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PIABA Bar Journal

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Features And Columns

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The Bar Journal of the Public Investors Arbitration Bar Association

From the Editor's Desk

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The PIABA Bar Journal is interested in receiving submissions from PIABA members and non-members, including experts, mediators, arbitrators and securities regulators. Manuscripts are reviewed prior to publication and are accepted for publication based on, inter alia, quality, timeliness and the subject's importance to PIABA and the arbitration/investor-attorney community. Individuals interested in contributing in the future should contact Jason Doss, Robin Ringo or any member of the Board of Editors. Your comments and contributions are always welcome.

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Winter, 2006 issue of *PIABA Bar Journal* is December 31, 2006. All submissions should adhere to the following format:

Written materials should be submitted on a disk in word or word perfect format with a printed copy.

1. One inch margins top, bottom and sides.
2. Single Space text; double space between paragraphs.
3. Do not indent paragraphs.
4. Put the title of the article at the top followed by the author's name and a short author biography.
5. Do not use footers or headers.
6. Use footnotes rather than endnotes.
7. Articles shall be submitted for black and white reproduction.
8. Attachments should be a clear, quality copy suitable for reproduction.
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10. PIABA reserves the right edit or reformat materials as required.

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President's Letter

Steven B. Caruso

As I begin my term as President of PIABA, I am pleased to be able to provide our membership with some of my thoughts and objectives for the coming year.

For those of you who were able to attend the PIABA 15th Annual Meeting in Tucson, Arizona this past October, I hope that you will share my opinion that this conference was, once again, a wonderful opportunity to share our experiences, collaborate on our strategies, and collectively increase our knowledge and wisdom - all of which will ultimately benefit our most important asset - our public investor clients.

Recently, I was asked to describe, in five words or less, what we at PIABA really do. After dismissing the all too natural "legalistic" response, the thought that most immediately came to mind was that we "deal in justice."

I would submit to each of you that we "deal in justice" whenever a public investor has been the subject of misconduct that has wiped out the assets which required a lifetime of blood, sweat and tears to accumulate; we "deal in justice" when that same public investor then initiates an arbitration proceeding and is subjected to a host of predatory motions and discovery abuses which seem to be more the norm, rather than the exception, in the mandatory dispute resolution forums of self-regulatory organization arbitration; and, most importantly, we "deal in justice" when the hopes and prayers of a public investor for the recovery of their financial security and dreams are presented before a panel of all-too-often conflicted and uncaring arbitrators.

During the coming year, I intend to continue to focus the spotlight of attention on what are often perceived as some of the more egregious components of the existing system of arbitration - the mandatory presence of "industry" arbitrators on every arbitration panel and the immorality of those purported "public" arbitrators who, despite their disarming label, have disclosed and/or undisclosed financial ties to the securities industry.

And I am particularly going to continue our attempt to expose the coordinated efforts, of some of our brethren on the defense side of the aisle, who seem to have now embraced extensive motion practice as some sort of terroristic blood-sport of overt intimidation.

As we continue to oppose motions to dismiss, for example, I am constantly reminded of the guidance that has been consistently provided by the United States Supreme Court, over the past century or so, on issues of a similar note:

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• "All parties . . . . must be given opportunity to cross-examine witnesses, to inspect documents, and to offer evidence in explanation or rebuttal. In no other way can a party maintain its rights or make its defense. In no other way can it test the sufficiency of the facts." [*Interstate Commerce Commission v. Louisville & N.R. Co.*, 227 U.S. 88 (1913)]; and

• "Particularly where credibility and veracity are at issue . . . . written submissions are a wholly unsatisfactory basis for decision" since "in almost every setting where important decisions turn on questions of fact, due process requires an opportunity to confront and cross-examine adverse witnesses." [*Goldberg v. Kelley*, 397 U.S. 254 (1970)].

While these words may have arisen from issues and forums that differ from what we are being confronted with in the context of securities arbitrations today, I would suggest to each of you that their underlying principles of morality and fairness have never been more applicable or more important.

In closing, I want to acknowledge and express my personal appreciation to all of the individuals who, on a daily basis, are the ones who "deal in justice" on behalf of our entire organization - my fellow directors; the chairs of our various committees; all of our members who tirelessly share their advice and guidance on our internal list-serves; and our wonderful team in Oklahoma, Robin Ringo, Karrie Ferguson and Tiffany Zachary.

Motions to Vacate: How Much Information Should Arbitrators Disclose?

J. Steven Parker

INTRODUCTION

NASD Dispute Resolution asks prospective arbitrators a series of questions designed to determine conflicts of interest or other circumstances from which partiality or bias may be inferred. Ostensibly NASD Dispute Resolution forwards the answers to the parties. Before the arbitration begins, each arbitrator takes an oath swearing that his answers were true.

This article will address whether an arbitration award should be vacated because of an arbitrator's false response to one or more questions that are designed by the NASD or other sponsoring forum to elicit circumstances evidencing possible bias. Furthermore, this article will discuss whether an arbitration award can be vacated on the basis that the arbitrator falsely certified in his oath that all required disclosures had been made. As will be explained in more detail below, the answer to both questions is almost certainly "yes."

In a fractured decision interpreting the Federal Arbitration Act ("FAA"), the U.S. Supreme Court established the broad rule that an arbitration award must be vacated when an arbitrator fails to *disclose all circumstances that might create an impression of possible bias.* The majority opinion in that Supreme Court case is unclear, and a special concurring opinion serves to obscure rather than illuminate the precise meaning of the rule the Court announced. In applying the rule, the lower courts have adopted two distinct approaches: The 5th, 8th, 9th, 11th, and D.C. Circuits will vacate an award when a non-disclosed circumstance demonstrates a mere "reasonable impression of partiality." The 2nd, 4th, 6th and 7th Circuits impose a higher burden, requiring a showing that "a reasonable person would have to conclude that the arbitrator was partial to one party or the other." Under the latter approach, many motions to vacate are denied because the arbitrator was unaware of the circumstance alleged to indicate bias, or because the non-disclosed relationship or circumstance was "trivial" or "insignificant."

Where an arbitrator answers a specific question falsely, however, vacatur is more likely not only because the question came to the arbitrator's mind, but also because the question is objective evidence of the sponsoring forum's and the parties' consideration of the materiality of the question. This fact all but precludes a finding that the nondisclosure is "trivial," and makes vacatur likely even under the more stringent test. The few cases that address false answers to specific questions favor vacatur. Analogous cases dealing

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with false answers by jurors during *voir dire* lend additional support in favor of vacatur.

NASD CODE OF ARBITRATION AND THE OATH OF ARBITRATOR

The parties to an NASD arbitration typically enter into an agreement by which they agree to arbitrate disputes arising between them pursuant to the Rules and Regulations of the National Association of Securities Dealers ("NASD"). Rule 10312 of the NASD Code of Arbitration Procedure ("NASD Rule") provides:

> 10312. Disclosures Required of Arbitrators and Director's Authority to Disqualify
>
> (a) Each arbitrator shall be required to disclose to the Director of Arbitration any circumstances which might preclude such arbitrator from rendering an objective and impartial determination. Each arbitrator shall disclose:
>
> > (1) Any direct or indirect financial or personal interest in the outcome of the arbitration;
> >
> > (2) Any existing or past financial, business, professional, family, social, or other relationships or circumstances that are likely to affect impartiality or might reasonably create an appearance of partiality or bias. Persons requested to serve as arbitrators must disclose any such relationships or circumstances that they have with any party or its counsel, or with any individual whom they have been told will be a witness. They must also disclose any such relationship or circumstances involving members of their families or their current employers, partners, or business associates.
>
> (b) Persons who are requested to accept appointment as arbitrators must make a reasonable effort to inform themselves of any interests, relationships or circumstances described in paragraph (a) above.
>
> (c) The obligation to disclose interests, relationships, or circumstances that might preclude an arbitrator from rendering an objective and impartial determination described in paragraph (a) is a continuing duty that requires a person who accepts appointment as an arbitrator to disclose, at any stage of the arbitration, any such interests, relationships, or circumstances that arise, or are recalled or discovered.

The same Rule provides the following procedure for challenging an arbitrator for cause:

> (d) Removal by Director
>
> > (1) The Director may remove an arbitrator based on information that is required to be disclosed pursuant to this Rule.
> >
> > (2) After the commencement of the earlier of (A) the first pre-hearing conference or (B) the first hearing, the Director may remove an arbitrator based only on information not known to the parties when the arbitrator was selected. The Director's authority under this subparagraph (2) may be exercised only by the Director or the President of NASD Dispute Resolution.
> >
> > (3) The Director will grant a party's request to disqualify an arbitrator if it is reasonable to infer, based on information known at the time of the request, that the arbitrator is biased, lacks impartiality, or has an interest in the outcome of the arbitration. The interest or bias must be direct, definite, and capable of reasonable

> demonstration, rather than remote or speculative.

Id. Subsection (e) provides that the Director of Arbitration will forward to the parties any information disclosed by an arbitrator under the Rule, except in limited circumstances enumerated under the rule that are not pertinent to this article.

NASD Dispute Resolution requires each eligible arbitrator to create and maintain an arbitrator profile. The profile is maintained via an "arbitrator update form," a blank version of which is accessible via the internet at http://apps.nasd.com /Mediation_&_Arbitration/ArbInfoUpdate.asp. The following message appears on the web page:

> It is essential that the information NASD Dispute Resolution provides to parties regarding the arbitrators on our roster be accurate and up-to-date. For this reason, arbitrators have a continuing obligation to update the roster information that we maintain on their behalf. Accordingly, if you are already an arbitrator on our roster, please use the following form to notify us of any new or revised information.

After spaces for the arbitrator to enter personal contact information, there is a list of eight questions. In addition to the Arbitrator Profile, NASD sends an "Arbitrator Disclosure Checklist" to each arbitrator appointed to a specific case.[1] The checklist recites:

> The Arbitrator Disclosure Checklist is sent to the arbitrators as part of the Oath of Arbitrator. It not only provides a reminder to the arbitrators to consider all possible disclosures, but also requires a complete explanation of any possible conflict with the parties.
>
> Please indicate your response to each of the questions listed below by checking the appropriate box. Please check "yes" or "no" to each question. Provide a **full explanation** to any question(s) to which you provided a "yes" response. All affirmative responses and explanations will be sent to the parties. (emphasis in original).

Following that introduction are 28 questions that each arbitrator must answer.

NASD Rule 10308 provides that after the commencement of arbitration the parties will be provided with a list of prospective arbitrators from which a panel will be selected. In addition to the Arbitrator Profile and the Arbitrator Disclosure Checklist, the practice of NASD is to send, concurrently with the initial list of names, a brief biography of each arbitrator. At the bottom of page one of this biography is, in summary format, a description of certain disclosures that have been made by each arbitrator. The summary is intended to alert the reader to possible disclosures from the checklist. Either party may strike one or more of the arbitrators for any reason. NASD Rule 10308 (c)(1).

Each arbitrator takes the following oath of arbitration:

> <u>Oath of Arbitrator.</u> The Oath of Arbitrator is executed by every arbitrator and returned to NASD Dispute Resolution before the arbitrator makes any decision or attends a hearing. As part of the Oath, you are required to review three documents: The Temporary and Permanent Disqualification Criteria; the Arbitrator Disclosure Checklist; and your Arbitrator Disclosure Report.

[1] This document is not typically sent to the parties unless the arbitrator answers one or more of the questions in the affirmative.

Following that statement is the actual Oath:

> Having been selected as an arbitrator to consider the matter in controversy between the above-captioned parties, I affirm that I am not an employer of, employed by, or related by blood or marriage to any of the parties or witnesses whose names have been disclosed to me; that I have no direct or indirect interest in this matter; I know of no existing or past financial, business, professional, family, or social relationship which would impair me from performing my duties; and that I will decide the controversy in a fair manner and render a just award.
>
> I have carefully read, reviewed, and considered NASD Dispute Resolution's Temporary and Permanent Arbitration Disqualification Criteria. I affirm that, based on the criteria, I am not temporarily or permanently disqualified from being an NASD arbitrator.
>
> I have reviewed and completed the Arbitrator Disclosure Checklist enclose, and certify that (check one):
>
> I have nothing to disclose.
>
> I made disclosures on the Arbitration Disclosure Checklist.
>
> I have carefully read, reviewed, and considered my Arbitration Disclosure Report and certify that (check one):
>
> > I have nothing additional to disclose. My Arbitrator Disclosure Report is accurate, current, and up-to-date.
> >
> > I have noted changes or corrections on the Report.

Among the Criteria for Permanent Disqualification is: "Misstatement or failure to disclose material information."

After it is confirmed on the record that all arbitrators had signed the oath and had no additional disclosures, the panel asks each party in turn whether they accepted the composition of the panel. If all parties accepted the panel, the arbitration proceeds with the Panel as constituted.

Discussion and Citation of Legal Authority

Section 10 (a) of the Federal Arbitration Act, 9 U.S.C. § 10, provides, in relevant part:

> (a) In any of the following cases the United States court in and for the district wherein the award was made may make an order vacating the award upon the application of any party to the arbitration
>
> > (1) Where the award was procured by corruption, fraud, or ***undue means***.
> > (2) Where there was ***evident partiality*** or corruption in the arbitrators, or either of them.
> > (3) Where the arbitrators were guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy; or of any ***other misbehavior by which the rights of any party have been prejudiced***. [or]
> > (4) Where the arbitrators ***exceeded their powers, or so imperfectly executed them*** that a mutual, final and definite award upon the subject matter was not made. (emphasis added)

* * *

Based upon the facts discussed above, if an arbitrator falsely answers a question on the application or checklist, either party would

have a good faith factual and legal basis to move for an order vacating the arbitration award on the following grounds:

> (1) under Section 10(a)(1), in that the arbitrator's giving of false answers to specific questions contained on the Checklist and Profile, and making false certifications in the Oath of Arbitrator, constituted undue means by which the award was procured.
>
> (2) under Section 10(a)(2), in that the arbitrator was evidently partial, as evidenced by his giving false answers to specific questions contained on the Application Checklist and Profile, and by his violation of the Oath of Arbitrator.
>
> (3) under Section 10(a)(3), in that the arbitrator's conduct in falsely answering specific questions bearing on his partiality constituted misbehavior by which the parties' rights to challenge him, either for cause or peremptorily, was substantially prejudiced; and
>
> (4) under Section 10(a)(4), in that the arbitrator violated his Oath of Arbitrator or was, in fact, permanently disqualified by virtue of his material omissions on the Checklist and Disclosure, thereby so imperfectly executing his powers that a mutual, final and definite award upon the subject matter was not made.

The present article focuses on the "evident partiality" ground. Any authority that also bears upon the other grounds will be noted.

1. Decisions Under the FAA

(a) The U.S. Supreme Court

In *Commonwealth Coatings Corp. v. Continental Casualty Co.*, 393 U.S. 145 (1968), the Supreme Court was called upon to interpret Section 10 (a)(2) of the FAA. The Court, through Justice Black, adopted "the simple requirement that arbitrators disclose to the parties any dealings that might create an impression of possible bias." *Id*. at 149. The Court found that the FAA shows "a desire of Congress to provide not merely for any arbitration but for an impartial one." *Id*. at 147. Accordingly, "we should, if anything, be even more scrupulous to safeguard the impartiality of arbitrators than judges, since the former have completely free rein to decide the law as well as the facts and are not subject to appellate review." *Id.* at 149.

The issue before the Court in *Commonwealth Coatings* was whether Section 10 (a)(2) of the FAA required the vacation of an award when one of three arbitrators had served as an engineering consultant for one of the parties to the arbitration. *Id*. at 146. In deciding the question, the Court cited *Tumey v. State of Ohio*, 273 U.S. 510, in which it had held that it was a denial of due process of law for a judge to preside over a criminal case when he had a pecuniary interest in the outcome. While noting that the *Tumey* decision was based upon a "constitutional principle," the Court could "see no basis for refusing to find the same concept in the broad statutory language that governs arbitration proceedings and provides that an award can be set aside on the basis of 'evident partiality' or the use of 'undue means'." *Commonwealth Coatings* at 148.

In a concurring opinion, Justice White, joined by Justice Marshall, added:

> The arbitration process functions best when an amicable and trusting atmosphere is preserved and there is voluntary compliance with the decree, without need for judicial enforcement. This end is best served by establishing an atmosphere of frankness at the outset, through disclosure by the arbitrator of any financial transaction which he has had or is negotiating with either of the parties . . . The judiciary should minimize its role in arbitration as judge of the arbitrator's impartiality. ***That role is best consigned to the***

> ***parties, who are the architects of their own arbitration process, and are far better informed of the prevailing ethical standards and reputations within their business***.

