Public Investors Arbitration Bar Association Vol. 9 No. 4 Winter 2002

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

Features And Columns

Winter President's Message — by J. Pat Sadler — 1

From The Professor:
A Primer on the Liability and Damages Provisions of Securities Acts – Part II, Rule 10b(5) and the Uniform Securities Act — by Joseph C. Long — 3

ProfLipner's "I Love New York Law"
Fraud in the Inducement: Claims Can Be Made Against Brokers (and Lawyers) — by Seth E. Lipner — 24

Expert's Corner
The Sale of Variable Insurance Products For Better or For Worse: Causes of Abusive Sales Practices — by Vincent Micciche — 27

Expert's Corner
Written Supervisory Procedures: A Plaintiff's Roadmap to Accountability — by Thomas M. Driscoll, Jr. — 36

Practitioner's Corner
Backbone Surgery for Dummies: How to Strengthen the Resolve of Your Arbitrators (and You) — by David E. Robbins — 41

View From The West
The California Situation: More Questions Than Answers — by Scot Bernstein — 47

Sales Culture of the Financial Services Industry: An Introduction to Issues Surrounding Commission-Base and Fee-Only Compensation Structures Advisors — by A. Todd Black — 57

Judicial Deference to SEC Precedent — by Richard G. Himelrick — 61

Howsam v. Dean Witter Reynolds, Inc. – Progress Toward A Goal of "Fair and Expeditious Resolution" of Disputes — by Barbara Black — 69

CRD Expungement: Law, Proposed NASD Rules, and Lawyer Ethics — by C. Thomas Mason III — 76

Cases & Materials — by Charles W. Austin — 98

www.PIABA.org

The Bar Journal of the Public Investors Arbitration Bar Association

From the Editor's Desk

by Andrew Stoltmann
PIABA Bar Journal
Editor-in-Chief
Maddox Hargett & Caruso
10 LaSalle Street, 35th Floor
Chicago, IL 60603
312.606.5200
Stoltmann1234@hotmail.com

The Bar Journal Board of Editors remains interested in contributions from PIABA members and non-members, including experts, mediators, arbitrators and regulators. Contributions may be in the form of one article or in a regular, four times a year column. Individuals interested in contributing in the future should contact any member of the Board of Editors or Robin Ringo. Your comments and contributions are always welcome.

PIABA Board of Directors

Philip M. Aidikoff
Charles W. Austin, Jr.
Robert S. Banks, Jr.
Scot Bernstein
Gail E. Boliver
Steven Caruso
Allan J. Fedor
Joel A. Goodman
Seth E. Lipner
C. Thomas Mason
Charles C. Mihalek
J. Pat Sadler
Laurence S. Schultz
Rosemary Shockman
Tracy Pride Stoneman

***PIABA Bar Journal** is a publication of The Public Investors Arbitration Bar Association (PIABA) and is intended for the use of its members. Statements and opinions expressed are not necessarily those of PIABA or its Board of Directors. Information is from sources deemed reliable, but should be used subject to verification.* *No part of this publication may be reproduced in any manner without the written permission of the publisher.*

2002 © PIABA

PIABA Bar Journal
2002 Board of Editors

Andrew J. Stoltmann
Editor-in-Chief
Chicago, IL

Ryan Bakhtiari
Managing Editor and
Arbitration Awards
Beverly Hills, CA

Charles W. Austin, Jr.
Cases & Materials
Richmond, VA

Joseph C. Long
From The Professor
Norman, OK

David Robbins
Practitioner's Corner
New York, NY

Jay Salamon
Expert's Forum
Cleveland, OH

Seth E. Lipner
Contributing Editor
Garden City, NY

Scot Bernstein
A View From The West
Sacramento, CA

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Spring, 2003 issue of *PIABA Bar Journal* is March 20, 2003. All submissions, regardless of length, should be accompanied by a computer disk of the submitted materials in word, word perfect or as a text document. Submissions may also be sent by e-mail to Robin Ringo at rsringo@piaba.org or Andrew Stoltmann at stoltmann1234@hotmail.com.

By mail, send submissions to:

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

President's Message

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.

2003 may be the most important year in the history of our bar association. Horrific scandals in the brokerage industry have cost the investing public losses estimated to be in the trillions of dollars. Major brokerage firms have agreed to pay $1.4 billion to head off regulatory investigations into the corruption and greed which has wiped out the life savings of thousands of mainstream Americans.

Worse, a review of early defensive pleadings being filed on behalf of major brokerage firms in the cases which are beginning to hit the arbitration system, shows that the firms are doing everything possible to avoid responsibility for their conduct. Customers were lied to and deceived in the name of underwriting profits, and to hear the firms' tell it, the customers are nothing more than victims of their own greed.

The confidence of the American public in the integrity of the brokerage industry and our capital system is, justifiably, at an all time low. The industry created this problem, but sadly they won't be the ones to solve it. The culture of a corporation, just like personal integrity, is slow to change. One would have hoped that our major brokerage firms would have apologized for the analyst scandals and accepted responsibility for the devastation of their clients' portfolios. But the same culture that tolerated these practices in the first place motivates the firms to deny responsibility.

If the public's confidence in the brokerage industry is to be restored, it is up to regulators, investor advocates and arbitrators to do the job. What the industry really understands is money. When fraudulent practices become no longer profitable, they will stop. Below are some suggestions of what each group identified above can do to accomplish the objective.

Regulators

(1) Make certain that all documents uncovered in the investigations which led to the global settlement are made available to every claimant who files an arbitration case. The documents need to be organized, catalogued and placed in a central clearinghouse where they are easily retrievable.

(2) Prohibit the firms from arguing that the global settlement does not constitute an admission of wrongdoing and that the existence and details of the global settlement are inadmissable in arbitration.

(3) Force the firms to create a meaningful restitution fund which is simple and accessible without having to retain an attorney and which results in no release to the brokerage firms for losses beyond those reimbursed through the fund.

(4) Maintain the role of the states in regulating broker misconduct, and don't financially cripple their ability to regulate by forcing them to finance the restitution fund with fine monies from the global settlement.

(5) Strengthen the penalties for industry misconduct.

Investor Advocates

(1) Prepare yourself to provide the best possible representation to your clients. Attend the PIABA meeting in October, share information with your peers, support PIABA's efforts to hold the industry accountable.

(2) Provide full disclosure to your clients about the arbitration process, the costs, the potential benefits and the scope of representation. Take only cases which you have the time, the expertise and the willingness to try.

(3) Report industry misconduct to NASD Enforcement, your state regulator and other appropriate bodies. Don't ignore improper defense tactics such as withholding of documents, bad faith arguments, etc. And follow up.

(4) Take strength from the justness of your cause. Many of your clients have been cheated out of a lifetime's savings. Demand justice. Yours is a noble cause.

Arbitrators

(1) Allow fair and appropriate discovery. Give investors a chance to prove their cases. This may involve some non-traditional discovery such as internal emails, deposition transcripts, etc. Don't let firms hide the ball.

(2) If the proof justifies it, don't be afraid to be outraged. Make sure the award reflects the misconduct.

(3) Be skeptical of the "down market" defense. A falling market does not justify fraud. And remember, the industry was not arguing that damages should be increased during the rising market of the late '90s.

(4) Realize that because of the training you have received as an arbitrator and the experience of hearing cases, you may be more knowledgeable than most claimants who assume that stockbrokers will be held to the standard of professionalism that the industry's advertising has promised.

There's a line from an old John Wayne movie where the Duke says "there's right and there's wrong, and sooner or later you have to choose one or the other." The industry has made its choice. Now we must make ours.

From The Professor - A Primer on the Liability And Damages Provisions Of Securities Acts - Part II, Rule 10b-(5) and the Uniform Securities Act

by Joseph C. Long

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

In the last issue of the Bar Journal, this column contained Part I of this article, covering liability and damages under the Securities Act of 1933. This issue carries the second installment of the article which is devoted to SEC Rule 10b-(5) and the state Uniform Securities Act of 1956.

I. SEC Rule 10b-(5)

A. Background of the Rule

SEC Rule 10b-(5) was adopted in a single morning in 1942. At that time, Section 17(a) of the 1933 Act[1] was SEC's primary enforcement tool against fraud. However, by its own language, Section 17(a) is limited to cases involving offers and sales of securities. This limitation followed the general pattern of securities acts at that time to limit coverage to offers and sales, and not to include **purchases.**[2]

The SEC Regional Office in Boston discovered a member of the board of a corporation who was soliciting the corporation's shareholder seeking to purchase their securities. The rub was that the directors had inside information that the corporation was about to declare its first dividend in a number of years. The director knew that the dividend was approximately the same as the price he was offering. So, in effect, he would immediately recover the cost of his purchases from the shareholders. The SEC sought a way to stop him from committing this fraud in connection with the **purchase** of securities from the public.

The Commission hit upon Section 10(b) of the Exchange Act which gave the Commission authority to adopt Rules to prohibit fraud. The Commission then took the language of Section 17(a) of the 1933 Act and modified it to read "in connection with the **purchase** or sale" rather than "in connection with the **offer** or sale". Voila, Rule 10b-(5) was born.[3]

The SEC intended the new Rule to be only an enforcement tool, under which it could bring civil injunctive actions and criminal prosecutions. However, four years after its adoption, the court in *Kardon v. National Gypsum Co.*[4] held that there was an implied cause of action under the Rule on behalf of a person who

---

[1]15 U.S.C. §77q(a).

[2]Sections 11 and 12 of the 1933 Act discussed in Part I are likewise limited to covering only offers and sales and not purchases. The same is true of the original Section 410, civil liability provision of Uniform Securities Act, as will be seen in the next section. However, many states have now altered their Section 410 to cover both purchases and sale. Section 410(h) makes clear there can be no implied cause of action under Section 101 of the Uniform Securities Act. Section 101 is the state equivalent of Section 17(a) of the 1933 Act and SEC Rule 10b-(5). Because of Section 410(h), Section 101 may only be used for administrative, civil **enforcement**, and criminal actions.

[3]SEC Rule 10b-5 provides:

> It is unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails, or of any facility of any national securities exchange,
>
> (1) to employ any device, scheme or artifice to defraud;
> (2) to make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading, or
> (3) 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 sale or purchase of any security.
>
> in connection with the purchase or sale of any security.

[4]69 F. Supp. 512 (E.D. Pa. 1946).

was defrauded into **selling** his stock. In the early 1950's, claimants pointed out that Rule 10b-(5) covered both purchases and **sales** and since *Kardon* allowed defrauded sellers to recover, defrauded **purchasers** also ought to have a cause of action. The federal courts agreed even though Sections 11 and 12(a)(2) of the 1933 provide for express remedies.

With these holdings, SEC Rule 10b-(5) litigation took off in the 1960's and early 1970's. It threatened to replace all suits under the Securities Act of 1933, the state securities acts, and state corporate law. However, beginning in the mid-1970's, the Supreme Court, starting with *Blue Chip Stamps v. Manor Drug Stores*,[5] closely restricted the reach of Rule 10b-(5). Today there is little difference in the elements of proof under Rule 10b-(5) and common law fraud. As a result, 10b-(5) is used mostly were the plaintiffs wish to try their case in federal court,[6] or in class or mass actions involving "covered" securities where 10b-(5) pre-empts all state securities and common law fraud claims.[7]

Under current case law, it appears that Rule 10b-(5) offers little or no advantage in arbitration over state securities act and common law claims. Therefore, allegations under the Rule should not be made unless there is a demonstrable reason for doing so.

B. Elements With Must Be Proven For Recovery Under 10b-(5)

Because of the restrictions which the Supreme Court has put on 10b-(5), liability under the Rule is not an easy case to prove. There are generally six elements which the plaintiff will have to prove. They are as follows:

(1) That the plaintiff was a purchaser or seller of the securities;

(2) That there was a violation of SEC Rule 10b-(5) by the defendant;

(3) That the violation of SEC Rule 10b-(5) took place in connection with the purchase or sale of the security;

(4) That the plaintiff relied upon the act representing the violation that caused the plaintiff's injury;

(5) That the violation was committed by the defendant with scienter; and

(6) That the necessary means of interstate commerce of the mails was used at some stage during the transaction.

If Subsection (2) of the Rule is relied upon, then there is a seventh element. The misrepresentations or omissions must be material. Most of these items have now been the subject of Supreme Court interpretation.

While all three sections of Rule 10b-(5) are usually alleged together without distinction as to which clause or subsection is relied upon, there are three different operative subsections which focus on different conduct. For example, under Subsection (2) a pure omission which does not make any statement made misleading is not actionable. However, a pure omission might be actionable under subsection (1) as a scheme to defraud or under subsection (3) as a practice which operates or would operate as a fraud. Further, subsection (1) talks in terms of fraud, while subsection (3) looks to the effect of the act, not the intent under which it was done.

1. Purchaser or Seller

In the mid-1980's, the federal courts were getting away from the requirement that the person be a purchaser or a seller. But, the Supreme Court in *Blue Chip Stamps v. Manor Drug Stores*[8] re-instated the purchaser or seller requirement. This requirement effectively eliminates a large group of people from coverage under the act. Often, management of the corporation will put out misleading information to its shareholders in order to induce them to continue to hold the securities of the company. When the company later goes bankrupt the shareholders have no recourse under SEC Rule 10b-(5) because they are not purchasers or sellers. Likewise, as in the *Blue Chip Stamp* case, the person who is induced not to buy the securities because of fraud will have no cause of action.

———————

[5]421 U.S. 723 (1975).

[6]All cases alleging violations of the 1934 Act must be brought in federal court. Unlike the 1933 Act, where there is concurrent jurisdiction in the state courts, under Section 27 of the Exchange Act, 15 U.S.C. §78aa, jurisdiction under the 1934 Act is exclusive in the federal courts.

[7]Section 28(f) of the Exchange Act of 1934, 15 U.S.C. §78bb(F).

[8]421 U.S. 723 (1975).

2. In Connection With

The violation has to have taken place in connection with the purchase or sale of the security. As a result, any fraud which takes place after the purchase or sale is not going to be actionable unless it is part of an ongoing scheme which took place before the purchase or sale. It is generally believed for many years that the fraud does not have to involve the securities bought or sold. It can involve the business of the corporation, or the securities given to secure the securities purchased, or any other transaction. The only requirement is that it have some nexus or connection with the purchase or sale of the security.[9] However, attitude of the federal courts may be changing on this point, and increasingly they may restrict recovery to fraud in connection with the securities themselves as opposed to collateral fraud.

By far the most important case in this area from the standpoint of arbitration proceedings is the decision in *SEC v. Vandford*,[10] decided last summer. The case involved a registered representative selling his customer's securities without the customer's knowledge or consent. He was then converting the money to his own use. The lower courts held this activity of converting the money was not in connection with the sale of securities and that Rule 10b-(5) did not provide a remedy. The Supreme Court reversed indicating the two acts were part of a common scheme and Rule 10b-(5) would cover the transaction.

3. Reliance

The plaintiff must have relied upon the violation of the Rule. This should be contrasted with the requirements of Section 12(a}(2) under the 1933 Act where reliance is specifically not an element of the plaintiff's case or a defense for the defendant. The same is true to a limited extent under Section 11. However, the Supreme Court in *Affiliated Ute Citizens v. United States*,[11] held that reliance will be presumed where suit is brought upon an omission under Subsection (2). Likewise, the Court in *Basic v. Levinson*,[12] held that the plaintiff could show reliance by using the fraud-on-the-market theory. Under this theory, the plaintiff in the case of a publicly traded stock merely indicates that he relied upon the market, and the entire market was mislead by the Rule 10b-(5) violation. The presumption of reliance on the market is, however, rebuttable by the defendant. The defendant is also given the affirmative defense of showing that it would not have changed the plaintiff's decision had the information been disclosed. This will occur where the defendant has no choice but to go through with the transaction regardless, as in the case where he must sell back his stock upon leaving his employment with the corporation. Also, in some cases, the buyer may indicate that he is not interested in learning about the stock because he has already made up his mind that he is going to take it come hell or high water.

4. **Loss Causation**

Also, under SEC Rule 10b-(5), the plaintiff must prove that the violation caused him injury. Contrast this with Section 12(a)(2). There the plaintiff does not have to allege or prove that the misrepresentation or omission caused his injury. Instead, the defendant can avoid some of the liability by showing that part of the decrease in the value of the securities was attributable to other factors.

5. Scienter

The Supreme Court in *Ernst & Ernst v. Hochfelder*,[13] held that the plaintiff will have to show the defendant acted with scienter in order to recover under SEC Rule 10b-(5). It defined scienter as meaning knowing conduct. It does <u>not</u> include the common law idea that the defendant has to intend to injure. The Supreme Court left open the question of whether any conduct short of knowing conduct would qualify, but made clear that negligent conduct would not suffice. The lower federal courts are not in agreement that reckless disregard will suffice. However, the standard for reckless disregard which is borrowed from the law of torts is so high that there is little difference between it and knowing conduct.[14]

____

[9]*Superintendent of Insurance v. Bankers' Life & Cas. Co.*, 404 U.S. 6 (1971).

[10]535 U.S. 813 (2002).

[11]406 U.S. 128 (1972).

[12]485 U.S. 224 (1988).

[13]425 U.S. 185 (1976).

[14]*Franke v. Midwestern Oklahoma Dev. Authority*, 428 F. Supp. 719 (W.D. Okla. 1976).

6. Use of the Jurisdictional Means

This requirement is the same as found in connection with Sections 11 and 12(a)(2) discussed in Part I of this article. It merely means that the plaintiff must allege and prove that the defendant used a means of communication in interstate commerce or the mails in connection with the violation. The use can come at the beginning of the transaction when the defendant calls the plaintiff for an appointment to present the investment opportunity. Or it can come at the end of the transaction when the stock certificate is mailed or the check mailed for collection. Because of the breadth of interpretation given this requirement, it is virtually impossible not to have used the jurisdiction means at some point, even if the actual purchase or sale took place in a face-to-face transaction. Therefore, application of the federal securities acts is virtually assured.[15]

7. Materially

When relying upon Subsection (2) of Rule 10b-(5), the plaintiff will have to show that the misstatement or omission is material. Materiality standard used under Rule 10b-(5) is the same as under all sections of the 1933 and 1934 acts. It was first developed in *TSC Ind. v. Northway, Inc.*[16] It was discussed in Part I in the discussion of Section 12(a)(2). Further discussion will not be undertaken here.

8. Persons Primarily Liable

Liability under SEC Rule 10b-(5) is not limited to those persons who purchase or sell securities. The introductory language to the Rule makes "any person" who violates the Rule liable. However, in the case of a material omission, the plaintiff will have to show that the defendant had a duty which arose outside the securities law to disclose this information.[17] In many cases, accountants and lawyers for an issuer may have information, but there is no duty on their part to disclose that information to the public or the particular buyer or seller. Further, in many cases, people with inside or non-public information may trade on that information without committing a violation of SEC Rule 10b-(5) if the person who acquires it is not breaching a duty not to disclose it. Thus, insiders and tippees, persons who acquire inside information from an insider or another knowing that the information is confidential and not to be disclosed, will be liable. Recently, in *United States v. O'Hagan,*[18] the Supreme Court extended this liability to cover persons who appropriate confidential information and then trade on it. For example, a lawyer involved putting together a take-over, buys stock in the target company before the take-over is announced. This theory is known as the "misappropriation" theory.

9. Persons Secondarily Liable

In addition to the primary liability outlined in the last paragraph, there is limited secondary liability under SEC Rule 10b-(5). Control person liability is imposed by Section 20 of the Exchange Act. However, the Supreme Court in *Central Bank v. Interstate Bank*[19] has held that neither of the common law concepts of aiding and abetting or conspiracy may be used in conjunction with SEC Rule 10b-(5). For many years, the doctrine of respondeat superior has also been used to impose liability under SEC Rule 10b-(5). It remains an open question whether such liability continues to apply after the *Central Bank* decision.

10. Liability Is Potentially Very Broad

The major advantage of SEC Rule 10b-(5) over the express causes of action is that the plaintiff does not have to show that the defendant is the person who sold or purchased from him. Merely, he must show that the defendant committed the violation. Thus, in *SEC v. Texas Gulf Sulphur Co.*,[20] the company whose stock was being bought and sold was held liable for failing to publish information concerning the corporation even though the company was not actively participating in the market by buying or selling securities. Again, however, the federal courts have shown a marked tendency to back away from

---

[15]This is important if plaintiff wishes to go to federal court. Jurisdiction of all Exchange Act of 1934 claims is exclusive in federal court.

[16]426 U.S. 438 (1971).

[17]*Basic, Inc. v. Levinson*, 485 U.S. 224 (1988).

[18]117 S.Ct. 2199 (1997).

[19]511 U.S. 164 (1994).

[20]401 F.2d 833 (2d Cir. 1968).

the extreme liability of *Texas Gulf Sulphur*.

11. Statute of Limitations

Since the cause of action under Rule 10b-(5) was implied for many years, there was no express statute of limitations governing 10b-(5) actions. In 1991, the Supreme Court adopted a uniform federal limitations period in *Lampf, Pleva, Lipkin, Prupis, & Petigrow v. Gilbertson*.[21] It selected a one-year and three year limitations period based upon Section 9(e) of the Exchange Act.[22] The period was one year from the date of discovery, but in no event more than three years after the violation. The Court made clear that It was basing the limitations period on Section 9(e) rather than Section 13 of the 1933 Act. Section 9(e) talks in terms of the one year period running from **discovery**. Section 13, on the other hand, provides the one year period running from either discovery or when the violation should have been discovered. The courts of appeals, however, ignored the hint from the Court that the period should run from **actual discovery.** Following their own prior precedent, these courts continued to make the one year period run from the date the violation should have been discovered.

This jerry-rigged limitations period was again changed by the Sarbanes-Oxley Act enacted late last summer. Section 804 of that act added a new subsection (b) to the **general federal statute of limitations.**[23] The change made the periods two and five years, two years from the date of **discovery** and not more than five years from the date of violation.[24] Note that Congress again used the word "discovery" rather than "discovery or when discovery should have been made." In light of the lower federal courts' refusal to take the hint from the Supreme Court in *Lampf*, a very strong argument can be made that Congress clearly did not intend the statutory period to start to run until **actual discovery.** It will be interesting to see if the lower federal courts continue their errant ways and whether the Supreme Court takes a case to straighten them out.

C. Damages Under SEC Rule 10b-(5)

As SEC Rule 10b-(5) creates an implied cause of action, there is no statutory provision outlining what the measure of recovery should be under the Rule. The problem is further exacerbated by the wide range of claims and factual situations covered by the Rule. As a result, the investor can use most any measure of recovery under Rule 10b-(5) that he can convince the court or arbitrators to award.[25]

Clearly, however, there are some traditional guidelines which can be identified.

1. Benefit of Bargain Damages

In the case where a security is sold in violation of SEC Rule 10b-(5) and the dispute is over the value of the security, the fairly standard measure of damages is the difference between the security as misrepresented and its true value on the date of purchase. In this case, the investor keeps the security and receives a common law damage award. This measure of damages is often referred to as the benefit of the

---

[21]501 U.S. 350 (1991).

[22]15 U.S.C. §78i(e).

[23]28 U.S.C. 1658(b). Unfortunately, this section was added on the floor and there is no explanation why the provision was added to the general statute of limitations rather than the Exchange Act of 1934. There are two plausible explanations. First, since the language used talks in terms of fraud, deceit, and manipulation, the amendment was directed only at SEC Rule 10b-(5) actions. Since these actions are implied, the statute of limitations should be in the general statutes, there being no particular section of the 1934 Act to attach it to.

The alternative theory is that the amendment is to apply to both Section 11 and 12(a)(2) actions under the 1933 Act **as well as** 10b-(5) actions. Therefore, since it applies to both acts, it should be in the general statute of limitations.

The author and other academics seem to favor the former rather than the latter view. Obviously, the issue will have to be settled by litigation.

[24]Date of violation may or may not be the date of sale. For example, it is possible for the sale to have taken place, but no jurisdictional means used until the stock certificates are mailed to the purchaser.

[25]The measure of damages discussion in 5D Arnold S. Jacobs, Litigation and Practice Under Rule 10b-(5) §2.03 (2001), runs well over a hundred pages. Cited hereinafter as "Jacobs, § ___."

bargain remedy.[26]

Probably the best example of the benefit of the bargain remedy is the *Miley*[27] recovery in churning cases. Here the investor is allowed to recover the value of his account at the end of the churning period and what the account would have made had it been "well-managed."[28]

The *Miley* approach recognizes that there are two different injuries involved in churning. First, the registered representative has breached his fiduciary duty to the investor. For this, the investor should be able to recover all the commissions paid in the churning transactions. Second, there is an economic loss which results from the churning itself.

Broker-dealers do not like the *Miley* remedy largely because it is difficult to identify what would be a "well-managed" account under the facts of the case.[29] Investors counter this by offering evidence of several different "well-managed" accounts. Then they leave it to the arbitrators or jury to select what they think is the appropriate one. Broker-dealers claim that this measure is "speculative and conjectural." Some courts have agreed and refused to apply the *Miley* concept.[30]

2. Resale Damages

Closely akin to the benefit of the bargain remedy is the *Chasins*[31] or re-sale remedy.[32] Here, the investor receives the difference between what he purchased the stock for and what he could sell it on the open market. Again, the investor keeps the security and receives a monetary award of the difference.

3. Out-of-Pocket Damages

The other popular measure of recovery is known as "the out-of-pocket" measure of damages. The Supreme Court has approved the use of this measure of damages in *Affiliate Ute Citizens v. United States*.[33] It works by taking the fair value of all the consideration paid by the investor, at the time of purchase, and subtracting the fair value of the securities purchased, at the time of purchase.[34]

All these remedies are essentially seeking to give the investor the value he would have received had there been no fraud.

4. Rescission

Finally, some courts have used a rescission measure of damages similar to that used under Section 12(a).[35] Here, the intent is to return the investor to the position he was in prior to the transaction.[36] In such case, the investor should be given pre-judgment interest on his investment, costs, and attorney's fees. Statutory rescission was discussed in Part I under Section 12(a), and again in the next section dealing with the Uniform Securities Act.

———————————

[26]Jacobs, §260.03(c)(v).

[27]Named for *Miley v. Oppenheimer & Co.*, 637 F.2d 318, 326-328 (5th Cir. 1981).

[28]Jacobs, §260.03[c][vii][E].

[29]Expert testimony on that subject has recently been labeled by the broker-dealers as “junk science” which should not be received.

[30]*See e.g., Nunes v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 635 F. Supp. 1391, 1396 (D. Md. 1986).

[31]Named after *Chasins v. Smith Barney & Co.*, 438 F.2d 1167 (2d. Cir. 1970), the first case to popularize this remedy.

[32]Jacobs, §260.03[c][iv].

[33]406 U.S. 128, 155 (1972).

[34]Jacobs, §260.03[c][ii].

[35]Jacobs, §260.03[c][iv].

[36]*Huddleston v. Herman & MacLean*, 640 F.2d 534, 554 (5th Cir. 1981).

II. Uniform Securities Act[37]

Since a previous issue of the Journal contained a detailed discussion of the Uniform Act, further discussion will not be undertaken. Instead, the focus here will be limited to liability and recovery issues.

Civil liability is imposed under the Uniform Securities Act by Section 410. Section 410(a)(1) covers registration violations and Section 410(a)(2) covers material misrepresentations and omissions. The **present** official text outlining recovery under the Uniform Act reads:

> [The investor may sue] to recover the consideration paid for the security, together with interest at six percent per year from the date of payment, costs and reasonable attorneys' fees, less the amount of any income received on the security, upon the tender of the security, or for damages if he no longer owns the security.

A comparison of this language with that of Section 12(a) of the federal 1933 Act, discussed in Part I, makes clear that Section 410(a) is modeled on Section 12(a). Section 410(a), however, allows the recovery of both costs and attorneys' fees not specifically allowed under Section 12(a).[38] Because of the similarity of language, many of the interpretations discussed in Part I concerning recovery under Section 12(a) are equally applicable under Section 410(a).

A. Liability under Section 410

As noted above, there are two different liability provisions within Section 410(a). Section 410(a)(1) deals with non-registration. The non-registration can be of the securities themselves, see Section 301, or of the broker-dealer or agent (registered representative) that sells them, Section 201(a). The 1956 Act does not provide for separate liability for investment advisors. States are increasingly adding additional provisions imposing liability upon investment advisers and their representatives. Of course, an investment adviser or his representative may also be a "seller" of unregistered securities. Or more importantly, if he is also executing the trades, he is a broker-dealer or agent who must be registered. Section 410(a)(2) is the anti-fraud section and prohibits the making of material misrepresentations or omissions. The elements to establish liability for the two subsections are slightly different.

1. Elements for Recovery for Non-registration Under Section 410(a)[39]

a. Plaintiff's Prima Facie Case

There are seven elements which an investor must allege and prove to establish a prima facie case under Section 410(a)(1). These elements are:

1. That there was an offer or sale,

2. That the offer or sale involved a security,

3. That the offer or sale took place in this state,

4. That the security was purchased by the plaintiff,

5. That there was a statutory violation of the registration requirements,

6. That the defendant is liable, either primarily or secondarily for the violation, and

---

[37]Technically, there are three Uniform Securities Acts: (1) the 1956 Act, (2) the Revised Act of 1985, and (3) the New Uniform Act of 2002. The 1985 Act was not well received and adopted in only a handful of states. The new 2002 Act has yet to be adopted in any states. However, many feel it will be widely adopted. The discussion here is based upon the 1956 Act which has been adopted in about forty states. Many of the remaining states have recovery provisions which are quite similar.

[38]Two other major differences should be noted. First, Section 410(a)(2) is not limited to misrepresentations or omissions in a registered prospectus. It applies to **all** transactions both primary and secondary. Second, Section 410 has no affirmative defense for the defendant as found in Section 12(b).

[39]Long, §9:13.

7.That the plaintiff is willing to return the securities, if he still owns them.

2. Things That Are Not Elements of Recovery[40]

There are a number of things which defendants will often claim that are elements of a prima facie case which **are not elements for recovery** under Section 410(a)(1). These non-elements are:

1. That the investor relied upon either the securities or the broker-dealer or agent being registered,[41]

2. That there was any injury to the plaintiff or that such injury was caused by the nonregistration,[42]

3. That the failure to register the securities or the securities professionals was a result of the "seller's" negligence or fraudulent act,[43] and

4. That the seller knew that the items sold were securities or that the securities or the securities professionals needed to be registered.

b. Statutory Affirmative Defenses[44]

To escape liability, the defendants can establish the following statutory **affirmative** defenses:

1. That the investor did not bring his action within the period of the statute of limitations;[45] and

2. That the securities sold or the broker-dealer or agent selling them was either excluded[46] or exempt[47] from registration.

c. Common Law Affirmative Defenses[48]

The better view[49] is that common law affirmative defenses have no application to causes of action brought under the securities act.[50] Only those affirmative defenses set

———————————

[40]Long, §9:16.

[41]*See e.g., Plunkett v. Francisco*, 430 F. Supp. 235 (N.D. Ga. 1977).

[42]*Kirchoff v. Selby*, 703 N.E.2d 644 (Ind. 1998)(loss causation not an element under Section 410(a)(1).

[43]Liability here is absolute in the absence of an affirmative defense. *See e.g., Gridley v. Sayre & Fisher Co.*, 409 F. Supp. 1266 (D.S.D. 1976).

[44]Long, §9:19.

[45]*See e.g., Arnold v. Dirrim*, 398 N.E.2d 426 (Ind. App. 1979). The treatment of the statute of limitations is a major difference between Section 12(a)(1) of the 1933 Act and Section 410(a)(1) of the Uniform Act. As seen in Part I, under Section 12(a)(1), compliance with the statute of limitations is an element of the investor's prima facie case. Under Section 410(a)(1), it is an affirmative defense which the defendant must allege and prove. The statute of limitations was also treated as an affirmative defense under SEC Rule 10b-(5) **prior** to the adding of a statutory statute of limitations by the Sarbanes-Oxley Act. It should remain an affirmative defense under Sarbanes-Oxley because the new statute of limitations was added to the general statute of limitations section rather than the Exchange Act. Therefore, it is not part of the cause of action.

[46]Both the definition of "security" in Section 401(1) of the Uniform Act and Sections 401(b) and (c) have exclusions from the definitions.

[47]Section 402(a) contains the securities exemptions, while Section 402(b) contains security transactional exemptions. The definition of a security in Section 402(l) has certain exclusion from the definition. Similarly, the definitions in Sections 401(b) and (c) have certain exclusions from the definition of "broker-dealer" and agent. The difference between an exclusion and an exemption is that an exception to the definition makes the whole act not apply. Whereas, in the case of an exemption, only **registration** is forgiven. The anti-fraud provisions of Section 101 and 410(a)(2) still apply.

[48]*See* Long, §9:21.

[49]*See e.g., Gowdy v. Richter*, 20 Ill. App.3d 514, 525, 314 N.E.2d 549, 557 (1974).

[50]*See* 12A Joseph C. Long, §9:29 Blue Sky Law (2002). Cited hereinafter as "Long, § ___".

out in the statute should be recognized. However, cases can be found applying the following common law affirmative defenses:

1. That the investor was in para delicto with the seller;

2. That the investor should be estopped from recovering;

3. That the investor has waived his right to recover; and

4. That the investor has ratified the transaction involving the violation.

d. Spurious Defenses[51]

Often defendants will raise to other defenses. However, these defenses are **spurious,** in that the investor has no duty to perform any of the claimed actions. The failure to perform such duties, then, can not be an affirmative defense to liability. There are four of the spurious defenses in the case of registration violations. They are:

1. That the investor knew that the securities or securities professionals needed to be registered and were not;

2. That the investor has a duty to perform due diligence;[52]

3. That the investor is guilty or either contributory or comparative negligence;[53] and

4. That the investor has not mitigated his damages.[54]

3. Elements for Recovery for Misrepresentations and Omissions Under Section 410(a)[55]

a. Plaintiff's Prima Facie Case

The first four elements and elements 6 and 7 which the plaintiff must establish for a prima facie case under Section 410(a)(2) are identical to those identified above for a non-registration claim. There are, however, two additional elements. The first new element which should be element (5) is "That the offer or sale of the securities was made through a material misrepresentation or omission."

In addition, there may be a new element (7)[56] "That the purchaser did not know the truth about the misrepresentations or omissions." The inclusion of this element is appropriate. A person can not be defrauded or deceived if he knows that he is being lied to because he knows the truth.[57] The issue here is whether this element should be an element of the plaintiff's case or an affirmative defense which the defendant should raise. The Uniform Act does not make this point clear. The federal courts under Section 12(a)(2) have treated it as an element of the plaintiff's prima facie case.

b. Things That Are Not Elements of Recovery[58]

Just as there are things in a case for non-registration which are not elements of liability, the same is true when dealing with misstatements and omissions. The following are **not** elements of a misrepresentation or omission case:

---

[51]*Id*.

[52]*See e.g., Fierer v. Ashe*, 142 Ga. App. 290, 235 S.E.2d 598 (1977).

[53]*Id*.

[54]*Odmark v. Westside Bancorporation*, 636 F. Supp. 552 (W.D. Wash. 1988).

[55]Long, §9:24.

[56]In which case, element (7) above becomes element (8) here.

[57]It is possible that he knows there is an inconsistency between oral representations and the printed documents. Thus, he knows that one of the statements cannot be correct. However, he did not know which one, **and he has no duty of due diligence to find out which one is wrong**. However, if he knows which one is wrong, then he cannot, and should not, recover because he is not mislead. Obviously, the test here is **actual knowledge**, not constructive knowledge or knowledge that he could or even should have acquired.

[58]Long, §9:26.

1. **That the investor relied[59] upon the material misrepresentation or omission;[60]**

2. **That there was any injury to the investor or that such injury was the result of the misrepresentation or omission;[61] and**

3. **That the material misrepresentation or omission was the result of the seller's negligence or fraudulent act.[62]**

c. Statutory Affirmative Defenses[63]

There are only two affirmative defenses to Section 410(a)(2) liability. They are:

1. That the action is barred by the statute of limitations;[64] and

2. That the "seller" did not know or with the exercise of reasonable care, could not have discovered the material misrepresentation or omission.[65]

d. Common Law Affirmative Defenses[66]

Again, the better view is that common law defenses are not available in securities actions. The only defenses which should be recognized are the statutory defenses discussed in the previous section.[67] However, as with registration violations, cases can be found to apply the common law defense of **in para delicto,** estoppel, waiver, and ratification.

e. Spurious Affirmative Defenses[68]

Three of the four spurious defenses discussed in the section on non-registration are also often raised in connection with material misrepresentation or omission violations under Section 410(a)(2). They are:

1. **That the investor has a duty to perform due diligence;[69]**

____

[59]Draftsmen's Commentary to §410(a), Clause (2), Louis Loss, Commentary on the Uniform Securities Act 148 (1958). *See e.g., Caldwell v. Trans-Gulf Pet. Corp.*, 322 So.2d 171 (La. 1975).

[60]As a result, investor sophistication is **immaterial** to a Section 410(a)(2) claim. *Cf. Wright v. Nat'l Warranty Co., L.P.*, 953 F.2d 256, 262 (6th Cir. 1992).

[61]*Kirchoff v. Selby*, 703 N.E.2d 644 (Ind. 1998); *Hines v. Data Line Sys. Inc.,* 114 Wash.2d 127, 787 P.2d 8 (1990). Thus, under Section 410(a)(2), there is no loss requirement or no loss causation.

[62]Liability on the seller is absolute unless he can establish one of the affirmative defenses outlined below. *Ritch v. Robinson-Humphrey Co.*, 142 F.3d 1391 (11th Cir. 1998) and *Gridley v. Sayre & Fisher Co.*, 409 F. Supp. 1266 (D.S.D. 1976).

[63]Long, §9:28.

[64]*Arnold v. Dirrim*, 398 N.E.2d 426 (Ind. App. 1979). The statute of limitations in the original act was two years from the date of the sale or the contract for sale. Section 410(e). Many states, however, have altered this period or start it from either discovery or when the cause of action should have been discovered through due diligence.

[65]*See e.g., Connecticut Nat'l Bank v. Giacomi*, 242 Conn. 17, 699 A.2d 101 (1997).

[66]Long, §9:29.

[67]*See e.g., Hall v. Johnston*, 758 F.2d 421 (Oregon Act); *Dunn v. Bemor Pet.*, 600 S.W.2d 302, 304 (Mo. App. 1984); and *Duperier v. Texas State Bank*, 28 S.W.3d 740 (Tex. App. 2000).

[68]Long, §§9:30-9:31.

[69]This means that the investor has no duty to investigate. He may take whatever the "sellers" tell him at face value, even though he has reason to believe that the information is misleading. *In re Olympia Brewing Co. Sec. Lit.*, 612 F. Supp. 1367, 1370 (N.D. Ill. 1985). As will be seen in the next section, the test is **actual** knowledge, not **constructive** knowledge. *See generally*, Long, §9:31.

2. **That the investor is guilty of either contributory or comparative negligence;**[70] and

3. **That the investor has a duty to mitigate his damages.**[71]

f. Investor's Knowledge[72]

As noted above, Section 410(A)(2) has a parenthetical clause which reads "the buyer not knowing of the untruth omission." This clause raises several problems. First, is it an affirmative defense which the defendant must allege and prove or is it a part of the investor's prime facie case? As noted above, the federal courts, under Section 12(a)(2), treat this as a seventh element of the investor's prima facie case. There appears to be little law under the Uniform Act on this point.

The second major issue is what is meant by "knowing." Does this mean actual knowledge or is constructive knowledge enough? The case law is clear that the test is **actual knowledge**.[73] This conclusion flows from the fact that the investor has no duty of due diligence.

Probably the most important example of the actual knowledge rule deals with the investor who is provided a prospectus, but like most people, does not read it. Is this investor charged with the information contained in the prospectus? The Tenth Circuit in *MidAmerica Federal Sav. & Loan Assoc. v. Shearson/American Express Inc.*[74] holds that he is not. The case involves the typical pattern where the selling agent tells the investor one thing and the prospectus tells the investor another. Shearson claimed that the investor should be charged with the information contained in the written prospectus. The court rejected this claim, saying:

> The fact that there may be both oral communications and a written prospectus involved in a transaction, and that Section 12(a)(2) places them in the alternative cuts against mandating that the prospectus take precedence, particularly here where the sales were induced by means of the oral misrepresentations.[75]

Further, had the investor read the prospectus, he would have known there was a contradiction between what he was told and the written prospectus. But he does not know which statement is correct. **Moreover, as the court correctly points out, he has no duty of due diligence to find out.**

4. Elements Which Are Common to Both Sections 410(a)(1) and (2)

Also as noted above, most of the elements of a cause of action under Sections 410(a)(1) and (2) are the same. Some comments on some of these elements is in order.

a. Offer or Sale[76]

It is important to note that the operative language of Section 410(a) talks in terms of **both offer and sale.** As a result, **it is possible to recover based upon the fact that the**

---

[70]*McCrachen v. Edward D. Jones & Co.*, 445 N.W.2d 375 (Iowa App. 1989) and *Duperier v. Texas State Bank*, 28 S.W.3d 740, 753 (Tex. App. 2000).

[71]*Weft v. G.C. Assoc. L.P.*, 630 F. Supp. 1138 (E.D. N.C. 1986) and *Odmark v. Westside Bancorporation*, 1988 WL 108288 (W.D. Wash. 1988).

[72]Long, §9:31.

[73]*Kelsey v. Nagy*, 410 N.E.2d 1333, 1336 (Ind. App. 1980) and *Duperier v. Texas State Bank*, 28 S.W.2d 740 (Tex. App. 2000).

[74]886 F.2d 1249 (10th Cir. 1989)(Oklahoma Act).

[75]*Cf. Geodyne Energy Income Prod. Partnership Z-E v. The Newtoon* Corp., 2003 Tex.App. LEXIS 614 (Jan. 23, 2003). This conclusion may seem harsh on the selling company which put the prospectus together. Should it be able to rely on the prospectus? No, if the "selling representative" makes contrary oral statements. However, this is the type of situation where the statutory affirmative defense will prevent liability being imposed on the selling company. It should be able to prove that it did not know of the oral misrepresentation and in the exercise of reasonable care could not have discovered it.

[76]*See* Long, §§9:35-9:37.

security or the securities professional was not registered at the time of the offer, even though the security or the securities professional was subsequently registered before the **actual sale** took place.[77]

Further, it should be noted that there may be both multiple transactions involving offers and sales in connection with a single block of securities. Finally, keep in mind that the terms "offer" and "sale" are defined terms under the Act.[78] A review of these definitions indicates that in securities law, these terms have a much broader definition than under traditional contract law. Note particularly that "the solicitation of an offer to buy" is an offer to sell. This fact is very important in most arbitrations. The client frequently sues his own broker and registered representative. Normally, these people are "buyers" agents and are not liable. Liability attaches only to "sellers."[79] However, "buyer's agent" becomes a "seller" when the sale is solicited.[80]

b. In This State[81]

The state securities laws are territorial in nature.[82] Thus, the Oklahoma Act does not attach to a sale of securities to an Oklahoma resident if the resident is physically present in Texas at the time of offer and sale.[83] Likewise, the Oklahoma Act will not attach simply because the "seller" happens to be incorporated or formed in the state.[84] As a result, the Delaware Securities Act does not apply to the sale of securities by all the Delaware corporations.

Some act constituting either an offer or a sale must take place in the state for the act to attach. In the simplest case, both the investor and the person selling it to him are located in a single state. In such case, the securities act of that state will govern.[85] Likewise, if an offer or sale is directed **from**[86] this state or **to** this state,[87] the local securities act will apply.

