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In this Issue

REGIONS MORGAN KEEGAN: THE ABUSE OF STRUCTURED FINANCE

Craig McCann, PhD, CFA[1]

Innovations in financial engineering have allowed investment banks to create securities backed by other securities rather than by bricks and mortar and business plans. These innovations have increased funding available to homeowners and businesses and provided investors with more varied opportunities. As these structured securities become more complex and opaque though, they allow advisors and managers, including mutual funds portfolio managers, to take on significant undisclosed risks.

Investors in six Regions Morgan Keegan ("RMK") bond funds lost $2 billion in 2007. This paper explains how extraordinary and undisclosed risks allowed these funds to generate higher returns than their competitors for many years but ultimately caused the funds' collapse in 2007.

The investors' losses were not the result of a "flight to quality" or a "mortgage meltdown." Diversified portfolios of high yield bonds and mortgage-backed securities did not suffer significant losses as the RMK funds suffered massive losses. The RMK funds collapsed because they held concentrated holdings of low-priority tranches in structured finance deals backed by risky assets.

RMK did not disclose in its Securities and Exchange Commission filings the risks it was exposing investors to by investing the majority of its portfolio in subordinated tranches of asset-backed securities until *after* the losses had occurred. RMK also misrepresented hundreds of millions of dollars of asset-backed securities as corporate bonds and preferred stocks in its SEC filings thereby making the funds seem more diversified and less risky than they were.

 Dr. McCann is the primary author of this report but the research was conducted by a team of professionals at SLCG including Sherry Liu, Geng Deng, Dana Lin and Sandy Eng. Eddie O'Neal, Paul Meyer and Lily Chu provided helpful comments and suggestions. Dr. McCann can be reached at 703-246-9381 or *craigmccann@slcg.com*.

RMK further misled investors in its SEC filings and marketing materials by comparing its funds to the Lehman Brothers Ba Index. This index contains only corporate bonds - no asset-backed securities which dominated the RMK funds' portfolios and which resulted in virtually all the investors' losses. RMK also misled investors by claiming that its funds were diversified.

I. INTRODUCTION

Six RMK bond funds – four closed-end funds (RMH, RHY, RMA and RSF) and two open-end funds (MKHIX and MKIBX) - collapsed spectacularly in 2007. The six funds had higher returns and yields than their peers in years prior to 2007, but lost 62% on average in 2007 while their peers had positive returns or only modest losses.[2]

The apparent superior performance of the RMK funds in earlier years and the spectacular losses in 2007 resulted from the funds' holdings of hundreds of low-priority *tranches* of structured finance deals. The structured finance deals held by the RMK funds included *collateralized debt obligations* (CDOs), c*ollateralized mortgage obligations* (CMOs), and *asset-backed securitie*s (ABS). The low-priority tranches that RMK purchased significantly leveraged up investors' exposure to the credit risk in mortgages, loans and bonds backing the tranches. The funds' prospectuses did not disclose the extraordinary amount of credit risk to which fund shareholders were exposed as a result of the low-priority tranches the funds' portfolio manager was purchasing.

Section II describes the six funds and illustrates their reported returns. Section III explains why the structured finance securities purchased by the RMK funds were dramatically more risky than investors were led to believe from the disclosures in the funds' filings with the Securities and Exchange Commission. Section IV provides a few examples of the securities held in the RMK funds. Section V highlights some of the misrepresentations in RMK's public filings and marketing materials.

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2. These losses in the RMK funds relative to their peers in the mutual fund and closed end fund universe are explored in more detail in "The Implosion of High Yield Funds 2007 – 2008" by Edward O'Neal, available at *www.slcg.com*.

II. REGIONS MORGAN KEEGAN BOND FUNDS

A. Investors Lost Over $2 Billion in Six RMK Funds

The six Regions Morgan Keegan bond funds that collapsed in 2007 are listed in Table 1. The four closed-end funds were initially offered between June 24, 2003 and January 19, 2006 and had net assets of $1.6 billion as of December 31, 2006. Morgan Keegan was the lead underwriter for the four closed-end fund offerings. The two open-end funds were issued on March 22, 1999 and had net assets of $2.2 billion as of December 31, 2006. The closed-end funds lost $1 billion in market value in 2007. The open-end funds net assets declined even more although some of the decline was due to investors redeeming shares.

Table 1
Regions Morgan Keegan Bond Funds

Fund Name	Ticker	Inception	Net Assets		2007 Returns	
			12/31/2006	12/31/2007	Capital Appreciation	Total Return
High Income	RMH	6/24/2003	$311.6 m	$115.5 m	-70.7%	-65.5%
Strategic Income	RSF	3/18/2004	$366.0 m	$134.2 m	-72.1%	-67.2%
Advantage Income	RMA	11/8/2004	$423.8 m	$161.9 m	-71.6%	-66.8%
M-S High Income	RHY	1/19/2006	$478.8 m	$159.5 m	-72.2%	-65.4%
Select High Income	MKHIX	3/22/1999	$1,251.6 m	$156.7 m		-58.4%
Select Intermediate	MKIBX	3/22/1999	$913.8 m	$168.7 m		-49.6%
			$3,745.6 m	$896.5 m		

The $3 billion drop in the funds' net assets reported in Table 1 are largely as a result of $2 billion in losses on securities held in the mutual funds' portfolios. These securities losses are listed in Table 2 with our estimate of investor losses.[3] Investors in these six funds lost more than $2 billion between March 31, 2007 and March 31, 2008.

3. The portfolio securities losses for the two open-end funds are for the 10-month period from June 30, 2007 to April 30, 2008. Adding investment losses in these two funds during the period from March 31, 2007 to June 30, 2007 adds about $100 million to the RMK funds' investment losses.

Table 2
Investors in the Six RMK Funds Lost $2 Billion
From March 31, 2007 to March 31, 2008

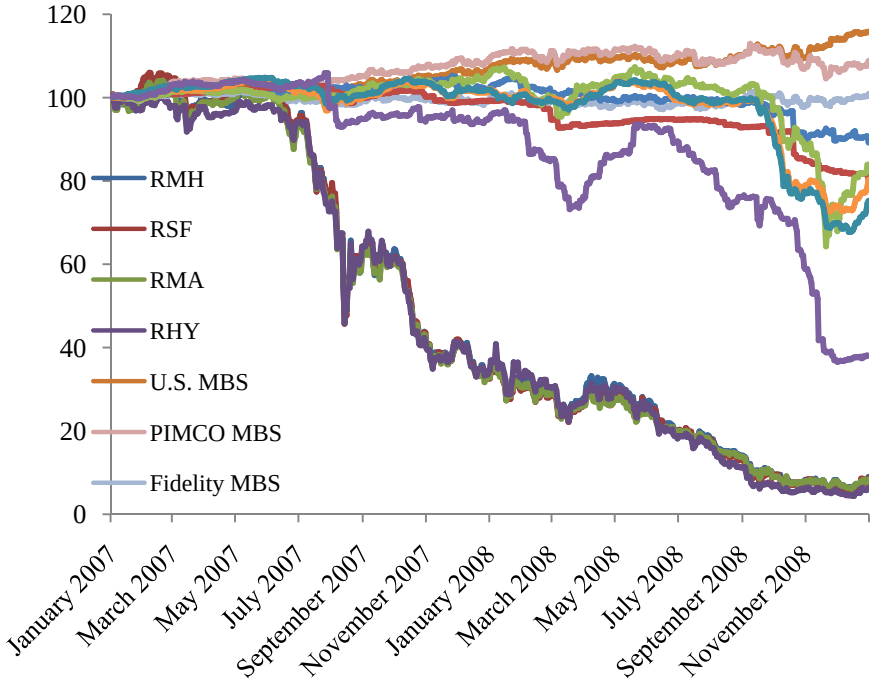
	Portfolio Securities[4]		Investor Losses	
Fund Name	Capital Gain/Loss	Net Gain/Loss	Capital Gain/Loss	Net Gain/Loss
Advantage Income	$(313,565,152)	$(270,000,647)	$(379,307,019)	$(281,465,563)
High Income	$(224,919,545)	$(194,593,637)	$(271,456,298)	$(238,037,475)
Strategic Income	$(272,382,430)	$(235,249,944)	$(327,115,002)	$(376,890,153)
Multi-Sector High Income	$(363,776,576)	$(317,940,696)	$(417,380,060)	$(327,419,955)
Select High Income	$(458,786,433)	$(415,321,470)	$(458,786,433)	$(415,321,470)
Select Intermediate Bond	$(404,876,746)	$(370,825,120)	$(404,876,746)	$(370,825,120)
Total	$(2,038,306,882)	$(1,803,931,514)	($2,258,921,558)	$(2,009,959,736)

B. The Losses Were Not From "Flight to Quality" or "Mortgage Meltdown"

The losses suffered by investors in the RMK funds were not the result of a "flight to quality." The values of $100 invested in each of the four RMK mutual funds on January 1, 2007 with re-invested dividends from January 1, 2007 to December 31, 2008 are plotted in Figure 1 along with several benchmark indexes from Lehman Brothers and three mutual funds which track the high yield and mortgage-backed securities markets. The RMK losses were clearly not the result of a collapse in the high yield bond market or as a result of a "mortgage meltdown."

4. These losses are virtually all in the funds' holdings of low-priority asset-backed securities; 97% of the unrealized losses between March 31, 2007 and September 30, 2007 in the Multi-Sector High Income fund's portfolio were in asset backed securities, only 3% were in corporate bonds.

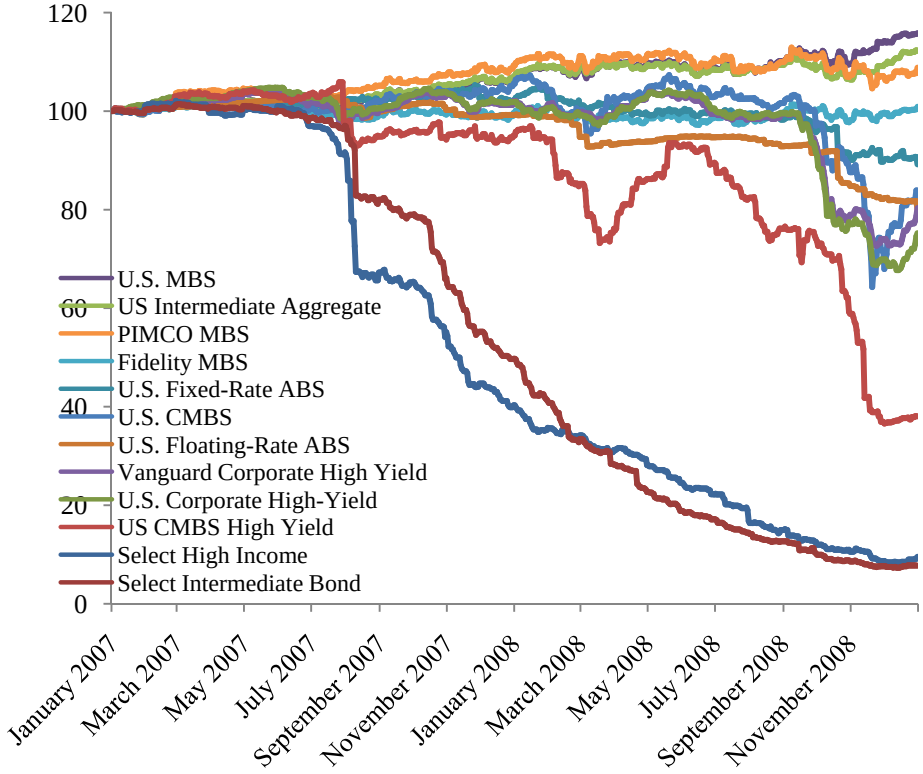
Figure 1
Regions Morgan Keegan Closed-end Funds' Closing Prices
and High Yield and Mortgage Benchmarks



The value of $100 invested in the two open-end funds from January 1, 2007 to December 31, 2008 is plotted in Figure 2 along with the same indexes plotted in Figure 1. These open-end funds tracked their claimed benchmarks more closely than did RMK's closed end funds until July 2007 and then fell off precipitously just like the closed-end funds.[5] As with the losses in the closed-end funds, the open-end funds' losses were not, the result of a "flight to quality" or a "mortgage meltdown."

5. The four closed-end funds had substantially the same investments as the Select High Income Fund (MKHIX) but were leveraged up 33%. This leverage, in part, explains why the four closed end funds plotted in Figure 1 exceeded the value MKHIX plotted in Figure 2 in 2006.

Figure 2
Regions Morgan Keegan Open-end Funds' NAV
and High Yield and Mortgage Benchmarks



C. The RMK Funds Were Not High Yield Bond Funds

Figure 3 plots the cumulative average value of $100 invested on December 31, 2006 into 35 non-RMK closed-end, high yield bond funds along with the four RMK closed end funds. The value of the non-RMK closed-end funds held up well during the decline in the value of mortgage backed securities through the summer of 2008. It was only with the collapse of the financial services industry in the fall of 2008 that non-RMK high yield, closed-end funds lost significant value.

Table 3 reports a simple statistical test to determine whether the 4 RMK closed-end funds suffered similar losses as other closed end funds, only differing in that the RMK funds suffered their losses earlier than the other funds. We calculate cumulative returns for the 35 non-RMK funds and the 4 RMK funds at each quarter end from June 30, 2006 to December 31, 2007. We then assess the average and cross sectional variation in the two groups of funds' returns to determine whether it is likely that the 39 funds' cumulative returns were generated from the same underlying economic forces. The far-

right column of Table 3 reports the likelihood that the 4 RMK funds losses were similar to the losses suffered by the non-RMK funds.

Figure 3
RMK Closed-end Funds
and High Yield Closed-end Bond Funds

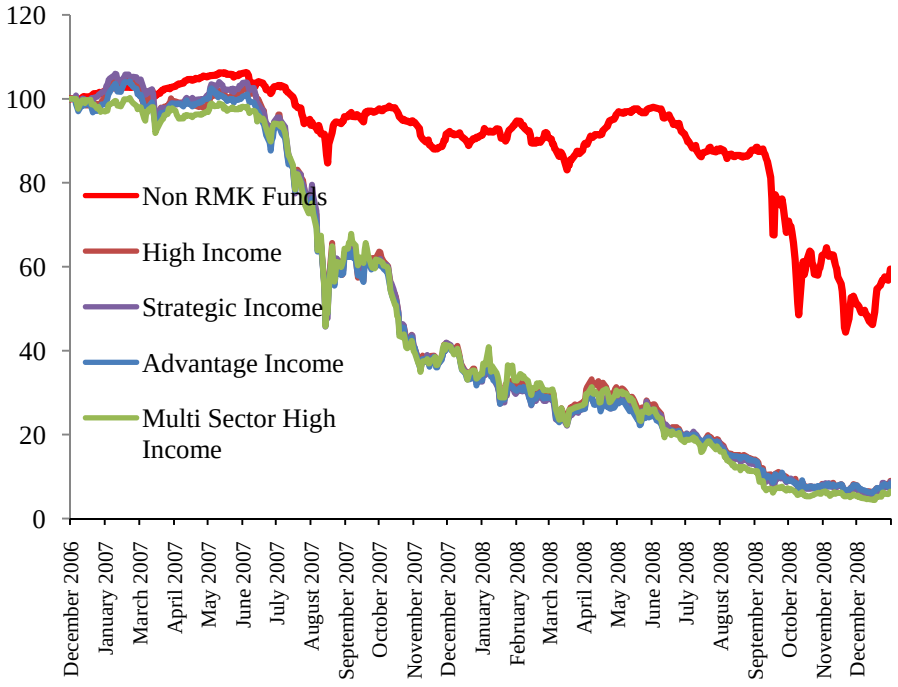


Table 3
Probability that RMK Closed-end Funds
Suffered Same Losses as High Yield Bond Funds, Just Earlier

	Average Cumulative Return From December 31, 2006		Probability That RMK Funds Were HY CE Funds
	35 Non-RMK Funds	4 RMK Funds	
6/30/2007	2.9%	-6.1%	1.6%
9/30/2007	-3.0%	-39.1%	0.0%
12/31/2007	-8.7%	-66.5%	0.0%
3/31/2008	-12.3%	-73.3%	0.0%
6/30/2008	-8.4%	-80.7%	0.0%
9/30/2008	-30.1%	-91.2%	0.0%
12/31/2008	-40.6%	-91.9%	0.4%

D. The RMK Funds Were Extraordinarily Risky

The closed-end funds were substantially riskier than their benchmark even before the sharp declines in 2007. Table 3 reports the standard deviation of daily returns for the four closed-end funds and the Vanguard fund that tracks the Lehman Brothers benchmark for 1-year, 2-year and 3-year periods ending March 31, 2007. The RMK funds were four to six times as volatile as their benchmark during the 1-year, 2-year and 3-year periods ending March 31, 2007.

Table 4
RMK Funds Were Much More Volatile Than Benchmarks
(annualized standard deviations, ending March 31, 2007)

	Prior Three Years	Prior Two Year	Prior One Year	April 2007 to September 2007
RMH	13.8% (4.8 ×)	14.0% (5.2 ×)	16.1% (6.2 ×)	55.0% (12.3 ×)
RSF	12.0% (4.2 ×)	11.7% (4.3 ×)	12.7% (4.9 ×)	56.7% (12.7 ×)
RMA	12.2% (4.3 ×)	12.0% (4.4 ×)	13.2% (5.1 ×)	54.4% (12.7 ×)
RHY	11.3% (4.2 ×)	11.3% (4.2 ×)	12.0% (4.6 ×)	59.1% (13.2 ×)
MKHIX	3.5% (1.2 ×)	3.4% (1.3 ×)	3.5% (1.3 ×)	21.8% (4.9 ×)
MKIBX	2.4% (0.5 ×)	2.3% (0.6 ×)	2.3% (0.6 ×)	15.7% (3.4 ×)

The statistics reported in Table 3 suggest that RMK was smoothing the NAV of its funds by not using reasonable estimates of market prices in its NAV calculations. The RMK closed-end fund's market prices were more than 3.5 times as volatile as the Select High Income (MKHIX)'s NAV during the periods covered by Table 3 even though they all held substantially the same portfolios. This suggests that MKHIX's true NAV was approximately twice as volatile as its reported NAVs.[6] Since RMK's closed-end funds had substantially the same portfolio holdings as its open-end fund and placed the same values on the individual holdings in their periodic reports, Table 3 suggests that RMK misstated the valuations of its closed end funds as well.[7]

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6. Jeffrey Pontiff, "Excess Volatility and Closed-End Funds," *American Economic Review* March 1997 pp. 155-169. Closed-end funds are typically 65% more volatile than their NAVs so, other things equal, the four RMK high yield closed-end funds will be 65% more volatile than the Vanguard open end fund used as a benchmark if the RMK portfolios are typical of high yield bond mutual funds.

7. The suggestion that RMK was smoothing its valuations is consistent with the substantial devaluations applied by the funds' subsequent portfolio managers. There was at least one very strong warning sign of the ultra-high level of risk being taken on in the mutual fund portfolios. Edward O'Neal finds that the yield on the RMK Select High Income Fund in the 2004 – 2006 period was far higher than that of other high yield mutual funds, indicating that the risk of this fund was clearly evident

III. THE RMK FUNDS MISREPRESENTED THEIR HOLDINGS

We have analyzed the portfolio holdings for the six RMK funds and determined that they all held heavy concentrations of low-priority tranches in asset-backed and mortgage-backed securities. The six RMK funds held three times as much structured finance securities as they held corporate bonds. *See* Table 5.[8]

Table 5
RMK Funds Were Structured Finance Funds
March 31, 2007

	% of Gross Assets in Structured Finance	% of Gross Assets in Corporate Bonds
Select High Income	67%	22%
Select Intermediate Bond	63%	29%
High Income	65%	24%
Strategic Income	65%	22%
Advantage Income	66%	22%
Multi-Sector High Income	70%	21%
Average	66%	23%

RMK frequently purchased all or almost all these relatively small, unique tranches. As a result of the mutual funds' portfolio manager's investment decisions, the funds' holdings were illiquid and could not be valued by reference to market prices of substantially similar assets. Regions Morgan Keegan misrepresented $446 million of these highly-leveraged, illiquid asset-backed securities as corporate bonds and preferred stocks as of March 31, 2007 in its filings with the Securities and Exchange Commission.

A. RMK Misrepresented $139.6 Million in Asset-Backed Securities Held by Select High Income fund as Corporate Bonds and Preferred Stocks

Table 6 lists the Select High Income funds' holdings on March 31, 2007 as reported by RMK and as corrected. RMK misrepresented $139.6 million

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in the years prior to the fund's meltdown. See "The Implosion if High Yield Funds 2007 – 2008" available at *www.slcg.com*.

8. Table 5 and many of our other examples come from March 31, 2007 filings. I chose this date because it precedes the significant losses identified in Table 2 and helps us identify the cause of those losses. The funds were concentrated in low priority tranches in structured finance deals and misrepresented those holdings well before and after March 31, 2007.

of MKHIX's asset backed securities on March 31, 2007 as corporate bonds or preferred stocks. Virtually all of the securities RMK classified as "Corporate Bonds – Special Purpose Entities" are asset-backed securities. Similarly, almost all the securities RMK classified as "Preferred Stocks" are equity tranches – i.e. the most highly leveraged tranches – in asset-backed deals.[9]

The asset-backed securities' offering documents and ratings agencies' releases clearly identify the securities RMK misclassified as asset-backed securities. RMK acknowledged its prior misclassification of these securities when it reclassified any remaining holdings in March 2008. The Select High Income fund actually held 66.6%, not 55.0%, of its net assets in asset-backed and mortgage-backed securities on March 31, 2007.

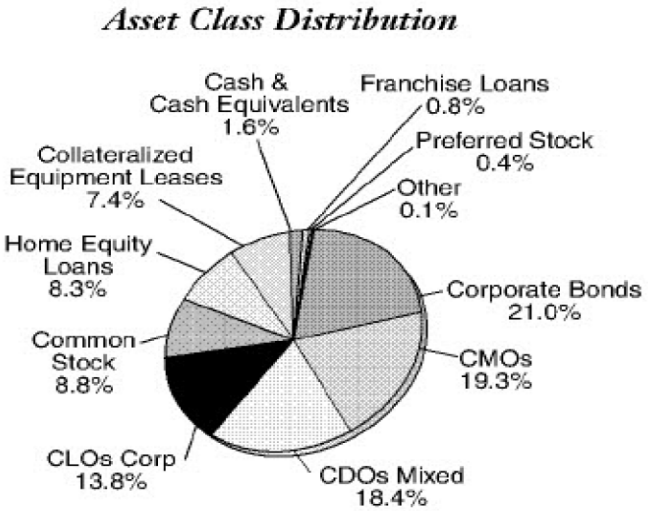
Table 6
RMK Misrepresented $139.6 Million
of the Select High Income funds' Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$661,308,326	**55.0%**	$800,901,653	**66.6%**
Corporate Bonds	$344,923,469	**28.7%**	$262,427,297	**21.8%**
Municipal Securities	$1,143,450	0.1%	$1,143,450	0.1%
Common Stocks	$108,727,164	9.0%	$108,727,164	9.0%
Preferred Stocks	$62,157,155	**5.2%**	$5,060,000	**0.4%**
Cash	$22,055,000	1.8%	$22,055,000	1.8%
Other Assets & Liabilities	$2,060,865	0.2%	$2,060,865	0.2%
Net Assets	$1,202,375,429	100%	$1,202,375,429	100%

Figure 4 excerpts a pie chart from a Morgan Keegan sales brochure reporting the Select High Income fund's asset allocation as of March 31, 2007 - the same "as of date" as RMK's SEC filing used to generate Table 6. The pie chart lists the corporate bond holdings at 21.0%. This is consistent with our corrected amounts in Table 6 but inconsistent with the amounts RMK reported to the SEC. Thus, Morgan Keegan had conflicting information about the fund's holdings on March 31, 2007 and on earlier dates.

9. Preference shares are not preferred stock. Preferred stock is typically more risky than corporate bonds but less risky than common stock. Preference shares in asset-backed securities deals on the other hand are equivalent to purchasing the entire portfolio of underlying assets with a margin loan equal to the face value of the other tranches offered and with margin interest payments equal to the interest paid to investors in the tranches. Preference shares thus are investments in the underlying assets leveraged up 50 or more times.

Figure 4
Contemporaneous Morgan Keegan Documents Have Inconsistent and Misleading Allocations



The Morgan Keegan pie chart in Figure 4 is also misleading. The structured finance securities holdings have been broken down into six subcategories, roughly based on industry, making the asset allocation appear more diverse than it actually was. The corporate bonds could as easily have been likewise broken down into industry categories but is instead reported as an aggregate number. If the structured finance securities in the pie chart were grouped together like the corporate bonds are the concentration in structured finance would have been apparent.

Table 7, 8, 9, 10 and 11 list the Select Intermediate Bond fund's and the four RMK closed-end funds' holdings on March 31, 2007 as reported by RMK and as corrected by SLCG. For each of these five funds' reported holdings there is a contemporaneous Morgan Keegan pie chart analogous to Figure 4 which shows inconsistent and misleading asset allocations. In addition to the misclassified $139.6 million of ABS securities in the Select High Income fund on March 31, 2007, RMK misclassified:

- $91.4 million of ABS securities held by Select Intermediate Bond. *See* Table 7
- $44.1 million of ABS securities held by High Income. *See* Table 8.
- $44.1 million of ABS securities held by Strategic Income. *See* Table 9.
- $59.3 million of ABS securities held by Advantage Income. *See* Table 10.
- $67.5 million of ABS securities held by Multi-Sector High Income. *See* Table 11.

Table 7
RMK Misrepresented $91.4 Million
of the Select Intermediate Bond Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$551,776,086	**54.3%**	$643,126,861	**63.3%**
Corporate Bonds	$372,954,691	**36.7%**	$292,363,916	**28.8%**
Government & Agency	$24,576,742	2.4%	$24,576,742	2.4%
Preferred Stocks	$27,372,060	**2.7%**	16,612,060	**1.6%**
Cash	$36,830,000	3.6%	$36,830,000	3.6%
Other Assets & Liabilities	$2,103,178	0.2%	$2,103,178	0.2%
Net Assets	$1,015,612,757	100%	$1,015,612,757	100%

Table 8
RMK Misrepresented $44.1 Million
of the High Income Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$217,523,259	**53.7%**	$261,617,844	**64.6%**
Corporate Bonds	$126,116,806	**31.1%**	$95,708,081	**23.6%**
Municipal Securities	$630,000	0.2%	$630,000	0.2%
Common Stocks	$37,463,032	9.3%	$37,463,032	9.3%
Preferred Stocks	$15,545,860	**3.8%**	$1,860,000	**0.5%**
Cash	$7,665,224	1.9%	$7,665,224	1.9%
Gross Assets	$404,944,181	100.0%	$404,944,181	100.0%
Margin Debt	$(101,685,277)[10]	-25.1%	$(101,685,277)	-25.1%
Net Assets	$303,258,904	74.9%	$303,258,904	74.9%

10. The closed-end funds' net assets could be, and were, leveraged 33%. Thus, investors in the closed-end funds were exposed to leveraged credit risk implicit in the portfolio's asset-backed securities holdings, further leveraged by the explicit borrowings.

Table 9
RMK Misrepresented $44.1 Million
of the Strategic Income Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$274,847,988	**56.4%**	$318,926,042	**65.5%**
Corporate Bonds	$139,415,826	**28.6%**	$109,023,632	**22.4%**
Municipal Securities	$630,000	0.1%	$630,000	0.1%
Common Stocks	$44,526,722	9.1%	$44,526,722	9.1%
Preferred Stocks	$15,865,860	**3.3%**	$2,180,000	**0.4%**
Cash	$11,885,850	2.4%	$11,885,850	2.4%
Gross Assets	$487,172,246	**100.0%**	$487,172,246	100.0%
Margin Debt	$(127,942,304)	**-26.3%**	$(127,942,304)	-26.3%
Net Assets	$359,229,942	**73.7%**	$359,229,942	73.7%

Table 10
RMK Misrepresented $59.3 Million
of the Advantage Income Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$306,132,730	**55.5%**	$365,461,619	**66.2%**
Corporate Bonds	$163,210,458	**29.6%**	$122,467,428	**22.2%**
Municipal Bonds	$787,500	0.1%	$787,500	0.1%
Common Stocks	$50,057,309	9.1%	$50,057,309	9.1%
Preferred Stocks	$20,965,859	**3.8%**	$2,380,000	**0.4%**
Cash	$10,895,909	2.0%	$10,895,909	2.0%
Gross Assets	$552,049,765	100.0%	$552,049,765	100.0%
Margin Debt	$(135,051,124)	-24.5%	$(135,051,124)	-24.5%
Net Assets	$416,998,641	75.5%	$416,998,641	75.5%

Table 11
RMK Misrepresented $67.5 Million
of the Multi-Sector High Income Fund's Asset-Backed Securities

	As Reported by RMK		Corrected	
Asset-backed Securities	$364,472,540	**58.7%**	$431,970,558	**69.5%**
Corporate Bonds	$174,108,322	**28.0%**	$129,527,163	**20.9%**
Common Stocks	$54,977,849	8.9%	$54,977,849	8.9%
Preferred Stocks	$25,436,859	**4.1%**	$2,520,000	**0.4%**
Cash	$2,202,458	0.4%	$2,202,458	0.4%
Gross Assets	$621,198,028	100.0%	$621,198,028	100.0%
Margin Debt	$(152,319,346)	-24.5%	$(152,319,346)	-24.5%
Net Assets	$468,878,682	75.5%	$468,878,682	75.5%

IV. ASSET-BACKED SECURITIES

A. Pass-through Asset-backed Securities

The simplest asset-backed securities are pass-through securities. Collateral assets are contributed to a trust which issues undifferentiated securities. Investors who purchase these securities receive a pro-rata share of the net cash flows from the underlying pool of collateral assets. A wide range of assets including residential mortgages, credit card debt, automobile loans and aircraft leases have been used as collateral to issue securities. The process of issuing securities backed by pools of assets is referred to as *securitization* and the underlying assets are said to be securitized. *Residential mortgage-backed securities* (RMBS) were the first, and remain a common, pass-through security.

Investors in pass-through securities are exposed to the risks of the underlying assets. Asset-backed securities have interest rate risk, credit risk and prepayment risk because of the behavior of borrowers and the features of the mortgages, loans or contracts. For example, a pool of mortgages has the interest rate risk, prepayment risk and credit risk of the individual mortgages in the pool. If 100 investors each purchase 1/100th interest in a pool of mortgages, the owner of each interest bears the same interest rate risk, prepayment risk and credit risk as the owners of the other interests and collectively they own all the risks of the entire portfolio.

B. *Structured Finance Asset-backed Securities (CMO/CDO/*ABS)

The cash flows coming out of a portfolio of assets – whether they are residential mortgages, credit card debt, auto loans or aircraft leases – do not have to be paid out in the strictly pro rata fashion. In securitization, the issuer customizes the to-be-issued securities and defines payment priorities and loss protection levels among them. These customized classes of securities backed by a common pool of assets are referred to as tranches after the French word for “slice”. It is common for the tranches to receive payments sequentially and to suffer losses in the reverse order sequentially.

As long as every dollar of principal and interest received from the underlying assets after servicing costs – but not a dollar more – is allocated to a security holder (or to the residual or equity interest), any pool of underlying assets, however homogenous, can support a wide variety of complex structured securities. When issuers create classes of securities that have less than a pro rata share of interest rate, credit or prepayment risk in the underlying pool of assets, they have to include classes with more than a

pro rata share of interest rate risk, credit or prepayment risk in the same deal since the underlying assets are the only source cash flows for the tranches.[11]

C. Synthetic Asset-backed Securities

The asset-backed securities described above are *cash* asset-backed securities; these securities hold underlying portfolios of assets that expose investors to risks and generate payoffs. Synthetic asset-backed securities - synthetic CDOs, for example - do not actually hold the underlying debt that generates the risk and risk premia. Instead, the issuer of a synthetic CDO invests the proceeds from issuing tranched securities in high-quality assets such as treasury securities or AAA-rated securities, which is used as collateral for the tranched securities issued and takes on the credit risk associated with an underlying virtual debt portfolio through the use of credit default swaps (CDS).[12]

D. Tranching and the Impact of Defaults

The impact of structuring securities and prioritizing losses from a pool of underlying assets on the returns to investors can be illustrated with a simple example. Consider a mutual fund company holding $1 million in each of 200 corporate BBB-rated bonds and issuing $200 million in undifferentiated securities. An investor who purchases $2 million of the issued securities will

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11. For a complete discussion of the securitization of mortgage-backed securities, see Adam B. Ashcraft and Til Schuermann, "Understanding the Securitization of Subprime Mortgage Credit," *Federal Reserve Bank of New York Staff Reports*, Staff Report no. 318, March 2008 available at *http://www.newyorkfed.org/research/staff_reports/sr318.pdf*. Also see Joshua D. Coval, Erik Stafford and Jakub Jurek, "The Economics of Structured Finance" available at *http://www.hbs.edu/research/pdf/09-060.pdf*.

12. I say *virtual* bond portfolio because the bond portfolio may not be held by any party to the transactions. The CDS is a bet on the value of these bonds. The tranching is also *virtual* in that, unlike cash CDOs, synthetic CDOs do not need to be fully subscribed for a deal to close. A tranche in a synthetic CDO can be completely customized without regard to other tranches which might be created from the same portfolio of reference securities.

