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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

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President's Column

Laurence S. Schultz

RE: Both FINRA and SIFMA Say Arbitration Is Fair Regardless of the Statistics and Investor Survey Results

Dear Members**,**

On June 4, 2008, I had the pleasure of participating in a *Securities Arbitration & Mediation Hot Topics 2008* program at the New York City Bar Association in New York. There were well over 100 attendees, including attorneys for both claimants and respondents, arbitrators, FINRA representatives, and brokerage personnel. Roger Dietz , a well-known mediator, was the chair.

My presentation related to the Arbitration Fairness Act of 2007. They only allowed speakers 15 minutes, so not a lot could be said. Here is a summary of my talk.

FINRA and SIFMA contend that investor arbitration is fair, and this position is essential to their defense of mandatory arbitration. In contrast, PIABA believes arbitration is unfair to investors.

While fairness is a subjective evaluation, two recent developments have significantly impacted the fair/unfair debate. One is the fact that arbitration results have deteriorated in the past few years, and the second is the SICA public survey results which found that a significant majority of investors believe arbitration is unfair.

The SICA study is the first truly broad-based survey of investors who actually had their claims decided in arbitration, and rebutted the industry's and regulators' long-held position that investors believe arbitration is fair.

And the deteriorating arbitration results have actually forced FINRA and SIFMA to change their position regarding the importance of arbitration statistics in evaluating arbitration fairness.

Both FINRA and SIFMA have long contended that the win rate for investors supports their fairness argument. For example, in 2005, Linda Fienberg testified before a congressional subcommittee that arbitration was fair to investors, emphasizing that investors had received compensation in 55% of the awards over the previous five years. At the same hearing, the president of the Securities Industry Arbitration Association (SIFMA's predecessor) testified that SRO arbitration was fair, citing a 52% win rate in over 31,000 cases decided from 1980 to 2001 and also citing a 55% win rate for 2004.

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However, the arbitration win rate has declined in six consecutive years since 2001, to just 42% in 2006 and 37% in 2007, both all-time record lows. Based on the deterioration of the numbers and contrary to the FINRA and SIFMA positions, the win rate, if anything, now indicates that arbitration is unfair, rather than that it is fair.

Faced with negative win-rate statistics, both FINRA and SIFMA have reversed their positions, and instead of embracing arbitration win rates as a measure of fairness, they now reject them as a fairness standard.

The most striking evidence of this flip flop was SIFMA's statement in its 2007 white paper supporting mandatory arbitration where it said:

> The rate at which claimants prevail over a specified period of time is not an empirically valid basis on which to judge the fairness of a dispute resolution forum.

Remember, this was just two years after the SIA president cited two decades of arbitration win rates as evidence that arbitration was fair. And it was during those two years that FINRA recorded its lowest win rates ever.

Both FINRA and SIFMA now contend that the recent low win rates, rather than reflecting a level of fairness, are due to the fact that there were large numbers of weak tech bubble and analyst scandal claims which generated a high percentage of investor arbitration losses, thus reducing the win rates. But this argument ignores that the tech bubble claims dated back to the spring of 2000 and the analyst claims to mid-2003. The vast majority of these claims had actually disappeared from the system by 2006, and few, if any, remained in 2007. PIABA's analysis of the 2006 arbitration awards revealed only 16 out of over 1,000 decisions that referenced analyst claims.

The fallback position for both FINRA and SIFMA is that the industry is now settling the good investor claims and arbitrating the bad claims and that this is decreasing the investor win rate compared to prior years. This is obviously nonsense because brokerage firms have always settled investors' good claims and arbitrated the bad claims.

A couple of the industry representatives in attendance at the NYC bar program simply could not restrain themselves during my presentation. One person actually stood, yelling out that I was being disingenuous.

In response, I pointed out that the declining win rate was a matter of pure numbers, and is beyond dispute. They could accept it or reject it as they saw fit. Further, the fact that both FINRA and SIFMA have relied on the win rates for many years but have now reversed their position and deny that win rates provide a standard for measuring fairness also is beyond dispute.

The bottom line is that neither FINRA nor SIFMA is going to give up the argument that arbitration is fair, regardless of what statistics may show, what investors may say, or what the evidence may be.

All in all, it was a fun time.

Larry

Recovery When the Brokerage Goes Out of Business

Leslie Trager

All too often, after a favorable arbitration award, a defunct brokerage attempts to fold its tent to avoid payment to its wronged customer. Its owners may do everything from retiring, joining another brokerage firm or reincarnating a new brokerage firm. This article will focus on the ability to recover on a judgment, entered as a result of an arbitration award, from the owner and/or the new entity.

Since New York law is often applicable either because the brokerage house was located in New York, did business through a clearing firm in New York, or the customer agreement provided for New York law to apply, this article will emphasize New York law. The remedies discussed can be brought either by the judgment creditor or, if there has been a filing in bankruptcy, by the bankruptcy or SPIC trustee.

There are three ways to recover on a judgment against a defaulting brokerage firm: (A) the New York State Debtor and Creditor Law; (B) Piercing the Corporate Veil; and (C) Continuation of Business Doctrine.

A. The New York State Debtor and Creditor Law

The easiest and cleanest claim against the former owners and other transferees is under Section 273-a of the New York State Debtor and Creditor Law. Section 273-a provides:

> Every conveyance made without fair consideration *when the person making it is a defendant in an action for money damages* or a judgment in such an action has been docketed against him, is fraudulent as to the plaintiff in that action without regard to the actual intent of the defendant if, after final judgment for the plaintiff, the defendant fails to satisfy the judgment. (emphasis supplied)

This statute allows a creditor to question all transfers made by the debtor back to the date when the arbitration was first filed. *See Dixie Yarns, Inc. v. China Grove Cotton Mills Co.*, 906 F. Supp. 929, 936 (S.D.N.Y. 1995) ("the arbitration proceeding qualifies as 'an action for money damages'" under section 273-a); *See also, JSC Foreign Economic Association Technostroyexport v. International Development and Trade Services, Inc.*, 295 F. Supp. 2d 366, 379 (S.D.N.Y. 2003).

Transfers subject to this statute include not only transfers made to the owners, but transfers made to anyone without fair consideration, and includes antecedent debt. While antecedent debt may constitute fair consideration, it must be

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made in good faith. "Transfers to a controlling shareholder, officer or director of an insolvent corporation [even for antecedent debt] are deemed to be lacking in good faith and are presumptively fraudulent...." *In re The CIT Group/Commercial Services, Inc. v 160-09 Jamaica Avenue Ltd.*, 25 A.D. 3d 301, 302 (1st Dept. 2006). *Julien J. Studley, Inc. v Lefrak*, 66 A.D. 2d 208, 213 (2nd Dept. 1979), aff'd on lower court opinion, 48 N.Y. 2d 954, held that corporate assets are a trust fund for creditors and "dealings of a dominant stockholder with the corporation are subjected to close examination."

Salaries paid to the owners can be questioned in light of all of the financial circumstances of the brokerage house. *See Gilmore Distilliries Co. v. Seidman*, 267 F.Supp. 915, 919 (E.D.N.Y. 1967), holding that transferees were liable under various sections of the New York State Debtor and Creditor Law, including Section 273-a with respect to salaries, stating:

> The compensation paid to a corporate officer must be in proportion to his ability, services and time devoted, *corporate earnings* and other relevant facts and circumstances. (emphasis supplied).

The *Gillmore* case went on to hold:

> It is common knowledge and experience that salaries of officers in an efficiently managed corporation must bear a reasonable relation not only to the services rendered but to the income of the business, both gross and net. Corporate directors and officials, in fixing their own salaries, must have some regard for the financial condition of the corporation. *Backus v. Finkelstein, D.C.*, 23 F. 2d 531, 537.

Although the statute uses the words "fraud" and "fraudulent", the vast majority of the courts have recognized that this is constructive fraud and does not require either proof of intent to defraud or pleading with specificity as is generally required for fraud. *See Eclaire Advisor Limited v. Daewoo Engineering & Construction Co. Ltd.*, 375 F.Supp.2d 257, 268 (S.D.N.Y. 2005); *Sullivan v. Kodsi*, 373 F.Supp.2d 302, 307 (S.D.N.Y. 2005); *Institution Consolidated Group, Inc. v. Davis Publishing Co.*, 2004 U.S. Dist. Lexis 4821 at 11 (S.D.N.Y. 2004); *Drenis v. Haligiannis*, 452 F.Supp.2d 418, 428, 429 (S.D.N.Y. 2006).

Another useful section of the Debtor and Creditor Law is Section 273. This section provides:

> Every conveyance made and every obligation incurred by a person who is or will be thereby rendered insolvent is fraudulent as to creditors without regard to his actual intent if the conveyance is made or the obligation incurred without a fair consideration.

This section allows the creditor to go back to transfers as of the date the creditor first became a creditor. For a brokerage house, this means the date the customer was first defrauded. Section 270 of the New York State Debtor and Creditor Law defines creditor as a "person having any claim, whether matured or unmatured, liquidated or unliquidated, absolute, fixed or contingent." In *Marcus v. Kane*, the Court held:

> 'Creditor,' as used in the statutes against fraudulent conveyances ... means one having a contingent liability as well as one whose claim is certain and absolute. When colloquially expressed, a creditor may be considered one to whom money is due, but, in the more extensive sense of the term, a creditor is one who has a right to recover money of another on any

> account whatever. .... One who has a right by law to demand either presently or at some future contingency the fulfillment of any obligation or contract, or one who has a legal right to damages capable of enforcement by judicial process, is a creditor ... When the judgment is obtained, it relates back and establishes the date as of the time when the original cause of action accrued.

Marcus v. Kane, 18 F.2d 722, 723 (2d Cir. 1927)

While the *Marcus* case dealt with an earlier statute, the court specifically noted that the result would not change under the present statute still in existence, and that the statute does not distinguish between tort and contract creditors. *See also Shelly v. Doe*, 249 A.D.2d 756, 757 (3d Dept. 1998), holding:

> [U]nder the Debtor and Creditor Law's broad definition of 'creditor', it is now accepted that in tort cases the relationship of debtor and creditor arises the moment the cause of action accrues (*See Marcus v. Kane*, 18 F. 2d 722, 723 ...)

For section 273 purposes, insolvency is defined in section 271 of the Debtor and Creditor Law to be "when the present fair salable value of his assets is less than the amount that will be required to pay his probable liability on his existing debts as they become absolute and matured." Naturally, the broker will point to its Focus Reports to show that it was not insolvent under this definition. In today's world of SIVs and other derivatives, it is certainly conceivable that such assets may never have been worth the value assigned to them in an earlier Focus Report, e.g. Bear Stearns.

Where a transfer is found to be "fraudulent" under one of the above sections, any transferee is liable under Section 278 of the New York State Debtor and Creditor Law unless the transferee paid fair consideration and is without knowledge of the fraud. Even if the transferee is without "actual fraudulent intent," a transferee who paid less than fair consideration will have liability for the value above the purchase price. Such liability is limited to the value of the property received in an amount sufficient to satisfy the claim.

Finally, it should be noted that attorney's fees may be recovered if actual intent to defraud is proved. Section 276-a of the New York Debtor and Creditor Law. Here, actual intent to defraud must be pleaded with specificity. But proving such actual intent is often not too difficult. As the court in *Shelly v Doe* held:

> Because direct proof of actual intent is rare, creditors may rely on 'badges of fraud' to establish an inference of fraudulent intent ... Factors that are considered 'badges of fraud' are (1) a close relationship between the parties to the transaction, (2) a secret and hasty transfer not in the usual course of business, (3) inadequacy of consideration, (4) the transferor's knowledge of the creditor's claim and his or her inability to pay it, (5) the use of dummies or fictitious parties, and (6) retention of control of the property by the transferor after the conveyance....

Shelly v Doe, 249 A.D. 2d. 756, 758 (3rd Dept. 1998)

B. Piercing the Corporate Veil

Another important way of imposing liability on the former owners is to pierce the corporate veil. The leading case in this area is *Williams Passalacqua Builders, Inc. v. Resnick Developers South, Inc.*, 933 F 2d 131, 139 (2nd Cir. 1991), which sets out the following factors to consider in determining whether to pierce the corporate veil:

> [T]he triers of fact are entitled to consider factors that would tend to show that defendant was a dominated corporation, such as: (1) the absence of the formalities and paraphernalia that are part and parcel of the corporate existence, i.e., issuance of stock, election of directors, keeping of corporate records and the like, (2) inadequate capitalization, (3) whether funds are put in and taken out of the corporation for personal rather than corporate purposes, (4) overlap in ownership, officers, directors and personnel, (5) common office space, address and telephone numbers of corporate entities, (6) the amount of business discretion displayed by the allegedly dominated corporation, (7) whether the related corporations deal with the dominated corporation at arms length, (8) whether the corporations are treated as independent profit centers, (9) the payment or guarantee of debts of the dominated corporation by other corporations in the group and (10) whether the corporation in question had property that was used by other of the corporations as if it were its own.

Id at 139.

The *William Passalacqua* case has been consistently followed in New York. *See, e.g.*, *Morris v. New York State Department of Taxation and Finance*, 82 N.Y.2d 135, (1993); *Solow v. Domestic Stone Erectors, Inc.*, 269 A.D.2d 199; 703 N.Y.S.2d 94 (1st Dept. 2000)*(*finding that one person dominated three corporations, and that the plaintiff had been wronged by making the corporations "incapable of honoring its obligation to plaintiff").

Under the standards set out in *Willliam Passsalacqua*, the corporate veil can be pierced when a corporation is used to commit a fraud *or* when the corporation is the alter ego, or dominated by, the corporation's owner. As one court explained:

> Piercing the corporate veil requires a showing that (1) the one corporation exercised complete domination of the other with respect to the transaction attacked, and (2) that such domination was used to commit a wrong against plaintiff which resulted in the plaintiff's injury.

Anderson Street Realty Corp. v. RHMB New Rochelle Leaving Corp., 243 A.D.2d 595, (2nd Dept. 1997) (citing *Passalacqua*)

The *Anderson Street Realty* Court went on to hold that the evidence showed the defendant appellant was the alter ego of another corporation stating:

> In the role of tenant the appellant dominated RHMB's affairs with respect to the subject premises which lead to the wrong now complained of by the plaintiff, that is, the nonpayment of rent. The evidence revealed: (1) an overlap in ownership of the two corporations; (2) an inadequate capitalization of RHMB; (3) payments of some if not all of RHMB's rent by the appellant; (4) the appellant's reference to itself as the parent company; and (5) that the appellant obtained insurance regarding the subject leased premises (which named the appellant as the insured on the policy).

In evaluating the alter ego, the courts have made it clear that it is not the title of officer, or shareholder which determines the results, but the control exercised by that person. For example, in the case of *Dominick & Dominick, Inc. v. George Town Securities Ltd.*, the Court held:

> [W]henever anyone uses control of the corporation to further his own rather than the corporation's

> business, he will be liable for the corporation's act upon the principle of respondent superior applicable even where the agent is a natural person.

Dominick & Dominick, Inc. v. George Town Securities Ltd., 1992 U.S. Dist. Lexis 5150, at 11 (S.D.N.Y. 1992). *See also*, *Sweden AB v. Oakley Furniture Design Ltd.*, 1987 U.S. Dist. Lexis 1785 (S.D.N.Y. 1987)(finding that the key to upholding a claim against an individual defendant was his control over the corporation and in effect the conversion of funds by that defendant otherwise belonging to the plaintiff).

The Court in *Austin Powder Company v. McCullough*, found facts that supported many of the arguments for piercing the corporate veil. Upon review of the facts, the Court held:

> In view of McCullough's testimony showing his complete control and domination of Tristate, and the under-capitalizing of the corporation, along with his disregard of corporate formalities and personal use of corporate funds, we find that plaintiff has produced sufficient evidence of wrongdoing to justify piercing the corporate veil as to McCullough.
>
> With respect to Anfo, it is clear from the record that McCullough operated Tristate and Anfo as one entity by co-mingling assets, conducting operations from the same office and paying management fees to Anfo from Tristate which served to divert these funds away from Tristate's creditors, confirming plaintiff's contention that the two corporations were inextricably intertwined and justifying a disregard of the corporate structure.
>
> When a corporation has been so dominated by an individual or another corporation and its separate entity so ignored that it primarily transacts the dominator's business instead of its own and can be called the other's alter ego, the corporate form may be disregarded to achieve an equitable result.

Austin Powder Company v. McCullough, 216 A.D.2d 825, 827 (3rd Dept. 1995)

The most common fact pattern for piercing a corporate veil is to show that the formalities of the corporate existence were not complied with, particularly corporate minutes, and the use of the corporation's funds for personal purposes. Personal purposes include putting family members and other similar relationships on the payroll, or otherwise paying them, paying for apartments, country clubs, credit cards, etc. and paying high compensation to the owners relative to the corporation's income. The aggregate dollar amount does not need to equal the amount of the judgment in order to be sufficient to warrant piercing the corporate veil.