It should be obvious from this last statement that in many cases two or more state securities acts will attach to a single transaction. For example, an offer to sell is made in California to an Oklahoma resident by a Florida resident. The offer is not immediately accepted. The Florida resident returns home and calls the Oklahoma resident, who likewise has returned home. Because of the offer in California, the California Act applies to the transaction. Because the seller is in Florida when he makes his second offer, this is an offer from Florida and the Florida Act attaches. Finally, because the Oklahoma buyer is in Oklahoma when he receives the offer to sell and says "yes," the Oklahoma Act attaches. Thus, the investor has a potential cause of action under the California, Florida, and Oklahoma Acts.

Where more than one state act may apply, there is no conflicts of law issue.[88] One state's act does not trump the other state's act. All the

---

[77]Official Comments to §410(a), Clause (1) states: "Clause (1) imposes civil liability when an offer violates one of the specified provisions even though the sale does not." Louis Loss, Commentary on the Uniform Securities Act 146 (1976).

[78]Sections 401(j)(1) and (2).

[79]Long, §9:56.

[80]Long, §§9:56-9:61.

[81]Sections 414(a)-(f). *See generally*, Long, Ch. 4.

[82]Long, §4:2.

[83]Long, §4:3.

[84]Long, §4:4.

[85]Long, §4:9.

[86]Long, §§4:24-4:35.

[87]Long, §§4:10-4:23.

[88]*See e.g., Lintz v. Carey Manor Ltd.*, 613 F. Supp. 543, 549 (W.D. Va. 1985). *See generally*, Long, §4:1.

statutes apply. As a result, in the above example, the investor may not have a cause of action for some reason in California (the securities and the securities professionals might have been registered there), nor does he have a cause of action in Florida (again, both the securities and the securities professional were registered in Florida), but he does have a cause of action in Oklahoma (the securities were registered there, as was the broker-dealer, but the registered representative was not). The fact that he has no cause of action under either Florida or California law, does not prohibit him from recovering under the Oklahoma Act.[89]

Further, the rights of an investor under a particular state's act **can not be terminated** by the inclusion of a choice of laws provision in a brokerage contract or other document.[90] The courts will not enforce such conflicts clauses because they are against public policy. Further, the inclusion of such provision in a broker-dealer's customer agreement violates the NASD Rules of Fair Practice. At least one broker-dealer has recently been disciplined for such inclusion.[91]

c. Purchaser[92]

In most cases there is no question who is the "purchaser" or investor entitled to bring suit under Section 410(a). However, there are a few cases where the "purchaser" is not so evident. For example, if a father buys the securities and has them placed in the name of his child. Who is the "purchaser"? It would seem that both ought to be treated as "purchasers" with the right to bring suit.[93]

d. Primary Liability[94]

The people who can be sued under Section 410(a) is probably the most important and most confused area under the whole section. There is no question that primary liability under Section 410(a) is limited to "sellers" of the securities. The problem is defining sellers. It is clear that the person who passes title to the securities is a "seller."[95] Likewise, it is clear that the seller's agent, the broker-dealer,[96] and his sub-agent, the registered representative,[97] are liable as sellers. Finally, it is clear that the purchaser's broker-dealer and registered representative will be "sellers," if they solicit the sale,[98] but not if the sale is unsolicited.[99]

It is also clear that others may be liable. The problem is drawing the line as to these "other people." The Supreme Court in *Pinter v. Dahl*[100] placed the limit as to these "other people" under the Securities Act of 1933 at those people who are directly involved in the solicitation of the sale and who are also at least partially motivated by a profit to the seller or themselves.[101] Prior to

———————————

[89] *See e.g., Lintz v. Carey Manor Ltd.*, 613 F. Supp. 549 (W.D. Va. 1985). *See also,* McClard, "The Applicability of Local Securities Acts to Multi-State Securities Transactions," 20 U. Rich. L. Rev. 139 (1985).

[90] Long, §4:17.

[91] *In re Prudential Sec. Inc.*, 2002 WL 31827874 (NASD Dec. 22, 2002). *See also* NASD Notice to Members 95-85 (Oct. 1995) and 94-54 (July 1994).

[92] Long, §9:40.

[93] *Utzman v. Carribean and Southeastern Dev. Corp.*, 107 Ga. App. 56, 129 S.E.2d 62 (1962); *Frenzel v. Lonnquist Co.*, 304 Ill. App. 377, 96 S.E.2d 687 (194). *But see Zack v. Sims*, 108 Ill. App. 3d 16, 438 N.E.2d 663 (1982).

[94] *See generally*, Long, §§9:51-9:69.

[95] Long, §9:53.

[96] Long, §9:53.

[97] Long, §9:54.

[98] Long, §9:59.

[99] Long, §§9:56-9:58.

[100] 486 U.S. 622 (1988).

Pinter, most lower federal and state courts followed a much broader definition of "seller" which included all those who "participated in the sale" or were "a substantial factor" in the sale.[102] Sometimes these people were identified by applying the old torts "But for" test.[103] The state courts are divided on whether to continue the "participation" test or adopt the *Pinter* test.[104] Unfortunately, in most states the issue is an open question. However, the investor should not automatically assume as the broker-dealers do, that the *Pinter* test will be followed.

Then there is the question of expanding the definition of "seller" by using common law agency concepts. The federal courts and most state courts have concluded that the doctrine of respondeat superior can be used to expand the definition of "seller."[105] Thus, the broker-dealer becomes liable for the acts of its registered representatives. But can the repondeat superior concept be extended to include "aiders and abettors" and "co-conspirators." The Supreme Court in *Central Bank v. First Interstate Bank*[106] refused to allow the use of these concepts under SEC Rule 10b-(5).[107] The lower federal courts seem to be restricting the use of these concepts under Section 12(a)(2).[108] What the state courts will do is not clear.[109]

It is certainly logical to adopt the concept of "co-conspirator" to expand the doctrine of "seller." It is nothing more than a practical application of the respondeat superior concept. Each conspirator that acts is the agent of the other conspirators.

In *Mosley v. Unruh*,[110] the court said that if a conspiracy is found, a non-acting co-conspirator would be liable:

> He would become under the law a co-conspirator and a principal, and under the well-established doctrine that the act of one of the conspirators is the act of all he would become in effect a seller within the meaning of the [securities] statute. To give the statute a narrower interpretation would open an easy path to its nullification.[111]

More recently, in *State ex rel. Mays v. Riddenhour*,[112] the court specifically refused to follow the *Pinter* limitation on the definition of "seller" and specifically re-affirmed the position taken earlier in *Mosley v. Unruh*,[113] that aider and abettor and co-conspirator liability were proper theories under the Kansas Securities Act. Addressing the status of conspiracy liability, the court said:

> Even though **Pinter** clearly rejects the use of [the conspiracy theory, we affirm its use in defining the seller

---

[101]Long, §9:4.

[102]Long, §§9:62-9:69.

[103]Long, §9:67.

[104]Long, §9:8.

[105]*See Hollinger v. Titan Capital Corp.*, 914 F.2d 1564 (9th Cir. 1990)(en banc), collecting cases.

[106]486 U.S. 622 (1988).

[107]Long, §9:5.

[108]Long, §9:7.

[109]Long, §9:11.

[110]150 Kan. 469, 95 P.2d 537 (1939).

[111]95 P.2d at 540.

[112]248 Kan. 919, 811 P.2d 1220 (1991).

[113]150 Kan. 469, 95 P.2d 537 (1939).

> of a security under the Kansas Securities Act.[114]

This same case also recognized the use of "aider and abettor."

This issue may be a moot question under the Uniform Act because Section 410(b) provides for statutory secondary liable. This secondary liability is quite broad.

e. Secondary Statutory Liability

Section 410(b) provides for secondary liability for certain groups for the acts of "sellers" liable under Section 410(a). This Section reads:

> Every person who directly or indirectly controls a seller liable under subsection (a), every partner, officer, or director of such a seller, every person occupying a similar status or performing similar functions, every employee of such seller who materially aids in the sale and every broker-dealer or agent who materially aid in the sale are also jointly and severally with an to the same extent as the seller....

Breaking this language down, there are five separate groups who may be liable here: (1) control persons;[115] (2) partners, officers, and directors;[116] (3) persons holding similar titles or performing similar functions to partners, officers, and directors;[117] (4) employees of the issuer who materially aid in the transaction,[118] and (5) broker-dealers and agents who materially aid.[119] If a person comes within one of these five categories, then he is **potentially** liable. He will not be actually liable unless he can not prove the affirmative defense that he did not know or in the exercise of reasonable care could not have found out the **facts**[120] on which liability of the "seller" is based.[121]

f. Control Persons[122]

Whether someone is a control person is a question of fact. It is not important how the control is exerted or whether it is direct or indirect. For example, stock ownership is one of the most common forms of control. However, the control can be indirect. Take the case of a holding company which owns all the stock in a subsidiary which, in turn, owns all the stock of a subsidiary, not an uncommon arrangement in the case of broker-dealers, the holding company would be an indirect control person of the subsidiary's subsidiary and the subsidiary would be a direct control person.

Unlike under Section 20(a) of the Exchange Act,[123] liability under Section 410(b) is status liability. If the person has control, he will be liable unless he can establish his affirmative defense.[124]

g. Employee Liability[125]

---

[114]*Id.* At 248 Kan. At 935, 811 P.2d at 1231.

[115]Long, §9:76.

[116]Long, §9:78.

[117]*Id*.

[118]Long, §9:82.

[119]Long, §§9:91-9:94.

[120]Not the law. Ignorance of the law is never a defense. Thus, the director does not need to know that what his company was selling was a security or that it needed to be registered. All he has to know or reasonably able to discover is that the company was selling something.

[121]Long, §9:95.

[122]Long, §9:75.

[123]15 U.S.C. §78t(a).

[124]*See e.g., Connecticut Nat'l Bank v. Giacomi*, 242 Conn. 17, 699 A.2d 101 (1997). *See generally*, Long, §9:79, §9:95.

[125]Long, §§9:82-9:90.

It is important to note here that the word used is "employee" not agent. Therefore, a fair reading of the language would seem to eliminate **outside** attorneys, accountants, and engineers from liability under this provision.[126] The liability is only imposed upon those employees "who materially aid" in the transaction. Therefore, liability here is **not** status liability as it is for control persons, officers, directors, and partners.[127]

h. Broker-dealer and Agent Liability[128]

The final category of persons potentially liable under Section 410(b) is broker-dealers and agents "who materially aid." Note that there is no limitation to "sellers" broker-dealer and agents. This clause covers **both "sellers"** and "**buyers**". As such, it is a statutory acceptance of the SEC "Shingle" theory. If one is going to do business as a securities professional, he has an obligation to see that the transactions he is involved in are done according to the law. Again, the obligation is not absolute because the securities professional is giving the affirmative defense of lack of knowledge or lack of negligence.

This provision is extremely important in arbitration. First, it allows the purchaser to seek liability against his own broker-dealer and registered representative. As was seen above, these people would not normally be liable as "sellers" in **an unsolicited transaction.** Second, this provision can be used to hold clearing brokers liable.[129] Finally, it can be used to advantage in "selling away" cases where the broker-dealer is clearly not the "seller" because the registered representative is operating outside the brokerage firm.[130]

i. Aiding[131]

The last two categories only impose liability upon the employees, broker-dealer, and agents, if they "aid" in the transaction. "Aiding" here is not the same as "aiding and abetting".[132] "Aiding and abetting" carries both a knowledge of the underlying violation and knowingly aiding of the violation. "Aiding", on the other hand, requires neither. Instead, liability will be imposed unless the employee, broker-dealer, or agent meets the inverse negligence affirmative defense.[133]

It also must be distinguished from "participating".[134] As *Prince v. Brydon*[135] pointed out, the two terms are not synonymous. A person may participate without materially aiding or materially aid without participating.[136] "Participating" focuses on the sales process itself, while "aiding" focuses upon those

———————————

[126]Long, §9:82, §9:84.

[127]Long, §9:83.

[128]Long, §§9:91-9:94. A number of states have altered this clause to apply to "any person" who materially aids. Under the broader language, professionals such as attorneys, accountants, and engineers may be held liable.

[129]*Koruga v. Fiserv Correspondent Serv., Inc.*, 183 F. Supp.2d 1245 (D. Ore. 2002), aff'd 2002 WL 530548 (9th Cir. Apr. 5, 2002). *See also In re Koruga*, 2000 WL 33530559 (NASD Abr. Oct. 5, 2001) and *In re Peers*, 2001 WL 1636289 (NASD Arb. Nov. 21, 2001). *See generally*, Jeannette Flippone, "Clearer Skies For Investors: Clearing Firm Liability Under the Uniform Securities Act," 39 San Diego L. Rev. 1327 (2002).

[130]Long, §9:95.

[131]Long, §§9:85-9:90.

[132]Long, §9:88.

[133]Long, §9:95.

[134]Long, §9:87.

[135]*Prince v. Brydon*, 307 Or. 146, 149, 764 P.2d 1370, 1371 (1988).

[136]*Id*.

activities which make the sale possible. Obviously, within this legal definition, whether an employee, broker-dealer, or agent "aids," is a question of fact.[137]

j. Materiality[138]

Finally in the last two categories, the "aiding" must be material. It is clear that materiality here is not the same as for determining whether a misrepresentation or omission is material under *TSC Ind., Inc v. Northway, Inc.*[139] The test for materiality is the importance of the aiding to the transaction. As *Prince v. Brydon* said:

> Whether one's assistance in the sale is "material" does not depend on one's knowledge of the facts that make it unlawful; it depends on the importance of one's person contribution to the transaction. Typing, reproducing, and delivering sales documents may all be essential to a sale, but they could be performed by anyone; it is a drafters knowledge, judgment, and assertions reflected in the contents of the document that makes it "material" to the sale.[140]

B. Measure of Recovery Under the Uniform Act

The Uniform Act speaks in terms of recovery and not damages. This is because, as will be seen below, the statute operates on a rescission principal. The investor should be made whole. This not only requires the return to the status quo prior to the transaction, but the investor must be paid compensation for the defendant using his money during the period from sale to date of recovery. To make the investor whole, he should be able to recover all expenses and costs incurred in persuading the defendant to make rescission. These expenses and costs obviously should include attorney's fees and any expert witness costs. As to these costs, the only fair way to be sure the investor is made whole is to award the actual expenses of the attorney and expert witness. In the case of an attorney, this may require that the fee be awarded on the basis of the contingent fee entered into by the investor.

1. When the Investor Still Owns the Securities

When the investor still owns the securities, it is clear that the remedy is statutory rescission. The investor may not keep the securities and sue for damages.[141] If he wants to keep the securities, then he should sue under SEC Rule 10b-(5). Obviously, then, rescission requires the investor to tender the return of the securities.[142] Further, since he will receive rescission, he must also give back any income he has received in the form of interest, dividends, capital distributions, or the like.

In exchange, under Section 410(a), the investor receives a return of his investment, plus interest on the investment from the date of investment to the date of payment,

---

[137]*See* Long, §9:87 for list of things which have been held to be material aiding. The issuer of viatical settlements was recently held to have "materially aided" in the sale of these interests, even though the sales were made by independent contractors. *Michelson v. Voisin*, 2003 WL 103273 (Mich. App. Jan. 10, 2003). This case also holds that if there is a violation of the state securities act, the entire agreement <u>including</u> the arbitration clause is void. This plaintiff did not have to arbitrate.

[138]Long, §9:89.

[139]426 U.S. 438 (1976).

[140]307 Or. 146, 149, 764 P.2d 1370, 1371 (1988).

[141]However, Section 410(h) specifically preserves all common law causes of action. As a result, a common law fraud or breach of fiduciary duty claim may be joined as discussed below.

[142]He does not have to tender the exact securities which he purchased. They may have been re-issued or transformed by a merger, consolidation, or stock split. As will be seen below, tender normally is made in the original complaint, but it may be made as late as the defendant's tender of the recovery.

plus costs and attorney's fees. This statutory measure of recovery can be reduced to the following formula:

> Recovery = (consideration paid + 6% interest from the date of purchase + costs + attorneys' fees) - (any income received thereon).

a. General Issues

Several things are important to note about recovery here. As with Section 12(a), this statutory remedy is exclusive under Section 410(a).[143] Second, and especially important in arbitration, award of statutory damages **is mandatory**, if a violation of the act is established.[144]

Thus, the court or the arbitrators may not refuse to give an award and in the amount determined by the statutory formula, if the plaintiff establishes a violation. It is **manifest disregard of the** law for arbitrators to award nothing or less than the statutory amount.[145]

b. Consideration Paid

"Consideration paid" here means the same as under Section 12(a). As a result, all subsequent loans or assessments are to be included[146] as is interest paid on margin debt or money borrowed from any broker.

c. Interest Paid

Care should be taken when dealing with the interest the investor is to receive. The Uniform Act provides for recovery of interest at six percent. Many states, however, have altered this provision to allow the recovery at a higher rate. Oklahoma, for example, allows recovery at ten percent, while Kansas has a 15 percent rate. Further, as in the case of Section 12(a), the Uniform Act does not indicate whether this interest is to be simple or compound. These points should be considered when deciding where to bring an action and under which state act.

d. Costs

Unfortunately, the Uniform Act does not define what "costs" are to be awarded. The limited case law under the Uniform Act suggests that "costs" will be limited to traditional "court costs."[147] "Court costs" normally do not include the cost of taking depositions or expert witness fees.

As a result, the conclusion to limit recovery to traditional "court costs" is unfortunate, if the goal of the Securities Act is to place the investor in the position he was before the transaction took place. He should be able to recover any number of expenses under this provision. Expenses may include telephone calls, travel, depositions, and expert witness fees.

e. Attorney Fees

The Uniform Act, unlike the federal recovery provisions, allows the recovery of reasonable "attorneys' fees." The courts are split as to whether the payment of these fees is in the discretion of the judge or mandatory. The better reasoned cases hold that the award of such fees is **mandatory**.[148]

There is also a question as to how such fees are to be calculated.[149] Most courts are presently using some form of calculation based on hours expended, with adjustments.[150] Many lawyers handle investor claim cases on a contingency basis. If the

---

[143]However, Section 410(h) specifically preserves all common law causes of action. As a result, a common law fraud or breach of fiduciary duty claim may be joined as discussed below.

[144]*Skurnick v. Ainsworth*, 591 So.2d 904 (Fla. 1991).

[145]*Id*.

[146]*Bradley v. Hullander*, 277 S.C. 327, 287 S.E.2d 140 (1982).

[147]*Id*.

[148]*Kelsey v. Nagy*, 410 N.E.2d 1333 (Ind. App. 1980) and *Criticare System, Inc. v. Sentek, Inc.*, 159 Wis.2d 639, 465 N.W.2d 216 (App. 1990).

[149]It is clear that the **amount** of the attorney fee award is discretionary with the trial judge. *City Consumer Serv. Inc. v. Horne*, 631 F. Supp. 1050 (D. Utah 1986); *Arnold v. Dirrim*, 398 N.E.2d 426 (1979); *Bradley v. Hullander*, 277 S.C. 327, 287 S.E.2d 140 (1982).

client wants to recover under this attorney fee provision, the lawyer should keep track of the hours expended.[151] Because many securities claims are small, it is possible to get an attorney fee award which exceeds substantially the amount of the investor's other recoveries under the Uniform Act.[152]

Again, under the principal that the investor should be made completely whole, the courts should make the award on the basis of the contingent fee contract as long as that fee is reasonable.[153]

2. When the Investor No Longer Owns the Securities

The present Uniform Act, like Section 12(a), merely indicates that the investor should be able to recover "damages" if he no longer owns the securities sued on. Neither Act attempts to define "damages." The original 1957 version of the Uniform Act did define damages. It provided:

> Damages are the amount that would be recoverable upon tender less the value of the security when the buyer disposed of it and interest at six percent per year from the date of disposition.

For some unknown reason, this provision was deleted when minor changes where made to the act in 1958.

The quoted language makes clear that the Uniform Act contemplated that "damages" here would be rescissional damages rather than common law damages. This conclusion is re-enforced by the statement in the Official Commentary:

> The measure of damages, when the plaintiff is not in a position to tender back the security, is the same under Clause (1) [non-registration] and (2) [material misrepresentations and omissions]. **It is designed to be the substantial equivalent of rescission.**[154]

Most states have adopted the original 1957 language spelling out damages. Another issue here is whether the investor has to pay interest on the income he receives. The following hypothetical indicates the importance of this issue where the same money is invested over and over again.
Assume that the investor starts his brokerage account with $100,000 on May 1, 2000. The $100,000 is invested in a single stock which decreases to $90,000. This stock is sold for $90,000 on July 15, 2000. On August 1, 2000, the $90,000 was re-invested in a different stock. By October 10, 2001, this new stock had declined in value and was sold for $80,000.

Applying the recovery formula, the consideration paid in the two transactions is $100,000 plus $90,000 for a total of $190,000. The investor is entitled to receive interest on the $100,000 from May 1, 2000 until judgment. Likewise, he is entitled to interest on the $90,000 from August 1. The question is does he have to **pay** interest on the $90,000 received July 15 and the $80,000 received on October 10? Will he receive interest on the full $190,000 or only on $20,000, his actual loss?

Section 12(a) of the 1933 Act and the present Uniform Act do not resolve this problem because they simply provide that the investor can recover "damages." However, the original text of the 1957 Uniform Act quoted above clearly indicates that the investor will have to pay interest on the income received. Most of the states have adopted the original version of the Uniform Act and not the present official version. As a result, the investor will recover only on his actual loss.[155]

However, in Florida, Illinois, and Texas, the statute **does not** provide

---

[151]*Bradley v. Hullander*, 277 S.C. 327, 287 S.E.2d 140 (1982).

[152]Normally, the investor's attorney must submit a list of his hours and evidence as to the reasonableness of the fee. *See e.g., Quick v. Woody*, 295 Ark. 168, 747 S.W.2d 108 (1988); *Miller v. Inverness Corp.*, 2000 WL 1687345 (Conn. Super. Oct. 19, 2000). Some courts deduct time spent on unsuccessful claims, others do not. *Burgess v. Premier Corp.*, 727 F.2d 826 (9th Cir. 1984).

[153]*Russell v. Dean Witter Reynolds*, 200 Conn. 172, 510 A.2d 972 (1986).

[154]*City Consumer Serv. Inc. v. Horne*, 631 F. Supp. 1050 (D. Utah 1986).

[155]Official Comment to §410(a): Measure of Damages, 7b Uniform Laws Annot. 644 (Master Ed. 1985); 1 Blue Sky L. Rep. (CCH) ¶5550. [Emphasis added.]

for payment of interest on the income received. The only case to consider the issue under the language in these states, *Kugler v. Southmark Realty Partners III*,[156] takes the position that interest **does not** have to be paid on the income received.

C. Other Rules of Damages

There are a number of other rules which shape the amount of recovery an investor can expect.

1. Each Transaction Separate

The first rule is that under the securities acts, **each transaction is a separate violation.** Under Section 410 of the Uniform Act, the investor **may, but does not have to sue to set every transaction aside.** He may elect to keep some transactions and disavow others. Broker-dealers will often try to persuade the court or arbitrators that the investor must accept or reject all transactions and may only recover the "net loss" in the account. This is not a correct statement of the law.[157] The investor is free to pick and choose, a practice the broker-dealers perjoritively call "cherry picking." Naturally, the investors tend to disavow those transactions in which they have suffered a loss, while retaining those transactions in which they made a profit.

The leading case in this area is *Kane v. Shearson Lehman Hutton*[158] where the court said:

> Kane is correct when he states that there is no support to be found under Federal or Florida law for the "netting" theory Shearson argues for here....
>
> Further, there is nothing in the language of [the Florida Securities Act] to indicate that the Florida legislature intended to force victims of fraud to aggregate their profits and losses from separate transactions that happen to involve the same defendant and thus reduce their recoveries. Instead, the plain language of the statute reveals the intent to allow a purchaser fraudulently induced into purchasing a security to rescind his purchase, or, if he has already sold at a loss, to be put by an award of damages in as good a position as if he had rescinded the transaction. **There is no indication that other transactions are relevant to this calculation at all.**

2. Investor Entitled to Maximize Recovery

The second rule is that the investor is entitled to maximize his recovery.[159] Both the Uniform Act[160] and the Securities Act of 1933[161] have a provision which preserves **all common law causes of action.** Therefore, it is possible to join common law causes of action with a securities act claim. It is also possible to join other statutory claims such as a claim under the state Deceptive Trade Practices Act or RICO statute.

This right to maximize damages is important for two reasons. First, where multiple counts are included, damages should be calculated under each theory. The investor, then, should be awarded the maximum

[155]Official Comment to §410(a): Measure of Damages, 7b Uniform Laws Annot. 644 (Master Ed. 1985); 1 Blue Sky L. Rep. (CCH) ¶5550. [Emphasis added.]

[156]The interest on the income received sets off the interest paid on the original investment except for the actual loss. Technically, in the above example, the investor will receive full interest on the first investment of $100,000 from May 1 to July 15. He then receives interest on his loss of $10,000 on to judgment. The same is true of the $90,000 investment. Interest on the full $90,000 until October 10 and then interest on only $10,000 thereafter.

[157]303 Ill. App.3d 790, 723 N.E.2d 710 (1999).

[158]*See e.g.*, *Kane v. Shearson Lehman Hutton*, 916 F.2d 643 (11th Cir. 1990); *Merchant v. Oppenheimer & Co.*, 568 F. Supp. 639 (E.D. Va. 1983), aff'd 739 F.2d 165 (4th Cir. 1984); and *Piantes v. Hayden-Stone, Inc.*, 514 P.2d 529 (Utah 1973).

[159]916 F.2d 643, 646 (11th Cir. 1990). [Emphasis added.]

[160]*Mid-America Federal Savings & Loan Assoc. v. Shearson/American Express, Inc.*, 962 F.2d 1470 (10th Cir. 1992); *Bateman v. Petro Atlas, Inc.*, [1978-1981] Transfer Binder Blue Sky L. Rep. (CCH) ¶71,463 (S.D. Tex. 1977).

[161]Section 410(h).

[162]Section 16(a). 15 U.S.C. §77p(a).

figure under one theory.

Further, it is possible to mix and match items of damages.[162] For example, the maximum amount of actual damages might be for common law breach of fiduciary duty. However, this claim does not allow recovery of interest, costs, and attorneys' fees which the Uniform Securities Act clearly does. Investor may recover the maximum actual damages for breach of fiduciary duties and the other items under the securities act.[163]

3. Punitive Damages

Finally, there is the issue of punitive damages. Punitive damages are not recoverable under either the Federal Securities Act of 1933 or the Exchange Act of 1934 because of the language in Section 28 of the 1934 Act.[164] Because there is no equivalent language to Section 28 in the Uniform Securities Act, it is far from clear that punitive damages may not be awarded under the Act. Following the federal precedent, however, conventional wisdom is that no punitive damages are not available under the Uniform Act either. However, it is clear that punitive damages can be awarded at common law for fraud and breach of fiduciary duty. Therefore, the investor should join claims under these theories with his securities claim. In such case, the maximum actual damage award might be for common law fraud. To this could be added the interest, costs, and attorneys' fees under the Uniform Securities Act. Finally, punitive damages might be added under the claim for breach of fiduciary duty.[165]

D. Counterclaims

In many arbitrations and litigations, broker-dealers will seek to make counterclaims against the investor arising out of the securities transactions. Such counterclaims should be denied in their entirety.[166] Section 410(f) provides:

> No person who has made or engaged in the performance of any contract in violation of any provision of this act or any rule or order hereunder, or who has acquired any purported right under any such contract with knowledge of the facts by reason of which its making or performance was in violation, **may base any suit on the contract.**[167]

---

[162]Section 16(a). 15 U.S.C. §77p(a).

[163]*Mid-America Federal Savings & Loan Assoc. v. Shearson/American Express, Inc.*, 962 F.2d 1470 (10th Cir. 1992); *Bateman v. Petro Atlas, Inc.*, [1978-1981] Transfer Binder Blue Sky L. Rep. (CCH) ¶71,463 (S.D. Tex. 1977).

[164]*Mid-America Federal Savings & Loan Assoc. v. Shearson/American Express, Inc.*, 962 F.2d 1470 (10th Cir. 1992); *Bateman v. Petro Atlas, Inc.*, [1978-1981] Transfer Binder Blue Sky L. Rep. (CCH) ¶71,463 (S.D. Tex. 1977); *E. H. Boerth Co. v. Lad Properties*, 82 F.R.D. 635, 646 (D.Minn. 1979).

[165]*See e.g., Young v. Taylor*, 466 F.2d 1329 (10th Cir. 1972).

[166]*Mid-America Federal Savings & Loan Assoc. v. Shearson/American Express, Inc.*, 962 F.2d 1470 (10th Cir. 1992); *Hunt v. Miller*, 908 F.2d 1210 (4th Cir. 1990); *Young v. Taylor*, 466 F.2d 1329 (10th Cir. 1972); *Bateman v. Petro Atlas, Inc.*, [1978-1981] Transfer Binder Blue Sky L. Rep. (CCH) ¶71,463 (S.D. Tex. 1977).

[167]*Criticare Systems, Inc. v. Sentek*, 159 Wis.2d 639, 465 N.W.2d 216 (App. 1990).

ProfLipner's "I Love New York Law" Column- Fraud in the Inducement: Claims Can Be Made Against Brokers (and Lawyers)

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.

It is not unusual for brokers to inflate their past when trying to sell their services, especially when speaking to high net worth clients. In a competitive environment, is such exaggeration "innocent", a necessary element of winning lucrative accounts, or is it legally actionable? The same question might be asked of lawyers, who might also be tempted to inflate their experience or qualifications. This article addresses both these situations.

The question addressed by this article might be put: When does such common "salesmanship" cross the line, from inactionable "puffing" to outright "fraud"? Can an investor who suffered bring suit because she financial ruin at the hands of a broker who made misrepresentations about, inter alia, his background, bring a suit on that basis? Similarly, when a can a client sue a lawyer for inflating his expertise?

The easiest starting point is the obvious: when the exaggeration concerns such objectively measurable facts such as quantifiable past performance, or number of cases handled, or licenses held, the legal violation seems clear. But what of more subjective misrepresentations of expertise? In these cases, careful legal analysis is required. Fortunately, New York law provides some solid bases upon which to frame just such an action.

In order for an investor (or client) to sustain a claim of "fraudulent inducement", the investor/client must show that (a) the false representations were not merely "puffing", and (b) that they were "material". In addition, proof of causation, knowledge and intent are required, but these would seem not be sticking points in cases of this kind, which are about "winning business", but producing losses.

Puffing: As stated, statements which can objectively be proven to be false are actionable, while subjective statements are more likely to be viewed as puffery. Thus, for example, a representation that an investment is "safe," *DH Cattle Holdings Co. v. Smith*, 195 A.D.2d 202, 208, 607 N.Y.S.2d 227, 231 (1st Dept. 1994), or vague statements that a broker is "experienced," *Glassman v. Catli*, 111 A.D.2d 744, 745, 489 N.Y.S.2d 777, 779 (2d Dept. 1985), are not sufficient.

But more detailed misrepresentations can cause a case to cross the boundary. For example, in dealing with brokers, the Southern District of New York declined to characterize as mere "puffing" a stockbroker's claim that he "had a thorough knowledge of gambling stocks and options", finding that that statement led to an actionable claim of fraud under 10(b). *Campo v. Shearson Hayden Stone, Inc.,* 1980 WL 1409 (S.D.N.Y. 1980). See also *Trans World Airways v. Catalano*, 1979 WL 1258 (S.D.N.Y. 1979) (finding as fraudulent a proxy statement containing a false statement that one person on the slate was a "retired Major General").

In another case, this one dealing with lawyers, an attorney with about two years' experience tried, in a written resume he gave a prospective client, to portray himself as an expert litigator in the fields of health care and labor law. He bragged about non-existent clients, and inflated his past - mostly per-diem landlord tenant work - into "particularly difficult and important cases". In a case brought against him by a disappointed client, neither the lower court nor the Second Circuit hesitated to characterize that conduct as "fraud". *Baker v. Dorfman*, 239 F.3d 415 (2d Cir. 2000)

It is not difficult to analogize "a thorough knowledge of gambling stocks and options" with "an area of expertise in concentrated stock positions"; or a "retired Major General" with a "an experienced securities arbitration attorney".

But what about less clear-cut things? For example, in a recent case, a broker at Merrill Lynch with limited experience told the client she was a "financial planner." The client had a complex situation, and was looking for just such an individual, who could integrate investments, life and retirement planning, and taxes. When the client's account was badly botched, he initiated an arbitration.

Research revealed that the use of the term "financial planner" is not regulated by the state in the same way terms like "broker" or "lawyer" are. The term "financial planner" derives from a course of study and degree first offered by a college in Denver, but it now encompasses a far broader range of financial professionals, only some of whom are members of the professional organization that offers a "certification" (a "CFP"). No state requires possession of the certification in order for a person to hold one's self out as a "financial planner." A CFP called to testify as expert could be expected to opine that the average Series 7 trained and licensed broker with two year's experience should not be holding him or herself out as a "financial planner", and that "recommending investments" is but a small part of a "financial planner's job."

The legal issue, however, has little do with the opinion of the expert. To resolve the question of whether the representation of being a "financial planner" was fraudulent, New York law provides a different formula:

> [P]uffing is permissible only where the ordinary purchaser would not be deceived by the exaggerated claims. The ordinary purchaser must recognize the puffery for what it is, and realize that he is not expected to rely on the claims made. [citations omitted]

Potamkin Cadillac Corp. v. Towne Cadillac Corp., 592 F.Supp. 801 (S.D.N.Y. 1984).

The first part of the definition implies that the "burden" of claiming puffery lies with the respondent; the second provides an objective test. The clear thrust is that the right to rely is established, in the absence of circumstances to the contrary. In the case of the Merrill Lynch broker, it was telling that (a) the title Merrill gives to its brokers is "financial consultant", not "financial planner", and (b) the employee was, at the time, beginning to take the courses necessary obtain the "CFP" certification. Nevertheless, the law permits some level of exaggeration, and arbitration is notorious for turning questions of law into questions of fact.

Materiality: Materiality (and its subjective cousin, reliance) is the second important element in a "fraudulent inducement" case. The more complex the investor's situation, the more likely one can establish materiality and reliance. The bigger the exaggeration, and the more it bears upon the situation at hand, the better the claim. For example, if an investor with a complex investment/tax situation is approached by a broker who falsely represents that in addition to being a broker, she is a lawyer and financial planner. The client chooses her as a broker over others competing for the business who did not have those qualifications. When the investor receives poor investment/tax advice, the claim for "fraudulent inducement" seems strong. By contrast, if the investor had a mundane situation, not implicating complex tax issues, materiality might not established.

Materiality also leads to an inference of the important element of causation, and probably supplies the basis for that needed aspect of the case as well.

Lawyers and Our Ethical Duties: Lawyers, of course, have an additional ethical responsibility. DR 1-102 prohibits lawyers from any form of dishonesty, in addition to a prohibition of fraud. EC 2-6 through 2-15 speak to an attorney's duties to use "special care" to be scrupulous in disseminating information about the attorney, his experience and background. Any Aadvertising stratagems [which] hinder rather than facilitate intelligent selection of counsel" are considered improper. (EC 2-10). And, most important, "employment should not be accepted by a lawyer who is unable to render competent service." (EC 2-30). Thus, in addition to a law suit, disciplinary consequences can result when a lawyer misleads a client into believing the lawyer has more experience or expertise than the lawyer actually has.

Deceptive Trade Practices: New York General Business Law section 349 makes illegal any deceptive practice used in business, and based upon the Fourth Department (intermediate appellate court) decision in *Scalp & Blade v. Advest*, 722 N.Y.S.2d 639 (4th Dept. 2001), such a claim is viable against a financial services firm. The court wrote:

Given the statute's explicit prohibition of "[d]eceptive acts or practices in the furnishing of any service" . . . and given the Court of Appeals' characterization of the statute as "appl[ying] to virtually all economic activity" [citation omitted] we see no basis for invoking any blanket exception under the statute

for securities transactions [citation omitted] or for limiting the statute's applicability to the sale of "goods".

The beauty of GBL 349 is that it provides a statutory basis for recovery of attorneys fees. The statute ought to cover many of the situations covered here.

Conclusion

There can be no doubt that a cause of action exists for clients and customers lured in by a salesman who lacks the qualification the salesman advertises. But any such claim must be well-developed, because the law in this area requires proof of exaggerations that are measurable and important.

Expert's Corner –

The Sale of Variable Insurance Products For Better or for Worse: Causes of Abusive Sales Practices

By Vincent Micciche CRCP

In 1980, Variable Universal Life (VUL) accounted for less than 2% of total permanent life insurance sold in the United States and was generally considered, by industry experts, to be exotic and applicable to a very narrow market. Those same experts could hardly imagine it possible that variable insurance sales would grow faster than any other life insurance product over the next two decades. By the year 2000, VUL sales had grown to account for nearly 50% of all new permanent insurance sold! During the same period of time, Variable Annuities (VA's) grew in popularity at an even more impressive rate. This phenomenal growth was influenced by many factors that will be explored in this paper, but none is more significant than the industry's willingness to give the consumer exactly what he wants – for better or for worse.

My career in the financial services industry began in 1978 when I took a position as a career agent with an old and established Mutual Insurance Company. Training was focused on product knowledge, application, and, most importantly, sales. I remember my General Agent, who was my mentor, telling me that the key to success was selling people what they want first and what they need later. He went on to teach that better understanding of human greed and fear would result in more sales. During all of that training, little time was spent on developing an understanding of the duty of care that is owed a customer by a financial intermediary. This is not a philosophy that I ascribe to and it did not sit well with me. Nonetheless, I believe that approach continues to this day and is one of the many reasons the insurance industry has become the target of litigation and the focus of attention of many regulators. Unfortunately, the structure of the industry allows for its less scrupulous representatives to engage in sales practices that place the public customer at risk of suffering enormous losses and the industry at risk of diminished credibility. The multi-billion dollar class action suits against insurance companies of late serve to illustrate the magnitude of the problem.

While I could write several volumes on this subject, this paper will provide an overview of insurance products and how they get from the manufacturer to the consumer. I will focus on those products that are registered securities called Variable Products. In addition, there is a section that explores the more common variable annuity sales infractions. To better understand how sales abuses may occur, a basic understanding of the product and its various distribution channels is required and is provided in the next two sections. If the reader is already familiar with these products and their means of distribution, he or she may wish to skip directly to Section IV. There, I examine the factors that influence the behavior and practices of those who sell them. The fifth and final section will present conclusions and summary.

Section I – Life Insurance and Annuities

Traditional fixed life insurance is either Term or Permanent. As the names would imply, one is designed to meet a temporary need and the other, a permanent need. Both are a guarantee on the part of the company to pay a death benefit when the insured dies, provided he has paid the annual premiums. All types of life insurance enjoy the same tax benefits, most notably; the death benefit proceeds are not taxable as income.

Annuities, whether fixed or variable, share common characteristics. Both are designed to provide tax-deferred accumulation of funds that may later be used to provide an income stream for the annuitant. In all cases there is an owner of the contract, a beneficiary, and an annuitant. Often, but not always, the owner and

Mr. Micciche is the CEO of an independently owned national broker/dealer that is insurance product specialized. He has over twenty years experience in senior management and compliance. He was recently granted the designation of Certified Compliance and Regulatory Professional CRCP from the Wharton-NASD Institute of Professional Development. He has taught, consulted and provided expert testimony on the subjects of variable product suitability, sales practices, and adequacy of supervisory systems for over 15 years. He can be reached at 585.385.3130, Extension 15, or email at Vincent@variablexperts.com.

annuitant are one in the same. All have a death benefit that is equal to at least the premiums paid less withdrawals. Because there is a death benefit, annuities are considered insurance instruments.

In order to sell either life insurance or annuities, life and annuities licensing is required in the state in which the sale occurs. An agent needs an insurance license, a variable product license, and a securities license consisting of either a Series 6 or 7. Sales of insurance and annuities are subject to regulation of the Insurance Department of the state and its Commissioner. Regulations are not uniform and vary widely from state to state.

Term Insurance
Term insurance premiums, when compared to permanent, are considerably less expensive, especially at younger ages. The premium of term insurance consists of the actual cost of insurance (COI) based on actuarial assumptions, administrative expenses, duration and a margin of profit. It is generally issued as a contract that is renewable or non-renewable up to a maximum age of 100. It can be issued as an annual renewable contract or as a longer contract such as 5, 10, or 20 years. The annual premium is guaranteed during the contract period and always increases when renewed. Term is ideal for insuring against the risk of death for a known period time, like the term of a mortgage. It may provide an inexpensive solution to one who has a large death benefit need but limited income with which to purchase the insurance. In this case, one can purchase term that can later be converted to permanent insurance without having to prove future insurability. While versatile and relatively cheap, term will eventually become prohibitively expensive, as the insured grows older. This insurance is designed to die before the insured does and thus represents a very lucrative product for the Insurance Company. Historically, less than 3% of term insurance contracts purchased would be in force when the insured died.

Permanent Insurance – Fixed - Whole Life and Universal Life
While more expensive, the annual premiums of Whole Life insurance are designed to be level over the life of the insured. Level premium is achieved by combining the average COI over the life expectancy of the insured and "overpayment" that is derived by Net Present Value calculations. Essentially, in the early years of the contract, the annual premium well exceeds the COI and the excess is invested by the Insurance Company to achieve a return that is necessary to support the mortality assumptions of the contract. As time progresses and the COI increases, the excess accumulation subsidizes the premium. Assuming that the insured meets the obligation of paying the premiums as due, this contract will remain in force and pay the death benefit regardless of age. Generally, Whole Life premiums and cash values are guaranteed.

The permanent contract is complex and has many working parts. This type of contract, unlike Term, has an accumulated cash value that can be borrowed from the policy, used to pay premiums, or in some cases increase the death benefit. It may also be used as an accumulation vehicle for the purpose of funding retirement or other future cash needs. A variation on Whole Life is Universal Life; the primary difference is that the insured has flexibility in paying the premiums. The premiums may be varied, within certain parameters, upward or downward. Many Universal Life insurance contracts are "current assumption" meaning the insurance company can change the COI or mortality charges of the contract under certain circumstances. This type of policy has less predictability of cost and cash values.

In either case, the obligation of the insured is to pay the premiums when due and the obligation of the insurance company is to pay the death benefit when the insured dies. The premiums paid to the insurance company are part of its general assets and are subject to significant reserving requirements. The investment risk of these assets is borne by the insurance company and, they are therefore, generally conservatively invested.

Variable Universal Life (VUL)
VUL, like the other forms of permanent insurance, can provide coverage throughout the life of the insured assuming the premiums are paid at a level necessary to maintain the contract. A distinct difference between VUL and the others is the fact that the insured, sometimes with the assistance of an advisor, selects the funds in which the premiums are invested and assumes the investment risk. The general assets of the company are not available to guarantee the contract. The premiums are periodically invested in sub accounts that are typically clones of brand name mutual funds. In some cases, the insurance company has proprietary funds available for selection as well. The expenses of management and administration of the sub accounts vary widely from policy to policy. Because the insured is assuming investment risk, VUL is a registered security and those who sell it must have, at least, an NASD series 6 license. Those who sell this product are subject to the regulation of both the NASD and the state Insurance Commissioner.

Fixed Annuities
These contracts credit the premiums paid into them with interest that is guaranteed by the general assets of the insurance company. The buyer may select different rates by locking in the interest for a certain period of time similar to what one might do with a certificate of deposit at a bank. In order to sell fixed annuities, the

salesperson must be a licensed insurance agent or broker.

Another type of fixed annuity is the Indexed Annuity. This contract basically allows for upside participation in the equities markets while providing guaranteed future values regardless of market performance. The means by which this occurs is quite complicated, and can be easily misunderstood by both the buyer and seller.

