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The P I A B A Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

September 1997 Volume 4 Number 3

In This Issue...

The PIABA Quarterly
The Newsletter of the Public Investors Arbitration Bar Association
September, 1997
Volume 4 Number 3

Editor's Notes

This issue of the *Quarterly* contains the second half of Tim O'Connor's article on SEC Decisions as Precedent in Arbitration.

The deadline for receiving submissions for the December 1997 issue of the Quarterly is December 5, 1997. All submissions, regardless of length, should be accompanied by a computer disk of the submitted material saved in either Word Perfect or as a text file.

Please send change of address information to Robin Ringo, 1111 Wylie Road, #18, Norman, OK 73069, Phone (888) 621-7484, E-mail: PIABA@mindspring.com.

Letter From the President

Rosemary Shockman SHOCKMAN & MCKEEGAN, P.C.
Scottsdale, Arizona

Dear Colleagues:

The NASD has submitted the proposed eligibility and fee increased rules to the SEC. PIABA has filed comments on the fee increase and anticipates filing comments on eligibility soon.

You will be receiving a letter form PIABA shortly urging your participation in the comment process.

On July 23, I met in Denver with Linda Fienberg and Deborah Masucci to discuss issues of concern to PIABA members. Boyd Page and Diane Nygaard participated by telephone. Lengthy discussions

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were held about our annoyance with the Statement of Claim "screenings" being conducted by non-attorney NASD claims personnel. These "inquiries" are routinely resulting in delays of service. Some claim that personnel has inappropriately questioned the substantive sufficiency of pleadings.

We anticipate NASD's response on this issue this fall.

Rosemary J. Shockman

From the Professor

By Joseph C. Long

As all PIABA members should know the NASD requires all arbitrators to undergo training before they can sit. During this training, the prospective arbitrators are given a number of publications to use as training aids and later as references during arbitration. There are three current publications being used. The first is the Arbitrators' Reference Guide, an undated pamphlet of some 29 pages. This reference consists largely of check lists, information sheets, and a shell award form.

The second is the Panel Member Participant's Guide. The current version of this Guide is forty-two pages long and dated November 1996. It is essentially a training document to be used in conjunction with the training presentation.

The final document is the Panel Member Course Preparation Guide. Again the current version is dated November 1996, but there has been an indication from the NASD Staff that the Preparation Guide will shortly be revised again. The Preparation Guide is a 225 page handbook for the arbitrators covering topics from discovery and running the hearing to deciding the case and calculating awards.

These last two topics, deciding the case and calculating the award, are of particular interest. The Preparation Guide purports to give the arbitrators a general outline of the applicable substantive law in these areas. Thus, the NASD is pre-conditioning the arbitrators as to what it thinks the law is or should be. This practice is insidious for three reasons. First, the NASD is pre-conditioning the arbitrators as to what it believes the law is before the parties get to make their presentation. Second, unless the claimants have obtained access to the Preparation Guide[1] and reviewed it, the claimant will not know that the pre-conditioning has taken place. Finally, the form and language of the Preparation Guide is such that arbitrators more than likely will consult it during deliberations to resolve disputed questions of law rather than making reference to the briefs or arguments of counsel. The Preparation Guide is presented as a neutral, independent statement of the substantive law. In fact, as will be seen below, the Guide, at least in a number of areas is not neutral, but favors the broker's view of the law.

Therefore, each claimant needs to be aware what this Preparation Guide says about a number of critical substantive issues. To be fair to the Preparation Guide, there are a number of items which are fairly and accurately presented and are worth pointing out to the arbitrators.

For example, there is a very interesting discussion of the arbitrator's duty which members may want to consider including in their closing argument. The Preparation Guide first discusses the arbitrators' duty to follow the law. It states: "As arbitrators, you are not strictly bound by legal precedent or statutory law. However, it's important that you not manifestly disregard the law."[2] The Guide then continues, saying: "If you show a manifest disregard for the

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law, your award may be vacated. In other words, if the parties have provided the panel with the law, the law is clear, and it applies to the facts of the case, do not disregard it."[3] Finally, the Guide emphasizes: "It is not the arbitrator's role to change the law; but to apply it. If you do not feel you can rule impartially on this issue, you should recuse yourself."[4]

These quotations illustrate two major points of difference between arbitration and a court proceeding which must always be kept in mind. First, while arbitrators are bound to follow the law, **if it is clear**, they, however, have wide leeway where the law is not clearly settled. Second, a proceedings to vacate an arbitration award is not an appeal. The court may not vacate an award merely because the arbitrators, in the opinion of the court, misapplied the law.[5]

These points are well illustrated by the opinions in **Skurnick v. Ainsworth**[6] and **Ainsworth v. Skurnick.**[7] The arbitrators found a registration violation of the Florida Securities Act, but then held that the plaintiff had suffered no damage and refused to make a monetary award. Upon a motion to vacate, the federal district court remanded the case to the arbitrators for clarification, indicating to them that if a registration violation was found the awarding of damages was mandatory. The arbitrators clarified that they had not found a registration, but again concluded that the plaintiff had suffered no damage and refused to enter a monetary award. An appeal was taken to the Eleventh Circuit. Since the issue of whether an award of statutory damages was mandatory under the Florida Securities Act was a matter of state law, the Eleventh Circuit certified the issue to the Florida Supreme Court. That Court, in **Skurnick I**, held that once a finding of a registration violation was found, an award statutory damages was mandatory.

The Eleventh Circuit then in **Skurnick II** vacated the arbitration award. However, in doing so, the court made clear that it could not do so where the arbitrators merely misinterpreted or misunderstood the law. Thus, a vacation proceedings is not like a normal appeal where the appellate court can correct mistakes of law. Instead the court followed the traditional analysis that the arbitrators must know what the law is and arbitrarily or capriously disregard the established law.[8]

Thus, in order for a claimant to have a reasonable chance of having an award vacated, his attorney must be sure to make two things clear to the arbitration panel. First, the attorney must outline clearly the elements of each of claimant's causes of action. Second, he must make clear to the panel that to find a violation and not to make an award, even when the violation may be considered a technical one such as non-registration, will constitute manifest disregard of the law.

