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The P I A B A Quarterly

The Newsletter of the Public Investors Arbitration Bar Association

June 1998 Volume 5 Number 2

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Editor's Notes

This issue of the *Quarterly* contains the first half of an article by Tim O'Connor on the use of NASD Notices to Members as precedent in arbitration proceedings. The second half will be included in the September issue of the *Quarterly*.

The deadline for receiving submissions for the September 1998 issue of the *Quarterly* is September 10, 1998. All submissions, regardless of length, should be accompanied by a computer disk of the submitted materials in either word perfect or as a ext file.

Please send change of address information to Robin Ringo, 1111 Wylie Road, # 18, Norman, OK 73069. Phone (405) 360-8776. E-mail: PIABA@mindspring.com.

The PIABA Quarterly 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.

Letter From the President

Diane A. Nygaard THE NYGAARD LAW FIRM Leawood, KS

Dear Colleagues:

The PIABA Board is finalizing plans for the 1998 annual meeting, to be held October 22-24 at the Disney Yacht and Beach Club in Orlando. We appreciate your suggestions for speakers and are hoping the convention will bring together the PIABA "community" for shared learning and fun.

Several of our members have made us aware of prejudicial actions by the NASDR, particularly allowing flagrant abuses by attorneys representing penny stock firms. We have submitted these letters to the NASDR and SEC. A face to face meeting is scheduled for later this summer between PIABA representatives and Linda Fienberg of the NASDR. Thank you for taking the time to document problems and forward the letters to PIABA.

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The NASDR has also agreed to change its training materials, based upon PIABA's suggestions. These changes will be sent to all arbitrators as important changes for their review. The new material will be available at the annual meeting and I'm sure you'll want to review this.

The Board has selected Mark Maddox to serve as next year's president. He has been a dedicated advocate on behalf of investors, and will serve PIABA well as the group continues to expand investor's rights to insure a fair determination of their cases.

PIABA's website is now running and is being expanded. Thank you to Cary Lapidus, Allan Fedor and other PIABA members who contributed their time to this. You can follow this work in progress at www.generationz.net/piaba.

Robin Ringo reports that the NASDR is now referring investors to PIABA. The SEC and many states also are making referrals, and PIABA's calls from investors has tripled over the last year. When calls come in, Robin provides the investors with a list of PIABA members in their state or region. We hope you are able to represent the people who call.

Please do not delay signing up for the Annual Meeting. As always, we will have a chance to hear excellent speakers, share experiences, and enjoy Disneyworld. I look forward to seeing you in Orlando in October.

Sincerely yours,

Diane A. Nygaard

From the Professor

By Joseph C. Long

With this issue we begin another innovation for the Quarterly. This innovation involves the occasional appearances by "Visiting Professors" who have ideas that will help all of our arbitration practices. The first "Visiting Professor" is Pat Sadler who outlines a recovery approach by using SEC Rule 10b-6.

Establishing Liability Under SEC Rule 10b-6 In Actions Against Second Tier Brokerage Firms

J. Pat Sadler SADLER & ASSOCIATES, P.C.
Atlanta, Georgia

It is the morning of the second day of the arbitration hearing on a case against a second tier brokerage firm in which your client has lost $100,000 on IPO and aftermarket trading in NASDAQ small-cap house stocks. You have alleged suitability violations, churning, misrepresentations and violation of SEC Rule 10b-5.

Your client has spent the first day of the hearing on the witness stand convincing the panel that he is more sophisticated than Warren Buffett, and that if he can run a successful business he can certainly read a prospectus and a brokerage statement. He admits, however, that he did not read any of the prospectuses which were sent to him because he was too busy.

If your case has been built strictly on

The PIABA QUARTERLY is published quarterly in the interest of the members of The Public Investors Arbitration Bar Association. Editor-In-Chief - Jerry Stanley; Associate Editor - Seth Lipner. The PIABA QUARTERLY welcomes information on cases or articles that would be of interest to PIABA members. Contributions should be mailed to:
The PIABA QUARTERLY, 7910 Wrenwood Boulevard, Suite B, Baton Rouge, Louisiana 70809; FAX (504) 926-4348. All copy is subject to the approval by the publisher. Any material accepted is subject to such revision as is deemed appropriate in the publisher's discretion.

traditional misrepresentation, churning and suitability allegations, it is probably lost. The brokerage firm is going to persuasively argue that all the accurate information about the company is right there in the statutory prospectus and that this information corrects or supersedes any verbal statements which may have been made. Even if your client was lied to, which of course they deny, the argument is that the Claimant's losses were caused by his own negligence in failing to read the information he was provided. I have seen too many panelists over the years who are ready and willing to accept this defense. Consequently, in second tier cases, I always try to develop additional theories of liability to supplement the conventional causes of action.

I have tried many IPO and aftermarket transactions cases against second tier firms and I cannot remember one that did not involve a violation of SEC Rule 10b-6. Yet, this may be the most under-used cause of action available to Claimant's lawyers. Indeed, a friend of mine who has sat on dozens of NASD and NYSE panels says he has never heard a case where the Claimant alleged a Rule 10b-6 violation.

