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In this Issue

The following PIABA Rule Proposal regarding *Elimination of FINRA-DR Mandatory Industry Arbitrator Pursuant to Commission Rule of Practice 192(a)* was submitted to the Securities and Exchange Commission by Brian N. Smiley on June 11, 2009.

Ms. Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: *Proposed Rule Change- Elimination of FINRA-DR Mandatory Industry Arbitrator Pursuant to Commission Rule of Practice 192(a)*

Dear Ms. Murphy:

Pursuant to Rule of Practice 192(a) of the Securities and Exchange Commission ("SEC"), the Public Investors Arbitration Bar Association ("PIABA") submits this rule change petition to the SEC to eliminate the requirement that an arbitrator affiliated with the securities industry sit on all public investor cases arbitrated before the Financial Industry Regulatory Authority ("FINRA")[1] in which the amount in controversy exceeds $100,000. PIABA proposes that investors and industry parties be given the choice to decline to have an industry arbitrator sit on panels that hear and decide their cases.

PIABA's petition seeks to revise the FINRA Code of Arbitration Procedure for Customer Disputes. PIABA believes Rule 12402 of the Customer Code, requiring industry arbitrators to serve in arbitration proceedings between public investors and industry members, unfairly and systemically shifts the balance of justice against investors. Requiring investors who believe they have been wronged by the securities industry to have claims decided by panels that must include a representative of that securities industry creates at the least the appearance of bias, if not actual

1. FINRA (formerly the NASD) was established pursuant to the Maloney Act amendments to the Securities Exchange Act of 1934. FINRA is the only organization permitted to be registered with the Securities and Exchange Commission as a national securities association. (*See* Maloney Act, 52 Stat. 1070 (1938), 15 U.S.C. §§ 78o-3, et seq., amending the Securities Exchange Act of 1934, 15 U.S.C. 78a, et seq.) FINRA is required to promulgate and enforce rules "to protect investors and the public interest," 15 U.S.C. § 78o-3(b)(6).

bias. In proposing the rule, PIABA draws attention to the fact that virtually all broker-dealer account agreements provide for mandatory arbitration before FINRA Dispute Resolution ("FINRA-DR"); there is accordingly no meaningful choice for wronged public investors. The doors to the federal and state judicial systems have been slammed shut on investors. In compelling investors to arbitrate their disputes, broker-dealers force them to give up significant substantive and procedural rights. For example, investors are deprived of complete and full discovery including the right to depositions, interrogatories and requests for admission, as well as procedural safeguards including meaningful *voir dire* and effective access to appellate review.

If investors were to have access to the courts, it is doubtful that they would be forced to try their cases before a jury comprised of four stockbrokers or their counsel out of twelve jurors (*i.e.*, one third of the triers of fact). Public investors who are compelled to arbitrate in a forum which is controlled by FINRA and heavily influenced by its securities industry members should not also be further compelled to have a member of that industry sit in judgment of their claims. PIABA further notes that while FINRA rules require the presence of an industry arbitrator on panels, there is no parallel requirement that investor advocates sit as arbitrators.

The details of the proposed changes and the reasons in support thereof are set forth below. The relevant revised rules are attached as Exhibit One to this petition.

I. PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION

PIABA is a bar association whose member attorneys are devoted to representing the interests of investors in disputes with the securities industry.[2] PIABA was established in 1990 as an educational organization for securities arbitration attorneys who represent the public investor in securities disputes. PIABA members are involved in promoting the interests of the public investor in securities and commodities arbitration by:

1. Protecting public investors from abuses in the arbitration process; and
2. Making securities and commodities arbitration as just and fair as possible through reforms to arbitration forum providers such as FINRA.

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2. PIABA's website may be accessed at www.piaba.org.

As part of our on-going effort to "level the playing field" in arbitration, PIABA has frequently *commented* upon proposed rules involving arbitration. In this instance, however, we believe that the public interest is served by PIABA *submitting* a rule proposal directly to the SEC rather than awaiting action that FINRA may never take on its own. FINRA's efforts at reform in this area, including setting up a pilot program wherein some firms in some cases volunteer not to require an industry panelist, are the proverbial example of too little, offered too late.

The need for permanent and meaningful reform has never been more urgent. In April of 2009, FINRA reported that investor arbitration filings increased 81% versus the same time period in 2008.[3] In the wake of the recent market collapse, many of these claims involve the loss of financial assets that retirees will never be able to replace. Accordingly, investors are flocking to FINRA with arbitration claims and can no longer afford to wait for FINRA to act to remedy what amounts to institutional unfairness. PIABA is therefore compelled to bring the instant proposed rule change directly to the SEC for its consideration.

II. STANDING

PIABA brings this rule change petition before the SEC pursuant to Commission Rule of Practice 192(a), which provides that, "Any person may request that the Commission issue, amend or repeal a rule of general application."

III. CURRENT RULES REGARDING THE INDUSTRY ARBITRATOR

FINRA's arbitration rules provide that all arbitration claims must be heard by a panel of three arbitrators whenever the amount in controversy exceeds $100,000. FINRA Code of Arbitration Procedure Rule 12401(c). The rules further provide that one of the panel members must be a "non-public" (i.e., industry) arbitrator. FINRA Code of Arbitration Procedure Rule 12402(b). The rule defines "non-public" arbitrator as any individual who currently works in the securities industry, worked in the securities industry within the past five years, or retired individuals who spent a substantial amount of their career employed in the securities industry. Code of

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3. http://www.finra.org/ArbitrationMediation/AboutFINRADR/Statistics/index.htm

Arbitration Procedure, Rule 12100(p)(1), (2). The rules also provide that any lawyer, accountant, or other professional who has devoted more than twenty percent of his or her work to the securities industry within the past two years is also deemed an industry arbitrator. Code of Arbitration Procedure Rule 12100(p)(3). In addition, certain individuals are deemed ineligible to be public arbitrators, such as spouses of securities industry personnel, investment advisers and professionals whose firms do a certain amount of work for the securities industry. Code of Arbitration Procedure Rule 12100(u).[4]

IV. SYNOPSIS OF PROPOSED RULE CHANGE

The instant rule proposal provides the parties with claims administered before FINRA-DR the option to choose whether an industry arbitrator sits on their particular case. Such a rule would be a significant improvement to the current system wherein FINRA requires that an industry arbitrator sit on every case where the amount of damages claimed exceeds $100,000.

PIABA proposes that all separately represented parties be given the option of striking any or all industry arbitrators generated through the list selection system at FINRA-DR in all cases involving a public investor. In the event that no industry arbitrators remain on the 'non-public arbitrator' list after submission by both sides, the third arbitrator appointed would be selected from the 'public arbitrator' list, or, in some instances, from the 'chair qualified' list. The ability to strike all arbitrators essentially gives parties the option to choose not to have an industry arbitrator to decide their claims. The proposed rule change essentially mirrors the FINRA pilot program with respect to the industry arbitrator discussed more fully below.[5] If, as some securities industry members claim, industry arbitrators are beneficial to investors, investors should be entitled to make that

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4. Industry arbitrators are no longer permitted to sit on single arbitrator cases where the amount in controversy is less than $100,000, unless a party requests a three member arbitration panel. Code of Arbitration Procedure Rule 12402 (b). Additionally, industry arbitrators are prohibited from serving as the chair of an arbitration panel to hear investor arbitration claims. Code of Arbitration Procedure Rule 12400(c). These prohibitions, while well meaning, do nothing more than perpetuate the conflicted industry arbitrator's presence on all other investor arbitration panels on claims in which the investors losses are significant and possibly life altering.

5. The FINRA-DR press release regarding the public arbitrator pilot program may be found at http://www.finra.org/Newsroom/NewsReleases/2008/P038958.

determination for themselves on a case-by-case basis rather than having it forced upon them in all arbitration proceedings.

V. HISTORY OF MANDATORY INDUSTRY ARBITRATOR

In 1953, the Supreme Court of the United States ruled, in *Wilko v. Swan,* 346 U.S. 427 (1953), that disputes involving the statutory investor protections set forth in the Securities Act of 1933 could not be forced into arbitration pursuant to pre-dispute arbitration agreements. In deciding the case, the U.S. Supreme Court recognized several inadequacies of arbitration as compared to court proceedings in resolving investment disputes. Following the *Wilko* decision, securities arbitration for investor claims arising under the Securities Act of 1933 and the Securities Exchange Act of 1934 was viewed as strictly voluntary on the part of the investor.

After *Wilko*, public investors essentially had the option of selecting SRO arbitration. Thus, the determination of whether a securities industry arbitrator was deemed a plus or a minus was for the public investor to decide.

In 1987, the U.S. Supreme Court again considered the issue of whether investors could be compelled to arbitrate claims involving statutory violations of the Securities Exchange Act of 1934[6] pursuant to pre-dispute arbitration agreements in the landmark case *Shearson/American Express, Inc. v. McMahon*, 482 U.S. 220 (1987). In reversing the long held position that investors could not be compelled to arbitrate these statutory claims, the Supreme Court issued a 5-4 decision ruling that pre-dispute arbitration agreements could be enforced with respect to these claims. Since the decision in *McMahon,* it has become generally accepted that the securities industry may compel individual investors to file claims in the industry's arbitral forums by pre-dispute arbitration clauses contained in brokerage account agreements. As the result of the *McMahon* decision, securities arbitration transformed from a largely voluntary process to a mandated forum for most aggrieved investors. It is often overlooked, however, that the dissenting opinion in *McMahon* raised serious concerns regarding the

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6. The *Wilko* decision did not specifically address claims under the Securities Exchange Act of 1934. However, it had widely been believed that the reasoning of the *Wilko* decision concerning the 1933 Act also applied to the 1934 Act. Additionally, the SEC had indicated that broker-dealers could not seek to enforce pre-dispute arbitration agreements for claims alleging violations of the Securities Acts (See NASD Notice to Members 83-73 regarding the adoption of SEC Rule 15c2-2).

fairness of the industry-sponsored securities arbitration process. The concerns raised in the dissenting opinion have largely proven prescient.

Partially dissenting in the *McMahon* case, Justice Blackmun called into question the basic fairness of the arbitration forums operated by the securities industry. In particular, Justice Blackmun, joined by Justices Brennan and Marshall, questioned whether the promised oversight by the SEC of the SRO sponsored arbitral forums adequately ensured that investors' claims could be fairly heard. The opinion specifically referenced the presence of the industry arbitrator in connection with the fairness of the arbitration process:

> Furthermore, there remains the danger that, at worst, compelling an investor to arbitrate securities claims puts him in a forum controlled by the securities industry. This result directly contradicts the goal of both securities Acts to free the investor from the control of the market professional. The Uniform Code [of Arbitration] provides some safeguards, but, despite them, *and indeed because of the background of the arbitrators, the investor has the impression, frequently justified, that his claims are being judged by a forum composed of individuals sympathetic to the securities industry, and not drawn from the public* . . . The uniform opposition of investors to compelled arbitration and the overwhelming support of the securities industry for the process suggest that there must be *some* truth to the investors' belief that the securities industry has an advantage in a forum under its own control." *See N.Y. Times*, Mar. 29, 1987, Section 3, p. 8., col. 1 (Statement of Sheldon H. Eisen, Chairman, American Bar Association Task Force on Securities Arbitration: "The houses basically like the present system because they own the stacked deck."). 482 U.S at 260-261 (footnotes omitted). (emphasis added)

Writing for the majority in the *McMahon* case, Justice O'Connor noted that the decision was based, in large part, on the expectation that the SEC would oversee the rules of the SRO arbitration forums. *Id.* at 233-234. Beyond overseeing the rules of the forums, Justice O'Connor also indicated that the SEC should mandate the adoption of any rules that it deemed necessary to advance investor protection:

> [T]he Commission has the power, on its own initiative, to "abrogate, add to and delete from" any SRO rule. . . . In short, the Commission has broad authority to oversee and to regulate the rules adopted by the SROs relating to customer disputes, including the power to mandate the adoption of any rules it deems necessary to ensure that

arbitration procedures adequately protect statutory rights. 482 U.S. at 233-234.

The dissenting justices were critical of the fact that the SEC had not conducted a study of the perceived inadequacy of the SRO arbitration system as it existed in 1987. *Id*., at 265. The *McMahon* dissent also suggested that studies of the mandatory arbitration system would likely reveal evidence as to the fairness (or lack thereof) of the process. *Id.* at 265 and fn. 20 (After noting the industry's use of statistics to support its claim of fairness, noting further that "[s]uch statistics, however, do not indicate the damages received by customers in relation to the damages to which they believed they were entitled. It is possible for an investor to 'prevail' in arbitration while recovering a sum considerably less than the damages he actually incurred.")

Since *McMahon*, a number of statistical studies have, in fact, been conducted to evaluate the fairness of industry sponsored mandatory arbitration. Not surprisingly, the studies have confirmed the long held belief that industry sponsored securities arbitration is not perceived as fair to investors and that recovery rates favor the securities industry.

VI. STUDIES SHOWING THE UNFAIRNESS OF SECURITIES ARBITRATION

The Securities Industry Conference on Arbitration ("SICA") was formed with the encouragement of the SEC to report on the various arbitration forums sponsored by the SROs.[7] In 2005, SICA undertook to perform an academic study of fairness in arbitration based upon empirical evidence. Specifically, the study sought to determine whether participants in securities arbitration believe that it is conducted simply, fairly, economically, and without bias by the arbitrators. Pace University School of Law conducted the study on behalf of SICA, with the assistance of the Cornell University Survey Research Institute. The study sought the opinions of nearly 30,000 individuals involved in the securities arbitration process, including investors, securities representatives and lawyers. Approximately 3,100 individuals returned responses to the detailed questionnaire. In February of 2008, SICA published the results of the study (Barbara Black, Jill I. Gross, "*Perceptions of Fairness of Securities Arbitration: An Empirical Study*," (2008).[8]

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7. The SICA Arbitrator's Manual 3 provides that "Since arbitration is the primary means of resolving disputes in the securities industry, the public perception of its fairness is of paramount importance." (January 2001).

8. http://www.slcg.com/pdf/news/Mandatory%20Arbitration%20Study.pdf).

The SICA study found a strong perceived bias with respect to industry sponsored securities arbitration. Nearly half of responding investors believed that arbitration panels were biased. Sixty-two percent of public investors felt that the arbitration process was unfair.[9] Seventy percent of public investors were dissatisfied with the outcome of their securities arbitration cases. Seventy-five percent of public investors found securities arbitration to be "very unfair" or "somewhat unfair" as compared to court.

The SICA study specifically probed issues relating to the mandatory industry arbitrator. Thirty-six and one half percent of the responding public investors found the industry arbitrator to be biased in favor of the industry respondents.

Following the release of the SICA study, the North American Securities Administrators Association (NASAA),[10] a group composed of state securities regulators from all fifty states, issued a statement calling for immediate reforms to the system. Karen Tyler, the president of NASAA, encouraged FINRA to take immediate action by stating:

> The first step toward improving the integrity of the arbitration system **must be the removal of the mandatory industry arbitrator** and a prohibition on ties to the industry on the part of the public arbitrator. NASAA has long held that a choice between arbitration and the courts for resolving disputes should be a fundamental right for investors. Because the arbitration system has evolved into a mandatory condition imposed by the industry, it is imperative that the system of dispute resolution be fair, transparent and free from bias.[11]

In 2007, an independent study was conducted to analyze investor recoveries in securities arbitration. J. O'Neal and D. Solin, "Mandatory Arbitration of Securities Disputes, A Statistical Analysis of How Claimants Fare," at 17 (2007).[12] The study examined all arbitration awards rendered in NASD and NYSE arbitral forums between 1994 and 2004. In light of the *McMahon* dissent's suggestion that customer "win" rates might not be as

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9. The industry may point out that *only* forty percent of the non-customers indicated that arbitration was unfair. That number is indicative of the serious problems associated with mandatory securities arbitration relating to fairness.

10. NASAA's web site is located at www.nasaa.org

11. http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/9081.cfm

12. Hereinafter the "O'Neal-Solin Study," accessible at: http://www.slcg.com/pdf/news/Mandatory%20Arbitration%20Study.pdf.

meaningful as data showing damages awarded versus damages sustained, the study focused primarily on the amount a public investor could expect to recover in securities arbitration. The numbers were discouraging, ultimately finding that the percentage of the amount awarded to public investors compared to the amount sought significantly decreased from 68% in 1998 to 50% in 2004. Through extrapolation, it was found that investors bringing securities arbitration claims could expect to recover only 20% of the amount sought. And as discussed *infra* at note 25, recovery rates for large claims against major brokerage firms are shockingly small.

Since the publication of the O'Neil-Solin Study, investors' chances of recovery have continued to decline. In 2006, the win rate for public investors in FINRA arbitrations declined to 42% and plummeted to 37% in 2007, before rebounding to a still dismal 42% rate in 2008.[13] Moreover, the experience of our members, who routinely represent investors in arbitration cases, is that full recoveries of statutory damages such as those provided under state securities acts are very much the exception, even when liability is established.

VII. CONSOLIDATION OF ARBITRAL FORUMS

The landscape of securities arbitration forums has also changed dramatically since the *McMahon* decision. The arbitration departments sponsored by the American Stock Exchange, Municipal Securities Rulemaking Board and the New York Stock Exchange no longer exist, having been merged into FINRA-DR and its predecessor, NASD-DR. Likewise, at the time of the *McMahon* decision, some investors had the option to pursue claims before the American Arbitration Association, without a mandatory industry arbitrator. This option no longer exists. Today, FINRA-DR, with its mandatory industry arbitrator requirement, holds a virtual monopoly on the hearing of investor claims, with no competitive incentive to provide better procedural options to wronged public investors.

Although not directly germane to the current rule change petition, the near monopolistic grasp of FINRA-DR over securities arbitration proceedings should raise serious concerns with the SEC. Subsequent to the *McMahon* decision, the Commission itself stressed the importance of public investor choice of arbitration forums and the competitive benefit to all parties

13. A "win" is not always a win. If a panel were to make a small award to a public investor, then assess forum fees in excess of the amount awarded, this would still be counted as a "win" in FINRA's statistics.

derived from such choices. *See* SEC *amicus* brief in *Roney v. Goren,* 875 F.2d 1218 (6th Cir. 1989), at pages 16-21. Today only one arbitral forum remains for hearing the claims of public investors. Indeed, if FINRA obtains jurisdiction over investment advisors, even more claims could be swept under its umbrella. Thus, it is imperative that this forum provide a fair opportunity for claims to be heard before truly impartial arbitrators.

VIII. FINRA PILOT PROGRAM

On July 24, 2008, FINRA announced that it was launching a two year pilot program that allows a limited number of public investor claimants to choose to have cases heard before panels without a public arbitrator. [14] FINRA did not give any reason for adopting the proposed pilot program, besides stating that, "This pilot will give investors greater choice when selecting an arbitration panel," and that, "Additionally, this program will allow us to see if a change in the way arbitration panels are selected is a better way to serve and protect the interests of investors."[15] Only eleven firms are participating in the pilot program and some firms which are facing hundreds of claims and major exposure have declined to participate, thereby indicating their unwillingness to have their liability determined by panels that do not include an industry arbitrator.

At the time the pilot program was announced, NASAA President Karen Tyler stated on behalf of her members, "FINRA's pilot program, while a positive step, does not go far enough toward resolving immediate investor harm." [16] According to NASAA, "the *immediate* removal of the mandatory industry arbitrator is a *critical* step toward restoring investor confidence in the fairness of the securities arbitration process." *Id.* PIABA agrees, and

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14. The Public Arbitrator Pilot Program is a two-year pilot, whereby eleven FINRA member firms have agreed to have a limited number of cases each year administered under the Pilot Program. In order for a case to be eligible, the case must name one of these eleven firms, and there can be no other named Respondent. Thus, in a case where an associated person is named as a party, the case is ineligible for the Pilot. For eligible cases, the procedure is described at: http://www.finra.org/ArbitrationMediation/Parties/ArbitrationProcess/NoticesToParties/P116995.

15. Comments of FINRA's then-Chairwoman, Mary Schapiro, FINRA News Release dated July 24, 2008. Available at the following link: http://www.finra.org/Newsroom/NewsReleases/2008/P038958

16. http://www.nasaa.org/NASAA_Newsroom/Current_NASAA_Headlines/9081.cfm

sees no reason why the pilot program should not be made permanent and apply to all securities firms and their registered representatives.

IX. NO SOUND ARGUMENTS SUPPORT THE MANDATORY INDUSTRY ARBITRATOR REQUIREMENT

The traditional justification for the use of industry arbitrators is that they provide needed expertise and guidance to the panel on matters involving the securities industry. While no empirical evidence exists substantiating this assertion, it is entirely possible, and indeed consistent with the experience of many of PIABA's members, that in years past industry arbitrators could be helpful to investors particularly when the misconduct at issue was isolated, rather than indicative of systemic, industry-wide abuses. However, the nature of problems in the securities industry and the make-up of the industry itself have changed in ways which makes the mandatory presence of an industry member on panels a net detriment to investors.

The significance of the role of the industry arbitrator can not be underestimated. Not only are they one of only three votes, but, at FINRA, industry arbitrators are given a significantly disproportionate voice in the process. FINRA's arbitrator training materials have explicitly advised arbitrators that in determining liability, "[w]hen the case is highly technical, the industry arbitrator might begin the discussion to help clarify industry terminology <u>or practices</u>."

Ironically, the undue influence of the industry arbitrator is further highlighted in the "*White Paper on Arbitration in the Securities Industry*" published in October 2007 by the Securities Industry and Financial Markets Association ("SIFMA").[17] SIFMA, which is the securities industry's trade association, describes as a particular *virtue* of the industry arbitrator:

> 'Industry' arbitrators also benefit the public panelists as they can serve to educate them about financial products and services, industry customs and practices and other legal industry-related issues. (SIFMA White Paper, at 35).

17. SIFMA White Paper, pp. 36-37. The White Paper is available at: http://www.sifma.org/regulatory/pdf/arbitration-white-paper.pdf

The SIFMA White Paper goes so far as to suggest that because of the presence of industry arbitrators on panels, "parties need not call expert witnesses in order to educate a panel about certain products or industry practices." (SIFMA White Paper, at 35-36). The suggestion that industry arbitrators serve as *de facto* expert witnesses should be deeply troubling for public investors. In the first place, as previously noted, the influence of the mandatory industry arbitrator is not counter-balanced by any requirement that one of the other arbitrators have the qualifications to offer a more investor or regulatory-oriented analysis of securities industry products and practices. Second, industry arbitrators who offer their opinions on these topics are not subject to cross-examination about any errors or biases that make their opinions unreliable. As a result, public investors may lose their cases on the basis of "expert opinions" that they never have an opportunity to confront or even hear.

