Public Investors Arbitration Bar Association Vol. 15 No. 2 Summer 2008

PIABA Bar Journal

STRATEGIES AND RESOURCES FOR YOUR PRACTICE

Features And Columns

www.PIABA.org

The Bar Journal of the
Public Investors Arbitration Bar

From the Editor's Desk

by Samuel B. Edwards
PIABA Bar Journal
Editor-in-Chief
Shepherd, Smith & Edwards
1010 Lamar, Suite 900
Houston, TX 77002
713.227.2400
713.227.7215 fax
sedwards@sselaw.com

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

Submission Requirements to PIABA Bar Journal

The deadline for receiving submissions for the Fall, 2008 issue of *PIABA Bar Journal* is November 21, 2008. All submissions should adhere to the following format:

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

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

Submissions may be sent by e-mail to Robin Ringo at rsringo@piaba.org or Samuel Edwards at sedwards@sselaw.com.

By mail, send submissions to:

PIABA
Attn: Robin Ringo, Exec. Dir.
2415 A Wilcox Drive
Norman, OK 73069
Office: 1.405.360.8776
Toll Free: 1.888.621.7484
Fax: 1.405.360.2063
E-Mail: PIABA@PIABA.ORG
Website: www.PIABA.ORG

PIABA Bar Journal *is a publication of The Public Investors Arbitration Bar Association (PIABA) and is intended for the use of its members. Statements and opinions expressed are not necessarily those of PIABA or its Board of Directors. Information is from sources deemed reliable, but should be used subject to verification.*

President's Column

Laurence S. Schultz

Dear Members:

Re: The Election
The Market Disaster of 2008
The Brokerage Industry Complicity and Mandatory Arbitration

By the time you read this, America will have a new President. Many observers have said this is the most important election of our lifetime. It is indeed the most important election for investors and for those who represent them. And for those who oppose mandatory investor arbitration, it may present the chance of a lifetime.

If we have a Democratic President, combined with a Democratic Congress, there is a strong likelihood that the Arbitration Fairness Act, which would ban mandatory arbitration, will actually come up for a vote in Congress. After 21 years of being denied access to the courts, investors may, just may, have an opportunity to return to the pre-McMahon structure, with arbitration being available as an alternative to court, at the election of the investor.

PIABA's position in support of investor choice was stated clearly in our written testimony before the Senate Finance Subcommittee on December 12, 2007 (see a copy of our written testimony on the Web site at https://secure.piaba.org/piabaweb/html/modules/ContentExpress/img_repository/December122007.pdf

We also issued a December 12th press release in support of the Arbitration Fairness Act. Virtually every member of the Board of Directors participated in the development of our position paper in support of the Arbitration Fairness Act, which would effectively prohibit pre-dispute arbitration clauses.

Assuming a Democratic victory, it will be more important than ever for PIABA to muster its forces in support of this legislation. And if the Republicans prevail, we must still continue the fight.

But the membership must appreciate the extent to which PIABA's positions, even on issues which may seem as obvious as opposing mandatory arbitration, remain subject to debate within our organization.

In 1990, when PIABA was formed, we did not oppose mandatory arbitration. Instead, our objective was to level the playing field to make the arbitration system fair for investors

Larry Schultz is a graduate of the University of Michigan Law School and has practiced in both Chicago and Detroit. He is a founding member and shareholder of the Troy, Michigan, law firm Driggers, Schultz & Herbst. He has specialized in securities law, with specific emphasis on securities litigation and arbitration, for over twenty years. He can be reached at 248-649-6000 or lssarb@aol.com.

and to educate our members in working within the existing arbitration rules and procedures.

It has only been after experiencing years of inexorable deterioration of arbitration results, where the investor win rate has declined from over 60 percent in the 1990's to just 37 percent in 2007, and where investor recovery rates have similarly declined from over 60 percent in the 1990's to just over 36 percent in 2006, that we have been forced to the conclusion that the system is fundamentally unfair and should no longer be imposed upon investors to prevent access to the courts.

But even now, opposition to mandatory arbitration is not by any means shared by all members of PIABA. Many members have voiced concern that banning mandatory arbitration will not assure investor choice. Their concern is that the brokerage industry will use its political and economic power to eliminate investor choice if they lose the right to impose mandatory arbitration on investors. And they believe the industry may persuasively argue that investor choice would be unfair because it would allow investors to cherry-pick big cases to go to court, leaving smaller cases for arbitration. And if the industry successfully defeated investor choice, and all cases went to court, the thought is that smaller claims, not viable for court proceedings, could no longer be economically pursued.

Further, attorneys whose practices include combining multiple claims involving product failures are concerned that, if forced into court, their claims would be tossed out based upon a SLUSA analysis. So their basic concern is that investor choice simply will not survive if mandatory arbitration is prohibited.

I still believe that, as set forth in our December presentation to Congress, PIABA must support the Arbitration Fairness Act and continue to oppose mandatory arbitration. I also believe the chances of losing investor choice are virtually nonexistent. Investor choice is a principle historically enshrined in the NASD and NYSE arbitration rules as part of the basic structure of self-regulatory arbitration. It has never been related to whether or not predispute arbitration agreements can be enforced. A change in the rule would require FINRA to support a new rule proposal banning investor choice and providing that FINRA investor arbitration could only occur by mutual consent. Practically speaking, this would result in dismantling of the FINRA investor arbitration system.

I question how FINRA, whose mantra is investor protection, could justify supporting an obvious anti-investor rule change to eliminate investor choice. It is also difficult for me to believe that the Securities and Exchange Commission (or whatever regulatory structure may succeed it after the self-destruction of our financial system is complete) could in the interest of investor protection support such a position.

Even more significant would be the position of Congress. I simply can't imagine that, after the brutal beating investors have suffered at the manipulative hands of both the brokerage and investment banking industries, any Democratic Congress which had just voted to ban mandatory arbitration in the interest of investor protection, would sit idly by while the brokerage industry counterattacks to deny its investor victims access to arbitration. Remember, we are dealing with a venal industry which in its unbelievable greed has just destroyed our entire economy, or at the very least come within an eyelash of doing so. Their political capital has been exhausted.

The bottom line is that the 2008 market debacle has resulted in investor losses greater than any in our lifetime, changing the lives of most investors forever and leaving many in ruin. We can only hope there will never be another point in time when investors will be so badly mauled.

But there also is a positive side to this calamity. Both the support and sympathy for investors, and the disgust and antipathy in

response to the greed and deception of the brokerage industry, may never be stronger. In this climate, a proposed ban on mandatory arbitration is as compelling as it could ever be, and the possibility of a follow-up ban on investor choice should be of no real concern.

And the chances of success are better still with the synergism of the disastrous market forces of 2008 and a Democratic political victory. There will never be a more opportune time to defeat mandatory arbitration and to improve the fairness of the arbitration process. We cannot pass it up.

In closing, I thank you for the opportunity to serve PIABA this past year and wish you all success in your future practice.

Sincerely,

Larry

Laurence S. Schultz
Driggers, Schultz & Herbst, P.C.
2600 West Big Beaver Road, Suite 550
Troy, Michigan 48084
Phone: (248) 649-6000
Fax: (248) 649-6442

The Prospectus Defense in Securities Arbitrations

Carl J. Carlson

Carl J. Carlson *received his B.A. from Stanford University (1972) and his J.D. from Stanford Law School (1976). He has practiced commercial litigation in Seattle for 30 years, and has handled securities arbitration cases since 1991. Mr. Carlson established his own firm in 1995 emphasizing investor litigation and trust and estate litigation. He recently completed a three year term on the Washington State Bar Association Board of Governors, and previously served on the King County Bar Association Board of Trustees. Mr. Carlson is an arbitrator for FINRA. He writes and lectures extensively on investor litigation and trust & estate litigation. He can be reached at carl@carlsonlaw.com, or 206-621-1111.*

Federal and state securities laws impose liability on a seller for making misrepresentations in a prospectus. This article covers the opposite case: the defense that a *truthful* prospectus was delivered to a customer, negating oral (or other written) misrepresentations.

The prospectus defense applies quite differently to statutory claims, as opposed to common law fraud and misrepresentation claims. While claimants' counsel often disregards federal statutory (or SEC Rule 10b-5) claims in the typical securities arbitration, most state securities acts are based largely on federal statutes. So understanding how the prospectus defense applies to state securities act claims must begin with understanding the federal statutes on which those laws are based. And understanding how the prospectus defense applies to common law fraud and misrepresentation claims must begin with the federal law that has developed under Rule 10b-5.

1. § 12(a) of the Securities Act of 1933: no reliance required, and no constructive knowledge of prospectus imposed on buyers.

§12(a)(2) of the Securities Act of 1933[1] [often referred to as § 12(2)] imposes liability for both oral and written misrepresentations made in connection with an *initial* public offering or distribution of securities—i.e., in a registered prospectus, or other solicitation materials used in connection with a registered securities offering. It does not apply to private placement memorandums, nor to transactions in the secondary market. Lipner, Seth E., and Long, Joseph C., *Securities Arbitration Desk Reference*, § 5:52 (2005) ("*Lipner & Long*").

Actual knowledge. Under §12(2) sellers are liable for misrepresentations only to "purchaser[s] not knowing of such untruth or omission." A claimant's *lack of actual knowledge* of the falsity of a representation is an element of a § 12(2) claim. So if a customer has actually read a prospectus and knows its contents prior to buying a security, the seller can assert disclosures in the prospectus in defense of claims

---

[1] 15 USCS § 77l. **Civil liabilities arising in connection with prospectuses and communications.** (a) In general. Any person who--

> (2) offers or sells a security . . . by the use of . . . a prospectus or oral communication, which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading (the purchaser not knowing of such untruth or omission), and who shall not sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of such untruth or omission, shall be liable. . . to the person purchasing such security . . . .

based on oral or other misrepresentations. The disclosures in a prospectus are generally held to be only one factor in considering whether a buyer had actual knowledge of the falsity of other representations, but often it is a decisive factor.

Constructive knowledge. But Respondents also sometime contend that, as long as the prospectus (or Offering Memorandum or Subscription Agreement) was delivered to a buyer, even if the buyer did not read the documents, knowledge of its contents should be imputed to him. That defense can be bolstered by an integration clause or other language in the offering documents reciting that the information in the official documents supersedes everything else and is the only information on which a buyer should rely.

The great weight of authority holds that in §12(2) claims mere delivery of a prospectus will not impose ***constructive knowledge*** of its contents on the buyer, largely because the explicit language of the statute makes only actual knowledge an element of the claim. *Casella v. Webb*, 883 F. 2d 805, 808-809 (9th Cir., 1989), and cases cited therein.

In *Casella v. Webb* the plaintiffs alleged both §12(2) and common law fraud claims. Plaintiffs asserted they had not read the Offering Memorandum, but had relied on the seller's oral representations about the securities. The trial court granted the defendants summary judgment on the ground that the buyers "are presumed to know the information contained in the Offering Memorandum and cannot rely on oral statements to the contrary." The 9th Circuit reversed, explaining the generally accepted rule:

> Constructive knowledge cannot bar a purchaser's recovery under section 12(2). . ..
> Sellers are charged with constructive knowledge under section 12(2), but purchasers are not. . . . [P]urchasers may recover unless they have actual knowledge of the untruth or omission. . . . "Constructive knowledge, which plaintiff might have acquired by exercising ordinary care, will not preclude him from recovery. . . . Contributory negligence has been rejected as a defense under § 12(2)." 3 A. Bromberg & L. Lowenfels, *Securities Fraud and Commodities Fraud* § 8.4(317), at 204.14-204.15 (1986). "A plaintiff under §12(2) is not required to prove due diligence. All that is required is ignorance of the untruth or omission." *Sanders v. John Nuveen & Co*., 619 F.2d 1222, 1229 (7th Cir. 1980) (citation omitted); *accord Alton Box Bd. Co. v. Goldman, Sachs & Co.,* 560 F.2d 916, 919 n. 3 (8th Cir. 1977); *Hill York Corp v. American Int'l Franchises, Inc*., 448 F.2d 680, 696 (5th Cir. 1971); cf. Gilbert v. Nixon, 429 F.2d 348, 356 (10th Cir. 1970).

2. State Securities Act claims patterned on § 12.

Three Uniform Securities Acts are presently in effect: the Uniform Securities Act of 1956, adopted (but often substantially modified) in about 30 states[2]; the Revised Uniform Securities Act of 1985 (RUSA), adopted in only 6 states[3], and the Uniform Securities Act of 2002, adopted in 10 states.[4] *Lipner & Long,* § 7.1; *Uniform Securities Act of 2002*, Prefatory Note. Several large states have not adopted any version of the Uniform Act, including California, Florida, Texas and Ohio. This discussion does not take into account variations in those states' statutes.

---

[2] See *Lipner & Long*, § 7.1 for a list of those states.

[3] CO, D.C., MT, NV, NM, and RI.

[4] ID, IA, KN, OK, ME, MO, SC, SD, VT and Virgin Islands.

The liability provisions of all three Uniform Acts (e.g., § 410 of the 1956 Act; § 509 of the 2002 Act) are patterned on § 12(2) of the 1933 Act, and likewise generally impose liability on a seller only to a "buyer not knowing of the untruth or omission". Persuasive authority holds that constructive knowledge of the contents of offering documents is not to be imposed on a buyer asserting a statutory claims under a state securities act patterned on § 12(2). *MidAmerica Federal Savings and Loan Ass'n v. Shearson/American Express, Inc*., 886 F.2d 1249 (10th Cir. 1989); *Marram v. Kobrick Offshore Fund, Ltd*., 2004 Mass. LEXIS 557 (Mass., June 10, 2004); *see Dunn v. Borta,*369 F.3d 421 (4th Cir. 2004).

In *MidAmerica Federal Sav. & Loan Assoc. v. Shearson/American Express, Inc.* a very sophisticated buyer—a bank—invested $10 million based on oral representations that left out certain facts. 886 F.2d 1249 (10th Cir. 1989). When the bank asserted claims under Oklahoma's Securities Act, the defendants argued that the omission had been later disclosed to MidAmerica in the prospectus. Rejecting that defense, the Tenth Circuit explained, in language worth quoting at length:

> [S]ection 408(a)(2) of the Oklahoma Securities Act . . . is meant to be read in coordination with the related federal securities provision, section 12(2). . .
>
> Shearson contends that . . . *Zobrist v. Coal-X, Inc*., 708 F.2d 1511 (10th Cir. 1983), mandates that the contents of a prospectus always be imputed to the purchaser who receives it. That case states that "the knowledge of information contained in a prospectus or an equivalent document authorized by statute or regulation, should be imputed to investors who fail to read such documents." *Id*. at 1518. *Zobrist*, however, . . . arose from a suit alleging [10b-5] violations. . . We decline to extend the rule in *Zobrist* to claims arising under section 12(2). . . .
>
> Under Rule 10b-5, unlike sections 12(2) or 408(a)(2), a purchaser must show justifiable or reasonable reliance on the defendant's misrepresentations in order to prevail. . . .
>
> Section 12(2), on the other hand, has no requirement of justifiable reliance on the part of a purchaser. Because of this, a purchaser's investment sophistication is immaterial to a section 12(2) claim. [Citations] A purchaser has no duty to investigate a seller's possible fraud and need not verify a statement's accuracy. . . .
>
> [P]laintiffs under section 12(2) are not held to the same standard of care as are plaintiffs under section 10b-5. . . . A plaintiff under § 12(2) is not required to prove due diligence. All that is required is ignorance of the untruth or omission." [Citation]

In *Dunn v. Borta* the plaintiff brought claims under Virginia's Securities Act based on oral misrepresentations. 369 F.3d 421 (4th Cir. 2004). *Dunn v. Borta* did not involve a prospectus, but rather facts that were available in the public record which contradicted oral misrepresentations made by the seller. The trial court held that because publicly available information that a reasonable investor would have considered disclosed the truth, the plaintiff had failed to allege a material misrepresentation. The Fourth Circuit reversed, holding that "the plain language of sections 13.1-502 and 13.1-522(A) of the Act does not impose on a purchaser of a security the duty to investigate a seller's statements." The court relied on federal § 12(2) case law that had "declined to impute constructive knowledge of the information contained in the prospectuses" to an investor:

> [I]n *MidAmerica Federal Savings and Loan Ass'n v. Shearson/ American Express, Inc*., 886 F.2d 1249 (10th Cir. 1989), the Tenth Circuit had occasion to construe . . . the Oklahoma Securities Act . . . . Observing that "section 408 is designed to protect purchasers," the court concluded that the Oklahoma statute required that the plaintiff demonstrate only a lack of actual knowledge of the misleading statement or omission, and it thus "declined to impute constructive knowledge of the information contained in the prospectuses to [the plaintiff]." . . .

After citing multiple cases reaching the same conclusion under § 12(2), the Fourth Circuit concluded by endorsing Professor Joe Long's analysis:

> In sum, we agree with these authorities and with the observations of a leading commentator on Blue Sky Laws, Joseph C. Long, that "the investor has no due diligence obligation to make any investigation concerning the investment or to verify any information. The [Uniform] Securities Act was intended to reverse the age-old concept of *caveat emptor* and replace it with the concept of *caveat venditor* or seller beware. Therefore, the investor is not charged with information which he might have acquired or with constructive knowledge." Joseph C. Long, 12A *Blue Sky Law* § 9: 24 (2003).

In the Comment to the § 509 of the 2002 Uniform Securities Act (the liability section), the drafters acknowledged that it imposed no requirement on the buyer to show reliance:

> [N]either causation nor reliance has been held to be an element of a private cause of action under the precursor to Section 509(b). *See Gerhard W. Gohler, IRA v. Wood*, 919 P.2d 561 (Utah 1996); *Ritch v. Robinson-Humprhey Co*., 748 So. 2d 861 (Ala. 1999); Kaufman v. I-Stat Corp., 754 A.2d 1188 (N.J. 2000).

Marram v. Kobrick Offshore Fund, Ltd., 2004 Mass. LEXIS 557 (Mass. June 10, 2004) addresses a different situation. The buyer asserting statutory securities act claims there *had* read the offering documents. He claimed to have bought the securities, however, "on the basis of" oral misrepresentations made in connection with the offering. The defendant argued the Subscription Agreement precluded that claim, since its terms recited that a buyer was buying solely on the basis of the written document:

> The Investor acknowledges that in making a decision to subscribe for Shares the Investor has relied solely upon the Memorandum. . .
>
> This Subscription Agreement constitutes the entire arrangement and understanding between the parties. . . , and supersedes any prior or contemporaneous . . . arrangements or understandings. . .

(Note, this is different from the common argument that facts disclosed in offering documents contradict or clarify oral statements such that, in light of all the circumstances, the oral statements did not constitute a misrepresentation. Without explicitly discussing this issue, the *Marram* court noted it was "far from obvious" that the statements in the offering documents "contravened the specific, detailed oral representations".)

After concluding that the Massachusetts Securities Act was substantially similar to the federal acts, including §12(2), the court held that integration-type language in offering documents did not estop the buyer from claiming to have bought on the basis of oral

representations, but might be *evidence* of the basis on which the buyer had purchased:

> The defendants assert that, as a matter of law . . . Marram purchased shares in the offshore fund solely on the basis of written representations contained in documents, whose truth is uncontested. . . . Were this a contract action [this defense] might have merit. But it is not. . . . [R]eliance and sophistication of the buyer are not elements of this statutory claim. And the existence of contradictory written statements. . . does not provide a defense to the charge of preinvestment materially misleading oral statements. See, e.g., *MidAmerica Fed. Sav. & Loan Ass'n v. Shearson/American Express, Inc., supra* at 1256 (liability even where misleading oral statements corrected by written prospectus); *Wright v. National Warranty Co., supra* at 262 ("Section 12 [2]. . . has no requirement of justifiable reliance. . . . [T]o permit the seller . . . discharge, or to defeat, his statutory obligation of truthfulness to the buyer merely by attaching an integration clause to a subscription agreement would enfeeble the statute. . . .)
>
> At trial the defendants may wish to introduce the written representations in the offshore documents as evidence to refute Marram's allegations. See *Meason v. Gilbert*, 236 Ga. 862, 864, 226 S.E.2d 49 (1976) (integration provision has "evidentiary value on the question of whether representations were made to the purchaser inducing the stock purchase other than those contained in the prospectus"). However, the mere existence of the integration clause is insufficient, in itself, to support the defendants' motion to dismiss the securities claim.

The *Marram* court also cited the anti-waiver provisions of the securities act in supporting its conclusion: "Other jurisdictions have held that written contract terms, including an integration clause, cannot be construed to waive the plaintiff's rights under Federal or State securities law."

3. Rule 10b-5 and common law misrepresentation claims; reliance required, but all relevant factors considered in assessing whether reliance reasonable.

The law is different for claims alleging 10b-5 or common law misrepresentation claims. The buyer's reliance on an alleged misrepresentation is an element of the claim. Providing the buyer with a prospectus does not *per se* defeat the reasonableness of a buyer's reliance on oral statements. "All relevant factors" must be considered. *Brown v. E.F. Hutton Group, Inc*., 991 F.2d 1020(2nd Cir., 1993); *Bruschi v. Brown*, 876 F.2d 1526 (11th Cir., 1989); *Zobrist v. Coal-X, Inc*., 708 F.2d 1511, 1517 (10th Cir., 1983) (But the disclosures in a prospectus may be so compelling as to be sufficient to show reliance on oral statements was unreasonable; see discussion below.).

In *Zobrist* the plaintiffs asserted 10b-5 misrepresentation claims. 708 F.2d 1511, 1517 (10th Cir., 1983). The sellers made oral statements to the buyers, but also provided the buyers with a Private Placement Memorandum prominently disclosing risks before, or shortly after, the purchase. (The *Zobrist* court did not appear to think it made a difference whether the materials were provided *after* the purchase, contrary to some cases; see below.) The Tenth Circuit held that distributing the Private Placement Memorandum did not *per se* make a buyer's reliance on oral statements unreasonable. But if the buyer's reliance on oral statements, in light of all relevant factors (including the disclosures in the prospectus), amounted to "culpable conduct" comparable to the seller's intentional misrepresentations, then that reliance is unreasonable:

> Justifiable reliance is not a theory of contributory negligence; rather, it is a limitation on a rule 10b-5 action which insures that there is a causal connection between the misrepresentation and the plaintiff's harm. . . .Only when the plaintiff's conduct rises to a level of culpable conduct comparable to that of the defendant's [intentional fraud] will reliance be unjustifiable. . . . In this circuit, such conduct must amount to at least reckless behavior. . . .
>
> [A] review of the cases from other circuits indicates that the following are all relevant factors in determining whether reliance was justifiable: (1) the sophistication and expertise of the plaintiff in financial and securities matters; (2) the existence of long standing business or personal relationships; (3) access to the relevant information; (4) the existence of a fiduciary relationship; (5) concealment of the fraud; (6) the opportunity to detect the fraud; (7) whether the plaintiff initiated the stock transaction or sought to expedite the transaction; and (8) the generality or specificity of the misrepresentations. . . .

The *Zobrist* formulation of the law is the rule in most (if not all) jurisdictions that have considered the issue.[5]

Zobrist characterized a buyer's conduct "culpable" and his reliance unreasonable when, considering all relevant factors, the investor "intentionally closed his eyes and refused to investigate the circumstances, in disregard of a risk known to him, or so obvious that he must be taken to have been aware of it, and so great as to make it highly probable that harm would follow." In *Brown v. E.F. Hutton Group, Inc*., *supra,* the Second Circuit deemed an investor's reliance "culpable conduct," or "recklessness", when "through minimal diligence he could have discovered the truth." 991 F.2d 1020(2nd Cir., 1993). Fundamentally the issue is whether in light of written disclosures, a buyer is on notice that inconsistent representations are palpably false, or put him on notice of that they likely could be false.

4. Constructive knowledge of the contents of a prospectus generally will be imputed to a customer in 10b-5 and common law fraud cases.

Under traditional tort law, one to whom intentionally false representations are made, intending that he rely on them, is generally entitled to rely on the statements and it under no duty to investigate further. An exception is made for misrepresentations that are patently obvious.[6] That exception likewise is applied in securities cases: failing to exercise diligence when confronted with patently obvious falsehoods is categorized as "reckless" or "culpable" conduct, which defeats an investor's right to rely on the misrepresentation. E.g., *Holdsworth v. Strong*, 545 F.2d 687, 692-695 (10th Cir., 1976) ("Plaintiff must show that he relied on the misrepresentations and that the reliance was justifiable [citing Prosser, Restatement of Torts]. And a plaintiff may not reasonably or justifiably rely on a misrepresentation where its falsity is palpable"); *accord, Grubb v.*

---

[5] *See e.g., Myers v. Finkle*, 950 F.2d 165, 166 (4th Cir. 1991); *Bruschi v. Brown*, 876 F.2d 1526 (11th Cir, 1989); *Kennedy v. Josephthal & Co*., 814 F.2d 798, 804 (1st Cir. 1987); *G.A. Thompson & Co. v. Partridge*, 636 F.2d 945, 955 (5th Cir. 1981); Straub v. Vaisman & Co., 540 F.2d 591, 598 (3d Cir. 1976)

[6] *Restatement (Second) of Torts*, § 540, *comment a*:

> "[T]he recipient is entitled to assume that a representation of fact material in affecting his decision to engage or not to engage in the particular transaction is honestly made. . . In the absence of obvious falsity or reason to know of facts making reliance unreasonable, there is no requirement that the recipient investigate the truth of the statements made to him."

Federal Deposit Ins. Corp., 868 F.2d 1151 (10th Cir., 1989).

Most courts that address the issue courts impose another exception in securities cases: investors have a duty to review information in formal documents required by the securities laws for the specific purpose of informing them about an investment, such that knowledge of the contents of offering document ***will be imputed to the buyer***. *Zobrist v. Coal-X, Inc*., *supra*, 708 F.2d at 1516-1517; *Myers v. Finkle*, 950 F.2d 165, 168 (4th Cir. 1991); *In re Hyperion Securities Litigation*, 1995 U.S. Dist. LEXIS 10020 (S.D.N.Y. July 12, 1995). In *Zobrist* the court explained:

> While in other cases the plaintiff failed to investigate information to which he had access, . . . or to read information which the defendants provided, . . . we have found no relevant cases wherein the plaintiff failed to read a prospectus or equivalent document which disclosed information in accordance with the requirements of the Securities Act of 1933. . . .
>
> [We see no reason to reward] investors to throw caution and prospectuses to the wind. . . .Thus, it is our view that knowledge of information contained in a prospectus or an equivalent document authorized by statute or regulation, should be imputed to investors who fail to read such documents.
>
> Charging [plaintiff] with constructive knowledge does no more than place him in a position equal to that of a cautious investor. . . . "

Similarly, in *Myers v. Finkle,* 950 F.2d 165, 168 (4th Cir. 1991) the court opined:

> [W]e are presented with an unusual factual situation in which the oral representations are contradicted by warnings contained in the private placement memoranda. The Myers concede that they "did not study" these documents. In our view, knowledge of information should be imputed to investors who fail to exercise caution when they have in their possession documents apprising them of the risks attendant to the investments. Investors are charged with constructive knowledge of the risks and warnings contained in the private placement memoranda.

Accord, Hyperion Securities Litigation ("a reasonable investor would have familiarized himself with the potential for loss disclosed in the prospectuses, rather than relying on the oral assurances of brokers who attended the roadshows. . . :" Investor's failure to read risks disclosed in prospectus in reliance on broker's oral statements deemed unreasonable, citing *Treacy v. Simmons*, 1991 U.S. Dist. LEXIS 5362 (S.D.N.Y. 1991))

5. Disclosures in a prospectus are often held to be sufficiently clear and stark as to be controlling, even in light of "all relevant factors."

Even when applying "all relevant factors" rule, courts not infrequently hold that the disclosures in offering documents are so clear and unequivocal that an investor's reliance on contrary oral representations is unreasonable as a matter of law. *See, e.g., Brown v. E.F. Hutton Group*, 735 F. Supp. 1196, 1202 (S.D.N.Y. 1990) ("Reliance on statements which are directly contradicted by the clear language of the offering memorandum . . . cannot be a basis for a federal securities fraud claim"); *Kennedy v. Josephthal & Co*., 814 F.2d 798, 804-05 (1st Cir. 1987) (offering memorandum's candid warnings made any reliance unjustified as a matter of law); *Hyperion Sec. Litig., supra* ("Any investor who relied on those statements, which flew in the face of the numerous cautionary statements in the

written offering materials, clearly did so unreasonably"); *Zobrist, supra,* at 1518 ("Not only did the defendants not conceal their fraud from [the buyer], they provided him with information and warnings which exposed the representations as false. . . [T]he warning on the first page of the memorandum contradicted the representations of no risk, and there were four full pages devoted to concise, informative descriptions of the risks inherent in coal mining and partnerships.")

But the mere fact that disclosures in a prospectus are imputed to a buyer who did not read a it is not necessarily determinative. In *Bruschi v. Brown*, 876 F.2d 1526, *supra*, the court explained "We have never held that, regardless of the circumstances, an investor is always precluded from recovering under Rule 10b-5 if the misrepresentations upon which the investor relied were oral and conflict in some way with contemporaneous written representations available to the investor." The quality of the disclosures in offering documents, and the reasons for not reading them, are part of the "relevant factors" in assessing the reasonable of an investor's reliance.