Id. at 151 (emphasis added). White's concurrence also emphasized that arbitrators are often effective in their adjudicatory function precisely because they are "men of affairs, not apart from the marketplace." *Id*. at 150. Arbitrators should not automatically be disqualified if the parties are either aware of a relationship that poses a potential conflict of interest or if "they are unaware of the facts but the relationship is trivial." *Id*. He concluded by stating, "If arbitrators err on the side of disclosure, which they should, it will not be difficult for courts to identify those undisclosed relationships which are too insubstantial to warrant vacating the award." *Id*. at 152.

(b) The Lower Courts

The vast majority of cases interpreting *Commonwealth Coatings* arise in cases involving the failure to disclose facts potentially indicating bias, as opposed to cases involving false answers to specific questions. The Circuit Courts of Appeals have struggled with the application of *Commonwealth Coatings* to these cases. One line of cases, represented by *Schmitz v. Zilveti*, 20 F. 3d 1043 (9th Cir. 1994), has held that evident partiality exists when undisclosed facts show a "reasonable impression of partiality." *Id.* at 1046. The other line of cases, represented by *Morelite Construction Corp. v. New York City Dist. Council Carpenters Benef. Funds*, 748 F. 2d 79 (2d Cir. 1984), have held that it is necessary to show that a reasonable person would have to conclude from the undisclosed facts that the arbitrator was partial to one of the parties. *Id*. at 84.

In *Schmitz*, an arbitrator failed to disclose that his law firm had previously represented the parent company of one of the parties to the arbitration, even though it was undisputed that the arbitrator was unaware of the representation. The court stated:

> In a nondisclosure case, the integrity of the process by which arbitrators are chosen is at issue. Showing a "reasonable impression of partiality" is sufficient in a nondisclosure case because the policy of [FAA] section 10(a)(2) instructs the parties should choose their arbitrators intelligently. The parties can choose their arbitrators intelligently only when facts showing potential partiality are disclosed. Whether the arbitrator' decision itself is faulty is not necessarily relevant. But in an actual bias determination, the integrity of the arbitrators' decision is directly at issue. That a reasonable impression of partiality is present does not mean the arbitration award was the product of impropriety.

Id. at 1047. While recognizing that *Commonwealth Coatings* imposed a duty to disclose, the Court also found that the NASD Code of Arbitration procedure imposed an additional duty upon an arbitrator -- the duty to investigate and disclose conflicts of interests. *Id*. at 1048. Whether actual partiality exists, "a reasonable impression of partiality can form when an actual conflict of interest exists and the lawyer has constructive knowledge of it." *Id*. Because the arbitrator had constructive knowledge of the undisclosed conflict (a conflicts check at his law firm would have revealed it), a reasonable impression of partiality existed. If, as the Supreme Court requires in *Commonwealth Coatings*, the parties are to be the judges of the arbitrators' partiality, duties to investigate and disclose must be enforced. It therefore is irrelevant that the arbitrator may have been actually unaware of the facts upon which the claim of partiality is based. *Id*. at 1049. The Court therefore vacated the award. *Id*. [2]

Many courts interpreting *Schmitz* have held that the evident partiality is established from the nondisclosure itself, regardless of whether the nondisclosed fact would establish bias. *See, e.g., Thomas James & Assoc., Inc. v. Owens*, 1 S.W.3d 315, 321 (Tex. App. 1999);[3] *Burlington Northern RR v. TUCO, Inc*., 960 S.W.2d 629 (Tex. 1997). Although not limited to cases in which the arbitrator was aware of the undisclosed facts, these cases have been described as establishing something akin to a *per se* rule requiring vacatur when the arbitrator knew of the facts that could lead to the alleged bias. *Overseas Private Investment Corp. v. Anaconda Co.,* 418 F. Supp. 107, 110 (D.C. Cir. 1976).

The 5th Circuit Court of Appeals recently affirmed an Order vacating an arbitration award based on the rationale in *Schmitz*. *Positive Software Solutions, Inc. v. New Century Mortgage Corporation*, 436 F.3d 495 (5th Cir. 2006)[4]. In *Positive Software*, following an adverse arbitration award, Positive Software conducted a detailed investigation into the arbitrator's background. *Id.* at 496. It discovered that the arbitrator and his former law firm had previously been involved in a professional relationship with New Century's arbitration counsel. *Id.* Soon thereafter, Positive Software filed a motion to vacate the arbitration award. The district court granted Positive Software's motion on the grounds that the arbitrator failed to disclose that "he had served as co-counsel with New Century's counsel over a period of years in significant litigation," and that his prior relationship "might create a reasonable impression of possible bias." *Id.* Further, the district court stated that the arbitrator's "failure to disclose that relationship deprived Positive Software of the opportunity to make an informed choice of arbitrators and requires vacatur of the award" and that any reasonable lawyer selecting a sole arbitrator would have wanted to know of the prior professional relationship. *Id*. Therefore, the district court held that the arbitrator's failure to disclose his prior relationship with opposing counsel created a reasonable impression of possible partiality that warranted vacating the award. *Id.* The district court also held that Positive Software did not learn of the arbitrator's prior professional relationship until after the arbitration and, therefore, did not waive its objection to the nondisclosure. *Id.*

Specifically approving *Schmitz*, the 5th Circuit held that an arbitrator selected by the parties displays evident partiality by the very failure to disclose facts that might create a reasonable impression of the arbitrator's partiality. *Id*. at 500. The Court stated, "The evident partiality is demonstrated from the nondisclosure, regardless of whether actual bias is established." *Id*. Citing to *Commonwealth Coatings*, the 5th Circuit went on to state that such a demanding disclosure rule ensures that the parties will be privy to a potential arbitrator's biases at the outset, when they are "free to reject the arbitrator or accept him with knowledge and relationship and continuing faith in his objectivity," and allows the parties, who are "far better informed of the prevailing ethical standards and reputations within their business," to be the "architects of their own arbitration process." *Id.*

By contrast, the *Morelite* line of cases, relying more upon Justice White's special

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[2] *Schmitz* also held that evident bias of a single arbitrator is sufficient to vacate an award. *Id*.

[3] *Thomas James* implies that where a nondisclosure violates a NASD Rule, that may constitute "other misbehavior by which the rights of any party have been prejudiced" within the meaning of Section 10(a)(3) of the FAA. *Id*. at 321-22. Even if a misrepresentation on the Checklist does not violate NASD Rule 10312, a violation of the oath may constitute "misbehavior."

[4] The court granted a motion for rehearing *en banc*. *Positive Software Solutions, Inc. v. New Century Mortgage Corporation*, 449 F.3d 616 (5th Cir. May 5, 2006).

concurrence in *Commonwealth Coatings*, tend to focus on both the arbitrator's awareness and the nature of the undisclosed relationship rather than the fact of nondisclosure itself. These cases are likely to deny vacatur where the arbitrator was unaware or the relationship or circumstance is "trivial." For example, in *Health Services Mgt. Corp. v. Hughes*, 975 F.2d 1253, 1264 (7th Cir. 1992), the Court held that the alleged conflict of interest "must be so intimate . . . as to cast serious doubt on the arbitrator's impariality," and that the interest or bias "must be direct, definite and capable of demonstration rather than remote or speculative." *Id*.

(c) Materiality of the Fact, a\k\a "Triviality"

Whether applying *Schmitz* or *Morelite*, the more material the omitted underlying fact, the more likely its nondisclosure is to be recognized as evident bias. So, for example, in *Thomas James* the court, applying *Schmitz*, found no evident bias because there were no facts from which bias could even be inferred. See *Thomas James & Assoc., Inc. v. Owens*, 1 S.W.3d at 321. By contrast, in *Olson v. Merrill Lynch, Pierce, Fenner & Smith*, 51 F. 3d 157 (8th Cir. 1995), the facts were sufficient to meet either test.

In *Olson*, an unsuccessful party to an NASD employment arbitration learned after the award that two of the three panelists were employed by firms that had ongoing business relationships with the respondent, Merrill Lynch. In fact, one of the arbitrators was Vice President, Chief Financial Officer, and Compliance Officer of an investment firm that managed bond issues syndicated by Merrill Lynch. Olsen moved to vacate, "arguing the nondisclosure showed evident partiality in the arbitrators." *Id.* at 158. The District Court denied Olson's motion.

On appeal, the Eighth Circuit reversed. In so doing, it recognized the disagreement among the Circuit Courts as to the proper meaning of *Commonwealth Coatings*. The Court found it unnecessary to select from the two competing views, however, holding that either approach resulted in a finding of "evident partiality" under these particular facts. The undisclosed relationship created an impression of possible bias, was substantial, and was not trivial; therefore, it met all of the possible tests used in implementing *Commonwealth Coatings*. *Id*. at 159.

The Court concluded with the following statement:

> Our view is especially fair because it realizes the terms of the parties' arbitration agreement in this case. Section 23 of the NASD arbitration rules, which the parties agreed would govern the arbitration proceedings, requires arbitrators to disclose, among other things, any existing or past financial, business, or professional relationships that "might reasonably create an appearance of partiality or bias." Under section 23, the duty of disclosure expressly extends to arbitrators' indirect relationships, specifically including those between the arbitrators' current employers and any arbitration party or its counsel. Indeed, courts have recognized arbitrators should disclose even indirect ties with parties before arbitration begins. This gives the parties, who are in the best position to judge an arbitrator's partiality, a chance to reject or accept an arbitrator with full knowledge of the arbitrator's connections.

Id. at 160 (citations omitted). *But see Montez v. Prudential Securities, Inc*. 260 F. 3d 980, 984 (8th Cir. 2001)("even if Benson's failure to disclose had violated NASD Rule 10312, 'that would not by itself, require or even permit a court to nullify an arbitration award.'")(quoting *Commonwealth Coatings,* 393 U.S. at 149).

There are very few cases interpreting the FAA that discuss the materiality of a false statement given in response to a questionnaire provided to the arbitrator by the sponsoring forum. In *Fields v. Freiberg*, (District Court, City and County of Denver Colorado, Case No. 02CV7622)(unpublished decision), the Court set aside an NASD arbitration award where the arbitrator failed to disclose "that his conduct was at issue in a pending arbitration involving similar allegations."[5]

Another such case is *Hartman v. Cooper*, 59 Md. App. 154 (1984), *overruled in part by Wyndham v. Haines*, 305 Md. 269 (1986). In *Hartman*, a medical malpractice case, an arbitration was commenced under Maryland's mandatory health claim law. Pursuant to the procedures under that law, a panel was selected, including Dr. William H.B. Howard. Dr. Howard was required by regulations to respond to a data sheet containing several questions for use by the parties in selecting a panel. In response to the question: Have you ever been sued or had a claim brought against you for medical malpractice?" Dr. Howard answered, "No." *Id*. at 158.

In fact, as discovered after the panel rendered an award, Dr. Howard had been sued in a medical malpractice claim in a case that was pending during the arbitration. The unsuccessful Plaintiff/Claimant in arbitration moved to vacate the award on the ground of evident partiality. *Id*. at 160. The trial court denied the motion to vacate. *Id*.

On appeal, the Court of Appeals reversed. Recognizing that the Maryland Arbitration Act was patterned after the FAA, it analyzed *Commonwealth Coatings*, concluding that the failure to supply the information "reasonably supported an inference of or the appearance of the existence of bias, prejudice or partiality or absence of impartiality." *Id*. at 167. This standard was later narrowed by the Maryland Court of Appeals to require vacatur only when the facts were sufficient to permit an inference of partiality, rather than its mere appearance. *Wyndham v. Haines*, 305 Md. 269 (1986). Because the *Hartman* court found both standards to be met, its holding would seem to remain valid. *See Parks v. Sombke*, 127 Md. App. 245 (1999) (harmonizing *Hartman* with *Wyndham*).

There are many cases arising in the context of jury *voir dire* that would seem analogous. As the Tenth Circuit has recognized, a civil litigant's right to a trial by jury, as encompassed in the Seventh Amendment to the U. S. Constitution, would be meaningless unless the jury is required to be fair and impartial. *Skaggs v. Otis Elevator Co*., 164 F. 3d 511, 514-15 (10th Cir. 1998). The right to an impartial jury "is neither enlarged nor diminished by the Fifth Amendment provision that a person shall not 'be deprived of life, liberty, or property, without due process of law.' [The] denial of trial by an impartial jury is also the denial of due process...." *Casias v. United States*, 315 F.2d 614, 615 (10th Cir. 1963).

In *Commonwealth Coatings*, *supra*, the Supreme Court equated the evident bias standard of the FAA to the impartiality requirements applicable to judges under the due process clause. Because the impartial jury requirements also arise under the Fifth Amendment, cases involving juror misconduct should be equally informative to questions involving interpretation of Section 10 of the FAA.

In cases involving claims of juror partiality, the Court has stated that a litigant is entitled to a fair trial, albeit not a perfect one. *McDonough Power Equip., Inc. v. Greenwood*, 464 U.S. 548, 553 (1984); *Skaggs*, 164 F. 3d at 515. As the Tenth Circuit stated in *Skaggs*:

> An impartial jury is an essential element of a litigant's right to a fair trial. The

[5] The decision was also based upon the procurement of an award through undue means under FAA Section 10(a)(1).

> examination of prospective jurors during *voir dire* is intended to expose possible juror biases and is employed to insure that jurors are impartial. Not all juror biases, however, adversely affect a litigant's right to a fair trial. To violate due process, the bias must affect the juror's ability to impartially consider the evidence presented at trial.

Id. (citations omitted). Thus, in order to establish juror bias sufficient to constitute a deprivation of the right to a fair trial, a litigant must prove that a juror failed to answer honestly a material question on *voir dire* ***and either***:

> (a) a correct response would have provided a valid basis for a challenge for cause; or
>
> (b) the juror's motive for answering dishonestly or additional circumstances outside the *voir dire* process demonstrate actual or implied bias.

Skaggs, 164 F. 3d at 516. Applying this rule, most courts have held that intentional concealment "has become tantamount to a *per se* rule mandating a new trial." *Brines v. Civis*, 882 S.W.2d 138 (Mo. 1994). Even in cases in which the concealment is unintentional, among the "additional circumstances" that may demonstrate implied bias is the situation in which the juror has a "close connection to the circumstances at hand." *Burton v. Johnson*, 948 F.2d 1150, 1156 (10th Cir. 1991). Thus when a juror falsely answered a question on *voir dire* in a domestic assault case that she had not been a victim of domestic assault, a new trial was warranted even though a correct response would not have resulted in a challenge for cause and her answer was not intentionally dishonest. *Id*.

If the rules regarding new trials based upon false statements by jurors are applied to arbitrator selection, vacatur will be required if the undisclosed fact would have been the basis for a proper challenge for cause. *See* NASD Rule 10308(f) (close questions to be resolved in favor of customer). Even if grounds for cause do not exist, the award should be vacated if the arbitrator's false statement was intentional or the circumstances were closely connected to those involved in the case.

For example, in *Pierce v. Altman*, 147 Ga. App. 22 (1978), a juror in a personal injury case answered during *voir dire* that he had never been a defendant in a lawsuit for personal injuries. Subsequently it was discovered he had been a defendant in a personal injury suit less than four years earlier. The Court explained the significance of the question presented to the juror:

> In the context of personal injury actions, where pro-plaintiff and pro-defendant passions abound, a party is entitled to know of circumstances which might arouse such a bias in a prospective juror. . . .The question was most likely material to a determination of partiality, for bias could reasonably be expected to ensue from the circumstances inquired about.

Id. at 24.; *accord Beggs v. C.I.T. Credit Corp*., 387 S.W. 2d 499 (Mo. 1985) (juror falsely stated that he had not been sued by credit companies; new trial ordered); *Stilwell v. Johnson*, 272 P. 2d 365 (Ok. 1954) (juror falsely stated that he had not been defendant in auto accident case; new trial ordered). This explanation would seem to be equally applicable to securities arbitrations.

The bias of jurors with similar life experiences was colorfully summarized by one judge in this way:

> One who has been assaulted, threatened with a deadly weapon and robbed is not likely to forget or forgive nor to treat lightly or even fairly similar

> conduct in others. This is a normal human reaction following customary behavior, expected and anticipated by the background of human experience.

U.S. v. McCorkle, 248 F.2d 1 (3d Cir. 1957) (*quoting State v. Grillo*, 16 N.J. 103, 116, 106 A.2d, 294). Civil defendants, like crime victims, often feel assaulted or violated by their civil opponent in a way that prejudices them against those asserting similar claims in similar cases.