A CDS is one of many types of credit derivatives that transfer credit risk from one party to another. Under the CDS the credit protection buyer makes periodic payments (the CDS premium) to the credit protection seller in exchange for a contingent payment triggered by a credit event such as a default on the underlying debt. Interest and principal from the portfolio of risk free securities combined with credit default swap premiums paid by the credit protection buyer are used to pay interest and principal to the synthetic CDO investors.

receive 1% of the principal and interest payments paid by the underlying bonds less the issuer's expenses. The investor will also suffer 1% of any credit losses on the bonds. If one of the corporate bonds defaults and half the face value is recovered, the net assets of the fund will drop by $500,000 and the interest proceeds will fall by the difference between the interest previously paid on the defaulted bond and the interest that will be received on the re-invested recovered proceeds. If our example portfolio suffers two defaults per year and the mutual fund company recovers 50% of the face value of the defaulted bonds, the mutual fund's assets will be reduced by 0.5% per year as a result of the defaults and will be receiving only roughly 99% of the portfolio's weighted-average coupon interest. Five or even ten defaults in a portfolio of 200 bonds do not have much impact on the returns investors receive.

Now consider the same portfolio of bonds being held in a trust and used as collateral to back $200 million of three classes of securities. The first class of securities – Class A – has a face value of $150 million. There are also $45 million face value of Class B securities and $5 million face value of Class M securities. Class A investors receive scheduled principal and interest payments before Class B investors who receive their principal and interest payments before Class M investors receive any payments. Once any overcollateralization and excess interest is consumed, the principal value of the Class M securities is written down as defaults in the underlying portfolio of assets occur.[13] After the Class M securities are written down to zero, the Class B securities start suffering write-downs with further defaults in the underlying assets.

Given the default and recovery rates assumed above, the Class M securities will be written down to zero within 5 or 10 years and so the interest received on the securities - and/or the discount in price paid for them - will have to compensate for this risk. If defaults increase and/or recovery rates decline, the Class M securities will be written down even faster and the interest received on the Class M securities will decrease more rapidly than expected as the principal is written down. Thus, the defaults in the bond portfolio which had relatively minimal impact on the investors in undifferentiated shares can have a dramatic effect on investors in low-

13. Overcollateralization occurs when the value of the underlying assets backing a deal exceeds the face value of the tranches issued. Initial losses occurring in the underlying assets will not cause write-downs to the tranches until the underlying assets are written down enough that the overcollateralization is eliminated. Also, in most deals the interest received on the underlying pool of assets is expected to exceed the interest paid to investors in the tranche. This excess interest is available in some deals to partially protect investors against initial losses in the underlying assets.

priority tranches of structured deals. The magnification of the impact of defaults in the underlying portfolio on the value of the tranche is leverage of the underlying assets' credit risk.

E. Risk Calculation Example: Synthetic CDOs

Investing in the low-priority tranches - like the M tranche in our example and most of the securities held in RMK's 6 funds - is extremely risky. If the tranches are fairly priced, their prices will reflect the expected value of cash flows discounted at a rate which reflects their risk. Other things equal, a tranche will be worth more the better the quality and diversification of the collateral assets and the more credit support the tranche receives from lower tranches, overcollateralization, excess interest or other credit enhancements. If defaults turn out to be higher than predicted by the models, the low-priority tranches get written down more rapidly. The negative impact on face value is foreshadowed by declines in the market value of the tranche.

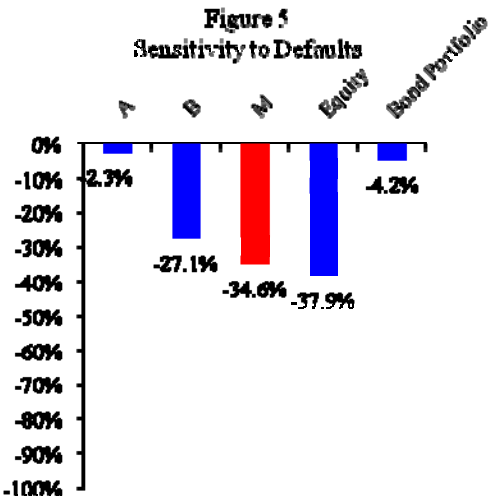
To illustrate the use of tranching to redistribute credit risk, consider the 10-year synthetic CDO described in Table 12.

Table 12
Example Synthetic CDO
Capital Structure

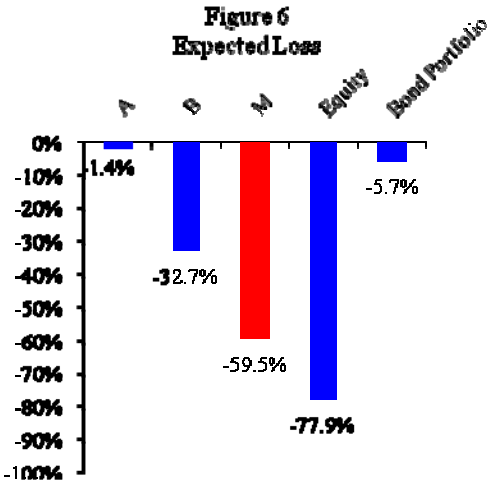
Tranche	Face Value	Par Spread	Sensitivity	Expected Loss	Unexpected Loss
A	$90,000,000	0.13%	-2.3%	1.4%	5.7%
B	$7,000,000	3.75%	-27.1%	32.7%	73.1%
M	$1,000,000	8.98%	-34.6%	59.5%	107.0%
Equity	$2,000,000	17.40%	-37.9%	77.9%	113.2%
	$100,000,000				
Bond Portfolio	$100,000,000	0.60%	-4.2%	5.7%	12.2%

The CDO references a portfolio of 100 corporate bonds, with a credit default spread on the bonds of 0.60% (corresponding to an annual 1% failure rate on the bonds) and a correlation of defaults across the bonds is 0.30. The CDO issues four classes of securities. The $90 million A tranche is the most senior and receives its scheduled principal and interest payments before the other tranches. The A tranche suffers principal write downs only after the equity, M and B tranches are written off completely. The $7 million B tranche is the next most senior and receives its scheduled principal and interest payments after the A tranche has received its scheduled payments but before the equity and M tranches and suffers principal write downs only after the equity and M tranches are written off completely.

We calculate four standard risk measures for each tranche and for the entire bond portfolio.[14] The first risk measure is the sensitivity of the market value of each tranche to changes in credit spreads compared to the sensitivity of the underlying bond portfolio. A 0.60% increase in the credit spread on the underlying bonds (corresponding to an increase in the annual failure rate on the bonds from 1% to 2%) would cause a 4.2% drop in the value of the bond portfolio but would cause a 34.6% drop in the value of the M tranche. *See* Figure 5. By this measure, the M tranche is 8.2 times as risky as the underlying assets. Notice that even though the A tranche is 90% of the capital structure it only drops in value half as much as the bond portfolio because 10% of the capital structure bears half the losses.

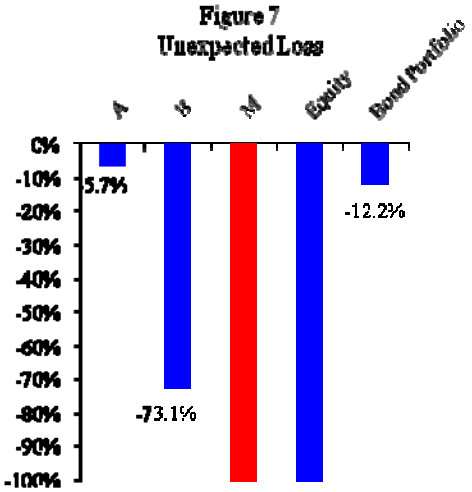


The second risk measure is the expected loss on the issue date over the life of the tranche. The expected capital loss on the underlying assets over 10 years is 5.7% while the expected loss on the M tranche is 59.5%. *See* Figure 6. By this measure, the M tranche is 10.4 times as risky as the underlying assets and more than 40 times as risky as the A tranche.

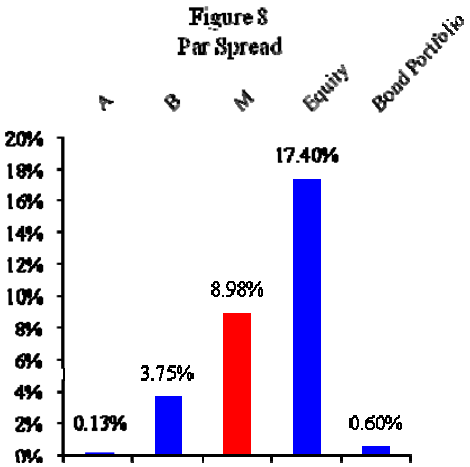


14. Michael S. Gibson, "Understanding the Risk of Synthetic CDOs" Federal Reserve Board working paper at *http://www.federalreserve.gov/pubs/feds/2004/200436/200436pap.pdf*. The risk analysis is slightly sensitive to assumptions about default rates, recovery rates, credit spreads and correlations. This example is similar to the IndyMac 2005-C M11 tranche described below which was the first-to-lose 1% of the capital structure in a deal with 2% overcollateralization.

The third risk measure is the loss suffered if credit losses on the underlying bonds were one standard deviation greater than expected. This is referred to as the unexpected loss although it is not that unusual since roughly 15% of the time the losses are expected to be greater than the unexpected loss. The unexpected loss on the underlying portfolio over 10 years is 12.2% while the unexpected loss on the M tranche is a greater than 100%. By this measure, the M tranche is more than 8 times as risky the underlying bond portfolio and 19 times as risky as the A tranche. See Figure 7.



The fourth risk measure is the additional interest above LIBOR required to compensate for the credit risk in the security. This is referred to as the par spread and was 0.60% for the bond portfolio. The par spread for the A tranche is only 0.13% reflecting the credit support (protection from credit losses) it receives from the more junior tranches. The 8.98% par spread for the M tranche is 15 times the par spread on the underlying bonds, reflecting the leveraged credit risk born by the M tranche. See Figure 8.



The M tranche in our illustration had 10 to 15 times as much credit risk as the underlying bonds. Even the B tranche in our illustration had 6 times as much credit risk as the underlying bond portfolio. As we will see next, virtually all of the RMK holdings had as much leveraged credit risk as the B and M tranches - and some of RMK holdings had as much credit risk as in the Equity tranche - in our example.

V. RMK MISREPRESENTED THE RISKINESS OF ITS FUNDS' ASSET-BACKED SECURITIES HOLDINGS

In addition to being understated, the asset-backed securities held by the RMK funds were virtually always the most risky tranches in asset-backed securities deals. For example, we were able to identify whether the tranches held were senior or subordinated for 147 of the 161 asset and mortgage-backed securities in the Multi-Sector High Income fund. Only nine of these 147 tranches were senior; 138 of the 147 were subordinated.

We illustrate how the majority of funds' holdings of structured securities lost virtually all their value in six months with five examples which are completely typical of the rest of the holdings. The prospectus or offering document for each of these five deals is available along with this paper at *www.slcg.com/research.php?c=1b&i=44.*

- **Webster CDO I Preferred Shares.** The Preferred Shares were the equity portion of Webster CDO I and were equivalent to an investment in the subprime debt backing the CDO leveraged up 23 to 1. RMK misrepresented this RHY holding as a *Preferred Stock* on March 31, 2007 but reclassified it as an *Asset-Backed Securities–Below Investment Grade or Unrated - Collateralized Debt Obligations* on March 31, 2008.
- **Eirles Two Ltd. 263.** RMK misrepresented this synthetic CDO to be a corporate bond in its SEC filings on March 31, 2007 for each of the four closed-end funds and for the Select High Income open-end fund. RMK reclassified this security as an *Asset-Backed Securities–Below Investment Grade or Unrated, Collateralized Loan Obligations* on March 31, 2008.
- **Preferred Term Securities XXIII.** RMK does not fully identify this $24 million CDO investment but misrepresented it to be a corporate bond, classified in RHY's March 31, 2007 holdings as a *Corporate Bonds–Investment Grade or Unrated*. RMK reclassified this security as an *Asset-Backed Securities–Below Investment Grade or Unrated - Collateralized Debt Obligations* on March 31, 2008.
- **IndyMac 2005-C M-11.** This holding illustrates RMK's concentration in tranches with highly leveraged exposure to subprime mortgages. RMK classified this RHY holding on March 31, 2007 as an *Asset-Backed Securities–Investment Grade, Home Equity Loans (Non-High Loan-To-Value).*
- **Kodiak CDO 2006-IA G, H, Income.** These three Kodiak tranches illustrates the complexity of RMK holdings. RMK classified these RHY holdings as *Asset-Backed Securities–Investment Grade - Collateralized Debt Obligations* on March 31, 2007 and as an *Asset-*

Backed Securities–Below Investment Grade or Unrated - Collateralized Debt Obligations on March 31, 2008.

A. Webster CDO I

Webster CDO I issued $1 billion in securities listed in Table 13. The RMK funds held $14.5 million face value of the equity tranche in Webster CDO I, Ltd which RMK misrepresented on March 31, 2007 as preferred stock. *See* Table 14.

Table 13
Webster CDO I
Capital Structure

Tranche	Face Value	Interest Rate	Ratings	
			Moody's	S&P
A-1LA	$609,000,000	3M LIBOR + 0.34%	Aaa	AAA
A-1LB	$158,000,000	3M LIBOR + 0.45%	Aaa	AAA
A-2L	$70,000,000	3M LIBOR + 0.54%	Aa2	AA
A-3L	$59,000,000	3M LIBOR + 1.45%	A2	A
A-4L	$10,000,000	3M LIBOR + 2.75%	Baa1	BBB+
B-1L	$32,000,000	3M LIBOR + 3.40%	Baa2	BBB
B-2L	$10,000,000	3M LIBOR + 3.85%	Baa3	BBB-
B-3L	$9,000,000	3M LIBOR + 6.50%	Ba1	BB+
P1 Comb (A3L & B3L)	$10,000,000		A2	N/A
Preference Shares	**$43,000,000**		**B2**	**N/A**
	$1,000,000,000			

Table 14
RMK Funds Held
$14.5 million of the Webster CDO I Preference Shares

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
12/31/2006	3,500,000	$3,150,000	2,000,000	$1,800,000	2,000,000	$1,800,000
3/31/2007	3,500,000	$3,150,000	2,000,000	$1,800,000	2,000,000	$1,800,000
6/30/2007	3,500,000	$2,712,500	2,000,000	$1,550,000	2,000,000	$1,550,000
9/30/2007	3,500,000	$525,000	2,000,000	$300,000	2,000,000	$300,000
12/31/2007	3,500,000	$35	2,000,000	$20	2,000,000	$20
3/31/2008	3,500,000	$35	2,000,000	$20	2,000,000	$20

	RMA			MKHIX	
Date	Face Value	Reported Value	Date	Face Value	Reported Value
12/31/2006	2,000,000	$1,800,000	12/31/2006	5,000,000	$4,500,000
3/31/2007	2,000,000	$1,800,000	3/31/2007	5,000,000	$4,500,000
6/30/2007	2,000,000	$1,550,000	6/30/2007	5,000,000	$3,875,000
9/30/2007	2,000,000	$300,000	9/30/2007	5,000,000	$750,000
12/31/2007	2,000,000	$20	12/31/2007	5,000,000	$50
3/31/2008	2,000,000	$20	3/31/2008	5,000,000	$50

The Webster CDO was a hybrid cash/synthetic asset-backed portfolio, holding some asset-backed securities such as subprime RMBS with weighted average FICO scores less than 600, CMBS, downgraded BBB securities, small business loan securities directly and entering into credit default swaps to bring the portfolio's asset-backed securities credit exposure up to $1 billion. The preference shares were the most illiquid, most risky portion of an illiquid, risky deal. Three features of the preference shares magnify risk. The preference shares were ranked the 15th out of 15 items in the interest waterfall and not eligible to receive any interest payment if default occurred. In addition, the preference shares were to receive principal payments, if any, only on the final maturity date. The $43 million preference shares were effectively an investment in the underlying subprime assets leveraged approximately 23 to 1.

RMK valued this equity interest in the Webster CDO I deal at $13.05 million on March 31, 2007, $2.175 million on September 30, 2007 and only $145 on March 31, 2008. As with the valuations of the Kodiak and IndyMac tranches, RMK's March 31, 2007 $0.90 valuation of the preferred shares in the Webster CDO is highly suspect since the claims of investors in the preference shares were subordinated to the claims of the investors in the rest of the deal.

B. Eirles Two Ltd. 263

Eirles Two Ltd. 263 was a synthetic CDO in which the returns to investors depended on credit default swaps issued on a $1 billion notional value portfolio of loans and bonds. See Table 15. RMK misrepresented these holdings as corporate bonds until March 31, 2008, when it was reported correctly as asset-backed securities.

Table 15
Eirles Two Ltd. 263
Capital Structure

Tranche	Face Value
A	$897,500,000
B	**$17,500,000**
C	$85,000,000
	$1,000,000,000

RMK's four closed-end funds and the Select High Income open-end fund purchased the entire $17.5 million B tranche in the Eirles Two Ltd. 263 series deal. During the half year period from September 20, 2007 to March 31, 2008, RMK suffered a steep loss of over 40% value of the securities they held. *See* Table 16.

Table 16
RMK Funds Held
$17.5 million of Eirles Two Ltd. 263

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
9/30/2006	3,500,000	$3,500,000	2,300,000	$2,300,000	3,500,000	$3,500,000
12/31/2006	3,500,000	$3,500,000	2,300,000	$2,300,000	3,500,000	$3,500,000
3/31/2007	3,500,000	$3,500,000	2,300,000	$2,300,000	3,500,000	$3,500,000
6/30/2007	3,500,000	$3,473,750	2,300,000	$2,282,750	3,500,000	$3,473,750
9/30/2007	3,500,000	$3,325,000	2,300,000	$2,185,000	3,500,000	$3,325,000
12/31/2007	3,500,000	$2,380,000	2,300,000	$1,564,000	3,500,000	$2,380,000
3/31/2008	3,500,000	$1,955,000	2,300,000	$1,311,000	3,500,000	$1,955,000

	RMA			MKHIX	
Date	Face Value	Reported Value	Date	Face Value	Reported Value
9/30/2006	3,500,000	$3,500,000	9/30/2006	4,700,000	$4,700,000
12/31/2006	3,500,000	$3,500,000	12/31/2006	4,700,000	$4,700,000
3/31/2007	3,500,000	$3,500,000	3/31/2007	4,700,000	$4,700,000
6/30/2007	3,500,000	$3,473,750	6/30/2007	4,700,000	$4,664,750
9/30/2007	3,500,000	$3,325,000	9/30/2007	4,700,000	$4,465,000
12/31/2007	3,500,000	$2,380,000	12/31/2007	4,700,000	$3,196,000
3/31/2008	3,500,000	$1,955,000	3/31/2008	4,700,000	$2,679,000

C. Preferred Term Securities XXIII

In September 2006, Preferred Term Securities XXIII (PreTS XXIII) issued the $1.56 billion in securities listed in Table 17. PreTS XXIII was the 23rd in a related series of cash flow trust preferred CDOs. The trust held trust preferred securities and senior and subordinated notes of banks, thrifts, insurance companies and REITs.

Table 17
Preferred Term Securities XXIII
Capital Structure

Tranche	Face Value	Interest Rate	Ratings		
			Moody's	S&P	Fitch
A-X	$33,500,000		Aaa	AAA	AAA
A-FP	$321,000,000	3M LIBOR + 0.20%	Aaa	AAA	AAA
A-1	$544,000,000	3M LIBOR + 0.31%	Aaa	AAA	AAA
A-2	$141,000,000	3M LIBOR + 0.39%	Aaa	AAA	AAA
B-FP	$57,600,000	3M LIBOR + 0.38%	Aa2	N/A	AA
B-1	$67,400,000	3M LIBOR + 0.62%	Aa2	N/A	AA
B-2	$31,000,000	5.792% / 3M LIBOR+0.62%	Aa2	N/A	AA
C-FP	$52,800,000	3M LIBOR + 0.73%	A3	N/A	A-
C-1	$81,200,000	3M LIBOR + 1.15%	A3	N/A	A-
C2	$28,000,000	6.322% / 3M LIBOR+1.15%	A3	N/A	A-
D-FP	$35,050,000	3M LIBOR + 1.60%	N/A	N/A	BBB
D-1	$72,500,000	3M LIBOR + 2.10%	N/A	N/A	BBB
Subordinate	$95,500,000	N/A	NR	NR	NR
	$1,560,550,000				

The RMK funds held $24 million face value in PreTS XXIII notes which RMK misrepresented as corporate bonds until March 31, 2008. *See* Table 18. RMK valued these securities at $0.99 on September 30, 2006 and then at $0.95 on December 30, 2006, March 31, 2007, and June 30, 2007. RMK finally lowered the value to $0.50 on September 30, 2007 and to $0.42 on December 30, 2007. The RMK filings do not identify which of the PreTS XXIII notes its funds held but the notes held lost 60% of their value between March 31, 2007 and March 31, 2008.

Table 18
RMK Funds Held
$24 Million of the Preferred Term Securities XXIII

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
9/30/2006	3,000,000	$2,964,000	2,000,000	$1,976,000	2,000,000	$1,976,000
12/31/2006	3,000,000	$2,913,660	2,000,000	$1,942,440	2,000,000	$1,942,440
3/31/2007	4,800,000	$4,560,000	3,200,000	$3,040,000	3,200,000	$3,040,000
6/30/2007	3,800,000	$3,600,500	3,200,000	$3,032,000	3,200,000	$3,032,000
9/30/2007	3,800,000	$1,900,000	3,200,000	$1,600,000	3,200,000	$1,600,000
12/31/2007	3,800,000	$1,734,700	3,200,000	$1,564,000	3,200,000	$1,460,800
3/31/2008	3,800,000	$1,581,940	3,200,000	$1,332,160	3,200,000	$1,332,160

	RMA			MKHIX	
Date	Face Value	Reported Value	Date	Face Value	Reported Value
9/30/2006	3,000,000	$2,964,000	9/30/2006	5,000,000	$4,940,000
12/31/2006	3,000,000	$2,913,660	12/31/2006	5,000,000	$4,856,100
3/31/2007	3,800,000	$3,610,000	3/31/2007	9,000,000	$8,550,000
6/30/2007	3,800,000	$3,600,500	6/30/2007	5,000,000	$4,737,500
9/30/2007	3,800,000	$1,900,000	9/30/2007	5,000,000	$2,500,000
12/31/2007	3,800,000	$1,734,700	12/31/2007	5,000,000	$2,282,500
3/31/2008	3,800,000	$1,581,940	3/31/2008	5,000,000	$2,081,500

D. IndyMac 2005-C

In September 2005, IndyMac 2005-C issued $686,700,000 in securities listed in order of priority in Table 19.

Table 19
IndyMac 2005-C Capital Structure

Tranche	Face Value	Interest Rate (LIBOR plus)		Ratings		
		Margin 1	Margin 2	Moody's	S&P	Fitch
A-I-1	$268,995,000	0.260%	0.520%	Aaa	AAA	AAA
A-II-1	$130,700,000	0.110%	0.220%	Aaa	AAA	AAA
A-II-2	$136,550,000	0.270%	0.540%	Aaa	AAA	AAA
A-II-3	$21,655,000	0.370%	0.740%	Aaa	AAA	AAA
M-1	$25,550,000	0.480%	0.720%	Aa1	AA+	AA+
M-2	$22,400,000	0.500%	0.750%	Aa2	AA+	AA+
M-3	$15,050,000	0.520%	0.780%	Aa3	AA	AA
M-4	$11,200,000	0.610%	0.915%	A1	AA	AA-
M-5	$11,200,000	0.650%	0.975%	A2	AA-	A+
M-6	$9,800,000	0.720%	1.080%	A3	A+	A
M-7	$10,500,000	1.200%	1.800%	Baa1	A	A-
M-8	$7,350,000	1.350%	2.025%	Baa2	BBB+	BBB+
M-9	$6,300,000	1.750%	2.625%	Baa3	BBB	BBB
M-10	$3,450,000	3.000%	4.500%	Ba1	BBB	BBB-
M-11	**$7,000,000**	**2.500%**	**3.750%**	**Ba2**	**BBB-**	**BB+**
	$687,700,000					

The net proceeds from the sale of these securities were used to purchase an underlying pool of mortgage loans. At origination, the IndyMac 2005-C deal had 1.9% overcollateralization. Once losses on the underlying pool of mortgages exceeded 1.9%, augmented or depleted by any net excess interest, the M-11 tranche would start being written down.[15]

The M-11 tranche was only 1% of the capital structure and was highly likely to suffer losses as 75% of the underlying mortgages were 2/28 and 3/27 hybrid adjustable rate mortgages. This type of mortgage had high probability of defaults because the mortgage interest rates had low teaser rates for the first two or three years followed by resets to market rates or higher for the twenty-seven or twenty-eight years left in the amortization schedule.[16] In addition, the borrowers whose mortgage notes backed the IndyMac tranches were lower credit quality borrowers. About 66% of the borrowers of the borrowers had FICO scores below 620. Over 39% of the mortgage loans were approved without adequate income or asset verifications. About 30% of the borrowers had Loan-to-Value ratios higher than 80% at the time of origination. The IndyMac CDO prospectus described the credit quality of the debtors as follows.

> Over 98% of the mortgage loans in the mortgage pool were made to borrowers with prior credit difficulties. We expect that the rates of delinquency, bankruptcy and foreclosure for such mortgage loans will be substantially higher than those of mortgage loans underwritten in accordance with Fannie Mae and Freddie Mac standards. [S-11]

The Multi-Sector High Income fund purchased the entire $7,000,000 M-11 tranche and suffered a nearly complete loss by September 30, 2007. *See* Table 20.

Table 20
RHY Held All $7 Million of the IndyMac 2005-C M-11 Tranche

Date	Face Value	Reported Value
3/31/2006	7,000,000	$5,600,000
6/30/2006	7,000,000	$5,600,000
9/30/2006	7,000,000	$5,600,000
12/31/2006	7,000,000	$5,600,000
3/31/2007	7,000,000	$5,320,000
6/30/2007	7,000,000	$4,900,000
9/30/2007	7,000,000	$965,720
12/31/2007	7,000,000	$969,500

15. As illustrated in Tables 14, 20, 22 and 23, long before principal write-downs start being taken the market value of the tranche will fall significantly, perhaps to zero.

16. For a discussion of the likely high default rates on 2/28 and 3/27 ARMs, see Christopher Cagan, "Mortgage Payment Reset" *First American Real Estate Solutions*, February 8, 2006.

RMK's purchase of the entire M-11 tranche illustrates the opportunity for abuse created by trading illiquid securities. The M-11 tranche was offered in October, 2005 at $0.71 per $1.00 of face value. RMK valued its M-11 holding at $0.80 in its reported holdings for March 31, 2006. This would imply a $630,000 unrealized gain (a 13% return) and an equal increase in the reported assets over the intervening five or six months. It's highly unlikely that the M-11 tranche was worth the $0.80 or $0.76 RMK valued it at on March 31, 2006, September 30, 2006 and March 31, 2007.

E. Kodiak CDO I

Kodiak CDO I issued $775 million in securities listed in Table 21. The $28,000,000 in Combination notes are created by combining $10,000,000 of the H notes and $18,000,000 of the Income notes.

The $752 million net proceeds from the sale of the Kodiak CDO 2006 securities was used to purchase trust preferred securities issued by real estate investment trusts (REITs) and home builders and commercial mortgage-backed securities (CMBSs).[17] The Kodiak CDO prospectus has extensive discussions of the risks associated with trust preferred securities issued by REIT. These securities are subordinated to the other indebtedness of the REIT and typically do not in any way restrict the ability of the REIT to issue additional senior debt. Trust preferred securities are a highly leveraged investment in the issuing REIT's assets. The low-priority tranches in the Kodiak CDO were thus highly leveraged investments *in highly leveraged investments* in REITs.

17. According to Fitch Ratings, the total collateral consists of 78% trust preferred securities issued by real estate entities, 17% senior REIT debts, and 5% CMBS.

Table 21
Kodiak CDO 2006-1A
Capital Structure

Tranche	Face Value	Interest Rate	Ratings		
			Moody's	S&P	Fitch
A-1	$338,500,000	LIBOR + 0.36%	Aaa	AAA	AAA
A-2	$103,500,000	LIBOR + 0.48%	Aaa	AAA	AAA
B	$83,000,000	LIBOR + 0.65%	Aa1	AAA	AAA
C	$30,000,000	LIBOR + 0.90%	Aa3	AAA	AAA
D-1	$13,000,000	Fixed 6.549%	NR	AA-	AA-
D-2	$5,000,000	Fixed 6.425%	NR	AA-	AA-
D-3	$29,000,000	LIBOR + 1.20%	NR	AA-	AA-
E-1	$5,000,000	Fixed 6.721%	NR	A	A
E-2	$29,000,000	LIBOR + 1.50%	NR	A	A
F	$7,000,000	LIBOR + 2.20%	NR	BBB+	BBB+
G	**$50,000,000**	LIBOR + 3.50%	NR	BBB	BBB
H	**$27,000,000**	LIBOR + 5.00%	NR	BB+	BB+
Income	**$54,700,000**	N/A	N/A	N/A	N/A
	$774,700,000				
Combination	**$28,000,000**	**N/A**	**NR**	**BB+**	**NR**

The RMK funds purchased $46 million of the three first-to-lose tranches issued by Kodiak CDO I.[18] *See* Table 22 and Table 23.

The funds valued their $46 million face value investment in this CDO deal at $43.1 million on March 31, 2007 but at only $0.1 million by March 31, 2008. The loss of $43 million (99.7%) in one year can easily be understood given the disclosures in the 232-page prospectus the Kodiak CDO 2006-1 deal. There were virtually no credit enhancements of Class G, H and Income Notes and the failure of the overcollateralization (OC) tests diverted cash flow from the tranches RMK purchased to pay principal of the senior tranches when defaults occurred in the underlying collateral.

18. The RMK funds' holdings of the Combination tranche provided it with underlying investments in the H and the Income tranches. The Kodiak Combination tranche is listed in the RMK funds' holdings as a zero coupon bond without G, H, Income or Combination qualifiers.

Table 22
RMK Funds Held
$18 Million of the Kodiak CDO 2006-1 G Tranche

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
12/31/2006	1,000,000	$975,000	1,000,000	$975,000	3,000,000	$2,925,000
3/31/2007	3,000,000	$2,910,000	3,000,000	$2,910,000	3,000,000	$2,910,000
6/30/2007	3,000,000	$2,730,000	3,000,000	$2,730,000	3,000,000	$2,730,000
9/30/2007	3,000,000	$810,000	3,000,000	$810,000	3,000,000	$810,000
12/31/2007	3,000,000	$285,000	3,000,000	$285,000	3,000,000	$285,000
3/31/2008[19]	3,133,608	$7,834	3,133,608	$7,834	3,133,608	$7,834

	RMA			MKIBX	
Date	Face Value	Reported Value	Date	Face Value	Reported Value
12/31/2006	1,000,000	$975,000	12/31/2006	6,000,000	$5,850,000
3/31/2007	3,000,000	$2,910,000	3/31/2007	6,000,000	$5,820,000
6/30/2007	3,000,000	$2,730,000	6/30/2007	6,000,000	$5,460,000
9/30/2007	3,000,000	$810,000	9/30/2007	6,000,000	$1,620,000
12/31/20007	3,000,000	$285,000	12/31/2007	6,000,000	$570,000
3/31/2008	3,133,608	$7,834	3/31/2008	6,267,216	$15,668

Table 23
RMK Funds Held
$28 Million of the Kodiak CDO 2006-1 Combination Tranche

	RHY		RMH		RSF	
Date	Face Value	Reported Value	Face Value	Reported Value	Face Value	Reported Value
9/30/2006	6,000,000	$5,400,000	4,000,000	$3,600,000	4,000,000	$3,600,000
12/31/2006	6,000,000	$5,550,000	4,000,000	$3,700,000	4,000,000	$3,700,000
3/31/2007	6,000,000	$5,490,000	4,000,000	$3,660,000	4,000,000	$3,660,000
6/30/2007	6,000,000	$4,920,000	4,000,000	$3,280,000	4,000,000	$3,280,000
9/30/2007	6,000,000	$1,380,000	4,000,000	$920,000	4,000,000	$920,000
12/31/2007	6,000,000	$495,000	4,000,000	$330,000	4,000,000	$330,000
3/31/2008	6,000,000	$15,000	4,000,000	$10,000	4,000,000	$10,000

	RMA			MKHIX	
Date	Face Value	Reported Value	Date	Face Value	Reported Value
9/30/2006	4,000,000	$3,600,000	9/30/2006	10,000,000	$9,000,000
12/31/2006	4,000,000	$3,700,000	12/31/2006	10,000,000	$9,250,000
3/31/2007	4,000,000	$3,660,000	3/31/2007	10,000,000	$9,150,000
6/30/2007	4,000,000	$3,280,000	6/30/2007	10,000,000	$8,200,000
9/30/2007	4,000,000	$920,000	9/30/2007	10,000,000	$2,300,000
12/31/2007	4,000,000	$330,000	12/31/2007	10,000,000	$825,000
3/31/2008	4,000,000	$10,000	3/31/2008	10,000,000	$25,000

19. The face value of the G tranche increased as of March 31, 2008 because interest payments due to investors in the G tranche were deferred as cash was diverted to pay promised principal and interest on the more senior tranches when defaults in the underlying assets caused cash flow shortfalls.

The Income tranche had no claim on the collateral assets and virtually no claim on the cash flow generated from the assets. The prospectus lists 28 prioritized claims on interest payments paid by the collateral assets; the Income tranche's claim on interest payments is 28th out of 28. That is, if after all the taxes, fees, expenses and interest on the A-H securities described in categories of claims 1 through 27 are paid in full, the Income tranche will receive payments. The prospectus lists 12 prioritized claims on principal payments from the collateral; the Income tranche's claim on principal payments is 12th out of 12. Again, only if every other category of claim on the payments paid by the collateral assets is paid in full, will the Income tranche receive payments.