The tendency is to neglect the first requirement. Many lawyers feel that an arbitration is won or lost on the facts and sympathy that can be engendered for the client. Certainly, these factors are important as they are in any law suit. But the panel needs to be clearly instructed upon the law as well.

Because the arbitration panel already has been provided with the NASD Preparation Guide, if the claimant is not familiar with its contents, he may have already lost his case without realizing it. The Preparation Guide contains a number of inaccurate statements as to the substantive law which tend to favor the broker.

One example serve to illustrate the point. In the section on Determining Damages, the Preparation Guide states:

> Before considering the issue of damages, the panel must decide the issue of respondent culpability as the cause of the alleged loss. If the panel is satisfied by a preponderance of the evidence that the claimant has proven that the respondent's misconduct resulted in damages to the claimant, the panel should determine an appropriate award of damages.[9]

I would submit that this paragraph is an inaccurate statement as to the ability of a claimant to recover under Section 410 of the Uniform Securities Act for at least four or five different reasons.[10] First, I take issue with the use of the words "respondent culpability" and "respondent's misconduct". These words suggest greater fault than is required for recovery under Section 410. Section 410 (a) (1) allows recovery where (1) the securities are not registered or exempt; (2) the registered representative or broker-dealer employs a registered representative which is not registered in the state. Section 410 (a) (2), on the other hand, prohibits the making of material misrepresentations and omissions. At this stage, it is sufficient to merely show that the material misrepresentation or omission was made, not the state of mind of the person making it.

Second, I take issue with the idea that the misconduct must be "the cause of the alleged loss." Loss causation has never been an element for recovery under either Section 410 (a) (1) or (2). In the case of Section 410 (a) (1), it is sufficient that the securities or the security professionals were unregistered in the state.[11] For the purposes of Section 410 (a) (2), it is sufficient to show that there was a material misrepresentation or omission, not that it caused the claimant any loss.[12]

Third, damage or loss is not an element of recovery under Section 410. The remedy under Section 410 is rescission.[13] Thus, the claimant is entitled to rescind a purchase of a security merely because the securities or the professionals were unregistered or a material misstatement or omission made. **No loss has to be suffered.**

It is important to note that the right of rescission is given only to the claimant and not to the violator. Further, the claimant can exercise this right on a transaction by transaction basis. As a result, for example, in the case of a violation of Section 410 (a) (1) for non-registration of the registered representative in the state, the claimant may keep all transactions in which he made a profit or is presently showing a profit and rescind all transactions in which he suffered a loss or shows a current loss. **The broker or arbitrators are not entitled to "net the account"**, by offsetting gains on some transactions against losses on others.[14]

Fourth, I object to the suggestion that the claimant has the burden of proof as to the motive of the respondent. Under Section 410(a) (1), motive is entirely irrelevant. If the securities or the professional are not registered, then the claimant is entitled to rescind. The respondent does not need to know that he or the securities are not registered or that he or they need to be registered. In the case of Section 410 (a) (2), the claimant need only show that the material misrepresentation or omission is made. The respondent is then given the affirmative defense of showing that he could not know or, **in the exercise of reasonable care, could not know**, of misrepresentation or omission. This is an inverse negligence standard where the respondent has to prove himself free of negligence.

Finally, I object to the suggest that the arbitrators have any discretion in determining the amount of the award. As noted above Section 410 specifically provides what the award must be. If the securities are still owned, the claimant returns the securities and any income received thereon, and receives the return of al the consideration, including commissions, he paid for the securities.[15] If the securities are no longer owned, then the claimant is entitled to rescissional damages which the statute defines as the difference between the purchase price, less the price at which the securities were sold and any income received on the securities while held. As the **Skurnick** cases discussed above indicate, these statutory damages must be awarded, if a violation is found. Failure to do so constitutes an arbitrary and caprious act on the part of the arbitrations and the award may be set aside for manifest disregard of the law.

In order to preserve their right to vacate for manifest disregard, Claimants must be aware of the errors in the Course Preparation Guide. They should specifically point these errors out to the arbitrators and supply them with the correct law. Finally, they need to impress upon the arbitrators that a failure to follow the law as outlined will be manifest disregard of the law, resulting the award to being vacated.

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[1] The Guide does not appear to be generally available. It is given to persons taking the arbitrators' training course. It shows a purchase price of $50.00. However, it is not known whether a potential claimant or his counsel can purchase the Guide directly from the NASD.

[2] NASD Panel Member Course Preparation Guide 170 (Nov. 1996).

[3] Id.

[4] Id. at 171. Later the Guide reiterates this point when it states: "The panel must rule for claimant when the facts in the case meet all elements of a particular statute or regulation. You may not agree with the required elements . . . ; nevertheless you must apply the statute or regulation. When the law

is clear, follow it." Id. at 177.

"A decision to vacate upon [the basis of manifest disregard of the law] requires something beyond failure on the part of the arbitrator to understand or apply the law." **Brothman v. Sant Cassia Investment Management**, 1997 WL 401671 at *3 (S.D.N.Y. July 16, 1997), citing **Siegel v. Titan Indus. Corp.,** 779 F.2d 891, 892 (2d Cir. 1985). See also **DiRussa v. Dean Witter Reynolds, Inc.,** 1997 WL 434575 (2d Cir. Aug. 5, 1997).

6 591 So.2d 904 (Fla. 1991).

7 960 F.2d 939 (11th Cir. 1992).