CONCLUSION

In conclusion, as explained above, arbitration awards should be vacated if an arbitrator falsely responds to one or more questions that are designed by the NASD or other arbitration forums to elicit circumstances evidencing possible bias. In addition an arbitration award can and should be vacated on the basis that the arbitrator falsely certified in his oath that all required disclosers had been made.

How Much Diversification Is Enough?

Frank Armstrong, III

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Whenever we come across road kill on the investment highway, we ask ourselves: “How could this happen?” The fact is, absent gross failure of investment policy and/or implementation, it should never happen.

There are a variety of proven techniques that lead directly to portfolio destruction. High up on the list is the failure to properly diversify. Diversification is the one free lunch in finance and investment practice. Prudent diversification is a prime responsibility of fiduciaries under common law, UPIA and ERISA. We diversify first and foremost to reduce risk to its lowest possible value.

But what should the standard be, and how much diversification is enough? This paper will look at how systematically diversifying a portfolio can reduce risk at the portfolio level while maintaining and/or enhancing returns. While the balance between risky and risk-free assets is critical for each investor, to illustrate the benefits of diversification, we first focus on the risky asset portion of the portfolio.

Risk and Return

Few investors are able to meet their reasonable economic objectives while investing in zero risk instruments, so they must assume some risk in their portfolios.

The trick is not to avoid risk, because investors are systematically rewarded for bearing risk. The trick is to manage it prudently within their risk tolerance, time horizon and liquidity needs to meet their unique objectives.

Financial economists have defined risk in the investment process as the standard deviation around the expected return of the portfolio. That’s a concept that doesn’t resonate with many investors who naturally think in terms of avoiding running out of money, preventing a financial disaster, or some other more personal definition. But the two concepts are directly related: The higher a portfolio’s standard deviation, the higher the probability that something awful might happen. It’s not a far stretch to think of standard deviation as a “danger index.” That’s why it is a required practice for all fiduciaries to model the risk reward characteristics of the portfolio.

Over time, investors are compensated for bearing discrete factors of market risk, and not compensated for anything else. So the investor’s job is to ruthlessly pare away any uncompensated risk. Why would anybody take a risk for which they are not likely to be rewarded? While there are

others, the biggest example of uncompensated risk is any risk that could be diversified away.

Risk and reward may be related in the global sense, but they certainly don't have to be in your portfolio!

It's true – risk and reward are related. There are no high return investments that do not carry high risks. That's certainly not new news. However, the equation cannot be reversed. We have all seen lots of high-risk strategies with disastrous results. Stated as clearly as possible, high-risk strategies may not (and most often do not) produce high rewards. Investors lose sight of this at their peril.

It is important to understand that excessive risk will most often not work itself out to an average return. A flameout anywhere along the way can destroy the entire financial future of the investor. Investors only get one chance to get it right. In real life, investors can't hit rewind and start over. Relying on averages to bail out a flawed strategy rarely works.

The often quoted, much misunderstood relationship between risk and reward holds true only in a special case: Risk and reward are related only for securities in a fully diversified asset class portfolio. As the investor moves from a fully diversified portfolio, he has no expectation of higher return, but he bears more risk. Since this additional risk earns no more return, it is uncompensated risk.

It is absolutely possible to construct an infinite number of portfolios with a 10% expected return. Some of them will have absurdly high risk. But one of them will have the minimum risk necessary to generate that rate of return. That portfolio dominates all other strategies, and every investor shooting for a 10% return should want to hold it.

The optimum equity portfolio will be defined as the one equity portfolio that has the highest expected return per unit of risk.

If asset class returns are plotted against risk as measured by standard deviation, the appropriate relationship is obvious. For instance, it is well known that stocks have a higher past and expected return than treasury bills, but carry more risk. Small companies carry more risk than large, and yield higher total returns over time than larger companies. Investors demand that additional return for putting up with the additional risk. These additional rewards are called risk premiums, and spring from priced risk factors.

It is no great mystery how this system works. The market's self-regulating, self-adjusting, self-correcting price mechanism almost instantly adjusts prices of stocks to the point where future returns justify their risks. The Invisible Hand never sleeps as millions of investors examine securities around the clock with an eye to future returns and risk levels.

In an efficient market, no stock can be expected to have a higher return than any other with similar characteristics. If it did, buyers would push the price up until the expected return was equal to other similar stocks. If most investors agreed that one small company stock had an expected return of 12%, while the other stocks of similar size and book-to-market ratio (BTM) had only an 11% expected return, the price of the first stock would almost instantly be pushed up to where it yielded 11% to the next purchaser.

If a company's prospects suddenly improve, that improvement will quickly be reflected in its stock price, adjusting its future expected return to the market average. News travels at the speed of light, and the opportunity to reap excess profits consistently is practically nonexistent.

Of course, individual stocks do have widely different returns. Because none of us can tell the future, there is an enormous amount of noise and uncertainty in the process. Some companies will do better than average, and some will crash. But no one can know consistently in advance which ones that will be. So unless you think you know better than

a few hundred million of your closest friends who are looking at the same data, it's delusional to think you can consistently pick winners.

In trying to "beat the market", investors pay a high price. Of course, there are transaction costs and taxes. These must be subtracted from whatever return is generated. As a result, the highest probability is that rate of return will go down. But by holding less than the full market portfolio, there is then a lot of uncompensated risk. That's risk for which one cannot expect additional return. True, the variation of returns is staggering. But in the net, the returns will not (and cannot) be higher. Lower return and higher risk is nobody's definition of an optimum portfolio.

Individual Stocks

The higher the concentration of holdings, the higher the uncompensated risk. At the far extreme, there is an Enron only portfolio. On the other end, there is the market portfolio. Both had the same estimated rate of return. But one portfolio is still standing and growing, while the other vaporized.

Individual stocks have a very high level of risk. Here are a few well known stocks with their annual standard deviation. However, the chance of total loss is not adequately captured by standard deviation at this level. Think Enron, Global Crossing, Eastern Airlines, etc. While the probability of a total blow up is small, the consequences are catastrophic.

Company Name	10 Yr Standard Deviation
Sirius Satellite Radio	114.13
Lucent Technologies	63.81
Dell	49.82
Starbucks	40.53
Microsoft	40.01
General Motors	35.73
Amgen	34.78
AT&T	29.03
Pfizer	25.16
General Electric	24.03

Sector Investing

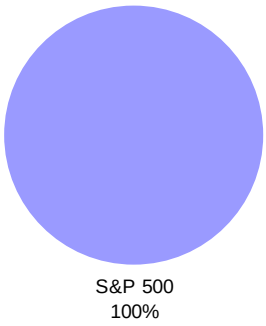
Sector funds are diversified within an industry group, but hardly a properly diversified portfolio. Sector fund investing is demonstrably not prudent. Extreme variations in total valuation are possible. Ask any tech fund investor how he enjoyed 2000 to 2002.

Sector Fund	Ticker	Morningstar Category	10 Yr Standard Deviation	10 Yr Return
Old Mutual Col Cir Tech A	OATCX	Specialty-Technology	44.90	0.38
US Global Inv Gold Shares	USERX	Specialty-Precious Metals	40.03	-0.84
Fidelity Sel Energy Serv	FSESX	Specialty-Natural Res	36.84	17.21
Fidelity Sel Devel Comm	FSDCX	Specialty-Communications	34.87	6.85
Fidelity Sel Biotech	FBIOX	Specialty-Health	32.02	10.05
Prudent Bear C	PBRCX	Bear-Market	25.22	-2.30
Fidelity Sel Brokerage	FSLBX	Specialty-Financial	25.14	18.11
Alpine U.S. Real Estate	EUEYX	Specialty-Real Estate	22.04	16.33
Fidelity Select Utilities	FSUTX	Specialty-Utilities	17.18	8.53

The S&P 500

Most investors define the market as being the S&P 500. That's an index of large domestic companies. Many investors still use this as an appropriate benchmark for the market.

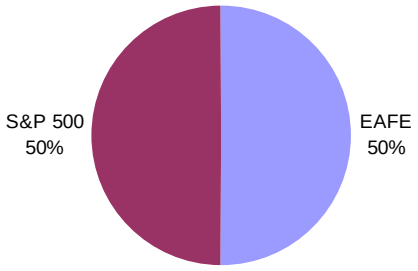
Portfolio	10 Yr Standard Deviation	10 Yr Return
Standard & Poor's 500	15.66	8.32



An International Portfolio

But the S&P is only one part of the optimum market portfolio. Adding an equal weighting of large foreign companies in developed markets will substantially lower risk. The most widely quoted benchmark representing this asset class is the Morgan Stanley Europe, Australia, and Far East index (EAFE).

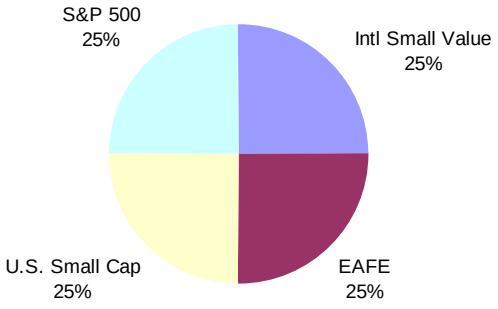
Portfolio	10 Yr Standard Deviation	10 Yr Return
50 % S&P 500- 50% MSCI EFA	14.40	7.63



Global Portfolios

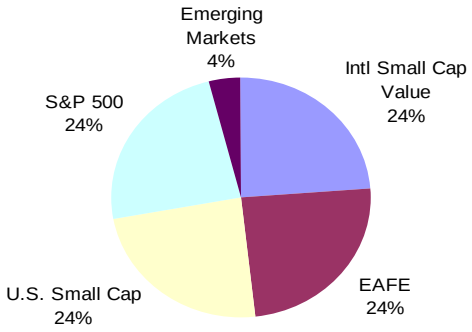
But the S&P 500 and EAFE omit many mid-sized and small companies. Addition of smaller companies will further lower risk at the portfolio level because they track differently from their larger cousins (low correlation).

Portfolio	10 Yr Standard Deviation	10 Yr Return
Global Portfolio Including Small Company Stocks	14.52	9.49



As it turns out, the optimum market portfolio is the global market. It would be ideal to hold a little pro rata share of every traded stock in the world. But one cannot expect to get every traded stock in every exchange in the world. Today's index funds and ETF's will capture in excess of 95% of the value of the world's capital markets. The risk level for the S&P 500 is substantially higher than the global market. International investing offers substantial risk reduction for long term investors. If a portfolio is only domestic large companies, an investor is taking far more risk than he or she needs to.

Portfolio	10 Yr Standard Deviation	10 Yr Return
Global Portfolio Including Emerging Markets	14.55	11.12



Emerging markets offer another opportunity to spread risk. While higher in volatility, their low correlation to developed economies reduces risk at the portfolio level while enhancing returns.

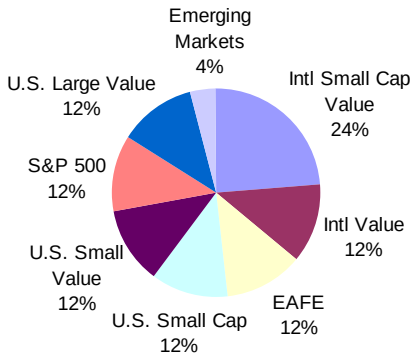
As a default portfolio, every investor should consider the global equity market portfolio. In fact, any investor that rejects the global equity market portfolio should have a very strong belief set to justify his/her position. Unfortunately, many investors have flawed belief sets, or none at all. So it's not unusual to hear variations of the following:

- I work for Enron. It's a great company. I know what's going on there.
- I can pick individual stocks that will beat the market.
- The U.S. is the only place to invest. The rest of the word is too risky.
- Energy will outperform the rest of the market.
- I'm a doctor. I understand health care stocks.

Not all of these people will crash and burn. A few lucky ones will prosper. After all, somebody wins the lottery every week. But the majority will pay a heavy price for failing to manage their risk properly.

That's not quite the end of the story. As it turns out, subsequent research indicates that investors may wish to overweight distressed companies (value stocks) on a global basis to capture additional returns. Value stocks may be considered as separate asset classes with low correlation to the traditional large capitalization market (The S&P 500 and EAFE). While these risks are different, the total risk at least as measured by standard deviation, is not increased. Inclusion in a portfolio may actually decrease risk.

Portfolio	10 Yr Standard Deviation	10 Yr Return
Global Portfolio Including Value Stocks	14.42	10.84

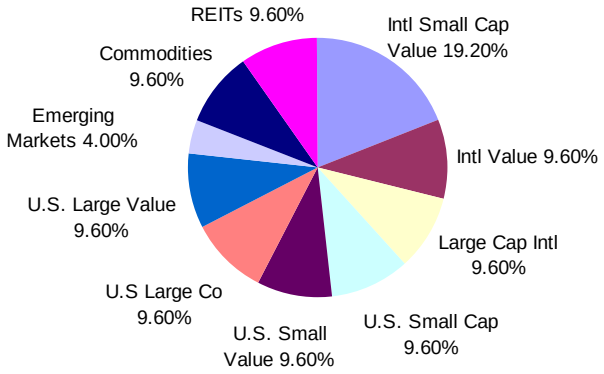


Investors may correctly have different tastes for these additional risk factors, so the amount of overweight (if any) may be adjusted for individual preferences.

Beyond traditional stocks

If the definition of markets is expanded to include real estate and commodities futures, there will be additional opportunities to diversify the portfolio and reduce risk.

Portfolio	10 Yr Standard Deviation	10 Yr Return
Global Portfolio Including REITs and Commodities	13.97	11.10



In both theory and practice, the portfolio with the widest diversification will have the lowest risk. Capital Asset Pricing Model (CAP-M) indicates that the optimum equity portfolio is the whole market. It's the one with the highest return per unit of risk. Anything less than the global portfolio is a bet against the efficient market and picks up a large amount of uncompensated risk.

Diversification between stocks and bonds

Of course, even an optimum risky portfolio may be far too much risk for a particular investor's unique situation. An investor should water down the risk level to accommodate his risk tolerance, need for liquidity, and time horizon. The appropriate way to accomplish this is to vary the mix of risky and risk-free assets. The academic answer is to utilize the local zero risk asset (The T-Bill in the U.S.), but in practice, a very high quality short duration bond fund is substituted.

Portfolio	10 Yr Standard Deviation	10 Yr Return
100% Global Equity Portfolio	13.97	11.10
70% Global Equity 30% Global Bond Portfolio	9.26	9.16
60% Global Equity 40% Global Bond Portfolio	7.83	8.48
50% Global Equity 50% Global Bond Portfolio	6.36	7.80
40% Global Equity 60% Global Bond Portfolio	5.02	7.10

As you can see, by including bonds, investors obtain a great deal of protection against volatile markets. Risk drops off a great deal faster than return when bonds are introduced. Investing at the appropriate level of risk is the key consideration for investment success.

Fortunately, financial markets allow investors to diversify their holdings, and today's investment tools and products can provide effective diversification at extremely low cost. The illustrated global portfolio can be obtained by using a combination of traditional true no load index funds and ETFs at an average weighted annual cost well below 0.5% at the fund level. It holds over 15,000 companies which represent over 95% of the value of the world's traded stocks.

Conclusions:

Investors do the darndest things! Left to their own devices, they can find an almost endless variety of creative ways to self-destruct. The do-it-yourselfers may have only themselves to blame, but when an investor consults a "financial advisor" he has every right to expect high level practice standards, professional knowledge and fiduciary prudence.

The benchmark for prudent diversification is the global market. Anything less is a real disservice to investors that fails to properly control risk.

Reasonable people may disagree on the finer points of investment policy. For instance, an individual investor may prefer to exclude either REITS or commodities, and/or may wish to tailor his exposure to either small companies or value. The tailored policy should be described in the Investment Policy Statement in detail, accompanied by appropriate capital market assumptions, and contain a risk reward model designed to meet the investor's unique requirements.

All investors need to spend as much effort on the risk side of the problem as on returns. Within broad limits, managing risk is more important to success than attempting to drive up returns. Investing should be the ultimate Tortoise and Hare story. Avoiding unpleasant surprises is the name of the game. If you think you just can't stand to have a boring portfolio, especially when everybody around you is talking about today's hot thing, just remember the Tortoise. He's the guy with the

low volatility fully diversified portfolio, and the eventual winner.

Disclaimer: This model is for general education purposes to illustrate the effects of diversification and could not have been implemented as described on the inception date. In developing our models we used data from Morningstar on real world mutual funds and ETF's. Some past index data is simulated where funds did not exist to implement asset classes. Additionally, past performance is no guarantee of future performance. Transaction fees, advisor fees and taxes would have reduced returns.

