illustrate other points; for example, that there was a pattern of taking very

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[2] Goldberg, Stuart, *Fraudulent Broker-Dealer Practices* (1978).

[3] *Michael David Sweeney*, SEC Release No. 34-29884 (October 30, 1991). See also *Shearson Lehman Hutton*, SEC Release No. 34-26766 (April 29, 1989).

[4] See McCann, Craig, and Richard G. Himelrick, "Spreads, Markups, Sales Credits and Trading Costs," *PIABA Bar Journal*, Summer 2002 for an explanation of calculating trading costs.

[5] Berg, Howard G. and J. Julie Jason, *op. cit*.

short-term trading gains and letting losses run.

Days Held Table

Number of Days Held	Number of Positions	Gain (Losses)
0 - 1 days	373	$ 26,001
2 - 7 days	220	$ 13,256
8 - 31 days	125	$ 7,899
32 - 180 days	26	($ 56,775)
181 days or more	6	($ 131,243)

III. The Looper calculation

It's no secret that I am fascinated by the Looper calculation, an arcane formula for determining ATR and BER.[6] [7] My fascination stems from the countless ways in which Looper is mis-named, mis-calculated, and mis-used by commentators, attorneys, and experts in arbitration.

The Looper Formula

Average monthly investment =
(Cash contributions + realized gains from securities purchased + dividends + sale proceeds from securities received - withdrawals - realized loses from securities purchased - margin interest and fees)
÷ total # of months

The calculation is difficult, primarily due to its treatment of received securities; however, it has merit and carries the weight of great authority.

The result of the calculation is *average monthly investment*, which is a measure of the size of an account, just as is average equity, and it may be substituted for average equity in the denominator of ATR and BER calculations.

Today, it is rarely used, primarily because of its difficulty. Its merit is that it permits ATR and BER to be calculated in situations in which equity cannot easily be determined; for example, when securities are unpriced on account statements. There is no reason to use Looper except in this circumstance, as there is also ample authority for the use of the equity calculation. One cannot generalize as to whether Looper turnovers are higher or lower than equity calculations, but it is useful to know that *Looper* itself provides authority for concluding excessiveness with ATR as low as 1.8.

Sometimes one will see a reference to a "modified Looper." There is no standard for exactly what constitutes a modified Looper; in fact, there seem to be many so-called "modified Loopers" out there, each modified in a different way. Usually, a "Looper" isn't a Looper at all, but rather an equity calculation made by someone who doesn't understand the difference; often, the modification is made to simplify the calculation, which deviates from established authority; and occasionally the calculation is another concept altogether, such as using total portfolio value for the denominator.

When presented with a "Looper" calculation, you must first determine whether it is, in fact, a Looper; second, whether it is correctly calculated; and third, if it claims to be modified, you must determine why it is modified and whether that makes sense; and then how it is modified and whether that makes sense.

IV. Mutual Funds and Unit Investment Trusts

Not too long ago, many of the concepts discussed below, such as breakpoint violations, deferred sales charges, and letters of accumulation referred only to open-end mutual funds. Today, however, UIT's have sales charge complexity similar to that of their mutual fund cousins.

In applying the investment company forensics suggested below, remember that they apply only to open-end mutual funds, not closed-end, exchange-traded funds. Finally, remember always to review the prospectus, since each fund family has its own unique schedule of sales charges, rights of accumulation, and other rights and restrictions, and there are frequently variations among the funds in a family.

A. Short-term holding periods

A short-term holding period on

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[6] *In the Matter of Looper and Company*, 38 S.E.C., 34-5676 (April 15, 1958). In evaluating *Looper's* stated turnover rates, don't forget to annualize the calculations.

[7] Calhoun, Mary E., "Looper Lives...And Other Observations on the Measurement of Excessive Trading," Securities Arbitration 1999, Practicing Law Institute (1999).

front-end-loaded mutual funds results in the effective forfeiture of the sales charge paid.

A short-term holding period on rear-end-loaded mutual funds causes a contingent deferred sales charge to hit the account.
The SEC has found very short-term trading of even closed-end funds to be improper.[8]

B. Switching

In a mutual fund switch, one fund is sold and another is purchased, causing the customer to incur sales charges, whether front- or rear-end, that would not otherwise have been incurred.

Switches may be valid and suitable, but must be in the investor's best interest, rather than based on incentives received by the registered rep.[9]

A switch may be considered more egregious if exchange privileges and a similar fund existed within the original fund family. [10]

Today, most brokerage firms have computer systems that will recognize same-day mutual fund switching, with the result that some registered reps try to "fly beneath the radar" by selling a mutual fund and buying a unit investment trust, or by keeping the funds in a money-market fund for a week.

C. Breakpoint violations

Mutual fund Class A shares are front-end loaded: a sales charge is charged upon purchase. However, the percentage sales charge declines with larger purchases. This is the "breakpoint" schedule.

For example:

Less than $25,000	5.50 %
$ 25,000 - $ 49,999	5.25 %
$ 50,000 - $ 99,999	4.75 %
$ 100,000 - $ 249,999	3.75 %
$ 250,000 - $ 499,999	3.00 %
$ 500,000 - $ 999,999	2.00 %
$1,000,000 or more	0.00 %

Since the higher the sales charge paid, the higher the broker's commission credit, the classic breakpoint violation occurs when the broker recommends a purchase of, for example, $24,500 in a mutual fund, thereby earning a higher commission, but causing the customer to pay a higher sales charge.[11]

One common issue that arises is the question of whether recommending diversification among several fund families is a breakpoint violation. This determination usually depends on the facts and circumstances specific to the investor and the funds.[12]

D. Rights of accumulation ("ROA")

Most, if not all, fund families permit rights of accumulation for Class A (front-end load) shares. So if a customer buys $30,000 Putnam Capital Appreciation in her single account plus $25,000 Putnam Europe Growth in a joint account, both purchases would qualify for the $50,000 breakpoint. Moreover, ROA may sometimes be aggregated retroactively.

A registered representative recommending and executing Class A shares has a duty to make sure that customers receive all ROA to which they are entitled.[13]

E. Letters of intent ("LOI")

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[8] *Frederick C. Heller*, SEC Release No. 34-31696 (January 7, 1993).

[9] NASD *Notice to Members* 94-16 (March 1994) and 95-80 (September 26, 1995). See also *Russell L. Irish*, SEC Release No. 34-7687 (August 27, 1965); *aff'd* 367 F.2d 637 (CA-1, 1966); *cert. denied* U.S. Sup. Ct. Feb. 13, 1967 and *Charles E. Marland & Co., Inc.* 45 SEC 632 (1974), *Winston H. Kinderdick*, SEC Release No. 34-12818 (September 21, 1976) and *Kenneth C. Krull*, SEC Release No. 34-41008 (February 1, 1999).

[10] *Dean Witter Reynolds*, SEC Release No. 34-43215 (August 28, 2000) and the related *Leslie E. Rossello*, SEC Release No. 34-43650 (December 1, 2000).

[11] See NASD IM 2830-1, NASD *Notice to* Members 98-98, *Shearson, Hammill & Co.,* SEC Release No. 34-7743 (November 12, 1965), *Houston A. Goddard & Ward H. Clarke,* SEC Release No. 34-32839 (September 2, 1993).

[12] See NASD *Notice to Members* 94-16 (March 1994).

[13] *Robert L. Den Herder*, SEC Release 34-39297 (November 5, 1997).

With a letter of intent, a customer purchasing shares of a Class A mutual fund signals his intention to buy more shares at some point during the coming 12 or 13 months, thereby becoming entitled to a higher breakpoint and a lower front-end sales charge.
Should the customer not meet the LOI commitment, the fund simply applies the higher sales charge to the account retroactively. In order to create the LOI, frequently all the registered rep has to do is indicate the LOI on the order ticket. In other words, signaling an LOI is a "no-brainer" on the part of the rep: if there is any chance whatsoever that the customer may make an additional commitment during the coming year, it should be signaled, since there is no penalty to either the customer or the rep if the commitment is not fulfilled.

The SEC has opined that failure to secure the customer lower sales charges through letters of intent and rights of accumulation may be a violation of Rule 2110 (just and equitable principles of trade).[14]

F. Class B shares

For Class B shares, no front-end load is charged. A declining contingent deferred sales charge ("CDSC") is applied if the shares are sold within the first 6 or so years. For example, 6% in the first year, 5% in the second year, and so on. Most, but not all, fund families offering B shares also offer A shares.

There's nothing inherently wrong with B shares; however, when B share purchases are made in excess of the typical $250,000 breakpoint, the investor would almost always be mathematically ahead had he instead purchased A shares.[15] [16] [17] Regardless of whether markets are advancing or declining, or whether the investor withdraws the funds in the first year or 12th year, this is true, unless something unusual about the fund's unique cost structure makes it untrue.

However, unlike A shares, in which the rep's commission credit declines if a lower sales charge is paid by the customer, reps are paid full commission credit, usually 4 to 6%, at the time the investor purchases B shares, regardless of the amount invested.

For example, an investor investing $1,000,000 in A shares would pay no sales charge. The rep would receive a nominal commission credit of perhaps $5,000. On the other hand, if invested in an assortment of B shares, the rep's commission credit could be as high as 40,000 to $60,000.

B-share suitability issues have become such a hot topic in regulatory circles that many brokerage firms have added B-share surveillance to their exception reporting.

V. Annuities

Variable annuities are securities that use mutual funds as the underlying investment component. Therefore, many of the concepts discussed under "Mutual funds," above, also apply to variable annuities. **Fixed annuities** are insurance products that invite scrutiny when sold or exchanged.

Annuities virtually always pay the advisor a hefty commission at the time of purchase, and charge the policyholder a substantial surrender charge if the policy is cashed in or exchange in the first 5 to 10 years. In evaluating any "1035 exchange" (named for the IRS code that permits a tax-free exchange of policies) into a new policy, these surrender charges must be evaluated, along with any "bonus" credits and fees, the "M&E" (mortality and expense) and other annual fees unique to every policy.

A careful mathematical analysis can demonstrate whether the cost of the exchange leaves the investor likely to ever break even.

VI. Defenses to churning calculations

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[14] *Harold R. Fenocchio*, SEC Release No. 34-12194 (March 11, 1976).

[15] *Michael Flanagan, Ronald Kindschi, & Spectrum Administration, Inc.,* SEC Initial Decision 34-160 (January 31, 2000). See also "Suitability Issues For Multi-Class Mutual Funds," NASD *Regulation & Compliance Alert* (Summer 2000), *Stifel, Nicolaus et al.,* , NASD Regulation (April 18, 2001) and *Wendell D. Belden*, NASD NAC decision, Complaint No. C05010012 (August 13, 2002).

[16] In some circumstances, C shares (with differing combinations of rear-end sales charges and annual fees) may be superior to both A and B shares.

[17] The Mutual Fund Calculator available on the SEC's website at *www.sec.gov* approximates the discrepancy in costs between share classes. For complete accuracy, a more sophisticated analysis is required.

A. Mistakes

In calculating ATR and BER, two common mistakes which overstate turnover are 1) including money-market fund purchases in the purchases total; and 2) including months after the effective close of the account in the calculation of average equity or number of months.

B. Faulty assumptions in calculating ATR and BER

1. *Annualizing ATR and BER for less than a year can lead to skewed results*. This usually occurs because of the initial investment effect in an account. Assume that I deposit $100,000 in January 2001, then invest it. I make no more purchases or sales that year. My average equity is $100,000. My ATR is 1.0.

If, however, I deposit the money in December 2001, my annualized ATR for that year is 12.0, which is clearly fallacious.

Avoid problems by presenting the calculation as it is, or even state "NM" (not meaningful), and then be clear not to draw attention to it in testimony. Your expert might even mention that it's important not to draw any conclusions from the 12.0 figure for 2001.

Not all short-term ATR's and BER's are unreliable, however; once the initial investment effect is eliminated, which can be done by subtracting the initial deposits from the purchase total, or initial costs from the cost total, respectively, the calculation is valid, unless the period is extremely short.

2. *Give the rep credit where due, but use focus periods.* Assume that an account is actively traded in 1999, then there are no purchases or sales for a 6-month period in early 2000. Trading resumes with a vengeance in July. Don't omit this"quiet" period when calculating turnover for the account as a whole.

The best practice is to do the calculation for the account as a whole, then do separate calculations for the active focus periods 1999 and late 2000, and tell the panel why it's appropriate to focus on those periods.

3. *Received and delivered securities present their own challenges*. Watch out for fallacies here; for example, skewing effects on a "Days Held" table.

C. Trompe l'oeil

1. *Total portfolio value.* In calculating ATR and BER, the denominator is average account equity (equity = total portfolio value minus margin debt). Respondents, however, would often prefer that the denominator be total portfolio value, which will dramatically understate the turnover rate in a heavily-margined account.

Claimants can be stalwart about the use of equity, as there is abundant authority for the use of this calculation; for example*, Looper* itself is adamant about excluding the margin debt from the calculation. Moreover, there are cases in which the use of total portfolio value has been specifically criticized.[18]

2. *"Modified Looper."* As noted above, sometimes experts will use a novel calculation, or a questionable one, such as using total portfolio value as the denominator, and title it "just a modified Looper."

3. *"You can't use ATR in an options account."*

The Options Study of 1978[19] was critical of the use of ATR in an options account, reasoning that short options that expired would not be reflected in the calculation. However, any such effect would almost always be very small; moreover, it would only serve to understate the customer's turnover calculation, thereby making it conservative. The Study came down squarely in favor of the use of a commission-to-equity ratio, of which BER, which includes margin interest, is a logical extension, as a means of evaluating accounts for excessive trading.

Usually, however, the options debate is more qualitative than quantitative, arguing that options are by design short-term instruments and that a higher turnover rate is expected. Here again, the use of BER will create the rebuttal for the argument: the harm in frequent trading is the cost. BER allows us to look at the cost of trading in an options account and evaluate whether it was suitable for the customer in question.

VII. Math, Truth, Smoke, Mirrors, and Common Sense

Arithmetic can take us only so far. When I testify as an expert witness with regard to the calculations described above, whether for claimants or on defense, I usually explain to the panel that there are few bright lines in evaluating

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[18] Shearson*, Hammill & Co.,* SEC Release No. 34-7743 (November 12, 1965).

[19] *Report of the Special Study of the Options Markets to the SEC* (December 22, 1978).

frequency of trading. Always, the calculations must be evaluated in light of a specific customer and his or her unique financial situation, level of understanding, and investment objectives. And always, they must be interpreted with common sense.

This seems obvious; however, it is remarkable how frequently this simple truth is overlooked in attorneys' arguments and expert testimony.

One good example comes with the "2-4-6 Rule" often applied to ATR. In Stuart Goldberg's formulation of the rule[20]:

ATR = 2 suggests the inference of excessive trading
ATR = 4 suggests the presumption of excessive trading
ATR = 6 suggests the conclusion of excessive trading

Attorneys and experts frequently argue that an ATR over 6 is *prima facie* evidence of churning, despite the fact that even Goldberg emphasized that this guideline applies only to conservative investors, not speculators and traders.

Likewise, it's always important to look for and understand any reason behind the numbers. For example, there may be valid reasons for making municipal bond tax swaps. Done correctly, they are a win-win strategy that provides a measurable dollar benefit to the customer as well as a nice credit for the rep.

Finally, once a panel thinks that your expert has used smoke and mirrors in her calculations, or that she is hiding anything from them, they will disregard anything she says.

So if the overall turnover in an account is 1.2, say so. And then direct the panel's attention to the focus period beginning July 1999. Point out the mutual fund swaps that provided no understandable benefit to the customer but paid a huge commission for the rep. In short, always present *all* of the calculations, then you or your expert can tell them why you want them to focus on certain periods, figures, or facts.

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[20] Goldberg, Stuart, *Customer Recovery Guide to Stockbroker Fraud and Securities Arbitration* (1987).

Does Your Broker Owe You Money?

by Dan Solin[1]

Dan Solin (www.dansolin.com) is a PIABA member with offices at 401 Broadway, Suite 306, New York, NY 10013. The above piece is an excerpt from Mr. Solin's recently released book: "Does Your Broker Owe You Money?" (Alpha Books), reprinted with permission. His book is available online at www.Amazon.com and in bookstores throughout the country. Mr. Solin can be reached at: (212) 226-0959. His e-mail address is: dansolin@earthlink.net.

After Don Zabawa was hit by a car while riding his bicycle, he turned over $125,000 to a stockbroker at FAS Wealth Management in Delray Beach, Florida, and asked him to invest the money in "safe investments," hoping to use income from the investments to support his family while he recuperated and could not work.

Unfortunately, his broker didn't heed his request.

In February 2002 an NASD arbitration panel awarded Zabawa $125,000 in damages, as well as $56,250 in attorney's fees and the NASD filing and hearing fees. Zabawa had alleged in his claim that the broker, the firm's owner, and the branch manager all contributed to his loss by churning his account, placing his money in unsuitable investments, and pressuring him to buy securities on margin.

The NASD tribunal found the three individuals jointly and severally liable for the award, meaning that one individual may have to pay the entire award if the others can't or won't.

William Bernstein, author of *The Intelligent Asset Allocator*, and a principal in the money management firm Efficient Frontier Advisors, has said:

There are two kinds of investors, be they large or small: those who don't know where the market is headed, and those who don't know that they don't know. Then again, there is a third type of investor, the investment professional, who indeed knows that he or she doesn't know, but whose livelihood depends upon appearing to know.

Those who manage money for pensions funds and institutional endowments realize that no one knows where the market is headed. Academics know that no one knows where the market is headed. Why don't brokers know it?

<u>Brokers are Trained to Manage Clients, Not Portfolios</u>

Brokers don't know these basic truths because they are not trained to know them. They are trained to sell. They are trained in cold calling, and in deal closing.

Despite brokerage firm marketing, which has changed the titles under which stockbrokers work from "account executive" to "financial consultant" and "financial professional," stock brokers are still basically sales people.

"The firm hires us to sell stocks or bonds, or whatever," says a former broker who has left the industry. "Brokers are not meant to be financial people and that is the problem in the system."

The vast majority of brokers are not trained in how to work with a client to establish the client's realistic expectations for a portfolio's return and risk, and how to create a portfolio that tries to derive that return while maintaining that risk.

Another former broker says, "Often, the broker's failure comes from not 'listening' to the client. Understanding how a client thinks about risk versus reward is a fascinating study in human psychology. The exceptional (financial) advisor will take the time to really understand the client and

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[1]An excerpt from Mr. Solin's recently released book: *Does Your Broker Owe You Money?*

assure that you are both on the same page, and speak the same language."