So what is this unknown creature of the 1934 Act rules? For our purposes, it will suffice to say that SEC Rule 10b-6 prohibits a broker who is participating in a particular distribution of securities (i.e., an IPO) from inducing aftermarket purchases in that security until after the broker has completed its participation in the distribution.

Recognizing A 10b-6 Cause of Action

Almost invariably, second-tier firms market their IPO by having their brokers get on the phone and obtain from their customers the largest possible dollar commitment for the new securities. When the IPO goes effective, the customer who has agreed to invest, $25,000, may find that his account receives 1,000 units (usually one share of common stock and one or two warrants to the unit) at the offering price of $4 per unit and 2,100 shares of stock at $10 per share in the first aftermarket trading. The problem, of course, is that this practice violates SEC Rule 10b-6. Whenever the customer agrees to purchase IPO units and aftermarket securities (whether units, shares, or warrants), at the same time, you have a potential 10b-6 violation.[1]

Pleading

Pleading 10b-6 violations is a fairly simple process. However, I think that it is important to use a two part approach. The first part simply involves pleading the elements of the rule. This requires the following allegations: (1) that Respondent XYZ Brokerage Firm was participating in a distribution of the securities of ABC Corporation,[2] (2) that the distribution of the securities of ABC corporation was completed no sooner than a certain date,[3] (3) that, before completing its participation in such distribution, Respondent XYZ Brokerage Firm unlawfully solicited aftermarket transactions in the securities of ABC Corporation from the Claimant.

If you plead those three elements, you have pled everything necessary to establish a violation of the rule. However, I like to go further and plead that a violation of SEC Rule 10b-6 also constitutes a violation of SEC Rule 10b-5. I do this for two reasons. First, it is well-settled that an implied private right of action exists for violation of Rule 10b-5 and, second, I don't get hung up on whether a violation of Rule 10b-6 creates a private right of action.

The 10b-6 Violation as a 10b-5 Violation

Section 10b is the broadest and most frequently used of the anti-fraud provisions of the 1934 Act.[4] Section 10b of the 1934 Act makes it unlawful for any person:

> "*(b) To use or employ in connection with the purchase of sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest for the protection of investors.*"[5]

Because of the way this section is worded, a person violates the statute by violating a rule that the SEC has adopted under it. Thus, all Section 10 rules, including

Rule 10b-5[6] and 10b-6 are anti-fraud rules.[7] It is my belief that a violation of Rule 10b-6 constitutes a device, scheme or artifice to defraud and, therefore constitutes a violation of Rule 10b-5(1). Further, I believe that such violation is an act, practice, or course of business which operates as a fraud or deceit which violates Rule 10b-5(3).

In order to examine how a 10b-6 violation constitutes a device, scheme or artifice which defrauds the public, let's go back to my example. For his $25,000, my fictitious customer got 1,000 units (consisting of one share and one warrant each) in the IPO at $4, and received 2,100 shares in the aftermarket at $10 per share. Since this entire transaction was arranged before the closing of the IPO, the customer was deprived of the right to have the initial aftermarket price established by the law of supply and demand. In a typical, legitimate IPO, the underwriter and selling group members sell the IPO shares in accordance with the terms of the prospectus. Once all the shares are sold, firms who intend to make a market in the securities will offer to buy shares in the marketplace from the original purchases in the IPO. They will do so at a price which they believe offers them an opportunity to make a reasonable mark-up profit on the resale of the securities to the public. Thus, the price paid the original investor is set in the marketplace, based on supply and demand.

Two factors may cause my fictitious client to pay more for his aftermarket shares than he would have absent a Rule 10b-6. First, the $10 a share selling price may not bear any relationship to the value the shares actually have in the open marketplace. Is the demand for these shares so great that the original IPO purchasers would only sell their shares if they can make a profit of $6 per share?

There is a second factor which often is present in the IPO's of the second tier brokerage firms. This is that the purchasers in the IPO may not be the only ones holding registered, tradable stock. Very often, the restricted stock of company insiders will be registered along with the stock to be sold to the public. Such shares normally will be subjected to a "lock-up" agreement between the underwriter and the insiders. Under this "lock-up" agreement, the insiders agree not to sell their shares for a certain period, usually 12-24 months, without the consent of the underwriter. Second tier underwriters have become notorious for releasing the insiders from their lock-up agreements and buying the shares from the insiders at a cheap price.[8] They then re-sell these shares to the public in the aftermarket at $10 or more. Last year, I participated in a case in which the underwriter purchased the entire 3,000,0000 shares of stock which were outstanding prior to the issuer's IPO. It subsequently re-sold these shares to the public on the first day of trading at a profit of $8 per share! This conduct, of course, has all sorts of 10b-5 implications in its own right in that it renders the prospectus inaccurate as to the existence and status of the lock-up agreement.[9]