Category	**Fund**
Small Cap	DFA Small Cap Portfolio
Small Cap Value	DFA Small Cap Value Portfolio
Large Cap	DFA Large Cap Portfolio
Large Cap Value	DFA Large Cap Value Portfolio
International Small Cap	DFA Intl Small Cap Value
International Small Cap Value	DFA Intl Small Cap Value
International Large Cap	DFA Intl Large Cap
International Large Cap Value	DFA International Large Cap Value
Emerging Markets	DFA Emerging Mkts Portfolio
REIT	Vanguard REIT Index Viper
Commodities	Pimco Commodities Real Return D
Fixed Income	DFA One Year Fixed Income

Are Structured Products Suitable for Retail Investors?

Craig McCann, PhD, CFA
and Dengpan Luo, PhD, CFA

Equity-linked notes - a type of structured product - are securities issued by brokerage firms and traded in the secondary markets like shares of common stock. These investments offer part of the upside from owning stocks but limit nominal losses if held until maturity. Once sold only to sophisticated investors, structured products are increasingly being sold to unsophisticated retail investors. Equity-linked notes are difficult to evaluate and monitor, have high hidden costs and are illiquid. They are therefore virtually never suitable for unsophisticated investors.

I. Introduction

Sales of structured products have soared in recent years as brokerage firms have found a retail market for products once sold only to sophisticated investors. According to the Structured Products Association – a trade group representing issuers and vendors – almost $50 billion of structured products were sold in 2005.[1]

Structured products can be too complex and opaque for retail investors and registered representatives to understand. This complexity and opaqueness allows structured products to survive in the marketplace despite their marked inferiority to traditional portfolios of stocks and bonds. The NASD has taken notice.

> In the current investment environment, investors and brokers are increasingly turning to alternatives to conventional equity and fixed-income investments in search of higher returns or yields. Such products, including … structured notes … are often complex or have unique features that may not be fully understood by the retail customers to whom they are frequently offered, or even by the brokers who recommend them. Some appear to offer benefits to investors that are already available in the market in the form of less risky, less complicated, or less costly products, prompting concerns about suitability and potential conflicts of interest. [*Notice to Members* 05-26, page 2.]

The focus of this paper is a particular type of structured product - equity-linked notes – but our analysis could be readily extended to other types of structured products. Equity-linked notes are not stocks, bonds or derivatives – they are hybrid securities. Equity-linked notes are listed on

[1] See "An Arcane Investment Hits Main Street: Wall Street Pushes Complex 'Structured Products,' Long Aimed at Institutions, to Individuals" *Wall Street Journal* June 21, 2006, D1. http://online.wsj.com/article/SB115085644419185995.html

the AMEX or the NASDAQ and trade, albeit thinly, in the secondary market. At maturity, these securities repay the offering price and perhaps some additional amount determined by a complicated function of the change in the value of the security or index since the offering date. The payoffs to equity-linked notes can be replicated with combinations of stocks, bonds, options and futures.

Brokerage firms issuing structured products under evocative brand names for sale to retail investors include Bank of America, Bear Stearns, CIBC, Citigroup, Goldman Sachs, JP Morgan, Lehman Brothers, Merrill Lynch, Morgan Stanley, UBS, Wachovia and Wells Fargo. Brokerage firms make money issuing equity-linked notes because the product they put together is worth significantly less than the offering price. In addition, the managers of the initial offering receive an underwriting spread or selling concession, and trading in the secondary market generates further retail commissions.

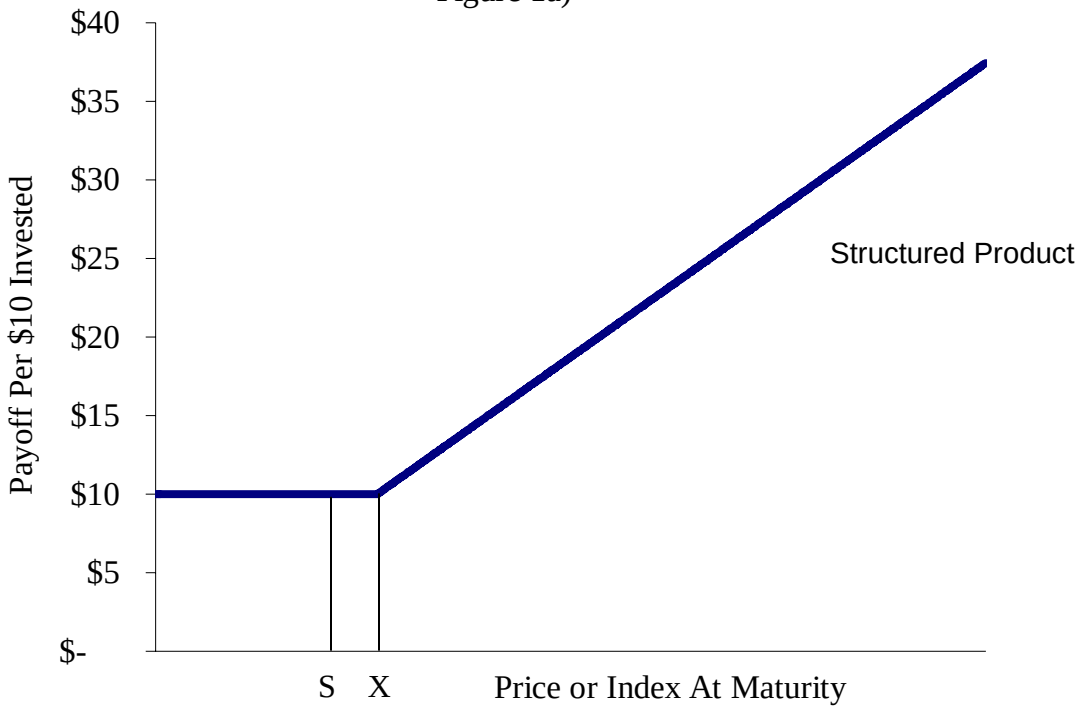
In what follows, we explain the basic features of equity-linked notes and illustrate the notes with a few real world examples. We then review the NASD's Notices to Members on the sale of structured products. We observe that the more complex and difficult to evaluate these products are, the greater the hidden costs investors pay relative to readily available, more transparent investments.

II. The Basic Equity-Linked Note Structure

Retail-oriented equity-linked notes have maturities of from one to ten years and typically do not pay interim interest or dividend distributions. The securities return the original issue price at maturity plus an additional amount depending on the value of the underlying stock or stock index at maturity.[2]

Figure 1a) illustrates stylized payoffs at maturity to a stylized equity-linked note.

Figure 1a)



The note is issued at an offering price of $10 when the stock price or stock index level is "S". At maturity, the note returns the $10 issue price plus a portion of the increase in the index beyond some threshold "X."[3] This threshold, X, is determined by multiplying the initial index level, S, by the cumulative impact of "clipping" the portfolio each year by the amount of the spread. For example, if we assume the annual spread equals is 2%, X is equal to 122% of S.[4] If the index level is less than X at maturity, the holder receives $10. If the stock price or index level is greater than X at maturity, the holder receives a fraction of the additional gains beyond X. Thus, in exchange for the promise that an investor will receive the original offering price, the investor gives up the dividends paid on the underlying stocks, all of the first 15% or 20% in capital gains and 15% or 20% of any gains beyond that.

Those familiar with options diagrams will recognize that Figure 1a) illustrates the payoffs at maturity to a portfolio comprised of a call option with a strike price of X on the underlying security and a $10 face-value zero-coupon Treasury security maturing when the call option expires.[5] This is a relatively easy portfolio to value and allows us to directly determine whether a simple structured product like the illustrated note is over-priced relative to alternative investments. Later, we report valuations of real world examples of structured products using this option-based approach.

An alternative way to evaluate a structured product is to compare it to a simple portfolio of stocks and bonds as suggested by the NASD in the quote at the beginning of the paper. Figure 1b) and Figure 1c) together illustrate this comparison.

Terminal values of portfolios of stocks and bonds are plotted in Figure 1b) for various levels of the underlying stock price or index. An investor who invests $10 in 10-year, zero-coupon Treasury bonds yielding 4.5% per year will have bonds worth $15.61 at maturity regardless of the stock price or index level.[6] An investor who buys $10 worth of stock and holds it for 10 years will own a stock position whose value will be a linear function of the stock price or index level at maturity.

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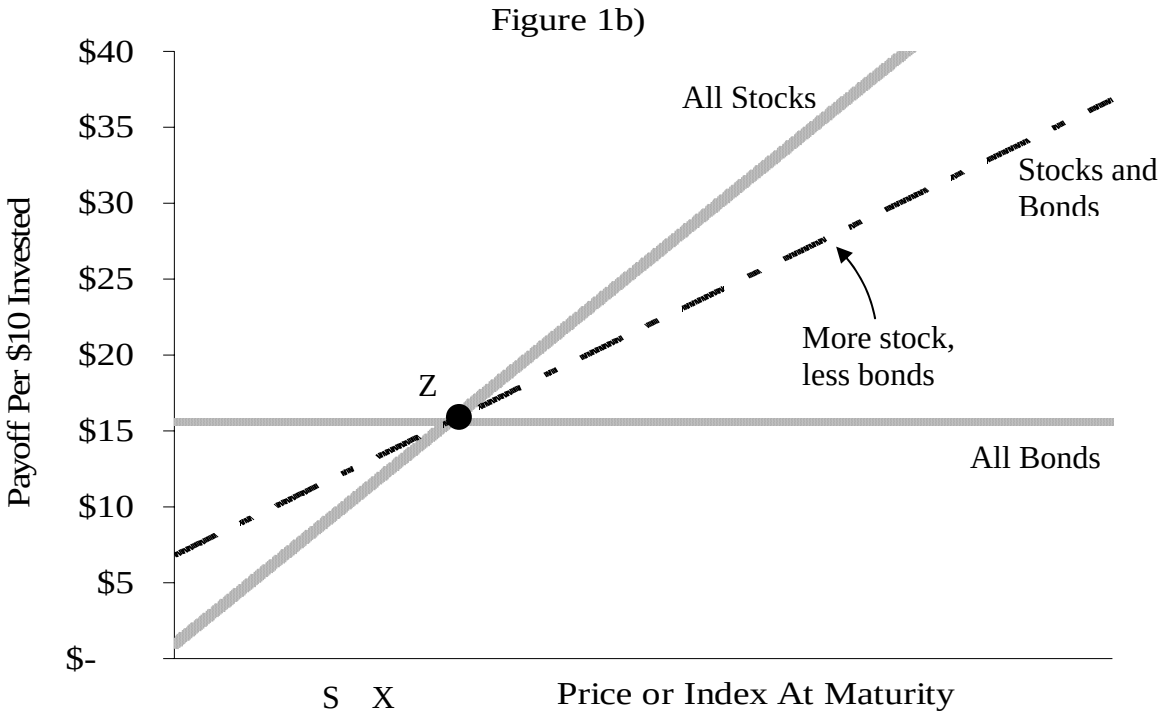
[2] The issue price is only 70% or 80% or less of what the US Treasury guarantees it will return on purely risk free securities held for 5 to 10 years and so this return of principal guarantee should not be oversold. The additional return paid on some equity-linked notes is a function not only of the increase in the value of the stock or stock index between the issue date and maturity but may also be a function of the particular evolution of the stock price or index level over that time period.

[3] Some equity-linked notes like the Intel-linked TARGETS® below do not guarantee return of principal.

[4] $X = (1 - 0.02)^{-10} \times S = 1.22 \times S$.

[5] Figure 1a) also illustrates the payoffs at maturity to a portfolio comprised of the underlying stock and a put option with a strike price of X and a short position of (X-$10) face-value zero-coupon Treasury security maturing when the put (and call) option expires.

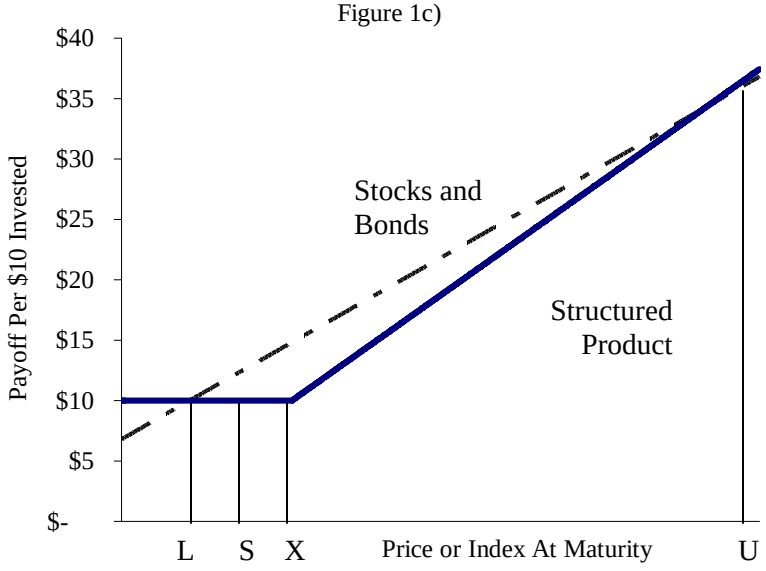
[6] $\$15.61 = \$10 * (1+ 4.5\%/2)^{2*10}$. We assume a 1.7% annual dividend yield on the average of the initial offering price and the offering price adjusted for the increase over the term in the index.



The payoffs at maturity to mixed portfolios of stocks and bonds are illustrated by straight lines rotated through the point, Z, where the all stock portfolio and the all bond portfolios' lines intersect. Portfolios with larger stocks allocations are represented by steeper lines reflecting that the value at maturity of more stock-laden portfolios is more sensitive to the level of the stock index than portfolios with less stock.

Figure 1c) combines the payoffs to the structured product from Figure 1a) with the payoffs to the mixed stock and bond portfolio from Figure 1b) and suggests a way to evaluate the structured product. For this illustration, we assume the stock and bond portfolio starts with 60% invested in stock and 40% invested in bonds and is *never* rebalanced. The structured product's $10 minimum value is greater than the value of the stocks and bonds at maturity if the stock index is below L. The structured product is also worth more than the mixed stock and bond portfolio at index levels above U because the structured product benefits from its greater sensitivity to stocks at very high levels of the stock index. For index levels between L (lower bound) and U (upper bound), the mixed portfolio of stocks and bonds is worth more at maturity than the structured product.

Figure 1c)



The lower bound, L, in our example is at approximately 50% of the initial index level so the stock index would have to decline approximately 50% over the 10-year term of the structured product for it to be worth more than the mixed portfolio of stocks and bonds. The upper bound, U, in Figure 1c) is at approximately 420% of the initial index level so the stock index would have to increase approximately 320% over the 10-year term of the structured product for it to be worth more than the stocks and bonds. While declines of more than 50% and increases of more than 320% over 10 years are not impossible, they are extremely unlikely.

A higher initial allocation to stocks rotates the dotted line counter-clockwise through Z, making it steeper and shifting both L and U to the right. A lower initial allocation to stocks rotates the dotted line clockwise through Z, making it flatter and shifting both L and U to the left. Thus the higher the initial allocation to stocks, everything else held constant, the greater the relative value of the downside protection but the smaller the potential upside advantage the structured product has over the stock and bond portfolio at very high stock market levels. The allocation to stocks and bonds in comparisons portfolios is determined to maximize the value of the stock and bond portfolio relative to the equity-linked note. This allows us to compare the equity-linked note to alternatives *already available in the market in the form of less risky, less complicated, or less costly products* as required by the NASD.[7]

Higher embedded costs in the structured product shifts X to the right and/or makes the upward sloping portion of the structured product's payoff line flatter, shifting U to the right. Lower embedded costs in the structured product shifts X to the left and/or makes the upward sloping portion of the structured product's payoff line steeper, shifting U to the left. As we will demonstrate next, structured products' costs are high and the more complex - and therefore the more opaque - the structure, the higher the costs.

Even though the stock and bond portfolio illustrated above is *never* rebalanced, the mixed portfolio of stocks and bonds will be worth more at maturity than the structured product almost all the time. The buy-it-and-

[7] *Notice to Members* 05-26, page 2.

forget-about-it portfolios are worth more at maturity than investments in the actual equity-linked notes at issuance analyzed, 94% to 97% of the time. If we assume that the comparison portfolio is rebalanced periodically, the simple stock and bond portfolios are worth more at maturity that the notes **100%** of the time.