The role of the industry arbitrator as the panel's FINRA-appointed expert on industry products and practices has become increasingly problematic for public investors who have been injured by industry-wide illegal and unethical practices that have come to light in recent years. The list of Wall Street scandals relating to products and practices that have lost investors billions of dollars over the last decade is distressing and lengthy, but must include, even in abbreviated form:

(a) pervasive conflicts of interest of Wall Street research and recommendations on "tech" stocks in favor of brokerage firms' investment banking clients;[18]

(b) abuses in the trading and sales of mutual funds;[19]

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18. In 2002, Bear Stearns & Co., CS First Boston, Deustche Bank, Goldman Sachs, J.P. Morgan Chase & Co., Lehman Brothers, Inc., Merrill Lynch & Co., Morgan Stanley, Salomon Smith Barney, Inc., and USB settled charges by state and federal agencies concerning the undue influence of investment banking relationships on favorable stock research reports. *See*, http://www.sec.gov/new/press/2002-179.htm.

19. In 2004, fifteen firms settled NASD and SEC charges relating to unfairly depriving customers of mutual fund breakpoints. The firms included: American Express Financial Advisors; Bear Stearns ; Legg Mason ; Lehman Brothers; Raymond James; Linsco Private Ledger; UBS; and Wachovia. *See*, http://www.sec.gov/news/press/2004-17.htm. In 2005, the NASD fined American Express, Chase Investment Services and Citigroup for improper sales of Class B and C shares of mutual funds. *See*:
http://www.finra.org/PressRoom/NewsReleases/2005NewsReleases/p013648

(c) deceptive seminars and marketing schemes aimed at the elderly and newly retired;[20]
(d) fraudulent and unsuitable sales of variable annuities, especially to seniors and for tax-deferred accounts;[21]
(e) dishonest and deceptive practices in connection with the conduct of auctions of "auction rate securities" ("ARS") and the mismarketing of such securities as money market or CD equivalents;[22] and
(f) fraudulent practices in connection with the securitization and retail sales of products backed by subprime loans.[23]

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20. A joint report by the SEC, NASAA and FINRA found a pervasive pattern of misleading, fraudulent, and unsuitable sales practices in investment seminars sponsored by securities firms for senior citizens. *See*, "*Protecting Senior Investors: Report of Examinations of Securities Firms Providing 'Free Lunch' Sales Seminars*" (Sept. 2007), available at: http://www.sec.gov/spotlight/seniors/freelunchreport.pdf

21. *See*, "*Joint SEC/NASD Report On Examination Findings Regarding Broker-Dealer Sales of Variable Insurance Products*" (June, 2004), available at http://www.sec.gov/news/studies/secnasdvip.pdf. As stated in *Money Magazine* (January, 2000 ed), *"variable annuities come with plenty of drawbacks: their fees are high, they're brain-numbingly complicated…they're often pushed on investors for inappropriate uses, such as IRA rollovers…*" Variable annuities often have large surrender fees and tax penalties that can tie up an investor's money for many years. However, they also generate some of the highest commissions of any products brokers sell. Thus, annual sales in 2007 were over $160 billion and net assets invested in variable annuities exceed $1.35 trillion dollars. Insurance Information Institute, Facts and Statistics,
http://www.iii.org/media/facts/statsbyissue/annuities/?table_sort_761676=3

22. Firms that have been implicated in ARS misconduct include: TD Ameritrade; Banc of America Securities; Bear Stearns & Co., Inc.; Citigroup Global Markets; Deutsche Bank; A.G. Edwards, Inc.; E-Trade; Goldman Sachs & Co.; H&R Block; Lehman Bros. Inc.; J.P. Morgan Securities, Inc.; Merrill Lynch Pierce Fenner & Smith, Inc.; Morgan Keegan & Company, Inc.; Morgan Stanley; Oppenheimer; Piper Jaffray & Co.; Raymond James; RBC Dain Rauscher, Inc.; SunTrust Capital Markets, Inc.; UBS; Wachovia Capital Markets, Inc.; and Wells Fargo & Co. The SEC's 2006 Consent Order against 15 firms for fraudulent practices in connection with ARS can be found at: http://www.sec.gov/litigation/admin/2006/33-8684.pdf.
A number of class actions brought on behalf of ARS purchasers are identified at
http://www.financialweek.com/apps/pbcs.dll/article?AID=/20080422/REG/323114373/1010/rss01&rssfeed=rss01 and http://www.girardgibbs.com/auctionrate.html

23. The SEC, FINRA, Justice Department and the states have initiated dozens of investigations relating to subprime securitization and sales. *See*, *"Prosecutors*

The major Wall Street firms and many lesser known ones have been named in class actions, investigated, and/or sanctioned for misconduct in one or more of these areas, many of which were accepted as "business as usual" in the securities industry. Yet the victims of these wrongs must select the arbitrators who will decide their claims from lists that include industry members whose own firms may have engaged in similar practices. These arbitrators are likely to be reluctant to find another firm liable for conduct that may be the subject of litigation or regulatory proceedings against their own employers. This conflict of interest creates at the least the appearance of bias. Worse still, if, as SIFMA points out, industry arbitrators serve to "educate" other panel members, this so-called "education" may consist of persuading them that the practices at issue are acceptable because "everyone does it." Thus, conduct that a judge or jury might remedy with a recovery of full damages may be excused altogether, or minimized with "compromise" awards.

The on-going consolidation of brokerage firms within the securities industry has compounded potential conflicts for industry arbitrators. In recent years, such well-known firms as Dean Witter, Prudential Securities, A.G. Edwards, Paine Webber, Bear Stearns, Wachovia and Merrill Lynch have been taken over by other broker-dealers. Faced with this consolidation trend, industry arbitrators may be reluctant to award substantial damages against firms that could well become their future employers. The same economic considerations may influence lawyers or accountants who serve as industry arbitrators, since their clientele may include brokerage firms that could be acquired by the firm whose conduct is at issue in the case before

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Widen Probes Into Subprimes" Wall Street Journal (Feb. 8, 2008); The Bureau of National Affairs, Inc., *In Three Dozen Subprime Investigations SEC Is Asking 'Who Knew What, When'*, 40 Securities Regulation & Law 7 (Feb. 18, 2008); David Scheer and Jesse Westbrook, *Brokers Probed by FINRA on Mortgage Securities Sales, Person Says*, Bloomberg.com (Jan. 4, 2008) available at: http://www.bloomberg.com/apps/news?pid=20601087&sid=apNYRLoCVcUk&refer=home; Edward Hayes, *FINRA Joins Mortgage Storm*, Wolters Kluwer Financial Services (Feb., 4, 2008), available at: http://www1.cchwallstreet.com/ws-portal/content/news/container.jsp?fn=02-04-08; *USA Today*, *Regulators' Subprime Mortgage Cases*, Feb. 18, 2008 available at: http://www.usatoday.com/money/economy/2008-02-18-4194118666_x.htm,; Memphis Commercial Appeal, Feb. 28, 200, "*Morgan Keegan CEO Is Leaving : SEC Seeks Facts On Losing Mutual Funds*" http://www.commercialappeal.com/news/2008/Feb/28/morgan-keegan-ceo-is-leaving/ (investigation of Morgan Keegan mutual funds tied to subprime).

them.[24] Against this backdrop it should not be surprising that statistically an investor's expected recovery rate (i.e., win rate times recovery rate) of substantial damages in a large claim against a major brokerage firm is far less than against smaller firms.[25] This suggests that some arbitrators are reluctant to antagonize major firms.

As the securities industry continues to consolidate, the pressure on industry arbitrators to avoid antagonizing the few remaining mega-firms will only increase. At the same time, it will be all the more imperative that the clients of those firms who have suffered substantial losses be afforded access to a forum whose arbitrators are truly impartial and disinterested.

X. CONCLUSION

Given the reservations and concerns expressed in the *McMahon* decision over twenty years ago, the time is ripe to review the adequacy of the SRO arbitration system with respect to the mandatory industry arbitrator requirement. At the time the initial rules requiring the presence of a mandatory arbitrator in investor arbitration claims were drafted by the SROs, the SEC exercised very limited oversight in connection with the rules of industry sponsored arbitration forums. Likewise, securities arbitration was largely viewed as voluntary at the time the mandatory industry arbitrator rules were adopted. Additionally, the landscape and rulemaking approval process today, including notice and the ability to comment on proposed rule changes, has become more transparent, allowing investors and their advocates a voice in the process. Most importantly, a number of empirical studies conducted in the wake of *McMahon* show that the use of mandatory industry sponsored arbitration has resulted in a substantial decrease in the percentage of arbitration awards rendered in favor of investors, and that the arbitration system is perceived as being unfair to investors.

In the final analysis, the requirement of a mandatory industry arbitrator is antithetical to the integrity of the arbitration process and to the fundamental principle that finders of fact should be disinterested in the outcome of the

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24. Additionally, lawyer-industry arbitrators may be hard pressed to accept certain theories of recovery or reject certain brokerage defenses while serving as "impartial" arbitrators, knowing that they will present the opposite positions on behalf of their industry clients.

25. According to the O'Neal-Solin Study, the expected recovery percentage of a claim of over $250,000 against one of the three largest brokerage firms was a paltry 12%, versus over 37% for claims under $10,000 against smaller firms.

cases they decide.[26] If panels need expertise to decide cases, the parties are free to retain expert witnesses and are, in fact, likely to do so in cases in which losses exceed six figures. These experts are subject to thorough and sifting cross-examination by all parties so that their biases and the validity of their opinions may be thoroughly explored. That is fair; allowing an industry arbitrator to opine on industry standards and practices behind closed doors is unfair.

We strongly urge the SEC to take a step that FINRA has been unwilling to take on its own. If, as the Supreme Court has said, the SEC has broad authority to mandate the adoption of any rules it deems necessary to ensure that arbitration procedures adequately protect investors, *Shearson/American Express v. McMahon,* 482 U.S. 220, 234-35 (1987), this is a propitious time for the Commission to act.

PIABA expects that the securities industry's opposition to this rule proposal will be fierce--thereby revealing the inherent unfairness of the industry arbitrator and member firms' strong desire to maintain the *status quo*.

Thank you for your kind consideration in advancing the interests of investor protection.

Sincerely,

Brian N. Smiley
PIABA President

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26. The importance of avoiding the appearance of bias in arbitrations was hammered home in Justice Black's opinion, writing for the majority in *Commonwealth Coatings Corp. v. Continental Casualty Co.,* 393 U.S. 145, 150 (1969): "[A]ny tribunal permitted by law to try cases and controversies not only must be unbiased, but also must avoid even the appearance of bias. We cannot believe that it was the purpose of Congress to authorize litigants to submit their cases and controversies to arbitration boards that might reasonably be thought biased against one litigant and favorable to another."

WHY PUBLIC SCHOOL DISTRICT EMPLOYEES NEED A LOW-EXPENSE GOVERNMENTAL 457(b) PLAN

Michael B. Engdahl, JD, CFP®[1]

I. INTRODUCTION

In "Reasons For and Responses To the Lack of Direct Access to No-Load, Low-Expense 403(b) Plans in Many School Districts" published in the Fall 2006 *PIABA Bar Journal*, I revealed that many school districts give 403(b) plan participant employees the option to invest only in high-cost variable annuities or high-cost load mutual funds. As a result, the tax advantages gained by 403(b) plan investors are being eradicated by high investment costs in school districts that deny their employees access to low-expense 403(b) plan accounts.

In my follow-up article entitled "Assisting School District Employees With Gaining Direct Access To No-Load, Low-Expense 403(b) Plan Accounts" published in the Fall 2007 *PIABA Bar Journal*, I described several potential legal actions that attorneys may recommend in an effort to assist school district employees with gaining access to low-expense 403(b) plan accounts. However, I warned that, since ERISA Section 4(b)(1) exempts from ERISA regulation "any employee benefit plan if such plan is a governmental plan," most attempts to bring an action under ERISA against a school district for breach of fiduciary duty will likely fail if the school district is a public school district.

This paper will discuss why public school employees desiring to gain access to a low-expense retirement plan should consider requesting that their employer make available a low-expense governmental 457(b) plan in addition to a 403(b) plan. This paper will also describe the key characteristics of the 403(b) plan and the governmental 457(b) plan as well as discuss the differences between the two plans.

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II. THE 403(B) PLAN DEFINED

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

III. 403(B) PLAN ELIGIBILITY REQUIREMENTS

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

IV. 403(B) PLAN CONTRIBUTION LIMITATIONS

Contributions to 403(b) plans are typically classified as either elective deferrals or non-elective contributions.[3] Elective deferrals are employee contributions made under a salary reduction agreement. A salary reduction agreement allows the employer to withhold money from the employee's paycheck and contribute the withheld money directly into a 403(b) plan account for the employee's benefit. The employee does not pay tax on these contributions until he or she makes a withdrawal from his or her 403(b) plan account.

Non-elective contributions are employer contributions made to an employee's 403(b) plan account that are not made under a salary reduction

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2. I.R.S. Publication 571, Tax-Sheltered Annuity Plans (403(b) Plans) For Employees of Public Schools and Certain Tax-Exempt Organizations, January 2009, p. 3.

3. Id.

agreement.[4] The employee does not pay tax on these contributions until he or she makes a withdrawal from his or her plan account.[5] Nonelective contributions include matching contributions, discretionary contributions, and mandatory contributions made by the employer.[6]

For year 2009, employees can contribute the lesser of $16,500 (the 2009 elective deferral limit) or 100% of includible compensation for the employee's most recent year of service.[7] Also, for those employees whose employers make non-elective contributions, the 2009 limit is the lesser of $49,000 or 100% of includible compensation.[8] However, it is important to note that the employee is still limited to the $16,500 elective deferral limit. For example, if the employee made elective deferrals totaling $16,500 in 2009, the employer could make non-elective contributions of no more than $32,500 assuming that the employee's includible compensation for 2009 is at least $49,000.

Any employee may make elective deferrals in excess of $16,500 in year 2009 if he or she qualifies to make either of two potential catch-up contributions.

The first potential catch-up contribution may enable an employee to increase his or her year 2009 elective deferral limit by $3,000.[9] To qualify, the employee must have completed at least 15 years of service with his or her employer and cannot have made elective deferrals of more than an average of $5,000 per year in previous years.[10] Contributions made under this catch-up provision cannot exceed $3,000 per year, up to a $15,000 lifetime maximum.

The second potential catch-up contribution allows employees age 50 or older any time during 2009 to increase their year 2009 elective deferral limit by $5,500.[11]

It is possible to take advantage of both catch-up contributions in the same year. Therefore, the maximum year 2009 elective deferral contribution an employee can make is $25,000 assuming he or she qualifies to make both catch-up contributions. However, if an employee is qualified to make both catch-up contributions, the first dollars contributed above the standard 2009 elective deferral limit ($16,500) are considered to be part of the employee's

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4. Id.
5. Id., pp. 3-4.
6. Id., p. 3.
7. Id., p. 9.
8. Id., pp. 4-5.
9. Id., p. 9.
10. Id., p. 9.
11. Id., p. 12.

15 years of service catch-up contribution; any additional dollars contributed over the 15 years of service catch-up contribution limit are considered to be part of the employee's age 50 or older catch-up contribution.

V. FEES AND EXPENSES ASSOCIATED WITH 403(B) PLAN INVESTMENT OPTIONS

A public school employee may invest his or her 403(b) account balance only in annuity contracts or mutual funds.[12] Since both annuities and mutual funds contain fees and expenses, one must become aware of the fees and expenses embedded within his or her potential investment options before committing to invest in a 403(b) plan.

According to a study conducted by Morningstar, Inc. in the late 1990s, the total yearly expenses of a variable annuity averaged 2.09% ($2,090 per year for every $100,000 invested) of the annuity's accumulation value.[13] Unfortunately, the total yearly expenses of many variable annuities are still around 2.00%. However, a few insurance companies provide variable annuities to investors at a much lower cost. For example, TIAA-CREF currently offers several investment options within its 403(b) plan variable annuity with total yearly expenses below 0.60% ($600 per year for every $100,000 invested).

In addition to total yearly expenses, annuity purchasers also need be aware of a potential surrender fee. The surrender fee is typically around 6% in the first year after purchase. However, it can be much higher. This fee generally declines and is eventually eliminated over a number of years. Furthermore, some no-load annuity companies, such as TIAA-CREF, impose no surrender fees on their annuities.

Like annuities, mutual funds contain several types of fees and expenses. The largest long-term expense is the annual expense ratio, which is stated as a percentage of total assets. Mutual fund annual expense ratios currently range from greater than 2.00% ($2,000 per year for every $100,000 invested) to less than 0.10% ($100 per year for every $100,000 invested). Some mutual funds also carry upfront sales charges or surrender charges.

High fees and expenses may dramatically affect the investment performance of an annuity or mutual fund over time. This fact has prompted

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12. Id., p. 3.

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

several recent warnings to investors from the Securities and Exchange Commission (SEC) on the SEC's Web site (*www.sec.gov*). For example, the SEC warns that when considering purchasing a mutual fund, "scrutinize the fund's fees and expenses. . . . A fund with high costs must perform better than a low-cost fund to generate the same returns to you. Even small differences in fees translate into large differences over time."[14]

In order to understand the potentially detrimental effect of purchasing an annuity or mutual fund with high fees and expenses, consider the situation in which three public school employees each have a 403(b) plan account worth $250,000. Investor 1 invests in a high-expense annuity within her 403(b) plan account with total yearly expenses of 2.00%. Investor 2 invests in an average-expense mutual fund within his 403(b) plan account with an annual expense ratio of 0.90%. Finally, Investor 3 invests in a low-expense mutual fund within her 403(b) plan account with an annual expense ratio of 0.10%.

According to the SEC's Mutual Fund Cost Calculator, available on the SEC's Web site at *www.sec.gov/mfcc/mfcc-int.htm*, if all three investors earn an 8% gross average annual rate of return, at the end of 20 years Investor 3 will have fared substantially better than her counterparts. Correspondingly, she will have accumulated approximately $169,658 more than Investor 2 and $364,232 more than Investor 1. The results are summarized below:

Total Cost of Holding Investment

Investor	Ending Value	(Total Fees + Foregone Earnings)
1	$ 777,923	$387,316
2	$ 972,497	$192,742
3	$1,142,155	$ 23,085

VI. THE LACK OF EMPLOYER SUPPORT FOR LOW-EXPENSE 403(B) PLANS IN MANY PUBLIC SCHOOL DISTRICTS

One would think that all public school employers would take an active role in ensuring that their employees have access to only low-expense 403(b) plan accounts. However, nothing can be further from the truth. According to financial columnist Jane Bryant Quinn, a public school typically "arranges

14. U.S. Securities and Exchange Commission, "Mutual Fund Investing: Look at More Than a Fund's Past Performance," May 8, 2007, p. 1 <*http://www.sec.gov/investor/pubs/mfperform.htm*>.

for [the employee] to invest through payroll deductions but pretty much ignores what's going on."[15] A reason for such apathy by many public school districts regarding ensuring that their employees have access to only low-expense 403(b) plan accounts is the lack of ERISA regulation of public school 403(b) plans.

According to ERISA Section 3(21)(A), an employer is a fiduciary with respect to a retirement plan and, thus, is subject to ERISA duties to the extent that the employer exercises any discretionary authority or discretionary control respecting management of the plan or has any discretionary responsibility in the administration of the plan. Correspondingly, one of these ERISA fiduciary duties should be to ensure that the retirement plan includes quality, diversified, and low-expense investment options.

However, ERISA Section 4(b)(1) exempts from ERISA regulation any employee benefit plan if such plan is a governmental plan. Therefore, since public school employees are governmental employees, they lack ERISA protection with respect to their 403(b) plan accounts. Correspondingly, public school employers have no duty imposed upon them under ERISA to ensure that public school employees have access to only low-expense 403(b) plan accounts.

VII. THE LACK OF UNION SUPPORT FOR LOW-EXPENSE 403(B) PLANS IN MANY PUBLIC SCHOOL DISTRICTS

If public school employees cannot count on their employers, one would think that they can always count on their unions to ensure that they have access to only low-expense 403(b) plan accounts. Again, nothing can be further from the truth. Some of the nation's largest teachers unions have joined forces with financial services companies to steer members into high-expense 403(b) plan contracts.[16] Teachers unions currently endorse financial services firms, 403(b) plan contracts, and financial products. In return, the financial services firms reciprocate with financial support for the unions. This scheme has led some teachers unions to endorse 403(b) contracts that provide the unions with sizable kickbacks as opposed to endorsing 403(b)

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

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

contracts that provide public schools employees with low-expense investment options.

For example, the relationship between the New York State United Teachers (NYSUT) and the ING Group recently prompted an investigation from the New York State Attorney General's Office. The investigation revealed that a 403(b) plan, offered by ING and endorsed by NYSUT's Member Benefits Unit, charged investors fees and expenses as high as 2.85% per year while offering only limited benefits.[17] The investigation also revealed that NYSUT's Member Benefits Unit endorsed ING's 403(b) plan even though less expensive alternatives were available, received undisclosed payments of as much as $3 million per year for endorsing ING's 403(b) plan, and took steps to conceal its financial arrangement with ING from its members.[18]

In addition, a class action lawsuit was recently filed on behalf of National Education Association (NEA) members against NEA, NEA Member Benefits Corporation, Nationwide Life Insurance Company, and Security Benefit Corporation.[19] The alleged facts are similar to those in the NYSUT investigation, and the plaintiffs claim that hefty payments were made from Nationwide and Security Benefit to NEA Member Benefits Corporation and were not disclosed to 403(b) plan participants of the plan NEA endorsed.[20]

VIII. THE DISADVANTAGES OF THE MULTIPLE 403(B) PLAN VENDOR SYSTEM

Since many public school district employers have historically taken a less than active role in ensuring that their employees have access to only low-expense 403(b) plan accounts, they have allowed almost any 403(b) plan vendor to offer its plan to employees. According to Wendy Dominguez in her September 2006 article published in *The CPA Journal*, this multiple

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

18. Id.

19. Morgenson, Gretchen, "Lawsuit Says Teachers Are Overcharged on Annuities," *nytimes.com,* July 17, 2007, p. 1 <*http:www.nytimes.com/2007/07/17/business/15suit.html?_r=1&oref=slogin&page wanted. . .*>.