> Burschi's failure to [read the prospectus]—and thereby discover the inconsistencies between the alleged oral misrepresentations and the written representations—does not make her reliance unjustified as a matter of law. . . .
>
> The fact that some information in the disclosure documents would have indicated that some of Brown's alleged oral misrepresentations were unreliable is a factor to consider, but . . . all of the relevant factors must be balanced. [Citation] Bruschi was unsophisticated and inexperienced in financial matters; Brown was her investment advisor. . . ; Brown undertook a fiduciary obligation to act in Bruschi's best interests. . . ; Bruschi did not read the disclosure documents because Brown advised her not to do so; Brown knew the misrepresentations were false. . . . When all factors are considered, it cannot be held as a matter of law that Bruschi's reliance on the alleged oral misrepresentations was not justified.

6. Post-sale delivery of prospectus disclosing the true facts does not cure prior misrepresentations on which a purchase is based.

It might seem self evident that, once a security has been purchased in reliance on misrepresentations, later learning the truth cannot "undo" the wrongful sale. But a good discussion of this concept is contained in *Crowell v. Morgan Stanley Dean Witter Servs. Co.,* 87 F. Supp. 2d 1287 (S.D. Fla.. 2000). The facts in *Crowell* are not very clear, but the defendants there argued that any omissions were fully disclosed in the "final prospectus." Addressing the bespeaks caution doctrine that is applied to forward looking statements in offering documents, the Eleventh Circuit noted that misrepresentation cases turn on "what information was available to the plaintiff at the relevant time. . . [W]here the information is provided after the fraudulently induced purchase occurs, such disclosures cannot be used to "cure" the alleged prior fraud."

The defendants in *Crowell* argued that since federal law[7] explicitly permits sellers to provide the final prospectus with the confirmation slip *after* a sale, refusing to the treat the disclosures as sufficient, curing prior misrepresentations, conflicts with federal law. The Eleventh Circuit responded,

> even though federal law permits the prospectus to be delivered concurrently with the confirmation of sale, it does not necessarily follow that such a document can be utilized

[7] 17 C.F.R. § 230.434(a)(2) (1999).

> to "cure" prior alleged misrepresentations or omissions. Rather, Rule 434 merely permits distribution participants to satisfy the prospectus delivery requirements through multiple documents that collectively contain all the information required by Section 10(a) of the Securities Act. . . . [P]laintiff does not allege that the . . . offering document failed to state certain information required by Section 10(a), and thus, Rule 434 irrelevant in this case.

The end

The Texas Supreme Court's Curious Approach towards Aiding and Abetting

Nelson S. Ebaugh

Federal courts have been hopelessly split on the minimum level of scienter necessary to prove aiding and abetting liability under the federal securities laws. For instance, some federal courts simply require proof of recklessness. Other federal courts, however, are not satisfied with mere recklessness. Instead, they require proof that the aider and abettor possess "general awareness by the aider and abettor that his role was part of an activity that was improper." This split regarding the requisite scienter is not limited to just these two positions. Among federal courts, there are at least four minimum levels of scienter that have been articulated in the aiding and abetting context. To this date, the United States Supreme Court has not resolved this multifaceted split among the federal courts.

All states periodically refer to federal court opinions construing the federal securities laws for guidance in interpreting their own blue sky laws. Consistent with this approach, in *Sterling Trust Company v. Adderley*, 168 S.W.3d 835 (Tex. 2005), the Texas Supreme Court looked to federal court opinions for guidance to decide what should be the minimum level of scienter necessary to prove aiding and abetting liability under the Texas Securities Act (the "TSA"). However, due to the multifaceted split among the federal courts on the subject, the Texas Supreme Court issued an unusual, and arguably mistaken, opinion in *Adderley*.

In *Adderley*, the Texas Supreme Court held that to prove aiding and abetting liability under the TSA, "the alleged aider must possess a 'general awareness that his role was part of an overall activity that is improper.'"[1] In other words, the alleged aider must possess "general knowledge" that his role was part of an overall activity that is improper. Knowledge is a higher mental state than is required by the express language of the TSA. The TSA provides that "reckless disregard for the truth or the law," a lower mental state, is sufficient to establish scienter in the aiding and abetting context.

The Texas Supreme Court did not engage in a meaningful analysis when it held that the general awareness standard should be applied to the TSA in lieu of less stringent standards of scienter articulated by the federal courts. Instead, the Texas Supreme Court simply adopted the standard that it believed had been embraced by "most" of the federal courts. But, as explained below, it is not clear that the standard chosen by the Texas Supreme Court had been adopted by most of the federal courts.

Nelson S. Ebaugh is the principal of Nelson S. Ebaugh PC, located in Houston, Texas. Mr. Ebaugh graduated from Georgetown University Law Center with an LL.M. in Securities and Financial Regulation. He may be reached at (713) 752-0700 or by email at nebaugh@ebaughlaw.com.

---

[1] *Adderley*, 168 S.W.3d at 842 (quoting *Gould v. American-Hawaiian S.S. Co*., 535 F.2d 761, 780 (3d Cir.1976)).

In addition, assuming that the standard embraced by the Texas Supreme Court had been adopted by most federal courts, that does not mean that the standard should have been applied to the TSA. The Texas Supreme Court should have weighed the pros and cons supporting each standard and made a decision on the relative merits of each standard rather than on what most federal courts have done. If it had done so, the Texas Supreme Court would likely have held that reckless disregard, alone, is sufficient to satisfy the scienter element for aiding and abetting liability.

A. Background of the TSA's Aiding and Abetting Provision

To fully appreciate the unusual nature of the *Adderley* decision, it is essential to understand the unique development of the TSA's aiding and abetting provision.

In 1963, Texas amended the TSA to adopt, almost verbatim, the portion of the Uniform Securities Act of 1956 (the "Uniform Act") that imposed civil liability upon primary violators of the securities laws. Although the Uniform Act contained an accompanying aiding and abetting provision, Texas declined to adopt this provision. In fact, for years the TSA did not expressly provide for aiding and abetting liability.

1. Adoption of Aiding and Abetting Provision

In 1977, Texas amended the Texas Securities Act (the "TSA") to include an aiding and abetting provision.[2] Because the Texas legislature was concerned with the Texas Supreme Court's liberal construction of secondary liability under the TSA, Texas refused to adopt the Uniform Act's aiding and abetting provision.[3] Instead, Texas adopted an aiding and abetting provision that was much narrower in scope than the Uniform Act's aiding and abetting provision.

Texas' aiding and abetting provision requires proof of scienter in order to establish liability.[4] The Uniform Act does not contain such a requirement. Under the Uniform Act, a person is strictly liable for aiding and abetting liability unless he can "sustain the burden of proof that he did not know, and in the exercise of reasonable care could not have known, of the existence of the facts by reason of which the liability is alleged to exist."[5]

2. Borrowing the Definition of Scienter for Aiding and Abetting from Federal Courts

In the early to mid 1970s, many federal courts required proof of scienter to establish primary liability under section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5. These courts generally identified the requisite scienter as "intent to defraud, reckless disregard for the truth, or knowing use of some practice to defraud."[6] For the most part, the TSA's aiding and abetting provision contains the same phrases. Presumably, the

---

[2] Tex. Rev. Civ. Stat. Ann. art. 581-33, Comment—1977.

[3] In *Brown v. Cole*, the Texas Supreme Court held that a person could be liable under the TSA if he served as "any link in the chain of the selling process." 155 Tex. 625, 291 S.W.2d 704, 708 (1956). "The Committee drafting section 33F as part of the 1977 revision intended that the provisions of Section 33F would control the broad implications of *Brown v. Cole* regarding the collateral defendants covered by section 33F." Hal M. Bateman, *Securities Litigation: 1977 Modernization of § 33 of the Texas Securities Act*, 15 HOUS. L. REV. 839, 853 (1978) (citations omitted).

[4] Tex. Rev. Civ. Stat. Ann. art. 581-33, Comment—1977 (Section 33F(2) of the TSA "makes a material aider liable equally with the violator, but only if the aider has the requisite scienter, i.e. intent to deceive or defraud, or reckless disregard.").

[5] Uniform Securities Act of 1956 § 410(a).

[6] *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 193 n. 12, 96 S.Ct. 1375, 47 L.Ed. 2d 668 (1976).

Texas legislature borrowed this language from the federal courts for the TSA's aiding and abetting provision. The TSA's aiding and abetting provision reads: "A person who directly or indirectly with intent to deceive or defraud or with reckless disregard for the truth or the law materially aids a seller, buyer, or issuer of a security is liable . . . jointly and severally with the seller, buyer, or issuer, and to the same extent as if he were the seller, buyer, or issuer."[7]

To establish primary liability under the Uniform Act, the plaintiff does not have to prove scienter.[8] The same is true under the TSA.[9] In fact, courts have described the TSA's primary liability provision as imposing strict liability.[10] In this regard, the Uniform Act and the TSA are in harmony.

As mentioned above, however, the Uniform Act and the TSA are in not in harmony as far as each Act's respective approach towards aiding and abetting liability. Instead, aiding and abetting liability under the TSA follows the approach of the federal courts. As a consequence, civil liability under the TSA is a hybrid of the Uniform Act and the federal securities law.

B. The Confused State of Aiding and Abetting Liability in the Federal Courts

Federal courts have never agreed upon the minimum level of scienter that is required to prove aiding and abetting liability under the securities laws.[11] And to date, the United States Supreme Court has not addressed the issue. Consequently, as far as aiding and abetting liability goes, there are at least four different versions of scienter under the federal securities laws.[12] Most of these versions provide that some form of recklessness will support the requisite scienter needed.[13] But, under at least one version, recklessness alone is insufficient to prove aiding and abetting liability.[14]

The federal courts that aren't satisfied with proof of recklessness, demand proof of a higher mental state. They demand that the alleged aider possess as least a "general awareness" of the primary violation before imposing aiding and abetting liability. Awareness of wrongdoing is synonymous with knowledge of wrongdoing.[15]

---

[7] Tex. Rev. Civ. Stat. Ann. art. 581-33F(2).

[8] Uniform Securities Act of 1956 § 410(a).

[9] *Herrmann Holdings Ltd. v. Lucent Techs. Inc*., 302 F.3d 552, 563 (5th Cir. 2002) ("[A]n article 581-33 claim does not require scienter.").

[10] *Sterling Trust Co. v. Adderley*, 119 S.W.3d 312 (Tex. App.—Fort Worth 2003) *rev'd on other grounds*, 168 S.W.3d 835 (Tex. 2005) ("Under the strict liability provisions of sections 33(A)(2) and (B), a plaintiff may recover against a seller without proof that the seller knew or should have known of the untruth or omission on which the plaintiff's claim is based.").

[11] Matthew L. Mustokoff, *Proving Scienter in SEC Aiding and Abetting Cases; Courts Apply Tougher Standard in Recent Decisions*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR (May 1, 2006).

[12] Kevin R. Johnson, *Liability For Reckless Misrepresentations and Omission Under Section 10(b) of the Securities Exchange Act of 1934*, 59 U. CIN. L. REV., 667, 685-95 (1991).

[13] *Id*.

[14] Mustokoff, *supra* note 11.

[15] *Howard v. SEC*, 376 F.3d 1136, 1142 (D.C. Cir. 2004).

C. Texas' Appellate Courts Mirror the Confusion in the Federal Courts

Just as the federal courts have been split on whether recklessness alone can qualify as scienter for aiding and abetting purposes, so were Texas' intermediate courts for a while.[16] At least one of Texas' intermediate courts did not require proof of general awareness to demonstrate an aider's scienter.[17] However, several other Texas appellate courts required proof of the aider's general awareness of the underling violation before imposing liability under the TSA aiding and abetting provision.[18] Consequently, the same split that had been playing out for years in the federal courts began playing out in the Texas courts.

D. The Texas Supreme Court Decides the Issue

In *Sterling Trust Company v. Adderley*, 168 S.W.3d 835 (Tex. 2005), the Texas Supreme Court resolved this split among Texas' intermediate courts. Relying heavily upon federal cases that have addressed aiding and abetting liability under Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5, the Texas Supreme Court held that proof of the aider's "general awareness" of the underling violation is necessary to establish aiding and abetting liability under the TSA.[19]

1. It is Unclear Whether Most Federal Courts Required Proof of General Awareness

The *Adderley* opinion, however, lacked a meaningful analysis to reach this conclusion. The Texas Supreme Court based its holding largely on the assumption that "most" of the federal courts in 1977 required proof of general awareness to prove aiding and abetting liability.[20] That was the extent of its analysis in deciding the difficult question about whether recklessness alone may suffice to establish aiding and abetting liability under the TSA.

Such an important issue deserved a more thorough analysis than this. Moreover, it is not even clear that most federal courts require proof of the aider's general awareness of the underling violation. At least one commentator has claimed that most federal courts do not require proof of "general awareness."[21] Another has implied as much.[22]

---

[16] *Adderley*, 168 S.W.3d at 840 (observing the split amongst the Texas intermediate appellate courts).

[17] *Id.*

[18] *Id.*

[19] *Id*. at 842.

[20] *Id*. at 840.

[21] Johnson, *supra* note 12, at 689-90. *But see* Don J. McDermett, Jr., Note, *Liability for Aiding and Abetting Violations of Rule 10b-5: The Recklessness Standard in Civil Damage Actions* 62 TEX. L. REV. 1087, 1096 (1984) ("[M]ost of the circuits have followed *Coffey*" which requires proof "that the defendant had a general awareness that his role was part of an overall activity that was improper."); Cheryl L. Pollak, Note, *Rule 10b-5 Liability after Hochfelder: Abandoning the Concept of Aiding and Abetting,* 45 U. CHI. L. REV. 218, 236 (1977) ("The mental state issue most consistently mentioned in the cases is the secondary defendant's knowledge of the principal's wrongdoing.").

[22] Robert S. De Leon, *The Fault Lines Between Primary Liability and Aiding and Abetting Claims Under Rule 10b-5*, 22 J. CORP. L. 723, 726 (1997) ("For aiding and abetting claims, plaintiffs [before *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 114 S.Ct. 1439, 128 L.Ed.2d 119 (1994)] were only required to plead (1) a violation of Rule 10b-5 by another party; (2) knowledge or reckless disregard of the violation by the aider and abettor; and (3) substantial assistance by the aider and abettor in the achievement of the violation.").

2. Public Policy Arguments For and Against the Requirement of General Awareness

In the end, it really should not have mattered whether or not most of the federal courts have adopted the general awareness standard in lieu of recklessness. Instead, it would have been better if the Texas Supreme Court had made a decision by carefully evaluating the pros and cons of the recklessness standard versus the general awareness standard. Unfortunately, most federal courts omit this analysis.

Federal courts tend to simply state in a conclusory fashion that the general awareness standard is, or is not, required without explaining the basis of their holding.[23] Therefore, it was not all that surprising when the Texas Supreme Court likewise failed to significantly delve into the public policy arguments for and against the general awareness standard.

In an opinion drafted by Judge Friendly, the Second Circuit of the U.S. Court of Appeals set forth a compelling reason for the application of the recklessness standard.[24] In that opinion, the Second Circuit observed: "'In our complex society the accountant's certificate and the lawyer's opinion can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.' . . . a lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand."[25] In *Adderley*, the Texas Supreme Court never considered this rationale in support of the recklessness standard. Perhaps if it had, it would have paused before adopting the general awareness standard. After all, the TSA should be construed to protect investors.[26] Judge Friendly's articulation of the recklessness standard would have protected investors without placing an undue burden on accountants and lawyers.

Many federal courts, if not most federal courts, have adopted the following definition of recklessness:

> [R]eckless conduct may be defined as a highly unreasonable [act or] omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.[27]

This standard would have been an excellent choice for the Texas Supreme Court to have adopted in *Adderley*. But unfortunately, the Texas Supreme Court did not even acknowledge this standard in its opinion. This recklessness standard is consistent with the recklessness language expressly provided for in the TSA. In addition, as noted by at least one commentator, "in many cases it will be virtually impossible for a plaintiff to show that an alleged aider and abettor had actual knowledge of the primary violation."[28] This definition of recklessness protects aiders

---

[23] Johnson, *supra* note 12, at 686.

[24] *SEC v. Frank*, 388 F.2d 486 (2nd Cir. 1968).

[25] *Id*. at 489 (citations omitted).

[26] "[B]ecause article 581--33 [of the TSA] is remedial in nature in the civil context, it 'should be given the widest possible scope.' *Flowers*, 472 S.W.2d at 115; *Anheuser--Busch*, 934 S.W.2d at 708. We are to construe the Texas Securities Act 'to protect investors.' TEX. REV.CIV. STAT. ANN. art. 581-10-1(b) (Vernon Supp.2001)." *Texas Capital Securities Inc. v. Sandefer*, 58 S.W.3d 760, 775 (Tex. App.—Houston [1st Dist.] 2001, pet. denied). *See also Aegis Ins. Holding Co. v. Gaiser*, No. 04-05-00938-CV, 2007 WL 906328 (Tex. App—San Antonio, March 28, 2007).

[27] McDermett, *supra* note 21, at 1102. *See also* Johnson, *supra* note 12, at 689-90.

[28] McDermett, *supra* note 21, at 1113.

and abettors that are simply negligent, but would allow recovery against aiders and abettors that have a mental state higher than mere negligence. Again, the TSA is to be construed to protect investors.

Federal courts have advanced at least one argument in support of the general awareness standard. However, this argument was not brought up in the *Adderley* opinion. The Fifth Circuit has stated that: "Without these limitations [i.e. the general awareness requirement], the securities laws would become an amorphous snare for guilty and innocent alike."[29] Echoing the same sentiment, the D.C. Circuit has stated that the general awareness element of aiding and abetting liability was "designed to insure that innocent, incidental participants in transactions later found to be illegal are not subjected to harsh . . . penalties."[30] No question about it, it would be wrong to subject a truly innocent person to aiding and abetting liability. But, if a person recklessly disregards a likely fraudulent transaction, that person is not completely innocent. Such individuals should be liable as aiders and abettors under federal law and the TSA.

As noted in the above paragraph, the Fifth Circuit and the D.C. Circuit had at one time required proof of general awareness to prove aiding and abetting liability. Yet these two Circuits have since relaxed, or entirely abandoned, the general awareness requirement. In *Akin v. Q-L Investments, Inc*, 959 F.2d 521, 526-527 (5th Cir. 1992), the Fifth Circuit held that an accountant may be liable as an aider and abettor if he "has furnished substantial and non-routine services but is not consciously furthering primary violations by his client." In *Howard v. SEC*, 376 F.3d 1136, 1143 (D.C. Cir. 2004), the D.C. Circuit held that "[a] secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct." The Texas Supreme Court relied heavily on precedent from the Fifth and D.C. Circuits in support of its holding that general awareness must always be proven.[31] Perhaps the Texas Supreme Court would not have imposed the general awareness requirement if it had been aware of the Fifth and D.C. Circuit's relaxation of this requirement.

3. Mistaken Reliance of Federal Precedent

Unfortunately, when it issued its opinion in *Adderley*, the Texas Supreme Court labored under an incorrect understanding of the level of scienter that the SEC must prove in aiding and abetting cases. In *Adderley*, the Texas Supreme Court stated that "SEC actions still require 'a general awareness by the aider and abettor that his role was part of an activity that was improper.'"[32] In support of this statement, the *Adderley* court quoted a phrase from *Howard v. SEC*, 376 F.3d 1136, 1142 (D.C. Cir. 2004). However, *Howard* does not stand for the proposition that the Texas Supreme Court claims it does. In fact, *Howard* stands for a position that is directly contrary to the Texas Supreme Court's position.

In *Howard*, the D.C. Circuit expressly held that the SEC is *not* required to prove that the aider had a general awareness that his role was part of an improper activity. According to the *Howard* court:

---

[29] *Woodward v. Metro Bank of Dallas*, 522 F.2d 84, 97 (5th Cir. 1975).

[30] *Investors Research Corp. v. SEC*, 628 F.2d 168, 177 (D.C. Cir. 1980).

[31] In *Adderly*, the Texas Supreme Court often cited to *Woodward v. Metro Bank of Dallas*, 522 F.2d 84 (5th Cir.1975) to support its decision. In *Adderly*, Texas Supreme Court also cited to several D.C. Circuit Court opinions as persuasive authority: *Investors Research Corp. v. SEC*, 628 F.2d 168 (D.C. Cir. 1980); *Graham v. SEC*, 222 F.3d 994 (D.C. Cir. 2000); *Howard v. SEC*, 376 F.3d 1136 (D.C. Cir. 2004).

[32] *Adderley*, 168 S.W.3d at 847 n.2.

> A secondary violator may act recklessly, and thus aid and abet an offense, even if he is unaware that he is assisting illegal conduct. . . . "[E]xtreme recklessness" may support aiding and abetting liability. "Extreme recklessness" – or as many courts of appeals put it, "severe recklessness" – may be found if the alleged aider and abettor encountered "red flags," or "suspicious events creating reasons for doubt" that should have alerted him to the improper conduct of the primary violator, or if there was a "danger . . . so obvious that the actor must have been aware of the danger."[33]

It is disappointing that the Texas Supreme Court was not aware of the true holding in *Howard*. If it had been, the Texas Supreme Court may have thought twice before adopting the general awareness standard in such a conclusory fashion. The *Howard* court's version of recklessness would have been a much more appropriate standard to apply to the TSA's aiding and abetting provision than the general awareness standard.

4. Inappropriate Reliance on Federal Precedent

Finally, the Texas Supreme Court failed to acknowledge a significant difference between aiding and abetting liability under the TSA as opposed to aiding and abetting liability under the federal securities law. The TSA expressly provides that aiding and abetting liability may exist if the aider possesses any one of the following mental states: intent, knowledge, or recklessness. For private litigants, there has never been a comparable provision under Section 10(b) of the Securities Exchange Act of 1934 or Rule 10b-5. Instead, aiding and abetting liability under Section 10(b) and Rule 10b-5 has always been an implied cause of action, with its contours defined by the federal courts. Consequently, upon its codification, the TSA's aiding and abetting provision had no analog in Section 10(b) or Rule 10b-5. For this reason alone, a more appropriate decision may have been made if the Texas Supreme Court had refrained from looking to the federal courts for guidance in interpreting the TSA's aiding and abetting provision.

Finally, it was inappropriate for the Texas Supreme Court to graft a requirement to the TSA that the legislature clearly did not intend to exist. If the Texas legislature had intended a general knowledge requirement, it certainly had the ability to include it in the TSA's aiding and abetting provision. After all, some federal courts had adopted a general awareness standard before Texas amended the TSA to include an aiding and abetting provision. But the fact that Texas did not do that speaks volumes.

E. Conclusion

Instead of holding that general awareness is required to prove aiding and abetting liability, the Texas Supreme Court should have held that reckless disregard, alone, suffices as scienter for aiding and abetting liability. As demonstrated above, the rationale for such a standard outweighs the rationale for the general awareness standard. Hopefully, when given the opportunity to consider the issue again, the Texas Supreme Court will follow the lead of the Fifth and D.C. Circuits and relax, or entirely abandon, the general awareness requirement as these federal courts have done.

---

[33] *Howard*, 376 F.3d at 1143.

Compulsory Arbitration: Its Impact on the Efficiency of Markets

Bradley R. Stark and
Ronald W. Cornew

Bradley R. Stark, MA, MSF, JD is an attorney who focuses his practice on complex cases involving currency trading, fraud, professional malpractice and both civil/criminal money laundering. In addition, Mr. Stark is an Adjunct in the Department of Finance at Florida International University in Miami, Florida. Mr. Stark can be reached at stark2@bellsouth.net or www.portfoliolaw.com.

Dr. Ronald W. Cornew is president of Market Consulting Corporation, a firm providing consulting services in various financial markets. He received a Doctorate of Science degree from the Massachusetts Institute of Technology and has served on the teaching staff at MIT, Simmons College and Florida International University. He has also consulted extensively in connection with litigation, and has served as an expert in arbitrations, reparations and court cases in federal, tax and various state courts in the areas of equities, fixed income securities, futures and derivatives. Dr. Cornew can be reached at marktcon@ix.netcom.com or www.market-consulting.com.

I. Introduction

In a recent paper entitled "Mandatory Arbitration of Securities Disputes – A Statistical Analysis of How Claimants Fare," Edward S. O'Neal and Daniel R. Solin have written, from a *quantitative* perspective, about the deterioration of investor returns in compulsory arbitration as a mechanism for resolving customer disputes in the securities industry.[1] Aided by Alan Greenspan's recent memoir,[2] this article will examine its *qualitative* failings and comment on various concepts including property rights, the rule of law, regulatory agency capture, path dependence, the role of lawyers and other topics related to compulsory pre-dispute arbitration.

One of the central goals of this article is a serious critique of arbitration as it has been practiced in the securities industry since the 1987 Supreme Court decision in *Shearson/American Express v. McMahon*.[3] We will examine the role of lawyers in defending property rights and how reform in the area of both the courts and arbitration procedures would counteract the effects of agency capture and the limitations of compulsory arbitration. As this article explains, allowing lawyers to more effectively defend the property rights of investors would enhance the long-term health and efficiency of the American securities markets to the benefit of both the securities markets themselves and their investors.

More than 20 years have passed since the *Shearson* decision, and we seek here to stimulate further discussion between both those who practice before industry forums such as PIABA members, as well as among members of the securities industry. By gathering diverse input, it should be possible to achieve a balanced approach to influence U.S. policy makers to produce necessary change without giving up the beneficial aspects of the present system. The public policy question of compulsory pre-dispute arbitration lies beyond normal party politics; meaningful reform should involve efforts to produce necessary change while avoiding exclusive appeal to one camp or ideology. Instead, the emphasis should be on fundamental fairness and improving market efficiency.

---

[1] Edward S. O'Neal and Daniel R. Solin, Mandatory Arbitration of Securities Disputes-A Statistical Analysis of How Claimants Fare (2007), http://www.smartestinvestmentbook.com or http://www.slcg.com/pdf/workingpapers/Mandatory%20Arbitration%20Study.pdf.

[2] Alan Greenspan, *The Age of Turbulence - Adventures in a New World* (2007).

[3] *482 U.S.220 (1987)*.

II. Property rights, the rule of law and compulsory arbitration

While it is true, as Chairman Greenspan observes, that "Few developing countries protect the property rights of even their own citizens as we do the property rights of foreigners,"[4] the U.S. system of protecting the property rights of investors in its own capital markets is seriously deficient.[5] This is surprising given the central role of the markets in capital formation, which is the engine of economic growth in the United States and--by extension--the world. Proceeding from the myth that investors "voluntarily" elect compulsory pre-dispute arbitration, both the Congress and the Supreme Court have allowed a system of compulsory pre-dispute arbitration to first develop and then flourish in the United States without serious public debate.

As almost all FINRA member firms have compulsory pre-dispute arbitration clauses in their customer agreements, and most will not waive such clauses even upon customer request, there is little that even a determined investor can do to avoid the reach of forced arbitration.[6]

Such clauses, however attractive they may have appeared for a time to both industry firms and investors, are increasingly unwise and unsustainable for the long term. While compulsory arbitration makes sense for both investors and the industry for smaller claims in which costs will consume the total award, such practices otherwise fundamentally undermine the rule of law and the protection the law provides to property rights which, as Chairman Greenspan observes repeatedly in Chapters 12 to 17 of his book, govern the economic growth of a nation.

The following list includes some of the more important ways in which arbitration as currently practiced in the securities industry operates that are *contrary to a respect for the right to property.*

1. **NASAA Speaks Out -** With the arbitration forums having been created by the industry without participation by individual investors, or investor organizations such as PIABA, the process is a creature of the securities industry and beholden to it, or so it would appear to investors required to use it. Anecdotal observation is that while there is often a broker or Branch Office Manager on an arbitration panel, there is almost never an average investor. The rule of law requires at least the appearance of impartiality and, while the various industry forums have never been implicated in major scandal, their origin and current constitution invites suspicion by those required to use them. The North American Securities Administrators Association (NASAA) has endorsed the Feingold Senate bill that would legislate a requirement of choice for the investor. As these state regulators are both knowledgeable about the industry and serve as proxies for the intent of the citizens of their states, private investors have already expressed their unhappiness with such compulsory arbitration.[7]

---

[4] Page 388.

[5] Chairman Greenspan is on record as generally against increased regulation in the markets. Our thesis is that compulsory arbitration and thus the limiting of individual's property rights is a form of increased regulation that benefits the industry at the expense of market efficiency.

[6] See Tanya Solov, Director, Illinois Securities Department, Illinois Secretary of State, testimony on behalf of the North American Securities Administrators Association before the United States Senate Committee on the Judiciary Constitution Subcommittee, (12/12/2007).

[7] See Jill I. Gross and Barbara Black, When Perception Changes Reality: An Empirical Study of Investors' Views of the Fairness of Securities Arbitration (2008), http://ssrn.com/abstract=1118430

2. **No Evolving Precedent -** Arbitration of customer disputes and its lack of publicly available, reasoned decisions lead to a lack of development of securities law and a body of decisions which constitute precedent, the basis of our legal system. The financial industry evolves quickly while the laws governing it have been frozen in time. Accordingly, both industry firms and individual investors will increasingly be unable to assess either the justness of their cause or the potential value of their claims. Cases are argued in arbitration in terms of case law and legal precepts established decades ago. As time passes, and participants employ newer investment vehicles through market innovations, the path to a proper arbitration decision will become less and less clear without the development of a body of appropriate case law. An already-existing example of this occurs in electronic trading, where concepts such as suitability are subject only to a slim body of SEC-promulgated regulatory precepts untested in any observable actions. Such disparities will grow with time. The rule of law requires a body of precedent to guide its application or, increasingly, it will not be a meaningful way to protect property rights of all market participants on both the sell and buy side (i.e. both securities firms and investors).