8 In order to establish manifest disregard it must be shown "(1) the arbitrators knew of a governing legal principle yet refused to apply it or ignored it altogether and (2) the law ignored by the arbitrators . . . [was] 'well defined, explicit, and clearly applicable to the case.'" **DiRussa v . Dean Witter Reynolds Inc.,** 1997 WL 434575 at *3 (2d Cir. Aug. 5, 1997).

Preparation Guide at 180.

10 For a general discussion of the elements of civil recovery under Section, see 11A Joseph C. Long, Blue Sky §§7.01[1] & [2] (1997). Forthcoming columns will discuss these elements in detail.

11 This is also true under Section 12 (1).

12 This also used to be true under Section 12 (2) of the Securities Act of 1933, currently 15 U.S.C.§771(a) (2). However Section 12 was amended to add a new section 12 (b), which allows the defendant to avoid liability if it can establish that the loss was due to other factors such as general market decline. Thus now under Section 12 (a) (2) loss causation is an affirmative defense.

13 In the case, the claimant no longer owns the securities, then the statute specifically provides for rescissional damages which it defines as the difference between the price paid for the securities, less the price received on sale and any income received on the security while it was held. **There is no duty to mitigate damages. Garretson v. Red-Co.,** 9 Wash. App. 923, 516 P.2d 1039 (1973).

14 **Kane v. Shearson Lehman Hutton, Inc.,** 916 F.2d 643 (11th Cir. 1990); **Merchant v. Oppenheimer & Co.,** 568 F. Supp. 639 (E. D. Va. 1983), rev'd in part on other grounds, sub nom. **Dixon v. Oppenheimer & Co.**, 739 F.2d 165 (4th Cir. 1984). As the court in **Kane** noted: "If the methodology [of netting] espoused by [Shearson] were adopted, it could serve as a license for broker-dealers to defraud their customers with impunity up to the point where losses equaled prior [or subsequent] gains." 916 F.2d at 646.

15 Plus interest from the date of the purchase, all costs, and a reasonable attorneys' fee.

PIABA Files A Petition For Three Rule Changes With The SEC

Submitted by Bob Dyer
ALLEN, DYER, DOPPELT & MILBRATH, Orlando, FL.

On Thursday, October 2, the Public Investors Arbitration Bar Association (PIABA) filed with the SEC a Petition requesting three new NASD rules. The three rules are intended to level the playing field for public investors who end up in compulsory arbitration.

The first rule gives public investors an absolute right to arbitrate securities disputes before the independent American Arbitration Association. Virtually all broker-dealers are members of the National Association of Securities Dealers (NASD). Since 1992, more than 80% of all new arbitrations were filed with the NASD. PIABA predicts that this "NASD Window" rule will significantly reduce the NASD's case load and present budget concerns. (The NASD recently filed a request with the SEC for an increase in arbitration filing fees.)

Back in September 1987, the SEC urged the Securities Industry Conference on Arbitration to request its members firms to include in customer agreements a provision allowing customers to arbitrate at the American Arbitration Association. But, according to PIABA's Petition,

> "...instead of more broker-dealers adding the AAA choice to their standard arbitration provisions, broker-dealers continue to eliminate the AAA forum. As of January 1, 1997, none of the 20 largest full-service broker-dealers afforded customers the right to arbitrate before the American Arbitration Association."

PIABA argues that these rules will go a long way toward addressing the concerns and recommendations of the Ruder Commission, whose January 1996 Task Force Report listed over 100 suggested improvements in the present industry arbitration system. PIABA's experience is that many of the securities frauds are perpetrated on the elderly -- and not only by telemarketing, the recent focus of the federal\state authorities looking at fraud on the elderly. All too often, trusting senior citizens are left on the brink of financial ruin. These people need an arbitration system they and their lawyers can have confidence in.

Among other benefits, the customer will be able to arbitrate before the AAA in his or her community, rather than traveling to a distant city or even another state.

The second and third rules apply to those public customers who elect to arbitrate before the NASD. The second rule gives customers the initial right to elect an all-public panel of three arbitrators. Presently, one of the three must be an industry person. Under the proposed panel composition rule, the NASD may determine the case is especially complicated or involves esoteric securities. These cases would be tried before an "Experienced Panel." Such a panel would be made up of one "Public" member, on "Industry" arbitrator and one "Investor Arbitrator." The Investor Arbitrator may be a present or former government official involved in securities regulation or a securities law teacher or an "Investor Advocate," defined in the proposed rule as "a person who devotes a substantial portion of his or her time to representing public investors in their disputes with broker-dealers." The obvious purpose of this rule is to balance the potential advocacy role of the industry member.

The third rule requires rotational selection of all panel members in customer disputes. Simply put, such a rule would prevent the repeated appointment by the NASD of favorite industry and public members. This rule would also carry out the intent of the Ruder Commission for a fairer method of selecting arbitrators. The constant reappointment of certain public as well as industry members in the past to note that "The hand that feeds is the hand that leads."

Under the rule, all members in each pool -- public, industry and "investor" -- would be randomly assigned a number. New pool numbers would get the next available number. The customer would be given lists of arbitrators assigned in strict numerical order. If an arbitrator is not selected by the parties form a particular list, he or she goes to the end of the line. The PIABA Petition argues that

> "The true rotational method of selecting public as well as Experienced panels is crucial to containing the growing cancer on the present system, which sees all too many so-called public arbitrators act in a pro-industry fashion.... These regularly-sitting arbitrators show as a group a pro-industry bent by almost any statistical and empirical analysis. They can best be described as quasi-professional arbitrators and keepers of the dike."

Smaller claims of $35,000 or less would be tried -- or submitted on the documents -- before a single public arbitrator, also selected by the rotational list method.