The funds purchased all of the $28 million Combination tranche and valued it at $0.90 per $1.00 on September 30, 2006 and incredibly at $0.915 on March 31, 2007. A simple calculation suggests that this tranche was worth substantially less than the value Regions Morgan Keegan placed on it. There was $752 million in collateral backing $720 million in rated securities. This leaves $32 million in underlying value at most backing the $54.7 million face value of Income notes. Thus, there was, at most, $0.58 in value backing each $1 of Income notes. Assuming $1 in value backing each $1 of H notes, there was at most $0.73 in value backing each $1 of Combination notes since the Combination notes are 35.7% H notes and 64.3% Income notes.[20]

VI. RMK FUNDS' PROSPECTUSES AND STATEMENTS OF ADDITIONAL INFORMATION FAILED TO DISCLOSE SUBSTANTIAL RISKS

A. Prospectus

The RHY prospectus dated January 19, 2006 describes the investment philosophy and process of the newly issued fund as follows.[21]

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20. This calculation is not to imply that there were assets actually backing the Income note component of the Combination notes but assuming the underlying collateral and all the rated tranches were fairly priced - and the deal was costless – there would be $0.73 in value at the offering for each $1.00 of the Combination tranche. Given the potential mispricing and the significant costs in the deal it is highly likely that the Combination notes were worth much less than $0.73 despite RMK's $0.90 valuation.

21. Both the RHY Prospectus and Statement of Additional Information can be found at *http://www.morgankeegan.com/MK/Investing/IProducts/RMKCEF /multi_sector.htm*.

> **Investment Philosophy and Process**
>
> ….
>
> The Adviser's ""bottom-up" strategy focuses on identifying special or unusual opportunities where the Adviser decides that the market perception of, or demand for, a credit or structure has created an undervalued situation. *The analytical process concentrates on credit research, debt instrument structure and covenant protection.* Generally, when investing in below investment grade debt securities, the Adviser will seek to identify issuers and industries that it believes are likely to experience stable or improving conditions. Specific factors considered in the research process may include general industry trends, *cash flow generation capacity, asset valuation, other debt maturities, capital availability, collateral value and priority of payments.* …. [p.16, *emphasis added*.]

Most of the securities the Multi-Sector High Income ultimately invested in were complex structures that provide very little information on underlying collateral and which require sophisticated modeling to understand and value. If the portfolio manager had performed the rigorous analysis described in the "Investment Philosophy and Process" in each funds' prospectus, the highly concentrated credit risk collected in these portfolios would have been readily apparent.

The Multi-Sector High Income Fund prospectus contains 14 pages of description of the risks to which investors in the fund would be exposed. There are 26 categories of risks described in the prospectus but it does not mention the highly concentrated credit risk the fund was taking on through its purchase of low-priority tranches in a wide range of structured finance deals. The prospectus does not even mention that cash flows from pools of assets including mortgages can be tranched. Instead, the prospectus describes the risks of investing in mortgage-backed and asset-backed securities as if investors were exposed to the average interest rate risk, prepayment risk and credit risk of the underlying assets. Many of the investments selected by Regions Morgan Keegan for this fund exposed investors to the credit risk equivalent to an investment in the underlying portfolio of assets leveraged up 10-to-1. The discussion of Leverage Risk reflects a limit of 1.33-to-1 on portfolio leverage but RMK's use of low-priority tranches in structured finance deals allowed the portfolio manager to dramatically leverage the credit risk in these bond portfolios. This leveraging of credit risk explains the high returns earned on the RMK funds in 2004-2006 despite the high annual expense ratios and the spectacular collapse of the funds in 2007.

B. Statement of Additional Information

Regions Morgan Keegan also filed a Statement of Additional Information (SAI) dated January 19, 2006 for the Multi-Sector High Income fund. The SAI, which is not automatically sent to investors, has 31 pages of descriptions of the securities the fund will invest in. The 78-page document explicitly mentions tranching in one paragraph and alludes to it in a second. Neither reference to tranching in the SAI tells investors that RHY will be concentrated in the lowest priority, highly-leveraged tranches in deals backed by assets with significant credit risk and that as a result investors will be exposed to extraordinary credit risk.

C. Semi-Annual Reports

RMK filed a semi-annual report for RHY as of September 30, 2006 wherein it describes the fund's risks as follows.[22]

> INVESTMENT RISKS: Bond funds tend to experience smaller fluctuations in value than stock funds. However, investors in any bond fund should anticipate fluctuations in price. Bond prices and the value of bond funds decline as interest rates rise. Longer-term funds generally are more vulnerable to interest rate risk than shorter-term funds. Below investment grade bonds involve greater credit risk, which is the risk that the issuer will not make interest or principal payments when due. An economic downturn or period of rising interest rates could adversely affect the ability of issuers, especially issuers of below investment grade debt, to service primary obligations and an unanticipated default could cause the Fund to experience a reduction in value of its shares. The value of U.S. and foreign equity securities in which the Fund invests will change based on changes in a company's financial condition and in overall market and economic conditions. Leverage creates an opportunity for an increased return to common stockholders, but unless the income and capital appreciation, if any, on securities acquired with leverage proceeds exceed the costs of the leverage, the use of leverage will diminish the investment performance of the Fund's shares. Use of leverage may also increase the likelihood that the net asset value of the Fund and market value of its common shares will be more volatile, and the yield and total return to common stockholders will

22. RHY's self-descriptions for the periods ending September 30, 2006, March 31, 2007 and September 30, 2007 are excerpted in Appendix 1.

> tend to fluctuate more in response to changes in interest rates and creditworthiness.

This description of investment risks is typical of each of the other RMK funds. Nowhere in this description is there any mention of the leveraged credit risk investors were exposed to as a result of the fund's concentration in low-priority tranches in structured securities. In the same semi-annual report as September 30, 2006, RMK described the fund's recent returns as follows.

> During the first half of RMK Multi-Sector High Income Fund, Inc.'s fiscal year 2007, which ended September 30, 2006, the Fund had a total return of 15.39%, based on market price and reinvested dividends. For the six months ended September 30, 2006, the Fund had a total return of 6.16%, based on net asset value and reinvested dividends. For the six months ended September 30, 2006, the Lehman Brothers Ba U.S. High Yield Index 1 had a total return of 4.12%. The Fund's strong market performance is a reflection of investor's desire for cash distributions as well as the stability of the Fund's net asset value offered by a very diverse portfolio.
>
> During the first six months of the 2007 fiscal year, corporate high yield debt and common stocks were the best performing asset categories. Credit spreads (the yield premium required for risky assets over riskless assets such as U.S. Treasuries) contracted, or shrank significantly in the corporate sector providing meaningful outperformance for corporate securities. In the asset-backed sector, however, concerns over the slow down in housing and real estate in general caused credit spreads to expand and acted to depress overall performance from our portfolio of mortgage related securities. Asset-backed bonds secured by aircraft leases, medical equipment leases and ship leases continued to perform very well.
>
> During the same period, we made substantial allocation shifts away from home equity loans and into collateralized loan obligations focusing specifically on packages of senior secured corporate loans, both domestic and international. Further allocation shifts will focus on moving out of some floating rate assets and into more fixed rate assets as we expect the Federal Reserve to begin lowering short term rates at some point in 2007.

As of September 30, 2007 - one year later - RMK slipped this sentence into the paragraph describing RHY's risks.

> The Fund's investments in mortgage-backed or asset-backed securities that are "subordinated" to other interests in the same pool may increase credit risk to the extent that the Fund as a holder of those securities may only receive payments after the pool's obligations to other investors have been satisfied.

RMK, in part, described RHY's recent returns as follows.

> The turmoil in the mortgage market that began in December 2006 and the credit crunch that began during the Fund's first fiscal quarter has continued to plague the performance of both the Fund's net asset value and market valuation. Although below investment grade corporate debt has held up reasonably well, any asset related to residential real estate has been materially devalued. This is especially true for mortgage-backed securities and collateralized debt obligations.
>
> The market's appetite for credit sensitive assets has totally reversed course from the prevailing environment of 2006. A massive unwind of leverage has literally evaporated market liquidity in all structured finance assets and put selling pressure on virtually all credit-sensitive assets. Although this has been a sector of the fixed income markets that has provided very satisfying results in past periods, 2007 has proven to be much more difficult than we could have anticipated.

Even these belated disclosures do not accurately reflect what happened to investors in RHY and the other RMK funds. RMK invested a substantial majority of the portfolios in low-priority tranches. It is not that these securities *may* increase credit risk, these securities dramatically do increase credit risk. Also, as RMK acknowledges that the 2007 losses were suffered because of the subordinated structured securities it held, it says for the first time that its prior returns were due to investments in the same risky structured securities. This leveraged credit risk was not previously disclosed to investors but would be well known to the portfolio managers who ran the funds.

Finally RMK gets closer to full disclosure a few months later when it filed the December 31, 2007 semi-annual report for its Select High Income fund.

> … The structured finance category has taken the hardest hit so far due to the implicit (i.e., built into the structures) and explicit (i.e., financed, or bought on margin) leverage employed for this asset category. ...

This appears to be the first disclosure by RMK that it was investing in securities that had the effect of leveraging up the credit risk investors in its funds faced.

VII. RMK FUNDS' PROSPECTUSES CONTAINED OTHER MATERIAL MISREPRESENTATIONS

A. RMK's Misleading Performance Comparisons

RMK compared the performance of the Select High Income fund and its four closed end funds to the Lehman Ba index. The Lehman Ba index contains only corporate bonds – no structured finance securities.[23] As we illustrated in Tables 5-11 above, the five RMK "high yield" funds invested 65% to 70% of their portfolio in structured finance securities and only 21% to 24% in corporate bonds. The SEC previously found that Piper Capital Management's comparison of one of its fund's returns to an index that contained none of the asset type that dominated its Institutional Government Income Fund's ("PJIGX") holdings was materially false and misleading.

Piper Jaffray marketed PJIGX in the early 1990s to investors who wanted to invest in short and intermediate term fixed-income securities issued by the U.S. government and government agencies. Over time, Piper Capital Management invested substantially all its portfolio in CMOs and leveraged up its portfolio with repurchase agreements. Many of the securities PJIGX loaded up on were inverse floaters. These securities were especially poorly described by the risk characteristics Piper Jaffray reported to investors. Prior to 1994 PJIGX reported high yields and returns and its portfolio manager, Worth V. Bruntjen, was proclaimed an industry superstar. As interest rates rose in 1994, PJIGX's net asset value plummeted well beyond what a true portfolio of short and intermediate term government bonds would have declined.[24] Ultimately, in settlement with the SEC Bruntjen was barred from the industry for five years.

The Administrative Law Judge (ALJ) found that Piper Capital Management's choice of benchmark was material to investors and was misleading because it didn't contain the same type of securities as the mutual fund held and because the comparison implied a lower interest rate risk than the portfolio actually had.

> "Similar reasoning would apply to PCM's use of the Merrill Lynch 3-5 Year Treasury Bond Index as a benchmark for

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23. The Lehman Brothers fact sheet for the Ba Index identifies its constituents as only corporate bonds. *See* Exhibit 2.

24. PJIGX's NAV fell in part because of the undisclosed interest rate risk in its portfolio and in part because of undisclosed liquidity risk. CMOs are not thickly traded and prices are approximations at best of what could be realized. Some of the prices Piper used to report its NAV had become stale in March 1993. The crisis at PJIGX became apparent with the coincidental failure of Askin Capital management when fresh prices turned out to be much lower than Piper had been reporting.

> Fund performance. PJIGX annual/semi-annual reports to shareholders systematically compared Fund performance to that index. … PJIGX marketing materials and sales presentations made similar comparisons. … I find and conclude that expressly comparing Fund performance to the Merrill Lynch 3-5 Year Treasury Bond Index establishes a substantial likelihood that reasonable investors would consider the comparisons important in making PJIGX investment decisions and would view the comparisons as significantly altering the total mix of available information. It follows that PPJIGX/Merrill Lynch 3-5 Year Treasury Bond Index comparisons were material to investors.
>
> The record casts doubt on PCM's claim that the Merrill Lynch 3-5 Year Treasury Bond Index was an appropriate risk/performance benchmark for PJIGX. The Fund's distinguishing feature was an extremely high proportion of CMO derivative securities. … The Merrill Lynch 3-5 Year Treasury Bond Index contained no CMOs/CMO derivative securities whatsoever. … Moreover, the record indicates that PJIGX exhibited *multiples* of the interest rate sensitivity exhibited by the Merrill Lynch 3-5 Year Treasury Bond Index. …" [25]

The Securities and Exchange Commission affirmed the ALJ's findings in a strongly worded Opinion that included the following.

> PCM further misled investors by comparing the Fund's performance to the Merrill Lynch three- to five-year Treasury Bond Index. The Merrill Lynch three- to five-year Treasury Bond Index, unlike the Fund, did not include CMOs. Thus, the Fund's increasing proportion of CMOs exposed it to interest-rate sensitivity not exhibited by the Merrill Lynch three- to five-year Treasury Bond Index. [26]

RMK's choice of the Lehman Ba index as its benchmark for the four closed end funds and for the Select High Income fund is virtually identical in all material respects to PCM's comparison of PJIGX's returns to the Merrill Lynch 3-5 Year Treasury Bond Index. 65% to 70% of the RMK funds' portfolios holdings by March 31, 2007 were asset-backed securities and other

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25. *In the Matter of Piper Capital Management, Inc., et al.* Initial Decision Release No. 175 File No. 3-9657 November 30, 2000 available at *www.sec.gov/litigation/aljdec/id175hpy.htm#P218_14823*

26. *In the Matter of Piper Capital Management, Inc., et al.,* Securities Act of 1933 Release No. 8276, August 26, 2003 available at *http://www.sec.gov/litigation/opinions/33-8276.htm*.

structured finance and virtually all of these securities were at or near the bottom of the deals' capital structure. The Lehman Ba index contained only corporate bonds making RMK's comparison materially false and misleading.

Not only did the Lehman Ba index not contain any of the structured finance securities that dominated the RMK funds' portfolios, the returns to the funds were not statistically similar to the returns on the Lehman Ba index.

Table 24 reports the correlation between the Select High Income fund's weekly returns and various Lehman indexes each calendar year from 2000 to 2007. [27] The Select High Income fund's returns were much more highly correlated with the returns to Lehman's ABS, MBS and CMBS indexes than they were to the Lehman Ba index in 2000, 2001, 2002 and 2003. By 2004 the correlations were about equal and thereafter the Select High Income fund's returns were much more highly correlated with the returns to Lehman Ba index than to the ABS, MBS and CMBS indexes. The Lehman Ba index was an inappropriate benchmark for the Select High Income fund given the lack of structured finance in the Ba index and the absence of any correlation to the Select High Income fund's returns. Since the RMK funds' holdings did not become more like corporate high yield bonds and less like ABS and MBS over time, the change in correlations suggests that the NAVs in 2005 and 2006 did not reflect the true values of the portfolio holdings.

Table 24
Correlation of Weekly Select High Income Returns
to Various Lehman Brother Indexes

Year	Ba: Corporate High-Yield	U.S. MBS	U.S. Fixed-Rate ABS	CMBS	CMBS High Yield	US Intermediate Aggregate	US Aggregate
2000	-17%	53%	42%	51%	35%	52%	49%
2001	17%	59%	53%	60%	64%	60%	65%
2002	11%	51%	53%	54%	45%	56%	54%
2003	20%	31%	50%	49%	52%	46%	48%
2004	41%	45%	42%	37%	32%	43%	41%
2005	39%	8%	1%	3%	6%	8%	10%
2006	53%	25%	24%	20%	12%	23%	20%
2007	17%	-10%	-24%	7%	31%	-16%	-15%

27. The results described in Table 24 and 25 are not sensitive to the choice of daily, weekly or monthly returns or to whether the correlations and r-squared statistics are calculated over 1-year, 2-year or 3-year periods.

Table 25 reports the R-squared statistics from regressing the Select High Income fund's weekly returns on various Lehman indexes. The r-squared statistics make the same two points as the correlations coefficients. The Lehman ABS and MBS indexes were more appropriate benchmarks for the Select High Income fund - and by extension the four closed end funds than the Lehman Ba index – and that the NAVs don't reflect the true economics of the funds starting sometime in 2004.

Table 25
R-Squared Statistics
Weekly Select High Income Returns Regressed
on Various Lehman Brother Indexes

Year	Ba: Corporate High-Yield	U.S. MBS	U.S. Fixed-Rate ABS	CMBS	CMBS High Yield	US Intermediate Aggregate	US Aggregate
2000	3%	28%	17%	26%	12%	27%	24%
2001	3%	35%	29%	36%	41%	36%	43%
2002	1%	26%	28%	29%	21%	31%	29%
2003	4%	10%	24%	23%	26%	21%	23%
2004	17%	20%	18%	14%	10%	19%	17%
2005	15%	1%	0%	0%	0%	1%	1%
2006	29%	7%	6%	5%	2%	6%	5%
2007	3%	1%	6%	1%	9%	3%	2%

B. RMK's Misleading Diversification Claims

RMK claimed that its high yield funds were diversified by virtue of investing in multiple asset classes. In the Piper Capital Management case, the ALJ found:

> Further, the report states that PJIGX "is invested in more than 200 different securities which offset one another and help the fund to perform well in a variety of economic scenarios" …, again implying diversification in the familiar sense. Further undermining PCM's reliance on technical accuracy is the fact that Bruntjen's unorthodox strategy of purchasing a variety of CMO derivative securities at a discount and actively managing the cash flows as they accreted to par … mystified even peer fund managers.
>
> … Finally, it was affirmatively misleading to characterize Bruntjen's cash flow management "diversification" and Fund leverage as risk/volatility hedges. …

PCM did not challenge the ALJ's conclusion on the materially misleading nature of PCM's diversification claims for PJIGX and so the Commission accepted the ALJ's findings on this point. RMK's repeated

claims that the four high-yield funds and the Select High Income fund were diversified rise and fall on the same hyper-technical defenses PCM advanced before the SEC. As with PJIGX, the RMK funds were highly leveraged bets on credit risk and were not "diversified" in the sense investors are encouraged to understand that term.

Morgan Keegan repeated many of the same diversification claims. If Morgan Keegan performed the due diligence required before recommending these bond funds[28] to its clients, it would have known that the claims of diversification it was advancing were materially false and misleading.[29]

VIII. CONCLUSION

Investors in Regions Morgan Keegan's six bond funds lost two billion dollars in 2007 because of losses on poor-quality asset-backed securities, leveraged up many times over by complex capital structures. A rudimentary analysis of the type RMK claimed to perform on its holdings would have determined that it was exposing investors to as much as 10 times the credit risk of the underlying, already risky, debt in exchange for 1% or 2% higher returns than a diversified, transparent high-yield bond portfolio would have earned.

In addition, Morgan Keegan told investors that it did in depth evaluation of the mutual funds it recommended to its retail customers.[30] Such an

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28. FINRA Notice to Members 04-30 *Sales Practice Obligations NASD Reminds Firms of Sales Practice Obligations in Sale of Bonds and Bond Funds* available at *http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p003130.pdf*

29. There are other parallels between the RMK funds and the Piper Jaffray fund highlighted by the SEC ALJ Findings and the Commission Opinion. For example, The SEC found that Piper Jaffray's use of weighted average life and duration were incomplete and misleading measures of interest rate risk for a portfolio that contained significant amounts of inverse floaters. Likewise, the RMK funds repeated references in its marketing materials to the funds' average credit ratings was incomplete and misleading since the ratings on structured finance – especially of the lowest priority tranches purchased by the funds – meant something very different than ratings on corporate bonds.

30. *See*
www.morgankeegan.com/MK/Investing/Newsletters/mor_invest0406.htm#1

> **Mutual Fund Research Sets Morgan Keegan Apart**
>
> Your Morgan Keegan financial advisor has just recommended that you add a certain mutual fund to your portfolio to strengthen your assets and increase the diversity and stability of your holdings. But how do you know that the mutual fund your advisor is offering is best for you? The answer:

evaluation of any of the six RMK funds discussed herein would have uncovered RMK's misrepresentation of risky asset-backed securities as corporate bonds and preferred stocks and the highly-leveraged credit risk in the low-priority asset-backed securities held in the funds which RMK had not disclosed.

The losses suffered by investors in these funds were not the result of a "flight to quality" or a "mortgage meltdown" as has been asserted. Investments in diversified portfolios of junk bonds and mortgage backed-securities did not suffer significant losses during the time period investors in RMK funds suffered catastrophic losses.

RMK did not fully or accurately inform investors in its bond funds of the risks of the subordinated tranches the funds held until well after the losses had occurred. Moreover, prior to March 31, 2008 RMK affirmatively misrepresented hundreds of millions of dollars of risky securities it held in these portfolios as corporate bonds and preferred stocks. RMK also misled investors by repeatedly comparing the performance of its funds to an index that contained none of the securities that dominated the RMK funds and by claiming that its funds were diversified.

Morgan Keegan's exceptional due diligence. At Morgan Keegan, mutual funds are subject to one of the most detailed, thorough and exhaustive due diligence processes in the industry. It is just another example of how Morgan Keegan puts the interests of our clients before everything else.

…

"We go beyond the past performance records provided by services like Morningstar," explains Gary Stringer, Director of Investments, Wealth Management Services at Morgan Keegan. "We're not so much concerned with what funds have done in the past, but with what they will do for us in the future. And the best way to do that is to really get to know the people managing the funds and learn as much as we can about how they intend to earn our clients money."

…

AN ANALYSIS OF THE SCHWAB YIELDPLUS FUND AND THE REASONS FOR ITS DOWNFALL

Bob Grosnoff[1]

Due to the mounting number of investors who have lost substantial sums of money by investing in the problematically marketed and solicited SchwabYieldPlus Fund (the "Fund"), this article analyzes the Fund's portfolios for 2006 through the last current reporting period of November 2008, while also providing historical price and dividend information going back to December 2002. The goal is to determine the reasons for the extensive losses in this Fund, which was marketed and solicited as a money market alternative when, in fact, it was anything but.

INITIATION AND EARLY YEARS OF THE FUND

The Schwab YieldPlus Fund was brought to market in October 1999. In its early years, it appears as if the Fund had a relatively stable net asset value (NAV) with a reasonable dividend paid to investors. For example, according to Yahoo, the Fund closed at $9.73 per share on December 31, 2002 while having paid 11.0 cents per share in dividends during the year. Year end closing prices from 2003 through 2005 showed minimal fluctuation in the price per share (December 2003 - $9.72; December 2004 - $9.69; and December 2005 - $9.66). Dividends per share for those years were 27.9 cents in 2003, 20.0 cents in 2004, and 17.5 cents in 2005.

At year end 2006, the Fund again saw little fluctuation in price, closing at $9.69 per share. It paid 45.2 cents per share in dividends. As of that year, the forms that Schwab filed with the SEC became available on line. My in-depth analysis of the Fund will begin as of that point.

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1. Bob Grosnoff is a former leading producer at Merrill Lynch and Branch Office Manager/Chairman's Council member at Prudential. He retired from the securities industry in 1994 after 25 years. Since his retirement, he has been retained in over 130 cases and testified as an expert about 100 times throughout the country. He is also one of the few outside experts who have been retained by the New York Stock Exchange Enforcement Division (now FINRA) as well as the NFL Players Association. Additionally, he has consulted with the New York Law School, Legal Services. Bob can be reached by e-mail at *expetwitness32@aol.com* or via cell at 602-502-4733.

YIELDPLUS PROSPECTUS REPRESENTATIONS

SEC Form 497, dated November 15, 2005 as amended August 17, 2006, was filed by Schwab for the Fund along with three other funds.

1. The section entitled ABOUT THE FUNDS stated:

"THE SCHWAB YIELDPLUS FUND is an ultra short-term bond fund, designed to offer high current income with minimal changes in share price. The fund invests primarily in investment-grade bonds. The fund offers the potential for higher yields than a money market fund. However, unlike a money market fund, its share price will fluctuate. The fund seeks to keep the average duration of its portfolio at one year or less."

2. The section entitled STRATEGY states:

"TO PURSUE ITS GOAL, THE FUND PRIMARILY INVESTS IN INVESTMENT GRADE (HIGH AND CERTAIN MEDIUM QUALITY, AAA TO BBB- OR THE UNRATED EQUIVALENT AS DETERMINED BY THE INVESTMENT ADVISOR) BONDS." Subsequent to this statement, the prospectus differentiates the type of securities in which it may invest.

"In choosing securities, the fund's manager seeks to maximize current income within the limit of the fund's credit and maturity policies. To help maintain a high degree of share price stability and preserve investor's capital, the fund seeks to keep the average duration of its portfolio at one year or less. Duration is a tool to measure interest rate risk." This was a reason for the lack of volatility exhibited by the Fund.

The prospectus says many other things including a section on risks, financial highlights, and performance. Essentially, the investors who purchased this Fund were told it was an ultra short term fund that was primarily invested in highly rated bonds with a maturity date of about one to two years. According to Schwab, this made the Fund an attractive alternative to an investment in money market that would have a higher yield than money market with only slightly higher risks.

SCHWAB YIELDPLUS FUND HOLDINGS

May 2006

The SEC Form N-Q is the quarterly schedule of portfolio holdings of management investment companies. The report for the period ending May

31, 2006 stated that the holdings of the Fund could be analyzed through a snapshot of the investments held at that time. The following chart illustrates the holdings by category along with their cost and approximate market value. At that time, the Fund had an approximate net value of $6,880,885,000 and a cost of securities of $6,914,204,000.(1).

Holdings by Category	**Cost (x 1000)**	**Value (x 1000)**
42.6 % Corporate Bonds	2,909,373	2,912,624
24.0 % Asset Backed	1,643,814	1,645,057
27.9 % Mortgage Backed	1,945,447	1,906,027
0.1 % US Government	5,466	5,466
2.9 % Commercial Paper	200,759	200,759
3.1 % Preferred	208,111	209,718
Other Investment Cos.	1,234	1,234
100.6 % Total Investments	6,924,204	6,880,885
Liabilities		(44,225)
Net Assets		6,836,660

Along with the general category of the holdings, this same information can be used in order to determine whether or not Schwab was adhering to the policy of having an "ultra short term maturity" fund (i.e. having an average duration of the fund at or below one year.)

The holdings at the time show 75 % of the $2,912,624 billion of corporate bonds were in maturities of one year or less. However, 25 % of the bonds were in maturities longer than one year. Some of the maturities were in the 20 year range, with the longest maturing in 2027.

(1) From here forward, I will leave out the last three zeroes as that is how they are reported on the form.

Of the $1,645,057 billion of market value of asset backed obligations, $295,479 million or 17.9 % were of maturities longer than one year, with a great many maturing in about 5 to 10 years. The longest maturity was in 2036.

Of the $1,906,027 billion mortgage backed securities, $1,460,459 (76.6 %) were in maturities ***longer*** than one year and only 23.4 % matured in one year or less. In addition, 21.6 % or $315,097 million of the longer term maturities were 25 years or longer, with the longest being 2036 or 30 years.

Footnote (a) of the document made the following disclosure: "Securities exempt from registration under Rule 144A of the Securities Act of 1933; these securities may be resold in transactions exempt from registration, normally to qualified institutional buyers." At the period end, the value of the unregistered securities amounted to $516,174 million (7.7 % of net assets). It was also reported that the Fund had a net unrealized depreciation of $33,878 million. Unregistered securities are not as liquid as registered securities because their sale is restricted only to qualified institutional buyers. As a result, they are much more difficult to price and to sell in times of need.

November 2006

Form N-Q for the period ending November 30, 2006 reported:

Holdings by Category	Cost (X 1000)	Value (X 1000)
47.1 % Corporate Bonds	4,550,381	4,564,549
13.9 % Asset Backed	1,346,729	1,349,074
34.2 % Mortgage Backed	3,300,593	3,309,850
0.1 % US Government	7,950	7,951
3.0 % Commercial Paper	288,026	288,026
0.7 % Preferred	70,427	70,390
Other	1,003	1,003
99.0 % Total Investments	9,565,109	9,590,843
Other Assets		96,901
Net Assets		9,687,744

The holdings at the time show that 63.6 % of the $4,564,549 billion of corporate bonds were in maturities of one year or less. This means that $1,657,115 (36.4 %) of the corporate bonds were invested in securities with maturities longer than one year. More importantly, 51.7 % ($857,500 of $1,657,115 of the long term corporate bonds were concentrated in the financial services industry, with many of the maturities as long as 2049. *This concentrated position would ultimately be a factor in the loss of net asset value of the Fund.*

Of the $1,349,074 billion of market value of asset backed obligations, only $134,818 million (10 %) were in maturities of longer than one year, with the longest maturity being 2035. Therefore, $1,214,256 billion (90 %) of the asset backed securities had maturities of one year or less.

The harbinger of the problems could be seen in the fact that mortgage backed obligations had now risen to $3,309,850 billion (34.2 %) of the funds assets, from $1,906,027 billion (27.9 %) of the funds assets only a few months earlier. Said another way, the net assets of the Fund went from $6,836,660 in March 2006 to $9,687,744 in November 2006. This represented an increase of $2,852,084. The increased purchases of mortgage backed securities totaled $1,403,823 (49.2 % of the overall net increase in the Fund's assets).

Footnote (a) of the document disclosed that the amount of unregistered securities in the portfolio was $1,269,733 billion (13.1 %). This amount of illiquid securities was almost double that of the previous report. It was also reported that the Fund had a net unrealized appreciation of $25,268 million.

As we went into 2007, the short term strategy of the Fund changed dramatically, and, as a result the net asset value ***decreased*** as the percentage of assets in longer term maturities and mortgage backed securities ***increased.*** The increase in illiquid securities also negatively affected the net asset value. On December 31, 2007, the net asset value of the funds was $9.07 per share.

On December 31, 2008, the net asset value was $5.58. In one year the net asset value ***decreased*** by $3.49 per share. This was a ***decrease*** in net asset value of 38.48 % in one year.

May 2007

Form N-Q for the period ending May 31, 2007 reported:

Holdings by Category	Cost (X 1000)	Value (X 1000)
45.1 % Corporate Bonds	5,985,952	5,993,310
10.9 % Asset Backed	1,444,182	1,442,119
46.5 % Mortgage Backed	6,203,156	6,177,217
1.1 % Preferred	142,692	142,347
1.3 % Short Term	170,944	170,945
104.9 % Total Investments	13,946,926	13,925,938
(3.8 %) Short Sales	(507,183)	(502,927)
(1.1 %) Other Liabilities		(145,028)
Net Assets		13,277,983

As of this date, $4,333,753 billion of the $5,993,310 billion (72.3 %) of the corporate bonds were in maturities of one year or less. As a result, $1,659,557 billion (27.69 %) was invested in corporate bonds with maturities longer than one year. Although slightly better than in November 2006, $727,334 million (43.8 %) of the longer maturities of corporate bonds were concentrated in the financial service industry.

The percentage of asset backed securities with maturities longer than one year was now down to 8/6 % ($124,266) of the total of $1,442,119 billion with maturities longer than one year.

Ominously, the amount of mortgage backed securities now rose to an extremely over concentrated 46.5 % of the portfolio. The overall portfolio value had increased from $9,687,744 billion at the end of November 2006 to $13,277,983 billion as of the end of May 2007. This represents an increase of $3,590,239 billion during the time period. Mortgage backed securities rose from $3,309,850 billion to $6,172,217 billion or an increase of $2,867,367 billion. The increase of investments in mortgage backed securities was responsible for 80 % of the increase in the overall value of the Fund. Clearly, as new money was flowing into the Fund, Schwab and its fund managers decided to concentrate almost all of the increase in funds in mortgage backed securities, much of which had long maturities.

Footnote (c) reported that the amount of unregistered securities had risen to $2,032,936 billion or 15.3 % of the Fund's total assets. It also reported that the Fund had a net unrealized depreciation of $21,012 million.

During this reporting period, the Fund's net asset value went from $9.69 per share to $9.68 per share, maintaining its previous stability.

On August 30, 2007, Evelyn Dilsaver, President and CEO of Charles Schwab Investment Management Inc. issued a report to the shareholders of Schwab money funds. Among the statements made was the following:

"Further down the maturity spectrum, our ultra short bond fund Schwab YieldPlus offers higher yield potential with higher risk potential than a money fund."

Although Ms. Dilsaver attempted to at least discuss risk, the representation of the YieldPlus fund as an "*ultra short bond fund"* was a glaring example of a misstatement of material information. That is because, based on its composition, this fund was certainly not an "*ultra short bond fund"* at this point in time.

November 2007

Form N-Q for the period ending November 30, 2007 reported:

Holdings by Category	Cost (X 1000)	Value (X 1000)
34.9 % Corporate Bonds	3,030,682	2,805,656
7.9 % Asset Backed	676,935	633,387
46.2 % Mortgage backed	3,728,687	3,708,305
1.0 % Preferred	82,211	81,924
6.6 % Short Term	528,268	528,425
96.6 % Total Investments	8,046,783	7,757,697
(0.7 % Short Sales	(59,629)	(59,041)
4.1 % Other Assets		328,045
		8,026,701

As of this reporting period, $1,737,588 billion of the $2,805,656 billion (61.9 %) of the corporate bonds were in maturities of one year or less. This means $1,068,068 billion (38.1 %) were in maturities of longer than one year. In addition, $558,776 million of these longer term maturities were concentrated in the financial services industry.