One former broker, in answering my question about whether she used Modern Portfolio Theory to help her clients construct portfolios, answered:

> To this day, I don't know if real asset allocation in a portfolio means large-cap, small-cap, etc. or individual sectors like technology, cyclicals, banking, etc., or if it means both.
>
> (Actually, asset allocation means allocation across the asset classes of stocks, bonds, and cash. Diversification means owning a number of different securities in one asset class, and also owning different asset classes.)
>
> As for standard deviation, etc., I worked for two (major brokerage) firms over almost five years and I can tell you what I learned about beta and standard deviation I learned on my own by asking questions.
>
> None of that[md]absolutely none of that[md]is taught in our training. Training for a new broker goes something like this: study and take the Series 7, 63, 65, and insurance exams.
>
> I spent three weeks in (class) learning about products, mutual funds, and learning to sell. If a broker wants to learn about (asset allocation and diversification) it has to be done on the broker's own time. Most would never take the time because for the first three to five years you are building your business.
>
> As much as I was a student of the market, I never considered what "risk" meant because I didn't have the experience or the training to understand how volatile a market could be.
>
> When you are young and starting out you go where the market is hot. If you don't, you simply don't have the strength or wisdom to argue with a client about why asset allocation works. As a matter of fact, for a broker starting in the mid-90s asset allocation did not work. And if you are a new broker building a business, you can't afford to lose a client. I can't tell you how many times clients would say to me 'how come we don't own Amazon or Yahoo?'
>
> Some time in 2000, (the firm's strategist) wrote a piece on why asset allocation was dead. No kidding. Boy did that reinforce what I already had come to believe. Boy should that guy be fired and pay back a lot of money to my clients.

This is the training many of your "trusted advisors" receive, and the support he or she gets from the analysts, market strategists, and other professionals in the firm who are supposed to assist brokers to do the best they can for clients. In reality, they are trained to do what is best for the company.

No wonder when you file an arbitration claim citing unsuitability, fraud, misrepresentation, and/or breach of fiduciary duty, the first thing the brokerage firm does is say, "Hey, you're a grown up, you shouldn't take what we say that seriously that you don't use your own judgment."

I say too bad for brokerage firms. They have to come to the realization that in the twenty-first century, with the increase in education for investors (of which I hope this book is a major part) their very existence depends on doing what is right for their clients.

Brokerage firms need to work harder to make sure brokers don't provide poor advice to clients. This doesn't mean that all clients will always listen to advice. After all, we all know that some people will always take less than prudent risks, even with their own money. But if clients expect brokers to be professionals who look after their the clients' best interests, brokerage firms should have an obligation to provide brokers with the training they need to help clients.

Then, if a client chose not to follow the broker's advice and later encounters a heavy loss, the firm could legitimately say, "we tried to help you, but you would not listen." Unfortunately, that is a far cry from where things are today in the brokerage industry.

Brokers, unfortunately, often don't know what they don't know, or if they do know they don't care. And they are too lazy, or too scared, or too greedy, to find work selling goods or services in some other industry where the standard of care is merely buyer-seller and not fiduciary.

<u>The Solin Theories For Enhancing Your Chances of Establishing That Your Broker Does Owe You Money</u>

So, how do you use the knowledge you gained in Chapter 5, and the understanding that by and large brokers do not use MPT in helping their clients to construct appropriate portfolios because they have no understanding of the

concepts to make a legitimate claim that your broker owes you money?

I have developed three theories under which you can proceed, and am beginning to argue these theories in arbitration proceedings, where appropriate and necessary (remember, there are so many brokers who engage in egregious activities {as demonstrated in Chapter 3} that you don't often need to use these theories to make a compelling case).

A caveat: It is by no means certain that, even if these theories are persuasively argued, arbitration tribunals will accept them. The makeup of these tribunals tends to be older men, who are very set in their ways and unaccustomed to dealing with anything that they have not heard many times before. It could take a serious effort on the part of a number of investors and attorneys, and a protracted period of time, to convince some of these tribunal members that since the rest of the financial world has long since accepted these theories, they should as well.

> THEORY 1: FAILURE TO COMPUTE OR DISCLOSE STANDARD DEVIATION, BETA, OR SOME OTHER REASONABLE AND WELL UNDERSTOOD MEASURES OF RISK MAY GIVE YOU A CLAIM FOR UNSUITABILITY

Let me state the obvious. It may well be that computing the standard deviation and beta of your investments will show that there is no liability. However, since stockbrokers don't understand it and don't run the calculations, a finding of no liability would be a random event. In all likelihood, given their need to generate commissions, and their instinct to follow the pack into the market's "hot areas," a computation of standard deviation and beta are likely to be powerful evidence of unsuitability when they show unacceptably high levels of portfolio risk.

My experience with clients (both investors and brokers) is that it is a rare broker who has any idea that these measurements exist, let alone how to properly use them.

The failure to understand and utilize Modern Portfolio Theory (MPT) and its attendant measurements of risk is inexplicable and indefensible, since except for the brokerage industry the entire financial and academic finance world relies so heavily on them.

In an article in the Ohio Northern Law Review, the author summarizes the widespread use of MPT as follows:

> MPT is used and endorsed by many in academia, in practice, and in government. Not only is MPT used by individual investors and mutual fund managers, it has also been applied to managing consumer loans, thrift institution investments, real estate, pension investments, international investing, and for insurance companies. Thus, today MPT is a central theme to many high-level investment strategies. The prime question however is whether it can be meaningfully applied at the basic retail level and, just as importantly, whether those who sit in judgment of broker conduct can apply it.
>
> The answer to this final question is: Why not?

Every investor case I take begins with an analysis by an expert in charge of the wealth management group at a large accounting firm. Part of that analysis is to run the standard deviation and beta for the portfolio. If they are out of whack, I use them as evidence of unsuitability. Why shouldn't all brokerage firm clients have the benefit of this analysis (i.e. understand the risk inherent in their portfolio) so they can avoid becoming my clients?

The key question in using standard deviation and beta as proxies for suitable or unsuitable investments is to establish thresholds that permit you to determine whether the standard deviation is indicative of unsuitability.

While each case is unique and depends on many factors unique to the individual investors, there is a general rule I have found useful in this analysis. A standard deviation 1.5 times the standard deviation in the market is suspicious, and a standard deviation 2.0 times the standard deviation in the market is strong evidence of the portfolio's unsuitability.

For example, for the 20-year period from 1979 to 1999, the Standard and Poors 500 index (a proxy for the U.S. stock market) had an average annual return of 17.88 percent and a standard deviation of 15.35 percent. When we look at a portfolio with an R-squared that correlates well to this benchmark (as many equity portfolios do) we go on heightened alert if the standard deviation is 23 or over, and we become reasonably confident that we have a valid suitability claim if the standard deviation is 30 or higher. Of course, this is the standard deviation that should apply to the portfolio in its entirety.

This is true even if the client needed or desired the risk of an all-equity portfolio. An all-equity

portfolio just isn't an appropriate portfolio for most clients. But I am at least trying to be somewhat conservative.
This does not mean that brokers should not or can not recommend "risky" investments to clients. Remember that we are looking at the standard deviation and beta of the client's entire portfolio, not just individual investments.

One thing MPT illustrates to investors is that you can add a risky investment or class of investments to a portfolio and actually reduce the portfolio's overall risk. So it is alright to add securities that are, in and of themselves, very risky, so long as they don't cause the entire portfolio to become overly risky. This is accomplished by making sure the risky security has a less than perfect correlation with the rest of the portfolio.

However, few brokers understand this concept, and even fewer implement it successfully within client portfolios.

The same is true with beta. Again, assuming a correlation with the S&P 500, there are many investors (like most widows, disabled people, retirees and others who cannot easily replace losses) where the beta on their portfolios should be significantly less than 1. For investor with a capacity for greater risk, it might well be that a beta as high as 1.25 would be appropriate, as long as the investor knows that his or her portfolio is 25 percent more volatile than the S&P 500.

A beta of 1.5 or higher is a cause for concern and would lead me to believe that the portfolio's volatility may well be too great for the investor to bear. If this is the case, the investor (who in all likelihood was never informed of the beta or its significance) may have a valid suitability claim against the broker and the brokerage firm for any losses incurred by the portfolio.

The bottom line is that since these risk tools are validated by overwhelming Nobel-Prize winning academic research and used by virtually every professional manager of institutional funds, your broker's failure to advise you of them and use them on your behalf (or at least explain them to you so you can make an informed decision) may well give you the keys to the arbitration forum door.

> THEORY 2: FAILURE TO DISCLOSE THAT THERE IS NO DATA INDICATING THAT BROKERS OR ANYONE ELSE CAN CONSISTENTLY TIME THE MARKET OR PICK WINNERS MAY GIVE YOU A CLAIM FOR FRAUD UNDER RULE 10(B)-5, MISREPRESENTATION, OR BREACH OF FIDUCIARY DUTY

Brokers can't time the market or pick stocks any better than you can. It has been proven time and again through rigorous academic research. Rigorous study has shown that asset allocation accounts for over 90 percent of portfolio returns, while market timing and security selection account for about 5 percent of the return.

The evidence of the efficiency of markets and the inability of anyone to successfully and consistently pick winners is so overwhelming that it is a mystery why brokers continue to be successful in convincing their clients they (or the firm's analysts, market strategists, and economists) can do so.

If anyone could beat the indexes and consistently pick winners, you would think it would be those highly paid professionals who make decisions for mutual funds that invest hundreds of millions of dollars. Yet numerous studies have shown that the majority of mutual funds under perform their relevant benchmark index each year. In one comprehensive study of pension fund managers (who you would assume would be extremely sophisticated managers) concluded that "pension fund equity managers seem to subtract rather than add value relative to the performance of the Standard and Poors 500 Index."

Yet brokers (most of whom do not have the background or experience that would permit them to be hired by a mutual fund, much less manage a portfolio of hundreds of millions of dollars) make the claim every day that they can choose the right stocks for your portfolio to outperform the market.

They do this without weighing the risk of these individual securities for their client portfolios. They do it without understanding the dispersion of possible returns (the standard deviation) the investment might generate, or how the particular security's standard deviation might affect the portfolio's overall volatility. And they do it without any support whatsoever that they have the ability to do so with any consistency.

Brokers pick up the phone and make recommendations to their clients to buy specific securities for specific reasons.

> As one former broker puts it:
>
> Here is how it goes. You come out of training, you are inundated with stock reports, mutual fund wholesalers, products out of the behind. How do you choose? Then, after a few years, oh my God here come the charts and

> graphs. The whole thing is a never-ending game and it is a game no broker can ever really win for very long.

> How do we decide what to do? Well, I would pick the (mutual fund) manager who had the best track record and do large cap growth, mid-cap growth/value, etc [el] until a few years went by and I realized the best track record means nothing for the future and the stocks in my mid-cap fund had all grown to be large cap so I wasn't really allocating anything.
>
> I would read my stock reports (believe me, no matter how you understand the bias, even the most seasoned brokers believed them) and buy a bunch of stock [el]mostly in technology because CNBC said the NASDAQ was going to catch up with the Dow and (the firm's market strategist) told me asset allocation was dead anyhow.
>
> But no one told us when to sell. We all sat there just watching and believing things couldn't fall the way they fell because they never had before. No one told us because our job is to sell. How could we do our job if we sat in cash? Most seasoned brokers, well, their accounts didn't look much better than mine.

If you knew that this was how your broker was going to carry out research, pick stocks, and time the market to try to help you manage your portfolio, would you invest with him or her?

THEORY 3: FAILURE TO DISCLOSE THAT THE OVERWHELMING ACADEMIC/HISTORICAL DATA INDICATE THAT PASSIVE FUNDS WITH LOW EXPENSE RATIOS TYPICALLY PERFORM BETTER OVER TIME THAN ACTIVELY MANAGED FUNDS MAY GIVE YOU A CLAIM FOR FRAUD (10(B)-5), MISREPRESENTATION, OR BREACH OF FIDUCIARY DUTY

Don't let actively managed funds make you passive about recovering your losses from your broker.

The sum of all the buyers and all the sellers in the market is, de facto, "the market."

The mathematical laws of probability and large numbers say that over time and a large number of transactions, the mean expected return will be, you guessed it, about the mean return of the Standard & Poors 500, which is most often used as the proxy for the stock market.

In any one year, some investors, mutual fund managers, and investment managers can and do "beat the market" in terms of gross returns. But, after you factor out management costs (for funds), transaction costs, bid-ask spreads, and finally the taxes on any gains taken (especially short-term gains from trading, which are taxed at your ordinary-income tax rate and not the long-term capital gains rate), it becomes that much harder to actually have a net return higher than the market average. And as you extend the time horizon over which this performance is measured, it becomes even harder.

Let's look at the math:

1. The mean return on all stock portfolios is essentially the S&P 500 return (about 11 to 12 percent a year historically since the Second World War).

2. The returns of all investor fall in a bell-shaped curve (and, since this is a very large sample, so it should be a "normal" or perfect bell curve).

3. The standard deviation of these returns for a one-year period is 8 percent. (This means that about one-third of investors earn between the mean and 8 percent less than the mean (between about 4 and 12 percent in real terms); another one-third earn between the mean and 8 percent more (between 12 and 20 percent); another one-sixth earn a return less than the mean minus 8 percent (less than 4 percent); and the final one-sixth earn a return greater than the mean plus 8 percent (above 20 percent).

(This assumption of a perfect bell curve, where 50 percent of all portfolios beat the market each year, is actually a bit generous. Academic studies of mutual fund managers show that about 45 percent of actively managed mutual funds actually beat the market in any given year. But I'm willing to be generous in order to simplify the equation, smooth the bell curve and make two important points, the first about cost and the second about beating the market over time.

First, if the average cost-equity ratio for an actively traded account or mutual fund is 2 percent, the number of investors and managers who "beat the market" on a net-cost basis is greatly reduced.

Do you like those odds?

Imagine that your broker had said

to you, "Mathematically, you have about a one-in-four chance of beating the market net of your costs THIS YEAR through a strategy of active stock trading or buying actively traded mutual funds."

Do you think you can be in the 25 percent of all investors who beat the market this year (either making your own investment decisions, allowing your broker to recommend stocks, or buying actively managed funds)? Maybe you do. Maybe you live in Lake Woebegone, with all the other good-looking women and above-average children. And remember, if your portfolio costs go from 2 to 4 percent (which can easily happen if you use a broker and actively trade individual stocks), your mathematical chances of beating the market go to maybe 15 percent.

But there's a second piece to what your broker would have had to say to you in order to be truthful, since, to use the mutual fund industry's standard disclaimer, "past performance is no guarantee of future returns."

"Oh, and by the way, the odds of doing it two years in a row are much less and the odds of doing it for 10 years running are infinitesimal." (Actually, statistically, without factoring in any costs, the odds of beating the market 10 years running are about 10 percent.)

> Would you have invested that way?
>
> Why don't they disclose this? Let's listen to what one former broker has to say again:
>
> If a client wanted to buy an index fund he or she certainly could. Of course, if a client wanted to buy an index fund, what good would a broker be? A client could go to Vanguard and buy it a lot cheaper. (My firm) had some index funds, as I am sure all firms do.
>
> No one showed us the difference between index and actively managed funds. A few years ago you could show a client an example of the Fidelity Magellan fund where the active manager hands down beat the indexes.
>
> Honestly, no one ever asked me about index funds (until the market began to fall apart in 2000) and the reason probably was that if people come to a broker, they want to do better than an index. I would have offered no value in a client's eyes if I said, "Hey, let's use indexes."

Remember the discussion in Chapter 2 about brokers having a fiduciary duty to their clients?

Doesn't this mean they have an obligation to you to disclose the overwhelming data that supports the superior long-term returns of low-cost index funds over higher-cost actively managed funds sold by brokers to their clients?

Doesn't this mean they have an obligation to you to disclose that 50 percent or more of assets in U.S. pension funds are invested passively (i.e. buying and holding all of the stocks in a group of indexes, or index mutual funds)?

Significantly, the standard for other fiduciaries those who manage trust accounts supports the view that the failure to disclose these facts violates this fiduciary duty.

Investment of trust assets is governed in many states by the Prudent Investor Rule, issued by the American Law Institute. In 1995, the Uniform Prudent Investor Act was adopted by many states. This Act sets forth the guidelines that should be followed by estate planning attorneys, trustees, and investment advisors who make decisions for hundreds of millions of dollars in trust assets. The Reporter's Notes to the Prudent Investor Rule state the following:

> Economic evidence shows that, from a typical investment prospective, the major capital markets of this country are highly efficient, in the sense that available information is rapidly digested and reflected in the market prices of securities. As a result, fiduciaries and other investors are confronted with potent evidence that the application of expertise, investigation, and diligence in efforts to "beat the market" in these publicly traded securities ordinarily promises little or no payoff, or even a negative payoff after taking account of research and transaction costs. Empirical research supporting the theory of efficient markets reveals that in such markets skilled professionals have rarely been able to identify under-priced securities (that is, to out-guess the market with respect to future return) with any regularity. In fact, evidence shows that there is little correlation between fund managers' earlier successes and their ability to produce above-market returns in subsequent periods.

Translation: There is no one, including your broker, who can demonstrate that he or she can beat the market with any

consistency, notwithstanding all of their research and diligence in an effort to do so. What's worse, fund managers have no greater success than individual brokers. Therefore, from a purely economic point of view, you would be better off with low-cost index funds. No doubt it is for this reason that the majority of all trust accounts are invested in index funds, aggregating hundreds of billions of dollars.

If these are the standards that govern the management of trust funds in many states, and if this is the way smart, sophisticated money is invested, is there any reason why your broker, who is also a fiduciary (or, at the very least, holds him or her self out as your "trusted advisor" and "financial consultant"), should not disclose these undeniable facts to you so you can decide whether or not to invest in the same manner.

If your broker has sold you actively managed funds without disclosing these facts to you, I can think of no reason why you should not be able to recover your losses from him or her.

<u>So, Does Your Broker Owe You Money?</u>

I have often said that I believe a very large percentage of all investors have valid claims against their brokers and brokerage firms, if they choose to pursue them. The reason I say this is because use of one of these three theories can vastly extend the range of broker conduct worthy of you filing a claim for relief where you have lost money in your investments.

In January 2002 I used the list-serve of the Public Investor Arbitration Bar Association (PIABA) to poll my colleagues on what percentage of people who inquire about the option of filing a claim have a legitimate claim. The results were kind of stunning.

Of the 54 responses I received, more than two thirds (37 respondents) said 40 percent or fewer potential clients had a claim. One respondent said only 5 percent have a claim, and an astounding 14 said only 10 percent have claims. Only five respondents (about 10 percent) believe that 70 percent or more of their potential clients have a claim.

Now, I must admit this was a non-scientific, one-question pop survey, and some of those who responded made it clear that their responses indicated how many clients they believe have a "winnable" claim as opposed to a legitimate claim. Others made it clear that many potential clients have a legitimate claim, but that their losses are too small to make it economically viable for an attorney to take such a case on a contingency-fee basis.