PIABA's Petition ends by urging the Commission to adopt these rules

> "... as representing the first significant step

in taking the securities arbitration system out to

> the exclusive control of the industry. For in the final analysis, it is the public that buys the securities, and that public is entitled to an arbitration system that is both fair and perceived to be fair. The Commission should settle for nothing less."

PIABA asks the Commission to give the public -- and all interest groups -- a full 60 days to comment on the proposed rules.

The Petition for these SEC-initiated rule changes will be presented to the Securities Industry Conference on Arbitration Wednesday morning, October 16 in Scottsdale, Arizona. PIABA's annual meeting will also be held in Scottsdale, October 16-18, and is open to the public and the securities industry in the first two days.

4th Circuit Limits The Power of The Court Once Arbitration is Ordered

Recently in the case of **Glass v. Kidder Peabody & Co., Inc.**, 114 F. 3d 446 (4th Cir. 1997), the issue of what authority a court continues to possess after it orders a case to arbitration was raised. In Glass, the trial court attempted to exercise supervisory authority over the case once it had ordered arbitration. When the parties did not undertake the arbitration within the time limit that the court set, the court dismissed the case before it and enjoined the plaintiff from pursuing the arbitration on a theory that plaintiff was guilty of laches. The Fourth Circuit reversed. It indicated that the trial court was correct in deciding the initial issue of arbitrability. However, its authority over the case ceased upon the entry of the order compelling arbitration. Quoting with approval from Justice Brennan's concurring opinion in **United Steelworkers of America v. American Mfg. Co.**, 363 U.S. 564, 571 (1960), it said: "[O]nce a district court has completed its substantive arbitration inquiry and ordered parties to arbitration . . . the district court has 'exhausted its function' and may not intervene again until a party objects to the arbitration award or seeks enforcement thereof". 114 F. 3d at 454.

The court went on to hold that defenses such as laches, delay, statute of limitations, or untimeliness are broad "waiver" defenses which can be raised to defeat compelled arbitration. However, these are defenses involve "procedural arbitrability" and must be presented only to the arbitrators, and not to the court.

Investor Can Not Enforce NASD Restitution Award

In what appears to be a case of first impression, the court in **Lang v. French**, 1997 U.S. Dist. LEXIS 12041 (E.D. La. Aug. 4, 1997), held that a private investor could not sue in federal court to enforce a restitution award entered against the defendant in an NASD disciplinary hearing. The District Business Conduct Committee issued a decision that French had engaged in a "scheme to defraud" Lang. Among other things, it ordered French to pay restitution in the amount of $50,000 plus interest. When the restitution wasn't paid, Lang filed suit to enforce the restitution order. The court refused, saying: "[T]he Court finds that it does not have the authority to adopt the judgment of a self-regulatory body as its own and enforce it." Id. at *7. However, the court went on to indicate that the SEC might be a proper party to seek enforcement of the restitution order.

While the decision seems accurate as far as it goes, it appears to miss the point. The decision of the Business Conduct Committee, at least as to the commission of the underlying conduct should be recognized in either litigation or arbitration under a theory of issue preclusion or collateral estoppel. Thus, at the very most, when Lang brings suit either in court or arbitration, the sole issue should be the amount of damages or restitution he should be entitled to. It could be argued that even this issue is precluded, if it can be shown that the amount of restitution ordered was based upon the statutory rescission or damage theories provided for in either the state or federal securities acts. The theory of issue preclusion or collateral estoppel provides the court or the arbitrator a quick and simple way to convert the findings of the District Conduct Committee into its own findings on which an appropriate judgment may be entered.

9th Circuit Holds That Minnesota State Law Controls, But Still Allows Punitive Damages

In a refinement of the **Mastrobuono** approach to the choice of laws issue, the Ninth Circuit in **Barnes v. Logan**, 1997 WL 4722075 (9th Cir. Aug. 20, 1997), held that a choice of laws clause indicating that "the rights and liabilities of the parties [would be] determined, in accordance with the laws of the State of Minnesota" required the application of the Minnesota punitive damage rule rather than the federal rule under the FAA. The court explained that under **Volt** the parties were free to substitute state law for federal law under the FAA as the rules of decision. The court then recognized that **Mastrobuono** modified this to the extent that only state substantive law, and not state special rules limiting the powers of arbitrators, would be incorporated by a choice of laws clause that generally called for the application of a particular state's law.

Citing **Gateway Tech., Inc. v. MCI Telecom Corp.**, 64 F.3d 993 (5th Cir. 1995), the Ninth Circuit, however, recognized that the substantive law of many states does not allow the award of punitive damages in certain cases, such as in the case of breach of contract. Such substantive law limitation on punitive damages, it indicated would be recognized under the conflict of laws clause even though federal law under the FAA without such clause would not restrict such recovery. The defendant argued that punitive damages in Minnesota were only available for torts involving personal injury, as opposed to economic loss. The court, after reviewing prior Minnesota precedent, disagreed and concluded that Minnesota law allowed punitive damages in economic loss cases including fraud. In doing so, the court relied upon **Phelps v. Commonwealth Land Title Ins. Co.**, 537 N.W.2d 371, 277 (Minn. 1995), which approved the awarding of punitive damages, **in addition to double damages** in an age and disability discrimination case. Can punitive damages be combined with treble damages in a RICO securities arbitration?

Supreme Court Nixes Nonlawyer Representation Florida In Securities Arbitrations

On July 3, 1997 the Supreme Court of Florida rendered its opinion in <u>The Florida Bar re: Advisory Opinion on Nonlawyer Representation in Securities Arbitration.</u>

The order finds that compensated nonlawyer representatives in securities arbitration are engaged in the unlicensed practice of law. As a result, the Florida Supreme Court enjoined non-lawyers from representing investors in securities arbitration proceedings for compensation.