20. Id.

403(b) plan vendor system has resulted in public school employees receiving substandard services and high-expense products.[21] In addition, the multiple vendor system has left some public school employers with coordinating payroll deductions to as many as 60 different 403(b) plan vendors.[22]

Furthermore, Dominguez states that the multiple vendor system is a disadvantage to employees since employees lose the economies of scale typically associated with one large retirement plan. For example, if through a request for proposal (RFP) process a school district selected only one 403(b) vendor, the single plan would be substantially larger than any of the current plans. This may allow employees the opportunity to invest in "institutional" share class investments as opposed to "retail" share class investments. Institutional share class investments typically carry significantly lower expense ratios than retail share class investments.

IX. THE GOVERNMENTAL 457(B) PLAN DEFINED

Because of the high expenses associated with many 403(b) plans, public school employees may be well advised to investigate an alternative retirement plan called a governmental 457(b) plan. A governmental 457(b) plan is a retirement plan designed for employees of state and local governments. Similar to a 403(b) plan, employees are not taxed currently on pay that is deferred under the plan or on any earnings from the plan's investment of the deferred pay. Also, similar to a 403(b) plan, employees are generally taxed on amounts deferred in the plan only when they are distributed from the plan.[23]

X. GOVERNMENTAL 457(B) PLAN ELIGIBILITY REQUIREMENTS

State and local governments are eligible to establish a governmental 457(b) plan for their employees. Therefore, the types of employees eligible to contribute to a 457(b) plan include state and local government workers, fire fighters, police officers, and public school employees. Since public

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21. Dominguez, Wendy, "The Disadvantages of Multiple Retirement-Plan Vendors," *The CPA Journal*, September 2006, p. 1 <*http://www.nysscpa.org/cpajournal/2006/906/essentials/p64.htm*>.

22. Id.

23. I.R.S. Publication 575, Pension and Annuity Income, 2008, p.5.

school employees are employed by a state or local government and their school is organized as a Section 501(c)(3) organization, they are eligible to contribute to a governmental 457(b) plan instead of or in addition to a 403(b) plan.

XI. GOVERNMENTAL 457(B) PLAN CONTRIBUTION LIMITATIONS

Employers generally do not make contributions to governmental 457(b) plans. Therefore, contributions to governmental 457(b) plans are typically classified only as elective deferrals.

For year 2009, employees can contribute the lesser of $16,500 (the 2009 elective deferral limit)[24] or 100% of includible compensation for the employee's most recent year of service.[25] However, an employee's elective deferral limit may be increased if he or she qualifies to make either of two potential "catch-up" contributions.

The first potential catch-up contribution allows an employee during any or all of the last three years ending before he or she reaches normal retirement age under the plan to increase his or her contributions to the lesser of the following:

1. Twice the dollar limit for the year ($33,000 for year 2009), or
2. The limit for prior years minus the amount deferred in prior years plus the lesser of :
   a. The employee's includible compensation for the current year, or
   b. The dollar limit for the current year.[26]

The second potential catch-up contribution allows an employee age 50 or older any time during year 2009 to increase his or her elective deferral limit by $5,500.[27]

It is *not* possible to take advantage of both catch-up contributions in the same year.[28] Therefore, the maximum year 2009 elective deferral

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24. I.R.S., "EP Team Audit (EPTA) Program – EPTA Compliance Trends & Tips – 403(b) Tax-Sheltered Annuity Plan, 457 Plan and Governmental Plan Trends," p. 3 <*http://www.irs.gov/retirement/article/0,,id=206498,00.html*>.

25. I.R.S. Publication 525, Taxable and Nontaxable Income, 2008, p. 9.

26. I.R.S. Publication 525, pp. 9-10.

27. I.R.S., "EP Team Audit (EPTA) Program," p. 3.

contribution an employee can make is $16,500 if he or she is under age 50 and not within three years of normal retirement age, $22,000 if he or she is age 50 or over and not within three years of normal retirement age, and $33,000 if he or she is within three years of normal retirement age.

XII. THE ADVANTAGES OF THE GOVERNMENTAL 457(B) PLAN SINGLE VENDOR – COMPETITIVE BID SYSTEM

Historically, many public school district employers that make available governmental 457(b) plans have taken an active role in ensuring that their employees have access to low-expense investments within their governmental 457(b) plan. Also, public school district employers typically make available only one governmental 457(b) plan to their employees. Furthermore, employers typically select a governmental 457(b) plan after seeking competitive bids from several governmental 457(b) providers.

This single vendor – competitive bid system allows the employer to take advantage of economies of scale and use its negotiating power to significantly reduce the governmental 457(b) plan expenses to be borne by its employees. The process also may allow employees to invest in low-expense institutional share class investments as opposed to retail share class investments. For example, the New York State Deferred Compensation Plan, a governmental 457(b) plan, allows participants to invest in the Vanguard Institutional Index Fund – Plus Shares, an index fund designed to mirror the Standard & Poor's 500 Index, with an expense ratio of only 0.025% ($25 per year for every $100,000 invested).[29]

XIII. COMPARING THE 403(B) PLAN TO GOVERNMENTAL 457(B) PLAN

Below is a comparison of the key features of the 403(b) plan and governmental 457(b) plan:

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28. Id.

29. The New York State Deferred Compensation Plan also charges participants a $20 annual fee and an asset-based fee of eight basis points annually ($80 per $100,000 of account value). The asset-based fee is charged only on accounts with balances in excess of $20,000 and capped for accounts exceeding $200,000. Therefore, the total cost ratio for an account with a $100,000 balance in the Vanguard Institutional Index Fund – Plus Shares would equal 0.125% ($125 per year for every $100,000 invested).

	403(b)	**Governmental 457(b)**
Eligibility	Employees of public schools or other tax-exempt organizations as defined by Section 501(c)(3) of the Internal Revenue Code	Employees of state and local governments, including public schools employees
Basic Employee Contribution Limit (2009)	Lesser of $16,500 or 100% of includible compensation	Lesser of $16,500 or 100% of includible compensation
Catch-up Contribution Limits (2009)	Age 50 or over, an additional $5,500 **AND** with 15 years of service, up to an additional $3,000 per year ($15,000 lifetime maximum)	Age 50 or over, an additional $5,500 **OR** if within three years of normal retirement age, up to $16,500
System Often Used To Select Vendor(s)	Multi-vendor system	Single vendor – competitive bid system

XIV. CONTRIBUTING TO A GOVERNMENTAL 457(B) PLAN INSTEAD OF A 403(B) PLAN

As previously noted, governmental 457(b) plans are similar to 403(b) plans. However, there are at least two key differences between the two plans that may make a governmental 457(b) plan more attractive than a 403(b) plan. First, governmental 457(b) plans typically utilize a single vendor – competitive bid system, which often results in lower-expense investment options than are offered in many 403(b) plans. However, some no-load mutual fund company 403(b) vendors, such as Vanguard or Fidelity, may offer lower-expense investment options than are available in some higher-expense governmental 457(b) plans. Second, a governmental 457(b) offers more generous catch-up contributions than a 403(b) plan when the employee is within three years of normal retirement age. However, a 403(b) plan may offer more generous catch-up contributions than a governmental 457(b) plan after an employee has completed 15 years of service assuming the employee is not within three years of normal retirement age.

In addition, governmental 457(b) plans do not impose a 10% penalty on withdrawals an employee makes from the plan before age 59 ½ if the

employee has terminated his or her employment.[30] In comparison, except for a few exceptions, 403(b) plans impose a 10% penalty on withdrawals taken from a 403(b) plan before age 59 ½ even if the employee has terminated from his or her employment.

XV. CONTRIBUTING TO A GOVERNMENTAL 457(B) PLAN IN ADDITION TO A 403(B) PLAN

In the preferred situation where a public school district employee has both a low-expense 403(b) plan and a low-expense governmental 457(b) plan available to him or her, the employee has a unique opportunity. Since any amount contributed to one plan does not reduce the amount that can be contributed to the other, the employee may be eligible to contribute pretax up to $58,000 between the two plans if he or she qualifies to make the maximum catch-up contribution to each plan.

XVI. CONCLUSION

Public school district employees desiring to gain access to a low-expense retirement plan account should consider requesting that their employer make available a low-expense governmental 457(b) plan. If the fees and expenses associated with the employee's governmental 457(b) plan are lower than the fees and expenses associated with his or her 403(b) plan account options, the employee should consider investing in the governmental 457(b) plan instead of a 403(b) plan. Furthermore, if the employee has a desire to make significant pretax retirement plan contributions and the fees and expenses associated with his or her governmental 457(b) plan and 403(b) plan are low, the employee should consider investing in both a governmental 457(b) plan and a 403(b) plan. Thus, in certain instances, the employee may be able to make pretax retirement plan contributions up to $58,000 in year 2009.

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30. Healy, Barbara, "Why Public School Districts Should Consider Adding an IRC 457 Plan," *403bwise.com*, p. 1 <*http://www.403bwise.com/features/457reasons_bh.html*>.

FAILURE TO SUPERVISE: A REASONABLY RESPONSIBLE RENDITION + RECOMMENDATIONS

Louis L. Straney[1]

April of 1989 was a month of contrast for me. To begin with, I received a Tiffany bowl from my firm, Drexel Burnham Lambert, marking my ten year anniversary. After unwrapping that famous blue box, my first thought was, *"wonder what I get for twenty years?"*. Later that week, my question was answered – absolutely nothing!

After being recognized as one of the most successful global investment firms, under pressure from the Securities Exchange Commission and others, Drexel pled *nolo contendere* to six felony counts of securities fraud and paid a $650 million fine. This put into motion a series of events that shuttered the 5000 employee private client operation. As I grew to better understand the collapse of a firm that could trace its Philadelphia-based roots to 1838, it became apparent that the focal point of Drexel's disintegration can be summarized as a massive failure to supervise its institutional trading operations.[2]

Even though the events related to the flawed controls at Drexel were well publicized and easily avoided, this was neither the first nor the final Wall Street experience with damages related to negligent supervision. It is the focus of this paper to illustrate the following:

- **Despite the fact that a well managed supervisory system is mandated and arguably is the most effective method of detecting and preventing misconduct, enforcement actions and sanctions are applied unevenly and, as applied, do not serve as effective deterrents. From a regulatory perspective and from a firm's response to monetary and legal sanctions, historically, there is**

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1. After getting his first supervisor's license in 1980, Louis L. Straney spent 24 years in senior supervisory management with a Member Firm and also has experience as a case study writer, financial consultant trainer, and business school Research Director. He recently authored a text and webinar series on Securities Fraud, which are used by the Association of Certified Fraud Examiners for training and continuing education. Lou is the founder of Arbitration Insight LLC, a consulting and litigation support practice. He serves as an Expert Witness in civil proceedings and arbitration. He is an NFA arbitrator with extensive experience in derivatives and structured products.

2. For additional information on this topic; James B. Stewart, *Den of Thieves*, Simon and Schuster, 1992 and Louis L. Straney, *Securities Fraud*, 1-889277-49-5, Association of Certified Fraud Examiners, Austin, TX

minimal evidence of effective remedial requisites such as specialized product training or professional development.

The value of training as it relates to investor protection has been widely recognized, but not widely applied. For example, [1] the trade group representing broker/dealers, Securities Industry and Financial Markets Association (SIFMA), in the white paper *Structured Products: Principles for Managing the Distributor-Individual Investor Relationship*, July 9, 2008, noted:

"Financial Advisor and Supervisor Training: Structured products vary a great deal as to their terms, risk/reward profile, liquidity/availability of a secondary market, underlying asset, and a variety of other factors. As such it is important that financial advisors interacting with individual investors have an adequate understanding of structured products in general as well as an understanding of the characteristics of the individual structured products being offered. The financial advisor should be able to clearly explain the product's features to an individual investor. Distributors should provide their financial advisors with the necessary training, in structured products, including both the benefits and risks of the products, and should consider providing educational materials on structured products generally, in a suitable form (including one-on-one meetings, written materials, class-based training, desktop training, or other forms, as appropriate). Such training should also be provided to those responsible for supervising financial consultants."

With new leadership in Washington and as legislative initiatives are launched to revise the structure and impact of our regulatory agencies, we have an excellent opportunity to focus on effective supervision as a partial solution to sales practice misconduct and the legitimate concern related to market integrity.[3] The goal of this paper is twofold:

1) **Emphasize that through the member-firm's duty of "final responsibility", each brokerage firm has the unique opportunity to craft a leadership role in assuring the integrity of our financial markets.**
2) **Suggest areas of improvement for regulatory oversight and enforcement.**

Before discussing the specific federal laws, regulatory mandates and proclamations related to the duty to supervise, it is important to establish a

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3. Recent trends in securities regulation are not encouraging. Refer to the Notes & Tables Section I. of this article

historical perspective. Even though it is not intended to be inclusive, the following chronology offers a representative sampling of benchmark events over the last 25 years.[4]

CHRONOLOGY

1982 – 1991: According to an October 1993 SEC order, Prudential Securities, Inc. (PSI) "repeatedly failed to supervise its employees properly, most blatantly in allowing them to defraud hundreds of thousands of investors in limited partnerships … without admitting or denying wrongdoing, PSI agreed to pay at least $371 million in fines and restitution."[5]

1982: The Commission, rejecting the idea that only direct supervisors had liability, sanctioned a general partner of Bear Stearns for failing to supervise a registered representative who had engaged in excessive options trading in numerous customer accounts.[6]

1986: Prudential Securities entered into an SEC Consent Order related to Captain Crab Inc., *"The case showed a pervasive weakness by the firm in supervising employees…[the action] was the fifth time since June, 1982, that the SEC found Prudential and its predecessor firm to have failed in their supervisory responsibilities. During the investigation, then SEC Commissioner Mary L. Shapiro declined to comment on the action but was quoted as saying* ***'in general, the agency will go right up the line to the most senior executives.'****(emphasis added).*[7] George L. Ball was CEO at the time and was never charged with any illegalities.

1989: Based in part on failure to supervise Michael Milken, Drexel Burnham Incorporated pled guilty to six felony counts and agreed to pay $650 million in fines. In 1993, Senior Drexel

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4. This chronology is drawn from multiple public sources deemed reliable. However, unknown to this writer, the ultimate adjudication of the event may have been revised.

5. Business Week, November 8, 1993, *Is George Ball's Luck Running Out?*

6. In the case of Michael E. Tennenbaum, Securities Exchange Act Release No. 18429 (January 19, 1982). Also refer to; Gary W. Chambers, Securities Exchange Act Release No. 27963 (April 20, 1990), Arthur James Huff, Securities Exchange Act Release No. 29017 (March 28, 1991), Gutfreund, et al., Securities Exchange Act Release No. 31554 (December 3, 1992) SEC Doc. 4392

7. Ibid, *Business Week*, November 8, 1993

executives, Frederick Joseph and Edwin Kantor, due to their negligent supervision of Michael Milken, were banned from firm supervision.

1996: The SEC suspended Melvin Mullin for ninety days and fined him $25,000 for his failure to reasonably supervise Kidder Peabody trader, Orlando Joseph Jett.

1997: As part of a settlement with the SEC and the CFTC, First Capital Strategists agreed to pay a fine of $2.6 million for its failure to supervise a trader.

2002: Smith Barney BOM was given a 90 day supervisory suspension for failure to supervise in a case related to WorldCom securities. The firm in a Consent Agreement agreed to a Censure, a $1 million fine, and $400 million in investigative costs.

2002: Directly related to the discovery that BOM Frank Gruttadauria had misappropriated nearly $40 million of client assets, regulators embark on an extensive review of protocols for supervising producing managers.

2003: For the period 1998-2000, the SEC brings its first "failure to supervise" action against the principal of an unregistered investment adviser to a hedge fund. The fund's director was required to pay restitution of approximately $600,000 to hedge fund investors for losses and was suspended for six months.

2005: Citigroup, American Express and Chase are fined $21 million by the NASD for "inadequate supervisory and compliance policies and procedures relating to mutual funds."

2005: The NYSE fined Morgan Stanley $19 million for its failure to adequately supervise two rogue brokers.

2006: The NASD fined Securities America $2.5 million and ordered $13.8 million in restitution in an investment scheme that targeted Exxon retirees.

2006: The NYSE Regulatory arm fined UBS $49.5 million for its failure to supervise and to maintain adequate books and records.

2007: The NASD fined Raymond James Financial Services (RJFS) $2.75 million for the period of 2000-2004 for the failure to maintain an adequate supervisory system to oversee the sales activities of the firm's 1,000 producing managers.

2007: Fidelity Investments was fined $3.75 million for failure to supervise the receipt of gifts by its traders.

2007: Wachovia Securities was fined $2 million and agreed to a Censure and restitution to clients in a case related to policies and supervision of its fee-based programs.

2008: Press reports indicate that the SEC brought a total of four "failure to supervise" actions against broker/dealers and seven persons registered with those firms. There is notable lack of reliable information related to previous years' actions. An SEC Report submitted to Congress in 2003 indicated that for the four years of 1998-2001, forty-five professionals were subject to broker-dealer "failure to supervise" violations.

2009: FINRA fines NEXT Financial Group $1 million for supervisory failures that led to churning of customer accounts and excess commissions. Related to these activities, FINRA also sanctioned the firm's former Chief Compliance Officer and Chief Operating Officer for failing to fulfill her supervisory obligations. This CCO was fined $35,000 and was suspended as a principal for two months. She was also required to re-take her supervisory exam and to take 15 hours of training on supervisory issues.

SUPERVISOR QUALIFICATIONS

Before discussing the specific statutory and regulatory foundation for supervision, it should be noted that the pre-requisites for qualifying as a securities sales supervisor are at best minimal.[8] Anyone who has passed the General Securities Examination, the Series 7, and has been employed at a member firm for at least four months is eligible to take the combined Series 9 and Series 10 Examinations, which replaced the former NASD Series 8 Examination. The Series 9/10 examinations consist of 200 questions, with roughly half of those related to sales supervision. A score of 70 is required for passing. Other anomalies that are inconsistent with the spirit of investor protection:

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8. For the determination of "*Who is a supervisor*?", *"Whether you are the chairman or president of the firm, an in-house lawyer or someone with lesser authority, the Commission should not in my opinion absolve you of the responsibility to act (emphasis in original transcript) when you see that the house is on fire, and you are in possession of some part of the hose"*, remarks of Mary L. Shapiro, SIA Compliance and Legal Seminar, March 24, 1993.

- It is often the case that those with only the minimum requirement of a Series 9/10 are placed in a supervisory role in areas where they have no license, such as; insurance products, foreign currency options, futures, and interest rate options.
- Unlike the requirements for SRO-mandated continuing education for Series7 licensed financial consultants, currently there are no specialized development requirements for supervisors.[9]

STATUTORY & REGULATORY REFERENCES

It is not a focus of this paper to address the controversial issue of "private rights of actions" based on violations of securities statutes or regulations. However, as noted in the opening comments by an SRO Panel's Chair, the arbitrators, if they feel it is warranted, are obligated to make referrals to the appropriate agency for further review. The "failure to supervise" is one of the eleven issues that are included in the FINRA Disciplinary Referral Form.[10] As a practical matter, any evidence of a failure to supervise is likely to be very relevant to the questions of misconduct and liability.[11]

> **Section 15(b)(4)(E) Securities Exchange Act of 1934:** Provides that the "Commission, by order, shall censure, place limitations on the activities, functions, or operations of, suspend for a period not exceeding twelve months, or revoke the registration of any broker or dealer if it finds... that such broker or dealer... has

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9. Most states that issue professional licenses for Master Barbers have apprenticeship and experience requirements that surpass those associated with the Series 9/10

10. FINRA Rule 1210(b) of the Customer Code and Rule 13104(b) of the Industry Code.

11. For additional citations on issues often associated with supervision; SEC Rule 10b-5, SEC Rule 17a-3, NASD Rule 2110, NASD Rule 2120, NASD Conduct Rule IM-2310-2, NASD Rule 2440, NASD Conduct Rule 2860, NASD Conduct Rule 3013, and Notice to Members (NTMs) specifically related to supervision (85-84, 86-65, 88-84, 89-34, 89-57, 91-48, 92-18, 96-33, 96-59, 96-82, 97-19, 98-11, 98-18, 98-38, 98-52, 98-96, 99-03, 99-45, 04-71, 05-44, 05-46, 05-67, 06-12, 07-64, 09-10), Royal Alliance Associates, Exchange Act Rel. No. 38 174, 1997 SEC Lexis 113, MSRB Rule G-27. No attempt has been made to provide a complete citation. Due to the limited scope of this article, the primary goal of these citations was to provide the substance of the guideline.

willfully aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of the Securities Act of 1933, the Investment Advisers Act of 1940, the Investment Company Act of 1940, the Commodity Exchange Act, [the Securities Exchange Act of 1934], the rules or regulations under any of such statutes, or the rules of the Municipal Securities Rulemaking Board, or has failed reasonably to supervise, with a view to preventing violations of the provisions of such statutes, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision."

15 U.S.C. § 78*o*(b)(6)(A): Authorizing the Commission to impose sanctions on any associated person of a broker-dealer that violates the federal securities laws.

Section 203(e)(6) (formerly Section 203(e)(5) of the Advisors Act of 1940: Authorizes the SEC to sanction an investment adviser that fails to supervise any person acting on its behalf who violates the federal securities laws.

NASD Rule 3010: Supervision of Sales Activities, among other things states that, *"Each member shall establish a system to supervise the activities of each registered representative, registered principal and other associated persons that is reasonably designed to achieve compliance with applicable securities laws and regulations, and with applicable NASD Rules. Final responsibility for proper supervision shall rest with the member."* Rule 3010 goes on to comment on areas such as written procedures, mandatory annual compliance meetings, internal inspections, review of transactions and correspondence, and the application to branch offices and Offices of Supervisory Jurisdiction (OSJ). **Section 15(b) of the 1934 Act** defines "reasonable supervision" as established procedures, and a system for applying such procedures, which would reasonably be expected to prevent and detect, insofar as practicable, any violations of the Act.