C. Continuation of Business Doctrine

Where a new company is formed, which has at least some of the same assets and ownership or control as the debtor company, this new company may be responsible for the judgment under the doctrines of "mere continuation" or *"de facto* merger". As the Court in *Miller v. Forge v. Mench Partnership Ltd.* held:

> To determine whether such a 'de facto merger' or 'mere continuation' of the predecessor's business has occurred, courts consider (1) continuity of ownership; (2) cessation of ordinary business by the predecessor; (3) assumption by the successor of liabilities ordinarily necessary for continuation of the predecessor's business; and (4) continuity of management, personnel, physical location, assets, and general business operation. *Nettis v. Levitt*, 241 F.3d 186, 193-94 (2d cir. 2001)(citations omitted). The determination of

> successor liability is 'fact-specific,' *Ryan, Beck & Co. v. Fakih*, 268 F.Supp.2d 210, 229 (E.D.N.Y. 2003), and courts are to analyze the facts 'in a flexible manner that disregards mere questions of form and asks whether, in substance,' it was the intent of [the successor] to absorb and continue the operation of [the predecessor].

Miller v. Forge v. Mench Partnership Ltd., 2005 U.S. Dist. Lexis 1524.

It is not necessary that ownership be identical, so long as there is continuity. *See Glynwed, Inc. v. Plastimatic, Inc.*, 869 F.Supp. 265, 276-77 (D.N.J. 1994)(finding continuity where three minority shareholders of predecessor were also shareholders of successor; *Allen Morries Commercial Real Estate Services Co. v. Numismatic Collectors Guild, Inc.*, 1993 U.S. Dist. Lexis 7052 (S.D.N.Y. 1993) (continuity established where 40% of prior ownership in the successor company).

The second factor, cessation of operations means that the debtor company has in effect become a corporate shell, even if not in fact dissolved. *See Fitzgerald v. Fahnestock & Co.*, 286 A.D.2d 573, 575 (1st Dept. 2001).

The third factor, assumption of liabilities necessary for continuation of the predecessor's business means assuming those liabilities necessary to continue the business. *See Miller v. Forge Mench Partnership Ltd., supra*, at 28-29. This would include payment of ongoing leases, prior telephone bills to insure continued telephone service and various financial services to insure their continuation.

The fourth factor - continuity of management, personnel, physical location, assets and general business operation - "provides what is arguably the most telling indication" of successor continuation. *Miller v. Forge Mench Partnership Ltd., supra*, at 30. This information is readily available from the BD report, the websites and general knowledge as to the locations of the former and present brokerage firm offices. The court will look at the facts to determine who is running the operation and whether it is essentially the same operation as the former firm. *See generally*, *Marvel v. Scan-Optics Inc.*, 509 F. Supp.2d 183 (D. Conn. 2007)(granting a preliminary attachment of the successor company's assets) and *Society Anonyme Dauphitex v. Schoenfelder Corp.*, 2007 U.S. Dist. Lexis 81496 (S.D.N.Y. 2007).

Not only may the successor company be liable for the debt, but the transfer itself may result in liability imposed on the original owners who approved that transfer under Section 273-a of the Debtor and Creditor Law cited above, up to the amount of the value of the assets at the time of transfer. This is particularly important where the successor company's assets have declined by the time judgment is entered against it. In *RTC Mortgage Trust, 1995 - S/N1 v. Sopher*, the court, in imposing liability not only on the transferee corporation but on the sole shareholder owner, held:

> The evidence establishes that Sopher, as the sole shareholder of Sopher & Co., sought to transfer substantially all of Sopher & Co.'s assets in order to frustrate the mortgagee's collection efforts. It also demonstrates that Sopher actively participated in planning and executing the transaction. While not a direct transferee, Sopher plainly benefitted from the transaction. By operation of the transfer, Sopher removed millions of dollars of assets from Sopher & Co. and, thereby, was able to continue his real estate brokerage business until it was sold for $1,500,000. Sopher also benefitted from the transaction because it prevented (or at least forestalled) circumstances that required repayment of the loan advanced to him by Sopher & Co. Accordingly, Sopher also is liable in money damages up to the value of the Judgment, but limited to the extent of

the value of the assets transferred by Sopher & Co. to Sopher Realty.

RTC Mortgage Trust, 1995 - S/N1 v. Sopher, 171 F.Supp.2d 192, 202 (S.D.N.Y. 2001), aff'd 31 Fed Appx. 37, 2002 U.S. App. Lexis 4373. *See also*, *Stochastic Decisions, Inc. v. DiDomenico*, 995 F.2d 1158, 1172 (2d Cir. 1993) (holding "The New York Court of Appeals has made it clear that the pertinent provisions of the New York Debtor and Creditor Law provide a creditor's remedy for money damages against parties who participate in the fraudulent transfer of a debtor's property and are transferees of the assets and beneficiaries of the conveyance."); *In re Montclair Homes, Goscienski v. LaRosa*, 200 B.R. 84, 97 (E.D.N.Y. 1996), where the court imposed liability on the defendant, La Rosa, who had "transferred all or substantially all of the assets of Montclair Homes, Inc. to other corporate entities which he controlled …"; *UFCW Local 174 Commercial Health Care Fund v. Homestead Meadows Foods Corp.*, 2005 U.S. Dist. Lexis 25922, where the court upheld a complaint against a person alleged to control a corporation making a fraudulent transfer.

Gathering Information

The basic sources of financial information are the debtor's financial records, the debtor's accountant, the debtor's banks, and the debtor's clearing firm.

With respect to the debtor, the following records should immediately be subpoenaed for the relevant time period: tax returns, all of the financial records, and particularly the general ledger and the general journal, all banking records, minute books, BD filings and Focus Reports. (BD filings and Focus Reports can also be subpoenaed from FINRA but the broker can get these more easily than the attorney.)

In addition to subpoenaing records of the company, the owner or others in control may also be compelled to produce these corporate records because they have control over the records. *See In re Flag Telecom Holdings, Ltd, Securities Litigation*, 236 F.R.D. 177 (S.D.N.Y. 2006) holding that a former officer, who during the litigation became a consultant, was required to produce corporate documents. In order to demonstrate that a party has control over documents, it is not necessary for the party to have physical ownership of the records, just the right to obtain them. *See*, *In re NTL, Inc. Securities Litigation*, 2007 U.S. District Lexis 6198 (S.D.N.Y. 2007) at 59-60 (holding the defendant had control over a non party's documents. "Under Rule 34," control does not require that the party have legal ownership or actual physical possession of the documents at issue; rather, documents are considered to be under a party's control when that party has the right, authority or practical ability to obtain the documents from a non-party to the action)(*citing Bank of New York v Meridien Biao Bank Tanzania Ltd,* 171 F.R.D. 135, 146-47 (S.D.N.Y. 1997).

With respect to the financial records, these records will most likely be on a computer. It is important to gain access, if possible, to those computerized records. Sitting at a terminal, an attorney or an accountant can look at trial balances and go to any subaccount that looks suspicious. A search can also be made by names of owners to determine salaries and other payments. Even a searchable CD of the basic records can be very useful in terms of locating the payments to owners and the owners' families.

Get the banking records from both the debtor and the banks. Initially ask for all the monthly statements and then go back and ask for checks that look relevant. Very often, the last four months or so before a broker's dissolution are when fraudulent transfers will be found, so look closely at this period. Check carefully to see whether the banking deposits and withdrawals agree with the debtor's financial records. In addition, it is often worthwhile looking at the checks and/or wires themselves to see where the money went in the final days. Make sure to obtain all

the records from all of a broker's banks. An examination of intra company transfers can act as a guide to finding all of the bank accounts.

The broker-dealer (BD) forms will pinpoint who was reported as a controlling person. Also, obtain the BDW (broker-dealer withdrawal) form which will disclose the name of the person who has custody of the records of the broker. These are required to be kept for 6 years. An attorney may want to subpoena this person to make sure where those records are and whether the broker has complied.

While Focus Reports are filed monthly, the important Focus Reports are the quarterly reports and the annual report because they require a financial statement. The financial statement attached to the annual report is audited and filed with both the SEC and FINRA. These financial statements will give a general idea as to the assets of the company and changes in the assets over a period of time, which may pinpoint when transfers were made. Subpoena all the accountants disclosed by the annual Focus Reports and the tax returns. Get the entire audit file for each of the relevant years, the accountants' notes relating to the preparation of the tax return, the trial balance and all adjusting journal entries. Adjusting journal entries can be particularly revealing in pointing to areas where improper transfers may have been made.

Lastly, the records from the clearing firm should also be subpoenaed, particularly the records of all the payments made to the brokerage firm. Trace these payments into the bank account records of the brokerage to make sure that they are all accounted for. Also, ask for any records relating to any loans made by the clearing firm to the brokerage. It is apparently not unusual for clearing firms to make such loans. It is important to determine who actually got the money, who was responsible for paying it back and who paid it back.

CONCLUSION

As the old joke goes, "where are all the customers' yachts." Brokerage owners usually manage to save themselves. Thus, it is often worthwhile pursuing these remedies to collect the arbitration awards.

"We Were Never Told These Things Could Fail": An Overview of the Auction Rate Securities Market

Jason A. Richardson

- My broker told me that auction rate securities were as safe as cash, and paid a better interest rate than money market funds. But now I can't access any of my savings, and I'm stuck with hundreds of thousands of dollars worth of bonds that I can't resell.

- I just sold my home and put the proceeds into auction rate securities until I could close on my next home. Now my account is frozen, and I won't be able to close on my new house.

- Our business covers expenses using the money we had in auction rate securities. For years we've always enjoyed earning a better than average interest rate on our cash savings, and never had a problem with liquidity. After the latest auction failures though, we may not be able to pay our employees.

Complaints such as these are sadly becoming commonplace as auction rate securities have recently failed to attract buyers in the market. Brokers have pitched auction rate securities as liquid, safe investments with interest rates slightly superior to conventional money market funds. Unwary investors, however, are now finding that their brokers may have misrepresented the risks associated with such investments. The intent of this article is to provide the reader with an overview of the auction rate securities market, as well as insight into the recent trend of auction failures.

Introduction

Auction Rate Securities ("ARS") typically take the form of either long-term bonds issued by municipalities and corporations (often referred to as "Auction Rate Certificates" or "ARCs"), or preferred shares with long-term or perpetual maturities issued by closed-end funds (often referred to as "Auction Rate Preferred Shares" or "ARPS"). ARS may provide investors with benefits that in some cases include competitive yields, frequent dividend/interest payments, tax exempt income and some degree of principal protection. Typically, the minimum investment is $25,000. ARS have been promoted as low risk, highly-liquid investments because investors traditionally had the option to sell these securities on a frequent basis. As a result, many investors have been advised to use ARS as a cash or money market equivalent.

From the issuer's perspective, ARS may be an attractive means of raising capital in comparison to other common

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alternatives, such as variable rate demand obligations ("VRDO"). A VRDO is a security for which the interest rate is reset periodically through a remarketing process or according to a specified index. VRDOs may be more expensive to issue than ARS, due to the fact that VRDO issuers must obtain a pricey letter-of-credit, honor "put" features (which permit bondholders to sell the bonds back to the issuer) and maintain high annual short term bond ratings. ARS carry the standard up-front issuing costs normally associated with fixed-rate bonds (industry standard is approximately $5/bond for initial placement fees plus annual fees of 25 basis points for broker/dealer fees and 1-2 basis point(s) for auction agent fees.)[1] ARS issuers have usually maintained high credit ratings by maintaining bond insurance.

ARPS are typically issued by exchange-traded closed-end funds. The fund's goal is to borrow at short-term interest rates (by issuing ARPS) and invest the proceeds in higher-yielding securities. By using leverage, the fund seeks to magnify its potential to earn profits. Because ARPS are a "preferred" class of shares separate and distinct from the fund's common stock, dividends due to ARPS investors must be paid before any dividends are paid to common shareholders.

In order to maintain a favorable credit rating for its ARPS, a closed-end fund must comply with asset coverage and maintenance requirements put in place by various credit rating agencies, which have the power to require the fund to retire all or part of its ARPS or to improve the overall liquidity and credit quality of its portfolio. Under the Investment Company Act of 1940, closed-end funds are subject to additional restrictions, including an asset coverage requirement that mandates that the market value of the assets of the underlying closed-end fund exceed the amount of ARPS outstanding by at least 200%.[2]

The Auction Process

ARS are bought and sold primarily through auctions that are held in regular intervals, usually every 7, 14, 28 or 35 days. In an ARS auction, a bidder will submit the lowest interest rate or dividend yield he or she is willing to accept for buying and holding the ARS throughout the next auction interval. If a bidder "wins" the auction, he or she is required to purchase the ARS at par value, and is entitled to receive interest (at each auction's "clearing rate") as long as the winning bidder holds the ARS. The rate of interest paid to the investor is reset after every auction.

In order to participate in the auction process, an investor must submit bids through a brokerage firm. The brokerage firm processes bids through a "trading desk," which confirms that all bids include the (a) precise investment amount; (b) specific desired dividend/interest rate; and (c) the name or CUSIP identifier of the security to be purchased. After the trading desk receives a valid bid, it will submit the bid directly to an auction agent. The auction agent collects the bids, allocates the ARS among the winning bidders, and determines the auction's "clearing rate."

The clearing rate is the rate that will be paid to all holders of that particular auction rate security until the next auction. The bidders specifying the lowest desired interest/dividend rates will be the first to receive a portion of that block. The next highest bidders will also be entitled to a portion of the auctioned securities. The point at which the last available security is allocated to the lowest remaining bidder triggers the clearing rate. The clearing rate will apply to the entire block of securities, even though the rate may be higher than the lowest bid.
There are several types of bids that investors

[1] Douglass Skarr, California Debt and Investment Advisory Commission, *Issue Brief: Auction Rate Securities* at 2 (August 2004), *available at http://www.treasurer.ca.gov/cdiac/issuebriefs/aug04.pdf*.

[2] 15 U.S.C. §80a-18.

who hold ARS may place at an auction.

Buy. This is a bid by a current holder who wishes to purchase additional securities.

Hold. An order to continue to hold a security purchased at a previous auction.

Hold-at-Rate. This allows a current holder to keep a previously purchased security as long as the new clearing rate is at or above the current rate. Note that if the auction's new clearing rate resets to a lower rate, the holder becomes obligated to sell the security at the auction.

Sell. This is the normal method of reselling a security purchased at a previous auction.

If a current holder chooses not to participate in a subsequent auction, or fails to timely submit a proper bid, most auction procedures provide that the holder will be deemed to have submitted a "hold" bid.

Auction Failures

Failed auctions occur when there are too few bidding buyers to take possession of the entire block of ARS offered at the auction (it is important to note that an "auction failure" is not the same thing as a bond default). For example, if a block of 1,000 ARS is offered at auction, but the auction agent only receives bids for 500, the auction will fail. If an auction fails, those currently holding ARS in their accounts will be unable to sell some (or all) of the securities in the auction. To compensate these holders for the diminished liquidity, the interest/dividend rate of their securities will reset to a (usually) higher, predetermined maximum rate until the next auction. As a matter of practice, brokerage firms have traditionally stepped in to prevent auction failures by bidding on enough securities to complete the auction. However, firms are not obligated or required by law to do so.

An auction failure may be devastating to both the issuer and the investor. The issuer may be saddled with crushing interest payments (sometimes 15% or more) that must be paid to current holders until the securities are either sold at the next successful auction or called in by the issuer. The investor may find that he or she is left holding an enormous position in securities that cannot be sold without a substantial discount. Investors who have placed a significant portion of their savings in ARS with the expectation of high liquidity may find themselves unable to use their cash for its intended purposes. These investors must either hold the ARS to maturity (which may be many years later) or sell the ARS to someone on the secondary market – potentially at a significant loss.

An auction may fail for several reasons, all of which are evidenced by a lack of willing bidders at the auction. An issuer's credit may deteriorate to the point that the ability of the issuer to continue making interest payments is placed in doubt. An issuer's insurer may be downgraded, signifying that the security of the underlying bond is compromised. More recently, auctions have failed because brokerage firms have chosen not to step in to save the auction from failure. In the past, these firms have taken the initiative to intervene in potentially failing auctions. Some firms may have taken steps to prevent auction failures in order to protect the interests of the issuer (the entity paying the brokerage firm substantial fees for taking the ARS to auction) from having to pay higher interest rates to investors.

Potential Conflicts of Interest

A variety of conflicts of interest may arise in connection with auction rate securities transactions. The brokerage firm may find itself serving two masters in its dual role as underwriter for the issuer and agent for the investor. For example, since the firm is appointed and paid by the issuer to serve as a broker/dealer in the auction, it may have an interest in obtaining a lower clearing rate to benefit the issuer. Alternatively, the firm may have an interest in obtaining a higher clearing

rate to benefit its investing customers or itself as an investor.

The firm may submit bids for its proprietary accounts ("proprietary" bids) to prevent a failed auction or an "outlier" bid from skewing the auction results. It may place such proprietary bids after it knows what bids were made by its investor clients and generally may do so up to a submission deadline that is later than the submission deadline for investor clients to submit bids to the firm. In some circumstances, a proprietary bid submitted by the firm will result in an investor not receiving securities that the investor otherwise would have received, or will result in a lower reset rate than otherwise would have occurred.

Can ARS Be Properly Categorized as "Cash Equivalents"?