The Court found that a non-lawyer who is retained to represent an investor in arbitration is engaged in the unauthorized practice of law in all three stages of arbitration--before the arbitration is filed, during the course of the arbitration proceedings, and, even after the arbitration proceedings, since any arbitration award can only be confirmed, vacated or collected through an action at law.

The Court specifically acknowledged that the rules governing the SRO do not expressly prohibit nonlawyer representation and that the *Arbitrator's Manual*, published by SICA, indicates that the parties may choose to appear represented by a person who is not an attorney. However, the Court noted that neither the rules provision nor the *Manual* constitute federal legislation (in contrast, for example, to the Administrative Procedure Act which authorizes nonlawyer representation), and that neither the rules nor the *Manual* condone nonlawyer representation for compensation.

The Court noted that its opinion specifically did not address: (1) the propriety of non-lawyer representation in other forms of arbitration; (2) the propriety of the investor's representation in securities arbitration by an attorney who is licensed to practice in another jurisdiction, but not Florida; and (3) the propriety of nonlawyer representation is securities arbitration to resolve claims of employees against securities firms or inter-industry disputes.

Michigan Court Recognizes Separate Arbitrable Claim for Misrepresentation as to the Value of a Limited Partnership

In EQ Financial Consultants Inc. et al. v. Blackward, In the Circuit Court for the County of Oakland, No. 97-538667-CZ, a Michigan State court recognized, as a separate claim, misrepresentations by a broker, as to the value and expected liquidation return of an equipment lease limited partnership (PLM), which induced the investor to hold the investment rather than sell.

Subsequent to the filing of the original arbitration demand, the United States Sixth Circuit Court of Appeals ruled that NASD § 15 and NYSE Rule 603 are absolute time bars, not subject to tolling. The Ohio Company v. Nemecek 98 F.3d 234 (6th Cir. 1996). As a result, the Blackward claimant had conceded that the issue as to the purchase of the partnership, which had occurred more than six years prior to the filing of the arbitration, was barred.

The Court then went on to determine whether the claim as to misrepresentation of value was a distinct cause of action or a mere tolling or discovery argument.

First, the Court noted that any such misrepresentation as to value to induce the holding of a security was not protected under the Michigan security statute, since that statute, like Federal Rule 10-5, extends protection only to a defrauded purchaser or seller, not to buying or selling stock.

However, the Court noted that Blackward had also alleged a cause of action based on breach of contract, common law fraud, promissory estoppel, negligence, malpractice, breach of fiduciary duty and violation of the Michigan Consumer's Protection Law.

Without indicating which of these theories may actually give rise to a cause of action in the instant case, the Blackward Court nonetheless held that these were genuinely asserted causes of action which occurred within the six year statute of limitations and that those claims were arbitrable.

Accordingly, the Court barred all claims more than six years prior to the filing date, dismissed the securities law claims and ordered the balance of the claims, based on misconduct which occurred within six years, to NASD arbitration.

Case Submitted by: Anthony Trogan, WEISMAN TROGAN YOUNG & SCHLOSS, Bingham Farms, MI

Massachusetts Supreme Court Refuses to Allow the Filing of an Arbitration Claim to Toll the Statute of Limitations

Submitted by: Thomas Mason, Tuson, AZ

In Shafmacker v. Raymond James, et al., 1997 WL 460 186 (Mass.), August 14, 1997, the Massachusetts Supreme Court refused to allow the previously filed NASD arbitration to interrupt the statute of limitations once the claims were then later filed in state court.

Shafnacker had filed an NASD arbitration in 1991 and had been awarded $210,000 in damages for investments which had been made within six years of her filing date. The NASD had declined jurisdiction on any of the transactions made more than six years prior to the filing date.

Within six months of the NASD decision, Shafnacker filed a complaint in state court seeking to recover on those claims barred by NASD 15. The plaintiff argued that equitable tolling of the statute of limitations should have occurred during the time the claim was in arbitration.

The Court found that the filing of the arbitration did not toll the statute of limitations, noting that equitable tolling is only used sparingly and that the filing of an arbitration claim did not fit into any of the standard exceptions which allow tolling. The Court pronounced that the arbitration claim more closely resembled those instances where tolling is not allowed, for example, "by the possibility of an administrative settlement of the dispute."

Citing an old First Circuit case United States ex rel. Wrenching Corp. Of America v. Edward R. Marden Corp., 406 F.2d 525 (1st Cir. 1969), the Shafnacker court disregarded the plaintiff's citations of more recent labor arbitration cases which would allow for tolling.

The Court gave the plaintiff a still admonition. "Thus, the proper procedure for a litigant in the plaintiff's situation is to file a complaint in [state court] within the time allowed by the statute of limitations and have the action stayed pending the results of the arbitration."

Missouri Court of Appeals Finds That Timeliness is for the Arbitrators

The Missouri Court of Appeals found that, under applicable Missouri law, arbitrators — and not courts — should determine the timeliness of arbitration claims. Consolidated Financial Investments v. Manion. Mo Ct. App., No. 70621, 06/27/97.

This was in spite of the fact that the arbitration agreement called for New York law to apply. In response, the Manion court said that it recognized that parties may choose the state law that will govern the interpretation of their contractual rights and duties, so long as the application of the chosen law was not contrary to the fundamental policy of Missouri. Moreover, any such choice of law, the Court opined, applies only to substantive law, and procedural questions are determined by the state law where the action is brought.

[Ed. Note: *This holding is premised on the finding that the six year rule is a procedural rather than a jurisdictional statute.]*

The Use of Securities and Exchange Commission Decisions as Precedent in Arbitration Proceedings

Timothy J. O'Connor, AINSWORTH, SULLIVAN, TRACY, KNAUF, WARNER & RUSLANDER, P.C., Albany, NY

This is the second of a two part Article, the first part of which appeared in the June 1997 issue of the Quarterly.