NASD Rule 3012: Supervisory Control Systems: requires a firm to *"(A) test and verify that the member's supervisory procedures are reasonably designed with respect to the activities of the member and its registered representatives and associated persons, to achieve compliance with applicable securities laws and regulations, and with applicable NASD rules and (B) create*

additional or amend supervisory procedures where the need is identified by such testing and verification. [12]

NTM 05-29 provides additional guidance to Rule 3012 by stressing that the Rule's general audit considerations and provisions do not independently provide an adequate and comprehensive supervisory control system or serve as a safe harbor for the member. Only through testing and verification can the specific needs of the organization be effectively determined.

NFA RULE 2-9. SUPERVISION: *[Effective date of amendments: October 29, 1991; January 19, 1993; March 15, 1994; April 23, 2002; and November 1, 2007.]* Each Member shall diligently supervise its employees and agents in the conduct of their commodity futures activities for or on behalf of the Member. Each Associate who has supervisory duties shall diligently exercise such duties in the conduct of that Associate's commodity futures activities on behalf of the Member.

ANALYSIS

Earlier in this article, I described sanctions and regulatory responses as "uneven".[13] If we are to assume that the investor and the securities markets are better served if the mandates and sanctions related to supervision are deterrents and not simply after-the-fact subjective punishment, it stands to reason that the above events should be measured against widely accepted "deterrent theory". One of the central issues related to deterrent theory is a cost-benefit analysis. In short, in order to evaluate human behavior, conclusions must be based on the assumption that there was a clear

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12. http://supervise.legalview.into/articles/58917/. This web site is sponsored by several law firms in various states

13. This notion of "unevenness" is clearly demonstrated on page one of the FINRA Quarterly Disciplinary Review (October 2008). Under the category of "Unethical Conduct" a sales assistant was barred in all capacities because she misappropriated $1000 from the broker she assisted, while on the other hand, a broker who completed a firm-element continuing education program on behalf of another firm employee was fined $5000 but only suspended for 30 days. In the same FINRA newsletter, a research analyst who traded in the stocks he included in his research reports, received a $5000 fine and suspended for 10 days. And in the January 2009 FINRA Quarterly Disciplinary Review, a registered representative was barred in all capacities for the misappropriation of $50 from a customer.

understanding of the pleasure or pain (punishment) associated with the act. Additionally, the delivery of both the pleasure and pain must be swift and significant.[14]

I would argue that a process that often imposes long-delayed and minimal punishment fails to meet the standard of an effective deterrent. In a universe of approximately 1,000,000 associated persons licensed to sell insurance and securities products at 5,000 broker/dealers and thousands of registered and unregistered investment advisers, as noted in the 2008 SEC results,[15] the likelihood of swift and severe punishment for negligent supervision is remote.[16] Uneven application of less than well defined proclamations, scattered among several regulatory agencies does not contribute to market integrity or investor protection.

Even though it is their full responsibility, training and professional development of supervisors and associated persons at member firms, even after repeated determinations of deficiencies, has not kept pace with rapidly expanding markets and investment product developments. Additionally, SRO qualification testing should meet the same standard of "needs assessment" that the regulators impose on members. For example, even though option trading is an important area of investor activity, I would argue that structured products and other non conventional investments are equally important and should require specialized training – on the firm level, locally, and nationally through the SROs and exchanges. Some of the most complicated leveraged products to have entered our financial system are being mass marketed by largely untrained registered representatives to uninformed private investors.[17]

In my opinion, the duty to supervise is far from static. Member firms have been given the full responsibility of compliance and supervision and should assume a leadership role in their concession that effective supervision can only be accomplished through a best efforts program of relevant training and development. Branch Office Mangers seldom have a mandate beyond

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14. Robert Keel, *Rational Choice and Deterrence Theory*, **http://www.umsl.edu/~keelr/200/ratchoc.html.** Also, Fraud Examiners Manual, Association of Certified Fraud Examiners, 2008, Vol. II, Theories of Crime Causation, section 4.201, as it relates to the principle of "utilitarianism".

15. Refer to Chronology, 2008

16. For comparison purposes, imagine an American city with a population of 1,000,000, much like Dallas, Texas. For a 20 year period, it would be reasonable to expect many more serious crimes than the few highlighted in this paper's Chronology.

17. Refer to citation in footnote # 1

their local zip code so the initiative must begin at the highest levels within the organization. BOMs can only supervise and conduct training on products and market conditions that they understand. I once brought a complicated situation to the attention of Frank Zarb, the President of Smith Barney Harris Upham. After explaining my dilemma, for which no regulatory or firm rule existed, his advice was straight forward, *"do the right thing"*. I respectfully suggest that investment community leaders take heed to those words.

RECOMMENDATIONS

The financial services industry, regulators and legislative leaders have skirted the troublesome issues long enough.[18] During a recent research effort published in this Journal[19], I found a U.S. Government Accountability Office (GAO) 2000 analysis of arbitration claims well researched, insightful and objective.[20] In my opinion, as with the mandate to "test and verify" compliance policies and procedures, it is now appropriate to have a third party extensive review conducted to verify several critical elements of securities regulation by a resource such as the GAO. For example:

- **Verify the effectiveness of the industry's enhanced supervisory system for financial consultants. Additionally, as an important element in investor protection, disclose that status on the FINRA CRD system.**
- **Determine the appropriateness of the content in the General Securities Examination, the Series7. Make certain that the focus of this license is consistent with current industry revenue areas and compliance hot spots.**
- **Evaluate the Sales Supervisor Examinations, the Series 9/10 and the Series 24. Supplement the basic requirement with a strenuous and relevant continuing education requirement.**
- **Match the broker-dealer continuing education curricula with the fast paced needs of the private investor and financial markets.**

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18. Refer to Notes & Tables, Section II., for extracts from the 1994 SEC "Large Firm Report".

19. Louis L. Straney, *Rethinking Self-Regulatory Organization Arbitration Awards*, Public Investors Arbitration Law Journal, Vol. 15 No. 2, Summer 2008

20. United States General Accounting Office, *Report to Congressional Requesters, Securities Arbitration: Actions Needed to Address Problem of Unpaid Awards*, GAO-GGD-00-115, June 2000

Eliminate any self-serving program that is dedicated to a sales and marketing effort.

- **Launch failure to supervise investigations immediately and impose disciplinary actions within six months of the reported incident.**
- **Create a separate regulatory branch for complex derivative and structured products. This would eliminate all existing turf battles, indecision, and absence of regulatory oversight. Standardize concepts such as "manipulation of markets" and "know your customer" across all areas of financial services. Provide substance and content to the often-discussed obscure concepts of "reasonable" and "adequate".**
- **Provide our regulators with sufficient legislative support, budgets, and human capital to accomplish this long overdue restructuring of financial services**

RESOURCES

Nicole A. Baker and Richard M. Phillips*, The Securities Enforcement Manual*, Second Edition, Krikpatrick & Lockhard Preston Gates Ellis LLP, the American Bar Association, 2008

J. Kirkland Grant, Securities Arbitration for Brokers, Attorneys and Investors, Quorum Books, 1994

SEC Commissioner, Isaac C. Hunt, Jr., 1997 speech to NSCP National Membership Meeting, National Society of Compliance Professionals, 1997, related to 1996 "*Joint Regulatory Sales Practice Sweep"*

NOTES & TABLES

I.

Regulatory Actions	2004	2008	Change
Investor Complaints Received	4,687	5,405	15.3%
New Disciplinary Actions Filed	1,396	1073	-23.0%
Firms Expelled	22	19	-13.6%
Firms Suspended	4	0	N/A
Individuals Barred	454	363	-20.0%
Individuals Suspended	379	321	-15.3%

Source: www.FINRA.org, extracted July 30, 2009

II.
U. S. Securities and Exchange Commission
Division of Market Regulation
Division of Enforcement

THE LARGE FIRM PROJECT

May – 1994
Select Extracts

- ✓ **<u>Executive Summary</u>: The examination indicated that some branch office managers were not implementing firm procedures adequately.**

- ✓ **<u>Executive Summary, Section 7</u>: The Staff believes that continuing education requirements for the securities industry act as a preventive device to avoid customer complaints.**

- ✓ **<u>Report, Section IV, Recommendations, 7 (Continuing Education):</u> In addition to concerns regarding the incidence of traditional sales practice problems, the Staff is also troubled by the proliferation of new and exotic investment products without assurances that the training and knowledge bases of the securities industry sales force has kept pace. In this regard, the Staff believes that continuing education requirements for the securities industry can prevent sales practice abuses from occurring in the first place**.

THE "PERFECT STORM" DEFENSE: BAD METAPHOR, BAD DEFENSE

*Prof. Seth E. Lipner**

INTRODUCTION

The year 2008 was particularly bad for the financial sector. But it came right on the heels of 2007, during which the problems created by the sub-prime/Alt-A mortgage mess were already sending tsunamis through the sector. Every financial firm with a link to the mortgage or the lending business was in trouble. Capital was drying up, and huge losses were on the horizon.

One year later, financial markets were on the verge of collapse, and banks and financial service companies were either dead or in need of resuscitation. And many investors' brokerage accounts had incurred large losses. The biggest losses were in accounts invested in the securities and the products issued or created by financial institutions. Now those investors are commencing arbitrations to recover damages caused by these events.

The defense, already being seen but not yet proved effective, is being referred to as "The Perfect Storm". The metaphor is meant to suggest an unforeseeable and unpreventable confluence of events that somehow explains, and excuses, omissions of material fact and the giving of negligent advice. This article explores these cases and this defense, asserting that the "Perfect Storm" defense should fail in most cases, and offering the reasons therefore.

WHO MADE THIS MESS?

The sub-prime/Alt-A[1] mortgage mess began to reveal itself in Spring

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1. The terms "sub-prime" and "alt-A" refer to mortgages (and other debt) issued to poor-credit borrowers, and usually involving irresponsible lending practices such

2007. By August of that year, Countrywide Mortgage, one of the biggest real-estate loan originators and seller of CMOs, was on brink of bankruptcy. Bank of America purchased Countrywide, saving the firm from bankruptcy. Countrywide CEO Angelo Mozillo walked away with millions, leaving behind a failed a company and a ticking time bomb.

But it was not only Countrywide. Virtually every major financial sector firm was chest-deep in bad mortgages and other bad debt. So eager to profit from the loan-selling frenzy, the Wall Street banks were buying mortgage-lending companies, and buying loans (mortgages and other debt, including credit-card debt, car-loan debt and various other forms of bad bank loans). The plan was to re-package all this debt for sale as securities, supposedly utilizing complex and untested "credit enhancements"[2] to keep the pipeline moving.

But the market's tolerance for the flood of these securities was disappearing. In law enforcement jargon, the jig was up. Not only was the business of making and re-packaging loans dying, but these firms were getting stuck holding what Congress would, in 2008, euphemistically call "Troubled Assets".

In Fall 2007, several prominent but supposedly-safe mutual funds encountered huge losses.[3] The low-quality, complex debt instruments that these funds owned were dropping in value. The funds reported declines in their Net Asset Value, or "NAV". As investors (institutions and individuals) saw these declines, they started selling fund shares. But as these redemptions rose, more of these "troubled" securities had to be sold, flooding the market. Prices plummeted further. There were few takers for the complex, precarious

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as "no doc" or "low doc" loans; loans with insufficient loan-to-value ratios; loans based on faulty, corrupt or inflated appraisals; and adjustable-rate loans with such pernicious features as low initial "teaser" rates and negative amortization. These loans were then "securitized", i.e. pooled, repackaged, sliced in tranches, and sold as CMOs, CDOs, sometimes facilitated through the creation and sale of Credit Default Swaps and other so-called credit enhancements and other exotic securities. Most economists agree that the current financial crisis has its roots in these reckless and bad lending practices.

2. Credit enhancements can range from external insurance to internal default priorities that supposedly reduce the default risk to which an investor is exposed. In many instances, such as those that underlie the 2007-2008 market crash, credit enhancements were used to elevate the credit ratings of certain types or tranches of debt.

3. The most prominent example is the six RMK (Morgan Keegan) bond funds, which have spawned what may be a record number of arbitrations.

debt instruments these funds were trying to sell, and the funds suffered even bigger declines.

Then, in early 2008, the major Wall Street firms found themselves unable to support the market for Auction Rate Securities (ARS). The leading financial services firms (all of which were deeply involved in the mortgage mess) thus decided they would stop bidding and buying these Auction Rate Securities. As a result, the market for ARS "froze" on February 12, 2008. The problem was not so much the quality of the "credit", but rather the liquidity in the market. The financial firms, which had created and for 20-odd years supported this market, could no longer bear the financial costs of holding up the market for ARS, as they no longer had enough capital. The disease was acute, and it was spreading.

A few weeks after the ARS markets collapsed, in March 2008, Bear Stearns announced it was out of money. The federal government acted quickly, bribing JP Morgan to take on the once-feral Bear in order to save it (or actually, to save Bear's "counter-parties"). For the next several months, the news media was filled with reports and projections as to which firm would fall next - and Lehman Brothers Holdings seemed always to top the list. But Lehman was not next (it was merely next-to-next).

In Summer 2008, Fannie Mae and Freddie Mac, the government-created mortgage giants, admitted they were on their way to the morgue. Again, capital problems and losses stemming from the over-extension of sub-prime and alt-A credit drove those firms to insolvency, re-organization, and a government take-over. All the common and preferred shareholders were wiped out.

Then, on September 15, 2008, Lehman Holdings filed bankruptcy. With debt reportedly as high as $620 billion, Lehman was over-leveraged and over-committed to bad mortgages, bad debt-instruments and other risky contracts, including those un-regulated "Credit Default Swaps".

The stock market dropped, led by huge declines in the value of banks and brokerages. Merrill was quickly sold to Bank of America, and Wachovia was bought by Wells Fargo. Washington Mutual was soon to be no more. The once-great Citibank appeared to be the next to go. Or was it going to be Morgan Stanley, or Goldman Sachs? Credit markets were freezing, in large part because the financial firms were out of capital. Anyone who owned their stock, or their bonds, or the other "products" sold by or tied to these firms, suffered huge losses.

THE CASES THE DEFENSE (AND THE MOVIE)

Some investors who were sold these investments have commenced arbitrations. The balance of this article examines a defense that is being used in these cases - "The Perfect Storm" defense. The argument is essentially that the losses suffered by investors were unforeseen and unprecedented, and that therefore it is wrong to blame the brokerages for the huge losses in their clients' accounts. As will be demonstrated, this defense is both legally flawed and factually inaccurate. Indeed, use of the defense is also as morally bankrupt as Lehman is actually bankrupt.

The Movie and the Metaphor

Before undressing this spurious defense, a point must be made about the movie whose title it bears. Indeed, the very allusion to the title of that movie presents both an inappropriate metaphor and an opportunity to discredit the defense.

The people portrayed in the movie - based on the real story of an ill-fated Gloucester, Massachusetts fishing boat - were big risk-takers in search of huge returns fishing in dangerous waters late in the season. The situation is thus not the least bit analogous to the cases now being brought by conservative investors. These people were not fishing for huge profits. And although they were indeed in dangerous waters, unlike the fishermen in the movie, they had no reason to know it.

If by referring to the "The Perfect Storm" the defense seeks to imply a confluence of unpredictable events, the metaphor is equally flawed. The movie concerned the weather, which, as we know, is impossible to accurately predict despite years of scientific study. While the same may be true of certain financial markets, those in the marketing departments of financial services firms would not create ads comparing their abilities to those of weathermen. Nor would investors hire financial advisors if those advisors asserted that their profession and their abilities were only as good as those who predict the weather.

The "Perfect Storm" metaphor thus fails - in fact, its use hurts the defense. But before analyzing the defense (*sans* metaphor), it is useful to look at the nature of the cases being brought to understand the defenses that will affect them.

The Cases

A great deal of "wealth" was lost in 2007 and 2008. Obviously, not all losses are compensable, and not all losers bring cases. This section will describe the cases that are being brought, focusing on those that are likely to be most successful. My assessment is based on experience and common sense.

In securities arbitration cases, factors that have traditionally influenced the outcome of cases will continue to do so. For example, those who can demonstrate the requisite levels of reliance and trust have better cases than those who cannot. Inexperienced/unsophisticated investors usually have stronger cases than experienced and knowledgeable investors, although intelligence and abilities in other fields is not the automatic equivalent of "investor sophistication".

In the situation presented in many of the cases now pending, certain other criteria will be important. For example, those whose 2007-2008 losses are in fixed income products (rather than, *e.g.* stocks) will find they have better cases than those who, in past cases, lost money in stocks. One typical stock-case defense - that "everybody knows stocks can go down" - does not apply to bond cases. A defense lawyer cannot take that phrase, delete the word "stocks", insert the words "bonds", and make a defense. Put simply, those with huge losses on the fixed-income side of their portfolios, *e.g*. those who own Lehman bonds and so-called "Structured Products", or FannieMae/FredieMac preferred stocks, or any variety of supposedly-safe bond mutual funds,[4] had no reason to expect losses that in some cases dwarf the losses incurred by those who owned portfolios of diversified stocks.

Those who were over-concentrated in securities of the financial sector (bonds or stocks) can bring the same kind of "failure to diversify" cases that were brought after the tech-wreck. The level of over-concentration, profits previously made, and whether losses should be "benchmarked" will, of course, become battleground issues in many, but not all, cases.[5]

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4. Examples include Schwab Yield-Plus, the RMK funds, and the Oppenheimer Rochester Municipals Fund.

5. The application of diversification principles to assets generally, and to stocks in particular, are somewhat different from the way one applies them to bonds. Put differently, a typical bond investor is seeking limited returns, and avoiding any risk that would jeopardize the limited returns of the bonds owned needs to be avoided. Thus, a stock portfolio might find diversification in 20 holdings representing 5% each. A concentration of 5% in the bonds of one issuer can have a disastrous effect if that issuer fails and the principal is lost.

Last, investment objectives, risk tolerance and the representations made are always key facts. Many investors suffered large losses in the early years of the decade. Their advisors represented to them that tools like asset allocation, diversification, professional management, elaborately-engineered products (e.g. "Principal Protected Notes") and so-called "Hedge" funds would provide safety. Often, however, that safety was illusory, and accounts that might have appeared diversified actually contained excessive risk.

In the end, each case will stand or fall on its own merits, especially the testimony of the witnesses and the documents put into evidence. Generalizations will, as always, be especially difficult, and a cookie-cutter or mass-tort approach to the prosecution or defense of investor cases will almost certainly fail. But that said, the "Perfect Storm" defense, sure to be seen soon at an arbitration theater new you, is fatally flawed.

THE FACTUAL FLAWS

Many of the investment losses incurred in 2007 and 2008 were neither unforeseeable nor unpredictable. Research will be the key to defeating the argument. For example, a modicum of effort reveals that owning securities issued by financial services firms was dangerous. Good facts can be found in academic articles, the popular press, a study of credit spreads, and in the financial statements of the firms.

A good example is to look at the GSEs - Fannie Mae and Freddie Mac. These two firms issued huge quantities of preferred stock in late 2007 and again in May 2008. These issues were heavily-sold by the underwriters and book-runners, and they were "saleable" because of the "implicit guarantee" that was said to exist because of the quasi-governmental status of the two entities. There was no such guarantee, especially with respect to these entities' preferred stocks. Many investors agreed to buy these securities, believing the representations that they were "safe", unaffected by the on-going sub-prime debacle. They were wrong, and the events were catastrophic, but they were not unforeseen. The storms were right there on the radar of securities industry weathermen, but they apparently didn't want to issue the storm warning. Perhaps it would have been bad for business.

By the time most investors were sold this investment, earnings at Fannie Mae had gone from a *profit* of $3.65 per share in 2006 to a *loss* of $2.63 in 2007. Similarly, Freddie Mac's earnings fell from $3.00 in 2006 to a loss of $5.37 per share in 2007. Indeed, that was the first loss reported by FNM and FRE over the last 5 years:

Annual Earnings per share for FNM and FRE 2003-2007

	2007	2006	2005	2004	2003
Fannie Mae	-2.63	3.65	6.01	4.94	8.08
Freddie Mac	-5.37	3.00	2.73	3.94	6.68

Both these firms had been forced to take enormous write-downs in 2007, and their capital levels were severely depleted. Fannie Mae and Freddie Mac responded to that depletion by issuing unprecedented amounts of (new) preferred stock in 2007. In 2007, Freddie Mac issued $8.6 billion in preferred stock. By contrast, it had issued only $1.5 billion in preferred in 2006, and none at all in 2005. Similarly, Fannie Mae issued $7.8 billion in preferred stock in 2007. These new offerings represented *more than 20%* of the total stockholders' equity in FNMA as of the end of the year 2007.

Put differently, Fannie Mae and Freddie Mac, unable to borrow, were being re-capitalized through the issuance of huge quantities of risky new preferred stock. The large preferred stock offerings by Fannie Mae and Freddie Mac themselves increased the riskiness of all the securities in those firms' capital structure. These firms had run out of money to lend, and the issuance of these large quantities of preferred stock was needed to keep them (precariously) afloat. But losses were continuing and mounting, and the firms' ability even to pay the dividend on the preferred stock was already in doubt. This was no time to buy junior securities.

Yet, billions of this preferred stock was sold to unsuspecting investors. If the warning signs described above were not relayed to the investor, or if they were (negligently) ignored by the advisor, a valid claim exists that material facts were omitted. The "Perfect Storm" defense will fail for lack of a factual predicate.

The Fannie Mae situation demonstrates how one can be successful overcoming the "Perfect Storm" Defense - conduct good fundamental research; that is, do the research the broker or advisor probably did not do before selling the security to the client. In the "asset gathering" world of modern broker-dealers, "advisors" are usually just product-purveyors, selling the various investment products created or endorsed by the firm where the advisor is employed. In many situations, it will be easily demonstrated that due diligence was weak or non-existent, that important negatives were ignored and omitted, and that the marketing materials for the products do not contain the required balanced presentation. A good prosecution will involve good research.

The "Perfect Storm" defense should fail in other financial-services-sector

cases as well. For example, if the advisors who sold Lehman Brothers securities argue that "No one thought Lehman was in that much trouble", they will be ignoring an obvious and damaging fact - the employers of these advisors were experiencing identical problems in their own mortgage portfolios. Even if the advisors did not know, the respondent *firms* knew about their own internal difficulties. They will not be successful when they assert, in essence, "we knew about our own serious financial problems, but we thought Lehman was safe."