For years it was standard practice at many brokerage firms to market auction rate securities as "cash equivalents." Investors were told that they could have access to their invested assets in as little as seven days. However, investors in many cases were never told that their ARS investments could become completely illiquid, and that in the event of an auction failure, they could face the prospect of holding securities with perpetual maturity periods. A quick look at well-settled professional accounting standards reveals that auction rate securities clearly do not fall into the definition of "cash equivalents," despite what was represented by the brokerage firms that sold them.

Two important organizations help define acceptable accounting practices in the United States: the Financial Accounting Standards Board ("FASB") and the Governmental Accounting Standards Board ("GASB"). Both FASB and GASB have published statements that define the term "cash equivalents" as "short-term, highly liquid investments" that are both a) "readily convertible to known amounts of cash," and b) "so near to their maturity that they present insignificant risk of changes in value because of changes in interest rates."[3] Both FASB and GASB have stated that generally, ***only investments with original maturities of three months or less met this definition***. Auction rate securities clearly do not fit within this definition. The underlying investments may have maturity periods of twenty years or more – and in the case of auction rate preferred shares, the maturity period may be perpetual. The major broker/dealers that actively marketed ARS to the public clearly had knowledge of these accounting standards for some time. Yet, they ignored generally accepted principles of accounting and financial practices when they marketed auction rate products to their customers as "cash equivalents."

Enforcement Actions Against Broker/Dealers Relating to Auction Rate Securities

In 2006, the Securities Exchange Commission ("SEC") announced the institution of proceedings against fifteen broker/dealer firms for engaging in prohibited practices in the auction rate securities market.[4] These firms consented to the entry of an SEC cease-and-desist order providing for censures, undertakings, and more than $13 million in penalties.

The SEC order found that, between January 2003 and June 2004, each firm engaged in practices that were not adequately disclosed to investors, which constituted violations of

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[3] *See*, FASB Statement of Accounting Standards No. 95; GASB Statement No. 9.

[4] Bear, Stearns & Co., Inc.; Citigroup Global Markets, Inc.; Goldman Sachs & Co.; J.P. Morgan Securities, Inc.; Lehman Brothers Inc.; Merrill Lynch, Pierce, Fenner & Smith Incorporated; Morgan Stanley & Co. Incorporated/ Morgan Stanley DW Inc.; RBC Dain Rauscher Inc.; A.G. Edwards & Sons, Inc.; Morgan Keegan & Company, Inc.; Piper Jaffray & Co.; SunTrust Capital Markets Inc.; Wachovia Capital Markets, LLC; and Banc of America Securities LLC. *See* SEC Release No. 34-53888 (May 31, 2006) (Administrative Proceeding No. 33-8684).

the securities laws. The violative conduct included allowing customers to place open or market orders in auctions; intervening in auctions by bidding for a firm's proprietary account or asking customers to make or change orders in order to prevent failed auctions, to set a "market" rate, or to prevent all-hold auctions; submitting or changing orders, or allowing customers to submit or change orders after auction deadlines; not requiring certain customers to purchase partially-filled orders even though the orders were supposed to be irrevocable; having an express or tacit understanding to provide certain customers with higher returns than the auction clearing rate; and providing certain customers with information that gave them an advantage over other customers in determining what rate to bid.

Some of these practices had the effect of favoring certain customers over others, and some had the effect of favoring the issuer of the securities over customers, or vice versa. In addition, since the firms were under no obligation to guarantee against a failed auction, investors may not have been aware of the liquidity and credit risks associated with certain securities. By engaging in these practices, the SEC found that the firms violated Section 17(a)(2) of the Securities Act of 1933, which prohibits material misstatements and omissions in any offer or sale of securities.

Self-Regulation of Auction Rate Securities Market

Perhaps in response to the SEC's actions in 2006, the Securities Industry and Financial Markets Association ("SIFMA") published its "Best Practices for Broker-Dealers of Auction Rate Securities" the following year.[5] The Best Practices were developed by a task force comprised of traders, lawyers and compliance officers from member firms of SIFMA that act as Broker/Dealers in connection with ARS programs. Among other things, the Best Practices provides the following guidelines:

- The broker-dealer's obligation to existing owners and potential owners is a normal dealer obligation to persons purchasing securities from a broker-dealer. Broker-dealers must comply with applicable securities laws and regulations and the rules of self-regulatory organizations applicable to transactions in auction rate securities.
- A broker-dealer should have policies and procedures, and a system for applying them, designed to help assure that its auction rate securities business complies with applicable laws and regulations.
- A broker-dealer should educate issuers and investors as to the material features of auction rate securities (including the ability of an investor to buy or sell auction rate securities in the secondary market other than through an auction).
- A broker-dealer should disclose to existing owners and potential owners that it may place one or more bids in an auction, and if true, that it routinely places bids in auctions generally, with knowledge of other orders.

The Best Practices may prove useful in establishing industry norms and appropriate standards of care owed to the investors.

Major Auction Failures in February 2008

In mid-February 2008, over 80% of all ARS auctions failed when a large number of major broker/dealers refused to continue to support the auctions.[6] As a result of the withdrawal of support by these major broker/dealers, the market for ARS collapsed, leaving the holders

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[5] *Available at http://www.sifma.org/services/pdf/AuctionRateSecurities_FinalBestPractices.pdf* ("Best Practices")

[6] Martin Z. Braun and William Selway, *UBS, Merrill Lynch Step Back From Auction-Rate Bond Bidding*, BLOOMBERG.COM (Feb. 14, 2008) *available at http://www.bloomberg.com/apps/news?pid=20601087&sid=apI.jYevq_4g*.

of more than $300 billion in ARS with no means of liquidating their investments. Uncertainty as to the future of the ARS market has spread, with some analysts at major brokerage firms speculating that the ARS market may actually "cease to exist" in the near future.[7]

The rash of auction failures has prompted several states' securities regulators to form a task force to probe the ARS market and determine whether laws were broken when the securities were sold to investors. Regulators in Florida, Georgia, Illinois, Massachusetts, Missouri, New Hampshire, New Jersey, Texas and Washington are investigating whether brokers misrepresented the securities in their marketing to individuals.[8] In addition, the Financial Industry Regulatory Authority ("FINRA") announced that it is also looking into the sales practices related to auction rate securities, and the SEC said it is participating in that investigation.[9]

Because of concerns about illiquidity of securities in the ARS market, FINRA issued Notice to Members 08-08, which temporarily increases margin maintenance requirements on ARS backed by fixed income products.[10] NTM 08-08 required FINRA member firms to impose a maintenance margin requirement of 25% of the current market value for all fixed income ARS, regardless of whether or not such securities are deemed to be investment grade. Furthermore, NTM 08-08 reminded member firms that ARPS issued by closed-end funds are not margin eligible under Regulation T and, hence, 100% maintenance margin is required on such securities.

NTM 08-08 was met with strong resistance by FINRA members, which demanded at least temporary relief from these margin requirements so that they could provide some liquidity to aggrieved ARPS investors. In response to these objections, FINRA announced by way of interpretive letter[11] that its member firms would temporarily be permitted to issue "non-purpose" loans to investors that are collateralized by ARPS, provided that all of the following requirements and conditions are met:

1. The ARPS pledged as collateral by the customer to the broker-dealer for the non-purpose loan must be rated in the highest rating category by a NRSRO and must not be subject to credit review by a NRSRO at the time that such credit is extended;
2. The aggregate amount of credit extended on such non-purpose loans to customers is not greater than 25% of the broker/dealer's excess net capital, computed as of the most recent month end and adjusted for any subsequent material decrease, at the time that such credit is extended;
3. The non-purpose credit extended to any single customer does not exceed 50% of the value of the ARPS pledged by the customer as collateral to such loan;

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[7] Martin Z. Braun, *Auction-Rate Market Will `Cease to Exist,' Citi Says,* BLOOMBERG.COM (Apr. 15, 2008) *available at http://www.bloomberg.com/apps/news?pid=20601087&sid=aOIsPiqQiqEU*.

[8] Press Release, North American Securities Administrators Association, State Securities Regulators Coordinate Ongoing Auction-Rate Securities Investigations (April 17, 2008), *available at http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/8627.cfm.*

[9] Francesco Guerrera and Joanna Chung, *Watchdogs probe auction rate securities*, FINANCIAL TIMES (Apr. 10, 2008), *available at http://www.ft.com/cms/s/0/7113ee86-0685-11dd-802c-0000779fd2ac.html*.

[10] FINRA Notice to Member 08-08 (Mar. 6, 2008), a*vailable at http://www.finra.org/RulesRegulation/NoticestoMembers/2008Notices/P038097.*

[11] Letter from Krisoula Dailey, FINRA, to Michael A. Macchiaroli, Esq., Associate Director, SEC Division of Trading and Markets (Apr. 11, 2008), *available at http://www.finra.org/web/groups/rules_regs/documents/rules_regs/p038317.pdf*.

4. A bank loan(s) is obtained by the lending broker/dealer for the aggregate amount of non-purpose loan(s) made to customers to finance the ARPS pledged as collateral by such customers.[12] Such bank loan(s) may only be collateralized by the ARPS pledged by the customer(s). Further, any/all bank loan(s) obtained pursuant to the foregoing must have a remaining maturity term of no less than six months at the time that such credit is extended;
5. The aggregate of all such non-purpose loans shall be considered as a scheduled capital withdrawal under NYSE Rule 326 and NASD Rule 3130, unless otherwise deducted in the computation of net capital;
6. The aggregate amount of the non-purpose loans extended to customers on ARPS that are financed by bank loans as per condition #4 above, should be included as a debit and a credit item in the customer reserve formula computation required by SEC Rule 15c3-3;
7. A broker-dealer must report on a monthly basis to FINRA the aggregate dollar amount of credit extended on these non-purpose loans to customers collateralized by ARPS.

Meanwhile, class action lawsuits and individual arbitration claims have been filed against brokerage firms on behalf of beleaguered ARS investors. Their claims assert causes of action relating to the misrepresentations made by brokers regarding the safety and liquidity of the investments. The investors allege that the firms failed to disclose and misrepresented material adverse facts which were known to them or recklessly disregarded by them. In addition, it has been alleged that the firms knew, but failed to disclose to the investors, that ARS were only liquid at the time of sale due to the fact that the firms were artificially supporting and manipulating the auction market to maintain the appearance of liquidity and stability. The firms allegedly knew, but failed to disclose to investors, that ARS would become illiquid as soon as the firms stopped maintaining the auction market.

The brokers who sold these products may have been misled by their employers about the nature of the products they were selling. *Registered Rep* reported that one UBS broker, when asked if he ever told his clients that they could lose money in the reset market, stated, "***No. Never. No.*** That's how the product was explained to us. It's as good as a money market." He also said access to the auction market "was a great prospecting tool" when meeting with wealthy potential clients. "Nobody ever thought these could lose money," he said. Another Smith Barney broker stated, "We were never, ever—ever, ever—told that these things could fail."[13]

Conclusion

Gretchen Morgenson of the New York Times aptly observed that "[i]nvestors across the nation are finding themselves in Wall Street's version of the Hotel California: they have checked into an investment they can never leave."[14] It is too early to tell when ARS investors may be able to divest themselves of their positions, and by what mechanism – whether by lawsuit, discount sales on the secondary market, successful future auctions, bond maturity or government intervention – divesture shall be accomplished. One thing certain, however, is that if the market for auction rate securities is to survive, the

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[12] Pursuant to Section 220.3(g) of Regulation T, a broker/dealer may arrange for the extension of credit to or for any customer, by any person provided the broker-dealer does not willfully arrange credit that violates Regulation U or Regulation X of the Federal Reserve.

[13] David A. Geracioti, *More Trouble in Auction Rate Securities Land*, REGISTERED REP. (Mar. 28, 2008), *available at http://registeredrep.com/regulatory/trouble_in_securities_land_03_28_2008.*

[14] Gretchen Morgenson, *As Good as Cash, Until It's Not,* N. Y. TIMES, March 9, 2008, *available at http://www.nytimes.com/2008/03/09/business/09gret.html.*

broker/dealers selling them to investors are going to have to overhaul their practice of risk and conflict of interest disclosures to sustain faith in the process.

Cleaning up the Cesspools

Frank Armstrong

A recent US Supreme Court case could go a long way toward clearing up the 401(k) landscape. In *LaRue v. DeWoldff, Boberg & Assoc., Inc.*, the Court held that an individual may sue defined contribution plan sponsors for any breach of fiduciary duty. While the specific facts of the *LaRue* case revolved around a simple administrative error, the court went far beyond administrative procedures in their ruling. The Court specifically cited Section 409 of ERISA which states:

> Any person who is a fiduciary with respect to a plan who breaches any of the responsibilities, obligations, or duties imposed upon fiduciaries by this title shall be personally liable to make good to such plan any losses to the plan resulting from each such breach, and to restore to such plan any profits of such fiduciary which have been made through use of assets of the plan by the fiduciary, and shall be subject to such other equitable or remedial relief as the court may deem appropriate, including removal of such fiduciary. A fiduciary may also be removed for a violation of section 411 of this Act.

88 Stat. 886, 29 U. S. C. §1109(a).

This language was crystal clear and unambiguous. Plan sponsors of substandard plans must be hearing footsteps today. The threat of litigation and personal liability may be the only way to get some plan sponsor's attention. Meanwhile, the plaintiff's bar can't help but have noticed an opportunity.

While certainly not true of all 401(k) Plans, many fall far short of their fiduciary obligations to prudently manage employee funds. A fundamental problem with 401(k) Plans is that while employees provide most or all of the funding, and bear most or all of the costs, the employer or plan sponsor provides the plan structure and a limited set of investment options. In many cases, the employee is faced with the fatal choice of selecting the least of a host of awful choices. Some plans are so costly and ineffective that the employee might rightly decide to opt out.

As Boomers reach retirement, more than just an isolated few will view their accumulations and ask: "Why so little? After all these years the account balances should be more. What happened?" At that point they might begin to compare prudent fiduciary standards with actual plan practices. The failure will certainly be found in the breach.

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Sage Harbor under Section 404(c)

Section 404(c) provides plan sponsors with a degree of safe harbor for employee directed accounts. But, contrary to what many employers believe, the requirements extend beyond simply offering a few mutual fund choices. In fact, there are 74 points and many single spaced pages of Section 404(c) which must be satisfied before the employer obtains safe harbor under that section. Few plans will meet the stringent requirements for appropriate diversification of asset classes, prudent selection of funds, cost disclosure, and education requirements that enable employees to make prudent decisions.

Potential Claims

The employee (or his legal team) may not have to look far:

- **Costs**
  It's never prudent to waste beneficiaries' money. So, it may be hard to justify a M&E charge inside an annuity group contract, separate account charges for each fund, high expense mutual funds, costly SMA's (Separately Managed Accounts), "special share" costs above retail cost, transaction fees, commissions, 12(b)-1 fees, surrender costs, custodian fees, and record keeping charges. While none of these charges are necessarily evil, and many are warranted, the sum totals born by participants can become abusive. Costs are a dead drag on performance, and it's the responsibility of the plan's fiduciaries to insure that each cost is appropriate for the function performed, and that the totals are not excessive.

  Hidden costs are a huge concern for the Labor Department. They have campaigned for greater disclosure and transparency. Additionally, to assist plan sponsors to identify costs they published a cost analysis spreadsheet published on their website at: www.dol.gov/ebsa/pdf/401kfefm.pdf

- **Conflicts of Interest**
  ERISA clearly states that plans must be run in the exclusive best interest of the participants. Fiduciaries must be diligent in preventing conflicts of interest and insure that where they exist they are fully disclosed. However, that obligation does not apply to the plan sponsor. It extends all the way down the chain to investment advisors, consultants, fund managers, administrators and record keepers. The entire chain must act prudently and in the exclusive best interest of plan beneficiaries. Therefore, conflicts of interest that potentially can affect plan performance like soft dollar policies, revenue sharing, best execution, pay to play, proprietary funds, preferred funds lists, order flow, and position in the trading queue must be thoroughly examined, documented, disclosed, and accounted for.

  This is another grave concern of the labor department. They recently released a study that found that more than half of the "pension consultant" firms were paid directly by the managers they recommended. See: STAFF REPORT CONCERNING EXAMINATIONS OF SELECT PENSION CONSULTANTS. http://www.sec.gov/news/studies/pensionexamstudy.pdf

  To assist plan sponsors to identify potential conflicts of interest, the Department of Labor published: "Selecting And Monitoring Pension Consultants - Tips For Plan Fiduciaries" *See*: www.dol.gov/ebsa/newsroom/fs053105.html

- **Underperformance**
  If the participants' fund choices underperformed the appropriate market index, they might rightfully wonder why. For instance, the participants might wonder how their domestic large company stock fund could have returned 3.5% per year less than the S&P 500 index for 11 years without being replaced. Can there possibly be a good answer for that? Were the funds prudently selected, appropriately monitored, compared to the proper index, and replaced if necessary in a timely manner? What was the rationale for not selecting a passive investment (index fund)? Where is the documentation, what was the procedure, were the funds selected in accordance with the Investment Policy Statement? These are all questions which a plan sponsor may be forced to answer in the future.

- **Disclosures**
  ERISA requires significant disclosures to plan participants. If the plan did not disclose costs, performance, and conflicts of interest, as noted above, to the plan participants, then the participants might wonder why that information was not provided as required by law.