Special attention needs to be paid to calculating damages from a Rule 10b-6 violation. It is necessary to remember that the rule violation applies only to the aftermarket purchase and not to the IPO purchase. Sometimes, this fact can actually result in an increase of your damages over those in a typical 10b-5 claim. To illustrate this point, assume that the stock which my fictitious investor purchased declined in value to $5.00 per share after the purchase. Our customer has a loss of $10,500, or $5 per share, on his 2,100 shares purchased at $10 in the aftermarket. However, he has a gain on the 1,000 units he purchased in the IPO. Assuming the warrants he acquired as a part of the units purchased are worth $2, he will have a profit of $3,000 when he sells his 1,000 units in the aftermarket. Damages for misrepresentation or unsuitability, under Rule 10b-5 the likely recovery is $7,500.[10] Under 10b-6, however, the damages should be $10,500 because the violation relates only to the aftermarket transactions and, no adjustment should be made for the profit on the initial IPO unit sales.

Proving the 10b-6 Violation

Proof necessary to establish a Rule 10b-6 violation is easy. You must first prove that the broker induced the customer to purchase the security in an aftermarket transaction, before the broker completed his participation in the distribution. This involves establishing two facts: (1) When did the broker complete his participation in the distribution,

and (2) when was the aftermarket sale solicited?

Proving When the Participation in the Distribution Ended

As to the first fact, paragraph (c)(3) of Rule 10b-6 establishes when a person is deemed to have completed his participation in a distribution. In the case of an underwriter, he is deemed to have completed his participation in a distribution "when he has distributed his participation, including all other securities of the same class acquired in connection with the distribution, and any stabilization arrangements and trading restrictions with respect to such distribution to which he is a party have been determined."

From the wording of the rule, it should be apparent that participation in the distribution ends no earlier than the sale of all IPO shares or units allocated to the participant. Typically, this will be on the effective date of the registration statement for the IPO. But, this is not always true. In cases where the underwriter has released insiders from a lock-up agreement and purchased their shares, a very plausible argument can be made that these shares were "acquired in connection with the distribution," thereby prolonging the underwriter's participation in the distribution, possibly for several months.

To investigate this issue prior to hearing, the following discovery should be undertaken:

1) Request a copy of the lock-up agreements from the underwriter, along with documents evidencing the release of shares from the lock-up agreement and the purchase of those shares by the underwriter.

2) Check with Disclosure, Inc. For SEC Form 4,[11] "filings by insiders of the issuer;[12]

3) Request trading account inventory records from the underwriter to show that it did not immediately liquidate its position in insider shares "acquired in connection with the distribution;[13]

4) Request the underwriter's records via order tickets, time-stamped confirmations, or in whatever form which shows the date and times that IPO purchases were confirmed; and

5) Check that the options may, in an individual case, prolong the term the underwriter is deemed to be participating in the distribution.[14]

Proving When the Aftermarket Sale Was Solicited

Establishing the underwriter's participation in the distribution extended beyond the effective date of the IPO, establishes the second element, after market solicitations, because the aftermarket confirmation will be dated as of a date clearly before the date upon which the distribution ended. However, most of the time, you aren't going to be able to establish this fact.

Many times, I have found other documentary evidence which supports my client's contention of a 10b-6 violation. The most obvious evidence involves using the broker's telephone records to show that there was no telephone contact between the broker and the customer between the time the IPO was completed and the time the aftermarket trades were executed. Compare these telephone records to either the broker's time-stamped order tickets or the NASDAQ time/ volume report which shows the time the transactions were reported to NASDAQ.[15]

If telephone records are unavailable or inconclusive, check the calendar of the claimant to see whether you can prove he was inaccessible between the times of the IPO and aftermarket transactions. For example, if the claimant is a surgeon who was operating during this entire period, he obviously was solicited for the aftermarket transaction prior to the IPO. Sometimes, the same thing can be accomplished by using the broker's calendar or his firm's attendance records. These may show that the registered representative was unavailable during the critical time period.

Another source of documentary evidence supporting the claimant's allegation may be found from his method of payment. In my example, if the fictitious investor sent a check in the amount of $25,000 two days <u>before the effective date of the IPO</u>, this should establish that he has been solicited to purchase $25,000 worth of securities <u>as of that</u>

time.

Complaints of other customers may also support claimants' allegations. The claimant may have a friend or business associate who dealt with this same broker and who had the same experience. If not, secure and examine the broker's U-4 filings and the firm's complaint file. The complaint file should be reviewed both as to this particular broker and as to this underwriting. Proof of other customers complaining about forced aftermarket purchasers before the IPO, will corroborate your client's allegations.
Sometimes it pays to go a little further and subpoena from the SRO's the statements of claim in any other arbitration proceedings which have been filed relative to this broker or this underwriting. You may find corroborating evidence of a 10b-6 violation even if the other claimant has not alleged a violation of Rule 10b-6. Some second tier firms have been known to be very blatant in their violations of 10b-6. They often tell their customers that in order to be allocated any units in the IPO, the customers will have to agree to take an aftermarket position. I have seen statements of claim which make this factual allegation but for whatever reason do not plead a 10b-6 violation.