Despite their complexity and exotic components, these are not registered securities products. Still, several insurance companies require securities licensing on the part of those who sell indexed annuities.

Variable Annuities – VA's
These contracts have many features that are similar to fixed annuities with one major difference. The purchaser/owner, sometimes with the assistance of an advisor, selects the investments into which the premiums are placed. These investments are again clones of brand name mutual funds, similar to those used in VUL and may include proprietary funds of the insurance company. The customer assumes the investment risk and may suffer principle losses. VA's may have death benefit guarantees beyond the premium paid like high water mark features that lock the death benefit at the highest value during the life of the contract. Others may have guaranteed rates of growth regardless of market performance. Naturally, these enhanced features and riders cost more than the basic contract and increase the annual expenses that are deducted from the contract value. As with VUL, the owner assumes the investment risk. In addition to licensing requirements as an insurance agent or broker, securities licensing is required as well. There are several states that are attempting to eliminate the dual regulation and bring the sales of VA's and VUL under the exclusive jurisdiction of the Insurance Department of the state.

In fixed annuities, the total account value and settlement option chosen will determine the amount of monthly income when annuitized. In VA's, while the owner is paying money into the contract, he is purchasing accumulation units that are later converted to annuity units. When the owner decides to annuitize, income is based on the number of annuity units and the then current value. Monthly income will vary with the value of the units. In some annuities, the owner may select a variety of annuity options including "guaranteed certain periods" such as 5, 10, or 20 years. In this case, if the annuitant dies prematurely, a monthly income is paid to the beneficiary for the balance of the guaranteed period.

All annuities enjoy tax-deferred growth of the monies that are deposit into them. Annuities can be purchased in one lump sum (single premium annuities) or over a long period of time. All are subject to federal tax penalties if withdrawals are made before age 59 ½. Annuities cannot defer taxes in perpetuity.

The features and riders that are available to the purchaser vary widely from company to company and state to state. In any case, additional guarantees and benefits cost more. Mortality and Expense (M&E) charges are applied to the contract on an ongoing periodic basis and can vary from under 100 basis points (BPS) to over 250 BPS annually depending on the sub-accounts that are selected and the riders attached. Annuities do not charge the customer an upfront sales load (although the broker may be paid one), but most apply a contingent deferred sales charge (CDSC) if the contract is terminated within the first 6 to 9 years. For stockbrokers, variable products are one of the highest commission products he or she can sell.

Section II – Common Sales Practice Violations in Variable Annuities

Variable annuities are very complex and misunderstood investments. Many stockbrokers perceive the insurance component as making these investments conservative, which is a misconception. Years ago, the NASD recognized that variable annuity sales were an area of concern and for that reason, published several Notices to Members (NTMs), regulatory pronouncements to brokerage firms and brokers, specifically focused on variable annuities. These documents provide a good framework for evaluating whether or not a client has a suitability, fraud or failure to supervise case against the firm for the broker's recommendation of a variable annuity investment.

NTM 96-86 lays out the specific factors that a broker should take into account when recommending a variable insurance investment to a particular client. It provides:

…registered representatives are required to make reasonable efforts to obtain information concerning the customer's financial and tax status, the customer's financial objectives, and such other information used or considered to be reasonable by the member or registered representative in making recommendations to the customer. Thus, for example, specific factors regarding a recommendation to purchase Variable Products that could be considered under the NASDs suitability rule include:

(i) a representation by a customer that his or her life insurance needs were already adequately met;

(ii) the customer's express preference for an investment other than an insurance product;

(iii) the customer's inability to fully appreciate how much of the

purchase payment or premium is allocated to cover insurance or other costs, and a customer's ability to understand the complexity of Variable Products generally;

(iv) the customer's willingness to invest a set amount on a yearly basis;

(v) the customer's need for liquidity and short-term investment;

(vi) the customer's immediate need for retirement income; and

(vii) the customer's investment sophistication and whether he or she is able to monitor the investment experience of the separate account.

NTM 99-35 states that "Typically, variable annuities are designed to be long-term investments for retirement. Withdrawals before a customer reaches the age of 59 1/2 are generally subject to a 10 percent penalty under the Internal Revenue Code. In addition, many variable annuities assess surrender charges for withdrawals within a specified time period after purchase."

One red flag for the securities practitioner is whether the variable annuity is being recommended in a retirement account. NTM 99-35 goes on to address the variable annuity in retirement accounts. It states, "While these variable annuities provide most of the same benefits to investors as variable annuities offered outside of a tax-qualified retirement plan, they do not provide any additional tax deferred treatment of earnings beyond the treatment provided by the tax-qualified retirement plan itself...When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account (e.g., 401(k) plan, IRA), the registered representative should disclose to the customer that the tax deferred accrual feature is provided by the tax-qualified retirement plan and that the tax deferred accrual feature of the variable annuity is unnecessary. **The registered representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit, and guaranteed fees, support the recommendation.** A member should conduct an especially comprehensive suitability analysis prior to approving the sale of a variable annuity with surrender charges to a customer in a tax-qualified account subject to plan minimum distribution requirements."

NTM 00-44 articulated a few additional pieces of information the broker should obtain from the client in order to perform a proper suitability analysis. It requires that the broker learn the client's sources of funds for investment and his or her existing investments and life insurance, time horizon, and risk tolerance, among other things.

NTM 00-44 further states that the "registered representative should document this type of information in a customer account information form and should submit it with every variable life insurance application. A registered principal should review the account information form and verify that the recommendation of both the policy and the sub-account allocation is consistent with the customer's investment objectives and risk tolerance...."

The NASD did not beat around the bush in NTM 00-44 with respect to the issue of a client's insurance needs and age. It states:

The member should consider whether the customer desires and needs life Insurance...

Members may wish to establish special supervision requirements for sales to older customers.

Life insurance is often appropriately purchased by older investors. However, variable life insurance may not be suitable for an older investor who is primarily seeking an investment rather than an insurance product.

NTM 00-44 recites that the NASD has found that the improper sale of annuities can violate the following NASD regulations:

NASD Rule 3010 (Supervision);

NASD Rule 2110 (Standards of Commercial Honor and Principles of Trade;

NASD Rule 2210 (Communications with the Public)(for the use of misleading sales literature); and

NASD Rule 2310 (Suitability Rule)

Since variable annuities have a variety of costs associated with them, NTM 00-44 specifies what the broker should be familiar with, as well as what must be conveyed to the customer. It states:

Registered representatives should be thoroughly familiar with the features and costs associated with each recommended variable life insurance policy, including surrender charges, premium and cash value charges, separate account charges, underlying fund fees, sub-account investment options, loan provisions, free-look periods, and policy premium lapse periods. The registered representative also should be able to clearly convey such information to the customer so that the customer can make an informed investment decision regarding the recommendation.

Based on the foregoing, the following factors should be considered closely to determine suitability:

1. If the customer is older (65 years+), retired, or otherwise in need of liquidity.

2. If the customer is older (65 years +), retired, or otherwise in need of income.

3. If the customer already has sufficient life insurance.

4. If the customer believed that there was little risk of loss with respect to the variable annuity.

5. If the customer was unaware of all of the various charges, tax penalties, and the free look period.

6. If the customer was in and out of several annuities (may be switching).

7. If the customer is in a low tax bracket.

As you can see from the NASD notices about variable annuities, special care must be taken by investment professionals when recommending them. Herein lies the problem: far too many insurance agents and stockbrokers that sell annuities believe them to be inherently conservative and suitable for most anyone when, in fact, annuities are suitable for a minority of investors.

Section III A Typical Distribution Model

The Manufacturer
VA's and VUL are mortality products involving actuarial assumptions and therefore are designed and manufactured by insurance companies. The companies submit products to the insurance departments of the states in which they intend to sell. The insurance departments review and eventually approve or decline approval of the product. Products are usually designed with significant input from the marketing department of the company, whose role is to analyze the needs and demands of the marketplace and present products and concepts that compete well. It then becomes the job of actuaries and financial analysts to design a product that meets marketing's demands and is financially viable for the company. As you might imagine, it can be a daunting challenge to create highly differentiated products in a market that is saturated with companies competing for market share.

The Distributor
The Insurance Company then enters into an agreement with a broker/dealer who signs dealer agreements with many other broker/dealers or registered persons. This component of distribution is similar to the underwriter of a mutual fund. For the most part, the distributor does not engage in retail sales.

The Wholesaler
The wholesaler is sometimes a wholly owned subsidiary of the insurance company and is registered as a broker/dealer. The role of the wholesaler is to provide marketing support to the network of broker/dealers that retail the product. It may actually process the business submitted by retail broker/dealers with which it has such a relationship. Compensation for the wholesaler is separate from the retail dealer concession that is disclosed in the prospectus and is paid by the insurance company. It may run as high as 25% of the gross dealer concession (GDC). In some cases, very large insurance brokerage operations may act as a wholesale insurance marketing organization (IMO). It is possible for a broker/dealer to act in the capacity of both retailer and wholesaler. The wholesaling broker/dealer should not be sharing wholesale compensation with the retail broker/dealer in order to entice them to do business.

The Retailer
This is the final step in product distribution where the public customer comes in contact with the registered representative (RR). The RR is registered with and supervised by the retailing broker/dealer. The entity with primary responsibility for suitability and supervision of the transaction is the retailing broker/dealer. The broker/dealer facilitates supervision of its RRs by establishing a network of offices of supervisory jurisdiction (OSJ) and branches. Both have a registered principal who supervises the activity of the RRs.

Retailers may include:

Wirehouse Firms
Brokerage General Agents (BGAs)
Independent Broker/Dealers
Bank owned Broker/Dealers
Registered Investment Advisors
Registered CPA's
Insurance Company owned
Broker/Dealers
Regional Firms

The above mentioned retailers have in common the ability to sell variable products to their clients, but the similarity ends there. The main difference lies in the supervisory structures of the firms and the presence or absence of conflicts of interest that may influence the selection and sale of products. Another notable difference is the level of training, education, and expertise of their RRs. The next section will examine these differences in more detail, as there are major factors that affect the culture in which the RR resides. There is little question that the perception of the RR regarding product suitability will vary dependent upon his expertise and function. There is an old cliché that I believe to be very applicable here; "When you are a hammer, everything looks like a nail."

Section IV – Factors that influence Sales Practices

Integrity, as defined by *Webster's New Universal Unabridged Dictionary*, is the quality or state of being of sound moral principle;

uprightness, honesty, and sincerity.

Anyone who has spent any significant amount of time in management or executive positions knows that the leadership's values affect the behavior of all subordinates. The ideal business model has an environment in which all members share the same values that are promoted by its leadership and management. We needn't look further than the front page of the newspaper to find countless examples of how corporate greed has shaped the demise of many businesses. I think it's safe to suggest that if integrity does not exist in leadership, one should not expect to find it in the rank and file.

The financial services industry is a place where its constituents can earn unlimited amounts of income, which is the allure for many. Hopefully, the desire to earn tremendous profits and income is balanced by a sense of public purpose, duty, and recognition of the extraordinary responsibilities that financial intermediaries have in today's capital markets. Public trust and confidence is essential in maintaining healthy financial markets and growth in capital. Images of Gordon Geko from the film *Wall Street* and his mantra "Greed is Good" inspire the less scrupulous to achieve unreasonable accumulation of wealth at the expense of uninformed investors who are pursuing their own aspirations in good faith.

The leaders of the financial services industry must be willing to accept the concept that the duty of care owed the customer is superior to all others. In my experience, there are environments in which this occurs and others where it does not. Whether by accident or design, the complex mechanisms of compensation, production requirements, conflicts of interest, and ambiguity of dual regulation have contributed to the growth of problems in sales practices. By aligning the values and goals of the industry with the mandates of the regulators, I believe we can achieve meritorious results for the public investors and the industry. At the same time, create a more stable and predictable environment for the professional financial practitioner.

Education and Qualification vs. Licensing

In the insurance industry, one of the most prestigious designations an agent can possess is Certified Life Underwriter (CLU). CLU training involves comprehensive study of products, their applications, financial planning, risk management, ethics, and more. It takes years to acquire. Generally speaking, the designee is a professional who has demonstrated discipline, dedication, and commitment to his profession. By way of his training and qualification he can render a high quality of service to his clients in helping them to achieve their financial goals regardless of how complex they may be.

Similarly, in the securities industry there are many professional education opportunities that lead to designations that distinguish one broker from another. In some firms, very rigorous training and educational prerequisites are necessary before one can become registered to sell product. The NASD requires fulfillment of Regulatory Element and Firm Element training requirements in order to maintain registration and active licensing. Many firms provide additional training on a frequent periodic basis and require the participation of all their RRs and their sales assistants.

Unfortunately, the nominal requirements to sell insurance or securities, is the acquisition of a license. Theoretically, a very unqualified person can take a one week crash course, find a sponsoring broker/dealer, pass an exam, and be selling financial products in less than a month! If someone is a good salesman and prodded by an override hungry manager, he might become very successful at selling inappropriate or unsuitable products to unknowledgeable and trusting customers.

Retirement plans, life insurance policies, and college education funds often represent the largest investments that a client will make in his or her lifetime. It seems reasonable that the investor is entitled to more than just a pleasant and well presented salesman. The qualification to advise such clients is implied in multimillion dollar ad campaigns, web-based access to all sorts of technologies, 800 numbers for instant customer support, and claims of billions of dollars in assets under management. The question remains, is the RR who is sitting across the table from the customer really competent to provide unbiased financial advice and products to the customer? Often, especially in insurance brokerage, we can find General Agents (GAs) and sales managers supporting their agents/RRs with feature driven product recommendations. These individuals are often much more sales and marketing oriented than technically qualified. In some cases that I am aware of, there are GAs and sales managers who regularly make recommendations in VUL and VAs while not being securities licensed!

A Clash of Cultures – Insurance and Securities Brokerage

Having spent twenty years working primarily with insurance people who also sell securities, I have been able to observe amazing dichotomies. Over the past twenty years, the worlds of insurance and securities brokerage have come much closer and almost merged. As a result, the main mechanisms that support sales are riddled with regulatory ambiguities, conflicts of interest, and most importantly very different approaches to supervision and control of sales practices.

The securities industry is arguably one of the most regulated that exists. The Securities Acts that followed the Depression were clearly centered on full disclosure of material information and fair dealing with customers. The NASD Rules of Fair Practice reflect that goal in the many rules regarding advertising, disclosure, compensation, and many others. The concept of non-flamboyant presentation of investment opportunities coupled with strong attention to suitability requirements should be the foundation of every sales presentation.

The insurance industry far too often has not embraced the same themes. It has always been extremely sales oriented and commission driven. Its approach to advertising, public communications, and disclosure is considerably different from the securities industry. One of the best examples I can think of is the life insurance illustration that consists of a very complicated spreadsheet that illustrates the hypothetical performance of the policy under a given set of assumptions. It is often more than ten pages long and very difficult to understand for even the agents who are selling them. Many insurance companies use these illustrations as sales tools rather than disclosure documents. Their marketing departments will often ask the agent to acquire an illustration of the policy they are competing against in the sale so they can tweak theirs to make it appear more competitive. I can't tell you how many times I've heard the phrase "It illustrates well," while listening to company wholesalers hawking the newest and latest product at sales conferences. The insurance sale is often an emotional one where it should be technical. The decision to purchase should be made based upon a rationale business decision.

There are many who would argue that by comparison, the insurance industry is virtually unregulated! I disagree. I believe that there are quantitative and qualitative differences between the insurance and securities industries that need to be aligned.

Incentives and Disincentives to Sell

The neutrality of a brokerage firm and its RRs is essential to providing the customer with unbiased recommendations. Unfortunately, there are many forces at play that can compromise the neutrality of the firm and result in "steering" of certain product sales. The investor can only assume that the RR is presenting suitable recommendations without prejudice of any sort. The investor cannot possible know the myriad factors that influence product selection by the RR. If the customers actually did know these things, would it influence their decision to buy? Let's look at a few.

- **Sales Contests** - While somewhat controlled on the securities side, they are commonplace and generally unrestricted in insurance sales. It is not unusual for insurance agents to win all expense paid trips or large cash bonuses if certain production levels are achieved in specific products. Even more dramatic are the ways in which insurance companies reward their BGA's for driving sales of specific products. Keep in mind that a typical BGA represents well over 30 insurance companies and their products. The companies have to compete for shelf space, and they do so aggressively.

- **Compensation –** As one might imagine, there are dramatic differences in compensation from company to company. In a market where product is very similar, if not identical in features, this is a powerful means of competing for sales. For example, once an RR has decided that an annuity would be an appropriate instrument for achieving the client's goals, he may choose from his firm's list of annuity products available - often exceeding 40 or 50. The kicker is that compensation can run from about 1% to over 7% depending on what is chosen. Assuming the contracts are virtually identical in features, the RR should be most concerned with the internal M&E charges, quality of sub-accounts, and overall service record of the insurance company, among other things. Sadly, the commission will often be given greater consideration than it should. It might be helpful for the client to know the full range of product choices available from his or her RR.

- **Minimum Production Requirements and Quotas -** In order for an RR to maintain his or her registration at a firm, there are commonly production requirements involved. These requirements will vary widely from firm to firm and will typically be the highest at wirehouses. During periods of significant market contraction like what we've seen since late 2000, RRs are under pressure to sell while the marketplace isn't interested in buying anything. Very often, insurance companies will provide bonus compensation to broker/dealers or BGAs for achieving particular quotas that are predetermined. Similarly, the companies might provide bonuses to their Regional Vice Presidents (RVP) for the same reason. There is little doubt that this creates a backdrop that encourages product concentration and raises suitability concerns, which is hardly in the customer's best interest.

Supervision and the Role of the Compliance Department

This is an area where one would expect to find some uniformity. On the contrary, there is a vast range of quality and effectiveness to be found in different types of firms. In traditional securities firms, supervision of an RR's activity is fairly straightforward as the RR and supervisor often are physically in the same place. The manager can readily review correspondences, files, notes, eavesdrop on conversations or meetings, and open the mail. The role of the supervisor is to ensure that the clients' best interests are being served by seeing to it that the RR is complying with the rules and regulations and the firm's policies.

Depending on the type of firm and situation, it may be less possible to provide in-person supervision of the RR and thus the firm must develop supervisory systems that adequately address that challenge. The problem in doing that arises in the interaction between marketing and compliance. In firms that concentrate on variable product sales, there is considerable interaction between the insurance company's wholesalers and the firms RRs. This may happen with or without the firms' knowledge and can lead to some serious problems. Keep in mind that the insurance company's goal is to sell more products and generate more premium income. Far too often, they are not as concerned as they should be with the appropriate and suitable application of that product in the context of the customer. In fact, when there is a problem, the insurance company will often distance itself from the firm, the RR and, in some cases, its own wholesalers.

I recently saw an example in a firm I know that illustrates this perfectly. The RR had sold a variable annuity that was among the more complex, having a guaranteed interest rate provision. To make a long story short, the client thought she had purchased an annuity that guaranteed a particular rate of growth if held more than 7 years and was planning on liquidating it at a future date beyond that horizon. Upon careful review by a relative who was in the business, she discovered that the guaranteed amount was only available if she annuitized. When she inquired with the RR, he also thought that she could liquidate the annuity and receive the guaranteed amount. The RR that sold that product had attended a sales seminar conducted by the insurance company along with many others where the wholesaler taught him how to sell the annuity. When the brokerage firm confronted the insurance company, the company suggested that the firm talk to the wholesaler, a different company that it had spun off years ago. When others that attended the seminar were polled, they agreed with the RR's understanding. The wholesaler adamantly denied having provided misinformation and the insurance company told the firm that the brokerage firm was exclusively responsible for the proper presentation of the product by the firm's RRs. The insurance company actually threatened action against the brokerage firm if that were to happen again. The brokerage firm acted responsibly and rescinded the policy without any assistance from the insurance company or the wholesaler. Insurance companies promote the sale of their products often in an irresponsible manner while distancing themselves from their distribution channel.

It is often the case that parties involved in the product selection and its promotion, are not responsible for fulfilling suitability requirements. This places an enormous strain on the firms who, for the most part, are very diligent and are striving to operate in a compliant manner. It puts an even greater strain on the RR, who is caught in a push – pull. Naturally, the best of all worlds is a good working relationship between marketing and compliance within a firm. Unfortunately, we are seeing an increasing reliance on outside marketing support by firms of all sorts.

Conflicts of Interest

It seems as though this problem should be neutralized by complete disclosure of all relevant information. But in practice, this does not happen. In the instance of insurance company owned broker/dealers, there is clearly a bias to sell the products of the parent as opposed to the many others that are available and that indeed may be more suitable for the investor. This may appear somewhat obvious and is very easy to see when the broker/dealer has the same name as the parent. In many cases the connection between a broker/dealer and the insurance company that owns it is obscure.

In the past few years the industry has seen a considerable amount of acquisitions and consolidations. There are now many firms that have emerged that "partner" with large financial institutions that have provided significant funding. In this case the relationship is even more obscure. Logic would dictate that those institutions would be able to influence the policies, operations, and maybe even the sales practices of the firm

The independent brokerage channel is responsible for the majority of insurance sales today. The real problem is the conflicted role of the BGA. This entity, while affiliated with or operating a branch office of a broker/dealer, represents many insurance companies on the fixed side. It is possible for those companies to incent sales of variable products by paying higher bonuses on the fixed business submitted by the general agent. This is particularly true when the BGA is part of a large consortium or producer group. The insurance company pools their production for the purpose of determining bonuses thus making it possible for them to earn huge

amounts of compensation that can be retained by them alone. In this scenario, the RR himself is unaware of the total compensation being received by his branch. Many of these types of firms pay out very high percentages of their dealer concession to their RRs and rely heavily on the bonus compensation they receive. Oftentimes, the BGA wholesales products to other broker-dealers who are desirous of tapping the BGA's insurance knowledge and expertise and getting the processing thrown in as well. Little do they know that they are often not being provided with objective recommendations. To make matters worse, the wholesaling BGA often fails to conduct a suitability analysis in the sale!

Section V – Summary

Despite the many problems associated with the distribution and sale of variable products, they remain among the most effective financial instruments available to the consumer today. There are many RRs that hold themselves to high standards of professionalism and morality and represent little or no risk to the investor. There are, however, a large and growing number of firms that are more concerned with profits than fiduciary responsibilities. Unfortunately, the credibility of the financial services industry is compromised each time there is discovery of wrongdoing on the part of a firm, financial institution, or RR. Abuses in sales of variable product can and must be curtailed if the public purpose is to be served.

The insurance industry lobby is very strong and has effectively warded off many attempts to bring insurance sales under closer supervision of the regulators. Many believe it has proven itself incapable of self-regulation. Because of its enormous size and profitability, it is able to operate with less consideration of compliance with rules and regulation and chalk up the fines it receives as a cost of doing business.

Certain reforms can be enacted that will allow for a meritorious relationship between financial institutions and public investors. The profitability of these institutions does not need to be compromised in order to protect the investor. On the contrary, as we improve sales practices, we reduce the enormous costs of litigation that are passed through to the public in the form of higher premiums and internal expenses.

Variable product sales are subject to two different forms of regulation that often conflict with each other and certainly vary in thoroughness and scope. Central regulation and enforcement would yield more effective customer protection while eliminating redundancy and the burden of dual licensing.

There is always an incentive on the part of the RR to gravitate toward higher commission products. If commissions on variable products were level, the companies would then have to compete purely on the merit of their products and the stature and reputation of their company. This would no doubt result in greatly improved products being brought to the marketplace and RRs making decisions based only on the customer's needs.

Lastly, insurance companies should be held to a higher standard of accountability in the marketing and support of their products. They should also be responsible for the activities of all parties associated with the sale of their products.

Expert's Corner–

Written Supervisory Procedures: A Plaintiff's Roadmap to Accountability

Thomas M. Driscoll, Jr.*

Thomas M. Driscoll Jr. has over 20 years experience in compliance, operations, and regulatory reporting for investment advisers and broker-dealers. He has also held the positions of Senior Examiner for both the NASD and the NYSE. He has occasionally served as an expert for both claimants and respondents in securities disputes. He has recently left a small regional firm to pursue a law degree and to devote his full time professionally to providing expert services on a wide range of issues. He can be reached at 330-332-2602. or e-mailed at driscoll@sky-access.com.

An article written by Joan L. Lavell and appearing in the Summer 2000 issue of the *Journal of Investment Compliance* is entitled rhetorically "Written Supervisory Procedures: Friend or Foe?" In the article, the author makes a compelling case for the preparation, distribution, maintenance, and enforcement of written supervisory procedures that are designed to ensure compliance with securities laws and regulations. After taking the reader through three hypothetical hearing situations wherein a compliance officer, testifying on behalf of his employing broker dealer, is discredited due to omissions, inaccuracies, and inconsistencies in his firm's written supervisory procedures, Ms. Lavell answers her own question when she refers to the firm's compliance manual as "the plaintiff's best friend."[1]

The Duty to Supervise

Supervision as an aspect of a broker-dealer's responsibility to its clients has its basis in the Securities Act of 1934, as amended. In 1963, the Securities & Exchange Commission was ordered by Congress to perform a special study of the securities markets. Prior to 1964 there existed no provision in the securities laws that specifically addressed a broker-dealers obligation to supervise its employees. Section 15(b)(4)(E) of the '34 Act, enacted by Congress as part of the Securities Act Amendments of 1964, reads as follows:

> *The Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer* if it finds, on the record after notice and opportunity for hearing, that such censure, placing of limitations, suspension, or revocation is in the public interest and that such broker or dealer, whether prior or subsequent to becoming such, *or any person associated with such broker or dealer*, whether prior or subsequent to becoming so associated--has willfully aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, this title, the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or *has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.*

Self-Regulation in the Securities Industry

Notwithstanding the duties and attendant sanctions expressed above, the regulatory structure of the securities industry virtually guarantees that Commission mandates find their way into the rules and regulations of the self-regulatory organizations, most notably the New York Stock Exchange and the NASD. In a speech to the Securities Industry Association Annual Meeting on November 9, 2001, then-SEC

---

[1]Lavell, Joan L. "Written Supervisory Procedures: Friend or Foe?", *Journal of Investment Compliance*, Summer, 2000.

Chairman Harvey Pitt remarked that,

> "the securities industry is unique....Congress gave it the privilege of regulating itself, in the first instance. This is a rare public trust, bestowed on precious few industries. It's a trust to which this industry must constantly be devoted, and against which it will continuously be measured."

Similar sentiments were voiced by Lori Richards, Director of the Office of Compliance Inspections and Examinations at the Commission, during testimony before the Subcommittee on Oversight and Investigations, Financial Services Committee of the U.S. House of Representatives. This testimony was given on May 23, 2002 as the Subcommittee was looking into issues raised by the Frank D. Gruttadauria matter. Ms. Richards noted:

> "A broker-dealers "duty to supervise' is a key aspect of the federal securities scheme...Self-regulation is the linchpin of the federal regulatory system for broker-dealers. At the most basic level, firms are responsible for their internal supervisory and compliance systems. Second, these efforts are supervised by the self-regulatory organizations. Finally, the Commission oversees the efforts of the firms as well as the SRO's."

New York Stock Exchange Rule 342[2], adopted in 1964 in response to the Securities Act amendments, is the primary Exchange rule that addresses supervision. Rule 342 reads, in pertinent part:

(a) Each office, department, or business activity of a member or member organization (including foreign incorporated branch offices) shall be under the supervision and control of the member or member organization establishing it and of the personnel delegated such authority and responsibility. *The person in charge of a group of employees shall reasonably discharge his duties and obligations in connection with supervision and control of the activities of those employees related to the business of their employer and compliance with securities laws and regulations.*

(b) The general partners or directors of each member organization shall provide for appropriate supervisory control and shall designate a general partner or principal executive officer to assume overall authority and responsibility for internal supervision and control of the organization and compliance with securities laws and regulations. *This person shall:*

> 1) *Delegate to qualified principals or employees responsibility and authority for supervision and control of each office, department, or business activity, and provide for appropriate procedures for supervision and control.*
>
> 2) *Establish a separate system of follow-up and review to determine that the delegated authority and responsibility is being properly exercised.*

In January 1982, the New York Stock Exchange published the seminal text *Patterns of Supervision: A Guide to the Supervision and Management of Registered Representatives and Customer Accounts*. This guide represents a milestone in the practice of supervision, describing the role of the branch manager, identifying suggested areas for review, special types of accounts and products, and generally clarifying the Exchange's expectations regarding supervision of sales personnel and customer account relationships. While Rule 342 and *Patterns of Supervision* discuss abstract concepts such as supervisory systems, structures, and control environments, and in fact provide practical, hands-on techniques for effecting supervision, they come up short with respect to explicitly mandating the assignment of specific supervisory tasks by specific supervisory individuals. That gap was bridged by the NASD in NASD Rule 3010.

NASD Rule 3010, closes the loop by mandating not only a system "reasonably designed" to achieve compliance with applicable rules, but also the establishment and maintenance of written supervisory procedures documenting the system. The rule itself is too lengthy to incorporate into this article, but some of the more pertinent passages have been extracted to illustrate the NASD's insistence that written supervisory procedures be prepared, maintained, distributed, and enforced:

> **(b)(1) Each member shall establish, maintain, and enforce written procedures to supervise the types of business in which it engages and to supervise the activities of registered representatives and associated persons that are reasonably designed to achieve compliance with applicable securities laws and regulations, and with**

---

[2] In an amendment to Rule 342 dated December 31, 1997, the requirement to document supervisory efforts and make such documentation available to the Exchange (and thereby discoverable) appears as Rule 342.16.

the applicable Rules of this Association.

NASD Notice to Members 99-45, entitled "NASD Provides Guidance on Supervisory Responsibilities" provides interpretation of the critical paragraphs of Rule 3010. With respect to paragraph (b), the main points to consider are:

- Supervisory procedures must be in writing
- Procedures must be reasonably designed to achieve compliance
- Procedures must be tailored specifically to a member's business and
- Ultimate responsibility for supervision rests with the member.

(b)(3) The member's written supervisory procedures shall set forth the supervisory system established by the member…, and shall include the titles, registration status, and locations of the required supervisory personnel and the responsibilities of each supervisory person as these relate to the types of business engaged in, applicable securities laws and regulations, and the Rules of this Association."

In this paragraph, the NASD mandates *accountability* for the performance of supervisory activities, requiring the names, qualifications, and locations of each responsible supervisor. The NASD also wants to see the actual supervisory steps to be taken, the frequency of the supervisory reviews, and how such reviews are to be documented.

(b)(4) A copy of the member's written supervisory procedures,

or the relevant portions thereof, shall be kept and maintained in each OSJ and at each location where supervisory activities are conducted on behalf of the member. Each member shall amend its written supervisory procedures as appropriate within a reasonable time after changes occur in applicable securities laws and regulations, including the Rules of this Association, and as changes occur in its supervisory system, and each member shall be responsible for communicating amendments through its organization.

Obviously, in this paragraph the NASD is insisting that written supervisory procedures become a living document rather than something static and out of date. They are also insisting that a current copy of the written supervisory procedures be kept at each Office of Supervisory Jurisdiction, a term defined within the Rule.

Opportunities for Plaintiff's Counsel

Each of the above referenced paragraphs represents challenges for compliance people within the industry, and each of these paragraphs provides potential opportunities for plaintiffs counsel. This point is not lost on Attorneys Robert P. Bramnik of Wildman, Harrold, Allen, & Dixon or Robert D. Owen of Owen & Davis, who co-authored "Elements of Claims and Defense in Securities Arbitrations." Per Attorneys Bramnik and Owen,

> "Allegations of failure to supervise allow the customer to ascribe the misconduct of the individual broker to the failure of his supervisors and employer to supervise his actions. This may be important to a claimant who has no other substantive claim against the deep pocket employer. Generally, the allegations will be no more specific than an assertion that the firm failed to supervise the broker's activities, which, in the charging paragraphs, give the basis for alternative theories of relief." [3]

With respect to opportunities then, one strategy to employ is to call into question the control environment of the broker-dealer, and by inference demonstrating that an individual broker's transgression could have and should have been avoided had proper controls been in place. In a speech before the Compliance & Legal Division of the Securities Industry Association on March 18, 1996, SEC Chairman Arthur Levitt made the following comment:

> "It is our belief that many cases of investor fraud, if not most, really constitute two failures- that of the broker and that of his supervisor. Supervisory negligence permits wrongdoing. That's why, in every examination we do, we will focus on supervision-just as, in every sales practice abuse case,

---

[3] Bramnick, Robt. P. and Owen, Robert D. "Elements of Claims and Defense in Securities Arbitrations", NASD Arbitrator Skills Training Handbook, May 1997

we've been asking 'Where's the supervisor? Did he ask the right questions? How did he let this happen?'"

These sentiments are reflected in

NASD Notice to Members 98-96, December 1998, in the wake of the over-the-counter trading scandal:

> "Establishing, maintaining, and enforcing written supervisory procedures is a cornerstone of self-regulation within the securities industry... Appropriately designed and implemented supervisory systems and written supervisory procedures serve as a "frontline" defense to protect investors from fraudulent trading practices and help to ensure that members are complying with rules designed to protect the transparency and integrity of the market."

Clearly, the expectation on the part of the regulators is that well drafted, comprehensive, current, and universally distributed written supervisory procedures provide supervisors with the guidance necessary to not only detect, but ideally, to prevent transgressions committed by individuals reporting to them. Furthermore, from the standpoint of the broker-dealer, adequate written supervisory procedures provide a broker-dealer with a defense against supervisory liability by creating a safe harbor under Section 15(b)(4)(E) of the '34 Act. At the end of paragraph (E), the following appears:

For the purposes of this subparagraph (E) no person shall be deemed to have failed reasonably to supervise any other person, if there have been established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any such violation by such other person,[4] and such person has reasonably discharged the duties and obligations incumbent upon him by reason of such procedures and system without reasonable cause to believe that such procedures and system were not being complied with.

Remarkably, despite the regulatory emphasis on supervision in general, and on written supervisory procedures in particular, the number of failure to supervise cases brought by the regulators is on the rise. Given the risks, why would a broker-dealer fail to devote the necessary attention to preparing, maintaining, and enforcing adequate supervisory procedures? Although situations will vary from firm to firm, some common reasons are as follows:

Resources - Drafting written procedures is generally viewed as a compliance function. Compliance departments are generally cost centers, not profit centers, and staffing tends to run rather lean, particularly in times such as these. Per Ms. Lavell, "written supervisory procedures tend to be one of the more neglected areas of compliance because of other demands on compliance personnel time."

Off the Shelf Solutions - In response to this demand for a document, and recognizing that the Compliance Department is already struggling with its existing workload, some firms opt to enlist the aid of a consultant or purchase an off-the-shelf "solution" from one of a number of vendors offering this type of service. These "solutions" incorporate varying degrees of input from those who will ultimately be bound by the terms of the document, but the result is generally viewed as a product rather than a process, and the document may bear little if any resemblance to the way business is actually done by the broker-dealer. The end result is a document with no ownership, loaded with generalities about supervision that few if any ever read, and doomed to almost instant obsolescence if not total irrelevance. Furthermore, once completed, the document will usually sit on the shelf undisturbed until an examiner arrives. A document such as this can present more problems for a firm than having no document whatsoever.

Maintenance - The one constant to which most individuals working in the securities industry are accustomed is change. New products, new regulations, new technology, industry consolidation, and employee turnover all contribute to an environment of perpetual change. In this environment, the challenge of maintaining a document that is comprehensive as well as current can be daunting.

Lack of Enforcement - One of the inherent conflicts embedded in the compensation structure of the traditional broker-dealer is the rewarding of individual brokers and their managers based upon "production," which typically represents commissions generated. In many firms, the branch manager is compensated not only on the basis of his personal production, which generally makes up the majority of his compensation, but also on the productivity, and thus the profitability, of his branch. The branch manager therefore has an incentive to encourage, rather than discourage, sales activities that may or may not be in the best interest of the clients. He also has incentives to recruit and hire brokers with potential to

____

[4] Lavell, Joan L. "Written Supervisory Procedures: Friend or F

generate significant revenues, regardless of past transgressions, rather than brokers whose production may be more modest. Furthermore, the branch manager's own personal production may not be subjected to adequate review by another principal within the supervisory structure of the broker-dealer. SEC Release Number 40765, dated December 9, 1998, makes reference to an Administrative Proceeding No. 3-9785 in the matter of FSC Securities Corporation. Paragraph II D. of the release states: "During the relevant time period, each of FSC's OSJ's was supervised by a Principal. Principals were the primary supervisors of the activities of the registered representatives who worked for them. These principals, in turn, had business and customers of their own. NO OSJ Principal's own business was supervised by any other single designated individual in the FSC organization. This system of supervising the OSJ Principals' own production was inadequate."

Conclusion

It is clear that in the securities industry, one key to defending against a charge of failure to supervise is to prepare, distribute, maintain, and enforce comprehensive written supervisory procedures. The regulators have put the industry on notice on numerous occasions regarding their obligations, but continue to confront situations where supervisory breakdowns have occurred and procedures have been found lacking. The written supervisory procedures of the respondent firm provide claimant's counsel with opportunities, whether the procedures are poorly drafted, and therefore indicative of a weak control environment, or well drafted, providing you with titles, names, reports, and techniques utilized by the respondent firm. In any event, your ability to move up the chain of accountability from retail broker to firm management may greatly increase your leverage in settlement negotiations or enable you to win awards that may otherwise have been lost.

So...are written supervisory procedures friend or foe? I suggest that more often than not, written supervisory procedures will become, if not your friend, at least an ally in your pursuit of plaintiff's awards.

References

Edmondson, Joe, "How to Limit the Exposure of Compliance Personnel to Claims of Failure to Supervise", *NSCP Currents, A Publication of the National Society of Compliance Professionals*, July/August, 2001

Ferrara, Ralph, Parker, Philip D., and Smith, Colby A., *Managing Marketers: Supervisory Responsibilities of Broker-Dealers and Investment Advisers*, 2000, CCH Incorporated, Chicago, Il

Lavell, Joan L. "Written Supervisory Procedures: Friend or Foe?" *Journal of Investment Compliance,* Summer, 2000

Levitt, Arthur "Our Partnership to Improve Practices", Speech to the Securities Industry Association, Compliance and Legal Division, March 18, 1996.

Richards, Lori A., "Testimony Concerning Issues Raised by the Frank D. Gruttadauria Matter", Before the Subcommittee on Oversight and Investigations, Financial Services Committee, U.S. House of Representatives, May 23, 2002

Pitt, Harvey L., Remarks at the Securities Industry Association Annual Meeting, November 8, 2002

National Association of Securities Dealers, Notices to Members 98-38, 99-45

NASD Manual, Rule 3010

NASD Regulation, Inc. Arbitrator Skills Training Program, May 21, 1997

United States Securities & Exchange Commission, Securities Exchange Act of 1934, Section 15(b)(4)(E), and Release no. 40765, December 9, 1998.

Practitioner's Corner– Backbone Surgery for Dummies: How to Strengthen the Resolve of Your Arbitrators (and You)

By David E. Robbins

Variations of the following situations have probably happened to you, and if, not, they will.

1. When the case is over, after you've received a favorable Award, you get a letter from your adversary saying that she has just discovered a witness who can categorically prove that your client committed perjury during the arbitration hearings. This new witness is your client's other broker whom he was trading with contemporaneously with the broker who had just lost the case. You knew about that other broker but had neither put him on your witness list nor referred to him during your client's testimony. Nor had the defense attorney thought to ask. Settle now, says the defense attorney, or she will move to vacate the Award because you obtained it through "corruption, fraud, undue means or misconduct" [Section (10a) of the Federal Arbitration Act – the "FAA"].

2. During the hearings, it was clear that one of the arbitrators really did not like your adversary. Who would? Whenever he objected to your questions, the arbitrator usually overruled the objection with a derisive comment about the attorney's lack of knowledge of arbitration procedures. You are concerned that the arbitrator's conduct may result in the vacatur of a favorable Award, so you say nothing when opposing counsel makes speech after speech about the unfairness of the proceeding. However, despite the arbitrator's attitude, your adversary got everything he wanted into evidence. After the case – a consensus Award in which rough justice was done for your client – the opposing attorney tells you of his intention to move to vacate the Award for "bias or partiality" [Section 10(b) of the FAA]. Settle now, says the defense attorney, or spend another year fighting this case in court, the result of which, he says with his usual cockiness, will assuredly result in retrying the arbitration – this time before a fair arbitrator.

3. Your adversary has asked the arbitrators for another adjournment – her third. The first was due to a mix-up in her calendar (double-booking cases) and the second was because of illness; she is the partner responsible the brokerage firm and, she insisted, no one at her 120 member law firm can take her place. Now it is a week before the re-re-scheduled hearings and your adversary calls you all apologetically. She just learned the branch manager is going on vacation and will not be able to get his deposit refunded. She is giving you a "heads-up" for a motion to postpone that she just faxed to the New York Stock Exchange staff attorney on the case. Her motion cites Section 10(c) of the FAA, warning the arbitrators that unless they grant this "most reasonable but unfortunate request" they run the risk of having their Award overturned by the court. To date, the panel has shown the backbone of a jellyfish and you are concerned that they will do so again, to the great annoyance and exasperation of your elderly client.

4. You are into day 13 of what you told your client would be a "three days at most" hearing. The direct examinations of your client, of a corroborating witness and of the broker took three hours. However, the cross-examination of each took a total of five days and now your adversary is on his eight witness, with no end in sight. It is clear that the defense game plan is a combination of "repetitive redundancy" and a war of attrition, hoping you or the arbitrators will say something, anything, to give him grounds to move to vacate the Award, which is almost certain to be adverse to his clients. The only ones who appear more upset than you with the glacial progress of the hearings are the two arbitrator wings. Is there anything you can do? Section 10 (c) of the FAA may

Copyright © 2003. All Rights Reserved. Mr. Robbins is on the Board of Editors of this *Journal* and can be reached at 212-755-3100 or DRobbins@KFYGR.com. He is a partner in the New York City firm of Kaufmann Feiner Yamin Gildin & Robbins LLP and chairs the annual PLI programs on securities arbitration. He is an arbitrator and mediator and the author of *Securities Arbitration Procedure Manual* (Matthew Bender, updated Nov. 2002 www.lexis.com).

provide some help.

5. The case you are bringing is a just one, but it is so damn old. There had been a serious question about arbitration eligibility but, thankfully, the U.S. Supreme Court has recently ruled that arbitrability is for the arbitrators to decide and not the courts. However, there are still statutes of limitation issues to contend with. It appears the arbitrators are moved more by the injustice to your client than a strict reading of the applicable statutes of limitation. In your adversary's pre-hearing motion to dismiss, she cites case after case on the timeliness issue since she knows her client is dead on the facts. After the motion is denied, she pounds on the law in her opening statement and does not put on a single witness, so sure, she says, that the statutes of limitation are clear and unequivocal and so certain that arbitrators who would disagree with her would be in "manifest disregard of the law". She has just completed her summation and it's now your turn. Should you deal only with the factual issues or should you also focus on the law?

To each of these scenarios, take heed – Your adversary is attempting to *litigate* a case that is being or has just been *arbitrated*. Litigation offers the loser an automatic right of appeal – not so in arbitration. Don't lose your resolve and certainly don't let the arbitrators cave in. This is the time for a backbone transplant. This is the time to educate the arbitrators, and perhaps yourself, that the arbitration should proceed to its conclusion and that its afterlife in court, on a motion to vacate, should be looked upon as a means by which your client can continue to earn the legal rate of interest on that favorable Award (which isn't a bad return these days).