- **Education**
  If the plan seeks safe harbor under Section 404(c), the plan sponsor must provide education to enable participants to build appropriate portfolios that match their objectives, time horizons and risk tolerance. The days when a plan could throw 50 or so mutual funds at the employees and let them figure it out are long gone. How is the employee to know that two tech funds are not prudent diversification, or that the "safe" bond fund is a guarantee to get no real (inflation adjusted) growth over her entire career? Either approach might easily lead to disaster, and the employee might wonder how that could have happened.

Bundled Approach

It is far too easy for the plan sponsor to cede total control to an organization that claims to handle everything. Almost by design, a bundled approach where one organization takes on all the roles required to operate the pension, leads to mischief. While a one stop shop sounds attractive to an overworked HR department or plan sponsor, the bundled approach can cloak critical cost, conflict of interests, and encourage non-involvement by the plan fiduciaries. "After all, XYZ Insurance Company handles all that for us" might be an honest, albeit problematic response because when the employee looks under the hood, what she finds may not be too pretty.

Class Actions

There were already a number of class action suits winding their way through the court system concerning excessive fees and conflicts of interest. While the *LaRue* case dealt with an individual's right to sue, the very broad language of the ruling can not help but bolster any case citing a fiduciary breach.

Today, word spreads at the speed of the Internet. Going forward, when one employee uncovers a breach, it's unlikely to be a secret for long. Those breaches that apply to the plan as a whole are much more likely to result in a class action suit against the plan sponsors and fiduciaries. This has not escaped the attention of the plaintiff's bar.

Because regulators have been unable and/or unwilling to apply well known fiduciary standards to pension plans, the employee's best hope of improving the plans they are offered may be through the courts.

403(b) and 457 Plans

All 457 Plans for state and municipal employees are exempt from ERISA, and 403(b) plans that are solely comprised of

participant contributions are also exempt. While the *LaRue* case dealt solely with ERISA accounts, 403(b) and 457 Account Sponsors should not infer that they will escape similar attention from disgruntled participants.

The Best Defense

Plans with well established and documented fiduciary standards have little to fear. Fiduciary compliance is the best defense against litigation. Prudence is not based on results, but on process. While prudent procedures and practices increase the probability of a good outcome for participants, plan sponsors are not being held accountable for guaranteeing investment results.

Prudent practices for pension plans are neither a mystery nor difficult to implement. Additionally, companies may find that total plan costs actually decrease when appropriate controls are installed.

Plan sponsors that are not certain their practices pass muster might start with a self assessment of their plan which is available on line at http://safe.actifi.com. Plan sponsors must simply answer 22 easy questions about their fiduciary practices. Each question will be fully explained with appropriate citations and documentation. If the sponsor can answer all the questions “yes”, they can sleep well at night. If not, they need to hire a qualified, independent “prudent fiduciary” who acknowledges his/her fiduciary status in writing to assist in the overhaul of the process from the ground up.

Additionally, sponsors may wish to conduct a consultant’s fiduciary audit, or apply for Cefex certification of their procedures.

Summary

The clock is ticking. There is little question that the *LaRue* case will lead to additional pension litigation. Fiduciaries that have breached their responsibilities will find themselves personally liable. Plan sponsors should adapt to the new reality and govern themselves accordingly.

Undisclosed Problems of Variable Life Investment Volatility: Companies' Failure to Train Agents About Its Consequences

Peter Katt, CFP, LIC

Variable life (VL) insurance has various equity and fixed-income sub-accounts from which policyowners select for the investment of their policy's cash values. Because VL policy expenses are high compared with whole and universal life (WL and UL), it makes sense from the broker's perspective to predominately select equity sub-accounts to reach for higher investment returns to recoup the higher expenses. A life insurance policy *investment strategy* that uses primarily fixed-income instruments is better done via WL or UL. Therefore, the appropriate investment for VL is equities, whose results are volatile and unpredictable with years of large gains and losses and herein lies a serious problem. Simply put, equity volatility and life insurance are a very bad mixture.

Insurance agents and buyers get their primary understanding about life insurance from illustrations provided by the insurance company. Illustrations show how a policy is *projected* to perform based on the premium pattern shown and pricing factors that remain constant throughout the illustration. The most important pricing factor is investment results, and equity volatility is simply not picked up in these illustrations because they require the use of constant yields. In addition to a constant yield that can be as high as 12%, illustrations require a zero yield be shown. But, showing zero is so foreign to our investment-view that it is utterly ignored by sellers and buyers and serves no purpose whatsoever.

There are two types of death benefit designs that can be used. One has level death benefits from time of purchase until the policy matures. The other has low initial death benefits relative to the intended premiums with death benefits expected to rise or fall as investment results are booked. This second death benefit design we might think of as a superfunded policy.

Regarding the level death benefit design, the presale illustration informs buyers of the premiums needed to maintain a level death benefit policy, but this *knowledge* of premium costs is an illusion because of investment volatility. Even in expert hands, managing premiums for level death benefit VLs is challenging. Unfortunately, very few sellers of VL have even the vaguest notion of how inaccurate their illustrated premiums are and this is passed on to buyers who bond with these premiums that have no chance of being correct.

In order to dislodge clients from their *loyalty* to the illustrated premium, companies selling VL should use *Monte Carlo* or stochastic testing to determine the chances various VL policy designs will fail if the illustrated premium is followed. Agents

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need to be trained to understand this information and Monte Carlo results should be embedded in all sales materials that agents show to prospective buyers.

Monte Carlo testing is a statistical technique that uses random numbers to simulate a particular phenomenon – in this case gross annual investment results funding a specific life insurance policy – over and over again so that the selling company is able to make an educated assessment about the likelihood of particular events occurring. In order to test VLs, extract the tested policy's mortality and expense components as well as its premiums and apply an appropriate arithmetic average investment return with a standard deviation for investment volatility. For example, the average annual return for stocks from 1926 to 2003 is 12.4% with a standard deviation of 20.4%. For each test, 1,000 scenarios are run using random investment results based on the defined investment average and standard deviation.

In practice, our Monte Carlo results have been fascinating. For a recent client that had purchased a level death benefit VL with an illustrated target premium several months before hiring us, we found that the probabilities of policy failure were 20%, 35% and 48% based on average equity fixed-account yields of 12%, 10% and 8% respectively. Further, we found that the average additional premiums needed on a present value basis at the time of purchase were $250,000, $450,000 and $600,000 to prevent policy failure. This Monte Carlo analysis laid the foundation for the client understanding that a premium management system was needed for his VL.

Monte Carlo testing is also invaluable in assessing potential advantages and disadvantages using superfunded VLs. For example, Tom's irrevocable trust has an income producing asset that is used to superfund two life insurance policies (i.e., policies having increasing death benefits). One is WL and the other is VL. Tom had two requests of us: 1) if more income than had been planned was available, what are the probabilities for *investing* the additional funds in WL vs. VL; and 2) should he consider replacing the VL with another WL policy. The WL policy's general portfolio has about 20% public and private equities and 80% fixed-income instruments, but its investment component of the dividend cannot produce a loss to the policy's cash values. VL investing is 100% equity sub-accounts. Using historical data and judgment, we assigned an arithmetic mean difference between net yields for WL (with 20% equities) and VL of 250 basis points, with a base case of 10% vs. 7.5%, and a standard deviation of 20% for VL. With respect to the first question of probabilities for investing the additional funds this year we found that there is a 65% chance greater value will be provided by the VL policy with 100% equities, but we also found there to be a 7% probability, by life expectancy, that the VL policy would fail. As to the second question about whether it would be better to replace the VL with another WL (using the maximum wholesale design to keep selling expenses at their minimum) we found that the VL policy has a 53% probability of producing better value, but a 10% probability of complete failure. (The reason for the higher chance of failure vs. the first question is because it assumes the additional investment to the VL policy is not made and therefore there is a lower level of funding). A 7% to 10% chance of failure with a superfunded VL is an extraordinary possibility and likely not at all understood by VL policyowners.

During our discussion of the Monte Carlo results, Tom wondered how the trust's VL *investment* could go to zero, thinking about equity investments not associated with VL. Equity investment volatility within life insurance has a negative synergy. The greatest internal expense of life insurance is the actual insurance cost, which is computed using the *net amount at risk* (NAR). NAR is determined by the difference between the policies death benefit and its cash value. If the death benefit is $5,000,000 and cash value is $2,500,000 the NAR is $2,500,000.

For a 75 year old male, the cost of insurance is $60,000 with a $2,500,000 NAR. But let's say the cash value drops 30% making the cash value $1,750,000 and NAR $3,250,000. This increases the cost of insurance to $78,000. Not only have the earnings on the cash value gone down, but the policy's costs have gone up 30%. This is why even a superfunded VL can completely fail. The negative synergy of lower investment base coupled with concurrent incurrence of higher costs is far worse for level death benefits designs with chances of policy failure dramatically higher. (Policy failure can be avoided with the infusion of larger premiums, but for testing purposes only one funding pattern is used).

Our firm does a considerable amount of litigation support in life insurance / annuity market misconduct cases. Two current cases deal with insurance agents replacing WL policies with VL because of representations that the policyowners could have more death benefit with less cost. In both cases, the representation was to transfer only the WL policy's cash values to *fully fund* the new VLs with no more premiums needed. In both cases, a 12% constant yield was illustrated for policies with level death benefits. Both have come apart because of significant stock market declines a few years after the transactions. Monte Carlo testing, using historical data from 1926 to the time each VL policy was purchased, shows that there was a 65% chance of policy failure in one and 55% in the other. The agents' dutifully illustrated the required constant yields, showing both 12% and zero. However, a Monte Carlo testing model would have illustrated the more relevant numbers showing a likelihood of complete failure.

A defense that is used in such cases is that NASD rules prevented Monte Carlo testing until recently. NASD Rule 2210 (d) (1) (D), which has been modified, stated "Communications with the public may not predict or project performance, imply that past performance will recur or make any exaggerated or unwarranted claim, opinion or forecast. A hypothetical illustration of mathematical principles is permitted, provided that it does not predict or project the performance of an investment or investment strategy." Certainly Monte Carlo testing is based on mathematical principles to determine the chances certain events will occur. It would be a significant miscarriage of justice if 12% constant yields are left standing as appropriate while the far more sophisticated and accurate Monte Carlo testing is determined to have been out-of-bounds. It is hard to imagine a better tool for assessing the risk / reward balance of a specific financial transaction and to define investor suitability.

Ultimately, there are a tremendous number of VL policies that are currently underwater or have a significant chance of becoming so without policyowners or their advisors realizing it. Monte Carlo testing discloses the dramatic effect equity volatility has on VL policies and has become a staple in helping clients assess VL purchases and premium management strategies.

More On Liability For Losses On Transferred-In Securities

Andy Whiteman

Charles Hunter's excellent recent article prompted me to add my thoughts on the liability of a broker-dealer for positions transferred into the account. In addition to the strategies discussed in Mr. Hunter's article, there are many other situations in which a successor broker-dealer may become liable for losses on transferred-in positions. This article will explore the additional factual and legal arguments that may be available to claimants.

Respondent's arguments concerning transferred-in positions generally include the following:

- Under Rule 2310, the broker-dealer's suitability obligation arises at the time of a recommendation to purchase, sell or exchange. There is no continuing duty to monitor implied by Rule 2310.

- Under the *Birnbaum* rule, adopted by the U.S. Supreme Court in *Blue Chip Stamps,* there is no liability under Rule 10b-5 for recommendations to hold or the failure to advise to sell. The reasoning of those cases is applicable to claims brought under States' versions of the Uniform Securities Act, which limit civil liability to those who offer, sell and purchase.

- As a matter of contract law, in a non-discretionary brokerage account, the broker-dealer's duty ends upon the execution of the transaction. *See, e.g., De Kwiatkowski v. Bear, Stearns & Co., Inc.,* 306 F.3d 1293 (2d Cir. 2002)

The argument about transferred-in positions frequently arises when the broker has changed firms. The new firm will argue that it cannot be held responsible for the broker's misconduct at his prior firm. Even if the positions were unsuitable at the previous firm, the new firm will often argue that it does not have responsibility for further losses on trades that it did not execute.

These arguments have some surface appeal, but oftentimes a contrary result is dictated by the relationship between the customer and the broker. Consider these examples:

- A broker-dealer may be liable if a broker promises to monitor the performance of investments in the customer's account, but negligently fails to do so.

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- A broker-dealer may be held liable if a broker negligently advises a customer to hold positions in the account.

- A broker-dealer may be liable if the broker is trading the account on a discretionary basis with the customer's approval, even if there is no formal grant of discretion.

- A broker-dealer may be held liable if the firm knows that that inherited positions were unsuitable when purchased at the predecessor firm.

- A broker-dealer may be held liable for negligent supervision.

- A broker-dealer may be held liable for breach of the duty to communicate with its customer.

These points will be discussed below, but before doing so, it is important to understand why the Rule 10b-5 cases cited by your opponent are not controlling. They are not because the federal securities statutes do not preempt state law claims.

I. Rule 10b-5 Cases are Inapplicable to State Law Claims

The Second Circuit, in *Birnbaum v. Newport Steel Corp.,* 193 F.2d 461 (2nd Cir. 1952), adopted the rule that only actual purchasers and sellers may recover in a private action under Section 10(b) of the Securities Exchange Act and Rule 10b-5. This holding was later affirmed by the United States Supreme Court in *Blue Chip Stamps v. Manor Drug Stores,* 421 U.S. 723 (1975). Not surprisingly, many lower court cases have followed the Supreme Court's direction.

In addition, the *Birnbaum* rule may doom claims brought under state securities statues, which typically contain the same offer, sale or purchase language as the federal laws. However, the unavailability of a Rule 10b-5 claim does not prevent a plaintiff from seeking to recover for violations of common law. In *Blue Chip Stamps,* the Court stated that the defrauded could pursue clams available to them in state court:

> Obviously this disadvantage [of the *Birnbaum* rule, limiting 10b-5 plaintiffs to purchasers and sellers] is attenuated to the extent that remedies are available to nonpurchasers and nonsellers under state law. [citations omitted]. Thus, for example, in *Birnbaum* itself, while the plaintiffs found themselves without federal remedies, the conduct alleged as the gravamen of the federal complaint later provided the basis for recovery in a cause of action based on state law. *See 3 L. Loss, Securities Regulation* 1469 (2d ed. 1961). And in the immediate case, respondent has filed a state-court class action held in abeyance pending the outcome of this suit. *Manor Drug Stores v. Blue Chip Stamps*, No. C-5652 (Superior Court, County of Los Angeles, Cal.).

Blue Chip Stamps v. Manor Drug Stores, 421 U.S. at 739, n. 9. Therefore, the Court, while recognizing that policy considerations justified limiting Rule 10b-5 claims to purchasers and sellers, did not view those considerations as sufficient justification for a total denial of relief to defrauded holders of securities. Stockholders who were not defrauded in connection with a purchase or sale retained their remedies available under state law.

Many courts have followed the Supreme Court's guidance. *See, e.g., Small v. Fritz Companies, Inc.,* 30 Cal 4th 167, 177, 65 P.3d 1255, 1261 (2003); *Gutman v. Howard Savings Bank,* 748 F.Supp. 254, 264-65 (D. N.J. 1990).

II. Liability Not Dependent on Whether the Account is Discretionary

Many cases hold that in a non-discretionary account relationship the broker's duty ends with the execution of the transaction. However, those cases may be distinguished if special circumstances are present.

A. Express Promise to Monitor the Account

The duty owed by a broker to his customer will vary, depending on the parties' relationship. Frequently, a broker will promise at the outset of his relationship that he will monitor the customer's account holdings. A promise to "watch the account" should be enforced by courts and arbitrators. *See Vucinich v. Paine, Webber, Jackson & Curtis, Inc.*, 803 F.2d 454, 460–61 (9th Cir. 1986) (finding that if the investor relied on broker's promise to monitor her account and his advice not to worry, broker's failure to do so would result in his liability for breach of fiduciary duty under California law). In addition, there could be a finding that the broker is in breach of contract or is negligent in failing to keep his eye on things if he agreed to do so.

B. Negligent Recommendations to Hold

Even in a non-discretionary account, a broker-dealer may be held liable for negligence in recommending that the customer hold securities positions. *See Ward v. Atlantic Security Bank,* 777 So.2d 1144, 1147 (Fla. App. 3rd Dist. 2001). A broker in a non-discretionary account relationship is responsible for the advice he gives.

C. Breach of Duty To Disclose in Special Circumstances

Special circumstances may require a broker to disclose information known to him, even in the absence of an express undertaking or a fiduciary duty as a part of the "fair dealing" requirement for brokers. *See Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1034 (4th Cir. 1997) (citing the SEC's explanation that, inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession). Therefore, for example, if the broker becomes aware that the fundamentals of a company have changed, the broker should share that information with the customer.

D. Knowledge of Management as Affecting Liability for Inherited Accounts

A position or portfolio that is unsuitable does not become suitable just because the account is transferred. A broker-dealer that inherits positions may be held liable if the firm is aware that the positions in the account are unsuitable when purchased at the prior firm. *See Duffy v. Cavalier*, 264 Cal. Rptr. 3d 740 (Cal. Ct. App. 1989) (court held that as a fiduciary, broker had a duty to tell client that client's investment objectives were unsuitable when it had knowledge of such, and to refrain from acting except upon the customer's express orders)

A broker-dealer will argue that it had no knowledge of the investment objectives of the prior account or whether the customer had unrealized losses on the positions transferred in. However, this argument cannot be made when the account followed the broker to the new firm. The knowledge of the broker is imputed to his new employer.