But I'm convinced many attorneys who practice in this area still believe that any claim without a clearly fraudulent practice is not a legitimate claim, or at least not one that is likely to get a favorable response from an arbitration tribunal. I'm equally convinced that if attorneys educated themselves about MPT and its uses as an offensive tool in investor arbitration proceedings, and properly presented the overwhelming data on these issues to a tribunal, we could, over time, get arbitration tribunals to accept the argument.

What does this all mean for you?

What I am saying is that, yes, there are a number of traditional theories under which you can recover money from your broker if he or she has committed a clear fraud or violation of the professional standards of one of the self regulating organizations such as the NASD or the NYSE.

However, historically, these traditional theories have affected only a small fraction of investors who have lost money in the stock market. But now, with the wide dissemination of knowledge about MPT, and with the ability of every investor (even those with modest portfolios) to find professional money managers who use MPT to their clients' advantage, the brokerage industry must begin using it as well.

When you add these new theories to the traditional theories, the vast majority of investors who have lost money in the largest market downturn in history (in terms of cumulative value lost from investment portfolios, over $4 trillion) have a possibility of collecting some of that lost wealth from brokers and brokerage firms.

These theories provide vast numbers of investors with the keys to the arbitration hearing room door, and the opportunity to recover their market losses from those who mislead them (either deliberately or out of ignorance) or who actively placed them in investments that can be proved mathematically to be too risky (too volatile) for their investment objectives and risk tolerance.

These theories can (and should) be as significant for investors seeking to recover their losses from brokers and brokerage firms as Modern Portfolio Theory was for the world of finance.

From The Professor –

A Primer on the Liability And Damages Provisions of Securities Acts – Part I, the Securities Act of 1933

by Joseph C. Long

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In the last issue of the Bar Journal, this column was devoted to a general discussion of the state securities (or "Blue Sky") laws. In this issue, I want to focus on the liability provisions of the Securities Act of 1933. In the next issue, I will focus on the civil liability provisions of the 1934 Securities and Exchange Act of 1934 and SEC Rule 10b-(5).[2]

There are three basic civil liability provisions in the Securities Act of 1933. They are Section 11,[3] Section 12(a)(1),[4] and Section 12(a)(2).[5] Each of these 1933 Act provisions is unique. Each is directed to the coverage of a particular problem and has its own elements of proof and damage scheme. There is, however, a limited amount of overlap between Section 11 and Section 12(a)(2) where the investor might have a cause of action under both sections.[6] In such case, the lawyer representing his client must examine the elements for recovery under each Section as well as determine which provides the greatest amount of recovery.

Actions to enforce liability under the three express liability provisions of the 1933 Act[7] may be brought in either state or federal court. Section 22[8] provides for concurrent jurisdiction except in the case of fraud class actions brought on covered securities.[9] It was envisioned that the investor could select which forum he chooses to litigate in. As a result, it was thought that the removal to federal court would be barred. However, in practice, not all courts have honored the concurrent jurisdiction provision and have allowed removal, especially where an action under the 1933 Act is coupled with a 10b-(5) claim or another cause of action which would normally be removable.

I. Section 11 of the Securities Act of 1933

The first Section of the 1933 Act to be considered is Section 11. Section 11 in the past has been the least used of the federal securities remedies. However, with the strictures of pleading particularity now imposed on SEC Rule 10b-(5) actions, Section 11 is being used more often in court litigation. Section 11 provides liability for material misrepresentations and

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[1]Primarily Section 10(b), 15 U.S.C. §78j(b).

[2]17 C.F.R. §10b-(5).

[3]77 U.S.C. §77k.

[4]15 U.S.C. §77l(a)(1).

[5]15 U.S.C. §77l(a)(2).

[6]This situation will occur where the offering is registered and the investor happens to be the first purchaser of the securities. In such case, the issuer and the underwriters are "sellers" of the securities liable under Section 12(a)(2). They are also persons who are liable under Section 11. As will be seen below, the elements of liability are quite different under each section.

[7]Contrast this with the requirement that all actions under the Exchange Act of 1934, including actions under SEC Rule 10b-(5), must be brought in federal court. 15 U.S.C. §78aa.

[8]15 U.S.C. §77v.

[9]Covered class actions for securities fraud are regulated by Section 16, 15 U.S.C. §77p. *See also* Section 21D of the Exchange Act, 15 U.S.C. §78u-4.

omissions contained in a registration statement. As a result, it **does not cover** such omissions or misrepresentations in private placements or when securities are sold illegally without registration.[10]

A. Who May Recover

Section 11 creates a very larger group of potential claimants. Section 11 does not have the quasi-privity requirement found in Sections 12(a)(1) and (2) where only the person who "buys" the securities from the seller may sue. Instead, under Section 11, the ability to sue runs with the securities covered by the prospectus. As a result, both first purchaser and the twenty-fifth purchaser of a security have a cause of action under Section 11. The only requirement is that the person bringing suit must be able to trace his securities to the block of securities covered by the registration statement.

B. Types of Liability

Section 11 does have two rather unique features. First, liability varies according to the persons sought to be held liable. The issuer is strictly liable for all material misrepresentations and omissions. On the other hand, all others are given an affirmative defense.

1. Non-Professionals

In the case of the non-professionals, this defense is two fold. As to the non-professional sections of the prospectus, the individual sought to be liable can avoid liability by showing, after a reasonable investigation, he has reasonable grounds to believe, **and actually does believe**, that there are not material omissions or misrepresentations in the prospectus.[11] As to the professional portions of the prospectus, after reasonable investigation, he has no basis to believe that the information in the professional's report is untrue or that the prospectus does not contain an accurate representation of the professional's opinion.[12]

2. Professionals

In the case of the professional, the affirmative defense is reversed. After reasonable investigation, he must have reasonable grounds to believe and actually believe that his professional report, as re-printed or summarized in the prospectus, does not contain any material misrepresentations or omissions.[13] As to the remainder of the prospectus, including the reports of other experts, he has to only have reasonable grounds to believe there are no misrepresentations or omissions.[14]

C. The Reliance Element

Section 11 is also unique in its treatment of reliance. It provides for alternative reliance requirements. Initially, reliance is not an element for recovery. However, after a particular event, the investor must prove reliance. The reliance shifting event is the issuance of a post-registration earnings statement.[15] The catch here is that the earnings statement **must be for a full twelve month period beginning after the effective date of the registration statement.** As a result, reliance will never be required for at least twelve months, and may be a non-element for as much as twenty-three months.[16] The important thing about this earnings settlement is that it shifts reliance not only for material misrepresentations and omissions in the financials, but for **all parts of the prospectus.**

D. Persons Primarily Liable

Section 11 provides a broad list of persons who are potentially liable. Included in the list of potentially liable are the issuer, all the statutory underwriters,

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[10]It also does not apply to offerings made under Regulation A, because Regulation A is an exemption created under Section 3(b) of the 1933 Act and **is not a registration**.

[11]Section 11(b)(3)(A).

[12]Section 11(b)(3)(B).

[13]Section 11(b)(3)(C).

[14]Section 11(b)(3)(D).

[15]Section 11(a).

[16]Even longer if the issuer does not issue an earnings statement.

professionals whose reports are a part of the prospectus, as well as the directors of the issuer and those persons who sign the registration statement.[17] As will be seen below, Section 12(a) liability is only imposed upon persons who "offer or sell" the securities.

E. Control Person Liability

To fully understand Section 11, two other sections must be read in conjunction with it. First, Section 15[18] imposes civil liability to all those persons who are control persons of any one of the individuals or entities liable under Section 11. In determining who will be classified as a control person, the question is asked: "Does the person, either alone or in conjunction with others possess the power, directly or indirectly, control the person primarily liable?" Note that the test is not whether the person **actually exercises the control,** merely whether he **has the power to control**.

The power to control is obviously a question of fact which must be determined on a case by case basis. However, the statute itself indicates two ways to control another, stock ownership or an agency relationship. Thus, a sole shareholder normally will be a control person.[19] Likewise, a broker-dealer will be the control person of its registered representatives because of the agency relationship between the two.[20] Directors and officers of a corporation or general partners normally will be considered control persons.[21]

It is important to note that liability under Section 15 is status liability.[22] This means that a control person is potentially liable merely because he is a control person. Unlike the control person liability provisions of Section 20(a) of the 1934 Exchange Act,[23] where a control person must be involved in the transaction, under Section 15 of the 1933 Act, involvement is not necessary if the person has the power to control.[24]

This liability, however, is not strict liability. The potentially liable control person is given an affirmative defense. He may avoid liability by proving that he had "no knowledge of or reasonable grounds to believe in the existence **of the facts** by reason of which"[25] his liability is alleged.[26]

F. Statute of Limitations

The statute of limitations for Section 11 is found in Section 13 of the 1933 Act.[27] It has a one and three year provision. Suit must be "brought within one year after the discovery of the untrue statement or the omission or **after such discovery should have been made by the exercise of reasonable diligence.**" However, such action must, in any event, be

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[17]*See* §§ 11(a)(1)-(5).

[18]15 U.S.C. §77o.

[19]*Schillner v. H. Vaughan Clarke & Co.*, 134 F.2d 875 (2d Cir. 1943).

[20]*Hollanger v. Titan Capital Corp.*, 892 F.2d 858 (9th Cir. 1990)(en banc); *Johns Hopkins University v. Hutton*, 422 F.2d 1124 (4th Cir. 1970).

[21]*Dyer v. Eastern Trust & Banking Co.*, 536 F. Supp. 890 (D.Me. 1971); *Miller v. Harro* (Kennedy, Third Party Defendant), 8 F.R.D. 67 (E.D.Pa. 1947).

[22]*G.A. Thompson & Co., Inc. v. Partridge*, 636 F.2d 945 (5th Cir. 1981).

[23]15 U.S.C. § 78u(a).

[24]*G.A. Thompson & Co., Inc. v. Partridge*, 636 F.2d 945 (5th Cir. 1981).

[25]15 U.S.C. § 77o.

[26]This affirmative defense is similar to that provided under Section 12(a) as discussed below. However, the defense because it talks in terms of "the facts" on which the primary liability is based, plays a very minor role under Section 12(a)(1). Whether something is a security and whether it needed to be registered are questions of **law**, not fact. Therefore, all a potentially liable control person has to know under Section 12(a)(1) is that the person controlled sold something. *Moerman v. Zipco*, 302 F. Supp. 439 (E.D.N.Y. 1969), aff'd 422 F.2d 671 (2d Cir. 1970).

[27]15 U.S.C. §77m.

brought no later than "three years after the securities were "bona fide [sic] offered to the public."

This summer, the Sarbanes-Oxley Act of 2002[28] amended the statute of limitations dealing with **some** securities issues. The bill added a new 28 U.S.C. §1658(b) which reads, in part:

> [A] private cause of action that involves a claim of fraud, deceit, manipulation, or contrivance **of a regulatory requirement** concerning the securities laws, as defined in section 3(a)(47) of the ... Exchange Act[29] ... may be brought no later than the earlier of--(1) 2 years after **discovery** of the facts constituting the violation; or (2) 5 years after such violation.

The use of the words "fraud, deceit, manipulation or contrivance" suggests that the bill **does not alter Section 13**. This conclusion is re-enforced by the first italicized language above which suggests that the new section is intended to control only **implied causes of action,** implied from a rule or regulation of the Commission, such as SEC Rule 10b-(5).

II. Measure of Recovery Under Section 11

Section 11 also has a unique statutory recovery provision.[30] The starting point for the calculation of damages is the purchase price paid by the investor for the securities. However, there is a cap upon the recoverable purchase price. Recovery may not exceed the original public offering price under the prospectus. This is important because it means that the investor may not be able to recover his entire investment. If the original offering price was $15, and he paid $25 for his shares in the after market, his recovery will be a **maximum of $15.** He will never be able to recover the $10 loss above the original offering price. From this amount, one of three figures are subtracted.

A. Alternative 1--Securities Already Sold

If the securities have already been sold before suit is brought, then the measure of damages is the difference between the original purchase price or the maximum recovery cap, whichever is the lesser, and market price at which the securities were sold. This recovery can be translated into the following formula:

> Recovery = (Original purchase price or the maximum recovery price, whichever is lesser)-(price at which securities sold).

For example, if the investor bought the stock at $13 in the after market, continuing the above example, if he sold the stock for $10, he would recover the difference between $13 and $10, or $3 a share. If we alter the example so that his purchase price was $25, then his recovery would be $15 less the $10 recovered in the sale. His actual damages in such case are $15, but he is only able to recover $5 of his loss because of the initial offering price cap.

B. Alternative 2--Stock Held At Time of Suit

The second figure that may be subtracted is the price of the security **at the time suit is filed,** if he still owns the securities at this point. Again, this figure sets the **maximum** which the investor can recover. Let's go back to our $13 purchase. At the time of suit, the price is $9 dollars. Even if the stock later drops to $5, he will only be able to recover $13 less $9 or a total of $4 rather than $13 less $5 or a total of $8.

C. Alternative 3--Securities Increase in Value After Suit Filed

The third alternative figure deals with an increase of the stock price **after filing of the suit and before entry of judgment. If during this period**, the price of the stock goes up beyond the price at date of filing, recovery is limited to the purchase price (or recovery cap whichever is less) and the highest market price during suit. Continuing with our example, the purchase price is $13 and the price at filing is $9. However, subsequent to filing, the price goes back up to $11. In such case, rather than collecting $4, or the difference between $13 and $9, the investor collects only $2, or the difference between $13 and $11.

The last two alternatives place the risk of loss due to market

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[28]Pub. L. No. 107-204, § 804(a), 116 Stat. 745, 801 (2002).

[29][Author's note] This section includes all seven of the securities acts from the Securities Act of 1933 to the Securities Protection Act of 1970.

[30]Section 11(e).

fluctuation on the investor. Alternative three forces the investor to sell the securities during suit, if the price rises above the market price at time of suit. Thus, he is required to mitigate his damages.

Alternative two limits his recovery if the market for the security continues to decline. Such decline may force the investor to sell his stock during suit in order to minimize his loss. However, under alternative two, he can not recover this additional loss from the defendant. This arrangement would seem to be a heads you win, tails I lose proposition for the investor.

D. Other Adjustments to Recovery

Two final adjustments may be required to be made to the award as determined above. Section 11(e) gives the defendant the affirmative defense of proving that the damages were not caused by the misrepresentations or omissions. To the extent that he sustains this burden as to all or any part of the damages, an adjustment has to be made. Finally, there is a limitation upon the liability of an underwriter, limiting its exposure under this section to the value of the securities it underwrote.

E. Recovery Elements Not Covered

It is important to note elements which are not included in the Section 11 recovery formula. First, there is no deduction required for any income received as there is under Section 12(a)(2). Second, except as noted below, there are no provisions for the recovery of costs, interest, or attorney fees.

In the federal courts, trial judges have authority to award pre-judgment interest. Normally, a successful plaintiff will be awarded pre-judgment interest from the date of investment to the date of judgment. The amount of pre-judgment interest is normally based upon the statutory post judgment rate.[31] The post-judgment interest statute also provides that the interest will be compounded annually. Normally, the state courts will only award simple pre-judgment and post-judgment.[32]

Attorney's fees are not awarded under the federal securities acts as a matter of right. Section 11(e) does allow recovery of attorneys' fees and costs of a suit when the court finds that the claim or **defense** "to have been without merit." **A plaintiff may be required to post a bond to cover such costs and attorneys' fees.** Obviously, this provision **which applies both the Section 11 and 12**, has an **in torrem** effect on plaintiffs. Fortunately, the courts seldom require the posting of a bond or award for attorneys' fees and costs against investors. The standard for liability under Section 11(e) is similar, but not identical, to that applied by the courts under Rule 11 of the Code of Civil Procedure.

F. Nature of Liability and Right of Contribution

Liability under Section 11 is joint and several as to all defendants,[33] except for outside directors.[34] Contribution as in the case of contracts is allowed.[35]

G. Punitive Damages

Finally, Section 11(g) makes clear that there can be no punitive damages under Section 11. As will be seen below, punitive damages can be awarded in a case where Section 11 claim is combined with a common law or breach of fiduciary claim where punitive damages, generally, may be awarded.

III. Section 12(a)(1) of the Securities Act of 1933

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[31]28 U.S.C. § 1961.

[32]This compounding of interest by the federal courts should be a factor when deciding whether to seek a confirmation of an arbitration award in state or federal court.

[33]Section 11(f)(1).

[34]Section 11(f)(2). Outside directors' liability is to be calculated according to Section 21D(f) of the Exchange Act. 15 U.S.C. § 78uD(f).

[35]Section 11(f)(1). No contribution is allowed if the person seeking contribution is guilty of fraudulent misrepresentation and the other person is not.

Section 12(a)(1)[36] imposes liability for violation of Section 5.[37] Most violations of Section 5 involve the sale of securities without an effective registration.[38] However, violations can also include the failure to deliver a statutory prospectus[39] to the buyer **when the securities are registered.**[40]

A. When Do Violations Occur

It should be noted that Section 5 may be violated at three different times. The first violation will occur when the **offer** of the unregistered security is made. However, the bare offer does not result in liability under Section 12(a)(1) because there is no sale.[41] The investor has suffered no damages at this point and there is nothing to rescind. Section 12(a)(1), however, is couched in terms of "offer" or "sale". As a result, if an unregistered offer is followed by a subsequent sale **after** the securities are registered,[42] the purchaser may sue on the illegal offer **even though the sale was legal**.[43]

A second violation of Section 5 will take place when the **sale** of an unregistered security is made. Obviously, this is the most commonly charged violation. Finally, a third violation of Section 5 will take place when the unregistered securities are **delivered.**[44] This last violation may be important for two reasons. First, persons who only take part in the delivery process and not the sales process will be liable. Thus, additional defendants may be potentially liable. Second, as will be seen below, the statute of limitations runs **separately on each of these violations.**[45] It is not uncommon for **delivery** to take place months **after** the sale.[46] For example, it is very common in the case of the sale of a fractional interest in an oil or gas lease to postpone delivery until after drilling has taken place and the well proved commercially profitable. If the well is not a producer, then assignment of the fractional interest often will not be made.

B. Evidence of Violation

Obviously, in order to recover, the investor must establish a violation of Section 5. A prima facie case here will require two things. First, the investor must establish that

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[36]15 U.S.C. § 77l(a)(1). For many years, until Subsection 12(b) was added, this Section was known as Section 12(1). Many of the older cases refer to it as such.

[37]15 U.S.C. § 77e.

[38]In such cases, normally the major dispute will be (1) over whether the items sold are a securities at all, or (2) whether an exemption from registration, such as Regulation D, is available.

[39]It is not sufficient that the investor be furnished a preliminary or "red herring" prospectus. The final statutory prospectus as written at the time the registration becomes effective must also be delivered.