In order to embolden the arbitrators, you should be aware of what has happened to others who have chosen that road (i.e., see Dead End*)*. Knowing the future can give you the courage of your convictions and can help a rudderless arbitrator more swiftly find his way to shore. This article will highlight some of the statutory and common law grounds to vacate arbitration Awards and will consider cases in which such motions were denied, which is still the norm. While a small minority of motions to vacate are successful, those cases, in all likelihood, will differ from your own. (That subject is for another article or further research on your part.[1])

First, the answers to the five scenarios:

1. **Fraud** - Don't settle. A motion to vacate will fail because your adversary cannot meet the very tough three-part test to vacate for fraud under Section 10(a) of the FAA (discussed below).

2. **Bias** - It's a bluff. An arbitrator must be fair to both sides. As long as all the hoped-for evidence comes in, personal comments do not generally rise to the level of bias required by Section 10 (b) of the FAA.

3. **Postpone** - The hearings can go forward, as re-re-scheduled. However, you need to instill confidence in the arbitrators that they can deny the motion to postpone because their decision will be upheld by any court, as far as Section 10(c) of the FAA is concerned.

4. **Evidence** - Based on Section 10(c) of the FAA, you can tell the arbitrators that enough is enough; they can call a halt to the unending and repetitive defense strategy without fear of recrimination by the courts. They can limit the introduction of such evidence and finish the case.

5. **Manifest Disregard** - In your summation, say something about the law, but don't worry about it too much. The judicially-created ground of "manifest disregard of the law" is the toughest of them all.

What follows are cases to support these conclusions.

Award Procured by Corruption, Fraud or Misconduct [Section 10(a)]

The question here is whether the rights of a party were prejudiced by the corruption, fraud or misconduct of an arbitrator, another party, or third person. Courts rarely find that "misconduct" took place when arbitrators admitted possibly prejudicial exhibits or testimony into evidence. The federal courts utilize a very tough three-part test to determine whether an arbitration award should be vacated for fraud under Section 10(a) of the Federal Arbitration Act:

1. Has the complaining party established the fraud by clear and convincing evidence, and not just by the preponderance of the evidence? *La Farge Conseils et Etudes, S.A. v. Kaiser Cement & Gypsum Corp.*, 791 F.2d 1334, 1339 (9th Cir. 1986).

2. Was the fraud [in Scenario #1 - the possible perjury of your client] not discoverable by the exercise of due diligence prior to or during the arbitration? *Karppinen v. Karl Kiefer Mach. Co.*, 187 F.2d 32, 35 (2d Cir. 1951).

3. Did the person seeking to vacate the Award demonstrate that the fraud materially related to an issue in the arbitration? *Harre v. A.H. Robins*,

---

[1] A comprehensive analysis of all grounds to vacate Awards can be found in Chapter 13 of my book, *Securities Arbitration Procedure Manual*.

750 F.2d 1501, 1503 (11th Cir. 1985); *Rozier v. Ford Motor Co.*, 573 F.2d 1332, 1339 (5th Cir. 1978); *Newark Stereotypers Union No. 18 v. Newark Morning Ledger Co.*, 397 F.2d 594, 599 (3d Cir.), cert. denied, 393 U.S. 954, 89 S. Ct. 378 (1968).

Here are two additional cases in which the courts denied motions to vacate on this ground.

1. Cross-examination could have uncovered "incorrect testimony" on direct.. Court found that had attorney done his job, his cross-examination could have uncovered perjured testimony of witness. *O.R. Securities v. Professional Planning Assocs., Inc.*, 857 F.2d 742 (11th Cir. 1988)

2. It was alleged that stock broker perjured himself during the course of the hearing. However, that perjury could have been proved at the hearing had opposing attorney called a witness whom the attorney knew could have rebutted that perjured testimony.. *Dean v. Paine Webber, Inc.* Fed. Sec. L. Rep. (CCH) ¶ 97,034, at 94,546 (S.D.N.Y. Oct. 13, 1992)

Partiality of the Arbitrator [Section 10 (b)]

The test that the courts apply in deciding whether to vacate for partiality is whether a reasonable person would have to conclude that an arbitrator was partial to one of the parties. *The appearance of bias alone is not sufficient*. An Award will be vacated when there is some personal interest on the part of the arbitrators that extends beyond any personal views on the merits of the case. These cases generally fall into two categories:

1. The arbitrator failed to disclose a prior, tangential business relationship between him and one of the parties; or

2. The arbitrator said something during the hearing that expressed partiality.

In most cases, even if an arbitrator displays a short temper with the way an attorney is conducting his case, that alone is insufficient to vacate an Award. Arbitrators have the power to move things along and they should use it, but they should use that power in a professional manner.

Stitz v. The Equitable Life Assurance Society ,2001 WL 274313 (S.D.N.Y. March 20, 2001) is an interesting case where a motion to vacate on this ground was denied. After 11 days of hearings, the arbitrators entered an Award in favor of the brokerage firm against Mr. Stitz, ordering him to repay unearned commissions and the brokerage firm's legal fees because of "often obstructionist behavior of [plaintiffs'] and their counsel." In their motion to vacate, Mr. and Mrs. Stitz contended that the Award should not be enforced because the arbitrators were guilty of corruption, misconduct, partiality and misbehavior. The plaintiffs charged that the Chairman's employment was not fully disclosed to the parties prior to the arbitration. While the Chairman had properly disclosed his employment in an updated resume to the NASD, the NASD's staff failed to update its records. There was nothing about the Chairman's employment that would serve to disqualify him or in any way cast doubt on his impartiality. In any event, in an act of excessive fairness to plaintiffs, the NASD honored their peremptory challenge to the Chairman and replaced him. "Although Plaintiffs contend that certain rulings and statements of the original Chairman demonstrated his bias, they do not provide a transcript of the proceedings. In any event, the rulings and comments that they allege were biased failed to establish that the panel was prejudiced against them."

In *Fort Hill Builders v. National Grace Mut. Ins.*, 866 F.2d 11 (1st Cir. 1989), an arbitrator's hostile comments were found to be insufficient to prove bias. And in *Remmey v. Paine Webber, Inc.*, Fed. Sec. L. Rep. (CCH) ¶ 98,366, at 90,504 (4th Cir. Aug. 19, 1994), an Award in favor of a brokerage firm and a broker could not be vacated on the asserted grounds that the Chair was especially solicitous of the brokerage parties' well-being, made several comments throughout the proceedings indicative of his empathy for the brokerage parties and had an alleged *ex parte* communication with the brokerage parties' counsel. The court found that the arbitrator's informal manner was his attempt to create a relaxed atmosphere that did not indicate a bias in favor of either side. "It is well established that a mere appearance of bias is insufficient to demonstrate evident partiality," said the court.

And in *Fairchild & Co., Inc. v. Richmond, Fredericksburg & Potomac R. Co.* 516 F. Supp. 1305 (D.D.C. 1981), the court held that even if one of the arbitrators displayed personal hostility toward Fairchild's attorney, manifested by rudeness and interruptions during the proceedings, the court would not vacate based on partiality. "An arbitrator's legitimate efforts to move the proceedings along expeditiously may be viewed as abrasive or disruptive to a disappointed party. Nevertheless, such displeasure does not constitute grounds for vacating an arbitration Award."

Arbitrator Refused to Postpone Hearing [Section 10(c)]

The guideline here is one of *reasonableness* and courts rarely second-guess a panel's determination on such a request. That is, unless both parties join in the request.

In *Bisnoff v. King*, 154 F. Supp. 2d 630 (S.D.N.Y. 2001), a broker's

motion to vacate was based on the panel's refusal to grant his request to postpone the hearings, made two and a half weeks before the scheduled hearings, because – he asserted - he literally did not have the heart to travel from New York to Raleigh, North Carolina and take part in the hearings. The substantive hearings had been scheduled at a pre-hearing conference, at which time no issue was raised about the broker's alleged cardiologic condition. While the arbitrators denied his postponement request, they permitted him to schedule and appear for a videotaped deposition, which they would use as his testimony. They also ordered him to be available by telephone during the week of the scheduled hearing to answer any questions they might have. The broker's credibility was apparently more strained than his heart, for the arbitrators learned that, despite his illness, George Bisnoff had been working approximately 30 hours per week as a stockbroker, which, noted the federal district court in an understatement, is a stressful occupation. District Judge Batts' reasoning in affirming the Award was a logical application of the law to the facts to the law:

> 1. "In evaluating an arbitrator's decision to deny a postponement, courts consider whether there existed a reasonable basis for the arbitrator's decision and whether the denial created a fundamentally unfair proceeding." Ottawa Office Integration, Inc. *v. FTF Bus. Sys., Inc.*, 132 F. Supp. 2d 215 (S.D.N.Y. 2001); *Tempo Shain Corp. v. Bertek, Inc.,* 120 F.3d 16 (2d Cir. 1997); *Roche v. Local 32B-32J Service Employees Int'l Union,* 755 F.Supp. 622 (S.D.N.Y. 1991).
>
> 2. "Thus, if there exists a reasonable basis for the arbitrators' considered decision not to grant a postponement, a court should be reluctant to interfere with the Award... [A]s long as there is at least a barely colorable justification for the arbitrators' decision not to grant an adjournment, the arbitration Award should be enforced."

Here are a few more cases on point:

1. Arbitrators refused to postpone final arbitration session when plaintiff's principal witness was unable to attend. Nothing in the FAA requires arbitrators under all circumstances to adjust their schedules to suit requests of any party. *Concourse Beauty School, Inc. v. Polakov*, 685 F. Supp. 1311 (S.D.N.Y. 1988)

2. Abitrators' refusal to postpone hearing was not misconduct that would warrant vacatur of Award, despite party's daughter's hospitalization for broken arm. Injury was never presented as life-threatening situation and there were no medical complications arising out of injury. *Berlacher v. Paine Webber, Inc.*, 9 F. Supp. 21 (D.D.C. 1991)

3. Customers received notice of the hearing date more than two months in advance, yet neglected to hire an attorney, prepare for hearing or request any extension of time until the week of the hearing. When the customer finally requested additional time, he supported his request only with vague allusions to his family's "very sorrowful physical and medial problem." The U.S. District Court for the Northern District of California found that the arbitrators acted within the scope of their discretion in declining to postpone the hearing and in conducting it in the customer's absence. *PaineWebber v. Barca*, 2000 U.S.Dist. LEXIS 10873 (U.S.D.C. N.D. Cal. July 28,2000)

Arbitrator Refused to Hear Evidence Pertinent and Material to the Controversy [Section 10 (c)]

Here, again, the burden is great on the party seeking to vacate. For example, in the case of *Sebbag v. Shearson Lehman,* Fed. Sec. L. Rep. (CCH) ¶ 95,775, at 98,729 (S.D.N.Y. Jan. 8, 1991), the Federal District Court for the Southern District of New York held that the refusal to hear and admit evidence is a ground for vacatur only if that refusal *severely prejudices the rights* of a party to the arbitration. "The arbitrators must not only have been in error when they chose to exclude evidence [a handwriting expert to prove forgery], but that error must have been so severe as to have damaged the rights of the party to the extent that he was deprived of a fair hearing."

In the Southern District of New York case of *Pompano Windy City Partners v. Bear Steams*, 794 F. Supp. 1265 (S.D.N.Y. 1992), the arbitrators had excluded a portion of an expert's testimony. The court held that the arbitrators were not obliged to observe the same "niceties" required by the Federal Rules of Civil Procedure and that they must only grant a "fundamentally fair" hearing. The Award was not vacated. The test is this: *Did the excluded testimony, or the refusal to listen to certain testimony, deny a party a fundamentally fair hearing*? If the hearing was fair overall, even improperly excluded evidence will not be a ground for vacatur. Case after case shows that courts will lean over backwards to uphold an arbitration Award even if the arbitrators have out rightly refused to hear certain testimony.

One of the reasons why arbitrations are taking so long these days is because arbitrators take in too much testimony because of a fear that their Award will be vacated. However, courts will, in almost every instance, uphold an Award even when the

arbitrators have excluded testimony. So if the arbitrators have already heard a line of testimony or the introduction into evidence of new documents would just be duplicative of other documents already in evidence, you should attempt to persuade the arbitrators to exclude it. There should be little fear that the Award will, as a result, be vacated.

Let me give you one more example of the heavy burden a party has in succeeding with a motion to vacate on this ground. In *Credit Suisse First Boston Corp. v. Crisanti*, 734 N.Y.S. 2d 150, 289 A.D. 2d 83 (1st Dept. 2001), there was a dispute over a terminated arbitrageur's entitlement to a bonus. The appellate court found that the lower court properly declined to vacate the Award on the ground (among others) that the arbitrators' refused to hear the testimony of a particular proposed witness, who would, it was claimed, have presented a different version of events than that provided by respondent. The court ruled that such arbitrator refusal to hear evidence was not fundamentally unfair since the panel had been apprised of the contents of the proposed witness' testimony during the several days of the hearing and his testimony would have been cumulative. See also, *Areca v. Oppenheimer & Co., Inc.*, 960 F. Supp. 52 (S.D.N.Y. 1997).

Arbitrators Manifestly Disregarded the Law

The best known judicially created ground to vacate an arbitration Award is "manifest disregard of the law." Few securities arbitration cases present a situation where the law on an issue is clear. Most of the cases are fact-intensive and "the law" is tangential at best to the witnesses' reenactment of events. On the other hand, when there is a clearly governing legal principle that is well defined, explicit, and applicable to the case, and the arbitrators choose to disregard that legal principle, then, in some areas of the country, the Award can be vacated on the ground that it was in manifest disregard of the law.

The leading case on this subject comes from the Court of Appeals for the Second Circuit: *Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Bobker,* 808 F.2d 930 (2d Cir. 1986), the court set down the requisites for the "manifest disregard" ground:

1. There must have been more than error or misunderstanding with respect to law;

2. The error must have been obvious and capable of being readily and instantly perceived by the average person qualified to serve as an arbitrator; and

3. The arbitrators must have appreciated the existence of a clearly governing legal principle (which must be well defined, explicit and clearly applicable) but must have decided to ignore or pay no attention to it.

Here are some examples where this heavy burden was not met. In Dr. Mohammed Al-Azhari v. Merit Capital Associates, Inc., 2000 U.S. Dist. LEXIS 3635 (S.D.N.Y. Feb. 14, 2000), a Southern District judge confirmed a $315,000 NASD arbitration Award and an order of attachment, after a New York Supreme Court judge had granted the customer's *ex parte* Temporary Restraining Order (in the amount of the Award). The brokerage firm and the broker argued that the arbitrators manifestly disregarded their "notice defenses" (i.e., the customer's alleged receipt without timely objection of trade confirmations and monthly account statement, revealing the allegedly unauthorized trades).

The court held that the brokerage firm and the customer's broker failed to show that the notice defenses constituted a clearly governing legal principle. The cases submitted to the court dealt with notice in a different context; they dealt with the start of the statute of limitations on actions based on those transactions. "Their cases recognize a notice defense only where respondent has moved to dismiss the complaint as time barred, which is not the case here, as petitioner's notice of claim indisputably was filed before the limitations period expired." And, with respect to the second question in manifest disregard arguments, the court found that the respondents had not shown that the arbitrators appreciated the existence of the notice defense and decided to ignore it.

Here is another case. After the Claimant won only $50,000 on a $600,000 claim for churning and unsuitability, he went to court and alleged that the Award was in manifest disregard of the law. The court concluded that, "This is not a case where one of the parties clearly stated the law and the arbitrators expressly chose not to follow it." During his summation, Claimant's attorney offered several damage theories, telling the arbitrators that he would leave it to their wisdom. The court - in *Dawahare v. Dean Witter Reynolds, Inc.*, 201 F.3d 666 (6th Cir. 2000) - held that the Claimant, thus, could not rely upon the wisdom of the decision makers without citing any rule of law to support his damages claim and then later argue that the arbitrators disregarded that law.

With many arbitration Awards getting larger, more and more attorneys are trying to have them vacated on, among other grounds, the judicially-created ground of "manifest disregard of the law and the evidence, or both," citing *Halligan v. Piper Jaffray,* 148 F.3d 197 (2d Cir. 1998). In *Cambell v. Cantor Fitzgerald & Co.*, 21 F. Supp. 2d 341 (S.D.N.Y. 1998), for example, the court refused to vacate an arbitration Award based on manifest disregard. It stated, at 349, that "*Halligan* does

not stand for the proposition that district courts may reweigh the evidence and second-guess the arbitrators' credibility determinations. Rather, *Halligan* holds that an arbitration Award may be set aside if it is in manifest disregard of the law or facts." In *Cowle v. PaineWebber, Inc.*, 1999 WL 194900 (S.D.N.Y. Apr. 7, 1999) , the court said that *Halligan* permits a court to modify or vacate an Award if there is strong evidence contrary to the findings of the arbitrators and the arbitrators have not provided an explanation of their decision.

And in *Josephthal & Co., Inc. v. Cruttenden Roth Inc.*, 177 F. Supp. 2d 232 (S.D.N.Y. 2001), an arbitration between two brokerage firms over compensation to be earned from a public offering of a company's shares, the arbitrators ruled that the firm holding the shares could sell them as long as the proceeds from that sale were placed in an unencumbered, separate escrow account. Josephthal contended that the arbitrators acted in manifest disregard of the law by not measuring the other party's damages at a different time. In order to establish manifest disregard of the law, ruled Judge Sweet of the Southern District of New York, Josephthal had to establish that the arbitrators "intentionally ignored what they knew to be obviously applicable and clearly governing law and, further, expressly did so on the record." The judge held that he was not at liberty to set aside an arbitration panel's Award because of an "arguable difference regarding the meaning or applicability of laws urged upon it…Moreover, an error in applying the 'wrong' theory of damages is not a manifest disregard of the law." See *Cole Publishing Co., Inc. v. Wiley & Sons, Inc.*, 1994 U.S.Dist. LEXIS 13786 (S.D.N.Y. 1994).

Conclusion

While the law usually takes a back seat to equitable principles in securities arbitration, knowing the law vacating Award will come in handy the next time your adversary threatens you with a motion to vacate or you are faced with arbitrators who lack gumption. To both your adversary and your arbitrators, stress the principles underlying the grounds to vacate arbitration Awards and emphasize that all the grounds are based on the precept that courts will not second-guess the arbitrators and that the arbitrators' conduct must be patently egregious to overturn an Award, maybe.

View from The West

The California Situation: More Questions Than Answers

Scot Bernstein

© 2003 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.

For fifteen years, investors have had only one way to pursue claims against their brokers. Californians now have four.

For fifteen years, the great majority of investors have had only one way to pursue individual claims against their brokers: arbitration before a securities industry self-regulatory organization ("SRO") arbitration forum, usually the National Association of Securities Dealers ("NASD") or the New York Stock Exchange ("NYSE").[1] California recently enacted new arbitrator disclosure laws and adopted extensive disclosure rules as authorized by those laws. The NASD and the NYSE thus far have refused to comply with California's arbitrator disclosure laws and rules. The odd result is that California investors currently have four distinct avenues for resolving individual claims against the securities industry.

Some of the avenues available to California investors involve exporting their cases to one of several other western states in an attempt to break the logjam caused by the SROs' refusal to comply with California law. As a result, the "California situation" described in the title is not limited to California. Instead, it pervades the West.

New choices and freedoms arrive lockstep with new uncertainty. Thus, the number of questions raised by this article far exceeds the number of answers. Indeed, given the substantial uncertainty accompanying the choices, the best way for practitioners to view the California situation is to recognize that, to a far greater degree than usual, we are dealing with wholly unknowable probabilities rather than predictable probabilities and relative absolutes.

The Focus of this Article

Suppose you toss a coin and tell me to "call it in the air." I say "heads." The coin comes up "heads." Does it even cross your mind to wonder how I knew the outcome in advance? Of course not. You know it was a lucky guess in a situation where I had a fifty percent chance of guessing correctly.

Next, suppose you win a garden-variety arbitration case. The respondent files a motion to vacate in which the sole argument is that the respondents disagree with the arbitrators' decision. The respondent does not even attempt to base its vacatur motion on any of the grounds set forth in the Federal Arbitration Act, the relevant state arbitration statute, or the applicable federal or state case law. Hearing these facts, I volunteer my prediction that the vacatur motion will be denied. If that subsequently turns out to be correct, you will not see my comment as a lucky guess; rather, you will say I stated the obvious.

Some of the events we deal with in our practices have outcomes that we can predict with a great degree of confidence. Others are a roll of the dice. Recognizing the difference is among the most important things we do.

Numerous ideas come to mind for possible articles about the California situation. One obvious possibility would be a thorough analysis of whether the Federal Arbitration Act ("FAA") preempts the California disclosure laws and rules. Another would be an attempt to determine whether the parties' waivers of rights created by the California statute and rules can be avoided on various theories. The problem with either of these subjects is that attempts to predict

court decisions on hotly contested issues are inherently unreliable. If

the best an article can do is give the reader a prediction that has, for example, a sixty or seventy percent chance of being correct, it is of limited value.

What practitioners need in this situation is a discussion that attempts to outline investors' options and the possibilities and uncertainties associated with each. That, unlike an attempt to guess what an appellate court ultimately may decide years in the future, may have value to those who are in the trenches today. That will be the focus of this article.

A Brief Background of the Law and the Controversy

Legislation and Rules

In 2001, the California Assembly and Senate passed Senate Bill 475 and sent it to Governor Davis, who signed the bill into law. Senate Bill 475 amended three sections and added two sections to the California Arbitration Act ("CAA"). California Code of Civil Procedure ("CCP") §§ 1281.6 (amended), 1281.85 (new), 1281.9 (amended), 1281.91 (new) and 1286.2 (amended). Unless otherwise stated, section references are to the CCP.

New section 1281.85 required the California Judicial Council to adopt ethics standards for neutral arbitrators and requires arbitrators to comply with those standards. The standards are required to be consistent with standards established for arbitrators in the judicial arbitration program. They may expand but may not limit the disclosure and disqualification requirements of the California Arbitration Act.

The Judicial Council adopted standards as directed. The standards are titled "Ethics Standards for Neutral Arbitrators in Contractual Arbitration" (the "Ethics Standards"). They can be found in

Division VI of the appendix to the California Rules of Court, and are available online at http://www.courtinfo.ca.gov/rules/amendments/arb_eth03.pdf. As required by section 1281.5, the Ethics Standards took effect on July 1, 2002.

Section 1281.9, as amended, requires arbitrators to disclose "all matters that could cause a person aware of the facts to reasonably entertain a doubt that the proposed neutral arbitrator would be able to be impartial." Items an arbitrator must disclose include but are not limited to the existence of any ground under CCP § 170.1 for the disqualification of a judge; details regarding all arbitration cases that have gone to award in the last five years in which the arbitrator served as a neutral or as counsel; personal and professional relationships with parties and counsel; and, most importantly, all disclosures required by the Ethics Standards adopted by the Judicial Council.

New section 1281.91 provides for disqualification of arbitrators in the following categories:

- arbitrators who fail to make required disclosures;

- arbitrators with respect to whom grounds for disqualification would exist under CCP § 170.1 if the arbitrator were a judge; and

- arbitrators whom a party wishes to disqualify after seeing the required disclosures.

Section 1286.2, as amended, makes explicit that the court shall vacate an award where

> "An arbitrator making the award either: (A) failed to disclose within the time required for disclosure a ground for disqualification of which the arbitrator was then aware; or (B) was
>
> subject to disqualification upon grounds specified in Section 1281.91 but failed upon receipt of timely demand to disqualify himself or herself as required by that provision."

This provision is particularly important. Not only does it spell out a ground for vacating an award, but it spells out a particularly liberal one that apparently lacks any requirement for a showing of prejudice.

The SROs' Response, Part 1: Refusal to Comply

The law and the accompanying Ethics Standards went into effect on July 1, 2002. The NASD and the NYSE stopped appointing arbitrators on the same day.

Approximately three weeks later, the NASD and the NYSE began offering parties to arbitrations the opportunity to stipulate to one of five hearing locations outside of California: Phoenix; Las Vegas; Reno; Portland; and Seattle. If the parties agreed, the SRO would provide arbitrators and a hearing in the agreed location.

Predictably, there were few such agreements. Overwhelmed and overworked by the large volume of investor claims arising out of years of securities industry misconduct, respondents and their counsel have even more than their usual desire for delay.

Thus, on August 30, 2002, the SROs amended the alternative venue provision to give investors a unilateral right to move their cases outside of California. That rule persists. Thus, for example, if a public customer with a case that

otherwise would be heard in San Francisco chooses instead to have it heard in Phoenix before an Arizona panel, the securities industry parties to the dispute are obligated to go along.

On October 1, 2002, the SROs added a new alternative: an investor could waive "all rights and remedies" afforded by the California arbitrator disclosure statutes and rules. The waiver rule, like the hearing location rule, operates unilaterally. If a public customer executes the waiver form, the securities industry parties are deemed to have waived the same rights and remedies. This rule, like the hearing location rule, remains in effect. See NASD Code of Arbitration Procedure Rule 10100.

The SROs' Response, Part 2: Litigation Against the State of California

The SROs have not limited their response to California's law and rules to the self-help and rulemaking they have engaged in to date. They have gone to court as well.

In July 2002, the NASD and the NYSE filed a lawsuit in the U.S. District Court for the Northern District of California, Case Number C 02 3486 SBA, seeking declaratory relief against the application of the Ethics Standards to their arbitrators. The defendants were the Judicial Council of California and each of its members: twenty-one individuals, including the chief justice and an associate justice of the California Supreme Court and thirteen other judges. The SROs then had at least some of the judges served with the summons and complaint in their courtrooms while court was in session.

I am unaware of any official explanation from the SROs as to why they felt it necessary to name the judges as defendants. I have read speculation, however, that naming a large number of prominent judges as defendants was a way to create conflicts of interest that would prevent many or most of California's large law firms from representing the Judicial Council and the individual defendants. Whatever the purpose, however, the SROs' approach did not prevent the defendants from securing the services of able counsel: Joseph W. Cotchett, of Cotchett, Pitre & Simon.

On November 12, 2002, the district court dismissed the SROs' lawsuit on Eleventh Amendment immunity grounds. *NASD Dispute Resolution, Inc. v. Judicial Council of California*, --- F.Supp.2d ---, Fed. Sec. L. Rep. P 92,211, 2002 WL 31521465 (N.D.Cal. Nov. 12, 2002). States can sue states in federal court. But the NASD and the NYSE are not states.

The SROs have filed a notice of appeal. And they still refuse to comply with California law.

Investors' Options

We are left in a bizarre situation in which California investors pursuing individual claims against their brokers have four alternative avenues for relief:

1. They can waive their rights and remedies under the California arbitrator disclosure laws and rules and go forward with arbitration in California before a California panel.

2. They can file with the NASD and move the arbitration to Phoenix, Las Vegas, Reno, Portland or Seattle, where it probably will be heard by a local panel.

3. They can file with the NYSE and move the arbitration to Phoenix, Las Vegas, Reno, Portland or Seattle, and take the chance that the NYSE, because it has inadequate numbers of local arbitrators in its rosters, will attempt to impose one or more California arbitrators on the parties.

4. They can file the case in court and attempt to avoid arbitration altogether.

The potential advantages and the uncertainties of each of these approaches are discussed below.

1. Waiver of Rights and Remedies -- Signing the SROs' Form

As described above, the NASD and the NYSE offer investors the opportunity to sign a waiver form by which they can waive their rights and remedies under the California Ethics Standards. The NASD waiver form is exceptionally broad, selecting the NASD Code of Arbitration Procedure and the FAA to govern "notwithstanding any contrary federal or state substantive or procedural law." If the investor executes the waiver form, the arbitration will proceed much as California arbitrations used to proceed -- or so it might appear. The question is whether the waiver is enforceable.

If the waiver is void or otherwise unenforceable, the liberal ground for vacatur now included in CCP § 1286.2 may give either party a good chance at vacating any award it finds distasteful. Finality of the award is among the most important promises of arbitration. If an arbitration forum cannot deliver on that promise, the desirability of arbitration fades.

Why would the waiver be void or unenforceable? There are many possible reasons and this discussion is not meant to catalog

them all. But here are a few obvious possibilities and other considerations.

a. Public Policy. The statute and rules may be nonwaivable as a matter of law. Securities practitioners are accustomed to statutory rights and remedies that by their own terms cannot be waived. Rights under federal and state securities laws come immediately to mind. But what if the law does not address the waiver issue expressly? Then the rights and remedies are either waivable or not.

California Civil Code § 3513, enacted in 1872, provides as follows:

> "3513. Any one may waive the advantage of a law intended solely for his benefit. But a law established for a public reason cannot be contravened by a private agreement."

As one might expect, this 130-year-old law has been interpreted many times. Some statutes have been held waivable, others not. As examples of cases in which waivers of rights have been held invalid under Civil Code § 3513, see *Grier v. Alameda Contra Costa Transit Dist.* (1976) 55 Cal.App. 3d 325, 334, 335 (provision in collective bargaining agreement authorizing greater wage deduction for tardiness than allowed by Lab.C. § 2928 held invalid under § 3513); *Henry v. Amrol* (1990) 222 Cal.3d Supp. 1, 272 Cal.Rptr. 134 (because most employees have some sort of paid vacation as a part of their total compensation, Lab.C. § 227.3 (giving terminated employees the right to be paid for accrued but unused vacation time) is a law "established for a public reason" within the meaning of Civil Code § 3513 and therefore cannot be waived).

Were the arbitrator disclosure statutes and rules "established for a public reason"? So it would seem, given their purpose of addressing perceived abuses and bringing them to an end. A few excerpts from the legislative history of SB 475 may help to shed some light on this. For example, the following genesis of the bill was made a part of the record from the Senate Floor on September 6, 2001:

> **"Genesis of the Bill**
>
> This bill springs from a concern mutually shared by Governor Davis, Chief Justice George and the author [Senator Escutia] that the Legislature must take a serious look at the growing use of private judges and how that growing use raises questions of fairness and the creation of a dual justice system that favors the wealthy litigant over the poor litigant. In theory, the publicly financed court system is supposed to provide all civil disputants, rich or poor, with an impartial forum within which to litigate and resolve their differences. In reality, however, a fair number of cases end up before a private judge or arbitrator pursuant to contractual agreements. And in many cases that stay in public court, litigants have been forced to pay additional fees when the court decides to appoint a private referee to resolve discovery disputes, with or without the consent of the parties.
>
> This rise in the use of private judges, private arbitrators, and private referees may be justified, perhaps, by the need for some litigants to reach a quicker resolution than might otherwise be available through the congested public court system. However, news accounts as well as appellate opinions have criticized the ease with which some public judges have transferred apparently routine discovery matters to private referees, many times over the objection of one or both of the parties. Courts have also been critical when a party's inability to pay the costs of a private arbitrator or a private referee operates to deprive that party of his or her right to discovery or to a fair hearing of the dispute.
>
> This bill is intended [to] address some of the concerns raised that increased use of private dispute resolvers creates a dual justice system. The bill seeks to address concerns of fairness by requiring private arbitrators to comply with ethical guidelines to be established by [the] Judicial Council. . . . ."

Comments made in the Assembly committee shed light on the motivation underlying the law as well. The following comments, for example, appear in the records of the Assembly committee's consideration of the bill on August 28, 2001:

> *Purpose*. This bill is sponsored by the Governor's Office and the Judicial Council, is intended to address concerns arising through the increased use

of private dispute resolution, including the creation of a dual justice system. The bill addresses fairness concerns by requiring private arbitrators to comply with ethical guidelines to be established by the Judicial Council. . . .

Establishment of Ethical Guidelines for Private Arbitrators. As this

Committee knows well, the growing use of private arbitrators - including the imposition of mandatory, pre-dispute binding arbitration contracts in consumer and employment disputes - has given rise to a largely unregulated private justice industry. While lawyers who act as arbitrators under the judicial arbitration program are required to comply with the Judicial Code of Ethics, arbitrators who act under private contractual arrangements are, surprising to many, currently not required to do so. Under the Judicial Code of Ethics, judicial arbitrators must uphold the integrity and independence of the judiciary, refrain from manifestations of any form of bias, and refrain from any public comment on pending matters, as well as nonpublic comments that might substantially interfere with the proceeding, among other requirements. Because these obligations do not attach to private arbitrators, parties in private arbitrations are not assured of the same ethical standards as they are entitled to in the judicial system. . . .

Eight days earlier, comments in the Assembly committee underscored the public nature of this problem:

> This provision appears appropriate not only to provide a remedy to consumers, who are often forced into private arbitration and who have suffered the arbitrator's non-disclosure, but equally important to provide arbitrators with an incentive to self-regulate. As the
>
> author explains, this self-regulation incentive is central to the purpose of the bill, given the continuing absence of any other public oversight of the arbitration industry. As the U.S. Supreme Court has commented [,] "we should, if anything, be even more scrupulous to safeguard the impartiality of arbitrators than judges, since the former have completely free rein to decide the law as well as the facts and are not subject to appellate review. (*Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 145, 149 (1968).)

Whether one likes or dislikes the Ethics Standards, or thinks they work a net benefit or a net harm for investors, the legislative history shows the legislature's intent to act with a public purpose. If so, the waiver of those provisions may well be unenforceable. And as goes the waiver, so goes the finality of the award.

Can one predict the ultimate outcome with any confidence? No. What this is about is probabilities. Compare this situation with the more familiar one in which an arbitration panel issues its award. What is the probability that a typical arbitration award will be vacated? Miniscule. What is the probability that a California arbitration award, issued pursuant to a waiver of the Ethics standards, will be vacated? Substantial. It may be hard to quantify, but the risk is too large to ignore. An arbitration forum that cannot return that probability to an appropriately low level is failing to deliver on a key promise of arbitration.

b. Duress. If the SROs obtain the waiver by economic duress, the waiver will be invalid. *Rich & Whillock v. Ashton*

Devevelopment, Inc. (1984) 157 Cal.App.3d 1154, 1158. Economic duress consists of "the doing of a wrongful act which is sufficiently coercive to cause a reasonably prudent person faced with no reasonable alternative to succumb to the perpetrator's pressure." *Id.*

Can an investor show that the SROs' refusal to comply with California law is wrongful? Can an investor show that letting a claim wither and dry was not a reasonable alternative to waiving rights under the California law? Either or both of these questions could reasonably be answered in the affirmative. Thus, the possibility of a successful voiding of the waiver on economic duress grounds cannot be ruled out at this stage. Once again, the finality sought by the participants may elude them.

c. Unconscionability. The waiver agreement is a contract of adhesion -- a contract drafted by a party with superior bargaining power and presented to the weaker party on a "take it or leave it" basis. When the NASD or the NYSE presents the waiver agreement to the investor, the investor has two choices: sign it and go forward with the arbitration that he or she came to the SRO to receive; or refuse to sign, and watch the claim wither on the vine.

The fact that a contract is one of adhesion does not, in and of itself, render the contract unenforceable. *Graham v. Scissor-Tail, Inc.* (1981) 28 Cal.3d 807, 817; *Armendariz v. Foundation Health Psych Care Services, Inc.* (2000) 24 Cal.4th 83, 113. But provisions that, considered in context, are "unduly oppressive or unconscionable" maybe be held unenforceable. *Graham v. Scissor-Tail, Inc.*, *supra., at 820; Stirlen v. Supercuts, Inc.* (1997) 51 Cal.App.4th 1519, 1530.

The key in California is whether the contract is both procedurally and substantively unconscionable in varying degrees. If it is, it is unenforceable. This, too, is a factual inquiry -- one that stands a reasonable chance of going either way, and therefore one that by itself raises from miniscule to significant the chance that an award will be vacatable.

d. Counterarguments and Counter-counterarguments: Federal Arbitration Act Preemption. A party defending an award against vacatur undoubtedly will assert that the FAA preempts the California Ethics Standards. Whether that party prevails will depend upon the breadth of the FAA's protection of an arbitration provision. If all the FAA does in putting arbitration provisions on a par with other contract provisions is assure that the parties will arbitrate, then the states ought to be able to provide procedural details such as the Ethics Standards. If the FAA's protection of arbitration clauses requires that they be enforced exactly according to their terms, and if those terms do not include an incorporation of California law, then the Ethics Standards might be preempted.

If this issue arises in the California courts, the answer is unclear. California's appellate decisions are in conflict. For example, compare *Mt. Diablo Medical Center v. Health Net of California, Inc.*, 101 Cal.App.4th 711, 124 Cal.Rptr.2d 607 (August 28, 2002) (California Arbitration Act's provisions are enforceable where they do not conflict with the Federal Arbitration Act's objective of enforcing agreements to arbitrate) and *Szetela v. Discover Bank* (2002) 97 Cal.App.4th 1094 (class action waiver in Discover Bank cardholder agreement declared unconscionable and invalid under California law) with *Discover Bank v. The Superior Court of Los Angeles County (Boehr)*, No. B161305, -------- Cal.App.4th --- (Cal. 2d App. Dist. January 14, 2003) (where a valid arbitration agreement governed by the FAA prohibits classwide arbitration, section 2 of the FAA preempts a state court from applying state substantive law to strike the class action waiver from the agreement).

The issue is being tested in the federal courts as well. As described above, the NASD and the NYSE are appealing the dismissal of their case against the California Judicial Council and its members. Both SROs also submitted a brief recently in *Mayo v. Dean Witter Reynolds*, U.S.D.C. N.D.Cal. Case Number 01 CV 20336 JF. In *Mayo*, the plaintiff is seeking to avoid arbitration on the basis of the SROs' refusal to provide arbitrators in compliance with California law. In their brief, the SROs argue that the Ethics Standards are preempted by both the FAA and the Securities Exchange Act of 1934 (the "Exchange Act"). *Mayo* is discussed in more detail below item 4c.

An interesting angle not addressed in the litigation that has taken place thus far is whether a California choice-of-law clause in the brokerage agreement compels a different analysis of the FAA preemption issue. Wedbush Morgan Securities and presumably a number of other broker-dealers expressly choose California law in their brokerage agreements. If the parties have chosen California law to govern their relationship, have they chosen to have the Ethics Standards apply? If they have, the FAA's requirement that the arbitration agreement be enforced might compel the SROs to comply with the Ethics Standards in those cases. See, *e.g., Volt Info. Sciences v. Leland Stanford Jr. U.* (1988) 489 U.S. 468, 109 S. Ct. 1248, 103 L. Ed. 2d 488. That would be a far cry from the preemption the SROs seek.

And here is a related twist. State arbitration laws may be incorporated into all SRO arbitrations, and not just the ones in which the state's law is selected in a choice of law clause. The starting point for this analysis is that broker-dealers' arbitration agreements routinely incorporate the arbitration rules of the NASD and, if applicable the NYSE. Even when they do not expressly incorporate those rules, the Uniform Submission Agreements do.

The rules include Rule 10100 of the NASD Code of Arbitration Procedure. Rule 10100 identifies a number of member practices in connection with arbitration that may constitute a violation of NASD Conduct Rule 2110 and a failure to adhere to just and equitable principles of trade. One of those practices, set out in Rule 10100(d), quoted below, expressly applies to proceedings at all SRO arbitration fora, including the NASD and the NYSE. That provision refers to vacatur proceedings "pursuant to applicable law." NASD Code of Arbitration Procedure Rule 10100 provides in relevant part as follows:

"10100. ADMINISTRATIVE PROVISIONS
IM-10100. Failure to Act Under Provisions of Code of Arbitration Procedure
It may be deemed conduct inconsistent with just and equitable principles of trade and a violation of Rule 2110 for a member or a person associated with a member to:
. . .

(d) **fail to honor an award**, or comply with a written and executed settlement agreement, **obtained in connection with an arbitration submitted for disposition pursuant to the procedures specified by the National Association of Securities Dealers, Inc., the New York**, American, Boston, Cincinnati, Chicago, or Philadelphia **Stock Exchange**s, the Pacific Exchange, Inc., the Chicago Board Options Exchange, the Municipal Securities Rulemaking Board, or pursuant to the rules applicable to the arbitration of disputes before the American Arbitration Association or other dispute resolution forum selected by the parties **where timely motion has not been made to vacate or modify such award pursuant to applicable law**; . . . . "

NASD Code of Arbitration Procedure Rule 10100 [emphasis added].

Does the reference to applicable law incorporate that law into the agreement? It seems logical that it would. The rules -- part of the agreement -- require payment of awards and make an express exception for parties pursuing vacatur "pursuant to applicable law." One cannot determine whether a party is within or outside of the exception without reference to "applicable law." So how can that law not be part of the parties agreement?

The next question is whether applicable law means state law -- California law in this case. Once again, the possibility cannot be ruled out. Parties to arbitration proceedings in California frequently file their confirmation petitions and vacatur motions in the California courts under the California Arbitration Act's confirmation and vacatur provisions. If that was within the contemplation of the parties, then "applicable law" should include it. So once again the FAA itself may dictate that the Ethics Standards and their liberal vacatur rule apply. As in the case of brokerage agreements that expressly select California law, if FAA preemption becomes FAA compulsion, the SROs' reliance on federal law will have backfired.

One final thought about FAA preemption: there always is the possibility that Congress might amend the FAA to make preemption express and all-encompassing in securities arbitration cases. In view of the public outrage at Wall Street's deliberate wrongdoing and deception of the public, however, and the millions of voting Americans harmed by that misconduct, many members of Congress may conclude that taking an anti-investor position is conduct inconsistent with principles of politics.

e. Is Nonwaivability Symmetric? Each of the nonwaiver arguments above appears geared toward protecting the consumer who signed the waiver. Maybe this is a situation in which an investor who signs a waiver will have a unilateral right to avoid it. In effect, this would give a customer a "put" on an adverse award. Perhaps an investor can increase the likelihood of that outcome by stating in writing that the signature is given under protest and only because of the SRO's threat to prevent the case from ever being heard if the waiver is not signed.

But courts dislike asymmetry in the allocation of rights. The old doctrine of mutuality of estoppel is just one of many examples of that phenomenon. So, foul as it may sound in this context, the courts may decide that what is good for the goose is good for the gander. Remember as well that the securities industry parties' waiver of their rights under the Ethics Standards, unlike the customers' waiver, is not expressly given. Instead, it is deemed given by virtue of NASD rulemaking on its members' behalf. All things considered, one cannot rule out the possibility that the respondents, rather than public customer claimants, would have the stronger claim to voidability of the waiver and vacatability of an adverse award.

Whichever outcome you think is more likely, one thing is clear: the probability of either is substantial. And the consequence of easy vacatability -- the opportunity or obligation to repeat an arbitration a second, third or subsequent time -- is expensive.

In a few pages, we have identified several legal theories, any one of which could void the SROs' waiver agreement and subject an arbitration award to vacatur on grounds far more liberal than the norm. Regardless of the ultimate disposition of these issues, an investor who chooses arbitration under a waiver agreement today

loses the relative assurance of finality that is a primary promise of arbitration.

2. NASD Arbitration Outside of California

Taking a case outside of California is in some sense just another way of waiving or attempting to waive the Ethics Standards. One desiring to vacate an award might make any of the nonwaiver arguments described above.

But there is a difference. The Ethics Standards are regulatory. They govern the conduct of arbitrators. They give the parties a remedy -- vacatur -- if the arbitrators do not adhere to the standards, but the primary thrust is to regulate the arbitrators' actions.

This matters because it is difficult to see how the Ethics Standards can govern the conduct of, for example, an Arizona arbitrator who does not set foot in California or at least does not serve as an arbitrator in California. Thus, while one might make nonwaiver arguments similar to those in the preceding section, intuition suggests that they would stand a far smaller chance of success.

Thus, for investors who need to make a choice today, who want arbitration and who want the finality that is a prime selling point of arbitration, NASD arbitration outside of California may turn out to be the most streamlined approach and the best avenue for relief.

3. NYSE Arbitration Outside of California

If one is going to take a case out of California, what is the difference between the NASD and the NYSE? The answer is pool size.