E. Breach of Duty to Supervise

FINRA Rule 2310 requires that the suitability of recommended trades be measured against the customer's financial situation, investment objectives *and other holdings.* Therefore, the branch manager, when evaluating a trade, must consider the customer's portfolio as a whole. In addition, the branch manager and the compliance department must look out for "red flags" in an account and take action to correct potential problems.

The duty to investigate "red flags" arises under FINRA Conduct Rule 3010(a), which requires that firms maintain a supervisory system "reasonably designed to achieve compliance with" securities laws and regulations and with FINRA rules. *Castle Sec. Corp.*, Exchange Act Rel. No. 52580, 2005 SEC LEXIS 2628, at *7 (Oct. 11, 2005). Supervisors have a duty "to investigate 'red flags' that suggest that misconduct may be occurring and to act upon the results of such investigation." *Michael T. Studer*, Exchange Act Rel. No. 50543A (Nov. 30, 2004); *George J. Kolar*, Exchange Act Rel. 46127 (June 26, 2002) ("[d]ecisive action is necessary whenever supervisors are made aware of suspicious circumstances, particularly those that have an obvious potential for violations."); *Quest Capital Strategies, Inc.*, Exchange Act Rel. No. 44935 (Oct. 15, 2001) ("supervisors must act decisively to detect and prevent violations of the securities laws when an indication of irregularity is brought to their attention"); *Consolidated Inv. Servs., Inc.*, 52 S.E.C. 582, 588 (1996) ("any indication of irregularity brought to a supervisor's attention must be treated with the utmost vigilance"). A supervisor's failure to recognize and act upon such red flags violates the duty to supervise reasonably under FINRA rules.

When the holdings of a transferred account are contrary to the customer's profile, the branch manager should investigate to determine whether corrective action should be taken. Whether the firm has breached its duty to supervise will depend on how out of whack the account appears to be, based on what is disclosed on the new account form. *See Banca Cremi, S.A. v. Alex. Brown & Sons, Inc.*, 132 F.3d 1017, 1034 (4th Cir. 1997) (citing the SEC's explanation that, inherent in the relationship between a dealer and his customer is the vital representation that the customer will be dealt with fairly, and in accordance with the standards of the profession). For example, the branch manager should investigate why an account coded for "income and safety of principal" is invested in speculative stock positions.

III. Breach of Fiduciary Duty in Discretionary Account Relationships

A discretionary account allows an investment broker to execute transactions without the client's prior approval. *See Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng,* 901 F2d 1124, 1128 (D.C. Cir. 1990). For example, the Fourth Circuit Court of Appeals in *Trumball Investments, Ltd. I v. Wachovia Bank, N.A.* , stated the following:

> In return for this grant of discretion, a broker operating a discretionary account typically owes greater duties to his client than a broker who must receive authorization for each transaction. *See, e.g., Indep. Order of Foresters v. Donald, Lufkin & Jenrette, Inc.,* 157 F.3d 933, 940-41 (2d Cir.1998) (noting that typically a broker operating a discretionary account has a general fiduciary duty to his client whereas a broker operating a non-discretionary account has narrower obligations); *Hill,* 790 F.2d at 824 (same); *see also Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc.,* 461 F.Supp. 951, 953 (E.D.Mich.1978) (describing a broker operating a discretionary account as "the fiduciary of his customer in a broad sense"). Most notably, the broker managing a discretionary account has to make investment decisions that are faithful to the needs and objectives of his client. *Leib,* 461 F.Supp. at 953.

Trumball Investments, Ltd. I v. Wachovia Bank, N.A., 436 F.3d 443, 445-46 (4th Cir. 2006), *cert. denied,* ___ U.S. ___, 127 S. Ct. 87 (2006).

Thus, in a discretionary account, the broker-dealer has the authority and duty to make investment decisions that "are faithful to the needs and objectives of the client." *Id*.

The existence of a fiduciary duty does not necessarily depend on whether the account is labeled discretionary or non-discretionary.

> Between the purely non-discretionary account and the purely discretionary account there is a hybrid-type account which plaintiff claims existed in this case. Such an account is one in which the broker has usurped actual control over a technically non-discretionary account. In such cases the courts have held that the broker owes his customer the same fiduciary duties as he would have had the account been discretionary from the moment of its creation.

Leib v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 461 F.Supp. 951, 954 (E.D. Mich. 1978), *aff'd,* 647 F.2d 165 (6th Cir. 1981). In *Baker v. Wheat First Securities*, the Court stated:

> The Court does not believe that the discretionary-nondiscretionary dichotomy is the shibboleth which Wheat attempts to make it out to be. While a few courts have based their holdings on the distinction, the Court does not find that the question will necessarily always be so neatly suitable for resolution. For instance, the same circuit which decided *Caravan Mobile Homes, supra,* the Ninth, has also held that California law, (which was applied in *Caravan Mobile Homes*) imposes fiduciary obligations "where the agent 'for all practical *1429 purposes' controls the account." *Leboce, S.A. v. Merrill-Lynch, Pierce, Fenner & Smith, Inc.,* 709 F.2d 605, 607 (9th Cir.1983). The Ninth Circuit also noted in *Mihara v. Dean Witter & Co.,* 619 F.2d 814 (9th Cir.1980), in the context of churning, that "the requisite degree of control is met when the client routinely follows the recommendations of the broker" such that "a pattern of de facto control by the broker" develops. *Id.* at 821. Although the Eighth Circuit in *McGinn* applied the discretionary-nondiscretionary distinction in finding no fiduciary relationship to arise under Minnesota law, a subsequent district court decision implies that the law of that state may be flexible to a degree on the point. The court in *Corbey v. Grace,* 605 F.Supp. 247 (D.Minn.1985), remarked that a plaintiff seeking to establish a fiduciary relationship with a broker had to "specify the content of [a] special agreement *or relationship*...."

Baker v. Wheat First Securities, 543, F.Supp. 1420, 1428-29 (S.D. W.Va. 1986).

Courts have found fiduciary relationships without undue emphasis being placed on the nature of the account, where the client routinely follows the recommendations of a broker such that a pattern of *de facto* control exists. In *Burns v. Prudential Securities, Inc.,* the Court stated:

> There exist, however, circumstances when an account is neither purely nondiscretionary nor purely discretionary. Some courts have held that if a broker assumes control over an account by acting without the customer's prior authorization, he owes his customer the same fiduciary duties he would have had if the account had been discretionary from the moment of its creation. *Id*.; *De Kwiatkowski v. Bear, Stearns & Co., Inc.* (C.A.2, 2002), 306 F.3d 1293; *J.C. Bradford Futures, Inc. v. Dahlonega Mint, Inc.* (C.A.6, 1990), 907 F.2d 150.

Burns v. Prudential Securities, Inc., 167 Ohio App.3d 809, 828, 857 N.E.2d 621, 635 (Ohio App.3d Dist. 2006)

Thus, if a broker assumes control of his client's account and performs transactions at his discretion without the customer's prior approval, the broker must take on the duties

of a discretionary broker, "including the continuing duty to keep the clients informed of financial information that may affect their investments and the duty to disclose all material information to the clients." *Id,* 167 Ohio App.3d at 828-29, 857 N.E.2d at 635-36. *See, also, De Kwiatkowski v. Bear, Stearns & Co., Inc.,* 306 F.3d 1293, 1308 (2d Cir. 2002) (fiduciary duty would be said to exist if the "account deviated from the usual nondiscretionary account in a way that creates a special duty beyond the ordinary duty of reasonable care that applies to a broker's actions in nondiscretionary accounts.").

The nature of the duty owed will vary, depending on the relationship between the broker and the investor. Such a determination is necessarily fact-based, and no bright line distinction exists as between discretionary and non-discretionary accounts. *See Romano v. Merrill Lynch, Pierce, Fenner & Smith,* 834 F.2d 523, 530 (5th Cir. 1987). A course of dealing in which the broker executes trades without the client's approval suggests that the account is discretionary. *See In re Murphy,* 297 B.R. 332 (Bankr. D. Mass 2003).

Further, ratification cannot occur until the customer has been provided with all relevant information and *then* manifests his intention to adopt the unauthorized transaction. *See Burns v. Prudential Securities, Inc., supra,* 167 Ohio App.3d at 829, 857 N.E.2d at 636, *citing Merrill Lynch Pierce Fenner & Smith, Inc. v. Cheng, supra,* 901 F.2d at 1129.

The facts of a case may support a finding that the broker was trading the account on a *de facto* discretionary basis. In that case, the broker owes the duty to exercise ordinary care to advise the customer that positions in the account should be sold.

Conclusion

There are many factual situations that may give rise to liability for positions transferred into an account, even in non-discretionary account relationships. Attorneys should interview their clients thoroughly to determine the nature of the relationship between client and the broker. Most clients will say that they were counting on their brokers to monitor their accounts and that they relied on their broker's recommendations to hold. In cases in which the broker has *de facto* control over the account, the case law holds that the broker has a fiduciary duty to monitor the account and take appropriate action to protect the customer's funds. A duty may also arise if the branch manager or compliance officer fails to act on red flags that indicate something is seriously amiss in the customer's account.

Recent Arbitration Awards

Jason M. Kueser

Evelyn Brandin, individually and as Trustee of the Brandin Trust v. JKR & Co., James Thomas, James Burchard and SJB Investments*;*
NASD Case No. 07-01095

This case involved the sale of seven Mutual Benefits viatical investment contracts. Claimant was directed away from the licensed broker dealer, JKR & Co., and encouraged to purchase the viaticals through an unregistered broker dealer, SJB Investments, which was owned by the licensed JKR & Co. broker, James Thomas and his partner James Burchard. Total investment $305,000.

Claimant asserted the following causes of action: breach of fiduciary duty, omissions and misrepresentations, negligence, violations of Nevada Revised Statutes sections 90.570 and 90.660, violations of Nevada Revised Statutes section 598.02 et seq. (deceptive trade practices), and violation of Nevada Revised Statutes section 688C et seq. and 688.510(2) (improper sale of viatical contracts).

Claimant requested compensatory damages of approximately $5,000,000 including lost profits if their monies had been prudently invested, pre- and post-judgment interest, attorneys' fees, punitive damages, a return of all fees, management charges and commissions, plus interest and costs.

Respondent requested dismissal of the Statement of Claim and costs, including forum fees and attorney's fees.

The panel awarded Claimants the following damages: Compensatory damages/Rescission totaling $304,671; interest of $127,821; attorneys' fees of $144,020; expert witness fees of $11,300 and punitive damages of $612,712.

Claimants' Counsel: David Liebrader, Esq., Law Offices of David Liebrader, APC, Las Vegas, Nevada.

Claimants' Expert: Joe Long, Norman, Oklahoma.

Respondent's Counsel: For Respondents James R. Thomas and JRK & CO., John P. Clone, Esq., Solana Beach, California.

Arbitrators: Robert Roseb (Chair), Dee Newell (Public) and Merrill Taylor (Industry).

This case is significant because it involved an open question of whether or not the viaticals were securities under Nevada law. Ultimately, the Panel ruled in favor of the investor,

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holding that viaticals are securities under Nevada law. The case also involved typical claims of "selling away" as the investments were not made through the FINRA brokerage firm, JKR & Co. Nevertheless, the Panel found both the brokers and the FINRA firm liable for all losses from the viaticals. The case is also significant because the panel awarded full statutory damages (principal, attorney's fees, interest and expert costs, AND tacked on an additional $612,712 in punitive damages for abusive discovery practices and outrageous supervision lapses.)

Quinault Indian Nation v. McDonald Investments, Inc., David Hohimer, and Michelle Hansen;
FINRA Case # 06-01149

This case involved an Indian Nation located in Washington State that invested $3.5 million of federal grant funds with McDonald Investments, Inc. (Key Bank's brokerage; subsequently sold to Wells Fargo Securities). The grant funds were to be used throughout the year to pay for operating expenses of the Nation. The Nation instructed that the funds were to be invested in liquid, extremely low risk ("something better than money market rates"), income producing investments.

McDonald brokers invested the entire $3.5 million in several closed-end mutual fund *IPO shares*. They further engaged in mutual fund switching, selling within 2-3 months some of the IPO shares in order to buy *new* IPO shares when new closed end funds came on the market. Prospectuses were sent to the Nation after the purchases.
McDonald Investments received a 4.5% "sales concession" on sales of closed end fund IPO shares. They sold such IPOs to many of their clients. The same closed end fund shares could have been bought for these clients on the secondary market *after* a few months, and the below par NAV plus the normal market discount were reflected in the share price—but they would have received only standard mutual fund commissions on such sales, much less than 4.5%.

The Nation's closed end fund shares held steady for 2-4 months, then dropped substantially. As a result of the drop in value, The Nation lost around $460,000 of its $3.5 million government funds within about 5 months.

Claims asserted included: misrepresenations and omissions, negligence, suitability, breach of fiduciary duty, failure to supervise, breach of contract, and violation of the Washington Consumer Protection Act.

The Nation requested rescission damages under Washington State's Securities Act (purchase price + 8%, less amounts received) which amounted to $860,000, about $200,000 statutory (but discretionary) attorneys fees, and $10,000 expert fees.

Respondents defended that the losses were the Nation's own fault because (1) it was a sophisticated institutional investor that should have independently evaluated the investments, and (2) the Nation's managers had a "fiduciary duty" to tribal members to read the Prospectuses, so they had no right to rely on Respondents' representations.

The Panel awarded the Nation: $392,766; no attorneys fees; no expert fees; and *ordered the Nation to pay $16,900, for ½ of the $33,800 hearing fees.*

Claimant's counsel: Carl J. Carlson and Jason T. Dennett, Carlson & Dennett, P.S., Seattle

Claimant's Expert: Scott Rhodes, Kutscher & Associates, Seattle

Panel: Laurie Law (Chair), John Cockburn (Public), Michael Reinhart (Industry).

Respondents' counsel: Rudy England, Lane Powell Spears Lubersky, Seattle; Shannon McDougald, Seattle.

This case is significant because Claimant was able to prove, using the work of Edward O'Neal as published in a previous PIABA Bar

Journal, that IPO shares of closed end funds will generally drop about 4% within a few months of issuance, because they *start* with a NAV less than par since the costs of issuing and selling the IPO shares are paid from the investors' payments, which reduces the closed end fund's total assets. The Underwriters support the price of the shares a few months, keeping it near par. When the Underwriters stop buying shares on the secondary market, the price drops (1) to reflect below par NAV, and (2) because closed end funds generally trade at a discount to their NAV. (See PIABA Bar Journal, Vol. 14, No. 2, "Closed-end Fund IPO's" by Edward O'Neal, which the Nation used at the hearing, for fantastic material if you have a similar case). In addition, the case was significant because at the hearing McDonald's supervisors acknowledged, as the Nation's expert testified, that there had been virtually no supervision of these transactions.

Michael Coutant and Tanis Goheen v. Morgan Stanley Dean Witter and David Owen Earle;
FINRA Case No. 2002-010359

Case Facts: This was an NYSE arbitration that was consolidated to FINRA after the merger. The case involved an employee of JDS Uniphase, and his wife, who transferred $1,000,000 in JDSU stock to Morgan Stanley Dean Witter. Claimants also had several million in additional JDSU options that had not been exercised and that had not been transferred to MSDW. Prior to transferring these options, Claimants met with the broker, who had prepared a financial plan. In the financial plan, the broker specifically acknowledged the options.

As the price of JDSU stock climbed, the value of Claimants' vested and unvested options exceeded $8 million (pre-tax and pre-exercise cost). The "net" value of the shares had the options been exercised was between $4 and $5 million. In a very short time, the value of JDSU stock plummeted, losing 90% of its market value.

The broker contended that he told Claimants to sell the options, but Respondents could not produce any notes showing that the broker had made such a recommendation. Claimants alleged that the broker instructed them to hold the options and that, because they were unsophisticated, they were waiting for the broker to provide a recommendation as to how they should manage the options.

Claimants argued that Respondents also had a duty to recommend a defensive or hedging strategy (such as a collar).

Claims Asserted: Suitability, misrepresentation, failure to supervise, negligence, and breach of fiduciary duty.

Defenses Raised: Various affirmative defenses. Respondents also argued that they did not have liability because there were no transactions in the account. Claimants opposed this argument by alleging that Respondents assumed responsibility for the unexercised options by including the options in the financial plan.

At the hearing, Claimants stated that had a collar been implemented, damages were between $2 and 3 million.

After a 15-day hearing, the Panel awarded Claimants $1,015,875.00 in damages, of which it determined Morgan Stanley Dean Witter was solely liable for $965,081.25 (95%) and the broker and Morgan Stanley Dean Witter were jointly and severally liable for $50,793.75 (5%). Despite this award, the Panel assessed the $36,000 in forum fees and $2,400 in costs equally between Claimants and Respondent MSDW.