[40]Section 5 may further be violated by the issuer (the issuer is the only person under the federal act who may file a registration statement), or affiliate thereof, selling securities covered by a registration statement which has been suspended by a stop order issued by the SEC. The stop order, in effect, causes the registration to be suspended. Without the registration, sales of these securities would be illegal unless an exemption was available. Normally, there will be no exemption available for the issuer or any of its affiliates. Secondary trading by persons other than the issuer or the affiliates may resume under the Section 4(1) exemption.

[41]The SEC, of course, can bring an enforcement action based on the bare offer.

[42]This is a practice known as gun jumping.

[43]*Diskin v. Lomasney*, 452 F.2d 871 (2d Cir. 1971).

[44]*Dupler v. Simons*, 163 F. Supp. 535 (D. Wyo. 1958); *Repass v. Rees*, 174 F. Supp. 898 (D. Colo. 1959).

[45]*Folse v. Combined Equities*, 592 F. Supp. 559 (W.D. La. 1984); *Grannemann v. Shipley Energy Corp.*, 1984 WL 205, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,726 (W.D. Okla. 1984).

[46]*Grannemann v. Shipley Energy Corp.*, 1984 WL 205, [1984 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 99,726 (W.D. Okla. 1984).

what he bought was a security. Then he must establish one or more violations of Section 5 as discussed above.

In the case of a registration violation, a prima facie case can be established any one of three ways.[47] The most common way is to present a certificate from the Secretary of the SEC indicating that the records have been searched and no registration for the block of securities in question has been found. The same may also be accomplished by an affidavit or live testimony to the same effect.

Once the investor has established a prima facie case of non-registration, the burden shifts to the defendant to prove that registration is not required. A claim of exemption from registration is an affirmative defense, which the defendant has to allege and prove.[48]

C. Nature of Liability

Liability under Section 12(a)(1) is virtually strict liability. Thus, **it is irrelevant why a person did not register the securities**.[49] The only defense is that the securities did not need to be registered because they were exempt.[50] The violator does not have to know that what he was selling was a security[51] or that it needed to be registered. All that is required is that he sold it and it is not registered or exempt. It follows from this conclusion that advice of counsel[52] or the SEC[53] is **not** a defense to this liability.

D. Who is Liable

Under Sections 12, both subsection 12(a)(1) and (2), liability is imposed only upon the immediate "offerors" and the "sellers" of the securities to the investor. For example, the ABC company sells unregistered securities to Mary Smith. Mary, in turn, re-sells the securities to Charlie Jones. Jones discovers that the securities were unregistered when ABC sold them to Mary. He can not sue ABC because ABC is not his "seller".[54] Mary, however, could sue ABC, even though she no longer owns the securities. Contrast this approach with that found under Section 11. Section 11 allows remote purchasers to sue as long as they can establish that the securities they bought came from the block of securities registered under the defective registration statement. As a result, both Mary and Charlie could sue under Section 11.

The obvious issue under Section 12(a) is to identify "offerors" or "sellers", who are going to be liable. Before discussing this issue directly, several general observations are in order.

First, I want to emphasize that persons who make offers to sell the securities are going to be liable.[55] This is true even though someone else completes the final "sale". Thus, if John and Larry make sales presentations to the investor, but Kent actually closes the sale, John and Larry are liable as "offerors" while Kent is liable as a "seller".

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[47]Often the defendant will not dispute that there has been a violation of Section 5, if the item sold is a security or if he cannot sustain his claim of exemption.

[48]*SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953).

[49]*Gridley v. Sayre & Fisher*, 409 F. Supp. 1266 (D.S.D. 1976).

[50]The exempt securities are outlined in Section 3(a) of the 1933 Act, while exempt transactions are covered by Section 4.

[51]This is either a question of law, *United States v. Austin*, 462 F.2d 724 (10th Cir. 1972), or a mixed question of law and fact. In either case, the seller is expected to know the law.

[52]*Smith v. Manausa*, 385 F. Supp. 443 (E.D.Ky. 1974); Hawes & Sherrard, Reliance on Advice of Counsel as a Defense in Corporate and Securities Cases, 62 Va. L. Rev. 3, 140-142 (1976).

[53]*Heard v. Savage*, 1978 WL 1145, [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,787 (W.D. Okla. 1977); *United States v. Anzelmo*, 319 F. Supp. 119 (E.D. La. 1970).

[54]He could sue Mary because she is his immediate "seller." If she is not an affiliate of ABC, *i.e.* a control person, Mary will escape liability because the sale to Jones is exempt under Section 4(1) as a secondary transaction.

[55]The definition of "offer" or "offer for sale" found in Section 2(a)(3) includes the solicitation of an offer to buy securities. This point is important because it means that the investor's broker-dealer and registered representatives become "offeror" and subsequently "sellers", if the transaction is a solicited transaction.

This illustration leads to the second important point. In most cases, there will be multiple "offerors" and "sellers" each of whom is liable. The investor may sue any or all the "offerors" or "sellers" or he may elect to sue any one. As the liability is joint and several, he may collect the entire judgment from a single individual. Further, the remaining "offerors" or "sellers" are not indispensable parties which must be joined. The defendant selected, however, may implead or file a third-party complaint against other offerors, sellers, or control persons.

This ability to sue one of many potential defendants is particularly important when the investor is bound to arbitrate with one or more of the defendants. He may sue those not subject to an arbitration clause. At the same time, he may file an arbitration against the others.

It is not possible to get all parties in the same forum. The parties who are not subject an arbitration clause can not be forced to arbitrate. They have not agreed to do so. Likewise, the intertwining doctrine can not be used to force all parties into court. The parties with arbitration clauses may not be forced into court even though the claims against them are intertwined with claims against others not subject to arbitration. The right to arbitrate must be respected. The result is an awkward bifurcated process which has potential for severe res judicata problems,[56] if one case is decided before the other.

I now turn to the difficult task of defining "sellers" for purposes of Section 12(a)(1) and (2). For many years, the lower federal courts fought over how broad the term should be. This dispute, at the federal level,[57] came to an end with the Supreme Court decision in *Pinter v. Dahl*.[58]

Pinter first acknowledged that there may be a number of "sellers" in a single transaction. It then confirmed the long standing belief that the person who transfers title is a "seller", even though he does not in any way participate in the selling process. In the case of the initial sale, this "seller" will normally be the issuer.[59] It also confirmed that the **"seller's"** (person who passed title) broker and registered representative[60] were also "sellers" because of their direct involvement in the solicitation of the sale.[61]

Pinter then rejected the broad concept favored by many of the lower federal courts that included all who participated in the sale as "sellers". The lower federal courts used different ways to define participation. Some used the torts concept of "but for". Others said that this was too broad and that the participation has to be a "substantial factor" in bringing the sale about before the participant became a "seller".

Instead of the rejected participation test, *Pinter* developed a two part test to define a "seller". First, the person had to be involved in the solicitation process, not merely a participant. Second, the person had to be motivated to participate in the solicitation, at least in part, by either of two motives: (1) serve the financial interests of himself (i.e. earn a commission or receive a free interest) or (2) serve the financial interest of the person passing title to the securities. A

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[56]Court decisions can be given res judicata or issue perclusion effect in arbitrations. The reverse is also true. Courts will often recognize the binding effect of an arbitration judgment.

[57]The dispute is still very much alive under state securities law because they are not bound by *Pinter v. Dahl*, 486 U.S. 622 (1988). *See* 12A Joseph C. Long, Blue Sky Law §§ 9:9-9:10 (2002)(hereinafter "Long, § .") for the states' reaction to *Pinter*.

[58]486 U.S. 622 (1988). *See* Long, § 9.4 for a detailed discussion of *Pinter*.

[59]A problem here has developed where there is a firm underwriting. In such case, technically, the issuer sells the securities to the underwriter. Then, the underwriter resells them to the public. Clearly, in this situation, the underwriter is the one to pass title to the investor. Even so, most courts have held the issuer to be a "seller."

Contrast this with a best-efforts underwriting. In the case of a best-efforts underwriting, the underwriter acts solely as the agent of the issuer. In such case, title passes from the issuer to the investor, and the issuer is clearly a "seller."

[60]**"Buyer's"** broker-dealer and registered representative in an **unsolicited** transaction **are not "sellers."** However, in the case of a **solicited** transaction, they become "offerors" by the solicitation of an offer to buy. *See* Section 2(a)(3), 15 U.S.C. § 77b(a)(3). If a single broker or registered representative represents both parties, then he or it is always a "seller" because of the representation of the person passing title.

[61]486 U.S. at 628.

person who is in the solicitation process, but who is motivated by seeing that the investor gets a "good deal" is **"not a seller".**

E. Secondary Liable "Sellers"

There is also a secondary or vicarious liability element to the concept of "seller". As will be seen below, Section 15 specifically provides for secondary liability on the part of control persons.[62] However, all the federal courts of appeals to consider the issue have now agreed that "seller" should include those persons who are liable through the application of respondeat superior.[63] A prime example of this type of liability is that of the broker for the violations of its registered representative.[64] Another example is the general partners in a partnership. A partnership is merely a mutual agency with each partner being the principal of the other partners when they act and the agent of the other partners when he acts.

While the lower federal courts were willing to extend the coverage of "sellers" through the use of respondeat superior, they were reluctant to apply the same analysis to co-conspiracy[65] and aiding and abetting. Any hope of using these concepts under Section 12 evaporated with the decision in *Central Bank v. First Interstate Bank,*[66] holding that these concepts could not be used in connection with SEC Rule 10b-(5).

F. Control Person Liability

As in the case of Section 11, Section 15 imposes secondary liability on anyone who is a control person of a person liable under Section 12(a)(1). This liability is joint and several as among the control persons, the person or persons controlled, and all other violators of Section 12(a)(1).

While, at first glance, people liable under Section 15 for violations of Section 12(a)(1) would appear to have the same affirmative defense as control persons have for Section 11 violations. However, the affirmative defense for a Section 12(a)(1) violation is extremely limited. It applies only when the control person "had no knowledge of or reasonable grounds to believe in the existence of the **facts** ...." The fact in the case of a Section 12(a)(1) violation is that something was sold. Whether that something was a security or whether it needed to be registered is a **question of law**.

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[62]Broker-dealers are control persons of their registered representatives, *Hillinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990)(en banc). Branch managers and other supervisory personnel may also be control persons.

[63]*See Hillinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990)(en banc), collecting cases. While all the courts talk in terms of respondeat superior, respondeat superior is not the correct concept here. Respondeat superior is used in connection with physical torts committed by a servant. In non-registration or misrepresentation cases, we are talking about non-physical or white collar torts.

There are two major differences here. First, in the case of white-collar torts, there does not have to be a master servant relationship, *i.e.* the person does not have to have the power to control the physical efforts of the employee. All that is required is that there be a principal and agent relationship. Registered representatives are agents of their broker-dealers, but may or may not be a servant of the broker-dealer.

Second, and most important, in the case of white collar torts, the person committing the tort does not have to be within the scope of his employment. Many broker-dealer respondent superior claim cases are disposed of by the court pointing out that the registered representative who trades away has no subjective intent to serve his master. Therefore, he cannot be within the scope of his employment.

In the case of white collar torts, no intent to serve the master is required. *See* Rest. 2d Agency, §§ 261-262 (1957). All that is required is that the registered representative is doing something similar to what he is employed to do. Selling securities certainly comes within that requirement. The restatement also points out that it is no defense to liability for the broker-dealer to claim that it did not benefit from the transaction.

[64]It should be obvious that parties may be "sellers" or liable for several reasons. A "sellers" broker-dealer will be a "seller" because it is in the direct solicitation process. It is also a "seller," under respondeat superior, for the conduct of its registered representative. Finally, the broker is a control person of its registered representative, liable under Section 15.

[65]Their reluctance in the case of conspiracy seems inconsistent having recognized respondeat superior and partnerships. A conspiracy is nothing more than a partnership formed to violate the law.

[66]511 U.S. 164 (1994). *See* Long, § 9:5 for a discussion of Central Bank.

G. Knowledge of Investor

In the case of a Section 12(a)(1) registration violation, prior knowledge of the investor of the violation is no defense. Thus, the investor can know that the item sold is a security and that it needed to be registered at the time he purchases and still sue to set the transaction aside. While allowing the investor to sue when he knew the transaction was tainted at the time of purchase may seem to be a harsh rule, it is logical for several reasons.

First, the federal government has an interest in the enforcement of the securities laws. If registration could be avoided by the investor knowing the securities were unregistered and the sale was illegal, the registration provisions would be a dead letter. Rather than registering the securities, all issuers would simply specifically inform the investor of the non-registration and its illegality and secure from him a written waiver of compliance. Such waivers would run contrary to the government's interest in protecting investors, even in spite of themselves. To insure that such waivers are not sought, Section 14 specifically makes void "Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of the Act" or the commissions rules and regulations.[67]

Further, as between the purchaser who is entirely innocent and seller who is not, it is better public policy to allow the innocent purchaser to recover. In such case, any windfall, if there is one, should go to the innocent investor rather than to the issuer who has violated the Act. This encourages issuers and sellers to register securities.

Finally, while there is no statutory provision[68] or case law to support it, the consensus is that the seller can avoid further liability to investors still holding their securities by making a rescission offer when it discovers the violation.

H. Statute of Limitations

The first thing to note about the statute of limitations is that the plaintiff must **allege and prove compliance** with it. The normal rule that the statute of limitations is an affirmative defense which the defendant must allege and prove has no application here. The reason for this reversal in the normal roles of the parties is that the statute of limitations here is treated as a statute of repose rather than a true statute of limitation. As a result, after the statutory period has run, the cause of action ceases to exist.

As with Section 11, Section 13 provides the governing statute of limitations. Section 13 contains a one and three year statute of limitations for Section 12(a)(1). However, the period is not calculated in the same way as under Section 11. For Section 12(a)(1), the statutory period is one year after the violation, but in no event more than three years after the securities are "bona fidely" offered to the public.[69]

Under this language, there are two issues which must be addressed. Note that the one year period runs from when the violation takes place. There are two elements to a violation of Section 5. First, there must be a substantive violation. This point has been discussed above.

Second, there must be a use of the "jurisdictional means". Even if there has been a substantive violation of Section 5, that violation is not actionable until some "means or instruments of transportation or communication in interstate commerce **or** the mails"[70] are used. The concept of the jurisdictional means has been stretched to the limit. The use of an airplane or an interstate highway is sufficient even though the trip is not across state lines. Likewise, the making of a local telephone call or the mailing of a letter within the state will be sufficient. The air controller, the interstate highway, and telephone systems are all interstate systems of communication.

Further, the use of the interstate system can come at any point in the transaction from the beginning to the very end. Thus, a local call to set up the original face-to-face presentation session or the final delivery of securities through the mail will suffice as will the seller's

[67]Securities Act of 1933, Section 14, 15 U.S.C. § 77n.

[68]*See* Uniform Securities Act § 410(e). There is no corresponding federal provision.

[69]The language of the Sarbanes-Oxley bill discussed above clearly does not apply to Section 12(a)(1) which covers only registration violations.

[70]Note that the use of the mails does not have to be in interstate commerce. The reason for this omission is that the federal government, by the Constitution, is given a monopoly to carry the mail.

bank sending the investor's check through the mail for collection. Obviously, from these examples, it should be clear that it is virtually impossible not to use the jurisdictional means at some stage during the transaction, even if the actual sale takes place in a face-to-face meeting.

The point here is that the one year portion of the statute of limitations does not start to run until **the last** of the two acts, either the substantive violation and the use of the jurisdictional means, **takes place.**

In the case of the three year provision, Congress did not indicate whether it was the **first or the last** time the securities were "bona fidely" offered to the public. If some con artist, like Glenn Turner, is able to sell his unregistered investment contracts to the public[71] for three years, do all the people who buy after the three years have no cause of action? I think that the better approach is to say that the statute runs three years from the last sale by the issuer. This approach allows for the tolling of the one year statute up to three years after the last sale when the cause of action expires. There are cases, however, taking both positions.

I. Tender of Securities

If the investor still owns the securities which are the basis for the suit at the time suit is filed, he needs to tender return of the securities and any income received thereon to the defendant or defendants.[72] As will be seen below, the reason for this requirement is that the main remedy under Section 12(a) is rescission. The investor gets his investment back, plus interest, and the defendant gets the securities, plus any income paid on them.

Tender does not have to be made until entry of the judgment. However, it is the common practice to include a formal tender provision in the original complaint.

J. No Liability for Non-registration of Securities Professionals

Further, it should be noted that Section 12(a)(1), unlike its counterpart Section 410(a)(1) of the Uniform Securities Act, does **not** provide a cause of action for non-registration of the securities professionals. Unfortunately, there also is no federal counterpart to this part of Section 410(a)(1) elsewhere in either the 1933 or 1934 Acts. As a result, under federal law, the failure of the broker-dealer or agent to register **does not cause civil liability**.[73]

K. Elements of a Section 12(a)(1) Case

In summary, the plaintiff to establish a prima facie case must allege and prove the following:

(1) That a security was sold;
(2) That the defendant is the seller of the security or a control person under Section 15;
(3) That the necessary means of interstate commerce or the mails was used in connection with the transaction;
(4) That there has been a violation of Section 5;
(5) That the statute of limitations contained in Section 13 requiring suit to be brought within one year after discovery of the misrepresentation or omission, but in no event more than three years after the sale, has not run; and (6) That the plaintiff has tendered the return of the securities since again Section 12(a)(1) is limited to a rescissionary remedy, if the plaintiff still owns the securities. Damages may be recovered, if the plaintiff no longer owns the securities.

It should be easy to establish a prima facie case. The plaintiff himself should be able to establish all of the six elements except (4). As noted above, in the case of non-registration, this element can be established by a certificate from the Secretary of the SEC.

L. Elements Which Plaintiffs Do Not Have to Prove

There are four things which defendants often will try to make elements of recovery under Section 12(a)(1) or require the plaintiff to prove. None of the following four are plaintiff's burden:

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[71]Are these sales since they are illegal sales "bona fidely" offered?

[72]Remember that the defendant often will not be the person who passed title to the securities to the investor. This is immaterial. If this defendant satisfies the judgment, he is entitled to the securities and any income thereon.

[73]The NASD and the SEC may take administrative action for such failure. The SEC, further, can obtain a civil injunction against further operation without registration. Finally, the United States Attorney can take criminal action for non-registration.

(1) That the securities are exempt;[74]

(2) That the plaintiff relied upon the non-registration of the securities;[75]
(3) That the plaintiff suffered some injury and that this injury was the result of the non-registration;[76] and
(4) That the failure to register was a result of the "seller's" negligence or fraudulent act.[77]

IV. Section 12(a)(2) of the Securities Act of 1933

Section 12(a)(2) is the main **statutory** provision imposing civil liability for the sale of security through either material misrepresentations or material omissions. All of the elements discussed in the last section dealing with non-registration are the same under Section 12(a)(2) except that instead of establishing a violation of Section 5 to recover, the plaintiff here must establish that a material misrepresentation or omission was made in connection with the offer or sale of the securities.