Finally, it is always worthwhile in discovery to seek the firm's policies and procedures designed to prevent violations of Rule 10b-6. You will be surprised how elaborate some of these policies and procedures are even in second tier firms also. It has been my experience that even if the policies and procedures exist that they are often not being followed. I once tried a case against a firm whose policy called for a file to be maintained of all 10b-6 complaints regarding each underwriting. In response to my discovery request, I was told that the file was empty. Fortunately, I had talked to attorneys for other claimants and had been able to obtain copies of complaint letters and correspondence between their clients and the firm's compliance director. At the hearing, I first let the compliance officer testify as to how seriously his firm took rule obligations under Rule 10b-6 and how he was proud to say that no other customers had never complained about such a violation. I was then able to sink this witness deep into the house of pain by confronting him with complaint letters and correspondence with his name on them.
Summarizing, the following documents may be helpful to you in proving that aftermarket purchases were solicited in violation of Rule 10b-6:

(1) Telephone records of calls from the broker to the client's phone number(s) and of calls from the client to the broker's toll-free telephone line;

(2) The claimant's canceled check, evidence of wire transfer, or other documents which will show payment for the aftermarket purchase before the completion of the IPO;

(3) Time-stamped order tickets or other records of original entry which show the exact time of the last IPO transaction by this brokerage firm and the aftermarket transaction(s) in the claimant's account;

(4) NASDAQ Time/Volume Report to show when IPO and aftermarket transactions were reported as having been executed by this firm;

(5) Complaints from other customers as to the registered representative and the underwriting, including copies of statements of claim in other arbitrations;

(6) The broker's policies and procedures designed to assure compliance with Rule 10b-6;

(7) The calendars of the claimant and the broker as well as the firm's attendance record.

Conclusion

Payday for many second tier firms comes both from their IPO's offerings and their participation in aftermarket trading in these securities on the first day. In my experience, if there is an aftermarket transaction with a second tier broker which occur on the same day as the IPO, there is almost always a of Rule 10b-6 violation. Proving the violation involves special challenge. You will have to establish the critical time periods. These periods are when a distribution ends and when aftermarket activity may lawfully begin. Counsel will often have to educate the arbitrators as to the requirements of the Rule. Many panelists have never heard of Rule 10b-6, much less what it requires. However, these challenges can be met. I believe that rule 10b-6 can

be a valuable tool to obtain an award for your client. This is particularly true in those cases where the suitability and misrepresentation claims have crumbled.

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[1] Of course, in order to establish a Rule 10b-6 violation it is not necessary for the customer to have purchased shares or units in the actual IPO. It is the act of inducing aftermarket purchases before the IPO is competed which constitutes the violation.

[2] Usually as underwriter or selling group member.

[3] I.e., the trade date for the IPO purchase at the price specified in the prospectus.

[4] SEC Broker/Dealer Law and Regulation, by Norman S. Poser, Little Brown & Co., at p. 226.

[5] 15 U.S.C. § 78j(b) [Emphasis added]

[6] Rule 10b-5 states as follows:

[7] Indeed the section heading immediately prior to Rule 10b-1 in the states: "Manipulative and Deceptive and Contrivances."

[8] Often the price is around $2.

[9] One can readily see why a special Rule, Rule 10b-6, was enacted to prohibit firms from arranging aftermarket transactions before the IPO distribution is completed.

[10] The $10,500 loss on the stock adjusted by the $3,000 profit on the sale of the units.

[11] Forms 4 are required to be filed by all officers, directors and 10 percent holders of securities in publicly traded issuers at the end of each month in which their beneficial ownership changes.

[12] If the underwriter happens to be less than candid in its discovery responses you may establish that shares were released from the lock-up agreement by reviewing these forms.

[13] Such failure lengthens the time period of his participation in the distribution for purposes of Rule 10b-6.

[14] After stating that an underwriter has completed his participation in a distribution once he has distributed his participation, the rule goes on to state as follows:

"Provided, however, that an underwriter will not be deemed to have completed his participation if he has obtained an option in connection with that distribution pursuant to which he purchases from the issuer an additional amount of securities not necessary to cover any syndicate short position that remains in connection with that distribution."

The mere existence of such an option also will prolong the time period during which Rule 10b-6 applies to the underwriter.

[15] NASDAQ refers to this report by a number of names. We have heard NASDAQ representatives call the report a TMTR Report, Market Maker Activity Report, and Time/Volume Trading Report.

Pennsylvania District Court Rules on Section 15 Tolling Argument

In Janney Montgomery Scott v. Simonye 1998 WL 195641 (E.D. Pa.), the Court was faced with the question of the eligibility requirements of Section 15 of the NASD Code of Arbitration and what types of claims which relate to the initial securities transactions which occurred more than six years prior to filing but yet could survive a Section 15 motion to dismiss.

Following the 3rd Circuit's precedence, PaineWebber v. Hoffman, 984 F. 2d 1377 (3rd Cir. 1993), the Janney Court barred all transaction related claims that were more than six years old from arbitration, including claims for churning,

unauthorized trading and unsuitability.