(v) Excessive account concentration and trading activity in a single stock - Matter of Dean Witter Reynolds, Inc.

In a situation where a particular broker appears to have "fallen in love" with a particular stock it has been determined that the branch manager has a heightened responsibility to make detailed inquiry of the facts and circumstances involving the accumulation of substantial positions in any one stock in customer accounts. In addition to concerns relating to customer victimization there may also be regulatory considerations which might require a 13D filing when share accumulation in any discernable mutually situated block of investors or customers exceeds 5% of the public float.

In the Matter of Dean Witter Reynolds, Inc., Administrative Proceeding File No. 3-7072, September 30, 1988, 41 SEC Docket 1307, 49 SEC 956, Release No. 34-26144, 1988 W.L. 240347 (S.E.C.), the Securities and Exchange Commission addressed a situation involving a registered representative in the Wayzata, Minnesota offices of Dean Witter who had accumulated a sizeable percentage of the float of Continental, a thinly traded AMEX stock. Noting that the number of shares held by the registered representatives in his accounts had increased steadily from 86,207 shares (9.6% of the float) to an office-wide position of 24.4% of the float in November of 1983, the Commission found that Dean Witter failed to reasonably supervise the manager and the registered representative, with a view toward preventing violations of Section 17(a)(1), 17(a)(2) and 17(a)(3) of the Securities Act and Section 10(b) of the Exchange Act and 10-b thereunder noting *inter alia*:

> At no time during the build up of this position did Dean Witter direct its branch manager or anyone else to contact clients to determine the nature of the statements made by the registered representative to these clients during a solicitation. Such inquiry, if made, may have revealed the misrepresentations and/or omissions made by the registered representative to solicit his customers.

These events show that Dean Witter did not effectively supervise the branch manger, who in turn, failed to fulfill some of his supervisory functions. The decision went on to note that:

> Once the Compliance Department became aware of the stock concentration and directed that trading restrictions be imposed, its steps to implement and enforce these restrictions were not effective.

Citing Smith, Barney, Harris, Upham & Co., Inc. et al. Exchange Act Release No. 21813 (3/5/85) the Commission noted that "[t]here must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity in a branch office . . ."

In the Matter of Frank J. Crimmins, Admin Proc. File No. 3-3261, 1973 SEC Lexis 3508 (8/31/73), aff'd 368 F. Supp. 270 (S.D.N.Y. 1973) aff'd 503 F 2d 560 (2d Cir. 1974), involved a branch manager who owned a considerable position in a particular security which was also being sold by brokers under his supervision in excessive concentrations. In faulting the branch manager for improper supervisory practices the decision noted that "the record establishes that Crimmins (the branch manager) never asked his salesman what they were telling the customers to whom they were recommending ESP (the stock in question)", (1973 SEC Lexis 3508 at page 26). In determining that the sales manager had failed to disclose his personal interest to customers, as well as the holdings of the broker under his supervision who solicited concentrated purchase transactions and shares of ESP stock the decision noted that:

> ...because of Crimmins' personal interest in ESP and because of his closeness to [the brokers] who also had personal interest in ESP, Crimmins should have been especially mindful of the need to insure that such personal interests were fully disclosed to customers to whom the stock was being recommended...[i]nstead, very surprisingly, Crimmins was of the quite erroneous belief that such personal holdings did not have to be disclosed.

The Administrative Law Judge in the Matter of Frank J. Crimmins, supra, determined that the manager had failed to reasonably supervise the trading activity of his brokers in shares of ESP stock with a view to preventing anti-fraud violations of Section 15(b)(5)(E) of the Exchange Act.

(vi) Responsibility of broker/dealers for activities of Investment Advisors under the Investment Advisors Act of 1940.

In the Matter of Shearson, Lehman Brothers, Inc., 36 SEC Docket 754, 49 SEC 619, Admin. Proc. File No. 3-6733 (8-12324)(801-00517), Release No. 34-23640 (Sept. 24, 1986), the United Securities and Exchange Commission determined that Shearson "failed reasonably to supervise" its registered representatives who were registered as investment advisors "with a view to preventing violations of Section 206 of the Advisor's Act and Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, thereby violating Section 15(b)(4)(E) of the Exchange Act and further directed that Shearson "engage an independent consultant with, with expertise in broker/dealer operations and acceptable to the Commission, who shall review and examine Shearson's supervisory and compliance procedures" with respect to eight separately enumerated points.

With respect to the supervisory shortcomings in the Utica Shearson Office, the decision noted in footnote as follows:

> "If a firm's established procedures for preventing and detecting fraud by employees come down in the last analysis to taking the employee's word on explanations when questionable events are looked into, then the procedures cannot be very effective." citing in the Matter of Charles Schwab & Co., Inc. [1983 - 1984 Transfer Binder] Fed. Sec. Law Rep. (CCH) paragraph 83, 469 at 86 506 (Dec. 28, 1983).

The decision also noted that the branch manager

> "sent incorrect letters as a result of monthly activity runs which automatically flag active accounts . . . although the responses to these letters were to go to compliance, there is no indication that Compliances' failure to receive any communication caused it to look further. Had it been pursued, Compliance would have known that the wrong letters were sent".

(vii) The emergence of the concept of financial planning has seen administrative decisions addressing the obligations of branch managers supervising financial planners.

In the Matter of Hodgdon & Co., Admin. Proc. File No. 3-533, 1969 SEC Lexis 2920 (5/15/69), the Commission determined that the supervisor had abdicated his supervisory responsibilities by failing to set up:

> ...machinery which would enable it to ascertain whether the financial plans were being property administered...salesmen were required to present financial plans for review only for the first year after completion of the basic training course...[t]hereafter, the submission for review of such plans as may have involved the complex problems was left to the salesmen's discretion.