Claimants' Counsel: Cary S. Lapidus, Kathy L. Monday, and Roger M. Schrimp

Claimants' Experts: Craig McCann and Paul F. Meyer

Respondents' Counsel: Boyd C. Sleeth and Eric G. Wallis, Reed Smith, Oakland, CA.

Respondents' Experts: Shel Ekdahl (collar strategies); Jefrey Schubert (suitability)

Arbitrators: Barbara M. Anscher, Lyman Dyson, and Susan J. Alexander

This case is significant because the Panel awarded more than $1,000,000 in damages against a firm and its broker when there were never any transactions in the account at issue.

Jean Locascio and Sandy White v. Trident Partners, Ltd. and Raymond Burghard;
FINRA Case No. 07-01431

This case involved the sale of class B share mutual funds and stocks to a widow in her early 70s. The source of the money came from a rollover from her 401k upon retirement. Initially, the broker purchased bond funds and corporate notes. During the first three years the income in the account was $51,000 and the broker collected undisclosed markups of $41,000. In March 2006, the broker sold the corporate notes and purchased one penny stock without authorization from the client. After that penny stock dropped in price, the broker purchased another penny stock without authorization. The pattern was repeated by the broker in several of his other accounts.

Claims Asserted: Unauthorized trading and unsuitability.

Defenses Raised: Various affirmative defenses; indemnification against broker who did not appear. The firm of attempted to obtain indemnification and/or contribution against the broker. The broker did not file a uniform submission agreement and did not appear the hearing.
Claimant sought $117,000 in damages at the hearing. Claimants also withdrew her claim for punitive damages prior to the hearing.

The panel awarded Claimants compensatory damages of $120,000 plus post-judgment interest at a rate of 9%. The panel also denied the firm's cross-claim in its entirety.

Claimant's Counsel: Seth E. Lipner

Respondent's Counsel: John E. Lawlor

Arbitrators: Charles S. Guggenheimer, Howard L. Greenberger, and Michael J. McAllister (Industry).

This case is significant as it was the first case that claimant's counsel had tried in which the arbitration panel rounded up the amount of damages in its award. In addition, Claimant was able to obtain essentially a full award with only a one-day hearing.

Michael Allinson v. Westcap Securities, Inc., Vision Securities, Inc., Glenn J. Meyer, and Scott Cusumano;
FINRA Case No. 07-01185

This case involved an 87 year-old Claimant, who was an officer in the British army during World War II and later became a Broadway actor. The broker first started handling Claimant's account when he was a representative of Westcap Securities, Inc. While the account was at Westcap, the broker churned the account for $90,000 in a 16-month period. Later, the broker transferred his business, including Claimant's account, to Vision Securities, Inc. In only three months after transferring the account to Vision Securities, the broker churned $25,000 in losses. The broker had previous cases against him.

Claims Asserted: Violations of FINRA rules, churning, breach of fiduciary duty, professional negligence, breach of contract, fraud, failure to supervise, and arbitral adjustment.

Defenses Raised: Various affirmative defenses.

Claimant withdrew his claims against Westcap Securities, Inc. and Scott Cusumano prior to the hearing.

The Panel awarded Claimant $125,000 in damages, divided as follows: (1)

Respondents Vision Securities and Meyer were jointly and severally liable to Claimant for $75,000; and (2) Respondent Meyer was solely liable to Claimant for $50,000.

Claimant's Counsel: Christopher J. Gray

Claimant's Expert: Nick Vu

Respondent's Counsel: Robert Heim

Arbitrators: Elizabeth Gilbert, Aaron Friedman, and Jeffrey I. Kahn (Industry)

This case is significant because the Panel awarded 3x the NOPs against the Broker-Dealer that handled Claimant's account for the period at issue in the arbitration.

Cases & Materials

Timothy A. Canning

Following are summaries of recent cases and other material that may be of interest from state and federal courts involving arbitration and/or securities, arranged generally by topic**.**

BEFORE THE ARBITRATION: COMPELLING/RESISTING ARBITRATION

Challenging Arbitration Agreements: Who Decides

Shammami v. Broad Street Securities, Inc.
(E.D.Mich., 2/13/2008) ___ F.Supp.2d ____, 2008 WL 408523

Where allegations of fraudulent inducement go to the entire contract, instead of to the arbitration clause alone, enforceability of the arbitration clause is a matter for arbitrators to decide. Further, dismissal of the suit, instead of a stay, is appropriate where all of the issues raised in the complaint are being ordered to arbitration. The party moving for arbitration cannot be compelled to initiate the arbitration or to pay the opposing party's filing fees.

In this case, the claimant filed suit against Broad Street Securities, Inc. ("Broad Street"), Pershing, LLC ("Pershing"), and The Bank of New York Mellon Corporation ("Mellon"), claiming that those firms and their employees churned his investment accounts and traded securities without regard to his stated objectives. Pershing moved to compel arbitration and dismiss the suit, in which Mellon (the parent company of Pershing) joined. Broad Street also joined the motion to compel.

In granting the motion to compel, the court rejected the customer's argument that the arbitration clause in the Margin Agreement should not apply because he was fraudulently induced to sign a separate agreement with Broad Street changing his investment objectives. Instead, the court held that there was no allegation that claimant was fraudulently induced to agreeing to the arbitration clause in the Margin Agreement. Rather, at most, claimant alleged that he was fraudulently induced into a separate agreement with Broad Street. Consequently, even if claimant's allegations related to the Margin Agreement, they would relate to the contract as a whole. Therefore, this matter must be resolved by an arbitrator.

After compelling arbitration, the court rejected the claimant's argument that the court action should only be stayed, not dismissed. According to the court, "The weight of authority clearly supports dismissal of the case when all of the issues raised in the district court must be submitted to arbitration."

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The court next rejected the claimant's argument that Pershing should "be required to initiate arbitration through NASD/FINRA in a prompt manner by submitting a Statement of Claim containing the essential allegations set forth in the complaint, and to pay the costs for filing arbitration of $1,500.00 as the party so moving." According to the Court, the claimant failed to point to any contractual or statutory provision requiring Pershing to initiate arbitration and pay the costs for filing arbitration, and, absent such authority, the Court was unpersuaded by claimant's arguments.

Resisting Arbitration: Bad Faith

Lesjak v. New England Financial
(Ind. App. 1/28/2008) 879 N.E.2d 1129

Bad faith litigation tactics in conjunction with resisting a motion to compel arbitration can be sanctionable misconduct. A brokerage firm that resisted submitting its claim against a former employee to FINRA arbitration was held to have acted in bad faith in doing so.

The court here had little trouble concluding that the brokerage firm, New England Financial, engaged in both procedural and substantive bad faith through its litigation tactics. The firm brought this court action to collect on a promissory note. The employee, a registered representative, demanded that the dispute be submitted to arbitration. The firm, however, fought its employee's demand for arbitration for months. After the employee successfully moved to compel arbitration, the firm moved for reconsideration. At that point, for the first time, the firm argued that arbitration before the NASD was impossible because it was really the firm's parent company who filed the suit, and the parent company was not a NASD member. The trial court accepted that argument, and vacated its order compelling arbitration. The employee appealed.

While the appeal was pending, and after the employee had submitted his opening brief on appeal, the firm dramatically reversed course and simply initiated the arbitration on the eve of the due date of its brief on appeal, informing the court that the NASD had agreed to accept the arbitration. Nonetheless, the court ordered the firm to file its brief by a date certain.

According to the court, the firm "likely hoped that it would not have to incur the financial and temporal expense of drafting an appellate brief. When, however, the final due date arrived, New England Financial defied this court's order and filed a motion for extension of time rather than a brief, which arrived a week later." In the end, after the employee incurred over $19,000 in attorney fees seeking to compel arbitration, New England Financial added a final insult to injury, by suggesting that the employee should be grateful for the outcome (i.e., that the firm voluntarily submitted the dispute to arbitration).

After ordering the firm to pay the employee's fees and costs on appeal, the court observed that it was not a close call to determine that the employee was entitled to attorney fees for the firm's conduct in the trial court, as well. The court remanded that issue to the trial court for its consideration.

Arbitration Required Under NASD Rules: Who Is A Customer

Herbert J. Sims & Co., Inc. v. Roven
(N.D. Cal. 3/7/2008) 2008 WL 686591

A FINRA member firm sought to enjoin a FINRA arbitration brought against it by individuals. As there was no arbitration agreement between the parties, the court analyzed whether the firm was required to arbitrate under FINRA rules. The court concluded that the arbitration claimants were not customers of the firm under FINRA rules, and granted the injunction.

The court relied on a number of factors in reaching its conclusion: First, the record showed that the claimants did not invest directly with the brokerage firm, or with an

agent or representative of firm. Rather, each of the claimants were clients of an investment advisor (who was not registered with the firm), and had accounts at another brokerage firm, not with this one. The investment advisor was not an employee, agent, representative or associated person of this firm.

Second, none of the claimants had an account or any written agreement with the brokerage firm, nor were there allegations that the claimants themselves had any communications, written or oral, with the brokerage firm.

The claimants' alleged connections to the brokerage firm were instead through the investment advisor's interactions with an employee of the brokerage firm. The investment advisor had purchased the firm's bonds for the claimants, but that transaction was handled through a second brokerage firm. The court held that the second brokerage firm could not be a "customer" under NASD rules. Therefore, even if the arbitration claimants showed that the second brokerage firm acted as their agent, the claimants did not accrue any right to customer status as a result of an agency relationship with the second brokerage firm.

Arbitration Required Under NASD Rules: Who Is A Customer

In re Prudential Equity Group, LLC v. Estate of Amiouny
(N.Y.A.D. 3/20/2008) 853 N.Y.S.2d 349, 2008 WL 740339

Under NASD rules, an investor could not compel arbitration of a dispute arising out of accounts held by non-member firms, even though the person handling the accounts at the non-member firms was also an associated person of a member firm.

In this matter, the account holder sought to arbitrate at the NASD a claim arising out of three accounts. The account holder had no individual accounts or business with the member firm, Prudential Equity Group, but did have three individual accounts with Prudential-Bache International Limited and Prudential-Bache International Bank. The latter two companies were not members of NASD.

The claims were not between a customer and a member as the account holder had no individual customer relationship with the NASD member firm; the account holder dealt only with the two European companies, which were not NASD members. While the broker for the three European accounts was also an "associated person" of the member firm, the broker was not acting on behalf of the member firm in connection with the three European accounts. The trading in these European accounts came within the purview of the European regulators.

The court concluded that the account holder's claims with respect to these accounts arose out of the business of two non-members and, under NASD Rule 10101, were not eligible for arbitration.

FAA Preemption: Other Forums / State Agencies

Preston v. Ferrer
(U.S. 2/20/2008) ___ U.S. ___, 128 S.Ct. 978

When parties agree to arbitrate all questions arising under a contract, the Federal Arbitration Act (FAA) supersedes state laws that lodge primary jurisdiction in another forum, whether judicial or administrative.

A contract between respondent Ferrer, who appears on television as "Judge Alex," and petitioner Preston, an entertainment industry attorney, required arbitration of "any dispute … relating to the [contract's] terms … or the breach, validity, or legality thereof … in accordance with [American Arbitration Association (AAA)] rules."

Preston invoked arbitration to recover fees allegedly due under the contract. Ferrer then petitioned the California Labor Commissioner

for a determination that the contract was invalid and unenforceable under California's Talent Agencies Act (TAA) because Preston had acted as a talent agent without the required license.

After the Labor Commissioner's hearing officer denied Ferrer's motion to stay the arbitration, Ferrer filed suit in state court seeking to enjoin arbitration, and Preston moved to compel arbitration. The court denied Preston's motion and enjoined him from proceeding before the arbitrator unless and until the Labor Commissioner determined she lacked jurisdiction over the dispute.

The Supreme Court reversed, on preemption grounds. The Court said the issue was not whether the FAA preempts the TAA wholesale. Instead, the issue was simply who decides - the arbitrator or the Labor Commissioner - whether Preston acted as an unlicensed talent agent in violation of the TAA, as Ferrer claims, or as a personal manager not governed by the TAA, as Preston contends.

The contract at issue clearly "evidenc[ed] a transaction involving commerce" under FAA § 2, and Ferrer has never disputed that the contract's written arbitration provision falls within § 2's purview. Ferrer sought invalidation of the contract as a whole. He made no discrete challenge to the validity of the arbitration clause, and thus sought to override that clause on a ground the arbitrator was to decide in the first instance.

Ferrer argued that the TAA merely requires exhaustion of administrative remedies before the parties proceed to arbitration, and hence there was no conflict between the two statutes. However, the court concluded that procedural prescriptions of the California's TAA law did conflict with the FAA's dispute resolution regime in two basic respects: (1) the TAA provision that grants the Labor Commissioner exclusive jurisdiction to decide an issue that the parties agreed to arbitrate and (2) another provision that imposes prerequisites to enforcement of an arbitration agreement that are not applicable to contracts generally.

The Court rejected Ferrer's contention that the TAA is compatible with the FAA because the TAA provision vesting exclusive jurisdiction in the Labor Commissioner merely postpones arbitration. Arbitration, if it ever occurred following the Labor Commissioner's decision, would likely be long delayed, in contravention of Congress' intent "to move the parties to an arbitrable dispute out of court and into arbitration as quickly and easily as possible."

The Court contrasted the arbitration clause at issue with *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 109 S.Ct. 1248, 103 L.Ed.2d 488. Unlike *Volt*, here the arbitration agreement speaks to the matter in controversy; both parties are bound by the arbitration agreement; the question of Preston's status as a talent agent relates to the validity or legality of the contract; there is no risk that related litigation will yield conflicting rulings on common issues; and there is no other procedural void for the choice-of-law clause to fill.

Further, the "best way to harmonize" the Ferrer-Preston contract's adoption of the AAA rules and its selection of California law is to read the latter to encompass prescriptions governing the parties' substantive rights and obligations, but not the State's "special rules limiting [arbitrators'] authority."

Compelling Arbitration: Refusal to Arbitrate

Carrington Capital Management, LLC v. Spring Investment Services, Inc.
(D. Conn. 08/02/2007) 2007 WL 2684728

A failure to agree on the venue of arbitration does not constitute a refusal to arbitrate under the FAA; as a result, a petition to compel arbitration did not lie.

In this matter, the plaintiff, a manager of hedge funds, and defendant, a broker-dealer which promoted and sold interests in hedge funds, entered into a consultancy agreement in which defendant was to promote and market plaintiff's funds on an exclusive basis. The underlying arbitrable dispute was whether plaintiff breached the agreement by failing to make payments to defendant after plaintiff and defendant discontinued their relationship.

The arbitration agreement between the parties provided for "arbitration in a location mutually agreeable by the parties governed by the laws of the Commonwealth of Massachusetts." The arbitration was commenced at the AAA. However, the parties could not agree on venue of the hearing. The defendant insisted on the arbitration being held in either Boston or Rhode Island. Plaintiff demanded that the arbitration be held in Connecticut or Illinois. When the parties could not decide on a "mutually agreeable" location, the plaintiff filed this action seeking to compel defendant to arbitrate, and requested the court to decide the venue of the arbitration.

Plaintiff argued that defendant had refused to arbitrate by failing to agree on a location for the arbitration. Defendant argued that in order to have standing to compel arbitration under 9 U.S.C. § 4, the moving party must be aggrieved by another party's complete refusal to arbitrate. Defendant contended that disagreeing on venue does not constitute a refusal to arbitrate under the plain language of the statute.

The court found that the defendant had not refused to arbitrate under 9 U.S.C. § 4. Therefore, the court concluded that it did not have jurisdiction to either compel arbitration or to order a location for such arbitration. According to the court, the arbitration agreement manifests the clear intentions of the parties to arbitrate in a mutually agreeable location. Considering that the Arbitration Act establishes that any doubts concerning the scope of arbitrable issues should be resolved in favor of arbitration, the Court could not assume that the parties intended to have a district court decide upon a location for the hearing.

Instead, in the event that the parties could not come to an agreement on a "mutually agreeable location," the AAA would choose the location. AAA Rule-10 states that if a party objects to the locale requested by the other party, the AAA shall have the power to determine the locale, and that the AAA's decision is final and binding.

DURING THE ARBITRATION

Venue Of The Hearing

Bernhard Mechanical Contractors, Inc. v. American Arbitration Ass'n, Inc.
(W.D.La. 2/20/2008) 2008 WL 706618

The AAA's decision on venue for an arbitration hearing could not be challenged in court, due to doctrine of arbitrator immunity.

A party to an arbitration pending before the AAA sought to challenge the AAA's decision on venue for the arbitration hearing. The party initially filed in Louisiana state court, and the AAA removed the action to federal court based on diversity jurisdiction. The party apparently did not name the other parties to the arbitration.

The court recognized that the party's right to contest the arbitration venue selected by the AAA would be effectively precluded unless suit against the AAA is allowed at this stage of the arbitration proceeding. However, in view of the strong language appearing in the opinions of the Fifth Circuit regarding "arbitral immunity", the court found that the claims regarding the AAA's venue selection were barred by "arbitral immunity."