However, the Court noted that Hoffman dictated that the language in the statement of claim generally dictates what constitutes a cause of action and that a claim should proceed to arbitration unless the asserted cause of action is not clearly indicated to be a mere tolling or discovery argument. As to a claim that the brokerage firm actively concealed the broker's wrongdoing, the Court noted that the Hoffman court stated that the concealment cause of action was not clearly a tolling or discovery argument, and could be reasonably construed as either a valid claim or a tolling argument. Whether the brokerage firm had a duty to inform the customer of the broker's wrongdoing, therefore, is a question appropriately left for the arbitrators, and is not susceptible to a Section 15 motion.

The Janney court then ordered to arbitration the remaining claimant's claims which consisted of breach of fiduciary duty, misrepresentation of material facts, failure to supervise, breach of contract, fraud, and negligence.

Ninth Circuit Precludes Arbitration of Title VII Claims

In Duffield v. Robertson Stephens & Co. 1998 WL 227469 (9th Cir. (Cal.), the Ninth Circuit weighed in on the arbitrability of Title VII claims issue, finding that the signing a U-4 did not require a brokerage firm employee to arbitrate Title VII claims.

The Court looked at the legislative history of the Civil Rights Act of 1991 and noted that, as of the time of the passage of the law, congress perceived the state of the law as forbidding compulsory arbitration agreements, and, at the very least, viewed them as inappropriate. In its finding, the Court further noted that Congress, in its deliberation of the Act, rejected an amendment that would have allowed compulsory arbitration agreements to be enforced.

Seventh Circuit Allows Arbitration Against Principals of Closed Broker/Dealer

In Miller v. Flume, 139 F. 3d 1130 (7th Cir. 1998), the Court was asked to decide whether an investor could compel a second arbitration against the principals of a closed broker/dealer.

The customers had secured an NASD arbitration award against the broker/dealer. After the arbitration, the broker/dealer filed to vacate the award and, during the time of the appeal, ceased operations. Also during that period, the individual broker defendants transferred assets to the parent company of the broker/dealer and to another broker/dealer which was controlled by one of the individual brokers.

The customer then filed a second arbitration claim against the individual brokers alleging that the brokers were former principals and control persons of the closed broker/dealer and described the fraudulent transfers of the assets of the broker/dealer.

The brokers filed a request for an injunction against the second arbitration, arguing that they had not consented to nor were they required to arbitrate by virtue of their NASD affiliation. The District Court found in favor of the brokers, relying on its findings that the customers were no longer "customers" within section 12(a) of the NASD Code of Arbitration Procedure and that the dispute over the collection of a judgement was not a claim "arising" in connection with transactions in the customers' accounts.

In reversing and compelling arbitration, the Seventh Circuit found that the brokers were "persons associated with a member" and therefore subject to the NASD's arbitration requirements. The Court also distinguished the cases that the lower Court had used to disqualify the customers as "customers" under NASD rules. The lower Court's

cases were in the circumstance where one firm sold its assets to another firm and the customers attempted to sue the new firm for transgressions that had occurred at the original firm. The Seventh Circuit found that, in the instant case, that the customers were "customers" both at the time the original fraudulent activities took place and when the assets of the broker/dealer were later fraudulently transferred. Lastly, the Appeals Court disagreed with and overruled the lower Court's narrow reading of "arising" in connection with transactions between a member and a public customer, noting that arbitration has been mandated in the circumstance of a broker's having borrowed and/or misappropriated client funds, which does not fit squarely under the notion of a transaction.

New York District Court Refuses to Vacate Punitive Damage or Attorney Fee Award Based on New York Choice of Law Provision

In Porush v. Lemire, 1998 WL 262581 (E.D.N.Y.), the Court was asked by the defendant in the arbitration, Porush (a former Stratton Oakmont principal), to vacate the arbitrators award of punitive damages and attorney's fees based on a New York choice of law in the arbitration agreement. Porush attempted to differentiated his case from Mastrobuono v. Shearson Lehman Hutton, 115 S.Ct. 1212, noting that the Mastrobuono arbitration agreement only called for a general application of New York law, whereas the agreement at issue provided that the substantive rights and liabilities of the parties should be determined by New York law. Porush argued that this evidenced a clear intent that excluded punitive damages from the arbitration, as was required by Mastrobuono.

The Court rejected the argument, noting that nothing in the subject choice of law clause mentioned punitive damages and therefore could not amount to the requirement of an unequivocal agreement to exclude punitive damages.

Porush made the same argument on attorney's fees, and the Court, citing PaineWebber v. Bybyk 81 F. 3d 1193 (2nd Cir. 1996) as controlling, rejected that argument and confirmed the arbitrators' award of attorney's fees.

The Use of NASD Notice to Members Bulletins as Precedent in Arbitration Proceedings

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

[This is the first part of a two part article, the second part of which will appear in the September 1998 issue of the Quarterly.]

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I. Introduction

This is the second of three articles dealing with sources of precedent and/or persuasive authority outside of state and federal court venued decisions. The first of three articles in this series was published in Securities Arbitration 1997 (Page 471-525, Practicing Law Institute) and was entitled, "The Use of Securities and Exchange Commission Decisions as Precedent in Arbitration Proceedings".