The percentage of asset backed securities with maturities *longer* than one year remained virtually the same as May 2007 (8.5 %), but the absolute number of asset backed securities with maturities longer than one year was now $54,006 million, down from $124,266 million in the previous period.

However, mortgage backed securities remained at an extremely over concentrated position of 46.2 %, with the absolute value of mortgage backed securities now valued at $3,708,305 billion. The total assets of the Fund went down from $13,277,983 billion to $8,026,701 billion, a drop of $5,251,282 billion. The drop in value of the mortgage backed securities from $6,177,217 billion to $3,708,305 billion represents $2,468,912, or 47 %, of that decrease.

The remaining $3,708,305 billion of mortgage backed securities can be further broken down as follows: $3,172,982 billion (85.6 %) was collateralized mortgage obligations with maturities longer than one year; $74,174 million (87 %) of the total of $85,246 commercial mortgages had maturities longer than one year. All of the $450,077 million of the Fannie Mae & Freddie Mac mortgages matured in over one year.

Footnote (c) reported the amount of unregistered securities was now $1,344,330 billion (16.7 %) of the portfolio. It was also reported that the Fund had unrealized depreciation of $290,255 million.

From May 31, 2007 through November 30, 2007, the net asset value of the Fund went from $9.68 to $9.17 and paid 21.6 cents in dividends. The beginning of the end was now quite near.

THE PRECIPITOUS DOWNFALL OF THE YIELDPLUS FUND

The net asset value of the Fund dropped dramatically from $9.17 per share as of the November 30, 2007 N-Q filing to $6.32 per share as of the May 31, 2008 N-Q filing, a loss of ***31 %***. During this time period, the Fund paid dividends of 21 cents.

On the November 30, 2007 N-Q filing, there were 119 different issues of mortgage backed securities with maturities longer than one year. These issues carried a cost of $4,112,310 ***billion*** dollars and a market value of $3,030,740 ***billion*** dollars. ***This represented a loss in value in this overly concentrated position of $1,081,570 billion dollars.***

There were only 12 issues with maturities of one year or less. All matured in the month of December 2007, had a cost basis of $143,095 million, and a market value of $142,242 million. Clearly the continued drop in value of these securities led directly to the drop in net asset value of the Fund.

LATER HOLDINGS AND PROBLEMS WITH THE YIELDPLUS FUND

After the first big drop, some of the worst securities were clearly sold, but the damage continued as Schwab was unable to easily dispose of illiquid and longer term mortgage backed securities. As the NAV and the size of the Fund plummeted, Schwab was unable to save it.

May 2008

The form N-Q for the period ending May 31, 2008 reported:

Holdings by Category	Cost (X 1000)	Value (X 1000)
7.4 % US Government	50,000	50,000
24.6 % Corporate Bonds	168,559	167,451
23.2 % Asset Backed	172,557	157,977
18.4 % Mortgage Backed	151,956	124,900
10.0 % Short Term	67,818	67,822
83.6 % Total Investments	610,890	568,150
16.4 % Other Assets		111,309
Net Assets		679,459

All of the US Government Bonds were in one issue: $50,000 million worth of a US Treasury Note maturing May 31, 2010.

One of the corporate bonds had a maturity of November 14, 2008. All of the remaining issues matured prior to that date.

Of the total of $157,977 asset backed securities, only three issues that totaled a cost of $40,219 million (25.4 %) had maturities over one year.

Of the collateralized mortgage backed securities, $34,415 million of $52,692 million (65.3 %) had maturities over one year.

None of the $69,326 million commercial mortgages had a maturity longer than one year, and one Fannie Mae mortgage had a maturity of 2018.

The Fund had unrealized losses of $42,741 million and $250,918 million, (36.9%) of the holdings were unregistered. For the first time, a footnote (f) stated that $73,468 million (10.8 %) of the portfolio was illiquid.

The net asset value of the Fund went from $6.32 on May 30, 2008 down to $5.53 on November 28, 2008, a drop of 79 cents or 12.5 %. Clearly the short term US Government and the corporate bonds maturing sooner than November 14 did not lose value. The drop in value could again be traced directly to the longer term collateralized mortgage securities.

November 2008

Form N-Q for the period ending November 30, 2008 reported:

Holdings by Category	Cost (X 1000)	Value (X 1000)
18.9 % US Government	63,232	65,008
25.8 % Corporate Bonds	89,025	88,429
20.4 % Asset Backed	99,168	70,146
7.5 % Mortgage Backed	42,630	25,596
12.3 % Commercial Mort.	71,263	42,131
15.2 % Short Term	52,207	52,207
100.1 % Total Investments	417,525	343,517
(0.1 %) Other Liabilities		(372)
Net Assets		343,145

All of the US Government Bonds were in one issue of a US Treasury Note maturing on June 30, 2010. All of the corporate bonds matured in one year or less. Of the total value of asset backed obligations, $39,116 million (55.8 %) had a maturity of longer than one year, with the longest issue maturing in 2022. Of the collateralized mortgage obligations, $10,372 (43.9 %) matured in longer than one year.

In addition, Schwab continued to be unable to liquidate some of the more exotic securities as $123,792 million (36.1 %) of the portfolio was in unregistered securities and $32,386 million (9.4 %) was illiquid. The Fund reported unrealized losses of $74,008 million. All of these losses were concentrated in either asset backed securities, mortgage backed securities, or commercial mortgage securities.

On June 2, 2008, the net asset value of the Fund was $6.32. On November 28, 2008, the net asset value of the Fund was $5.53, showing the residual effects of the failed strategy as the Fund continued to drop despite changes to the portfolio. This losing streak still has not ended, as the closing NAV of the Fund on March 30, 2009 was $4.68.

SCHWAB'S MARKET DEFENSE

Charles Schwab is trying to blame "the market" for the downfall in the NAV of the Fund. Based on the evolution of the Fund's composition, such a claim is simply false. During the period of time between the November 30, 2007 N-Q and December 16, 2008, the Federal Reserve Open Market Committee lowered interest rates eight times. The total amount that the Fed lowered rates was 4.25 percentage points. Had the Fund invested in bonds of good quality, as they were mandated by their prospectus, and not concentrated their positions in mortgage backed securities as they recklessly did, the NAV of the Fund would have benefited from the strong bond market

of 2008. The Fund would have increased instead of decreasing from $9.17 on November 30, 2007 to $5.58 on December 31, 2008 (-39.1 %).

The following chart illustrates the changes in the interest rates brought about by the Federal Reserve Board Open Market Committee as it was on November 30, 2007 through the end of 2008:

Date	Decrease	Level
October 31, 2007		4.50 %
December 11, 2007	0.25 %	4.25 %
January 22, 2008	0.75 %	3.50 %
January 30, 2008	0.50 %	3.00 %
March 18, 2008	0.75 %	2.25 %
April 30, 2008	0.25 %	2.00 %
October 8, 2008	0.50 %	1.50 %
October 29, 2008	0.50 %	1.00 %
December 16, 2008	0.75 to 1.00 %	0 to 0.25%

Schwab uses the term "Duration" in its literature. "Understanding Duration", an article published by Blackrock, says: "In 1938 economist Frederick Macaulay suggested duration as a way of determining the price volatility of bonds." "Macaulay duration" is now the most common duration measure.

Duration can help predict the likely change in the price of a bond given a change in interest rates. As a general rule, for every 1 % increase or decrease in interest rates, a bond's price will change approximately 1 % in the opposite direction for every year of duration. For example, if a bond has a duration of 5 years, and interest rates increase by 1 %, the bond's price will decline by approximately 5 %. Conversely, if a bond has a duration of 5 years and interest rates fall by 1 %, the bond's price will increase by approximately 5 %.

If the Schwab YieldPlus Fund truly had a portfolio of high quality bonds with a one to two year duration, as it was publicly marketed, its NAV would have increased by approximately 4 to 8 % during the period from November 2007 to the end of 2008 instead of decreasing in value by 39.1 % as it did.

SCHWAB'S MITIGATION DEFENSE

The issue of mitigation of damages will certainly be an issue raised by the defense to their cases. Whether investors are sophisticated or not, if they were told that the Fund consisted of high quality securities with maturities of one year or less (even two years), those investors would not be inclined to redeem their shares at a reduced price when they could hold those shares until the securities contained within the Fund matured and paid full par value.

If their Schwab brokers told them that the shares were only down due to "the market," then holding onto their shares made even more sense.

MATERIAL MISSTATEMENTS AN OMISSIONS

There were numerous misstatements in the offering documents and sales material related to the YieldPlus Fund (i.e. inconsistent with the facts). For example, Charles Schwab misstated material information when it stated that YieldPlus Fund was an ultra short term fund designed to offer high current income with minimal changes in share price. It certainly was not an ultra short term fund and it certainly had more than a minimal change in share price.

Charles Schwab misstated material information when it stated that to help maintain a high degree of share price stability and preserve investor's capital, the Fund seeks to keep the average duration of its portfolio at one year or less. The average duration of the portfolio was much longer than that.

SCHWAB'S OWN REDEMPTIONS IN THE YIELDPLUS FUND

January 2008

As of January 31, 2008, the N-Q for Schwab Target Funds 2010, 2020, 2030, 2040 and the N-Q for the Retirement Income Fund disclosed that those funds held the following positions of Schwab YieldPlus Fund Select Shares.

Fund	Number of Shares	Approximate Value
Target 2010	353,466	$3,157,000
Target 2020	280,711	$2,507,000
Target 2030	203,296	$1,815,000
Target 2040	139,398	$1,245,000
Retirement Income	2,004,334	$17,899,000

In early April 2008, Charles Schwab distributed a document entitled "Schwab YieldPlus Fund Additional Information for YieldPlus Investors as of 4/1/08." In the YieldPlus Facts section, it states:

"Several Schwab Funds have redeemed shares of Schwab YieldPlus Fund. On April 1, 2008 the Retirement Income Fund redeemed its last remaining shares resulting in Schwab Funds no longer holding the Schwab YieldPlus Fund."

In contrast, between February 1, 2008 and March 31, 2008, Schwab was actively urging their investors in YieldPlus not to redeem their shares. During the same time, other Schwab funds were liquidating their entire positions in YieldPlus.

Schwab is correct in noting that redemptions helped cause the downfall of the YieldPlus Fund. However, it was Schwab's own redemptions in the early part of 2008 that largely contributed to this problem. On February 1, 2008, YieldPlus closed at $8.39. The net asset value of YieldPlus did not break below $8.00 until March 17, 2008. On March 31, 2008 the net asset value was $7.17.

In addition to the other Schwab Funds liquidating positions, some of the managers of YieldPlus Fund were also liquidating their own personal holdings in YieldPlus. Schwab also filed Form 497 with the SEC. Part of this form discloses the holdings of Schwab Trustees and Fund Managers in the various Schwab Mutual Funds. This form reported the following:

OWNERSHIP OF FUND SHARES: The following table shows the dollar amount range of the Portfolio Managers' "beneficial ownership" of shares of the funds they manage as of August 31, 2006. Dollar amount ranges disclosed are established by the SEC. "Beneficial ownership" is determined in accordance with Rule 16a-1 (a) (2) under the 1934 Act.

Portfolio Manager	Fund	Dollar Range of Fund Shares
Kimon Daifotis	YieldPlus Select Shares	$10,001 – 50,000
Steven Hung	YieldPlus Investor Shares	$1 – 10,000
Matt Hastings	YieldPlus Select Shares	$1 – 10,000

Same report as of August 31, 2007

Kimon Daifotis	YieldPlus Fund	over $100,000
Matt Hastings	YieldPlus Fund	$1 – 10,000

Steven Hung is not listed as owning any shares

Same report as of October 31, 2007

None of the Portfolio Managers listed in this report owned any YieldPlus shares.

CONCLUSION

The Schwab YieldPlus Fund was mismarketed and misrepresented. It was sold to investors who were not given all of the information that should have been provided to them in order for them to make informed investment

decisions. Since it was marketed as a money market alternative, few would have invested in it had they known the truth. Schwab's YieldPlus Fund invested heavily in long term mortgage securities, asset backed securities and lower quality, longer term maturities that eventually caused the downfall of its net asset value. Numbers don't lie.

Notes & Observations

ASSERTING CONSTRUCTIVE TRUSTS IN ASSET FORFEITURE PROCEEDINGS - A VIABLE OPTION FOR RECOVERING ASSETS FOR VICTIMS OF INVESTMENT SCAMS

Jason R. Doss[*]

I. INTRODUCTION

It is no secret that this has been the year of the Ponzi scheme. If you follow the news, it seems as though each day brings a fresh new story about how federal prosecutors have foiled yet another scheme perpetrated by the likes of Bernie Madoff and other mini-Madoffs. While the Securities Exchange Commission does not keep statistics on Ponzi fraud, according to the New York Times, the agency brought cases involving losses of over $200 million between October 2008 and January 2009.[1] In addition, Bart Chilton, a commissioner at the Commodities Futures Trade Commission (CFTC) has been quoted as characterizing the recent influx of Ponzi scheme cases as "rampant Ponzimonium."[2] According to the Financial Times, the CFTC has filed charges against 15 alleged Ponzi schemes as of March of this year, compared with 13 during the all of 2008. If that rate were sustained, the CFTC could end the year filing more than 60 cases.[3]

These often incredible scam stories typically end sadly for victims because rarely are there deep pockets to repay investors their losses. Furthermore, investors who actually have the foresight to pull their money out early are increasingly at risk of being forced to return their ill-gotten gains. For example, Irving Picard, the trustee appointed to recover Madoff's assets on behalf of the victimized investors, recently sent out an estimated 200-plus letters to some of Madoff's former investment clients requesting

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1. Leslie Wayne, *Troubled Times Bring Mini-Madoffs to Light*, New York Times, January 27, 2009.

2. Jason Szep, *U.S. regulator probing "rampant Ponzimonium"*, Reuters, March 20, 2009.

3. Javier Blas, *Watchdog fears market 'Ponzimonium'*, Financial Times, March 20, 2009.

that they give back money they withdrew before his financial scam collapsed.[4]

One of the main tools governmental agencies use to recover assets from criminals and eventually to repay victims as restitution is the asset forfeiture process. Today, some 200 federal criminal and drug control laws include provisions for asset forfeiture.[5] In addition, the 50 states and the District of Columbia all have forfeiture provisions of their own.[6] The underlying policies behind allowing the government to confiscate criminal assets is clear; criminals should not be able to profit from the crimes they commit and the assets they amass as a result of their criminal endeavors. The assets should be used to compensate their victims.

Proponents of the process believe that governments do not utilize the asset forfeiture laws enough, while those opposed to the process believe that asset forfeiture laws give the government too much power and that the laws violate the civil liberties of citizens.[7] Critics also claim that the asset forfeiture process is fundamentally flawed because those laws also allow governmental agencies to "profit" from law enforcement.[8] As a result, a substantial proportion of law enforcement agencies are dependent on civil asset forfeiture as a necessary budgetary supplement.[9] This perceived/actual conflict of interest could affect not only the types of cases criminal prosecutors choose to pursue but also an agency's decision-making capabilities surrounding the distribution of assets to victims. Given the recent influx in the number of collapsed Ponzi schemes, the underlying tension between victims' interests and governmental interests will no doubt

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4. Kevin McCoy, *Madoff clients told to return money they'd withdrawn*, USA Today, April 22, 2009.

5. Charles A. Intriago and Robert A. Butterworth, *Fund Government With Dirty Money*, New York Times Op-Ed, April 28, 2009.

6. *Id.*

7. *Id*. See also www.fear.org (website of non-profit organization, Forfeiture Endangers Americans Rights (FEAR).

8. According to a recent article on www.assetforfeiture.com, in at least one instance, a prosecutor from Delaware County, Indiana, actually personally profited from the asset forfeiture process by entering into various confidential settlement agreements (or CSAs) that allowed him to personally collect a percentage of the proceeds of civil forfeitures in cases where he was simultaneously prosecuting the suspect on criminal charges. The prosecutor, Mark R. McKinney, apparently will not be criminally charged but will face disciplinary charges that he committed various ethical violations as a result of his conduct. See Mary Spicuzza, *No criminal charges in case against embattled Indiana prosecutor*, www.assetforfeiture.com, May 13, 2009.

9. John Worrall, *Addicted to the drug war: The role of civil asset forfeiture as a budgetary necessity in contemporary law enforcement*, Journal of Criminal Science, Vol. 29, Issue 3, May-June 2001, pages 171-187.

become more strained as the sheer magnitude of assets being seized by governmental agencies accumulates due to criminal prosecutions of these schemes.

Many attorneys do not know that third party victims (e.g. victims of investment fraud or Ponzi schemes) have the right to petition the court not only to challenge the government's authority to seize property confiscated in criminal prosecutions but also to challenge the government's discretion in how it distributes seized assets to the victims. Attorneys who represent investors that are victims of Ponzi schemes or other similar investment scams commonly focus only on finding solvent defendants and filing lawsuits. Most of the time, attorneys turn down these cases if no deep pockets are easily found. Even when attorneys accept these cases, they often recommend that their clients consider any money received from the government in the form of restitution to be a gift. The methodology used by the government to obtain and distribute assets in many instances goes unchecked and the government simply distributes seized assets back to investors often on a *pro rata* basis.

In many circumstances, the *pro rata* distribution of seized assets to victims may be the fairest result (e.g. when all of the victims' investments are pooled together). In other circumstances, however, a *pro rata* distribution may not be so fair (e.g. when a particular victim's investment can be traced to an account). Indeed, what constitutes a "fair" distribution falls within the proverbial gray area.

The purpose of this article is to raise awareness about a viable alternative for maximizing the recovery for investors who can trace their seized assets or other property. Third parties who wish to challenge the federal government's ("Government") authority and discretion described above must file a petition for an ancillary hearing pursuant to 21 U.S.C. 853(n). As described below, a recent decision out of the Eleventh Circuit, *United States v. Shefton*, 548 F.3d 1360 (11th Cir. 2008) permits victims of investment scams who have the ability to trace their assets to recoup *all* of their losses (as opposed to receiving only a *pro rata* share) in the asset forfeiture process by asserting constructive trust legal interest in the forfeited property.

This article will provide a brief description of what petitioners seeking to amend forfeiture orders pursuant to 21 U.S.C. §853(n) and §853(n)(6)(A) must establish to prevail. The article will also discuss the recent case *United States v. Shefton*, 548 F.3d 1360 (11th Cir. 2008) and how its holding improves investors' rights in ancillary forfeiture actions brought against the Government.

II. GENERAL DESCRIPTION OF ANCILLARY PROCEEDING BROUGHT PURSUANT TO 21 U.S.C. §853

Section 853 governs criminal forfeiture proceedings, *see* 28 U.S.C. §2461(c), and provides that persons convicted of certain criminal violations shall forfeit to the United States any property used to commit or facilitate the crime, or any property "constituting, or derived from, any proceeds the person obtained" from the crime (21 U.S.C. §853(a)(1)-(2)). "All right, title, and interest" in the forfeited property "vests in the United States upon the commission of the act giving rise to forfeiture." 21 U.S.C. §853(c).

Section 853(n) establishes a procedure for third parties who claim an interest in forfeited property to avoid its forfeiture. Such parties may "petition the [district] court for a hearing to adjudicate the validity of [their] alleged interest in the property." *Id*. §853(n)(2)[10]. Section 853(n)(6) establishes the standard by which third party interests are adjudicated and states:

> If, after the hearing, the court determines that the petitioner has established by a preponderance of the evidence that-
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> (A) *the petitioner has a legal* right, title, or *interest in the property, and such* right, title, or *interest renders the order of forfeiture invalid in whole or in part because the* right, title, or *interest* was vested in the petitioner rather than the defendant or *was superior to any right, title, or interest of the defendant at the time of the commission of the acts which gave rise to the forfeiture* of the property under this section; or
>
> (B) the petitioner is a bona fide purchaser for value of the right, title, or interest in the property and was at the time of purchase reasonably without cause to believe that the property was subject to forfeiture under this section;
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> the court shall amend the order of forfeiture in accordance with its determination.

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10. Section 853(n)(2) states in full, "Any person, other than the defendant, asserting a legal interest in property which has been ordered forfeited to the United States pursuant to this section may, within thirty days of the final publication of notice or his receipt of notice under paragraph (1), whichever is earlier, petition the court for a hearing to adjudicate the validity of his alleged interest in the property. The hearing shall be held before the court alone, without a jury."

21 U.S.C. §853(n)(6).

Because investment fraud often involves the use of misrepresentations and/or omissions to induce an investor to invest in schemes, victims who file §853(n)(2) petitions to recover their investments often bring claims pursuant to §853(n)(6)(A), as opposed to asserting that they are "bona fide purchaser[s]" pursuant to §853(n)(6)(B).

A petitioner asserting a claim pursuant to §853(n)(6)(A) must allege and ultimately establish by a preponderance of the evidence that: (1) the petitioner had a legal interest in the forfeited property, and (2) the petitioner's interest was superior to the criminal defendant's interest in the forfeited property (3) at the time of the fraud. *See United States v. Shefton*, 548 F.3d 1360, 1364 (11th Cir. 2008). If a petitioner can demonstrate all three elements, then the order of forfeiture is invalid. *See Id.* (citing to 21 U.S.C.§853(n)(6)(A)).

State law is applied to determine the nature of the petitioner's interest in the forfeited property. *See Id.* at 1364. However, whether the petitioner's interest in the forfeited property is superior, rendering the forfeiture order invalid, pursuant to §853(n)(6), is a matter of federal law. *Id.* [11]

III. *UNITED STATES V. SHEFTON* IS AN IMPORTANT CASE THAT PROTECTS INVESTORS' RIGHTS

As stated above in the Introduction, *United States v. Shefton*, 548 F.3d 1360 (11th Cir. 2008) is an important case because its holding and rationale permit victims of investment scams who have the ability to trace their assets to recoup *all* of their losses (as opposed to simply recovering a *pro rata* share) through the asset forfeiture process by asserting an interest in the

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11. *See also United States v. Kennedy*, 201 F.3d 1324, 1334 (11th Cir. 2000) *U.S. v. Speed Joyeros, S.A.*, 410 F. Supp. 2d 121,125 (E.D.N.Y. 2006) (state law determines what interest the claimant has; "[t]he effect of that property interest—i.e., whether it satisfies the requirements of the federal forfeiture statute—is necessarily a matter of federal law"); *BCCI Holdings (Final Order of Forfeiture and Disbursement)*, 69 F. Supp. 2d 36, 57 (D.D.C.1999) ("the nature of the claimant's interest is determined by reference to applicable state property law, but the determination of whether such an interest defeats the United States' claim to the property under section 1963(l) is a matter of federal law"); *U.S. v. Trafigura AG*, 2008 WL 4057907, at *3 n.4 (S.D. Tex. Aug. 26,2008) ("the law of the jurisdiction that created the property right determines the petitioner's interest, while the effect of that property interest, i.e. whether it satisfies the requirements of the forfeiture statute – is a matter of federal law").

forfeited property in the form of a constructive trust. To fully understand the significance of the case, a brief summary of its facts is necessary.

Shefton involved a mortgage fraud scheme by which the defendant obtained approximately $727,000 in loan proceeds from Long Beach Mortgage Company ("Long Beach") by presenting fraudulent documents. *See Shefton* at 1361. The defendant fraudulently diverted the loan proceeds to himself rather than paying off existing mortgages to obtain clear title of the purchased property, which would ensure Long Beach would be given its desired security position. *See Id.* at 1361-1362. Attorney's Title Insurance Fund, Inc. ("Fund") issued title insurance policies to Long Beach that insured Long Beach's security deeds securing the new loans. *See Id.* at 1361.

The defendant in *Shefton* was indicted and subsequently plead guilty to wire fraud. *See Id.* Thereafter, the Government sought and was granted a preliminary order of forfeiture by the district court. *See Id.* at 1362. The Fund in *Shefton*, pursuant to 21 U.S.C. §853(n)(6)(A), asserted a legal interest in the forfeited property that the defendant obtained from the Long Beach loan proceeds, which was traced to the funds in the defendant's bank accounts and to cash held by the defendant. *See Id.* at 1362. The Fund asserted that Long Beach was entitled to a constructive trust on the forfeited property. *See Id.* at 1361-1362.

The Government moved to dismiss the Fund's petition arguing that the Fund was one of many victims of the fraud and was merely an unsecured creditor lacking standing to contest the forfeiture. *Id.* at 1362. The Government also asserted that the Fund did not have a legal interest in the forfeited property, as required by §853(n)(6)(A). *See Id.* The district court in *Shefton* granted the Government's motion to dismiss. *See Id.* at 1363. On appeal, the Eleventh Circuit reversed the district court's dismissal of the Fund's petition. *See Id.* at 1366.

The *Shefton* case contains three important holdings. First, *Shefton* held that despite being an equitable remedy, a constructive trust is a cognizable "legal interest" pursuant to §853(n)(6)(A). *Id*. at 1366.[12]

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12. In holding that a constructive trust is a recognizable legal interest that could defeat a forfeiture order pursuant to §853(n)(6)(A), the *Shefton* Court agreed with the majority of other courts. See *United States v. $4,224, 958.57*, 392 F.3d 1002, 1004-05 (9th Cir. 2004) (stating that if the petitioners can prove the defendant defrauded them of funds he forfeited to the government, they are beneficiaries of a constructive trust and can challenge the forfeiture); *United States v. Schwimmer*, 968 F.2d 1570, 1574 (2d Cir. 1992)(holding that Congress's reference to “legal right, title, or interest” included interests arising in equity and that “a constructive trust warrants an amendment of an order of forfeiture ... if ... the property ordered forfeited is traceable to property held in constructive trust”); *United States v. Lavin*, 942 F.2d 177, 185-87 & n.10 (3d Cir. 1991)(concluding that Congress's reference in §853(n) to “legal” interests extended also to equitable ones, but determining that §853(n)(6)(A) did not apply under the facts of the case because the defendant's forfeiture-causing drug

Next, the *Shefton* Court expressly rejected the holding and rationale of the only case holding that a constructive trust cannot invalidate a forfeiture order, *United States v. BCCI Holdings, (Luxembourg), S.A.*, 46 F.3d 1185 (D.C. Cir. 1995). Prior to *Shefton*, the Government has relied on *BCCI* to successfully defeat constructive trust claims brought by victims pursuant §853(n)(6)(A). In its rejection of *BCCI*, the *Shefton* Court stated that *BCCI*'s holding was based on two incorrect premises. First, according to *Shefton*, *BCCI* incorrectly held that constructive trusts do not arise until announced by a court. *See Shefton* at 1366 (citing *United States v. 1419 Mount Alto Road*, 830 F.Supp.1476, 1481-82 (N.D.Ga. 1993)). Importantly, *Shefton* held that a constructive trust arises immediately upon transfer of the loan proceeds to the defendant. *See Id.* Second, *Shefton* stated that *BCCI* incorrectly held that petitioners must establish that their interest is superior to the Government's interest as opposed to the criminal defendant's. *See Id.* citing *BCCI,* 46 F.3d at 1191. As pointed out by the Court in *Shefton*, petitioners are required to show that their interest is superior to the *defendant's* interest in the forfeited property. *See* 21 U.S.C. §853(n)(6)(A) (stating that a criminal forfeiture order may be invalidated if "the petitioner has a legal right, title, or interest in the property ... [that] was superior to any right, title, or interest of the *defendant* at the time of the commission of the acts which gave rise to the forfeiture" (emphasis added)).

This holding is significant for a couple of reasons. As stated above, in order to prevail on asserting a claim pursuant to §853(n)(6)(A) a petitioner must establish: (1) a legal interest in the forfeited property, and (2) that the petitioner's interest was superior to the criminal defendant's interest in the forfeited property (3) at the time of the fraud. See *Shefton* at 1364. Under the rationale in *BCCI*, no petitioner would ever be able to prevail under a constructive trust theory because the constructive trust interest would not exist until announced by a court after the commission of the fraud. As a result, under *BCCI*, a petitioner's constructive trust claims would always fail elements (2) and (3) above. As a result, *Shefton* expressly rejected *BCCI*'s rationale.

Finally, *Shefton* held that the remission process, outlined in 21 U.S.C. §853(i), is *not* an adequate remedy at law that precludes an equitable remedy such as a constructive trust. *See Shefton* at 1365. Before courts will impose

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trafficking activity began three years before his constructive-trust-causing embezzlement); *United States v. Campos*, 859 F.2d 1233, 1238-39 (6th Cir. 1988) (stating in dicta that a constructive trust would constitute a superior interest under §853(n); *United States v. Marx*, 844 F.2d 1303, 1308 (7th Cir. 1988) (holding that a constructive trust interest in forfeited property can entitle a petitioner to relief from forfeiture).

an equitable remedy such as a constructive trust, most state laws require individuals to show that no other adequate remedy at law exists. The Government has long argued that the availability of the remissions process, as outlined in 21 U.S.C. §853(i), is an adequate remedy at law that always precludes the imposition of constructive trusts. The *Shefton* Court rejected the Government's argument, however, and held that remission through a non-judicial remedy such as petitioning the Attorney General was "certainly not as complete or effectual as the equitable relief of a constructive trust." *Id*. This is because the remission process gives the Government unfettered discretion to distribute seized assets " in the interest of justice." *Id.* at 1365.

As a result of the above, the petitioner in *Shefton* was entitled to the imposition of a constructive trust over the traceable seized assets and was entitled to recover all of its losses through the forfeiture process.

IV. CONCLUSION

In sum, given the recent influx in the number of collapsed Ponzi schemes, the amounts of money seized by the Government through the asset forfeiture process will certainly be on the rise. As a result, attorneys who represent defrauded investors should be aware that the asset forfeiture process permits fraud victims to challenge not only the Government's authority to seize property confiscated in criminal prosecutions but also the right to challenge the Government's discretion in how it distributes seized assets to the victims. Due to the inevitable shortage of solvent defendants that are either directly or tangentially involved in investment scams like Ponzi schemes, in many circumstances, the only viable option for recovering any assets is through the asset forfeiture process.

As stated above, a recent case out of the Eleventh Circuit, *United States v. Shefton*, 548 F.3d 1360 (11th Cir. 2008), helps investors' rights in forfeiture proceedings by holding that victims of investment scams who have the ability to trace their seized assets can recoup *all* of their losses (as opposed to simply recovering a *pro rata* share) by asserting a constructive trust. This new case hopefully will provide victims of investment scams and the attorneys who represent them new opportunities to recover losses from a new source, the Government.

"HELP, MY INVESTMENTS HAVE FALLEN AND THEY CAN'T GET UP": CONSIDERATIONS IN DECIDING WHICH CASES TO TAKE AND WHICH TO PASS

Richard A. Lewins[1]

This is the first installment of several articles aimed at helping newer PIABA members, as well as others new to the practice of securities arbitration, to successfully untie the Gordian knot otherwise known as FINRA arbitration. In this article, we will examine the threshold issue of what to look for and what to avoid when considering representation of a customer case in a FINRA arbitration.

The issues discussed in this article are by no means hard and fast rules, nor an exhaustive list. These are the author's opinions and musings based upon fourteen years in the securities industry in various capacities including registered representative, registered principal, regional sales manager, regional marketing manager, compliance officer and in-house counsel, as well as twelve years representing over 300 individuals in claims against the industry.

You must start your assessment the minute the phone rings with a potential client on the other end and hear their voice for the first time. How do they sound? How do they present themselves and their situation? Are they articulate or incoherent? Do they sound sincere? Why is any of this important? These issues will all be incredibly important if you take this case. The reason is arbitration is a court of equity, not a court of law. While we would like to think that if we present strong, cogent legal arguments supported by common law and/or statute, the law will carry the day. The reality is that arbitration is for the most part "arbitrary", and while there are as many theories as cases as to why arbitrators do what they do, the one constant is if the arbitrators do not like the client or feel sympathy for him/her on some level, the arbitrators are very unlikely to award the customer any money. While an attorney can prep or "woodshed" clients in anticipation of their testimony, when clients get on the witness stand, they will be who they are, and that is what the arbitrators will see and hear. Usually those first few interactions on the phone or in person will give an

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attorney a good feeling about whether or not this person is someone the arbitrators will want to award money.

With that backdrop, you should listen to the story with a purpose. Specifically, you should be listening for two things; a hook and a link. The hook is that bad act or acts that set the case apart from, "I lost money, so somebody must have done something wrong". Sometimes that is easy, or easier, as in the case of unauthorized trading, or a double digit cost to equity ratio in an account coded for 'conservative growth', or an account coded for 'income' with no income producing investments.

Other times, as in most cases where suitability is at issue, the hook may be more difficult. What you should always keep in mind, especially in times like these where the overall market has suffered a decline, is that you must be able to differentiate your client's situation from that of the arbitrators. What I mean is that most if not all of the arbitrators are sophisticated business people, who for the most part are investors themselves in the securities markets in one form or another. They are not dependent on their portfolio for income, unlike a great many of our clients. Their mind set is, "I lost money too, and no one is giving me my money back, so why should I award this person money that is unavailable to me as an investor?" You need to be able to articulate and demonstrate what circumstances make your client deserving. Are they elderly (which given the average age of the arbitrators I have seen recently may not differentiate them)? Are they retired and attempting to live modestly? Are they infirm? Are they under educated, both from a scholastic and investment standpoint? These are the types of people that are most unlike the arbitrators, who are often working, successful and educated both scholastically and financially.

In addition, it is important that you know the answers to four questions: (1) Who filled out the new account worksheet/forms? When or did the client receive a copy of it? Did the client open their confirmations and monthly statements when they received them? When the client first discovered something was wrong, what did he/she do?