III. Three Paradigmatic Equity-Linked Notes

To illustrate structured products, we examine equity-linked notes from Merrill Lynch, JP Morgan, and Citigroup.

A. Merrill Lynch's S&P 500 Market Index Target-Term Securities - MITTS®

On August 30, 2002, Merrill Lynch issued S&P 500 Market Index Target-Term Securities - MITTS® - maturing on September 4, 2009 at a $10 offering price to trade on the AMEX under the ticker symbol MKP. The potential returns to these notes are tied to the level of the S&P 500 Index at maturity reduced by a 2.2% annual adjustment factor.

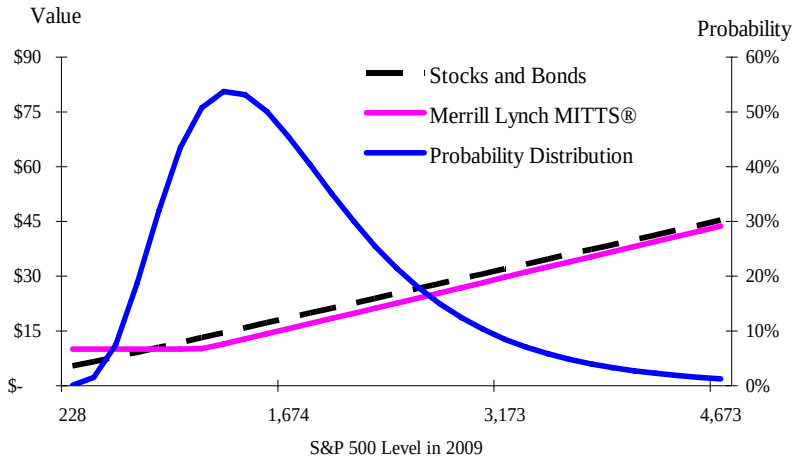
The notes were priced based on the S&P 500 closing level on August 29, 2002 of 917.80. The notes will pay $10 plus a return equal to the percentage excess, if any, of 85.7% of the S&P 500 level at maturity over the initial 917.80 index level. Thus, if the S&P 500 closes below 1,070 on September 4, 2009, holders will just receive the $10 initial offering price. If the S&P 500 closes above 1,070 on September 4, 2009, holders will receive 85.7% of the difference between the ending S&P 500 level and 1,070 divided by the 917.80 starting level. If, for example, the S&P 500 closes at 1,600 on September 4, 2009, holders will receive $14.94 per note.[8]

Merrill Lynch's $10 MITTS® maturing on September 4, 2009 provided $8.80 worth of investment value at issuance for each $10 invested. The difference, $1.20 or $12.0%, is a good measure of the hidden costs investors paid at the offering to buy Merrill Lynch's notes. The expected value of the MITTS® note at maturity was $17.43, but the expected value of the Treasury securities and stock portfolio when the MITTS ® note matures was $19.55. For every $1 in expected value at maturity when the MITTS® note is superior to the Treasury securities and stock portfolio, investors give up $44 in expected value at maturity when the MITTS® structured product is inferior to the Treasury securities and stock portfolio (index levels between 700 and 7,600 at maturity).

Figure 2 illustrates the results of Monte Carlo simulations, comparing the MITTS® equity-linked note to a portfolio initially invested 75% in stocks and 25% risk-free Treasury bonds. The portfolio of Treasury securities and stocks is worth more than the MITTS® note for all levels of the S&P 500 on September 4, 2009 between 700 and 7,600. Based on realistic assumptions, we determined that the probability that the S&P 500 Index level on September 4, 2009 will between 700 and 7,600 is 95%. That is, investors who bought the MITTS® note in the offering would be worse off 95% of the time at maturity than if they had invested in a simple buy-it-and-

[8] $14.94 = $10 × [1 + {(0.857×1,600 - 917.80) ÷ 917.80}].

Figure 2
Merrill Lynch MITTS
and 25% Treasuries / 75% Stock



forget-about-it portfolio of stocks and bonds. For simplicity, we assumed that the initial portfolio of stocks and bonds is never rebalanced during the full seven-year term. If instead we rebalance the portfolio periodically depending on changes in the S&P 500, the probability of the portfolio of stocks and bonds exceeding the value of Merrill Lynch's MITTS® September 4, 2009 increases to **100%**. Even very infrequent rebalancing based on crude rules of thumb increases the probability that the portfolio of stocks and bonds will exceed the value of Merrill Lynch's MITTS® at maturity to 99.5%. That is, investors who bought the MITTS® note at issuance are always worse off at maturity than if they had invested in a portfolio of stocks and bonds and rebalanced periodically.[9]

B. JP Morgan's July 7, 2009 Capped Quarterly Observation Notes

On June 22, 2004, J.P. Morgan issued Capped Quarterly Observation Notes linked to the S&P 500 maturing on July 7, 2009 at a $1,000 offering price to trade on the AMEX under the ticker symbol JPL.G. Like the MITTS® analyzed above, JP Morgan's notes are linked to the S&P 500 index, but they are much more complicated.

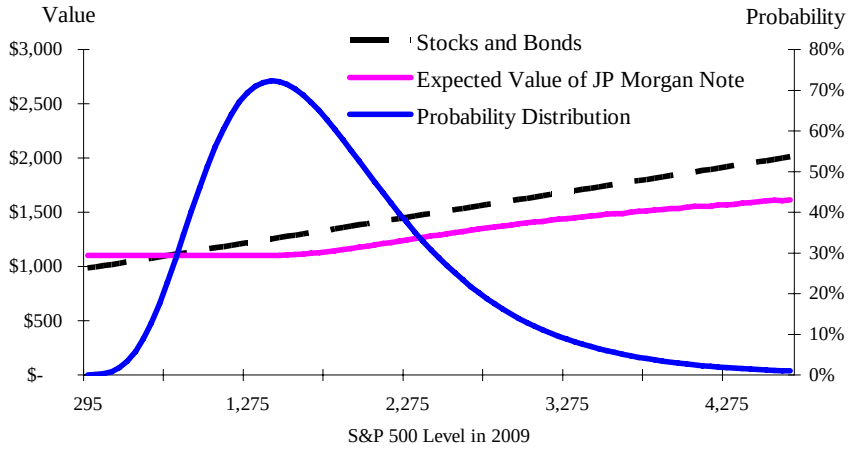
The notes were priced based on the initial S&P 500 level of 1,134. At maturity, the notes will pay the greater of $1,100 or $1,000 plus a return which is a function of the sum of the 20 quarterly changes in the S&P 500 during the 5-year term. The individual quarterly returns to be added together are capped at 6%. By returning at least $1,100 the issuer guarantees at least a 1.9% per year return, but capping and not compounding the quarterly returns severely limits the upside potential from stock market gains. JP Morgan's Capped Quarterly Observation Notes is an extraordinarily complicated investment as it depends not only on the change in the value of the index over the life

[9] There is a close correspondence between equity-linked notes and equity-indexed annuities. In our prior research on equity-indexed annuities, we compared the value of the equity-indexed annuities at the end of surrender periods with simple buy-and-forget-about-it portfolios and found the equity-indexed annuities inferior more than 95% of the time. We are currently extending our equity-indexed annuities research to include periodic rebalancing and find, as herein, that simple comparison portfolios of stocks and bonds, periodically rebalanced, beat the high cost, complex investment essentially 100% of the time.

of the note, but also on the pattern of the interim index level changes.

JP Morgan's Capped Quarterly Observation Notes provided investors $882.80 worth of investment value per $1,000 bond at issuance. The difference, $111.20 or $11.1%, is a good measure of the hidden costs investors paid at the offering to buy JP Morgan's notes. The expected value of JP Morgan's structured note at maturity was $1,183, but the expected value of the Treasury securities and stock portfolio at maturity was $1,348. For every $1 in expected value at maturity when the note is superior to the Treasury securities and stock portfolio (index levels below L or above U), investors give up $191 in expected value at maturity when JP Morgan's note is inferior to the Treasury securities and stock portfolio.

Figure 3
JP Morgan Capped Quarterly Observation Notes and 75% Treasuries / 25% Stock Portfolio



We compared the Capped Quarterly Observation Notes to a portfolio initially invested 25% in stocks and 75% in risk-free Treasury bonds without rebalancing using a Monte Carlo simulation. Figure 3 illustrates the results of our simulations. Because the value of JP Morgan's equity-linked note is a function of the quarterly returns over the note's 5-year term and not just the level of the index at maturity, we plot the average value of the note for each index level considering all the possible paths to arrive at that level. The portfolio of Treasury securities and stocks is worth more than the expected value of the JP Morgan note for all levels of the S&P 500 on July 7, 2009 above 775. Based on realistic assumptions, we determined that investors who bought the JP Morgan note at issuance would be worse off 97% of the time at maturity than if they had invested in a simple buy-it-and-forget-about-it portfolio of stocks and bonds.

As with the MITTS®, incorporating rebalancing into the comparison makes JP Morgan's notes look even worse. Simple periodic rebalancing makes the stocks and bonds portfolio better than the JP Morgan note **100%** of the time.

C. Citigroup's February 15, 2008 Intel-Linked TARGETS®

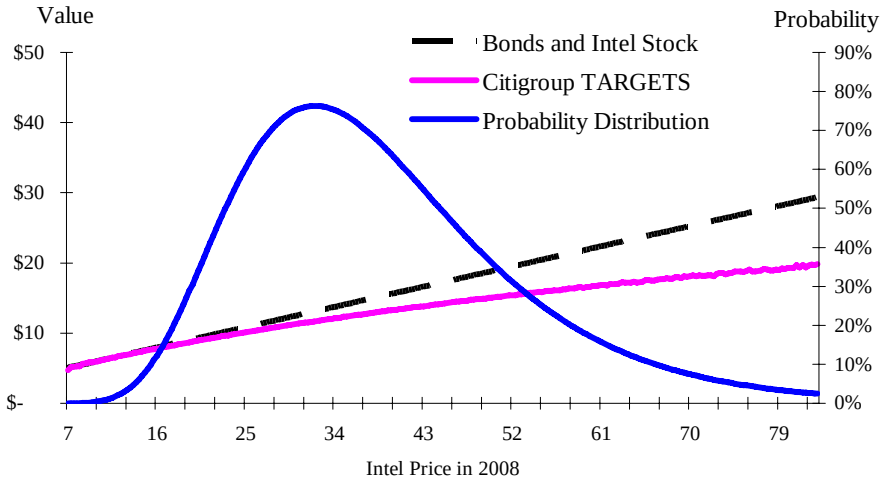
On February 25, 2005 Citigroup issued Targeted Growth Enhanced Term Securities TARGETS® linked to Intel's stock price maturing on February 15, 2008.[10] These notes were issued at a $10 offering price and

were listed on the AMEX under the ticker symbol TOI. The notes pay a 1.75% quarterly coupon but, unlike the Merrill Lynch and JP Morgan notes above, there is no guarantee that investors will get back their principal. The maturity payment is a function of the sum of the monthly returns to Intel with a 4.5% monthly cap and a -12% monthly floor.

Citigroup's TARGETS® provided investors $8.28 worth of investment value per $10 note at issuance. The difference, $1.72 or $17.2%, is a good measure of the hidden costs investors paid at the offering to buy Citigroup's notes.

We compared the TARGETS® note to a portfolio initially invested 75% in Intel stock and 25% risk-free Treasury bonds and never rebalanced. Figure 4 illustrates our simulation results.[11] The expected value of Citigroup's TARGETS® at maturity was $12.85, but the expected value of the Treasury securities and Intel stock portfolio at maturity was $15.33. For every $1 in expected value at maturity when the note is superior to the Treasury securities and stock portfolio, investors give up $117 in expected value at maturity when Citigroup's TARGETS note is inferior to the Treasury securities and Intel stock portfolio.

Figure 4
Citigroup Intel-linked TARGETS
and 25% Treasuries / 75% Stock Portfolio



The portfolio of Treasury securities and Intel stock is worth more than the expected value of the TARGETS® note for virtually all levels of Intel's stock price on February 15, 2008. Based on realistic assumptions, we determined that investors who bought Citigroup's Intel-linked TARGETS® at issuance would be worse off 94% of the time at maturity compared to the buy-it-and-forget-about-it portfolio of stocks and Treasury securities. As with the previous examples, incorporating periodic rebalancing of the Intel stock and bonds portfolio based on simple rules of thumb makes it worth more than

[10] Other brokerage firms including Merrill Lynch and Morgan Stanley have issued notes tied to Intel stock.

[11] As with the JP Morgan note, because the value of the Intel-linked TARGETS® note is a function of the pattern of interim returns over the note's term and not just the level of the index at maturity, we plot the average value of the note for each index level considering all the possible paths to arrive at that level.

Citigroup's Intel-linked TARGETS® **100%** of the time.

IV. Additional Considerations

In addition to being complicated and costly as demonstrated above, equity-linked notes are illiquid, have disadvantageous tax treatment and are difficult to properly monitor.

Trading volume in equity-linked notes is miniscule compared to the stocks or stock indexes they are linked to. For example, from the issue date of Citigroup's Intel-linked note, Intel has traded an average of sixty-five million shares per day, more than seven thousand times the average daily trading volume of Citigroup's Intel-linked notes. If we compare the dollar value of trading volume instead of just the number of shares, Intel's average daily volume is closer to twenty thousand times as great as the note's average trading volume.

The IRS imputes interest income to equity-linked notes even if the note does not pay a coupon, meaning investors might need to pay taxes each year out of other resources. The returns on these notes are treated as ordinary income and taxed at current margin income tax rates rather than at the typically lower capital gains rates which would be applied to capital gains on the stock portion of the stock and bonds portfolio.

Sophisticated analysis is required to determine the effective allocation between stocks and bonds in an equity-linked note. Investors who purchase an equity-linked note in any significant amount will therefore not be able to effectively monitor and rebalance his or her portfolio. Moreover, because of the structure of these notes, the effective asset allocation moves perversely with dictates of prudent portfolio rebalancing.[12]

V. Regulation

Equity-linked notes are registered with the Securities and Exchange Commission and are sold by brokerage firms. The NASD has issued several Notices to Members addressing its concern that structured products are inappropriately being sold to retail investors. These notices – NTM 03-71 *Non-Conventional Investments*, NTM 05-26 *New Products* and NTM 05-59 *Structured Products* – each make the same basic points.

1. **Members must perform due diligence to understand the material features of the structured product.** Equity-linked notes are financially equivalent to combinations of bonds and options on the linked stock or stock index. It is relatively straightforward for the issuers and brokerage firms selling these products to model and value these components.

> … a member must perform appropriate due diligence to ensure that it understands the nature of the product, as well as the potential risks and rewards. [*Notice to Members* 05-59, page 5.]

2. **Members must perform a "reasonable basis" suitability determination.** This first level suitability analysis focuses on the product and determines whether the product is suitable for *any* investor. The modeling required for effective due diligence should allow brokerage firms to determine the value of the equity-linked note at issue and in the secondary market by comparison to the cost of the simpler bond and option components which replicate the payoffs at maturity of the structured product.

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[12] *See* William Reichenstein, "Insured Investment Products: The Reality Behind the Hype", AAII Journal, November 2004, pp. 10-15.

> …NASD expects members to exercise their market expertise to recognize those situations where the materiality of difference is not in doubt and, consequently, identify that the lower yielding instrument does not represent a reasonable rate of return given the attendant risks as compared to other similarly composed products or direct investments in the underlying components of such products with similar risk/reward attributes. [Notice to Members 05-59, page 6.]

3. **Members must perform client-specific suitability determinations.** Structured products that pass the reasonable-basis suitability analysis must then be evaluated on a client-by-client basis for suitability. The risk-return tradeoff embodied in the structured product must be appropriate for the potential investor and the investor must understand the product. Moreover, analogizing structured products to combinations of stocks or bonds and options the NASD reminds members that

> Rule 2860(b)(19)(B) requires that "no member or person associated with a member shall recommend to a customer an opening transaction in any option contract unless the person making the recommendation has a reasonable basis for believing, at the time of making the recommendation, that the customer has such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction, and is financially able to bear the risks of the recommended position in the option contract". [Notice to Members 05-59, page 6.]

4. **Members must present fair and balanced disclosures of the material aspects of the structured product.** The NASD appears to have been especially concerned that promotional materials would be incomplete and therefore false and misleading – violations of the NASD rules which cannot be cured by statements in an accompanying prospectus or prospectus supplement.

> Members are further reminded that providing risk disclosure in a prospectus supplement does not cure otherwise deficient disclosure in sales material, even if such sales material is accompanied or preceded by the prospectus supplement. [Notice to Members 05-59, page 3.]