3. **Inherently Biased Arbitrators -** The selection of arbitrators occurs in a manner that largely precludes the possibility of a full spectrum of allowable decisions under law. A hallmark of the current FINRA arbitration procedure is the practice of making available copies to both parties of previous awards in which the arbitrator has participated, and then allowing arbitrators to be selected in a voting process. Accordingly, a large body of arbitrators "know" that they cannot award punitive damages, attorney's fees or, often, even a large award where they are otherwise appropriate without risking the appearance of having a customer bias that will cause attorneys representing industry clients to rank them lower for future panels. This tends to produce an industry bias in panels and constitutes a breach of the respect for rights to property. It is particularly unfortunate in those instances where it leaves rogue firms or rogue brokers relatively unpunished by even the standards of the most-staunch industry advocate.

4. **Bush League Decision Making -** The decision-making-by-amateurs aspect in which arbitrators – no matter how skilled they may be in securities knowledge – who appear to lack the legal or forensic skills routinely applied to decision making in the court room also undermines the arbitration system. Further, such decisions lack the possibility of appellate review, which has a prophylactic effect upon the conduct of a trial or arbitration. While arbitration as guided by a skilled chairperson is often a model of effective dispute resolution, it can and frequently does reveal amateurishness on the part of the chair or one or more members of a panel. The rule of law requires more than knowledge of the industry regulated. If it did not, we might still be turning to all manner of industry organizations for dispute resolution services as was once the case when, in the Middle Ages, such dispute resolution was the exclusive province of the medieval guilds. The long list of qualifications required to become an arbitrator and the financial hurdle imposed upon such individuals is a far cry from a 'jury of peers' chosen in a court of law from rolls of voters. Yet, it is the results of people taken from voter rolls that arbitration panels should replicate if arbitration results are to be seen to be as fair as jury trials.

This is only a sampling of the reasons why those compelled to arbitrate may in practice experience a diminution in the protection of their property rights. No better example of the loss of property rights through a failure of the rule of law exists than in that body of judicial decisions holding that arbitration decisions *do not even have to be legally correct*. In this regard, the standard for review on a motion to vacate when trying to overturn an arbitration award is almost an insurmountable hurdle which has recently been added to by the decision of a Supreme Court holding that even manifest disregard for the law is not a stand-alone basis for overturning an arbitration award.[8]

From this perspective, it is also possible to see the fallacy of seeking to justify compulsory pre-dispute arbitration on the basis that the average of awards in arbitration equals the average awarded in comparable court cases. We doubt this proposition is correct factually, but even if true, it is misguided.[9] As Chairman Greenspan points out,[10] a lack of legal certainty undermines the rule of law. Fairness in both the reality and appearance of awards is required if property rights are to be respected.

The force of these arguments may initially lack persuasion to industry members who look on the many benefits of arbitration for them alone – smaller awards, usual confidentiality of both discovery and arbitration results, relative lack of exposure to punitive awards or attorney's fees though provided for by law. – until the day when the lack of legal certainty and the inability to subsequently overturn even huge wrongful awards against industry members drives home the point relative to the benefits of the rule of law. Presumably as a hedge against this possibility, arbitration agreements routinely preclude bringing class actions in arbitration although the logic supporting compulsory pre-dispute arbitration dictates that it should apply to them as well – the agreements of all class members are equally "voluntary".

III. Path dependence, caveat emptor, regulatory agency capture and the appropriate role of the lawyer in the defense of property rights and the rule of law

What investor protection exists today has been achieved against a background of *caveat emptor* (buyer beware). As such, our legal framework and regulatory structure exhibit path dependence which implicitly requires the attorney, in seeking to vindicate the rights of his client, in the eyes of both the industry and the public, to defend his position in the process and the actions he has taken. As costly as prior litigation may once have been to the securities industry, the attorney plays an essential role in the vindication of property rights through seeking to enforce the rule of law. If Chairman Greenspan is right in his thesis that it has been the rule of law that has facilitated the great growth in the American economy, then surely this would

---

[8] *Hall Street Associates, L.L.C. v. Mattel, Inc*., 128 S. Ct. 1396 (2008). This recent Supreme Court decision indicates that "manifest disregard" of the law as a basis of judicial review is simply a shorthand for the well-known basis appearing in the Federal Arbitration Act (FAA), 9 U.S.C. Sections 10 and 11, and not the basis for expanded review. Alternately, if an expanded basis for review under *Wilko v. Swan*, 346 U.S. 427, 74 S. Ct. 182, 98 L. Ed. 168 based on manifest disregard did once exist, it is now overturned. While the court intriguingly suggests that "the FAA is not the only way into court for parties wanting review of arbitration awards", the authors have seen little previous sympathy by the court for numerous petitioners who have sought such routes including various state law or common law approaches "where judicial review of (a) different scope is arguable."

[9] O'Neal and Solin, *id.* As indicated previously, the decline in the size of arbitration awards documented by these authors has almost surely resulted in average arbitration awards falling below what might have been achieved in a courtroom setting.

[10] Page 332.

not have occurred without the participation of the lawyer.[11]

While regulation and regulators have their role, regulation and regulatory agencies have too often been subject to "agency capture" and do not in general represent a resource to which the individual investor can turn for detection and rectification of fraud.[12] Self regulation can suffer from the same limitations and in an amplified fashion. Agency capture is a concept first developed in economics and since embraced in regulatory legal decisions. To summarize the concept, agencies formed to protect consumers and smaller interests who have less of a voice in public policy are often ultimately 'captured' by the industry the agency was designed to regulate. The reason this occurs is that, once the initial focus upon the wrongs that led to the creation of the agency has become history, the greater resources of the industry (and thus its influence on the regulatory agency) allow the industry to control and manipulate the very agency designed to regulate it and safeguard the public. Many argue that the S.E.C. and FINRA are captured agencies.[13]

The history of our financial markets is one of *caveat emptor.* Every attack on this principle has been met with shrill warnings that changes to the status quo will endanger the efficiency of markets and, thus, our privileged way of life that derives from our economic

---

[11] See particularly chapters 12 to 17 of Greenspan's book.

[12] Greenspan at 375. A counter example occurs in the futures industry where the Commodity Futures Trading Commission (CFTC) administers reparations procedures as part of a three-way dispute resolution process allowing the disgruntled investor to select from among reparations, arbitration before the National Futures Association (or the American Arbitration Association) and Federal Court. The reparations process is conducted by a CFTC administrative law judge. However, the Wall Street Journal reported on December 13, 2000 that one administrative law judge, Bruce Levine, had never ruled in favor of an investor in eight years at the CFTC. While the presumptive bias against investors was moderated by initiation of settlement procedures between parties by Judge Levine's clerk who one author (RWC) personally observed produce an excellent settlement for a deserving claimant, the failure of the CFTC to take action relative to an administrative law judge who failed to rule for an investor in nearly 180 cases is deeply disturbing. "Agency capture" is a term that hardly does justice in this situation and would appear to underlie a much more deeply-rooted bias against futures investors within the commission that must go beyond mere appearance.

[13] Two recent articles in The New York Times provide excellent examples of agency capture at the S.E.C., which is directly related to the current financial meltdown in America. In the first, an action in 2004 of the five members of the Securities and Exchange Commission which led to what has been called the most serious financial crisis since the 1930s is detailed. Stephen Labaton, *Agency's '04 Rule Let Banks Pile Up New Debt*, N.Y.Times, Oct. 2, 2008. In approving an exemption favored by the five big investment banks including Goldman Sachs, which at the time was led by Henry M. Paulson, Jr. who later became US Treasury Secretary and now leads the US recovery effort, the Commission set the stage for subsequent disaster. The exemption changed the so-called "net capital rule" and allowed the banks to "unshackle billions of dollars held in reserve as a cushion against losses in their investments". *Id..* It contributed directly to excessive leveraging in mortgage-backed securities and other instruments including credit derivatives, which later was responsible for the demise of Bear Stearns and Lehman Brothers, and crippled Merrill Lynch and Morgan Stanley. In the second article, the inspector general of the Commission is reported as having concluded that the Commission should "consider disciplining its director of enforcement and two supervisors" in connection with the firing of an agency lawyer for trying to interview influential Wall Street insider John J. Mack who later became the chief executive officer of Morgan Stanley. The inspector general is reported as having found evidence that "raised serious questions about the impartiality and fairness" of an investigation into possible illicit trading at a giant hedge fund. The inspector general's 191 page report adds further support to accusations of widespread S.E.C. "failing to aggressively regulate financial institutions at the heart of the subprime mortgage crisis." Walt Bogdanich, *Impartiality of S.E.C. Is Questioned*, N.Y. Times, Oct. 7, 2008.

system.[14] Reality is the exact opposite. With each measure of increased accountability and transparency has come a commensurate increase in market efficiency. History is our teacher on that score.

For example, the first request by a stock exchange for information regarding earnings, assets and liabilities was rejected by corporate management in 1825 as a threat to competition within the securities industry. Until 1869, a company could issue shares at will without disclosing the total number issued. The Securities and Exchange Act of 1934 abolished stock pools, insider trading and deliberate disinformation, all designed to fraudulently manipulate stock prices. This legislation was met with a boycott of the capital markets wherein underwriters refused to issue new stocks.

The President of the New York Stock Exchange – an individual later imprisoned for his acts – proclaimed that "the nation's securities markets would dry up".[15] This position had been clearly articulated years earlier by *Barron's Financial Weekly*, which argued that short term manipulation of stock prices was not a concern to long term investors. Even the creation of the Federal Reserve in 1914 was met with concern by market participants as interference by outsiders.

We now know that these grudging changes toward respect for individual property rights and transparency have increased market efficiency. For example, market participants justify price to earnings ratio expansion over the history of the markets to increased safety within the markets, safety created by these very reforms that were so stridently opposed.

Studies show that the individual's efforts to protect his or her own property rights lead to a greater degree of market efficiency. "Uncertainties that stem from the arbitrary enforcement of the body of prevailing rules are reflected in higher risk and cost of capital which, in turn, inhibit economic growth."[16] Indeed, the rise of America as a haven for investors and flight capital from other countries exists only because of our respect for and enforcement of property rights.[17]

Financial markets are too dynamic to be effectively regulated to avoid all future crises. Regulation usually is sufficient only to prevent future crises of the same type being specifically targeted for regulation from reoccurring, and even that is not certain. Regulation cannot anticipate and reliably deal with future innovations that might threaten the economic system.

For every threat created to the economic system, there are third parties who are at risk. Empowering these third parties to protect themselves by respecting their property rights via litigation should be part of any system designed to help to avoid future economic dislocations. So long as third parties are not

---

[14] B. Mark Smith, *Toward Rational Exuberance: The Evolution of the Modern Stock Market* (2001).

[15] Opposition continued for four years after the creation of the S.E.C. until one of its chief protagonists, N.Y.S.E. President Richard Whitney, filed for bankruptcy and was indicted for fraud. B. Mark Smith, *id.*

[16] Rafel La Porta, Florencio Lopez-de-Silanes, Andrei Shleifer, What Works in Securities Law, The Journal of Finance Vol. 61 (2006).(Authors examine 49 countries and "find little evidence that public enforcement benefits stock markets, but strong evidence that laws mandating disclosure and facilitating private enforcement through liability rules benefit stock markets." *Id*).

[17] "Market transactions are inhibited if we cannot trust the reliability of counterparties' information. The ability to rely on the word of a stranger is integral to any sophisticated economy. …To be sure, the history of business is strewn with Fisks, Goulds, and numerous others treading on, or over, the edge of legality. But they were a distinct minority. If the situation had been otherwise, the United States at the end of the nineteenth century would never have been poised to displace Great Britain as the world's leading economy." Alan Greenspan, speech at the 2004 Financial Markets Conference of the Federal Reserve Bank of Atlanta, Sea Island, Georgia, April 16, 2004.

restricted in their ability to adapt to threats to their property, they are able to be more vigilant of financial innovation, and thereby strengthen and promote it.

For example, in the current sub-prime mortgage crisis where lending institutions acted as if mortgagee credit worthiness was no longer an issue, investment banks were comfortable bundling suspect mortgages into securities because the recourse of the private investors was limited by rules against aiding and abetting liability, by compulsory arbitration, and by the total lack of ability to fix personal responsibility on the actions of individual investment bank personnel. This is also illustrated by the analyst scandal associated with the last stock market crash of 2000 where, under the system of securities law enforcement now in place, relatively few investors ever received compensation for the conduct of Jack Grubman at Citibank/Salomon Smith Barney and Henry Blodgett at Merrill Lynch. Indeed, Blodgett remains active in the industry. Arbitration was no remedy.

How can the great players in the securities industry be expected to obey the law when, because of compulsory arbitration and other favorable laws that serve to regulate markets for the advantage of the industry, they have largely been exempted from it? Often it is the small investor bringing his claim in a court of law that serves as the early warning system of wide-spread wrong-doing.

Current economic problems are typical of those problems of the past. The solution is reflected in the history of the markets. Increased transparency, sensible regulation, and the ability of the individual investor to enforce his or her property rights in a court of law are important parts of any solution to preventing future economic problems.

IV. The Future

The role of the lawyer in the defense of property rights and the rule of law remains essential, and our discussion on compulsory arbitration and its limitations is seen to be a discussion about the nature of the forums available to the lawyer in seeking to vindicate the property rights of clients. In the past, these rights were enforced through a court system, and it was in part a failure of that court system that put the securities industry on the path of compulsory arbitration.[18] Had improvements in the courts been undertaken (including, say, a Federal Small Claims Court with simplified and quicker procedures where there was diversity and amounts between $75,000 and perhaps $2,000,000 in dispute), the compulsory pre-dispute arbitration system of today might never have come into existence. But accepting that it may be desirable to live with a truly voluntary arbitration system in the future, what can be said about attainable improvements?

Contrary to earlier critical comments, if conducted properly, arbitration of securities disputes does have a number of distinct advantages that exist for both the investor and the securities firm.

1. **Expeditious -** It is relatively quick, and is becoming quicker now that the cases generated by the market decline of 2000 – 2002 have largely passed through the system. And if FINRA gets its way to provide for a single arbitrator for cases up to $100,000, that will speed up the process.

2. **Less Expensive -** It is usually inexpensive or at least less expensive than going to court, particularly when the complexity of the dispute requires no more than a limited number of days of arbitration.[19]

---

[18] As part of their decision-making process in *Shearson* the justices of the Supreme Court apparently considered the impact of the workload on the Federal Courts. See Dissent of Justice Blackmun, Shearson/American Express v. McMahon, 482 U.S. 220 (1987).

[19] O'Neal and Solin, *id.* Panel fees ultimately act as a brake on the cost effectiveness of FINRA arbitration.

3. **Confidential** - It permits a greater degree of confidentiality for both clients and firms who do not wish client losses and other confidential records (including asset records and tax returns) to become public.

However, these advantages are largely mitigated by the disadvantages created in the current arbitration system. A major failure of the arbitration system arises because of its compulsory nature and the way in which it has choked off the development of securities law with its consequent erosion of the rule of law generally. While we do not wish to indicate what system would better replace it, we do look with favor on the CFTC system, in which the client is offered a pre-dispute *choice* between arbitration and going to the courts as one alternative.[20]

While we are mindful that the choice between arbitration and court was available before *Shearson* and that few investors selected arbitration, we feel that the circumstances are different today and that steps exist which the industry might take that would result in many more investors selecting arbitration *if given a free choice.* Group behavior is path dependent and the existence of a number of well-honed arbitration mechanisms and a skilled body of arbitration practitioners (that exist within PIABA and the Compliance and Legal Division of the SIFMA) would help assure the continuity of arbitration for years to come, particularly given the benefits of speed, cost and confidentiality. As a further benefit, any such free choice system would still have some investors selecting the court approach, which would allow for independent case law development.

One proposal for increased fairness in arbitration would be if arbitration panels were instructed that violations of a Notice to Members (NTM) provides a basis for strict liability and that once determined to exist, damages are appropriate. Today, the industry is fond of noting in its Answers to Statement of Claims that violations of NTMs are not a basis for relief. NTMs regarding suitability are of limited usefulness if, at arbitration hearings, industry lawyers are free to argue that NTMs have no import and that, say, Modern Portfolio Theory is just a theory and not for everyone in spite of instruction from regulators on the point. This last sentiment, which is often heard at arbitration where lack of proper diversification is an issue, is particularly unfortunate since the foundation of investing is Modern Portfolio Theory which was developed in 1952 by Dr. Harry Markowitz, for which he won the Nobel Prize. Modern Portfolio Theory is not new, and it is widely accepted as accurate.

To strengthen the appeal of arbitration in a truly-voluntary environment, the current system should be strengthened by establishing a pool of funds to assure that those who successfully prosecute their claims to an award would be paid irrespective of the financial viability of the firm against which an award is made. By giving arbitration such a distinct advantage over litigation--where litigants often see victory unmatched with corresponding compensation--the securities industry could take a significant step toward increasing the attractiveness of its forum.[21] Alternatives include requiring firms to carry appropriate insurance (that covers intentional wrongdoing by officers and employees and not just negligence), and/or to have higher minimum capital reserves. Firms with fraudulent intent who are subject to repeated claims should be squeezed out of business as quickly as possible.

In addition, reform in arbitrator selection procedures--to remove selection bias--is needed. This should be matched by further efforts to improve the quality of arbitration

[20] The choice is actually three-way as the client may also select Reparations, as discussed in an earlier footnote.

[21] See U.S. General Accounting Office, Rep. No. 66D-00-115, *Securities Arbitration: Actions Needed to Address Problems of Unpaid Awards* (2000).

pools in order to improve the attractiveness of arbitration. The latter has been an industry focus in recent years and is much needed. We see no solution to the problems of arbitrator selection mentioned earlier than the random selection of arbitrators from a pool of truly neutral individuals operating without allegiance to the industry. Some have suggested that public arbitrators for arbitration panels be selected from voter rolls, much as current grand jury pools are constituted. They certainly need to be paid better, and compensated for study time so that they come to the hearing prepared.

Along with these more obvious changes, arbitration forums should experiment with other potential reforms to generate further improvements. Now that the various securities arbitration forums are no longer choked with cases, experiments should be made in such areas as reasoned awards and partial appeal rights in cases where one party or another feels at the outset that such procedures are necessary. Lastly, the investor and his attorney need to be brought into the rule-making process for arbitration.

So the task before us should entail a dual approach which embodies the right of the investor to freely select, or freely reject, arbitration in an atmosphere that provides for quick, efficient dispute resolution by arbitration with as much potential certainty as such a forum can provide -- all with the objective of enforcing property rights in an effective manner. By such action, an improved dispute resolution system for the Twenty-First Century will result. It will benefit the investor and the industry alike and, by maximizing the growth potential of the securities industry through further development of the rule of law, it will improve the American economy as a whole.

Making arbitration a choice will serve to pressure FINRA to evolve still further. By creating an incentive to make arbitration more desirable to the public investor, it will spur innovation that satisfies the interests of the small investor, the employees of the securities industry, and the industry as a whole.

V. Market Efficiency

Ultimately, the goal of the markets is to deploy capital efficiently. It is this efficiency that drives the economic engine of capitalism. Regulations designed to benefit the industry and insulate it from liability do not create free markets. Rather, regulated markets with an industry bias cause the inefficient deployment of capital. When individuals cannot vindicate their property rights through efficient and fair dispute resolution, it is the market itself that ultimately loses efficiency. An *inefficient* industry pays the price in terms of lower gains. This is a clear lesson of history.

Every dollar lost or inefficiently deployed due to poor investment advice, irrational exuberance, or through fraud is a dollar that is unavailable for sound investment in our economic system. Such wasted capital is a form of nutrient that is not being placed on the plant that could grow in our economic garden and mature into a fruit-bearing tree, but rather, it is a nutrient that is being wasted. If so much money had not been poorly deployed in the analyst debacle of the late 1990s and the subprime markets situation today, our economy would not now be headed to potential recession, or worse.

The inability of investors to effectively enforce property rights through some more efficient mechanism, whether it be through litigation, arbitration, binding mediation through a truly neutral third party, or an administrative law judge, leads to market inefficiency, which is detrimental to the health of our economic system. In the short run, market inefficiencies benefit only those few who encourage them while in the long run they are harmful to the American economy, as Chairman Greenspan so perceptively notes.

Rethinking Self-Regulatory Organization Arbitration Awards

Louis L. Straney

Arbitration Awards, when considered in context, can be valuable resources for all constituents of the process, including public investors, counsel, regulators and government policy makers. After analyzing the case abstracts of self-regulatory organizations (SRO) arbitration panel Awards for the first six months of 2008, I have to agree with the Captain of Road Prison 36 in the 1967 film classic, Cool Hand Luke: "What we got here is… a failure to communicate"

At the foundation of this communication failure is the attempt to reduce the multivariate information in Awards to a single data point -- reaching for the so-called "bottom line". There is valuable arbitration Award data at hand, but there is a widespread deficiency in analyzing and communicating it accurately. This article will explain why that is so and what to do about it.

It is axiomatic, I believe, that any fundamentally flawed approach leads to oversimplification and conjecture. As an alternative to this confusion, based on my experience in the securities industry and utilization of data management tools, I will offer an alternative approach. The notion of a single representative "customer" will be abandoned and will be replaced with four distinctly differentiated categories of constituents. Much of the confusion related to Awards can be illustrated by the following quotations and graphic illustrations of often cited empirical research that targeted the "single data point" conclusion.

- "In 2007, nearly 80% of customer cases, closed through settlements or Awards, resulted in monetary or non-monetary recovery for the investor"[1]
- "They (the investors) obtain recoveries in 40% of cases that proceed to hearing"[2]
- "The Total Percentage of Claimants Who Recover Damages or Other Relief in Arbitration By Settlement is Favorable – Graphic Representation of > 60% Since 2003[3]
- Award as a Percent of Request for All Cases where Arbitrators Found for Investors, Graphic Representation indicating a peak of 68% in 1998, with the latest being 50% in 2004[4]

Louis L. Straney spent 24 years in senior supervisory management with a Member Firm and has extensive experience as a case study writer and business management Research Director. Lou is the founder of Arbitration Insight, LLC, a consulting and litigation support practice. He serves as an Expert Witness in arbitrations and civil proceedings related to securities, commodities, variable contracts, and derivatives and can be contacted directly at louis@straney.net.

---

[1] FINRA, 2008.

[2] Gross, Jill I., 2007.

[3] SIFMA, 10/2007.

[4] O'Neal and Solin, 2007.

For the legal community, investors, associated persons and member firms to associate any insight with these representations, one must first be willing to embrace the following assumptions:

- It is acceptable to blend and "average" dissimilar data
- It is acceptable to assume that the definitions of terms such as "customer", "recovery", "favorable Award" and "other relief" are self-evident and can be universally applied

Following those very premises, a decision maker must then accept the concept often referred to as a "win rate" in the range of something between 40% and 80%.[5] We should abandon the traditional single data point approach and adopt a methodology that will yield worthwhile and compelling results.

Overview

My analysis of the SRO case abstracts concludes that there are four distinct categories of constituents who comprise in excess of 80% of all arbitration cases.[6]

(1) Public investor v. member firm and/or associated person
(2) Member firm v. public investor
(3) Associated person v. member firm
(4) Member firm v. associated person

The absence of an acknowledgement of these distinct constituencies, all with unique features and objectives, is analogous to blending the flight speed of birds with that of insects, bats and supersonic aircraft and representing that "things with wings fly at an average air speed of 100 mph"— technically accurate, but of little practical value. With readily available data management resources and robust discussion in an open forum, accurate and reliable analysis is possible. Let me explain how this can be accomplished.

Methodology

The Financial Industry Regulatory Authority (FINRA) "Awards Online" internet resource was utilized in my research (the Report) to identify all SRO cases where an arbitration panel rendered an award, January – June, 2008.[7] After eliminating duplicate entries, 542 cases were examined. Even though there were some interesting seasonal aberrations in certain elements of the data, the monthly decision rate can be described as balanced at approximately 100 cases per month. All obvious FINRA data entry errors, such as a decision date prior to the filing date, were corrected. In several instances, no hearing venue was provided in the case abstracts; however, no attempt was made to use other means to approximate the venue. Other considerations include the following:

- In the case of an unspecified Claim, any monetary Award was designated as a 100%, Award – Claim Ratio (ACR)[8.] Conversely, an unspecified claim absent of a monetary Award was designated as 0%.

---

[5] Imagine "win rate' being a vehicle's speedometer and the driver explaining to the highway patrol officer that he was *certain* that he was traveling at 40 mph, but possibly 50 mph, maybe 60 mph, or even 80 mph.

[6] The balance of the cases often entail "one-off" Intra-Industry Claims such as a Member Firm versus another Member organization for complaints related to Financial Consultant recruiting practices, or Exchange Floor Broker trade disputes.

[7] The term "Panel" shall refer to the NASD Rule 12800 *"Paper Cases*" with one arbitrator or a (3) person Panel for cases with claims exceeding $ 25,000.00.

[8] Central to the methodology of this Report is that the ACR is meaningful only when it is associated with one of the four constituent categories.

- The Report reflects all claims and amended claims in the SRO abstracts.
- Public investor claims against member firms were distinguished from public investor claims against member firms and associated persons.
- When provided, for future analysis, a primary-party gender identifier was utilized.
- Any party having *pro se* representation was identified.
- Reasoned and time barred decisions were identified.
- Withdrawn, dismissed, confidential and stipulated Awards are recorded but not included in quantitative calculations.
- A random sampling of the data input determined that the margin of error was 1% +/-, well within an acceptable range.[9]
- No pre-judgments were made relative to the merits of the claims, damage requests or decisions.
- This research effort and subsequent Report are strictly proprietary and received no support or underwriting from any individual or organization. The Report is also Copyright Registered ©.

Research Hypothesis

Through a combination of industry insight, disciplined data collection and business management tools, arbitration Award decisions can be analyzed and filtered to provide valuable information to all constituents considering disputes with brokerage firms. The first step in this process is the recognition of the benchmark constituencies followed by organizing the Award data from each constituent's perspective.

AWARD CLAIM RATIO (ACR) CATEGORY PROFILES

	Claimant	Respondent	# Cases	% of Total
1	Public Investor	Member Firm	97	18%
	Public Investor	Member Firm + Assoc. Person	147	27%
2	Member Firm	Public Investor	38	7%
3	Member Firm	Associated Person	92	17%
4	Associated Person	Member Firm	64	12%

Due to rounding, Report percentages may not total 100%

Analytical Results

Even though the Report's Award – Claim Ratio results have been determined for each of the four constituent categories, it is beyond the scope of this article to attempt to discuss all aspects of the results. However, some highlights of the Report's findings can serve as a prologue to future research and dialogue.

- The decision for Claimant's counsel to include the Associated Person as well as the Member Firm is often debated. The Report clearly indicates that there is a notable advantage of 14% in the Award when only the Member Firm is named.
- Employment dispute related claims often involving complex labor and statutory issues comprise nearly 30% of SRO cases.

[9] With the exception of the very thorough GAO study of Award collections, past research often fails to incorporate a verification of the margin of error for data input.

- For the 38 cases involving a Member Firm's claim against a Public Investor, 93% of the Awards were greater than 99% Award Claim Ratio (ACR.)[10]

- In the 64 cases where an Associated Person brought a Claim against a Member Firm, 54% of the Awards were 0% ACR and 79% were less than 40% ACR.

- For the 92 cases with a Member Firm as Claimant and an Associated Person as the Respondent, 60% of the Awards were greater than 99% of the Claim.

- In the 147 cases where a Public Investor filed a Claim against a Member Firm and an Associated Person, 59% received no Award compared to the 97 cases with 53% receiving no Award when the Public Investor's Claim is limited to the Member Firm as sole Respondent.

Beyond the results set forth above, there is a wealth of information that should be considered for case budgeting and strategic planning, but much of that is beyond the limited scope of this article.

Public Investor Observable Trends

Since no pleadings or hearing transcripts were reviewed, the Report must solely rely upon the Claims as described in the case abstracts. However, it is my experience that the abstracts are generally representative of the central issues. For the cases analyzed in the Report, so-called "Analyst Claims" have all but disappeared. Product areas such as Mutual Funds and Variable Contracts were often cited, but for the period examined there were only three specific security Claims (Enron/Worldcom, Yield Plus, QQQ option contracts).

Even though it is a much discussed topic for the legal community, there was just one Claim of "Elderly Abuse" which was denied with a Reasoned decision.[11] There was one case with a "Selling Away" Claim and the decision was also Reasoned.[12]

Outnumbering these specific Claims was a relatively large number of operational and account administration complaints. These 14 administrative complaints were evenly split between two categories of responding firms, (1) those that could be described as primarily offering discount trade execution services and (2) major investment banking organizations.

Practical & Strategic Considerations

- The research included 100 cases with Compensatory Claims of $1,000,000 or greater. 54% of those Compensatory Claims were so-called "Round Dollar"[13]; 36 of these cases (67%) were denied damages. This is an unfavorable relationship to the master data file's overall recovery results.

- Compensatory Public Investor Claims against Member Firms for $ 25,000 or less received 0% Awards in 38% of the cases, a very favorable comparison to the 50%+ for all monetary levels of Claims.