New Account forms are important, as this is in many instances the one document that purports to lay out the client's investment objective(s) and risk tolerance. I cannot tell you how many times a client has told me that the broker took down the information over the phone, or a sales assistant took down the information, or that he just signed a blank form that the broker told him would be filled in later. This is the document that theoretically controls what investment recommendations are suitable for the broker to make, and the document that the broker's supervisor is to refer to when reviewing trades for suitability. As a result, your client's understanding of, participation in and review of the information found on these documents is crucial.

Questions concerning whether the client received and read the confirmations and monthly statements go to the "M" word, mitigation. While

in theory, and even according to some statutes, the client has no duty to mitigate damages and you will argue tirelessly and persuasively on that issue, the reality is most panel members will want to know and will most likely consider what your client did to protect himself or herself. Getting a banker's box of three years worth of unopened confirms and statements from your client is not a good thing. Arbitrators expect every Claimant on some level to take an interest in their life savings, which in many cases is what is at stake. The, "I trusted my broker" mantra is reasonable and acceptable…to a point. Forget unfair, forget unjustified; at some point in the broker/client relationship where the bad conduct takes place over a number of years, the arbitrators will hold your client accountable for what happened, and you need to consider this when deciding whether or not to accept a case and where to place your and your client's expectations for amount of recovery.

The second thing you should be listening for in your initial conversation with a potential client is the link. The link is being able to tie the conduct complained of to the client's damages. While in most cases that is not too difficult, i.e., unsuitable recommendation leads to client's losses, there are instances when making that connection is tricky. Cases that depend to a great degree on lack of supervision, and/or where there is an empty chair (selling away, broker theft, broker deceased), and violations of internal policies come to mind. Most arbitrators like nice, neat, simple cases. When it comes to liability, they want you to give them the financial equivalent of the robber standing over the body with the gun in their hand, the smoke still coming from the barrel and no one else in sight, not the financial equivalent of *Palsgraf v. Long Island Railroad*. Keep in mind when evaluating potential cases, the more removed the claim is from the person who did the client wrong, the more work you must do to convince the panel.

If during your initial meeting with the potential client you find both a hook and a link, you believe the client will be likeable and you can distinguish their losses from the arbitrators', ask the client to forward you supporting documentation. This should include the New Account Form, New Account Worksheets, copies of statements and confirmations (if they are unopened, leave them that way), any correspondence in any form, i.e. letters, emails, faxes, and any hypotheticals or illustrations they were shown. If they have taped any conversations, you will want to hear those as well.

What you are looking for are consistencies, or inconsistencies, between what your potential client has told you happened and what the documents say. One of the key items you will be looking for is withdrawals from the account. Sometimes potential clients remember how much they started with and how much they have now, and "forget" that they took out money. There may be justification for the withdrawals, but you need to be clear in analyzing the case how much the account lost versus the difference between starting and ending balances, which may include significant withdrawals.

If there is a significant amount of activity, in a number of securities, in several accounts that spans several years you may want to consider having a damage analysis done up front, instead of waiting until later in the process. This is especially important in cases where high turnover/high cost to equity ratio may come into play. In fact, many attorneys will not agree to take a case until a damage analysis has been run. You also want to get a sense for how the account(s) was allocated amongst different types of investments and asset classes. Many times the broker will tell the client that they are diversified because they own several different funds, but a closer analysis reveals that the holdings of the different funds are quite similar. The important thing is that you have a feel for the value of the case so you can discuss it with your potential client at the outset, and set the expectation level accordingly.

Having a realistic view of the case and expectations is crucial from the outset. Nothing is worse than battling the other side and your own client at the same time. Your potential client needs to know the strengths and weaknesses of their case; not only from a fact specific perspective, but relative to the forum, arbitration through FINRA. They need to know what is reasonable to expect, which may differ significantly from what is fair and just.

Case evaluation is critical; particularly when you are working on a contingency fee basis. Most attorneys cannot afford to tilt at too many windmills. Your best chance at getting good results is to start with good clients that have good facts. While that may sound obvious and trite, it is all the more important in a forum whose membership is made up of the people you are bringing claims against.

In the next article we will discuss the wonderful world of discovery, or as the defense firms like to refer to it, “button, button, who’s got the button.”

1. What documentation to send?
2. How to evaluate that documentation?
3. What specific things should the attorney look for?
4. How to get documents when Respondents are hiding the ball.

RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

Maria Brezden, et al. v. Associated Securities Corp., et al.;
FINRA Case No. 07-03054

This claim was brought by approximately 16 families on behalf of themselves, their family trusts, IRAs and profit sharing plans. Claimants were all clients, in one form or another, of Respondent, Jeffrey Allan Forrest. Forrest was a registered principal of respondent Associated Securities Corporation ("ASC") and a Certified Financial Planner and Registered Investment Advisor. Forrest operated his financial planning business through a separate entity called WealthWise, LLC. Forrest held various securities licenses including Series 6, 7, 8, 24, and 63, as well as appropriate licenses to sell insurance in California. He also held, and held himself out as holding the following financial planner designations: MSFS; MS; and CSPG.

The focus of Claimants' claims related to Respondents' investment in Apex Equity Options Fund L.P., which the Panel found to be "a managed fund that, by its terms and nature, was authorized to engage in highly speculative options trading" and that "the managers of Apex lost all of the money entrusted to them by all of the investors, including those Forrest recommended." In total, Claimants collectively lost more than $8 million in Apex. Meanwhile, Forrest collected undisclosed fees of more than $800,000 from 2005 to mid-2007.

Forrest sold Apex as a safe, secure, and liquid investment. During meetings that Forrest sponsored for his clients, Apex's managers made the same misrepresentations. However, the Panel found that this was "completely at odds with the rights conferred upon the fund manager and restrictions imposed upon Claimants by the Private Placement Memorandum." Forrest also recommended other non-traditional investments to his clients. Although Claimants requested relief related to these investments, the real focus of the case, as noted by the Panel, was the sale of Apex to Claimants. The Panel ultimately denied Claimants' claims as to the other investments.

Claimants requested the following relief: (1) General and Compensatory Damages In an amount according to proof, but not less than $9,613,467.00 minus any amounts withdrawn; (2) Lost opportunity costs In an amount according to proof; (3) Rescission of all unsuitable Investments Respondents recommended; (4) Punitive damages in an amount according to proof; (5) Punitive damages in an amount according to proof pursuant to California

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Civil Code Section 3345; (6) Interest at the legal rate on all sums recovered; (7) Costs, including attorneys' fees pursuant to California Welfare & Institutions Code Sections 15610.27, 15610.30, 15657 and 15657.1; and, (8) Other relief as deemed just and appropriate.

Claimants asserted the following causes of action: 1) Breach of Fiduciary Duty; 2) Constructive Fraud; 3) Fraud by Misrepresentation and Omission; 4) Elder Abuse; 5) Failure to Supervise and Control; and, 6) Violation of State and Federal Securities Laws; FINRA Rules of Fair Practice and NYSE rules.

Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

Award: The Arbitration Panel awarded Claimants $8,858,596 in damages. The Panel found that the Forrest was liable for fraud and that the broker-dealer (Associated Securities) was jointly and severally liable for Forrest's fraudulent conduct in connection with the sale of Apex to the Claimants. The Panel denied Respondent ASC's "selling away defense" after determining that Forrest was not an ostensible agent of Associated Securities, but rater, an actual agent "because of the measure of control ASC could exercise over Forrest's activities."

Claimants' Counsel: Philip M. Aidikoff, Esq. & Robert A. Uhl, Esq., Aidikoff, Uhl & Bakhtiari, Beverly Hills, California

Respondents' Counsel: David S. Markun, Esq., Markun Zusman & Compton LLP, Pacific Palisades, California (Respondent Associated Securities Corp.); Thomas Rittenburg, Esq., Lewis Brisbols Bisgaard & Smith LLP, Los Angeles, California (Respondent Jeffrey Alan Forrest); and, Jonathan Schwartz, Esq., Law Offices of Jonathan Schwartz, Marina Del Rey, California (Respondent Dane Christopher Streeter).

Claimants' Expert: Paul Meyer, Securities Litigation Consulting Group.

Respondents' Experts: Mary Cobb, John Maine, and Dave Paulakitis.

Arbitrators: Mark Priver (Chairperson), Robert Ruben (Public), and Kenneth Miller (Non-Public)

This case is significant for several reasons. First, the Arbitration Panel issued a reasoned award, which spanned approximately ten pages. Second, the Panel's compensatory damages award was equal to approximately 92% of the relief requested. However, the Panel's award was in excess of 100% of the damages related to the Apex fund, which was the only investment for which the Panel found Respondents liable. Third, the Panel distinguished *Asplund v. Selected Investments in Financial Equities, Inc.*, 86 Cal. App. 4th 26 (2001), which is a case that is frequently cited and criticized.

Edward L. King, Jr. and Roderick E. King v. Morgan Keegan & Company, Inc.;

FINRA Case No. 08-00336

This was a suitability case related to various closed-end and open-end mutual funds managed by Morgan Keegan. The specific funds at issue were the following: (1) Regions Morgan Keegan High Income Fund; (2) Regions Morgan Keegan Advantage Income Fund; (3) Regions Morgan Keegan Multi-Sector High Income Fund; (4) Regions Morgan Keegan Strategic Income Fund; (5) Regions Morgan Keegan Select Intermediate Bond Fund; and, (6) Regions Morgan Keegan Select High Income Fund.

Claimants asserted the following claims: (1) misrepresentations and omissions; (2) violation of the Alabama Securities Act; (3) violation of the Alabama Deceptive Trade Practices Act; (4) breach of fiduciary duty; (5) violation of NASD Conduct Rules; (6) negligence; (7) failure of supervision; (8) breach of contract; (9) fraudulent misrepresentation; and, (10) vicarious liability. Claimants requested the following relief: (1) compensatory damages in excess of $420,000; (2) punitive or treble damages; (3) pre-judgment interest; (4) attorneys' fees; (5) costs; and, (6) other further relief.

Respondent denied the allegations in the Statement of Claim and raised various affirmative defenses.

Award: The Panel awarded Claimants: (1) Compensatory Damages of $455,669.00; (2) Pre-judgment interest of 6% per annum; (3) $12,500 in costs (including $7,500 in expert witness fees); (4) $600 in filing fees; and (5) $151,738 in attorneys' fees.

Claimants' Counsel: Andrew Stoltmann, Esq., Stoltmann Law Offices, P.C., Chicago, Illinois

Respondent's Counsel: S. Lawrence Polk, Esq., Sutherland Asbill & Brennan, LLP, Atlanta, Georgia

Claimant's Expert: Rick Evans, Forensic Investments, LLC

Respondent's Expert: Michael Weiner, Bates Private Capital

Arbitrators: Lita S. Menkin, JD (Chairperson); James Edward Seale (Public); and M. Bruce Adelberg (Non-Public)

This case is significant because the Panel awarded more than 100% of the compensatory damages requested, plus more than $150,000 in attorneys fees, costs, and pre-judgment interest in a suitability case. The Panel specifically based its award of attorneys' fees on the Alabama Deceptive Trade Practices Act.

Diana Landau, as Trustee for the Laura E.A. Forrester Hearell Revocable Trust v. Morgan Keegan & Company, Inc.;
FINRA Case No. 08-01276

This was a suitability case brought by the trustee of a trust related to various Morgan Keegan funds. The specific funds at issue were the following: (1) Regions Morgan Keegan Advantage Income Fund; (2) Regions Morgan Keegan Multi-Sector High Income Fund; and (3) Regions Morgan Keegan Select Intermediate Bond Fund. Claimant made several investments in the funds in 2006 and early 2007 based upon information provided by Respondent. Claimant alleged that her loss was the result of Respondent's failure to disclose facts about the funds, that the funds' assets were invested in violation of restrictions on the amount of illiquid securities in which the funds were permitted to invest, that the funds' investments exceeded the 25% limit on investments in a single industry, and that the funds' portfolios were exposed to concentrations of credit risk because of heave investments in collateralized debt obligations.

Claimants asserted the following claims: (1) misrepresentations and omissions; (2) violation of the Missouri Securities Act; (3) violation of NASD Conduct Rules; (4) breach of fiduciary duty; (5) negligence; (6) failure to supervise; (7) breach of contract; (8) fraudulent misrepresentation; and, (9) vicarious liability. Claimant requested that the Panel award $89,653 in compensatory damages, plus other unspecified relief. At the close of the hearing, Claimant requested $173,043, inclusive of compensatory damages, punitive damages, interest, attorneys' fees, and costs.

Respondent denied the allegations in the Statement of Claim and raised various affirmative defenses.

Award: The Panel awarded Claimants: (1) Compensatory Damages of $51,304.00; (2) Pre-judgment interest of 8% per annum on the compensatory damages; (3) punitive damages of $50,000; (4) $8,000 in costs (including $7,500 in expert witness fees); and (5) attorneys' fees equal to one-third (1/3) of the sum of the compensatory damages, punitive damages, and interest awarded.

Claimants' Counsel: Andrew Stoltmann, Esq., Stoltmann Law Offices, P.C., Chicago, Illinois

Respondent’s Counsel: Terry R. Weiss, Esq., Greenberg Traurig, LLP, Atlanta, Georgia and Tucker H. Byrd, Esq., Greenberg Traurig, LLP, Orlando, Florida.

Claimant’s Expert: Rick Evans, Forensic Investments, LLC

Respondent’s Expert: Bruce Kramer

Arbitrators: Michael S. Hill (Chairperson); Bruce D. Horton (Public); and Kathryn Elizabeth Matlock (Non-Public).

This case is significant for several reasons: First, the Panel awarded $50,000 in punitive damages, pursuant to *Werremeyer v. K.C. Auto Salvage,*

Co., Inc., 134 S.W.3d 633, 635 (Mo. 2004). In *Werremeyer*, the Supreme Court of Missouri upheld an award of punitive damages in a fraud case related to the purchase of an automobile. Notably, the *Werremeyer* court also held that Plaintiffs were entitled to pre-judgment interest "on their entire judgment" (including punitive damages). *See* 134 S.W.3d at 637. However, the Panel specifically awarded pre-judgment interest only on Claimant's compensatory damages. In fact, in *Werremeyer*, the Missouri Supreme Court specifically overruled a prior decision by the Missouri Court of Appeals (*Hoskins v. Business Men's Assurance*, 116 S.W.3d 557 (Mo. Ct. App. 2003), in which the court overturned the trial court's award of pre-judgment interest on a punitive damages award.

The case is also significant because the Panel awarded Claimant costs (including expert witness fees) and attorneys' fees equal to one-third (1/3) of the sum of the compensatory damages, punitive damages, and interest awarded. The Panel based the attorneys' fees award on the Missouri Securities Act, which provides for "reasonable attorneys' fees determined by the court." Mo. Rev. Stat. 409.5-509(a)(1),(3) (2009).

***Philip Lee Willingham and Melinda H. Oates v. Morgan Keegan & Company, Inc.*;**

FINRA Case No. 08-00910

Claimant is a 55-year old retired cattle/timber farmer. On October 22, 2003, he invested approximately $72,750 into the RMK Select Intermediate Bond Fund. Dividends were reinvested in the fund. As of February 29, 2008, this position was valued at $20,935. Mr. Willingham lost $51,815 in the RMK Select Intermediate Bond Fund.

On March 9, 2006, Claimant invested $80,706 in the RMK Multi-Sector High Income Fund. Throughout the next several months, he reinvested $13,889 in dividends. On August 15, 2007, this position was sold for $36,529. As a result, Claimant lost $58,066 in the RMK Multi-Sector High Income Fund. Claimant's Morgan Keegan broker made each of the recommendations at issue.

In the Statement of Claim, Claimant requested: (1) actual damages in excess of $109,881.00; (2) well-managed damages had the account had been properly invested; (3) pre- and post-judgment interest at the legal rate; (4) costs of arbitration, including filing fees, expert witness fees, reasonable attorneys' fees, arbitrator fees and expenses; and, (5) punitive damages.

Claimants asserted the following claims: (1) violation of the "Know Your Customer Rule" as well as the duty to monitor and disclose material information; (2) misrepresentation and omission of material facts; (3) breach of fiduciary duty and constructive fraud; (4) breach of contract; (5) common

law fraud; (6) violation of NASD Conduct Rules; (7) negligence and breach of duty; (8) respondeat superior; and, 9) negligent supervision.

Respondents denied the allegations in the Statement of Claim and raised various affirmative defenses.

Award: The Panel awarded Claimants $187,215 in compensatory damages.

Claimant's Counsel: Mark E. Maddox, Esq. and Keith L. Griffin, Esq., Maddox Hargett & Caruso, P.C., Fishers, Indiana.

Respondent's Counsel: John N. Bolus, Esq. and Joshua D. Jones, Esq., Maynard Cooper & Gale, P.C., Birmingham, Alabama.

Claimant's Expert: Dr. Craig McCann, Securities Litigation Consulting Group

Respondent's Expert: Charlie Meyers

Arbitrators: Donald Milo Helton (Chairperson); Norman David Freeman (Public); and Coleman Robert Perry, Jr. (Non-Public).

This case is significant because the Arbitration Panel awarded Claimants $187,215, which represents approximately 170% of the actual damages claimed. In addition, the Chairperson had been on two previous arbitration panels that awarded $0 in damages to claimants in proceedings related to Morgan Keegan funds.

Shari Ackerman, et al. v. Morgan Keegan & Company, Inc.;
FINRA Case No. 08-01188

There were four Claimants in this case. Two of the Claimants (Ackerman and Bush) were very inexperienced with investments or finances of any kind. The other Claimants (Majeriks) had a higher net worth and had been investing, somewhat aggressively, for years. The case related to Claimants' investments in the Regions Morgan Keegan Select High Income Fund – C (RHICX). Claimant Ackerman alleged damages of $38,737 and Claimant Bush alleged damages of $37,958.

Claimants asserted the following claims: (1) breach of fiduciary duty; (2) breach of contract; (3) unsuitability; (4) failure to supervise; (5) violations of securities regulatory rules; (6) violations of the Alabama Securities Act; and (7) common law claims.

Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

Award: The Panel awarded Claimant Ackerman and Bush damages of $38,737 and $37,958, respectively. However, the Panel denied the claims of the other Claimants. In addition, the Panel awarded Claimants Ackerman and Bush post-judgment interest at a rate of 6%, plus $4,474.24 in costs, which represented 2/3 of the costs set forth in an affidavit by Claimants' counsel.

Claimants' Counsel: Debra Brewer Hayes, Esq. & Eric Osteen, Esq., The Hayes Law Firm, P.C., Houston, Texas.

Respondent's Counsel: Carl Burkhalter, Esq. & Andrea Morgan Greene, Esq., Maynard, Cooper & Gale, P.C., Birmingham, Alabama.

Claimant's Expert: Dr. Craig McCann, Securities Litigation Consulting Group

Respondent's Expert: Charlie Meyers

Arbitrators: J. Maxwell Williams (Chairperson); Earle Park Kelley (Public); and Richard David Schultz (Non-Public).

This case is significant because the Panel awarded Claimants 100% of their damages, plus post-judgment interest an costs. This was Claimants' counsel's first case against Morgan Keegan and was tried as a suitability case. Claimants were successful in limiting the testimony of Respondent's expert in that the Panel did not allow Mr. Meyers to testify regarding "tranches" or the "risk involved in the tranches."

Jo L. Wright v. Morgan Keegan & Company, Inc.;
FINRA Case No. 08-00647

Claimant is a secretary at a church and was a customer of Regions Bank in Indianapolis. She had saved a little more than Twenty Thousand Dollars ($20,000) held in a savings account and a Ten Thousand Dollar ($10,000) Certificate of Deposit purchased on May 1, 2006 at Regions Bank for a 13 month term with an annual percentage yield of 5.23%. Before the maturity of her CD, the bank advised Claimant to invest all of her savings and CD funds in the Morgan Keegan Select Intermediate Bond Fund. To facilitate this investment, she was sent to a Morgan Keegan broker (in the Regions branch).

The broker told Claimant to withdraw her money from the CD six months early and invest it along with her savings account money in the Intermediate Bond Fund. Her total bond fund purchase amounted to Twenty Thousand Eight Hundred Eighty-Nine Dollars Fifty-Six Cents ($20,889.56). She did not fill out a "New Account Form" at or near the time of the purchase and was not told of the fact that the Intermediate Bond Fund was heavily invested in volatile asset-backed securities. She was also not given a prospectus.

In June, 2007, the bond fund started to decline rapidly and from June to December, 2007 lost about 50% of its value. The value of her investment in the bond fund at the time it was sold on December 18, 2007 was $9,909.42. Despite her lack of investment experience and desire for safety and income, her savings were depleted by half in 367 days. Claimant requested compensatory damages of $10,980.14.

Claimant asserted the following claims: (1) breach of fiduciary duty; (2) negligence; (3) misrepresentations and omissions; (4) suitability; (5) fraud; (6) breach of contract; (7) negligent supervision; (8) respondeat superior; and, (9) control person liability under the Indiana Securities Act.

Respondent denied the allegations made in the Statement of Claim and asserted various affirmative defenses.

Award: The Panel awarded Claimant $6,000 in compensatory damages, plus $12,000 in attorneys' fees.

Claimant's Counsel: Mark E. Maddox, Esq., Maddox, Hargett & Caruso, PC, Fishers, Indiana.

Respondent's Counsel: Jason M. Hale, Esq., Bass, Berry & Sims, PLC, Nashville, Tennessee.

Arbitrator: Daniel P. Urban (Chairperson)

This case is significant because although the Arbitrator's damage award was equal to approximately 60% of compensatory damages claimed, the Arbitrator also awarded Claimant $12,000 in attorneys' fees, which was equal to 200% of the amount of compensatory damages awarded.

CASES & MATERIALS

Timothy A. Canning[1]

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

BEFORE THE ARBITRATION:

Compelling Arbitration: 3rd Party Beneficiaries & Customers

Interactive Brokers, LLC v. Duran
(N.D. Ill., 2/17/2009) 2009 WL 393827

A brokerage firm is not obligated to arbitrate claims asserted by customers of an investment advisor, where the investment advisor clients had no relationship with the brokerage firm, contractual or otherwise, despite allegations that the brokerage firm failed to detect, prevent or report the investment advisor's fraud.

Customers of an investment advisor (Enterprise) filed an FINRA arbitration claim against Enterprise and four brokerage firms with which Enterprise did business. The public customers alleged that they entrusted certain investment assets to Enterprise, which Enterprise then commingled with the assets of other customers and used to fund speculative margin trading at the brokerage firms, which was neither authorized by nor intended to benefit these particular public customers.

Interactive is a "discount" online brokerage firm that does not give trading advice or make recommendations and that does not manage or otherwise exercise discretion over customer accounts. Enterprise opened two trading accounts at Interactive, only one of which was used.

Interactive executed online trades selected by Enterprise and carried the resulting positions in an online account in the name of Enterprise. None of the public customers ever opened, maintained, controlled, or traded in an account at Interactive or entered into an account or customer agreement with Interactive.

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1. 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.

As to the brokerage firms, Enterprise's customers alleged that they were secondarily liable as aiders and abettors. Specifically, Enterprise's customers alleged that the brokerage firm Interactive was responsible for their investment losses because Interactive negligently or recklessly failed to detect, prevent, and report Enterprise's fraud. The customers also alleged that Interactive and the other brokers violated state Blue Sky laws.

After the arbitration claim was filed, Interactive filed suit seeking to enjoin the arbitration, on the grounds that Interactive was not obligated to arbitrate the claims asserted by Enterprise's customers. The Enterprise customers conceded that they did not have arbitration agreements with Interactive. Instead, the Enterprise customers contended that they were third party beneficiaries of an arbitration agreement between Enterprise and Interactive.

The court concluded that the Enterprise customers were not third party beneficiaries of the arbitration agreement between Enterprise and Interactive, and that the Enterprise customers were not customers of Interactive. The Arbitration Agreement between Enterprise and Interactive extended only to controversies or claims between Interactive and "the undersigned Customer" (i.e., Enterprise). The arbitration provision in the Customer Agreement was somewhat broader, extending the definition of "Customer" to include six categories of related persons: Customer's shareholders, officers, directors, employees, associates or agents. However, "customers of a customer," were not included under either agreement.

The court also pointed to the following facts: (1) the Enterprise customers entrusted their assets to Enterprise, not Interactive; (2) the customers had no contact with Interactive and did not allege that Enterprise or Interactive held Enterprise out as Interactive's agent; (3) the Enterprise customers did not even know of Interactive or that Enterprise maintained an account there; (4) Enterprise's accounts at Interactive were in Enterprise's name alone, not the name of any customer; (5) none of the Enterprise customers ever opened, maintained, controlled, or traded in an account at Interactive or entered into an account or customer agreement with Interactive.

Under these circumstances, treating Enterprise's customers as Interactive's customers would stretch the word "customer" beyond its meaning.

The court enjoined the Enterprise customers from proceeding with the arbitration proceedings initiated against Interactive in Dallas, Texas; Houston, Texas; and Madison, Wisconsin.

Challenging Arbitration Agreements: Substantive Unconscionability: Costs of Arbitration

***Kam-Ko Bio-Pharm Trading Co. Ltd-Australasia v. Mayne Pharma (USA*)**
(9th Cir. 3/11/2009) 560 F.3d 935

A commercial arbitration clause was not substantively unconscionable where the high cost of the arbitration was or could have been known by the party challenging the arbitration clause, and was within that party's control.

In this non-securities case, a party to an arbitration agreement – Kam-Ko -- contended that an arbitration clause should not be enforced because of the high cost of arbitration (which in this case was estimated to exceed $285,000).

Kam-Ko and Mayne had entered into a Royalty Agreement, which contained an arbitration clause. After a dispute arose as to how much was due under the Royalty Agreement, Kam-Ko filed a request for arbitration with the ICC.

The ICC first required Kam-Ko to pay a $2500 non-refundable deposit. The ICC then required a provisional advance from Kam-Ko of $45,000 with credit for the previously paid $2500. After some delay, Kam-Ko's principals personally loaned the company the money to pay the balance due. The ICC confirmed the parties' choices of one arbitrator each, appointed a third arbitrator to act as chairman of the tribunal, and set the advance costs at $220,000 to be split by Kam-Ko and Mayne, with credit to Kam-Ko for the amount it had previously paid.

Kam-Ko objected to the $220,000 amount as "confiscatory and punitive," and as "wholly unforeseeable to the parties." Mayne also objected to the amount, saying it "appears excessive and is unduly burdensome to both parties." Neither party submitted further payment to the ICC. Under ICC arbitration rules, for the arbitration to proceed, Kam-Ko, as the claimant, was required to pay the entire amount due, or some form of security in lieu of cash, if Mayne did not pay. After a number of extensions of payment deadlines, the ICC deemed the arbitration withdrawn. The ICC fixed the costs already incurred in the arbitration at $40,053, deducted that amount from Kam-Ko's payments of $45,000, and refunded $4,947 to Kam-Ko.

Kam-Ko challenged the arbitration clause as being substantively unconscionable. Under Washington state law, substantive unconscionability may exist where a clause or term in the contract is alleged to be one-sided or overly harsh. Shocking to the conscience, monstrously harsh, and exceedingly calloused are terms sometimes used to define substantive unconscionability. When the courts use the expression 'unconscionable' in classifying a fee, they mean an amount under the circumstances which neither party can sensibly argue to be otherwise. Under Washington law,

substantive unconscionability alone can support a finding of unconscionability. Additionally, in a commercial context, the relevant clause must be substantively unconscionable at the time of contracting.

Although Kam-Ko cited cases which hold that high arbitration costs can effectively deny a plaintiff access to a forum to obtain justice and thereby render an arbitration clause unconscionable, the court distinguished those cases on the grounds that they all involved contracts of adhesion in either a consumer or employment context. In this matter, the contract was executed in a commercial context.

Further, in a purely commercial transaction, the fact that an unfortunate result occurs after the contracting process does not render an otherwise standard limitation of remedies clause substantively unconscionable. Thus, the fact that Kam-Ko is now a mere shell company that distributed many millions of dollars directly to its stakeholders and hence is "unable to pay" the arbitration fees many years after it proposed and agreed to the arbitration clause, is insufficient to set aside the arbitration clause.

The court concluded that the arbitration agreement before it was not substantively unconscionable, pointing to a number of factors: (1) Kam-Ko itself proposed the arbitration agreement in the original Royalty Agreement; (2) Kam-Ko effectively controlled the amount of arbitration expenses and fees it would incur, which were based on the sum it chose to claim to be in dispute and the number of arbitrators it requested when it filed the arbitration claim; (3) the arbitration forum rules Kam-Ko had in its possession clearly indicated that arbitration expenses and fees might be as high as $286,088.20; (4) Kam-Ko failed to provide any evidence regarding what other arbitration fora would charge to conduct the arbitration it sought or the administrative expenses that the ICC would actually incur in arbitrating the matter; and (5) it is well known that in international commercial arbitrations, the fees of the arbitral tribunal can be considerable.

Challenging Arbitration Agreements: Costs of Arbitration Violative of Public Policy

Brady v. Williams Capital Group, L.P.
(N.Y.A.D. 4/30/2009) --- N.Y.S.2d ---, 2009 WL 1151322

A clause in an arbitration provision in an employment agreement which required an employee to pay one-half the arbitrator's cost was invalidated as violative of public policy, where it would effectively preclude the employee from vindicating her rights in the arbitration forum.

This dispute arose from an employment discrimination arbitration commenced by Lorraine C. Brady (Brady) against her former employer, The

Williams Capital Group, L.P. (Williams) before the American Association Arbitration (AAA). In accordance with its own "employer pays" rule, which requires the employer to pay the arbitrator's compensation, the AAA sent the employer a bill for $42,300, which represented the entire advance payment for the arbitrator's compensation. The employer refused to pay the entire advance payment, and demanded that the employee (Brady) pay half, in accordance with the parties' arbitration agreement in the employee manual. Brady refused to make any payment.

The AAA cancelled the proceedings. The employee then sought a court order compelling the employer to arbitrate in compliance with the AAA rules. (The employee had also filed suit against the AAA, seeking to compel it to administer the arbitration, which a lower court had summarily rejected on the grounds that the AAA was immune from suit [summarized in PIABA Bar Journal, Vol 14, No. 3, Fall 2007, p. 66].)

The court first held that the AAA's "employer pays" rule did not supersede the "fee-splitting" provision of the parties' arbitration agreement with regard to the arbitrator's compensation. The arbitration agreement took precedence over the AAA rules since the parties explicitly agreed to be bound by the provisions of the arbitration agreement where there was a conflict between the agreement and the AAA rules, including the arbitrator's compensation. The parties were free to have the AAA rules supersede the arbitration agreement where there was a conflict between them, but decided to do otherwise.

However, the court went on to hold that the fee-splitting arbitration provision should be invalidated as violative of public policy in this instance.

The US Supreme Court has made clear that arbitration agreements are only enforceable "so long as the prospective litigant effectively may vindicate [his or her] statutory cause of action in the arbitral forum." The court here adopted the "case-by-case" approach to arbitrator compensation, which primarily involves comparing the financial means of the aggrieved employee to the costs associated with arbitrating the dispute, while relying on the fact that in the judicial forum a litigant pays only a minimal fee and does not have to pay other services pertaining to the adjudication of the matter.

The court concluded that the record was abundantly clear that the arbitration clause requiring the employee to share half the cost of the arbitrator's compensation would require her to bear a significant arbitration cost-$21,150. While this amount alone is substantial, it did not include other arbitration fees and costs that would have to be borne out equally by the parties.

Moreover, the employee provided sufficient information about her precarious financial situation. At the time she sought a court order to compel arbitration, Brady had not been gainfully employed for the 18-month period

following her termination by Williams. A $21,150 cost may not seem onerous in light of Brady's earning history, ranging from $100,000 to $400,000 during her five-year period of employment with Williams. Yet, Brady was terminated and no longer commanded such a yearly salary. In fact, it is undisputed that, at the time of the arbitration, she was still unemployed.

Thus, the employee adequately carried her burden of demonstrating that she was not in a position to afford the cost associated with the arbitration, and was therefore effectively precluded from vindicating her rights in the AAA forum.

As to litigation costs, the court rejected the dissent's position that the employee's litigation cost would be much higher than one-half of the arbitrator's fees. According to the court, it is common knowledge that an employee filing an employment discrimination claim in the federal courts must pay a minimal filing fee, generally only a few hundred dollars. The costs of maintaining and operating the court system, including the salaries of judges and other court employees, are borne by the taxpayers, not the litigants themselves. While the employee filing in court is likely to incur the costs of legal representation, her attorneys may be likely to take the case on a contingency fee basis. Also, if the employee's suit is successful, the remedies available under federal anti-discrimination legislation include the award of attorney's fees. Thus, in general, it cannot be disputed that the out-of-pocket expenses for an employee filing a legal suit are minimal.

Instead of voiding the entire arbitration agreement, however, the court concluded that the appropriate remedy was to sever the improper provision of the arbitration agreement, rather than void the entire agreement and force Brady to pursue her claims in state or federal court.

Compelling Arbitration: Deference to State Court Judgment

Oakwood Capital Management, LLC v. Donovan
(N.D. Miss., 3/25/2009) 2009 WL 804690

After a state court enjoined an arbitration proceeding, a federal district court could not then compel arbitration, under the Rooker-Feldman doctrine.

In this matter, clients of a registered investment advisor (RIA) filed an arbitration claim with the AAA in California, against the RIA and a Mississippi bank. The Bank was named in the arbitration because it was a trustee of some of the trusts whose assets were managed by the RIA. The trusts were for the benefit of minors and grandchildren of the clients. The Bank, however, did not have any arbitration agreements with the RIA (or the clients), and therefore sought to enjoin the AAA proceeding by filing an

action in Mississippi state court. The RIA was named in the state court proceeding, but did not participate in it. The Mississippi state court ruled that it had exclusive jurisdiction over certain trusts and minor's claims, that the Bank was not bound to arbitrate, and permanently enjoined the arbitration proceeding.