5. **Members must have adequate supervisory procedures in place**. Firms must have written procedures to adequately analyze new products and to ensure that registered representatives are adequately trained to - and in fact do - carefully evaluate the suitability of the new product on a customer by customer basis. Written procedures must also be developed to make sure all sales materials provide a fair and balanced portrayal of the risks and rewards on a structured product.

6. **Members must train their registered representatives**.

> Training for all persons should emphasize that, due to the unique nature of these products, many investors, especially retail investors, may not understand the features of the product, and may not fully appreciate the associated risks of investing in them. Moreover, in light of the fact that investors may be

> turning to these products as an alternative to traditional equity and fixed income investments, it is crucial for registered persons to have a full and balanced understanding regarding both the risks and the rewards of these products. [Notice to Members 05-59, page 7.]

VI. Conclusion

Equity-linked notes are complex, opaque and expensive – and the more complex and opaque they are, the more expensive they are. Even with the best disclosure materials and the most thoroughly trained and supervised registered representatives, it is unlikely that retail investors can understand the risk-return tradeoff and the costs being incurred in some of the complex equity-linked notes and structured products currently being marketed.

Moreover, we find simple portfolios of stocks and bonds can be purchased and periodically rebalanced which will yield more wealth at maturity than an investment in any of the three equity-linked notes we have analyzed at issuance whatever the level of the S&P 500 or whatever the stock price. These products add nothing to retail investors' portfolios that can't be acquired from investments "already available in the market in the form of less risky, less complicated, or less costly products" and therefore fail the "reasonable-basis" suitability requirement for sale to retail investors.

Reasons For and Responses to the Lack of Direct Access to No-Load, Low-Expense 403(b) Plans in Many School Districts

Michael B. Engdahl, JD, CFP®

Editor's Note – by Jason R. Doss

"Teachers who want to establish a supplemental retirement savings account through their employer typically must invest their savings in 403(b) plans. These plans were traditionally known as tax sheltered annuities (TSA's) because, historically, teachers were only permitted by the Internal Revenue Code to purchase annuities in these accounts. Even though the tax laws changed many years ago to allow teachers to purchase mutual funds within 403(b) plans, school districts have been slow to change. As a result, many school district continue to only give teachers the option to invest in high cost variable annuities sold by insurance companies.

By publishing this article, I hope to raise awareness of this important issue with the readers of this publication and spawn ideas that could help the thousands of teachers in this country who are being sold overly-expensive and unsuitable insurance products within their supplemental retirement accounts. Thank you."

I. INTRODUCTION

In order to assist employees with achieving their dream of retiring at a reasonable age, Congress has provided certain retirement plan tax incentives. Many of these tax incentives allow an employee to invest in a retirement plan pre-tax, allow the earnings on investments within the plan to grow tax-deferred, and create no taxable event until the employee takes distributions from her plan. Furthermore, the specific tax-favored retirement plan created by Congress for employees of school districts is called a 403(b) plan.

This paper will discuss the inner workings of 403(b) plans in school districts and evaluate the investment options available to 403(b) plan participants. Also, this paper will evaluate the impact of high fees and expenses on 403(b) plan investment performance. In addition, this paper will discuss several reasons why many school districts deny employees direct access to no-load, low-expense 403(b) plans. Furthermore, this paper will discuss responses of the NASD, Congress, and 403(b) plan participants to employees' lack of direct access to no-load, low-expense 403(b) plans. Finally, this paper will discuss how some teachers unions have joined forces with 403(b) plan providers to direct members into high-expense 403(b) plans, how the proposed repeal of I.R.S. Revenue Rule 90-24 may eliminate some school district employees access to no-load, low-expense 403(b) plans, and why attorneys who educate themselves on the current 403(b) plan marketplace will likely benefit significantly be representing school district employees.

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II. THE 403(b) PLAN DEFINED

A 403(b) plan is a retirement plan designed for employees of tax-exempt organizations. The plan confers upon such employees two main benefits. First, employee contributions to a 403(b) plan are excluded from the employee's income in the year the contributions are made. Second, earnings and gains on investments within an employee's 403(b) plan are not taxed until the employee withdraws money from his plan.[1]

A. 403(b) Plan Eligibility Requirements

Only employees of tax-exempt organizations, defined by Section 501(c)(3) of the Internal Revenue Code as qualified employers, may participate in a 403(b) plan.[2] According to the I.R.S., a qualified employer is an organization that is "organized and operated exclusively for religious, charitable, scientific, public-safety testing, literary, or educational purposes."[3] These types of institutions generally include K-12 public schools, colleges, universities, hospitals, libraries, philanthropic organizations, and churches.

B. 403(b) Plan Contribution Limitations

The following types of contributions can be made to 403(b) plans: (1) elective deferrals, (2) nonelective contributions, and (3) after-tax contributions.[4] Elective deferrals are employee contributions made under a salary reduction agreement. This agreement allows the employer to withhold money from the employee's paycheck and contribute the money directly into a 403(b) plan for the employee's benefit. The employee does not pay tax on these contributions until she makes a withdrawal from her 403(b) plan. Most, if not all, of the 403(b) contributions made on behalf of employees of school districts are elective deferrals.

Nonelective contributions are employer contributions made to an employee's 403(b) plan that are not made under a salary reduction agreement.[5] The employee does not pay tax on these contributions until he makes a withdrawal from his plan.[6] Nonelective contributions include matching contributions, discretionary contributions, and mandatory contributions made by the employer.[7]

After-tax contributions are contributions an employee makes with funds that she must include on her tax return.[8] A salary payment on which income tax has been withheld is a

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[1] I.R.S. Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations, March 2006, p. 3.

[2] Id.

[3] I.R.C Section 501(c)(3).

[4] I.R.S. Publication 571, p. 3.

[5] Id.

[6] Id.

[7] Id.

[8] Id.

source of these contributions.[9] Furthermore, if the plan allows the employee to make after-tax contributions, the contributions are not excluded from the employee's income and the employee cannot deduct the contributions on his tax return.[10]

For year 2006, employees can contribute the lesser of $15,000 (the 2006 elective deferral limit) or 100% of includible compensation for the employee's most recent year of service.[11] Also, for those employees whose employers make nonelective contributions, the 2006 limit is the lesser of $44,000 or 100% of includible compensation.[12] However, it is important to note that the employee is still limited to the $15,000 elective deferral limit. For example, if the employee made elective deferrals totaling $15,000 in 2006, the employer could make nonelective contributions of no more than $29,000 if the employee's includible compensation for 2006 is at least $44,000.

Additionally, a special "catch-up" provision may enable an employee to increase her elective deferrals by $3,000 in 2006.[13] To qualify, the employee must have completed at least 15 years of service with her employer and cannot have made elective deferrals of more than an average of $5,000 in previous years.[14] Contributions made under this catch-up provision cannot exceed $3,000 per year, up to a $15,000 lifetime maximum.[15] Finally, if the employee is age 50 or older during any time in 2006, he may contribute an additional $5,000.[16]

III. INVESTMENT OPTIONS AVAILABLE TO 403(b) PLAN PARTICIPANTS IN SCHOOL DISTRICTS

A school district employee may invest her 403(b) account balance only in annuity contracts or mutual funds.[17]

A. Annuity Contracts

The type of annuity available for utilization by 403(b) investors is called a deferred annuity. In a deferred annuity, monetary value accumulates over a number of years through periodic payments (salary reductions). Furthermore, when the investor reaches retirement, he may choose to either have the accumulation paid to him in installments or take withdrawals from the deferred annuity.

There are two types of deferred annuities

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[9] Id.

[10] Id., pp. 3-4.

[11] Id., p. 8.

[12] Id., p. 4.

[13] Id., p. 8.

[14] Id.

[15] Id.

[16] Id., p. 11.

[17] Id., p. 3.

available to 403(b) investors: fixed annuities and variable annuities. In a fixed annuity, the interest rate on invested dollars has a guaranteed minimum rate and is augmented with additional interest if such interest is earned by the insurance company offering the fixed annuity. Alternatively, in a variable annuity, money is invested at the discretion of the 403(b) investor in various separate accounts that usually consist of diversified portfolios of stocks and/or bonds.

B. Mutual Funds

Mutual funds are investments that are, in some ways, similar to variable annuities. Like variable annuities, mutual funds provide individual investors with a simple and diversified way of investing in the stock and/or fixed income markets. Typically, a mutual fund sells shares of the fund to the public and uses the proceeds to invest in a diversified portfolio of securities on behalf of the mutual fund shareholders.

IV. FEES AND EXPENSES ASSOCIATED WITH 403(b) PLAN INVESTMENT OPTIONS

There are fees and expenses associated with annuities and mutual funds which must be considered by the 403(b) plan participant before he decides to invest in a 403(b) plan.

A. Fees and Expenses Associated With Annuity Contracts

According to a study by Morningstar, Inc. in the late 1990s, the total yearly expenses of a variable annuity averaged 2.09% of the annuity's accumulation value.[18] However, a few insurance companies provide variable annuities to investors at a much lower cost. For example, TIAA-CREF currently offers variable annuities to 403(b) plan participants with total yearly expenses ranging from 0.42% to 0.63%.[19] Typical fees and expenses that a variable annuity investor incurs include the mortality and expense risk charge, the investment management charge, the contract fee, and the surrender fee.[20]

The mortality and expense risk charge typically guarantees that, if an annuity investor dies before her contract expires, the annuity investor's beneficiaries will receive the greater of the market value of the contract on the annuity investor's date of death or the total amount contributed to the annuity by the annuity investor. This charge also compensates the insurance company for the risk of having to make annuity payments to the annuitant if she lives beyond her life expectancy. Morningstar recently estimated that this charge averaged 1.1% of the annuity's accumulation value per year.[21] However, some low-expense variable annuity companies charge less than 0.10% per year.[22]

The investment management charge is the fee that goes to pay for the services of the money manager and asset management company in charge of selecting and managing the investments within a variable annuity's separate accounts. Morningstar recently estimated that this charge averaged 0.82% of the annuity's accumulation value per year.[23] However, some low-expense annuity companies charge less than 0.20% per year.[24]

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[18] Tam, Pui-Wing, "Buyers Need to Be Aware of Annuity Fees," The Wall Street Journal, June 1, 1998.

[19] For more information, visit TIAA-CREF's website at www.tiaa-cref.org.

[20] Tam.

[21] Id.

[22] For example, TIAA-CREF's annual mortality and risk expense charge currently ranges between .005% and .05% per year. For more information, visit TIAA-CREF's website at www.tiaa-cref.org.

The contract fee, or annual policy fee, is another administrative charge levied by the insurance company. This charge remains fixed from year to year and normally averages between $25 and $75 per year. Also, if the annuity's accumulation value grows large enough, some insurance companies will waive this charge.[25]

Finally, the surrender fee is the charge incurred by some annuity investors who withdraw money from an annuity within several years of the annuity's purchase. This fee is normally around 6% in the first year after purchase, but can be much higher. Furthermore, this charge generally declines by one percentage point a year so that after a certain number of years an annuity investor no longer faces a surrender fee when he takes a withdrawal from his annuity.[26] However, some no-load annuity companies, such as TIAA-CREF, impose no surrender fees on their annuities.[27]

B. Fees and Expenses Associated With Mutual Funds

Mutual fund fees and expenses can be classified as either front-end loads, back-end loads, or expense ratios. All mutual funds have expense ratios. In addition, many, but not all, funds have front-end or back-end loads.

A front-end load is a sales charge levied on the initial investment into some mutual funds. This charge may be incurred when an investor purchases a mutual fund from a commission-based investment salesperson. Although many front-end load funds charge a front-end load of around 5%, some funds impose charges as high as 8.5%.[28]

A back end-load is a sales charge levied on the redemption amount of some mutual funds. Many back-end loads are in the form of declining redemption fees where the percentage sales charge declines each year the fund is held. For example, a fund might charge a six percent declining redemption fee. In such a case, an investor might incur a six percent redemption fee if he liquidates the fund within the first year after purchasing the fund, a five percent redemption fee if he liquidates the fund within the second year after purchasing the fund, and so on. After six years no redemption fee would be charged.

Expense ratios are annual fund expenses stated as a percentage of total assets. Expense ratios may include management fees, fund operating expenses, and 12b-1 fees.

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[23] Tam.

[24] For example, the investment management charge for all of TIAA-CREF's subaccounts are currently under 0.20%. For more information, visit TIAA-CREF's website at www.tiaa-cref.org.

[25] Tam.

[26] Id.

[27] A no-load annuity company is an annuity company that imposes no upfront sales charges or surrender fees on its annuities.

[28] Many front-end load funds also qualify for breakpoint discounts. A breakpoint discount reduces the front-end sales charge the investor pays and is based on the size of the cumulative investment. The discount increases as the size of the cumulative investment increases.

The management fee is generally the single largest expense in the expense ratio. This fee generally is paid to the investment manager for managing the mutual fund's investments. Additionally, operating expenses go toward running and operating the mutual fund. Combined management fees and operating expenses may range from less than 0.20%[29] of the value of an investor's mutual fund per year to over 1.0%.

12b-1 fees are typically levied only by funds that use commission-based salespeople to distribute their products. The fee is a form of trailing commission and is paid to the salesperson over a number of years. Additionally, 12b-1 fees can increase a mutual fund investor's overall expense ratio by as much as 1.0% per year.[30]

Once its fee structure and expense ratio are determined, a fund is then usually classified either a class A share, class B share, class C share, or no-load mutual fund. Class A share funds usually have front-end loads and little or no 12b-1 fees. Class B shares usually have back-end loads and high 12b-1 fees. However, the 12b-1 fees of class B shares are generally significantly reduced shortly after the fund's redemption fee period expires. Class C shares normally have no front-end loads, a one-percent back-end load, and high 12b-1 charges that do not reduce when the fund's redemption period expires.

Finally, no-load funds have expense ratios, as do all funds, but do not have front-end loads or back-end loads. In addition, no-load funds have little or no 12b-1 fees. Furthermore, no-load funds are typically purchased directly through the fund company itself without the intervention of a commissioned-based salesperson.

C. The Effect of High Fees and Expenses on Investment Performance

High fees and expenses may dramatically affect the investment performance of an annuity or mutual fund over time. This fact has prompted several recent warnings to investors from the Securities and Exchange Commission (SEC) on the SEC's web site (www.sec.gov). For example, the SEC warns that when considering purchasing a mutual fund, "scrutinize the fund's fees and expenses. . . . A fund with high costs must perform better than a low-cost fund to generate the same returns to you. Even small differences in fees translate into large differences over time."[31]

Furthermore, in an effort to assist investors with better understanding the effect of fees and expenses on their investments, the SEC recently created an online tool called the Cost Calculator. According to former SEC Chairman Arthur Levitt, "the Cost Calculator takes some of the mystery out of mutual funds by enabling investors to evaluate and compare costs."[32] In order to use the calculator, which is available on the SEC's web site, investors must plug in actual fees and expenses of their annuity or mutual fund, estimate how long they plan on holding the investment, and estimate the investment's average annual rate of return.

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[29] For example, the current expense ratio for the Vanguard 500 Index Fund Investor Shares is 0.18%.

[30] Dalton, Michael A., et al., Personal Financial Planning Theory and Practice, Kaplan Financial, St. Rose, Louisiana (2005), p. 563.

[31] U.S. Securities and Exchange Commission, "Mutual fund Investing: Look at More Than a Fund's Past Performance," p.1 <http://www.sec.gov/investor/pubs/mfperform.htm>.

[32] Burns, Judith, "SEC Tool to Calculate Costs of Funds," The Wall Street Journal, April 7, 1999.

For example, suppose five investors recently inherited $100,000 a piece and each decides to invest his or her money into a diversified investment portfolio. Investor 1 places her money in a variable annuity with total yearly operating expenses of 2% and a six-year declining surrender charge. Investor 2 invests his money in a class A mutual fund with a 3.25% up-front sales charge and a yearly expense ratio of 1.0%. Investor 3 invests her money in a class B mutual fund with a yearly expense ratio of 1.8% and a six-year declining surrender charge. The expense ratio, however, reduces to 1.0% in year seven. Investor 4 invests his money in a class C mutual fund with a 1.8% yearly expense ratio. Finally, Investor 5 invests her money in a no-load mutual fund with an annual expense ratio of 0.2%.

According to the SEC Cost Calculator, if all investors earn a gross average rate of return of 11%[33] and hold their investments for 20 years, at the end of 20 years Investor 5 will have fared substantially better than her counterparts. As Table 1 shows, she will have accumulated approximately $136,596 more than Investor 2, $146,498 more than Investor 3, $213,940 more than Investor 4, and $236,341 more than Investor 1.