Arbitrator Classification

SR-NASD-2007-21
73 Fed Reg 15025 (3/20/2008)
http://www.finra.org/web/groups/rules_regs/documents/rule_filing/p038160.pdf

This rule change imposes additional qualifications for being classified as a public arbitrator. With this change, to be classified a "public arbitrator", the arbitrator's firm must not have derive $50,000 or more in annual revenue in the past two years from professional services rendered to certain persons or entities relating to any customer disputes concerning an investment account or transaction, including law firm fees, accounting firm fees, and consulting fees. This rule change amends both the Customer Code (Rule 12100(u)) and Industry Code (Rule 13100(u)) and was approved by the SEC on March 20, 2008.

According to FINRA, this change in conjunction with the "10 percent" revenue limitation will ensure that "arbitrators whose firms receive a significant amount of compensation from any persons or entities associated with or engaged in the securities, commodities, or future business are removed from the public roster."

Insurance Coverage

Ryan v. National Union Fire Ins. Co. of Pittsburgh
(D. Conn 3/31/2008) 2008 WL 901476

An insurance company had a duty to defend a brokerage firm in a customer claim where a portion of the claim had no connection to the fact that the account was discretionary and the policy excluded claims brought on discretionary accounts.

In this action, a brokerage firm and its principals brought suit against its insurance company to recover costs of defending itself in an NASD arbitration proceeding brought by a former customer of the firm. The insurance company initially denied coverage, but after the customer's arbitration hearing had started, the insurer agreed to provide a defense. The insurance company also ultimately paid the arbitration award.

The customer had alleged damages arising, in part, from the brokerage firms' discretionary control over the customer's account. The insurance policy for the firm excluded coverage for claims brought on discretionary accounts. Although the customer alleged that the broker exercised such discretionary control, a number of the claims asserted by the customer did not depend on the degree of control the broker exercised, and had no causal nexus to the broker's control of the account. These included the allegations that the broker made inappropriate investment recommendations; and that the broker committed fraud or negligent misrepresentation by, inter alia, failing to disclose the risks and costs associated with margin trading, the volatility of the stocks in the customer's account, and the amount of commissions the brokers received, and by falsely marking unsolicited trades as solicited.

Under these circumstances, the insurance company had a duty to indemnify the brokers and the firm. Accordingly, the insurance company had a corresponding duty to defend.

Representing Parties in Arbitration: Fee Splitting

Prudential Equity Group, LLC v. Ajamie
(S.D.N.Y. 2/27/2008) --- F.Supp.2d ----, 2008 WL 510047

A fee sharing agreement between attorneys who were representing a party in an arbitration held in New York could be enforced as written, even though one of the attorneys was not licensed to practice law in New York.

This case involved a dispute between two groups of attorneys who had represented a party in an arbitration held in New York. One

group ("Weiss") was licensed to practice in New York; the other group ("Ajamie") was not. The attorneys had entered into a fee-sharing agreement, from which the Weiss group was attempting to escape.

Prudential Equity filed this interpleader action regarding the disposition of the attorneys' fees arising out of an arbitration, because of a dispute between the attorneys over who should get the fees, and in what amount.

The Weiss group contended that the fee-sharing agreement with the Ajamie defendants could not be enforced, and that the Ajamie defendants were therefore not entitled to any of the attorneys' fees because Ajamie engaged in the unauthorized practice of law by participating in an arbitration in New York when he was not admitted to the New York bar.

Even though the court concluded that "this argument wins the Oscar for chutzpah" as Weiss brought Ajamie into the arbitration, the court relied on New York case law holding that a non-New York lawyer participating in an arbitration in New York did not commit unauthorized practice under New York law. The court then observed that the three requirements for fee sharing under New York law (DR 2-107(A)) were met, partly due to the fact that "by a writing given the client, each lawyer assume[d] joint responsibility for the representation". The fee agreement made plain to the clients and to Ajamie that Weiss, while remaining jointly responsible for the representation, was delegating the actual trial work to Ajamie and, concomitantly, was now providing Ajamie with a larger share of the fee.

This rule would require Ajamie to pay the attorneys he hired to work on the arbitration were it not for the fact that the amended fee agreement also contained a specific provision to the contrary. The agreement provided that Weiss agreed to pay all amounts due to other lawyers or law firms who made a claim or lien in the case, from his share of the attorneys' fees.

Representing Parties in Arbitration: Attorney Discipline

Attorney Grievance Com'n of Maryland v. Parsons
(Md 4/15/2008) --- A.2d ----, 2008 WL 1722075

An attorney (who was also president and legal counsel for a NASD member firm) was disbarred for (1) lying about his licensing status, in an application for admission pro hac vice in an Illinois action; (2) unauthorized practice of law; and (3) approving a press release for his company in which it was stated that the company had $100 million under management, when in fact the company had only $20 million under management, a fact known to the attorney.

As to the unauthorized practice of law, respondent attorney had been "decertified" by the Maryland bar in 1997, and had never been admitted to practice law in any jurisdiction other than Maryland and the District of Columbia. The facts showed that even though the attorney was not admitted in the State of New York, and did not have an active license to practice in any jurisdiction in the United States at the time, he nonetheless held himself out as a general counsel to DuPont Direct Financial Holdings, Inc. and DuPont Securities Group, Inc. on numerous occasions and represented individuals and companies in arbitration proceedings on several occasions in New York and in other states. On one occasion, he represented parties in a court proceeding in the Northern District of Illinois. As a result, the attorney was clearly practicing law in New York and elsewhere without being licensed to do so.

As to the misrepresentation as to the company for which he worked, the attorney's conduct violated Rule 8.4(c), which prohibits attorneys from engaging in conduct involving 'dishonesty, fraud, deceit or misrepresentation.'

The evidence showed that the attorney, as president and general counsel of DuPont

Direct, approved the issuance of a press release which was designed to deceive potential investors in his company by making the company appear more successful than it actually was. His motive in doing so was to induce potential investors to buy stock in a company in which he served as president, director, and chief legal officer based on false representations. His failure to defend himself in the NASD proceeding in which the press release was an issue reinforces these conclusions. His conduct was deceitful and violated Rule 8.4(c).

AFTER THE ARBITRATION CHALLENGING/CONFIRMING ARBITRATION AWARDS

Scope of Judicial Review of Arbitration Awards

Hall Street Associates, L. L. C. V. Mattel, Inc.
(U.S. 3/25/2008) 552 U.S. __, 128 S.Ct. 1396, 2008 WL 762537

Parties to an arbitration agreement cannot contractually agree to expand the scope of judicial review of an arbitration award under the Federal Arbitration Act.

The Federal Arbitration Act (FAA), 9 U. S. C. §§9–11, provides expedited judicial review to confirm, vacate, or modify arbitration awards. Under §9, a court must confirm an award unless it is vacated, modified, or corrected as prescribed in §§10 and 11. Section 10 lists grounds for vacating an award, including where the award was procured by "corruption," "fraud," or "undue means," and where the arbitrators were "guilty of misconduct", or "exceeded their powers". Under §11, the grounds for modifying or correcting an award include "evident material miscalculation", "evident material mistake", and "imperfect[ions] in [a] matter of form not affecting the merits".

In this case, the parties' arbitration agreement required the court to vacate, modify, or correct any award if the arbitrator's conclusions of law were erroneous. The District Court largely upheld the arbitrators' award, applying the parties' stipulated review standard. The Ninth Circuit reversed, holding that the arbitration agreement's terms fixing the mode of judicial review were unenforceable, given the exclusive grounds for vacatur and modification provided by FAA §§10 and 11.

The Supreme Court held that the FAA's grounds for vacatur and modification of awards are exclusive for parties seeking expedited review under the FAA. The court viewed §§9–11 as the substance of a national policy favoring arbitration with just the limited review needed to maintain arbitration's essential virtue of resolving disputes straightaway. The court held open the possibility that there may be other avenues for judicial enforcement or review of arbitration awards, other than under the FAA.

Vacatur:
Manifest Disregard, Res Judicata

Tortorich v. Musso
(E.D. La. 11/1/2007) 2007 WL 3244396

NASD Arbitrators act within their authority when they decide whether a prior arbitration award was res judicata and therefore barred a subsequent arbitration proceeding.

In this case, the investors had prevailed in an arbitration claim against Morgan Stanley. The investors then filed an arbitration against the Morgan Stanley brokers involved in their account. The brokers successfully moved the arbitrators to dismiss the second arbitration on grounds of res judicata. The investors' petition to vacate was denied by the court.

The investors argued the arbitrators manifestly disregarded the law regarding the privity element of res judicata, and thereby incorrectly decided that the first arbitration against Morgan Stanley barred the second arbitration against the brokers. The court

concluded that any error the arbitrators may have made in disregarding the cases cited by the investors on the issue of privity as an element for res judicata was not based upon ignoring a clearly governing principle of law.

Vacatur:

Arbitrator Bias
Manifest Disregard
Forum Fees

Merrill, Lynch, Pierce, Fenner & Smith, Inc. v. Clemente
(3rd Cir. 3/31/2008) 2008 WL 857756

A joke about cash in an arbitrator's exhibit binder was not enough to raise an impression of bias; an arbitration panel's decision on the authenticity of a document cannot be reviewed under the manifest disregard of the law standard; and because plaintiffs voluntarily submitted their dispute to NASD arbitration, they cannot later complain about the forum fee allocation by the arbitrators.

Plaintiffs filed a Statement of Claim with the National Association of Securities Dealers, Inc. ("NASD") against Merrill Lynch, stemming from an alleged "stop-loss order" that would have bound Merrill to either liquidate or convert the plaintiffs' investments if the value of the investments dropped by a certain percentage. After a fourteen-day arbitration hearing on plaintiff's claim, the panel denied all relief to the plaintiffs, and assessed forum fees on each party. Plaintiffs sought to vacate the award, which was denied by the district court.

The instances that the plaintiffs cited as demonstrating the arbitrator's bias did not rise to the level of demonstrating "evident partiality" in the court's view. First, the plaintiffs argued that the defendants' counsel and one of the arbitrators had an exchange in which counsel gave the arbitrator an empty binder, and the two joked that cash was inside the binder. The joke, while not in the best judgment of either the arbitrator or counsel, does not "powerfully suggest[ ]" that the arbitrator was so biased that he could not render a fair decision, especially considering that it was clearly a joke that was heard by everyone at the hearing.

Second, the plaintiffs alleged that the same arbitrator and Merrill Lynch personnel had ex parte communications, and argued that the arbitrator "likely determined ... that they were really 'a bunch of nice guys'" and " passed these sentiments on to the fellow panelists," and the three panelists decided to find in the defendants' favor as a result. The court concluded that this argument was, at best, speculative, and was far too tenuous for a reasonable person to conclude that the three panelists were biased in favor of the defendants.

Finally, the plaintiffs alleged that the same arbitrator possibly communicated with a Smith Barney executive regarding this arbitration because, when the plaintiffs contacted the executive to possibly testify on plaintiffs' behalf, he stated that he was aware that the arbitrator was on this panel. Plaintiffs argued that this alleged communication constituted witness tampering. However, the plaintiffs offered no proof as to how the executive knew the identity of the arbitrator; thus, any theory is once again speculative, and even if it were true, the contact involved one arbitrator, not the panel. Moreover, the plaintiff testified that the executive's reason for not serving as a witness for the plaintiffs was because he served on other arbitration panels, not because of any contact with the arbitrator, thus negating any suggestion of witness tampering.

The plaintiffs then argued that they presented the panel with a document that was "the equivalent of a smoking gun," and as a result, any decision other than one in favor of the plaintiffs demonstrated a "manifest disregard" of the laws of negligence and fraud. However, the authenticity of this document, which was a fax on Merrill Lynch's letterhead discussing the plaintiffs' instructions regarding their "stop-loss" order, was a contested issue during the arbitration proceedings. Thus, the

panel's decision did not demonstrate that it made a choice to manifestly disregard the law, but instead only that it made a choice not to credit a document as authentic. This question was one of fact, not of law, and therefore, the court could not find that the panel manifestly disregarded the applicable law.

The plaintiffs also argued that the panel's award of forum fees against the plaintiffs was invalid because it was unconscionable. Here, the plaintiffs chose to submit their claim with the NASD, seeking a NASD arbitration; the plaintiffs were not bound to arbitration "on a take-it-or-leave-it basis." Further, the arbitrators did not interpret or apply the provision to shift all of the costs to the plaintiffs. Instead, the panel assigned only fifty-two percent of the forum fees to the plaintiffs. Therefore, the panel's award of forum fees to the plaintiffs based on the arbitration provision was not unconscionable.

Vacatur:

Motion To Dismiss

Application of Statute of Limitations in Arbitration

Berkley v. Merrill Lynch, Pierce, Fenner & Smith

(S.D. Ohio 3/19/2008) 2008 WL 755875

Arbitrators did not manifestly disregard the law by applying state statute of limitations in granting a motion to dismiss a public customer's arbitration claim.

In the underlying arbitration, a NASD panel of arbitrators granted Merrill Lynch's motion to dismiss. Plaintiffs/claimants sought to vacate the arbitration award, raising a number of issues.

First, plaintiffs contended that the arbitrators demonstrated a manifest disregard of the law by failing to follow Ohio legal precedent, which holds that statutes of limitations are inapplicable to arbitrations. Second, plaintiffs further argued that the arbitrators also completely disregarded the Indiana Securities Act which provides a three year statute of limitations that begins to accrue upon actual knowledge of a violation of the act.

The court rejected those arguments, holding that the case law on statute of limitations was not a clearly defined legal principle. That case law had not been treated as controlling law by any other court. In contrast, other cases have indicated that a statute of limitations, albeit it a federal one, would be applicable in an arbitration proceeding. The court also pointed to the portion of NASD Rule 10304 which states that "This Rule shall not extend applicable statutes of limitations" as supporting the application of state statute of limitations. The court also pointed to the fact that the plaintiffs had argued to the panel that the statute of limitations, even if applicable, was tolled. The court therefore concluded that the arbitrators were presented with conflicting theories on the statute of limitations, and hence it was not a clearly defined legal principle that the arbitrators ignored.

Next, plaintiffs argued that the panel engaged in misconduct when they denied plaintiffs a hearing, by granting the motion to dismiss. Plaintiffs contended that they did not have an opportunity to put forth evidence as to the merits of their claims or even to the factors relevant to statutes of limitations, such as evidence needed to determine when those statutes accrued, tolled or lapsed. The court also rejected that argument. Plaintiffs admitted that the arbitrators heard oral arguments via a telephonic hearing. The court stated that there was no indication in the record that plaintiffs were not permitted to submit affidavits in support of their memorandum in opposition to the motions to dismiss. Since the panel did not issue a detailed opinion, there is no evidence that the panel did not treat the facts, as set forth in the statements of claims or as argued by counsel, as true for purposes of ruling on the motions to dismiss.

Plaintiffs then argued that the arbitrators exceeded their powers and imperfectly executed their powers by not holding a hearing and by dismissing plaintiffs' claims with prejudice, since the NASD Code of Arbitration Procedure Rule 10305 only allows for dismissal without prejudice. Although NASD Rule 10305 does permit dismissal without prejudice, Rule 10214 says that panels "shall be empowered to award any relief that would be available in court under the law." Because plaintiffs responded to the motions to dismiss and participated in oral arguments at the telephonic hearing, the court declined to find that the plaintiffs were denied fundamental fairness.

Vacatur: Institutional Bias

The Coffee Beanery Ltd. v. WW L.L.C.
(E.D. Mich. 5/23/2007) 501 F.Supp.2d 955, 2007 WL 1500533

An amorphous institutional predisposition in favor of one party by an organization administering an arbitration is not sufficient to vacate an arbitration award.

In this matter, a losing party to an AAA arbitration sought vacatur of the award on numerous grounds. The party argued that "[n]owhere was it disclosed to them that they would have to arbitrate their Maryland statutory claims in Michigan at great expense and ... that the AAA is biased or that the costs of an AAA arbitration ... are exceedingly high and unduly burdensome." Respondents then set forth fourteen aspects of AAA's arbitration process they believed "mandate that the arbitration be vacated."

The court summarily rejected each of those contentions. To the extent there was any merit to respondents' claim that the AAA is biased in favor of large corporations, such a broad indictment of the association fails to demonstrate "evident partiality" under Section 10 of the Federal Arbitration Act. The party seeking invalidation must demonstrate more than amorphous institutional predisposition toward the other side.

The party seeking vacatur also claimed that a witness gave false testimony at the arbitration hearing. To merit the vacation of an arbitration award for fraud as a result of false testimony, the movant must establish (1) clear and convincing evidence of fraud, (2) that the fraud materially relates to an issue involved in the arbitration, and (3) that due diligence would not have prompted the discovery of the fraud during or prior to the arbitration.

Even assuming that movants were able to prove the first two elements, there can be no doubt that movants were aware of or could have discovered the alleged falsity of the witness' testimony during the arbitration. Because movants therefore had the opportunity to cross-examine witness with regard to the alleged perjury, the court concluded that fraud was not a basis for vacating the arbitration award.

Vacatur/Remand: Ambiguous Award

Rich v. Spartis
(2nd Cir. 2/08/2008) 516 F.3d 75, 2008 WL 343330

Remanding a matter to the arbitrators for clarification is appropriate where the award is so ambiguous that the court could not tell whether the award was based on investments for which claimants could not recover due to their participation in a class action involving those investments.