The Commission went on to note that the failure of the supervisor to supervise financial plans was due to the fact "[h]is activities were directed primarily toward supervision of the firms trading, the consideration of all offers for underwritings and the daily review of order tickets".

The Commission went on to note that numerous customers had excessive concentrations of securities for which the broker/dealer was an underwriter or securities that were sold out of the broker/dealer trading account as a principal, as well as excessive concentrations of speculative real estates syndications and found that:

> [t]he foregoing demonstrates registrant's inordinate concentration on recommendations and selections of securities for its clients from which it could derive the greatest amount of compensation...[c]ertainly, registrant's recommendations could have been made from the virtually unlimited choice available to it on the exchanges and over-the-counter...[i]n that event, of course, registrant would have been restricted to the lesser compensation to be realized from agency transactions. (See Hodgdon & Co., Admin. Proc. File No. 3-533, supra, 1969 SEC Lexis 2920 at page 89-90).

(viii) The duty of supervision extends well beyond the branch office.

It has long been held that a broker/dealer cannot rely on a system of supervisory procedures which rely solely on supervision by branch office managers (see in the Matter of Shearson, Hammill & Co., 42 S.E.C. 811, 838-844(1965)). The notion of a chain of command within the supervisory scheme of a broker/dealer is central to a number of administrative decisions which have held broker/ dealers liable for poor branch office oversight by regional managers and compliance and legal department personnel. In another often cited decision of the Commission, the duty of supervision was summarized in the leading case of Reynolds and Co., 39 S.E.C. 902 (1960), as follows:

> We have repeatedly held that brokers and dealers are under a duty to supervise the actions of employees and that in large organizations it is especially imperative that the system of internal control be adequate and effective and that those in authority exercise the utmost vigilance whenever even a remote indication of irregularity reaches their attention...

The administrative decisions of the SEC recognize a comprehensive duty of supervision which extends well beyond the branch office level to include regional sales managers, compliance officers and, in certain circumstances, attorneys in the legal departments of brokerage firms.

Many arbitration cases turn upon what obligation, if any, individuals employed in the broker/dealer's compliance or legal departments have with respect to the supervision of trading activity and what affirmative duty, if any, such person will have to intervene when improprieties arise. In the Matter of John H. Gutfreund, Admin. Proc. File No. 3-7930, Securities Exchange Act of 1934, Release No. 34-31554, 1992 SEC Lexis 2939 at page 47 (12/3/92), it was noted that in "...determining if a particular person is a "Supervisor" depends on whether, under the facts and circumstances of a particular case, that person has a requisite degree of responsibility, ability or authority to affect the conduct of the employee whose behavior is at issue" (citing in the Matter of Arthur James Huff, supra, and went on to note that "persons occupying positions in the legal or compliance departments of broker/dealers have been found by the Commission to be "Supervisors" for purposes of Sections 15(b)(4)(E) and 15(b)(6), (citing First Albany Corporation, Supra and Gary W. Chambers, Exchange Act Release No. 27963 (April 30, 1990) and Michael E. Tennenbaum, Exchange Act Release No. 18429 (January 19, 1982)).

(ix) The duty of the branch manager to meet with the customer in person or contact the customer by telephone.

The compliance officer in the Matter of the Application of Bradford John Titus, supra, claimed that he had "insufficient personnel to management 60,000 accounts effectively." The decision went on, however, to cite Stewart K. Patrick, 51 S.E.C. 419, 422 (1993) for the proposition that: ... supervision, by its very nature, cannot be performed by the employee himself". Rita H. Malm, 58 S.E.C. Docket at 130 for the proposition that ". . . we have emphasized that there must be adequate follow-up and review when a firm's own procedures detect irregularities or unusual trading activity" and went on to suggest that the mere expedient of a phone call to the customer by the branch office manager would have served to better afford the firm a better understanding of "the customer's understanding as to suspicious activity in his or her account".

In the Matter of Prudential Securities, Inc., Admin. Proc. File No. 3-8209, Securities Exchange Act of 1934, Release No. 33082, 1993 SEC Lexis 2866 at 65, in faulting branch office manager practices at Prudential Securities, it was suggested that the simple expedient of direct contact between the branch office manager and the customer would be an appropriate supervisory practice to prevent trading improprieties in customer accounts. The decision noted that:

> [i]n implementing the recommended procedures, PSI failed to require branch office managers to review adequately the activity in customer accounts and communicate relative information to customers.

The Commission has recognized the simple step of a branch manager contacting a client by telephone or meeting with a client in person as one of the most effective tools in assuring proper supervisory practice to prevent customer victimization.

(x) Branch managers obligation to detect and prevent abusive cross-selling practices.

Branch managers are responsible for assuring that brokers under their supervision do not engage in any "no net selling" practices, a practice which involves a broker refusing to execute a customer sale order for a particular security until a purchaser has been found. This tactic is known as "cross trading" and is particularly prevalent with Rule 15g-2 "designated securities" or "penny stocks" for which certain broker/dealers serve as a predominate market maker who, in addition, may "dominate and control" trading activity and usually thinly traded, low-priced stock.

In the Matter of C. James Padgett, et al. Admin. Proc. File No. 3-7164 (SEC) Securities Exchange Act of 1934, Release No. 38423, 1997 SEC Lexis 634 (March 20, 1997), supra, pg. 35, it was determined that the four branch managers involved there failed to act with the requisite degree of *scienter*:

> [b]y discouraging agents from executed customer net sell orders and encouraging them to cross orders, they acted, at a minimum, in reckless disregard of the customers interest in prompt execution and sale. In many instances, the branch offices managers knew that orders were being delayed due to their practices or policies. We, therefore, find that Gibs, Sullivan, Sutton and Baird wilfully violated Sec. 17(a) of the Securities Act and Sec. 10(b) of the Exchange Act and Rule 10b-5 thereunder.