A. Similarities and Differences Between Section 11 and Section 12(a)(2) Liability

Section 12(a)(2) differs in several substantial ways from Section 11as discussed above. The first major difference is that liability under Section 12(a)(2), like Section 12(a)(1), is limited to "sellers" directly connected to the sale of the securities to the plaintiff. Section 11 has a much wider list of potentially liable defendants. Included in the list of potentially liable defendants are the issuer, all the statutory underwriters, professionals who reports are a part of the prospectus, as well as the directors of the issuer and those persons who sign the registration statement.[78]

Second, Section 11 creates a much larger group of potential claimants. Section 11 does not have the quasi-privity requirement found in Sections 12(a)(1) and (2) where only the person who "buys" the securities from the seller may sue. Instead, under Section 11, the ability to sue runs with the securities covered by the prospectus. As a result, both first purchaser and the twenty-fifth purchaser of a security have a cause of action under Section 11. The only requirement is that the person bringing suit must be able to trace his securities to the block of securities covered by the registration statement.

Third, under certain circumstance, reliance on the material misrepresentations or omissions must be shown under Section 11. As will be seen below, reliance **is never** an element of a Section 12(a)(2) action.

There are also several similarities between Section 11 and 12(a)(2). Under both sections compliance with the statute of limitation is a primary element. It is not an affirmative defense. Likewise, under neither provision does the plaintiff have to prove causation or injury. Instead, the defendant is given an affirmative defense of establishing that part or all of the loss was not caused by the misrepresentation or omission.[79]

Finally, the most important similarity is that both sections **only involve** misrepresentations or omissions in **registered offerings.** The language of Section 11 makes clear that it only applies to registered offerings. However, the language of Section 12(a)(2) does not have such a clear limitation written into the statute. As a result, for many years, Section 12(a)(2) was considered to apply to all transactions. It did not matter whether the transaction involved registered distributions or exempt securities or transactions. Nor was it significant that the transaction was a primary or secondary trade, Section 12(a)(2) applied. The

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[74]*SEC v. Ralston Purina Co.*, 346 U.S. 119 (1953). If the defendant fails to establish by a preponderance of the evidence that he is entitled to an exemption from registration, plaintiff wins. *Henderson v. Haden Stone, Inc.*, 461 F.2d 1069 (5th Cir. 1972); *Upton v. Trinidad pet. Corp.*, 652 F.2d 652 (5th Cir. 1981).

[75]*Pinter v. Dahl*, 486 U.S. 622 (1988).

[76]*Id*. This is based upon the idea that the main remedy is rescission. Obviously, a plaintiff will normally not want to rescind a transaction unless there has been a decline in the value of the security. If the security is selling for more than he paid for it, he will simply sell the security and make a profit.

[77]*Gridley v. Sayre & Fisher*, 409 F. Supp. 1266 (D.S.D. 1976).

[78]*See* §§ 1(a)(1)-(5).

[79]As originally written, there was no affirmative defense in Section 12(a)(2). However, in 1996, Congress added a new subsection (b) to section 12, allowing the defendant to escape liability if he can prove that part or all of the loss was not a result of the material misrepresentation or omission.

Supreme Court, in a very poor and unfortunate decision, *Gustafson v. Alloyd Co.*[80] limited the reach of Section 12(a)(2) to registered offerings.[81]

B. Similarities and Differences Between SEC Rule 10b-(5) and Section 12(a)(2) Liability

There are far more differences between Section 12(a)(2) and SEC Rule 10b-(5) than similarities. While the statute of limitations is an element of proof under Section 12(a)(2), it is an affirmative defense in the case of SEC Rule 10b-(5). Also as a result of the new Sarbanes-Oxley amendment discussed above, it now appears that Section 12(a)(2) continues to have a one and three year statute of limitations under Section 13, while SEC Rule 10b-(5) has a new two and five year statute.

Likewise, reliance, causation, and injury are all elements of recovery under SEC Rule 10b-(5). None of these are elements under Section 12(a)(2). Plaintiff must prove scienter either in the form of a knowing act or reckless disregard under SEC Rule 10b-(5). Under Section 12(a)(2), as will be seen below, the defendant is given an affirmative defense of establishing that he was not negligent in order to avoid liability. Further, as was seen above, Section 12(a)(2) limits recovery to the immediate "sellers". An action under SEC Rule 10b-(5) can be brought against **any person** who violates SEC Rule 10b-(5) in connection with the **purchase**[82] or sale of a security.

Finally, the coverage of SEC Rule 10b-(5) is much greater than Section 12(a)(2). While Section 12(a)(2) covers only material misrepresentations or omissions, SEC Rule 10b-(5) in addition covers schemes to defraud and schemes which would have the effect defrauding.[83]

C. Materiality

In order for a misrepresentation or omission to be actionable under Section 12(a)(2), it must be material. The same standard for materiality is used throughout both the 1933 and 1934 Acts. The test was originally developed in *TSC Industries Inc. v. Northway, Inc.*[84] Altered to use under Section 12(a)(2), this test reads:

> [A misstatement or] omitted fact is material if there is a substantial likelihood that a reasonable [purchaser or seller] would consider it important in deciding [whether or not to purchase or sell].... Put another way, there must a substantial likelihood that the disclosure of the [misstatement or the] omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of the information made available.[85]

Note that under this test, the plaintiff does not have to show that he would not have purchased had this information been disclosed or not misstated, merely that he would have considered it important in making up his mind.

This test is usually an objective one. Would the reasonable investor consider the omission or misstatement material to his decision making process? However, the test takes on a subjective character where the "seller" knows that the buyer considers some information to be particularly material when a reasonable person might not.[86]

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[80]513 U.S. 561 (1995).

[81]The Court seems to say that Section 12(a)(2) would apply to an offering which should have been registered and was not. If this is true, then only exempt securities or transactions would not be subject to Section 12(a)(2).

[82]Neither Section 11 nor Section 12(a)(2) covers misrepresentations or omissions made in connection with the “purchase” of a security. If a person owning securities is conned into selling them by material misrepresentations or omissions, his only remedy is common law.

[83]SEC Rule 10b-(5)(a) and (c) respectively. The difference between these two provisions is one of intent. Schemes to defraud focus on the intent of the person doing the act. Schemes which would have the effect of defrauding focuses upon the effect upon
[84]426 U.S. 438, 449 (1976).

[86]*See generally*, Long, §§ 10:43-10:50.

[85]*Id.*

[86]*See generally*, Long, §§ 10:43-10:50.

D. Omissions and Misrepresentations

Under Section 12(a)(2), all material misrepresentations are actionable. The same **is not true** of material omissions. For a material omission to be actionable, the omission must make some thing which is said misleading. Thus, pure omissions are not actionable. The distinction here is largely academic because if the defendant provides any written documents or makes any oral representations mostly likely something said will be misleading without the information omitted.

The following are examples of material omissions or misstatements:[87]

(1) Failure to provide adequate financial information;
(2) Failure to disclose the payment of commissions or other remuneration, especially finder's fees and fees to plaintiff's agents for putting plaintiff into deal;
(3) In an oil and gas deal, failure to disclose liability on deal (unlimited liability in the case of fractional lease and management contract as a joint venture).
(4) Failure to disclose that the securities sold were not registered under the federal or state statute, if required.[88]
(5) Failure to disclose that promoters have been enjoined or convicted of securities or similar violations.[89]
(6) Failure to disclose or misstate promoter's prior track record.

E. Plaintiff's Knowledge

As was outlined above in the discussion of Section 12(a)(1) involving a Section 5 violation, the plaintiff's knowledge that a violation has taken place is irrelevant to his ability to recover. **Such, however, is not the case under Section 12(a)(2).** The statute specifically says that the plaintiff cannot know the truth about the omission or misstatement **at the time of the sale** and later bring suit. This arrangement makes sense. If the plaintiff knows that he is being lied to because he knows the truth, then he is not misled and he should have no cause of action.

However, it is important to understand the limitations upon this concept. The language of the statute reads: "the purchaser not **knowing** of such untruth or omission." The use of the word knowing means that this is an actual knowledge standard. Constructive knowledge is not sufficient.[90]

The corollary to this actual knowledge requirement is that there is no due diligence duty on the part of the investor and no duty to investigate even when he believes that there may have been a material misrepresentation or omission made. As will be discussed below, the defendant has an affirmative defense that he did not know or in the exercise of reasonable care could not have discovered the truth concerning the misrepresentation or omission. The interplay between the plaintiff's knowledge requirement and the defendant's affirmative defense was discussed *In re Olympia Brewing Co. Sec. Lit.*[91] where the court said:

> [T]he statutory language of § 12[(a)](2) clearly indicates that plaintiff must not have known of the untruth or omission, while putting the burden on defendant to show that it does not know or with reasonable care could not have known of the untruth or omission. This tends to establish that the drafters did not intend to require reasonable inquiry by the purchaser. This conclusion is strengthened by § 13. . .which prescribes the limitations period applicable to § 12[(a)](2). There, plaintiff's claim must be brought within one year after the discovery of the untruth or omission, or after such discovery should have been made through the exercise of "reasonable diligence" by the plaintiff. While due diligence is incorporated in the section prescribing the limitations period, it is absent in the section creating liability.

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[87]Arnold S. Jacobs, Litigation and Practice Under Rule 10b-(5), § 61.04 (2002) has over 100 pages with case citations to things which plaintiffs have **alleged** are either material omissions or misrepresentations.

[88]*Securities Div. V. Harootunian*, [1978-81 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,651 (Mass. Sec. Div. 1981).

[89]*Kirk v. State*, 611 S.W.2d 148 (Tex. Civ. App. 1981)(criminal convictions); *Securities Comm'n v. McGovern*, [1978-81 Transfer Binder] Blue Sky L. Rep. (CCH) ¶ 71,438 (N.D. Dist. Ct. 1978).

[90]*Casella v. Webb*, 883 F.2d 805, 809 (9th Cir. 1989)(constructive knowledge is not a bar to recovery under Section 12(a)(2)); *MidAmerica Fed. Sav. & Loan Assoc. v. Shearson/American Express, Inc.*, 886 F.2d 1249 (10th Cir. 1989)(same).

[91]612 F. Supp. 1367, 1370 (N.D. Ill. 1985).

This distinction becomes very important in the case where oral representations by seller's agent say one thing and the written prospectus indicates another. If the customer does not read the prospectus, then he is not charged with constructive knowledge of the written statements which conflict with the oral representations he received. If he does read the prospectus, he knows that there is a conflict between it and what he was told orally. Obviously, there is a material misrepresentation as a result of the conflicting statements. This the reader knows. However, he **does not** know which statement is misleading. **Further, he has no duty to inquire to establish what the true facts are.**[92] To the contrary, it is the duty of the "seller" to ensure that conflicts either within the prospectus and written sales materials or between the prospectus and oral representations are eliminated.[93]

F. Defendant's Affirmative Defense To Liability

The plaintiff does not have to prove that the misstatement or omission occurred as a result of the defendant's negligence or fraudulent act. Instead, the defendant is given an affirmative defense. He may avoid liability if he can show that he did not or in the exercise of reasonable care could not have found out the untruth or omission. This is an inverse negligence standard. The defendant, in order to avoid liability, has to prove himself free of negligence. A very difficult thing to do.

G. Reliance and Causation

The plaintiff does not have to prove either reliance or causation. Reliance is not an element to recovery because the statute is based upon the concept of deceit. In the case where the plaintiff still owns the securities, he does not have to prove causation because the remedy is rescission. Nor should he have to do so if he sold the securities because the statute has been interpreted to provide for rescissional damages. However, in 1996, the defendant was given an affirmative defense to avoid the full amount of the rescission. He may avoid paying any part of the rescissional damages which he can establish were not attributable to the misrepresentations or omissions made. This new defense may cause problems in those cases where the plaintiff still owns the securities and he paid for the securities with consideration other than cash. Prior to the amendment, the remedy would be to return the non-cash consideration, if the securities seller still owns it, or rescissional damages if not. Now, only rescissional damages may be possible where the defendant has established an entitlement to a causation credit.

H. Control Person Liability

As in the case of Section 11 and Section 12(a)(1), Section 15 imposes secondary liability on anyone who is a control person of a person liable under Section 12(a)(2). Who is a control person for purposes of Section 12(a)(2) will be the same as in the case of Sections 11 and 12(a)(1) discussed above.

As noted above, Section 15 does provide the control persons under Sections 11 and 12(a)(2) with an affirmative defense. The standard here is much the same as given primary violators under Section 12(a)(2). The control person must prove he "had no knowledge of or reasonable grounds to believe in the existence of the **facts** ...." The defense gives a great deal more protection under Section 12(a)(2) than it does under Section 12(a)(1) where most of the issues are questions of law. Still, the defense is an inverse negligence one where the defendant has to prove himself free of negligence. Proving a negative is always difficult, and few control people have succeeded in establishing the defense.

I. Statute of Limitations

As with Sections 11 and 12(a)(1) the statute of limitations governing claims under Section 12(a)(2) is found in Section 13. Again, it is a one and three year statute. However the pattern here is slightly different as in the other two Sections. The one year provision, like under Section 11, runs from the date that the investor knew or should have known of the material omission or misrepresentation. Thus, it is a notice statute, and the

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[92]However, as *In re Olympus Brewing Co.*, 612 F. Supp. 1367, 1370 (N.D.Ill. 1985), quoted above, indicates the investor would be put on inquiry notice so that the statute of limitations under Section 13 would begin to run .

[93]It is not sufficient to put an integration clause in the final sales contract. Such clause does not shield the "seller" from his statutory duty of making sure there are no misrepresentations or omissions.

investor cannot stick his head in the sand. He must investigate once he has notice that a misrepresentation or omission might have taken place.[94]

The three year period begins "after the sale". Determining when a "sale" has taken place has caused problems in this context. Is a sale an instantaneous thing or does it continue over a period of time? When additional capital contributions are expected, is there a single sale which is not complete until the last payment has been received or are there multiple sales made each time a contribution is called for. The federal courts are widely divided on these issues. Authority can be found which supports most of the above outlined possibilities.

J. Elements of Plaintiff's Prima Facie Case Under Section 12(a)(2)

In summary, the elements of a suit under Section 12(a)(2) which the plaintiff must allege and prove are:[95]

(1) That a security was sold;
(2) That the defendant is the seller of the security or a control person under Section 15;
(3) That the necessary means of interstate commerce or the mails was used in connection with the transaction;
(4) That in the course of the sale a material misrepresentation or omission was made either orally or in writing;
(5) That the statute of limitations contained in Section 13 requiring suit to be brought within one year after discovery of the misrepresentation or omission, but in no event more than three years after the sale, has not run; and
(6) That the plaintiff has tendered the return of the securities since again Section 12(a)(2) is limited to a rescissionary remedy, if the plaintiff still owns the securities. Damages may be recovered, if the plaintiff no longer owns the securities.

K. Non-Elements Which Defendants Will Attempt to Insert

Defendants will often try to introduce additional elements which are not a part of recovery under Section 12(a)(2). These additional defenses are:

(1) That the investor has a duty to perform due diligence;[96]
(2) That the investor is guilty of either contributory or comparative negligence;[97] and
(3) That the investor has not mitigated his damages.[98]

It can also be expected that defendants will attempt to raise common law defenses such as waiver, estoppel, ratification, and in para delicto. The federal case law is not well-developed as to the availability of common law defenses in securities act cases.[99] There is limited authority suggesting that at least some common law defense can be used to defeat claims under Section 11 and 12(a)(2).[100]

V. Measure of Recovery Under Section 12(a)(1)

The measure of recovery under Sections 12(a)(1) and (2) are the same except for the new affirmative defense applicable to Section 12(a)(2). That defense will be discussed below. The key to recovery under Section 12 is to understand that it is a rescission

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[94] *In re Olympus Brewing Co.*, 612 F. Supp. 1367 (N.D.Ill. 1986), quoted above.

[95] *See generally, Gridley v. Sayre & Fisher, supra.*

[96] *Casella v. Webb*, 883 F.2d 805 (9th Cir. 1989); *Sanders v. John Nuveen & Co.*, 619 F.2d 1222 (7th Cir. 1980), *Alton Box Co. v. Goldman Sachs & Co.*, 560 F.2d 916, 919 (8th Cir. 1977).

[97] *Comeau v. Rupp*, 1988 WL 93, 977 (D. Kan. 1988).

[98] *Randall v. Loftsgaarden*, 478 U.S. 647 (1986).

[99] *See Pinter v. Dahl*, 486 U.S. 622 (1986) suggesting that in para delicto may have a very limited role under Section 12(a).

[100] *See* Long, §9:29 for a discussion of the use of these common law defenses under state securities laws. Generally, the common law defenses have been rejected for use under the state acts.

section and **not a common law damages provision.** Its basic purpose is to put the investor back in the position he was in before the transaction took place.[101] Further, it is important to understand that the rescission remedy of Section 12 is **mandatory, not optional.** The investor, as a result, cannot file a Section 12 claim and seek common law damages.

A. Remedy Where Securities Still Owned

If the securities are held at the time of judgment, then the investor's remedy is straight rescission. This is the only option. He may **not** seek damages and retain the securities purchased.[102] The investor returns the securities to the person held liable. This person may, or may **not**, be the person who transferred title to the securities to him. A "seller" liable under Section 12 includes the broker-dealer or registered representative of the person actually passing title or any other person involved in the sales process.

In turn, the person held liable must return the consideration paid by the investor to him. Again, the person who is required to pay may not be the person who received the consideration originally.[103] This consideration can be made of several things.[104] Certainly, it includes the money paid at the time of the purchase and any installments that may come due later. Also, in the case of oil and gas offerings, it will also include any equipment and completion costs.[105]

The investor is entitled to interest on this consideration, However, as one would expect in a rescission situation, the investor must return the securities to the person he is holding liable. Further, the investor must return any income that he has received on the security.

In exchange, the "seller" of the security will return the consideration. This rule can be reduced to the following algebraic formula:

Recovery = (consideration paid + interest thereon) - (securities + income received).

This recovery formulation works quite well when both the consideration paid and any income received is cash. It does not work well when property, services, or a legal obligation,[106] rather than cash, are given in consideration for the securities, or where the income received is not paid in cash, but takes the form of transfer of stock, property, services performed, or the entering into a legal obligation. Services obviously cannot be returned. Property may have been sold or changed substantially in value.

In such case, specific rescission is not possible. Instead of a return in kind, the courts assign a monetary value to the property, stock, services, and then apply the formula as outlined above. This practice is known as the award of rescissional damages (as opposed to common law damages).