---

[10] This result includes multiple Awards against Citigroup (CGMI) clients with unsecured account debits associated with the Initial Public Offering of Vonage in 2006. Future results will likely smooth out the imbalance created by the Citigroup claims. However, if the CGMI cases are excluded, no Member Firm as a Claimant received less than a 100% ACR from a responding Public Investor.

[11] FINRA 06-01722, California hearing.

[12] FINRA 06-04110, North Carolina hearing.

- Depending on the constituent category, Punitive Damages and Fees were Awarded to the Claimant in 20% - 24% of the cases. However, in only 3.6% of all cases were Punitive Damages of $10,000 or greater awarded.

- Compensatory Awards greater than $ 250,000 occurred in 6.3% of all cases. The largest Award was $10,000,000, with additional Punitive Damages of $2,000,000.

Additional Research

Arbitration Awards consisted of multivariate data. To be more specific and to quantify that description, the number of possible sorting results for my Report is a very intimidating number: $1.84467441 \times 10^{13}$.

However, it has always been my objective to provide accurate information that addresses the needs of practitioners and decision makers. For this research, mathematics will be a *means* and certainly not an *end product.* As more case data is gathered, future work needs to be conducted in such areas as: Comprehensive Cost Analysis, Pro Se Results, Geo-Mapping For Charting Regional Patterns, Gender Related Issues, Trust Account Awards Compared to Individual Accounts, Impact of Postponed Hearings and many others.

Conclusion

Another Award results quotation illustrates the Captain's observation related to the failure to communicate. "For the first six months of 2008, 45% of $1,000,000 Compensatory Claims received a favorable Award". My research can certainly support that observation. However, the conclusion fails to mention that there were only eleven $1,000,000 Claims with just five receiving some Award. The Awards for these five cases ranged from a 2% ACR to a maximum of 15% ACR – not exactly robust results. Additionally, the observation fails to note that nearly 70% of all SRO Round Dollar Claims were denied.

When contemplating the filing of an arbitration Statement of Claim with a self regulatory organization, investors and their counsel will ultimately commit both time and capital in their efforts. The same consideration is true for Member Firms and Associated Persons. Additionally, regulators and government officials often establish policy based on their understanding or perception of arbitration results. The goal of this article is to raise the awareness of this "failure to communicate" and to establish a respected tradition of rethinking often cited results and to encourage rigorous and innovative research.

[13] Examples of "Round Dollar"; $ 1,000,000, $ 1,500,000, $ 2,500,000, $3,600,000…$ 10,000,000

REFERENCES

Aaron, A. n.d., SIPC/Investor Protection Trust Survey: 4 out of 5 U.S. Investors Fail "Survival Skills" Survey Test, (online) July 13, 2008, www.SIPC.org/media /release/13Dec05.cfm

Securities Industry and Financial Markets (SIFMA) Arbitration and Litigation Advisory Committees and the Compliance and Legal Division of SIFMA, White Paper on Arbitration in the Securities Industry, October, 2007, p.64.

Senator Russ Feingold and Congressman Hank Johnson, sponsors, Arbitration Fairness Act of 2007, H.R. 3010, (online) July 16, 2008, referred to The U. S. House of Representatives Judiciary Committee and pending hearings, www.hankjohnson.gov/theissues.shtml

Robbins, David E., 2001 & 2003, Securities Arbitration Procedure Manual, Matthew Bender

O'Neal, Edward S. and Solin, Daniel R., Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare, Business Wire, June 12, 2007.

United States General Accounting Office (Thomas J. McCool, Director, Financial Institutions and Markets Issues), June, 2000, Report to Congressional Requesters, Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards, GAO-GGD-00-115

Ruder, David S., 1996, Securities Arbitration Reform, Report of the Arbitration Policy Task Force to the Board of Governors, National Association of Securities Dealers.

Gross, Jill I., 2007, McMahon Turns Twenty: The Regulation of Fairness in Securities Arbitration, DigitalCommons@Pace, http://digitalcommons.pace.edu/lawfaculty/451

Financial Industry Regulatory Authority, Inc (FINRA), 2008, FINRA Arbitration Awards Online, http://finraAwardsonline.finra.org/search

Shearson/American Express v. McMahon, 482 U.S. 220 (1987).

A Primer on Hedge Funds

John J. Duval, Sr.*

John J. Duval, Sr. has been an arbitrator for the NASD and NYSE (now FINRA) since 1998 as well as a Mediator. He retired from Merrill Lynch where he was a broker, branch office manager, and district-level manager in the New York City District of the firm. He has also completed NASD Mediator training. In addition, he serves as a consultant and expert witness in securities cases having offered testimony in over 45 cases as well as being retained in over 150 cases since 2002. His previous publications were based on variable insurance investments and are a result of one of his positions with Merrill Lynch as District Annuity Specialist. (The articles are available on his website: www.johnduval.com) He is currently Managing Member of Duval Asset Management, an investment advisory firm and is co-founder of a hedge fund. He is also a candidate for the NASD-Institute at Wharton CRCP (Certified Regulatory and Compliance Person) designation. He can be reached at joduval@aol.com.

How It All Began

The first hedge fund was started in 1949 by Alfred Winslow Jones, son of the GE-famous Arthur Winslow Jones, while he was a journalist for *Fortune Magazine*.

Jones had a fascinating early life. He was born in Melbourne, Australia, and moved to the U.S. when he was four years old. After graduating from Harvard, he toured the world as a purser on a tramp steamer and later joined the U. S. Foreign Service, where he was vice consul for the U.S. Embassy in Berlin during the 1930s, as Hitler rose to power.

During the 1940s, Jones was a writer for *Fortune Magazine*, covering a myriad of subjects. In 1941, he finished his PhD in sociology at Columbia. Then, in 1949, his research for a Fortune article titled, "Fashions in Forecasting," led him to analyze a new class of stock market timers as he was looking for approaches that offered a return better than a "fair game".

The research gave him the idea to try his own hand at investing. Two months before the *Fortune* article went to press, Jones established an investment partnership that would exploit this new style of investing. He raised $100,000, $40,000 of which was his own. In its first year, the partnership's gain on its capital came to a very respectable 17.3 percent.[1]

Jones hired legal counsel to operate 'under the radar' and without the cost and time of registration (i.e., Securities Act of '33). His lawyers obtained the following: *exemption* from the Act of '33 by virtue of Regulation D's Safe Harbor provision, and later, D-506 'private placement', the *exclusion* from the Investment Company Act of '40, and the *exemption* from the Investment Advisers Act of 1940.

However, these exemptions and exclusions initially restricted the fund to 99 investors and the fund had to be a limited partnership. (Years later, the rules were revised expanding the number of investors). Further, the partnership could not advertise or solicit investors. (That's why you still do not see public ads such as those frequently put out by mutual funds.)

But, unlike most mutual funds, Jones's new partnership could use leverage (margin) to increase performance as well as short selling for performance and sometimes to reduce the risk. Jones's compensation consisted of management fees

[1] Wikipedia

charged to the fund and, because of his exemption, he implemented an incentive fee of 20% of the profits. (This fee is also known as a performance fee, participation rate or carried interest.)

Hedge Fund Fees

While some funds charge significantly higher fees (for example, Steve Cohen, who runs SAC Capital Management, LLC, takes 40-50% of the profits), typically the performance fee is 20% of the profits and often called 2-20, meaning a 2% management fee and a performance fee of 20% of the annual profits.[2] This 20% incentive fee can be substantial and is the reason one often reads about a manager's income being in the millions and even in the hundreds of millions. Doing the math, if a billion-dollar hedge fund makes 10%, or $100 million, the incentive fee to the manager is $20 million. This would normally be taxed at a capital gains rate and is in addition to the $20 million of management fees. As a result, the manager makes a total $40 million fee; not a bad year.

Jones continued, quietly, until 1966, when another *Fortune* writer became curious as to his life and career after leaving the magazine. Being interviewed by *Fortune*, he was asked the name and nature of his fund. He replied that he 'hedged' his bets in the fund. The Fortune writer than called it a "hedged fund".

Others Are Established

On a 10 year basis, Mr. Jones' hedge fund had beaten the top performer Dreyfus Fund by 87%. This led to a flurry of interest in hedge funds and within the next three years at least 130 hedge funds were started, including George Soros' Quantum Fund and Michael Steinhardt's Steinhardt Partners[3]

Regulation of Hedge Funds

Hedge fund growth hasn't gone unnoticed by regulators and Congress. There have been changes in the laws and rules along the way. First, the rules now require that investors in hedge funds be either 'accredited' or 'qualified', meaning the investors must have a high net worth and/or annual income.

In 1996, the cap on the number of investors was eliminated, provided that all investors beyond 100 were 'qualified'. As long as a hedge fund keeps the total number of investors to 499, it avoids becoming a reporting entity. If a fund has $10 million or more in assets and 500 or more investors, it must file a 10-Q.

Again, because of the exemptions, hedge funds aren't required to provide disclosure as required if they were registered and regulated. Also, the 2006 *Pension Protection Act* restricts ERISA pensions to a maximum of 25% invested in a hedge fund. By the end of 2006, there was over $1.3 trillion invested in hedge funds. And, *between 50% to 70% of the daily volume on the New York Stock Exchange is accounted for by hedge funds*.[4]

Their Structure

Structurally, hedge funds use a Prime Broker who is either separate from a bank or is a bank. The Prime Broker facilitates the trading as well as the leverage or margin loans provided by the bank. It can be thought of as providing a hedge fund with a turn-key infrastructure in a box. Most large banks have set up Prime Brokerage units. For example, Goldman Sachs calls theirs "Global Securities Services".

Technically, Prime Brokers are broker/dealers that clear and finance customer trades executed by one or more broker/dealers,

---

[2] FINRA Institute at Wharton, Hedge Funds Training Manual

[3] Wikipedia

[4] FINRA Institute at Wharton, Hedge Funds Training Manual

known as executing brokers. A Prime Broker may also act as custodian for the customer's securities and funds.[5]

The degree or amount of leverage is one of the reasons for the abnormal profits and losses in a hedge fund. While the ordinary margin investor is limited to the Regulation-T requirement (i.e., 50%), the hedge fund exemption enables the margin to be whatever the bank is willing to lend it.

The Precedent of *Long Term Capital*

Hedge funds aren't required to publish their performance, their activity or even their positions. Occasionally, one learns a lot of details about a hedge fund after it implodes. Long Term Capital (LTC) had a huge, 7-year successful run before being liquidated in 2000. The model was based on hedged-arbitrage. (As no arbitrage is risk- free, LTC thought they had a way to hedge their currency risk. Hence, hedged-arbitrage. A more common arbitrage would be to buy Anheuser Busch and sell InBev who announced a BUD takeover. There is always a discount (risk) to the takeover price so a fund could attempt to hedge the risk through futures and options.) But, as there is no perfect model, this model did not stand up to the 1998 Russian default on its debt. The fund was not allowed to fail as it had bank loans that were simply too large. Had it been allowed to fail, a financial crisis would have taken place. Thus, an effort organized by the New York Federal Reserve Bank resulted in most major Wall Street firms and banks contributing capital to save the fund, avoid the crisis, and then conduct a subsequent orderly liquidation. Notably, only Bear Stearns declined to participate in the bail-out.

This is a classic illustration of incredible leverage. Managed by world-famous financial people, including two Nobel Prize-winning economists (Wall Street levity using the phrase: Nobel Dumbells), the fund was allowed to leverage over 30 times the capital base. In addition, LTC had over $1.2 trillion of assets *off* the balance sheet in the nature of swaps and futures. It doesn't take much market movement to wipe out a hedge fund's capital when banks make loans of this magnitude to hedge funds.

Long Term Capital's incentive fee was 25%, not the traditional 20% and investors had to agree to a 3-year commitment. Thus, for years the managers enjoyed millions in income. As the fund became more and more confident, it began to take larger and larger unhedged positions.[6]

Thus, the term hedge fund is often a misnomer. In fact, most of the tragedies in hedge funds are the result of the fund not being hedged - simply taking huge bets that fail.

Getting In

An investor's entry into a hedge fund is normally done through an Offering Memorandum that consists of three parts: Operating Agreement, Private Placement Memoranda, and a Subscription Agreement. (In the hedge fund I recently started, there are 71 pages.)

One of the challenges Claimants' attorneys have if they represent an investor who they believe has suffered losses by virtue of wrongful hedge fund conduct are the reams of documents the investor has to sign. These documents are loaded with disclaimers that disclose the risk and leverage. Most documents warn of *total loss*.

However, when a Registered Representative of a member firm recommends or solicits a hedge fund, then industry rules and regulations do apply. These are addressed below.

---

[5] FINRA Institute at Wharton, Hedge Funds Training Manual

[6] San Jose State University, Department of Economics

Getting Out – Definition of Terms

Exiting from a hedge fund can be tricky and lengthy. Because of the extensive use of derivatives and leverage, fund managers try to restrict liquidity so as not to disrupt complicated positions. There can be a 'lock-up' period, which can range from six months to three years. Advance notice of withdrawal is usually required in periods of 30 days to 180 days. There are also 'side pockets', 'gates', and 'holdback provisions'. These are as follows:

Side pockets: An investment pool within the hedge fund that is typically made up of hard-to-value and illiquid assets. It is operated separately and the management determines which investors may invest in the 'side pocket' investments. An example would be the investment in a privately-owned business.

Gates: A provision sometimes present in governing documents only allows a limited partner to redeem a certain percentage of his capital each fiscal period. Gates are most often associated with hedge funds that carry illiquid positions such as those that invest in private equity.

Lock ups: A period of time following the initial subscription during which an investor cannot redeem his capital from the fund. This period is traditionally six months to three years.

Hold-back provisions: The percentage of a redemption 'held-back' by the fund pending an end-of-year audit. It is typically 5% and is disbursed post-audit after adjustments. Monies held back do not, ordinarily, earn interest or any other return.

Notice Period: The minimum number of days required to notify the fund of an investor's intent to redeem capital prior to the actual redemption which takes place at the end of one of the fund's fiscal periods. A period of 180 days is not unusual.

There are other terms that are often used in hedge fund agreements:

Hurdle Rate: A minimum that the hedge fund manager must earn each fiscal period in order to be entitled to the incentive fee. Generally, if a hurdle rate applies, the incentive fee only applies to the profit earned in excess of the hurdle rate.

Catch-up provision: A provision that sometimes is in governing documents that kicks in after the hurdle rate has been exceeded. Essentially, the incentive fee applies to 100% of the hedge fund's income over the hurdle rate until the hedge fund manager has been "caught up."

Hedge Fund Investing Techniques

Hedge fund investing techniques are typically very sophisticated and complex. For example, there are "swaps" - bilateral agreement in which two parties, called counterparties, agree to exchange a series of payments over time. Swaps can involve index performance, bond performance and credit default swaps. The last is the exchange of a fixed rate based on a benchmark such as LIBOR (premium) from the hedge fund (buyer) to a CDS Dealer (seller) in return for credit protection to the hedge fund (buyer). Derivatives such as options and futures are commonplace in the pursuit of both performance and, sometimes, to actually hedge.

Other strategies include, but are not limited to, Quantitative Approaches - selecting securities based on complex mathematical relationships, arbitrage including equity sectors, currencies, M&A parties, short selling and "Pairs Trades" (buy Best Buy, short Circuit City). And the list goes on….

There is one universal problem in evaluating hedge funds and their performance: *No one index has emerged as the industry standard.* Because of this fact and others, it is essential for the member and the member associate to

'know their customer', know the product, and perform full disclosure.

Hedge Fund Suitability and Transparency

Let us migrate into hedge fund suitability and some industry ramifications. As a first step, it is important to know about hedge fund transparency. Here is what the FINRA training manual on hedge funds says about transparency:

> [It] refers to the ability to know what positions a portfolio manager holds and the true values of those holdings. Because hedge funds frequently do not disclose their positions (secrecy is a hallmark of hedge funds), it can be difficult for an investor in a hedge fund, such as a pension fund, to know what it is really invested in and what the true value of its investment is. Thus, hedge fund investments often 'lack transparency'.

Hedge funds are notoriously difficult to define. The term appears nowhere in the federal securities laws.

Categories of Investors Allowed

There are different categories of investors allowed under the various laws including '33 Act exemption (Regulation D, Rule 506, no dollar limit), exemption from Investment Advisors Act of 1940 (Section 203 (b)(3)), and the Investment Company Act of 1940 (Section 3 (c)(1). While most hedge funds choose an exemption or exclusion, they certainly can register under the '33 Act and several have done so. These funds are typically larger and distributed through broker/dealers, which subjects them to full compliance with industry regulations (just as any of their other products).

The Holy Grail of suitability - NASD 2310 - still applies to hedge fund sales when recommended by brokers of member firms.

Sales practices

FINRA has expressed concern about the areas of "retailization", Funds of Funds, including Registered Funds, and Capital Introduction services of Prime Brokers and other Third Party Marketers (TPM).

Retail–ization is the advertising and broad-based solicitation of investors for a hedge fund. This practice is against the rules and regulations of FINRA. Typical prohibited activities include luncheons and public seminars featuring hedge funds. The reason is that hedge fund investors must fall into an accepted category and be judged suitable for such an investment. Broad-based advertising or public seminars promoting hedge funds do not allow individual due diligence of a potential investor.

A Fund of Funds (FOF) is a hedge fund that has no trading strategies of its own, except to invest in hedge funds. Even if an FOF registers its securities under the '33 Act, it is still required to be sold only to qualified investors.

While it is legal for a Prime Broker to conduct Capital Introduction Services that bring qualified purchasers to unregistered hedge funds, the scale of this activity has increased markedly in recent years and has invited more evaluation from FINRA. In 2003, the NASD (now FINRA) published a *Notice to Members* (NTM 03-07) that reinforced the standards of conduct for members, including Prime Brokers, in selling hedge funds, especially to retail investors. Specifically: disclosure in promotional efforts, suitability, supervision of associated persons, and the training of associated persons regarding features, risks and suitability of hedge funds.

Both Claimants' counsel and the industry's general counsels should be aware of the unique points in this Notice 03-07. For example, "Members also must provide investors with any prospectus or other disclosure document of the hedge fund (or Fund of Funds). Members should bear in

mind, however, that providing a prospectus does not satisfy the duty to provide balanced sales materials and oral presentations." Further, "NASD also is concerned that customers may not fully understand the risks associated with hedge funds."

FINRA enforcement actions have already taken place involving hedge funds. In 2004, UBS was found to be in violation of advertising rules. Specifically, "Fund seeks 20 to 25%." Also in 2004, Citigroup was found to have violated advertising rules with the following: "Seeks an annualized return of 15% or more." CIBC, in 2005, was found to have violated marketing and advertising rules by not properly disclosing risks specific to the funds' objectives and the advertisement of a registered fund in a periodical contained insufficient risk disclosure.

Other Reading

The following, from FINRA's training manual, is a list of Suggested Reading Web sites on hedge funds:

Regulation of Hedge Funds
www.cme.com/files/hedge.pdf

Marketing
www.cm-p.com/pdf/hedge_fund_marketing.pdf

Sales Practices
www.cm-p.com/pdf/hedge_fund_practices.pdf

Margin Exemptions for Customers of Primary Government Bond Dealers and What Really Happened to Bear Stearns & Co.

Steven H. Levine

Steven H. Levine is the Chairman of the Hoot Group, Inc. which is a Global Margin Credit Advisor, Wall Street Consultant and Expert Witness Service. He spent the last 45 years devoted to the Margin-Credit Risk Compliance Operations and Clearance side of the Industry. For 25 years, Mr. Levine was the NYSE Assistant Chief of Credit Regulations and is the co-author of the Credit and Margin rules for the entire financial community using the NYSE Margin Interpretation Handbook. Mr. Levine can be reached at 570-595-9770 or bighootoftx@aol.com.

Margin Background for Exempted Securities

Most practitioners are familiar with the general margin requirements outlined in the Federal Reseve Board's "Margin Rule Regulation – T, often abbreviated to "Reg T". However, Reg T is only applicable to equity securities. One of the major provisions of the "NYSE Margin Rule 431" I helped write, develop, and enforce was the Margin Application for Exempted Securities, Corporate and Fixed Income Bonds; including the Margining of CMOs and CMO Related Products. Historically, all non-equity securities, including exempted securities, were subject to their "good faith" margin provisions. The NYSE was given the responsibility to adopt Margin requirements for non-equity securities.

In 1975, Congress passed the first major overhaul of the securities industry since 1934. The "Securities Act of 1934" was created at the same time the FRB's Reg T and the NYSE's "Margin Rule 431" were also adopted. The "Securities Reform Act of 1975" gave the SEC its broad regulatory powers which are still in place today. One of the major concerns that the SEC's Division of Market Regulations had was the need for uniform margin rules among all the US Exchanges so that one Exchange would not have an advantage over another because of lower Margins.

The NYSE was given the leadership role by the SEC to adopt uniform margins, which also included exempted securities. I was given the task to complete a comparison Margin Review of *all* of the US Exchanges and the NASD Margin Rules & Regulations. As a result of my review and recommendations, the NYSE created both *THE NYSE INTERPRETATION HANDBOOK* and bulletins known as *INFORMATION MEMOS*, which apprise NYSE member firms of new and pending margin changes. Another NYSE Margin bulletin that was created is known as *THE NYSE INTERPRETATION MEMOS* and it announced the NYSE's and FRB's "Regulation – T" new and updated interpretations to their Margin Provisions. Subsequently, the FRB adopted its own *SECURITIES CREDIT TRANSACTIONS HANDBOOK*.

Margin Ability of the First CMO – GNMA

In 1975, the SEC Division of Market Regulations was concerned with the rapid increase in the unregulated GNMA market which had no set margin, capital or clearance requirements. Again, the SEC requested that the NYSE adopt uniform margin, capital, clearance and compliance rules and regulations involving an exempted security.

The major emphasis to the changes was to impose SEC—NYSE Capital Restrictions in order to curtail the "Firm" from overextending, overexposing, and creating concentration positions in the trading of one type of security, even though it was a US Government Agency Security. This became the foundation for the margin treatment of customers of Primary Government Bond Dealers.

Margin Exemptions for Customer of Primary Government Bond Dealers

In 1960, the Fed, along with the FRB of New York Oversight, established the concept of Primary Government Bond Dealers to assist the FED in the distribution of US Government Securities. This was done in order to finance the US Government and to meet payroll obligations to government employees. As market makers, the Bond Dealers created the liquidity that was needed to both trade and fund the Government Securities. Over the next several years, this concept was expanded to include the US Government agencies of: HUD, FNMA, FREDDIE MAC, and the securities issued by them.

In order to HEDGE their positions, the SEC, in the late 1980's, defined O-T-C options created by the Bond Dealers as Exempted Securities, thereby exempting the O-T-C options from the Margin treatment as a regular O-T-C option, which had much higher Margin requirements that then made it very costly or even prohibited from trading the O-T-C options.

On or about 1979, the NYSE member firms who were Primary Government Bond Dealers asked the NYSE to exempt their customers from NYSE "Margin Rule 431" margin requirements and were willing, in lieu of margins, to take the appropriate capital charges. This action was done on the basis that the Bond Dealers knew their customers, and that they were willing to take capital charges because it was their Firm's capital that was at risk.

In this regard, the NYSE adopted a special US Government Securities Margin Exemption for the Bond Dealer customers. The exemption provided that if the Margin requirements are lower than the SEC Capital Proprietary US Government Haircut Deductions, a deduction in computing the Bond Dealers net capital will be made to the extent that the equity in a customer's account is less than such Haircuts.

Over the years, the NYSE US Government Securities "Margin Rule 431" requirements were reduced to the levels of the SEC Capital Requirements for US Broker-Dealers. The NYSE adopted additional, and similar, Margin exemptions for different types of customers, also making them subject to the SEC's Capital Haircut Charges. The NYSE Margin Requirement for US Government Securities that are 20 years or more to maturity, which most CMO's and CMO-related products fall under, is 6% of the current market value. This is equal to 16.6 – 1 margin leverage.

Mark to the Market

Given that the basis for determining margin compliance is the market value of the security, NYSE "Margin Rule – 431" required a "Mark to the Market" in order to determine the true market value that the NYSE member can realize upon the liquidation of the security. This is required in order to determine if the US Broker – Dealer must take SEC – NYSE Capital Charges, also known as a Cash Margin Deficiency Charge (CMD charge). It has been the violation of this fair valuation procedure that has created many of the problems that resulted in the demise of firms such as Bear Stearns.

The SEC Forces Primary Government Bond Dealers to be Members of the NYSE or the NASD

Due to the 1975-1976 expansions in GNMA volume, the SEC forced those dealers that had separate non-regulated entities to either become a member of the NYSE or the NASD

or to merge the entity into an existing affiliate that was already a member of the NYSE or NASD; the Bond Dealer would have to cease to exist if it refused. The major purpose was to put the Bond Dealers under uniform capital and regulatory control with the SEC, SROs, and the FRB of New York Oversight. However, as is now clear that these entities did not follow through with their regulatory responsibilities, resulting in catastrophic losses to many firms and devastation that will change the face of the securities business forever.

Bear Stearns & Co. and Bear Stearns' Two Hedge Funds Downfall Attributed to Margin Credit Capital Over Leveraging and Inflated CMO – CDO Prices

In the early part of 2003, when Bear Stearns & Co. controlled the CMO – CDO Market, it was known on "the street" that Bear Stearns & Co. had inflated their CMO – CDO Capital Assets as high as 30%. The same held true for June and July of 2007.

Bear Stearns could not take a true value "Mark to the Market" against its then $20 Billion capital assets that the Firm leveraged 30 -1, thereby booking its assets at $600 Billion. To do so would have clearly resulted in a situation that would quickly destroy Bear Stearns' capital base. Additionally, Bear Stearns' $20 Billion capital base was not true cash belonging to Bear Stearns, but rather it represented short term cash loans that Bear Stearns perpetually rolled over and over. As a result, there was a double edged sword that made any markdowns catastrophic. As a result, Bear Stearns simply did not appropriately mark their CMO and CDO assets correctly.

A further problem for Bear Stearns was its hidden CMO –CDO Investment Banking relationship with Merrill Lynch, Pierce, Fenner, and Smith (MLPFS). As a result of the relationship, Merrill Lynch, in less than two years, took over Bear Stearns & Co. as the number one CMO –CDO Investment Banking firm in size, securitization, and volume.

A major part of Merrill Lynch's Investment Banking relationship with Bear Stearns & Co. was that Merrill Lynch used its own research department to repeatedly recommend Bear Stearns' stock, including and up until the Federal government's announcement on March 16, 2008 of Bear Stearns' merger with JP Morgan Chase. The Federal Government provided a $30 Billion guarantee and an immediate lowering of the FED's interest rate by ¼ %. Since the summer of 2007, with the demise of Bear Stearns' two Hedge Funds, it was in Merrill Lynch's financial best interest to have Merrill Lynch recommend, repeatedly, Bear Stearns' stock as a take over stock price in the $85 -– $105 price range (using Bear Stearns' then Book Value of $85 per share, in addition, add on a 20% premium or $17 over Bear Stearns' Book Value = a Target Price of $103+ per share).

Since January 2007, when Bear Stearns' stock hit an all time high of $170 per share, the stock, in less than 15 months, dropped over 140 points until the "close" on March 14, 2008. On Monday, March 17,2008, the stock hit a new low of $2 per share, which was equal to a 168 point loss since its January 2007 high.

The problems for Bear Stearns and the overall CMO-CDO market was first realized with the implosion of two Bear Stearns hedge funds. The demise of Bear Stearns' two Hedge Funds not only had a spill over effect, but also created a hidden domino effect upon Merrill Lynch's CMO –CDO capital assets and hidden actual worth. The result was the November 2007 firing of Merrill Lynch's then CEO, and Chairman, Mr. Stan O'Neal. The continuous "write–offs" of billions of dollars worth of Merrill Lynch's CMO –CDO capital assets, presently estimated at $40 Billion, led to the need for the Firm to try to raise additional replacement capital.

Moreover, the ultimate effect was the demise of Bear Stearns itself. With the capital base eroded, Bear Stearns was clearly bankrupt under most standards. However, historically, the Federal Government would not allow, and has not allowed a Primary Government Bond Dealer to go into Chapter 11 because to do so would cause havoc in the US and Global Government Securities – Bond Markets. It would cause a loss of creditability for the US Government and the Federal System. Instead, the Federal Government will force the Firm to either terminate its relationship with the Fed or find a merger partner that is better capitalized and who is already a Primary Government Bond Dealer. This action is exactly what the Fed did to Bear Stearns & Co., thus forcing it to merge with and into JP Morgan Chase Securities, Inc., paralleling its actions in the early 1990's when the Federal Government did the same thing to Salomon Brothers, a NYSE Member Firm. Today, Salomon Brothers no longer exists.

The Three Tier Leveraging of CMO – CDO Related Products

All the NYSE Member Firms who are Primary Government Bond Dealers are also Prime – Brokers who clear for Hedge Funds. Many of the Firms also own an affiliate or have a division that clears and carries, fully disclosed, for other introduced Broker – Dealers, who in turn, have retail Margin customers that are introduced to the Carrying – Clearing Firms; these firms are legally responsible for Margin compliance since they are the Firms who are extending the credit, not the Margin customer nor the introduced Firm.

1st Tier consists of an NYSE Member Firm Primary Government Bond Dealer leveraging capital of 30 – 1 or higher.

2nd Tier consists of Hedge Fund Customers clearing through the same NYSE Member Firm who is also a Prime Broker and a Primary Government Bond Dealer leveraging margin of 20 – 1 or higher.