THE LEGAL FLAWS

The "Perfect Storm" defense also suffers from legal flaws. Mostly, it confuses the concepts of "negligence" and "causation". It also ignores simple, basic rules about disclosure[6] and reasonable care.[7]

The legal rule governing "fault" is simple - one who commits a wrong is liable for the damages "substantially caused" by the wrongdoing. A showing of substantial causation (embedded, primarily, in the concept called "cause-in-fact") can be defeated only if there was a different, "superseding" cause.[8] The fact that our economy is now suffering from a huge decline - the economic "crisis" - is not a "superseding" cause.

In addition to the fact that the economic condition created by the sub-prime debacle is not a superseding cause, another legal rule - the so-called "thin-skull plaintiff" rule - applies. The rule provides that if an act was wrongful (*e.g.* negligent), then the wrongdoer is liable for all the injuries caused, even if the extent of the injury was exacerbated by the pre-existing condition of the plaintiff.

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6. Non-disclosure cases can be sub-divided into those involving Prospectus delivery (*e.g.* IPOS, mutual funds, hedge funds) and those where no prospectus was delivered (e.g. secondary market purchases, managed account services). The former presents special challenges - although in most cases neither advisor nor client will testify that s/he read the prospectus. Regardless of the situation, a prospectus is always a great source of information about risks that should have been disclosed.

7. For a legal analysis of the requirement of brokers and advisors to exercise reasonable care in their recommendations and communications, see Lipner & Catalano, The Tort of Giving Negligent Investment Advice, 39 Memphis L. Rev. 863 (2009)

8. A superseding cause is one which breaks the chain of causation, and is usually the result of the unforeseeable intervention of another cause. See *Mutual Life Ins. Co. v. Dodge*, 11 F2d 486, 489 (1926), *cert. den*. 271 U.S. 667.

The classic statement of the rule is:

> If a man with an abnormally thin skull be truck a blow which would not seriously injure a normal man, but which causes his death, it is perfectly plain that the cause of death is not the thinness of the skull, but the receipt of the blow.[9]

The rule applies fully to the investment context. If a portfolio was poorly - negligently - constructed, or a material risk disclosure was not made, the defendant is liable for the full loss, even if the extent of that loss was not foreseen. The defense cannot avoid full responsibility by asserting that the losses were not foreseeable because it did not know that the wrongdoing would lead to catastrophic losses.

In other words, the focus of a securities case - for both the advocates and the arbitrators - should be on the wrongdoing, not on the virtually-unprecedented chain of events that eventually produced the losses. If an advisor made misrepresentations, or there were omissions of material fact, the advisor is responsible for the resultant loss, even if the loss was exaggerated by the financial crisis. If risky or volatile securities were sold to an investor whose risk tolerance was low, the advisor should not be able to argue that no one thought things would get as bad as they got. The wrong was committed. There was no "superseding" cause. The cause was the bad investment; the damages are the damages.[10]

CONCLUSION - THE ENVIRONMENT

The financial services industry bore significant responsibility for leading investors to over-invest in technology stocks in 1999 and 2000. But in 2002 and 2003, when it all came tumbling down, the financial services industry was able to shift the blame to others bad-actors like CEOs Bernie Ebbers, Ken Law, and Dennis Kozlowski, and to the accountants and auditors of the companies whose high flight turned into a sudden and steep descent.

In 2009, however, the financial industry will find no such "fall guys" - other than themselves, that is. They won't be able to use "the market", in the form of a weather-phenomenon-cum Hollywood-hit, as the foil this time.

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10. Conversely, if due diligence was exercised, full disclosure was made, and if and the recommendation was suitable, then no wrong was committed.

The American public and FINRA's arbitrators have seen too vividly how lying and greed on Wall Street fueled the current economic crisis. Huge salaries to executives, excessive compensation tied to short-term productivity, and an arrogant sense of entitlement, combined with a "public-be-damned" attitude,[11] left the nation on the brink of disaster.

The "Perfect Storm" defense has as little a place in securities arbitration as the "blame the victim" defense has in an assault case. In the end, it will fail because it will re-focus the arbitration on what was wrong with Wall Street. It is time for the securities industry to "fess-up", do the moral thing, and take responsibility, this time, for ruining so many people's lives.

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11. E.g. the Congressional testimony of Richard Fuld, former CEO of Lehman, trying to justify the hundreds of millions he earned as he drove that company into the ground.

JOINDER OF CLAIMS – OPPOSING SEVERANCE IN FINRA ARBITRATION[1]

Charles M. Thompson[2]

INTRODUCTION

As more Wallstreet products falter, the need to join multiple Claimants together has grown much stronger for many attorneys and their clients. When such group claims are filed, Respondents generally argue that severance is necessary because of the need to assess each claim on its own merits, in order to avoid confusion of the issues and to prevent unfair prejudice. The unspoken truth is that Respondents seek severance for a different reason. Respondents seek to sever claims because allowing the claims to proceed together will often reveal to a Panel a hidden, yet strikingly pervasive, pattern of misconduct. Moreover, Respondents are generally well aware that severance will impose expensive logistical burdens on Claimants which could effectively thwart, and in some cases effectually prevent, their ability to bring their claims individually.[3] The positive effect that joinder has on a case for Claimants cannot be overstated. Under it, the "defense" of "he said – she said" is virtually destroyed.

Respondents often seek severance without any regard whatsoever for the delay and utter waste of resources that severance would cause. To strike fear in arbitrators unwilling to hear a long arbitration case, Respondents often time exaggerate the length of any hearing of multiple Claimants in order to justify severance. To sever a cluster of claims does not minimize hearing length. Rather, severance increases the combined hearing time.

Unlike Respondents, Claimants do not generally possess abundant litigation cash reserves. Severance of claims would literally require that each

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1. Much of this article is based on accumulated contribution from many PIABA members over the last several years.

2. Charles M. Thompson is a Birmingham, Alabama based attorney with over 40 years of trial and arbitration experience. During his years as an attorney, Mr. Thompson has represented Claimants/Plaintiffs in hundreds of cases involving air crashes, car crash-worthiness, class actions, wrongful death cases and other complex litigation. After beginning his work in securities matters in the mid-80's, he now specializes in securities fraud/investor arbitration claims. Mr. Thompson may be reached at cmtlaw@aol.com or (205) 995-0068.

3. A severed claimant has to re-file his/her claim with attendant fees; i.e., the case goes back to the beginning with all new administrative procedures.

and every Claimant prepare similar and sometimes identical cases on an unnecessarily wasteful and repetitive manner. In addition, these severed claims create administrative problems for FINRA. Excessive arbitration pools would have to be generated. New arbitrators would have to be selected for each Claimant. Put simply, an arbitration process whose legitimacy inheres in its "expediency" and "efficiency" could very well end up being wasteful, dilatory, and expensive, in addition to being against prevailing law. Such a result is clearly prejudicial to Claimants and improper.

SEVERANCE HIGHLY IMPROPER

In filing a claim involving multiple Claimants, their lawyer would be well-served to repeatedly aver common questions of law and fact amongst the Claimants; i.e. explain in detail how all accounts were composed principally of the same investments, involved the same firm, the same broker or office, the same causes of action, or the same period of time, etc.

Respondents often argue that the Claimants have not set forth sufficient facts to meet the standard enunciated in the Code of Arbitration Rule 12312(a), which provides for joinder of Claimants "if the claims contain common questions of law or fact and," if they "assert any right to relief jointly and severally; or arise out of the same transaction, occurrence, or series of transactions or occurrences." Thus, Claimants should keep an eye on being sure that the conditions are fully satisfied: (1) joint and several claims, (2) based upon the same or series of transactions (3) where questions of law or fact will arise in the hearing.

Be prepared for Respondents' primary argument that the "true claim" of Claimants is based on suitability which requires individualized hearings. It should be argued, however, that the suitability analysis of each Claimant is part and parcel of all arbitration claims, meaning that suitability is one of many issues in every case and is not to be considered as a primary determinant as to whether joinder is allowed under Rule 12312(a). In arguing against Respondents' assertion that "suitability" analyses compel severance, Claimants should take advantage of the opportunity to list and argue the common wrongs committed by the Respondents against all the Claimants.

THE LAW REGARDING PERMISSIVE JOINDER IS UNEQUIVOCAL

Rule 12312(a) is substantially identical to Rule 20 of Federal Rules of Civil Procedure. Where federal rules and its court-determined progeny are helpful to the decision-making of arbitrators, such should be used in the arbitrators' evaluation. Rule 20, FRCP states in detail as follows:

> All persons may join in one action as plaintiffs if they assert any right to relief jointly, *severally*, or in the alternative in respect of or arising out of the same transaction, occurrence, or *series of transactions or occurrences and if any question of law or fact common to all these persons will arise in the action*. ... A plaintiff or defendant need not be interested in obtaining or defending against all the relief demanded. Judgment may be given for one or more of the plaintiffs according to their respective rights to relief, and against one or more defendants according to their respective liabilities (emphasis added).

Applicable case law universally supports Claimants' position of joinder. As opposed to the inapplicable "cherry-picking" of citations often advanced by Respondents, ***the reality is that joinder is to be liberally allowed***. In the case of *Gould v. The Cornelius Company*, 258 F. Supp. 701 (1966), the court aptly stated the position as pertains to the joinder of plaintiffs:

> In support of the joinder, the Plaintiff cites, inter alia, *Boysell Co. v. Franco*, 26 F.Supp. 421 (D.C.Ga. 1939) and *Harman v. Scott*, 183 F.Supp. 138 (D.C.Ohio 1960). These cases support the general proposition that where the acts of defendants are joint and relate to the same article (securities in the instant case), the Court, in the interest of justice, can order the actions tried together. *The court endorses and approves of the liberal joinder provisions* of the Federal Rules of Civil Procedure to avoid a waste of judicial effort (emphasis added).

As referred to by the *Gould* court, there is a "liberal joinder" of parties plaintiff in order "to avoid a waste of judicial effort." Argue repeatedly the "liberal joinder" case law.

Faced with abundant case law dictating joinder, Respondents normally fail to site any convincing, applicable procedural law in support of severance. Claimants' counsel should take time to read the cases often espoused by Brokers. Respondents primarily cite (i) class action law which is totally inapplicable and (ii) an occasional isolated case which is peculiar to its individual facts and esoteric at best. On the other hand, there is abundant

case law calling for the liberal allowance of joinder for efficiency purposes with the further provision that the claims do not have to be identical to one another. In the securities case of *Dougherty vs. Mieczkowski, Prudential-Bache Securities, Inc. et al*, 661 F. Supp. 267 (1987), the court, declared as follows as pertains to Rule 20, FRCP, on joinder:

> As this Court has noted, the Rule "does not require precise congruence of all factual and legal issues . . . . " *Mesa Computer Utilities, Inc. v. Western Union Computer Utilities,* 67 F.R.D. 634, 637 (D.Del. 1975). By its terms, *Rule 20(a)* only requires a single basis of commonality, in either law or fact, for the joinder to be acceptable. See *Mosley, 497 F.2d at 1334* (Rule does not establish "qualitative or quantitive test for commonality").

Thus, as the Delaware court in the above mentioned *Dougherty* case clarified, there do not have to be mirror image claims for Plaintiffs (Claimants) to join in a cause of action. *Dougherty* further states that to determine if there is permissive joinder of parties, the substantive claims are to be looked to, to discover the necessary "unifying elements."

FEDERAL COURTS AND THE U.S. SUPREME COURT PROMOTE JOINDER OVER SEVERANCE

The Claimants' attorneys should research joinder decisions in his or her own jurisdiction. Since I am in the 11th Circuit, as are most of our local arbitrators, I make an argument using principally case law from our Circuit and state. As opposed to Respondents' argument, which is based upon unique facts in several isolated cases, Claimants should argue in support of their position their own Federal Circuit's decisions as well as the U.S. Supreme Court holdings. In my home jurisdiction, the seminal 11th Circuit case of *Alexander v. Fulton County*, 207 F.3d 1303, (11th Cir. 2000), provides applicable guidance. In that case, eighteen employees of the Fulton County Sherriff's Department brought suit alleging racial discrimination in their workplace. All Claimants had experienced varying acts of discrimination by various means at different times. The defendant filed a Motion to Sever arguing that permitting joinder would "confuse the jury and unfairly prejudice their defense." *Id*. at 1322. The motion was denied and the defendant appealed. The 11th Circuit reiterated the general rule that a party seeking joinder under Rule 20 may do so by asserting 1) a right to relief arising out of the same transaction or occurrence, or series of transactions or occurrences, and 2) (based upon) some question of law or fact common to all

persons seeking to be joined." *Id*. at 1323. The court further observed that "***the United States Supreme Court has instructed the lower courts to employ a liberal approach to permissive joinder of claims and parties in the interest of judicial economy: 'Under the Rules, the impulse is towards entertaining the broadest possible scope of action consistent with fairness to the parties; joinder of claims, parties and remedies is strongly encouraged."*** (emphasis supplied) Id. at 1323 (citing *United Mine Workers v. Gibbs*, 383 U.S. 715, 724 (1966). With respect to the meaning of the terms "transaction or occurrence," the Court stated that the term "[t]ransaction' is a word of flexible meaning. It may comprehend a series of many occurrences depending not so much upon the immediacies of their connection as upon their logical relationship." *Id*. (citations omitted). Indeed "all 'logically related' events entitling a person to institute a legal action against another generally are regarded as comprising the same transaction or occurrence." *Id*. (citations omitted). *See also* oft-quoted *Mosley v. General Motors Corporation*, 497 F.2d 1330, 1333 (8th Cir. 1974) (holding that the term "transaction" in Rule 20 includes "*all reasonably related claims for relief* by or against different parties to be tried in a single proceeding. *Absolute identity of all events is unnecessary.*") (emphasis supplied). Even a "*pattern or practice*" of conduct by a defendant or defendants may satisfy the first prong of the Rule 20 inquiry." *Id*. (emphasis supplied).

With respect to the second prong of the Rule 20 inquiry, the 11th Circuit further observed that the Rule "does not require that *all* questions of law and fact raised by the dispute be common, but only *some* question of law or fact be common to all parties." Id. at 1324. The Court concluded that

> [g]iven the common core of allegations, the substantial overlap of particular claims, and the logical interconnection of several of the different forms that the alleged discrimination took, we are satisfied that the district court did not abuse its discretion in finding that the efficiency of a consolidated trial outweighed the potential for unfair prejudice or jury confusion.

The above described cases are highly illustrative in at least two respects. First, they naturally help to clarify FINRA's joinder rule. Second, a comparison between the facts of the above cases and the facts of the Claimants lawyer's instant case should be argued, including argument that for the Panel to find severance it would be more than a "stretch" and an obvious break from the Supreme Court's and the Federal Circuit's mandate that joinder is "strongly encouraged."

At its most basic level, the purpose of the joinder rule is undoubtedly to promote judicial economy by permitting the joinder of plaintiffs (and

Claimants) with the same grievances. To the extent that multiple grievances are based on a similar set of facts, involve a common defendant (Respondent) and/or are simply smaller components of a larger pattern of deception or malfeasance, an attorney may presupposed that such grievances are obviously proper candidates for joinder under Rule 12312(a) and its judicial counterparts. It is clear that the claims of parties seeking joinder need not be mirror images of one another. As long as the claims derive from a similar "*pattern or practice*" and involve "*some* question of law or fact," joinder is proper. *Alexander*, 207 F.3d at 1323. To reiterate, the U.S. Supreme Court has stated in no uncertain terms that permissive joinder should be granted "liberal[ly]" and is "strongly suggested." *Gibbs* at 724.

Despite this reality, Respondents continue to argue that joinder is inappropriate. Respondents write their briefs craftily. Remember to read their cases. They often do not stand for what the Respondent claims. When analyzed, their arguments are weak, poorly supported, and patently incorrect. Respondents will continue to assert that Claimants possess highly-individualized claims based on separate purchases and sales transactions, the defense and resolution of which will require detailed and fact intensive inquiries into the transactions to be completed by each individual Claimant. At best, these allegations demonstrate that Respondents are attempting to ignore the facts and applicable law of the case.

You must hammer away that the similarities among Claimants' claims greatly overshadow the differences, realizing that Respondents will seek to paint a starkly different picture. In essence, Respondents will draw the attention to vague distinctions between the histories and investment profiles of Claimants as illustration[s] of why joinder is improper for the whole group. Respondents' concentration on the Claimants, however, is misdirected. It is not the Claimants' circumstance that is controlling under FRCP Rule 20 and R. 12312(a). It is instead that the wrongful activity of Respondents require (i) joint and several rights to relief, based upon (ii) the same series of transactions, (iii) involving common questions of law or fact.

Respondents often, though mistakenly, argue that a Panel will be unable to keep the issues and facts straight in a hearing of multiple Claimants. In short, Claimants' counsel should use this argument as an opportunity to "deify" the Panel that the reverse is true - pee on their leg about how little trouble they will have. Claimants should contend that the Panel is more than capable of hearing each of the Claimants' stories - especially since all of Claimants' stories will be remarkably similar.

Use your opportunity to point out to the Panel the common acts of wrongdoing by the Respondents and the similar harm done to the "widows

and orphans" you represent. Argue that all the Claimants ultimately ended up losing a considerable amount of money through the total fault of the wrongful and ubiquitous practice of Respondents[4].

Claimants should insist that Respondents cannot possibly suggest with a straight face that their claims are not "reasonably related." The landmark case of *Mosley v. General Motors Corporation*, 497 F.2d 1330, 1333 (8th Cir. 1974), as well as *Alexander v. Fulton County*, id, have wonderful language to help attorneys in arguing a pattern and practice.[5] Also, refer to the most basic of law books - BLACK'S LAW DICTIONARY (7th ed. 1999)(defining a "pattern" as "[a] mode of behavior or series of acts that are recognizably consistent.").

RESPONDENTS' UNSPOKEN MOTIVATION BEHIND SEEKING SEVERANCE

Put simply, what Respondents really seek to achieve through severance is to divide and conquer Claimants one by one. The benefit of this strategy to Respondents is clear: First, and most obvious, by forcing each Claimant to proceed individually imposes temporal and financial constraints that would not otherwise be present if Claimants were permitted to proceed as a whole. Given the resources of some Claimants, these temporal and financial constraints could conceivably bar some from filing individual claims at all. Secondly, forcing Claimants to proceed individually enhances Respondents' ability to defend these cases. While each of the joined claims clearly possess intrinsic merit, they remain subject to the traditional imaginary defense that it was the Claimant – not the broker – who was controlling the investment decisions. This defense weakens significantly, however, if a number of similarly aggrieved investors join together and demonstrate the existence of a common pattern of misconduct by Respondent.

Respondents rue the day that each of the joined Claimants takes the witness stand and recounts their similar experience before a Panel. The Claimants' attorney would do well to read *Treece v. Hochstetler*, 213 F.3d 360, 363 (7th Cir. 2000) wherein the Seventh Circuit Court of Appeals recounted the basic test governing the admissibility of "similar fact" allowed into evidence under Federal Rules of Evidence 404(b). According to the

4. No grouping of Plaintiffs/Claimants are identical, which is the test posed by Respondents, but not required by prevailing legal decisions.

5. Claimants would do well in multiple Claimants cases to seek to aver a pattern and practice of similar wrongdoing by Respondent.

Court, evidence of a pattern of misconduct by a defendant is admissible when:

> (1) the evidence is directed toward establishing a matter in issue other than the defendant's propensity to commit the crime charged; (2) the evidence shows that the other act is similar enough and close enough in time to be relevant to the matter in issue; (3) the evidence is sufficient to support a jury finding that the defendant committed the similar act; and (4) the probative value of the evidence is not outweighed by the danger of unfair prejudice.

Id (internal citation omitted). *See also, U.S. v. Robinson*, 161 F.3d 463, 467 (7th Cir. 1998).

CONCLUSION

Through severance of claims, Respondents seek to obscure the truth; not further it. The vast amount of law requiring joinder, enhancing judicial economy, and the pursuit of justice all literally shout in favor of joining claims. Respondents' severance motions are a transparent attempt to "hide the ball" and impede justice.

Argue repeatedly that arbitration is supposedly an inexpensive way to settle disputes between the parties, and not a back-breaking division of the same claims into multiple and burdensome proceedings. Point out that it would be bordering on the ridiculous to have the individual Claimants be required to have separate cases assigned. It would be a ludicrous exercise for FINRA administrators to divide all of the cases into separate claims, set up separate files on each one of them, resubmit arbitrators' lists to the parties for selection and then go through the unnecessary procedure of multiple pre-hearing conferences and schedules, duplicative case work and preparation, not to mention the unavoidable risk of inconsistent results. Point out that there would be multiple conflicts in the parties' availability, their attorneys' availability as well as witnesses' and experts' availability, and that the only simple, logical and efficient manner to resolve a group of claims is to deny the Motion to Sever and leave the claims to proceed as one case.

End your argument against severance by pointing out that precluding joinder would inevitably breed the precise type of waste and duplication that FINRA Rule 12312(a) and its judicial counterparts were enacted to avoid.

RECENT ARBITRATION AWARDS

Jason M. Kueser[1]

Everett C. Ross, individually and as trustee of Everett C. and Imogene G. Ross Trust, et al. v. Charles Schwab & Co., Inc.
FINRA Case No. 08-02082

Charles Schwab marketed and sold its Yield Plus fund to Claimants as a cash alternative. Claimants' investment objective with this portion of their portfolio was capital preservation and income. Between 2001 and 2006, Schwab's San Francisco bond desk recommended Yield Plus purchases totaling more than $1.1 million.

Claimants asserted the following causes of action: (1) Breach of Fiduciary Duty; (2) Breach of a Written Contract; (3) Constructive Fraud; (4) Fraud by Misrepresentation and Omission; (5) Negligence; (6) Respondeat Superior; (7) Negligent Supervision and; (8) Violations of the California Securities Act. At the close of the hearing, Claimants requested damages of $432,189.00, which represented the total amount of market-adjusted damages, plus attorneys' fees and expert witness costs.

Claimants' net out of pocket loss was $157,498 and their market adjusted damages were $312,220.

The Panel found in favor of Claimants and ordered Charles Schwab to pay Claimants compensatory damages of $157,498.00, plus $16,000 in expert witness fees, and $300.00 in costs. The Panel also ordered Charles Schwab to pay 100% of the hearing session fees ($9,450.00).