A NASD panel awarded claimants damages against Solomon Smith Barney, Inc. ("SSB") and stockbroker representatives employed by SSB. Claimants' statement of claim in the arbitration focused on losses sustained in Worldcom stock. Claimants did not opt out of the Worldcom class action. Claimants and SSB agreed that Claimants could not be awarded any damages arising out of their Worldcom losses. However, there was a dispute between the parties as to whether evidence of non-Worldcom losses or other damages were presented or argued to the arbitrators. The arbitrators did not make clear

whether their award was related to Worldcom or to other investments or losses.

At SSB's request, the district court vacated the award. The district court found that "[t]he award's own description of the claims focused exclusively on WorldCom and described no other stock." In addition, the arbitrators refused to clarify their award (at the parties' request) after the arbitrators were informed that no recovery could be had for WorldCom losses. The District Court concluded that the award must be vacated on the ground that the arbitrators exceeded their authority when they granted damages based on claimants' WorldCom trading losses

The Court of Appeals remanded. After acknowledging that an arbitration panel may render a lump sum award without explaining its reasons for the award, the court concluded that the unique situation presented here dictated that the award be clarified. All parties agreed that the claimants could not recover for their WorldCom trading losses, but it was not clear whether those losses were reflected in all, part, or none of the award. What was missing was an assessment by the arbitration panel sufficient to enable the court to determine the validity of the award in this unusual case. The confusion in the award arises from the actions of the panel itself.

In ordering a remand for clarification, the court expressly did not require the arbitrators to state their reasons, but required the arbitrators to explain their "indefinite, incomplete, and ambiguous award" to allow effective judicial review. The court emphasized that the reason for remand to the arbitrators was not simply due to the fact that a lump sum was awarded without explanation, but was due to the unique circumstances of this case where it was impossible to tell what the lump sum was for.

Confirmation of Award
Not Violative of Public Policy
Not Irrational
Not Exceed Enumerated Limit on Power

NFB Inv. Services Corp. v. Fitzgerald (N.Y.A.D. 3/18/2008) 854 N.Y.S.2d 457, 2008 WL 740516

A NASD arbitration award in favor of a former brokerage firm employee, for defamation and expungement arising out of the "reasons for termination" reported by the brokerage firm to the NASD, was not violative of public policy, was not irrational and did not clearly exceed a specifically enumerated limitation on the arbitrator's power, and was therefore properly confirmed.

The brokerage firm fired the respondent, who was its employee and a broker, on the ground that he violated New York State Insurance Department Regulation 60 when he undertook to sell an annuity for a client, the proceeds of which he ultimately used to purchase a new annuity for the client. In a form required to be filed with the NASD, the firm reported that it fired the respondent for the violation. Asserting that the claimed violation was a pretext for firing him, the employee initiated an arbitration proceeding before the NASD to purge the NASD form of the claimed violation and for damages for defamation.

The arbitration panel rendered a decision purging both the original NASD form and an amended form regarding a client complaint that was filed by the brokerage firm subsequent to firing the employee. The panel awarded the respondent the sum of $50,000 in damages for defamation. The brokerage firm sought to vacate the arbitration award under New York arbitration law.

In rejecting the brokerage firm's arguments, the New York state court held that an arbitrator is not bound by principles of substantive law or rules of evidence, and may

do justice and apply his or her own sense of law and equity to the facts as he or she finds them to be. The lower court properly determined that the arbitration award was not violative of public policy, was not irrational and did not clearly exceed a specifically enumerated limitation on the arbitrator's power. (The court did not discuss *Rosenberg v. MetLife, Inc*., (NY 3/29/2007) 8 N.Y.3d 359, 866 N.E.2d 439, 834 N.Y.S.2d 494, in which the court held that statements on a U-5 form were privileged under New York law. However, the arbitration award in this case was issued before that decision, and the lower court confirmed the award before the Rosenberg decision was issued.)

Vacatur: Expungement

Kay v. Abrams & NASD
(N.Y. Sup. 2/21/2008) 853 N.Y.S.2d 862, 2008 WL 451440

In the absence of grounds to deny confirmation of an arbitration award which included an expungement directive, the New York Attorney General would not be granted leave to intervene in a petition to confirm that arbitration award. An arbitration award granting expungement but not containing any of the findings listed in NASD rule 2130 can still be confirmed in court.

In this matter, a broker sough confirmation of a FINRA arbitration award which included an expungement directive to FINRA. The arbitrators did not hold an evidentiary hearing, but the award did specify one of the grounds for expungement as listed in NASD Rule 2130. FINRA did not object to confirmation of the arbitration award, but the New York Attorney General sought leave to intervene in the action to confirm the award.

The Attorney General contended that the State of New York had certain ownership interests in the CRD records. The Attorney General took the position that because of the claimed partial state ownership interest in CRD records, the arbitrator lacked the power to grant expungement as such an order would, in essence, be destroying state property. Consequently, according to the Attorney General, the court lacked the power to confirm the award.

FINRA, on the other hand, took the position that it waived its right to be a party in this confirmation proceeding since the arbitrator made one of the three findings required under Rule 2130. FINRA stated its intent in adopting Rule 2130 was to in no way affect the law with respect to the judicial confirmation of arbitration awards.

The court concluded that since no basis had been alleged to deny confirmation, other than the legal arguments of the Attorney General referred to above, the broker's motion to confirm the award was granted. In light of the foregoing, the application of the Attorney General to intervene was denied as moot.

However, the court acknowledged that it had reservations about the existing law on the issues presented in this case, which resulted in the confirmation of an award on which the arbitrator gave no explanation for his factual finding.

Vacatur/Modification: Attorneys Fees

Morrell v. Wedbush Morgan Securities Inc.
(Wash.App. 3/11/2008) 178 P.3d 387, 2008 WL 639629

A trial court lacks the authority to modify an arbitrators' award to include attorney fees, where the arbitration panel specifically declined to award attorney fees to either party.

In the NASD arbitration underlying this action, the arbitration panel awarded the customer claimants damages against Wedbush Morgan Securities, Inc. for breach of fiduciary duty – but in a lesser amount than claimed. The panel denied the claimants' unsuitability claim and did not reach their breach of contract claim. The arbitration panel also awarded prejudgment interest on the compensatory

damages award. The panel declined to award attorney fees to either party.

The customer claimants sought a court order modifying the arbitrators' award to include an award of attorney fees pursuant to a contract between the claimants and Wedbush Morgan which provided for an award of attorneys fees to the prevailing party. The trial court modified the arbitration award and granted the customer claimants their attorney fees. The court of appeals reversed, holding that under either California or Washington law, the court did not have the authority to modify the arbitrators' decision denying attorney fees to the customer claimant.

The court first rejected Wedbush's claim that forum selection clause in account agreement required that the action seeking to modify the award must have been filed in California. According to the court, because the customers lived in Washington, the broker was in Washington, and the arbitration hearing was held in Washington, enforcement of the forum selection clause would be unreasonable.

The account agreement provided for the application of California law. However, instead of addressing the conflicts of law issues, the court analyzed the case under both California and Washington arbitration law, and reached the same conclusion.

Applying California law, the court held that the arbitrators did not exceed their powers in holding that the customers were not the prevailing party and thus not entitled to attorney fees. The customers had asked the arbitration panel to award them their attorney fees, and the panel declined to do so in light of all of the claims and defenses raised.

Applying Washington law, the court concluded that the face of the award showed that the customers succeeded on only one of their eight original claims and that their final award was decreased by the panel's conclusion that the customers should have mitigated their losses, and by the recognition of the partial redress Wedbush had already provided. According to the court, the face of the award supported the panel's decision that neither party prevailed for the purpose of awarding fees.

SUBSTANTIVE ISSUES

Broker Regulations

Record Retention Requirements for Broker Dealers Relaxed
http://www.finra.org/RulesRegulation/NoticestoMembers/2008Notices/P038023

On February 19, 2008, the SEC issued a no action letter at the request of FINRA that relieves broker dealers of the obligation to retain certain records that are on the Web-CRD system, as follows:

> On the basis of the facts and representations contained in your letter, the Division will not recommend to the Commission enforcement action under Rule 17a-4 if a FINRA member relies on Web CRD to satisfy its record retention requirements under Rule 17a-4 for the following registration-related records filed with and maintained on Web CRD:
>
> • Form U4 amendments that do not require the registered person's signature;
>
> • Form U5 filings (both initial Forms U5 and any amendments) that do not require the registered person's signature; and
>
> • Form BR filings (both initial Forms BR and any amendments).

ERISA: Participant Standing

LaRue v DeWolff, Boberg & Assoc., Inc.
(U.S. 2/20/2008) ___ U.S. ___, 128 S.Ct. 1020.

A participant in a defined *contribution* pension plan governed by ERISA does have standing to enforce fiduciary obligations of the plan administrator, whereas a participant in a defined *benefit* pension plan does not have standing to bring such a claim.

In this case, the petitioner, a participant in a defined contribution pension plan, alleged that the plan administrator's failure to follow petitioner's investment directions "depleted" his interest in the plan by approximately $150,000 and amounted to a breach of fiduciary duty under the Employee Retirement Income Security Act of 1974 (ERISA). In dismissing the claim, the lower courts held that ERISA provides remedies only for entire plans, not for individual plan participants.

The Supreme Court reversed. Although ERISA does not provide a remedy for individual injuries distinct from plan injuries, it does authorize recovery for fiduciary breaches that impair the value of plan assets in a participant's individual account. Section 502(a)(2) of ERISA provides for suits to enforce the liability-creating provisions of section 409 of ERISA, concerning breaches of fiduciary duties that harm plans. The principal statutory duties imposed by § 409 relate to the proper management, administration, and investment of plan assets, with an eye toward ensuring that the benefits authorized by the plan are ultimately paid to plan participants. The misconduct that the participant alleged in this case fell squarely within that category.

The Court distinguished this case from instances where the claimant is a participant in a defined benefit plan. In those situations, the ERISA plan promises participants a fixed benefit. Misconduct by such a plan's administrators would not affect an individual's entitlement to a defined benefit unless it creates or enhances the risk of default by the entire plan.

For defined contribution plans, however, fiduciary misconduct need not threaten the entire plan's solvency to reduce benefits below the amount that participants would otherwise receive. Whether a fiduciary breach diminishes plan assets payable to all participants or only to particular individuals, it creates the kind of harms that concerned § 409's draftsmen.

Statute of Limitations: Right to Remedy

Lopardo v. Lehman Bros., Inc.
(N.D. Ohio 3/6/2008) 2008 WL 657830

A provision of a statute of limitations in Ohio's blue sky law was found to violate the Ohio state constitution's "right to remedy" provision, to the extent the statute of limitations barred an action regardless of when or whether the injured person discovered the harm.

In this action, former customers of a broker sought to recover damages for securities fraud. The brokerage firm moved to dismiss, relying primarily on statute of limitations found in Ohio state securities law.

The court first rejected the firm's claim that the plaintiff (the purported beneficiary of a trust) did not have standing to pursue the claim. The firm relied on the brokerage account statements, which reflected that the account was titled as being in a trust, of which the plaintiff was allegedly only a beneficiary. However, according to the court, the fact that a securities account is titled as a trust doesn't necessarily mean that the account was in fact held in a trust. Based on the evidence before the court, there was no way to determine whether the account at issue is a trust account with a separate trustee, or whether the plaintiff, in fact, owned the account.

The firm had also moved to dismiss based on the running of the statute of limitations under

Ohio's state securities laws (among other arguments). The court extensively analyzed the distinction between statute of limitations and statutes of repose, in connection with the Ohio constitution's "right to remedy" provision. That section provides:

> [a]ll courts shall be open, and every person, for an injury done him in his lands, goods, person, or reputation, shall have remedy by due course of law, and shall have justice administered without denial or delay.

The court concluded that statutes of repose – in which the limitations period could expire before a legally cognizable injury had even occurred -- were not invalid under that provision. In contrast, however, statute of limitations that cut off recovery after an injury has occurred but before the injured person discovered or reasonably could have discovered the injury, were invalid under the Ohio constitution.

Turning to the Ohio securities act's time limitations, the court held that the provision that sets an absolute time bar for claims to be filed (which at the time was four years from date of the transaction), regardless of whether the victim knew about his or her claim, violated the Ohio state constitution's "right to remedy" provision.

Statute of Limitations: Continuous Relationship

Ciccone v. Hersh
(S.D.N.Y. 1/08/2008) 530 F.Supp.2d 574

Absent special circumstances, a broker does not owe a fiduciary duty to his customer in a non-discretionary account beyond the purchase of the investment. Further, the statute of limitations could not be tolled under the "continuing relationship of trust and confidence" theory beyond the last date the parties communicated.

In this case, a former floor trader for Charles H. Schwab Inc. sought to recover damages from his investment advisor and broker. The broker had been the personal investment and financial advisor for the investor since 1992.

The investor was employed by Schwab for approximately eighteen years and was entitled to receive options for shares of stock in Schwab as part of his compensation package upon retirement. By April 2000, the shares had declined in value from approximately $7 million to $5 million. In May 2000, the investor retired from Schwab and received approximately $5.6 million in exchange for the shares.

In or around March and April 2000, the investor sought advice from the broker about retirement and investment options. The broker advised the investor to put a substantial amount of his retirement funds into a variable annuity, which the investor did. By September 2001, the value of the annuity had decreased by more than 50 percent, but the broker advised the investor to remain in the annuity. The investor last communicated with the broker in or about January or February 2002. In November 2002, the investor was informed that Nationwide Planning Associates ("Nationwide") was the current broker/dealer of record for the annuity and that the broker was still the agent of record.

The court first rejected the investor's argument that the broker owed a fiduciary duty beyond the purchase of the annuity, based on its application of *De Kwiatkowski* principles. According to the court, with respect to nondiscretionary accounts, the Second Circuit has recognized that, in "special circumstances," a broker may owe a broader duty to a client than a purely transactional one to prevent the brokers from taking "unfair advantage of their customers' incapacity or simplicity." The court was not persuaded that the investor here was the "naive and vulnerable client[s]" protected by "special circumstances". The investor did not allege that he had "impaired faculties", "a closer than arms-length relationship with [the broker]," or that he was "so lacking in

sophistication that de facto control of the [investments was] deemed to rest in [the broker]." On the contrary, the investor had worked on the floor of the New York Stock Exchange for Schwab for over twenty years and retired as a floor broker responsible for executing trades. Accordingly, the theory of "special circumstances" did not broaden the scope of the broker's duty to the investor beyond that owed at the time the investments were purchased in 2000.

The court then rejected the investor's claim the statute of limitations was tolled until 2005. The investor argued that there was a continuing relationship of trust and confidence, because the broker remained the "agent of record" on the investments until 2005. The court was not persuaded that the investor retained a continuous relationship of trust and confidence with the broker with respect to the investments through 2005 because: (1) the investments were purchased in 2000; (2) the broker lacked discretionary authority to make any changes to the investments; (3) the investor retained control over the investments and full responsibility for trading decisions with respect to the annuity; (4) the investor was aware that the annuity's value had decreased by 50 percent in 2001; (5) in 2002, the broker told the investor that there was a possibility the annuity might lose all of its value; and (6) the investor did not communicate with the broker since in or about January or February 2002.

Even if the investor could sufficiently establish that a form of fiduciary relationship existed between the parties based on the broker's advice and other actions pertaining to the investments, the latest date plaintiffs could argue that such a relationship existed would be in January or February 2002, when the parties last communicated. Therefore, February 2002 was the latest date the cause of action could have accrued or the last date on which the statute of limitations may have been tolled. Since this action was commenced in February 2006, more than three years after the latest date for accrual or when tolling stopped, the statute of limitations had run.

Jurisdiction of State Courts under SEA

Financial Industry Regulatory Authority, Inc. v. Fiero
(N.Y. 2/07/2008) 10 N.Y.3d 12, --- N.E.2d ----, 2008 WL 320330

State courts do not have subject matter jurisdiction over an action by NASD/FINRA to collect a disciplinary fine; instead, such an action must be filed in the U.S. district courts, under the Securities Exchange Act.

In this case, NASD brought this action to enforce and collect a penalty imposed on the brokers as a result of disciplinary proceedings under the Securities Exchange Act, for violations of the Securities Exchange Act and its implementing rules. The NASD was not seeking to adjudicate a state law claim.

Section 27 of the Securities Exchange Act vests federal district courts with exclusive jurisdiction to entertain such a suit. Thus, state courts do not possess the power to hear and decide this controversy.

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Upcoming Events:

Deadline for receiving submissions to the Summer 2008 Bar Journal, August 1, 2008

PIABA Board of Directors Meeting, July 19-20 2008. The Ritz-Carlton Dearborn. Dearborn, Michigan.

PIABA 17th Annual Meeting. Expert, Consultant & Mediator Materials due to PIABA Office, August 1, 2008

Deadline for receiving submissions to the Fall 2008 Bar Journal, October 3, 2008

PIABA 10th Annual Securities Law Seminar, October 22, 2008. The Broadmoor. Colorado Springs, Colorado.

PIABA 17th Annual Meeting, October 23-25, 2008. The Broadmoor. Colorado Springs, Colorado.

PIABA Annual Business Meeting and Election of Directors. October 23, 2008. The Broadmoor. Colorado Springs, Colorado.

PIABA Board of Directors Meeting, October 26, 2008. The Broadmoor. Colorado Springs, Colorado

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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