The NASD's arbitrator pool is large enough in the non-California "alternate hearing locations" to be able to fill a panel with non-residents of California in most if not all cases. The NYSE, in contrast, has few enough arbitrators in at least some of those locations to have to import arbitrators from elsewhere. And from what state is the NYSE filling the gaps? California.

Having even one California arbitrator on an arbitration panel for a year-long dispute in which only a few days of hearing will take place outside of California may cause the award to be vacatable by either party. The disclosure rules embodied in Standard 3 of the Ethics Standards apply not only to cases in which the hearing is to take place in California (which may include cases that the parties originally contemplated would be heard in California), but also to all cases to which the California Arbitration Act applies. Standard 3 provides as follows:

> "(a) Except as provided in this standard and subdivision (b)(12) of standard 7, these standards apply to all persons who are appointed to serve as neutral arbitrators on or after July 1, 2002, in any arbitration under an arbitration agreement, if:
> (1) The arbitration agreement is subject to the provisions of title 9 of part III of the Code of Civil Procedure (commencing with section 1280) [*i.e.*, the California Arbitration Act]; or
> (2) The arbitration hearing is to be conducted in California."

The test is disjunctive. Stepping outside of California for the hearing -- a few days near the end of a year-long case administration -- should not defeat the applicability of the California Arbitration Act to the case. If that sort of thing worked, numerous California businesses could avoid regulatory and policing statutes by the simple ruse of operating from outside of the state for a few days each year.

It would be odd indeed if spending four or five days out of state during a year in which the arbitrators were deciding discovery motions and the like from their offices in California could eviscerate a law passed by the elected representatives of thirty million people. Remember that, by and large, these are cases in which an arbitration agreement was signed in California; the interactions and the relationship between the parties took place in California; the dispute between the parties arose in California; and the contemplation at the time the arbitration agreement was signed was that the hearing would take place in California. In the face of this, any confidence that a California arbitrator can step across the state line for a few days and absolve himself or herself of the consequences of violating California law seems misplaced.

Moreover, NASD Rule 10100(d), discussed in item 1d above, refers to vacatur proceedings "pursuant to applicable law." If "applicable law" includes the CAA, Rule 10100(d) imports the CAA into the SRO rules and, therefore, into the parties' arbitration agreement. Thus, Rule 10100(d) might meet Standard 3's requirement of applicability of the CAA as one of two possible prerequisites to Standard 3's own applicability to a case. Rule 10100(d), while contained in the NASD Code of Arbitration Procedure, expressly makes itself applicable to arbitrations at all SRO fora, including the NASD and the NYSE.

The Ethics Standards recognize the reality that an arbitrator has an impact on a case for the entire

period of his or her service and not just during the hearing. Standard 4(a) provides as follows:

> "Standard 4. Duration of duty
>
> (a) Except as otherwise provided in these standards, an arbitrator must comply with these ethics standards from acceptance of appointment until the conclusion of the arbitration. "

Thus, the Ethics Standards appear to pose a problem for all California arbitrators who fail to comply. The vacatur provisions of the California law turn that problem into a problem for the parties -- or at least for parties who desire finality as part of the arbitration bargain.

The NYSE does not agree that the issues raised above are a problem. But it has not explained its reasoning in recent correspondence sent to my office. Rather, it simply has stated its conclusion:

> ". . . it is the opinion of the New York Stock Exchange, Inc., that California arbitrators may serve outside of California without violating California Ethics Standards for Neutral Arbitrators."

The NYSE's conclusory statement misses the point. What the NYSE overlooks is that California arbitrators appointed to panels for cases that will have their hearings outside of California will do the rest of their work on those cases -- attending pre-hearing conferences, deciding various pre-hearing disputes, dealing with discovery matters and so on -- from their offices ***inside*** California. Can those arbitrators serve ***inside*** of California without violating the Ethics Standards? The NYSE does not address that question.

Thus, whatever the basis for the NYSE's assertions -- FAA preemption, Exchange Act preemption, or a belief that stepping out of state for a few days of hearing nullifies the applicability of the law to the entire year of arbitrator service -- the NYSE's apparent confidence in those assertions is misplaced.

The reality is that arguments can be made both ways regarding the applicability of the California arbitrator disclosure rules to California cases transferred outside of California for the hearing. Predicting the ultimate outcome of those issues with any accuracy is not possible. What is clear is that, if California arbitrators sit on the arbitration panels in those cases, and if they do not comply with the California Ethics Standards, the probability of vacatur increases to a level substantially greater than the near-zero probability that is supposed to characterize arbitration. That takes away the finality that is a key benefit of arbitration and renders false or misleading any advertising or other representations regarding finality of NYSE arbitration awards in these cases. Thus, a California investor who wants an out-of-state arbitration and who wants finality should file the claim at the NASD.

4. Court

The last approach is to file the investor's case in court. One basis for a court filing might be that the SROs' refusal to appoint arbitrators voids the arbitration agreement. The argument might be couched in terms of impossibility of performance: the arbitration agreement calls for arbitration at the NASD or the NYSE, and both are refusing to appoint arbitrators. The agreement is impossible to perform, so the parties must go to court to resolve their differences. Other arguments might be made as well, and some of those are discussed in the paragraphs that follow.

At this time, I am aware of a number of cases in which plaintiffs have filed their cases in court. Not surprisingly, the broker-dealer defendants in those cases have filed motions to compel the plaintiff to arbitrate at the SROs' arbitration fora. I have had an opportunity to read the plaintiffs' points and authorities in support of their oppositions to those motions in two of the cases. The cases are discussed briefly below.

a. ***Marla Jean Esser v. UBS Painewebber,Inc., Donie King, et al***, San Diego County Superior Court case number GIC 794740. Esser's opposition advances three theories: first, that the contract to arbitrate is contrary to public policy requiring that arbitrations include arbitrators and hearing, because the SROs cannot or will not provide either; second, that the contract is illegal in that the arbitration it would compel would be contrary to the Ethics Standards and the underlying statutes; and third, that the arbitration agreement is unconscionable. Esser defeated the defendants' motion to compel arbitration. UBS Painewebber has appealed.

PIABA member Timothy Karen was able to obtain Esser's points and authorities from her legal counsel, James R. Ballard. He posted those papers on the PIABA bulletin board on January 7, 2003, under the heading "California Case Where Court Denied Arb."

b. *James Dick v. James Atrat and U.S. Bancorp Piper Jaffray, Inc.*, U.S.D.C. E.D.Cal. case number CIV-F-02-6264 REC SMS. PIABA member Scott Shewan represents the plaintiff in that

matter. His well-reasoned and insightful opposition to the defendants' petition to compel arbitration advances two primary theories.

First, he argues that the SROs' refusal to appoint arbitrators constitutes a failure of application of the arbitration provision. He does not assert a state contract law defense to the arbitration clause. Rather, he argues that the arbitration agreement is limited to two fora -- the NASD and the NYSE -- and that neither of them will appoint arbitrators. Mr. Shewan cites *In re Salomon Inc. Shareholders Derivative Litigation*, 68 F. 3d 554 (2d Cir. 1995), a case that remained in court over the broker-dealer's objections after the NYSE declined to arbitrate the dispute because its arbitration rules were ill-suited to derivative claims. Mr. Shewan argues that, with both fora out of the picture, there is no arbitration agreement to enforce, and the motion to compel arbitration must be denied.

Mr. Shewan argues in the alternative that his client is entitled to have the court appoint a single arbitrator under section 5 of the FAA. That section requires the court to appoint an arbitrator when the agreement does not provide a method of selecting an arbitrator or where it does provide a method but where for any reason there has been a lapse in the naming of an arbitrator.

Mr. Shewan's opposition and his declaration were posted to the PIABA bulletin board on January 16, 2003, under the titles "Memorandum of Points and Authorities in Opposition to Petition to Compel Arbitration" and " Declaration of Scott R. Shewan in Opposition to Petition to Compel Arbitration." Oral argument in the case has been rescheduled for February 18, 2003.

c. ***Richard Mayo v. Dean Witter Reynolds, Inc.***, U.S.D.C. N.D.Cal. case number 01 CV 20336 JF. Plaintiff Richard Mayo has sought to vacate the court's initial order compelling arbitration on the grounds of impossibility. Mayo also opposes the assignment to a hearing situs in Nevada because that would deprive him of his rights under California law, rendering the obligation to arbitrate unconscionable. The defendant asserts that Mayo can have a fair arbitration without the benefit of the Ethics Standards.

After hearing oral argument on November 25, 2002, the Court decided on its own to request supplemental briefing from the parties regarding any conflict between California public policy as expressed in the Ethics Standards and the FAA. The court also invited the NASD, the NYSE and the Judicial Council to submit amicus briefs on the subject of federal preemption.

The NASD and the NYSE filed a joint brief on January 6, 2003. As described above, the SROs argue that the Ethics Standards are preempted by both the FAA and the Exchange Act. PIABA member Timothy Canning posted the SROs' *Mayo* brief on the PIABA Bulletin Board on January 13, 2003, under the title "California Standards: NASD/NYSE Brief in Mayo." Further oral argument in the case currently appears to be scheduled for February 10, 2003.

Securities industry respondents will have still more counterarguments to attempts to escape arbitration clauses. Besides those described above, they undoubtedly will argue that all they are insisting on is a waiver of rights that did not even exist when the arbitration agreement was signed. Thus, the investor's position after signing the waiver will be no different than what the parties contemplated when they signed the brokerage agreement. Still, neither party can claim to have anticipated that the investor would be required to give up important new rights in order to counter the threat that his or her claim would be put into permanent purgatory.

Investors who look to the courts as an avenue for recovery can expect resistance not only from the securities industry defendants but, if *Mayo* is any guide, from the SROs as well. Moreover, pursuing this approach may lead to years of appeals. Thus, short-term success is by no means assured. It therefore makes sense to choose this approach with caution, and to reserve it for those cases in which court is plainly preferable to arbitration.

Conclusion

Investor claims in California are subject to a new uncertainty. That uncertainty is likely to diminish with the passage of time. But the wheels of justice can turn slowly, and legislative solutions can be slower still. Thus, the new uncertainty, and the complexity of the decisions we must make in the face of it, may be with us for the foreseeable future.

---

[1] I appreciate the thoughtful comments on earlier versions of this paper from Tom Mason. He has improved it. Any remaining problems are my responsibility.

Sales Culture of the Financial Services Industry: An Introduction to Issues Surrounding Commission-Based and Fee-Only Compensation Structures Advisors

By A. Todd Black CFP

A. Todd Black, CFP(R) is President of Dogwood Capital Management, Inc., a fee-only wealth management firm. He is a member of the National Association of Personal Financial Advisors (NAPFA) and the Association for Investment Management and Research (AIMR). His areas of expertise include financial planning and investment management. He can be reached at (770) 205-7981 or via email at toddblack@dogwoodcapital.com.

Financial products are sold, not bought. This is the reason that commission-based sales forces will always be the foundation of the financial services industry. Financial firms know that if their product is sold by a qualified salesperson, and the sales relationship is nurtured, the investor is much more likely to hold on to the product for the long haul (and thus pay more fees to the firm). It is cheaper to keep the customers that you have than to go and find new ones, so maintaining a sales force to service customer relationships is critical to the success of the industry.

Consumers purchase financial products because they trust the salesperson who recommends them. The sales culture of the financial services industry and human nature can lead to abuse and unsuitable product recommendations. This drives the need for well-informed legal counsel to protect consumers who have entrusted the wrong product salesman with their financial future.

Most financial products are commission-based. This does not make them bad. Not many people are qualified to design or choose the optimal insurance product to meet their individual needs. I don't mind paying my insurance agent a commission to help me to choose the right product to ensure that my family is taken care of if I am disabled or if I die. He is offering me a service that deserves fair compensation. But it is human nature to abhor being sold. No one likes to be manipulated, and the traditional product-driven, commission-based sales culture that permeates the financial services industry does not always serve the best interests of the consumer.

As consumers became more educated and less inclined to be sold financial products, there has been a transformation in the financial services industry. All of the sudden, there are no more stockbrokers or insurance agents. Financial product salespeople have evolved into "Vice Presidents", "Financial Consultants", "Estate Planning Specialists", "Financial Planners", and all manner of intriguing and captivating titles denoting trustworthiness, wisdom, experience and financial acumen. These titles are meant to boost professional credibility, and to provide consumers with confidence that they are being advised rather than sold, which may or may not be reality.

The vast majority of financial advisors are commission-based registered representatives. These professionals include stockbrokers, insurance agents, and most financial planners. The term "registered representative" signifies that they are agents of their broker-dealers and as such, are licensed with the National Association of Securities Dealers (NASD). Securities licenses authorize registered representatives to receive commissions for the sale of financial products. Common securities licenses include the Series 6 (to sell mutual funds and variable annuities), Series 7 (to sell stocks, bonds, mutual funds, options and other non-traditional assets), and Series 63 (registered investment adviser license). Insurance agents are required to be licensed for each product that they sell (life, variable life, long term care, etc.).

Broker-dealers are in the business of selling financial products. They commonly distribute mutual funds, insurance products, and non-traditional financial assets (like limited partnerships, hedge funds, and unit investment trusts). The broker-dealer landscape is broad. It includes the large "wire house" firms headquartered on Wall Street, regional retail brokerage firms, and independent broker-dealers of all sizes.

Registered representatives are distribution agents for the broker-dealers. It is their job to sell the

products to the investing public. When a stockbroker, financial planner or insurance agent sells a product, the financial product company gives the broker-dealer a commission. The broker-dealer, in turn, pays the salesperson a percentage of this commission, depending upon the level of production (or sales) that he generates for the firm.

Broker-dealers refer to their registered representatives as "producers". It is every registered representative's goal to be a "Top Producer". This means that he is among the top ranked generators of sales commissions for the firm, and is among the highest compensated agents. As in any sales culture, compensation is the ultimate benchmark used to measure each registered representative's effectiveness. Some firms have what is known as a "million dollar roundtable". In order for a registered representative to sit at this table, he must generate more than one million dollars in commissions for the year. Top producers might win a trip to Hawaii or a new set of golf clubs or some other form of "soft dollar" (non-cash) compensation. Perhaps they will receive a plaque and special recognition at the annual sales meeting. When broker-dealers recruit registered representatives from competing firms, they request documentation of the representative's historic commissions to ensure that they are hiring top talent.

Broker-dealers attract top producers by offering a wide range of financial products to sell to the investing public. They perform due diligence and negotiate sales agreements for mutual funds, limited partnerships, unit investment trusts, separate accounts, insurance products (life, disability, health, long term care, annuities, viaticals, etc.), wrap account services, money management platforms, and brokerage services. Broker-dealers provide educational opportunities and sales training to attract, develop and retain top talent. Large brokerage firms have training programs in which they school their new recruits in the fine art of cold calling (also known as "dialing for dollars"), and referral generation techniques from centers of influence (such as accountants and attorneys).

Product companies, like mutual funds and insurance companies, also contribute strategies and resources to broker-dealers to educate registered representatives to sell their products more effectively. They employ wholesalers to court and solicit business directly from the top-producing registered representatives. They might use "soft dollar" incentives like sponsoring client appreciation luncheons or paying for other costs that the registered representative might have. There are strict legal guidelines regarding soft dollar incentives, but there are also a lot of gray areas that are exploited.

Another way that broker-dealers and product companies aid registered representatives is by providing turnkey sales support for complex cases. For example, suppose a registered representative finds an elderly wealthy prospect with altruistic motives and a portfolio of highly appreciated stock that is not paying a dividend. The prospect can't sell the stock without taking a huge hit in taxes. The prospect doesn't have any cash to buy the product, so the registered representative can't make a sale. How can the registered representative sell his wealthy prospect this product that will solve the client's problems and earn him a healthy commission? He calls up his broker-dealer and/or the product company and explains the situation. They come up with a strategy and walk the registered representative through it. In this example, they would set up a charitable remainder trust, gift the stocks to the trust (prospect gets a big tax deduction), sell the stocks (prospect doesn't pay any taxes) and reinvest in the proceeds in the investment products that the registered representative wishes to sell (that will produce an income stream for the prospect). They would also set up an irrevocable life insurance trust and sell the client a second-to-die life insurance policy to replace the assets that the client is giving away so the heirs would not come back and sue the registered representative for convincing their parents to give away their inheritance. In this example, the registered representative sold investments and insurance while providing the prospect with tax benefits, an income stream, and a tax-free inheritance for his heirs. If properly executed, this registered representative is a hero. Registered representatives seek out broker-dealers that will support them with a quiver full of good product offerings and strategies (like the one illustrated above). Furthermore, having an advanced strategy as an arrow in your product offering quiver is impressive to prospects, and an ego boost for the registered representative.

Back office sales support is the true function of a broker-dealer. If a registered representative is particularly entrepreneurial and effective in product sales, he will seek out an "independent" broker-dealer that generally offers higher commission pay-out rates. The large "wire house" firms like Merrill Lynch and Solomon Smith Barney aren't as lucrative in their payout rates as the independent broker-dealers are.
There is a huge push among financial services firms to have their stockbrokers and insurance agents to become financial planners. This is indicative of the industry-wide desire to be perceived as a trusted personal advisor rather than a product salesman. The Certified Financial Planner™ (CFP) designation has grown as the industry benchmark for

financial competency. The CFP Board stresses ethical conduct, full disclosure of all pertinent issues including compensation, and continuing education requirements. Many firms require all new hires to obtain the designation by a specified time after their recruitment.

The financial planning process revolutionized the financial services industry. The consumer has benefited because their entire financial picture (including investments, taxes, estate planning, retirement planning and individual special needs) is being analyzed and the various components are being synchronized to reach their long-term goals. Broker-dealers and registered representatives have benefited because it enables them to sell more products to each client.

COMPENSATION STRUCTURE:

Financial professionals are compensated one of three ways: 1. receive commissions only, 2. receive fees-only, or 3. receive fees and commissions or fee-offset. A great debate is raging in the financial services industry about how its participants are paid, and what value they are offering for their compensation. As disclosure and investor education has improved, the difference between financial product sales and objective investment and financial advice has been exposed. Consumers want objective advice. They want to be advised not sold. Unfortunately, the commission structure of a product offering sometimes clouds the issue of suitability for individual investors.

Selling financial products can be an extremely lucrative career. The commission structure for different financial products is constantly evolving. Another word for a commission in the financial services industry is "load". Mutual funds and insurance products are among the most popular loaded investment options. If you see a mutual fund advertised as a "no load" fund, it does not pay a commission to registered representatives for distribution. If you see a fund that has a 12b-1 charge, this represents a load or commission that is paid to the registered representative. Funds refer to these costs as "marketing expenses". They are varying commission schedules for mutual funds. The funds are classified as A, B, or C shares.

A shares pay a 5% commission up front, which is taken directly from the principal that is initially invested in the fund. For every year that the investor owns the fund, the mutual fund company pays a "trail" of 0.25% of the balance invested. This commission trail is intended to compensate the advisor for continuing his service of the account. A shares have the lowest expense ratios relative to the other load shares (B and C) because they have low commission trails. This commission structure was popular among transaction oriented registered representatives that want to generate the most commissions in a short period of time. This is the original commission payment structure for the mutual fund industry.

B shares pay the advisor 4-5% up front commission, but they don't take the money out of the principal as it is initially invested (the way the A shares do). Instead, they charge the investor a higher expense ratio for the first five years that they own the fund so they can recoup the commissions that they paid to the registered representative. After five years, the B share becomes an A share, and the annual expense ratio declines to reflect that the commission has been paid off by the investor. When an investor purchases a B share, he is told there is a "back end load", which means if you sell the fund within five years after purchasing it, you will be hit with sales penalties. They penalties decrease each year on a sliding scale until they disappear entirely when the fund becomes an A share. This penalty represents a refund of the sales commission that the fund paid the registered representative for distributing its product. Because of the five-year holding period minimum, B shares offer less flexibility for investors than other options that are available. Generally, if an investor wished to sell the B share, he could do so and re-purchase another B share mutual fund in the same fund family, assuming there are other suitable funds available. The B shares' lack of flexibility is a hindrance. What if the manager dies or is not good and the fund family has no other suitable options? What if the investor has an emergency and needs the money sooner than expected? B shares are usually sold to younger investors that have less money to invest.

C Shares are also known as "level load" funds. These mutual funds pay a 1% commission to the registered representative each year. Because of this, their annual expense ratio is similar to or higher than B share mutual funds. This commission structure is becoming increasingly popular with registered representatives who want to gather assets under management and design a steady income stream for themselves.

When mutual funds pay commissions and take out fees, the investor does not see it (except in the case of A shares where the commission amount is deducted up-front). However, commissions are explained in the fund's prospectus. Not many investors read the prospectus prior to the sale of a mutual fund, but registered representatives are required by law to distribute them to their clients when they make the sale.

Insurance products pay significant commissions and trails, and the range of products is staggering. Usually an agent will focus on a range of hot or well-known insurance product lines and get licensed to sell

them. The commission schedules for insurance products can range from 40% to 70% of the initial premium paid by the client. This doesn't even include commission trails that agents receive each year as the insurance is renewed. There are over three million insurance product salesmen in the United States. This is the largest segment of the financial services industry. Insurance is also one of the oldest financial products sold.

Unconventional products include limited partnerships, hedge funds, and unit investment trusts. Limited partnerships were in vogue in the 1980s during the tax-shelter hay days. There are still a few around. They usually pay an up-front commission of 8% of the invested capital. The danger with limited partnerships is that they are illiquid, and the limited partner investor has no rights. They get their money back when the general partner deems it is time. This could be five to twenty five years from the time of the initial investment. Hedge funds generally pay commissions under the same structure that mutual funds do. Unit investment trusts are unmanaged baskets of stocks or bonds that pay commissions similar to "A" share mutual funds.

In the last twenty years, comprehensive "Fee-Only" financial planning has exploded onto the financial services scene. The National Association of Personal Financial Advisors (NAPFA) is the preeminent trade organization for comprehensive, Fee-Only financial planners in the United States. The members of this organization provide consumers and institutions with comprehensive and objective financial advice on a "Fee-Only" basis, keeping only the best interests of the client in mind- with neither the advisor nor any related party receiving compensation contingent on the purchase or sale of a financial product. In essence, they are objective and un-biased financial advisors, not financial product salespeople.

"Fee Only" adherents argue that commission-based compensation is not conducive to the spirit of a fiduciary relationship. Critics cite the potential for conflict of interest where a registered representative might have the incentive to put his financial interests before the best interests of the client. There are several facts that support this position. Registered representatives are measured by the dollar amount of commissions that they generate for the broker-dealer (i.e. the "million dollar roundtable") and they receive incentives from product companies (cruises, golf outings, trips to Hawaii, etc.) for sales volume.

Registered representatives argue that fiduciary responsibility is a matter of the individual's character. It is up to each salesperson to choose to act according to his conscience and sell only the most suitable products in the best interest of each client. There are ample regulations and laws in place to ensure that the registered representative behaves reputably, and industry watchdogs and administrative bodies (such as the Certified Financial Planner Board) have strict guidelines pertaining to its members' conduct and ethics. Compliance with these laws and regulations is a huge responsibility (and liability) of the broker-dealers, and they take it very seriously. Broker-dealers employ compliance officers (also known as the "sales prevention team") to ensure that registered representatives stay out of gray areas (and arbitration proceedings).

This argument is right about one thing: the underlying foundation of a successful financial advisory relationship is character. In many cases, registered representatives are behaving honorably and in the best interests of their clients. However, there are inherent flaws in this system, and circumstances where abuses can and will occur. The temptation for registered representatives to act in their own best interest is great, and sometimes, "the spirit is willing but the flesh is weak".

Sun Tzu wrote in his classic book, *The Art of War*, "Know your enemy and know yourself and you can fight a hundred battles without disaster." The mandate of the Public Investors Arbitration Bar Association is to represent investors in disputes with the securities industry. To serve your clients effectively, it's important to be familiar with the structure of the securities industry and the sales culture that it propagates. After all, financial products are sold, not bought.

Judicial Deference to SEC Precedent+

By Richard G. Himelrick

Mr. Himelrick is a PIABA member and shareholder in the Phoenix firm of Tiffany & Bosco, P.A. He may be reached at 602-255-6021 or rgh@tblaw.com.

The law does not pretend to punish everything that is dishonest. That would seriously interfere with business.[1]

Clarence Darrow

Introduction

Administrative agencies create law in a variety of ways, including regulations, interpretative releases, and adjudicated decisions.[2] This regulatory law often has precedential value in judicial decisions.[3] The Securities and Exchange Commission,[4] National Association of Securities Dealers,[5] and state securities agencies[6] are the primary producers of administrative precedent in the securities field. This article begins with a general overview of judicial deference to agency precedent. It then examines the special rules governing agency decisions under the Supreme Court's *Chevron* doctrine.[7] Following that, the Supreme Court's application of *Chevron* to SEC precedent is discussed.[8] Finally, the article explores the relevance of *Chevron* to the Eleventh Circuit's decision in *ETS Payphones.*[9] It concludes, contrary to the panel in *ETS,* that under *Chevron* the Eleventh Circuit was required to defer to prior SEC precedent interpreting the meaning of investment contracts.

A practice insight is also advanced.

____

1 *The Quotable Lawyer* 23 (Tony Lyons ed., 2002).

2 *See, e.g.,* Manuel F. Cohen & Joel J. Rankin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in their Development*, 29 Law & Contemp. Probs. 691 (1964) (discussing the ways in which the SEC develops legal standards).

3 *See, e.g., Skidmore v. Swift & Co*., 323 U.S. 134, 140 (1944) (explaining that courts and litigants may properly resort to administrative rulings, interpretations, and opinions for guidance); *see also* the discussion of *Skidmore* in the text accompanying notes 14-16 *infra.*

4 *See generally* Timothy J. O'Connor, *The Use of Securities and Exchange Commission Precedent in Arbitration Proceedings,* in Securities Arbitration 1997: Arbitration Comes of Age 2, at 471 (PLI Corp. Law & Practice Course Handbook Series No. B4-7195, 1997), *available in*
Westlaw, 999 PLI/Corp. 471.

5 *See generally* Timothy J. O'Connor, *The Use of NASD Notice to Members Bulletins as Precedent in Arbitration Proceedings,* in Securities Arbitration 1998: Refining Practices and Techniques 1, at 253 (PLI Corp. Law & Practice Course Handbook Series No. B-1061, 1998),
available in Westlaw, 1061 PLI/Corp. 253.

6 *See, e.g.,* PIABA's Amicus Brief in Support of Petition for Prehearing at 5-6 & n. 1, *SEC v. ETS Payphones, Inc.,* 300 F.3d 1281 (11th Cir. 2002) (citing decisions by 16 state securities agencies holding, contrary to the Eleventh Circuit, that the programs under which ETS's payphones were sold are securities). Ten of these decisions are available on Westlaw: *ETS Payphones, Inc.,* 2001 WL 422179 (Ala. Sec. Comm'n Feb. 6, 2001); *Jerome Alex Zanowski,* 2000 WL 1847107 (Ariz. Corp. Comm'n Nov. 30, 2000); *ETS Payphones, Inc.,* 2002 WL 1586379 (Ind. Div. Sec. June 7, 2002); *National Communications Marketing, Inc.,* 1998 WL 704697 (Kan. Sec. Comm'n Sept. 25, 1998); *Phillip L. Helton,* 2001 WL 1193030 (Mo. Div. Sec. Oct. 2, 2001); *Robert L. Scott,* 2002 WL 31089631 (Ohio Dept. Comm'n Aug. 29, 2002); *Linda L. Eberly,* 2002 WL 1151509 (Pa. Sec. Comm'n May 9, 2002); *Gary Randolph Hayden,* 2002 WL 1575117 (Tex. St. Sec. Bd. July 9, 2002); *National Communications Marketing, Inc.,* 2001 WL 236889 (Wash. Sec. Div. Feb. 26, 2001); *Jerry Klemp,* 1999 WL 20390 (Wis. Comm'n Sec. Jan. 8, 1999).

7 *See Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.,* 467 U.S. 837 (1984).

8 *See SEC v. Zandford,* 122 S.Ct. 1899, 1903 (2002).

9 *SEC v. ETS Payphones, Inc.,* 300 F. 3d 1281 (11th Cir. 2002).

As litigators, our search for useful precedent is endless. The citations we need to persuade often evade us. Frequently, federal or state administrative precedent can fill the gap, and when the practitioner is fortunate enough to find an SEC opinion based on adjudicated facts, the decision can be invaluable. If the decision qualifies for *Chevron* treatment, and it often will, deference to the SEC's views is mandatory. The following discussion develops this theme.

Judicial Deference to Administrative Precedent

The twentieth century witnessed enormous growth in administrative law. By the time of Franklin Roosevelt's New Deal, administrative agencies "decided thousands and thousands of controversies, big and small; and came to countless courtlike decisions each year."[10]

Both state and federal courts commonly afford judicial deference to statutory interpretations by administrative agencies.[11] If the statute is one the agency is entrusted to enforce,[12] the courts often give the agency's interpretation considerable weight.[13] Justice Jackson's opinion in *Skidmore v. Swift & Co.*[14] provides the classic description of judicial deference to administrative interpretations of statutes:

> We consider that the rulings, interpretations and opinions of the Administrator under this Act, while not controlling upon the courts by reason of their authority, do constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance. The weight of such a judgment in a particular case will depend upon the thoroughness evident in its consideration, the validity of its reasoning, its consistency with earlier and later pronouncements, and all those factors which give it power to persuade, if lacking power to control.[15]

Skidmore's "power to persuade" standard continues to be applied with vigor in contemporary Supreme Court decisions.[16]

A variety of factors explain judicial willingness to defer to the statutory interpretations of agencies. In many instances an agency's hearing officers and staff will have technical

---

[10] Lawrence M. Friedman, *American Law in the 20th Century* 170 (2002).

[11] *See, e.g., Skidmore v. Swift & Co.,* 323 U.S. 134, 140 (1944) (explaining that courts and litigants may properly resort to administrative rulings, interpretations, and opinions for guidance); *Jenney v. Arizona Express, Inc.,* 89 Ariz. 343, 346, 362 P.2d 664, 667 (1961) (deferring to Arizona Corporation Commission's statutory interpretation and stating that "although we are not bound by the administrative interpretation, where any serious doubt as to the proper interpretation exists we will not adopt one different from that adopted by the appropriate administrative body.").

[12] For a court to attach weight to an agency's statutory interpretation, the statute must be one the agency is charged with administering. *See, e.g., State v. Turner,* 175 Ariz. 256, 259, 855 P.2d 442, 445 (App. 1993) (explaining that weight will be given to an agency's "construction of the statutory scheme which it is entrusted to administer."). Agency interpretations of a statute under which the agency has neither rule-making nor adjudicatory responsibility are entitled to no deference. *See, e.g., Metro. Stevedore Co. v. Rambo,* 521 U.S. 121, 137 n. 9 (1997) (denying *Chevron* deference to agency interpretation of the Administrative Procedure Act because the APA is not a statute the agency is "charged with administering"); *Jennings v. Woods,* 194 Ariz. 314, 327, 982 P.2d 274, 287 (1999) (stating, as to a statute under which the Arizona Corporation Commission had no administrative responsibility, that the Commission's interpretation "can be given no effect by this court.").

[13] *E.g., Davis v. Arizona Dept. of Revenue,* 197 Ariz. 527, 530, 4 P.3d 1070, 1073 (App. 2000) ("Although this Court is not bound by an agency's interpretation of a statute that it enforces, absent contrary legislative intent, we generally afford an agency's construction 'great weight.'"); *State v. Turner,* 175 Ariz. 256, 259, 855 P.2d 442, 445 (App. 1993) ("Along with legislative history, we have long recognized that, when a statute is silent or ambiguous, we will give considerable weight to an administrative agency's construction of the statutory scheme which it is entrusted to administer.").

[14] 323 U.S. 134 (1944).

[15] *Id.* at 140.

[16] *See, e.g., United States v. Mead Corp.,* 533 U.S. 218, 234-39 (2001) (explaining *Skidmore's* continued importance and remanding for consideration of whether the agency's decision qualified for *Skidmore* deference); *see also* Thomas W. Merrill & Kristin E. Hickman, *Chevron's Domain,* 89 Geo. L. J. 833, 852-56 (2001) (discussing *Skidmore).*

expertise the courts lack. And unlike a court, which is limited to deciding the case before it, the agency will typically have ongoing responsibility for the statutory scheme.[17] Thus, the agency is likely to be better informed than the courts about the statutory history and the practical implications of competing interpretations.[18] Additionally, the agency's officers and staff will characteristically have more time to devote to the issues raised by a controversy or problem.[19] More time, coupled with what are often broad investigative powers,[20] means more information will frequently be available in the agency setting than judicially.

Still another consideration is the duration of the agency interpretation. If the agency's interpretation is a long standing one, it may be fair to conclude the legislature is familiar with the agency's view and has acquiesced in it.[21] The public too may have relied on the agency's interpretation.[22] As a result, the statutory interpretations of administrative agencies often evidence public and legislative expectations. This is especially so when the legislature has delegated interpretative authority to an agency.[23] For all these reasons a court might reasonably conclude that an agency's interpretation is entitled to deference.[24]

Chevron Deference

The Supreme Court's decision in *Chevron U.S.A., Inc. v. Natural Resources Defense Council, Inc.*[25] is one of the most important in administrative law.[26] As explained by one commentator, "[i]n an extraordinarily wide range of areas--including the environment, welfare benefits, labor relations, civil rights, energy, food and drugs, banking, and many others--*Chevron* has altered the distribution of national powers among courts, Congress, and administrative agencies."[27] *Chevron* did this by expanding the range of circumstances in which judicial deference to agency interpretations of federal statutes is mandatory. Before *Chevron,* deference was mandatory only when Congress explicitly delegated interpretative authority to an agency.[28] In other instances, only discretionary deference based on *Skidmore's* "power to persuade" standard

---

[17] *See, e.g., Jennings v. Woods,* 194 Ariz. 314, 322, 982 P.2d 274, 282 (1999) (explaining that A.R.S. § 44-1821 "grants the [Arizona Corporation] [C]ommission open-ended rule-making power to 'carry out the provisions' of Arizona's Blue Sky laws.").

[18] William N. Eskridge, Jr., Phillip P. Frickey & Elizabeth Garrett, *Legislation and Statutory Interpretation* 313 (2000).

[19] Henry Hart Jr. & Albert Sacks, *The Legal Process: Basic Problems in the Making and Application of Law* 1290 (William Eskridge Jr. & Phillip Frickey eds. 1994 (from the 1958 tent. ed.)).

[20] *See, e.g., Carrington v. Arizona Corp. Comm'n,* 199 Ariz. 303, 305, 18 P.3d 97, 99 (App. 2000) (describing the Arizona Corporation Commission's investigative powers and the "wide berth" the courts give the Commission when reviewing the validity of its investigations).

[21] *See, e.g., Long v. Dick*, 87 Ariz. 25, 29, 347 P.2d 581, 583-84 (1959).

[22] *See, e.g., Begay v. Graham*, 18 Ariz. App. 336, 339, 501 P.2d 964, 967 (App. 1972).

[23] *See, e.g.*, A.R.S. § 44-1821(A) (delegating authority to the Arizona Corporation Commission "to carry out" the Arizona Securities Act by enacting appropriate rules and regulations); *see also United States v. Mead*, 533 U.S. 218, 226-27 (2001) (holding that *Chevron* deference depends on a determination that Congress delegated interpretative authority to the agency).

[24] *See generally Bragdon v. Abbott*, 524 U.S. 624, 642 (1998) ("the well reasoned views of the agencies implementing a statute 'constitute a body of experience and informed judgment to which courts and litigants may properly resort for guidance.'" (quoting *Skidmore v. Swift & Co.*, 323 U.S. 134, 140 (1944))).

[25] 467 U.S. 837 (1984).

[26] *See generally* Merrill & Hickman, *supra* note 16.

[27] Cass R. Sunstein, *Law and Administration After Chevron,* 90 Colum. L. Rev. 2071, 2075 (1990) (footnotes omitted).

[28] Merrill & Hickman, *supra* note 16, at 833.

applies.[29]

Under *Chevron*'s doctrine of mandatory deference courts must initially determine "whether Congress has directly spoken to the precise question at issue."[30] If Congress did, "that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress."[31] If, however, "the statute is silent or ambiguous with respect to the specific issue, the question for the court is whether the agency's answer is based on a permissible construction of the statute."[32] In short, *Chevron* deference is a two-step procedure in which the court first asks whether the statute has a gap or is ambiguous. If the answer is yes, the court then asks whether the agency's interpretation is reasonable. Thus, when the statute is ambiguous and the agency's interpretation is reasonable, the agency's construction controls.

SEC v. Zandford

Last Term, in *SEC v. Zandford,*[33] the Supreme Court applied *Chevron* to uphold the SEC's statutory interpretation in a case decided under rule l0b-5 and § 10(b) of the Securities Exchange Act of 1934.[34] Although *Chevron* was decided 18 years earlier, the SEC had not previously argued for *Chevron* deference.[35] Indeed, in the years before *Zandford* the SEC's statutory views were rebuffed in a series of cases narrowing investor protection under rule 10b-5.[36]

Zandford concerned interpretation of the "in connection with" phrase in rule l0b-5 and § 10(b). A broker persuaded his customer, an elderly man named Wood, to open a discretionary account for himself and his mentally retarded daughter.[37] The broker then misappropriated the account's proceeds by transferring funds from the Woods' account to accounts the broker controlled.[38] Some of the transfers were accomplished by writing checks that required sales of securities in the Woods' mutual fund.[39] The Fourth Circuit concluded the broker's conduct was a straightforward scheme to steal the Woods' assets rather than securities fraud.[40] The broker's theft, according to the Fourth Circuit, was not sufficiently connected with the sale of securities to establish a violation of § 10(b).[41]

---

29 *See United States v. Mead Corporation,* 533 U.S. 218, 221 (2001) (holding *Chevron* inapplicable but concluding that under *Skidmore* the agency's ruling was "eligible to claim respect according to its persuasiveness").

30 467 U.S. at 842.

31 *Id.* at 842-43.

32 *Id.* at 843.

33 122 S.Ct. 1899 (2002).

34 15 U.S.C. § 78j(b).

35 Respondent's Brief in *Zandford* at 43, *available in* 2002 WL 405094. In *Basic Inc. v. Levinson,* 485 U.S. 224 (1988) the Supreme Court, without explanation of what deference standard it had in mind, stated that the SEC's views were "helpful" and entitled to "due deference." *Id.* at 239 n. 16.

36 *E.g., Central Bank of Denver, N.A. v. First Interstate Bank of Denver, N.A.*, 511 U.S. 164, 175-77 (1994) (rejecting the SEC's position on aiding and abetting under rule 10b-5); *Lampf, Pleva, Lipkind, Prupis & Petigrow v. Gilbertson*, 501 U.S. 350, 361-62 (1991) (rejecting the SEC's position on the length of a federal statute of limitations for rule 10b-5 actions); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 738 (1975) (rejecting the SEC's position on standing under rule 10b-5).

37 *Zandford*, 122 S.Ct. at 1901.

38 *Id.*

39 *Id.*

40 *See id.* at 1901-02.

41 *See id.*

In the Supreme Court, the SEC argued for *Chevron* deference.[42] The Court agreed and reversed the Fourth Circuit. Citing *United States v. Mead Corporation*,[43] a case clarifying the scope of *Chevron's* mandatory deference, the Court held:

> In its role enforcing the Act, the SEC has consistently adopted a broad reading of the phrase "in connection with the purchase or sale of any security." It has maintained that a broker who accepts payment for securities that he never intends to deliver, or who sells customer securities with intent to misappropriate the proceeds, violates § 10(b) and Rule l0b-5. [Citations omitted]. This interpretation of the ambiguous text of § 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable. [Citing *Mead]*. For the reasons set forth below, we think it is.[44]

This holding is unusually important and exciting for practitioners who represent investors. It marks a potential watershed. It represents the first time the Supreme Court has embraced *Chevron* in a case involving SEC precedent. By citing *Mead,* a product of *Chevron,* the Court demonstrated its intent to require mandatory deference to SEC statutory interpretations under *Chevron's* two-step test. Given the SEC's historically broad view of the securities statutes *(Zandford* is an example), SEC statutory interpretations usually favor investors.

Mead clarified the type of administrative precedent entitled to *Chevron* deference. In turn, *Zandford* shows that SEC decisions can pass muster under *Mead*.

Mead holds that statutory interpretations by agencies are entitled to *Chevron* treatment "when it appears that Congress delegated authority to the agency generally to make rules carrying the force of law, and that the agency interpretation claiming deference was promulgated in the exercise of that authority."[45] Congress usually contemplates administrative action with the force of law "when it provides for a relatively formal administrative procedure tending to foster the fairness and deliberation that should underlie a pronouncement of such force."[46] Although delegation may be shown in a variety of ways, the courts most often infer delegation when the agency either has the power to engage in notice-and-comment rulemaking or to decide controversies through formal adjudication.[47] *Zandford* applies *Mead* and holds that reasonable SEC interpretations of ambiguous federal securities statutes, when rendered in the context of formal adjudication, are entitled to mandatory deference.[48]

SEC v. ETS Payphones, Inc.

SEC v. ETS Payphones, Inc.[49] illustrates the potential efficacy of *Chevron's* law of mandatory deference. In *ETS* the Eleventh Circuit rejected the SEC's arguments that an arrangement for the sale and leaseback of pay telephones was an "investment contract" and, therefore, a security. In a single paragraph seemingly designed to create a record rather than to persuade, the SEC invoked *Chevron's* analysis in a petition for rehearing.[50] When this article was submitted for publication, the Eleventh Circuit had not ruled on

---

[42] Petitioner's Brief in *Zandford* at 37-38, *available in* 2001 WL 1663770.

[43] 533 U.S. 218 (2001).

[44] *Zandford*, 122 S.Ct. at 1903.

[45] 533 U.S. at 226-27.

[46] *Id.* at 230.

[47] *Id.* at 227, 230-31.

[48] *See Zandford*, 122 S.Ct. at 1903.

[49] 300 F.3d 1281 (11th Cir. 2002).

[50] Citing *Zandford,* the SEC's Petition for Rehearing makes the following deference argument:

> The panel's decision also conflicts with the Commission's administrative interpretation that "investment

the petition.

ETS investors entered into prearranged transactions in which they purchased a pay telephone and then leased it back to ETS.[51] Under the leases, investors received fixed monthly payments that were contractually guaranteed.[52] The Eleventh Circuit held on two grounds that the leaseback program was not an investment contract under the Supreme Court's *Howey* test.[53] First, *Howey* requires an investment of money with the expectation of profits. The ETS programs did not satisfy the profits element.[54] Investors were not in a position to reap capital appreciation or to participate in the profits of ETS or those produced by their telephone.[55] The investors' financial return was a fixed monthly sum rather than a return based on participation in profits.[56] Second, even if the investors' return could be construed as profits, the transactions did not satisfy *Howey's* requirement that the profits derive solely from the efforts of others.[57] Investor returns were contractually guaranteed by their leases. Because the returns were guaranteed, they were not derived from the efforts of ETS or its promoter.[58] In sum, the elements of a fixed return and a contractual guarantee convinced the Eleventh Circuit that investors were in no sense participating in profits derived from the efforts of ETS or its affiliates.

Whether the Eleventh Circuit correctly applied the *Howey* test is not the subject of this article. In their briefs requesting reconsideration, PIABA and the SEC have argued persuasively that the *ETS* panel misinterpreted *Howey.* My interest is in whether *ETS* can be squared with *Chevron* and *Zandford*--an issue only touched upon in the SEC's petition for rehearing.[59]

ETS* and *Chevron

As discussed previously, *Chevron* established a two-step test for determining whether deference to an agency's statutory interpretation is required. *Zandford* in turn ruled that *Chevron's* law of mandatory deference applies to SEC decisions memorializing formal adjudications.[60]

Before *Chevron* can be applied, relevant precedent must exist at the administrative level. We turn therefore to the SEC's administrative interpretation of investment contracts, first generally and then specifically as to those, like the one in *ETS,* that involve fixed returns that are guaranteed.