Normally, the monetary value will be set as of the date of transfer of

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[101]Remember that an illegal **offer** as well as an illegal **sale** violates both Sections 5 and 12(a)(1). The bare offer does not, however, create liability because there is nothing to return in rescission. However, if the illegal offer is followed by a legal sale, then Section 12(a)(1) allows the investor to rescind the **sale** on the basis of the illegal **offer**. Further, it is possible that the illegal sale, while legally complete, is still executory. In this case, the investor may ask the court to forgive his obligation to complete the contract. *Byrnes v. Faulkner, Dawkins, and Sullivan*, 550 F.2d 1303 (2d Cir. 1977).

[102]*Randall v. Loftsgaarden*, 478 U.S. 647, 655 (1986).

[103]For example, it could be the broker-dealer or registered representative who sold the securities or a control person. Likewise, the issuer, in a public offering, usually will not receive the entire selling price. Some of the money will go for costs and underwriting fees. In such case, the issuer still must return the entire purchase price. *Stadia Oil & Uranium Co. v. Wheelis*, 251 F.2d 269 (10th Cir. 1957).

[104]*See generally*, 17 J. William Hicks, Civil Liabilities: Enforcement and Litigation Under the 1933 Act, § 5:57, "Consideration Paid–Identifying Consideration."

[105]*See e.g., Wall v. Wagner*, 125 F. Supp. 854 (D. Nebr. 1954).

[106]In the case of a legal obligation entered into by the investor, the proper remedy may be to cancel the obligation. *Western Federal Corp. v. Davis*, 553 F. Supp. 818 (D. Ariz. 1982). However, if the obligation is owed to a third party, then the court should order the defendant held laible to fulfill the legal obligation. *See Foster v. Financial Technology, Inc.*, 517 F.2d 1068 (9th Cir. 1975).

the property or the rendering of the services. However, if the property given by the investor has increased in value, **due to circumstances other than the purchaser's own efforts**, courts will normally award the investor this increase.

B. Remedy Where Securities Sold

In the alternative, if the securities have been sold, then under Section 12 the statute provides he is entitled to "damages." The Act does not further define these damages. However, from a very early date, the courts have held that damages here should be rescissional damages rather than common law damages. As a result, the amount of recovery is the difference between the price at which the securities were purchased and the price at which the securities were sold.[107]

The same adjustments are then made as outlined above where the securities are still owned. The result expressed as an algebraic formula is:

> Recovery = (consideration paid + interest thereon) - (price at which the securities were sold + income received).

There are several questions which remain to be answered in connection with the "price at which the securities are sold." Does the sale have to be made on the open market? If not, does it have to be, at least, an arms' length transaction? Does the selling price have to bear a reasonable relationship to the existing market price at the time of sale?

One state case, *Garretson v. Red Top-Co, Inc.*,[108] suggests that the court should take the **actual** sales price without regard to any of the above considerations. I think that most courts will not take the actual price when it appears that the price is not a fair one. However, the key is the fairness of the price received and not whether it was an open market or arms' length transaction. Both of these elements tend to show that the price was fair. However, a price may be fair without either of these factors being present. Especially in the case of securities not traded in the over-the-counter market or where there is a thin market with few recent transactions, the investor should be given the benefit of the doubt as to the fairness of the sale price.

Second, the statute does not establish a specific rate of interest. What rate should be used? The tendency of the federal courts is to use the post-judgment interest rate as calculated under the post-judgment interest statute which has general application.[109]

However, such rate may not be appropriate. The professed goal of the securities acts as noted above is to return the investor to the position that he would have been had there been no investment. If this idea is applied to the calculation of interest, the court should select a rate that will provide the investor the amount of income **he could have earned on his investment had he not invested.**[110]

Further, the statute does not indicate whether the interest is to be simple or compound. Most state statutes dealing with post-judgment interest provide for recovery of simple interest. However, the federal statute[111] requires the interest to be compounded annually. Assuming that the federal courts will apply the post-judgment rate as the pre-judgment rate, there is no reason why the compounding feature should not also apply.

Two other issues also need to be addressed. Section 12, unlike Section 11 does not have a point at which the evaluation becomes fixed. Under Section 11, this point is at the time of the filing of the suit. However, Section 11 is not a pure rescissionary statute. In the case

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[107] *Cady v. Murphy*, 113 F.2d 988 (1st Cir. 1940).

[108] 9 Wash. App. 923, 516 P.2d 1039 (1973).

[109] 28 U.S.C. § 1961.

[110] 17 J. William Hicks, Civil Liability: Enforcement and Liability Under the 1933 Act, § 5:59 (2002).

[111] 28 U.S.C. § 1961.

of a pure rescission damages provision such as Section 12 is, it would seem that fixing the amount of rescission at the time of filing of the suit is inappropriate.

Allowing the investor to sell his securities during suit and, thereby, increase the loss which the defendant must pay, may be undesirable. However, the statutory language does not suggest that there is any prohibition against sale at any time before judgment. The Supreme Court, in *Randall v. Loftsgaarden*,[112] indicated that Congress intended to place the risk of market fluctuation squarely upon the defendant. If the court feels that it is inappropriate for the investor to be able to speculate after the suit has been filed, it might require early tender of the securities into the registry of the court or issue an injunction against the investors' sales.[113] These later remedies, however, seem to impinge upon the discretion which Congress intended to give the investor in this area.

The second issue deals with the payment of interest. The first part of Section 12 clearly indicates that the investor is to receive interest on his investment from the date of that investment. Again, the statute does not establish a cut-off point for the payment of interest. Should it be the date of filing or the date that judgment is entered?[114] The public policy of making the investor whole would seem to indicate that the interest runs until judgment.

C. The Section 12(b) Defense to Amount of Damages

There is one notable adjustment which must be made if the defendant is able to sustain his affirmative defense under Section 12(b). Section 12(b) allows the defendant to reduce the amount of the potential recovery under Section 12(a)(2) by the amount that he can show was not caused by the material misrepresentation or omission.

The algebraic formula, adjusted for the affirmative defense, is:

> Recovery = (consideration paid + interest thereon) - (price at which the securities were sold + income received) - (damages defendants establish as not resulting from misrepresentation or omission).

[112]478 U.S. 647 (1986).

[113]*See* 17 J. William Hicks, Civil Liabilities: Enforcement and Litigation Under the 1933 Act, § 5:56 (2002).

[114]Clearly, after judgment, the amount of interest on the entire judgment, including punitive damages, interest, and costs will be controlled by the federal or state post-judgment interest statute, *Mid-America Sav. & Loan Assoc. v. Shearson/American Express, Inc.*, 962 F.2d 1470 (10th Cir. 1992)(Oklahoma Act).

Recent Arbitration Awards

by Ryan Bakhtiari

Richard S. Breiman et al. v. Round Hill Securities, Inc. et al.
NASD Case No. 01-00254

Claimants asserted the following causes of action: breach of fiduciary duty, negligence, negligence per se, negligent misrepresentation, common law fraud, breach of contract, respondeat superior, violations of California Corporations Code Sections 25210 and 25410, violation of NASD Conduct Rule 2310, 2210, 2110, 2120, 3010 and 1031. Claimants requested compensatory damages, interest, lost opportunity damages, punitive damages and costs including attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and requested dismissal of Claimants' claims and the assessment of costs against Claimants.

Respondent Louis J. Bacher, Jr. did not file with the NASD a properly executed Uniform Submission Agreement, however, having answered the claim, appeared and testified at the arbitration hearing, the panel found that Respondent Bacher, Jr. to be bound by the determination of the panel on all issues.

Prior to the hearing the panel granted the motion to dismiss of Respondent Burchard, Jr., denied the motion to dismiss of Respondent Minka and denied Respondent Round Hill's motion to strike certain testimony and exhibits.

1. The panel found Respondents Round Hill and Bacher, Jr. jointly and severally liable and were ordered to pay Claimants compensatory damages of $1,447,298.

2. Respondents Round Hill and Bacher, Jr. are jointly and severally liable and were ordered to pay Claimants interest in the amount of 5% percent per annum, compounded annually on $1,447,298 from September 1, 1999, until the date that the compensatory damages are paid to Claimants.

The award is significant because the Claimants were able to demonstrate that their broker of record, Respondent Bacher, worked and introduced Claimants to a "co-broker" named Lawrence Greenwood. In fact, Mr. Greenwood was not a licensed broker and was a convicted felon. Despite the fact that Mr. Greenwood was not licensed as a broker, Round Hill permitted Mr. Greenwood to work at their Danville office, make investment recommendations and trade the account of Claimants.

Claimants' Counsel - Cary S. Lapidus, Esq. of the Law Offices of Cary S. Lapidus

Respondents' Counsel - Gilbert R. Serota, Esq. of Howard Rice Nemerovsky Canady Falk & Rabkin on behalf of Respondents Round Hill Securities, Inc., Robert J. Holub, Robert S. Minka and Gerald H. Burchard, Jr.; Philip A. McLeod, Esq. of Keesal, Young & Logan on behalf of Respondents Hotovec, Pomeranz & Co., Inc. and Jeffrey Pomeranz; and Michael J. Abbott, Esq. of Jones, Bell, Abbott, Fleming & Fitzgerald on behalf of Respondent Louis J. Bacher, Jr.

Claimants' Expert - Joseph Long
Respondents' Expert - John Maine

Hearing Situs - San Francisco, California

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.

Arbitrators - Dean J. Dietrich, Esq., Public/Chairman; Laurie "Moon" S. Meyer, Public; Carlos Richard Mangum, Industry

Jeston L. and Phyllis M. Fulton v. Morgan Stanley Dean Witter, Inc. A.G. Edwards & Sons, Inc., et al.
NASD Case No. 00-01343

Claimants asserted the following causes of action: breach of fiduciary duty, fraud, negligence, negligent misrepresentation, violation of the Securities and Exchange Act of 1934, Section 10(b) and Rule 10b-5, violation of Arkansas Uniform Securities Act, A.C.A. paragraph 23-42-101 *et seq.* or alternatively the Missouri Securities Act RSMo. section 409.411. Claimants requested compensatory damages, lost opportunity damages, interest, punitive damages, costs and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and alleged the following affirmative defenses: statute of limitations, failure to mitigate, waiver and failure to state a claim. Respondents requested dismissal of Claimants' claims and the expungement of this claim from McWhorter's CRD record, costs and attorneys fees.

Prior to the hearing Claimants advised the NASD that all claims against Respondents Morgan Stanley and McWhorter were dismissed with prejudice.

1. The panel found Respondents A.G. Edwards and Hardie jointly and severally liable and ordered to pay Claimants compensatory damages of $1,070,079 plus interest at the rate of 5 percent per annum accruing from May 1, 1999 until the date of payment of the Award.

2. The panel found Respondents A.G. Edwards and Hardie jointly and severally liable and ordered to pay Claimants $95,000 as partial reimbursement for expenses and $600 as reimbursement for the NASD filing fee.

3. The panel recommended expungement of this claim from McWhorter's CRD record pursuant to NASD Notice to Members 99-09 and 99-54.

4. The panel found Respondents A.G. Edwards and Hardie jointly and severally liable and ordered them to pay $74,250 in forum fees.

The case surrounds the sale of Claimants' sanitation business to U.S. Waste in August 1995, in exchange for publicly traded stock in U.S. Waste which after a merger became Waste Management. When Waste Management executives disclosed accounting discrepancies and other fraudulent activity resulting in the drop in Waste Management stock, Claimants' concentrated position was in an unprotected position. In addition to the size of the award, the award is significant because the damages awarded to Claimants included reimbursement of expenses and the order requiring A.G. Edwards to pay for the 56 hearing sessions totaling $74,250 in forum fees.

Claimants' Counsel - Joseph D. "Chip" Sheppard, III, Esq. of Carnahan, Evans, Cantwell & Brown, P.C.

Respondents' Counsel - Paul D. Allen, Esq. of Morgan Stanley Dean Witter, Inc. and M. Jane Matoesian, Attorney at Law of A.G. Edwards & Sons, Inc.

Claimants' Expert - Charles E. Fath and James French

Respondents' Expert - James E. Brucki, Jr. and Micahel A. Davis

Hearing Situs - Springdale, Arkansas

Arbitrators - Fred M. Acuff, Jr., Esq., Public/Chairman; Edward A. Nelson, Public; B. David Jarashow, Esq., Industry

Douglas T. and Deborah L. Millar v. Merrill Lynch Pierce, Fenner & Smith, Inc.
JAMS Case No. 1410003079

Claimants asserted the following causes of action: breach of contract, negligence, suitability and fraud. Claimants requested compensatory damages, punitive damages, costs and attorneys fees. The case was originally filed with the New York Stock Exchange on June 29, 2001 and then transferred to JAMS.

Prior to the hearing the panel denied Respondents motion for partial summary judgment.

1. The panel found that Respondent Merrill Lynch breached its contractual obligations and duties owed to Claimants in failing to formulate and implement strategies in managing a concentrated position in FreeMarkets, Inc. stock.

2. The panel also found that Respondent Merrill Lynch failed in its duty to develop and adequately explain to Claimants the advantages and disadvantages of their need based solutions for the

holding of a concentrated stock position.

3. The panel further found that the Claimants had instructed Respondent Merrill Lynch to sell a significant portion of their holdings in the FreeMarkets concentrated position when the stock reached a certain level consistent with Claimants stated growth objectives. Respondent Merrill Lynch "is liable for not effecting the requested, and plainly called for, sale of 100,000 shares on September 5, 2000. These breaches damages claimants by depriving them of the extent of monetization of their FreeMarkets stock which would have occurred if Merrill Lynch had properly discharged its duties."

4. The panel also found that "[w]ithin a reasonable time after September 5, 2000, Claimants knew or should have known that no stock was sold that day and had a duty to take reasonable steps to mitigate their damages. However, given Dave Foster's urging to 'stay the course,' Scott Umstead's assurance that Dave was the best Merrill had, the evaluation of Claimants' longtime financial advisor Todd Foster that they were in good shape and should indeed stay the course, and the continuing recommendations of the Merrill Lynch Research Department to buy and accumulate FreeMarkets, Inc. stock the duty to mitigate did not mandate that Claimants sell immediately."

5. The panel determined damages resulting from Respondents failure to sell 100,000 shares of Free Markets, Inc. on September 5, 2000, by taking the difference between the average price September 5, 2000, and the sale in mitigation on December 26, 2000.

6. The panel found that Respondent Merrill Lynch also failed in its duty to identify and explain to Claimants monetization strategies appropriate to Claimants investment objectives and circumstances. The panel found that the covered call strategy recommended by Respondent postponed monetization and was inconsistent with Claimants investment objectives. The panel did not award damages for this breach of duty because Claimant was unable to prove that they sustained any damages for this claim.

7. Respondent Merrill Lynch was ordered to pay $7,741,305 in damages which included interest at the "ten year tax free municipal bond rate on September 5, 2000, increased to account for the fact that Claimants will be required to pay taxes on this award at ordinary income rates." The panel used an interest rate of 7.69 percent.

The award is significant because Merrill Lynch failed to provide the proper advice and counsel to public investors in connection with the management of a concentrated position. The panel found that Merrill Lynch had duties to give proper advice regarding monetization of a concentrated position and to execute Claimants order to sell when the value of the position rose to a level consistent with Claimants' objectives. The panel also rejected the notion that a covered call strategy could be used to monetize the concentrated position. The option contains a written dissent by arbitrator Stanley S. Harris. The award is believed to be the largest award of monetary damages against a major broker dealer in a customer dispute.

Claimants' Counsel - Robert B. Sommer, Esq. and James L. McKenna, Jr., Esq. of Hergenroeder, Rega & Sommer, LLC

Respondent's Counsel - Richard R. Nelson, II, Esq. and Anthony Cillo, Esq. of Cohen & Grigsby, P.C.

Claimants' Expert - Craig McCann, Ph.D, CFA

Respondents' Expert - Unknown

Hearing Situs - Pittsburgh, Pennsylvania

Arbitrators - Curtis E. von Kann, Chairman; Philip S. Cottone; Stanley S. Harris

Ashley Rhoden v. Ameri-First Securities Corporation, et al.
NASD Case No. 01-02707

Claimant asserted the following causes of action: intentional infliction of emotional distress, assault and battery, and sexual harassment against Respondent Bruteyn; unauthorized trading and fraud against the others Respondents. Claimant requested actual damages, damages for mental anguish and pain and suffering, punitive damages.

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

Prior to the hearing Claimant filed a motion to bar respondents' defenses. The arbitration panel ruled that Respondent would be permitted to testify and cross-examine witnesses but were precluded from offering any documents into evidence or call any third party witnesses at the arbitration hearing.

1. The Panel found Respondents Ameri-First Securities Corporation, Reynolds, Bruteyn, and Chatham jointly and severally liable for $236,714 as compensatory damages for breach of contract, breach of industry standards, failure to supervise, violations of state securities laws, violation of the Texas Deceptive Trade Practices Act and fraud. The Panel specifically found that the aforementioned Respondents committed fraud.

2. Respondents Ameri-First Securities Corporation, Reynolds, Bruteyn, and Chatham were found liable for attorneys' fees in the amount of $25,000 pursuant to the Texas Securities Act, the Texas Deceptive Trade Practices Act and for breach of contract.

3. Respondents Ameri-First Securities Corporation, Reynolds, Bruteyn, and Chatham were found liable for witness fees of $3,000 and costs of $750.

4. Respondents Ameri-First Securities Corporation, Reynolds, Bruteyn, and Chatham were found liable for pre judgment interest in the amount of $49,243.

5. Respondent Bruteyn was found individually liable for $85,000 as damages for intentional infliction of emotional distress and assault and battery.

6. Respondents Ameri-First Securities Corporation, Reynolds, Bruteyn, and Chatham were assessed $6,000 in forum fees.

The case is a good example that all customer claims, including claims for mental suffering and battery, must be arbitrated. The award also evidences the fact that arbitrators used their authority to address wrongdoing outside the scope of the purchase and sale of securities. The arbitrators' finding of fraud is significant because Claimant's counsel specifically requested this relief to vitiate the effect of a bankruptcy filing. The case is also important because the panel granted Claimant's motion to bar and precluded Respondents from offering any documentary evidence or calling third party witnesses in their defense. The award is significant in its citation to statutory authority (*i.e.*, the Texas Securities Act and the Texas Deceptive Trade Practices Act) for the award of attorneys fees.

Claimant's Counsel - Tracy Pride Stoneman, Esq. of Tracy Pride Stoneman, P.C.

Respondents' Counsel - none

Claimant's Expert - Douglas J. Schulz of Invest Securities Consulting, Inc.

Respondents' Expert - None

Hearing Situs - Dallas, Texas

Arbitrators - Maxel B. Silverberg, Public/Chairman; Donald C. Hood, Public; Todd R. Gough, Industry

***Secured Equity Title, et al. v. Monroe Parker Securities, Inc. et al.* NASD Case No. 98-03337**

Claimant asserted the following causes of action: breach of fiduciary duty, churning, misrepresentations and unsuitability in relation to transactions in common stocks. Claimant requested compensatory damages, interest, punitive damages, costs and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and alleged the following affirmative defenses: failure to state a claim, assumption of risk, laches, waiver, estoppel, ratification, contributory negligence, lack of fiduciary duty, failure to mitigate and unclean hands. Respondents requested dismissal of Claimant's claims and the assessment of attorneys fees and costs against Claimant.