TABLE 1 – EFFECT OF FEES ON INVESTMENT PERFORMANCE OVER TIME

INVESTOR	INVESTMENT	TOTAL COST OF INVESTMENT[34]	END OF HOLDING PERIOD TOTAL
1	Variable Annuity	$267,985	$538,246
2	Class A Fund	$168,240	$637,991
3	Class B Fund	$178,142	$628,089
4	Class C Fund	$245,584	$560,647
5	No-load Fund	$ 31,644	$774,587

V. REASONS FOR THE LACK OF DIRECT ACCESS TO NO-LOAD, LOW-EXPENSE 403(b) PLANS IN MANY SCHOOL DISTRICTS

In spite of the SEC's recommendation that fees and expenses should be scrutinized carefully and the wealth of information indicating that high fees and expenses may significantly hamper long-term investment performance, many school districts do not allow their employees direct access to no-load, low-expense 403(b) plans. Instead, according to noted financial columnist Jane Bryant Quinn, a school district typically "arranges for [the employee] to invest through payroll deduction but pretty much ignores what's going on."[35] The reasons for such

[33] The SEC estimates that the average return for the S&P 500 stock index over the past 30 years has been approximately 11%. See http://www.sec.gov/investor/tools/mfcc/get-started.htm.

[34] The Total Cost of Investment is the sum of the total fees paid plus the foregone earnings.

[35] Quinn, Jane Bryant, "403(b) Gets a Little More Like It's Cousin," washingtonpost.com, July 8, 2001, p. 2.

apathy by many school districts regarding ensuring low-expense investment options for employees include the lack of ERISA regulation of 403(b) plans and concern about the school district's liability for withholding excess taxes from 403(b) plan participants.

According to ERISA Section 3(21)(A), an employer is a fiduciary with respect to a retirement plan and, thus, is subject to ERISA fiduciary duties "to the extent" that the employer "exercises any discretionary authority or discretionary control respecting management" of the plan or "has any discretionary authority or discretionary responsibility in the administration" of the plan. Correspondingly, one of these ERISA fiduciary duties should be to ensure that the retirement plan includes quality, low-expense investment options. However, since most 403(b) plans are individual plans in which the employer merely arranges for the employee to invest through payroll deductions into a plan chosen by the employee, such plans are not subject to ERISA regulation.

In addition, the complex set of rules which govern how much an employee can contribute to a 403(b) plan each year have prevented some school districts from granting their employees direct access to no-load, low-expense 403(b) plans. Moreover, these complex rules have caused great concern to school districts ever since the I.R.S. began auditing 403(b) programs in the 1990s. According to the I.R.S., an employer "could be the subject of penalties for federal income tax withholding and FICA (if applicable) tax that should have been withheld on the excess contribution."[36]

Furthermore, in order to reduce potential liability for excess employee 403(b) contributions, many employers have turned to the use of hold harmless agreements. These agreements purport to transfer liability that might result from improper 403(b) withholdings to investment providers. However, many no-load annuity and mutual fund providers have refused to sign such agreements since the I.R.S. has stated that the employee, not the investment provider, is the individual or entity responsible for monitoring contributions to the employee's 403(b) plan.[37] Also, many of these agreements do not even allow a 403(b) participant, who invests in a no-load annuity or mutual fund, to have his or her CPA or tax attorney complete a maximum allowable 403(b) contribution calculation on a yearly basis and submit the calculation to the employee's school district.[38] Therefore, in some school districts, the only 403(b) plan investment options from which employees have to choose are high-expense variable annuities or mutual funds offered by commission-based salespeople who, acting as an agent for their investment provider employer, have agreed to do a yearly maximum allowable 403(b) plan contribution calculation for their school district employee customers.

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[36] Internal Revenue Service, "Retirement Plans FAQ regarding Tax Sheltered Annuities," p. 1 <http://www.irs.gov/retirement/article/0,,id=96975,00.html>.

[37] For example, IRS Publication 571 states that "this publication can help you better understand the tax rules that apply to your 403(b) (tax-sheltered annuity) plan." In addition, the publication states that "you," in other words the employee, "should figure your MAC (maximum amount contributable to your 403(b) plan) for the current year" See IRS Publication 571, p. 2 and p. 4.

[38] For example, several hold harmless agreements, which were drafted by 403(b) service providers and placed in force between Western New York public school districts and 403(b) service providers, allowed only the "service provider" to perform the calculation and submit the calculation to the school district.

VI. THE NASD'S RESPONSE TO THE LACK OF DIRECT ACCESS TO NO-LOAD, LOW EXPENSE 403(b) PLANS IN MANY SCHOOL DISTRICTS

Partially in response to the previously mentioned monopolistic power exercised by insurance companies in selling high-expense annuities to 403(b) plan investors, the National Association of Securities Dealers, in 1999, issued Notice 99-35 in order to remind NASD members of their responsibilities pertaining to variable annuity sales in tax-deferred accounts. The notice states:

> When a registered representative recommends the purchase of a variable annuity for any tax-qualified retirement account . . . the registered representative should disclose to the customer that the tax-deferral accrual feature is provided by the tax-qualified retirement plan and that the tax-deferred accrual feature of the variable annuity is unnecessary. The registered representative should recommend a variable annuity only when its other benefits, such as lifetime income payments, family protection through the death benefit and guaranteed fees, support the recommendation[39]

The Notice further states that an NASD member "should conduct an especially comprehensive suitability analysis prior to approving the sale of variable annuities with surrender charges to a customer in a tax-qualified plan subject to minimum distribution requirements."[40] In 403(b) plans, minimum distributions are required to begin by April 1 of the year after the account owner turns age 70 ½.[41]

The result of the NASD's filing of Notice 99-35 has been a flood of class action lawsuits filed by investors, who were sold variable annuities within their tax-deferred accounts, against the insurance companies whose agents recommended the purchase of the annuities. Most of the claims allege that the insurance companies did not honor the guidelines set forth in the notice, and some of the claims have resulted in substantial settlements.[42] For example, American Express recently agreed to pay more than $215 million in benefits to more than two-million class participants.[43]

Furthermore, the lawsuits appear to by aimed only at insurance companies who sell high-expense, agent sold annuities in tax-deferred accounts to investors and are not aimed at insurers, like TIAA-CREF, who offer no-load, no surrender charge, low-expense variable annuities directly to investors in tax-deferred accounts. Also, most of the suits ask for insurers to repay "superfluous" insurance fees and refund surrender charges on inappropriately sold policies.[44] The suits also seek to stop "deceptive" sales practices by the insurance companies.[45]

VII. EMPLOYEE RESPONSES TO THE

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[39] NASD Notice to Members 99-35, p. 3 <http://www.nasd.com/web/groups/rules_regs/documents/notice_to_members/nasdw_004395.pdf>.

[40] Id.

[41] I.R.S. Publication 571, p. 13.

[42] Panko, Ron. "Can Annuities Pass Muster?" *Best's Review*, July 2000, p. 106

[43] Id.

[44] "What a Deal: A Lawyer is Suing to Prove the Obvious; that Variable Annuities in Qualified Plans are Not a Bargain," *Dow Jones Investment Advisor*, December 1999, p. 20.

[45] Id.

LACK OF DIRECT ACCESS TO NO-LOAD, LOW-EXPENSE 403(b) PLANS IN MANY SCHOOL DISTRICTS

Even if an employee's only 403(b) plan options are high-expense annuities or mutual funds, there are several courses of action that the employee can take to gain eventual access to no-load, low-expense 403(b) plans. For example, the employee can form a committee within his school district and ask the school district to include, in its 403(b) plan options, at least one no-load annuity or mutual fund company. In addition, when petitioning the school district, the committee should provide the district with research illustrating the long-term detrimental effect of high-fees and expenses on investments. Also, the committee should point out the potential benefits to the district for allowing direct access to no-load, low-expense 403(b) plans.

One such benefit to the school district the committee should mention is that, if a no-load, low-expense 403(b) option is provided, each employee's future 403(b) account balance may be substantially greater than if the employees were forced to invest in high-cost investments. The committee should further explain that a higher account balance would be beneficial to the school district because many employees may be able to retire sooner. For example, assume that because a teacher periodically invests in a no-load, low-expense variable annuity or mutual fund her 403(b) account balance at age 60 is $200,000 more than it would have been if she was forced to invest in high-cost investments. Also, assume that because her 403(b) account is $200,000 larger, the teacher decides to retire at age 60 as opposed to age 63. This would result in over $100,000 of cost savings to the district if the retired teacher was making $70,000 a year at age 60 and the district replaced the retired teacher with a new teacher to whom they paid only $35,000 a year.

Also, the employees should explain to the school district that providing direct employee access to no-load, low-expense 403(b) plans may better help the school district to attract and retain employees. Many school districts in the country that are facing teacher shortages may find this argument particularly persuasive.

If, however, after pointing out the benefits of providing *direct* access to no-load, low-expense 403(b) plans, the school district still refuses to facilitate a payroll remittance to such plans, the employees should consider taking advantage of I.R.S. Revenue Rule 90-24 in order to gain *indirect* access to no-load, low-expense 403(b) plans. Under this rule, if an employee transfers funds from one 403(b) account to another, and the transferred funds continue to be subject to the early distribution restrictions as set forth in the Internal Revenue Code, the transfer is not an actual distribution and, consequently, is not a taxable transfer.[46] Also, the rule states that "it is irrelevant whether a complete interest or a partial interest is transferred, and whether the transferring individual is a current employee, a former employee or a beneficiary of a former employee."[47]

To effectively facilitate a 90-24 asset transfer and avoid sales and surrender charges, the employee should consider taking the following steps. First, from the school district's list of approved 403(b) plan vendors, the employee should find a vendor who offers a no-load money market mutual fund within

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[46] Internal Revenue Service Revenue Rule 90-24, p. 3 <http://taxlinks.com/rulings/1990/revrul90-24.htm>.

[47] Id.

its 403(b) plan. (Many money market mutual funds, even if offered by high-expense mutual fund or insurance companies, do not impose any sales or surrender charges.) Second, the employee should open up a new 403(b) plan account with the approved 403(b) plan vendor offering the no-load money market mutual fund as an investment option. Third, the employee should open up a 403(b) plan account with a no-load, low-expense annuity or mutual fund company.

Fourth, the employee should instruct the employer to remit the employee's 403(b) plan contributions to the approved vendor. Fifth, the employee should periodically (every three to six months) facilitate a 90-24 transfer from the money market fund in the approved vendor's 403(b) plan to the 403(b) plan which offers no-load variable annuities or mutual funds.

It is important to note that, although the I.R.S. allows employees to facilitate a 90-24 transfer, the employer and the approved vendor must permit such transfers in order for the 90-24 transfer to be facilitated. Fortunately, many employers and approved vendors currently allow 90-24 transfers.

VIII. THE LACK OF UNION SUPPORT FOR DIRECT ACCESS TO NO-LOAD, LOW-EXPENSE 403(b) PLANS IN MANY SCHOOL DISTRICTS

In their quest to gain direct access to no-load, low-expense 403(b) plans, one would think that school district employees can count on their union for help. However, some of the nation's largest teachers unions have joined forces with financial services companies to steer members into high-expense 403(b) plans.[48] Teachers unions currently endorse financial services firms, 403(b) plans, and financial products. In return, the financial services firms reciprocate with financial support for the unions.[49] For example, the National Education Association collected nearly $50 million in royalties in 2004 on the sale of annuities, life insurance and other financial products.[50] In addition, the New York State United Teachers (NYSUT) has received as much as $3 million a year from ING Group for encouraging its 525,000 members to invest in an annuity sold by the insurance company.[51]

The relationship between NYSUT and ING recently prompted an investigation by New York State Attorney General Eliot Spitzer. The investigation revealed that a 403(b) plan, offered by ING and endorsed by NYSUT's Members Benefits unit, charged investors fees and expenses as high as 2.85% per year while delivering only limited benefits.[52] The investigation also revealed that NYSUT's Member Benefits unit endorsed ING's 403(b) plan even though less expensive alternatives were available, received undisclosed payments of as much as $3 million per year for endorsing ING's 403(b) plan, and took steps to conceal its financial arrangement with ING from its members.[53] In June 2006, NYSUT's Members Benefits unit entered into an agreement with Spitzer to resolve the investigation.[54] Under the agreement, the

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[48] Kristoff, Kathy M. "Unions' Advice is Failing Teachers." latimes.com, April 25, 2006, p. 1 <http://www.latimes.com/business/la-fi-retire25apr25,0,6936648,print.story?coll=la-home-bu…>.

[49] Id.

[50] Id., p. 2.

[51] Id., p. 2.

[52] New York State Attorney General. "NYSUT's Members Benefit Unit Settles Probe: Settlement is Part of Ongoing Investigation of Retirement Products," p. 1 <http://www.oag.state.ny.us/press/2006/jun/jun13b_06.html>.

[53] Id.

unit promised to adopt a series of reforms and pay $100,000 to cover the costs of the investigation.[55]

IX. THE POTENTIAL REPEAL OF REVENUE RULE 90-24

Since some teachers unions have turned out to be poor allies in school district employees' quest for direct access to no-load, low-expense 403(b) plans, many employees are thankful that they may be allowed indirect access to such 403(b) plans via 90-24 transfers. However, in November 2004 the Treasury and I.R.S. proposed revised regulations concerning 403(b) plans.[56] The proposed regulations seek to eliminate all 403(b) transfers to a 403(b) plan that is not offered by an employer approved 403(b) vendor.

In their written comments to the Treasury and I.R.S. on the proposed regulations, National Tax Sheltered Accounts Association advisors Kristi Cook and Ellie Lowder explained effect of the potential restrictions on 90-24 transfers in the following way:

> The proposed regulations provide for the repeal of Rev. Ruling 90-24 and the imposition of a limitation on transfers and exchanges *only* to vendors that are authorized under the current employer's "plan," or to the venders of a new employer if the participant leaves the employment of one employer and begins work for a new 403(b)-eligible employer. The new limitation completely eliminates the ability of 403(b) participants to transfer one 403(b) account to another 403(b) account of a provider that is not part of the employer's 403(b) arrangement, and eliminates the ability of 403(b) participants to transfer the account values after they are no longer working (either retired, or working for an employer that is not eligible to sponsor a 403(b) arrangement).[57]

Fortunately, there is still time for employees to facilitate a 90-24 transfer to a no-load, low-expense 403(b) plan that is not an employer approved 403(b) vendor since the final regulations will not be effective earlier than January 1, 2008.[58]

X. ATTORNEY RESPONSES TO THE LACK OF DIRECT ACCESS TO NO-LOAD, LOW EXPENSE 403(b) PLANS IN MANY SCHOOL DISTRICTS

The fact that employees in many school districts lack direct access to no-load, low expense 403(b) plans is certainly bad news to such employees. However, the aforementioned lack of access is potentially good news to attorneys representing school district employees in disputes with the financial services industry. Attorneys, who educate themselves on the current 403(b)

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[54] Id.

[55] Id.

[56] Department of the Treasury, Internal Revenue Service. "Revised Regulations Concerning Section 403(b) Tax-Sheltered Annuity Contracts". REG-155608-02. November 16, 2004 <http://www.irs.gov/pub/irs-regs/15560802.pdf>.

[57] Cook, Kristi and Ellie Lowder. "Written Comments from the National Tax Sheltered Accounts Association on the 403(b) Proposed Regulations," p. 13.

[58] Internal Revenue Service. "Delay in Effective Date for Regulations Under Section 403(b)." IR-2006-136. August 29, 2006 <http://www.irs.gov/newsroom/article/0,,id=161446,00.html>.

marketplace, will likely benefit significantly by representing school district employees in at least two ways.

First, attorneys will likely benefit from continuing to bring class action lawsuits against insurance companies whose agents improperly sold annuities to school district employees within their tax-deferred 403(b) accounts. According to the Spectrem Group, a Chicago-based research firm, of the approximately $600 million invested in 403(b) plans at the end of year 2005, almost 500 million was invested in annuities.[59] The class action suits will likely continue to allege that such annuities were unsuitable for the employees and that the annuity salespeople violated provisions within NASD Notice 99-35. In addition, some creative class-action attorneys may assist school district employees in filing lawsuits against teachers unions for steering members into high-expense, union-endorsed 403(b) plans. Credible online tools, such as the SEC Cost Calculator, may be of assistance in computing and establishing damages.