In discussing *Chevron* deference in *Zandford* the Supreme Court observed that "the SEC has consistently adopted a broad reading of the phrase 'in connection with the

---

> contract" includes investments in mortgages that pay profits in the form of fixed interest payments, if accompanied by service agreements minimizing the risk of loss to investors. *See Abbett, Sommer & Co., Inc.,* 44 S.E.C. 104, 107-109 (1969) (mortgage notes accompanied by services including investigation of property and mortgagor, collection of monthly payments for investors, and undertaking to repurchase notes). As the Supreme Court recently held, in *SEC v. Zandford,* 122 S.Ct. at 1903, the Commission's reasonable interpretation is entitled to deference.

SEC's Petition for Rehearing in *ETS* at 9.

[51] 300 F.3d at 1282.

[52] *Id.* at 1284-85.

[53] *SEC v. W.J. Howey Co.*, 328 U.S. 293 (1946).

[54] *SEC v. ETS Payphones, Inc.*, 300 F.3d at 1284-85.

[55] *Id.*

[56] *Id.*

[57] *Id.* at 1285.

[58] *Id.*

[59] *See supra* note 50 and accompanying text.

[60] *Zandford*, 122 S.Ct. at 1903.

purchase or sale of any security."'[61] The Commission has also consistently advocated an expansive interpretation of investment contracts. Years before *Howey* the Commission emphasized the need to look "through the form of the interest involved to determine the substance and true nature of the arrangement."[62] To accomplish this the Commission articulated the investment contract formulation later adopted in *Howey.*[63] In the years since *Howey* the Commission has continued to advocate a broad, flexible construction of investment contracts.[64] Thus, the SEC has a long history of liberally interpreting investment contracts to promote investor protection.

In its enforcement role under the securities laws, the SEC has rejected the investment contract analysis advanced by the Eleventh Circuit in *ETS*. In *Abbett, Sommer & Co.,*[65] an enforcement action, a company marketed mortgage notes under a program that included collection services and investigation of the value of the property and any encumbrances on it.[66] Although the notes paid a fixed rate and were promoted through a payment "guarantee," the SEC concluded the arrangements were investment contracts.[67] Similarly, in *Prime Investors Inc.*,[68] a case decided on appeal from NASD disciplinary proceedings, a brokerage firm sold instruments under an investment program that paid a fixed 12% a year.[69] The program's promoter was responsible for managing investors' money in a pooled account at the brokerage firm.[70] The investments were touted as providing a "Guaranteed Return."[71] Despite the guaranteed, fixed return, the SEC concluded the arrangement was an investment contract.[72]

Both *Abbett* and *Prime Investors* were decided in contested proceedings leading to adjudicated facts. They are both formal decisions of the type *Zandford* holds are eligible for *Chevron* deference. We move therefore to *Chevron's* two-step test.

Step one under *Chevron* asks whether the statute is ambiguous. In the context then of *ETS*, the question is whether the statutory language defining securities to include

———————

[62] *In re Natural Resources Corp.,* 8 SEC 635, 1941 WL 36308, at * 2 (1941).

[63] *Compare id. at * 2*-3 (referring to participation in a common enterprise and explaining that transactions are "investments contracts where, in substance, they involve the laying out of money by the investor on the assumption and expectation that the investment will return a profit without any active effort on his part, but rather as the result of the efforts of someone else."); *with SEC v. W.J. Howey Co.*, 328 U.S. 293, 298-99 (1946) ("an investment contract for purposes of the Securities Act means a contract, transaction or scheme whereby a person invests his money in a common enterprise and is led to expect profits solely from the efforts of the promoter or a third party").

[64] *See, e.g.,* SEC Release Nos. 33-5211 and 34-9387, 1971 WL 120481 * 3 (Dec. 7, 1971) (stating in reference to investment contracts that "[t]he term 'security' must be defined in a manner adequate to serve the purpose of protecting investors."); SEC Release Nos. 33-5018 and 34-8733, 1969 WL 96367, at * 1 (Nov. 12, 1969) ("The statutory policy of affording broad protection to investors is not to be thwarted by unrealistic and irrelevant formulae." *(quoting Howey,* 328 U.S. at 301)); SEC Release No. 33-4877, 1967 WL 87734 * 1 (Aug. 11, 1967) ("Interests in novel and uncommon ventures fit the broad definition of an "'investment contract.'").

[65] 44 SEC 104, 1969 WL 95359 (1969).

[66] 1969 WL 95359, at * 3.

[67] *Id.* at * 2-3.

[68] 64 SEC Docket 633, 1997 WL 163992 (1997).

[69] 1997 WL 163992, at * 4.

[70] *Id.*

[71] *Id.*

[72] *Id.* at * 7 n. 24.

investment contracts is ambiguous. The answer is undebatable. *Howey* itself recognized that "investment contract" is a statutorily undefined term that embodies a "flexible" standard "capable of adaption."[73] An amorphous term like this is inherently ambiguous. The first requirement for *Chevron* deference is thus met.

Step two under *Chevron* asks whether the agency's interpretation is reasonable.[74] The question in the context of *ETS* is whether the SEC's administrative conclusion that investment programs like the *ETS* arrangement are investment contracts is reasonable. On that, no more need be said than that 16 state agencies concluded ETS's investment programs are securities.[75]

In summary, each *Chevron* deference requirement exists for the SEC's interpretation of ETS's investment program. First, the SEC has a longstanding interpretative position on investment contracts that rejects narrow readings or formulas that promoters can easily evade. In two contested proceedings leading to formally adjudicated decisions, the SEC found investment contracts despite arrangements structured to provide a guaranteed, fixed return. Second, "investment contract" is an ambiguous term whose meaning continues to evolve. Third, the SEC's administrative decisions finding investment contracts despite guarantees and fixed returns reflect a reasonable interpretation of a statutory term that is designed to promote the broad reading needed for investor protection. In these circumstances the Eleventh Circuit was required under *Chevron* to defer to the SEC's administrative interpretation.

Conclusion

The SEC, NASD, and state securities agencies routinely create and enforce the securities laws. Each year these federal and state agencies publish tens of thousands of pages of rules, decisions, and interpretative releases. Most of this material is electronically available in a searchable format through Westlaw, Lexis, and websites maintained by the SEC, NASD, and state securities agencies.

Federal and state courts alike recognize the value of administrative interpretations as a source of law. The Supreme Court has encouraged deference to the statutory interpretations of administrative agencies under both *Skidmore's* discretionary power to persuade standard and *Chevron's* two-step, mandatory analysis. Deference doctrines also exist under state law.

Despite judicial doctrines that provide a framework for citing and analyzing the interpretative weight of agency precedent, not much use of this agency law is made in securities litigation. The courts, practitioners, and the agencies themselves have been remiss. The SEC's failure to argue for obligatory deference in the 18 years between *Chevron* and *Zandford* is an example.

Many opportunities for the development of securities law are suggested by *Zandford. Chevron* deference is a ubiquitous theme in the Supreme Court's jurisprudence. Now that the High Court has applied *Chevron* to an SEC decision, citation of and deference to SEC precedent in federal securities litigation will undoubtedly expand.[76] Opportunities to argue for deference, even if only under a *Skidmore*-type standard*,* exist in state court litigation as well. By advancing deference doctrines to support adoption of agency interpretations, the investors' bar can enhance the development of sound securities doctrine. In time, the securities agencies, both state and federal, will likely realize their power and increase the output of reasoned decisions. In tandem, the private bar and securities regulators can expand the base of investor protective, remedial-driven securities precedent.

---

[73] *Howey*, 328 U.S. at 298-99.

[74] *Chevron,* 467 U.S. at 843.

[75] *See* authorities cited *supra* note 6.

[76] *See, e.g., In re Enron Corp. Sec., Derivative & Erisa Litig.*, 2002 WL 31854963, at *20-22 (S.D. Tex. 2002) (citing *Zandford* and using *Chevron*-type analysis to adopt SEC's position on primary liability of secondary actors).

Howsam v. Dean Witter Reynolds, Inc. – Progress Toward a Goal of "Fair and Expeditious Resolution" of Disputes

By Barbara Black

Barbara Black is a Professor of Law and Co-Director, Securities Arbitration Clinic, Pace University School of Law, White Plains, New York. She may be reached at 914.422.4333 or bblack@law.pace.edu.

On December 10, 2002, the Supreme Court announced its decision in *Howsam v. Dean Witter Reynolds,* Inc.,[1] holding that ordinarily arbitrators, and not judges, should decide whether a securities arbitration claim is barred under NASD Rule 10304, its six-year eligibility rule.[2] Part One of this article describes the Court's holding in *Howsam.* Part Two assesses *Howsam*'s significance in arbitration jurisprudence. Part Three looks at post-*Howsam* eligibility rule issues. The article concludes by arguing that although *Howsam* provides welcome clarification of the minimal judicial role in arbitration proceedings, questions and confusion about SRO eligibility rules are likely to continue, and NASD should eliminate its eligibility rule.

PART ONE

In 1997 Karen Howsam (Howsam) began an NASD arbitration proceeding against Dean Witter Reynolds, Inc. (Dean Witter) pursuant to the pre-dispute arbitration agreement (PDAA) contained in the customer's agreement. The PDAA was a typical one, providing that "all controversies" arising from the customer's securities dealings with Dean Witter would be determined by arbitration before an SRO.[3] The PDAA also contained a New York choice-of-law clause. Howsam alleged that Dean Witter made material misrepresentations in recommending limited partnership interests, and that, relying on the misstatements, she purchased unsuitable investments in 1986. She also alleged that she continued to hold the investments until 1994 because of Dean Witter's ongoing assertions that the investments were sound.

In response, Dean Witter brought an action in federal district court to enjoin the arbitration on the ground that the dispute was ineligible for arbitration under NASD Rule 10304. The district court found that the PDAA evidenced the parties' intent to have the arbitrators decide whether the claim was arbitrable and dismissed the action. The Tenth Circuit, however, reversed. Viewing the application of NASD's eligibility rule as an aspect of the general question of arbitrability, it applied the test set forth in *First Options of Chicago, Inc. v. Kaplan*[4] that courts should decide questions about arbitrability unless there is "clear and unmistakable evidence"[5] that the parties intended the arbitrators to

____

[1] 537 U.S. (2002). All page citations are to the Court's unedited slip opinion released on December 10, 2002. Seven justices signed the Court's opinion; Justice Thomas filed a concurring opinion, and one justice did not participate.

[2] NASD Rule 10304 states that "[n]o dispute, claim, or controversy shall be eligible for submission to arbitration under this Code where six (6) years have elapsed from the occurrence or event giving rise to the act or dispute, claim or controversy." For background on NASD's eligibility rule, see Barbara Black, *Securities Arbitration is not Supposed to be so Complicated: Arbitrability, the Eligibility Rule, and Whose Law Decides,* 30 SEC. REG. L. J. 134, 140-42 (2002). The New York Stock Exchange has an identically worded rule, NYSE Rule 603, although it is not clear that the two SROs apply their rules in the same way. *See* Robert S. Clemente, *Update 2000: Securities Industry Arbitration: Differences in the Rules and Procedures of the NYSE and NASD*, SECURITIES ARBITRATION 2000, 93, 96 (PLI).

[3] The facts are taken from Howsam v. Dean Witter Reynolds, Inc., 261 F.3d 956, 958 (10th Cir. 2001), *rev'd* 537 U.S. _____ (2002).

[4] 514 U.S. 938 (1995). The Kaplans sought to vacate an arbitration award on the ground that they were not individually bound by an arbitration agreement signed in the name of Mr. Kaplan's wholly owned corporation.

[5] *Id.* at 964.

decide the issue. The Tenth Circuit

concluded that neither the language of the PDAA nor NASD's uniform submission agreement met this test. It also rejected Howsam's argument that the New York choice of law clause required following New York precedent that found similar language met the "clear and unmistakable evidence" test. As the Tenth Circuit viewed it, the Federal Arbitration Act (FAA) created a federal substantive law of arbitrability.[6]

Prior to the Supreme Court's decision, ten circuits had addressed the issue of whether the court or the arbitration forum decided eligibility rule issues, and they were equally divided. All circuit courts assumed that the issue was a federal question.[7]

In *Howsam* the Supreme Court began its analysis by restating established principles, noting that since arbitration is a matter of contract, "a party cannot be required to submit to arbitration any dispute which he has not agreed so to submit."[8] Accordingly, while the Court has adopted a "liberal federal policy favoring arbitration agreements,"[9] there is an exception to this policy: the question of arbitrability -- whether the parties have submitted a particular dispute to arbitration -- is "an issue for judicial determination [u]nless the parties clearly and unmistakably provide otherwise."[10]

The Court next turned its attention to the issue at hand: is the issue of whether a claim is stale under NASD Rule 10304 a question of arbitrability, and it quickly concluded that it is not. Not every "potentially dispositive gateway issue"[11] presents a question of arbitrability; the phrase has "a far more limited scope."[12] In rather cumbersome language, the Court set forth the test as follows:

> The Court has found the phrase applicable in the kind of narrow circumstances where contracting parties would likely have expected a court to have decided the gateway matter, where they are not likely to have thought that they had agreed that an arbitrator would do so, and, consequently, where reference of the gateway dispute to the court avoids the risk of forcing parties to arbitrate a matter that they may well not have agreed to arbitrate.[13]

The Court provided two illustrations of arbitrability issues that courts should decide: first, a dispute about whether the parties are bound by an arbitration clause (as where one party was not a signatory to the agreement)[14]; second, a dispute about whether an arbitration clause in a concededly binding contract applies to a particular type of controversy.[15] In these circumstances, a party should not be forced to have this disputed issue decided by an arbitrator, when he is asserting that he never agreed to submit the matter to arbitration.

In contrast, "'procedural' questions which grow out of the dispute and bear on its final disposition"[16] are presumptively questions for the arbitrator. Since the party entered into an arbitration agreement that

---

[6] 261 F.2d at 966-67.

[7] The analysis of the circuit courts is described in more detail in Black, *supra* note 2, at 144-45.

[8] p. 3, quoting from Steelworkers v. Warrior & Gulf Nav. Co., 363 U.S. 574, 582 (1960).

[9] *Id.*, quoting from Moses H. Cone Memorial Hospital v. Mercury Constr. Corp., 460 U.S. 1, 24-25 (1983).

[10] *Id.*, quoting from AT&T Technologies, Inc. v. Communications Workers, 475 U.S. 643, 649 (1986).

[11] *Id.*

[12] p.4

[13] *Id.*

[14] *E.g.*, the situation in *First Options*, *supra* note 4.

[15] *E.g.*, in AT&T Technologies, Inc. v. Communications Workers, 475 U.S. 643 (1986), the issue was whether a labor-management layoff controversy was covered by the arbitration clause of a collective-bargaining agreement.

[16] p. 4.

covers this type of controversy, it is reasonable to presume the parties expected that the arbitrators would decide these issues.[17] The Court gave as examples prerequisites or conditions precedent to arbitration[18] and "allegations of waiver, delay, or a like defense to arbitrability."[19] The Court also quoted approvingly from the commentary to a state uniform arbitration statute that "in the absence of an agreement to the contrary, issues of substantive arbitrability ... are for a court to decide and issues of procedural arbitrability , i.e., whether prerequisites such as *time limits*, notice, laches, estoppel, and other conditions precedent to an obligation to arbitrate have been met, are for the arbitrators to decide."[20]

Having drawn this distinction between questions of arbitrability and other potentially dispositive gateway issues, the Court found that NASD Rule 10304 is a time limit that does not present a question of arbitrability; therefore, whether a claim is time-barred under the rule is an issue presumptively for the arbitrator, not for the judge.[21] It also observed that "the NASD arbitrators, comparatively more expert about the meaning of their own rule, are comparatively better able to interpret and to apply it."[22] This provides further support for presuming that the parties to an arbitration agreement expected the arbitrator to decide the issue.[23] Finally, "for the law to assume an expectation that aligns (1) decisionmaker with (2) comparative expertise will help better to secure a fair and expeditious resolution of the underlying controversy -- a goal of arbitration systems and judicial systems alike."[24]

Dean Witter also argued that even if the eligibility rule issue was not entitled to "an antiarbitration presumption,"[25] the language of the contract made it clear that the parties intended the courts to decide the issue. Its argument was as follows: the parties had executed NASD's uniform submission agreement, which incorporates by reference NASD Rules, and NASD calls Rule 10304 an eligibility rule. Eligibility means arbitrability; ergo, the parties intended courts to decide this question. The Court's response was straightforward: "[w]e do not see how that is so."[26] This "plain meaning" interpretation of "eligibility" is unpersuasive, particularly since another NASD rule sets forth NASD's view that arbitrators decide eligibility rule issues.[27]

Justice Thomas wrote a brief concurring opinion, agreeing with the outcome, but asserting that the agreement's choice of law clause determined that result. Since the PDAA specified a New York choice of law clause, and since New York's highest court had previously held that arbitrators decided eligibility rule issues,[28] he agreed with the majority's result, but not its reasoning.

PART TWO

Many wondered, after the Court granted certiorari in *Howsam*, what prompted it to do so. Approximately

---

[17] *Id.*

[18] p.5

[19] *Id.*, quoting from Moses H. Cone Memorial Hospital v. Mercury Constr. Corp., 460 U.S. 1, 24-25 (1983).

[20] *Id.*, quoting from the Revised Uniform Arbitration Act of 2000, § 6, comment 2, 7 U.L.A. at 13 (omissions and emphasis in original).

[21] *Id.*

[22] *Id.*

[23] pp. 5-7.

[24] p. 6.

[25] *Id.*

[26] *Id.*

[27] NASD Rule 10324 states that "arbitrators shall be empowered to interpret and determine the applicability of all provisions under this Code."

[28] Smith Barney Shearson Inc. v. Sacharow, 91 N.Y. 2d 39 (1997).

9,000 cases are on the Supreme Court's docket each term; oral arguments are heard in only about 86 of them.[29] It was hard to believe that the justices would give priority to resolving the conflict among the circuits about an SRO's eligibility rule, particularly since most of the disputes over the rule arose out of the marketing to investors of unsuitable or fraudulent limited partnerships that for the most part ended by the late 1980s.

If the Court intended, when it granted certiorari, to address a weightier issue, it must have decided that this case was not the appropriate vehicle. The opinion addresses the issue presented in workmanlike fashion; while the Court's analysis is persuasive,
it does not read like an opinion that engaged much of the Court's attention. To be fair, the proposition that parties who entered an agreement to arbitrate all their disputes before a designated arbitration forum would expect the arbitrator to decide timeliness issues arising under the forum's rules sounds, as an abstract concept, self-evident. The greater difficulty is explaining how five circuits could have reached the opposite conclusion, and the Supreme Court, wisely, does not bother with this.

The opinion makes it clear that "arbitrability questions" are but a subset of "all gateway dispositive issues," sets forth a test for identifying an "arbitrability question" based on the likely expectations of the parties [30] and provides two examples. In *Prima Paint Corp. v. Flood & Conklin Mfg. Co.*,[31] the Court identified a third situation in which courts decide whether a matter should be submitted to arbitration: where a party claimed that he was fraudulently induced to enter the arbitration agreement itself. Arbitrators, on the other hand, could take the dispute if the party challenged the entire agreement as the product of fraudulent inducement. By not referring to this situation, did the *Howsam* court intend to signal that it might reconsider the *Prima Paint* distinction between arbitration agreements and entire contracts and hold that assertions that the party was fraudulently induced to enter the entire contract also is an arbitrability question under *Howsam*'s "likely expectations of the parties" test? We do not know, but someone will certainly make the argument.

In its past decisions, the Supreme Court has not been clear on the appropriate relationship between federal and state law in deciding arbitrability issues. While the FAA creates a body of federal substantive law of arbitrability,[32] cases have found room for state law principles governing contract formation issues. In *First Options of Chicago, Inc. v. Kaplan,*[33] the Court held that courts should apply to arbitrability questions ordinary *state* law contract principles that govern the formation of contracts, but with one qualification: there must be "clear and unmistakable" evidence to rebut the presumption that courts decide questions of arbitrability.[34] Although the Court does not state that this qualification is mandated by the FAA, that is the clear inference.

The Supreme Court also has treated inconsistently choice of law clauses contained in arbitration agreements. In *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University,*[35] the Court did not question the state court's finding that a contract containing a California choice of law clause evidenced the parties' intent to adopt California arbitration procedures, rather than the FAA's. It further found that the FAA did not preempt application of the state arbitration procedures. In

---

[29] A statistical recap of the Supreme Court's workload during the last three terms is found at 71 U.S.L.W. 3080 (2002).

[30] *See supra* note 13 and accompanying text.

[31] 388 U.S. 395 (1967).

[32] *See* Moses H. Cone Memorial Hosp. v. Mercury Const. Corp., 460 U.S. 1, 22 (1983), Perry v. Thomas, 482 U.S. 483 (1987).

[33] 514 U.S. 938 (1995).

[34] *Id.* at 944.

[35] 489 U.S. 468 (1989).

[36] 514 U.S. 52 (1995).

contrast, in *Mastrobuono v. Shearson Lehman Hutton, Inc.*,[36] the Court itself determined the scope of a New York choice of law

> clause in an arbitration agreement, interpreting the clause to mean that principles of New York substantive law would determine the parties' obligations, but not including New York's refusal to allow arbitrators to award punitive damages.

Unfortunately, the Court did not take the opportunity in *Howsam* to provide further clarification. The implication of the majority opinion, just as in *First Options*, is that the question of arbitrability is a federal question; it refers to "a liberal federal policy favoring arbitration agreements,"[37] followed by recognition of "an exception to this policy."[38] It is puzzling, however, that the majority opinion does not write one sentence to reject Justice Thomas's assertion, in his concurring opinion, that the New York choice of law clause determines the outcome.[39] Under Justice Thomas's approach that finds that this is not a federal question, the possibility exists of a different outcome under another state's law, surely not a desirable result. It may be that the majority of the justices thought the point was sufficiently clear that it did not warrant rebuttal; it may be that they decided to leave this question unresolved.

What the Court did do, in *Howsam*, however, is important. The opinion sends a strong message: the importance of minimizing judicial involvement in the arbitration process in order to promote the goal of "a fair and expeditious resolution" of the dispute – the goal, it notes, of both arbitration and judicial systems.[40] Lower courts should heed the message and resist efforts by parties in arbitration to involve the courts in their disputes, as this exacerbates the trend toward making securities arbitration more complex and litigious. Brokers increasingly are seeking judicial review of customers' awards through motions to vacate on grounds of "manifest disregard of law,"[41] although the statutory bases for vacating awards are narrow and do not include review of the merits.[42] As just one recent example, a firm attempted to vacate a customer's award based on suitability violations, based on caselaw that there is no implied cause of action for violations of SRO rules. Fortunately, the court rejected the broker's argument,[43] but claimants can expect more attempts.

PART THREE

Howsam does not eliminate all of the problems associated with the eligibility rule. *Howsam*'s presumption that arbitrators decide eligibility rule issues is just that. Since arbitration is a matter of contract, the parties could agree to judicial determination of eligibility rule issues. Since brokers write the PDAAs, it is important that NASD adopt a rule prohibiting brokers from requiring judicial intervention in eligibility rule disputes.

In addition, *Howsam* did not address another eligibility rule issue: whether a customer can bring her claim in court if the arbitration forum finds that it is barred under the eligibility rule. Even though NASD takes the position that a determination of ineligibility leaves the claimant free to pursue any available judicial remedy, most courts that have addressed the issue hold that a claimant whose

---

[37] p. 3.

[38] *Id.* The Court does cite as authority, however, the uniform state arbitration statute.

[39] Smith Barney Shearson Inc. v. Sacharow, 91 N.Y. 2d 39 (1997), the New York decision Justice Thomas relies upon, did not base its decision on state law, but primarily looked to Supreme Court precedent.

[40] p. 6.

[41] The Supreme Court first suggested that "manifest disregard of law" might be a basis for vacating an arbitration award in Wilko v. Swan, 346 U.S. 427 (1953), *overruled,* Rodriguez de Quijas v. Shearson/Am. Express Inc., 490 U.S. 477 (1989). Most circuits have adopted the standard as an additional ground for vacating awards, and the Supreme Court , in dictum, approved its use in *First Options*, 514 U.S. at 941-42. For further discussion, *see* Barbara Black and Jill I. Gross, *Making it up as they go Along: The Role of Law in Securities Arbitration,* 23 CARDOZO L. REV. 991, 1031-34 (2002).

[42] U.S.C. § 10.

[43] Freeman v. Arahill, Index No. 111119/01 (N.Y. Sup. Ct., N.Y. Cty. Oct. 18, 2001).

claim is ineligible under an SRO's six-year rule cannot litigate the claim in court.[44] As a consequence, even if the claim may not be barred under the applicable statute of limitations, a claimant is left without any forum in which to bring his claim.

NASD has been considering changes to Rule 10304 for some time.[45] Pending before the SEC are a proposed rule change dealing with the eligibility rule ("proposed eligibility rule")[46] and another proposed rule change dealing with required disclosures in the PDAA ("proposed disclosure rule").[47] NASD originally filed the proposed rules with the SEC in 1997; when interest in the issue was revived after the grant of certiorari in *Howsam*, the SEC again asked for comments.[48]

NASD's goal in the proposed eligibility rule is to make the rule the equivalent of the forum's statute of limitations to serve a simple and straightforward "gatekeeping" function. All claims are eligible for arbitration unless challenged,[49] and NASD's Director makes an early determination of eligibility on the parties' submissions.[50] The Director applies a "bright-line" test, with no extensions of time for fraudulent concealment.[51] The Director's determination is final;[52] the arbitrators have no authority to consider eligibility issues,[53] and the parties cannot seek a judicial review of the Director's decision.[54] A claimant is not barred from bringing ineligible claims in court,[55] and a claimant with some eligible and some ineligible claims may at his option bring all claims in court.[56] Finally, the proposed rule change confirms existing law that parties are free to

____

[45] These are discussed in more detail in Black, *supra* note 2, at pp. 148-152.

[46] Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to the Eligibility of Claims for Arbitration, Exchange Act Release No. 34-39487, 63 Fed .Reg. 588 (Jan. 6, 1998).

[47] Self-Regulatory Organizations; Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc. Relating to Amendments to NASD Rule 3110(f) Governing Use of Predispute Agreements With Customers, Exchange Act Release No. 34-42160, 64 Fed.Reg. 66,681 (Nov. 29, 1999).

[48] Self-Regulatory Organizations; Notice of Filing of Amendments No. 5 and 7 to a Proposed Rule Change by the National Association of Securities Dealers, Inc. Regarding the Eligibility of Claims for Arbitration, 67 Fed. Reg. 19,464 (Apr. 19, 2002). Until recently, the fate of these two proposed rule changes had been linked to another controversial proposed rule change limiting the amount of punitive damages in arbitration, *see* Self Regulatory Organizations, Notice of Filing of Proposed Rule Change by the National Association of Securities Dealers, Inc., Relating to Punitive Damages in Arbitration, Exchange Act Release No. 34-39371, 62 Fed. Reg. 64,428 (Dec. 5, 1997). The NASD requested the SEC to move forward on the proposed eligibility rule and stated it would also file a similar request with respect to the proposed disclosure rule. Amendment No. 7 to Proposed Rule Change (Mar. 15, 2002), available at http://www.nasdadr.com/rule_filings_index.asp#97-41.

[49] NASD Proposed Rule 10304(a)(1), set forth in *Notice of Amendments No. 5 and 7,* 67 Fed. Reg. at 19,464-65.

[50] *Id.* at (a), (b).

[51] *Id.* at (a)(2).

[52] *Id.* at (b)(4).

[53] NASD Proposed Rule 10324, set forth in *Notice of Amendments No. 5 and 7,* 67 Fed. Reg. at 19,465.

[54] Proposed Rule 10304(b)(4). The NASD stated it was considering making it a violation of the disciplinary rules for members to challenge the Director's eligibility decisions. 63 Fed. Reg. at 593.

[55] NASD Proposed Rule 10304(d)(3).

[56] *Id.* at (c)(1).

[57] *Id.* at (d)(2).

raise any applicable statute of limitations defense before the arbitrators or the court.[57]

The proposed disclosure rule would mandate disclosure that arbitration forum rules may impose time limits for bringing a claim in arbitration and that "in some cases" an ineligible arbitration claim may be brought in court.[58] The PDAA must state that the arbitration forum rules are incorporated into the agreement.[59] The proposed disclosure rule also prohibits the PDAA from including any condition that limits: (1) the SRO rules; (2) the ability of a party to file any claim in arbitration; (3) the ability of a party to file any claim in court permitted to be filed in court under the arbitration forum's rules; or (4) the ability of arbitrators to make any award.[60] Finally, if a customer files a complaint in court and the broker seeks to compel arbitration of some of the claims, the broker must agree to arbitrate all of the claims contained in the complaint if the customer so requests.[61]

Adoption of the proposed rules should solve both of the previously identified post-*Howsam* issues. It would prevent brokerage firms from drafting PDAAs that require judicial resolution of eligibility rule issues and would eliminate the unfairness of barring from court a claim that is ineligible for arbitration.

The proposed rule changes, however, have one significant flaw: the Director should not decide any eligibility questions. NASD's desire for a simple, straightforward rule that can be quickly and finally applied at the outset of the arbitration process is understandable; this leads to its proposal to have the Director make the decision on the parties' submissions. Nevertheless, the arbitrators should determine eligibility rules, just as they decide all legal issues, including statute of limitations. Caselaw and experience teach that application of the eligibility rule is not always capable of a decision on the papers. For example, the parties may dispute whether the broker made oral misrepresentations about the value of an investment that caused the claimant not to sell the investment within the past six years. This decision involves more than simply consulting a calendar and should more properly be made by the arbitrators, not by the Director. NASD has, in recent years, devoted many resources to improving the quality, training and selection of arbitrators. It has worked hard to appoint the arbitrators at an earlier stage of the process. It should put these efforts to greater use by having the arbitrators decide eligibility rule issues.

Finally, one must question why NASD insists on maintaining the eligibility rule. It serves very little beneficial purpose, especially in comparison with its costs, and should be eliminated. The commonly given justifications for retaining the rule are that brokerage firms may no longer have records after six years[62] and a fear that arbitrators may not apply statute of limitations defenses strictly.[63] As to the first concern, arbitrators can certainly take into account the firm's inability to produce records after six years; indeed, the lack of documentation may hurt the customer more than the firm, since the customer has the burden of proving her case. As to the second concern, brokerage firms can raise statute of limitations defenses with the arbitrators and seek a pre-hearing dismissal on these grounds. This should be adequate protection against most stale claims. There is no more reason to distrust the arbitrators' ability to decide statute of limitations issues than other legal issues. If there is a problem, the appropriate way to solve it is to provide better training of arbitrators on legal issues, including the statute of limitations.

CONCLUSION

Howsam affirms the importance of "a fair and expeditious resolution" of arbitration disputes. For this the Supreme Court deserves our thanks. Lower courts should heed its message and resist efforts by disappointed arbitration participants to make judicial involvement in the arbitration proceedings more intrusive, as by providing for judicial review of arbitration awards on a "manifest disregard of the law" basis. Nonetheless, so long as there is an eligibility rule, complexities and confusion will remain over its application. The preferred solution is for NASD to eliminate the rule. If NASD retains the eligibility rule, it must adopt rule changes to make clear that: (1) brokerage firms cannot provide in their PDAAs that courts will decide eligibility rule issues; and (2) claimants whose claims are ineligible under NASD's eligibility rule are free to pursue those claims in court.

---

[58] NASD Proposed Rule 3110(f)(1)(F), set forth in *Proposed Rule Change*, 64 Fed. Reg. at 66,681.

[59] *Id.* at (f)(1)(G).

[60] *Id.* at (f)(4)(A).

[61] *Id.* at (f)(5).

[62] *Proposed Rule Change*, 63 Fed. Reg. at 589.

[63] *Id.*

CRD Expungement: Law, Proposed NASD Rules, and Lawyer Ethics

C. Thomas Mason, III[1]

C. Thomas Mason, III is a PIABA member residing in Tucson, Arizona. Mr. Mason is on the PIABA Board of Directors. He may be reached at 520.299.5900 or ctm@ctmason.com.

Introduction

The NASD wants to bring expungement[2] back with expanded breadth, posing huge dangers for public investors. This article explores the NASD's new proposed rule permitting expungement, what it means for arbitration procedures and settlement, and your ethical responses when the respondents come knocking with expungement demands.

Through expungement, associated persons[3] and broker-dealers can totally erase adverse entries from their permanent licensing file. Expungement may be an essential element in maintaining accurate records in the Central Registration Depository (CRD). It is also a technique that has been seriously abused by industry respondents, often with the complicity or agreement of claimants' counsel.

Operated by the NASD and jointly administered with NASAA,[4] the CRD is the primary resource for state and federal securities regulators and SROs for licensing and registration. Since the NASD's Public Disclosure Program began in 1992, regulators have promoted the CRD as a valuable source of information for the investing public.[5]

> For instance, you can find out if brokers are properly licensed in your state and if they have had run-ins with regulators or received serious complaints from investors. You'll also find information about the brokers' educational backgrounds and where

———————

[1] 2003 by C. Thomas Mason III. I wish to thank Scot Bernstein for his many useful thoughts in improving this article. I appreciate the willingness of several present and former state securities administrators to speak with me. I also want to acknowledge Larry Schultz, of Driggers, Schultz & Herbst (Troy, Michigan), and Chuck Austin (Richmond, Virginia), for their diligent and dogged efforts opposing expungement and uncovering industry practices. The faults in this article and views I express here are my own, and do not necessarily reflect the positions of PIABA or its board of directors.

[2] To 'expunge' means 'to destroy; blot out; obliterate; erase; efface designedly; strike out wholly. The act of physically destroying information ... in files, computers, or other depositories.'" *Snyder v. City of Alexandria*, 870 F.Supp. 672, 683 (E.D.Va. 1994) (quoting BLACK'S LAW DICTIONARY 522 (5th ed.1979)).

[3] "Associated person" is the official title of all persons who are, anticipate being, or should be registered with the NASD. NASD, Inc. By-Laws, Art. I, para. (ee); NASD Rule 1011(b). Most, but not all, associated persons are the folks we commonly refer to as registered representatives or stockbrokers.

[4] Organized in 1919, the North American Securities Administrators Association "is the oldest international organization devoted to investor protection. It is a voluntary association whose membership consists of 66 state, provincial, and territorial securities administrators in the 50 states, the District of Columbia, Puerto Rico, Canada, and Mexico." NASAA, http://www.nasaa.org/nasaa/abtnasaa/overview1.asp; NASD News Release, October 2, 2002, http://www.nasdr.com/news/pr2002/release_02_049.html (All websites cited in this article were visited between January 2 and 15, 2003.)

[5] Congress mandated that the NASD publicly disclose the employment and disciplinary history of its members and their associated persons in the Securities Enforcement Remedies and Penny Stock Reform Act of 1990, section 15A(i), now 15 U.S.C. § 78o-3(i). It required the NASD to "establish and maintain, within one year of its enactment, a toll-free telephone listing to receive inquiries regarding actions involving its members and their associated persons and promptly respond to such inquiries in writing." *Order Approving Proposed Rule Change Relating To Release Of Certain Information Regarding Disciplinary History Of Members And Their Associated Persons Via Toll-Free Telephone Listing*, Release No. 34-30629, 51 S.E.C. Docket 488, 1992 WL 87786 (April 23, 1992). The NASD did not enter into the public disclosure program voluntarily or out of the goodness of its heart.

> they've worked before their current jobs.[6]

SEC Chairman Arthur Levitt stated in testimony to Congress,

> Investor protection also entails helping investors protect themselves. To do so effectively, I believe that investors need information about their registered representative before they open an account. It is essential that an investor be able to choose a registered representative who is trustworthy and reliable.[7]

The NASD brags that the online Public Disclosure Program "is the #1 resource tool for the general public and private investors for information about brokers, now receiving over 2.4 million searches per year and responding to most of them within minutes."[8]

However, the securities industry has undermined the CRD's accuracy and reliability by getting accurate material data expunged from the record. Industry respondents have heavily abused expungement in recent years. They have routinely inserted demands for wiping CRD records clean into their answers to statements of claim, and misused settlement negotiations to coerce claimants into granting improper expungements in return for settling the dispute.

Complaints about these abuses from state securities regulators and investors' lawyers prompted the NASD in January 1999 to impose a moratorium on expungements arising from customer complaints unless the order to expunge was issued by a court of competent jurisdiction.[9] The securities industry vigorously opposed the restriction. Impelled by industry demands to broaden the ability to expunge brokers' records, the NASD undertook a multi-year effort to develop a rule or interpretation permitting expungement. This culminated in a formal rule filing advocating broad latitude for expungement. The NASD's proposed Rule 2130 went to the SEC in mid-November 2002 for publication in the Federal Register and comment through the SEC's public rule-making process.[10]

This article will demonstrate why Rule 2130, if approved as submitted, will be a catastrophe for the CRD, broker regulation, investor protection, and customer arbitration. Securities regulators—the NASD, NASAA, and SEC—will abdicate their responsibilities to the public if they approve the proposed rule.

To understand why the NASD's proposal is so terrible, we will carefully parse the text of the rule. We will also examine the CRD and expungement in their broader contexts, including the legal status of the CRD, why an accurate and unbowdlerized CRD is vital, and why highly limited expungement—if done right—can be a valuable corrective mechanism.

We will also examine important legal ethics concerns. Claimants' lawyers already face serious ethical challenges whenever expungement is raised. Rule 2130 will exacerbate the situation. Lawyers generally worry that they may not be serving their client if they reject expungement in settlement. That is a false reason to expunge. On the contrary, if lawyers agree to improper expungements, they will violate their professional duties and can expose themselves to discipline, court sanctions, and, in the worst case, criminal penalties.

Current Expungement Criteria

At present, under rules that have existed since the CRD began in 1981, NASAA's official position is that expungement is permitted only where the information is "factually impossible" and the expungement is ordered by a court. The SEC acknowledged this restrictive rule, describing factual impossibility in releases in 1999 and 2000:

---

[6] SEC, "Protect Your Money: Check Out Brokers and Advisers," http://www.sec.gov/investor/brokers.htm.

[7] Testimony of Arthur Levitt, SEC Chairman, concerning the Large Firm Project, before the Subcommittee on Telecommunications and Finance, U.S. House of Representatives (September 14, 1994), 1994 WL 499982, also on the SEC website at http://www.sec.gov/news/studies/rogue2.txt.

[8] http://pdpi3.nasdr.com/pdpi/REq_Type_Frame.asp.

[9] NASD Notice to Members (NTM) 99-09, effective January 19, 1999, http://www.nasdr.com/pdf-text/9909ntm.txt.

[10] See NTM 99-54, http://www.nasdr.com/pdf-text/9954ntm.txt; NTM 01-65, http://www.nasdr.com/pdf-text/0165ntm.txt; SR-NASD-2002-168, http://www.nasdr.com/pdf-text/rf02_168.pdf, and its preceding news release, http://www.nasdr.com/news/pr2002/release_02_049.html. As of mid January 2003, the SEC had not yet published the rule proposal in the Federal Register or posted it on the SEC website.

> NASD Regulation occasionally receives requests to expunge an event from CRD where the person who was the subject of the CRD filing can demonstrate to the NASD's satisfaction that *it was factually impossible for him to have been involved in the event (e.g., a person was named in an arbitration as a branch manager of a firm, and the person was working at a different firm at that time).* NASD Regulation and the North American Securities Administrators Association ("NASAA") agree that factually incorrect information can be expunged from the CRD if the person obtains a court order of expungement.[11]

Without that level of factual impossibility, expungement is impermissible. Until Rule 2130 or a variant is adopted, Respondents have no basis for asking for exoneration—and claimants are wrong to accede—except in that rare and obviously justifiable circumstance. A colorable claim founded in good faith on facts involving the registered person *cannot* be expunged under the current rules.

Proposed Expungement Rule

Proposed Rule 2130 will turn this situation upside down. It freely permits whitewashing the broker's record whenever the investor's complaint "lacks factual basis" or is dismissed on grounds equivalent to Fed.R.Civ.P. 12(b)(6), or results in a CRD entry that is deemed "defamatory". It also permits expungement in every other circumstance where the NASD decides not to contest the request, and whenever the confirming court disregards the NASD's opposition.

The proposed rule deals solely with customer disputes. Broker-employer disputes are not addressed, since the NASD says they are handled separately. The proposed rule states:

2130. Obtaining an Order of Expungement of Customer Dispute Information from the Central Registration Depository (CRD System)

(a) Members or associated persons seeking to expunge information from the CRD system arising from disputes with public customers must obtain an order from a court of competent jurisdiction directing such expungement or confirming an arbitration award containing expungement relief.
(b) Members or associated persons petitioning a court for expungement relief or seeking judicial confirmation of an arbitration award containing expungement relief must name NASD as an additional party and serve NASD with all appropriate documents.
(1) Upon request, NASD may waive the obligation to name NASD as a party if NASD determines that the expungement relief is based on judicial or arbitral findings that:

> (A) the claim, allegation or information is without factual basis;
> (B) the complaint fails to state a claim upon which relief can be granted or is frivolous; or
> (C) the information contained in the CRD system is defamatory in nature.

(2) If the expungement relief is based on judicial or arbitral findings other than those described above, NASD, in its sole discretion and under extraordinary circumstances, also may waive the obligation to name NASD as a party if it determines that:

> (A) the expungement relief and accompanying findings on which it is based are meritorious; and
> (B) the expungement would have no material adverse effect on investor protection, the integrity of the CRD system, or regulatory requirements.[12]

NASD's Rule Proposal Is A Catastrophe In Waiting

If approved without significant changes, new Rule 2130 will blow the doors off the CRD.

(1) It will turn demanding and negotiating expungements into a free-for-all, leaving only the NASD to seek to block the eventual court order if, in its sole discretion, it chooses to make the attempt.
(2) Expungement demands will appear in virtually every defense and every settlement discussion, vastly increasing the "litigation" component of arbitration and the ethical pressures on claimants' counsel.
(3) It will necessitate dispositive motions to dismiss in every case. Respondents' counsel will probably commit malpractice if they don't make the attempt to get the arbitrators to dismiss investors' claims.
(4) It will make counterclaims that

---

[11] Amendments to the Public Disclosure Program, Release No. 34-42402, 71 S.E.C. Docket 1483, 2000 WL 143334, *3 (February 7, 2000) (emphasis added).

[12] SR-NASD-2002-168, http://www.nasdr.com/pdf-text/rf02_168.pdf, pp. 18-19. (Citations to SR-NASD-2002-168 in this article are taken from NASD's proposed text of the SEC's release, pp. 17-31 of the rule filing.)

your complaint "defamed" the broker the general practice rather than the exception.
(5) It will ultimately destroy what's left of the reliability and integrity of the CRD.
The discussion proposals in NTM 01-65 had presented a careful analysis of expungement criteria. They provided certain safeguards for the CRD as a public record, but substantially expanded the circumstances under which a registrant could wipe a nasty from the file. The final proposal is enormously broader than the concepts floated in NTM 01-65.

Amazingly, NASD touts the proposed rule as "*limiting* the removal of customer dispute information" from the CRD.[13] That is clearly untrue when compared to the longstanding current rule. It is untrue even when compared to the concepts proposed in NTM 01-65.