Attorneys representing parties in arbitration proceedings are increasingly being asked by Arbitration Panels to produce concise citations to authority to support their clients positions. Unlike exhaustive briefs which might be filed in federal court venued securities fraud cases, many arbitrators are simply looking for one or two cases to support an award. Since the ruling of the United States Supreme Court in Shearson/American Express v. McMahon, which has resulted in the majority of customer claims being resolved in arbitration proceedings versus court venued proceedings versus court venued proceedings, there is a dearth of case law within the past ten years addressing the obligations of a brokerage firm to the investing public. The bulletins of the National Association of Securities Dealers, Inc., (known as NASD) Notice to Members offer guidance to the practitioner and Arbitration Panels on virtually any issue involving the obligations of the brokerage firm to the investor.

II. Historical Background

NASD Notice to Members, published by the National Association of Securities Dealers, Inc., have been relied upon in varying degrees in court cases and have offered guidance to the courts in fashioning theories of liability. See United States v. NASD, 422 U.S.; 95 Sct 2427; 45 L.Ed. 486 (1975); Harden v. Raffensperger Hughes & Co., 65 F 3d 1392 (7th Circuit 1995) at 1401; General Bond & Share Co. v. SEC, 39 F 3d 1451, 1456 (10th Cir. 1994); 932 F. Supp. 1509 and 1538.

NASD Notices to Members serve a number of different purposes including notifying members and affiliated members of the following:

1. Proposed changes or actual changes in rules or procedures regulating broker dealer conduct.

2. Summaries of NASD disciplinary proceedings.

3. Requests for comments from members on issues affecting broker dealers and their members.

4. Interpretations of policy and directives on broker dealer conduct and procedures.

Section 1(a)(3) of Article VI of the NASD By-Laws delegates interpretation of NASD Rules by the NASD Board of Governors to the staff of the NASD. NASD Notice to Members originate from

the Offices of General Counsel of NASD, Inc., NASDAQ and/or NASD Regulation with most of them being issued from NASD Regulation. Unfortunately, the text of many NASD Notices to Members do not indicate which of the three General Counsel Offices specific Notices to Members are issued from. Ultimately, the Offices of General Counsel of NASDAQ and NASD Regulation are accountable to the Office of General Counsel of NASD, Inc., and all Notices to Members have the implicit approval of NASD, Inc., even though they may have issued from NASDAQ or NASD Regulation.

Policy pronouncements announced in Notice to Members require approval of the Board of Governors of the NASD. Likewise, any intended rule changes to be made by the NASD which constitute a material change of policy or practice are required to be filed with the Securities and Exchange Commission for approval pursuant to SEC rule 19b-4 and Section 19(b) of the Securities and Exchange Act of 1934 (see also 36 CFR Section 240).

The full text of NASD Notices to Members from January 1, 1997, onward are available free of charge on the NASD Regulation web site (www.nasdr.com) with executive summaries of NASD Notice to Members issued in calendar year 1996 being accessible through the same web site. Although the NASD has incorporated and annotated index for NASD Decisions from January 1, 1998, through the present onto the web site, Notices to Members as a matter of course with the understanding that rule changes and policy pronouncements and clarification are to be made available or otherwise made known to registered representatives and associated persons as part of an ongoing duty of broker dealer supervision and continuing education.

Specific Notices to Members can be obtained by written request to NASD Support Services Department, 1735 K Street, N.W., Washington DC 20006-1500. An annual subscription is available to the public at large at the present annual subscription rate of $225.00 per year by writing NASD Media Source, P. O. Box 9403, Gaithersburg, MD 20898-9403.

The NASD Notice to Members bulletins addressed in this article will be limited primarily to this last category relating to interpretations of policy and directives on broker dealer conduct rules and procedures.

III. The Joint Regulatory Sales Practice Sweep: Heightened Supervisory Procedures NASD Notice to Members 97-19

NASD Regulation and the New York Stock Exchange recently made findings and recommendations in their Joint Regulatory Sales Practice Sweep focusing on the necessity of close supervision for certain registered representatives with regulatory or complaint histories with recommendations on hiring procedures and the need to implement heightened supervisory procedures for these brokers. The memorandum noted that:

> A firm that hires one or more registered representatives with a history of customer complaints, disciplinary actions, or arbitrations, or that employs a registered representative who develops such a record during his or her employment, should recognize that it has heightened supervisory responsibilities that will require, it at a minimum, to examine the circumstances at each such case and make reasonable determination whether it's standard supervisory and educational programs are adequate to address the issues raised by the record of any such registered representative.

The memorandum goes on to state that firms which do not have a standard supervisory policy in place to deal with such representatives have an obligation to implement such policies to provide heightened supervisory procedures where warranted.