3rd Tier consists of introduced Margin Customers of the same NYSE Member Firm, Prime – Broker, Primary Government Bond Dealer leveraging Margin of 10 – 1 or higher.

Margin Capital Quicksand Trap

What you have here is not a Margin Bubble, but rather a Margin stack of cards or dominoes waiting to cave in at the first true "Mark to the Market" value. It does not matter if it is done first from the top or from the bottom or from the middle. It also does not matter if all of the Capital – Margin CMO – CDO positions are the same, similar, or related, which also includes their ratings. Once the true "Mark to the Market" has been done, all of the previous inflated prices will disappear creating an immediate Margin Capital Quicksand Trap. The results are huge losses, write-offs, and SEC – NYSE Capital Charges equal to 100% of the Debit Balances. The "Quicksand Trap" immediate effects are to the Firm's net worth earnings and the SEC's Capital Focus Report of the US Broker –Dealer.

Today, there is an estimated $11 Trillion worth of mortgage markets, and each of at least six NYSE Member Firms (out of the 22 US Primary Government Bond Dealers), has capital assets between $20-$30 Billion. Included in this group was Goldman Sachs & Co., which had $40 Billion in capital assets. Each firm had leveraged their capital assets at 30-1 or higher for an estimated combined total worth of $5.4 Trillion.

Firms' Violations

Individually and collectively there were major violations of the Fed's and the SEC's "Safety and Sound Provisions" by the involved Banks, Brokerage Firms and Primary Government Bond Dealers. There were major violations of Regulatory Capital, the SRO's Margin - Capital Credit - Risk Rules,

Regulations, and Procedures thereof, in addition to the Brokerage Firm's own House Margin Credit Risk Compliance and Operational Rules and Procedures.

Additional violations include:

- Sales Practices and Failure to Disclose to Customers,
- Fiduciary and Duty to Care,
- Failure to Know Your Customer,
- Over Extension of Margin Credit to Margin Customers,
- Repeated Failures of Pricing and Trading Systems,
- Failure to Accurately "Mark to the Markets",
- Violations of Books and Records,
- Self Dealings,
- Failure to Supervise.

Concluding Summary

By all appearances, the involved NYSE Member Firms, who were also Primary Government Bond Dealers, Prime – Brokers for Hedge Funds, and Clearing and Carrying Firms for other US Broker – Dealers individually and collectively, operated criminal enterprises. The involved CMO's and CMO-related products created the largest fraudulent "Pump and Dump" scheme I've ever seen that has affected the investing public in the United States and in the Global Marketplace. These dishonest actions also hold true for the present legal problems in the Auction Rate Securities Market because they involve the same NYSE Member Firms and cover the same period of time.

Every security holds risks, some more than others. In those instances where securities become non-liquid and have no active marketplace, or cannot accurately be priced or liquidated (sold) promptly, the security cannot be Margin or ceases to be Margined. There is no risk reward nor are there any economic incentives for Margin Customers to Margin leverage 5-1 or 10-1 or higher, etc. for particular bonds or securities. This is especially true if the monthly Broker's Margin Interest charges, which Brokers compound daily, exceeds the interest income received from the Margin leverage positions.

Since the mid 1980's, in response to Margin Customer's complaints, the SEC, NASD, and NYSE Examiners and their Enforcement Investigators have referred to the above mentioned in order to determine both the suitability of the Customer's Margin Securities and the over extension of credit by their Brokerage Firms. This action was highlighted by the SEC, NASD, and the NYSE with regard to the 1987 Market Crash, the Technology Stock Market Bust of the early 1990's, and in the Margin Overleveraging of CMO's and CMO-related products. Unfortunately, Margin Overleveraging still exists today and needs to be curtailed.

Recent Arbitration Awards

Jason M. Kueser

Wilson, et al. v. Benson York Group, Inc., Robert Marcus, Jr., Kevin Brennan, and John Conroy,
FINRA Case No. 05-04849

Claimants, who were unsophisticated investors, lost nearly 100% of their investment, approximately $200,000, in ten months. $150,000 went to the firm for commissions, fees, and margin interest. After the filing of the claim, Benson York closed its doors. The Claimants amended their claim to name the CEO and President of Benson York under theories of control person liability.

Claimants asserted the following causes of action: Violations of Alabama Securities Act, Breach of Contract, Fraud, Misrepresentation and Omission, Control Person Liability

The Respondents denied the allegations and asserted various affirmative defenses.
All Respondents were found jointly and severally liable for Compensatory Damages in the amount of $201,345 with interest thereon at 6% until paid; Attorneys' fees of $70,472; Costs of $18,077; and Punitive Damages of $30,000, for a total award of $319,894.

Claimants' Counsel: Robert A. Kantas and Jason A. Richardson of Shepherd, Smith, Edwards & Kantas, LLP, Houston, Texas.

Respondent's Counsel: Charles M. O'Rourke, Woodbury, New York

Claimants' Expert: Jerrod R. Summers, CFP

Respondent's Expert: None

Arbitrators: Samuel Appel (Chair), W. William Harness (Public), Don M. Bieger (Non-Public)

This case is significant because it resulted in findings of fraud and of violation of the securities act, resulting in a non-dischargeable award. During closing, Claimants' counsel requested specific findings of fact from the Panel against the control persons, explaining to them that if they gave those findings of fact in the Award, it would become non-dischargeable in bankruptcy. The Panel found specific violations of the Alabama Securities Act, and further found that "Respondent Marcus churned Claimants' accounts with the acquiescence of Respondents BYG, Brennan and Conroy and that Respondents BYG, Marcus, Brennan and Conroy perpetuated a fraud upon the Claimants."

Jason M. Kueser is an associate with the Nygaard Law Firm, in Leawood, Kansas. Mr. Kueser can be reached at Jason@nygaardlaw.com

Keith A Grice, individually and as personal representative for the Estate of .I. Max Grice, Roger D. Weed, Dr. Howard L, Brazil, J. D. Russell, and Joyce Russell v. Morgan Keegan & Company, Inc.;
FINRA Case No.: 07-02010.

This was a multi-party case involving three investors. One Claimant was a middle-aged truck driver with present day nominal earnings. Another Claimant was a surveyor with the State of Alabama and had placed inherited money with Morgan Keegan. The third Claimant was a cardiologist from Birmingham who had moved to Montgomery, the location of the Morgan Keegan office in question. In all respects their accounts were churned. Furthermore, all three of the investors were in the same speculative investments during the churning. The investments were Finisar, QLogic, Sanmina, and others. Claimants' investigation showed that at least a dozen other clients had been equally churned in the same speculative stocks. In addition, the Montgomery office of Morgan Keegan had been cited for 23 different infractions from 1999 through 2005. The result was a complete bar to the stock brokers in question. They were never allowed, according to Alabama Securities Commission findings, to sell stocks for any entity again. The two Montgomery supervisors in question were also barred temporarily with the option allowed for them to retake their Series 7 and only be permitted to sell stock in the future; they were barred from ever being supervisors. The Claimants tried the case as an unsuitability/no supervision/churning case.

Claimants asserted the following causes of action: Breach of Contract; Violation of NASD and NYSE's Know Your Customer Rule; Unsuitability; Failure to supervise; and, Violations of securities laws, including securities regulatory rules, common law claims and the Alabama Fraud Statute and Securities Act.

Respondent denied liability and asserted various affirmative defenses.

During the evidentiary hearing, Claimants clarified their requests for relief to include their combined net-out-of-pocket losses of $280,210, plus punitive damages.

The Panel entered the following compensatory damages awards to Claimants:
Claimant Brazil: $ 14,000.00
Claimant Grice: $ 90,000.00
Claimant Weed: $128,965.00

This award represented approximately 80% of net-out-of-pocket losses. In addition, the Panel awarded post-judgment interest on the respective compensatory damages awards at the rate of 6% per annum. However, because the fraud statutes of limitations had run prior to Claimants' counsel having the case referred to him, no punitive damages were allowed.

Claimants' Counsel: Charles M. Thompson, Esq., Charles M. Thompson & Associates, P.C., Birmingham, Alabama.

Respondent's Counsel: John Starnes, Vice President, Associate Attorney, Morgan Keegan & Company, Inc., Memphis, Tennessee, until on or about May 12, 2008; thereafter, Bradley B, Rounsaville, Esq., Maynard Cooper & Gale, P.C., Birmingham, Alabama.

Claimants' Expert: Susan Rapier (damages), Lane Fentriss (suitability).

Respondent's Expert: Steve Scales.

Arbitrators: William Harness (Chair); Donald Milo Helton (Public); Robert E. Graves (Non-Public)

This case is significantas this was one of a "daisy chain" of cases regarding the operation of the Montgomery, Alabama Morgan Keegan office from 1999 through 2005. Claimants' counsel's employee located records on the internet that showed the stock brokers in question had been punished to the point of being disallowed from selling stocks and a similar, but temporary "disbarment" of the

managers. In addition, Claimants' counsel had attempted to subpoena records from the Alabama Securities Commission, which is required by Alabama law to affirmatively respond to subpoenas from FINRA. The Alabama Securities Commission received the subpoena and refused to respond claiming that all of their studies were confidential and their official position is they do not respond to even requests in the form of subpoenas from FINRA. Lastly, this case is significant because Claimants' counsel used an in-house employee who has an MBA in accounting as well as Series 7, 63, 65 and other securities licenses to testify in support of well-managed portfolio damages over Respondent's counsel's objection.

Steven E. Quint v. Citigroup Capital Markets, Inc. f/k/a Salomon Smith Barney and Joseph C. Denicola;
FINRA Case No.: 07-01653

This is a case related to the sale of a penny stock to Claimant. The broker sold Claimant a penny stock without providing any required risk disclosures. Soon before the transaction, Citigroup became a market maker in the penny stocks sold to Claimant. During discovery, Citigroup inadvertently produced order tickets related to the customer's account. From these, evidence was presented that showed the broker entered each trade as "unsolicited". The arbitrator found that the broker did this to avoid supervisory scrutiny. At the hearing, the broker continued to misrepresent the facts and circumstances related to the purchase by claiming that the sales of the stock to Claimant's account and several other clients' accounts were "coincidentally" and "accidentally" marked as "unsolicited." The broker had a history of complaints; however, Citigroup failed to take any steps to properly supervise him. At the hearing, the arbitrator found the supervisor was completely unaware of any of the regulatory requirements surrounding his obligation to supervise this broker and the transactions. The arbitrator also found that Citigroup had notice of the broker's actions because other customers had previously complained about being sold the same penny stock. Nevertheless, Citigroup took no action to protect Claimant or other clients of the broker.

Claimant asserted the following causes of action: Breach of Fiduciary Duty; Violation of FINRA rules; Common Law Fraud; Negligent; Negligent Hiring, Retention, and Supervision; Misrepresentation; and, violation of Fla. Stat. § 517.301.

Respondent denied liability and asserted various affirmative defenses.

The single arbitrator awarded approximately $103,000.00 in total, including $44,865.00 in compensatory damages, plus interest in the sum of $8,465.23 and punitive damages of $50,000.00.

Claimant's Counsel: Randall C. Place, Esq., The Law Offices of Place and Hanley, PLLC (and Scott Silver of Blum & Silver, LLP)

Respondent's Counsel: Douglas B. Appel, Senior V.P. and Assoc. General Counsel for Citigroup

Arbitrator: Monica I. Salis

This case is significant because it resulted in a single arbitrator awarding what amounted to essentially full damages plus punitive damages and statutory interest as permitted under Florida law. This case was posted on Bloomberg.com, where a Citigroup representative was quoted as saying the firm was "disappointed with the award" and that the firm, "entirely disagree[d] with it." (http://www.bloomberg.com/apps/news?pid=newsarchive&sid=aVwloASI_zms). In addition, the arbitrator entered approximately two pages of findings in support of her award.

Charles B. Lee & Denise P. Lee vs. Raymond James Financial Services, Inc., Moseley and Associates, LLP, and John M. Moseley;
FINRA Case No. 06-04074

This case involves an early retiree taking distributions under § 72(t). As a retiree, he desired and needed income. However, because he was under age 59 ½, he received distributions under § 72(t) of the Internal Revenue Code. Respondent Moseley had discretionary authority over the account and charged Claimant a management fee. Ultimately, Respondent purchased few, if any, income producing investments and relied on capital gains from the purchase and sale of stocks to meet Mr. Lee's "income" needs.

Claimants asserted the following claims: Unsuitability, misrepresentations, omissions, breach of fiduciary duty, failure to supervise.

Respondents denied liability and sough expungement and costs assessed against Claimants.
The claim specifically requested compensatory damages of $640,000.00; however, the account actually earned a net profit of $75,000.00 over its life.

Award: Compensatory damages of $225,000, plus reimbursement of filing fees ($375.00).

Claimants' Counsel: Richard A. Lewins, Esq., Burg Simpson Eldredge Hersch & Jardine, P.C., Dallas, Texas.

Respondents' Counsel: Erin Linehan, Esq., Raymond James Financial Services, Inc., St. Petersburg, Florida.

Claimants' Expert: Jerrod Summers

Respondents' Expert: Ken Collier

Arbitrators: Phillip Lee Scheidt, Ph.D (Chair), James Douglas Haigh (Public), and W. Donald Parr (Non-Public)

This case is significant as the Panel was persuaded to ignore the fact that the account was profitable and elected not to use the netting formula Respondents asserted as a defense to any losses.

Steve and Christy Routh v. ING Financial Partners, Inc., Locust Street Securities, Inc. and Frank Dean Barber;
FINRA Case No. 07-02704

Claimants alleged that Barber, an agent of ING and Locust Street, misrepresented and concealed material facts regarding an unsuitable 412(i) plan, annuities, whole life insurance, and B-share mutual funds.

Claimants asserted the following claims: misrepresentation, breach of fiduciary duty, negligence.

Respondents generally denied any responsibility and Respondents ING and Locust denied the allegations made in the Statement of Claim and asserted affirmative defenses including the following: failure to state a claim; ratification; estoppel; waiver; assumption of risk; and lack of causation.

Claimants requested restoration of lost insurance premiums of $168,000, disgorgement of commissions on annuities and mutual funds, interest, and attorneys' fees.

Award: The Panel awarded $168,000 against Respondent Barber.

Claimants' Counsel: John Miller, Swanson Midgley, LLC, Kansas City, Missouri.

Respondents' Counsel: Ross A. Anderson, Esq., Whyte Hirschboeck Dudeck S.C., Milwaukee,
Wisconsin for Respondent Barber; Jesse Linebaugh, Esq., Faegre & Benson LLP, Des Moines, Iowa for Respondents ING and Locust Street.

Claimants' Expert: None

Respondents' Expert: Greg Wood

Arbitrators: Michael D. Fitzgerald (Chairp) and Michael Braude (Non-Public). The third arbitrator withdrew from the case after a hearing on August 20, 2008 and the parties agreed to proceed with only two arbitrators.

This case is significant because the arbitrators in effect ordered the financial advisor to refund all premiums paid for whole life insurance that was cancelled when it became apparent that the 412(i) plan under which it was purchased would not be approved by the IRS.

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

Enforcing Arbitration Agreements: Parent Corporation

Whitemaine v. Aniskovich
(Nev., May 15, 2008) 124 Nev. 29, 183 P.3d 137

A parent corporation can enforce an arbitration agreement contained in an employment agreement between an employee and a subsidiary corporation, even where there is an integration clause in the agreement between the parent corporation and the employee.

Here, the employee/plaintiff signed two employment agreements, one with an NASD member firm (BAIS) and another with its parent corporation which is not an NASD member firm (BofA). The BAIS employment agreement contained an arbitration agreement; the agreement with BofA did not. However, the BofA employment agreement contained an integration clause, which the employee contended prevented BofA from relying on the arbitration clause in her BAIS employment agreement.

The court concluded that the employee was still obligated to arbitrate her claims against BofA (the parent corporation), because the Bank of America and BAIS employment agreements actually formed one agreement, featuring an integration clause, an arbitration clause, and all the remaining provisions of those two agreements.

Two instruments are presumed to be a single contract if (1) they are contemporaneously executed, (2) they concern the same subject matter, and (3) one of the instruments refers to the other. The court then considered whether this general presumption extends to a case where the agreements are executed between different parties and when one of those agreements contains an integration clause. The court concluded that an integration clause would not prevent the two instruments from being considered as one.

Therefore, the district court properly ordered the employee to arbitrate her claims against Bank of America even though the employee was solely a Bank of America Insurance Services employee when her claims arose.

Timothy A. Canning, an attorney in Arcata, California, is a PIABA member whose practice is devoted primarily to representing parties in securities and investment – related disputes, in court and in arbitration.

Challenging Arbitration Agreements: Grand Scheme to Defraud

Amoroso v. Metropolitan Life Ins. Co.
(N.Y.Sup. 4/14/2008) 19 Misc.3d 1119(A), 2008 WL 1724002

A brokerage firm's motion to compel arbitration of a customer's claim is properly denied under either the Federal Arbitration Act or under New York law, where the customer sufficiently alleged facts to show a grand scheme to defraud that permeated the entire agreement, including the arbitration clause.

In this action, plaintiff had received a significant sum of money from the "September 11th Victim's Compensation Fund". Plaintiff alleged that defendants knew of her fragile mental/emotional/physical state and fraudulently induced plaintiff into purchasing several different accounts/investments from defendants and in the course of doing so plaintiff was defrauded. Plaintiff further alleged that defendant Kevin Dunn forged signatures, made false representations, procured fraudulent accounts and transactions, and overall attempted to defraud the plaintiff out of the money she received from the Fund.

Defendants, in lieu of an answer, filed a motion to compel arbitration pursuant to the arbitration provision contained in the MetLife Securities Investment Account Application & Agreement that plaintiff purportedly signed.

The court denied defendants' motion to compel arbitration. While the FAA strongly favors resolving disputes in favor of arbitration, the parties are still free to add qualifications to arbitration clauses that state law govern the arbitration agreement and its enforcement. The court found that the parties' intentions were to have New York law govern the account agreement, including the arbitration provision. The agreement was entered into by two New York domiciliaries, with transactions occurring within the State of New York and with a provision in the arbitration clause that selects New York Law as governing any dispute. Further, no transactions occurred outside the State of New York and therefore, the defendants failed to provide any evidence establishing that the contract at issue "affects interstate commerce"

The court concluded that both federal and New York law agree on the interpretation of whether allegations of fraud in the inducement of the contract require the parties to submit to arbitration. Under both New York and federal law, the courts are required to treat an agreement containing an arbitration clause as if there were two separate agreements: the substantive agreement between the parties, and the agreement to arbitrate. Further, in considering the two separate agreements, it is settled that unless it can be established that there was a grand scheme to defraud which permeated the entire agreement, including the arbitration provision, the arbitration provision may still be valid despite an underlying allegation of fraud on the substantive contract.

In considering whether the plaintiff established a "grand scheme" to defraud, courts have taken into account whether the agreement resulted from "arm's length negotiations" where the parties dominant intention was to resolve the dispute by arbitration or whether the wording of the arbitration clause is broad enough to encompass claims of fraudulent inducement.

Here, the court concluded that the plaintiff pled sufficient allegations which, if true, would invalidate the entire agreement, including the arbitration clause.

Challenging Arbitration Agreements: Who Decides

Magnolia Capital Advisors Inc. v. Bear Stearns & Co.
(11th Cir. 4/3/2008) 2008 WL 879973

Where a party resisting arbitration produces evidence to substantiate its claim that no

arbitration agreement existed, a trial was required under the FAA as to whether an agreement to arbitrate existed

Magnolia was a registered investment advisory firm whose primary activities involved recommending and directing securities transactions to its clients. Magnolia's principal made the recommendations and transactions with clearing agent Bear Stearns through Paragon Financial Group, an introducing broker dealer. Bear Stearns was to provide daily status reports containing accurate and up-to-date information on Magnolia's client accounts. In its suit against Bear Stearns, Magnolia alleged that Bear Stearns, for various reasons, failed to provide the daily reports, causing Magnolia clients substantial losses when margin calls were unexpectedly issued, forcing liquidation of those accounts. Accordingly, Magnolia brought claims for negligent misrepresentation, negligence, fraudulent misrepresentation, and tortious interference with existing business relationships.

Bear Stearns filed a motion to dismiss or compel arbitration of those claims, citing certain provisions contained in an "Options Information Form and Agreement" ("Options Form") as proof that Magnolia had agreed to resolve all disputes by arbitration. Magnolia denied having entered into that agreement.

The court held that a trial was required to determine whether there was a binding agreement to arbitrate. Only when there is no genuine issue of fact concerning the formation of the agreement should the court decide as a matter of law that the parties did or did not enter into such an agreement. Further, as in the case of any other summary judgment, a district court considering the making of an agreement to arbitrate should give to the party denying the agreement the benefit of all reasonable doubts and inferences that may arise. In 9 U.S.C. § 4, the FAA provides for a trial when the making of an agreement to arbitrate is in issue. The court found that Magnolia produced evidence sufficient to substantiate its unequivocal denial of having made any such agreement to arbitrate.

Arbitration Required Under FINRA Rules: Who Is A Customer

McMahan Securities Co. L.P. v. Aviator Master Fund, Ltd.
(N.Y. Sup. 5/13/2008) --- N.Y.S.2d ----, 2008 WL 2128066

An NASD member firm may be compelled to arbitrate claims by investors who dealt with the member firm as a placement agent for an issuer.

In this case, respondents (who were hedge funds) filed an NASD Statement of Claim against petitioner McMahon in July 2007, alleging fraud, negligent misrepresentation, negligence and violation of the Blue Sky laws of California, Connecticut and Minnesota, arising out of the Funds' investments in securities for which McMahon acted as an underwriter. Since no written agreement to arbitrate existed between the parties, the hedge funds sought arbitration under NASD Code of Arbitration Procedure Rule 12200, which would compel McMahon to arbitrate, as a result of its NASD membership, upon the request of a customer. McMahon then filed this court action, seeking to stay the NASD arbitration arguing, inter alia, that the hedge funds were not customers of McMahon in relation to the transactions at issue.

After concluding that the transactions in issue were subject to the Federal Arbitration Act, the court then concluded that the relationship between McMahon and the hedge funds fell within the scope of NASD rules which obligated McMahon to arbitrate the Funds' claims.

The court applied the new code's rule 12200's definition of customer, which the court found to be very broad, and which also includes customers of any person associated with the member. Here, the hedge funds dealt with McMahon as the issuer's

Placement Agent, during the Offering. Institutional investors who enter into subscription agreements with third-party representatives of an NASD member qualify as the member-firm's customers in a private placement transaction, and hence can compel arbitration pursuant to Rule 12200.

As an alternative basis for compelling arbitration, the Funds also alleged that McMahon was negligent in permitting its representatives to participate in the offering. The NASD requires that its members supervise the activities of its associated persons. Therefore, any dispute arising from a firm's lack of supervision over its brokers arises in connection with its business activities. Here, the essence of respondents' negligence claim was that McMahon failed to supervise the activities of its own representatives in connection with the fraud and misrepresentations perpetrated on the Funds.

Waiver of Arbitration: Litigation Conduct

Perry Homes v. Cull
(Tex., 5/2/2008) --- S.W.3d ----, 2008 WL 1922978

Waiver of the right to arbitrate by litigation conduct can be raised in an action to vacate the arbitration award; it is a question for the court to decide, not the arbitrators.

According to the Texas Supreme Court, since 1846, Texas law has provided that parties to a dispute may choose to arbitrate rather than litigate. But that choice cannot be abused; a party cannot substantially invoke the litigation process and then switch to arbitration on the eve of trial. There is a strong presumption against waiver of arbitration, but it is not irrebuttable.

Here, the Plaintiffs vigorously opposed (indeed spurned) arbitration in their pleadings and in open court; then they requested hundreds of items of merits-based information and conducted months of discovery under the rules of court; finally, only four days before the trial setting, they changed their minds and decided they would prefer to arbitrate after all, under precisely the same clause and conditions to which they had originally objected. Having gotten what they wanted from the litigation process, they could not switch to arbitration at the last minute. The court vacated the arbitration award and remanded the case to the trial court for a prompt trial.

Addressing the question of whether waiver of arbitration by litigation conduct could be raised post-arbitration, the court acknowledged that doing so may create a “huge waste of the parties' resources.” But if review is available before arbitration, parties may also waste resources appealing every referral when a quick arbitration might settle the matter. Frequent pre-arbitration review would inevitably frustrate Congress's intent “to move the parties to an arbitrable dispute out of court and into arbitration as quickly and easily as possible.” The court recognized the potential for waste, but that is a risk a party must take if it moves for arbitration after substantially invoking the litigation process.

Waiver of arbitration by litigation conduct is an issue to be decided by the courts, not the arbitrators. When waiver concerns limitations periods or waiver of particular claims or defenses, arbitrators decide those issues. Parties generally intend arbitrators to decide matters that “grow out of the dispute and bear on its final disposition,” while they intend courts to decide gateway matters regarding whether the parties have submitted a particular dispute to arbitration. Waiver of a substantive claim or delay beyond a limitations deadline could affect final disposition, but waiver by litigation conduct affects only the gateway matter of where the case is tried.

As waiver by litigation conduct goes solely to the arbitration clause rather than the whole contract, consistency suggests it is an issue for the courts

Finally, simply because the party did not ask the court to make any judicial decisions on the merits of their case does not mean that the party could not have waived the right to compel arbitration. Waiver involves substantial invocation of the judicial process, not just judgment on the merits.

Like any other contract right, arbitration can be waived if the parties agree instead to resolve a dispute in court. Such waiver can be implied from a party's conduct, although that conduct must be unequivocal. And in close cases, the "strong presumption against waiver" should govern.

Under Texas law, waiver may not include a prejudice requirement, but estoppel does. In cases of waiver by litigation conduct, the precise question is not so much when waiver occurs as when a party can no longer take it back.

The court applied the totality-of-the-circumstances test in deciding that the Plaintiffs waived their right to compel arbitration; discovery is not the only measure of waiver. Here, when the Defendants initially moved to compel arbitration, the Plaintiffs filed a 79-page response opposing it, asserting that the AAA "is incompetent, is biased, and fails to provide fair and appropriate arbitration panels." They complained of the AAA's fees, and asserted that as a result the "purported arbitration clause is unconscionable and unenforceable, and this court's enforcement of such would be nothing short of ridiculous and absurd." This, plus their prayer asking the trial court to deny the motion to compel arbitration "in its entirety," convinced the court to deny the motion to compel arbitration.

It is also unquestionably true that this conduct prejudiced the Defendants. "Prejudice" has many meanings, but in the context of waiver under the FAA it relates to inherent unfairness-that is, a party's attempt to have it both ways by switching between litigation and arbitration to its own advantage.

Plaintiffs got extensive discovery under one set of rules and then sought to arbitrate the case under another. They delayed disposition by switching to arbitration when trial was imminent and arbitration was not. They got the court to order discovery for them and then limited their opponents' rights to appellate review. Such manipulation of litigation for one party's advantage and another's detriment is precisely the kind of inherent unfairness that constitutes prejudice under federal and state law.

DURING THE ARBITRATION

Court Involvement In Ongoing Arbitration

Sampson v. Judicial Arbitration and Mediation Services
(Cal.App., 4/30/2008) 2008 WL 1892686

While an arbitration is pending, a court cannot direct a private arbitration service to vacate appointment of an arbitrator where the arbitration rules specify that disputes concerning the appointment of the arbitrator are to be resolved by the arbitration service.

In this matter, petitioners sought a writ of mandate directing Judicial Arbitration and Mediation Services, Inc. (JAMS) to vacate its appointment of an arbitrator and initiate new appointment proceedings. The petitioners contended that JAMS did not follow its own rules in appointing an arbitrator, and sought a court order requiring JAMS to: "(a) Set aside their order appointing the Honorable Charles A. Legge as binding arbitrator of their dispute; (b) Re-initiate the appointment of an arbitrator anew and in accord with their established Rule for conducting such proceedings; and, (c) Adopt such procedures as required with the approval of the disputing parties, to satisfy the qualifying requirements for the selection of an arbitrator established by their alleged contract(s)."

The petition named JAMS and Judge Legge as respondents, but did not name the other party to the arbitration. The other party successfully moved to intervene in the writ

proceedings, and both JAMS (together with Judge Legge) and the other party to the arbitration opposed the petition.

In affirming the denial of the petition, the court concluded that, once a motion to compel arbitration is granted, it would be wholly incompatible with established policies of the law to permit a court to then intervene in, and necessarily to interfere with, the arbitration ordered. In large measure, it would not only preclude the parties from obtaining an adjustment of their differences by a tribunal of their choosing, but it would also recreate the very delays incident to a civil action that the arbitration agreement was designed to avoid.

Petitioners contended that they were entitled to relief because JAMS employed "an ad hoc arbitrator selection process that does not comply with JAMS' own Rule 15." This is exactly the kind of arbitral error that is for JAMS to resolve, according to the court. JAMS Rule 11(d), in effect at the commencement of the petitioners' arbitration, provides that: "Disputes concerning the appointment of the Arbitrator and the venue of the Arbitration, if that determination is relevant to the selection of the Arbitrator, shall be resolved by JAMS." To the extent that anything done by the arbitrator selected by JAMS affects the ultimate award, the Legislature has provided a means for the award to be vacated or corrected by a court (§§ 1286.2, 1286.6.). These limited statutory bases for judicial review reflect a balancing by the Legislature between the expedience and financial savings the arbitration process is intended to provide and the risk that an erroneous private arbitration decision will go uncorrected. More intrusive judicial action was not warranted.