NASD's comments accompanying the proposed rule assert, "NASD and other regulators participating in the CRD system agree that expungement is extraordinary relief."[14] The rule itself completely undermines that principle.

NASAA added its support to the rule filing, apparently not realizing that the final rule is vastly different from the scheme proposed in NTM 01-65 or that litigation realities will cause it to produce tremendously adverse unintended consequences. Christine Bruenn, NASAA president and Maine's securities administrator, is quoted as saying, "This new rule will help protect investors by maintaining the integrity of the CRD system. These new standards will reduce the possibility that a broker would be able to use arbitration and the courts to get a clean CRD record."[15] Unfortunately, reality will likely be the opposite of official expectations.

No Standards

There are so many defects in the proposed Rule 2130 that it's hard to decide which one to discuss first. One of the less obvious problems—but ultimately one of the most important—is the rule structure itself.

Look carefully at how it's organized. *The rule does not prescribe any standards for arbitrators or courts* who are asked to expunge a record. Paragraph (a) requires a court order directing expungement or confirming an arbitration award that granted expungement. Paragraph (b) requires the interested party—the member or associated person—to notify the NASD of a proposed court action. They can ask the NASD to waive its participation in the action. If the NASD does waive, the court action seeking expungement will be uncontested. If the NASD does not waive, they must name the NASD as an additional party.

The only standards in the rule apply solely to the NASD and its decision to participate in the court action. *The criteria do not apply to the parties, or to the arbitrators, or to the courts!* Under the plain language of the rule, they apply only to the NASD. They do nothing more than provide guidelines to the NASD for deciding whether to waive participation. The NASD is supposed to consider four possible criteria, including a catch-all:

(1) There are "findings" that --
> (A.) the item is "without factual basis";
> (B) "the complaint fails to state a claim upon which relief can be granted or is frivolous";
> (C) the information is "defamatory";

(2) or the NASD, in its sole discretion, determines that the findings are "meritorious" and expungement will have "no material adverse effect" on the CRD, regulators, or investor protection.

Nothing in the rule says that arbitrators or settling parties have to limit the award (including stipulated awards) to the criteria that interest the NASD. To the contrary, the catch-all in subpart (2) expressly envisions that the findings may be based on entirely different grounds. Conceivably, the expungement directive can come in an award with no articulated grounds at all.

NASD's commentary accompanying the proposed rule suggests that it

---

[13] News Release, http://www.nasdr.com/news/pr2002/release_02_049.html (emphasis added).

[14] SR-NASD-2002-168, p. 23.

[15] News Release. The Securities Arbitration Commentator, usually perspicacious, similarly opined that "the road to actual expungement will be far more uncertain and expensive" and "even deserving brokers seeking expungement will be significantly affected." *NASD Expungement Rule Teed Up With SEC*, SAC Ref. No. 02-40-02, SAC Arbitration Alert 2002-40 (10/9/02). SAC's comments were apparently based on the news release, which preceded the rule filing by 6 weeks and did not give an accurate picture of the rule.

may pursue disciplinary action against members who "seek to expunge any arbitration award that does not contain an expungement order and a finding of at least one of the criteria described in the Notice."[16] That is an empty and unenforceable threat. Because the criteria on their face clearly do not bind members or arbitrators and since the rule expressly allows for expungement in additional undescribed circumstances, NASD would have no basis for such enforcement action.

Of course, while satisfying one or more of the specific criteria is not required, it is highly desirable. Being able to present the NASD with an award containing the right language will mean that the expunger is home free. The NASD will waive the requirement that it be named as a party to the court action, which can then proceed uncontested.

We'll examine the criteria separately. We will also examine whether the NASD can advocate its internal guidelines to a court, revealing some of the serious flaws that make the NASD's promise to protect the CRD look like a paper tiger. First, we look at the likely effects the Rule 2130 will have on investor arbitrations and negotiated settlements.

Expungement Brawl

The proposed rule will turn respondents' expungement demands into no-holds-barred combat. At present, NASAA's strict criteria and NASD's NTM 99-09 impose meaningful constraints on expungement in customer disputes. Any stipulated awards or agreed settlements that do not satisfy the standard of "factual impossibility" are tampering with public records, unethical for claimant's counsel, and a fraud on the court and the public.[17]

Proposed Rule 2130 would throw away that lid. In the absence of explicit and rigorous standards applying to the parties and to the arbitrators, respondents will be free to demand expungement in nearly all circumstances. The NASD's criteria are so broad that they provide no practical disincentive to respondents and virtually no restraint on any party.

Given the importance of a clean CRD record, both for longevity in the securities business and for defending against other customer complaints, claimants should assume that respondents will demand expungement in nearly all cases.

Respondents will surely insert CRD whitewashing into the picture at every opportunity, including settlement discussions and mediation. They will not wait and present their request only at the evidentiary hearing so the arbitrators can render an award. This constant pressure will significantly increase the ethical burdens on investors and their lawyers.

Proposed Rule 2130 virtually invites respondents to coerce customers into agreements to expunge the CRD via stipulated awards. In NTM 01-65, the NASD denounced such behavior as violating "high standards of commercial honor and just and equitable principles of trade" in Rule 2110. Because of NASDR's and NASAA's concerns over the dangers of settlement coercion, NTM 01-65 proposed that only the "clear error" criterion should be permitted in stipulated or agreed awards.[18]

That caution too has been abandoned. The NASD's comment that "NASD is cognizant of the importance of ensuring that the expungement policy does not have an overly broad chilling effect on the settlement process" overtly condones respondents' inclusion of expungement demands in settlement.[19]

----

[16] SR-NASD-2002-168, p.30.

[17] See the Legal Ethics section at the end of this article.

[18] Despite the numerous complaints of coercion that led to NTM 99-09, NASD in NTM 01-65 pretended to believe that "it is unlikely that claimant or claimant's counsel would agree that the claim or information at issue was lacking in legal merit or was defamatory in nature." SR-NASD-2002-168, p. 29, reiterating the statement from NTM 01-65. NASDR has ample facts showing that its "belief" is ill-founded.

[19] SR-NASD-2002-168, p. 23. Freeing respondents to obtain expungement through settlement was a major point in the SIA's comment letter on NTM 01-65. http://www.sia.com/2001_comment_letters/pdf/CRDInfo.pdf.

[20] See Scot Bernstein, "Your Clients' Right To A Hearing, 9.1 PIABA B.J. 42 (Spring 2002); C. Thomas Mason III, Challenging Experts In Securities Arbitration, Securities Arbitration 2000 725 (Practicing Law Institute, Corp. Law & Pract. Course Handbook Series #1196, vol. B0-00KP, 2000), at pp. 739-741 (describing what constitutes a "hearing" in Rule 10303).

The proposed rule freely reopens the avenue of coercive misconduct, with little possibility that it can be adequately policed. The NASD's turnabout, whether from hypocrisy or naïveté, is astonishing.

Motions To Dismiss

Proposed Rule 2130 will effectively require respondents to file dispositive dismissal motions in every case. Respondents' counsel will probably commit malpractice if they don't make the attempt to get the arbitrators to dismiss investors' claims.

Criterion (1)(B), "the complaint fails to state a claim upon which relief can be granted", is virtually a verbatim recitation of the standard for dismissing a complaint in Fed.R.Civ.P. 12(b)(6). All a respondent needs for expungement is to win a motion to dismiss on that basis. This creates a host of problems.

First, dispositive motions are totally impermissible unless the claimant waives, in writing, the right to an evidentiary hearing prescribed in NASD Rule 10303(a).[20] Proposed Rule 2130 seeks to dignify and render indispensable an illegitimate practice.

Second, even if the claimant knowingly and deliberately waives her right to an evidentiary hearing, there are no due process protections to ensure that the "motion to dismiss" is decided solely on Rule 12(b)(6) criteria. The standards for 12(b)(6) dismissal in court are well-established: The tribunal must accept the well-pleaded allegations in the complaint as true and draw all reasonable inferences in favor of the plaintiff. Dismissal is proper only where it is clear "beyond doubt that the plaintiff can prove no set of facts in support of his claim which would entitle him to relief."[21]

The purpose of a motion to dismiss is solely to test the sufficiency of the complaint and not to investigate the substance of the claims;[22] "importantly, it does not resolve contests surrounding the facts, the merits of a claim, or the applicability of defenses."[23] Dismissal by motion is a "harsh remedy which must be cautiously studied, not only to effectuate the spirit of the liberal rules of pleading but also to protect the interests of justice."[24]

In arbitration, however, most panelists are not former federal judges. To review a motion to dismiss, the arbitrator must understand (a) the legal standard for review, (b) the necessary elements of each cause of action, (c) how to find those elements in the statement of claim under liberal pleading standards, and (d) the proper procedure of dismissing without prejudice, including permitting the claimant to amend the pleading unless amendment would be futile. Most arbitrators do not have the necessary skills to apply Rule 12(b)(6) standards consistently and accurately.[25]

In fact, many panelists have trouble separating respondents' contentious factual disputations from evaluating the bare sufficiency of the pleading. Respondents' counsel know this and attempt to take full advantage of arbitrators' ignorance and the absence of due process. Respondents' counsel are notoriously sloppy in their motion

____

[20] See Scot Bernstein, *Your Clients' Right To A Hearing*, 9.1 PIABA B.J. 42 (Spring 2002); C. Thomas Mason III, *Challenging Experts In Securities Arbitration*, SECURITIES ARBITRATION 2000 725 (Practising Law Institute, Corp. Law & Pract. Course Handbook Series #1196, vol. B0-00KP, 2000), at pp. 739-741 (describing what constitutes a "hearing" in Rule 10303).

[21] *Conley v. Gibson*, 355 U.S. 41, 45-46 (1957).

[22] *Graham v. Sauk Prairie Police Commission*, 915 F.2d 1085, 1100 (7th Cir. 1990); *Republican Party of North Carolina v. Martin*, 980 F.2d 943, 952 (4th Cir. 1992).

[23] *Edwards v. City of Goldsboro*, 178 F.3d 231, 234 (4th Cir. 1999); *see* 5A CHARLES A. WRIGHT & ARTHUR R. MILLER, FEDERAL PRACTICE AND PROCEDURE § 1356 (1990).

[24] *Morse v. Regents of University of Colorado*, 154 F.3d 1124, 1127 (10th Cir. 1998).

[25] Occasionally, we find a sophisticated exception. See *Birkelbach v. Boston Group*, NASD Docket 99-00813, 2000 WL 1919800,, *3 (Nov. 16, 2000), in which the arbitrators permitted amendment in response to a motion for more definite statement, granted the respondents' motion to dismiss the first amended complaint without prejudice, permitted a second amended complaint, and ultimately dismissed the entire case without prejudice under Rule 10305(a) and referred the parties to their remedies at law. All three arbitrators are experienced lawyers, and two are PIABA members.

practice. They make no serious effort to meet the standards by which a tribunal would review such motions. They "forget" that a motion to dismiss can only question the sufficiency of the pleadings. They do not evaluate the complaint within its four corners, accepting its statements to be true, but persistently demand an evaluation of "evidence" relating to contested facts. They fill their memoranda with disputed facts and contentious defenses which have no place in a motion to dismiss. These "errors" that even a second year law student would not make are so common that they suggest deliberate efforts by respondents' counsel to bamboozle arbitrators who do not have legal training or extensive litigation experience.

Such misconduct could be sanctionable under Rule 11 or 28 U.S.C. § 1927 if presented before an experienced judge. Ironically, panelists' unfamiliarity with legal procedure—which makes respondents' abuse dangerous—also makes it difficult for claimants to get comparable sanctions in arbitration. How do you convince an arbitrator who doesn't realize that he's being hoodwinked to award sanctions against the hoodwinkers?

Third, dispositive motion practice mirroring Rule 12(b)(6) will introduce detailed pleading standards into a forum that promises that pleading will be minimal. The U.S. Supreme Court says that a complaint is sufficient if it provides "'a short and plain statement of the claim' that will give the defendant fair notice of what the plaintiff's claim is and the grounds upon which it rests."[26] NASD Rule 10314 requires even less: "The Statement of Claim shall specify the relevant facts and the relief sought." Neither a complaint nor a statement of claim has to be self-proving, for "details of both fact and law come later, in other documents,"[27] and in the hearing on the merits. Introducing 12(b)(6) motion practice raises the ugly spectre of elaborate arguments over, for example, the applicable pleading standards for federal securities claims under the Securities Exchange Act and Rule 10b-5. This is a debate on which even the federal circuit courts of appeal cannot agree.[28] Moreover, PSLRA imposes a freeze on all discovery until the motions to dismiss are resolved,[29] forcing panels to render dispositive decisions before the claimant receives any discovery. Legitimizing dismissal motions on 10b-5 pleading standards will not only drag out the proceedings but also put a premium on respondents' stonewalling skills to keep relevant documents out of claimants' hands.

Motions to dismiss replicating Rule 12(b)(6) criteria do not belong in arbitration, and particularly not when the prize for winning is a wiped-clean CRD record. This is especially true while the SROs and the SEC preserve the philosophy that investors can represent themselves and vindicate their claims. The scheme of proposed Rule 2130 will take away several of the advertised benefits of arbitration: a guaranteed evidentiary hearing; minimal motion practice; informal pleading requirements; expeditious resolution; and the ability to proceed without counsel. To borrow PIABA member William Torngren's phrase, it is another stop on the boulevard of broken promises.

"**Defamatory" Is Improper**

There is no need or justification for a "defamatory" criterion with customer complaints. This is a slop-over from the broker-firm arena, where defamation of individual brokers on the CRD does occur, generally at the hands of former employers and supervisors. The NASD's rule filing gives no more justification than to say that the standard "has been used successfully in the arbitration forum in registered representative/member firm arbitrations, and NASD believes that it is appropriate as proposed."[30]

It is emphatically not appropriate. NASD's rule proposal totally ignores the absolute privilege and immunity that applies in judicial, quasi-judicial,

———————————

[26] *Leatherman v. Tarrant County Narc.Intell & Coord.Unit*, 507 U.S. 163, 168 (1993), quoting Fed.R.Civ.P. Rule 8(a)(2).

[27] *Mid America Title Co. v. Kirk*, 991 F.2d 417, 421 (7th Cir. 1993).

[28] There is a 'widespread disagreement among courts as to the proper interpretation of the PSLRA's heightened pleading requirement.'" *Phillips v. LCI Int'l, Inc.*, 190 F.3d 609, 620 (4th Cir. 1999) (quoting In re Silicon Graphics, Inc. Sec. Litig., 183 F.3d 970, 973 (9th Cir. 1999)). See Brent Wilson, *Pleading Versus Proving Scienter Under the Private Securities Litigation Reform Act of 1995 in the Ninth Circuit* [...], 38 Willamette L. Rev. 321, 324-329 (2002) (reviewing circuit decision).

[29] "In any private action arising under this chapter, all discovery and other proceedings shall be stayed during the pendency of any motion to dismiss...." 15 U.S. C § 78u-4(b)(3)(B).

[30] SR-NASD-2002-168, pp. 28-29.

and contractual arbitration proceedings.[31] It will effectively communicate to the arbitrators that such immunity does not apply in arbitration. That is utterly false, but many arbitrators will not know that.

Including a “defamatory” criterion in NASD rules attempts to create a counterclaim which simply does not exist. Allowing purported defamation as an expungement criterion in investor complaints invites—indeed, virtually mandates—respondents’ retaliatory counterclaims against the investor for alleged “defamation.”

A “defamatory” criterion in Rule 2130 will have other negative consequences. Most importantly, it will seriously chill investors’ ability to bring claims against their brokers. For respondents, that may be even more valuable than a clean CRD. Defamation counterclaims are an intimidation tactic that strikes at clients’ worst fears: "Do you mean I could lose MORE money?" PIABA members already reported an upsurge in such counterclaims in 2002.[32] Adding “defamation” as an accepted means of wiping the customer’s complaint off the CRD is like throwing gasoline on a fire.

Counterclaims for defamation will vastly complicate arbitration proceedings. Claimants will have to educate the arbitrators about absolute immunity and seek to have the counterclaims dismissed.[33] If that fails, claimants will pursue discovery requests seeking, among other things, the unredacted names and addresses of all of the broker's clients, since they will be in the best position to know what his business reputation is. Naturally, that will lead to a discovery fire-fight. If the case eventually gets before the arbitrators, there will be additional hearing dates and concomitant costs. The arbitrators will have to decide which state’s law of defamation to apply, a particularly difficult problem when the broker and customer reside in different states and the CRD is a national publication. All of this complexity and expense is totally improper.

____

[31] “A party to a private litigation ... is absolutely privileged to publish defamatory matter concerning another in communications ... during the course and as a part of, a judicial proceeding in which he participates, if the matter has some relation to the proceeding.” RESTATEMENT OF TORTS 2d, § 587 (1977). “‘Judicial proceedings include all proceedings in which an officer or tribunal exercises judicial functions ... an arbitration proceeding may be included.”’ Bushell v. Caterpillar, Inc. 291 Ill.App.3d 559, 562, 683 N.E.2d 1286, 1288 (Ill.App. 1997) (quoting RESTATEMENT OF TORTS 2d, § 587, comments b and f) (emphasis added by the court). “[P]rivilege for communications made in the context of judicial, quasi-judicial, or legislative proceedings [is] a complete immunity from suit, not a mere defense to liability.” *Shanks v. AlliedSignal, Inc.*, 169 F.3d 988, 992 (5th Cir. 1999); see also *Hugel v. Milberg, Weiss, Bershad, Hynes & Lerach, LLP*, 175 F.3d 14, 16 (1st Cir. 1999) (“A statement falls outside the privilege only if it is “so palpably irrelevant to the subject matter of the controversy that no reasonable man can doubt its irrelevancy or impropriety.’”).

See M. Schneiderman, Libel and slander: *application of privileges attending statements made in course of judicial proceedings to pretrial deposition and discovery procedures*, 23 A.L.R.3d 1172 (1969); W. E. Shipley, Libel and slander: *privileged nature of communications made in course of grievance or arbitration procedure provided for by collective bargaining agreement*, 60 A.L.R.3d 1041 (1974). (John B. Lewis & Lois J. Cole, *Defamation Actions Arising From Arbitration And Related Dispute Resolution Procedures-Preemption, Collateral Estoppel and Privilege: Why The Absolute Privilege Should Be Expanded*, 45 DePaul L. Rev. 677 (1996), observe that the rule is not absolute in labor arbitrations under a collective bargaining agreement). See also Sheri L. Marvin, *Libel and Slander: Deposition testimony and other statements taken in connection with private, contractual proceedings are protected from tort liability by the absolute immunity granted under California’s litigation privilege*, 22 Pepp. L. rev. 1322 91995).

“This absolute privilege shields speakers from liability even if their motives were malicious, or they knew the statement was false, or their conduct was otherwise unreasonable.” *Imperial v. Drapeau*, 351 Md. 38, 44, 716 A.2d 244, 247 (Md.App. 1998); see *Odyniec v. Schneider*, 322 Md. 520, 588 A.2d 786 (Md. 1991) (expert witness’ allegedly defamatory statements made in connection with arbitration are absolutely privileged, just as they would be in court, even when the remarks may have been gratuitous, unsolicited, and said outside the actual hearing); *Sturdivant v. Seaboard Service System, Ltd.*, 459 A.2d 1058 (D.C. 1983) (absolute immunity to complaining witness’ statement).

[32] Correspondence on file with the author.

[33] Ironically, this will reverse the usual roles of customers and respondents regarding dismissal under Rule 10303. Claimants will have to argue that pre-hearing dismissal is legitimate, and respondents may find themselves contending that Rule 10303 gives them an absolute right to an evidentiary hearing on their claims.

Defense lawyers advocating expungement state that "traditional defamation principles apply in arbitration just as they do in the rest of society."[34] They evidently forget that in the rest of society, allegations in court pleadings get absolute privilege and immunity from suit. Furthermore, civil lawsuits are part of the permanent public record and are not expungeable.

Members of the securities industry are not entitled to greater protection from complaint or suit than other members of society. Nor do they have any greater right to retaliate for alleged "defamation" in the pleadings. Like other members of society, they have no right to claim that a customer's complaint "defamed" them.

Catch-Alls

The criterion of "without factual basis" is too vague. It is dangerous, both to those trying to maintain an accurate CRD and to brokers trying to correct legitimate errors.

The NASD says that it includes the "factually impossible" and "clear error" standards that presently exist, but offers no further explanation.[35] Yet the phrase "without factual basis" is clearly much broader than the examples previously quoted for factual impossibility.

In arbitrators' minds, "without factual basis" could mean nothing more than the claimant failed to meet her burden of proof. Unless the arbitrators give more than just a one-sentence finding, neither the NASD nor state securities regulators will ever know otherwise. That is obviously not an adequate basis for expunging an investor complaint from the permanent record.

The NASD's own catch-all is even broader. The NASD permits itself to determine—in its sole discretion—that the findings supporting the expungement order are "meritorious". How will it know? Whom will it ask? What constitutes "meritorious"? This provision is nothing but a blank check to the NASD to expunge whatever it wishes.

Together with a blank check, the proposed rule has no accountability. There is no requirement for the NASD to maintain records of what action they take, so regulators and the public will never know what they did, who did it, why they did it, how many expungements were permitted to proceed unopposed, how those determinations were made and by whom, how many requests were opposed and on what grounds, and so on.

NASD Enforcement Uncertain

The meat of proposed Rule 2130 is in the NASD's participation in court proceedings, ostensibly to oppose improper expungements. The rule requires naming the NASD as an additional party in such confirmation and expungement proceedings. However, the rule proposal itself provides no assurances that NASD will actively oppose objectionable attempts to expunge, or that NASD's opposition will be effective. The entire enforcement side of proposed Rule 2130 is highly doubtful.

NASD's comments accompanying the rule filing assert, "The proposed rule will state that NASD will participate in such judicial proceedings and will oppose expunging dispute information in such judicial proceedings" unless the tribunal made specific findings satisfying the NASD's criteria.[36] In fact, the proposed rule says no such thing.[37] There is nothing in proposed Rule 2130 declaring or requiring that the NASD "will oppose" anything.

Former state securities administrators who have dealt with the NASD on CRD issues question the NASD's commitment to permitting expungement only in compelling and exceptional circumstances. One former state commissioner wrote privately,

> [I] had to deal with the NASD on CRD matters from the day that CRD was proposed. No good can come from the NASD, on its own, being allowed to decide what is on the system and what is not. ...

---

[34] Mark J. Astarita, *Rogue Customers*, http://www.seclaw.com/docs/1097.htm (Oct. 1997). The statement by itself is true—but only when it means the opposite of what Mr. Astarita intended.

[35] SR-NASD-2002-168, p. 28.

[36] SR-NASD-2002-168, p. 20.

[37] The reader wonders if NASD changed the text of the proposed rule after the comments were drafted – and after NASAA gave its *nihil obstat* to those concepts.

Trust me, the NASD will never fight to keep something in the records of CRD.[38]

Another former state commissioner and NASAA official, who has been intimately involved in the expungement controversy, is less pessimistic: "I honestly believe that the NASD will fight expungement in all but the most obvious cases. There is no way they will accept expungement if money changes hands."[39]

Not Binding On Courts

Even if we assume the most optimistic view, there is no assurance that the NASD's opposition will have one whit of impact on the courts. Simply put, the criteria in proposed Rule 2130(b) may be binding on the NASD, but they are not binding on federal or state judges.

The NASD's purported protections are predicated on its discretion to appear in court to oppose the expungement. (Let us suspend skepticism and assume for the moment that the NASD would rigorously oppose expungement proceedings that did not meet the highest standards of scrutiny.) But the success of its opposition may be highly doubtful.

What grounds would the NASD use to convince a court not to confirm the expungement order in an arbitration award?

If it asks the court to vacate the award under normal procedures of the Federal Arbitration Act, it will fail. The NASD's opposition cannot be based on any of the statutory criteria for vacatur in 9 U.S.C. § 10(a), on the criteria for modifying an award in 9 U.S.C. § 11, or on manifest disregard of the law. Proposed Rule 2130 is not a law, just a rule of the SRO. Since the rule is in the 2000 series, it is not a rule of arbitration, it is not binding on the arbitrators, and it does not limit their powers. Arbitrators are free to issue expungement orders on any grounds they choose. Further, proposed Rule 2130 does not prescribe criteria to the court for determining whether expungement is permissible. As we have seen, it only defines the circumstances under which the NASD may waive participation in the court proceeding. Unless the NASD can show that the award was obtained by fraud, corruption, or misconduct of the arbitrators, there is no reasonable hope of blocking confirmation of the expungement.

Another theory suggests that the NASD could oppose the expungement in its capacity as administrator of the CRD responsible for protecting the public record.[40] I have found some small support for this in labor cases, one by the National Labor Relations Board, another by the Connecticut State Board of Mediation and Arbitration.[41] But again, the three criteria in 2130(b)(1) govern the NASD's choice to intervene, not the court's evaluation in confirming or denying the award. While the court might give some deference to the NASD's views,[42] there is no assurance that the court would adopt the NASD's criteria for its own decision.

Factual Basis From Where?

Furthermore, unless the arbitrators give written explanations, how is anyone—including the NASD—going to know what criteria were applied?

---

[38] Private communication, Jan. 6, 2003 (on file with the author). This commissioner was horrified to discover NASD's sloppy controls over CRD information. For example, "13 people had authority to enter fingerprint information directly into the CRD without a tracking mechanism even though only 2 people actually handled the fingerprint cards – it would have been worth a $1000 bucks for a felon to have one of these people enter that they had a clean rap sheet and no one would have known."

[39] Private communication, Jan. 6, 2003 (on file with the author).

[40] I thank Scot Bernstein for this suggestion. The NASD itself is silent on the entire question.

[41] See *International Longshoremen's and Warehousemen's Union, Local 32 v. Pacific Maritime Ass'n*, 773 F.2d 1012, 1020 (9th Cir. 1985) (NLRB may intervene to oppose an award that, if enforced, would undermine a section 10(k) NLRB work assignment); *City of Milford v. Local 1566, Council 4, AFSCME*, 200 Conn. 91, 510 A.2d 177 (Conn. 1986) (although State Board did not have interest in whether award was ultimately vacated or confirmed, it had significant interest in protecting validity of procedures used to determine award).

[42] *Littman v. Morgan Stanley Dean Witter*, 337 N.J.Super. 134, 143, 766 A.2d 794, 799 (N.J.Super. 2001) (NASD's rule filing commentary is entitled to deference); *First Heritage Corp. v. NASD*, 785 F.Supp. 1250, 1251 (E.D.Mich. 1992) (same). We should note that in other cases, courts have routinely disregarded the commentary in SEC

Since the arbitrators can't be deposed, what will the NASD do? Factual basis is also troublesome in stipulated awards, since the arbitrators may not have made an independent decision.

Will the NASD go to the parties' counsel and get affidavits? The rule filing suggests this possibility: "In connection with making the required arbitral findings in such cases, NASD will explore the use of telephonic versus in-person hearings, as well as the option of making a decision based on briefs and affidavits from the parties and relevant third parties."[43]

Will you as claimants' counsel swear under oath that the claim that you agreed to expunge, which you submitted in good faith and which you know in your heart to be meritorious (after all, they just paid you to settle it!) – will you swear that it was frivolous, or without factual basis, or failed to state a claim on which relief could be granted?? If so, you're in deeper trouble than the broker.

Any claimant's counsel who grants such an affidavit—or permits respondents' counsel to make such representations on her behalf—will commit a fraud on the court,[44] violate the professional responsibility rule requiring candor toward the tribunal,[45] and participate in a conspiracy to falsify or tamper with public records. Perjury carries civil and criminal penalties. So does tampering with public records.
No lawyer who values his or her liberty, property, ethical obligations, and license to practice law can participate in such a scheme and provide the NASD the "factual basis" that it seeks.[46]

Missed Opportunity

The enforcement situation would be very different if the expungement criteria were binding on members and arbitrators. For example, the proposed rule could have a counterpart or cross-reference in the NASD Code of Arbitration Procedure, limiting arbitrators' power to grant expungement except in specifically delimited circumstances and requiring reasoned findings substantiating such a recommendation. If arbitrators issued an award (including a stipulated award) that did not satisfy the requirements, the arbitrators would exceed their powers or render an imperfect award. The proposed expungement would be vacatable under 9 U.S.C. § 10(a)(4)[47] or modifiable under § 11(c). The NASD's criteria would be directly imported into the judicial proceeding and would govern the court's decision.

The fact that the NASD did not write the rule in this manner causes us to question its commitment to opposing nonconforming expungements. Undoubtedly the NASD and NASAA folks who originally developed this proposal had a rational idea of how it would function. However, the way proposed Rule 2130 finally turned out, the NASD's purported protection of the CRD is mostly chimerical. Gertrude Stein would recognize the situation immediately – there's no There there.

———————————

rulemaking. They did this repeatedly in Rule 10304 / Sec. 15 eligibility rule decisions contravening the 1984 rule amendment that expressly intended to "make the Code's time limitation co-extensive with various state statutes of limitations and permit all securities-related disputes which are eligible for a judicial disposition to be resolved by arbitration." SEC File No. SR-NASD-84-16, Release No. 34-21188, 31 SEC Docket 31 (Aug. 2, 1984). See C. Thomas Mason III, *Irreducible Disagreements: The Six-Year Rule Revisited*, 1 SECURITIES ARBITRATION 1997 557 (Practising Law Institute, Corp. Law & Pract. Course Handbook Series #998, vol. B4-7195, 1997), at p. 578; contrast *Bayley v. Fox*, 671 N.E.2d 133 (Ind.App. 1996), discussed at pp. 695-696, which supported its decision with the SEC's release but without giving it deference.

[43] SR-NASD-2002-168, p. 29.

[44] See, among many, *Hongsermeier v. C.I.R.*, --- F.3d ----, 2003 WL 132992 (9th Cir., Jan. 17, 2003) (conduct designed to prevent the court and public from learning of settlement agreements was a fraud on the court, and no showing of prejudice is required).

[45] See ABA Model Rule 3.3; C. Thomas Mason III, *Lawyers' Duties of Candor Toward the Arbitral Tribunal*, 1 SECURITIES ARBITRATION 1997 59 (Practising Law Institute, Corp. Law & Pract. Course Handbook Series #998, vol. B4-7195, 1997).

[46] See the Legal Ethics section at the end of this article.

Accurate CRD Is Vital

The ability to correct inaccurate or defamatory entries is very important. The CRD is—or should be—vital to the career of a broker. Regulators' "Rogue Broker" projects condemned the practice of hiring peripatetic bad brokers and retaining them despite numerous customer complaints.[48] A massive overhaul of the CRD recommended by the "Large Firm Project" made it a more effective tool for firms trying to avoid problem brokers, for regulators in their investigations, and for public customers seeking information about their advisors. The NASD summarized the importance of the CRD in NTM 01-65:

Regulators use the registration information, and other information contained in the CRD system, to assist them in fulfilling their regulatory responsibilities, including making determinations about registration and licensing of firms and associated persons. Member firms use the CRD system to help them meet their registration, licensing, and certain other compliance obligations. Much of the information reported to the CRD system is made publicly available, either by NASD Regulation through its Public Disclosure Program (PDP) or by the SEC and individual state securities administrators pursuant to applicable law.

Negative information on the CRD can end brokers' careers and deprive them of their livelihood. "Ever try to switch brokerages with such a record? You are radioactive," writes a defense lawyer.[49]

Less measurably, CRD dings can adversely affect or can diminish a broker's ability to attract and retain conscientious clients. As investors become more aware of the online public disclosure information, flawed though it is, and the more complete paper record from state securities administrators, they can proactively screen potential advisor relationships and not do business with brokers whose records concern them. A broker may never know what good clients chose not to do business with him or her because of information on the CRD, but the effects are there.

It is therefore essential that CRD records be accurate, complete, and comprehensible. This is particularly significant because the CRD combines the worst features of self-reporting and adversary reporting with few of the cross-checks and protections that ordinary public records have.

CRD Is A Public Record

The CRD is a public record, literally and legally. Yet it differs from other "normal" public records in some significant ways. A broker's CRD record is very public. Most portions are available online,[50] or by picking up the telephone and calling either the NASD Public Disclosure Program or—better—the state securities division.[51] In this way, the CRD is more public than most public records, which have been slower to convert to online access.

———————————

[47] One court questioned, without deciding, whether an award can be partially vacated using the standards of § 10. *Legion Ins. Co. v. VCW, Inc.,* 198 F.3d 718, 721 n. 5 (8th Cir. 1999). However, the issue appears more theoretical than real, since courts routinely do exactly that. See, e.g., *Lummus Global Amazonas S.A. v. Aguaytia Energy del Peru S.R. LTDA.*, --- F.Supp.2d ----, 2002 WL 31401996 (S.D.Tex. 2002) (rejecting the restriction); *Davis v. City and County of San Francisco*, 984 F.2d 345 (9th Cir. 1993) (vacating just the award of expert fees); *United Food & Commercial Workers v. National Tea Co.*, 899 F.2d 386 (5th Cir. 1990) (vacating injunctive portion of award); *Landy Michaels Realty Corp. v. Local 32B-32J, Service Employees Intern. Union, AFL-CIO*, 954 F.2d 794 (2nd Cir. 1992) (vacating damages portion of arbitration award).

[48] See "Joint Regulatory Sales Practice Sweep: A Review of the Sales Practice Activities of Selected Registered Representatives and the Hiring, Retention, and Supervisory Practices of the Brokerage Firms Employing Them" (March 1996). The Sweep combined the resources of the SEC, NASD, NYSE, and NASAA to review problem brokers and the hiring, retention, and supervisory practices of firms employing them. The report is available at http://www.sec.gov/news/studies/sweeptoc.htm. The Sweep followed "The Large Firm Project: A Review of Hiring, Retention and Supervisory Practices" by the SEC's Division of Market Regulation and Division of Enforcement (May 1994), http://www.sec.gov/news/studies/rogue.txt.

[49] Bill Singer, *Street Legal: Charged, Therefore Guilty*, REGISTERED REP. (Feb. 1, 2002), http://registeredrep.com/ar/finance_street_legal_charged/index.htm.

[50] In 2002 the NASD decided to limit public online access through the internet to specified hours during the day and early evening: "The web site is available from 7.00 a.m. to 11 p.m. ET Monday through Friday and 8.00 a.m. to 8.00 p.m. ET Saturday and Sunday." http://pdpi.nasdr.com/pdpi/ (after hours). For totally unexplained reasons, NASD shuts off access during the hours when working investors with children finally have free time to get onto their computers. This particularly affects investors in western and Pacific states, since the system closes down at 8 PM

More importantly, the CRD is legally a public record. NTM 99-54 acknowledged NASAA's longstanding insistence on this point:

> NASAA has informed NASD Regulation that, in its opinion, according to various state laws, information submitted to the CRD system is deemed to have been filed with each state in which the subject person or entity seeks to be registered. Therefore, according to NASAA, information in the CRD system that may be the subject of an arbitrator-ordered expungement is in many cases a state record, and some state laws currently do not recognize the authority of an arbitrator to expunge a state record or do not otherwise permit such expungements because of state recordkeeping requirements.

In 1999, the SIA pooh-poohed that concept.[52] In a letter responding to NTM 99-54 and advocating a return to the free-and-easy days of arbitrator-ordered expungements, the SIA claimed that the only support for "state record" status came from an opinion of the Florida Attorney General. The SIA did not do its homework before attempting to refute Florida's position. Its argument about state law is simply wrong.

The Florida Attorney General concluded that CRD records are state records and cannot be expunged except in conformity with Florida law. The opinion further stated, "An agency may not avoid its responsibility under the Public Records Act by transferring custody of a record to another entity."[53]

California statutes unambiguously designate CRD records as a "public record" which is available for public inspection. See Cal.Corp.Code § 25247 and Cal.Gov.Code § 6254.12. The latter reads:

> Any information reported to the North American Securities Administrators Association/National Association of Securities Dealers' Central Registration Depository and compiled as disciplinary records which are made available to the Department of Corporations through a computer system, shall constitute a public record.

You can't get much clearer than that. And there are numerous other examples. The Oklahoma securities commissioner may designate filing depositories—including the CRD—for records required to be filed and maintained under the Oklahoma Securities Act.[54] At the time of the SIA's letter, Arkansas treated securities agents' filings under the Arkansas State Records Management and Archives Act and permitted the state commissioner to participate in the CRD for maintaining and retaining such public records.[55] Many other states authorize their securities commissioner to participate in the CRD for the purpose of centralizing and streamlining record-keeping, filing, and retention.

I have not found a state that has abandoned its own regulation of

____

Pacific time on weekdays and 5 PM on weekends. For investors overseas, the problem is even worse. NASD's computers don't sleep; they certainly don't sleep 8-12 hours a night. There is no rational explanation for this denial of service, except to make it difficult for some members of the public to obtain valuable information.

[51] The NASD's PDP summaries often have significantly less information than printouts from state securities administrators. Seasoned practitioners refer to the online report as "CRD-Lite" and, whenever appropriate, get the full report from their state securities division. A full critique of the online disclosure system is beyond the scope of this article.

[52] http://www.sia.com/1999_comment_letters/html/nasd99-7.html (July 30, 1999).

[53] Advisory Legal Opinion by Robert A. Butterworth, Attorney General of the State of Florida, AGO 98-54 (August 28, 1998), http://legal1.firn.edu/ago.nsf/aaee37715760bbce852563cc001bacf7/d3d4288d6bfa789085256671004cada9!OpenDocument

[54] 71 Okl.St. § 411.

[55] Ark.Code § 23-42-206. The entire State Records Management and Archives Act was repealed in 2001 for reasons that have nothing to do with the CRD. Acts 2001, No. 1252, § 1.

brokers and agents in favor of whatever the NASD unilaterally decides to keep in the CRD. Mr. Mark Sendrow, Director of the Arizona Securities Division and a member of the NASAA board, puts the matter in perspective: When the states and the NASD got together some twenty years ago to create the CRD, no state gave up its records simply by having asked the NASD to coordinate the national system.[56]

It's illegal to tamper with or falsify a public record.

Self-Reporting Problems

The CRD is essentially a self-reporting system. Associated persons are required to update their own U-4.[57] Sometimes this is done by the registered representative himself, usually in conjunction with the firm's legal or compliance department. There is a structural incentive to disclose as little as possible and to spin it in the broker's favor. The results, as anyone who has received public disclosure information from the NASD has already noticed, are typically meaningless, self-exculpatory denials and blah-blah that are useless for investors. Self-reported entries on the CRD generally cannot be considered to be true and accurate disclosure of the investors' complaints.

In some ways, the CRD would be far more useful for investors if the complaining party were permitted to submit a summary of the complaint. This would at least counterbalance the one-sided self-interested reports that the CRD currently contains. However, it would open up brokers to genuine defamation by their unhappy customers. While NASDR could provide protections by having the Enforcement Division check the investor's proposed CRD entry to ensure that it accurately reflects the allegations in the complaint that the investor intends to prove, that could prove more troublesome than the current system.

Broker-dealers also have an incentive to obfuscate and exculpate on CRD entries regarding their brokers. They won't say anything that may concede wrongdoing by this registered representative or that may reveal a pattern of flawed supervision by the firm. In addition, when the broker is still a valued producer, the firm won't want to say anything that could cause the broker's clients or prospective customers to turn away.

Ex-Employers Can Become Adversaries

On the other hand, firms can become brokers' adversaries. Once a registered representative has left the firm, she becomes vulnerable to vicious, retaliatory, and ultimately defamatory entries on her CRD record. We see this particularly after the broker and firm have been hit with complaints or arbitration awards to investors. The U-5 filing is an opportunity for the firm—especially the branch office manager—to blame the departed representative for the supervisor's or firm's failings, or simply to vent personal conflicts between the representative and her superiors. Such instances are particularly pernicious when the personal conflict was sexual harassment or other civil rights violations by the superior.

When firms file ugly U-5s sliming the representative's record, prospective employers reading those reports can and do refuse to hire the representative. Negative reports can drive the representative out of the securities industry, costing her career and her livelihood.

These dangers, more than any other, motivate thoughtful advocacy of finding means to expunge inaccurate or defamatory information. The National Association of Investment Professionals (NAIP)[58] has been at the forefront of this effort. Predictably, brokerage firms have a different idea of U-5 disputes. In their view of the world, "Disgruntled former employees not infrequently threaten groundless defamation actions based on these filings."[59]

In my experience, mean-spirited CRD filings by former employers do occur. For example, in the early 1990's, Prudential Securities was in the dock for its massive multi-billion dollar systemic corporate fraud in the

---

[56] Personal communication, Jan. 15, 2003.

[57] "We wish to reiterate that the responsibility for maintaining the accuracy of the Form U-4, by updating the information in the filing, as necessary, lies with the registered representative." *Frank R. Rubba*, Release No. 34-40238, 67 S.E.C. Docket 1305 (July 21, 1998).

[58] See http://www.naip.com/ (not to be confused with http://www.naip.org/, the National Association for Indexed Products). (The website is not kept up to date very well.)

[59] Daniel L. Goelzer, Baker & McKenzie, Statement of the Securities Industry Association concerning the Securities Litigation Reform Act before the Telecommunications and Finance Subcommittee of the House Committee on Commerce, February 10, 1995, 1995 WL 57110, at n. 34 (advocating legislation to grant firms absolute immunity for their statements on former employees' U-5s).

creation and marketing of limited partnerships. The company lied to its employees about the safety and profitability of its limited partnerships; loyal and otherwise conscientious employees believed their company and unwittingly passed on the lies to their valued clients. The limited partnerships went down the tubes, taking investors' money with them and causing a national scandal. Investors sued, regulators investigated, and Prudential paid nearly $2 billion in awards, judgments, regulatory fines, and legal fees.

In numerous cases, investors deliberately did not name their financial consultant as a respondent, recognizing that the rep was also victim of Prudential's lies. They wanted simply to recover their money and did not want to harm their financial consultant. Where the broker had left Prudential Securities by the time the case was resolved, Prudential often reported the outcome on an amended U-5, even though allegations of wrongdoing were against the company itself and there were no allegations of sales practice violations by the rep. This practice was particularly offensive where the U-5 amendment resulted from an award through the SEC's expedited arbitration process, which recognized the corporate wrongdoing. Prudential had no reason to besmirch the CRD of its former employees, other than out of spite or retaliation for their having moved to more reputable firms and taken the tattered remnants of their client book, or to perpetuate Prudential's corporate fiction—which it maintained in spite of facts and evidence and regulatory findings—that the limited partnership debacle was simply the fault of irresponsible representatives.[60]

A second example comes from Prudential Insurance and its broker-dealer subsidiary Pruco Securities, and the product failure of its "vanishing premium" life insurance arising from systematic company-wide deceptive marketing.[61] Once again, when clients complained, the company sought to blame the individual representative/agents, even when clients clearly stated that they had no complaints about the agent. In cases I worked on, the pattern was clear: if the agent was still with Pruco, there was no amended U-4 unless there was an unavoidable complaint that the agent's conduct exceeded the company's own mispractice. But after the agent left Pruco, there was no restraint. Managers filed amended U-5s retroactively to tarnish the agent with earlier complaints which, if they were reportable at all, should have been filed on the rep's U-4 many months earlier. A number of former representatives brought claims for defamation. They were often successful both in collecting money and in obtaining nonmonetary relief that can be even more valuable—they got the offending entries in their CRD record amended or expunged.[62]

The third example, involving cases of sexual harassment or other civil rights violations, is perhaps the ugliest. When the representative leaves the company, the branch office manager submits a U-5 with trumped-up reports of poor work habits, inability to deal with clients, failure to follow supervisor's instructions, etc. Violations of personal dignity are followed by actions that threaten her livelihood. Such statements on a U-5 are even more potent in jeopardizing an individual's career than customer complaints because of their content. The representative's only long-term remedy is to get the false report expunged from the CRD.