After the state court enjoined the arbitration, the RIA filed a declaratory relief action in Mississippi federal court, seeking to compel the clients to submit to AAA arbitration in California and stay the Mississippi state court action. The federal court declined to do so, on grounds of the Rooker-Feldman doctrine.

The Rooker-Feldman doctrine prevents lower federal courts from directly reviewing state court decisions unless Congress has enacted legislation that specifically authorizes the federal courts to do so. Rooker-Feldman applies in cases brought by "state-court losers" complaining of injuries caused by a state-court judgment rendered before the district court proceedings were commenced and which invites district court rejection of the state court judgment.

The court concluded that the RIA qualified as a "state court loser" under Rooker-Feldman doctrine. The state court's permanent injunction was entered against "all defendants" including the RIA. The state court judge estopped the entire arbitration proceeding from going forward, not just arbitration claims involving the Bank. The RIA made it clear that it would prefer to arbitrate, by its stance in state court, by its filings in federal court, and by its inclusion of an arbitration clause in its contracts. Hence, the RIA was a "state court loser."

Further, the injury for which the RIA sought redress in federal court was caused by the state court judgment. The RIA voluntarily waived its right to enter an appearance in the state court action, and did not make any argument against the injunction at the hearing in state court. Unlike the doctrine of collateral estoppel, the fact that the RIA did not actively participate and assert its claims at the permanent injunction hearing in the state court did not prevent Rooker-Feldman from barring the federal court litigation. Finally, the state court expressly retained "exclusive jurisdiction" over all of the minors' claims and the grandchildren's trusts.

In order to grant the RIA the relief it sought, the federal court would necessarily have to determine that the state court's judgment was erroneously entered or would have to take action that would render the state court's judgment ineffectual. The court thus found that the RIA's federal action seeking to compel arbitration was "undoubtedly inextricably intertwined" with the state court's judgment enjoining the arbitration.

As a result, the federal court dismissed the RIA's case under the Rooker-Feldman doctrine.

Arbitration Agreements In Void Contracts

WS Liquidation, Inc. v. Etkin & Co., Inc.
(W.D. Pa. 1/22/2009) 2009 WL 161662

Whether a contract was void "ab initio" was a question encompassed within the arbitration clause contained in the contract.

Here, a business attempted to avoid arbitration of a claim brought by a "finder" of investors for the company. The finder claimed that the company breached its contract to compensate him for his services. That contract contained an arbitration clause, and the "finder" had commenced an arbitration at the AAA.

The company argued that the "finder" was in fact acting as a securities broker. Because the "finder" was not licensed as such, the contract was void "ab initio" and the arbitration clause unenforceable.

The court first held that any arguments regarding voidness of the contract are within the scope of the arbitrators' authority. The company, however, attempted to cast its position as a challenge to the arbitration clause of the contract. The company contended that the arbitration clause was inconsistent with the arbitration process envisioned by the Securities Exchange Act, with which the "finder" would have had to comply had he been properly licensed.

The court rejected those contentions. The company's complaint in court related to the entire contract and not to its specific arbitration provision independently, by seeking "a judgment declaring the May 17, 2005 Letter Agreement null, void and unenforceable." Further, there was no causal connection between the alleged misrepresentation regarding the finder's failure to register with the SEC and the arbitration clause.

The court recognized that the arbitrators could find the entire contract was void *ab initio*, which would mean that the court enforced an arbitration clause in a void contract. While this result may seem paradoxical, it is exactly the result contemplated by the Supreme Court in *Buckeye Check Cashing v. Cardegna* (2006) 546 U.S. 440, 126 S.Ct. 1204.

Arbitration Required Under FINRA Rules: Who Is A Member

Shacknai v. Mathieson
(D. Ariz. 2/25/2009) 2009 WL 482561

In order to compel a customer to arbitrate a dispute under FINRA rules, a brokerage firm is obligated to show that it is a member of FINRA in good standing.

This dispute arose out of losses incurred through an insurance premium financing arrangement. In early 2004, the 2004 Trust purchased two Pacific Life Insurance Company life insurance policies upon the advice of Mathieson, a Merrill Lynch "insurance and wealth planning specialist." The 2004 Trust used a loan to purchase the policies, and pledged a MLPFS account held by the Shacknai 1999 Trust ("1999 Trust") as collateral for the loan. The account had been opened by Shacknai on April 21, 2000 and transferred to the 1999 Trust in August, 2001. To open the account, Shacknai entered into a client relationship agreement with MLPFS in which he agreed to arbitrate.

Plaintiffs first argued that the 2004 Trust cannot be compelled to arbitrate because it did not sign an arbitration agreement with defendants. Although not a signatory, the firm argued that the 2004 Trust is estopped from avoiding arbitration because it exploited and directly benefitted from the account agreements. However, the court ruled that the defendants did not show that the 2004 Trust knowingly exploited or sought to enforce any agreement containing an arbitration clause. Moreover, Merrill Lynch had the option to require the 2004 Trust to sign a client relationship agreement prior to the sale of the insurance policies but failed to do so. The 2004 Trust was not bound by the agreements signed by Shacknai and the 1999 Trust.

The remaining plaintiffs who had signed an arbitration agreement challenged the defendant firms' right to bring arbitration in the selected forum. The arbitration agreement stated that any arbitration must be conducted by FINRA and in accordance with its rules. Plaintiffs contended that the "insurance exception" in the FINRA code of arbitration procedure exempts this dispute from arbitration since it was a "dispute involving the insurance business activities of a member that is also an insurance company." FINRA Code of Arbitration Procedure, § 12200.

The court ruled that this exception was inapplicable to the dispute. According to this court, the "insurance exception" only applies where a dispute is insurance-only or intrinsically insurance. Here, plaintiffs' claims were based on tort and contract principles and did not require any special knowledge of insurance law to be decided.

However, the FINRA arbitration rules also require that a dispute be between "a customer and a member or associated person of a member" and prohibits arbitration compelled by "[a] member whose membership is terminated, cancelled, suspended, or revoked." FINRA Code of Arbitration Procedure, § 12200, 12202. Defendants did not address whether each party moving to compel arbitration is either a FINRA member or associated person. Without this information, the court could not determine if these defendants had a right to compel plaintiffs to arbitrate at FINRA.

Accordingly, the court denied defendants' motion to dismiss and compel arbitration.

DURING THE ARBITRATION

Prior Court Action and Current Arbitration; Scope of Release

Sweeney v. Sweeney
(N.J. Super. A.D. 3/12/2009) 405 N.J.Super. 586, 966 A.2d 54

A general release executed in a divorce action between a stockbroker and his spouse did not release claims the spouse had against her ex-husband's brokerage firm arising out of her ex-husband's mismanagement of her investment accounts.

Appellant, RBC Dain Rauscher, Inc. (RBC), appealed from two orders which (a) denied with prejudice RBC's motion to intervene and stay arbitration, (b) granted the cross-motion of plaintiff to compel arbitration, and (c) referred the matter for FINRA arbitration.

In this matter, a stockbroker's spouse had turned money over to her stockbroker husband to invest and manage. The stockbroker husband was employed by RBC Dain Rauscher. Spouse and stockbroker later divorced, and entered into a Property Settlement Agreement ("PSA") that contained a mutual release clause. That clause stated: "the parties give up any and all claims that each might have against the other by reason of any matter." The PSA also recited that the stockbroker and his spouse agreed not to "annoy, molest or otherwise interfere with the other party, nor with the peace and comfort of the other, nor with the person or business of the other." The PSA did not did not mention the brokerage accounts.

Almost two years after the divorce, the spouse filed a Statement of Claim with FINRA against RBC, alleging, among other things, mismanagement of her accounts, breach of contract, breach of fiduciary duty and breach of the duty to supervise. In response, RBC appeared in the state court divorce action, filed a post-judgment motion to intervene in the divorce action and moved to stay the FINRA arbitration. The family court denied RBC's motion to intervene, denied RBC's motion to stay the FINRA arbitration, and granted the spouse's motion to compel arbitration.

On appeal, RBC contended that as a result of the spouse's PSA and Judgment of Divorce, her arbitration claims were barred by res judicata and by the "entire controversy" doctrine (which requires parties to join "virtually all causes, claims, and defenses relating to a controversy between the parties engaged in litigation.") RBC also claimed that it is a third-party beneficiary of the Judgment of Divorce and that, under the doctrine of respondeat superior, the spouse's release of her stockbroker husband released RBC as well.

Turning first to the "entire controversy" doctrine, that doctrine required the court to consider fairness to the parties, as the polestar of the application of the rule is judicial fairness. In considering fairness, the court noted that RBC was not a party to the divorce proceeding and, so far as the court could discern, no issues concerning the management of the brokerage accounts were raised in the divorce action. Hence, RBC was not prejudiced by any decision or disposition of any issues in the parties' divorce proceeding.

More importantly, the spouse's claims against RBC arose, not out of her marital relationship with the stockbroker, but rather out of her own direct contractual relationship with RBC. There is no indication that RBC's handling of these assets was an issue that was disputed or raised by either party in the action for divorce, and RBC offered no equitable or legal reason to bar the spouse for not having brought her securities claims against RBC in her divorce action against her ex-husband.

Turing to the scope of the release in the PSA, the court again found that there was no evidence that the spouse raised the alleged financial misconduct during the divorce proceedings or that the court made any findings regarding the diminution or dissipation of the couple's assets. Nor was there any indication in the record that any alleged financial losses were considered in allocating property for equitable distribution. In fact, the spouse's account had been derived from pre-marital assets and had been maintained separately. Consequently, that account was not subject to equitable distribution in the divorce proceeding.

Further, the PSA release related only to marital and testamentary rights and other rights or claims personal to the divorcing parties. The release did not purport to benefit others who may somehow stand in privity or succession to these parties. Plainly, according to the court, the release did not purport to release persons whose obligations arose from separate relations, contractual or otherwise.

RBC further contended that arbitration between the spouse and RBC was barred by collateral estoppel. However, RBC failed to establish that the stockbroker's alleged mishandling or misconduct in relation to any of the brokerage accounts was raised, stipulated or adjudicated in the divorce proceeding. There was no evidence that the issues regarding the stock account had been litigated in any manner in a prior action. Thus, collateral estoppel did not apply.

The lower court's orders were affirmed.

Parallel Arbitration and Criminal Proceedings: Stay

U.S. v. Financial Industry Regulatory Authority
(E.D.N.Y. 4/09/2009) --- F.Supp.2d ----, 2009 WL 947064

Absent evidence of prejudice to a criminal prosecution, a FINRA arbitration proceeding will not be enjoined pending resolution of a related criminal case.

In this matter, the U.S. Attorney in New York sought to enjoin a FINRA arbitration proceeding against Bear Stearns & Co., pending completion of a related criminal case.

The arbitration was between RaceTrac Petroleum, Inc. ("RaceTrac"), and Bear Stearns & Co., Inc., Bear Stearns Securities Corp. and Bear Stearns Asset Management, Inc. (collectively, "Bear Stearns"). Although the defendants in the criminal case were not parties to the arbitration, both proceedings involve the same subject matter -- namely, whether the criminal defendants' conduct in connection with the hedge funds they managed amounted to securities fraud. As a result, many of the witnesses to be called at the arbitration are potential witnesses in the criminal case.

Determining whether to enjoin a civil proceeding in the face of a related criminal case is essentially a question of balancing the private parties' interest in a prompt resolution of the civil matter with the government's interest in preserving the integrity of the criminal proceeding.

The U.S. Attorney's first concern was to prevent the criminal defendants from having an opportunity to build a defense tailored to the Government's case. However, the court observed that the criminal defendants had a right to obtain evidence about the government's case directly from the government.

The U.S. Attorney then argued that early disclosure of the identity of the government's witnesses would increase the risk of "suborning perjury" by way of witness intimidation. The court ruled that whatever the risk is that those witnesses will be intimidated or asked to testify falsely, allowing the arbitration to go forward will not increase it.

The court also found that there was no risk of unfair surprise flowing from the privilege against self-incrimination if the arbitration went forward before the criminal trial. The testimony that would be adduced at the arbitration is equally available to both the government and the defendants.

In sum, the only "prejudice" to the U.S. Attorney that the court could discern was that allowing the arbitration to go forward would result in the criminal defendants having more information than they would otherwise be entitled to at this stage under the Federal Rules of Criminal Procedure. This loss of the government's usual tactical advantage was insufficient to justify enjoining the arbitration.

Arbitrators Authority To Sanction Attorneys

Bak v. MCL Financial Group, Inc.
(Cal. App. 1/20/2009) 170 Cal.App.4th 1118

FINRA arbitrators have jurisdiction over attorneys who represent parties in arbitration, sufficient to impose monetary sanctions for the attorney's conduct in the arbitration.

An attorney for a respondent brokerage firm in a FINRA arbitration appealed from a state trial court judgment confirming an award issued by an arbitration panel, which had ordered him to pay $7,500 in sanctions as a result of his conduct during a prehearing dispute over the production of documents. The attorney contended that the arbitrators exceeded their powers by doing so and the trial court erred by failing to strike the sanctions order when confirming the arbitration award. The court affirmed the trial court's judgment.

The arbitration arose from a dispute over commissions. The arbitration claimants (the employees) left the arbitration respondent brokerage firm's employ and sued to recover the amount they believed was due under their respective contracts with the firm. The brokerage firm filed a cross-complaint against the former employees as well as obtained a preliminary injunction that prohibited the employees from soliciting the firm's current and prospective clients.

During a prehearing document production and information exchange, the employees delivered documents to the brokerage firm. After doing so, the employees discovered the material included 112 pages of documents they claimed were subject to the attorney-client privilege. The employees' counsel sent the firm's attorney a letter informing them of the privileged documents, claiming they had been inadvertently produced, and demanding that the firm return them immediately.

The brokerage firm's attorney returned the privileged material. Before doing so, the firm's attorney made a cursory review of the documents, copied them, and then placed the copies in a sealed envelope, which he sent to a staff attorney at FINRA who was handling the case. The attorney for the firm also created a spreadsheet outlining key information culled from the limited information reviewed.

Upon learning of the attorney's actions, the employees filed an emergency motion with the arbitrators for an order prohibiting the brokerage firm from using the privileged documents and seeking destruction of the documents unilaterally sent to FINRA. The firm's attorney filed a response, acknowledging that he had agreed not to use the privileged documents. However, he claimed that copying the documents was appropriate.

After a hearing, the panel issued an order that directed the firm's attorney to pay the employees' counsel the sum of $7,500 as a sanction for copying the privileged documents, and required him to execute an affidavit that neither he nor anyone in his office retained copies of the privileged material, that they did not give copies to anyone else, and that no other copies of the documents exist. The attorney submitted the requested affidavit. He also twice unsuccessfully sought reconsideration of the sanctions award.

The attorney contended that the trial court should have vacated the sanction award, because he merely appeared as an attorney for one of the parties to the arbitration, the panel lacked the authority to sanction him. The attorney further contended that the sanctions were invalid because the arbitration panel failed to comply with the requirements of California's Code of Civil Procedure sections governing sanctions in state court litigation.

The court rejected the attorney's contentions. After distinguishing prior case authority holding that an outside trial attorney is an independent contractor to a corporation, the court concluded that the attorney was acting as an agent for his client. FINRA's arbitration rules provide "parties shall have the right to representation by counsel at any stage of the proceedings." (Code of Arbitration Procedure, Rule 10316.) The attorney admitted that he appeared in the arbitration as counsel for the brokerage firm which was bound by the arbitration agreement.

The law of principal and agent is generally applicable to the relation of attorney and client. By voluntarily appearing for defendants in the arbitration proceedings, which included conducting prehearing discovery, and in responding to plaintiffs' claim some of the documents they produced were privileged material, the attorney subjected himself to the jurisdiction of the arbitration panel and was subject to its rulings.

Further, the panel did not state it was relying on California's Code of Civil Procedure as a source for its authority to sanction the attorney. Nothing in the FINRA Code of Arbitration Rules required the arbitrators to decide issues in accordance with California law. The parties' registered representative agreements, which contained the arbitration clause, declared the contract was to be governed by Colorado law. Under these circumstances, for the trial court to vacate the sanctions order would have amounted to "a classic case of the trial court declining to confirm an arbitration award because it disagree[d] with the merits of the decision."

The court affirmed the trial court's confirmation of the arbitrators' sanction award against the attorney for the brokerage firm.

AFTER THE ARBITRATION

Settlement Agreements Enforceable

Kowalchuk v. Stroup
(N.Y.A.D. 2/10/2009) 873 N.Y.S.2d 43

Objective evidence of an intent to be bound by a settlement agreement and assent to the terms of the settlement is sufficient to create an enforceable settlement agreement, even where the parties had not yet signed a formal settlement agreement, where there was no evidence that the settlement was contingent upon a formal, signed agreement.

In this matter, an elderly widow and her son brought an NASD arbitration claim against a stockbroker, asserting that the broker had fraudulently or negligently handled their accounts, and seeking judgment for losses of $832,000. After the arbitration hearing was completed, but before a decision was rendered, the parties negotiated a settlement, in the amount of $285,000.

On February 6, Plaintiffs' counsel sent defendant's counsel a draft settlement agreement. Defendant's counsel responded on February 12 with his own draft. On February 14, defendant's counsel advised plaintiff's counsel that his client had executed the settlement agreement.

On February 15, the NASD sent the arbitration award to the parties, via regular mail. The award was for approximately $89,000, far less than the settlement amount of $285,000.

On February 16 – apparently before either side had received the award -- plaintiffs' counsel emailed defendant's counsel: "Please fax your client's executed agreement to me ... and notify the NASD. I will forward my clients' executed copies as soon as they are received."
That same day, defendant's counsel faxed plaintiff's counsel a "signed and approved settlement agreement," and stated that he would be forwarding to plaintiff's counsel and to the NASD a "confirmation of settlement." He asked that plaintiffs' counsel send him "your signed counterpart."

Also on February 16, defendant's counsel faxed the NASD advising that the arbitration "has been settled," asking that the arbitrators be so advised so that no award would be entered.

On February 20, defendant's counsel, having now received a copy of the award, advised plaintiffs' counsel that defendant had instructed him to "withdraw the offer of settlement," and advised the NASD that defendant intended to honor the award and had withdrawn the "offer of settlement" because it "did not receive the settlement and release documents executed by [plaintiffs] accepting the settlement."

On February 21, by fax and overnight mail, plaintiffs' counsel sent defendant's counsel a copy of the settlement agreement signed by plaintiffs. The cover letter acknowledged having been advised that defendant did not intend to honor the settlement agreement, and asserted that defendant had clearly approved its terms, and reserved plaintiffs' rights to "enforce the agreement as written."

In response to plaintiffs' attempt to enforce the settlement agreement, defendants argued that plaintiff's settlement offer had never been accepted by defendant, and that defendant made a timely and effective revocation of his offer to settle.

The court rejected both arguments. The February 6 e-mail sent by plaintiffs' counsel establishes that it was the defendant who made an offer, including all the essential material terms of that offer, and that plaintiffs accepted that offer. If any confirmation were needed that plaintiffs' counsel had accurately framed and characterized defendant's offer, the subsequent e-mails satisfied any such concerns.

Inasmuch as there was nothing unclear, ambiguous, or equivocal about plaintiffs' February 6 e-mail responding to defendant's offer, it constituted an effective acceptance.

Defendant then contended that the offer was revoked before it was accepted, relying on the fact that plaintiffs had not yet signed the formal writing by the time they heard of the NASD award, after which defendant quickly communicated an intent to revoke his offer.

In order to treat the contract formation process employed here as ineffective to bind him, as well as to contend that his offer was revoked prior to any proper acceptance, defendant relies on the rule that if the parties contemplate a reduction to writing of their agreement before it can be considered complete, there is no contract until the writing is signed. Defendant contends that because the formal writing prepared for both parties' signature contained language making reference to it being "complete and binding" upon signature of all the parties, that writing indicates the parties' intent not to be bound until the point that all parties have signed the document.

This rule has been explained as distinguishing between a "preliminary agreement contingent on and not intended to be binding absent formal documentation," which is not enforceable, and a "binding agreement that is nevertheless to be further documented," which is enforceable with or without the formal documentation.

Here, none of defendant's correspondence indicated an intent not to be bound until an agreement was executed by both parties. Indeed, defendant's counsel affirmatively notified the NASD that a settlement was reached, without any assurances that plaintiffs had executed the agreement; his letter

to the NASD stated "Please be advised the above captioned arbitration has been settled."

Defendant's offer was accepted prior to the purported revocation, so as to create a binding agreement between the parties. This in turn provided for sufficient consideration for the agreement to be enforced; as a bilateral contract such as this one, in which promises are exchanged, consideration consists of the acts mutually promised. Plaintiffs' agreement to withdraw the claim they made to the NASD, and defendant's agreement to pay the money, constituted fair consideration.

Finally, even if the e-mails had failed to evidence the existence of a contract, the formal written document signed just by defendant would have sufficed to establish the existence of the parties' agreement, since an unsigned contract may be enforceable, provided there is objective evidence establishing that the parties intended to be bound.

CHALLENGING/CONFIRMING ARBITRATION AWARDS

Vacating the Award: Failing to Follow Arbitration Rules

Raitport v. Salomon Smith Barney, Inc.
(N.Y.A.D. 12/23/2008) 57 A.D.3d 904, 870 N.Y.S.2d 414

FINRA's failure to adhere to its own Code of Arbitration Procedure when it removed an arbitrator does not provide a basis for vacating an award, under New York arbitration law.

In May 2003, the petitioners initiated an arbitration claim before the NASD, against the respondents, Salomon Smith Barney, Inc, and CIBC World Markets Corp., a/k/a CIBC Oppenheimer & Co., Inc. The petitioners alleged that the respondents' brokers failed to protect the value of their investments, which the petitioners had held in nondiscretionary brokerage accounts.

Just before the actual hearings began, at the request of the brokerage firm, and over the petitioners' objection, the NASD Director of Arbitration removed one of the arbitrators from the panel assigned to hear the petitioners' claims. Another panel member then recused himself. Two new members were appointed, and the arbitration proceeded before the reconstituted panel.

At the conclusion of the arbitration, the arbitrators denied the petitioners' claims in their entirety. The petitioners then sought to vacate the arbitration award, contending that the NASD's removal of the arbitrator had violated NASD Rules 10308 and 10312 and impaired the integrity of the arbitration process.

The court rejected petitioners' arguments. Even if it accepted the petitioners' contention that the NASD Director of Arbitration removed one of the arbitrators in contravention of NASD Rules 10308 and 10312, a mere failure to follow contractual procedures does not constitute a ground for the vacatur or modification of an award under New York law.

Further, the court held that the petitioners waived their objection that the reconstituted panel was unqualified or biased against them by not objecting when they learned of the arbitrators' alleged lack of qualification or bias.

Collecting the Award: Dischargeable in Bankruptcy

Sherman v. Potapov
(D.Mass. 3/30/2009) 403 B.R. 151, 2009 WL 820266

An NASD award arising out of stockbrokers shifting money from one non-discretionary account without the account holder's permission to another account in order to "save" a brokerage firm from insolvency was non-dischargeable as the brokers' acts constituted embezzlement.

Here, the debtors -- brokers and principals in a small brokerage firm – were trying to obtain a discharge of an NASD arbitration award against them and in favor of a client of the firm.

The underlying arbitration award arose out of the following events. The brokerage firm faced a crisis when three client margin accounts went negative and those clients failed to meet the margin calls. Essentially, the accounts all held short positions in technology stocks at a time when technology stocks were increasing in value. These three customers were friends of the owner of the brokerage firm.

Under the protocols of the brokerage firm's clearing house, if the brokerage firm's customers failed to pay their margin calls, the accounts would be liquidated. If the customers' accounts did not have sufficient value to cover the deficiencies, the clearing firm could require the brokerage firm and its agents to cover them. If the brokerage firm did not have sufficient capital to satisfy the losses, the clearing firm could shut down the brokerage firm's business operations and hold the firm's principals personally responsible for satisfying the deficiencies.

To avoid that outcome, the principal of the brokerage firm instructed a broker to transfer the negative positions out of the three friends' accounts and into two other customer accounts, using those accounts to absorb the losses and satisfy the deficiencies, which the broker did without the other customers' knowledge or consent. As a result, one of the other customers lost $983,000.

The losing customer filed an NASD arbitration claim against the firm, the principal and two brokers. The arbitration panel awarded the customer his entire loss of $983,000. The principal and two brokers then individually filed Chapter 7 bankruptcy petitions, seeking to discharge the NASD arbitration award.

The seven page arbitration award decision did not set forth any specific findings of fact, nor did it discuss the actions of each individual broker. Instead, the arbitrators, in articulating a "full and final resolution of the issues submitted for determination," merely outlined the procedural history of the arbitration and held that the brokers were jointly and severally liable to the clients in the amount of $983,000. No transcript from the arbitration hearing was submitted to the court.

The brokers argued that because the transfers were made in an attempt to save the brokerage firm, the brokers lacked the fraudulent intent necessary for embezzlement. In some cases, courts have found that a debtor did not have the necessary fraudulent intent when the debtor used money in violation of contractual obligations with the intent to keep his company afloat so that it could eventually pay all its debts. However, another line of cases runs in the opposite direction, holding that even where the debtor's intent was to repay the victim from future profits from the continued operation of the business, taking the funds still constituted embezzlement.

Here, even if the principal and brokers truly were trying to save the brokerage firm, that fact was not dispositive. The principal shifted the financial burden of a bad trading strategy from favored clients, who were his friends, to an absent client. The transfer was not disclosed and there was no evidence that the principal reasonably believed that the losing client would approve it. Indeed, there is evidence that the principal initially refused to meet with the losing client or take his phone calls after the transfer and, when finally confronted, lied about the circumstances of the transfer and threatened that the losing client would get nothing if he went to the authorities.

The bankruptcy court thus found that the principal had the requisite mental state for embezzlement and therefore his debt to the losing client – the arbitration award -- was nondischargeable.

OTHER ISSUES

Brokerage Firm's Failure To Disclose Problem Broker

Travelers Casualty v. AXA Advisors
(W.D. Okla. 2/27/2009) 2009 WL 523192

A brokerage firm may be liable for negligence and constructive fraud to another brokerage firm, which hired a former employee of the first firm, where the first firm fails to make a full and complete disclosure regarding problems with that employee.

A registered representative was employed by a brokerage firm (AXA). The registered representative left and joined a second firm (Wilbanks). AXA made misleading disclosures to Wilbanks about the registered reps' character, and did not disclose to Wilbanks the registered rep's dishonesty, deceit, and violations of policy and procedure. While at Wilbanks, the registered rep continued to engage in a Ponzi scheme, initially started at AXA. The registered rep's misconduct ultimately resulted in Wilbanks' insurer paying out on a fidelity bond.

Wilbanks' insurer sought to recover from AXA the funds it paid out on Wilbanks' behalf.

In opposing that attempt, AXA contended that the insurer's action was one for contribution from a joint tortfeasor, an action which was barred under Oklahoma law (the Uniform Contribution Among Tortfeasors Act). According to AXA, it had participated in a multi-party settlement of 43 arbitration cases involving the representative. AXA represented that it paid in excess of 92 percent of the settlement consideration. AXA asserted that Wilbanks fully participated in the settlement negotiations. Along with AXA, Wilbanks was released from liability by the claimants. Hence, according to AXA, it could not be held liable to any other joint tortfeasor for contribution.

The insurer, however, argued that the prohibition on contribution does not apply to breaches of trust or other fiduciary duty, and that AXA's conduct amounted to a breach of an independent duty. In substance, the insurer asserted that AXA set the registered rep "adrift in Wilbanks' harbor like a bomb-ship laden with dynamite." The insurer pointed out that Oklahoma law follows the rule that a party who has no duty to speak, but makes a disclosure nevertheless, undertakes to speak truthfully and if the party suppresses pertinent facts or states less than the whole truth, that party may be subject to liability to the party who relied upon the statements made. The insurer argued that because AXA failed to speak the whole truth as to the registered rep upon inquiry from Wilbanks, it is subject to liability under Oklahoma law for negligence and constructive fraud.

The court agreed with the insurer. The insurer was bringing independent claims for breach of a duty that AXA owed to Wilbanks, which resulted in damages which the insurer, as Wilbanks's subrogee and assignee, sought to recover. The insurer's claims were not bottomed on contribution, nor did plaintiff seek to recover an amount paid in excess of its pro rata share of liability. Although the insurer sought to recover the amount paid to defend and to settle the arbitration cases, the insurer alleged that that amount was the damage suffered as a result of the breach of duty by AXA which was owed to Wilbanks.

The court concluded that plaintiff asserted a claim for breach of duty by defendant, not a claim for contribution from defendant.

SROs Can Pursue Former Members

Fiero v. Financial Industry Regulatory Authority, Inc.
(S.D.N.Y. 4/02/2009) --- F.Supp.2d ----, 2009 WL 875318

FINRA has the power and authority to pursue former members in court in order to collect disciplinary fines FINRA imposed on those former members.

After FINRA's state court action to collect a disciplinary fine was dismissed for lack of jurisdiction, the persons against whom the fine was levied brought this declaratory relief action in federal court, seeking a declaration that FINRA could not recover those penalties. FINRA counterclaimed to recover those penalties. The court dismissed the declaratory relief action, and denied a motion to dismiss FINRA's counterclaim.

The controversy in this action began when FINRA commenced a disciplinary proceeding against the Fieros on February 6, 1998 for allegedly executing a "bear raid" of short selling in order to manipulate the price of certain securities. The FINRA hearing panel issued a decision concluding that the Fieros had violated § 10(b) of the Exchange Act, SEC Rule 10b-5, and NASD conduct rules. The Fieros appealed this decision to the NAC, which affirmed. In addition to barring John Fiero from associating with any NASD member, and expelling Fiero Brothers, Inc. from FINRA membership, the NAC affirmed the $1,000,000 fine and $10,809.25 in costs imposed on the Fieros jointly and severally. The Fieros did not pursue their appeal to the SEC and the NAC decision became final.

FINRA then filed a breach of contract action in New York state court seeking to collect the fines and costs. The New York Court of Appeals vacated the judgment in favor of the NASD, and dismissed FINRA's claim for lack of subject matter jurisdiction (a summary of the New York state

opinion can be found in the PIABA Bar Journal, Vol. 15, No. 1 (Spring 2008) at page 53).

This federal court declaratory relief action by the Fieros followed, with FINRA asserting a counterclaim to recover the disciplinary fine and costs.

In reviewing whether the federal court had subject matter jurisdiction, the court analyzed the relationship between FINRA, its members, and the Securities Exchange Act. The court observed that while the Exchange Act (and the regulations promulgated under it) empowered FINRA to operate as an SRO, neither the Exchange Act nor the SEC directly administers the disciplinary proceedings or imposes fines. Instead, FINRA conducts those activities as a private corporation and binds its members through contract. Therefore, it is the contractual relationship between FINRA and the Fieros that creates FINRA's right to collect, not federal statute.

The court concluded that FINRA's substantive claim against the Fieros was not created by federal law. However, the court concluded it had subject matter jurisdiction by way of diversity.

Turning to the substance of the two motions, the court rejected the Fieros' claim that the state court's disposition implicitly found FINRA's cause of action preempted, and that the decision was res judicata as to FINRA's state law claim. Since the state court dismissal was for lack of subject matter jurisdiction, it was not an adjudication of the merits, and hence had no res judicata effect.

The Fieros argued that FINRA lacks the authority to collect the fines it imposes on firms or individuals who are no longer members of FINRA. That argument was premised on the theory that FINRA needs express regulatory authority to institute court proceedings to collect fines. The Exchange Act, however, chose to entrust SROs with the power to "promulgate and enforce rules governing the conduct of its members." The Exchange Act further chose to use corporations and not regulatory agencies to carry out these functions.

In New York, "[t]he ability to sue is among those rights to which a corporation with active status may avail itself." Both New York law (the law which governed the contract at issue here) and Delaware law (the law which governed the corporate affairs of FINRA) authorize corporations to sue and be sued.

FINRA relies upon New York State contract law for its right to impose and collect fines and penalties. Neither the Exchange Act nor the regulations promulgated pursuant to it contain any provisions intimating that Congress intended to preclude FINRA from taking enforcement actions like the one it has undertaken against the Fieros. To the contrary, the Exchange Act's decision to entrust SROs with the responsibility of regulating their members implies that an SRO is authorized to use its powers under state law, including the corporate form and contract, to carry out its mandate.

The court concluded that neither the Exchange Act nor SEC regulations limit FINRA's ability to pursue its contract claim against the Fieros. Therefore, the Fieros have no possibility of relief based on these statutes and regulations, and the court granted FINRA's motion to dismiss the Fieros' declaratory relief action.

The Fieros raised a plethora of arguments against FINRA's counter-claim, all of which the Court rejected. First, FINRA's collection action was not subject to time limits under the Federal Arbitration Act because the disciplinary proceeding provided for in the underlying contracts was not an arbitration. FINRA's proceedings by which the Fieros were disciplined were quasi-prosecutorial, not merely a method of dispute resolution.

In the prototypical arbitration, when a dispute within the scope of the agreement arises, the parties have a mutual right to initiate the process, and to participate in the selection of an impartial arbiter. Here, the Fieros had no right to institute a similar action against FINRA in a neutral forum. This mutuality characteristic of an arbitration is lacking in the FINRA proceedings at issue, which constituted a disciplinary action resulting in a penalty.