This decision affords counsel in arbitration proceedings involving low-priced securities considerable guidance in framing a theory of recovery and also serves to focus the documentation and type of testimony required to best represent the interests of a defrauded investor in low-priced securities cases.

(xi) Duty of branch manager and supervisory personnel to ensure that investors are being provided with rights of accumulation for mutual funds sales commission discount breakpoints

In the Matter of Robert J. Check (Advest, Inc. 8-21409), Admin. Proc. File No. 3-6783, (S.E.C. 1987 Sec Lexis 4322 6/26/87), dealt with a determination that the mutual fund sales manager failed to call to the attention of the compliance department at Advest, Inc. certain mutual fund sales commission breakpoint problems which he was made aware of by way of inquiries from Advest salesmen. In addressing the shortcomings of the mutual funds sales manager, the Commission noted that:

> It appears that Check's review of mutual fund order tickets was self-limited to determining if order ticket information supplied by salesmen was sufficient for him to execute a trade. The absence of information on the ticket regarding ROA (Rights of Accumulation) and LOI (Letters of Intent) did not trigger any inquiry of the salesmen on the possibility of a breakpoint having been reached, although on the immediate sale represented by a ticket under review Check would require a salesmen to recognize the breakpoint if reached in that particular sale. As justification for his inaction in ascertaining whether the salesmen were quoting customers their rights, Check asserted that the salesmen have the responsibility to complete the ticket and that his duty was confined to entering the ticket as a trade unless the ticket had been incorrectly completed.

The Commission disagreed with the mutual funds sales managers contention and determined that he had abdicated his supervisory duties as a mutual funds sales department head (also, see in the Matter of Robert J. Check, Admin. Proc. File No. 3-6783, Securities Exchange Act of 1934, Release No. 26367, 1988 Lexis 2483, (12/16/88)).

(xii) The duty to assure proper supervision of satellite branches and single broker branch offices.

The great bull market of the 1980 and 1990's has seen an unprecedented growth in broker/dealers specializing in one man offices or all satellite offices as distinguished from the conventional branch office with a sizable number of brokers and managerial, administrative and operations personnel. This boom has not been without its compliance problems as the potential for problems, or at least the temptation to engage in questionable activity, may be more pronounced in circumstances where there is no ongoing day to day supervision.

In the Matter of Royal Alliance Associates, Inc., Administrative Proceedings File No. 3-9223, SEC, Securities Exchange Act of 1934 Release no. 38174, 1997 SEC Lexis 113 (1/15/97), the Commission made certain findings relating to supervisory shortcomings in certain branch offices of a broker/dealer having supervisory responsibility for 2,700 registered representatives in approximately 1500 offices supervised by off-site "managing executives". The "managing executive" of the Greensboro, North Carolina office was found to have obtained funds from customers by forging their signatures on third party checks and solicited customers for fictitious CD's, bonds and other securities which were paid for by the customers with checks issued directly payable to the managing executive or his DBA rather than to Royal Alliance, the broker/dealer. The scheme was further complicated by the fact that the managing executive used a pooled account involving converted funds in a bank account in his own name to pay "dividends" or distributions to customers on the fictitious investments. Plus, other illicit activities including churning and the generation of false confirmations to conceal the diversion of funds, as well as fictitious monthly account statements. A similar scheme was perpetrated by a "managing executive" and the broker/dealers' Cocoa Beach, Florida offices.

The decision of the Commission noted that the branch office examination "relied to a large extent on the managing executive's responses to a checklist of questions". The examiners engaged in a review of such key documents as the sales logs, the product cross-index and customer holding pages, 1997 SEC Lexis 113 pages 8-9. In finding these supervisory practices deficient, the Commissioner determined that:

> [T]he examiner failed to detect that the managing executive's sales log, product cross-index and customer holding pages did not reflect variable annuity, limited partnership and mutual funds transactions...[T]he omission of variable annuity, limited partnership and mutual funds transactions from the books and records of the Greensboro office should have raised a red flag, since the managing executive derived most of his commissions by selling those products.

The Commissioner also determined that copies of checks made payable directly to the managing executive or his DBA should have been easily detected. The Commissioner also faulted the broker/dealer for failure to keep a proper log of signature guarantees and the use of the signature guarantee stamp by the "managing executive". The Commissioner went on to find that the broker/dealers "failure to scrutinize adequately the securities-related businesses of its registered representatives which were conducted beyond the direct aegis of the firm, was a certain recipe for trouble", 1997 SEC Lexis 113 at page 14, and faulted the broker/dealer's wholesale failure to have a proper procedure for detailed, surprise inspections of small branch/single registered representative offices, (citing in the Matter of Consolidated Investment Services, Exchange Act Release No. 36-687 (1/5/96)).

CONCLUSION

In the Matter of Hodgdon & Co., Admin. Proc. File No. 3-533, 1969 SEC Lexis 2920 at page 87 (5/15/69), it was noted that:

> [i]t has long been established that the relationship of a securities dealer or a salesman to an uninformed client is one of trust and confidence which approaches and perhaps equals that of a fiduciary...[i]t arises out of the superior sophistication of the dealer, the reposal of special confidence by the customer in the dealer as specially qualified in the securities field and the dealer's acceptance of this reliance...[i]t imposes upon the dealer the responsibility and duty to act in the customer's best

interest in effecting transactions in his account (citing Lawrence R. Leehy, 13 S.E.C. 449, 505 (1943); Mason, Moran & Co., 35 S.E.C. 84, 89 (1953); Looper & Co., 38 S.E.C. 294, 300 (1958) and Haley & Company, Inc., 37 S.E.C. 100,106 (1956)).

The administrative decisions of the Securities and Exchange Commission cited in this article should afford the practitioner authority to provide to an Arbitration Panel as to appropriate branch manager supervisory practices which should be taken when "red flags" are raised.

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