The following Respondents were dismissed prior to the arbitration hearing because of bankruptcy filings, settlements or because they could not be located: Duke & Co., Inc., David Reimer, Jon DeMichiel, Lawrence A. Rosenberg, Charles Bennett, Julia A. Mold-Torres, George Constanzo, William Rothholz, March K. Swickle, Gregg Adam Thaler, Thomas Michael Rensvold, Salvatore Saporito.

Prior to the hearing the panel determined "that it had jurisdiction over J.B.O. Holdings pursuant to the contract between Claimant and J.B. Oxford, an affiliate of J.B.O. Holdings."

Prior to the hearing the panel ordered Respondent Felix Oeri to produce documents, which were previously ordered to be produced and sanctioned Respondent Oeri $5,000 per day for each day that the documents and information were not produced to Claimant. This sanction was issued and began to run on September 1, 2001.

1. The panel found Respondents J.B. Oxford & Co., Felix Oeri, E.B.C. Trust Corp., Bryan Herman and Alan Lipsky jointly and severally liable and were ordered to pay Claimant compensatory damages of $2,000,000.

2. The panel found Respondents

Felix Oeri, E.B.C. Trust Corp., Bryan Herman and Alan Lipsky jointly and severally liable and were ordered to pay Claimant punitive damages of $4,000,000.

3. The panel found Respondents J.B. Oxford & Co., Felix Oeri, E.B.C. Trust Corp., Bryan Herman and Alan Lipsky jointly and severally liable and were ordered to pay Claimant $250 for Claimant's filing fee.

4. The panel found Respondent Felix Oeri liable and ordered him to pay Claimant $1,300,000 as a sanction for "failing to permit discovery as ordered."

5. The panel awarded Claimant interest at the rate of 10 percent from the date of the award until the award is paid. The forum fees were assessed to Respondents J.B. Oxford & Co., Felix Oeri, EBC Trust Co., Bryan Herman and Alan Lipsky jointly and severally for $20,100 and to Respondent Monroe Parker Securities, Inc. for $7,600.

The award is significant because the compensatory and punitive damages totaled $6,000,000. The award is also important because of the monetary sanctions issue against Respondent Oeri, first for $5,000 per day, for each day that documents and information were withheld from Claimant and also for the award of $1,300,000 at the conclusion of the case. The amount of sanctions awarded is likely attributable to the commencement of the sanction on September 1, 2001, and the failure to produce documents and information for an extended period of time.

Claimants' Counsel - Joseph J. Dehner, Esq. of Frost & Jacobs LLP

Respondents' Counsel - Ernest Edward Badway, Esq. of Saiber, Schlesinger, Satz & Goldstein on behalf of John Patrick Clancy and David Michael Levy; Cynthia M. Schleindl, Esq. of Miller, Milove & Kob on behalf of J.B. Oxford & Co., William Rothholz of Duke & Co., Inc. on behalf of Duke & Co., Inc.; Eugene Ingoglia, Esq. of Swindler Berlin Shereff Friedman on behalf of David William Reimer and Jon Joseph DeMichiel; Michael D. Brofman, Esq. of Certilman Balin Adler & Hyman, LLP on behalf of Charles Thorton Bennett and Gregg Adam Thaler; Thomas C. Green, Esq. of Sidley Austin Brown & Wood, LLP on behalf of Felix Oeri; Thomas T. Prousalis, Jr., Esq. of Law Offices of Thomas Prousalis, PLLC on behalf of Richard MacLellan and E.B.C. Trust Corp.; Ari H. Jaffe, Esq of Kohrman, Jackson & Krantz, PLL on behalf of J.B. Oxford Holdings, Inc.; Richard W. Levitt, Esq. of the Law Offices of Richard W. Levitt on behalf of Alan Scott Lipsky; Scott L. Silver, Esq. of Gusrae, Kaplan & Bruno on behalf of Bryan Herman; David Gordon, Esq. of the Law Offices of David Gordon on behalf of Ralph Joseph Angeline.

Respondents Monroe Parker Securities, Inc., Richard Stephen Levitov, Lawrence Allan Rosenberg, Julia Antigone Mold-torres, George Anthony Constanzo, Jr., William Joseph Rothholz, Victor Ming Wang, Marc Kevin Swickle, Salvatore Saporito, Walter Senior and Thomas Michael Rensvold were *pro se.*

Claimants' Expert - None

Respondents' Expert - None

Hearing Situs - Cincinnati, Ohio

Arbitrators - Benjamin B. Segal, Esq., Public/Chairman; Michael Paolucci, Public; Jerome A. Stricker, Industry

William H. Shoemaker, et al. v. JW Genesis Finacial Services, Inc., et al.
NASD Case No. 00-04082

Claimants asserted the following causes of action: breach of contract, negligence, fraud, unsuitability, failure to supervise, breach of fiduciary duty, churning, omissions, misrepresentations, unauthorized trading, excessive markups, violation of NASD rules, violations of sections 9 and 10 and Rule 10b-5 of the 1934 Securities Exchange Act, violation of the 1933 Securities Act, violation of the Texas Securities Act, and Violation of the Texas Deceptive Trade Practices Act. Claimants requested compensatory damages, recission, lost opportunity damages, interest, punitive damages, costs and attorneys fees.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and alleged the following affirmative defenses: failure to state a claim, damages caused were not attributable to certain Respondents, damages were caused by market conditions, statute of limitations, estoppel, waiver and ratification. Respondents requested dismissal of Claimants' claims, costs and attorneys fees.

Prior to the hearing Claimants settled their claims with Respondents Avidon, Beyer, Feldman, O'Callaghan, Elkes and Dalton Kent. At the hearing Claimants orally requested sanctions against Respondent JW

Genesis for noncompliance with discovery.

1. The panel found Respondents JW Genesis n/k/a First Union Securities liable to Claimants for $375,000 in compensatory damages, less a settlement credit of $275,000 from the pre-arbitration settlement. The panel ordered JW Genesis n/k/a First Union Securities to pay $100,000 to Claimants as compensatory damages.

2. The panel ordered JW Genesis n/k/a First Union Securities to pay Claimants interest at the rate of 10 percent on the award of $100,000 from the date of service of the award until the award is paid.

3. The panel found Respondents JW Genesis n/k/a First Union Securities liable to Claimants for $80,000 in attorneys fees.

4. The panel granted Claimants motion for discovery sanctions and ordered Respondents JW Genesis n/k/a First Union Securities to pay Claimants $25,000.

The award is significant in that Claimants suffered no out-of-pocket losses while their account was at JW Genesis. The principal issue was JW Genesis' liability for damages suffered due to the continuing fraud of the brokers after they left JW Genesis to start their own (now insolvent) broker dealer. Respondents' counsel employed the unique tactic of arguing that Claimant William Shoemaker, who suffers from Alzheimer's, was competent to be cross-examined. The award is also significant because the panel award $80,000 in attorneys fees and sanctioned Respondent JW Genesis $25,000 for non-compliance with discovery.

Claimants' Counsel - John O'Neill, Esq. and Regan D. Pratt, Esq. of Clements, O'Neill, Pierce, Nickens & Wilson, LLP

Respondents' Counsel - Michael J. Stanley, Esq. of Beirne, Maynard & Parsons, LLP on behalf of JW Genesis, Andrew J. Lewander, Esq. and David S. Hoffner, Esq. of Swidler Berlin Shereff Friedman, LLP on behalf of David L. Avidon, Glenn I Beyer, Justyn S. Feldman, Hugh O'Callaghan, Alan L Elkes, David Mugrabi and Dalton Kent Securities Group, Inc.

Claimants' Expert - Andy Via, Max Moudy, Dr. James Claghorn, M.D. (psychiatrist)

Respondents' Expert - None

Hearing Situs - Houston, Texas

Arbitrators - R. Lee Britton, Jr., Esq., Public/Chairman; Henry R. Barracano, Public; Mark C. Watler, J.D., Industry

Cases & Materials

by Charles W. Austin, Jr.

Charles W. (Chuck) Austin, Jr., Richmond, Virginia, 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.

COURT DECISIONS

FEDERAL COURTS

First Circuit

In re Atlantic Pipe Corporation,
No. 02-1339
(1st Cir. Sept. 18, 2002)

Lengthy discussion of the powers of federal courts to order parties to non-binding mediation.

Second Circuit

DeKwiatkowski v. Bear Stearns & Co., Inc.,
No.01-7112
(2d Cir. Sept. 19, 2002)

A virtual hornbook of the law (or, at least the Second Circuit's version of it) of the responsibilities of brokers in discretionary vs. non-discretionary accounts. Reversal of large jury verdict on the grounds of insufficient evidence supported a finding that a broker undertook any role triggering a duty to volunteer advice and warnings between transactions to a nondiscretionary customer, or that the broker was negligent in performing those services it did provide.

Caiola v. Citibank, N.A.,
No. 01-7545
(2d Cir. June 27, 2002)

Cash-settled over-the-counter options are "securities" under the Securities Exchange Act of 1934.

Coleman & Company Securities v. Giaquinto Family Trust,
No. 00 Civ 1632,
2002 U.S. Dist. LEXIS 18426
(S.D.N.Y. Sept. 27, 2002)

Respondent investors filed an arbitration claim against petitioners, a securities broker-dealer and others, asserting, inter alia, fraud, negligence, breach of contract, and securities violations. The state court imposed a temporary stay of arbitration. The broker-dealer removed the case to federal district court and moved for summary judgment. Intervenor-petitioner, a part owner of BD, moved to permanently stay all claims against him.

The negligence claims accrued on the dates of the various transactions, rather than the date that the investment adviser left the broker-dealer. Moreover, the negligent supervision claim accrued on the date the investment adviser left the broker-dealer's employ. Whether the claims under the New Jersey Uniform Securities Law accrued on the transactions date or when the investment advice was rendered, they were barred as those dates were more than two years before the claims were filed. The discovery rule and equitable tolling did not apply as the investors should have known of the alleged misconduct well before they filed the arbitration action. Specifically, the investors knew that they were investing in non-public companies and that the companies remained non-public, contrary to the investment adviser's promises, long before they filed their claims. The investors also knew that the investments were illiquid and risky.

Finally, the investment adviser's attempts to conceal the fraud were unsuccessful because even if the portfolio appraisals were misleading, the investors knew that the investments were risky and illiquid. The claims against the part owner were permanently stayed.

The motions for summary judgment were granted. The part owner's motion to permanently stay the arbitration proceedings against him was granted.

Kruse v. Sands Brothers & Co. and Peter Pak,
02 CV 5912,
2002 U.S. Dist. LEXIS 18767
(S.D.N.Y. October 3, 2002)

Respondents "Counter-Petition to Vacate" did not constitute a proper motion to vacate an arbitration award under 9 U.S.C. §10, and because the three month time limit to file a proper motion to vacate had elapsed, the "counter-petition to vacate" was denied. "A party cannot initiate a challenge to an arbitration award by filing a complaint or an application."

Hardy v. Walsh Manning Securities & Skelly,
No. 02 Civ. 1522,
2002 U.S. Dist. LEXIS 16589
(S.D.N.Y. September 4, 2002)

NASD had jurisdiction over the firm and its CEO on the basis of their agreements with NASD and even though the firm had withdrawn from membership and CEO was no longer associated with member firm. Firm and CEO had waived any objection to arbitration by failing to timely object to the arbitrator's jurisdiction. The arbitration panel did not improperly rely on *respondeat superior* principles to hold the firm liable as the account manager was the firm's employee and the mere fact that he violated the firm's published policies did not insulate the firm from liability.

Raiola v. Union Bank of Switzerland,
No. 98 Civ. 5031,
2002 U.S. Dist. LEXIS 12541
(S.D.N.Y. July 9, 2002)

Discussion of evidentiary standards in arb ("need only hear evidence that is material and relevant and courts can interfere with evidentiary decisions only if they deprived party of fundamentally fair arbitration process") and standards in 2nd Circuit for disqualifying counsel.

Third Circuit

In re: NAHC Securities Litigation,
No. 01-4132
(3d Cir. October 2, 2002)

Third Circuit has its first opportunity to decide whether the statute of limitations under a 10b and 10b-5 claim is triggered by "inquiry notice" or "actual notice" and decides that "inquiry notice" is the proper point in time from which the statute of limitations should run.

Perry v. Markman Capital Management & London, 2002 U.S. Dist. LEXIS 19103
(E.D. Pa. October 4, 2002)

Court found that, although it had *in personam* jurisdiction over investment advisory firm under Pennsylvania's long-arm statute, "corporate shield doctrine" prevented Court from exercising *in personam* jurisdiction over individual broker defendant. Arbitration agreement between Charles Schwab and plaintiffs did not inure to benefit of investment advisory firm.

Signator Investors v. Olick,
Civil Action No.96-4460, 2002 U.S. Dist. LEXIS 15766 (E.D. Pa. August 23, 2002)

Member firm could not be obligated to arbitrate malicious prosecution claim brought by former registered rep arising out of counterclaim filed by member firm against registered rep in arbitration several years earlier. Court held that claim not within the purview of CAP Rule 10101 because registered rep was not seeking to arbitrate as an investor or employee, but rather as an allegedly wronged litigant.

West v. Zurich American Co.,
No.02-CV-546
(E.D. Pa. June 26, 2002)

When a Pennsylvania state court compels arbitration and one of the parties later returns to the same court seeking modification of the arbitration award, the second party cannot then remove the dispute to federal court, since the petition to modify does not qualify as an "initial pleading" under the federal removal statute.

Fifth Circuit

Gulf Guaranty Life Ins. v. Connecticut Gen. Life Ins.,
No. 01-60582
(5th Cir. August 30, 2002)

Under the FAA, jurisdiction by the courts to intervene into the arbitral process prior to issuance of an award is very limited. Courts are limited to determinations regarding whether a valid agreement to arbitrate exists and the scope and enforcement of the agreement, including the arbitrability of given underlying disputes under the agreement. The FAA does not provide for any court intervention prior to issuance of an arbitration

award beyond the determination as to whether an agreement to arbitrate exists and enforcement of that agreement by compelled arbitration of claims that fall within the scope of the agreement even after the court determines some default has occurred. Challenges to the procedural aspects of arbitration are for the arbitrator to decide, while challenges to the substantive arbitrability of disputes are for the courts to decide.

Gandy v. Gandy,
No. 02-50185
(5th Cir. July 22, 2002)

Bankruptcy court has discretion to ignore FAA and refuse to compel to arbitration "core proceedings."

Westmoreland v. Sadoux, No. 01-20793
(5th Cir. July 18, 2002)

Vacatur of district court order compelling arbitration with non-signatory to arbitration agreement. Fifth Circuit joins 1st and 9th circuits in ruling that mere agency is not enough to invoke an arbitration agreement to which the agent is not a party. "There are two circumstances under which a nonsignatory can compel arbitration. First, when the signatory to a written agreement containing an arbitration clause must rely on the terms of the written agreement in asserting its claims against the nonsignatory. Second, when the signatory to the contract containing a arbitration clause raises allegations of substantially interdependent and concerted misconduct by both the nonsignatory and one or more of the signatories to the contract." Good - if brief - discussion of the differences among the circuits as to when a non-signatory agent can invoke arbitration agreement.

Investment Partners, L.P. v. Glamour Shots Licensing, Inc.,
No. 01-60651
(5th Cir. July 15, 2002)

Prohibition against punitive damages in arbitration agreement does not operate to prohibit award of statutory treble damages under anti-trust laws. As such, punitive damages prohibition does not render arbitration agreement void as against public policy.

Downer v. Siegel, *et al*,
Civ. Action No. 02-1706,
2002 U.S. Dist. LEXIS 17752 (E.D. La. Sept. 19, 2002)

When the contract in question is within the coverage of the Federal Arbitration Act, if the claim is fraud in the inducement of the arbitration clause itself--an issue which goes to the making of the agreement to arbitrate--the federal court may proceed to adjudicate it, but the federal court cannot consider claims of fraud in the inducement of the contract itself. Court also held that §3 of the Federal Arbitration Act does not require that an agreement be signed in order to enforce an arbitration agreement contained within it.

Sixth Circuit

Fazio, *et al* v. Lehman Bros., *et al*,
2002 U.S. Dist. 15174
(N.D. Ohio July 19, 2002)

Firms' motions to compel arbitration of investors' claims relating to theft by broker were denied as there was no enforceable contract where there was no meeting of the minds under account agreements; broker intended to steal money, not invest it.

Robert J. French, *et al* v. First Union Securities
Case No. 3:02-0140,
2002 U.S. Dist. LEXIS 14059 (M.D. Tenn. June 24, 2002)

Putative class action involved failure of BD (First Union) to disclose to customers broker's
shady background and customers' claims that they wouldn't have conducted business with broker (and hence sustained their losses) had they known. Lengthy opinion discusses (1) whether claims were "in connection with purchase or sale of a covered security" such that they were preempted by SLUSA; (2) Whether a broker not acting in a discretionary capacity nonetheless had a fiduciary duty to clients; (3) Whether public availability of info about broker through CRD preempted common law duty to disclose the negative information, whether on CRD or not; and, (4) Whether NASD CAP Rule 10301 barred compulsory arbitration of all claims brought in putative class action or just class claims (In a case of first impression, the Court -by its own admission - somewhat sidestepped this issue. First, it dismissed the class claims for failure to adequately plead damages. It then proceeded to interpret the CAP Rule as allowing compulsory arb of "non-class claims," because the putative class action in which they had been raised had been dismissed. Theory behind this was, to rule otherwise would allow abuse and circumvention of CAP Rule by appending non-class claims to otherwise specious class action).

Seventh Circuit

Nissan North America v. Jim M'Lady Oldsmobile, Inc.,
No. 01-2993
(7th Cir. October 3, 2002)

Non securities case. Seventh Circuit decides district court erred in compelling arbitration because the only contract in the record that contains an arbitration clause, the dealer agreement, expired by its own terms before petitioner filed for arbitration. Vacated and remanded.

Jack Green, *et al* v. Nuveen Advisory Corp.,
No. 01-3671
(7th Cir. July 8, 2002)

Interesting discussion of the fiduciary duty of advisers under the Investment Company Act and the use of leverage in closed-end funds.

Tarrson v. BLC Partners, LP, *et al*
No. 01 C 7761,
2002 U.S. Dist. LEXIS 17880 (N.D. Ill. Sept. 18, 2002)

Because Defendants specifically moved to arbitrate before NASD in New York under terms of customer agreement, Court denied motion - without prejudice - on the grounds that, where an arbitration agreement contains a forum selection clause, only the district court in that forum can issue a §4 order compelling arbitration.