Further, the court observed that the Fieros had access to levels of appellate review of FINRA's disciplinary decision, including review by the SEC and the federal Court of Appeals. This review is much broader than that envisioned in the FAA, which mandates that the district court "must" enforce the award unless it is vacated on limited statutory grounds.

The court ruled that there was a contract between the Fieros and FINRA which required the Fieros to pay fines imposed by FINRA. The Fieros voluntarily applied for and were accepted into the membership of FINRA. The language of the agreements originally signed by the Fieros and FINRA by-laws and rules are clear and unambiguous. By signing FINRA's membership forms, and taking the steps necessary for FINRA membership, the Fieros bound themselves to the rules of FINRA.

The Fieros further claimed that because FINRA had never before exercised any contractual right to collect fines from former members, it was equitably estopped from doing so now. Equitable estoppel, however, did not apply here. There were no actions taken, or not taken, by FINRA that could "work an injustice" should FINRA be allowed to collect the fines and costs to which it was contractually entitled. Even if FINRA had a "longstanding practice to suspend any fine assessed against an associated person or member firm unless and until said person or firm sought to reenter the industry," as the Fieros alleged, the change in policy does not rise to the level of working any injustice sufficient to warrant equitable estoppel.

The Fieros also contended that under New York law, private corporations did not have power to collect fines, and that a private corporation could not file suit to collect such fines.

First, Delaware law, which controls the dispute between FINRA and the Fieros, contains no indication that it ever imposed such a disability on corporations when it came to collecting debts. But should Delaware state law fail to empower not-for-profit corporations to sue members to collect fines, FINRA's status as a quasi-governmental agency would remove that disability.

Second, according to the court, New York amended its corporations law in 1970 to allow corporations to impose fines and penalties on their members. New York law now recognizes the right of private corporations to recover penalties through suit.

The court found the Fieros' arguments for non-enforcement of the disciplinary penalties insufficient to survive a motion to dismiss, and for the same reasons found them insufficient to defeat FINRA's counterclaim.

Measure of Damages

In re UBS Auction Rate Securities Litigation
(S.D.N.Y. 3/ 30/2009) 2009 WL 860812

After accepting rescission of their investment in ARS, purchasers could not pursue "benefit of the bargain" damages against the seller or control persons of the seller.

In this matter, plaintiffs had purchased auction rate securities ("ARS") from UBS. UBS Securities managed periodic auctions where these securities traded. Plaintiffs' securities fraud claims were based on alleged misrepresentations and omissions regarding the liquidity of the ARS and the ARS auction market, and on alleged misrepresentations and omissions regarding UBS's involvement in and manipulation of ARS auctions.

In response to a regulatory investigation arising out of the failure of ARS auction markets, UBS (as well as other brokerage firms) entered into a "Regulatory Agreement" which required UBS to refund the purchase price of the ARS to certain customers. Under the "Regulatory Agreement," persons who rescinded their investment in ARS could also pursue "consequential" damages.

Plaintiffs in this matter elected to have UBS buy back their ARS at par value, yet continued with this action seeking additional damages. To justify their damages allegations after availing themselves of the relief in the Regulatory Agreement, plaintiffs attempted to characterize their damages as out-of-pocket damages.

The key question addressed by the court was whether the plaintiffs, having accepted a rescission of their ARS investments, still had any cognizable damages, a required element for Rule 10(b)(5) claims. The court

accepted as true plaintiffs' allegations that UBS's fraudulent acts prevented plaintiffs from receiving a sufficiently high rate of interest or dividends to compensate them for the risk of illiquidity associated with their ARS investments.

The court concluded that this theory of damages was not an "out-of-pocket" measure of damages, but was instead a "benefit-of-the-bargain" measure of damages.

When plaintiffs elected to have UBS buyback their ARS at par value, they received a full refund of the purchase price. Therefore, plaintiffs had already been returned to the position they were in before they purchased the ARS and before any fraud ensued. Plaintiffs seek to recover that which they were entitled to receive when they purchased ARS, but plaintiffs' acceptance of a full refund of the purchase price of the ARS operated to rescind those purchases.

A defrauded plaintiff has the option of rescinding a transaction and being restored to his prior position, or of affirming the transaction and suing for the damages suffered. Rescission and restitution are alternatives to money damages; a plaintiff cannot both rescind a transaction and ask for the benefit of the bargain rescinded. Instead, if a transaction is rescinded, a plaintiff is only entitled to that which is necessary to restore him to his earlier position.

Plaintiffs could not seek additional interest or dividends as benefits of ARS purchases they had already elected to disavow. Plaintiffs had already been restored to the position they were in before UBS's fraudulent conduct. Given their election of the rescission under the Regulatory Agreement, plaintiffs were entitled to no more.

Finally, plaintiffs also sought recovery under a control person liability theory against UBS AG, UBS Securities, and the Individual Defendants. Because controlling persons are only jointly and severally liable with the primary violators for damages caused by the primary violation, a plaintiff can recover no more from the control person defendants than the actual damages he suffered for the primary violation.

Since plaintiffs could not successfully allege damages for a primary violation of the federal securities laws, they could not recover for control person liability either.

Failure to Supervise

Glonti v. Stevenson
(S.D.N.Y. 2/6/2009) 2009 WL 311293

Constructive knowledge of employee's wrongdoing is insufficient for pleading an aiding and abetting claim.

Former customers who sustained huge losses in their brokerage accounts at Lehman Brothers, due to excessive trading by their broker, sued branch managers of brokerage firm, alleging that the branch managers had a professional responsibility to monitor the broker and the broker's trading activity, and should have known that his trading was excessive and unauthorized.

The former customers had filed an arbitration claim against Lehman Brothers, which was stayed due to Lehman's bankruptcy. The former customers then filed this action against the branch managers, who elected not to move to compel arbitration.

The court first dismissed all of plaintiff's claims except aiding and abetting a fraud, based on statute of limitations. All of the activity in the accounts occurred more than 6 years before this case was filed. Further, plaintiffs were asked to review their brokerage accounts and confirm by signature that "all transactions were executed with your knowledge and consent and that they are consistent with your investment objectives as reflected in our records." Plaintiffs were alerted to the dramatic losses in their accounts before they received, reviewed, and signed that letter.

Plaintiffs argued that the limitations period should not be triggered because they were not aware of defendants and defendants' full responsibilities until September 8, 2008, when Lehman Brothers produced a copy of its Policies and Procedures Manual or until May 27, 2008 when plaintiffs received production of certain supervisory reports relating to defendants' responsibilities. However, the statute of limitations is not tolled for a plaintiff's leisurely discovery of the full details of the alleged scheme, especially where, as here, plaintiffs had an opportunity to review their accounts and to sign off on the broker's trading activity. Instead, the period runs from the time at which plaintiff should have discovered the general fraudulent scheme.

As for aiding and abetting a fraud, plaintiffs' allegations fell far short of what is required to raise an inference of actual knowledge of fraud on the part of the branch managers. Plaintiffs have alleged only facts tending to show that defendants should have been alerted to the fraud because of their positions of seniority at Lehman Brothers and the legal and professional responsibilities imposed by the SEC and NASD. Plaintiff did not allege facts showing that the branch managers did know about the fraud. New York courts have consistently held that constructive knowledge is insufficient to support a claim for aiding and abetting common law fraud.

WHERE WE STAND

Historically, PIABA has commented on a number of issues[1], 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.

1. To review all PIABA Comment letters, visit www.PIABA.org. For more information, contact Brian Smiley, bnsmiley@sbpllplaw.com, Scott Shewan, scottshewan@att.net or Robin S. Ringo, rsringo@piaba.org for assistance.

The following PIABA Comment Letter regarding *FINRA Regulatory Notice 09-25 – Suitability and Know Your Customer Rules* was submitted to the FINRA by Brian N. Smiley on June 26, 2009.

Ms. Marcia E. Asquith
Office of Corporate Secretary, FINRA
1735 K Street, N.W.
Washington, D.C. 20006-1506

RE: FINRA Regulatory Notice 09-25
Suitability and Know Your Customer Rules

Dear Ms. Asquith:

On behalf of the Public Investors Arbitration Bar Association (PIABA), I am pleased to comment on the above-referenced proposed changes to the Suitability Rule and the Know Your Customer Rule, FINRA Rules 2111 and 2090. PIABA generally supports this rule proposal, which arose out of the need to harmonize NASD and NYSE rules pertaining to recommendations by registered representatives to public customers. However, PIABA also believes some revisions are necessary to ensure the protection of public customers.

PIABA is a nationwide bar association comprised of attorneys who represent investors in securities arbitrations, primarily before FINRA Dispute Resolution. Since its formation in 1990, PIABA has promoted the interests of the public investor in all securities arbitration forums. Our members and their clients have a strong interest in the implementation and oversight of FINRA rules, especially those which are designed to provide critical protections to public investors. The Suitability and Know Your Customer rules exemplify the bedrock obligation of broker-dealers and their representatives to provide prudent investment advice, tailored to the needs and objectives of their clients.

PIABA SUPPORTS PROPOSED FINRA RULE 2111(A) GOVERNING SUITABILITY AND THE SUPPLEMENTARY MATERIAL THEREUNDER

We note first that the NASD Suitability Rule, which is current NASD Rule 2310, was specifically limited to recommendations of a "purchase, sale or exchange of any security." We applaud the new language in proposed Rule 2111(a), which requires a reasonable basis for any "recommended transaction or investment strategy." We view this language as a long-

overdue clarification of the suitability obligation, which in our view recognizes the realities of today's financial services industry. FINRA member firms and their representatives no longer limit themselves to recommending purchases and sales of particular securities; presently, member firms and associated persons have and continue to recommend overall investment strategies. Moreover, we note that in its training for licensure, the New York Stock Exchange teaches its brokers that they have a duty to monitor a customer's portfolio and make recommendations consistent with changes in economic conditions and financial conditions as well as the customer's needs and objectives.[1] It is wholly appropriate that brokers have a reasonable basis for the overall strategy and management of a customer account, as well as for recommendations of specific securities.

We also support and appreciate the proposed rule's list of nine specific factors to be considered by a member firm in making a recommendation. This is a significant improvement over the short list of factors contained in current NASD Rule 2310(b). The rule as proposed will provide brokers with a clear road map for compiling and analyzing customer-specific information in the course of deciding what recommendations to make to the customer. It is also helpful that the rule retains the requirement that representatives take into account any other information which the member firm or representative considers to be reasonable.

We support the retention of the "fair dealing" language in Section .01 of the Supplementary Material. It is important for those persons subject to these rules to understand that the requirement of fair dealing underlies all of the specific rules, and provides the philosophical underpinning of the suitability rule in particular.

We also support the three components of suitability identified in Supplementary Material 2111.02. In particular, it is appropriate to emphasize that the suitability obligation must encompass having a reasonable basis to recommend the security in question. We support the rule clarifying that members have a due diligence requirement, and we agree that the level of required due diligence will be dependent upon the facts and circumstances of each case. The customer-specific obligation is properly identified and defined. Finally, though we have proposals below for revisions, we support the identification of "quantitative suitability" as a category of unsuitable recommendations. We believe that the term is an improvement over words previously used, such as "churning."

Finally, we support the addition of Supplementary Material 2111.03, which places the obligation on the broker to consider whether the customer can afford the transaction or strategy which is being recommended. This language is consistent with case law and with several published SEC

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1. Content Outline for the General Securities Registered Representative Examination (Test Series 7), New York Stock Exchange 1995.

decisions in disciplinary proceedings. We also agree with the point that the broker should consider whether an investment or strategy continues to be affordable. The rule change confirms the broker's duty to continue to assess the customer's financial situation.

Notwithstanding PIABA's overall support of the rule proposal, we believe that there is ample room for improvement. The next section of this letter sets forth our proposals for Rule 2111(a) and the supplementary material thereunder.

PROPOSED REVISIONS TO RULE 2111 AND SUPPLEMENTARY MATERIAL

DEFINITION OF "RECOMMENDATION"

The proposed rule noticeably lacks any definition of what constitutes a "recommendation." Member firms and their registered representatives often argue that a "recommendation" applies only to recommended purchases of securities, but not to recommendations given by brokers to hold or sell. While we believe that the insertion of the term "investment strategy" into the suitability rule goes a long way toward ameliorating this concern, we believe it would be useful to regulators and those they regulate if the rules clarified that a recommendation to "hold" is subject to the suitability rules.

As part of the Consolidated FINRA Rulebook, PIABA suggests that Proposed Rule 2111, or the supplementary material that ultimately accompanies the Rule, is the logical place to define and clarify what constitutes a "recommendation" to a customer. Neither current NASD Rule 2310 nor NYSE Rule 405, which are the subject of the current consolidation effort, clearly establishes what constitutes a "recommendation." There has been much debate over this very issue. NASD Notice to Members 96-60, issued thirteen years ago, generally states that "a broad range of circumstances may cause a transaction to be considered recommended…." A very useful definition of this important concept can be found at Incorporated NYSE Rule 472.10 /09 "Communications with the Public – Definitions", which defines a recommendation as "…any advice, suggestion or other statement, written or oral, that is intended, or can reasonably be expected, to influence a customer to purchase, sell ***or hold*** a security" (emphasis added).

From a public customer's viewpoint, a recommendation to hold a security can have the same economic effect as a recommendation to buy or sell. By including this long-standing definition in the proposed rule, this important concept can be spelled out and provided to member firms and public investors alike so that everyone can understand the common meaning of what constitutes a "recommendation" and ensure that the term is not defined as relating only to a recommendation to buy or sell. When a broker recommends that a customer hold a security, such recommendation must also

be suitable for the customer based on all relevant factors. A broker should ascertain whether the investment remains suitable if he or she is going to recommend that a customer hold a security, as the customer's financial situation, or other relevant factors, may have changed dramatically since the time the security was purchased. Many firms argue that the definition of a recommendation contained in NYSE Rule 472 has no bearing on the suitability of their recommendations to customers, but rather relates strictly to analyst communications with the public. Now is a perfect opportunity for FINRA to clarify that the suitability rule applies to recommendations to buy, sell, or hold a security.

EXAMPLES OF UNSUITABLE RECOMMENDATIONS IN CURRENT IM-2310-2

We are also concerned with the absence of language in the proposed rule mirroring current IM-2310-2 ("Fair Dealing With Customers"). IM-2310-2 contains several real-life examples of what constitutes unsuitable or fraudulent conduct. PIABA recommends that the proposed rules be expanded to include those bright-line examples, or that supplementary materials be added to the current rule to retain these provisions. In many respects, proposed Supplementary Material 2111.01-.03 overlaps current IM-2310-2 in terms of content. However, PIABA believes that the wholesale consolidation (and in some instances, deletion altogether) of the material in IM-2310-2 would be a disservice to public investors. Under the current proposal, for example, there is no specific guidance as to unauthorized transactions or recommendations to buy low-priced securities. These omissions should be rectified.

Similarly, we would like to see included in the new rule the qualification contained in IM-2310-2, that practices enumerated in the proposed rule are not all-inclusive. Any rule governing suitability should be viewed and interpreted broadly, and not in a limiting fashion.

QUANTITATIVE SUITABILITY

PIABA is concerned with the concept that quantitative suitability applies only when a broker has actual or *de facto* control over the account. Any recommendation that is unsuitable is unsuitable, whether a broker had control over the account or not. Furthermore, the concept of "*de facto* control" requires a legal analysis, which may vary dramatically from state to state. The vast majority of brokers and their supervisors cannot be expected to undertake this analysis on a day-to-day and account-by-account basis. We recommend that this portion of the rule be deleted.

Moreover, FINRA and the SEC have already opined that the control element is not always outcome determinative in a quantitative suitability setting, and that the suitability rule can be violated even if the "control"

element is not met. As the SEC has recognized, "excessive trading represents an unsuitable frequency of trading and violates NASD suitability standards." *Paul C. Kettler*, 51 S.E.C. 30, 32 (1992); *see also Harry Gliksman*, Exchange Act Rel. No. 42255, at 4 (Dec. 20, 1999); *Michael H. Hume*, Exchange Act Rel. No. 35608, at 4 n.5 (April 17, 1995). Even in cases where a customer affirmatively seeks to engage in highly speculative or otherwise aggressive trading, a representative is under a duty to refrain from making recommendations that are incompatible with the customer's financial profile. *See Rafael Pinchas*, Exchange Act Rel. No. 41816, at 11 (Sept. 1, 1999) (customer's desire to "double her money" does not relieve registered representative of duty to recommend only suitable investments); *see also John M. Reynolds*, 50 S.E.C. 805, 809 (1992) (regardless of whether the customers wanted to engage in aggressive and speculative trading, the representative was obligated to abstain from making recommendations that were inconsistent with their financial situation).

Thus, if a customer wishes to trade beyond his means or in such a way that makes it almost impossible to cover the costs of the account, the customer should be notified of that fact. Under the proposed rule, the broker would be permitted to stand on the sidelines and turn a blind eye to the trading activity under the guise that she was not controlling the account. Such a concept is at direct odds with FINRA's stated commitment to protecting investors.

PIABA FAVORS GREATER DOCUMENTATION OF THE SUITABILITY EXEMPTIONS FOR INSTITUTIONAL INVESTORS

PIABA is concerned with the portion of the proposed revisions that would seek to eliminate and/or substantially reduce the express suitability obligations that are applicable to institutional investors under IM-2310-3.

Under the proposed revision that has been presented for consideration in Rule 2111(b), an institutional investor would potentially lose all of the suitability protections that presently exist if certain "clear exemptions" were applicable, including, but not limited to, if the institutional investor were to "affirmatively indicate" that it was "willing to forego the protection of the customer-specific obligation of the suitability rule."

There is no discussion, however, as to whether this "affirmative" indication would need to be evidenced in a written document that the institutional customer would be required to sign or as to whether any specific disclosures of the material terms and conditions that are associated with the waiver of the suitability protection rule would be required to be evidenced in a written document that the member or associated person would be required to provide to the institutional customer. This kind of "waiver," if appropriate at all, simply cannot be accomplished by boilerplate contractual terms.

Accordingly, we would recommend that proposed Rule 2111(b) be amended so as to require that: (a) the "affirmative" indication to be made by an institutional customer would be evidenced in a written document that the institutional customer would sign; and (b) that, in connection with the same, the disclosures of the material terms and conditions that are associated with the waiver of the suitability rule's protections would be evidenced in a written document that the member or associated person would provide to the institutional customer.

PIABA SUPPORTS RETENTION OF THE "KNOW YOUR CUSTOMER" RULE

We are gratified to see that FINRA intends to retain the iconic "Know Your Customer" Rule, formerly set forth in NYSE Rule 405. We have always felt that the Know Your Customer Rule goes beyond the FINRA Suitability Rule, so we are pleased to see that the crux of the rule appears in proposed Rule 2090. While we have some important suggestions for this Rule, we wish to state our support for the Rule's inclusion in the consolidated handbook.

One of the key components of this Rule is that it applies without regard to the need for a "recommendation." In the Regulatory Notice, FINRA recognized that this is an obligation which arises at the outset of the parties' relationship, without regard to whether a recommendation has occurred.

We also note with approval that a member firm is not only required to "know" the essential facts about a customer, but is required to "retain" that information. We have some concern that there is no requirement of written documentation or substantiation in the Rule; however, we trust that this issue will be covered in other rule changes or by reference to the existing SEC Rules regarding document retention.

PROPOSED REVISIONS TO RULE 2090

Noticeably absent in proposed Rule 2090 is language from current NYSE Rule 405 that requires a broker to use due diligence to learn the essential facts relative "every order, every cash or margin account," in addition to the information relating to the customer. Rather, the proposed Rule would limit the member's obligation to learning about the customer. This would appear to shrink the due diligence obligations of the member firm to a marked degree. We are troubled by the omission of this language, and we hope FINRA will consider reinserting the language from the original Rule 405.

We are especially concerned about the omission of an important word in transforming NYSE Rule 405 into FINRA Rule 2090. Rule 405 requires

firms to know essential facts relating to every "order." Owing to the use of the word "order" the NYSE Rule recognizes the obligation of a firm to not only "Know Your Customer," but to "Know Your Security." There should not be room for anyone to argue that the latter duty has been diminished by the rule change, particularly at a time when the complexity of investment products challenges even the most "sophisticated" customers.

We also note that the current version of NYSE Rule 405 requires a member firm to learn the essential facts relative to "every person holding a power of attorney over any account" carried by the firm. In short, the current rule requires the firm to "know the customer's agent" as well as to know the customer. The new Rule again curtails the firm's due diligence obligations, by limiting the firm's obligation to learn the essential facts about *the authority* of any person acting on behalf of the customer. We would be sorry to see the firm's due diligence obligations lessened in this manner. We hope FINRA will consider reinstating the member firm's obligation to "know the agent" as well as the customer.

Finally, proposed Rule 2090 is unclear about exactly who has the due diligence obligations. Former Rule 405 makes it clear that the member firm is required to exercise these due diligence obligations through an officer or compliance official. We are very concerned that firms will use the proposed Rule to take the position that the broker's attempt to learn the essential facts about a customer is enough. This is a serious contraction of the firm's management and supervisorial obligations, and one which we doubt FINRA intends. Therefore, we suggest that the rule be revised, or that supplementary material be added, to clarify that the firm can only carry out these due diligence requirements through an officer or compliance professional.

CONCLUSION

We are greatly encouraged by FINRA's proposed rules, although we believe that there is significant room for improvement. We urge FINRA to file these rule proposals with the SEC, after adopting the recommendations set forth in this letter. FINRA's mission of providing investor protection will best be served by the proposed revisions.

Please do not hesitate to contact me should you desire further discussion of the above. Thank you for your courtesy.

Respectfully,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Brian N. Smiley
President

The following PIABA Comment Letter regarding *SR-FINRA-2009-013 – Proposed changes to the Tolling Provisions of Rules 12206 and 13206 of FINRA's Code of Arbitration Procedure* was submitted to the Securities and Exchange Commission by Brian N. Smiley on April 28, 2009.

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE.
Washington, D.C. 20549-1090

RE: File No. SR-FINRA-2009-013

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Bar Association (PIABA), I am pleased to comment on the above-referenced proposed changes to the tolling provisions of Rules 12206 and 13206 of FINRA's Code of Arbitration Procedure. 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 applauds FINRA's proposals. The amendments would clarify rules to make plain the intent that applicable statutes of limitation are tolled when a person files a FINRA arbitration. We concur with FINRA's identification of the issues and the legal support for the amendments. While this letter will focus on Rule 12206 of the Customer Code, we have no objection to the identical changes proposed to Ruled 13206 of the Industry Code. Accordingly, we submit that the SEC should approve the proposed rule changes without delay.

Provided below is a brief summary of some important points raised by FINRA. They include the well supported facts that (1) these proposals reflect necessary clarifications to the Code provisions; and (2) the proposals are eminently consistent with the purposes of investor protection mandated by Section 15A(b)(6) of the Securities Exchange Act of 1034 ("Act").[1]

1. 15 U.S.C. 78s(b)(1).

I. THE AMENDMENTS REFLECT APPROPRIATE AND NECESSARY CLARIFICATIONS TO THE TOLLING PROVISIONS OF THE ARBITRATION CODE

Rule 12206(c) of the Code of Arbitration Procedure for Customer Disputes is FINRA's eligibility section of the Code. FINRA aptly explains that the intent of existing Rule 12206(c) has been to allow for tolling of statutes of limitations upon the filing of a FINRA arbitration, even when those disputes might subsequently be found ineligible for FINRA arbitration. Accordingly, when claims are dismissed as ineligible for arbitration, "**FINRA believes that….the rule should be read to provide that a firm...has implicitly agreed to suspend any statute of limitations defense for the time period that the matter was in FINRA's jurisdiction**." *See, File No. SR-FINRA-2009-13,* Section II A (1), page 15.

Despite the intent that applicable limitations periods be tolled for all arbitrations when filed, a few courts opined that the language of FINRA's older eligibility rules, similar in pertinent part to the current rule, was unclear as to this intent. A thorough and accurate review of these decisions is set forth in FINRA's filing of proposed rule changes. We agree with FINRA that any apparent confusion concerning the tolling question is sufficient reason to now clarify that tolling will occur in all cases filed in its forum. In addition, we agree that the simple changes proposed should eliminate any doubt concerning the tolling issue within the eligibility rule.

Moreover, the amendment should proactively curb expensive and unnecessary litigation of the tolling issue. For example, if an arbitration is dismissed as ineligible, and the parties proceed to court as permitted by Rule 12206(b), the new rule would make clear that the time to file in court has been tolled while the matter was on the FINRA docket. Without the amendment, there could be a wholly unintended proliferation of court litigation as to whether the limitations had been tolled during that time frame.

II. THE PROPOSED AMENDMENTS PROMOTE INVESTOR PROTECTION AND EQUITABLE PRINCIPLES OF TRADE

The investor who files an arbitration claim ought not be penalized for doing so if FINRA jurisdiction is ultimately denied. Even though a customer might be subject to a contract with a mandatory arbitration clause, it is possible for FINRA to deny jurisdiction of his or her claim against a broker-dealer. For example, under FINRA Rule 12203, the Director of Dispute Resolution is authorized to deny use of the forum if he determines that the subject matter of the dispute is inappropriate. In addition, Rule 12205 provides that shareholder derivative actions may not be arbitrated. As we submit this comment, one broker-dealer which is involved in hundreds of

arbitration claims concerning the failure of its junk bond funds is asking arbitrators to dismiss the claims against it on the dubious ground that they are derivative claims against the funds and are therefore barred by Rule 12205. The clarifications proposed to Rule 12206 would mitigate the injustice of an investor filing a claim with FINRA, having it dismissed on jurisdictional grounds and losing the right to sue in court due to the passage of limitations periods. Under the proposed rule, filing in arbitration would serve as the functional equivalent of filing a complaint in court, for statute of limitations purposes.

The failure to toll limitations periods would erode already precarious investor perceptions of the mandatory arbitration system. Many investors are aware that their securities claims are subject to mandatory arbitration. For those who may file in arbitration with that understanding, and who are told potentially much later that their claims are ineligible and that too much time has passed to file in court, the resulting distrust could be palpable.

Certainly, simple fairness concerns favor the tolling clarifications set forth now by FINRA. The proposed rule advances investor protection by helping to ensure that when the investor must file in court after a finding of ineligibility, he will be treated as if he had filed originally in court.

CONCLUSION

FINRA has proposed equitable amendments and should be commended for its thoughtful treatment of the tolling issues. PIABA submits that the Commission should approve the amendments as written and without delay.

Respectfully,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Brian N. Smiley
President, 2008-2009

The following PIABA Comment Letter regarding *SR-FINRA-2009-008 – Proposed Revisions to Forms U4 and U5* was submitted to the Securities and Exchange Commission by Brian N. Smiley on April 10, 2009.

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street NE.
Washington, D.C. 20549-1090

Re: Proposed Revisions to Forms U4 and U5
SR-FINRA-2009-008

Dear Ms. Murphy:

On behalf of the Public Investors Arbitration Bar Association (PIABA), I am pleased to comment on the above-referenced proposed changes to Forms U4 and U5.

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.

As advocates for investors with grievances against persons in the securities industry, PIABA members have a special interest in full and fair disclosure of available information concerning customer complaints, court actions and arbitrations, alleging wrongdoing by FINRA registered persons. As such, we support the changes to Forms U4 and U5 to include questions that would enable FINRA to identify findings of willful violations of law and/or regulations that are a basis for statutory disqualification of an associated person. We support the proposed rule change that requires reporting of arbitration cases in which a registered person is not named as a party respondent, but in which a registered person's conduct is nonetheless the subject of the claimant's misconduct allegations against the member firm. We oppose any dollar value threshold for the reporting of settlements and/or awards in FINRA arbitration proceedings. Finally, we question the wisdom of the proposed rule change that would permit member firms to amend the reason for termination of a registered person's employment without a court order or arbitration award.

PIABA SUPPORTS THE PROPOSED PROVISIONS CONCERNING AMENDMENTS TO FORMS U4 AND U5 TO IDENTIFY WILLFUL VIOLATIONS OF LAW AND/OR REGULATIONS

The first proposal would amend Question 14E FINRA's Forms U4 and U5 (the "Forms") to specifically request information that would permit FINRA to identify persons subject to statutory disqualification as a result of a finding of intentional violation of law or regulations. PIABA supports the proposal because the current questions on the Forms are insufficiently specific to elicit information that would identify some persons as disqualified under these statutory provisions.

Section 15(b)(4) of the Securities Exchange Act of 1934 ("Exchange Act") *requires* the censure, placing of limitations on the activities, functions, or operations of, or suspension for a period not exceeding twelve months, of any associated person who has willfully violated the Securities Act of 1933, the Exchange Act, the Commodities Exchange Act, the Investment Company Act of 1940, or the rules of the Municipal Securities Rulemaking Board. 15 U.S.C. 78o(b)(4). Thus, it was Congress's clear intent to require self-regulatory organizations who are delegated regulatory authority pursuant to the Exchange Act to identify and disqualify *all* persons found to have committed willful violations of the enumerated laws and/or regulations.

The proposed amendment should be approved by FINRA because it would protect investors by effectuating the statutory disqualification provisions of the Exchange Act and promoting full and fair disclosure without unduly burdening FINRA member firms.

PIABA SUPPORTS REQUIRING REPORTING OF ALL ARBITRATION CLAIMS ALLEGING SALES-PRACTICE MISCONDUCT BY A REGISTERED PERSON

The second proposal would revise Questions 14I(2) and (3) on Form U4 and Questions 7E(2) and (3) on Form U5 to require firms to report, as customer complaints, allegations of sales practice violations made in arbitration claims and civil lawsuits against registered persons who are not named as parties in those proceedings. PIABA supports this rule change without reservation.

PIABA is deeply concerned about the lack of integrity of the CRD system. The CRD system provides 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 ("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 factor has been the proliferation of expungement orders. FINRA has taken and continues to take action to ensure that the expungement procedure is not abused. PIABA supported FINRA's most recent rule proposal in this regard.[1]

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 problem is the subject of this proposed revision to the Form U4 and U5. Under the current reporting system, a written complaint such as a letter to a FINRA member firm alleging that a registered person committed a sales practice violation must be reported, but a written allegation of such a violation contained in the text of an arbitration statement of claim or civil lawsuit complaint is not required to be reported unless the registered person is also named as a party to the proceeding.

The current system thus mandates a Form U4 filing and CRD public disclosure of a sales-practice complaint by an investor who feels sufficiently aggrieved to send a note, or even an e-mail, to a member firm, but does not require disclosure of the identical claims of investors who feel aggrieved enough to sue the firm with identical allegations but where the registered person is not named in the case caption as a party. This has led to many anomalous results, and PIABA strongly feels that there is no supportable rationale for permitting the non-reporting of these claims. For example, where a public investor chooses not to name an individual registered representative in the caption of an arbitration claim upon the advice of counsel, that broker will not be required to report the claim.

It is important to note that many attorneys recommend to their clients that they name only the firm in an arbitration proceeding since the firm is legally responsible for the wrongful conduct of its employee. Yet if that same customer had gone to a different attorney who filed the same claim, but named the individual representative as a respondent in the arbitration, the broker would have to report the claim. There is no reason to have different reporting requirements for the same conduct, depending upon the attorney's strategic decision to name or not name the individual wrongdoer as a respondent.

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1. See Letter of Laurence S. Schultz, President of PIABA, to Nancy Morris, SEC, dated May 16, 2008. PIABA's comment letters are accessible through www.piaba.org.

In addition, this reporting loophole impacts arbitration settlement negotiations between the parties, dictated by the named registered person's objective of avoiding a permanent report on the CRD. Under the current rules, if a named registered person participates in a settlement of $10,000 or more, the settlement will appear on the registered person's CRD. However, if the named registered person and the firm arbitrate the claim to a zero award, the CRD disclosure may be removed from the reporting system. The current rule thus encourages claimants' counsel not to name individual registered persons as arbitration respondents, in order to avoid providing the member firm an artificial incentive to arbitrate, rather than settle the claims.

The net effect of the current system is that complaints of serious wrongdoing by registered persons who are not named in proceedings are not reported on the CRD. The proposed rule change will close this problematic loophole in the reporting rules and promote full and fair disclosure of customer complaints charging misconduct by registered persons.

PIABA OPPOSES ANY ARBITRARY DOLLAR VALUE THRESHOLD FOR REPORTING OF ARBITRATION AWARDS AND SETTLEMENTS

Both the current rule requiring the disclosure of claims settled for $10,000 or more and the proposed change requiring disclosure of settlements of $15,000 or more impose a completely arbitrary threshold for reporting arbitration settlements. PIABA views the change from $10,000 to $15,000 as relatively immaterial; as a matter of principle, however, PIABA opposes *any* monetary threshold for the reporting of settlements.

Both the current rule and the proposed change permit registered persons to essentially ensure that they will retain a "clean" CRD if they pay the customer a settlement sum under the threshold. There is, however, no basis for *assuming* that a payment of up to $10,000 (or $15,000) represents a settlement for nuisance value of a non-meritorious claim. Such a settlement may in fact be reasonable compensation for egregious conduct such as unauthorized trading or misrepresentation.

PIABA believes that the proposed change should be revised to eliminate *any* monetary threshold for the reporting of settled claims, and require all settled sales-practice claims to be reported. Prospective customers and other persons can then decide for themselves in an environment of full disclosure whether a financial settlement of a customer case is a material factor in their evaluation of the ability, integrity and trustworthiness of a registered person.