Specific recommendations in addressing problem registered representatives include the recommendation of "the individual who will oversee the activities of the registered representative such be adequately qualified and have the appropriate training and experience to provide adequate supervision", with a further recommendation that "the firm also should

review the registered representatives CRD record and the nature of the activities in which he or she is, or will be, engaged (considering, for example, the types of products he or she plans to sell and reviewing the persons top accounts, including changes or trends in account activity and commissions earned)". With regard to the specifics of the structure of such heightened supervision, it was recommended that:

> The firm should consider meeting with the registered representative and the person who is or will be his or her supervisor, during which the supervisor's understanding of the prior conduct of the registered representative and willingness to accept responsibility of his or her supervision can be confirm.

With such specific recommendations there should be very little guess work as to what is required of brokerage firms when dealing with problem registered representatives.

The memorandum also directs that the actual structure and implementation of a heightened supervisory arrangement for a particular registered representative should be known to all parties participating in such an arrangement noting that:

> For such procedures to be effective, the firm should alert the registered representative and the supervisor to the terms of the special supervision, including the period of time the special supervisory procedures will be in effect...the firm could require the registered representative and his or her direct supervisor to sign an acknowledgment, indicating their understanding and their agreement to abide by the terms of the special supervision for the requisite time period...it is also advisable for the firm to document the termination of a period of special supervision, including an assessment of whether the objectives of the supervisory arrangement were met...it is important that firms retain evidence of special supervision.

The memorandum has made very clear of what is expected of broker dealers with a heightened supervisory obligation with problem brokers.

Specific recommendations were made in the memorandum relative to new account procedures and specifically relating to completion of customer account information on new account form and initial trades in new accounts. Specifically, the memorandum recommends that "[i]n addition to the normal requirements for opening a new account set out in NASD Rule 3110...the manager might choose to speak with all or selected new account holders or to independently verify the customer information on the account form on a random or consistent basis, depending on the situation...[i]f the firm deemed it prudent in view of prior activities, it might prohibit any trading until the account information or the order information could be independently verified with the customer". This logical extension of a broker dealer's duty of supervision would have to be adhered to in order to show full compliance.

The memorandum also recommends that the heightened supervisory requirements and restrictions might include that:

> [w]hen reviewing conduct to determine whether heightened supervision is warranted, firms should focus on whether a specific type of transaction was involved in prior problems, and should consider prohibiting like transactions, or requiring supervisory approval of all such transactions in advance of execution, as is routinely required in many firms in the case of low-priced securities, options and discretionary trades.

The recommendations in the memorandum could not be more specific - problem brokers should be closely monitored in order to assure that they do not repeat improper sales activities which his or her firm has actual notice of. Notice to Members 97-19 followed on the heels of the "rogue broker" policy pronouncements of the Securities and Exchange Commission in 1995.

IV. Bank Brokerage NASD Notice to Members 97-89-Requirements Applicable to Brokers/Dealers Operating on the Premises of Financial Institutions

With the gradual chipping away at the Glass-Steagall Act which required the separation of banking from the securities brokerage business, the investing public has been faced with the mushroom of branch banks on Main Street offering savings accounts and certificate of deposit accounts as well as securities brokerage services. The rapid growth of this phenomenon has been accompanied in many instances without a commensurate growth of an appropriate supervisory and compliance structure at banking institutions sufficient to supervise the activities of individual brokers at bank branch offices. Banks have been remiss in making known to the banking public that investments in the financial markets offer a wholly different risk profile than that of federally insured bank deposits.

The Securities and Exchange Commission approved NASDR Rule 2350 imposing specific requirements on broker/dealers transacting business on the premises of banking institutions (Release No. 34-39294, 11/4/97). The main thrust of this requirement is comprehensive customers disclosure and written acknowledgment "intended to assist investors in making investment decisions based on a better understanding of the distinction between insured deposits and uninsured securities products" with the requirement that investors in such situations provide a "written acknowledgment in all but rare circumstances...at or prior to the time that a customer account is opened by a member on the premises of a financial institution where retail deposits are taken" to the effect the broker affiliate shall disclose orally and in writing, that the securities products purchased or sold in a transaction with the member:

i. are not insured by the Federal Deposit Insurance Corporation;

ii. are not deposits or other obligations of the financial institution and are not guaranteed by the financial institution; and

iii. are subject to investment risks, including possible loss of the principal invested with a further proviso that

the broker/dealer "make reasonable efforts to obtain from each customer during the account opening process a written acknowledgment" of the above (see NASDR Rule 2350).

Notice to Members 93-87 (December 1993) and Notice to Members 94-16 (March 1994) also deal with the interplay of banks and brokerage firms. These notices are directed to the respective obligations of banking institutions under the rules of fair practice to the investing public relative to the marketing of mutual funds as replacements for maturing certificates of deposits and communications and disclosures of material information about mutual funds sales.

In Notice to Members 97-89 (SEC Approves Bank Broker/Dealer Rule; effective February 15, 1998) members were advised of SEC approval of new NASD(R) rules 2350 in SEC release no. 34-39294 (11/4/97) which specified requirements applicable to broker/dealers operating in the premises of financial institutions. This Notice addresses 11 practical questions with comprehensive answers as to the exact manner in which bank broker/dealers must comply with the comprehensive new guidelines regarding the provision of comprehensive disclosure to banking clients advising them of the separateness and different risk and security parameters of bank investing versus investing in the securities markets with a further requirement of obtaining a written acknowledgment from the client of advisement of the required disclosures.