But Employer Defamation Is Already Covered

These abuses legitimately support appropriate mechanisms for expungement. However, it is important for us to recognize that they are totally unaffected by proposed Rule 2130. All of these

---

[60] Prudential denies all this, of course, but the defamation claims against the company speak for themselves.

[61] See *In re Prudential Insurance Company America Sales Practice Litigation*, 148 F.3d 283 (3rd Cir. 1998) and related decisions.

[62] Prudential was certainly not the only firm to engage in such practices. *Dawson v. New York Life Ins. Co.*, 135 F.3d 1158, 1163-4 (7th Cir. 1998), responded to concerns that giving securities firms absolute privilege for remarks on the U-5 "will invite vindictive brokerage firms to embellish customer complaints so as to harm the reputations of agents who have fallen into disfavor." The court rejected the employer's plea for absolute immunity and stated that "while even meritless complaints against agents must be reported on Forms U-5, individual agents can rest assured that securities firms do not have free rein to report customer complaints in any way they like, exaggerating complaints or inventing them wholesale with absolute immunity to do so."

problems, the primary impetus of the NAIP, are employee-firm disputes. By its own terms, proposed Rule 2130 expressly deals only with customer complaints and offers no solace or protection against wrongful actions by firms toward their own former employees. The NASD's rule filing acknowledges this discrepancy. Under already existing policy, the NASD will honor—without a court order—expungement directives arising from employee-firm disputes "in which the arbitration panel states that expungement relief is being granted because of the defamatory nature of the information."[63]

Since correcting the greatest source of inaccurate or defamatory information is already in place and is not affected by the proposed rule, we have to question what genuine wrongs the proposed rule intends to address. None is apparent.

"Rogue Customers" and Frivolous Complaints

Some defense counsel complain of "rogue customers" whose irresponsible filings unjustly besmirch brokers' records.[64] Of course, the number of times respondents' counsel cry that the claim is frivolous is several orders of magnitude larger than the number of cases in which the arbitrators agreed that was true. The databases are replete with awards reciting respondents' boilerplate in which the arbitrators found wrongdoing and entered awards against the respondent.

However, some investors have filed truly frivolous and harassing claims against brokers. Not only do arbitrators flatly reject such claims, some of the awards even assessed forum fees and/or attorney fees against the complainant as penalty for bringing a frivolous case.[65] The awards are public, and the brokers certainly reported the successful outcome to the CRD, so there is no need for expungement.

Besides forum fees, attorney fees, and sanctions in the arbitration, the appropriate remedy for demonstrably frivolous and harassing claims is an action for malicious prosecution. Its functions are:

> to recompense a defendant sued in a malicious and baseless legal action for: (1) his attorney fees; (2) his costs; (3) his psychic damage from the shock of the unfounded allegations in the pleadings; and (4) the loss of his reputation in the community as a result of the filing and notoriety of the base allegations in the pleadings which are public records.[66]

The basic elements of tortious wrongful prosecution are generally: "(1) favorable termination of the prior proceeding, (2) lack of probable cause to support the original action,

____

[63] SR-NASD-2002-168, p. 22 n. 4

[64] See Mark J. Astaria, *NASD Expungement Order Proposal Release*, http://www.seclaw.*com/docs/expungement1201.htm (Dec. 17,* 2001) (criticizing NTM 01-65)*,* and his earlier editorial, *Rogue Customers*, http://www.seclaw.com/docs/1097.htm (Oct. 1997*),* in which he complained of customers "who send complaint letters, file regulatory complaints, commence arbitrations and start federal lawsuits, accusing their brokers of a wide variety of fraudulent activity, when the customer himself knows that the complaint is without merit." It might be noted that in the 1990s, Mr. Astarita's law firms represented some of the most unsavory members of the securities community.

[65] For example*:* "In awarding attorney's fees, the panel considered the claim brought against Respondent to be frivolous in nature." *Texvest Factors & Financial Svcs Corp. V. Shearson Lehman Brothers,Inc.*, NASD Docket 91-02519, 1993 WL 147553, *2 (Feb. 12, 1993). "Claimant is liable to and shall pay to Respondent Mercer $15,000.00 for attorney's fees and legal expenses incurred as a result of the frivolous and defamatory nature of the claim." *Redwing Robin L.P. v. Southern Financial Group, Inc.*, NASD Docket 99-02504, 2000 WL 1278039, *4 (June 12, 2000) (also ordering expungement, conditioned on confirmation from a court of competent jurisdiction). The Securities Arbitration Commentator, Inc. Has an entire package of awards in which the arbitrators have awarded sanctions of various kinds. P.O. Box 112, Maplewood, NJ 07040; 93 Riggs Place, So. Orange, NJ 07079-973-761-5880, fax 973-761-1504.

[66] *Walford v. Blinder, Robinson & Co., Inc.* 793 P.2d 620, 623 (Colo.App. 1990) (quoting *Stanley v. Superior Court*, 130 Cal.App.3d 460, 181 Cal.Rptr. 878 (Cal.App. 1982)), cert. Dismissed sub norm. *Keller v. Walford*, 498 U.S. 977 (1990). (PIABA member Steve A. Miller of Denver represented the Walford plaintiffs.)

and (3) malice in bringing that action."[67] In most jurisdictions, an arbitration award terminated in favor of the broker will support such an action, even though arbitrators are not required to make detailed findings and the hearing records maybe incomplete.[68] "[A] malicious prosecution action involves not a review of the reasons for the decision in the prior action, but rather an analysis of the circumstances that led the [complainant] to pursue that action."[69]

Those well-recognized remedies—especially compensation for unfounded allegations and loss of reputation (items (3) and (4) above)—are the legitimate relief that aggrieved brokers are seeking through the jerry-rigged alternative of expungement. Such private relief can be obtained without the disadvantages of tampering with public records designed for investor protection.

De Facto Expungements

The securities industry already exercises its own de facto whitewashing of the permanent record simply by not reporting adverse events to the CRD. Distressingly many members—including biggest top-tier firms—continue to fail to comply with basic reporting requirements of CRD registration forms and NASD Rule 3070. NASD's occasional enforcement has been lackluster at best. The virtual absence of systematic enforcement is all the more incomprehensible since the NASD already gets full information regarding investors' arbitration complaints, as well as notices that cases have settled.

Historically, the right hand did not communicate with the left hand. Dispute Resolution did not communicate investor complaints or trends to Enforcement.[70] Both the NASD and the NYSE have been amazingly lax in coordinating information they already received—statements of claim vs. U-4/U-5 filings; notices of settlement vs. U-4/U-5/BD—and instituting appropriate regulatory actions.

____

[67] *Andrus v. Estrada*, 39 Cal.App.4th 1030, 1039, 46 Cal.Rptr.2d 300, 305 (Cal.App. 1995); see also RESTATEMENT OF TORTS 2d, § 674. The *Andrus* decision gives a fascinating history of wrongful civil prosecution, showing that the cause of action has existed in the common law since before 1269.

Some American courts prefer to call the tort action arising from civil disputes "abuse of process" or "wrongful use of civil proceedings", leaving "malicious prosecution" to complaints arising from criminal matters. In some of those states, the difference is more than just nomenclature. "Under New York law, an abuse of process claim 'has three essential elements: (1) regularly issued process, (2) an intent to do harm without excuse or justification, and (3) use of the process in a perverted manner to obtain a collateral objective.'" P*SI Metals, Inc. v. Firemen's Ins. Co.*, 839 F.2d 42, 43 (2nd Cir. 1988) (*quoting Curiano v. Suozzi*, 63 N.Y.2d 113, 116, 469 N.E.2d 1324, 1326 (1984). The NY Court of Appeals also wrote that "the institution of a civil action by summons and complaint is not legally considered process capable of being abused." *Id*. This is an emphatic substantiation that claimants are immune from defamation for allegations made in the course of an arbitration claim.

[68] E.g., *Walford v. Blinder, Robinson & Co., Inc.*, 793 P.2d at 623; *Neely v. First State Bank, Harrah, Okla.*, 975 P.2d 435 (Okla. 1998); *Taylor v. Peoples Gas Light & Coke Co.*, 275 Ill.App.3d 655, 656 N.E.2d 134 (Ill.App. 1995); *Eurotech, Inc. v. Cosmos European Travels A.g.*, 189 F.Supp.2d 385 (E.D.Va. 2002); *Luppo v. Waldbaum*, 515 N.Y.S.2d 871 (N.Y.App.Div. 1987); *see also Pujol v. Shearson/American Express, Inc.,* 877 F.2d 132 (1st Cir. 1989); *International Medical Group, Inc. v. American Arbitration Ass'n, Inc.*, 312 F.3d 833, 845 (7th Cir. 2002).

However, the remedy is not available in California: "Whether the underlying action started in court or in arbitration, if it ends in contractual arbitration, that termination will not support a malicious prosecution action." *Brennan v. Tremco Inc.*, 25 Cal.4th 310, 314, 20 P.3d 1086, 1088, 105 Cal.Rptr.2d 790, 792 (Cal. 2001). To the extent that this disadvantages brokers in California, it is a self-inflicted problem that the securities industry has created by insisting that even its own employees give up their legal rights and submit all disputes to arbitration. It does not justify expungement.

[69] *Walford v. Blinder, Robinson & Co., Inc.*, 793 P.2d at 623.

[70] This was evident in the Prudential Securities limited partnership scandals, where the NASD had the earliest and best knowledge of the breadth and depth of the problem, yet did nothing with it. The massive enforcement case was later developed by state securities administrators, which Johnny-come-lately NASD joined at the tail end. See KURT EICHENWALD, SERPENT ON THE ROCK (HarperBusiness, 1995).

At the NASD's Fall Securities Conference, October 2002, Mary Shapiro, President of NASDR, Inc., informed me that those days are over at the NASD. Just as law enforcement and intelligence agencies discovered after September 11, 2001 that they didn't use information they already had and are now seeking better coordination, the NASD is developing information-sharing infrastructure to assemble data more meaningfully and ensure that the information is readily available for all departments to use. If the new discipline succeeds, the industry will be much less able to benefit from de facto whitewashing.

Ignoring Expungeable Complaints

Even the best coordination depends on someone getting the information in the first place. The proposed Rule 2130 gives additional incentive to brokers and firms simply not to comply with the U-4 reporting rules for customer complaints other than statements of claim. Those rules that are already inadequately observed and even more rarely enforced.

Consider what can happen if an investor submits a written complaint to the firm that triggers a "Yes" answer on the broker's U-4 or U-5.[71] The firm aggressively and reflexively denies the complaint. The investor decides not to pursue the matter in arbitration. Maybe she got intimidated; maybe the claim wasn't large enough to attract competent counsel. The broker now has an unadjudicated ding on his record. Under the NASD's public disclosure rules, it will disappear from public view, though not from the permanent record, in 24 months.

But the broker doesn't want to wait. He wants it cleared off now, and he wants it permanently removed so that state regulators won't see it. What is to prevent him from filing a declaratory action in court seeking expungement on the grounds that the customer's "unsubstantiated" and unadjudicated allegations were "without factual basis"?

There will be only one voice speaking—the broker's—so the success rate of such actions should be high. The customer won't be there to contest the broker's self-serving rendition of the events. The NASD won't have any contrary facts of its own, and it certainly doesn't have the manpower to independently investigate the underlying merits of every investor complaint that brokers want to expunge. An affidavit from the firm averring that the customer's complaint was "without factual basis" will satisfy the provisions of Rule 2130 and should permit the expungement to go without NASD opposition.

Since uncontested expungement actions cost money and take time, why should the broker and firm report the customer's complaint at all? After all, it'll get expunged anyway if the customer doesn't follow through with a claim in arbitration. If there is an arbitration claim, it has to be reported under a different question, 14I(1), of Form U-4. So why bother? Just wait and see if you have to answer question 14I(1) and forget about reporting complaints on 14I(3).

Obviously, this behavior is wrong. But it is a low risk, high return, profit-maximizing choice. NASD enforcement of 14I(3) violations is virtually nonexistent. Even if the firm is caught, the penalties are negligible—generally less than the legal fees and the broker's lost production expended in formal expungement proceedings.

Protecting Producers Vs. Protecting Investors

A useful way to view the expungement question is as a choice of which mistakes are worse—Type I or Type II errors.

Type I: Accurate information about a broker or firm that was improperly expunged

Type II: Inaccurate information about a broker or firm that was unfairly retained without an adequate mechanism for correcting or removing it

From the perspective of securities industry members, it is clearly preferable to eliminate Type II errors. If a bad broker undeservingly gets a clean record, that's better than a good broker getting hurt by something false.

From the perspective of public protection, however, the scale is reversed. The NASD's and the state securities administrators' responsibilities under the securities laws require subordinating individual brokers' or firms' interests to the public welfare. Type II errors are less bad than Type I errors that can put the public in jeopardy.

A bad representative or brokerage firm can do enormous damage to many people. A bad representative or brokerage firm that was able to continue preying on the public because adverse information was wiped off their record is enough to show that such expungement cannot

---

[71] Question 14I(3) of Form U-4, ver. 2002, requires disclosure of investment related, customer initiated written complaints alleging sales practice violations and damages of at least $5,000, or theft, forgery, misappropriation, or conversion. Current Forms U-4, U-5, BD, BDW, and associated instructions are available on the NASDR website at http://www.nasdr.com/3420d_adopted.asp.

be permitted.

Such examples abound. PIABA members all too frequently see recidivists with cleansed records. *Forbes* magazine reported on one such repeat-victimizer and the huge harm caused to the public:

> Investors in the last seven years have lost some $125 million in a Ponzi scheme allegedly conducted in part by brokers registered with a small California firm headed by Carl Martellaro. What many of those investors didn't know—in fact, couldn't know—was that Martellaro himself had been accused in a similar scheme five years ago. Then, two investors filed complaints claiming they had lost $1.75 million in investments with First Associated Securities Group, of which Martellaro was president. Why didn't investors know that? Because the information had been expunged - legally - from records of the [NASD]. Martellaro's attorney ... had offered to settle the earlier cases only if the investors allowed them to be deleted from Martellaro's record with the NASD.[72]

There is no justification for a system that allows such predators to continue operating. Type I errors of expunging genuine information and leaving the public at risk are far more objectionable than Type II mistakes.

NASD's "Balancing" Is Misguided

The NASD's rule filing and press release speak several times of trying to "balance" the interests of the public and securities regulators with brokers' interests. It claims that its duty as operator of the CRD

> requires the NASD to balance three competing interests: (1) the interests of NASD, the states, and other regulators in retaining broad access to customer dispute information to fulfill their regulatory responsibilities and investor protection obligations; (2) the interests of the brokerage community and others in a fair process that recognizes their stake in protecting their reputations and permits expungement from the CRD system when appropriate; and (3) the interests of investors in having access to accurate and meaningful information about brokers with whom they conduct, or may conduct, business.

This is fallacious. NASD's scale is out of whack.

There is no question that brokers deserve a fair process. However, expungement is not the proper way to achieve it. In seeking to satisfy the brokerage community, the NASD forgets that its statutory mandate is *investor protection*. The SEC recites constantly that the NASD's rules must "be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, and, in general, to protect investors and the public interest."[73] Properly viewed, there can be no "balancing" act – the NASD's task in operating the CRD is to protect investors and the public interest. All other considerations must be subordinated to that responsibility.

> The bottom line is expungement is not required. The danger of expunging information which would benefit investors clearly offsets any detriment that a broker may suffer because the broker does not like the disclosure. The purpose of the CRD system is to protect the investing public. The function of NASDR in administering the system is to protect the investing public. Its objective should not be to protect the broker. Stockbrokers work in an extremely sensitive area, obtaining control over investors' personal assets, and the more information the investor can get about the broker, the better.[74]

The current rule is adequate to protect the CRD and public investors, as long as claimants' counsel understand and follow their legal and ethical duties.

Whitewashing Is Wrong

Is expungement a proper corrective

____

[72] Michael Freedman, *The X-ed Out Files*, Fobes, Dec. 25, 2000, http://www.forbes.com/fobes/2000/1225/6616280a.html.

[73] E.g., Release No. 34-42402, 71 S.E.C. Docket 1483, *supra* note 11, citing Securities Exchange Act § 15A(b)(6).

[74] Laurence S. Schultz, Letter to Richard E. Pullano, NASDR, July 28, 2000. 5 U.S.C. 78o-3(b)(6).

solution for CRD errors? Despite militant advocacy from the SIA and the NASD's persistence in trying to create a framework that will satisfy the industry, a convincing case for expungement has not been presented.

Any kind of system that creates the possibility for respondents to strong-arm claimants in settlement negotiations is clearly beyond the pale. A system that gives respondents powerful incentives, as the proposed Rule 2130 does, to convert arbitration into federal style litigation—minus due process protections and the learnèd judge on the bench—should also be condemned.

We can again look to the public court system and the rights of ordinary citizens for guidance. As we've observed, citizens have no ability to "expunge" the historical facts of civil lawsuits that were filed against them, no matter how frivolous or vexatious the claim may have been. Why should stockbrokers—alone among American citizenry—be able to change public records to whitewash their personal history? No other person can do that in civil matters.

The purpose of CRD is to provide and preserve information, not to conceal or whitewash it. It is preposterous to imagine someone going to the Clerk of the Court and asking the court to expunge the fact that they were sued for things they did in their professional capacity.

Court records are open for full public inspection. This is a significant difference between the CRD and other public records. The public is not limited to reading a brief self-serving obfuscatory summary prepared by the defendant. "The public's right of access ... envisions a pervasive common law right to inspect and copy public records and documents, including judicial records and documents."[75] Interested persons—including the press—can study the underlying documents, including the pleadings, moving papers, affidavits, and other items in the record. If someone (a doctor, a lawyer, for example) has a blot on their record in the form of a lawsuit by an unhappy client, the public record contains full details. If the claim is frivolous or harassing, that point will be made in abundance in the record.

There are extremely valuable reasons for public access that the SROs as arbitration forum sponsors should seriously consider. SRO arbitration would improve immeasurably as a genuine socially responsible dispute resolution system if these fundamental principles were heeded.

> [T]he right of access strengthens confidence in the courts: The public's exercise of its common law access right in civil cases promotes public confidence in the judicial system by enhancing testimonial trustworthiness and the quality of justice dispensed by the court. As with other branches of government, the bright light cast upon the judicial process by public observation diminishes possibilities for injustice, incompetence, perjury, and fraud. Furthermore, the very openness of the process should provide the public with a more complete understanding of the judicial system and a better perception of its fairness. In addition, access to civil proceedings and records promotes public respect for the judicial process and helps assure that judges perform their duties in an honest and informed manner.[76]

In contrast to normal public records, investors examining the CRD know only that a complaint was filed. They do not know any of the genuine details, nor do they have any means of ascertaining the quality and seriousness or frivolousness of the claims. This, too, is a self-inflicted problem created by the securities industry, by insisting that all disputes by resolved by arbitration and by refusing to make arbitration pleadings and related documents available for investors to examine.

By compelling arbitration, the securities industry successfully hides almost all evidence of its misconduct from the public record and public inspection. That secrecy is incalculably valuable to the industry. It has no right to ask for yet more exceptions to fundamental American principles by demanding to be able to rewrite history in its own favor.

The industry has already determined that keeping secret all but the iceberg's tip of its wrongful conduct is more important than giving public access to documents correcting or explaining the occasional mistakes that may appear in the CRD records of individual members or associated persons. Having thus created a system that already gives it enormous benefits at the expense of investor protection, the securities

---

[75] *In re Cednat Corp.*, 260 F. 3d 183,192 (3rd Cir. 2001) (internal quote marks omitted)..

[76] *Id.* (Internal quote marks and citations omitted).

industry is not entitled to yet another exceptional procedure of unwriting history, whitewashing employees' records, and allowing bad brokers and members to continue to prey on an unsuspecting public.

LEGAL ETHICS: JUST SAY "NO"!

Expungement is not and should never be a bargaining chip in settlement. Unable to get expungement under the existing NASAA criterion of "factual impossibility", the brokerage industry has taken matters privately into its own hands and for a number of years has been abusing the issue of expungement by using it as a settlement demand.

Both the sole standard at present (factual impossibility) and the proposed criteria (no factual basis, unable to state a claim or frivolous claim, defamatory filing) show clearly that your decision is not a matter of business negotiation, but instead one of professional responsibility. A decision regarding expungement is not your client's—it's yours. If the currently proposed criteria are adopted, your answer must be **NO** unless the situation meets one of those criteria. Until then, your answer must be **NO** unless it satisfies the standard of "factual impossibility."

Ethical and professional responsibility considerations prevent expungement from even getting to the settlement table just as surely as they prevent demands or agreements to limit lawyers' future practice.[77] Lawyers who say that they'll negotiate over expungement because they're hired to represent their client, not the investing public, are missing that essential point. It's not a question of "getting the best deal for your client" – the issues are much bigger than that.

Unless you have made a genuine mistake, you must not agree to an expungement in settlement, since it means you agree that the claim was baseless, unmeritorious, even frivolous, *ab initio*. This is not the client's decision—it is yours as the lawyer. You signed the pleading, and in doing so you warranted that the allegations were well-founded in fact and law and that the complaint was not presented for an improper purpose. If you did not have adequate basis for that belief, you would rightly be subject to sanctions and/or discipline.

If you did not file a frivolous, meritless, baseless claim, you cannot agree to expunge in settlement. To expunge the record means that you now believe, and are willing to state under oath, that the broker did nothing wrong and that your complaint against him was totally improper. That would be a lie and an ethics violation. As we saw above, the NASD or the respondents may ask you for such a sworn declaration that can end up being presented to a court.
Moreover, the lie is not just between the parties—you would be lying to the court. There is never an excuse for that.

Further, as long as you cannot state, under oath, that your original claim was wholly without merit, by agreeing to an expungement you are falsifying a public record. As we saw above, any claimant's counsel who grants such an affidavit or permits respondents' counsel to make such representations on her behalf commits a fraud on the court, violates the rule requiring candor toward the tribunal, and participates in a conspiracy to falsify or tamper with public records. Perjury carries civil and criminal penalties, as does tampering with public records. No lawyer who values his or her liberty, property, ethical obligations, and license to practice law can participate in such a scheme.

If perjury and tampering with public records weren't enough, remember that federal and state regulators use the CRD as their primary source of information about registered persons. Filing false information or submitting documents with material omissions to the CRD is a federal crime. Individuals deliberately submitting inaccurate information have been criminally prosecuted for federal mail fraud, 18 U.S.C. § 1341, and for making a false statement to government, 18 U.S.C. § 1001.[78] Do you really want to lie on behalf of the

———————

[77] Compare your state's version of ABA Model Rule 5.6.

[78] *U.S. v. Turner,* 22 Fed.Appx. 404, 2001 WL 1216987 (6th Cir. 2001). Sixth Circuit rules permit citing unpublished opinions if a party believes that it "has precedential value in relation to a material issue in a case, and that there is not published opinion that would serve as well...." U.S.Ct. Of App. 6th Cir. Rule 28(g), 28 U.S.C.

respondent broker and expose yourself to such penalties?

Under no stretch of any imagination can such behavior be justified or condoned. A lawyer's responsibility to advocate zealously for his client does not permit him to step outside the bounds of the law.[79]

> Attorneys are officers of the court and their first duty is to the administration of justice. Whenever an attorney's duties to his client conflict with those he owes to the public as an officer of the court, he must give precedence to his duty to the public. Any other view would run counter to a principled system of justice.[80]

No amount of self-delusion to encourage settlement will suffice to change that reality.

These obligations make the decision easy—it's out of your hands, and out of your clients' hands. We cannot agree to acts that are illegal or contrary to the rules of professional conduct.

Another consideration should also give pause, though if violating your professional responsibilities and participating in criminal acts don't worry you, this won't either. By agreeing to an unmerited expungement, you will be lying to the entire investing public of America. You would be telling them—falsely—that the complaint you signed against this broker was meritless, and that they can confidently make a decision to invest with him knowing that your earlier allegations were so baseless that they deserved to be wiped off the record.

You know that's not true, the broker knows it, his lawyer knows it, and the firm knows it. But the innocent folks out there that you'd be lying to don't know it. How will you feel when they are hurt by your deception? And if you're inclined to say that you're not hired to represent the public, remember the lives and savings that have been wrecked by brokers like Carl Martellaro. Think of your own clients, put a face to the hurt, and realize that you may have enabled it.

When respondents come demanding expungement, JUST SAY NO!

———————————

[79] See *State v. Turner*, 217 Kan. 574, 538 P.2d 966, 87 A.L.R.3d 337 (Kan. 1975); *Hitch v. Pima County Superior Court*, 146 Ariz. 588, 708 P.2d 72 (Ariz. 1985); *State ex rel. Oklahoma Bar Ass'n v. Tweedy*, 52 P.3d 1003 (Okla. 2000). The duty of the lawyer as an advocate is to represent his client "zealously within the bounds of the law." C.P.R. Canon 7. We are not discussing conscientious civil disobedience here, but note that even in such cases, the lawyer cannot act with impunity but must be prepared to accept the legal consequences of his acts.

[80] *Van Berkel v. Fox Farm and Road Machinery*, 581 F.Supp. 1248, 1251 (D.Minn. 1984), citing *Theard v. U.S.*, 354 U.S. 278, 281 (1957).

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

Supreme Court

Howsam v. Dean Witter
Case No. 01-800
(U.S. Supreme Court
Dec. 10, 2002)

Arbitrators, not courts, are to decide 6 year "eligibility rule" issues

Second Circuit

Decicco, *et al* v. Colombo
2002 U.S. Dist. LEXIS 23008
(S.D.N.Y. Nov. 25, 2002)

Plaintiffs moved to vacate arbitration award on the grounds that arbitrators had manifestly disregarded the law regarding the statute of limitations. Court refused to vacate award, reasoning that, because the arbitrators had considered plaintiffs' motion to dismiss on statute of limitations grounds and denied it, the court believed that the issue had been fully and fairly considered by the arbitration panel, and, therefore, plaintiffs had failed to meet the high burden iimposed under a "manifest disregard" challenge.

Third Circuit

In re Teu Holdings
2002 Bankr. LEXIS 1539
(D. Del. Nov. 1, 2002)

Court will enforce the arbitration clauses to the extent that they are enforceable since the claims involve non-core matters and enforcement of such clauses will not subvert any provisions or underlying policies of the Bankruptcy Code

Sixth Circuit

Javich v. First Union Securities, Inc.
Case No. 02-3352 - 3355
(6th Cir. Jan. 10, 2003)

An appointed receiver has asserted claims belonging to receivership entities, and is bound to arbitration agreements to the same extent that those entities would have been absent his appointment as receiver.

Cohen v. J.B. Oxford & Co.
2002 U.S. Dist. LEXIS 21177
(S.D. Ohio Oct. 9, 2002)

Petitioner, a receiver, initiated a NASD arbitration against several securities companies; most of those parties were dismissed or settled. The remaining dispute was between respondent clearing broker and the receiver over an arbitration award against the broker. The receiver sought an order confirming the award. The broker moved to vacate the award.

Receiver argued the standard of review of an arbitration award was narrow and codified under the Federal Arbitration Act, 9 U.S.C.S. § 10(a). The broker instead challenged on the standard of "manifest disregard of the law," arguing it was a clearing broker, and as such, had no contact with clients and therefore no fiduciary duties to the introducing broker's customers. The court found substantial evidence to support the arbitration award; the arbitrators did not manifestly disregard the law. The arbitrators relied, on credible testimony from the receiver's expert, who stated he had never seen a case where a clearing broker had as much knowledge, gave as much material assistance and participated as actively in a fraud as here. Court further found support for award of punitive damages under Ohio law when wrongdoing is "particularly gross or egregious," and that J.B. Oxford could not avail itself

of the "ostrich defense" to escape liability for punitive damages.

Seventh Circuit

Press v. Raether
2002 U.S. Dist. LEXIS 19586
(E.D. Wis. Sept. 27, 2002)

Plaintiff, part owner of a company which provided managerial services to NASD member firm, considered an "associated person" of member firm for the purposes of compelling arbitration of claim against him, because his day-to-day involvement in the management of the firm caused him to "occupy a similar status" to that of a "partner, officer, director, or branch manager" of the member firm for the purposes of the NASD By-Laws, particularly since Plaintiff had signed a U-4 years before. Court also held that, because the Statement of Claim pleaded that the member firm's actions toward them were part of a larger "boiler room" operation created and encouraged by Plaintiff and others, the claim "arose in connection with " Plaintiff's activities as an "associated person."

Stone v. Doerge, *et al*
2002 U.S. Dist. LEXIS 19568
(N.D. Ill. Oct. 15, 2002)

Defendant served as the introducing broker for two accounts which were maintained by and cleared through Bear Stearns. Each account agreement mandated arbitration of controversies arising between the trustee and any entity or any broker for which Bear Stearns acted as clearing agent, among other things. Although it was clear that the account agreements included a valid agreement to arbitrate, the parties disputed whether the agreement to arbitrate applied to the underlying controversy that gave rise to the instant lawsuit. Based on the language of the arbitration provision, the court could not conclude that the parties intended to arbitrate disputes not involving the Bear Stearns or disputes where Bear Stearns did not maintain accounts and did not act as clearing agent. According to Defendants, because they were broker for which Bear Stearns acted as clearing agent, all disputes of any kind between the trustee and defendant company were subject to arbitration under the account agreements. The court rejected such an expansive reading of the arbitration provision.

Ryan Beck & Co. v. Campbell
2002 U.S. Dist. LEXIS 23110
(N.D. Ill. Nov. 26, 2002)

Customer's arbitration against Ryan Beck on "successor liability" grounds enjoined. Good discussion of successor liability.

Olson v. Wexford Clearing Services
2002 U.S. Dist. LEXIS 24988
(N.D. Ill. Dec. 31, 2002)

Losing investor in arbitration filed motion to vacate under Section 10 of the FAA more than 3 months after arbitration dismissed. Investor argued that the arbitrators' ruling dismissing his claims were not "final," in part because the investor filed with the arbitrators a motion for leave to file a Second Amended Statement of Claim after the arbitrators had dismissed the claim, and the 3 month limitation under the FAA was tolled by that filing. Court rejected investor's arguments and confirmed arbitration award dismissing claims.

Ninth Circuit

SEC v. J.T. Wallenbrock & Assoc., *et al*
Case No. 02-55481
(9th Cir. Dec. 12, 2002)

Interlocutory appeal involving question of whether 90 day promissory notes ostensibly secured by accounts receivable of Malaysian latex glove manufacturers. Court affirms C.D. California's ruling that, under the *Reves* test, the subject notes were securities.

Tenth Circuit

In re Freddie L. Hooks
2002 Bankr. LEXIS 1322
(W.D. Okla. Sept. 5, 2002)

Non-securities case. Brief but good discussion of the circumstances under which a bankruptcy court can compel "core" proceedings to arbitration.

Eleventh Circuit

CFTC v.
R.J. Fitzgerald & Co
No. 01-14780
(11th Cir. Oct. 29, 2002)

District Court erred in finding that defendant's TV commercial and seminar did not violate the Commodities Exchange Act, as both were deceptive and misleading, unquestionably material to the potential customer, and promulgated with the requisite scienter. These solicitation devices also violated the Act because they failed to disclose extremely material information that any reasonable investor would want to know before committing money.

Horner, Townsend & Kent v. Hamilton
2002 U.S. Dist. LEXIS 21033
(N.D. Ga. Aug. 6, 2002)

Although Plaintiff BD denied the existence of an arbitration agreement between itself and customers of one of its registered representatives in this "selling away" case (ETS Payphones), the broker-dealer was not able to satisfy the 2nd "prong" of the "two prong test" utilized in the 11th Circuit to determine arbitrability

by producing evidence to support its claim that the investors were not "customers" of its registered represenative. Court denied Plaintiff's motion to enjoin the arbitration instituted by the customers and granted the customers' motion to compel arbitration.

Goff Group v.
Greenwich Insurance Co.
2002 U.S. Dist. LEXIS 21521
(M.D. Ala. Oct. 30, 2002)

Non-securities case. Relying heavily on the Supreme Court's reasoning in *Mastruobono*, court finds that choice of law and venue provision in contract providing for the resolution of disputes in state or federal court in Pennsylvania did not negate the mandatory arbitration provision in the same contract, particularly in light of the strong presumption in favor of arbitrability under the FAA.

STATE COURTS

California

Garcia v. Directv, Inc.
No. B158570
(Cal.App. Dist.2 12/11/2002)(Unpublished)

Discussion of whether, and under what circumstances, the Federal Arbitration Act preempts California law allowing classwide arbitration.

Delaware

Parfi Holding AB, *et al* v.
Mirror Image Internet, *et al*
C.A. No. 18507
(Delaware Supreme Court, 11/27/02)

An arbitration clause, no matter how broadly construed, can extend only so far as the series of obligations set forth in the underlying agreement. Arbitration clauses should be applied only to claims that bear on the duties and obligations under the agreement.

Florida

Summit Brokerage v. Cooksley
No. CA 02-11137 AO
(Fla. Circuit Court, Palm Beach County, 11/1/02).

Notwithstanding that Claimant never had account with brokerage firm in this "selling away" case, because he purchased securities from registered representative of BD, Claimant was a "customer" of BD for the purposes of demanding arbitration under NASD CAP Rule 10301(a).

Ohio

State ex rel Cincinnati Enquirer v. Joyce, Commr.
97 Ohio St.3d 192,
777 N.E.2d 253
(Ohio 11/06/2002)

Discussion of when, and under what circumstances, investor complaints filed with the Ohio Division of Securities must be released to the public and the press.

Oklahoma

Clark v. Clark
2002 OK CIV APP 96
(Okla.App. 10/18/2002)

Confirmation of arbitration award in favor of Merrill Lynch reversed. Plaintiff/Appellant, a residuary beneficiary of a trust, was not bound by an arbitration agreement signed by the Trustee which Plaintiff did not agree to and had no knowledge of.

Texas

Caldwell v. State
No. 01-01-00895-CR
(Tex.App. Dist.1 12/12/2002)

Discussion of whether a "rice for diamonds exchange Ponzi scheme constituted a "security" within the meaning of the Texas Securities Act.

SEC ADMINISTRATIVE PROCEEDINGS

In the Matter of
Frank Thomas Devine
Admin. Proc. File No. 3-10518
1934 Act Release No. 46746
2002 SEC LEXIS 2780
(Oct. 30, 2002)

Promissory notes from which proceeds were purportedly to be used to purchase viatical interests deemed to be "securities" within meaning of the federal securities laws. SEC sustains NASD imposition of sanctions against Devine for "selling away" without prior permission of firm.

In the Matter of
Edgar M. Reed
Admin. Proc. File No. 3-10919
1940 Act Release No. 25786
2002 SEC LEXIS 2723
(Oct. 25, 2002)

Chief Investment Officer of registered investment advisor sanctioned for aiding, abetting and causing violations of Rule 17a-7 by engaging in a series of prohibited "cross trades" and mismarking order tickets.

SEC v. Michael Rivers & Thomas Hall
Lit. Release No. 17828
2002 SEC LEXIS 2809
(D. Minn. Nov. 5, 2002)

Individuals sanctioned for "marking the close" market manipulation scheme and US Bancorp Piper Jaffray fined $100,000 and required to create a marking the close exception [*4] report, and to create at least eight District Sales Supervisors to replace the single position previously responsible for supervising "producing" branch managers.

In the Matter of
Steven J. Erlsten, *et al*
Admin. Proc. File No. 3-10033
Initial Decisions Release No. 217
(Nov. 8, 2002 - Slip Opinion)

Individuals sanctioned for violating Section 17a of the 33 Act and Section 10b of the 34 Act failing to advise customers that they were receiving payments from stock promotion firm to recommend securities. Detailed discussion of the concepts of "materiality," "in connection with" and "scienter" under the federal securities laws.

In the Matter of
FXC Investors Corp.
Admin. Proc. File No. 3-10625
Initial Decisions Release No. 218
2002 SEC LEXIS 3168
(Dec. 9, 2002)

Registered Investment Advisor and its President violated multiple sections of the Investment Advisers Act by distributing misleading historical performance information to services which it knew would distribute the information to institutional investors and the press and for distributing misleading marketing materials to the investing public. Detailed discussion of the elements of "aiding and abetting and causing" violations of the IA Act of 1940 and the precedential force and effect of prior SEC settlements, no-action letters, speeches by commission members and default orders.

In the Matter of
Michael F. Flanagan
Admin. Proc. File No. 3-10530
2003 SEC LEXIS 40
Jan. 8, 2003)

Individual who served as president, chief operating officer, and principal of member firm violated NASD registration rule by permitting representatives who were not registered with his member firm to solicit and confirm indications of interest in an initial public offering of securities, and violated NASD discretionary trading rule by executing customer trades in aftermarket following instructions of representatives of another member firm, without customers' written authorization to act at the direction of such representatives. Held, Association's findings of violations, sanctions and hearing costs it imposed are sustained.

AROUND THE SROs

NASDR

Notices to Members

02-85 NASD Requires Immediate Member Firm Action Regarding Mutual Fund Purchases and Breakpoint

02-74 NASD Requests Comment on its Public Information Review Initiative

National Adjudicatory Council Decisions

Dept. of Enforcement v. Pacific On-Line
Trading & Securities
Disciplinary Proceeding No.
C01000037 (Nov. 27, 2002)

Respondents failed to file Pacific On-Line's Internet website with NASD as advertising material when Pacific On-Line became an NASD member in violation of NASD Conduct Rule 2210. Additionally, the website omitted material information concerning the risks of day-trading and contained misleading communications, in violation of NASD Conduct Rule 2210.

Dept. of Market Regulation
v. Ko Securities, Inc.
Disciplinary Proceeding No.
CMS000142
(Nov. 13, 2002)

Respondents effected short sales without making and annotating the affirmative determinations required for each short sale. Respondent firm also failed to maintain a record of the terms and conditions, time of entry, and time of execution of each transaction.

NYSE

Information Memos

02-65 Amendments to NYSE Arbitration Rules, including 601, 607 & 629 (increasing ceiling on claims eligible for simplified arbitration from $10,000 to $25,000) and Rule 617 (increasing maximum adjournment from $1,000 to $1,500).

02-53 Waiver of California Ethics Rules for Arbitrators

02-51 SEC approves amendments to NYSE Rule 342 ("Offices-Approval, Supervisions and Control") that recognize the NASD's General Securities Principal Examination (Series 24) as an acceptable qualification alternative to the General Securities Sales Supervisor Qualification Examination (Series 9/10) for supervisory persons whose duties do not include the supervision of options or municipal securities sales activity.

Hearing Panel Decisions

A.G. Edwards & Sons
No. 02-156 (Oct. 2, 2002)

Violated Rule 342 by failing to maintain appropriate procedures for supervision and control; recommended and sold unsuitable securities; made misrepresentations and/or omitted to dislcose materials facts in connection with the sale of securities; violated Rule 410 by effecting account designation changes without prior written authorizations; violated Rule 405(2) by failing to supervise diligently accounts handled by registered representatives; violated Rules 405 and 401 by failing to use due diligence to learn essential facts relative to customer accounts; violated Rules 401 and 440 and SEC Rules 17a-3 and a-4 by failing to make and preserve required and timely records. Consent to censure.

Involved inappropriate sales of "Callable Cds" between 1996 and 2000; failure to maintain accurate customer account information; employee trading of securities on Firm research department's restricted securities list; allowing producing BOMs to review and approve their own correspondence and communications with the public, account designation chages and order errors; and failed to prevent statutorily disqualified individuals from associating with the firm.

Sutro & Co., Inc.
No. 02-215

Fined $75,000 for, among other things, allowing person who had not passed the Compliance Official Qualification Exam (Series 10) to act as Compliance Director for a year and allowing unregistered persons to act in capacities for which registration was required.

Tucker Anthony, Inc.
02-216

Now a part of Dain Rauscher, Tucker Anthony found in violation of: Rule 342 by failing to reasonably supervise and control the actions of its floor brokers and failing to establish and maintain appropriae procedures for supervision and review; and, Rule 410 and 440 and SEC Rules 17a-3 and a-4 for failure to maintain copies of order tickets for certain "cross-trades" effected during 1999-2000 and failure to produce certain "error account notices."

Deutshce Bank Securities
Goldman Sachs
Morgan Stanley DW, Inc.
Salomon Smith Barney
US Bancorp Piper Jaffray
02-223

Member firms sanctioned and fined for violations of Rule 440, §17(a) of the '34 Act and SEC Rule 17a-4 for failure to maintain copies of e-mail communications.

Merrill Lynch
02-228

Violated Rule 346(f) by having 23 persons associated with the firm that were subject to statutory due to criminal convictions; Violated Rule 351(a)(9) by failing to promptly report its association with persons subject to a statutory disqualification; and violated Rule 342 by failing to provide for, establish, and maintain adequate procedures to ensure compliance with NYSE rules and federal securities laws relating to the employment of statutorily disqualified individuals. Merrill had been sanctioned for this very same thing back in June of 2000, and the NYSE found them to have failed to implement appropriate system of follow-up and review to prevent this from happening again. Merrill fined $300,000 and ordered to hire outside consultant to design appropriate system and file report evidencing implementation of and compliance with the consultant's system.

Announcements From The PIABA Office

Office Staff:

Robin S. Ringo, Exec. Director
rsringo@piaba.org

Karrie Ferguson, Office Assistant
kferguson@piaba.org

Josh Edge, Website
joshedge@piaba.org

2241 W. Lindsey St., Ste. 500
Norman, OK 73069
Toll Free: 1.888.621.7484
Office: 1.405.360.8776
Fax: 1.405.360.2063
E-Mail: piaba@piaba.org
Website: www.PIABA.org

Upcoming Events:

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 Fall 2002 issue of *PIABA Bar Journal*)

James Michael Abernethy	(480) 596-1986
Hugh Berkson	(216) 781-5515
Adam Bond	(508) 946-1212
Daniel T. Brier	(570) 342-6100
Gerald Clay	(808) 535-8400
Philip Feldman	(305) 770-0003
Joel D. Feldman	(215) 735-3716
Stuart E. Finer	(315) 735-7509
William Garvin	(850) 422-3400
Frank V. Ghiselli	(713) 623-4220
Gregory Good	(520) 628-8221
Andrew C. Hall	(305) 374-5030
James D. Hartt	(602) 468-6450
Jeffrey Hellman	(203) 368-4234
Val Hornstein	(415) 454-1490
Carla T. Hurlbert	(804) 285-1941
Philip Isley	(919) 833-7373
B. David Jarashow	(973) 735-0565
Robert T. Kelly, Jr.	(570) 342-6100
Michael Lynch	(708) 352-9600
Joseph Matricciani	(410) 828-8787
Ken Miller	(310) 394-4747
Thomas J. Momjian	(610) 667-6800
Bertrand C. Moser	(713) 807-7455
Jerrold Parker	(516) 466-6500
Robert Pearl	(585) 454-7550
Thomas D. Pigott	(419) 776-4567
Claude Ramer	(865) 694-6148
David Rudolf	(919) 967-4900
Robert F. Saint-Aubin	(775) 329-5505
William Martin Seiler	(901) 843-7688
Gary Shipman	(910) 762-1990
Kenneth Shore	(214) 292-2600
Perry Shuttlesworth	(205) 322-1411
Marvin L. Szymkowicz	(301) 951-9191
Ronald H. Thrash	(713) 227-2400
Christopher Harold Tovar	(713) 227-2400
N. James Turner	(407) 422-6464
John Van Gorder	(516) 798-1503
Sol H. Weiss	(215) 735-2098
Richard West	(973) 847-5936
Mitchell Wexler	(312) 474-1000
Michael J. Willner	(215) 864-2800