PIABA OPPOSES GIVING MEMBER FIRMS FREE REIN TO AMEND THE REASON FOR TERMINATION OF EMPLOYMENT OF REGISTERED PERSONS

Under current practice, as recited in the proposed changes, member firms do not have the ability to amend the reason for termination or date of termination after the initial filing of Form U5. Instead, member firms can place a Registration Comment on the WebCRD to explain "unusual circumstances or irregularities in an individual's registration history that: (1) relates to the date or reason for termination on the Form U5; and (2) cannot be addressed otherwise through a form filing . . . ." Alternatively, the member firm or registered persons may follow the expungement procedure set forth in NASD Rule 2130.

FINRA proposes to allow member firms to amend the reason for, or date of, termination without any arbitration award or court order. Member firms would, however, have to give a reason for the change. FINRA would notify other regulators and the broker-dealer currently employing the person (if the person is with another firm) when a reason for termination or date of termination has been amended.

PIABA has no objection to the rule proposal insofar as it relates to the change in the date of termination. Obviously, if an error is made in the date reported, that should readily be subject to correction. However, PIABA is concerned about granting the same latitude to firms wishing to make changes in the *reasons* for a broker's termination.

While it is certainly more expedient for member firms to amend the reason for termination of a registered person without a court order or arbitration award, PIABA is concerned about the potential for abuse and collusion. In some circumstances, departing registered persons have financial disputes with member firms. For example, promissory notes may exist to repay a registered person's "draw" against commissions, or a registered person may be obligated for a portion of a sum advanced by the member firm to resolve a customer arbitration or satisfy an arbitration award. Certainly, where the member firm and departing registered person have financial issues to resolve and may be otherwise adverse, it is possible that amendment of the reason for termination of the registered person may become a subject of bargained-for exchange as the parties negotiate their other issues. This would not lead to greater integrity of the reporting system.

The present rule's requirement that a member firm obtain an arbitration award or court order in order to make an amendment to the reason for termination serves an important purpose by requiring member firms to explain the reason(s) for the change to an impartial decision maker. The current process effectively requires the member firm to make a verified statement setting forth a legitimate reason for the change in the reason for

termination. While sharp practices unfortunately may develop under any set of rules, and while the current requirement of judicial/arbitral approval of changes does not guarantee accurate and transparent reporting, the proposed change lessens rather than increases the likelihood of trustworthy information and increases the potential for collusion.

CONCLUSION

For the above reasons, PIABA respectfully requests that FINRA approve the changes to reporting on Forms U4 and U5 with respect to arbitration claims in which registered persons' conduct is complained of but as to which registered persons are not named as party respondents. We favor elimination of any arbitrary monetary threshold for the reporting of customer arbitrations and oppose permitting member firms to unilaterally change the reasons for a broker's termination.

Thank you for your consideration.

Respectfully,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Brian N. Smiley
President

The following PIABA Comment Letter regarding *SR-FINRA-2008-024 - Amendments to Discovery Guide in FINRA Arbitrations* was submitted to the Securities and Exchange Commission by Brian N. Smiley on March 27, 2009.

Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090

RE: Amendments to Discovery Guide in FINRA Arbitrations
SR-FINRA-2008-024

Dear Ms. Murphy:

Thank you for the opportunity to comment upon the above-referenced proposal regarding changes to the Discovery Guide which applies to FINRA arbitration matters. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA"). PIABA is a national bar association whose members are devoted to the representation of public investors in arbitration proceedings. As such, we are keenly interested in the discovery procedures pertaining to FINRA arbitrations.

PIABA applauds the effort of FINRA to resolve the litany of issues that have presented problems with discovery in FINRA arbitration proceedings. However, the rule proposal in its current form is unacceptable. While some of the proposed changes do represent an improvement in the amount of material which investors will be able to obtain from member firms, we believe the additional burdens placed on investors in discovery outweigh the burdens placed on the industry. Moreover, some of the shortcomings of the present version of the FINRA Discovery Guide are not addressed by the rule proposal. While we will address both the positive and negative aspects of the new code provisions fully below, our overall feeling is that the negative aspects significantly outweigh the positive.

This comment letter will set forth PIABA's general observations concerning the new rule proposal. PIABA's comments as to the specific provisions of the rule proposal are contained in the attached Appendix, which should be considered an integral part of this comment letter.

FINRA arbitration proceedings have been criticized as biased in favor of the securities industry for many years. The criticism is supported by empirical evidence. In 2007, customer claimants received an award of any

kind in only 37% of arbitration hearings.[1] Those receiving an award could not expect to receive more than 30% of their damages.[2] According to a GAO Study in June 2000, there is also only a 39% chance of collecting the entire award.[3]

In addition to the low recovery rates, another significant criticism has been the widespread discovery abuses committed by FINRA member firms in connection with customer disputes. Such abuses became so prevalent as to warrant the issuance of FINRA Notice to Members 03-70, admonishing member firms of their duty to cooperate with discovery in arbitration proceedings and advising firms that FINRA would refer perceived abuses for disciplinary review.

All of this points up the need for reform in FINRA's discovery procedures. In the current Discovery Guide, which was promulgated a decade ago by FINRA Notice to Members 99-90, FINRA provided that certain documents would be presumptively discoverable in all cases, and others would be presumptively discoverable in certain types of cases. While the current Discovery Guide resolved some of the issues which had repeatedly resulted in discovery motion practice, discovery abuses continued to be widespread. Clearly, more reform is needed.

The proposed revisions to the Discovery Guide move in the wrong direction in light of today's financial crisis. Rather than imposing a higher standard of accountability on the financial services industry, the new revisions increase the burden on the public customer. Investors have lost the right to bring their claims before a jury of their peers and instead are forced to seek relief in an industrysponsored forum. Instead of recognizing the fact that the industry has a presence on most arbitration panels, the revisions to the Discovery Guide further erode the rights of the public investor.

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1. See FINRA Dispute Resolution Statistics, available at: http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm

2. Edward S. O'Neal and Daniel R. Solin, *Mandatory Arbitration of Securities Disputes: A Statistical Analysis of How Claimants Fare*, available at: http://www.smartestinvestmentbook.com/pdf/061307%20Securities%20Arbitration%20Outcome%20Report%20FINAL.pdf.

3. United States General Accounting Office, *Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, available at: http://www.gao.gov/archive/2000/gg00115.pdf.

THE INDUSTRY IS GIVEN A FISHING EXPEDITION INTO PRIVATE FINANCIAL INFORMATION WHICH IS PREDOMINANTLY IRRELEVANT

Under the current Discovery Guide, member firms and their associated persons are presumptively entitled, in every case, to a broad range of personal financial information relating to the customer claimant. The customer is required to provide financial statements, personal tax returns, business tax returns, and information about other securities accounts. Under the current Guide, these documents must be produced for a period commencing three years before the first transaction at issue until the filing of the Statement of Claim.

The current Discovery Guide has perpetuated an improper and false understanding of the law in securities fraud cases, and many other cases which find their way into FINRA arbitration. In essence, the Discovery Guide propagates the myth that FINRA arbitrations are all about placing the customer on trial. The industry often defends cases which are not defensible by proving that the customer was wealthy enough to have taken the risks involved, even if the wealthy customer was, in fact, extremely risk-averse. The SEC has repeatedly rejected this concept.[4] If a customer is lied to, it is irrelevant that the customer had some risky stocks at another firm eight years earlier.[5] If a customer gives an order which is not timely executed, it should not matter whether the customer was a pauper or a king. Yet by providing the industry with the customer's private financial information in every case,

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4. It is well-established that wealth of the customer (however accumulated) and sophistication are not bases for recommending risky investments, nor are they defenses to claims of unsuitability. See *Arthur Joseph Lewis*, 50 S.E.C. 747, 749 (1991) ("the fact that a customer ... may be wealthy does not provide a basis for recommending risky investments."); *David Joseph Dambro*, 51 S.E.C. 513, 517 (1993) ("Suitability is determined by the appropriateness of the investment for the investor, not simply by whether the salesman believes that the investor can afford to lose the money."); see also *Krull v.SEC*, 248 F.3d 907 (9th Cir. 2001) (giving deference to the SEC's interpretation of "unsuitability" under the NASD's Rules of Fair Practice) (citing *Alderman v. SEC*, 104 F.3d 285, 288 (9th Cir. 1997)).

5. Hellie could not ignore his instructions on the basis of [the customer's] prior transactions. . . . If, as Hellie claims, he was uncertain as to what [the customer] meant by "medium risk," he was not free to guess at its meaning by following [the customer's] prior course of trading. *In re Hellie*, 50 S.E.C. 611, 613-14 (1991) (footnotes and citations omitted); see also *DBCC v. Wayne Vaughn*, 1998 NASD Discip. LEXIS 47 (October 22, 1998) ("A customer's prior transactions, however, are not relevant in a suitability determination...")

FINRA has led arbitrators to believe that the customer's wealth, or lack thereof, is the critical issue in every case.[6]

The rule which governs the industry is the "Know Your Customer" Rule. FINRA is instituting a "Know Your Arbitration Opponent" rule in its stead. The question is not what the broker can find out about the customer now that he has been named as a respondent in a customer-initiated proceeding; rather, the question is what the broker did or did not learn about the customer before making a recommendation. With so much attention directed to enabling the industry, through discovery, to learn everything about a customer, the focus on learning what actually happened is relegated to secondary importance.

In some cases, industry respondents have taken the fishing expedition to an extreme. They have routinely sought information regarding bank accounts, loan documents, insurance information and the like, both through document requests and third-party subpoenas. These demands have been extremely intrusive of the customer's private information, and if anything, have had a chilling effect on customers' willingness to pursue valid claims. Moreover, these kinds of demands have added to the burden of customers in FINRA arbitrations, as they have necessitated extensive motion practice and hearings with the arbitrators. A number of states recognize the importance of protecting individuals' privacy by making bank records confidential. The logic behind this is simple: what people choose to spend their money on should not be open for the consumption of others. The prejudice from permitting the dispersal of private, personal expenditures far outweighs any potential probative value.

Rather than putting an end to this continuing injustice, the proposed Discovery Guide would make the situation worse. Tax returns, financial statements and brokerage accounts would now be presumptively discoverable for *five* years prior to the first transaction at issue, rather than three years, and the duty would continue up until the completion of discovery. We are troubled by the first transaction at issue being the signifying event; a suitability case, for example, may span the entire life of the account. If a case is filed six years after the first transaction at issue, and discovery ends a year after the case is filed, customers will have to dig up ***twelve years*** worth of financial information and hand it to the firm, whether or not the firm thought it was important when the recommendations were made.

Even in a suitability case, it is difficult to justify requiring a customer to dig back so far into her private financial history. What the customer was buying at age 52 is irrelevant to the customer's needs and objectives at age

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6. This is reinforced by FINRA's own rule petition, where FINRA repeatedly states that the rule will "provide parties with a broader understanding of the customer's financial status."

62. This information is completely irrelevant in many cases, such as in unauthorized trading, cases, fraud cases and cases involving Ponzi schemes and other due diligence failures. Yet, the customer's financial history under the Discovery Guide is presumptively discoverable in *every* case.

Similarly, it is difficult to understand the relevance of documents generated at other securities firms after the statement of claim is filed. What the customer is doing with other financial advisors or firms one month prior to the hearing is completely irrelevant to the case, and is no business of the respondents.

Perhaps the most odious section of the proposed Discovery Guide is the provision relating to loan documents. List 2, Category 12 presumptively requires the customer to identify all loans applied for by the customer, or guaranteed by the customer, from 5 years prior to the first transaction complained of through the filing of the Statement of Claim. This includes car loans, mortgage loans, home equity loans, credit card applications, personal loans, and loans that the drafters of the rule never considered. Once these loans are identified by the customer, the customer must provide the opposing party with an authorization directed to the third party lender for all loan applications.

A private citizen's loan information is not the kind of information which should have to be divulged as a prerequisite to making a claim against one's financial advisor. The probative value of the information on loan applications is nearly nonexistent in most cases; in those cases where firms have attempted to get third party subpoenas for such information, arbitrators usually refuse to issue the subpoena. The relevance of this private financial information is vastly outweighed in nearly every case by the customer's privacy rights. If such information was not relevant to the member firm when the account was opened, there is no reason to require its production now. There is no reason to make such information presumptively discoverable in all cases. In those few cases where such information might actually have some relevance, the firm can ask the arbitrator to issue a subpoena.

The current Discovery Guide already sends the wrong message to aggrieved investors and to the arbitrators who hear and decide their cases. Investors learn quickly that they must forfeit any right to financial privacy, even if their financial situation is completely irrelevant to the case. This has the effect of discouraging customers from asserting valid claims, and increases the financial and emotional toll of taking one's trusted advisor to arbitration. Arbitrators are led to believe that it is acceptable for the industry to delve into the personal and private lives of those who deign to sue member firms, without regard to relevance.

The proposed Guide is even worse. If FINRA truly wants to level the playing field, it should start by addressing the onerous production requirements of the Discovery Guide for customers in FINRA arbitrations.

THE BURDENS PLACED ON CUSTOMERS ARE DISPROPORTIONATELY HIGHER THAN THOSE PLACED ON THE INDUSTRY

Several of the provisions in the proposed Discovery Guide are beneficial to customers, and PIABA supports the inclusion of those provisions in a new Discovery Guide. Nonetheless, many proposed provisions drastically increase the presumptive discovery burden on customers. The cumulative effect of the proposed changes is to increase the burden on customers disproportionately to the burden imposed on member firms and associated persons.

There are five glaring examples of heightened obligations on customers, with no reciprocal obligations on the part of the industry.

Production of information absent an information request. List 2, which sets forth the documents to be produced by customers in all cases, contains three new items which appear to require the customer to provide *information*, in addition to documents. List 2, Item 4 requires the customer to identify all securities firms where the customer has maintained an account, from 5 years prior to the account or transactions at issue until the completion of discovery. This is an unprecedented expansion of the burden on customers, as it makes the provision of *information*, rather than *documents*, presumptively discoverable.

Item 5 is even worse. That category requires the customer, in all cases, to turn over "all agreements, forms, information or documents" relating to the accounts or transactions at issue. How a customer is to turn over all "information" is completely unclear. Certainly we understand this to mean that the term "information" refers to documents in tangible form. We are concerned, however, that firms will argue that the customer must be presumptively required to respond to interrogatories propounded by the firm. This would be completely contrary to the strong presumption *against* interrogatories in FINRA arbitrations. The word "information" must be removed from this Item.

Finally, Item 12 requires the customer to identify every loan he has applied for or guaranteed, beginning 5 years before the first transaction at issue in the claim, through the filing of the Statement of Claim. Apart from the incredibly intrusive nature of this category, as set forth above, it is another occasion where the customer is presumptively required, without any showing of relevance, to provide information to the opposing side.

Nowhere does the proposed Discovery Guide impose upon the industry a similar obligation to provide information without being asked. This is one example of the disproportionality of the burdens placed on customers.

The affirmation that tax returns are the same as those filed with the IRS. The proposed Discovery Guide contains a requirement that, in connection with the production of tax returns, the customer must "represent" that the tax

returns being provided are identical to those filed with the Internal Revenue Service. No similar obligation is imposed on the industry. There is no reason for the Discovery Guide to impose such an obligation on the customer in the first place. The List could simply require that the tax returns produced by the customer must be identical to those filed with the IRS—this should be sufficient to satisfy any concerns.

The written authorization to third parties to require the production of documents. List 2, Item 4 provides an unprecedented duty on the part of customers to not only identify all securities firms with which they have dealt, but also to provide the industry parties with a "written authorization allowing the respondent . . . to obtain the account statements directly from each securities firm." Presumably, the customer or her lawyer will be required to prepare these written authorizations. This places a brand new burden on the customer; whereas the brokerage firm formerly was required to prepare a subpoena and ensure that it passed muster over the customer's potential objections, now the customer is expected to do the respondent firm's work. Again, there is no similar obligation on the part of the member firms or their associated persons.[7]

Even worse, Item 12 requires the customer to prepare and execute an authorization directing each lender or prospective lender to release the loan application. PIABA strongly opposes this requirement. These loan applications could have a lot of personal information, financial or otherwise, which should not be subject to discovery. This provision removes the arbitrators from the role of "gatekeeper" with regard to the issuance of subpoenas. Customers should be entitled to the benefit of such neutral review before third parties are required to turn over their personal financial information. Indeed, there is no certainty that the lender or prospective lender will send only the loan application; a bank lender may, for example, release checking account information.

Only customers are required to prepare and sign these authorizations; the industry is not required to grant access to third party discovery without the protections and safeguards of the subpoena process. The disparity is unprecedented and unfair.

Production of tape recordings. List 2, Category 8 makes presumptively discoverable any recordings of conversations or telephone calls in the customer's possession. There is no such requirement on the part of the member firm or associated persons. Yet, production *is* required under the current Discovery Guide (List 1, Item 7).

This omission is baffling. In nearly every case, there is a sharp divergence in the factual testimony of the customer and the associated

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7. If such a provision is retained, however, we agree that it should remain limited to monthly statements from third party firms.

person. There is nothing as relevant as a tape recording of conversations between the broker and the customer. Yet, whereas the customer is required to turn such tapes over (which is entirely appropriate), the industry is permitted to suppress this important evidence. There is no possible justification for FINRA to have omitted this item from the industry's list.

FINRA may say that recovery of these tapes is overly burdensome for the industry. However, there can be no question that, if the tapes support the firm's position, they will show up at the 20-day exchange (but not necessarily during discovery). If they support the customer's story, they will never see the light of day. The industry must be held to the same duty of disclosure as the customer in regard to recordings.

Production Of Prior Complaints And Settlements.

List 2, Item 11 requires customers to provide copies of all complaints and statements of claim previously filed by the customer with regard to securities matters. The customer is also required to provide the final awards, judgments or settlement agreements resulting from these prior cases.

The industry, by contrast, is required by List 1, Item 6 to provide complaints against the associated person involved, if they allege "conduct similar to that alleged in the Statement of Claim against the associated person."

Limiting the production in this manner is unnecessary. It is unlikely that an associated person would have so many customer complaints or regulatory investigations involving him or her that production of *all* such complaints would be unduly burdensome. If so many complaints did exist against one individual that it would be burdensome to produce them, then they *should* be produced, as an excessive number of complaints would support a claim of failure to supervise or evidence a need for heightened supervision of that individual. It is possible that a number of complaints were expunged and therefore not known to the customer in the case, or to the public in general. Accordingly, *all* customer complaints regarding an individual representative should be produced. Certainly a customer is required to provide all complaints involving securities; there is no justification for the different rule for the industry.

Moreover, there is no reason to require a customer to provide the judgment, award or settlement agreement, without requiring the same of the industry. Again, the impact is disproportionate as to the customer.

THE NEW PROVISIONS RELATING TO PRODUCTION BY INDUSTRY RESPONDENTS SHOULD BE RETAINED IN THE FINAL RULE

Some of the proposed revisions to the Document Lists are designed to require greater cooperation by member firms and associated persons in the production of documents. These are helpful changes, as the new Guide will state that these documents are presumptively discoverable. This should result in fewer arguments and less motion practice concerning the discoverability of these documents.

Claimant-Specific Information

List 1 sets forth the documents which the industry respondent is presumptively required to turn over in every customer case. The new proposal expands some of the customer-specific information to be made available. For example, List 1, Item 3 now requires the firm to produce all information in the firm's possession relating to the customer's "employment status, financial status, annual income, net worth, investment objectives and risk tolerance." This information should clearly be turned over in every case. It is essential for the claimant to know what the firm thought was important enough to be found out about the customer when the transactions at issue occurred. Similarly, Item 4 provides that the firm is to turn over documents relating to the trading strategies used in the customer's accounts, together with any documents reflecting supervisory review of the strategies. This is the kind of information which a firm should be compiling for its customer accounts, and clearly they should retain and turn over these documents in arbitration proceedings.

Manuals

Tremendous resources have been devoted to motion practice concerning the production of compliance and other supervisory manuals. Firms have proven resistant to turning these manuals over, despite their clear relevance to industry standards and practices. List 1, Item 7 now makes it clear that manuals of all kinds are to be produced, together with updates, tables of contents and compliance bulletins. This language should be helpful in getting customer claimants the documents they need to establish their case, and will cut down on expensive and wasteful motion practice.

Supervisory Documents

The new Guide would expand member firms' obligation to turn over supervisory documents. This is a welcome change. Firms have often sought

to prevent disclosure of these documents, claiming non-existent or discredited privileges, such as the "self-evaluative" privilege. Yet, if these matters were venued in court, supervisory documents would be ordered to be produced in nearly every case.

The proposed rule would make exception and activity reports discoverable in every case, rather than just cases alleging failure to supervise (List 1, Item 9). This proposal also broadens the language to include "similar reports," so that firms can no longer avoid disclosure by naming their exception reports something else.

List 4 defines the presumptively discoverable documents to be turned over by the firm and its associated persons in cases alleging failure to supervise. While we support many of the changes to this list, we believe the documents identified on List 4 should be discoverable in every case. Documents reflecting supervisory review of the broker and of the customer's accounts are nearly always relevant. There is no reason to limit the discoverability of these documents to cases where "Failure to Supervise" is alleged.

List 4, Item 4 requires the firm to turn over documents and notes reflecting communications between the subject broker and the firm's compliance department. This category of documents has often been inappropriately claimed as privileged, and we welcome the addition of these documents to the presumptively discoverable list. Moreover, we note that the communications are not limited to those concerning the claimant or the claimant's accounts, but include all such communications. In a case where failure to supervise is alleged, this makes sense. An arbitration panel should want to see what supervision is taking place, or not taking place, as the case may be.

List 4, Items 7 and 8 require the firm to turn over any notes or memoranda evidencing supervisory review of the customer's accounts, and to turn over copies of correspondence with the customer showing supervisory review of the correspondence. There should be documentation to establish that supervision of the customer's accounts is occurring. Clearly, that documentation should be produced to the customer in arbitration. These are welcome additions to the Guide.

Despite the expansion of some of the supervisory materials, there is a glaring omission in the new Guide. The proposed Guide does a good job of requiring the industry to prove that it was supervising the claimant's *accounts*. However, industry rules require diligent supervision of both the customer's accounts *and the broker*. The current Discovery Guide requires firms to turn over, in connection with exception reports, "all other documents reflecting supervision *of the Associated Person(s)* and the customer accounts at issue." (Current List 5, Item 4; emphasis added.) In the new rule, there is no longer a requirement to turn over "all other" supervisory documents related to the supervision of the *broker*. Whether or not the omission was

inadvertent or purposeful, this language must be restored to the Discovery Guide.

Documents Relied Upon By The Broker

List 7 requires the firm and associated persons in a negligence/breach of fiduciary duty case to turn over certain documents prepared by or used by the broker, or given to the customer. We welcome the addition of the language requiring the production of "performance or risk data." (The same language is added to List 11, for suitability claims.) The inclusion of this language will require the production of documents which will establish whether or not the broker was doing his or her job.

Unauthorized Trading

List 9 corrects a couple of obvious problems with the existing Discovery Guide for cases where transactions are alleged to have been unauthorized. First, Item 1 in the new Guide does away with the term "order ticket," which has essentially become obsolete. Rather, the proposed rule requires the functional equivalent, using the "memorandum of each order" language which tracks the SEC's document retention rules (see SEC Rules 17a-3 and 17a-4). This will cover the electronic media which firms may now be using. The new rule also makes it clear that the document should show the compensation, both gross and net, to the associated person. Clearly, a broker's compensation goes to the incentive he or she might have had to enter an unauthorized trade.

List 9, Item 4 requires the member firm to turn over all of the broker's trades from 10 days prior to 10 days after the alleged unauthorized trade. This is a welcome addition to the Guide. Such information is often the most compelling evidence as to whether a trade was authorized or not. Similarly, where there is a dispute as to whether a trade was "solicited" or "unsolicited," this information usually resolves the issue.

Unsuitability

List 11 expands some of the documents which the firm must turn over in cases alleging lack of suitability. Item 2 requires the member firm and associated person to produce agreements relating to the broker's compensation, including whether it is fee-based. This is appropriate in every case, and certainly should be produced in suitability cases.

List 11, Item 3 requires the production of all documents between the firm/associated person and the customer relating to "asset allocation, diversification, trading strategies and market conditions related to the customer's account(s)." Given the dictates of Modern Portfolio Theory, one

would expect a broker who is making recommendations to the customer to have some documents within this category. If they exist, they are highly relevant to the suitability claim, and they should be turned over. If they do not exist, the claimant should be made aware of this so that he can make inquiry at the hearing as to why there are no such documents in existence.

Product Cases

List 12 is completely new and relates to documents which should be turned over by the industry in cases involving specific products. This is an important addition to the Discovery Guide, and PIABA strongly supports it.

Item 1 permits the customer claimant to identify up to 5 particular products at issue, and the firm is then required to provide the broker's trading activity, compensation, etc. for those particular securities. This is the closest thing in the new Discovery Guide to full commission runs, which we believe should be made available in nearly every case. However, at least in cases where particular products are at issue, much of the information will now, finally, be presumptively discoverable.

Item 2 provides protection to non-party clients of the firm, but still requires the inclusion of information concerning the customer's account, the broker's accounts and related accounts, and whether the account is an IRA. The inclusion of the broker's account information on these product cases is a welcome change. Item 2 also makes it clear that, in some cases, it may be appropriate to identify more than 5 such securities, and such a request may be made; however, beyond the first five securities such information would not be *presumptively* discoverable. It is critical that the rule state that the number 5 is not sacrosanct, but may be expanded in appropriate cases.

Items 3 and 4 relate to insurance products which provide a death benefit. These kinds of cases have become more prevalent, and it is sensible to require the production of these documents.

Item 5 fleshes out the broker's incentives to sell the product at issue, including commissions, bonuses and the like. We support the inclusion of this item as well.

Commission Runs

While there are some improvements in the proposed Guide with regard to trade and commission runs, PIABA believes that full commission runs should be turned over in all cases. If arbitration, and the discovery procedures, are intended to get at the truth, full commission runs should be presumptively discoverable. They often contain the kind of information which can be relevant in many arbitration matters. For example, full trade runs often show that the broker was trading a particular security in a number of his accounts, while marking the orders "unsolicited." This helps to

establish that the broker was, in fact, initiating the trades in the security; it also helps to establish that the supervisors failed to heed a clear red flag when there are numerous unsolicited transactions in a single security. FINRA has demonstrated its ability to protect the privacy of non-party clients by allowing redaction of some identifying information; therefore, there is no valid reason to limit the production of this information in FINRA arbitrations.

If a member firm is entitled to know the type of trading a client was doing years before the conduct at issue in the case, surely the customer should be able to see the trading and investment strategies the broker was engaged in with his other clients contemporaneously with the handling of the claimant customer's account. Commission runs are the most efficient way to demonstrate whether the conduct complained of by the customer was the result of the client's particular desires or of the associated person's standard practice.

GENERAL OBSERVATIONS

Method Of Producing Documents

Absent from both the current and proposed Discovery Guides is any attempt to address the method of production. Although arbitration is intended to be a more expeditious method for resolving disputes than court, there are some court rules that may provide insight into fair means of addressing certain problems that arise. One such example is the method of producing documents. Rule 34 of the Federal Rules of Civil Procedure allows the requesting party to designate the manner in which electronically stored information is to be produced. *See* Fed. R. Civ. P. 34(b)(10(C). Rule 34 also requires that a party produce documents "as they are kept in the usual course of business or … organize and label [the documents] to correspond to the categories in the request." *See* Rule 34 (b)(2)(E)(i). There is currently no such requirement that the documents be produced in any organized fashion, and they are often produced by industry respondents in a haphazard manner regardless of the volume of documents produced.

Language Conforming To The Sec's Document Retention Rules

A number of provisions regarding the production of documents by member firms or associated person(s) permit the respondent to make the unilateral determination as to what documents are related to the issues in the statement of claim, or what conduct is similar to the conduct alleged to be at issue. *See, e.g.*, List 1, ¶¶ 6,7, List 4 ¶¶ 3, 5, and 6. The vagueness of these

provisions vests sole interpretation in the responding party to determine which documents are responsive. Granting such unfettered discretion is likely to perpetuate ongoing discovery abuse.

We recognize and appreciate the fact that some of the language used in the proposed Lists conforms to the language of the SEC's document retention rules. For example, the term "memorandum of each order" in List 9, Item 1 tracks the document retention rule of SEC Rule 17a-3 (a)(6). Firms will no longer be able to say they are unable to turn over "order tickets" because they no longer keep them. Similarly, the term "account record" in List 1, Item 1 tracks SEC Rule 17a-4.

By conforming the language of the Discovery Guide to the SEC Rules, FINRA takes away the firms' ability to claim they do not understand what the Discovery Guide means. Moreover, if they claim that no such documents exist, they will need to explain why they have failed to keep the documents which the SEC requires them to keep.

We welcome any changes to the Guide which would remove ambiguity.

Confidentiality

An increasing trend in FINRA arbitration proceedings has been for arbitrators to enter blanket confidentiality orders in proceedings. This trend reflects either a misunderstanding or disregard for general principles governing confidentiality.

In April 2004, FINRA published an article in "The Neutral Corner", an educational newsletter for arbitrators, entitled "Arbitrators and Orders of Confidentiality."[8] In the article, FINRA explains that while arbitrators must treat all aspects of arbitration as confidential, the concept of confidentiality applies to arbitrators' ethical duty to maintain the details of proceedings in confidence. Parties, unlike arbitrators, "are generally free to disclose details of their own proceedings as they see fit." The article advises arbitrators that "the party asserting confidentiality [in the context of discovery] has the burden of establishing that the documents in question legitimately require confidential treatment." The article further identifies the factors that arbitrators should consider in determining whether certain documents warrant the issuance of a confidentiality order.

None of these caveats appears in the Discovery Guide itself, which addresses the topic of confidentiality only so far as to advise that parties may enter a stipulation regarding confidentiality or arbitrators may enter a confidentiality order. As a result, arbitrators often grant confidentiality when

8. The Neutral Corner, *Arbitrators and Orders of Confidentiality*, April 2004, available at: http://www.finra.org/ArbitrationMediation/Neutrals/Education/NeutralCorner/P010040

requested, seemingly without engaging in the necessary analysis to determine whether a confidentiality order is warranted. By publishing The Neutral Corner article, FINRA implicitly recognized that the party requesting confidentiality bears the burden of demonstrating its necessity. By failing to include a discussion of the relevant factors in the Discovery Guide, or at a minimum reminding arbitrators of the existence of that burden, FINRA ignores the repercussions of the statements regarding confidentiality in the Discovery Guide in its current form.

Ills arising from this include member firms' routine attempts to require that the documents be used only in the pending arbitration. Where members firms succeed in this effort, they will essentially prevent similarly situated customers from obtaining those documents. If they fail to succeed, they will still have driven up the time and expense required for motion practice. Either way, the member firms are making arbitration less fair and more expensive to customers. At a minimum, then, the Neutral Corner Article should be reprinted with the Discovery Guide.

FINRA should take this opportunity to include some sort of standard that arbitrators are to use when ruling on demands for confidentiality. FINRA recently indicated that it would reference the Neutral Corner article, but not change the introductory language on confidentiality. As many arbitrators and parties will have easy access to the Discovery Guide, but not necessarily to the Neutral Corner article, we feel such provision is inadequate to address the deficiency in informing arbitrators of their obligations when evaluating a request for a confidentiality order.

No Requirement To Plead Causes Of Action

The Discovery Guide provides lists of documents that are presumptively discoverable based upon certain causes of action in addition to those documents to be produced in all cases. Providing different lists based upon causes of action, however, wrongly implies that customers have a duty to plead specific causes of action. Under the Code of Arbitration Procedure, claimants are not required to plead causes of action, but only to specify "the relevant facts and remedies requested." *See* Code of Arbitration Procedure, Rule 12302(a)(1).

It may be appropriate to eliminate the lists, particularly because there are few categories of documents that are contained within these lists, and simply identify documents that are presumptively discoverable in all cases. While the Code of Arbitration Procedure controls the arbitration process, arbitrators may rely upon the provisions in the Discovery Guide as support for interpreting provisions of the Code. In this situation, an arbitrator may incorrectly infer that, because document lists exist for various causes of action, a claimant must actually plead causes of action. Eliminating the individual lists would not create an undue burden upon the parties, as parties

may object even to presumptively discoverable documents listed in the Discovery Guide. Implying that only certain pled causes of action will prompt the production of certain categories of documents may be a disadvantage to pro se parties, as well as to counsel who wish, for strategic or stylistic reasons, to avoid setting forth specific causes of action in statements of claim.

Affirmation That No Responsive Documents Exist

The current Discovery Guide provides that a party requesting documents may also request from the producing party an affirmation that no responsive documents exist after the producing party has conducted a good faith search. Neither the current Discovery Guide, nor the proposed revisions, requires a party to identify the person who conducted the search or provide the title or position of the person who conducted the search. We would like to see such a provision added.

CONCLUSION

Attached to this letter is an Appendix setting forth additional comments with respect to the specific items on the lists, all of which are incorporated into this letter by reference.[9]

The history of discovery abuse by member firms underscores the need for a firm, clear list of documents that are presumptively discoverable in all FINRA arbitration cases. Some of theproposed changes are a step in the right direction toward clarifying some language and creating new categories of documents that are to be presumptively discoverable. They do not, however, go far enough to level the playing field in arbitration matters. The proposed Discovery Guide unfortunatley perpetuates much of the unfairness which has been observed in FINRA arbitration procedings. The comments and concerns outlined herin will, we hope, go towards making FINRA discovery practive more fair for all parties involved.

Respectfully,
PUBLIC INVESTORS ARBITRATION
BAR ASSOCIATION
Scott R. Shewan
Exectuive Vice President/President-Elect

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9. www.piaba.org; Newsroom; Amendments to Discovery Guide in FINRA Arbitrations SR-FINRA-2008-024