AFTER THE ARBITRATION CHALLENGING/CONFIRMING ARBITRATION AWARDS

Vacatur: Manifest Disregard
Barclays Capital Inc. v. Shen
(N.Y.Sup. 4/22/2008) 857 N.Y.S.2d 873, 2008 WL 1809406

Where an NASD arbitration panel awarded punitive damages arising out of defamatory statements on a U-5 form, the punitive damage award must be vacated as being in manifest disregard of the law.

Petitioner Barclays Capital Inc. brought this petition seeking an order vacating the award by an arbitration panel of the NASD, but only to the extent it awarded punitive damages to respondent Elizabeth Bing Shen, its former employee. Shen answered the petition and cross moved for an order confirming the award in its entirety.

The petition and cross motion focused on whether the NASD arbitration panel's award of punitive damages to Shen was rendered in manifest disregard of the law, as recently established in Rosenberg v. MetLife, Inc., 8 NY3d 359 (2007) (Rosenberg II).

Barclays contended that the arbitrators knew about and then proceeded to ignore the holding in Rosenberg II, which precludes any monetary damages, including punitive damages, for defamatory statements made about a terminated employee in a U-5 filing. Barclays contended that application of the legal principles set forth in Rosenberg II is a complete bar to Shen from recovering punitive damages on any statement in the U-5 because the contents of that form are absolutely privileged. Barclays further contended that the award of punitive damages violates public policy because it has a chilling effect on the free and open disclosure of information relevant to potential securities violations.

Shen, on the other hand, argued that the award of punitive damages was legally consistent with Rosenberg II and not made in manifest disregard of the law. Shen argued that the arbitrators did not, in fact, award her punitive damages on her defamation claim, but ordered the expungement of her records, which is wholly consistent with Rosenberg II. Further, Shen contended that the panel did not give a reason why it awarded Shen punitive damages, nor was it under any

obligation to do so. Shen argued further that the arbitration panel has the broad authority to make awards, including punitive damages awards. Finally, Shen argued that in the absence of any punitive damages awarded by the panel specifically for her defamation claim, they could have been awarded for any number of reasons.

However, the court could not discern any colorable basis to otherwise support an award of punitive damages. The punitive damages must therefore have been awarded for the defamation claim, because that is the only basis on which Shen sought such damages. Shen made this point clearly in her own Statement of Claim. The arbitrators were bound to rule only on matters presented to them by the parties.

It was beyond dispute that the panel was familiar with the Rosenberg II decision. The decision and its impact on the pending arbitration had been vigorously argued before the panel in both oral and written motions by petitioner. The record does not reveal the substance of the opposition by Shen. While there is some indication about the parties having orally argued the motion to the arbitrators in a phone conversation, there is no other indication that Shen actually opposed the application.

Thus, the court held that this was one of those rare cases where the panel, aware of the applicable law and attendant public policy considerations, chose to ignore it. The two prongs of the manifest disregard doctrine were satisfied in this case, and the award of punitive damages was vacated.

Vacatur/Modification: Attorneys Fees

Barrett v. Investment Management Consultants, Ltd.
(Colo.App. 6/12/08) --- P.3d ----, 2008 WL 2372066

Arbitrators did not exceed their authority in awarding attorneys fees where authorized under a state securities act; the FAA also authorizes arbitrators to award attorneys' fees.

In this matter, Barrett engaged respondents to provide investment advice and manage his individual retirement accounts. The parties' investment management agreement set forth respondents' duties and provided that any disputes between the parties would be settled by arbitration. While the agreement included a paragraph stating that it was to be interpreted in accordance with Colorado law, the arbitration provision of the agreement stated: "This arbitration agreement shall be enforced and interpreted exclusively in accordance with applicable federal law, including the Federal Arbitration Act." The agreement contained no provision regarding an award of attorneys' fees in the event of arbitration.

A dispute arose between the parties after the value of Barrett's portfolio declined significantly. In 2004, the parties submitted the dispute to a National Association of Securities Dealers (NASD) arbitration panel in accordance with their agreement. Barrett asserted claims for violation of the Colorado Securities Act (CSA), section 11-51-501(1)(b), C.R.S.2007; breach of fiduciary duty; and breach of contract. In addition to compensation for his financial losses, Barrett sought recovery of his attorneys' fees on his CSA claim. Respondents denied liability and asked for an award of their attorneys' fees and costs incurred in defending against Barrett's claims.

Following a hearing, the arbitration panel ordered respondents to pay Barrett $221,100, with interest at eight percent per annum from the date of the award, as compensatory damages. They also awarded Barrett attorney fees in the amount of $187,000. The brokers filed a motion to vacate the award, arguing that the arbitration panel exceeded its power when it awarded attorneys' fees because the parties had not agreed to allow the arbitrators to make such award.

The trial court granted Barrett's motion to confirm the arbitration award.

On appeal, the brokers argued that it was "unclear" whether the arbitrators based the fee award on Barrett's CSA claim or on his common law claims. However, the record showed that Barrett requested such fees only on his CSA claim. Attorneys' fees were available under the CSA if the requisite factual showing was made.

The fact that the arbitrators mistakenly referenced an inapplicable Uniform Arbitration Act provision as authority for awarding attorneys' fees did not require the district court to vacate the award, because such fees could properly be awarded under federal law, which governed the arbitration proceedings.

In arguing for a contrary conclusion, the brokers pointed out that they had not agreed that attorneys' fees could be awarded, and they relied on Colorado cases holding that attorneys' fees may not be awarded in arbitration proceedings absent such agreement. The court rejected that contention, holding that under federal law, arbitrators may award attorneys' fees even absent an express agreement by the parties.

The brokers also argued that awarding Barrett the full amount of the attorneys' fees he requested would give him a windfall, inasmuch as his attorneys had taken the case on a contingent fee basis that required Barrett to pay them only one-third of the judgment amount. However, because a contingent fee agreement is only one factor to be considered in determining a reasonable attorneys' fee award and does not impose an automatic ceiling on such award, the court held that the arbitrators were not required to limit their attorneys' fee award to the amount Barrett was obligated to pay under the contingent fee agreement.

Collecting The Award

In re Smith
(M.D. Fla., 3/31/08) 2008 WL 898185

A former broker's bankruptcy discharge was denied, where his move to Florida was intended to insulate assets from creditors who had securities claims against the broker.

The debtor/broker had lived in Alpine, California, and was a licensed insurance agent. The broker was in the business of selling life insurance, annuities, and investments for approximately 25 years and had resided in San Diego County, California for over 20 years. The broker was associated with Rushing River Financial Services ("Rushing River") and Legacy Financial Services ("Legacy"), which are both broker dealers. Rushing River approved and sanctioned the broker's sale of investments in Alpha Telecom, Inc. ("Alpha"), which involved the purchase of pay phones that were to have a minimum monthly guaranteed return.

The broker sold investments in Alpha to several individuals, many of whom were retired. These individuals lost their entire investment in Alpha when the Securities and Exchange Commission filed suit against Alpha alleging securities fraud and obtained an injunction prohibiting Alpha from continuing its business, which resulted in Alpha filing for bankruptcy.

On August 12, 2002, a number of Alpha investors named the broker and his wife as defendants in a lawsuit filed in California, alleging, inter alia, professional negligence, breach of fiduciary duty, and fraud. By this time, the broker had already been named as a respondent in a NASD arbitration proceeding commenced by other Alpha investors.

After these actions had been commenced, the broker and his wife made numerous trips to Florida, ultimately selling their house in California and using those proceeds to buy a house in Florida. However, while the broker

was setting up this move, he told the Alpha investors at his deposition that he had no plans to move out of California.

After moving to Florida, the broker filed for bankruptcy, and sought a general discharge.

The court concluded that the broker manifested an intent to "hinder, delay, or defraud" the Alpha investors by being dishonest with them regarding his plans to move from California. The broker did not merely convert non-exempt assets into exempt assets within the year prior to filing for bankruptcy, but he did so with the actual intent to hinder, delay, or defraud the Alpha investors. The broker therefore was not entitled to a general discharge.

Arbitrator Immunity

Jimenez v. National Ass'n of Securities Dealers
(N.D.Cal. 5/5/2008) 2008 WL 1994893

The NASD is protected by arbitrator immunity from claims that the NASD violated the Securities and Exchange Act by mishandling a public customer's arbitration claim.

Public customer Jimenez filed an NASD arbitration claim against her former financial advisors (the "Prozan defendants"). An NASD panel dismissed her case, on a motion by the Prozan defendants. Jimenez then filed this action to appeal from and vacate the final NASD arbitration award.

Jimenez alleges that NASD violated her due process rights by rendering its award without a hearing. She further alleges that NASD and the Prozan Defendants concealed from her that Laurence Prozan's wife, Linda Drucker ("Drucker"), was a high official within NASD and sat on a committee that oversees the assignment of arbitrators. Jimenez believes that Drucker improperly contacted the three arbitrators on the panel and pulled strings in order to pressure the arbitrators into dismissing the arbitration without a hearing. Jimenez also alleges that the arbitrators refused to hear pertinent evidence and conducted an ex parte hearing with Laurence Prozan and his attorney.

Jimenez asserts a claim against the NASD and the Prozan Defendants under the Securities and Exchange Act of 1934, 15 U.S.C. § 78a, et seq. ("Securities and Exchange Act"). She alleges that the NASD is subject to suit under the Securities and Exchange Act "because it fits within the definition of a securities organization as stated in this statue" and that "[i]t regulates securities dealers and brokers and conducts arbitrations by disgruntled clients against their brokers ... and must be brought in under this statute." She alleges that the NASD and the Prozan Defendants violated the Securities and Exchange Act by delaying and obstructing the arbitration hearing and by preventing her from presenting evidence in her case.

The court granted NASD's motion to dismiss on arbitrator immunity grounds, finding that NASD is immune from suit (perhaps broader than immunity from damage actions). The court then dismissed Jiminez's claim as to the Prozan Defendants, because the conduct she contends violated the Securities and Exchange Act was allegedly committed by the NASD – which is immune from suit – and not the Prozan Defendants.

SUBSTANTIVE ISSUES

Aiding & Abetting/ Assisting A Fraud

Benton v. Merrill Lynch & Co., Inc.
(8th Cir., May 5, 2008) 524 F.3d 866

A brokerage firm did not aid and abet state securities law violations and did not assist a common law fraud allegedly committed by an individual who had opened an institutional account at the brokerage firm, where that individual had already fraudulently obtained the investors' funds prior to opening the account.

In this action, plaintiff-investors had loaned money to David Howell, a self-described trader, in exchange for promissory notes, which guaranteed them a specific return on their investment. Sometime in 2001, in an effort to induce the investors to loan him money, Howell falsely represented "he had discovered a system of investment which was yielding returns of ninety percent." Rather than invest their money for them, Howell advised the investors he would "borrow" the money as a loan, invest it as his own, and later pay them back the full amount of the loan plus a specified rate of return, which was considerably higher than the plaintiffs could obtain from banks or in the capital markets. Howell misrepresented his net worth and falsely told investors half of the total funds he would invest belonged to him, when, in actuality, he obtained such funds fraudulently from another group of investors not involved in this litigation.

Relying on Howell's false representations, the investors obtained from Howell the written promissory notes which required him to pay back the loans plus a specified rate of return in monthly installments. The notes also gave the investors the right to demand immediate payment of the principal and all accrued interest if Howell failed to timely pay any monthly installment of principal or interest.

According to the investors, in 2002, after Howell had obtained the money from them, he set up an institutional account at Merrill Lynch. By the summer of 2002, Howell had lost all of the money the investors had loaned him and was unable to make the monthly payments required by the promissory notes. Shortly thereafter, Howell committed suicide.

In June 2006, the investors brought this action against Merrill Lynch, asserting claims for violation of the Arkansas Securities Act and common law fraud. The Complaint alleged Merrill Lynch allowed Howell to trade securities through an institutional account even though it knew or reasonably should have known: (1) Howell did not meet the requirements to trade through an institutional account and (2) Howell was virtually impecunious and that in fact he was trading futures contracts using funds obtained from Plaintiffs. According to the investors, this conduct aided and abetted Howell in violating the Arkansas Securities Act and in perpetrating common law fraud upon them.

The district court granted Merrill Lynch's motion to dismiss the investors' claims. The district court concluded such a claim would require that the alleged aider and abettor knowingly and intentionally assisted the fraudulent acts, and concluded that the complaint lacked any allegation Merrill Lynch knowingly and intentionally assisted Howell's fraudulent representations to the investors.

On appeal, the investors argued that the allegations in the complaint revealed that Merrill Lynch materially aided Howell's unlawful sale of promissory notes by providing an avenue for Howell to further invest the funds that Howell had procured from Plaintiffs. The court of appeals concluded that "providing an avenue" was insufficient to state a claim for aiding and abetting under Arkansas law.

According to the court, there was nothing in the complaint alleging Merrill Lynch aided, assisted, or was in any way involved in Howell's sale of the promissory notes. The fact Merrill Lynch may have helped Howell by providing him an avenue for further investing is irrelevant to whether it aided Howell's sale of the promissory notes to the investors. It is irrelevant because it occurred after Howell sold the promissory notes to the investors and, therefore, could not have aided the sale of the promissory notes.

It is not enough for the investors to allege Merrill Lynch was Howell's broker-dealer; they must also allege Merrill Lynch materially aided in the sale of the promissory notes. Only then would the burden shift to the broker-dealer to prove it lacked knowledge. The Complaint in this case does not allege Merrill Lynch aided Howell's sale of the promissory notes. Therefore, contrary to the

investors' argument, it did not have the burden of alleging lack of knowledge.

Accepting as true the investors' allegations that: (1) Merrill Lynch should have known Howell was using his account to trade money provided by others, (2) Howell was losing large sums of money, and (3) Howell did not qualify for institutional investor status, such evidence would not establish Merrill Lynch committed fraud. The investors did not allege that Merrill Lynch made a false representation on which the investors relied; indeed, the investors do not allege Merrill Lynch ever communicated with them.

According to the court, what the investors seek to hold Merrill Lynch liable for occurred prior to the time Merrill Lynch became involved with Howell. Specifically, the investors allege Howell committed a fraud when he induced them to invest money (by purchasing promissory notes) through false representations. Only after Howell committed the alleged fraud did he open an account with Merrill Lynch to trade or otherwise deal in securities. The Complaint did not, however, allege Merrill Lynch assisted Howell in making false statements or that it even knew of his misrepresentations to the investors.

Statute of Limitations: Discovery

Travis v. The Vanguard Group, Inc.,
(E.D. Pa., 5/15/2008) 2008 WL 2073372

Unless a plaintiff was prevented from accessing her information about her securities account, the fact that she was relying on her husband was not sufficient to toll the running of the statute of limitations for federal securities law violations.

In October 2003, Plaintiff permitted her then-husband, John Delaney, to open an investment account for her at Vanguard, an investment management firm. Delaney opened the account under Plaintiff's married name, Joy D. Delaney, and recommended that Plaintiff divide her initial investment of $600,000 among eleven Vanguard funds. Plaintiff followed the recommendation. Delaney assured Plaintiff that her portfolio would satisfy her conservative investment objectives. After opening the account for Plaintiff, Delaney became employed by Vanguard as a registered representative. He remained in that position until early 2006.

Beginning in January 2004, Delaney made over 450 unsuitable trades in Plaintiff's accounts without her knowledge or consent, depleting her assets. Delaney handled the family's finances, opened account statements, and paid the family's bills. Plaintiff did not open any account statements from Vanguard, and relied on Delaney to ensure that her investments suited her financial objectives. Delaney repeatedly reassured Plaintiff that her accounts were doing well.

By December 2005, Plaintiff had become concerned about her relationship with Delaney. As a result, despite Delaney's assurances, Plaintiff opened her Vanguard account statement and was shocked to learn that her balance had fallen from $600,000 to less than $2,000.

Plaintiff alleged that each of the unauthorized transactions was performed by Delaney during the course of and within the scope of his employment at Vanguard, and that Vanguard failed to supervise Delaney and monitor her accounts. Defendants sought dismissal of the action, arguing, inter alia, that it was filed beyond the applicable statute of limitations.

The parties did not dispute that Plaintiff actually discovered the alleged fraud in late 2005 when she opened an account statement from Vanguard that revealed that her assets had declined drastically. The crux of Defendants' argument was that in the exercise of reasonable diligence, Plaintiff should have reviewed the monthly account statements Vanguard sent her, and therefore she was on notice of the alleged fraud in early 2004. The statements would have disclosed the sharp decline in her account.

The court held that Plaintiff had sufficient information to trigger “storm warnings” of fraudulent activity, despite her lack of actual knowledge. Storm warnings may include any financial, legal or other data that would alert a reasonable person to the probability that misleading statements or significant omissions had been made.

Though Plaintiff was unsophisticated in financial matters in general, and in the securities industry in particular, and had no experience or knowledge with respect to investments, Plaintiff's subjective knowledge or expertise was irrelevant to this inquiry.

Investors are presumed to have read prospectuses, quarterly reports, and other information relating to their investments. In the absence of any allegation that Plaintiff was prevented from accessing or reviewing her account statements, or that the statements contained inaccurate or incomplete information, Plaintiff was on inquiry notice of the alleged fraudulent activity in early 2004. The statute of limitations thus began to run in early 2004, and expired in early 2006, approximately a year and a half before she commenced this action.

Had Plaintiff exercised reasonable diligence and reviewed her account statements, she would have learned far sooner that her account was not being managed in a manner consistent with her conservative financial goals. Her misplaced reliance on her husband's assurances, when directly contradicted by account statements available to her, cannot serve to toll the statute of limitations. Plaintiff's securities fraud claims were ruled time-barred and dismissed.

Fiduciary Relationships

Boyer v Salomon Smith Barney
(Ore 6/19/2008) ___ P.3d ___, 2008 WL 2446302

A contract provision in a commodities account agreement prevented the relationship between the broker and the client from becoming a “special” or fiduciary relationship under Oregon law.

In this commodities margin case, plaintiff Robert J. Boyer sued defendants Salomon Smith Barney for negligence and breach of contract, asserting that the broker’s handling of certain commodities trades caused plaintiff to suffer significant financial losses. The trial court granted defendants' motion for judgment on the pleadings as to the negligence claim. The breach of contract claim went to trial, where the jury returned a verdict for defendants. Plaintiff appealed, assigning as error only the trial court's ruling granting judgment on the pleadings as to the negligence claim.

Plaintiff alleged that his investment account was subject to trading limits or margin limits. Although plaintiff began getting margin calls from Smith Barney, defendants continued to give plaintiff margin credit and regularly allowed plaintiff to trade beyond margin limits, as long as plaintiff paid his margin calls.

On December 13, 2000, plaintiff received a margin call for $6,422. That same day, he delivered $7,422 to Smith Barney. The broker, however, allegedly failed to properly account for the $7,422 payment, and mistakenly believed that plaintiff had not made the payment.

The next day, December 14, 2000, plaintiff placed two orders with the broker -- one for crude oil contracts, and another for natural gas contracts. Smith Barney accepted both orders. Plaintiff's order for crude oil contracts was filled that same morning; however, the broker canceled the order for natural gas contracts before it was filled, without plaintiff's authorization or consent. Plaintiff alleged that, if the order for natural gas contracts had been filled, it would have made money for him and helped reduce his margin debt.

One day later, on December 15, the broker liquidated plaintiff's crude oil contracts by forced sale. Plaintiff alleged that the sale caused him immediate losses of $12,200,

which then resulted in additional forced sales from his investment account.

Plaintiff alleged that the broker knew or should have known that accepting the December 14 orders would place plaintiff above his margin limits, that the broker would not fill both orders, that the broker would force plaintiff to liquidate the order that they did fill within one day, and that such forced liquidations create extraordinary risk for the investor.

Plaintiff further alleged that the broker also knew or should have known how important it was for plaintiff to have timely and accurate information in order to make informed decisions about his investments. Nevertheless, the broker accepted both of the December 14 orders without telling plaintiff that it would fill only one of them, and without telling plaintiff that the one that it filled would be subject to a forced sale the following day.

Plaintiff alleged that, had he been told that the broker would fill only one of the orders, he would have chosen the natural gas order, which would have been profitable and kept plaintiff within his margin trading limits.

In affirming the trial court's decision on the negligence claim, the Oregon Supreme Court concluded that: (1) The relationship between plaintiff and Smith Barney was that of principal and agent; (2) such a relationship can -- and often will -- be a "special" one; but (3) the particular provisions of the contract between the parties in this case prevented the parties' relationship from being a "special" one that would permit imposition of tort liability on the broker.

According to the court, the contract between the parties established that plaintiff and defendants had "otherwise agreed" that defendants were not "subject to a duty to use reasonable efforts to give [plaintiff] information which [was] relevant to affairs entrusted to [defendants]." The contract provided that the broker "may" act without notice, "when and if you [the broker] deem appropriate based upon your [the broker's] own business judgment." The court concluded that, read as a whole, the contract allowed the brokers to act to protect their interests; plaintiff's interests clearly were subordinate.

The court also rejected the plaintiff's claim that the broker harmed him "[b]y accepting [his] December 14, 2000[,] orders." Plaintiff pointed to no duty on the broker's' part -- either in contract or in tort -- to refuse to accept plaintiff's order. Moreover, plaintiff had not alleged any facts that showed, either directly or by inference, how the act of acceptance, qua acceptance, caused him damage.

The court expressly reserved the question as to whether any outside source of law -- such as statutes, regulations, or the rules of various licensing agencies and commodity exchanges -- might create the duty plaintiff sought to impose on the broker. Industry standards, statutes, or regulations could, in a particular case, provide a basis in law for liability on a broker's part. In this case, however, such a duty could not be made out from plaintiff's relatively narrow allegations.

Fiduciary Relationships: Non-Discretionary Accounts

U.S. v. Wolfson,
(S.D.N.Y. 5/5/2008) 2008 WL 1969730

A broker has limited fiduciary duties even in a non-discretionary account, with respect to the trades executed by the broker, and the fiduciary relationship includes an obligation to provide accurate, material information about that trade.

In this criminal matter, a defendant broker convicted of securities fraud moved for a new trial, arguing among other things that the jury instructions were defective because they allowed the jury to convict based on a theory that the jury could have found a fiduciary relationship between a broker and a customer. The broker contended no fiduciary

relationship existed as a matter of law since the broker was not handling a discretionary account.

The court rejected that argument, stating: "That is simply not true." According to the court, the charge in this case was, in all material respects, taken from the charge approved by the Second Circuit Court of Appeals in United States v. Szur, 289 F.3d 200 (2d Cir. 2002), which held that a broker has limited fiduciary duties with respect to the trades executed by the broker, and that fiduciary relationship includes the obligation to provide accurate, material information about that trade.

Material information may well include that the broker is receiving bribes for that transaction. Thus, even in the absence of any general fiduciary duty resulting from discretionary authority, a broker may be under a duty to disclose exorbitant commissions because the information would have been relevant to a customer's decision to purchase the stock.

Fiduciary Relationships: Non-Discretionary Accounts, Mark Ups & Mark Downs

Baber v. First Republic Group, L.L.C. (N.D.Iowa, 6/6/2008) 2008 WL 2356868

An investor may have viable claims for excessive and secret markups and markdowns on share prices charged by his broker-dealer and account representative, even where there is no express contract governing the charges, and even where the charges were disclosed on trade confirmations; a broker can be a fiduciary to an investor in a non-discretionary account, and a failure to adequately disclose markups and markdowns can be a breach of that duty.

Here, an investor sought damages against a brokerage firm for excessive markups and markdowns, asserting a number of different causes of action. The brokerage firm moved for summary judgment, which the court denied. The court analyzed each cause of action asserted by the plaintiff, and concluded that a jury question existed as to each claim.

As for the investor's breach of contract claim, there was no express contract between the parties regarding commissions or markups. The court was not willing to use the NASD policy or rules regarding markups as an appropriate basis for implying a "reasonable commissions" term in the parties' implied agreement concerning brokerage services. However, applying contract law, the court was willing to supply a term which is reasonable in the circumstances.

In this case, a term which is reasonable in the circumstances would be a term that any commissions, or markups or markdowns, charged by the broker for its services must be reasonable under the circumstances of each transaction. Whether the amounts charged were reasonable was a question for the jury to decide.

Relevant factors to determine whether a markup or markdown is reasonable or excessive include, among others, the following: (1) the best judgment of the broker or dealer as to the fair market value of the securities at the time of the transaction; (2) the expense involved in effecting the transaction; (3) the fact that the broker or dealer is entitled to a reasonable profit; (4) the expertise provided by the broker or dealer; (5) the total dollar amount of the transaction; (6) the availability of the security in the market; (7) the price or yield of the security; (8) the resulting yield after the subtraction of the mark up compared to the yield on other securities of comparable quality, maturity, availability; (9) the risk and the role played by the broker or dealer; and (10) the nature of the professional's business. There are at least jury questions as to whether the markups and markdowns charged to Baber are reasonable in light of these factors.

The court also rejected the firm's argument that the investor ratified the markups and

markdowns as a matter of law. Instead, it was a jury question as to whether the investor understood at the time of the transactions that he was being charged the allegedly unreasonable markups and markdowns, such that his failure to complain about them at the time constitutes ratification, and whether the investor unreasonably failed to complain about what he considered unreasonable markups and markdowns when he did learn what his confirmation slips and monthly statements showed.

The court also denied summary adjudication on the cause of action for breach of the covenant of good faith and fair dealing. A reasonable juror could find that charging markups and markdowns over a two-year period that approximately equaled the total value of the investor's account destroyed or injured the right of the investor to receive the fruits of the contract, that is, growth of the account.

As to the claim for breach of fiduciary duty, there was no doubt in the court's mind that the broker was under a duty to act for or to give advice for the benefit of the investor upon matters within the scope of their broker-investor relationship. The broker was authorized to act on the investor's behalf to make trades in his account, even if they were only to make the trades the investor expressly authorized; the broker exercised influence over the investor, and the investor placed confidence in the broker, as shown by the investor's observation that the broker was a "very persuasive talker"; and despite the investor's extensive investment experience, there was an inequality of the parties with regard to information about investments and how transactions were effectuated and a dependence to advise him about investment choices, where the investor testified that he had no experience with markups or markdowns. The court found, as a matter of law, that the broker owed the investor a fiduciary duty.

The court also concluded that charging, but failing to disclose, excessive markups or markdowns for the broker's personal gain would also be an abuse of a customer's confidence and a betrayal of trust. A reasonable juror could also find that such conduct reflected self-dealing, dishonesty, and a total willingness to compromise the interests of the broker's client, and that repeated instances of such conduct suggest a lack of remorse.

The court next concluded that there were genuine issues of material fact as to whether the defendants' disclosure of the markups and markdowns they were charging were sufficient to permit investors to make an informed decision about the transaction. A reasonable juror could find that the disclosures of the markups and markdowns were made only after the fact and only in a manner that was likely to mislead or confuse an investor who at least arguably had no prior experience with markups or markdowns.

A reasonable juror could also find that the disclosures were misleading, because the markups and markdowns were not shown with other fees or commissions. Indeed, a reasonable juror could infer that the purpose of disclosing the reported prices and markups and markdowns in the manner shown was to disguise the charging or the amounts of such fees or commissions.

Fiduciary Relationships: Clearing Firms

Wehrs v. Benson York Group, Inc.
(N.D.Ill. 3/18/2008) 2008 WL 753916

A clearing firm does not breach any fiduciary duties it may have to a client of an introducing broker, where the clearing firm declines to accept trading instructions directly from the client.

In this case, plaintiff William R. Wehrs sought damages from his former securities broker, Benson York Group, Benson York's employees, Kevin Brennan and Kevin Wells, and Benson York's clearing broker, North American Clearing, Inc. ("NAC"). Wehrs alleges that the introducing brokers are liable

for violations of both Section 10b of the Securities Exchange Act of 1934 and Securities and Exchange Commission Rule 10b-5, as well as for common law fraud, negligence, and breach of fiduciary duty.

The complaint alleged that the introducing broker bought certain shares in plaintiff's account on margin, without authorization. NAC cleared all of the unauthorized trades. When plaintiff discovered the unauthorized trades, plaintiff contacted the clearing firm directly, instructing it to reverse all of the unauthorized transactions. The clearing firm declined to do so, stating that it could only accept instructions from the introducing firm. The clearing firm ultimately sold the positions at a loss, due to a margin call. Plaintiff lost approximately $92,000 as a result of the unauthorized trades.

The only claim plaintiff brought against the clearing firm was a claim for breach of fiduciary duty. The court dismissed that claim.

The clearing firm argued that because clearing brokers do not owe a fiduciary duty to the customers of an introducing broker, plaintiff's claim that it breached a fiduciary duty to him should be dismissed. A clearing firm's customers are other broker dealers for whom the clearing firm purchases and sells securities, not individual investors. Because of its status as a clearing broker, NAC does not interact directly with investors. Because a clearing firm must take its order from the primary broker dealers, not individual investors, NAC did not serve in fiduciary capacity to the plaintiff.

The plaintiff contended that the clearing firm breached a fiduciary duty to him through its involvement in the purchases made by the introducing broker, its refusal to sell his stock upon his request, and the sale of the stock on margin call. Plaintiff also argued that a clearing broker may be liable for the manipulative or deceptive schemes of an introducing broker.