In re: Thomas D. Hiles,
No. 02-81018,
2002 Bankr. LEXIS 912
(C.D. Ill. August 15, 2002)

State court actions against securities dealers whose liability is derivative of individual debtor-broker not enjoined by automatic stay provisions of bankruptcy code. Additionally, state law claims against debtor-broker with respect to which a determination of his liability is a prerequisite to recovery from non-debtor codefendants are not stayed, even though ultimate dischargeability of any finding of the broker's liability must be determined by bankruptcy court and even though allowing state court proceedings to go forward may set debtor-broker up for a *collateral estoppel* argument in a subsequent non-dischargeability proceeding in bankruptcy court.

Wilhelm v. A.G. Edwards & Sons,
No. 02 C 31
(N.D. Ill. June 21, 2002)

Suit brought on behalf of estate. Decedent and her son opened a joint trading account with the securities broker at a time when decedent was mentally incompetent, and deposited stocking having substantial value into the account. The son, with the broker's acquiescence, proceeded to loot the account. The customer agreement among the decedent, the son, and the broker, was silent on the issue of who would decide arbitrability. Thus, the parties did not agree to have the arbitrator decide which issues were arbitrable, and the issue of whether the parties' disputes were arbitrable was properly before the court. The court found that, because the dispute over the decedent's capacity to contract directly related to the making of the agreement to arbitrate, it was for the court to resolve. The executor contended that his claims were under common law, so that under the applicable statute of limitations, as tolled by the decedent's disability, suit was timely. The broker argued, and the court agreed, that the Illinois Securities Law governed the executor's claims, which were based on fraud, and that under its statute of limitations that did not allow for tolling, the suit was time-barred.

Eighth Circuit

Smart v. Sunshine Potato Flakes, L.L.C.,
No. 01-3132
(8th Cir. 10/07/2002)

Plaintiff appeals confirmation of arbitration award. Whether the doctrine of election of remedies bars defendant from bringing its motion to confirm in the district court after unsuccessfully attempting to remove plaintiff`s state court action to the federal court in New Mexico. Whether the doctrines of preclusion, estoppel, or election of remedies bar a party from sequentially pursuing alternative venues that may be available. Affirmed.

Washington Square Securities v. Sowers,
No.02-CV-976,
2002 U.S. Dist. LEXIS 15957 (D. Minn. August 12, 2002)

Selling away case. Court decides victims are "customers" and broker's activities - when alleged in connection with firm's failure to supervise - involves member firm's business for the purposes of determining member firm's obligation to arbitrate under NASD CAP. "[The BD] seems to be asking the Court to impose a very high degree of control on the investors, when it seems far more reasonable to place the burden of controlling stockbrokers upon the brokerage firm with which they are affiliated. It is, typically, the

brokerage firm's duty to exercise supervision over registered representatives."

Broughton, *et al* v. Hold Brothers On-Line Investment Services,
Civil No.01-1128,
2002 U.S. Dist. LEXIS 15061 (D. Minn. August 12, 2002)

Individual required to arbitrate breach of contract claim against member firm by virtue of signing U-4, even though individual failed licensing exam and member firm was not signatory to U-4.

Ninth Circuit

Stone & Webster, Inc. v. Baker Process, Inc.,
210 F.Supp.2d 1177
(S.D. Cal. 2002)

Parties may contract around the FAA via a choice-of-law clause. That is, parties to an arbitration agreement subject to the FAA, may - through a choice-of-law clause - choose to be bound by state rules of arbitration instead of the FAA. While the FAA pre-empts application of state laws which render arbitration agreements unenforceable, it does not follow, however, that the federal law has preclusive effect in a case where the parties have chosen in their arbitration agreement to abide by state rules. To the contrary, because the thrust of the federal law is that arbitration is strictly a matter of contract, the parties to an arbitration agreement should be at liberty to choose the terms under which they will arbitrate. Where parties have chosen in their agreement to abide by the state rules of arbitration, application of the FAA to prevent enforcement of those rules would actually be inimical to the policies underlying state and federal arbitration law, because it would force the parties to arbitrate in a manner contrary to their agreement.

Brookstreet Securities v. Bristol Air, Inc., *et al*
No. C 02-0863,
2002 U.S. Dist. LEXIS 16784 (N.D. Cal. August 5, 2002)

Complaint to enjoin NASD arbitration proceedings filed by a number of investors arising out of losses in accounts at Brookstreet maintained by an individual not associated with Brookstreet who had swindled investors and deposited money in Brookstreet account. Detailed discussion of BD's obligation to arbitrate disputes - including the issue of arbitrability - in the absence of any agreement between the parties and entirely on the basis of BD's NASD member status. What constitutes a "customer" for the purposes of the NASD CAP?

Tenth Circuit

Dumais v. American Golf, No. 01-2224
(10th Cir. August 15, 2002)

Court joins other circuits in holding that an arbitration agreement allowing one party the unfettered right to alter the arbitration agreement's existence or its scope is illusory.

In re: Primeline Securities Corp.,
No. 00-3214
(10th Cir. July 03, 2002)

Liquidation proceeding of a failed broker-dealer. Claimants are not entitled to SIPA customer status with respect to funds sought to invest in a pooled investment scheme or other unidentified investment vehicle, but are entitled to such status for funds sought to invest in debentures.

Eleventh Circuit

SEC v. ETS Payphones,
No. 01-10107
(11th Cir. August 6, 2002)

Court decides that payphone leaseback scheme did not constitute securities because SEC could not show that investors "expected profits to be derived solely through the efforts of others" as required under the *Howey* investment contract analysis.

Terrell v. Amsouth Investment Services,
Case No: 8:02-cv-925
2002 U.S. Dist. 12489
(M.D. Fla. July 3, 2002)

Terminated broker not required to arbitrate his claim under Florida Whistleblower's Act. This conflicts with Florida state court decision issued in another case earlier this year (*Prudential Securities, Inc. v. Katz*, 807 So.2d 173 - *see* Summer 2002 *PIABA Bar Journal*)

STATE COURTS

Arizona

Hallmark Industries, L.L.C. v. First Systech International,
52 P.3d 812
(Ariz.App.Div.2 9/05/2002)

Good discussion of the "intertwining doctrine" to avoid arbitration.

California

Frederick v. First Union Securities, Inc.,
100 Cal.App.4th 694,
122 Cal.Rptr.2d 774 (Cal.App. Dist.2 7/29/2002)

Plaintiff's shareholder derivative suit compelled to arbitration where there was a "broad arbitration agreement" between corporation on whose behalf plaintiff brought derivative suit and broker-dealer defendant who was market maker in corporation's securities.

Galoostian v. Dupone,
No. B155065
(Cal.App. Dist.2 7/25/2002)
UNPUBLISHED

Registered rep of Merrill Lynch, who was not a signatory to arbitration agreement between Merrill and customers, was nonetheless entitled to benefit of arbitration agreement because complaint alleged that registered rep was acting as Merrill's agent.

Colorado

Joseph v. Viatica Management, LLC,
No. 01CA1398
(Colo.App. 08/01/2002)

Colorado Court of Appeals holds that viaticals in question constituted "securities" for the purposes of the Colorado securities laws.

Florida

Brown v. McCutchen,
819 So.2d 977
(Fla.App.Dist.4 6/26/2002)

Court refuses to enjoin arbitration brought against member-firm which executed trades placed by Claimants' investment advisor.

Georgia

Progressive Data Systems, *et al* v. Jefferson Randolph Corp., *et al*
No. S01G1765
(Ga. 07/15/2002)

"Manifest disregard of the law" is not a legitimate basis under Georgia arbitration law to vacate an arbitration award.

Illinois

A.G. Edwards, Inc. v. Secretary of State, Department of Securities of the State of Illinois,
331 Ill.App.3d 1101,
772 N.E.2d 362
(Ill.App. 06/27/2002)

Appellate court affirms trial court's ruling quashing a subpoena *duces tecum* issued by Illinois securities regulators for personal bank account records of 3 brokers in AGE's Waterloo, Illinois office after a routine audit on the grounds that the subpoena was an unconstitutional invasion of privacy which exceeded the regulators' powers under the Illinois securities laws, and the subpoena was not sufficiently related to the audit.

Minnesota

Benson-Moosbrugger v. Day, No. C3-02-34 (Minn.App. 07/16/2002)
UNPUBLISHED

Good discussion of what constitutes a "security," a "securities purchase" and a "securities sale" for the purposes of the Minnesota Securities Act.

Missouri

Shervin v. Huntleigh Securities Corporation,
No. ED80271
(Mo.App. E.D. 9/17/2002)

Husband, customer of BD, instructs BD to transfer assets out of account which BD knows customer's ex-wife has an interest in due to court order entered in divorce proceedings. BD fulfills customer's transfer request without informing wife. Wife - not a customer of BD - sues for breach of fiduciary duty and negligence. Court held that, even though wife not customer of BD, BD had fiduciary duty to wife and transfer constituted a breach of that duty.

Ohio

Perrysburg v. City of Rossford,
2002 -Ohio- 5498
(Ohio App.Dist.6 10/11/2002)

Discussion of what constitutes a "security" for the purposes of the Ohio Securities Act.

Glick v. Sokol,
No. 01AP-1224
(Ohio App.Dist.10 9/10/2002)

Ohio Court of Appeals rules that viaticals sold to plaintiff-appellee prior to amendment of Ohio Securities Act to include viaticals as covered securities were not securities, even though the Ohio Division of Securities had earlier issued a ruling declaring the viaticals sold to plaintiff-appellee to be securities.

South Carolina

Bazzle v. Green Tree Financial Corp.,
No. 25523
(S.C. 08/26/2002)

Where arbitration agreement is silent of the allowance of class-wide arbitration, South Carolina Supreme Court adopts "California" approach and determines class-wide arbitration is allowable under §4 of the FAA. Good discussion of the views different courts take on this issue.

Stokes v. Metropolitan Life Insurance Company,
No. 3551
(S.C. App. 09/23/2002)

Terminated registered rep filed claim against employer for breach of contract, trespass and conversion. Met Life moved to compel all claims to arbitration based on RR's U-4. Trial court compelled breach of contract to arbitration, but refused to compel trespass and conversion claims to arbitration and compelled Met Life to proceed with discovery in the court proceeding. South Carolina Supreme Court reversed the trial court, holding that trespass and conversion claims arose out of the termination of RR's employment and thus, must be arbitrated.

South Dakota

Nature's 10 Jewelers v. Gunderson,
2002 S.D. 80, 648 N.W.2d 804,
(S.D. 07/10/2002)

Where arbitration agreement was executed months after franchisor's rights to sell franchises had been revoked, arbitration agreement was void and could not be enforced.

Texas

In re Lynch,
No. 05-02-00381-CV (Tex.App. Dist.5 10/1/02)

Plaintiff, a client of Salomon Smith Barney (SSB) filed suit against SSB, Merrill Lynch and others accusing them of engaging in a global conspiracy "to artificially inflate the value of the securities, particularly in the area of Internet stocks, by issuing overly optimistic reports and predictions, and making secret arrangements with favored dealers and customers to manipulate the aftermarket, to thereby secure for themselves outrageous and obscene profits." SSB successfully compelled arbitration on basis of arbitration agreement with Plaintiff. Although Plaintiff was not customer of Merrill, Merrill also moved to compel arbitration, which motion was denied by the trial court. Texas Court of Appeals reversed and compelled Plaintiff to arbitrate claim against Merrill on the grounds that equitable estoppel allows a nonsignatory to compel arbitration when a signatory to a contract containing an arbitration clause raises allegations of substantially interdependent and concerted misconduct by both the nonsignatory and one or more of the signatories to the contract.

Crown v. Wellness International Network, Ltd., No. 05-00-01713-CV
(Tex.App.Dist.5 8/21/2002)
UNPUBLISHED

AAA arbitrator's non-disclosed ownership interest in major competitor of one of the parties to the arbitration is not sufficient evidence of "evident partiality" to vacate arbitration award.

Wisconsin

State v. Johnson,
No. 01-1092-CR
(Wis.App. 08/29/2002)

Discussion of promissory notes as "securities" for the purposes of the Wisconsin securities laws.

SEC ADMINISTRATIVE PROCEEDINGS

In the Matter of the Barr Financial Group,
Administrative Proceeding
File No. 3-9918
2002 SEC LEXIS 1594
(June 21, 2002)

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, specifically by inflating the amount of assets under management and lying about Barr's education.

In the Matter of Portfolio Advisory Services, LLC,
Administrative Proceeding File No. 3-10807, 1940 Act 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.

In the Matter of George J. Kolar,
Administrative Proceeding File No. 3-9570, 1934 Act Release No.46127,
2002 SEC LEXIS 1647
(June 26, 2002)

Detroit metropolitan area manager for Dean Witter failed to exercise reasonable supervision over registered representative who violated registration and antifraud provisions of the securities laws in "selling away" case. Manager suspended for six months from association with any registered broker or dealer in a supervisory capacity, and fined $ 20,000.

In the Matter of Donna N. Morehead, Administrative Proceeding File No.3-10814,
1934 Act Release No.46121,
2002 SEC LEXIS 1623
(June 26, 2002)

From 1998 through 2001, a former registered representative of FASCO (and of other broker-dealers registered with the Commission) willfully violated Section 17(a) of the Securities Act of 1933 ("Securities Act"), Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, by switching customers between variable annuities in a series of transactions that he knew, or was reckless in disregarding, had no economical value, for the purpose of generating commissions. The representative also made materially misleading statements and omitted to disclose material information to his customers in connection with variable annuity sales, in order to induce customers to switch from one variable annuity to another.

During the period from September 1999 through May 2001, when Morehead was the supervisor of the registered representative at FASCO, approximately 38 customers switched variable annuities in approximately 47 transactions, upon the recommendation of the registered representative. Those transactions resulted in significant direct charges assessed against the customers. The switches also generated hundreds of thousands of dollars [*4] in commissions, paid by the annuity issuers. Respondent failed reasonably to supervise the registered representative with a view toward preventing and detecting his securities laws violations. In particular, Respondent failed to investigate adequately red flags raised by the numerous switches of variable annuities and, thus, failed to detect and prevent his fraudulent conduct.

In the Matter of Daniel Richard Howard, Administrative Proceeding File No. 3-10392
1934 Act Release No.46269,
2002 SEC LEXIS 1909
(July 26, 2002)

Appeal of NASD disciplinary action. Even accepting broker's testimony that elderly customer of modest means wanted to purchase low-priced, risky stocks, a broker's recommendations must be consistent with the best interest of customer. Excessive trading in account also constitutes unsuitability.

In the Matter of G. Bradley Taylor,
Administrative Proceeding File No.3-9955,
2002 SEC LEXIS 2429
(Sept. 24, 2002)

Registered representative who was also branch manager found to have violated Section 17(a) of the '33 Act, Section 10b of the '24 and and Rule 10b-5 by failing to disclose to his customers and customers of the brokers under his supervision that he was receiving free shares of company's stock in exchange for selling stock to his customers and encouraging brokers to sell the stock to their clients. Good discussion of *scienter* and the fiduciary relationship between a broker and his customers.

AROUND THE SROs

NASDR

Notices to Members

02-69 Clarification of Member Obligations Regarding Brokered Certificates of Deposit

02-66 SEC Approves NASD Rule 2315; Recommendations to Customers in OTC Equity Securities

02-64 NASD Advises Members that Participation in Tying Arrangements that Violate Federal Statutes Also Violate Just and Equitable Principles of Trade

02-61 SEC Approves Proposed Changes to the Taping Rule and NASD Interpretive Material 8310-2

02-59 SEC Approves Amendment to Rule 10314 Regarding Specificity of Answers Filed in Arbitration; Effective October 14, 2002

02-58 SEC Approves Default Procedures Regarding Suspended or Terminated Respondents Who Fail to Answer Arbitration Claims

02-57 Use of Negative Response Letters for the Bulk Transfer of Customer Accounts

02-53 NASD Files Proposal to Amend Rule 3070 to Require Filing of Criminal and Civil Complaints and Arbitration Claims with NASD; Revises "No Action" Letters

02-49 NASD Adopts Amendments to IM-8310-2 Concerning Release of Disciplinary Information to the Public

02-40 NASD Requests Comment On Proposed Amendments to NASD Rule 2320 (Best Execution Rule)

National Adjudicatory Council Decisions

Dept. of Enforcement v. Morgan Stanley DW, Inc., et al
Disciplinary Proceeding No. CAF000045 (July 29, 2002)

Hearing Panel dismissed the case on the grounds that the action was filed beyond the time limits set forth in the Securities and Exchange Commission's decision in *Jeffrey Ainley Hayden*, Exchange Act Rel. No. 42772, 2000 SEC LEXIS 946 (May 11, 2000). Held, Hearing Panel's dismissal of the case affirmed.

Dept. of Enforcement v. Belden
Disciplinary Proceeding No. C05010012
(August 13, 2002)

Hearing panel found violations of Conduct Rules 2110 and 2310 based on unsuitability of recommending and selling customer "B" shares of mutual funds rather than "A" shares. Affirmed.

NYSE

Information Memos

02-42 Alerting customers to adjustments to options contracts resulting from corporate actions

02-40 Amendment to Rule 407 Regarding Private Securities Transactions

02-37 Renewal of Supplementary "List Selection" Methods for Selecting Arbitrators

02-33 Increase in Honorarium for Arbitrators

02-31 Update regarding NYSE Rule 351 - Associated Person Reporting Requirements (Correction of version contained in IM 02-29)

Hearing Panel Decisions

Prentice Securities, Inc.,
No. 02-150 (July 19, 2002)

Recommended securities to customers which were unsuitable and violated Rule 342 by failing to reasonably supervise and control its business activities.

Crowell Weeden & Co.,
No. 02-109 (May 22, 2002)

Violated Exchange Rule 345A by permitting registered persons who had not complied with continuing education requirements to perform duties requiring registration; Violated Rule 401 by failing to conduct formal analysis of best execution data; Violated Rule 342.16 by failing to supervise review of correspondence of a producing branch manager; Violated Rule 342 by failing to assure compliance with continuing education and best execution requirements.

Floor Broker Network, Inc., No. 02-106 (May 24, 2002)

Violated Exchange Rule 342 in that it failed to establish and maintain appropriate procedures for supervision and control including a separate system of follow up and review.

Announcements From The PIABA Office

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Upcoming Events:

PIABA Board of Directors Meeting, March 9-10, 2003. Atlanta, Georgia. Location to be Announced.

PIABA 12th Annual Meeting, October 22 - 26, 2003. La Quinta Resort, La Quinta, California.

New Members:

(since publication of Summer 2002 issue of *PIABA Bar Journal*)

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Maria M. Cardenas	(210) 231-0919
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Gary Clouse	(310) 458-3860
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