Second, attorneys will likely benefit by representing employees in their quest to have a no-load, low expense mutual fund company added to their employer's list of approved 403(b) vendors. Such legal representation may prove invaluable to school district employees during a time when the potential repeal of Revenue Rule 90-24 is looming and brokerage and insurance companies are fighting hard to prevent employees from gaining direct access to no-load, low expense 403(b) plans. For example, a New Jersey math teacher recently convinced his school district to add no-load, low expense mutual fund company Vanguard to the school district's list of approved 403(b) vendors.[60] In addition, the teacher organized seminars for his fellow teachers and convinced 50 of them to sign up with Vanguard as their new 403(b) plan provider. Furthermore, even though the teacher was not compensated in any way from his campaign and the information presented in his seminars was thorough and balanced, a sales agent for AXA-Equitable Life Insurance Co., one of the school district's other 403(b) approved vendors, threatened the teacher with legal action.[61]

XI. CONCLUSION

In conclusion, 403(b) plans offer significant tax advantages to employees of school districts who desire to accumulate wealth and retire at a reasonable age. However, the tax advantages gained by 403(b) plan investors are currently being eradicated by high investment costs in school districts that deny their employees direct access to no-load, low-expense 403(b) plans. Furthermore, the proposed regulations may also deny many school district employees indirect access to no-load, low-expense 403(b) plans by repealing Revenue Rule 90-24. One can only hope that school districts and teachers unions will take a more proactive stance in ensuring that employees have direct access to no-load, low-expense 403(b) plans. Such a result would surely be of great benefit to ***both*** school district employees and school districts. However, until such a stance is taken, many attorneys will remain busy representing school district employees in

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[59] Wasik, John F., "New Jersey Teacher Wins Fight on Retirement Fees." Bloomberg.com, October 2, 2006, p. 1 <http://www.bloomberg.com/apps/news?pid=20601039&sid=aQm8SUAzWPHk&refer=home>.

[60] Id.

[61] Id.

their quest to gain direct access to no-load, low expense 403(b) plans and in class action lawsuits against high-expense 403(b) plan providers and, perhaps, teachers unions.

Improving Your Mediation Experience: Practical Tips and Suggestions

David Lichter, Esq.

David Lichter is an experienced attorney who has mediated hundreds of securities arbitration matters across the country and who has lectured on mediation on the state and national levels. He is an approved mediator for the NASD and an arbitrator for both the NASD and the NYSE. He is A/V rated by Martindale-Hubbell and is included in the 2007 Edition of The Best Lawyers in America in the specialty of Alternative Dispute Resolution. For more detailed information you may visit his website at www.HLGlawyers.com <http://www.HLGlawyers.com> or he may be contacted at dlichter@HLGlawyers.com or (305) 933-9970.

While securities mediations deal with different facts and arguments, they nevertheless share many similarities. That, at least, has been my observation over the years as a mediator and practitioner. And while each mediation has its own course and pace, with no *One True Path* toward settlement, helpful information can be gleaned from their common characteristics. What follows are time-tested ways to improve your chance of reaching settlement in a securities arbitration mediation, based on those similarities.

Things to Consider Before Filing the Statement of Claim

Does it make a difference for purposes of mediation who gets named in the arbitration Statement of Claim? Perhaps. There has been a lot of chatter since the NASD's revised expungement rule became effective that naming a broker or other potential respondents (i.e., a branch manager) might hamper the mediation process since those respondents would have a much harder time getting themselves expunged. It's clear the NASD is taking the expungement process seriously and that, as a result, they are harder to come by. It also seems logical that naming a broker or branch manager isn't going to win you any friends at the broker dealer (at least if they are still employed); the named party, if present at the mediation, may be more intransigent as a result.

I haven't seen any real evidence that naming the broker or others has hampered the settlement process. That being said, I certainly haven't seen any evidence that naming a broker or a branch manager helps get cases settled. As a result, while there may be strategic reasons for naming a broker or others (perhaps if the broker has left the firm and is an independent source from whom you can or may need to collect, or if you simply want to have the broker's activities become a matter of record), I see no good reason to name a broker or others in management, at least for purposes of mediation. Besides, they could hire separate counsel, bringing them to the mediation and making settlement all the more difficult (since those attorneys will, naturally, want their opinions heard).

Prior to the Mediation

What To Give Your Mediator And Some Thoughts On Preparation

Some of what you give your mediator may be driven by your experience with the particular mediator or a mediator's specific request. I've always found it useful to have, at a

minimum, a copy of the Statement of Claim, the Answer (at least if it is a narrative Answer and doesn't simply deny everything), a damage analysis and, depending upon the matter, some key documents. A summary of settlement negotiations (if any) is also very helpful, as is a summary that tells me something different from the Statement of Claim.

Simply dumping some home-generated numbers on the mediator or the other side may not be the best way to proceed, however. Nor can you necessarily rely on your in-house numbers cruncher or outside expert to always get it right. At a minimum, check your damages analysis before the mediation. I have had a number of mediations where one side or the other was embarrassed to discover that their numbers were wrong. The side in control of the numbers usually enjoys a decided bargaining advantage. Needless to say, explaining such glitches to your client is difficult at best.

In most mediations, "the numbers are what the numbers are." Ideally, both sides could save time and money if they agreed in advance on retaining <u>one</u> expert if a simple profit and loss statement is all that's needed. But the ideal is not the reality, unfortunately. If you want your expert to run a few scenarios you'd rather review first to see how they look, using one expert is obviously out of the question. That doesn't mean, however, that you should play *hide-the-ball* with the other side until the mediation. At a minimum, consider exchanging profit and loss statements with the other side to make sure you're on the same page before the mediation begins. That way you will avoid wasting time arguing with the other side about what the "true" numbers are. If your numbers don't agree, in advance of the mediation, take a look at the time parameters each side is using. The difference in starting and ending dates for the analyses accounts for many discrepancies.

Run the numbers from different perspectives. This may involve several different analyses. These can include: (a) looking at performance during different time periods, (b) comparing your client's account performance to different indices, or (c) using a model portfolio. The *Principia Pro* or *Morningstar Portfolio* comparisons are particularly helpful. These compare your client's portfolio to a selected index (often, but not always the S&P and/or some blended benchmark). They also compare its sector holdings on a percentage basis with that index (i.e., how much technology your client has compared with an index) and measure the volatility (i.e., standard deviation) or risk of your client's portfolio against a selected index. Depending on the particular case, doing a "if it ain't broke don't fix it analysis" (i.e., what would have happened if the broker had never touched the portfolio) can be very helpful.

There's nothing wrong with talking to the mediator in advance of the mediation session. Indeed, communications should be encouraged by the mediator. This is particularly helpful if one or more of the parties has some personal issues or hot buttons of which the mediator should be aware. In the Southeast (where I primarily mediate) counsel are generally accustomed to making some opening remarks. If one side chooses to forego those comments, I like to be informed in advance to let the other side know. As often as not, once one party decides not to do an opening, the other side won't either.

<u>Pre-Mediation Settlement Discussions</u>

Parties should have pre-mediation settlement discussions if they think it makes sense. There's nothing wrong with trying to narrow the gap before you begin mediating. If you've established some type of floor or ceiling on an offer and/or demand as a precondition to mediation, put that floor or ceiling in writing. People are not always on the same page when on the telephone. I've been at more than one mediation where one side or the

other made accusations of bad faith resulting from a miscommunication (or deliberate deception, depending on who you ask) between counsel.

Who Attends

Broker? If you are not going to bring all of your clients when there are several claimants involved (which is often unnecessary if the number of real decision-makers is limited), make sure you check with the other side to avoid any initial problems. This is usually a non-issue if this item is discussed in advance of the mediation conference. For example, if you think the broker is important to have at the mediation (and I usually prefer his or her presence so I can question the broker), ask the other side to bring the broker. They may not accede to your request, but I have seen it happen on a number of occasions.

Format? Consider the format you'll use in presenting your position. PowerPoint? An organized three ring binder? A few comments and nothing more? Obviously, every case is different. Studies show that people remember better the things they *see* rather than things they *hear*. This would suggest that a PowerPoint presentation or notebook would be preferable to some unadorned opening remarks. But both of these mediums are subject to overuse, however. PowerPoint quickly gets boring, so I suggest you stick to your main points and save the slides for key documents or charts, and not narrative descriptions, quotes from the NASD Manual or long case citations. The same is true for the binder, although you can add additional paper (tabbed) to make you look very prepared while only spending time on a limited number of the tabs. I think the effect of an organized presentation is helpful not only to persuade respondents' counsel, but to let their client know you take the case seriously and are ready to go to the arbitration hearing.

At the Mediation

Beginning

Setting the right tone is critical. Setting the wrong tone will move things in the wrong direction and force the mediator to spend valuable time cleaning up your mess. There are plenty of ways to get your point across during your opening comments that don't include personally attacking the broker or the broker-dealer as the Evil Empire. Nor should the opening be a re-reading of your Statement of Claim; you can assume that the respondents and, hopefully, the mediator have read it, so hit the high points of what the case is really about. It's generally more effective, in my view, to direct your comments to the person on the other side holding the checkbook than the mediator.

A lot of lawyers do not let their clients speak at mediation. There are often many good reasons for this (such as "My client is an unlikeable or lousy witness and I don't want the other side to know"). On the other hand, if you have a nice widow who will make a good impression without screwing things up, you should have her speak. The more sympathetic your client appears, the more money you are likely to get to settle.

Your First Demand

Except in the rare instance, your first demand should not include amounts allocated for punitive damages or attorney's fees. It's clear that for most cases, respondents aren't ever going to pay a settlement that includes these items (since they might as well go to arbitration). Putting them in your first demand usually just makes the other side defensive and gets things off on the wrong foot. Moreover, the response you receive will often be as low in the other direction. Starting somewhere south of your maximum number is a good way to get the process off on the right foot.

Strategies

There's nothing wrong with saving some cards to play during the mediation. But don't get so bound up with litigation strategy that you refuse to play *anything* in your hand as the parties begin to move toward each other. You can dole the information out slowly; this will often encourage the other side to do the same.

While "free discovery" should never be the sole purpose of any mediation, it's certainly a side benefit that often occurs. Assuming you're comfortable with the way things are progressing and you trust your mediator, then play that last card if you have a reasonable belief that it will bridge the gap. It's always harder for mediators to do their job if you don't give them the tools to work with. And *please* don't give up on the process too early. You can keep talking even as you load the car and drive to the arbitration hearing.

The Settlement Agreement

To the extent possible, try to execute a complete settlement agreement and release *at the mediation.* This avoids "buyer's remorse" on either side as well as extended lawyer haggling over what in the final analysis are usually meaningless distinctions. If your client's English is poor, make sure the settlement agreement contains a line at the end in his or her native language that the agreement has been translated and that he/she understands its contents. Then have your client initial his/her name next to that paragraph.

Post-Mediation

The fact that a matter does not resolve at mediation doesn't mean it won't settle later. Good mediators will periodically check with you following an unsuccessful mediation to see if they can do anything to help get the case resolved and will work with both sides to try and bridge the gap. Don't give up!

Recent Arbitration Awards

Jason R. Doss, Esq.

Howard Reid and Theresa Reid v. Continental Broker-Dealer Corp., Gregory M. Hasho, Thomas Michael Tiernan, Jr. Dominick Michael Bianco, Leon Fintz, David Harry D'Agostino
NASD Case No. 05-01067

Claimants alleged that Respondents mismanaged their accounts. The brokerage firm and its control persons were named in the action. Claimants asserted the following causes of action: violation of industry rules including the NYSE and NASD "Know Your Customer" rules, breach of contract, breach of fiduciary duty, churning, common law fraud, negligence and respondeat superior. Prior to the arbitration hearing, the broker-dealer filed for bankruptcy.

Claimants requested compensatory damages in the amount of $1,000,000.00, interest rescissionary damages and punitive damages.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various defenses. At the hearing, Claimants settled their claims with Respondent Bianco.

The Panel found Respondents Hasho and Fintz jointly and severally liable and required them to pay Claimants the sum of $133,002.00 plus prejudgment interest at a rate of nine percent from February 1, 2001 until the date of the award. The Panel also assigned 100% of the cost for the hearing to Respondents Hasho and Fintz jointly and severally.

The award is significant because the Panel held the control persons of the broker-dealer individually liable for failing to supervise.

Claimants' Counsel- Scott L. Silver, Esq., Blum & Silver, LLP, Coral Springs, Florida

Susan Unger v. McLaughlin Piven, Vogel Securities, Inc., Sean Davis, James Joseph McLaughlin, Sr., James Cecil McLaughlin, James Michael Kennedy and Edward Thomas Brienza
NASD Case No. 01-03194

Claimant alleged that Respondents mismanaged their accounts by investing in highly speculative technology based mutual funds. The brokerage firm and its control persons were named in the action. Claimants asserted the following causes of action: breach of contract, negligence, breach of fiduciary duty, and failure to supervise.

Jason Doss is a partner with the law firm of Page Perry, LLC in Atlanta, Georgia and has been a member of PIABA since 2001. His practice focuses almost exclusively on representing private investors in securities arbitrations against brokers and their firms. Mr. Doss graduated from the University of Florida with a B.A. in Environmental Science in 1997. He received his J.D. degree from Florida State University College of Law in May 2002. While at Florida State, he received the Mock Trial Best Advocate Award and the Mock Trial Coaches Award. He is a member of the Florida and Georgia bars.

Claimant requested compensatory damages in the amount of $750,000.00, prejudgment interest, rescission, punitive damages, costs, and for other relief as is just and proper.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various defenses. Prior to the hearing, Claimant dismissed Respondent Sean Davis and James Joseph McLaughlin, Sr.

1. The Panel found Respondents McLaughlin Piven, J. McLaughlin, Kennedy, and Brienza liable and required them to pay Claimant the sum of $448,415, plus interest at the rate of nine percent from June 31, 2001 to the date that payment of the award.

2. The Panel also required Respondents McLaughlin Piven, J. McLaughlin, Kennedy, and Brienza to pay $9,600 in attorney's fees pursuaunt to the Federal Arbitration Act.

3. The Panel recommended the expungement of all reference to James Joseph McLaughlin, Sr.

The award is significant because the Panel held the control persons of the broker-dealer individually liable for failing to supervise.

Claimants' Counsel- Darren C. Blum, Esq., Blum & Silver, LLP, Coral Springs, Florida

Steven and Janet Goldstein v. Pacvest Associates, Inc. Barry Michael Kornfeld and Robert K. Mann
NASD Case No. 05-04437

Claimant alleged that Respondents mismanaged their accounts by investing in the MarketShield Mutual Fund Program.

The brokerage firm and its control persons were named in the action. Claimants asserted the following causes of action: violation of industry rules including the NYSE and NASD "Know Your Customer" rules, unsuitability, misrepresentation and omission of material facts, negligent supervision, retention and hiring of employees, breach of contract, breach of fiduciary duty, churning, common law fraud, negligence and respondeat superior.

Claimant requested compensatory damages in the amount of $100,000.00, prejudgment interest, rescission, punitive damages, costs, and for other relief as is just and proper.

Respondents denied the allegations of wrongdoing set forth in the Statement of Claim and asserted various defenses. Prior to the arbitration hearing, Respondent Kornfeld filed for bankruptcy.

The Panel found Respondents Pacvest and Mann jointly and severally liable and required them to pay Claimants the sum of $73,336.30.

The award is significant because the Panel held the control persons of the broker-dealer individually liable for failing to supervise.

Claimants Counsel- Blum & Silver, LLP, Coral Springs, Florida

Respondents' Counsel- David Constantino, Esq., The Law Office of David Constantino, Worcester, Massachusetts; Llloyd R. Schwed, Esq. Kublicki Draper, P.A. West Palm Beach, Florida.

Announcements From The PIABA Office

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Upcoming Events:

PIABA is now accepting hotel reservations for the PIABA 16th Annual Meeting, Ritz Carlton Hotel Reservations. Contact Karrie Ferguson for assistance.

PIABA Board of Directors Meeting, March 10-11, 2007. The Four Seasons. Dallas, TX.

PIABA Board of Directors Meeting, July 14-15, 2007. To Be Announced.

PIABA 9th Annual Securities Law Seminar, October 17, 2007. Ritz Carlton. Amelia Island, Florida.

PIABA 16th Annual Meeting, October 18-20, 2007. Ritz Carlton. Amelia Island, Florida

PIABA Annual Business Meeting and Election of Directors. October 18, 2007. Ritz Carlton. Amelia Island, Florida

PIABA Board of Directors Meeting, October 21, 2007. Ritz Carlton. Amelia Island, Florida.

For more information pertaining to upcoming PIABA meetings, contact the PIABA office or visit the PIABA website at www.PIABA.org.

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