New York courts have consistently held that absent extenuating circumstances, a clearing broker does not have a fiduciary duty to an individual investor. The court concluded that the plaintiff did not allege any circumstances that could be found "extenuating" under the existing law.

Instead, plaintiff alleged only that after the contested sales occurred, he asked NAC to sell his stock and NAC said that it could not do so. Later, apparently when plaintiff's account fell below its maintenance margin, NAC sold his stock on margin call. These allegations did not suffice to state a claim that NAC had and breached any fiduciary duty to plaintiff.

Where We Stand

Historically, PIABA has commented on a number of issues, on both a formal and an informal basis, which are directly applicable to our promotion of the interests of public investors in securities arbitration proceedings that are conducted before the Financial Industry Regulatory Authority ("FINRA").

For example, among the issues that generated the most interest, from and/or on behalf of the members of our association, were proposed amendments to the rules concerning:

- Abusive pre-hearing dispositive motion practices; and
- The adoption of specific procedures that arbitrators will be required to follow before granting the extraordinary remedy of the expungement of prior customer complaints from the registration records of registered representatives.

In this section of the *PIABA Bar Journal*, we will share with our readers the comment letters and formal positions that have been submitted on behalf of our association, during the quarter, to the various regulatory authorities so that all of our constituents will know exactly where we stand.

To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Laurence S. Schultz, lssarb@aol.com, Brian Smiley, bnsmiley@sbpllplaw.com or Robin S. Ringo, rsringo@piaba.org for assistance.

Public Investors Arbitration Bar Association

May 16, 2008

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2008-010
Proposed FINRA Customer Code Rule 12805
New Expungement Procedures

Dear Ms. Morris:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") to comment on the above-referenced rule change concerning expungement proceedings before FINRA arbitration panels.[1] PIABA strongly supports this rule change as a step in the right direction. However, we encourage FINRA and the SEC to continue to work toward restoring the integrity of the Central Registration Depository ("CRD") system.

PIABA is a bar association comprised of attorneys who represent investors in securities arbitrations. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in FINRA rules which govern the arbitration process. PIABA members are regular users of the CRD system and believe that all public investors should have free and unfettered access to information about their brokers.

The CRD System

PIABA is deeply concerned about the lack of integrity of the CRD system. The CRD system forms the underpinning of FINRA's Broker Check system. As such, it is used by public investors who desire to obtain information about their broker, or about a broker to whom they are considering entrusting their life's savings. Self-regulatory organizations and state regulators utilize the system in carrying out their regulatory functions, and the CRD system is jointly owned by FINRA and the North American Securities Administrators Association

[1] The FINRA filing also proposed Rule 13805 for the Industry Code; as an advocate for the public investor, PIABA is primarily concerned with proposed Rule 12805 for the Customer Code.

Public Investors Arbitration Bar Association
2415 A Wilcox Drive Norman, OK 73069 Phone: (405) 360-8776 Fax: (405) 360-2063
Toll Free: (888) 621-7484 Website: *www.PIABA.org* Email: *piaba@piaba.org*

("NASAA"). The accuracy and integrity of the system are of utmost importance to the public.

Unfortunately, the CRD system falls far short of the accuracy which its users have a right to expect. A number of factors have contributed to this. One problem has been the "loophole" which permits non-reporting of claims against brokers who are not named as parties in the caption of a court action or arbitration proceeding. FINRA has recently taken steps toward closing that loophole, which will be the subject of another comment letter. Another problem has been, quite simply, failure to report. We note with approval that FINRA has increased its disciplinary filings against firms and brokers that refuse or neglect to make timely reports to the CRD.

A third factor which has undermined the CRD system's integrity has been the proliferation of expungements procured as a condition of settlement of customer claims. As detailed below, it became commonplace for brokers to demand that a public investor stipulate to an arbitral award of expungement as a condition to payment of a monetary settlement, and arbitration panels routinely signed these stipulated awards. Thus, users of the CRD system could have no faith in the accuracy and integrity of the system. It is this problem which the proposed rule seeks to address.

Expungement Procedures

Virtually everyone agrees that expungement should be an extraordinary remedy to be invoked only in extreme cases. Both the regulators and the public are entitled to know a broker's record. For this reason, it is important that expungement requests be subjected to considerable scrutiny. The record should not be wiped clean simply because a case has settled, or even because a case was eventually found to be without merit.

PIABA has been advocating for better expungement procedures for many years.[2] Prior to 2004, there were no rules providing guidance to arbitrators as to when expungement of a broker's record might be appropriate. As a result, arbitrators' decisions concerning expungement were often inconsistent and arbitrary. Moreover, it had become commonplace for industry respondents in FINRA arbitrations to demand, as a condition of a monetary settlement, that the

[2] *See*, e.g., Letter of Phillip M. Aidikoff, President of PIABA, to Barbara Sweeney, NASDR, dated December 26, 2001 ("Aidikoff Letter"); Letter of Charles W. Austin, Jr., Executive Vice President of PIABA, to Margaret H. McFarland, SEC, dated March 28, 2003 ("Austin Letter"). PIABA's comment letters are accessible through www.piaba.org.

investor claimant stipulate to an award of expungement. PIABA was on record as stating that this was the most "pernicious and insidious aspect of the expungement system."[3]

In response, the NASD promulgated Rule 2130 of the NASD Conduct Rules, which was intended to halt the practice of routinely granting expungements by stipulated awards in connection with settlements of valid claims. Pursuant to the Rule, an expungement could only be granted upon an affirmative arbitral or judicial finding that:

1. The claim, allegation or information is factually impossible or clearly erroneous;

2. The registered person was not involved in the alleged investment-related sales practice violation, forgery, theft, misappropriation, or conversion of funds; or

3. The claim, allegation, or information is false.

A premise behind this rule was that the requirement of these findings would minimize the incidence of stipulated expungements. While expressing doubt that the rule change would accomplish all it was supposed to, PIABA supported the rule as an improvement upon the system which then existed.[4]

Unfortunately, PIABA's concerns were well founded. While there was a decrease in the number of stipulated expungements, industry respondents continued to find ways to convince some public investors to stipulate to the predicate facts in connection with settlements. In many cases, respondents paid significant monies to settle a matter where the settlement included a stipulated award reciting that the claim was "factually impossible," or "false."

To compound the problem, arbitration panels generally signed the stipulated expungement award without taking any demonstrated steps to satisfy themselves that the case before them was in fact without merit.

PIABA undertook a study of all of the NASD customer-member arbitration awards issued during the calendar year 2006.[5] We learned that 71% of

---

[3] Austin Letter, *supra* note 2, p. 1.

[4] *Id*.

[5] *See* PIABA Press Release of September 24, 2007, at www.piaba.org.

the stipulated awards submitted to NASD panels that year requested expungement of the complaint from a broker's CRD record. Even more disturbing was the fact that 98% of the expungement requests by stipulation or settlement were granted by the NASD panels. In calendar year 2006 alone, one broker had eighteen (18) separate customer complaints expunged from his record by 18 separate NASD panels. In essence, a broker who paid 18 customers to settle their claims ended up with a clean record.

What was especially disturbing about this trend was that, in nearly all of the cases, the panels apparently accepted the parties' stipulation without performing any investigation into whether the cases were meritorious, or whether money had even been paid in connection with the dismissal of the claims. Regulators and investors were being denied the ability to get a true picture of a broker's record; yet there was no indication anyone had vetted the stipulations to make sure they had some relation to the truth.

The Proposed Rule

The rule proposal fills a void in the Code of Arbitration Procedure and addresses many of the problems with the current expungement system.

- The rule requires a recorded hearing regarding whether expungement is appropriate. It is no longer enough that the parties agree to expungement, or that the parties recite a predicate fact such as "the claim is false."

- The panel is to review settlement documents to determine whether monetary compensation was given. While we agree this is a step in the right direction, we also believe that the payment of a settlement in an amount which exceeds the $10,000 reporting threshold on Forms U-4 and U-5 should at least raise a presumption that expungement is not appropriate.[6] Further, PIABA believes there should be an express presumption in all cases that claims should not be expunged on the CRD record unless the person seeking expungement is able to overcome the presumption by a preponderance of the evidence.

- The rule requires the panel to explain in writing why expungement should be granted. This will provide a reviewing

[6] We note that FINRA has proposed an increase in this minimum reporting requirement to $15,000. *See* FINRA Regulatory Notice 08-20.

court, as well as interested regulators, with information upon which to base their decisions.

- The costs for a hearing seeking expungement must be charged against the party seeking expungement. This is only fair, as there is no reason to saddle an investor claimant with this expense.

It is of critical importance that the arbitration panels have clear guidance when considering expungement requests. Between proposed Rule 12805 and Conduct Rule 2310, the panels will be in a much better position, substantively and procedurally, to strike the appropriate balance between the broker's right to be free of frivolous claims and the public's right to know. This is a major improvement over the existing system, and PIABA supports the rule change.

PIABA Proposal – Regulators, Not Arbitrators, Should Perform This Function

In essence, the CRD system is owned by the self-regulatory organizations and by the state regulators. While we believe the public must have full disclosure of a broker's record, it may well be argued that the regulators have the greatest interest in the integrity of the system and the accuracy of the information reflected in the CRD. We therefore encourage FINRA, the SEC, and NASAA to explore ways of taking expungement decisions out of the hands of arbitrators altogether.

FINRA arbitration is, at root, a private dispute resolution mechanism. The purpose of FINRA customer arbitrations is to resolve disputes between investors and the members of the securities industry. This purpose stands in stark contrast to the mission of the regulators. Regulators are tasked with upholding the rules governing the industry and with meting out discipline against those who violate the rules.

Given the contrasting duties and missions of the arbitrator and the regulator, it makes little sense to entrust arbitrators with decisions which really should be made by regulators. This does not leave arbitrators completely out of the regulatory process, nor should it. At the beginning of every arbitration hearing, the panel chairperson advises that parties that the panel is entitled to make a disciplinary referral to FINRA if the panel determines that a statute or rule has been violated. FINRA takes such referrals seriously and commences its own investigation and proceedings to determine whether disciplinary action is appropriate.

Panels should have the same referral abilities with regard to expungements – but they should not be the final decision-makers. In a contested hearing, panels could recommend that FINRA consider expungement if the panel found that one of the Rule 2310 grounds was satisfied. In the case of a settlement, the panel could hold a hearing as contemplated by Rule 12805 to determine whether the factual predicates for such a referral could be made.

To implement this approach, PIABA proposes the formation of a regulatory tribunal which would make the final recommendation regarding expungement. We understand that this proposal would require additional work on the part of the regulators involved. It may be that NASAA, as an owner of the CRD system, would be interested in operating such a tribunal. Alternatively, the function may fall to FINRA. Currently, the self-regulatory organizations and state regulators have delegated this important regulatory task to arbitrators who have no regulatory training, experience, or inclination. The experiment has failed. The result, sadly, has been a CRD system which is completely untrustworthy. We encourage FINRA, the SEC, and NASAA to consider a structure which will shift this regulatory function to the regulators, where it belongs.

Conclusion

PIABA supports the proposed rule as a vast improvement over the present state of affairs. Thank you once again for the opportunity to comment on this proposed rule.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

s/Laurence S. Schultz
Laurence S. Schultz
President, 2007-2008

Contact Information:
Laurence S. Schultz, Esq.
Driggers, Schultz & Herbst, P.C.
2600 West Big Beaver Road, Suite 550
Troy, Michigan 48084
Phone: (248) 649-6000
Fax: (248) 649-6442
E-mail: LSSARB@AOL.COM

Public Investors Arbitration Bar Association

April 25, 2008

VIA E-MAIL TO RULE-COMMENTS@SEC.GOV

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2007-021
Proposed Revisions to 12206 and 12504 of the FINRA Customer Code
Motions to Dismiss

Dear Ms. Morris:

I write on behalf of the Public Investors Arbitration Bar Association (PIABA) in further support of the above-referenced FINRA rule change. We have already written to express our support of the rule change, and to request its approval on an accelerated basis.[1] The purpose of this letter is to respond to the comments of the Arbitration, Litigation Advisory and Clearing Firms Committees of the Securities Industry and Financial Markets Association (SIFMA) in its letter of April 7, 2008 (the "SIFMA letter").

As the mouthpiece of the securities industry, it is not surprising that SIFMA is critical of the rule revisions. While giving lip service to the concept of bringing an end to abusive or frivolous motions, SIFMA has proposed revisions which would gut the rule and only encourage wasteful and unmeritorious motions to dismiss.

Discouraging Motions to Dismiss

The SIFMA letter seeks deletion of the policy statement in proposed Rule 12504(a)(1), which reads: "Motions to dismiss a claim prior to the conclusion of a party's case in chief are discouraged in arbitration." This language is far from "superfluous," as claimed by the SIFMA letter. Rather, it goes to the very heart of the distinction between arbitration and litigation.

Arbitration is intended to provide a speedy and economic alternative to litigation. As such, the NASD Code of Arbitration Procedure eschews strict pleading requirements (Customer Code Rule 12302(a)(1)), and discourages depositions and interrogatory-style requests for information (Customer Code Rules 12507(a)(1) and 12510). Inserting pre-hearing motions to dismiss into this scheme, most of which are

[1] Letter of Laurence S. Schultz, President, Public Investors Arbitration Bar Association, March 18, 2008.

Public Investors Arbitration Bar Association
2415 A Wilcox Drive Norman, OK 73069 Phone: (405) 360-8776 Fax: (405) 360-2063
Toll Free: (888) 621-7484 Website: *www.PIABA.org* Email: *piaba@piaba.org*

denied, is inconsistent with the concept of economy. As the proposed rule recognizes, such motions should be permitted only in the most unusual of circumstances.

Moreover, it must be remembered that there is almost no judicial review of FINRA arbitration awards. The grounds for vacatur are very narrow. Unlike court, where an appellate court may review the grant of dispositive motions for errors of law, an arbitration award will generally be left undisturbed except for arbitral misbehavior as provided under the Federal Arbitration Act, or "manifest disregard of the law," a standard which requires that the court uphold arbitration awards even when the court is convinced that the panel misapplied the law or the facts. Given this profound potential for irreversible error and in order to preserve at least the perception that each party will have his "day in court," nearly every case must have an evidentiary hearing. Accordingly, the policy statement discouraging pre-hearing dispositive motions is an important component to the overall Code, and ought to be approved.

Clearing Firm Disputes

The SIFMA letter takes aim at FINRA's failure to include language in the rule which would enable clearing firms to file pre-hearing motions to dismiss. SIFMA argues that, since clearing firms owe no duties to the customer, and are not liable for the conduct of the introducing broker, they should be permitted to get out of the case at the outset.

SIFMA's argument rests upon an outright misstatement of the law. The SEC has ruled that a clearing firm can indeed be responsible to investors when it "enables" an introducing firm to defraud its customers.[2] There is abundant case law holding that clearing firms are not immune from liability, and can be liable for the fraudulent acts of the introducing broker.[3] These cases hold that clearing firms can be liable as would be any participant in a fraudulent scheme under the Blue Sky statutes and at common law. In short, clearing firms may not turn a blind eye to the fraudulent conduct of their correspondent firms and blithely collect their fees without fear of liability.

Clearing firms are rarely named in cases where the introducing broker is a large, reputable firm. In many cases, the clearing firm is named as a respondent based on assertions that the clearing firm helped to perpetrate a fraud on the investing

---

[2] *In The Matter* of *Bear Stearns Securities Corporation,* 99 LEXIS 1551.

[3]See, e.g., *Koruga v. Fiserv Correspondent Services, Inc.,* 183 F.Supp.2d 1245 (D. Or. 2001), *aff'd,* 2002 U.S.App. LEXIS 6439 (9th Cir. 2002); *McDaniel v. Bear Stearns & Co., Inc.,* 196 F.Supp.2d 343 (S.D.N.Y. 2002); *Hirata v. J.B.Oxford & Co.,* 193 F.R.D. 589, 600 (S.D. Ind. 2000).

public by clearing for a "bucket shop" introducing broker, or similar allegations. In such cases, the liability of the clearing broker will depend on what the clearing firm knew, and when, and what it did as a result. These are inherently factual issues, which cannot be resolved without full documentary discovery and an evidentiary hearing. Yet, under the current system, the filing of a pre-hearing motion to dismiss by any named clearing firm is inevitable. It is precisely this kind of conduct which adds complexity and expense to a procedure which is supposed to be an economical alternative to litigation.

We oppose SIFMA's proposed language to permit motions to dismiss by clearing firms.

Executives Named as Respondents

Proposed Rule 12504(a)(6)(B) would permit a motion to dismiss where "the moving party was not associated with the account(s), security(ies), or conduct at issue." The SIFMA letter raises a hypothetical where the chief executive of a large wirehouse is named as a party, and asserts that such a party should have the ability to obtain dismissal by a pre-hearing motion. They conclude that the rule should be amended to permit a motion to dismiss where "the moving party was not involved in, or had no personal knowledge of, or had no direct supervisory control over, or owed no legal or regulatory duty with respect to, the account(s), security(ies), or conduct at issue."

Aside from the fact that executives of large, solvent firms are rarely named as respondents in customer arbitrations,[4] SIFMA's proposed language is emblematic of why pre-hearing motions to dismiss should not be allowed. Almost by definition, the named respondent's involvement, or personal knowledge, or supervisory control, present factual issues. These types of issues are not appropriate for pre-hearing dispositive motions. As we pointed out in our previous comment, the procedural checks and balances in our court system are absent in arbitration – there are no depositions or sworn interrogatory answers, for example – so it makes no sense to have arbitrators deciding factual issues on pre-hearing motions to dismiss.

---

[4] Generally speaking, such executives will receive full indemnification from their firms, so this is really not an issue. Where the naming of the executive becomes an issue is when the firm is insolvent, or on the brink of becoming insolvent. In such a case, many state securities statutes, patterned upon Section 509(g) of the Uniform Securities Act of 2002 or Section 401(a) of the predecessor Uniform Act, provide that the officers, directors or other "control persons" are equally liable with the firm for violations of the Blue Sky statutes unless they can prove that they had no knowledge or grounds to know about the conduct giving rise to the liability. The federal securities laws have a similar provision. 15 U.S.C. 77o. Once again, the control person's state of knowledge is a factual issue, which should not be determined upon a motion to dismiss.

What SIFMA urges here is an expansion of the grounds upon which a motion can be made. We are already concerned that the language of FINRA's proposed rule may be somewhat ambiguous as to the meaning of the term "associated with," and that some respondents may see it as an opening to permit motions to dismiss by control persons, clearing firms and the like.[5] We adamantly oppose the expansion of this rule to include such fact-based motions.

Legal Impossibility

The SIFMA letter cites to three potential situations which would give rise to a complete defense of legal impossibility on a pre-hearing motion to dismiss: (1) U-5 defamation under New York law;[6] (2) *res judicata*; and (3) lack of standing. From this, they urge that the rule be expanded to permit motions to dismiss based on "legal impossibility."

It is not hard to envision large numbers of motions to dismiss being brought on the ground of "legal impossibility," should this language be adopted. When FINRA sought to limit motions to dismiss to "extraordinary circumstances," virtually every subsequent motion to dismiss asserted that the circumstances of its case were "extraordinary." Likewise, with SIFMA's change, respondents would no doubt routinely argue that it will be "legally impossible" for a claimant to prevail. It is not likely that many such motions would be granted, but that is not the point. The new rule also is intended to do away with unmeritorious motions to dismiss and eliminate the burden of responding to them. By broadening the scope of permissive motions to include something this vague, one can fully expect that respondents will latch on to the language, routinely file such motions, and claim that their flawed motions are made in good faith.

Adoption of SIFMA's "legal impossibility" language would also take a step down the dangerous path of requiring legalistic pleadings. Under Rule 12302(a)(1) of the Customer Code, all that is required in a statement of claim is to "specif(y) the relevant facts and remedies requested." Given how often public investors file claims *in propria persona,* it would be unfair to require statements of claim to satisfy some particular legal form. One can easily imagine an industry respondent filing motions to dismiss claims against an unrepresented public investor who lacks the training necessary to enable him to frame his claim in such a way as to pass legal muster.

---

[5] We do not believe, however, that this is FINRA's intention. We trust that FINRA will clarify the proper scope of this rule if industry respondents begin to find ways to abuse the "associated with" language.

[6] As this does not implicate the Customer Code in any way, PIABA expresses no opinion as to whether there should be an exception in the corresponding Industry Code rule.

Adoption of SIFMA's proposed language would lead to further abuse of pre-hearing motions by industry respondents, and will do nothing to further investor protection. PIABA opposes the expansion of the proposed rule to include "legal impossibility" as a ground for dispositive motions.

Time-Barred Claims

The SIFMA letter bemoans the loss of the industry's ability to file dismissal motions based on statutes of limitations. These types of motions are entirely inappropriate in FINRA arbitrations, and represent a large portion of the abusive motions filed by industry respondents.

To begin with, it must be remembered that proposed Rule 12206(b) has in fact codified the right to make motions to dismiss based upon the six-year eligibility rule. Thus, there are safeguards in place to prevent truly "stale" claims from proceeding all the way through to hearing. As SEC Rules require many client documents to be retained for a minimum of six (6) years, SIFMA's expressed concerns about loss of documents and dimming memory ring hollow. See SEC Rule 17a-4(a) and (c).

Many jurisdictions have express authority to the effect that statutes of limitations do not apply in private arbitration proceedings.[7] Inserting a rule permitting motions to dismiss based on time bars may lead arbitrators to believe that such authority is superseded by FINRA's belief that such statutes do in fact apply.

More to the point, most statutes of limitations in securities arbitration matters raise issues of fact, which require an evidentiary hearing. Many of the statutes of limitations relating to securities fraud are discovery-based – thus, there is nearly always an issue of fact as to when actual discovery occurred, and whether sufficient diligence was exercised by the claimant. The state statutes of limitations usually also have tolling provisions, which again raise issues of fact. In short, even in those few states where statutes of limitations may have application, hearings are necessary to determine whether the statute has run. It is for this very reason that most motions to dismiss on the basis of the statute of limitations are denied. Yet, claimants are

[7] See, e.g., *NCR Corp. v. CBS Liquor Control,* 874 F. Supp. 168 (S.D. Ohio 1993), *partially modified on unrelated grounds,* 1993 WL 767119 (S.D. Ohio Dec 24, 1993) (NO. C-3-91-027, C-3-01-031) *aff'd sub nom.* NCR Corp. v. Sac-Co., 43 F.3d 1076 (6th Cir. Ohio 1995), cert. denied sum nom. *Sac-Co Inc. v. AT&T Global Info. Solutions Co.,* 516 U.S. 906, 116 S. Ct. 272, 133 L. Ed. 2d 193 (1995); *Son Shipping Co. v. De Fosse & Tanghe,* 199 F. 2d 687 (2d Cir. 1952); *Har-Mar, Incorporated v. Thorsen & Thorshov, Inc.,* 218 N.W.2d 751 (Minn. 1974); *Carpenter v. Pomerantz,* 36 Mass. App. Ct. 627, 634 N.E.2d 587 (1994); *Lewiston Firefighters Association v. City of Lewiston,* 354 A.2d 154, 167 (Maine 1976); *Skidmore, Owings and Merrill v. Connecticut General Life Insurance Company,* 25 Conn. Sup. 76, 197 A.2d 83.

repeatedly required to incur the expense of defending such motions, and are normally assessed half the forum fee for the telephonic hearing.

We believe the time-bar exception to the prohibition on motions to dismiss should be limited to motions based on the six-year eligibility rule, as the proposed rule is currently drafted.

Procedural Issues

The SIFMA letter predictably decries those portions of the proposed rule which provide protection to investors. Absent these provisions, however, the rule will be a paper tiger, lacking any real teeth.

The requirement of unanimity is a necessary protection because FINRA rules do not require all or even any of the arbitrators to be lawyers, while mandating that one arbitrator must be associated with the securities industry. Even more important, as noted above, there is no appeal for erroneous arbitration awards based on factual or legal errors. This provision of the rule should be retained.

The SIFMA letter opposes the provision which mandates the assessment of forum fees against unsuccessful movants. This is one of the key provisions of this rule revision, and it must be retained. SIFMA asserts that it is patently unfair to penalize a party who files a motion in good faith, "in reliance on the accuracy and completeness of the papers filed by the opposing party." Once again, SIFMA attempts in a backhanded way to impose strict pleading requirements upon public investor claimants, where the rules clearly do not require such strictness. It is not unfair to require a brokerage firm which files a motion which is discouraged under the rule to be assured of the correctness of its position. Rather, the *status quo* is patently unfair. Despite the fact that a minuscule percentage of dispositive motions are ever granted, it is currently the norm to require the claimant to pay half of the forum fees for the hearing on the motion. This simply adds insult to injury, in view of the fact that the claimant has already been required to respond to the unmeritorious motion in the first place. Only by requiring the moving party to be sure of its grounds will the glut of weak motions ever come to an end.

Finally, the SIFMA letter seeks to turn the attorney fee provision on its head. Under the rule proposal, the panel is entitled to award attorney fees against a losing moving party where the motion was deemed to be frivolous. SIFMA argues that this is fine, so long as the panel makes the decision to award such fees *sua sponte*. SIFMA goes on to argue that, if the party opposing the motion has the temerity to point out to the panel its authority to award such fees and request such an award, the panel may assess sanctions *against the party which successfully defeated the motion*! Obviously, this would have an *in terrorem* effect on claimants who might well be entitled to reimbursement for their fees incurred in opposing a frivolous motion. The industry is looking for a free ride – they can make whatever motions they want without any fear of serious reprisals.

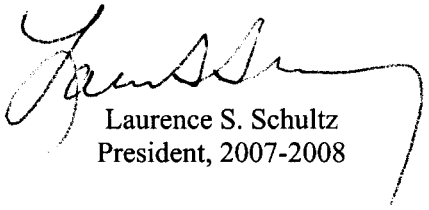
Nancy M. Morris
April 25, 2008
Page 7

Conclusion

The securities industry's opposition to this rule change is not surprising. FINRA is clearly making an effort to fill a procedural vacuum which has been exploited by the industry to the detriment of those investors who seek justice in the only forum open to them. FINRA is to be commended for this effort. We again wish to express our support for this rule, and request its speedy approval and implementation.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION



Laurence S. Schultz
President, 2007-2008

Contact Information:
Laurence S. Schultz, Esq.
Driggers, Schultz & Herbst, P.C.
2600 West Big Beaver Road, Suite 550
Troy, Michigan 48084
Phone: (248) 649-6000
Fax: (248) 649-6442
E-mail: LSSARB@AOL.COM

April 18, 2008

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: File No. SR-FINRA-2008-005
Procedures for Submissions to Arbitrators
After Case Is Closed

Dear Ms. Morris:

I write on behalf of the Public Investors Arbitration Bar Association (PIABA) to comment in opposition to FINRA's proposal to adopt Rule 12905 of the Code of Arbitration Procedure for Customer Disputes.[1] PIABA is an national bar association dedicated to the protection of the rights and interests of public investors in securities and commodities arbitration. Our members and the investors we represent have a strong interest in the rules that govern the arbitration process at FINRA. Our concern as to FINRA rule proposals is even greater now that FINRA has combined with the New York Stock Exchange to establish a monopoly over the investor arbitration process.

PIABA opposes this rule change because it does not provide investor protection and will actually harm investors. We believe that FINRA intended by this rule to resolve an administrative issue. However, in its application, the rule is likely to do more harm than good, which apparently FINRA did not foresee.

The Proposed Rule Would Increase Motion Practice and Attorney Fees

Contrary to the stated purpose of reducing attorney fees, this rule would likely extend the ever-increasing motion practice in arbitration to the post-award period. It would result in either increased attorney fees for customers or, in some cases, generate additional arbitrator orders after *ex parte* proceedings without customer representation. Public customers who have already been denied relief at the cost of thousands of dollars of forum fees would be justifiably unwilling to incur the expense of responding to post-award motion practice.

[1] The amendment also proposes adoption of Rule 13905 for Industry Disputes, but PIABA is primarily interested in the potential harm this proposal poses to the investing public.

Public Investors Arbitration Bar Association
2415 A Wilcox Drive Norman, OK 73069 Phone: (405) 360-8776 Fax: (405) 360-2063
Toll Free: (888) 621-7484 Website: *www.PIABA.org* Email: *piaba@piaba.org*

Nancy M. Morris
April 18, 1008
Page 2

While FINRA's intent was to reduce the attorney fees incurred by both sides, an examination of the rule shows that this will rarely be the result. To begin with, the very existence of a procedure in the Code of Arbitration Procedure for post-award submissions will encourage an increase in these proceedings. When such a motion is made, there will be the necessity for a response. In the end, the proposed FINRA procedures will result in more attorney fees than under the current system.

The Proposed Rule Is Potentially Harmful to Investors

The most noteworthy ground for post-award review in proposed Rule 12905(a) is: "(2) at the request of any party . . . for ministerial matters." This provides the opportunity for a great deal of mischief. In support of its proposal, FINRA states that parties currently file post-award motions "to obtain expungement relief that a party failed to request during the life of the case, to correct what a party perceives to be a mistake in the award, or to request that forum fee allocations be changed." What is unclear is whether these requests will be considered "ministerial" under the proposed rule. It is hard to imagine how a post-award request for expungement and additional fees could be considered simply ministerial, or how it could be of any benefit to public investors. Rather, it is easy to see how it could be abusive.