Claimants' Counsel: Ryan K. Bakhtiari, Esq., Aidikoff, Uhl & Bakhtiari, Beverly Hills, California; David Meyer, Esq., David P. Meyer & Associates Co., LPA, Columbus, Ohio.

Respondent's Counsel: Stacey M. Garrett, Esq. and Terry Ross, Esq., Keesal, Young & Logan; Richard Karoly, Charles Schwab & Co., Inc.

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

Respondent's Expert: Greg Kyle and John Maine

Arbitrators: Kevin K. Forrester (Public Chairperson), Nancy J. Spieczny (Public), and James H. Fehlberg, CFP (Non-Public)

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[1] Jason M. Kueser is with The Kueser Law Firm, in Lees Summit, Missouri. Mr. Kueser can be reached at jason@jmkesquire.com.

This case is significant because the Claimant recovered 100% of their net out of pocket losses and expert witness costs. Additionally, the entire cost of the hearing was assessed against Charles Schwab. The award represents a finding of responsibility against Charles Schwab and requires Charles Schwab to pay all of the Ross Claimants' net out of pocket losses. This case appears to have been the first of many YieldPlus cases in which Schwab was forced to pay full net-out-of-pocket losses to the Claimant.

Phillip Rein v. Stifel, Nicolaus & Company, Inc.
FINRA Case No. 07-01495

Claimant was a former Procter & Gamble employee who retired in his early forties with more than $700,000 in a stock option plan. He established a retirement account with Respondent in order to generate annual retirement income of approximately $55,000. Respondent's broker subscribed to the "total return" philosophy and invested half of Claimant's life savings into three equity money managers and the other half of the qualified portfolio into a variable annuity that was also invested entirely in equity sub-accounts. The equities within the money manager accounts and the annuity were, in large part, volatile positions – the standard deviation for the portfolio was approximately 24 during a time period when the S&P 500 was 20 and a balanced portfolio of the aggregate bond index and the S&P was 10. As a result of Respondent's failure to properly allocate the portfolio and the aggressive equity positions, the value of Claimant's life savings declined significantly. While a portion of the decline was attributable to withdrawals, Claimant's portfolio declined to approximately $420,000 in less than two years. Claimant opened his account in January 2000 and closed it in December 2001.

The Statement of Claim was filed on May 9, 2007. Respondent argued the eligibility rule and statute of limitations beginning in a Motion to Dismiss and continued through closing arguments. Respondent's position was that the statute of limitations and eligibility period began when the account was opened and damages began to accrue.

Mr. Rein was awarded $220,944 in compensatory damages, which were based upon a prudently-managed portfolio theory, plus post-judgment interest.

Claimant's Counsel: Peter Mougey, Esq., Levin, Papantonio, Thomas, Mitchell, Echsner & Proctor, P.A., Pensacola, Florida.

Respondent's Counsel: M. Jane Matoesian, Esq., Greensfelder, Hemker & Gale, P.C., St. Louis, Missouri.

Claimant's Expert: Rick Evans

Respondent's Expert: None

Arbitrators: Albert J. Haller (Chairperson), Michael L. Lyons (Public), and Edwin R. Cohen (Non-Public)

This case is significant as the Panel rejected Respondent's arguments related to the eligibility rule and statute of limitations. The Panel's refusal to apply either limitations period as Respondent sought appears, at least in part, due to the Panel's conclusion that that Respondent owed Claimant a fiduciary duty and, as a result, placed the burden on Respondent to fully disclose the fact that the portfolio was not properly invested. Respondent never met its burden of full disclosure and argued that the portfolio was appropriate. The award is also significant because Claimant took early retirement in his forties. Although Respondent argued that an equity portfolio was appropriate, the Panel awarded damages based upon a prudently-managed portfolio theory.

Jin O. Cha, lan Kim, Jun H. Kwon, Terry and Chong M. Cha, Charles and Sara Cho, Sang Kyun Kim, Paper Design Clothing, Inc., Won P. Yim, and Chong Suk Yim v. EI Asset Management, Inc.

FINRA Case No. 07-02044

Claimants were either relatives or acquaintances of each other. They were all cultivated by a Wall Street broker through an initial cold call to one of them. Claimants' sophistication in securities varied to different degrees from never having had a securities account to having traded stocks for a number of years. However, none of them ever traded options before the accounts at issue were opened. Most of the losses were from trading calls in Nektar Therapeutics. The claims were primarily for breach of fiduciary duty based upon unsuitability and lack of diversification, and fraud. More than $900,000 in losses came from call options in Nektar Therapeutics alone.

Claimants asserted the following causes of action: 1) breach of fiduciary duty: unsuitable investment recommendations; churning; price manipulation; over-concentration in technology and biotech sectors; failure to diversify; risky options trading; and failure to implement Claimants' objectives; 2) constructive fraud; 3) negligent misrepresentations; 4) breach of contract; 5) respondeat superior; 6) failure to supervise; and 7) violations of Sections 10 and 20 of the Securities Exchange Act of 1934 and Rule 10(b)-5, Sections 12(2) and 15 of the Securities Act of 1933; California Corporations Code Sections 25401, 25500, 25501 and 25504; NASD Conduct Rules Section 2110, 2120, 2310 and 3010 and New York Stock Exchange Rule 405.

In their First Amended Statement of Claim, Claimants requested rescission damages or, in the alternative, compensatory damages in the amount of at least of $1,422,975.00.

The Panel ordered Respondent to pay compensatory damages totaling $1,655,995.00, plus pre-judgment interest at 7% per year from the approximate date that Respondent filed its Answer through the date of the Award. In addition to the compensatory damages award, the Panel ordered Respondent to pay $1,000,000.00 in punitive damages. The Panel also ordered Respondent to pay 100% of Claimants' costs ($12,228.70), Claimants' expert witness fees ($34,415.18), and the hearing session fees ($40,800.00)

Claimants' Counsel: Mark I. Zussman, Esq., Law Offices of Marc I. Zussman, Los Angeles, California

Respondent's Counsel: Edwin J. Boyle, Esq. and Ami Shah, Esq., Wilson, Elser, Moskowitz, Edelman & Dicker LLP, New York, New York.

Claimant's Expert: Arthur Gooding, Ph.D

Respondent's Expert: No expert

Arbitrators: Susan Gans-Smith (Chairperson), Constance Boukidis (Public), and James Murphy (Non-Public).

This case is significant because the Panel awarded nearly 100% of market adjusted damages. Since the S&P was up during this period of time, the award was approximately $300,000.00 more than the net out of pocket losses. Secondly, the panel, in finding fraud, awarded $1,000,000.00 in punitive damages, plus all costs and forum fees against Respondent. The parties entered into a confidential settlement after the award was issued.

Lawrence Donald Casey, Lawrence Donald Casey, IRA, Noel A. Vitug, Jr., Noel A. Vitug, Jr., IRA, Rose Vitug, and Bruno and Carol Anne Schmidt, individually and as JTWROS v. John F. Winnick, I.C.R. Financial Center, Inc., Adolf F. Kohn, Charles J. Helfrich, Jr., Irene Maria Gerold, and Angeles Capital Group, LLC.

FINRA Case No. 08-00738

Claimants were victims of a $21,000,000 ponzi-like investment scheme involving securities issued by two companies, Real Estate Fund, LLC and Heritage Funding Group, Inc. Claimants collectively invested and lost approximately $245,000.00 in the scams, which were solicited and sold by Respondents I.C.R. Financial Center, Inc. and John Fredrick Winnick. According to Claimants, ICR and Mr. Winnick solicited and sold the securities in question via material misrepresentations and/or omissions of fact

which included *inter alia* Respondents' failure to disclose the involvement of a recidivist securities law violator named Richard Houghton. Unbeknownst to Claimants, Mr. Houghton was intimately involved with the issuers of the securities in question and more importantly was an undisclosed principal with broad managerial authority over ICR's operations and as such was a control person of Respondent ICR.

The issuers, Real Estate Fund, LLC and Heritage Funding Group, Inc., filed for bankruptcy in January 2007. Ultimately, Real Estate Fund, LLC, Heritage Funding Group, Inc. as well as their principals Michael R. Bretzel and Lawrence Ford, II were also the subject of an SEC complaint for injunctive relief, which was filed in Florida on April 12, 2007. In June of 2007, the California Department of Corporations also issued a Desist and Refrain Order against Heritage and Respondent ICR for engaging in the unlawful sale of unregistered securities.

Respondents ICR, Winnick, Kohn, Helfrich, and Gerold each failed to comply with their voluntary production obligations pursuant to Rule 12506 and failed to respond to any of Claimants' discovery requests. Respondents ICR, Kohn, and Helfrich did not attend the hearing on the merits. Respondent Gerold appeared pro se and Respondent Winnick appeared and was represented by Art Leider.

Claimants asserted various common law claims for relief as well as statutory claims alleging violations of the California, Nevada, and Florida Securities Acts. Specifically, Claimants alleged that Respondents I.C.R. and Winnick breached their fiduciary duties by recommending unsuitable, highly speculative, and unregistered securities to Claimants. All Respondents were alleged to have defrauded the Claimants by not disclosing material facts relating to the securities offered and by concealing and omitting material facts. They were also alleged to have violated the California Corporations Code, Section 25401 (2004) by knowingly selling securities to Claimants who were not accredited and to whom they did not disclose material facts, and by misrepresenting the nature of the security and the returns they were to receive. Respondents Helfrich and Kohn were alleged to be control persons in violation of the California Corporations Code Section 25504 for aiding in the sale of the securities and as such, are jointly and severally liable with the other Respondents.

Claimants also alleged that Respondents also violated the Florida Securities Acts, Section 517.301 (F.S.A.) and the Nevada Securities Acts (NRS Sec. 90.570) for violations mirroring the California Securities Acts. Both the Florida and Nevada laws authorize recovery of attorneys' fees.

In the Statement of Claim, Claimants requested:

1. Damages in the amount of approximately $242,000.00 plus stated interest on each of Claimant's transactions;

2. Statutory interest, costs, and reasonable attorneys' fees;

3. Punitive damages due to Respondents' wanton, willful, and malicious conduct in an amount to be determined by the Panel; and

4. Any other relief the Panel may deem appropriate.

The Panel found Respondents violated the California, Florida and Nevada Securities Acts, and that Respondents intentionally, willfully, and knowingly caused the Claimants to fill in their applications in a manner inconsistent with Claimants' abilities, background, financial status or suitability for these offerings. They also willfully and knowingly misrepresented the true owners of I.C.R., the commission earned, and risk of purchasing these offerings. The Panel also found that Respondents willfully, intentionally and egregiously made misrepresentations to Claimants Noel and Rose Vitug concerning the nature and risk of purchasing these securities, knowing that they were not and could not be accredited, that they did not have knowledge or experience in the purchase or sale of securities, and that at the time of the sale to these Claimants, they had a negative net worth.

The Panel ordered Respondents to pay $223,467.16 in compensatory damages, plus $55,866.79 in attorneys' fees, $65,825.46 in pre-judgment interest (at 10% per annum), $8,083.11 in costs, and $50,000 in punitive damages. The Panel also ordered Respondents to pay Claimants sanctions in the amount of $20,500.00 ($5,000.00 for each of four Respondents and $500.00 for the fifth Respondent).

Claimants' Counsel: Richard A. Nervig, Esq., Richard A. Nervig, P.C., Fallbrook, California

Respondent's Counsel: Arthur S. Leider,Investors Arbitration Specialists, San Diego, California (Winnick); Adolf Kohn, I.C.R. Financial Center, Inc., San Diego, California (I.C.R. Financial); Respondents Kohn, Helfrich, and Gerold appeared pro se.

Arbitrators: Mandel E. Himelstein (Chairperson), Mary Elizabeth Goerdes (Public), and James O. Gulllou, Sr. (Non-Public)

This case is significant because the Panel awarded attorney's fees even though such fees are not available under the California Corporate Securities Law of 1968 and the case was heard in California. The Panel appears to have relied on the fact that the state of incorporation and/or the principal place of business of the issuers were sufficient to invoke application of the Florida and Nevada Securities Acts, which do allow for an award of attorney's fees. Additionally, the Panel awarded 100% of Claimants' out of

pocket losses, plus pre-judgment interest, costs, punitive damages, and sanctions (payable to Claimants).

David L. Woods and Twila R. Woods, Trustees of The Woods Family Living Trust v. Raymond H. Johnson, Pinnacle Advisors Group, LLC, WFG Investments, Inc., and National Financial Services LLC
FINRA Case No. 08-00455

Claimants met the Respondent broker (Johnson) in 1984. They attended the same church each Sunday, participated together in many church activities, and became good personal friends. As members of the same church, they had many mutual friends and attended many of the same religious and social functions. Claimants and the broker maintained a pleasant and friendly relationship for over twenty years. Due to this friendship and the church connection, Claimants felt the broker would never be anything but honest and trustworthy.

Claimants had investment accounts managed by the broker for approximately one year in the mid-1980s, but moved the assets to be managed by a family member when they moved to St. Louis, Missouri in 1988. Claimants returned to Arizona in May 1990 and, in the spring of 2005, Claimants decided to move their financial assets from St. Louis to Arizona for ease in management and communication. Because of their past business relationship and their ongoing friendship, Claimants opened accounts with the broker at Wachovia Securities. At the inception of the professional relationship in 2005 and in reliance upon their trust and confidence in the broker, Claimants disclosed many things to the broker that exposed several of Claimants' vulnerabilities to the broker.

Shortly before May 1, 2006, the broker advised Claimants that he was leaving Wachovia Securities and solicited Claimants to move their accounts to Pinnacle Advisors, where the broker would be working as an affiliate of WFG Investments, Inc., a registered broker dealer. Claimants agreed to do so and on or about May 1, 2006, opened three accounts through the broker at Pinnacle Advisers. These accounts were held in custody by National Financial Services, LLC, with WFG Investments, Inc. as the broker-dealer.

In connection with each of the new trust accounts, Claimants specified, among other things, the following account profile in its Brokerage Account Applications:

Risk Tolerance: Moderate
Time Horizon: Long (Over 10 years)
Investment Objective: Capital Appreciation

Investment Knowledge: Limited as to all except None as to options and variable contracts.

Claimants specifically declined to specify "trading profits" or "speculation" as an investment objective with respect to any of the trust accounts.

In connection with the opening of these new trust accounts, Claimants reiterated the understandings they had developed with Johnson at the time they opened accounts with him at Wachovia Securities. Those understandings were: (a) on Claimants' part, that as trustees and consistent with past practice, they were long term investors, not traders or speculators, and they wanted to invest only in blue chip stocks and AAA bonds with absolutely no "junk bonds" or other bonds below AAA; and (b) on Johnson's part, that he would provide better service than Claimants had received in St. Louis at lower overall cost than they had been charged in St. Louis.

In May 2006, the broker caused the securities then held in Claimants' Wachovia Securities Account to be transferred in kind to the Pinnacle/WFG/NFS accounts (approximately $5,387,000 in total assets). Of this amount, approximately $1,154,000 consisted of stock in Energizer common stock, which the Claimants had instructed the broker was to be held and not sold. Thus, the net amount of assets in the accounts subject to the broker's discretionary management control was approximately $4,233,000. Of this $4,233,000, approximately $75,000 was in cash; approximately $1,338,000 was in one account invested only in municipal bonds; and approximately $2,820,000 was in a separate account which was invested approximately $173,000 in bonds, approximately $1,118,000 in bond funds, approximately $1,284,000 in equities, and approximately $245,000 in equity mutual funds. The total discretionary portfolio allocated to equities was approximately $1,529,000.

Between May 2006 and July 2007, contrary to the instructions provided to the broker orally and in writing in the account profiles, the broker conducted some estimated 1,047 short-term trades during a fourteen month period resulting in $1,023,000 in losses to Claimants, including more than $450,000 in commissions and other fees (not including spreads on bond purchases and sales or mutual fund fees received by Respondents, neither of which are disclosed on trade confirmations) to be charged to Claimants. Many of the investments made were clearly inconsistent with the investment objectives and risk tolerances governing the trust account.

Claimants asserted the following claims against Respondents: 1) Violations of Rule 10(b), 10(b)-5 of the Securities and Exchange Act of 1934; 2) Violation of Arizona Blue Sky Laws; 3) Violation of the Arizona

Consumer Fraud Act; 4) Breach of Fiduciary Duty; 5) Fraudulent Misrepresentation; 6) Negligent Misrepresentation; 7) Breach of Contract; and 8) Breach of the Covenant of Good Faith and Fair Dealing. Claimants initially requested $528,000 in compensatory damages, plus punitive damages of not less than $1,000,000 and attorney's fees and expert fees. At the close of the hearing, Claimants requested damages of $4,395,000, including damages for losses due to breach of duty, lost profits, pre-judgment interest at 10% per annum, emotional distress damages, $2.8 million in punitive damages, attorneys' fees, costs, and other expenses.

The Panel ordered the broker to pay compensatory damages of $750,000, plus $1.5 million in punitive damages for "fraud and acting with malice pursuant to *Jerman v. O'Leary*, 145 Ariz. 397, 402 (Ariz. Ct. App. 1985)." The Panel also ordered the broker to pay post-judgment interest of 10% per annum on the compensatory and punitive damages. The Panel ordered Respondent WFG to pay compensatory damages of $500,000 for failure to supervise, plus post-judgment interest of 10% per annum on the compensatory damages. Lastly, the Panel found the broker and WFG were jointly and severally liable for Claimants' attorneys' fees ($150,000), FINRA filing fees and other arbitration costs ($5,000), and other costs ($45,000).

Claimants' Counsel: K. Layne Morrill, Esq., Morrill & Aronson, P.L.C., Phoenix, Arizona

Respondent's Counsel: Paul J. Roshka, Jr., Esq., Roshka DeWulf & Patten, PLC, Phoenix, Arizona

Claimants' Experts: Giandomenico (John) Rende (securities) and Sandra Lines (forensic)

Respondents' Experts: Jay Rosen and Vadim Khavinson.

Arbitrators: Richard L. Merkel (Chairperson), Philip B. Whitaker (Public), and Jeffrey Charles Young (Non-Public)

This case is significant because: (1) The Panel's Award specifically stated that it "doubts the credibility of Respondent Raymond H. Johnson;" (2) the Panel ordered the broker to pay punitive damages equal to 200% of the compensatory damages awarded, in addition to ordering the firm to pay $500,000 in compensatory damages for failure to supervise; and (3) the Panel ordered Respondents to pay $200,000 in attorneys' fees, costs, and other expenses.

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

Arbitration Agreements: Conflict Between Agreements
A broadly-worded arbitration clause in an employment agreement trumps a forum-selection clause in a subsequently-executed promissory note.

Bear Stearns & Co. Inc. v. Gordon
(S.D.N.Y. 7/01/2009) 2009 WL 1904567

In this case, Bear Stearns sought to recover amounts purportedly due from former employees pursuant to promissory notes. An employment agreement between the parties executed prior to the promissory notes contained an arbitration clause. However, the promissory notes did not contain an arbitration clause, but had a forum selection clause. The forum selection clause provided that the parties agreed to "submit to the jurisdiction of the courts of the State of New York for the purposes of any action on or related to this Note, the liabilities of the enforcement of either, or all of the same."

After Bear Stearns filed a court action to collect on the notes, the defendant employees moved to compel arbitration.

The court held that the forum selection clause was somewhat ambiguous, because it did specifically mention that the arbitration clause in the employment agreement would not apply. Bear Steams opposed defendants' motions on the grounds that its claims on the promissory notes were not related to defendants' employment, and also on the grounds that the forum clause in the promissory note required defendants to submit to the courts of the State of New York.

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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.

The court rejected both arguments. The forum selection clause included in the promissory note was non-exclusive and did not make any reference to arbitration or to the previously executed employment agreement. This ambiguity, according to the court, triggered application of the rule that doubts about arbitrability should be resolved in favor of coverage.

The employment agreement expressly contemplated that Bear Stearns would loan money to its new employees, and that promissory notes would subsequently be executed. The employment agreements imposed the obligation to execute the notes in the form annexed to the employment agreement. Hence, the court concluded, disputes over non-payment of the promissory notes were within the scope of the agreement to arbitrate in the employment agreements.

Arbitration Agreements: Enforcement By A Non-Signatory

A non-party to an arbitration agreement can compel arbitration against a signatory to the agreement, where the signatory seeks to derive a direct benefit from the contract containing the arbitration agreement.

In re James E. Bashaw & Co.
(Tex. App. 7/23/2009) --- S.W.3d ----, 2009 WL 2231710

In this case, a registered representative (Kovacs) was hired by a "branch" of the broker-dealer LPL. The "branch manager" was individually registered with FINRA, but his independent contractor business was owned by a corporation ("JEBCO") which was not a registered broker-dealer. Kovacs executed a "Representative Agreement" and a U-4 with LPL, both of which contained an arbitration clause. JEBCO was not a party to the Agreement or to the U-4. Instead, Kovacs and JEBCO had a separate written agreement regarding Kovacs's compensation, but which did not include an arbitration clause.

When Kovacs attempted to transfer his business to a different branch of LPL (which was owned by a different company), JEBCO and the branch manager terminated the registered representative's registration, thereby blocking his attempt to transfer his business.

Kovacs brought suit for damages for unpaid commissions, libel, slander and other tort theories, initially against both the individual employer and JEBCO, but then subsequently dismissed the individual employer. JEBCO then sought to compel arbitration pursuant to an arbitration clause in the

agreement between the registered representative and LPL, even though the company itself was not a party to that contract.

The court ordered the parties to arbitration.

According to the court, under both Texas and federal law, if a party or nonparty seeks to derive a direct benefit from a contract containing an arbitration clause, he may be compelled to arbitrate under the doctrine of "direct benefits estoppels." Whether a claim seeks a direct benefit from a contract containing an arbitration clause turns on the substance of the claim, not artful pleading. If liability arises solely from the contract containing an arbitration clause, or involves claims that must be determined by reference to the contract, those claims are arbitrable. However, if liability arises from general obligations imposed by law, then those claims can be litigated.

The court concluded that Kovacs was "artfully pleading" tort theories against the unregistered company to avoid arbitration of claims which could only be determined by reference to his Representative Agreement or U-4. Kovacs was seeking a direct benefit from the contracts with LPL that contain the arbitration provisions. It would have been inequitable to allow Kovacs to seek to enforce rights that depend on his entitlement to receive commissions or to transfer his business that flow from his agreement with LPL and at the same time avoid the arbitration provision contained in that agreement.