V. Branch Office/Satellite Office Supervisory Obligations NASD Notice of Members 80-20; NASD Notice to Members 86-65; NASD Notice to Members 89-34 and NASD Notice to Members 92-18

i. Notice to Members 80-20 (November 12, 1980)

In Notice to Members 80-20 (May 12, 1980), the NASD set forth a supervisory check list to be used in branch office examinations in order to "provide those responsible for branch office supervision with some helpful reminders of what could be done to avoid

unintentional violations of applicable rules and regulations". In issuing the same, the NASD sought to provide "a guide to members in developing and maintaining the supervision policies and procedures necessary to meet their own needs".

The supervisory checklist set forth in Notice to Members 80-20 consists of 8 pages of specific requirements addressing money and securities handling, books and records, sales practices, correspondence and advertising, options, municipal securities transactions, trading and order room operations, supervision of accounts, supervision of branch offices, supervision of other branch offices (for branches which have supervisory jurisdiction over other branches) and the need to assure compliance with applicable state laws. The supervisory check list contained in Notice to Members 80-20 can be a valuable tool in cases involving supervisory shortcomings and can afford the framework for establishing supervisory standards in cases involving alleged trading improprieties in branch offices.

ii. Notice to Members 86-65, Compliance with NASD Rules of Fair Practice in the employment and supervision of off site personnel (9/12/86).

In defending customer complaints of brokerage misdeeds involving their registered representatives, many firms try to distance themselves from the misdeeds of individual brokers by claiming that the individual broker is merely an independent contractor and not an employee of the firm. In addressing this issue in NASD Notice to Member 86-65, it was noted that:

> irrespective of an individual's location or compensation arrangements, all associated persons are considered to be employees of the firm with which they are registered for purposes of compliance with the NASD Rules governing the conduct of registered persons and the supervisory responsibility of the member...[T]he fact that an associated persons conducts business at a separate location or is compensated as an independent contractor does not alter the obligation of the individual and the firm to comply fully with all applicable regulatory requirements.

This Notice to Members noted that regardless of the full-or part-time status of a registered person and regardless of whether or not such registered persons are engaged in other business enterprises such as insurance, real estate sales accounting or tax preparing, the fact of their location away of offices of members "because of their location and other circumstances of their employment, off-site personnel have a greater opportunity than on-site personnel to engage in undetected selling away".

iii. NASD Notice to Members 89-34. Specific Recommendations on Supervision.

In NASD Notice to Members 89-34, Guidelines for Compliance with the NASD Rules of Fair Practice and Supervisory Requirements, (April 1989) clarifies previous amendments to former Article III, Section 27 of the Rules of Fair Practice.

First, this Notice directed that the supervisory system established in compliance with Article III, Section 27 "must cover all aspects of the firm's investment and banking and securities business, including back office; corporate financing; trading activity; market services such as SOES, OTC, NASDAQ/NMS trade reporting; and so forth". The Notice also set forth that a simple telephone interview is inadequate compliance with the annual compliance interview requirement of former Section 27(a)(7).

With regard to the type of records the firm should maintain to establish compliance with former Article III, Section 27 as amended, the Notice noted that the purpose of the requirement is three-fold:

1. To provide the member an opportunity to review the product mix and method of operation of each representative and emphasize compliance issues related thereto;

2. To provide the representative an opportunity to ask any questions he or she may have and receive authoritative guidance; and

3. To communicate regulatory

developments, firm policies, and similar information to the representatives.

The Notice also sets forth the mode of record keeping required to evidence compliance with the above suggesting the maintenance of "records that reflect the date and location of the interview or meeting, the attendees, and the subjects discussed".

VI. Variable Annuity Contracts

Variable annuity contracts have been aggressively marketed by brokerage firms as evidenced by the astronomical growth in sales volume. In NASD Notice to Members 86-96 (December 1986), NASD Regulation reminded members and associated persons that sales of variable contracts are subject to NASD suitability requirements given their status as securities under the Securities Act of 1933 and set forth that all of the suitability requirements of Rule 2310 applicable to other securities are applicable to variable contracts. Specifically, the notice that, "...specific factors regarding a recommendation to purchase variable products that could be considered under the NASD 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 a 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;

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

These particulars form a precise frame work for any practitioner making any inquiry into public customer case involving possible variable contract abuses.

Notice to Members, Notice No. 86-96 also highlighted the need to be vigilant for abuses in the area of variable contracts noting that;

> NASD Regulation is aware of the practice whereby a registered representative replaces a customers existing variable contract with a new variable contract that doesn't improve the customer's existing position, but generates a new sales commission for the registered representative.

Thus, any replacements of an existing variable contract with a new variable contract are subject to close scrutiny with the requirement that the solicitation of such a change be motivated primarily by suitability consideration as opposed to other concerns such as the generation of commissions (see Rule IM-2310.2(b)(2) of the NASD Conduct Rules).

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