At present, customers lose 63% of FINRA arbitrations, receiving no award, usually with forum fees assessed against them, and it is likely that most post-award proceedings would be commenced by prevailing brokerage firms against losing investors. For example, a member firm could go back to the panel and argue that its own attorney and forum fees be awarded against the investor because the panel ruled the customer's claim is without merit. In this instance, the investor would be forced to pay additional attorney and forum fees just to defend the member firm's requests before a demonstrably unfriendly arbitration panel that had already ruled against the customer. The brokerage firm may even be encouraged to negotiate dismissal of such post-award claims in exchange for an agreement for expungement.

And under the proposed rule, prevailing brokerage firms would be encouraged to take a second bite by seeking additional relief, including expungement, which had not been previously raised, briefed, or argued. In such a situation, investors who had already suffered significant investment losses, had all claims denied by a FINRA panel, and had been assessed large

forum fees likely will decline to pay additional forum and attorney fees to oppose expungement before a panel already proven unsympathetic. In such cases, the record of the arbitration claim may ultimately be expunged from the CRD triggered by post-hearing motions presented to the panel *ex parte*. In the event such a post-award expungement motion is granted and the expungement is ultimately successful, the public disclosure of individual broker records would become a further sham. We recognize that FINRA is already concerned with the expungement procedure and that there is another proposed rule pending which is intended to address expungement. In our view, however, inserting a rule which codifies and encourages expungement post-award motion practice would only add to the problem.

Even winning customers could be subject to post-award motions. Given the inclusion of "miscalculation of damages" in the definition of "ministerial," we are concerned that firms may use this 30-day post-award filing window to attack the damage award itself. Post-award motions relating to attorney fees and forum fees will provide a further basis to wrongfully attack awards. Moreover, it is unclear from the rule how the filing of a post-award motion would affect the firm's obligation to timely pay an adverse award.

The Rule Should Be Rejected

As FINRA and SICA have acknowledged, the law generally provides that the arbitrators' authority ends when the arbitrators render their decision. It would be improper for FINRA to now preempt a generally accepted state and federal legal principle by adopting this new rule.

FINRA has not demonstrated a real need for this proposed rule. According to the FINRA proposal, the problem is "several requests each year from parties" in cases that have been closed for long periods of time. Moreover, FINRA tells us that, in nearly all cases, the panels refuse to reopen the proceedings to grant the requested relief.

These are not compelling arguments to allow a post-award motion practice which will burden the arbitration proceedings, particularly where investors will be negatively affected.

Public Investors Arbitration Bar Association
2415 A Wilcox Drive Norman, OK 73069 Phone: (405) 360-8776 Fax: (405) 360-2063
Toll Free: (888) 621-7484 Website: *www.PIABA.org* Email: *piaba@piaba.org*

Nancy M. Morris
April 18, 1008
Page 4

We respectfully request that this proposed rule be rejected. Thank you for the opportunity to comment on this proposed rule change.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

Laurence S. Schultz
President, 2007-2008

Contact Information:
Laurence S. Schultz, Esq.
Driggers, Schultz & Herbst, P.C.
2600 West Big Beaver Road, Suite 550
Troy, Michigan 48084
Phone: (248) 649-6000
Fax: (248) 649-6442
E-mail: LSSARB@AOL.COM

Public Investors Arbitration Bar Association

April 16, 2008

Nancy M. Morris,
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2008-009
Proposed FINRA Amendment to Customer Code Rule 12400(c)
Chairperson Eligibility Requirements

Dear Ms. Morris:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") to comment in opposition to FINRA's proposed change to Rule 12400(c) (eligibility for chairperson roster). PIABA is a national bar association dedicated to the protection of the rights and interests of public investors in securities and commodities arbitration. Our members and the investors we represent have a strong interest in the rules that govern the arbitration process at FINRA. Our concern as to FINRA rule proposals is even greater now that FINRA has combined with the New York Stock Exchange to establish a monopoly over the investor arbitration process.

Rule 12400(c) currently requires that a FINRA arbitration chairperson must either have completed FINRA's chairperson training or "have substantially equivalent training or experience." FINRA now proposes to delete the "substantially equivalent training or experience" language of the Rule, thereby extending its monopoly over arbitrator training to include mandatory training of the arbitrators whom it will deem to be "chair-qualified." The proposed change will have the effect of extending FINRA's influence over case outcomes and actually will increase the unfair packing of FINRA arbitration panels with repeat arbitrators who have an established tendency to favor securities industry respondents. Allowing FINRA to tighten its control over its dispute resolution monopoly will increase the investing public's distrust in the process – a distrust that is well-documented in a recent independent survey commissioned by the Securities Industry Conference on Arbitration.[1]

In order to understand our strong opposition to this seemingly minor rule change, it is important to reconsider PIABA's longstanding opposition to the existence of a separate, chair-qualified list.

The chairperson roster is the list of arbitrators eligible to chair a FINRA arbitration panel. Three lists of potential arbitrators are provided for striking and ranking by the parties: (1) a list of eight potential chairpersons, all of whom must meet FINRA's definition of "chair-qualified" arbitrators; (2) a separate list of eight potential public non-chair arbitrators; and (3) a list of eight potential industry arbitrators. Under the list selection rule that the SEC approved, the non-chair public arbitrator list contains names drawn from both the roster of non-chair-qualified public arbitrators *and* the roster of chair-qualified arbitrators. Thus, the "chair-qualified" arbitrators' names are put into the hat twice for list-selection purposes rather

[1] Jill I. Gross and Barbara Black, "Perceptions of Fairness in Securities Arbitration: An Empirical Study—Report to the Securities Industry Conference on Arbitration" (February 6, 2008). The report is available online at http://www.law.pace.edu/files/finalreporttosica.pdf.

Public Investors Arbitration Bar Association
2415 A Wilcox Drive Norman, OK 73069 Phone: (405) 360-8776 Fax: (405) 360-2063
Toll Free: (888) 621-7484 Website: *www.PIABA.org* Email: *piaba@piaba.org*

than just once like all of the other arbitrators, with the result that the deck is stacked in their favor.[2]

Segregating the chair-qualified public arbitrators from the rest of the public arbitrators runs contrary to FINRA's purported principle that "all arbitrators on the lists will have the same chance of being selected for any case."[3] Creating a system where chair-qualified arbitrators are favored in the list-selection process compounds the imbalance dramatically. As FINRA and the SEC are aware, it is possible to demonstrate mathematically, without any need for statistical or empirical data, that: (1) the current deck-stacking rule will increase chair-qualified arbitrators' odds of having their names sent to the parties for striking and ranking and will decrease non-chair-qualified arbitrators' odds of having their names sent out on those lists; and (2) the increases and decreases for the two groups of arbitrators are quantifiable and predictable.[4]

Giving some potential arbitrators preferential treatment in the selection process creates an arbitration forum that utilizes a small group of "repeat" arbitrators who will hear a disproportionately large number of cases. Independent studies have established that "repeat arbitrators" are more likely to produce rulings that favor defendants or respondents[5] who frequently are repeat players in the process.

The pool of "repeat arbitrators" – now called "chair-qualified arbitrators" – is not dominated by active practicing attorneys who serve on FINRA panels as a public service. More often, these "repeat arbitrators" are retired or semi-retired attorneys who hope to be appointed to FINRA arbitration panels as often as they can get assigned. It therefore is in the self-interest of the "repeat arbitrators" to refrain from rendering awards that might offend the securities industry members that are "repeat players" in the forum and thereby jeopardize the arbitrators' chances of being appointed in the future. Given that self-interest, it should surprise no one that "repeat arbitrators" are more likely to render decisions that favor "repeat players" who have disproportionate ability to control the arbitrator's future assignments. In FINRA arbitrations, this means that "chair-qualified arbitrators" are more likely to render decisions that favor FINRA's members.

---

[2] Rule 12403(a)(3) provides as follows: "If the panel consists of three arbitrators, the Neutral List Selection System will generate the chairperson list first. Chair-qualified arbitrators who were not selected for the chairperson list will be eligible for selection on the public list. An individual arbitrator cannot appear on both the chairperson list and the public list for the same case."

[3] NASD argument in support of its original amendment proposing the three-list arbitrator selection process currently utilized by FINRA. Response to comments and Partial Amendment 5, dated August 15, 2006. File SR-NASD-2003-158 at page 22.

[4] See Scot Bernstein, "Stacking the Deck in Arbitrator List Selection: A Study in Regulatory Failure and a Practical Look at the Consequences," *PLI Securities Arbitration 2007* (August 2007), copies of which are available through Westlaw and at *www.sbernsteinlaw.com*. An earlier version of Appendix B to that PLI chapter, containing the algebraic proof that quantified the problem that would arise as a result of the NASD's proposed deck-stacking rule, was submitted to the SEC by Mr. Bernstein in May 2006 as a public comment in response to the NASD's May 4, 2006, Partial Amendment Number 5, Amendments to the NASD Code of Arbitration Procedure for Customer Disputes, File Number SR-NASD-2003-158. The same proof appeared as an attachment to a public comment letter submitted to the SEC by Mr. Bernstein and C. Thomas Mason III in October 2006 in response to the NASD's Partial Amendment No. 7, Amendments to the NASD Code of Arbitration Procedure for Customer Disputes, File Number SR-NASD-2003-158.

[5] See, *e.g.*, MARCUS NIETO & MARGARET HOSEL, ARBITRATION IN CALIFORNIA MANAGED HEALTH CARE SYSTEMS (California Research Bureau, Dec. 2000) (finding that where a small group of repeat arbitrators handled many of Kaiser Permanente's arbitration claims, 75% of those arbitrators ruled in favor of the defense in 80% of the cases; overall, after surmounting other systemic disadvantages, plaintiffs' chances of winning an award were 15%-25% better with an infrequent arbitrator than with a repeat player arbitrator); Lisa B. Bingham, *On Repeat Players, Adhesive Contracts, and the Use of Statistics in Judicial Review of Employment Arbitration Awards*, 29 McGeorge L. Rev. 223 (1998); Marc Galanter's classic study, *Why the "Haves" Come Out Ahead: Speculations on the Limits of Legal Changes*, 9 Law and Society Rev. 95 (1974).

Thus, repeat arbitrators are the opposite of Article III judges, who cannot be fired and whose pay cannot be reduced during their lifetimes. We point this out only to show that we as a nation have understood, since at least 1789, the undesirable consequences of allowing adjudicators of disputes to be subject to political or monetary incentives and pressures. There is no reason to pretend that those long-understood principles of human nature have somehow changed.

One of the obvious solutions to having too many "repeat arbitrators" hearing cases is to have newer, perhaps less jaded, arbitrators assigned to sit on panels. Unfortunately, with the current rule's dramatic increase in the likelihood that "chair-qualified" arbitrators will dominate arbitration panels, it becomes correspondingly more difficult for those newer arbitrators to be seated on panels.

Moreover, as Rule 12400(c) also requires a non-lawyer arbitrator to have served on three cases through award as a prerequisite to achieving "chair-qualified" status,[6] it will become more and more difficult for newer arbitrators to get to the point where they have an equal likelihood of being included on lists sent to the parties for striking and ranking. This results in an entrenchment of repeat arbitrators on panels, rather than the opposite. And it is in direct conflict with FINRA's policy that all arbitrators should have an equal chance to serve.

FINRA's proposed change to the eligibility standard for the roster of chair-qualified arbitrators will further reduce the potential size of FINRA's pool of favored arbitrators. And a smaller, more exclusive list of "repeat arbitrators" will increase the likelihood that each member of that roster will serve on even more panels and will render more decisions favorable to securities industry members. This will work to the detriment of public customer claimants, whose chances of achieving a favorable award are decreased by the presence of "repeat arbitrators." It also will give further support to the public perception that the FINRA arbitration monopoly is a playing field tilted in favor of FINRA's member firms, a place where investors cannot get a fair shake.

If the goal is to provide an "equal chance" arbitrator selection process and a forum through which public customers can have an opportunity for a fair adjudication of their claims, the proposed rule change is counterproductive and must be rejected. Further, the SEC should seize this opportunity to do away with the deck-stacking rule and revisit its original decision to allow FINRA to maintain a separate list of "chair-qualified" repeat arbitrators. Such a change would clearly be in the public interest.

Thank you for allowing us to comment on this proposed rule change.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION

Laurence S. Schultz
President, 2007-2008

Contact Information:
Laurence S. Schultz, Esq.
Driggers, Schultz & Herbst, P.C.
2600 West Big Beaver Road, Suite 550
Troy, Michigan 48084
Phone: (248) 649-6000
Fax: (248) 649-6442
E-mail: LSSARB@AOL.COM

[6] Arbitrators who are attorneys must sit on two cases through award.

Public Investors Arbitration Bar Association

March 18, 2008

Nancy M. Morris, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-0609

Re: Proposed Revisions to Rules 12206 and 12504 of the NASD Code of Arbitration Procedure – Motions to Dismiss
SR-FINRA-2007-021

Dear Ms. Morris:

On behalf of the Public Investors Arbitration Bar Association (PIABA), I am pleased to comment on the above-referenced rule changes concerning motions to dismiss in FINRA arbitrations. PIABA strongly supports these rule changes, and requests that the Commission approve the proposed revisions on an accelerated basis.[1]

PIABA is a bar association comprised of attorneys who represent investors in securities arbitration. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities and commodities arbitration forums. Our members and their clients have a strong interest in the rules which govern the FINRA arbitration process.[2]

The Need for the Rule Change

Currently, FINRA's procedural rules do not provide for motions to dismiss in advance of the evidentiary hearing. However, as FINRA stated in this rule filing, this is not the first attempt to codify such a procedure. FINRA first attempted to delineate the grounds for pre-hearing dismissals and the procedure for such motions as part of its Code Rewrite originally filed with the Securities and Exchange Commission in October 2003. The provisions of the Code Rewrite relating to dispositive motions turned out to be quite controversial, and ultimately were withdrawn from the Code Rewrite. Subsequently, FINRA submitted the dispositive motion proposal in a separate filing, and this proposal was also withdrawn.

[1] As an organization which advocates for the public investor in securities arbitrations, our comment is directed primarily to the proposed revisions to the Customer Code, in Rules 12206 and 12504 of the NASD Code of Arbitration Procedure. We note, however, that FINRA has proposed identical rule changes for the Industry Code in Rules 13206 and 13504. We are generally supportive of these conforming revisions.

[2] Like FINRA's staff in its filing, we will use the term FINRA to refer both to the NASD and FINRA.

Public Investors Arbitration Bar Association
2415 A Wilcox Drive Norman, OK 73069 Phone: (405) 360-8776 Fax: (405) 360-2063
Toll Free: (888) 621-7484 Website: *www.PIABA.org* Email: *piaba@piaba.org*

Since 2003, FINRA's stated position as reflected in these proposals has been that the parties had a right to a hearing in arbitration and that except for certain eligibility motions, dispositive motions are discouraged and should only be granted in extraordinary circumstances. The "extraordinary circumstances" standard is not part of the current proposal. See Securities Act Release No. 54360 (August 24, 2006), 71 FR 51879 (August 24, 2006) (File No. SR-NASD-2006-088).

Though rarely granted, in recent years dispositive motions have been routinely filed by the industry and pose a significant burden on the arbitration process. As PIABA pointed out in our comment to the August 26, 2006, FINRA dispositive motion rule proposal,[3] lawyers who represent the industry in customer arbitrations were told at seminars that motions to dismiss should be routinely raised in every answer to every statement of claim.

On many occasions, industry respondents filed more than one motion in a single case, or made motions for reconsideration of the panel's denial of a motion to dismiss. While, as noted, very few of these motions were successful, our members and their clients were still required to expend time and money to respond to the motions, thereby increasing the expense of a procedure which was intended to be more informal, expeditious and cost-effective than litigation. Furthermore, even where investors prevailed in these motions, arbitration panels commonly assessed half of the forum fees incurred on the motion to the public investor.

To demonstrate the industry's abuse of the dispositive motion practice, PIABA has provided more than 150 examples of dispositive motions to FINRA.

Dispositive motions are clearly being abused by industry respondents to burden the arbitration process and prejudice investor claimants. We are gratified that FINRA has acknowledged the problem and is taking decisive action to restore the investor's right to present evidence at a hearing in support of his or her claim.

Motions to Dismiss Are Inappropriate in FINRA Arbitration

The rule revisions which are the subject of this filing recognize that the vast majority of customer claims involve factual disputes between a public investor and his or her broker, which can only be resolved by the panel after

[3] See letter to Nancy M. Morris from Robert S. Banks, Jr., PIABA President 2005-2006, regarding SR-NASD-2006-088, dated September 21, 2006.

an evidentiary hearing. FINRA's effort to reconcile these competing interests represents a workable compromise.

It is universally accepted that arbitrations should be less formal, less time-consuming, and less expensive than litigation. To this end, discovery in arbitration is very limited, essentially consisting of document production and a limited number of requests for information. Court-style depositions are strongly discouraged, and court-style interrogatories to address factual questions are typically not permitted. Parties must rely on the arbitration hearing itself to provide the essential factual support for their claims.

In truth, nearly all of the motions to dismiss filed by respondents in FINRA arbitrations are more akin to court-style motions for summary judgment, the essence of which is that after full discovery, including depositions, interrogatories, and requests for admissions, no material question of fact remains, and one party is entitled to judgment as a matter of law. Such a proceeding, styled as a motion to dismiss in arbitration, simply has no place in a process which restricts discovery and relies on a hearing to resolve factual disputes.

Equally significant is that in court proceedings, if summary judgment is granted, the losing party has an automatic right to appeal where an appellate court in a *de novo* judicial review takes a fresh look at the lower court decision to assure the losing party has not been a victim of an erroneous legal or factual determination. In contrast, in arbitration there is no appeal from the grant of a motion to dismiss, so that not only are losing claimants denied a hearing to address factual issues, they are precluded from a judicial review of potential error in the dismissal of their claims. This result is particularly troubling in view of the fact that the deciding arbitrators typically not only have no judicial experience, they may not even be lawyers. Thus, the motion to dismiss procedure is fundamentally unfair to claimants and has no place in arbitration.

<u>The Proposed Rule Revisions Strike a Fair Balance Between Competing Interests</u>

The FINRA proposed rule changes permit pre-hearing dismissals in three narrow circumstances: (1) where the claim is ineligible for arbitration under the six-year eligibility rule; (2) where there is a settlement agreement or release signed by the claimant which previously released the claim; or (3) where the named respondent was not associated with the account(s), security(ies), or conduct at issue.

As might be expected with any compromise, there are parts of this rule which PIABA finds unpalatable. PIABA believes that pre-hearing motions to dismiss should not be permitted in any circumstance. Even these three narrow grounds for motions to dismiss will typically require fact-oriented motion practice. There may be tolling provisions applicable to motions made under the eligibility rule; these issues require an evidentiary hearing. Similarly, it seems apparent that the last prong will encourage branch office managers and control persons, who may be liable under federal and state securities statutes, to improperly seek dismissal on the ground that they were not directly involved with the account which is the subject of the claim, even though such involvement may not be necessary to establish liability. These motions will require the claimant to spend significant time to marshal and present evidence to establish to the panel's satisfaction the need for an evidentiary hearing. None of this is consistent with the stated objectives of arbitration, to streamline procedures and provide a cost-effective dispute resolution mechanism. PIABA believes these matters, while not specifically addressed in the rules, should be the subject of FINRA rule comment, making it clear that the pre-hearing dismissal rules are to be strictly interpreted and that they are not intended to allow dismissal of claims of secondary liability, including those based on causes of action establishing liability for persons not directly associated with the accounts, securities, or conduct at issue.

Despite our concerns, PIABA is supportive of this rule. The clear delineation of the grounds for a motion to dismiss should preclude a majority of the motions to which our members and their clients have been subjected. FINRA also has built into the rule several provisions designed to discourage all but meritorious motions. These provisions give comfort that the proposed rule will indeed have the intended effect of making the filing of motions, and certainly the granting of such motions, a rarity. These provisions include the following:

- The rule states, clearly and succinctly, that pre-hearing motions to dismiss are discouraged. Rule 12504(a)(1).

- Motions to dismiss can no longer be filed with the answer to the statement of claim. Rule 12504(a)(2). This practice was abused by respondents. It resulted in procedural inconsistencies and required the preparation of briefs and forced unnecessary and unproductive hearings at the earliest stages of the proceedings. Moreover, some respondents filed motions to dismiss without even filing an answer; the new rule would prohibit that practice.

- The new rule guarantees sufficient notice and an opportunity to respond, including an opportunity to be heard orally, in person or by telephone. Rule 12504(a)(3) and (5). These provisions simply preserve minimal due-process protections.

- The oral hearing must be recorded. Rule 12504(a)(5). This would provide a record in the event a vacatur action were filed.

- Motions to dismiss must be heard by the entire panel. Rule 12504(a)(4). A decision granting (but not denying) a motion to dismiss must be unanimous, and the reasons would have to be provided in the written award. Rule 12504(a)(7).

- Multiple filings of the same motion to dismiss are prohibited, absent an order from the panel to the contrary. Rule 12504(a)(8). This would put a stop to one of the abusive tactics our members have observed.

- The panel is prohibited from considering or acting upon a motion to dismiss not brought under one of the three grounds. By proscribing even consideration of such motions, the rule makes clear a motion to dismiss on other than the specified grounds would exceed the panel's jurisdiction.

- The rule *mandates* that forum fees be assessed against the party who unsuccessfully makes a motion to dismiss. Moreover, the panel is authorized to assess attorney fees or any other appropriate sanctions against a respondent who files a frivolous motion to dismiss. These provisions should discourage the filing of weak and frivolous motions, which we routinely see under the current system.

PIABA also supports that portion of the eligibility rule which requires that a panel specifically state its grounds for granting a motion to dismiss on eligibility grounds, and refrain from deciding on any other ground. Rule 12206(b)(7). Under current practice, panels sometimes fail to specify the grounds for their decision to grant the motion. This is a problem because a claimant whose case is dismissed on eligibility grounds still has the right to go to court with the claim. Rule 12206(b). When panels fail to set forth the reason for their decision, the parties are unable to determine whether the dismissed case could be re-filed in court. The revision to Rule 12206(b)(7) resolves this issue.

To summarize, PIABA believes that the revisions to the rules will materially reduce the number of motions to dismiss in arbitration and strongly supports the changes. The rule changes should substantially improve a situation which has unjustly caused delays, driven up the cost of arbitrations to claimants, and resulted in unfair dismissal of claims for investors who simply want their "day in court." We urge the approval of the rule revisions.

Accelerated Approval

Finally, we request the Commission consider approval of this filing on an accelerated basis. Clearly, the approval of this amendment by a unanimous National Arbitration and Mediation Committee (NAMC), including both public and industry representatives, is an indication that the rule is deserving of expedited approval. We also understand that the FINRA Board unanimously approved these changes.

We must also emphasize that, despite FINRA's efforts to discourage the filing of motions to dismiss, and the filing of this proposed rule change, respondents continue filing fact-based dispositive motions in large numbers. The only way this will end is for the Commission to promptly approve this rule proposal.

Conclusion

We request the Commission approve these rules on an accelerated basis. Thank you for your consideration of this important matter.

Respectfully,

PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Laurence S. Schultz
President, 2007-2008

Contact Information:
Laurence S. Schultz, Esq.
Driggers, Schultz & Herbst, P.C.
2600 West Big Beaver Road, Suite 550
Troy, Michigan 48084
Phone: (248) 649-6000
Fax: (248) 649-6442
E-mail: LSSARB@AOL.COM

Public Investors Arbitration Bar Association

February 25, 2008

Nancy M. Morris
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: SR-FINRA-2007-042 Rule Proposal Regarding Electronic Filing

Dear Ms. Morris:

Thank you for the opportunity to comment on the Rule Proposal of the Financial Industry Regulatory Authority ("FINRA") to amend NASD Rules 12302 and 13302 regarding electronic filing of Statements of Claim (SR-FINRA-2007-042). I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") in support of the above-referenced rule proposal. The proposed rule would remove the 50-page limit on Statements of Claim filed through the Online Arbitration Claim Filing System ("the System") and would allow parties to submit Statements of Claim and exhibits through the System.

On behalf of PIABA, I support the proposed rule and urge its adoption. PIABA is a bar association dedicated to the protection of investors' rights in securities arbitration proceedings. PIABA supports the proposed rule, as it is a positive step in creating a more efficient and accessible claim-filing system. The proposed rule will make it easier for investors to submit their claims through the System, especially if they have a considerable number of pages attached as exhibits, as Statements of Claim often do. The proposed rule is beneficial as it could also save mailing or messenger costs, help reduce the need for paper storage, and reduce significant time delays inherent with paper filings.

While PIABA believes that this proposed rule is a step in the right direction, more needs to be done. If a claimant submits the Statement of Claim through the System, he or she is still required to send payment for filing fees in the mail by check. The filing of separate parts of the claims via both mail (for the check) and electronic submission (for the Statement of Claim) discourages the use of the online claim filing system.

One way to correct this problem would be to allow claimants to pay the claim filing fees online, by accepting payment from credit cards, much in the same way many federal and state courts currently operate. In nearly all of the federal district courts, the parties can submit pleadings, motions, briefs, and other documents through the court-sponsored filing system (the Case Management/Electronic Case Filing System or "CM/ECF"). Once a filing is submitted to the CM/ECF, the other counsel of record will automatically receive an electronic, file-stamped copy of the submission via e-mail within only a few minutes. Many federal courts have recently adopted procedures to accept credit cards for the payment of filing fees for the CM/ECF. A similar system used by FINRA could expedite the processing of filed pleadings and motions and would create efficiencies.

In addition, the current online filing system is not user-friendly. The current system can be difficult to use, especially for those who consider themselves to be "computer illiterate." Users who are unable to understand the system simply give up and file their claims via mail.

Public Investors Arbitration Bar Association
2415 A Wilcox Drive Norman, OK 73069 Phone: (405) 360-8776 Fax: (405) 360-2063
Toll Free: (888) 621-7484 Website: *www.PIABA.org* Email: *piaba@piaba.org*

PIABA supports the acceptance of this new rule, and hopes that FINRA will continue to find ways to create a more efficient, more user-friendly claim filing system. I would like to thank you once again for the opportunity to comment on this rule proposal.

Very truly yours,

Laurence S. Schultz
President

Laurence S. Schultz, Esq.
Driggers, Schultz & Herbst, P.C.
2600 West Big Beaver Road, Suite 550
Troy, Michigan 48084
Phone: (248) 649-6000
Fax: (248) 649-6442
E-mail: LSSARB@AOL.COM

Announcements From The PIABA Office

Office Staff:

Robin S. Ringo, Executive Director
rsringo@piaba.org

April Bowers
abowers@piaba.org

Tiffany Zachary, Technical Assistant
tzachary@piaba.org
Direct: 1.918.794.8669

To Contact the PIABA Office:
Direct: 1.405.360.8776
Toll Free: 1.888.621.7484
Fax: 1.405.360.2063

PIABA
2415 A. Wilcox Drive
Norman, OK 73069
Email: piaba@piaba.org
Website: www.PIABA.org

Upcoming Events:

Deadline for receiving submissions to the Fall 2008 *Bar Journal*, November 21, 2008

Deadline for receiving submissions to the Winter 2008 *Bar Journal*, December 15, 2008

Deadline for receiving submissions to the Spring 2009 *Bar Journal*, February 23, 2009

PIABA Board of Directors Meeting, March 14-15, 2009. Location to be Announced

PIABA Board of Directors Meeting, July 18-19, 2009. Location to be Announced

PIABA Securities Law Seminar, October 28, 2009. La Costa Resort & Spa, Carlsbad, California

PIABA Annual Meeting, October 29-31, 2009. La Costa Resort & Spa, Carlsbad, California

PIABA Annual Business Meeting and Election of Directors. October 29, 2009. La Costa Resort & Spa, Carlsbad, California

PIABA Board of Directors Meeting, November 1, 2009 La Costa Resort & Spa, Carlsbad, California

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

New Members

Stefan Apotheker	(954) 763-4700
Jay Aughtman	(334) 269-2343
William Bankston	(907) 276-1711
Joel Beck	(678) 344-5342
Robert Benbenek	(314) 961-0330
Alan Busch	(214) 855-2880
Christopher Cooke	(650) 638-2370
Jeanne Crandall	(214) 760-8100
David Darnell	(949) 975-7500
Mark Haber	(415) 217-7300
William Hawkins	(615) 726-0050
Kenneth Jones	(615) 726-0050
Thomas Krebs	(205) 254-1407
Mark Krudys	(804) 692-8244
Kyle Lakin	(949) 640-8222
Charles Liberis	(850) 433-9647
Eric Ludin	(727) 572-5000
Julie Mathew	(212) 943-1233
John Murrin	(952) 994-1066
Andrew Platt	(817) 877-1700
John C. Porter	(770) 829-3850
Russell Smith	(330) 434-7167
Lars Soreide	(954) 763-4700
Scarlette Tuley	(334) 396-2142
Matthew Wilson	(614) 384-7031

New Student Members

Victoria Cantrella	(908) 208-7112
Ilya Chikvasvili	(718) 990-6930
Paul Darakjian	(201) 739-8540
John DiCioccio	(718) 990-6930
Timothy Fox	(718) 990-6930
Lawrence Han	(516) 924-0307
Richard La Rosa	(718) 990-6930
Joseph Odato	(646) 265-4181
Alexander Ponze	(718) 990-6930
Jean Post	(718) 990-6930
Thomas Rooney	(718) 990-6930
Peter Ryan	(203) 470-4461
Robert Van DeVeire	(718) 990-6930