Furthermore, all of JEBCO's alleged misdeeds were alleged to have been committed by the branch manager, who was also the sole shareholder and officer of JEBCO; and JEBCO's alleged misdeeds, including the libel and slander claims, were committed by the branch manager pursuant to his authority as a Branch Office Manager for LPL.

The court further concluded that the agreement between JEBCO and Kovacs could only be understood and implemented in the context of the business relationships and party rights established in the LPL agreements. Kovacs had to rely on his Representative Agreement with LPL to be entitled to receive any commissions at all under his subsequent agreement with JEBCO, and JEBCO's authority to offer compensation to Kovacs depended on its own representative and branch office agreements with LPL.

Therefore, the court concluded that determination of JEBCO's liability on Kovacs's claims for breach of the terms of the Compensation Agreement must necessarily "be determined by reference to" the agreements setting out the working relationships among JEBCO, Bashaw, and LPL.

The court then addressed the impact of the release contained in the U-4, which specifically authorized "all my employers ... to furnish to any ... prospective employer, or any agent acting on its behalf, any information they have, including without limitation my creditworthiness, character, ability,

business activities, educational backgrounds, general reputation, history of my employment and, in the case of former employers, complete reasons for my termination." The U-4 also released "each employer, former employer and each other person from any and all liability, of whatever nature, by reason of furnishing any of the above information."

The court acknowledged that JEBCO's agreement with LPL did not give JEBCO authority to commit libel or slander. However, the branch manager and JEBCO were authorized by Kovacs's form U-4 to report to any prospective employer "any information they have," including information about Kovacs's general reputation and employment history, and the reasons for his termination – which was the information which Kovacs claimed to be libelous. Any claims arising out of the supply of this information are directly referable to Kovacs's employment relationship and his Representative Agreement and form U-4, both of which contained arbitration clauses.

Pursuant to the Representative Agreement with LPL, Kovacs's claims are claims that "relate to the Representative's association with or termination from LPL." Pursuant to the U-4, they are claims involving JEBCO's passing of information for which indemnity is provided. Thus, the court concluded, it was for an arbitrator to determine whether Kovacs's libel and slander claims had merit or were subject to the release in his U-4.

Enforcing Arbitration Agreements: Successors In Interest as Third Party Beneficiaries

A successor brokerage firm can enforce an arbitration agreement in a U-4 form between a registered representative and the predecessor brokerage firm, as a third-party beneficiary.

Monsefi v. TD Ameritrade, Inc.
(Cal. App. 5/20/2009) 2009 WL 1395798

A registered representative signed a U-4 agreement with brokerage firm Kennedy Cabot in 1995. Over the years, through various mergers and acquisitions, the firm became known as TD Ameritrade, Inc. Monsefi remained employed at "Ameritrade" at all times between 1997 and 2006. During this time period, Monsefi executed at least two amendments to his U-4 to disclose customer complaints.

After the broker terminated his employment with Ameritrade, he brought a claim in court against Ameritrade. Ameritrade moved to compel arbitration

of the dispute, pursuant to the arbitration agreement in the broker's U-4 form. The court held that the broker was obligated to arbitrate his dispute.

The court reasoned that a Form U-4 and its arbitration clause is a contract between the registered representative and FINRA. A third party is entitled to performance under a contract when the language of the contract shows that it was the intention of contracting parties to secure to the third party the benefits of contract's provisions.

The court concluded that the U-4 form reflected an intention on the part of the broker and FINRA to secure to Ameritrade the benefits of the form's arbitration provision, for a number of reasons.

First, the Form U-4 did not expressly exclude Kennedy Cabot's successors as intended third party beneficiaries of its arbitration provision.

Second, arbitration is the rule, not the exception, in the securities industry, and the broker cannot be surprised that he would be subject to the arbitration provision, and cannot reasonably expect that he may avoid arbitrating his work-related disputes based on the happenstance of his employer's purchase by another firm.

Third, the common meaning of the words "my firm" plainly refer to the firm for which the broker was working and, since he regularly amended his Form U-4 during the time he was working for Ameritrade, he must have understood that he was, with each amendment to his Form U-4, extending the third party benefit of its arbitration provision to Ameritrade.

Pre-Arbitration Discovery

Prior to commencing arbitration, brokerage firms are entitled to limited judicial discovery to uncover names of potential parties to the contemplated arbitration, under New York state law.

VTrader Pro, LLC v. Pires
(N.Y. Sup. 4/16/2009) --- N.Y.S.2d ----, 24 Misc.3d 828, 2009 WL 1272077

In this matter, a brokerage firm (VTrader Pro) sought a court order permitting discovery into the names of potential arbitration defendants, prior to filing the arbitration claim. The firm intended to seek recovery in FINRA arbitration of over $3.8 million for the allegedly improper trading of shares of Inter Oil Corp. The firm claimed that on June 19, 2008, 422,600 shares of the stock were wrongfully sold at a 30% premium above the then market price. The firm intended to commence arbitration in accordance with the procedures of FINRA.

The underlying dispute between various broker-dealer organizations concerned the alleged manipulation of certain securities traded on national securities and exchange markets. As such, the dispute was to be resolved within the context of arbitration. Specifically, the dispute was to be submitted to FINRA under the Industry Code, which contains a comprehensive system of rules and procedures regarding discovery in arbitration.

The brokerage firm which sought pre-filing discovery did not dispute that FINRA's Code of Arbitration Procedure for Industry Disputes (Industry Code) provides a mechanism for obtaining discovery during an arbitration. However, the firm contended that there is no provision under FINRA rules for discovery in aid of contemplated arbitration, which they needed in order to uncover the names of the sellers of the stock.

Respondents Kellogg Capital Group, LLC and Joseph Avazedo Pires objected to the subpoenas, arguing that: (1) any discovery should be pursuant to the Industry Code, and (2) the court could not issue the subpoenas because the dispute is governed by the Federal Arbitration Act (FAA).

The court rejected respondents' arguments. The court opined that in seeking judicially approved pre-arbitration discovery, the firm did not seek to circumvent the jurisdiction of FINRA by commencing a proceeding in this court. Nor were the petitioners relying upon the arbitration provisions of the CPLR in derogation of the FAA. Rather, the issue at hand is one of timing.

While the Industry Code appears quite comprehensive and unambiguous as to discovery within the context of the actual arbitration, it is silent as to pre-arbitration discovery. The FINRA procedures for obtaining discovery become effective after arbitration has commenced, an arbitration panel has been selected, and a discovery application has been made to the panel. Hence, the applicability and, in this instance, the demonstrated need for pre-arbitration discovery has been sufficiently established so as to seek and obtain judicial, rather that arbitral, redress.

New York state law provides that before an action is commenced, discovery in aid of bringing the action, to preserve information or to aid in arbitration, may be obtained, but only by court order.

However, pre-action discovery in connection with an out of court arbitration is frowned upon by the courts. The judicial attitude is that since the parties have chosen an arbitral, rather than judicial, tribunal for their dispute, they should ordinarily seek their disclosure before the arbitrators

Nonetheless, there are times when the court can be prevailed upon to act when discovery is needed to present a "proper case" to the arbitrator. One such instance is where, as here, the application was to obtain limited

information as to the identity of potential defendants against whom an action (or arbitration) may exist. Failure to learn the identity of the potential additional parties to the underlying trading activity before the arbitration commences would likely cause prejudice and unnecessary delay.

The court granted the firm's request solely to the extent of permitting the issuance of subpoenas to enable them to learn the names of the parties against whom they may have a claim in the contemplated arbitration.

Enjoining a Pending Arbitration

Plaintiff, who misrepresented his status as an authorized person for an entity's stock account, was not entitled to enjoin the brokerage firm's third party claim against him.

Bonnant v. Merrill Lynch, Pierce, Fenner & Smith, Inc.
(S.D.N.Y. 6/25/2009) 2009 WL 1809980

In this matter, the plaintiff had opened an account with Merrill Lynch on behalf of an entity, stating that he was authorized to transact investment decisions on behalf of that entity. Plaintiff listed himself as an "additional client" and as an "individual accountholder".

After the account sustained losses as a result of trading in naked options and swaps, other persons commenced a FINRA arbitration against Merrill Lynch and Merrill Lynch Capital Services (MLCS) on behalf of the entity. These other persons alleged that plaintiff did not have authority to trade securities on behalf of the entity.

Merrill Lynch and MLCS answered the statement of claim, and filed a third-party claim, naming plaintiff as a cross-respondent. Plaintiff then filed this action, seeking to enjoin the prosecution of Merrill Lynch and MLCS' claim against him in the arbitration. After observing that plaintiff could show irreparable harm if Merrill Lynch's claims against him were not arbitrable, the court then concluded that the plaintiff did not satisfy the second element for preliminary injunctive relief, in that he did not demonstrate a sufficient likelihood of success on the merits.

Plaintiff signed the account-opening agreement for the entity's account in an individual capacity, which obligated him to "arbitrate any controversies" regarding the account that arise with Merrill Lynch. Plaintiff's second signature, as a separate "[a]ccountholder," indicated that Plaintiff opened the entity Account in both representative and personal capacities.

Therefore, plaintiff was contractually obligated to arbitrate disputes with Merrill Lynch.

Although Defendant MLCS was not a signatory to the agreements which plaintiff signed with Merrill Lynch, principles of estoppels barred plaintiff from successfully challenging the arbitrability of MLCS's third-party claim against him. MLCS may successfully invoke these estoppels principles because: (1) the third-party claim by MLCS is intertwined with the agreements signed by plaintiff underlying the entity account; and (2) the relationships between the entity accounts, plaintiff, Merrill Lynch, and MLCS are such that plaintiff may not avoid his obligation to arbitrate this third-party claim with MLCS.

As to balancing hardships, plaintiff misrepresented to Merrill Lynch that he was the beneficial owner of the entity Account. Defendants relied on plaintiff's misrepresentation during the administration of the entity's account by extending credit based on the parties' agreements. Moreover, representatives of the entity commenced the arbitral proceedings that plaintiff now attempts to enjoin. The balance of hardships cannot be said to "decidedly" favor a litigant who seeks to benefit from deception and avoid the consequences of his previous representations.

The plaintiff's application for a preliminary injunction was denied.

DURING THE ARBITRATION

Telephone Conference Is An Insufficient Hearing

A telephone conference between the arbitrators and the parties' attorneys on a motion to dismiss on statute of limitations grounds was not a sufficient hearing under former FINRA rules.

Andrew v. CUNA Brokerage Services, Inc.
(Pa. Super. 5/27/2009) --- A.2d ----, 2009 WL 1464964

In this case, the court vacated an arbitration award, where it was entered after a motion to dismiss had been granted following a telephone conference.

In seeking to vacate the award, the claimant relied on the version of the NASD Code that existed prior to April 16, 2007. Specifically, Appellant relies on Rule 10303(a) of the NASD Code, which provides that "any dispute, claim or controversy ... shall require a hearing unless all parties waive such hearing in writing and request that the matter be resolved solely

upon the pleadings and documentary evidence." The claimant also relied on Pennsylvania state law which provides that an arbitration award may be vacated or modified upon a clear showing that a party was denied a hearing.

In support of vacatur, the claimant argued that the telephone conference at which the arbitrators heard only the arguments of counsel regarding the respondents' motion to dismiss was simply a pre-hearing argument which did not qualify as a full and fair evidentiary hearing upon which an arbitration award could be entered. Claimant contended that the arbitration panel was not presented with all the evidence needed to ascertain when his causes of action arose; the arbitration panel could not have properly considered the pertinent limitations periods in the absence of a full and fair fact-finding hearing. The arbitration panel was not in possession of adequate information from which to determine whether and when claimant knew or should have known that he had a cause of action.

The court agreed. The failure of the arbitrators to consider material evidence constitutes the denial of a full and fair hearing. In the instant case, after careful review, the arbitration panel should have conducted a hearing to consider evidence and testimony as to whether claimant's causes of action were timely. The court directed the trial court to vacate the arbitration award and remand to the arbitration panel for an evidentiary hearing and disposition.

Discovery Sanctions: Dismissal by Arbitrators

FINRA arbitrators do not have to impose lesser sanctions before dismissing an arbitration claim as a sanction for discovery abuse.

Kurley Dog Inv., LLC v. Buckley
(Conn. Super. 4/22/2009) 2009 WL 1424701

FINRA arbitrators can dismiss arbitration for plaintiff's failure to comply with discovery orders and other discovery abuse, even where lesser sanctions have not been imposed.

In this matter, the plaintiffs had been sold an investment by a FINRA registered investment broker. The investment did not do well and the plaintiffs sued the broker, eventually ending up in FINRA arbitration.

On the date of the scheduled arbitration, the arbitration panel dismissed the plaintiffs' claims for failure to comply with the discovery procedures of FINRA.

In denying the plaintiffs' motion to vacate the award, the court rejected the plaintiffs' arguments that the arbitrators had to first impose lesser sanctions prior to imposing dismissal as a sanction. The court pointed to the plaintiffs' pattern of failing to comply with the discovery under the FINRA arbitration rules as an adequate foundation for the arbitrator's decision to dismiss their claims with prejudice.

Staying Other Litigation Pending Arbitration

Bank's action to collect a margin debt would not be stayed pending arbitration between a customer and the Bank's sister financial services firm, where the bank itself was not a FINRA member and the margin agreement specifically excluded collections from the arbitration provision between the financial services firm and the account holder.

UBS Bank USA v. Mullins
(D. Utah 5/19/2009) 2009 WL 1407991

An investor, Mullins, had a margin account at FINRA member UBS Financial Services. UBS Bank financed the margin account, via a "Credit Line Agreement". Following a market crash in 2008, Mullins's portfolio decreased in value substantially and was no longer adequate to satisfy the margin requirements of UBS Bank. Once the UBS portfolio value dipped below the margin requirement, UBS Bank sold the stocks in Mullins's UBS portfolio and filed this suit against Mullins for the unpaid balance, approximately $300,000.

After the Bank filed this suit, Mullins filed a claim with FINRA against UBS Financial Services seeking damages in excess of $1.5 million for "unsuitable investment recommendations, misrepresentations and omissions, breach of fiduciary duty, breach of contract, failure to supervise, fraud, constructive fraud, negligence and gross negligence, and violation of securities law."

Mullins then moved this court to stay the Bank's collection proceedings pending the outcome of the FINRA arbitration against UBS Financial Services. The court denied the motion to stay.

After reviewing the Credit Line Agreement between Mullins and UBS Bank, the court found that Mullins's Motion to Stay the court proceedings was specifically barred by the contract. The Credit Line Agreement provided:

"Any arbitration proceeding between Borrower (or any other Loan Party) and the Securities Intermediary, regardless of whether or not based on circumstances related to any court proceedings between the Bank and the Borrower (or other Loan Party), will not provide a basis for any stay of the court proceedings."

The Credit Line Agreement expressly defined UBS Financial Services as a Securities Intermediary. Mullins agreed to this provision, and the Bank had distributed the funds associated with the Credit Line Agreement.

The court rejected Mullins's argument that staying the collection proceedings pending results of the FINRA arbitration will greatly promote judicial efficiency. He alleged that proceeding with the UBS Bank litigation simultaneously with the FINRA arbitration against UBS Financial Services will be a waste of scarce judicial resources as many of the same issues, evidence, and witnesses will be involved.

However, according to the court, the two proceedings involved two separate entities and two separate contractual obligations. The FINRA arbitration concerned Mullins's relationship with UBS Financial Services and the brokerage services they provided. The UBS Bank litigation concerned Mullins's contractual obligations to UBS Bank under the Credit Line Agreement.

Consequently, any claims settled against UBS Financial Services will have no effect on Mullins's obligations under the Credit Line Agreement with UBS Bank. The court therefore concluded that a stay of proceedings pending arbitration was not appropriate.

CHALLENGING/CONFIRMING ARBITRATION AWARDS

Manifest Disregard of the Law: Well Managed Portfolio

The failure to find liability under the "well managed portfolio" theory does not constitute manifest disregard of the law or an irrational outcome sufficient to vacate an award.

Franko v. Ameriprise Financial Services, Inc.
(E.D. Pa. 6/11/2009) 2009 WL 1636054

After losing a FINRA arbitration, the investors/claimants moved to vacate the award on the grounds that the award was completely irrational and

in manifest disregard of the law. The arbitrators had found that the claimants' losses were due to "market conditions," and that the "spread of investments ... were within an acceptable spectrum and quality, as well as within the industry norm for the times and suitable to Claimants' objectives."

The claimants maintained that these findings were "completely irrational" in light of evidence that: (1) their withdrawal rate was 8.5% and experts recognize a high failure rate for retirement portfolios with withdrawal rates in excess of 7%; (2) "31 of the 42 securities recommended to, and purchased by" them were proprietary and shelf-space funds, which "almost without exception" were unrated, rated "above average risk," or rated "below average return" by Morningstar; and (3) the S & P 500 Index outperformed their investments.

The court first noted that the claimants had not provided a complete record of the arbitration proceedings; therefore, the claimants could not meet their burden of showing that the record, as a whole, contained no support for the arbitration award.

Nonetheless, the court continued, concluding that there was record support for the Arbitration Panel's findings. Most notably, the firm presented expert testimony at the arbitration that its investment recommendations for the claimants were suitable under the circumstances, and that the asset allocations were proper for early retirees who were long-term growth and income investors.

Furthermore, even though claimants presented evidence showing that investment portfolios with an 8.5% withdrawal rate had a high failure rate, there was also evidence that the claimants dictated their withdrawal rate insofar as they specifically requested account distributions of over $52,000/year in order to maintain their standard of living.

The respondents also presented evidence to dispute claimants' evidence that their portfolio contained 31 funds that were not treated favorably in the Morningstar ratings. Respondents' expert testified that, "from a historical perspective, the recommended mutual funds were at or near the top of their respective asset classes and had longstanding and solid performance history, or were mirror-images of funds of longstanding top performing mutual funds."

Finally, even though it was apparently undisputed that the S & P 500 outperformed the claimants' investment, the arbitrators were free to give no material weight to this isolated fact. The claimants cited no authority for the proposition that a broker or investment advisor is liable to his clients any time he fails to match the S & P 500's returns. Indeed, according to the court, such a basis for liability would be particularly inappropriate here, where the

claimants consistently argued that the brokerage firm failed in its duties by recommending a portfolio that was too risky in that it was too heavily weighted to equities.

The claimants' argument that the Arbitration Panel manifestly disregarded the well managed portfolio theory, which is a damages theory, is also meritless. The claimants failed to establish that the Arbitration Panel manifestly disregarded any legal authority regarding breach of fiduciary duty.

Vacating Awards: Changes to U-5 forms

FINRA arbitrators have the authority to direct that the "reasons for termination" section of a registered representative's U-5 form be changed from "involuntary" to "voluntary", even if the "voluntary" designation is patently untrue.

Behnen v. A.G. Edwards & Sons, Inc.
(Mo. App. 5/5/2009) 285 S.W.3d 777, 2009 WL 1197089

A former brokerage firm employee sought damages and changes to his U-5 form following his termination by A.G. Edwards & Sons, Inc. A.G. Edwards terminated Behnen's employment for violations of company policies and procedures. In accordance with NASD rules, A.G. Edwards filed a Form U-5 which described the circumstances of Behnen's termination. The stated reasons for termination were "violation of firm policy and industry rules and regulations," and "violation of firm policy regarding the receipt of commissions by a corporate officer." A.G. Edwards checked box 7F (1) on the form, which stated the employee was terminated "after allegations were made that accused the individual of violating investment-related statutes, regulations, rules or industry standards of conduct."

Behnen then filed an action in Missouri state court, claiming defamation, fraud, and negligent misrepresentations related to his termination and the reasons for termination listed on the Form U-5. He sought compensatory damages and an amendment of his Form U-5 to show he was terminated without cause. The parties had an arbitration agreement that covered this claim, thus the court stayed the proceedings and directed the parties to arbitration.

On 2 May 2007, the arbitration panel issued its award in favor of the employee, Behnen. The award included compensatory damages and

expunged Behnen's Form U-5 on the basis that it was defamatory. The panel ordered the form amended to state Behnen was voluntarily terminated.

A.G. Edwards then filed a motion to vacate the award. The court vacated the award in part, on the grounds that the panel's decision to list "voluntary" as the reason for termination on the Form U-5 was in excess of the panel's authority because it was inaccurate-- Behnen did not voluntarily leave his employment – and the NASD requires member firms such as A.G. Edwards to file "complete and accurate" information on the Form U-5.

Behnen appealed, seeking to reinstate the panel's award.

Behnen argued that the NASD does not prohibit this sort of change. There are rules and statutes that allow for the punishment of those filing false records, but there is no stated general prohibition and nothing specifically touching the change to the form made here. Behnen argues that arbitration panels routinely make the exact Form U-5 change at issue here, and it is not an excess of their power to do so.

The court agreed. Arbitration awards will be vacated as an excess of power only if the arbitrators decided matters which were beyond the scope of the agreement or were clearly not submitted to them. This is true even if the relief would not be available under the law or shows a clear disregard for the law. Because the arbitrators decided an issue which was within the scope of the agreement, they did not exceed their powers in ordering a change of the Form U-5 in light of their other findings.

However, the author of the opinion noted "the antithetical nature of reversing one improper order to reinstate an award that is arbitrary and capricious, but that is how our standard limits us. In my estimation, we essentially affirm what was patently untrue."

Vacating Awards: Jurisdiction

An arbitration claim asserting violations of a state age discrimination act is insufficient for subject matter jurisdiction in the federal courts for a petition to vacate, even if that act is interpreted in accordance with federal law.

Holland v. Wachovia Securities, LLC
(S.D.Cal. 5/15/2009) 2009 WL 1396361

A federal court did not have subject matter jurisdiction over a petition to vacate a FINRA arbitration award where there was no diversity jurisdiction and the award was rendered under state age discrimination act.

In this case, a former employee of a brokerage firm commenced an arbitration proceeding, contending that the securities firm violated various age discrimination acts. After a hearing, the arbitrators denied the employee's claim, and awarded attorneys fees against the employee and in favor of the brokerage firm because the claim was "frivolous". The employee filed this action in federal court, seeking to vacate the award.

The court framed the subject matter jurisdiction issue to revolve around whether the employee's allegation of manifest disregard of federal law necessarily depends on resolution of a substantial question of federal law. The employee asserted that the award was made in manifest disregard of the federal Age Discrimination Employment Act. The court disagreed.

The arbitrators had clearly stated in the written arbitration award that "the Panel has determined that William Holland's claim for age discrimination was frivolous, and therefore it has made an award of attorney's fees as against William Holland, as allowed under Cal. Govt.Code Section 12965(b) ...." The Panel awarded attorneys' fees to Respondents under the fee shifting provision set out in the California Fair Employment and Housing Act and did not rely upon the Age Discrimination Employment Act. The fact that the California Fair Employment and Housing Act is construed in accordance with federal law does not give rise to federal question jurisdiction.

The court therefore concluded that the disposition of the petition to vacate the arbitration award does not necessarily depend on resolution of a substantial question of federal law. Accordingly, the court was without subject matter jurisdiction to entertain the petition.

Bankruptcy Discharge

In order to be exempted from a bankruptcy discharge, a debt arising out of securities violations or fraud must first be memorialized in an award, judgment, or settlement agreement in a forum other than bankruptcy court.

In Re Jafari,
(D. Colo. 2/3/2009) 401 B.R. 494

In this adversary proceeding in bankruptcy court, former investors of the debtor sought to have their claims against the debtor exempted from discharge, on the grounds that their claims arise out of securities law violations.

The Debtor was a financial advisor who solicited the plaintiffs' investment in a financial services company named Mountain Resources, Inc. ("MRI"). The Debtor was an officer, director, and shareholder of MRI. Plaintiffs made investments by giving the Debtor authority to exchange the stocks in their trading accounts for stock in MRI. Debtor provided statements to Plaintiffs indicating that their investments were growing, when in fact MRI was experiencing financial difficulty and eventually became insolvent. Plaintiffs lost their entire investment in MRI.

In the adversary proceeding, plaintiffs alleged numerous securities law violations as well as fraud. But plaintiffs had not filed an action in another forum to obtain an order, judgment, or decree holding the Debtor liable for securities violations or securities fraud. Nor had they entered into a settlement agreement with the Debtor resolving a claim for securities violations or securities fraud. The only action plaintiffs took was to file this adversary proceeding, asking the Court to hold their claims nondischargeable.

The bankruptcy court concluded that plaintiffs' claim was not exempted from discharge because plaintiffs had not obtained an order, judgment or settlement agreement finding that the Debtor committed securities law violations.

Section 523(a)(19) renders nondischargeable debts arising from securities law violations and fraud in connection with a purchase or sale of securities. It was added to the Bankruptcy Code by § 803 of the Sarbanes-Oxley Act of 2002. See Sarbanes-Oxley Act of 2002, Pub.L. No. 107-24, § 803(3), 116 Stat. 745. Section 523(a)(19) was subsequently amended by the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005 ("BAPCPA").

In order to come within this exemption from discharge, the plaintiffs must establish that the debt is for violation of securities laws or for fraud in connection with the purchase or sale of a security (the "Subsection A requirement"). In addition, the debt must be memorialized in a judicial or administrative order or settlement agreement (the "Subsection B requirement"). If Plaintiffs cannot establish both requirements, their claim fails.

As originally enacted, § 523(a)(19) required a pre-bankruptcy judgment, order or settlement agreement memorializing liability for the debt as a condition of nondischargeability, necessitating that the written document establishing liability had to come from outside the bankruptcy court. The pre-bankruptcy requirement was subsequently removed by Congress.

The plaintiffs argued that the removal of the requirement of a pre-bankruptcy determination authorizes this Court to determine both liability and nondischargeability, and to rely on its own finding of liability to satisfy the Subsection B requirement when rendering the decision on nondischargeability.

However, the legislative history emphasizes that a primary purpose of this statute was to ensure that judgments and settlements from state securities fraud cases are non-dischargeable without the need to re-litigate the matter in bankruptcy court. Thus, the court concluded that, absent a settlement agreement or other consensual determination of liability, Subsection B evidences a conscious choice to have the liability determination occur outside of the bankruptcy forum, whether it occurs pre- or post-bankruptcy. Once liability has been imposed, then either a bankruptcy court or a non-bankruptcy court may determine the application of this nondischargeability statute.

Because plaintiffs had not obtained a liability determination outside of the bankruptcy forum, their motion for non-dischargeability was denied.

OTHER ISSUES

Clearing Firm Liability: To The Introducing Broker

Stern v. Legent Clearing LLC
(N.D. Ill. 7/28/2009) 2009 WL 2244616

A court-appointed receiver of a brokerage firm (Enterprise) sought to recover damages from the brokerage firm's clearing firm (Legent), arising out of Legent's conduct in connection with Enterprise's trading and fraudulent use of its own clients' assets to provide collateral for highly speculative trading strategies that were contrary to the instructions of certain of Enterprise's clients, were detrimental to their interests, and which were not fully disclosed to Enterprise's clients.

According to the receiver's allegations, Legent worked with Enterprise to transfer approximately $49 million in customer mutual funds from Advisory Financial Services Corporation ("AFC") to Enterprise's account at Legent. Legent – the clearing firm -- knew that the mutual funds were contained in IRA and 403(b) accounts that could not properly be used for margin, and yet Legent orchestrated the transfer of these individual customer funds into Enterprise's omnibus account to support margin trading. Further, the

complaint alleged that Legent enabled the transfer even though it knew that the paperwork signed by the individual account holders did not permit the use of their assets for margin trading.

Legent's motion to dismiss the receiver's complaint was denied.

The court first rejected the clearing firm's argument that the receiver lacked standing. Even though there were a number of claims asserted by former customers of Enterprise against Legent in other forums (arbitration primarily), the court observed that the receiver was asserting claims for the benefit of Enterprise, not Enterprise's customers, and that the receiver was asserting different causes of action against the clearing firm than the customers were asserting.

The court then ruled that the allegations in the complaint were sufficient to hold the clearing firm liable. The clearing firm argued that it could not be liable for the acts of its introducing brokers or its introducing brokers' customers. Legent relied on the principle that a clearing broker, when acting within the scope of its traditional clearing functions, does not owe a fiduciary duty to customers of its introducing broker and cannot be held liable for the acts or omissions of its introducing brokers.

The court held that the receiver's complaint alleged facts which, if true, showed that Legent went beyond the traditional functions of a clearing broker, by knowingly enabling Enterprise to misuse its customers' accounts. For example, Legent engaged in direct conversations with Enterprise, advised Enterprise on trading strategies, and controlled the ability of Enterprise customers to withdraw assets from their accounts, including retirement accounts that could not properly be pledged to collateralize Enterprise's margin trading.

In addition, the receiver alleged that Legent performed its normal, ministerial clearing functions with actual knowledge that it was aiding and abetting the introducing firm's fraud and breach of fiduciary duty. Actual knowledge of any fraud or breach of fiduciary duty is an additional factor that, according to the court, weighed against Legent's attempt to avoid liability.

The court denied the clearing firm's motion to dismiss.

Application of Consumer Protection Acts to Financial Services

New Jersey's Consumer Fraud Act does not cover securities, as securities are not included in the definition of "merchandise" and the sale of securities is not a "service".

Lee v. First Union National Bank
(N.J. 6/3/2009) 199 N.J. 251, 971 A.2d 1054

The New Jersey Supreme Court held that a securities broker's fraudulent activity, in connection with his handling of client funds intended for the purchase of a security, did not subject the broker, the bank that employed him, or brokerage firm that registered him, to liability under the New Jersey Consumer Fraud Act ("CFA"). The sale of securities is not covered under the CFA and recognition of a separate "service" to purchase securities would thwart the CFA's design to keep the sale of securities beyond the CFA's application.

In this case, plaintiff Lee had received $12,000 in settlement of a personal injury action. Shortly after receiving her settlement check, she went to the Elizabeth branch of defendant, First Union National Bank (First Union), where she maintained a checking account. On that day, she deposited $5,000 from the settlement into her checking account and took the remaining $7,000 in cash. While at the Elizabeth branch bank, Lee asked about making an investment and was referred to defendant, Gregory Mack, who worked as an investment counselor at the bank's facility in Hillside. As it turns out, Mack held dual employment within the First Union family of entities. He was a First Union employee as well as an employee of First Union Brokerage Services, Inc., where he served as a registered representative.

Lee met with Mack that same day. He recommended that she purchase a mutual fund known as Evergreen Omega. Based on Mack's recommendation, Lee decided to invest $2,000 by purchasing 61.52 shares of Evergreen Omega. She opened a brokerage account with First Union Brokerage Services and signed a mutual fund disclosure statement, which indicated that she understood the prospectus for the Evergreen Omega Fund. She gave Mack $2,000 in cash to effectuate the purchase.

Unbeknownst to Lee, Mack did not deposit in the brokerage account the $2,000 in cash that she had given to him. On May 25, 2000, when brokerage records indicated that the mutual fund purchase was confirmed, the bank's records revealed not only that the $2,000 had not been deposited in the brokerage account to cover the purchase, but also that Lee had made withdrawals from her checking account during the intervening period, bringing her checking balance down to $591. As a result, Lee's brokerage account had insufficient funds from which to draw in order to pay for the Evergreen Omega unit shares and complete the transaction. The bank applied $500 from Lee's checking account as partial payment for the purchase. It then liquidated $1,500 of the mutual fund units, which had been

allocated to Lee's brokerage account, in order to cover the remainder of the balance due to Evergreen Omega Fund for the purchase. That reduced Lee's total trade amount from a $2,000 interest to a $500 interest in the Evergreen Omega Fund.

According to Lee, she spoke with Mack after she became aware of those events and he admitted that he had not deposited the $2,000 cash that she had given him to pay for the mutual fund purchase. She claims that he admitted to converting the money for personal use and offered to give her $1,500 if she would agree not to tell his supervisor about his transgression. Lee would not accept less than the entire $2,000 in return and, when Mack refused, Lee initiated the instant action, asserting a claim under the Consumer Fraud Act (among others).

The trial court dismissed the CFA count. The New Jersey Supreme Court affirmed.

After observing that the CFA's operative terms are to be applied broadly to protect consumers from a wide variety of abhorrent deceptive practices, the court stated that it must nevertheless abide by the definitions that control the boundaries of the Act's reach. The court concluded that securities intentionally were not included in the definition of "merchandise" under the CFA, and further concluded that characterizing Mack's conduct as a fraudulent "service" was an impermissible contortion in order to draw it within the CFA's reach. Doing so would thwart the legislative design that the CFA not intrude in the area of securities sales.

As stated by the court, the CFA was not meant to reach the sale of securities and that this limitation prevents plaintiff from characterizing Mack's alleged abhorrent behavior as a "service" connected with the sale of securities. After all, any transaction involving "merchandise" (whether CFA-covered or not) would involve the "service" of providing the merchandise; therefore, permitting CFA liability for "services" in connection with items that are not "merchandise" under the CFA would effectively provide an end-run around the statutory definition of "merchandise." This would render the definition of "merchandise" in the CFA superfluous and make the CFA's breadth limitless.

Conversely, according to the court, its interpretation does not render the term "services" superfluous because it is limited in the context of an excluded category of "merchandise." When an entire category of items, such as securities, is intentionally excluded from the definition of "merchandise" under the CFA, the service of selling that item is an inseparable component of the marketplace for that item.

The Supreme Court affirmed the trial court's dismissal of the CFA claim.

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.

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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 *File Number SR-FINRA-2009-050, FINRA BrokerCheck Disclosure* was submitted to the Securities and Exchange Commission by Brian N. Smiley on September 4, 2009.

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

RE: File Number SR-FINRA-2009-050
FINRA BrokerCheck Disclosure

Dear Ms. Murphy:

I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") regarding the above-referenced proposal concerning the expansion of information that will be available through BrokerCheck to the public. 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 that govern the arbitration process, as well as rules that benefit the public investor.

PIABA endorses the current rule proposal, as any effort to increase the amount of information regarding individuals formerly registered with FINRA that is available to the public is a positive one. We do so, however, with great reservations. We believe that the rule change could and should go much further by including, for an indefinite period of time, other categories of information that are available concerning currently registered representatives. FINRA's explanations for expanding the time period during which it discloses final regulatory orders, while continuing to limit the disclosure of other, equally important and relevant information, are inconsistent and unpersuasive.

ADDITIONAL INFORMATION REGARDING FORMER ASSOCIATED PERSONS SHOULD BE MADE AVAILABLE PERMANENTLY TO THE PUBLIC

Under the current disclosure system, once an individual ceases to be registered with FINRA for at least two years, no information is available about that individual through BrokerCheck. The new FINRA proposal would extend the availability of all final regulatory actions that have been reported to the Central Registration Depository ("CRD") system for associated persons, as well as "administrative" information, such as employment and registration history, irrespective of whether such persons continue to be registered. The proposal, however, leaves out significant additional information that would benefit the investing public.

FINRA'S STATED PURPOSE FOR THIS RULE PROPOSAL OF PROVIDING INFORMATION TO INVESTORS REGARDING INDIVIDUALS WHO ARE NO LONGER REGISTERED BUT MAY BE IN POSITIONS OF TRUST IS BEST SERVED BY EXPANDING THE SCOPE OF THE RULE

FINRA identifies the primary purpose of BrokerCheck as "help[ing] investors make informed choices about the individuals and firms with which they may wish to do business." FINRA further acknowledges that the purpose of the proposed rule change "would allow the public access to information about formerly registered persons who, although no longer in the securities industry in a registered capacity, may work in other investment-related industries or attain other positions of trust and about whom investors may wish to learn relevant disciplinary information." FINRA, however, chooses to limit the information that is permanently available only to final regulatory orders. This is troubling because there is important additional information disclosed through BrokerCheck for current registered representatives that would serve the purpose of the current proposal by providing relevant information to investors who utilize BrokerCheck to investigate former brokers.

Currently, under FINRA Rule 8312, an investor who wishes to investigate a broker's history is able to ascertain the following, so long as the broker is registered, or has been within the previous two years:

- Customer complaints
- Arbitration actions filed against the broker

- Bankruptcies
- Liens
- Certain criminal complaints and charges made against a broker

FINRA'S EXPLANATION FOR NOT INCLUDING INFORMATION OTHER THAN FINAL REGULATORY ORDERS IS ILLOGICAL AND INCONSISTENT

FINRA reasons that the expansion of the time during which final regulatory actions will be available through BrokerCheck is appropriate because final regulatory actions are available to the public anyway. All of the other categories of information identified above, except for customer complaints made to a broker's employer, are also publicly available through any number of sources, but not necessarily to the public investor who uses BrokerCheck. FINRA's justification makes no sense in light of its failure to include other categories of publicly available information. Moreover, arbitration actions, bankruptcies, liens, and especially *criminal actions* would all be of extreme importance to an investor who uses BrokerCheck to gather information on an individual who may be handling his or her money, or who may be gaining access to an investor's assets through a position of trust.

FINRA also claims that final regulatory orders "are subject to procedures that allow an opportunity for the subject person to present arguments to a fact-finder about the allegations prior to the final disposition of the matter." FINRA also claims that arbitration claims, unlike final regulatory actions, "may not be subject to procedures that allow an opportunity for the subject person to present arguments to a fact-finder about the allegations prior to final disposition." All parties named as respondents in an arbitration action, however, are given opportunity to respond to the allegations asserted against them, and are entitled to appear at all hearings, just as in regulatory enforcement proceedings. Moreover, as previously noted, FINRA Rule 8312 allows individuals to submit a comment that addresses any disclosed information, thereby alleviating any cries of unfairness regarding the procedures related to arbitration actions.

FINRA comments that its refusal to include criminal charges and convictions is related to the possibility that such charges and convictions "subsequently may have a different disposition, which may significantly change the meaning of the matter as originally reported." This assertion seems illogical. A criminal charge is a criminal charge. Form U-4 requires the disclosure of certain criminal convictions *and charges,* not only such

charges as ultimately resulted in a conviction. Moreover, such information is already disclosed for currently registered individuals and for those who have been registered within the last two years. FINRA has determined that this information is relevant and furthers its objectives in providing information to investors. Finally, if a conviction met with a subsequent different disposition, such as being overturned on appeal or sealed for some reason, then it may not even be subject to disclosure.

FINRA finally claims that certain financial information, such as bankruptcies or liens, are not material enough to warrant disclosure. Such information, however, may shed light on an individual's level of financial responsibility and may be absolutely material to an investor who seeks to determine whether he or she wishes to entrust money or personal affairs to a formerly registered person.

FINRA explains more than once that a broker has an opportunity to submit a statement regarding any disclosed events. The ability for a broker to offer his or her own statement addressing disclosed information more appropriately achieves the balance between fairness to the individual and disclosure to the public of adverse information that FINRA claims to seek. FINRA's current proposal does not go far enough to achieve the balance between the two interests, instead tipping the scales in favor of hiding otherwise relevant and important information regarding former registered representatives.

AGGRIEVED INVESTORS MAY REQUIRE ACCESS TO INFORMATION FOR SEVERAL YEARS AFTER A BROKER LEAVES THE INDUSTRY

In this rule proposal, FINRA has focused almost exclusively on the needs of investors to learn about their brokers *before* they invest. However, FINRA's mission must also include the protection of investors who have gotten into a dispute with their broker or former broker.

It is not unusual for aggrieved investors to seek out a lawyer and file an arbitration claim several years after the events which gave rise to their losses. In fact, the FINRA Code of Arbitration Procedure makes claims eligible for submission to arbitration for up to six years after the event or occurrence giving rise to the claim. (FINRA Customer Code of Arbitration Procedure, Rule 12206(a).) Currently, in many instances attorneys consult BrokerCheck to procure information about a broker who wronged their clients, only to learn that the broker left the industry more than two years earlier. This makes

it difficult to learn important facts (which may, for example show that the brokers engaged in similar misconduct) about the brokers which were previously public record. There is no reason to remove these disclosures from the public record; doing so is antithetical to FINRA's mission of protecting investors.

This state of affairs leads to a somewhat anomalous result. An aggrieved investor has more trouble learning about a broker whose misconduct led to his termination by a reputable firm than he has learning about a broker whose conduct was not serious enough to warrant termination. This makes no sense. Moreover, it makes no sense for FINRA to be jumping through hoops to protect the "privacy rights" of these bad brokers, to the detriment of the investors which it is supposed to protect.

As an association of attorneys who represent aggrieved investors in FINRA arbitration proceedings and in court, PlABA believes that all of the information which is disclosed for current FINRA members and associated persons should remain in the public domain indefinitely. If there were a bona fide need to balance competing interests, the period should be lengthened to at least 6 years, to coincide with the arbitration eligibility rule.

CONCLUSION

There are many career paths that a former associated person could take that would place him or her in a position of trust with access to client funds. A client would likely want to know the full extent of the person's prior history, and should be entitled to that information if it has previously been available to the public. The instant proposal should not be limited just to final regulatory orders, but should include all information now subject to disclosure for currently registered individuals in order to accomplish FINRA's stated objective of allowing investors access to relevant information that they need to make an informed decision. Expanding the scope of disclosed information also serves the overarching objective of FINRA of investor protection, even at the risk of potential inconvenience to associated persons who may properly be asked to make public disclosure as a condition of the privilege of obtaining securities licenses.

Ultimately, we feel strongly that any move to disclose information to the public that is not currently available is a positive step. Accordingly, the current proposal should not be rejected, but we do believe that its scope should be increased to allow public access to information that is not covered by the proposal. For the reasons set forth above, PIABA recommends that the

current rule proposal be approved with the inclusion of the categories outlined above.

Please do not hesitate to contact me should you require additional information or wish to discuss this important topic.

Yours very truly,
PUBLIC INVESTORS ARBITRATION BAR ASSOCIATION
Brian N. Smiley
President

The following PIABA Comment Letter regarding *SR-FINRA-2009-041, Rule Proposal Regarding Changes in FINRA Rules 12100, 12506, and 12902* was submitted to the Securities and Exchange Commission by Brian N. Smiley on July 29, 2009.

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

Re: SR-FINRA-2009-041 Rule Proposal Regarding Changes in FINRA Rules 12100,12506, and 12902

Dear Ms. Murphy:

Thank you for the opportunity to comment on the above-referenced Rule Proposal of the Financial Industry Regulatory Authority ("FINRA") to amend FINRA Code of Arbitration Procedure Rules 12100, 12506, and 12902. I write on behalf of the Public Investors Arbitration Bar Association ("PIABA") in support of the changes to Rules 12100 and 12506 but in objection to Rule 12902.

PIABA is an international bar association, consisting of approximately 500 members, dedicated to the protection of investors' rights in securities arbitration matters. As such, PIABA is deeply concerned with the procedural rules which govern arbitration proceedings in the FINRA forum.

PIABA supports proposed Rules 12100(r) and 13100(r). PIABA believes that the definition of "associated person" should include those individuals who have applied for registration, in addition to those who are currently registered. This would help clarify which individuals are subject to FINRA's jurisdiction and help avoid needless disputes over this issue.

PIABA also supports proposed Rule 12506(a), which would encourage parties to download the Discovery Guide from the website. Currently, it is FINRA's practice to mail a copy of the Discovery

Guide to each party. Many attorneys who handle FINRA arbitration cases are already familiar with the Discovery Guide and do not need it re-sent to them in every case. Moreover, it would probably save FINRA considerable expense and effort and avoid wasting paper.

However, FINRA should continue to make sure that the parties and their attorneys are aware of the Discovery Guide. FINRA should make this notification sufficiently conspicuous so that it will be noticed by all concerned. Furthermore, PIABA believes that FINRA should provide a paper copy of the Discovery Guide to a party upon request. Finally, FINRA should also ensure that the version of the Discovery Guide that is posted is actually the version that was disseminated by way of Notice to Members 99-90. The version posted on the FINRA website as of July 21, 2009 did not contain the same introductory language and formatting as the 99-90 version. For example, it does not include an explanation concerning requests for information, as does the 99-90 version of the Discovery Guide.

Finally, PIABA opposes the proposed change to Rule 12902. The new language could discourage customers from filing counterclaims against member firms that bring claims against them. Even in the event that a customer files counterclaims and prevails against the member firm, this language suggests that the customer could still be liable for such hearing fees. FINRA's stated objective is "to protect investors and the public interest." This proposed language would be contrary to that stated objective.

In sum, PIABA supports the acceptance of proposed Rules 12100 and 12506 but objects to proposed Rule 12902. I would like to thank you once again for the opportunity to comment on this rule proposal.

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